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LEADING INDEPENDENT ANALYSIS OF IRAN'S ECONOMY

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VERITY FOCUS

Economic implications of rollover of interim agreement

Rollover agreed to 24 November

Iran and the E3+3 have agreed to continue to look for a comprehensive solution to the Iranian nuclear issue. After 6 months and a total of over 50 days of talks, Iran and that E3+3 agreed to extend the interim deal by a further 4 months to allow more time for talks. It's clear that major issues remain to be resolved, particularly over Iran's future enrichment capacity, but officials justified the extension on the grounds that enough headway has been made to make agreement by November a possibility.

Under the terms of the extension, both sides will continue to abide by all measures agreed to in Geneva last November that have not expired. For Iran, this includes the ongoing commitment not to enrich uranium above 5 percent, to halt any further advances in their nuclear programme, and to continue to allow the IAEA access to sites and information. In addition, Iran has committed to take further steps towards neutralising its former stockpile of 20 percent enriched uranium.

In return, the E3+3 has committed to enable the repatriation of an additional USD 2.8 billion of Iran's frozen overseas assets in 6 installments over the course of the extension period. Iran repatriated USD 4.2 billion of its frozen overseas assets during the six months following the implementation of the first interim agreement.

Market reacts positively

Once it became clear that negotiations would continue beyond July, there were signs that some confidence returned to the Iranian market. Investors welcomed the 4-month extension of the interim agreement, and the further short period of breathing space for the economy in which no new sanctions were introduced.

The returning confidence is reflected in the small rise of the stock exchange. After a decline of 21 percent in the first half of 2014, from a high of 89355.7 on 6 January to 70341.5 on 30 June, the main index rallied in July to 74997.6 at the end of July, an increase of 7 percent from 30 June. In terms of volume of trade, at the end of June, activity on the stock exchange was at a low point. Fewer than 30,000 trades were made on 30 June, down from 139,000 on 6 January, signifying a lack of confidence. Trading had picked up again at the end the month with more than 50,000 trades made on 28 July, a further sign of the returning confidence.

However, the market is volatile and demand remains unstable. Investors will continue to be cautious in the knowledge that the positions of the E3+3 and Iran are far apart. A comprehensive agreement in November is far from guaranteed, while additional sanctions measures are a near certainty if no deal can be reached.

Pressure will be maintained and economy will stagnate

Overall, Iran's economy will continue to stagnate. The limited nature of the sanctions relief will lead to little if any immediate economic improvement. Weighed against the major structural problems facing the Iranian economy, which VERITY has described in detail, and ongoing sanctions pressure, the USD 4.2 billion of unfrozen funds Iran has received to date provided little stimulus to recovery. The additional USD 2.8 billion will not be enough to tip the balance.

The E3+3 will look to maintain pressure on Iran. Following the precedent of the first interim agreement, new designations are likely within the first few weeks of the extension period as the US seek to punish sanctions evaders and deter international trade with Iran.

With no prospect of a significant increase of foreign capital before 24 November, growth will remain weak and the market depressed. Now, as much as ever, Iran's economic prospects are linked to the nuclear issue. The potential is enormous, but the prospects for uplift are tied down by international sanctions. President Rouhani and his capable team of advisers know this. They now have four more months in which to persuade the Supreme Leader.

Sanctions to follow if Iran fails to reach a comprehensive agreement by November

Both the E3+3 and Iran have played up the progress the negotiations have made to date. IAEA inspectors have confided that Iran has stuck to all of its promises under the interim agreement. Various options for a proposed solution to the future of the IR-40 heavy water reactor at Arak have also been discussed.

Major disagreements remain, however. Most difficult is the degree to which Iran will be able to enrich uranium under the terms of a comprehensive deal. Sources close to the talks have revealed that the key sticking point is the number of centrifuges Iran can have to enrich uranium. The other big issue still to be resolved is PMD, or whether Iran's nuclear programme has had military dimensions in the past.

Without progress on these key issues before November, the negotiations are likely to break down. Analysts agree that the US Congress is unlikely to take action before the US mid-term elections in November. But if there is no deal by 24 November, Congress is likely to lose patience with the negotiatons and new sanctions will follow. New sanctions are likely to involve further restrictions on Iran's crude exports,and significant restrictions on condensate and petroleum products. The scale of the impact of new sanctions on the Iranian economy is difficult to predict. It is likely, though that Iran would face a further period of, possibly severe, recession.

JULY NEWS ROUND-UP

Macro economic news

Annual inflation rate drops to 25 percent ahead of schedule

Iran's Central Bank (CBI) reported on 27 July that Iran's annual inflation rate has dropped to 25.4 percent. Inflation was running at over 70 percent when Rouhani took power a year ago. Bringing inflation under control was a key target for President Rouhani. The government had aimed to bring the annual inflation rate to below 25 percent by the end of the financial year. That aim now looks certain to be achieved before the first half of the year is up. This is a stunning achievement for which Rouhani's economics team deserves real credit.

President called to account over subsidy payments

The Iranian parliament has called on President Rouhani to clarify the state of the government's accounts in relation to payment of government subsidies. The influential parliamentary Budget and Planning Commission has raised concerns that the government is spending more on compensation to those no longer receiving subsidies than it is saving from not making the subsidy payments. A Commission member told *Etemaad* newspaper that revenues from subsidy elimination during the first quarter of the Iranian year were down a third on predicted levels, to IRR 105 trillion. Meanwhile the cash transfer payments to offset the subsidy elimination totalled more than IRR 150 trillion over the same period. This was unsustainable, according to a Commission member.

Government targets growth with USD 18 billion spending plans

The Iranian government has plans to invest USD 18 billion from the National Development Plan according to a government spokesman. The government will invest USD 4 billion on developing South Pars gas field. A further USD 7 billion will be spent on buiilding new power plants and developing upstream industries. USD 2 billion will be spent on growing Iran's steel sector, USD 2 billion on Iran's petrochemical sector, USD 1 billion on transportation infrastructure, and USD 2 billion on agriculture and other industries. After years of underinvestment in Iran's energy and industrial sectors, the government's spending plans will be welcome news to industries still mired in recession.

Banking news

Banking regulations relaxed in Tehran

Municipal authorities in Tehran have relaxed the regulations for businesses to obtain loans for operating in the capital. Banks have been encouraged to issue more loans to business customers, with the municipal authorities now requiring companies to pay deposits of between 10 and 13.5 percent. The authorities' actions were likely a response to the 7 percent fall in the number of constuction permits issued in Tehran, according to statistics provided by the Iranian Statistics Centre.

Oil and gas news

Iranian crude exports stay above 1.2 million barrels

Iran exported 1.2 million bpd of crude oil in June 2014, according to *Reuters*. June's export totals fell nearly 10 percent compared to May, when Iran sold 1.33 million bpd. The fall was attributed to China and India, Iran's two biggest oil customers, reducing their imports in June, likely a result of seasonal repairs and mainenance.

Nevertheless, even at the reduced level, Iran's oil exports in June still tracked above the limit of about 1 million bpd imposed by the US under the interim agreement. The US appears to be allowing Iran some flexibility in order to provide breathing space for the Iranian economy. But VERITY expects the US will respond to any company seeking to import Iranian oil significantly above the US limit.

No profits expected from government investment in oil industry while sanctions remain

The Iranian oil industry has received tens of billions of dollars in investment from Iranian government sources within the last few years in order to reduce the impact of international sanctions on Iran. However, the money has been inefficiently invested, and industry sources reveal that the Iranian government is unlikely to receive a return on its investment. Sanctions effectively prohibited international companies from investing in Iran's oil industry. Crucially, sanctions also cut Iran off from foreign expertise and latest technology that enable an efficient return on investment. For as long as international sanctions remain, according to industry sources, investments in Iran's oil industry are unlikely to return a profit.

Other news

Water rationing introduced in Tehran suburb; other cities to follow

Water rationing has been introduced in Karaj city, a sprawling suburb of Tehran with a population of over 1.5 million. Environmental experts have predicted that other cities will follow suit. Earlier this year, Iranian officials warned that 500 municipalities faced critical shortages (see VERITY 33). A study by the Wold Resources Institute in 2013 ranked Iran as in the top 25 most water-stressed nations.

Politicians and experts in Iran disagree over how to respond to the risk of water shortages. Tehran governor, Seyed Hossein Hashemi, said that rationing this summer could be avoided in the city if residents cut their water consumption by 20 percent. Experts, however, argue that a more profound solution is required. A solution, argues Iranian climatologist Nasser Karami, needs to extend beyond water conservation to reverse the exploitation of groundwater supplies, of which only 30 percent remains.

Boeing reaches agreement to sell aircraft parts to Iran Air

US aircraft manufacturer Boeing has reached an agreement to sell aircraft parts to Iran. Under the terms of the agreement, Boeing will sell goods and services related to flight safety. Boeing, who received a licence from the US Treasury to sell spare parts to Iran, said that its agreement with Iran Air covered aircraft parts, manuals, drawings, service bulletins, navigation charts and data, but not new aircraft. Iran Air said that they would initially requrie 100 aircraft if economic relations with the West were returned to normal. Iran Air estimates its future aircraft needs at around 400 aircraft, according to *Reuters*.

Statistics

GDP Annual Growth Rate
2015: 1.5% (IMF estimate for 2014-2015)
2014: -1.7% (IMF estimate for 2013-2014)

Tehran Stock Exchange Main Index (TEDPIX)
30 July 2014: 74997.6

Annual Inflation:
Official figure: c.19%

Unemployment:
Official figure: c.10.4%

Exchange Rates:
USD: IRR
Currency Centre (CTC) rate: 26,252
Open Market Rate: 31,500