VERITYIRAN.COM
LEADING INDEPENDENT ANALYSIS OF IRAN'S ECONOMY

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ROUHANI'S IRAN: ONE YEAR IN

One year into Rouhani's tenure there are justified plaudits for Iran's economic management, but the recession remains severe with dramatic downside risks. This month we focus on Iran's water crisis. VerityIran's view is that any business optimism is wholly contingent on a breakthrough in sanctions.

In the wake of last month's nuclear deal, conservatives in Tehran and Washington have disparaged the value of talks, but the markets have priced in this political manoeuvering and the business community remains hopeful of further progress by the new November deadline.

Nuclear talks are the single most crucial factor shaping Iran's economic prospects and investors are experienced in seeing through the rhetoric that builds up around negotiation deadlines. The Supreme Leader's provocative comments on 16 August that talks with the US were "useless" prompted a chorus of hard-line support and subdued President Rouhani's own optimistic line for a week or so. But the markets are used to "*two steps forward, one step back*" in dealings with the West and VerityIran's view is that conservative sabre-rattling is generally priced into market expectations. Chart 1 shows the volatility in the Tehran stock market in the month approaching the 20 July deadline, which has since settled back to its longer term trajectory, shown in Chart 2. If actions speak louder than words, investors will play closer attention to the fact that talks resumed in a constructive fashion this month and the UN Nuclear Watchdog said Iran had begun to comply with the terms of the interim agreement.

Chart 1. TEPIX stock market index.
3 May 2014 – 23 August 20014

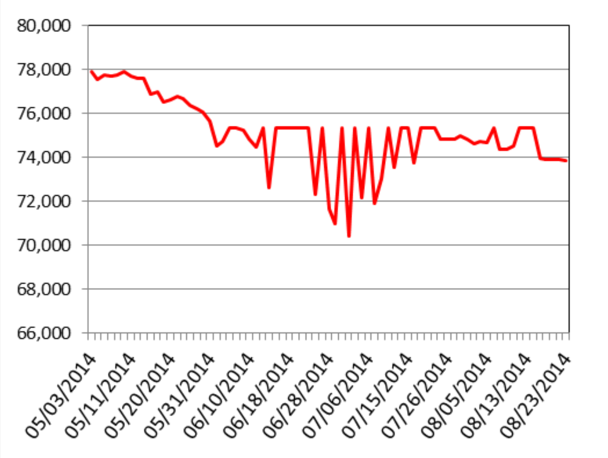
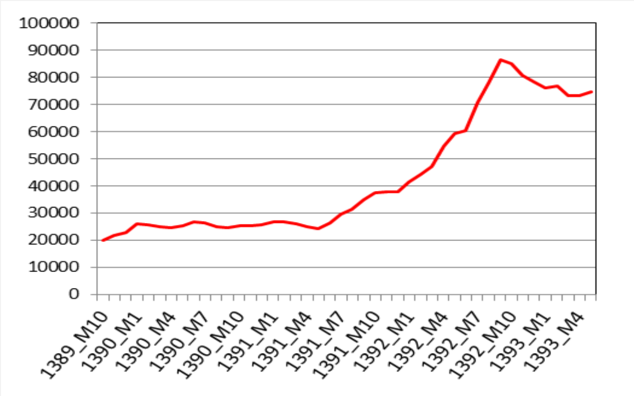


Chart 2. TEPIX stock market index.
1389 M10 to 1393 M4



The IMF praised Rouhani's government this month for its capable stewardship of the economy over the past year; VerityIran's view is more pessimistic on the downside risks.

The Director of the IMF's Middle East and Central Asia Department said "the process of stabilisation has taken hold in Iran", pointing to a significant improvement in inflation, which the Fund estimates has fallen from more than 40% when Rouhani took office to just over 25% now. The IMF forecasts GDP growth of 1.5% this Iranian year, having contracted 5.8% in 1390 and further last year. Vice President Nobakht's comments a day later chimed with this, predicting an end to Iran's negative growth rate this year. VerityIran's own estimates, using a combination of official statistics and street level data, suggest that inflation is indeed improving rapidly but from a much higher level than official data admits and high levels of liquidity mean it will remain high in 1392 at around 33% (see Chart 3). Our GDP forecast is also more pessimistic. VerityIran economists don't expect growth until 1393 at the earliest, under the assumption of no significant change in international sanctions (see Chart 4). The down side risks of a failure of talks would drastically change this forecast for the worse; we expect failure would result in a severe demand shock, as exports drop, government spending and investment freeze up, and households further reduce consumption.

Chart 3. Inflation index. Official rate (blue) and VerityIran estimates (red)

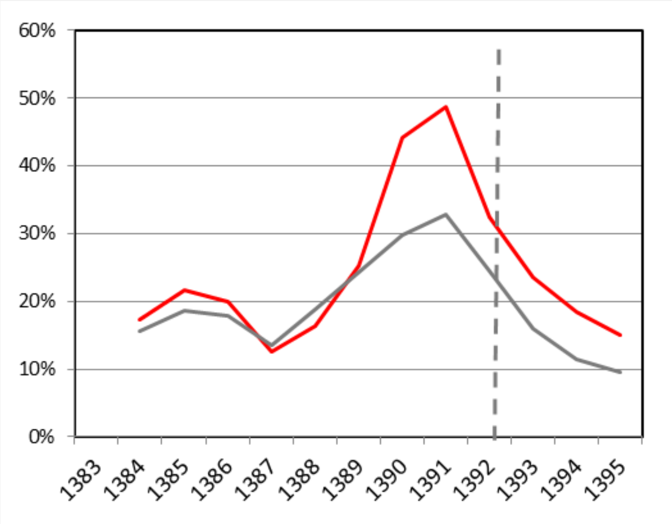
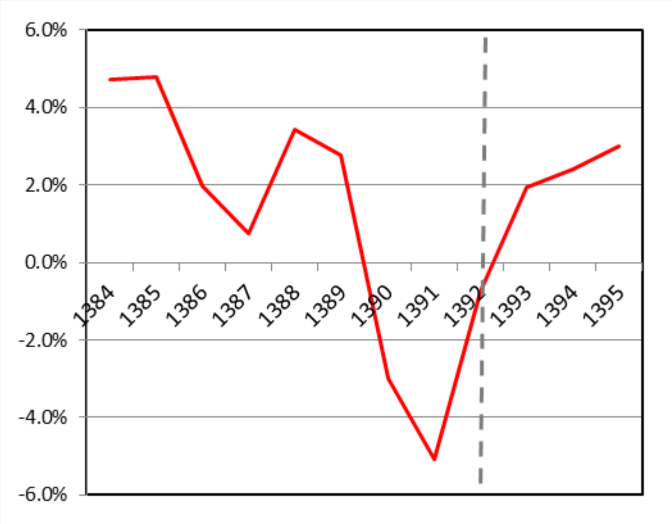


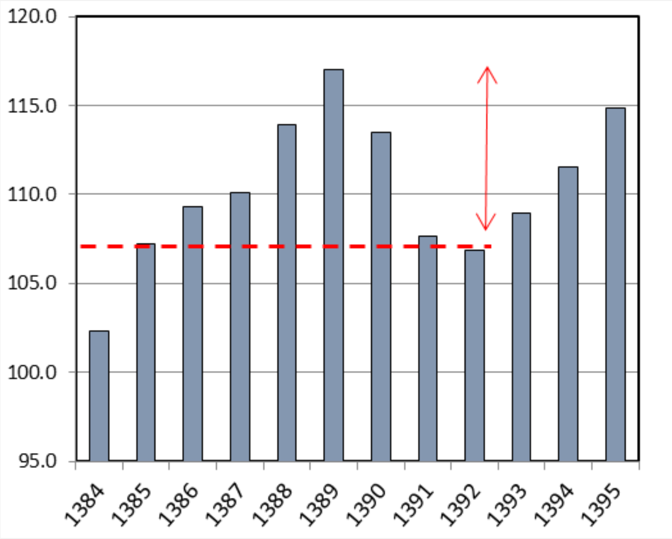
Chart 4. VerityIran GDP forecast (y-o-y % growth rate).



Indeed, despite the positive overtures, Iran's economy is still severely depressed.

Chart 5 illustrates how much smaller Iran's economy is today compared to 3 years ago. Employment figures suggest there were 700,000 fewer jobs in manufacturing at the turn of the year, compared to a year earlier. Real food expenditures are down 14 percent year on year, which is no surprise given the rate at which inflation is outpacing wage rises. Even the Minister of Economic Affairs and Finance said this month that purchasing power had fallen 20% in the past 2 years.

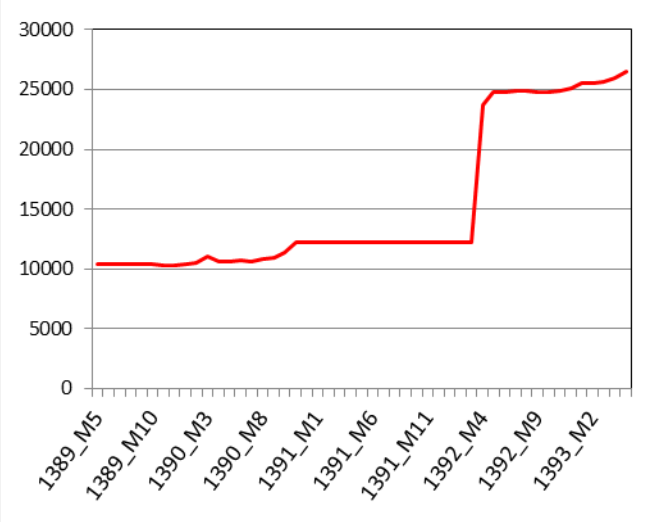
Chart 5. Iran's GDP levels (1383 = 100)



VerityIran's view on Rouhani's first year in power is that his economic agenda has been smartly devised and professionally implemented, but it is inevitably flawed without sanctions relief.

Rouhani's priority has been to stabilise the money supply and restore order to government balance sheets, building some much needed confidence back into the economy. In the absence of any real public stimulus though (public spending fell from 19.5% of GDP in 1390 to less than 15% last year), Rouhani has placed his faith in the private sector to lead the recovery. But business confidence is fickle and private enterprises face a cliff-edge if negotiations end badly this year. Business confidence is leveraged against expectations of an eventual breakthrough in sanctions. If that doesn't come, Iran's bubble will burst. Our sources report an increasing number of firms that haven't yet gone bust but are technically insolvent and are keeping business open on credit in the grizzly hope of a sanctions breakthrough. The longer these firms wait the larger the losses will be and a senior adviser to Rouhani's government, Torkan, suggested this month that the true size of bad debts in the banking system could already be as high as IRR 160 trillion (around US$51bn), twice the original figure predicted. This illustrates just one element of the financial shock that could reverberate around the Iranian economy should talks fall apart.

Chart 6. Rial official exchange rate (IRR/USD)



This year's water shortages in Iran pose a different, but no less pressing, problem for the Iranian economy than sanctions and require urgent investment, but are the funds available to avert catastrophe?

Water rationing is now being implemented in cities across the country. This month the Director of the Tehran Water Company said Tehran's reserves covered only 40 days and would require a 25% reduction in consumption if they were to last until the autumn. Shortages are devastating the rural economy in Isfahan, and Lake Orumiyeh in the north west is on the brink of ecological catastrophe having lost 95% of its capacity in the last two decades. Iran's water shortages are a product of rapid population growth and industrialisation in dry areas but also gross mismanagement– including a severe lack of infrastructure investment and perverse subsidies that encourage unsustainable consumption.

Analysts estimate US$100bn (IRR 313 tn) of investment in irrigation systems is required over the next decade – apparently US$4bn (IRR12.5 trn) to reverse the disappearance of Lake Orumiyeh. To provide a sense of scale, this is equivalent to around 15% of one year's entire investment in the Iranian economy. Rouhani has repeatedly stated the importance of the water crisis and Iran's proud history of engineering and irrigation is well known, so a solution is possible. But enormous amounts of capital are required, while the government's financing capacity is constrained by sanctions. In VerityIran's view, this level of financing is unfeasible without sanctions relief.

Iran's oil exports to China have reportedly risen 5% from June to July 2014, and all of 40% compared to the same period last year, but sanctions continue to restrict the revenues to barter trade only.

Chinese volumes have held at over 550kbpd, close to their pre-2012 trend levels, but importantly, no progress has been made in liquidating Iran's cash revenues from the trade, which are restricted by sanctions to the purchase of Chinese goods. VerityIran's view is that the absence of a significant increase in Chinese liftings from Iran, despite Iran's enormous spare capacity, is very telling about the real appetite for Iranian oil in the global market. Iran's overall crude exports remain pegged slightly above the 1mbpd permitted by the interim deal, suggesting Iran's customers are still not willing to risk a breach in sanctions, not even China. Should the US authorities at some point choose to tighten restrictions further, VerityIran predicts Iran's consumers are more than likely to fall in line.

Russia's highly publicised U-turn on a promised US$1.5bn per month oil deal with Iran raised eyebrows across the oil industry, but left the National Iranian Oil Company empty handed.

Reports of a highly lucrative 5-year oil-swap deal with Iran emerged from the Russian energy ministry on the 5th August, which would significantly boost Iranian production. But only a day later, the Russian energy ministry reneged on the statement and rapidly de-escalated expectations, saying no volumes had been agreed. A misstep by the Russian authorities on a highly controversial diplomatic and legal matter. In fact, our industry experts suggest the arrangement was never likely to lead to anything given the practical limitations. A crude-swap would have been technically very difficult given the lack of Russian refineries near big ports to process the oil. It would also have been directly subject to US and EU sanctions and would have doubtless led to the further isolation of Russian banks and energy companies, which VerityIran believes would be a risk too great for the Russian authorities.