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LEADING INDEPENDENT ANALYSIS OF IRAN'S ECONOMY

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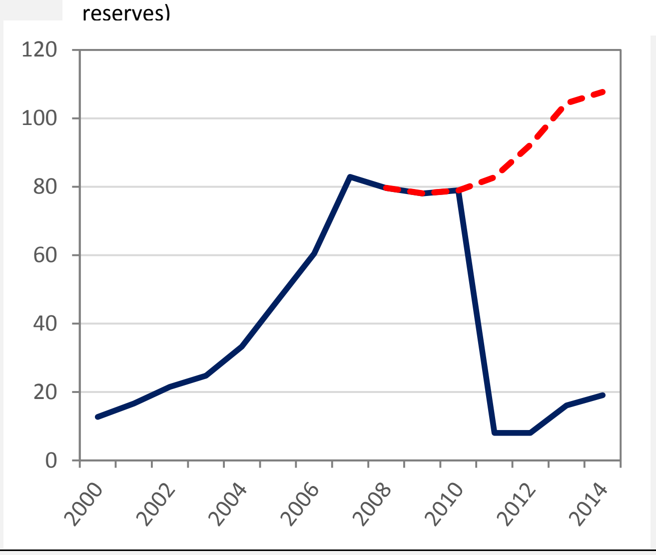
Is Iran facing a liquidity crisis?

Amidst some positive news on the economy, the business community is growing aware of the enormous downside risks on the horizon as nuclear talks again come to a head. Our exclusive sources reveal the severity of the situation, with Iran facing a potential liquidity crisis and a perfect storm in the financial sector if hope of sanctions relief is permanently lost.

Verity has learned that Iran is facing an imminent liquidity crisis due to international sanctions constraints. Our sources have revealed that Iran requires an additional US$10 billion in hard currency to sustain normal government operations until the end of November 2014 (mid-Azar), and is struggling to source it. Iran is expecting receipt of US$2.8bn of its overseas assets as agreed under the extension of the interim agreement with the P5+1. Even if transmitted promptly and in full this will not be sufficient to plug the gap, according to our sources. International financial institutions are still highly reluctant to deal with any Iranian banks for fear of US sanctions repercussions – even when the trade appears to be permitted under the interim agreement.

If talks breakdown, there is a real risk of a perfect storm building for the Iranian financial system, leading to a severe depression. A permanent breakdown in talks, and consequently the loss of any prospect of removing sanctions, would slam the breaks on economic activity in Iran – as we reported last month, many businesses are avoiding insolvency only in the hope of a breakthrough in sanctions. Lack of access to foreign exchange reserves and the international money markets would leave the Central Bank of Iran (CBI) without a buffer against a currency crisis, just as confidence in the rial crashes. With a renewed spike in inflationary pressure, a likely credit-crunch, new waves of bankruptcy, renewed pressure on the government accounts and a banking sector overwhelmed with non-performing loans (already estimated at around 30%) – the authorities would face an impossible economic policy challenge.

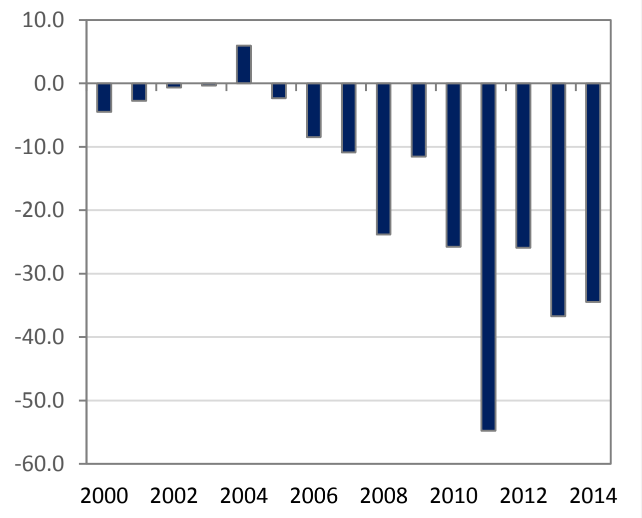
Fig 1. Iran's Accessible Foreign Exchange Reserves
US$bn, (blue line accessible reserves, red-line is actual reserves)



Acute shortfalls in foreign exchange reserves will restrict the CBI's ability to stabilise the domestic currency market in the event of a shock to confidence. On 6 September, the Government's economic spokesman Nobakht said Iran's forex revenues this year would be less than US$25bn, including the assets released by the interim agreement. Fig 1 shows Verity estimates of Iran's "accessible foreign exchange reserves", which have plummeted since 2011 (blue line). The dotted red line is our estimate of actual foreign exchange reserves, including those that are locked up by financial sanctions.

Part of the problem is years of high level corruption in the currency markets and abuse of Iran's dual exchange rate system. A report from the President's office recently claimed that US$22bn was grafted from government accounts in the final three years of the Ahmadinejad administration; distributed by the CBI through exchange shops in Iran, UAE, Turkey and Iraq to non-existent businesses. Our sources confirm that shell companies were being used to allocate forex at subsidised rates for the importation of critical goods, but were immediately selling the currency onto the black-market for a substantial mark-up.

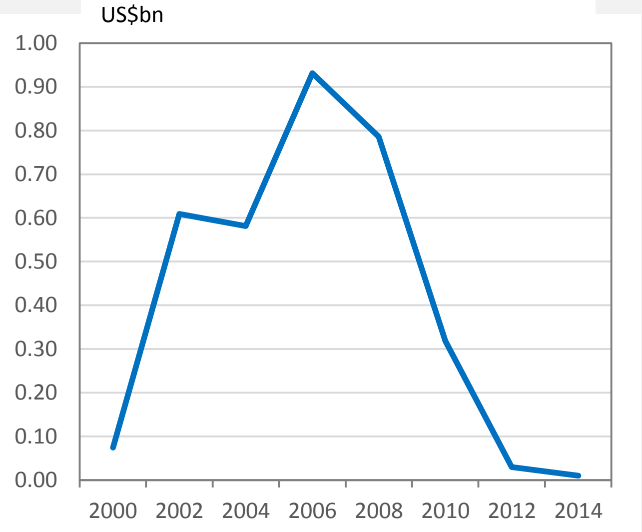
Fig 2. Iranian Capital Flight
US$bn (negative figure is Capital leaving the country)



Capital flight, a perennial problem in the Iranian economy under normal conditions, is now leaking tens of billions of dollars out of the economy on an annual basis (see Fig 3.). The capital account is further diminished by a halt on investment inflows since sanctions hit in 2012. Fig 4. shows the drop off in inward foreign direct investment (FDI) as sanctions escalated in recent years.

On a positive note, the Central Bank of Iran won a victory in the European courts. The European Court of Justice decided to override a 2012 freeze on CBI assets, ruling that the case was based on confidential evidence against which Tehran could not mount a defence. Unfortunately for the CBI, there are virtually no practical implications from the decision as later provisions against Iran remain in force. Even if funds in EU banks were unfrozen, the lack of access to SWIFT clearing system, the reluctance of Western banks to deal with Iranian entities and the remaining threat of US financial sanctions mean the funds would still be unlikely to return into circulation.

Fig 3. Inward Foreign Direct Investment Flows
US$bn



Despite the colossal risks on the horizon, the Rouhani administration has been building a positive narrative on the economy in recent weeks – and it is grounded, at least, in some honest numbers. The economy minister Tayb-Nia stated that economic growth rates had moved into the black for the first time after three years of negative economic growth. Government spokesman Nobakht also claimed growth in the first quarter of this year was 0.5% and would rise to 1% by the next quarter. ***Verity baseline forecasts do not disagree with a potential return to year-on-year growth this year, although this outcome is entirely contingent on progress in nuclear negotiations***. Meanwhile, the CBI announced a drop in inflation figures to 23.2% in Tir (month ending 22 July), falling from 25.3% the previous month. In addition, manufacturing output in the Automotive sector is said to have leapt 74% in the first five months of the year. The 230% growth in car imports however, with almost 50,000 cars imported in the first five months of the year alone, adds another strain on increasingly scarce foreign exchange.

New employment statistics remain depressing though, and debate has become increasingly heated over the value and honesty of official statistics. The Iran Statistics Centre claimed unemployment levels of 10.4% in 1392, but critics point to a number of inconsistencies. For example, with over 50% unemployment for women and over 30% for new college graduates, many ask how the national level can be below 20%. Also, the anecdotal experience of hundreds of businesses and thousands of employees over the last two years jar with the steady and stable nature of employment statistics. The director of Majlis Research Centre MP Jalali was quoted as saying "the statistics system in Iran is a catastrophe", and that many statistics are "completely wrong". Verity's view is that the validity of official statistics has been improving under the Rouhani administration but in sensitive areas, like unemployment, the government continues to obscure bad news and tinker with the parameters.

Iran's exports have expanded but its trade balance has deteriorated, placing further pressure on foreign exchange stockpiles. The latest trade figures from the Iran Customs Administration suggest foreign trade in the first five months of this year (or late March to late July 2014) increased by US$8.9 billion compared to the same period last year, reaching US$41.6bn. Welcome news for many Iranian businesses, but the trade balance has deteriorated. Imports rose by 33.6% to US$22bn, whilst exports rose 20.8% to US$19.6bn. In addition, our sources say Iran's petrochemical exports are still hampered by sanctions, despite the suspension of the sales embargo under the interim nuclear agreement. The problems stem mostly from the refusal of insurance companies to work with the National Petroleum Company and its partners to insure the cargo. Verity sources suggest the 4 and 6 month sanctions windows provided by the interim agreements fit awkwardly with shipping cycles and are not long enough to provide assurances to major insurers.

Finally, the Government managed to overcome hard-line opposition to grant 3G and 4G licences to Iran's two principal mobile operators this month, who rapidly rolled out high speed connections to their tens of millions of subscribers. With many Iranians illegally circumventing the firewall on banned social media sites such as YouTube and Twitter, authorities have forced mobile phone operators to reduce internet speeds in order to restrict access. The new licences are the latest in a string of recent measures to reverse those considerable constraints on the digital economy– service providers recently increased bandwidth

Fig 4. Iran GDP growth forecasts (Verity forecast) % change in GDP, y-o-y

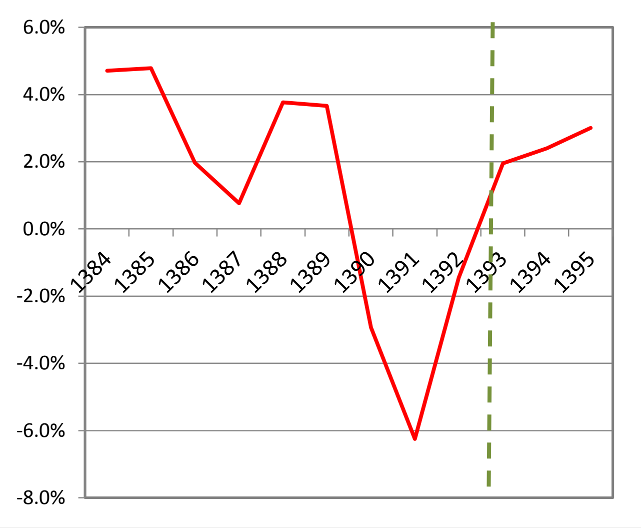


Fig 5. Fixed broadband subscriptions per 100 inhabitants

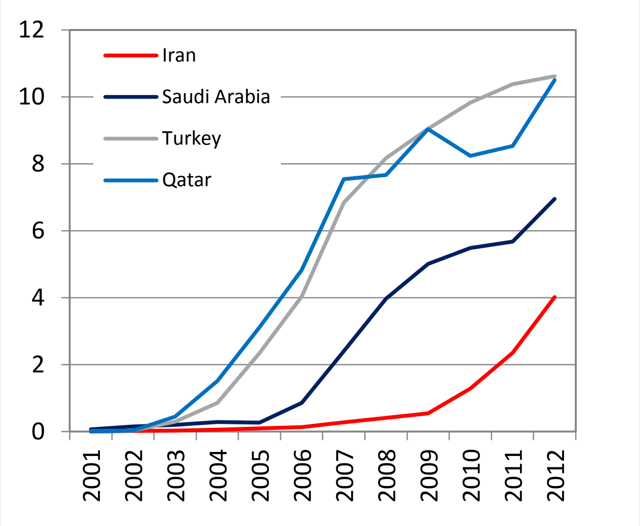
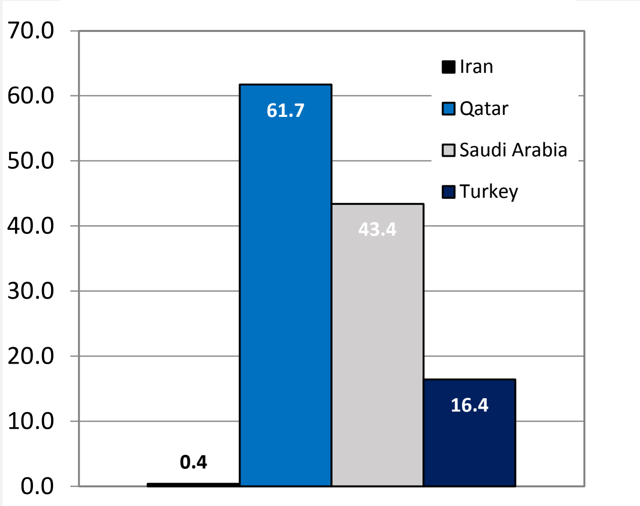


Fig 6. Active mobile broadband subscriptions per 100 inhabitants



available for fixed internet connections in homes, for example. Verity's view is that this is a very welcome development for consumers and businesses alike in Iran, where internet speeds are desperately slow compared to any developed economy and even their near neighbours and competitors. Figures 5 and 6 show how far behind connectivity in the Iranian economy has fallen.