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LEADING INDEPENDENT ANALYSIS OF IRAN'S ECONOMY

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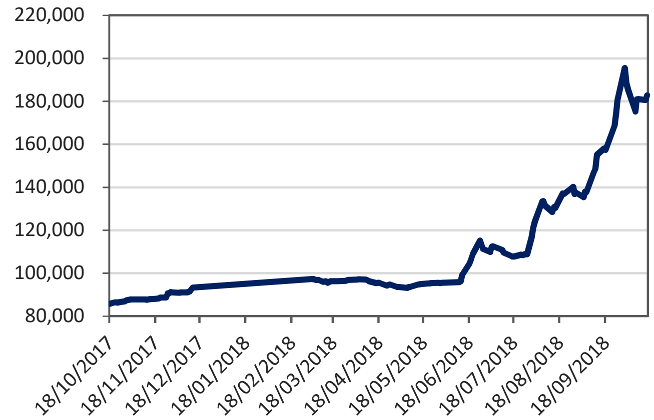
Special Purpose Vehicle brings a glint of optimism

Against a backdrop of tightening US sanctions, the Tehran stock index has rocketed. The paradox is largely explained by the distortionary effects of a collapse in the value of the rial, which has brought high levels of rial liquidity. But good news stories on Europe's new Special Purpose Vehicle for facilitating legitimate trade with Iran and the Parliament's ratification of the FATF anti-corruption measures have also played a significant role.

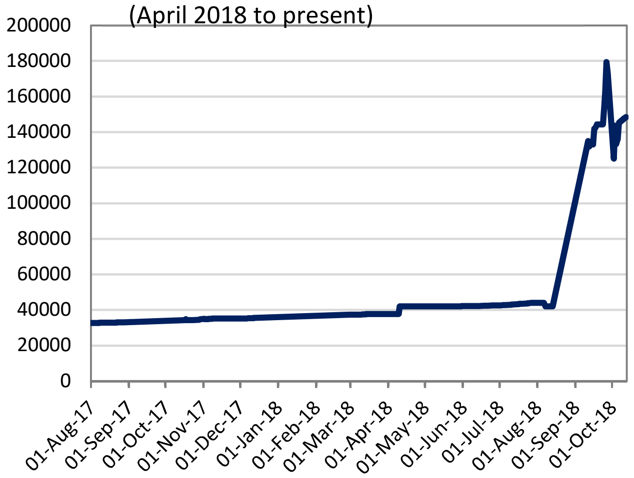
Fig 1. TEDPIX All Shares Stock Index
(October 2017 to present)



In spite of growing pressures on the Iranian economy, the Tehran Stock Exchange (TSE) has hit historic highs in recent weeks after the biggest "bull run" in its 50-year history (Fig 1). However, what is good news for many investors is not necessarily a sign of economic health. The principal driver of the spike has been a liquidity rush caused by the depreciation of the rial, which has multiplied the rial revenues of Iran's big commodity exporters. The rial has lost approximately 75 percent of its value in the past year (Fig 2).

The market was also given a boost by the announcement of a new European Special Purpose Vehicle (SPV) for circumventing US financial sanctions. The European Union's High Representative, Federica Mogherini publicly stated her intention to make the euro-based mechanism operational by November, and has seven European Central Banks behind the scheme. The SPV is designed to facilitate payments for legitimate financial transactions between European businesses and Iranian entities in a way that avoids contact with the US dollar markets and the SWIFT payment system. It can also extend to non-European entities too. It is likely to operate as a form of triangular bartering system, with an escrow account positioned in the middle, facilitating exchanges between the two parties in a way that avoids their direct interaction. For example, an Indian purchaser of Iranian crude might pay into the SPV, and an Iranian manufacturer can settle its purchase of equipment from Europe by drawing on the same funds.

Fig 2. Rial to USD official exchange rate
(April 2018 to present)



The SPV is a significant step forward in establishing the new parameters for Iran's trade with the world, under a post-US JCPOA agreement, but it is no panacea for Iran's economic woes. Indeed, many of the technical details are yet to be ironed out. The scheme smartly minimises the number of necessary transactions foreign partners have to make, but is not invulnerable to legal attack or political pressure. Its success will depend on committed European authorities are to withstand such pressure, and to protect the banks and other third parties that enter the SPV's orbit. Even if the mechanism can be made to work well for trade, it remains to be seen whether it can be successfully adapted to facilitate foreign investment in Iran, or the joint venture arrangements sorely needed by Iranian industry. With the most basic trade financing agreements still being worked out, the feasibility of these more complex financial arrangements is not known.

Confidence was also lifted by the Iranian Parliament's long-awaited ratification of the corruption-busting Financial Action Task Force (FATF) recommendations for banking practice. The new regulations place Iran's banking system more closely in line with global rules on tackling terrorist funding and money laundering and are crucial to maintaining its connectivity with the international financial system. The vote was a notable win for President Rouhani, who argued prominently for the bill as a means to safeguard Iranian banks against US pressure overseas, as well as a powerful weapon against fraud and corruption at home. The bill was fiercely opposed by hard-line politicians, who decried the 'westernisation' of Iran's financial system and suggested it would reduce Iran's room for manoeuvre under sanctions. But it is widely suspected that those voting against the bill were heavily influenced by wealthy vested interests with a history of exploiting the very same dark spots in the Iranian banking system the bill is designed to clean up, to launder money and siphon public funds. The measures will make that particular branch of criminal activity more difficult, which will be bad for some, but clearly of benefit to the Iranian economy.

After a highly volatile three months in the currency market, the authorities appear to have successfully brought the rial under some control. Following a substantial capital injection and a severe crack down on black market traders – coinciding with the sentencing to death of three "currency market manipulators", the rial regained 25 percent of its value in just two days, to reach 140,000 to the USD. The correction was so rapid, that households rushed to sell off their hard currency reserves. Many commentators claimed the dollar's decline as proof of the damaging role that currency traders and exchange houses have played in feeding the turmoil of the markets. It is plain to see that this stability is based on rather extraordinary set of capital controls, but the President has made it clear he intends to sustain them for the rest of the year and the Central Bank has been granted new authority to engage in open market operations and to rein in cash-rich speculators from fuelling market volatility. So the settled rate, may hold fast for the near future.

Fig 3. Real inflation CPI

International estimate