



IRAN'S PRICE PRECIPICE

Understanding the drivers behind Iran's skyrocketing inflation and its impact on the population.

Castlereagh
Associates

ECONOMIC RISK SERIES NO.3 | MAY 2019

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EXECUTIVE SUMMARY

- **Findings:** The official inflation rate in Iran increased from 7% in March 2018 to 42.5% in February 2019. Over the same period, the USD/IRR free-market rate increased by 170%. The situation has resulted in a colossal rise in consumer prices, heavily impacting Iranians' purchasing power.
- **Explanation:** While the IRR's devaluation on the free market has certainly impacted price levels, the immediate drivers behind the rapidly increasing prices are the currency peg and the government's mismanagement of the economic crisis.
- **The Economist View:** The Iranian state is growing more anti-free market and increasing its intervention in the economy, thus harming its future prospects.
- **Living in Iran:** From E-Coupons to queues in meat shops, the US's withdrawal from the Joint Comprehensive Plan of Action (JCPOA) has directly impacted Iranians' livelihoods.
- **Poverty Rate:** On the back of rising consumer prices the poverty threshold for a family of four in Tehran increased by at least \$44 in 2018, bringing many Iranians under the poverty line.

Who are we?

Castlereagh Associates is a research and analysis company, providing clients with key insights to support their decision-making and enable them to build more competitive and resilient businesses on national, regional and global levels.

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Inflation Rate:

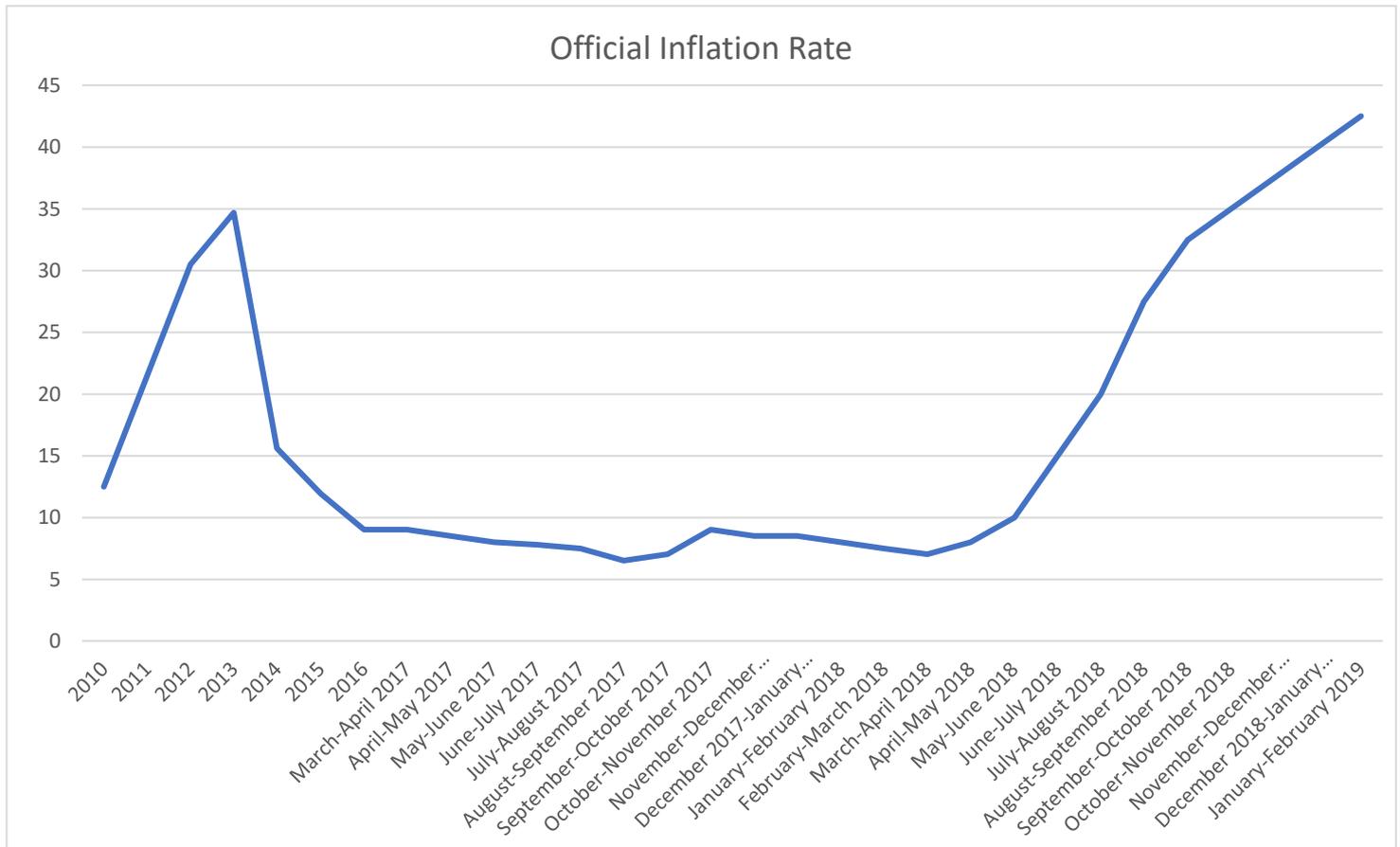


Figure 1. Official Inflation Rate in Iran from 2010 to February 2019

Source: Data has been compiled from the Central Bank of Iran for the 2010-16 period and from Iran's Statistics Centre thereafter.

High inflation is commonplace in Iran. The country has experienced single-digit rates just four times over the last 40 years. During President Hassan Rouhani’s first term, which ran from 2013-17, inflation was successfully brought below 10%, thanks to not only tighter monetary and fiscal policies but also people’s rising expectations preceding the JCPOA. This praiseworthy achievement was short-lived: Iran is currently experiencing one of its highest inflation rates in recent years, alarming the Central Bank of Iran (CBI), which stopped releasing its numbers from December 2018 onwards.

Exchange Rate:

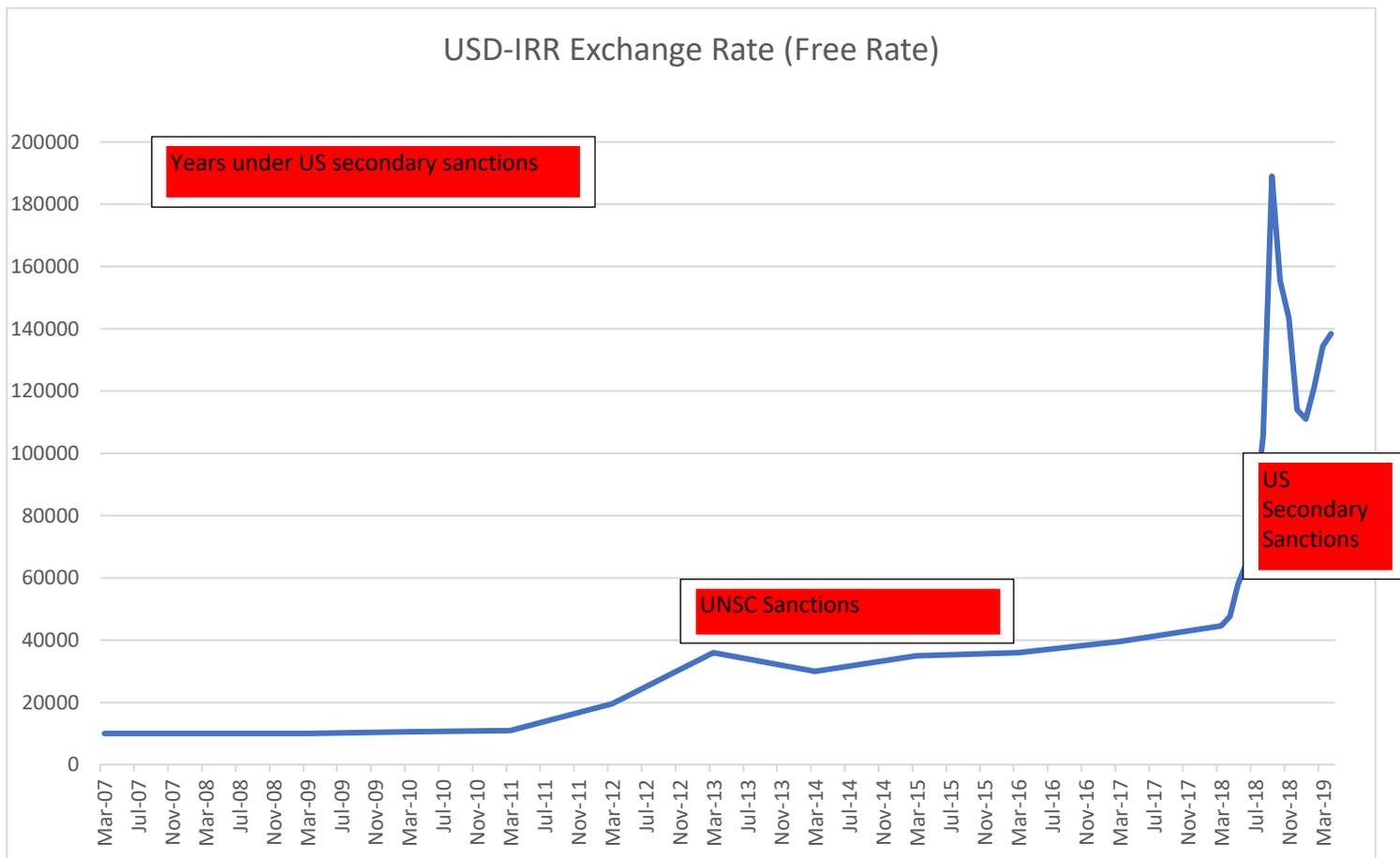


Figure 2. US Dollar to Iranian Rial Exchange Rate on the Free Market 2007-March 2019

Source: Data compiled from *Donya-e-Eqtasad* and Bonbast.com.

This is the second time in a decade that Iran’s currency has lost half of its value over a 12-month period. Both devaluations were linked to secondary sanctions imposed by members of the international community. In 2012 the US dollar gained 116% in value against the rial, and in 2018 it climbed 165%. While currency devaluation has been a persistent trend over the last 30 years, in mid-2018 a milestone was reached when the rial dropped below IRR100,000:\$1 – a record low.

In September 2018 the IRR/USD exchange rate reached its highest recorded level, at

IRR
190,000:\$1

The currency fluctuations seen in 2018 were the result of what the late economist John Maynard Keynes would call an activation of the people's animal spirits. As sanctions and economic recession loomed large, Iranians rushed to buy safe assets such as foreign currencies and gold, thus hiking the value of the US dollar.

In an economy which primarily exports raw goods and imports manufactured ones, changes in the currency market have a direct impact on the inflation rate. Put simply, a more expensive US dollar means that importers must hike prices, thus raising inflation. However, it would be incorrect to assume that all of Iran's economic problems are due to a strong US dollar. The free forex market has its own speculative dynamics and, therefore, does not paint an accurate picture of Iran's economy. Iran retains a peg of IRR42,000:\$1 for around 100 basic commodities, which helps to stabilise inflation when the US dollar gains in value.

Many economists agree that the currency peg is a poisoned gift from the government to the economy. Introduced on the 10th April 2018 in anticipation of the resumption of US sanctions, the peg was followed by a policy outlawing the open forex market. The approach threw the rial into a free-fall on the black market, where the US dollar tripled in value in the space of a few months. The rial's devaluation was exacerbated by arbitrage, rent-seeking and corruption in the forex market, as those with access to the official rate sold their foreign currency at a premium on the black market.

The exchange rate unification policy was stopped on the 6th August that year, with a move by the new CBI head, Abdolnasser Hemmati, to allow economic actors to trade foreign currency freely in the hope that it would stabilise the forex market. When the US dollar was being traded at a record IRR190,000 in late September, Hemmati adopted additional policies to halt the currency's free-fall. The government used scare tactics to urge people to sell their US dollars while pumping its own reserves into the market and cracking down on exchange bureaux by limiting individual sales of US dollars to \$300. This policy was relatively successful in propping up the rial, which was trading at IRR140,000 against the dollar as of April 2019.

In 2018:

25% of exporters' foreign currency earnings were repatriated

Source: Donya-e-Eqtasad

Yet, the US's designation of the IRGC as a terrorist entity in that month and its refusal to renew oil waivers continues to create instability on the forex market. It is highly likely that the US dollar will grow stronger in 2019, thus forcing the government to revise its currency peg by devaluing its official rate and bringing it closer to the open rate market. Regardless, the official rate of IRR42,000:\$1 is seen as unsustainable as it puts too much strain on the country's foreign reserves. In the months following its introduction, daily registrations by importers wanting to access the rate reached \$1bn, according to the economist daily

*Donya-e-Eqtasad*¹. While the government has yet to review those requests, a large number are thought to be fraudulent. Iran's ICT minister, Mohammad Javad Azari Jahromi, published a list in late 2018 which showed that out of the €220m taken by 40 companies in August-September of that year, only €75m was used to import basic commodities. Overall, the highest estimates show that the official exchange rate has cost the government around \$19.2bn.

Another government failure concerns the NIMA system, an online market opened in late January 2018 to enable exporters to sell their foreign currency earnings to importers at above the official rate but below the free market rate. This policy created a third exchange rate and was backed by a legal requirement that exporters repatriate their foreign earnings as soon as possible. Yet, it was a complete failure: between March 2018 and March 2019, only 25% of exporters' foreign currency earnings were retrieved, mostly from non-oil exports, such as petrochemicals.

It is therefore very difficult to envisage a continuation of the current currency system in Iran. US-based economist Djavad Salehi-Isfahani told *Donya-e-Eqtasad*² that the government's currency policies are problematic because they not only incentivise smuggling and speculation, but also because they negatively impact local producers as well as exporters, who are wrongly deemed guilty of capital flight. The official rate creates a situation in which foreign goods are cheaper than domestically produced ones at times of sanctions, which dissuades Iranians from buying locally made goods and undermines the Supreme Leader's vision of a self-sufficient "Resistance Economy."

A move by the government to re-evaluate its currency policies and bring the official rate closer to IRR100,000:\$1 appears inevitable. This would exacerbate inflation, but not uncontrollably so. On the bright side, a new rate would allow local production to soar and exports to grow, thus minimising losses from decreasing oil exports. More importantly, it would prevent rent-seeking, a major factor behind inflation. Yet, for this policy to be adopted, the government must first understand that inflation is influenced by forces other than the currency market.

¹ Donya-e-Eqtasad, March 2018, "The Threat of Populism: Analysis from Ali Mirzakhani, p.48-51"

² Donya-e-Eqtasad, March 2018, "The Threat of Populism: A Different Experience with the World", p.82-83.

Prices in Detail:

Product	Price March 2017 (IRR and USD)	Price August 2018 (IRR and USD)	Price October 2018 (IRR and USD)	Price March 2019 (IRR and USD)
Average Sq metre in Tehran	56,000,000 IRR <i>1,513 USD</i>	71,000,000 IRR <i>1,918 USD</i> 670 USD	81,000,000 IRR <i>2,189 USD</i> 586 USD	99,672,000 IRR <i>2,693 USD</i> 741 USD
Peugeot Pars LX (made in Iran)	430,000,000 IRR <i>11,625 USD</i>	690,000,000 IRR <i>18,648 USD</i> 6,509 USD	795,000,000 IRR <i>21,486 USD</i> 5,760 USD	1,008,000,000 IRR <i>27,243 USD</i> 7,494 USD
Renault Talisman car (imported)	2,600,000,000 IRR <i>70,270 USD</i>	4,450,000,000 IRR <i>120,270 USD</i> 41,981 USD	5,200,000,000 IRR <i>140,000 USD</i> 37,681 USD	6,400,000,000 IRR <i>172,972 USD</i> 47,400 USD
Bahar Azadi gold bullion coin	15,900,000 IRR <i>429 USD</i>	38,930,000 IRR <i>1,052 USD</i> 367 USD	44,750,000 IRR <i>1,209 USD</i> 324 USD	45,500,000 IRR <i>1,229 USD</i> 337 USD
IPhone X (256 GB)	69,330,000 IRR <i>1,873 USD</i>	136,480,000 IRR <i>3,688 USD</i> 1,287 USD	162,000,000 IRR <i>4,378 USD</i> 1,173 USD	152,900,000 IRR <i>4,132 USD</i> 1,136 USD
Microsoft Surface Pro 4-E	63,920,000 IRR <i>1,727 USD</i>	153,620,000 IRR <i>4,151 USD</i> 1,449 USD	179,200,000 IRR <i>4,834 USD</i> 1,298 USD	135,500,000 IRR <i>3,662 USD</i> 1,007 USD
1L Bottle of milk	28,000 IRR <i>0.75 USD</i>	33,000 IRR <i>0.89 USD</i> 0.3 USD	37,000 IRR <i>1 USD</i> 0.2 USD	45,000 IRR <i>1.21 USD</i> 0.33 USD
2.5L Yoghurt	85,000 IRR <i>2.2 USD</i>	88,000 IRR <i>2.37 USD</i> 0.83 USD	110,000 IRR <i>2.97 USD</i> 0.79 USD	135,000 IRR <i>3.64 USD</i> 1 USD
1kg Red meat (Sheep)	394,000 IRR <i>10.5 USD</i>	570,000 IRR <i>15.4 USD</i> 5.37 USD	750,000 IRR <i>20 USD</i> 5.4 USD	950,000 IRR <i>25 USD</i> 7 USD
1kg Chicken	88,000 IRR <i>2.37 USD</i>	108,000 IRR <i>2.91 USD</i> 1 USD	96,000 IRR <i>2.59 USD</i> 0.69 USD	165,000 IRR <i>4.45 USD</i> 1.22 USD

1kg Rice	120,000 IRR <i>3.24 USD</i>	123,000 IRR <i>3.32 USD</i> 1.1 USD	165,000 IRR <i>4.45 USD</i> 1.2 USD	198,000 IRR <i>5.35 USD</i> 1.47 USD
1kg Red beans	75,000 IRR <i>2 USD</i>	85,000 IRR <i>2.29 USD</i> 0.8 USD	90,000 IRR <i>2.43 USD</i> 0.65 USD	130,000 IRR <i>3.51 USD</i> 0.9 USD
1kg Peas	90,000 IRR <i>2.43 USD</i>	95,000 IRR <i>2.56 USD</i> 0.89 USD	124,000 IRR <i>3.35 USD</i> 0.89 USD	130,000 IRR <i>3.15 USD</i> 0.96 USD
1kg White sugar	28,000 IRR <i>0.75 USD</i>	33,000 IRR <i>0.89 USD</i> 0.3 USD	37,000 IRR <i>1 USD</i> 0.26 USD	70,000 IRR <i>1.89 USD</i> 0.52 USD
4L of Washing-up liquid	170,000 IRR <i>4.59 USD</i>	175,000 IRR <i>4.7 USD</i> 1.65 USD	201,500 IRR <i>5.4 USD</i> 1.46 USD	245,000 IRR <i>6.62 USD</i> 1.82 USD
1kg Bananas	38,500 IRR <i>1 USD</i>	75,000 IRR <i>2 USD</i> 0.7 USD	115,000 IRR <i>3.1 USD</i> 0.8 USD	137,000 IRR <i>3.7 USD</i> 1.01 USD
1kg Watermelons	22,000 IRR <i>0.59 USD</i>	23,000 IRR <i>0.6 USD</i> 0.2 USD	13,000 IRR <i>0.35 USD</i> 0.1 USD	25,000 IRR <i>0.67 USD</i> 0.18
1kg Apples	110,000 IRR <i>2.97 USD</i>	115,000 IRR <i>3.1 USD</i> 1 USD	85,000 IRR <i>2.29 USD</i> 0.6 USD	115,000 IRR <i>3 USD</i> 0.85 USD

Figure 3. Prices Surveyed in Iran for Castlereagh Associates

Source: Data gathered in Iran for Castlereagh Associates; Open Market Exchange rates from Bonbast.com.

Understanding the table:

The USD prices in orange do not reflect real prices, but the cost of a product in USD calculated using the IRR/USD rate in March 2017. This is to illustrate how the purchasing power of Iranians has declined over the past two years.

The USD prices in black have been calculated using the free market exchange rate.

March 2017 Prices have been converted to the dollar at a rate of 37,000 IRR/USD

August 2018 Prices have been converted to the dollar at a rate of 106,000 IRR/USD

October 2018 Prices have been converted to the dollar at a rate of 138,000 IRR/USD

March 2019 Prices have been converted to the dollar at a rate of 135,000 IRR/USD

As figure 3 shows, consumer products are becoming more expensive for Iranians and cheaper for foreigners. For example, the cost of a high-end mobile phone on the free market has fallen by some 40% in US dollar terms since 2017, but increased by 120% using our method to calculate Iranians' purchasing power.

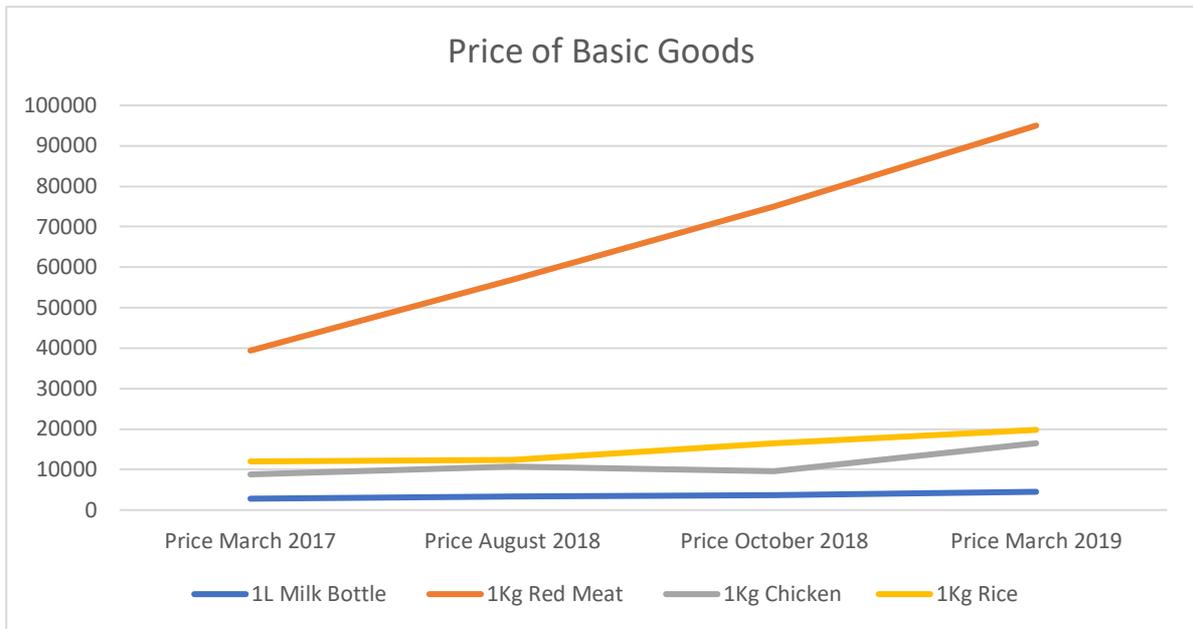


Figure 4. Price of Basic Goods

Source: Data gathered in Iran for Castlereagh Associates

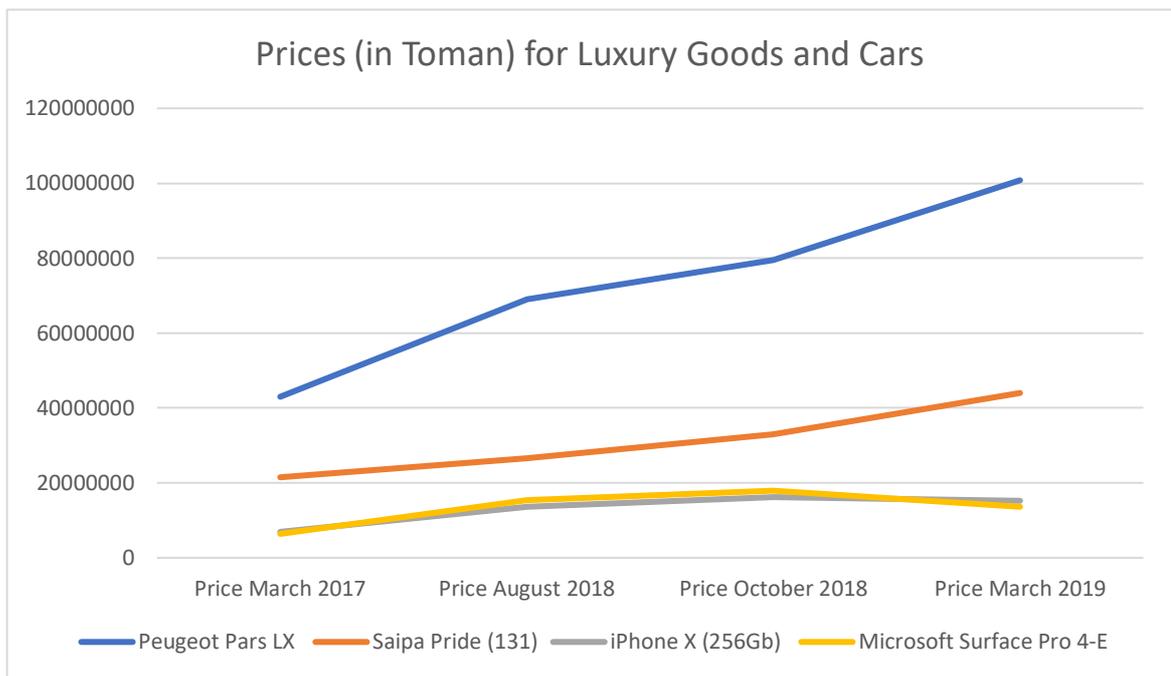


Figure 5. Price of Luxury Goods

Source: Data gathered in Iran for Castlereagh Associates

As figure 5 illustrates, a high-end mobile phone in 2019 cost nearly as much as a low-cost car in 2017, and a low-cost car cost as much as a mid-range car in 2017. Both the tech and automobile market have declined substantially in the last few years. Despite having a tech savvy and fashion-conscious youth, Iran's

smartphone market has contracted by 50-70% while the mobile phone repairs market has soared, as more people opt for repairing old phones over buying new ones. A visit to Charsoo Bazaar and the Bazaar-e-Mobile – two of Tehran’s newest tech malls – revealed a surprising absence of the latest gadgets, which indicates that prices are prohibitively high.

The Economist View:

In 2018:

Food Prices Increased
by
80%

Housing Prices
Increased by
100%

Source: RFI

At the end of 2018 President Hassan Rouhani’s government lost its few remaining free-market-supporting cabinet members. For many economists interviewed by *Donya-e-Eqtasad*, this exodus was both foreseeable and welcome in light of the negative impact the government’s continued interventions had on the economy.

In fact, 2018 saw not only the sacking by Parliament of the finance minister Masoud Karbasian but also the departure of roads and municipalities minister Abbas Ahmad Akhoundi, who resigned over differences in opinion with the president and the government’s heavy-handed approach to the economy. Leading economist and former presidential economic adviser Masoud Nili allegedly refused the post of Minister of Economy due to Rouhani’s unwillingness to bring structural changes to economic policymaking.

In spite of Rouhani’s early pro-free-market rhetoric, most liberal economists in Iran think that his government does not believe in the science of economics. Talking to *Donya-e-Eqtasad*³, Ali Mirzakhani said that the government’s approach to economic policymaking was more relevant to the bazaar than the free market, meaning that its policies changed on a daily basis and were based on faulty economic views. For instance, the government’s reaction to soaring prices prioritised security over economic growth. It cracked down on “economic disrupters” and speculators, without any real economic impact. It has also failed to introduce policies to decrease the overall price level, instead focusing on lowering the price of a few basic commodities without considering the price linkages between various products. As a result, products that the government promised to render more available have seen shortages.

The government’s inadequate response to the crisis has hit its credibility hard, undermining Rouhani’s claims that US secondary sanctions were solely responsible for the worsening economic conditions. For Mohsen Jalalpour, the former president of Iran’s Chamber of Commerce, Rouhani’s government simply

³ Donya-e-Eqtasad, March 2018, “The Threat of Populism: Analysis from Ali Mirzakhani, p.48-51”

had no strategy to face those sanctions, nor was it active enough during the years of the JCPOA. During that period, the government relied too heavily on expectations that foreign direct investment would increase and, later on, that the EU would protect Iranian economic interests following US's exit from the JCPOA. In 2019 Iran finds itself in the same place as it was in 2012, sanctioned and in stagflation. In July 2018 some 37 Iranian economists voiced their concerns over the government's handling of the economy in a letter to Rouhani. This led to a meeting with the president a few months later, however, so far none of their recommendations have been acted upon.

If Nili had been appointed Minister of Economy, he could have brought about much needed structural reform. In March 2019 Nili told *Donya-e-Eqtasad*⁴ that if the current situation had a silver lining it was that Iranians were aware of the headwinds facing the country in 2019: inflation, recession and an uncertain future.

Living in Iran:

Despite financial distress and low investment sentiment, commercial activity has remained surprisingly robust. For example, 218m transactions were conducted on the 19th March 2019, the day before Norooz (the Iranian new year), a 26% increase over the previous year, according to the national payment company Shaparak⁵.

In March 2019, during the runup to Norooz, Castlereagh Associates interviewed shop owners in Tehran about their approach to business during the economic downturn. Most said that maintaining large inventories was key. On Mirdamad street, a European menswear brand selling mid-range suits was advertising sales as high as 70%. The shopkeeper told Castlereagh Associates that without these sales, he would not be able to keep his business afloat.

In many ways, sellers have benefitted from the currency devaluation, as most imported their goods long before foreign currencies soared and are selling them at the new exchange rate, thus maintaining huge profit margins. For instance, the mid-range menswear shop owner told us that his stock dated back to late 2017, when he was able to buy material at a maximum rate of IRR70,000:€1. In March 2019 these same products were being sold at the IRR150,000:€1 rate, which the majority of Iranians can no longer afford, hence the severely reduced prices.

⁴ Donya-e-Eqtasad, March 2018, "The Threat of Populism", p.192-199

⁵ Shaparak, 21/03/2019, "Growth in number of Shaparak transactions in March 2019"

Although the strategy of selling older stock contributes to the economic crisis, it is the only way that shopkeepers have found to stay in business.

For other businesses and people in general, life is much harder. The cost of some products, such as meat and paper, have increased by at least 150%, which has led to the bankruptcy of many restaurants and printing shops.

The high cost of meat has forced the economy to turn to a more updated version of the rationing system it used during wartime in the 1980s: E-coupons. Introduced in March 2019, the system is designed for underprivileged citizens. Recipients, who receive the coupons by text message, pay approximately IRR600,000 for 1kg of meat instead of IRR1.1m but must undergo long queues and shop on specific days of the week. The difficulty in buying meat led the government in April 2019 to remove it from the list of products that can be imported at the official rate, reducing the profit opportunity for speculators by 300%.

While overall consumption increased during Norooz, spending on travel dropped. Some 40% of Iranians surveyed by *Donya-e-Eqtesad* cancelled their Norooz trip in 2019. Only 13% travelled abroad, while 45% travelled domestically, according to Radio France Internationale.⁶Travel costs were lower than previously, with budgets per person at around 1m Toman (IRR 10,000,000) maximum.

Poverty:

3.4%

of the population is addicted to drugs.

Source: Deutsche Welle (using official sources)

Higher prices are having a disastrous impact on the lower-income strata of society, the middle class and the productive parts of the economy. Crucial items, including medicine, are unaffordable for a large portion of the population, and it is common for families to rely on relatives abroad for prescriptions. For the poorest segments, it is sometimes necessary to resort to extreme measures to raise cash, such as selling a kidney. Women are likely to suffer more from the impact of sanctions than men, not only because the burden of subsistence will fall on their shoulders, but because there is a positive correlation between unemployment and domestic violence, prostitution and drug usage.

⁶ RFI, 19/03/2019, Economic Podcast Shahrokh Behzadi with Parastoo Fakharian.

In general, all these social ills are linked to poverty, which has undeniably increased in the recent years. As shown in figure 6, the official urban poverty threshold has kept rising, thus putting more people in the “absolute poverty” category. For instance, the poverty line for a family of four in Tehran increased by IRR6m in 2018, some \$44 on the free market, or \$160 using our method to calculate Iranians’ purchasing power.

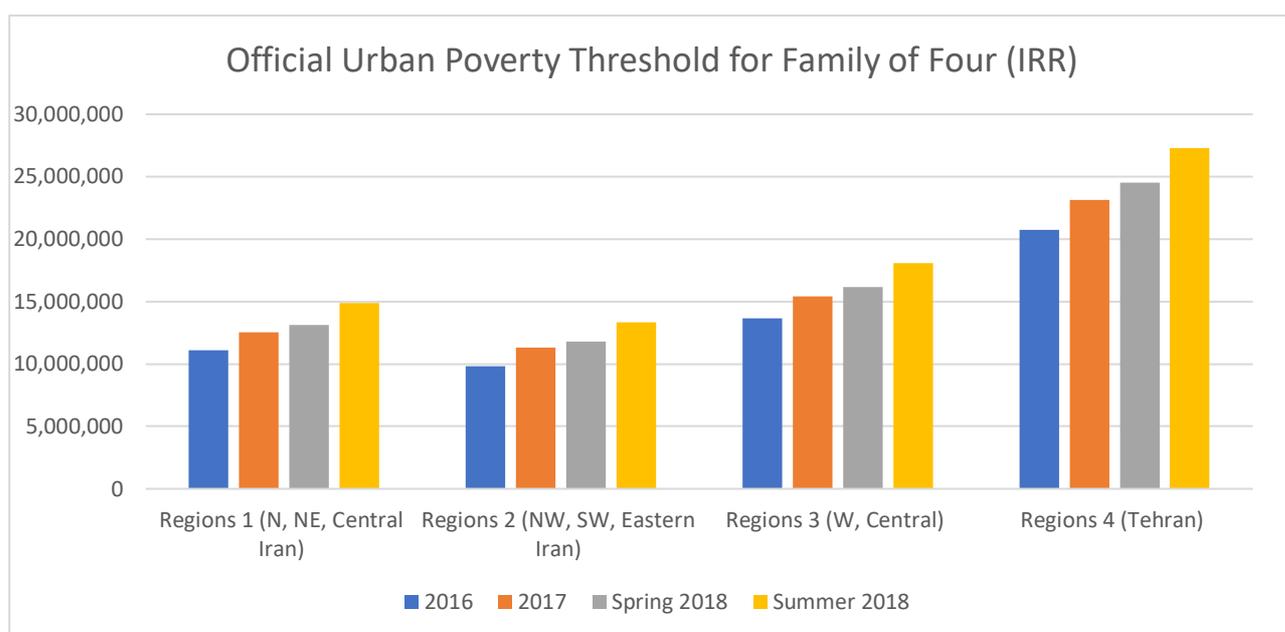


Figure 6. Official Urban Poverty Threshold for Family of Four (in IRR)

Source: Donya-e-Eqtasad 22/11/18, “Update of the Poverty Rate in Iran”

The official poverty threshold is not likely to offer a realistic representation of poverty in the country. In 2017 the economist Hossein Raghfar estimated that a family of four would need IRR40m to escape “absolute poverty”.⁷ compared to the official estimate of IRR28m for a family of four living in Tehran. According to Raghfar, 27m Iranians lived under the absolute poverty threshold in 2017. Although these high estimates are only a loose guide, it is important to note that since 2017, overall prices have at least been tripled, meaning that more Iranians could now be considered living under the absolute poverty threshold.

Although the sanctions cannot be held completely responsible for the multiple and rising social problems, the reality is that US pressure has immediately impacted the currency market, which itself has increased inflation, thus drastically lowering Iranians’ purchasing power and creating more poverty and

⁷ KhabarOnline, 21/03/18, Infographics: Poverty Rate in 2017/28 Million People in absolute Poverty”.

social problems. The three most prevalent issues in Iran are drug usage, depression and prostitution. Although statistics on these are hard to come by, in 2017 the Minister of Hygiene said that at least 12.6% of the population was estimated to suffer from depression compared to a global average of 10%⁸. A recent study on prostitution by Iran's Centre for Women Studies and Research found that at least 14% of prostitutes had a qualification above the high-school diploma and that 9% were forced into prostitution by a husband or partner for extra money⁹. According to another survey, changes in family circumstances was found to be a common cause of women entering prostitution. Around 44% of the prostitutes interviewed by the survey were widowed, 39% were divorced and just 11% were married. The largest proportion of respondents –approximately 42% – found clients through personal relations or social media; 25% were contacted mostly by phone; and 22% found clients on the streets. Of the nine clients per week these women dealt with on average, they believed 80% were employed and from a wealthy background, and that more than 40% were married.

Depression and prostitution are often linked to drug use in Iran. In 2018 Iran's Counter-Narcotics Centre announced that 2.8m people were using drugs on a continuous basis in the country, a number twice as high as in 2011.¹⁰ Some 67% of drug users were using opium, 11% heroin and crack, 8% crystal meth.

⁸ ISNA, 8 April 2017, "Depression Rate is 12.6% in Iran."

⁹ IranArt, 22.05.18, High Statistics of Forced Prostitution in Iran

¹⁰ DW, 26/03/18, "The Number of Drug Addicts has doubled since 2011"



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LONDON

London Office

Castlereagh Associates Consultancy Limited
Suite 1.5A, 1st Floor, Millbank Tower
London SW1P 4QP
United Kingdom
T: +44 (0)203 740 3884
M: +44 (0)7979 212 633
Email: contact@castlereagh.net

 [@CastlereaghA](https://twitter.com/CastlereaghA)



Castlereagh Associates Consultancy Limited