ECONOMIC SERIES ON IRAN:

Castlereagh Associates presents its assessment of Iran’s economy in 2018.

Castlereagh Associates

ECONOMIC RISK SERIES NO.3 | MAY 2019

Castlereagh
Associates

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Dear Reader,

In November 2018 we released the first edition of the Castlereagh Economic Series, focused on Iran's economy. The report is divided into two parts and examines the international and domestic dimensions of the Islamic Republic's economic crisis. Due to the report's success, we decided to create five shorter reports, which take the pulse of the Iranian economy by examining price levels, money supply, smuggling and corruption, international trade, domestic production and, finally, the 2019-2020 budget.

With the resumption of US secondary sanctions starting in August 2018, Iran's economy took a great hit, sliding by as much as 3.9% in that year, according to the IMF. Yet, its predicament is not solely caused by sanctions. A myriad of other problems, mostly caused by government policies and local mismanagement, are to be blamed for rising inflation, a weak currency and stagnant growth. In the following five reports, we examine the main causes of Iran's economic malaise. Combining field work, access to local media and research in Persian, we are proud to present Castlereagh Associates' unique economic outlook on Iran and an unbiased assessment of the opportunities and challenges therein.

We at Castlereagh Associates appreciate how political risk can affect the operations, viability and profitability of a business as directly and swiftly as any financial, physical, or market risk factors. From our London headquarters, it is my pleasure to place my experience in the private sector, media, government and academia at the service of our clients. Supported by a team of talented professionals, each with their own unique skillset, geographical and topical expertise, we are developing unique risk analysis products, based on advanced methodologies, cutting-edge research and a high-level global network.

I invite you to closely follow our company and to get in touch with us for tailor-made products.

H.E. Dr. Adel Al-Toraifi
Chairman and Managing Director

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SUMMARY

- In 2018-19 (Persian Year 1397), inflation in Iran increased by a factor of six – from 7% to 42.5% – and the value of the US dollar against the rial rose by a factor of 3.5 – from IRR40,000 to IRR140,000. Iran's economy shrank by 3.9% in 2018 instead of the projected 1.6%, and in 2019 could contract by 6% instead of the expected 3.6%, according to IMF estimates.[1]

- Although sanctions have clearly animated the people's Keynesian "animal spirit" and bolstered speculation in Iran, it is the government's policies, or lack thereof, which have caused the greatest harm to the economy. While some policy decisions were aimed at curtailing the impact of sanctions, others simply reflect what Iranians call the "crisis of mismanagement."

- While the current official exchange rate with the US dollar is IRR42,000 for basic commodities, the market rate is much weaker, at around IRR140,000. This has incentivised rent-seeking and engendered a new trend of reverse smuggling, whereby corrupt networks with access to goods imported at the official rate, such as livestock and wheat, re-export them at the market rate.

- Continuously high inflation is the direct result of the uncontrolled rise of the money supply, which has tripled over the last few years. In addition to the current economic crisis of stagflation – a combination of slow economic growth and rising inflation – the risk of a banking crisis in Iran is high, due to the significant rise in non-performing loans and the state's increasing inability to rescue bankrupt lenders.

- For Iran's government, finding a way out of the current economic crisis would require substantial and far-reaching reforms, such as the adoption of a new currency, permission for the Central Bank of Iran (CBI) to operate independently and an overhauling of the banking system, which would involve stricter adherence to international financial norms. However, recent policies bolstering the conservatives' claim that Iran is a fortress under attack on all sides have made it increasingly less likely that reforms of this nature will be carried out.

- In lieu of seeing its power wane during sanctions, the Islamic Revolutionary Guards Corps (IRGC) is undergoing leadership changes, to be fitted more tightly under Supreme Leader Ayatollah

[1] Reuters, 29/04/19, "Iran inflation could reach 40% this year as economy shrinks further-IMF"

Ali Khamenei's supervision and expand its role in the country's "Resistance Economy" - aimed at boosting Iran's self-sufficiency in economic and military terms. While the IRGC's economic and financial influence have been put under pressure, its military and political role will continue to increase. For instance, while the army's budget decreased by 8% in 2019-20, the IRGC's grew by 25%.

- As a result of government policies and sanctions, the poverty threshold continues to increase while social problems, such as corruption, drug abuse, prostitution and mental illness, are on the rise. Consumption remains strong, but the financial strain caused by inflation is likely to result in a large drop in spending.

- On the productive side of the economy, non-oil exports are performing well, with the value of outbound shipments increasing by just under 15% in 2018 compared to the previous year. However, the rising cost of production has greatly impacted local producers, principally in mining and industry. Oil, which accounts for approximately 50% of total exports, has lost at least $10bn in revenue as a direct result of US sanctions. The non-extension of waivers by Washington is likely to lead to a further drop in oil revenues.

- This loss is expected to have a substantial impact on fiscal stability. Economists in Iran anticipate that the budget deficit for the financial year 2019-20 will reach 20%. According to our own worst-case scenario estimate, in which Iran exports just 650,000 barrels per day of oil, the deficit will be closer to 45%. In this situation, the government will be forced to either reduce spending, a move likely to prove deeply unpopular with the public, or borrow from the CBI, which would exacerbate inflationary pressures on the economy.

- Government spending in 2019 will be directed towards minimising the impact of sanctions and stagflation on Iranians. A substantial portion of the budget will be dedicated to fossil fuel and import subsidies, which themselves incentivise rent-seeking and speculation. Foreign reserves will be further depleted to lessen the effects of the crisis and repair damage caused recent flooding, which is estimated at around $2.5bn.

Politics behind the Economy:

According to US-based economist Djavad Salehi-Isfahani, the solution to Iran's economic crisis cannot be found in any book on economics or even in the experience of other countries[2]. One key reason for this is that the Islamic Republic has effectively sanctioned itself. In conversation with the economic news outlet *Donya-e-Eqtesad,* the economist Moussa Ghaninejad said that the country lacked an adequate economic policy to deal with the crisis, and that it was unclear whether the foreign ministry had formed any clear response to the imposition of sanctions[3]. According to Ghaninejad, an increasing number of officials are treating the current situation as similar to that of the 1980s, when Iran was at war with Iraq and the government took control of the banks and large industries, and introduced rationing. During this period, much of the world ignored Iran's economic potential, cutting it off from foreign direct investment (FDI) flows and pushing the country's economic actors towards a policy of isolation and self-reliance.

In truth, it is likely that the Islamic Republic's isolationist agenda has exacerbated the economic challenge it currently faces. According to Ghaninejad, Iranian foreign policy is driven by the assumption that the international community has actively prevented the country from developing economically. While decades of sanctions might justify this view, the reality is that the republic has failed to garner enough international support to weather their impact.

Even the lifting of sanctions under the Joint Comprehensive Plan of Action (JCPOA) did little to spur the government to adopt policies aimed at attracting FDI and encouraging domestic growth. Instead, officials put the onus on foreign investors to establish economic relations with the Islamic Republic and seek out investment opportunities. Even the withdrawal of the US from the nuclear deal has not prompted the Iranian government to adopt more market-friendly policies towards the remaining signatories. According to Ali Mirzakhani, another economist interviewed by *Donya-e-Eqtesad*, this has caused an increasing number of Iranians to blame the JCPOA for the current economic crisis.

The US's exit from the JCPOA and the EU's weakness in defending it have not only increased nationalistic sentiment in Iran but also bolstered the narrative that Iran has no friends on the world stage and is therefore forced to exist permanently on the brink of war. It is this same belief that powers Ayatollah Khamenei's

[2] Donya-e-Eqtesad, March 2018, "The Threat of Populism, p.82-83"
[3] Donya-e-Eqtesad, March 2018, "The Threat of Populism, p192-199"

"economic resistance" model which, similar to the policies of the 1980s, involves replacing imports with locally produced goods.

This model is directly tied to the 1960-1970s economic theories emanating from Latin America, particularly those of the German-American economic historian and sociologist Andre Gunder Frank. According to Ghaninejad, liberal economic ideals of the free market are increasingly under siege in Iran as more people adopt the view that conditions in the pre-1989 era preceding the privatisation and economic liberalisation campaign led by Ayatollah Hashemi Rafsanjani were better, with lower inflation and a much stronger currency. Yet, as economist and President of the Board of Trustees of the National Development Fund of Iran Ahmad Doost Hosseini states, there can be no economic development without FDI and with an industry solely geared towards import substitution.

In addition to losing faith in the international community, Iranians also have less confidence in their own government and officials. During his first term, President Hassan Rouhani was the darling of reformists, who viewed him as a great changemaker, with the ability to rejuvenate the economy and improve relations with western powers. Today, however, Rouhani has lost much of his credibility, as the major economic successes of his first term, which included reducing inflation down to single digits, have dissipated. Economists interviewed by *Donya-e-Eqtesad* have suggested that as far as the economy is concerned, there is little to differentiate Rouhani from his predecessor Mahmoud Ahmadinejad, with both leaders yielding to the urge to massively interfere in the economy.

Rouhani's failure to make the case for reform and the free markets represents a huge loss for the reformists, the only political faction deemed moderate by Western powers. Now, two years into his second term, Rouhani has not only hardened the anti-establishment beliefs of Iranians opposed to the Islamic Republic, but also restored the image of the conservatives, who are likely to reap big victories in the 2020 parliamentary elections and the 2021 presidential election. Renewed pressure from Washington has enabled Ayatollah Khamenei to undermine Rouhani's position and strengthen the more ideological factions of the Islamic Republic, which relish open conflict with the US.

Whilst the current geopolitical environment is very tense and could change the Islamic Republic's priorities, Iran still wants to maintain its strategy of "heroic restraint" towards the US by remaining in the JCPOA while it waits out the presidency of Donald Trump. In ideological terms, the Supreme Leader and the IRGC have tolerated the government's overtures to the West, a position they find treacherous to the ideals of the revolution but needed for the survival of the regime. While this tactic is the one most likely be successful in avoiding war, it is likely to cost Iranians in terms of personal freedoms and public space. The ball, therefore, remains in the people's court. According to the economist Masoud Nili, the population's latent lack of trust in the state and the current political climate will result in the rise of left-wing populism in its most Iranian form, meaning more government intervention in the economy and heightened right-wing rhetoric towards the rest of the world.

Alternatively, weakening support for the government and growing criticism of Iran's isolationism amongst a wide array of shapers of public opinion, from reformist intellectuals to even conservative politicians, could lead to more popular pressure on the state to back down from economic interventionism, and serve to promote free markets and civil liberties. Yet, today, popular discontent is far removed from its previously more civil and progressive form. Widespread protests in early 2018 were largely a reaction against worsening economic conditions than social injustice, more closely related to the Arab Spring's "hunger protests" than the 2009 Green Movement's social and political reform campaign.

While this creates a dangerous situation for Iran's internal stability, it also means that potential protests are likely to be less well-organised and effective, and therefore easily repressed by the police and Bassij. While it is possible to say that sanctions have partially succeeded in spreading anger and discontent among the population, this does not encourage people to take on the streets as Iran's security apparatus effectively demonstrated its capabilities in 2009 during the Green movement's protests.

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