# Iran’s Economy Is Stagnating Even Before New U.S. Sanctions Hit

by Patrick Clawson

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Brief Analysis

## The impact of imminent sanctions will be magnified by the economy’s recent struggles, and Tehran’s bad financial policies will only make matters worse.

The consequences of new U.S. sanctions are just beginning to unfold, but Iran’s economy is already in a precarious position. Since this spring, it has experienced an unexpected recession, and government policy has exacerbated the situation. Life will get tougher in Iran, but the big question is whether the Islamic Republic believes its economy can muddle through until the Trump administration leaves office.

## INFLATION, EMPLOYMENT, AND INVESTMENT

The numbers evidence a worsening situation. The Majlis Research Center estimates that Iran’s GDP will fall by 0.8% in the 2018/19 Iranian fiscal year and 2.5% in 2019/20. The IMF’s predictions—especially when compared to its March estimate that the Iranian GDP would increase annually by 4.0%—have become gloomier; its October forecast now shows a decline of 1.5% this year and 3.6% in the next. In describing these changes, the IMF’s most recent World Economic Outlook stated that “Prospects for 2018-19 were marked down sharply for Iran, reflecting the impact of the reinstatement of U.S. sanctions.”

According to Iran’s two consumer price indices, this is just the start of their troubles. The Statistical Center of Iran showed that inflation levels in September were at 5.4%, which translates to an 88% annual rate when compounded monthly. Similarly, the Central Bank showed inflation that month at 6.1%, which would mean a 103% annual rate. At levels this high, the rial's value relative to the dollar will continue to plummet.

In late September, heavy-handed pressure on traders saw the exchange rate drop, but this has since settled at about 140,000 rials to the U.S. dollar—three times the rate before March 21, the Iranian New Year. With the arrests of numerous traders and the death sentences imposed on two purveyors of gold and foreign exchange, the rate could presumably stabilize for a while. But economic fundamentals dictate that it will fall again; inflation invariably drives domestic costs up. Since the Iranian people tend to fixate on the dollar rate as a barometer of the economy's condition, the government typically wastes many scarce resources to prop up the rial instead of addressing other problems.

The national employment rate, for one, has not increased enough to mitigate inflation. The problem is worst for the well-educated. By some accounts, a third of men and half of women under thirty with college degrees are unemployed. The Management and Planning Organization reports that 44% of Iran's unemployed have a college degree. Moreover, the Ministry of Education reports that 20,000 people start doctoral programs every year, but there are only jobs for 4,000-5,000 of them. According to a report in *Donya-ye Eqtesad*, a mid-October poll by the Tehran Chamber of Commerce, Industries, Mines, and Agriculture unsurprisingly found that 76% of respondents "believed that private sector activities were declining" and that "the situation would be further aggravated in the future."

Admittedly, there are some positive signs. The Tehran Stock Exchange is up 90% from the Iranian New Year to mid-October—a direct result of the crisis in confidence with banks and the fears of inflation, both of which have led to a flood of money into stocks. However, this still leaves stocks, as valued in dollars, declining sharply. Furthermore, Iranians are only investing in those items deemed capable of preserving their value. For instance, locally made Pride cars, infamous for their low quality, are sold out for months in advance despite the 50% price increase in August alone. The housing market, though, has seen a sharp drop-off in sales activity; people may be afraid to commit in these uncertain times.

Overall, exports are up and imports are down, providing a much-needed boost to GDP. From April to September, non-oil exports totaled $13.7 billion compared to $11.1 billion a year earlier, while imports were valued at $22.2 billion compared to $24.8 billion last year. In other words, the trade balance unrelated to oil improved by $5.2 billion, while the deficit was only $8.5 billion—which is almost covered by the $7.02 billion in petrochemical exports, relieving some pressure on reserves. This improved trade balance lessened the fall in GDP.

## BAD DECISIONS

Positive indicators aside, Tehran's questionable economic decisions have contributed to the gloomy overall forecast. Fararu reported that in a two-and-a-half-hour meeting with President Hassan Rouhani on October 15, more than thirty economists criticized the government's economic policies as "politically motivated" and "short-term" solutions, while complaining about the quality of people on his economic team. Additionally, rather than celebrating the increase in agricultural exports—tomato shipments are up 145%, and potatoes 12%—the Rouhani government has blamed them for rising food prices. For instance, it has tried, unsuccessfully, to impose a ban on tomato exports, one of the few bright spots for long-suffering farmers.

Other commodities and resources have also fallen under the scrutiny of economists. The price of gasoline in rials, for example, has not been adjusted since May 2015 even though the rial has lost 75% of its value on the free market. This August, gasoline consumption was at 100 million liters per day, almost 25 million higher than the previous year. Iranians are not necessarily traveling more; rather, gas has become incredibly cheap. At the official rate, it costs 10,000 rials ($0.24) per liter, or $0.07 at the free market rate—compared to $1.20 in Turkey, $0.73 in Afghanistan, $0.65 in Pakistan, and $0.63 in Iraq. At least 20 million liters of gasoline is smuggled abroad each day, all of which Iran has to import back into the country because its refineries can only make enough gas to meet the real domestic demand, not the smuggling-induced inflated demand.

Adding to these issues, controversial exchange rate policies have been draining public finances and enriching corrupt elites. The dollars earned from exporting oil are almost all converted at the low official rate, with the result that government oil revenue from April to September was only 82% of the budgeted amount, according to Central Bank data. Had this revenue been converted at the free market rate, government earnings would have reached at least 250% of the budget, resulting in a large surplus. Meanwhile, the Central Bank announced on October 20 that it will be providing $9.5 billion at an official rate of 42,000 rials per dollar for “essential goods.” Not surprisingly, extensive anecdotal evidence suggests that many of these goods are sold at prices that echo the free market rate of about 140,000 rials per dollar, with middlemen pocketing the substantial difference—potentially $30 billion.

But the single worst set of policies continues to be in the monetary and banking sectors. The Central Bank has been flooding the economy with liquidity; by late August, debts to the Central Bank rose 35%, or 1.48 quadrillion rials, allowing banks to lend money to failing companies and the government so that they can pay workers and therefore forestall protests. Meanwhile, little has been done to address the structural shortcomings of the banks, which go beyond the money-laundering issues flagged by international watchdogs at the Financial Action Task Force.

To be fair, part of the problem is that Rouhani is constrained by powerful forces, especially the Islamic Revolutionary Guard Corps. According to Department of Environment head Issa Kalantari, the Ministry of Agriculture is “under the influence of military institutions” and therefore often adopts counterproductive policies. The IRGC’s penchant for building dams—600 in the last thirty years, compared to 14 in the shah’s last twenty years—has been a leading cause of environmental problems as water is diverted to inefficient agricultural projects. In response to such accusations, the IRGC has arrested numerous environmental activists.

## SHOWING IRAN IT CANNOT WAIT THINGS OUT

The Islamic Republic may believe that it can outlast the new round of U.S. pressure, based on the assumption that these constraints will dissipate once Trump leaves office. But Washington has been framing the reimposed sanctions as counterterrorism measures, increasing their likelihood of surviving U.S. political shifts.

A key step was the October 16 designation of various entities as Specially Designated Global Terrorists (SDGT) under Executive Order 13224, which financially targets those providing support to terrorists or acts of terrorism. This designation included Bank Mellat, one of Iran’s largest state-owned banks—which had previously been named for counterproliferation activities but was removed as part of the nuclear deal. The designation also involved a variety of important economic actors that were never targeted previously, not even at the height of nuclear sanctions. The newly designated Bonyad Taavon Basij, its offshoot Mehr Eqtesad Bank, and the linked Mehr Eqtesad Investment Company hold shares in many important enterprises. Some of the Treasury’s SDGT designations included entities that had never been classified as such by the U.S. government, including the largest steel mill in the Middle East, Esfahan’s Mobarakeh Steel Company, the Iran Tractor Manufacturing Company, and Iran Zinc Mines Development Company. Rather than waiting to do sequential designations as was the past practice, Treasury listed several of these companies for supporting another entity designated that same day.

This suggests that the Trump administration will be particularly far-reaching and rapid in its designations. Many of the already classified entities had received waivers from secondary sanctions but still could have been cited previously for both terrorism and nuclear proliferation concerns. Yet previous administrations decided to cite them only for nuclear-related issues in order to preserve the option of waiving sanctions in the advent of a nuclear deal. The approach underlying the October 16 designations was not to reiterate those nuclear concerns, but to demonstrate that these entities provide material support for terrorism.

While European countries have many disagreements with the Trump administration about Iranian nonproliferation, more counterterrorism cooperation may be achievable if the Trump team can make a convincing case linking designated entities to terrorism. After all, Iran is active in supporting terrorism not only in the Middle East, but also in Europe and beyond. In the eyes of Americans and Europeans alike, opposing Iranian support for terrorism tends to be less controversial than endorsing Trump's approach to counterproliferation. To the extent that officials can build broad support at home and abroad for the new designations by grounding them in a counterterror rationale, the pressure tactics could outlast the Trump administration. If Tehran comes to believe that the new sanctions will persist until a broader agreement is reached on nuclear and non-nuclear matters, then its confidence about waiting things out would likely be shaken.

## NEXT STEPS

Many argue that the pain of sanctions will be felt by the Iranian middle class rather than the elite. But the prevalence of sanctions-evading corruption in Iran can be turned from a problem into an opportunity for Washington. Given the outrage in Iran about those who reap privileges from widespread graft, the U.S. government has much room to spread information about how the *aqazadeh*—the children of the elite—are living. Luxagram, a private Iranian social networking app which describes itself as "a fun and quirky way for you to share your luxury moments with your affluent friends," is subscription-only, but the "Rich Kids of Tehran" website is free. Even former president Mahmoud Ahmadinejad offered an excellent suggestion in this regard when he tweeted, "Mr @realDonaldTrump release the list of relatives of #Iranian Government officials that have #GreenCards and #BankAccounts in the #UnitedStates if you have such a list."

While some say that the Trump administration has little credibility with the Iranian public, it can offset this problem by drawing on the extensive information about corruption provided by Iranian sources. Hardline-dominated state television often highlights corruption by political opponents, but information on the hardliners themselves is buried. A good place to start digging is the Instagram account of Mehdi Sadrossadati, a young cleric who regales his 255,000 followers with stories about the luxurious lifestyle of clerics and *aqazadeh*.

Moreover, on July 18, the reformist newspaper *Sharq* published an article on how the financial institution Samen al-Hojaj lost $3 billion belonging to its 3 million deposit holders, primarily by making loans at 3% to well-connected clients and paying astronomical salaries to officials and their families. In response, the company's managing director, Abolfazl Mir Ali, announced that he was suing the newspaper, even though all of its information came from what a prosecutor had presented in open court. Mir Ali, who once brandished a gun to intimidate the Central Bank governor, was recently pictured standing next to Iran's prosecutor-general. Combined with the pressures stemming from new sanctions, such high-profile domestic cases provide a deep well from which Washington can draw to show Iranians just how much their leaders are endangering their economic future.

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