

Iran's Post-Deal Economic Stagnation Challenges Rouhani

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Brief Analysis

The Iranian president has taken steps to limit his vulnerability to a plodding recovery, but over time a failure of sanctions relief to bring about dramatic economic improvements could harm his political outlook.

On October 5, the International Monetary Fund (IMF) highlighted Iran's weak present economic situation. International and U.S. sanctions on Iran remain little changed until "Implementation Day," which is some months off. The oil price drop may well cost Iran more income than it will earn from sanctions relief. This makes for a challenging political environment for President Hassan Rouhani.

Weak Economic Results Post-Nuclear Deal

The IMF press release quotes Martin Cerisola, who led the September 19-30 mission to Iran: "The economy is weak at present [with] significantly slowed-down economic activity since the fourth quarter of 2014/15 [i.e., January-March 2015]. The economy may have contracted during the first half of 2015/16." Such an assessment would fit with the report from the Statistical Centre of Iran that states industrial production fell 2 percent in that January-March 2015 quarter compared to a year earlier. Cerisola forecasts that if sanctions are not lifted soon, the economy could continue to shrink through March 2016.

The obvious reason the economy has not benefited from the nuclear deal is that very little sanctions relief has been provided yet. The preexisting sanctions regime remains almost entirely in place until Implementation Day, which is not until mid-2016 given its dependence on Iran completing a variety of not-necessarily-easy tasks.

Nor did the nuclear deal bring a burst of optimism from Iran's business community. The widely watched indicators of the business mood are the dollar exchange rate and the Tehran Stock Exchange (TSE) main index. The Lausanne

agreement of April 2, 2015, caused the TSE index to jump from 61,533 to 70,844, after having been closed since March 18 for the Nowruz holiday. The index then bounced around, falling and advancing, before reaching 69,433 on July 14, the date the comprehensive nuclear deal was reached. Since then, the index has fallen steadily to 61,209, as of October 6. The prospect of a comprehensive accord would seem to have been figured into business plans before the July 14 milestone, and the index is now at pre-Lausanne levels -- and 30 percent below the 89,500 peak of January 2014, when hopes about a Rouhani boom had led to an unsustainable bubble. In short, Iranian businesspeople have reacted to the nuclear deal in a much more restrained manner than foreign -- most especially European -- businesspeople who see Tehran as a potential El Dorado.

In fact, expectations of sanctions relief have curtailed consumer spending. The most obvious case has been the auto industry, which looms as large in the Iranian economy as does its much bigger counterpart in the U.S. economy. Already, with the limited relief in the interim agreement that came into effect in January 2014, Iran's production of new cars -- known there as "zero cars," referring to zero mileage on the odometer -- rose to 1.09 million in 2014/15 from .74 million in 2013/14, although that was still well below the 1.65 million peak in 2011/12, before the full impact of sanctions had been felt. Auto producers' hopes for a further rebound have been hard hit by the "No to zero cars" campaign, which promoted a boycott of high-price, low-quality Iranian-made cars in the expectation that cheaper, better cars from Europe would soon become available. Minister of Industries and Commerce Mohammad Reza Nematzadeh responded with a statement that it was "very natural" to hope for lower car prices, but that the nuclear agreement alone couldn't spur that outcome. He also bemoaned that "home appliance sales have fallen 5 to 6 percent since the nuclear deal."

A Difficult Economic Environment

The problems facing the Iranian economy extend well beyond the delayed sanctions relief. In particular, Iran has been badly hurt by the dramatic oil price drop; the OPEC marker crude price went from \$100.75 per barrel in August 2014 to \$45.46 in August 2015. Since Iran's oil exports were more or less constant over that period, its oil revenue fell in half. The \$55 per barrel price drop means that exports of 1.2 million barrels per day produce annually \$24 billion less revenue for either the government or the government-owned oil companies. That is a real problem for a country with government expenditures of about \$65 billion a year. Oil Minister Bijan Namdar Zanganeh has said state officials are "in tears" at each month's end as they struggle to find the \$1.4 billion to make payments due each family under an Ahmadinejad-era program. Many infrastructure projects have been delayed or suspended.

Iran claims that post-Implementation Day, it will be able to ramp up oil production rapidly, with some officials speaking about an additional 500,000 barrels a day within a few months and a million within a year. Even if these claims are accurate, Iran can increase output only by making substantial investments; its production costs are not as low as those of the Arab states across the Gulf. And then there is the significant problem of the market's oversupply of oil. As Cerisola warned, "Iran's full return to the oil market could bring oil prices down further, and force additional fiscal adjustment."

The end of the global commodity boom has hit Iran in other ways. Whereas in 2014, before prices dropped more than 50 percent, Iran was the world's ninth largest iron exporter, exports in 2016 are projected to be only two-thirds that level because so many private mines are closing. By 2019, Iran may not export iron at all, according to Keyvan Jafari Tehrani of the country's Iron Ore Producers and Exporters Association. The copper industry has been similarly hurt. A rare bright spot for Iran has been this year's disastrous pistachio harvest in California, which had overtaken Iran as the world's largest producer of the nut.

The economy also suffers from holdover Ahmadinejad-era problems. The banking system is burdened by bad loans made for political reasons, not least of which are the massive loans for the ill-conceived Mehr housing program. Such bad loans have limited the banks' ability to lend to productive enterprises and led the Central Bank of Iran, as a strategy to recapitalize the banks, to keep interest rates high even as inflation has fallen. The shortage of bank loans has worsened the impact of the government arrears to suppliers built up in the late Ahmadinejad period. And the shortage of bank lending has hurt the residential building business; residential construction permits issued by the largest cities have fallen by half over the last two years, and the demand for construction materials is down 30 percent.

The Main Challenge: Domestic Policy

As the IMF's Cerisola put it, "Risks to the outlook are significant, and longer-term prospects will depend crucially on the depth of reforms that are undertaken...Ultimately, if mild reforms are implemented the sanctions relief will have only a moderate positive impact on the economy. If, on the other hand, more assertive and deeper reforms along the lines [the IMF mission recommended] are carried out, the boost to confidence and investment inflows would put Iran's economy on a significantly higher growth trajectory." That bland statement papers over the bitter opposition from beneficiaries of corruption, quasi-monopolies held by those close to the Islamic Revolutionary Guard Corps (IRGC) or Supreme Leader Ali Khamenei's investment arm, and the welter of rules that protect inefficient state-linked enterprises. Arbitrary and unaccountable interference in economic and commercial matters, including expropriations, is not necessarily in Rouhani's power to stop.

In the shorter term, macroeconomic policy is an area of great controversy. Rouhani has largely focused on curbing inflation, with the purported goal of lowering it to single digits, a level rarely seen in the Islamic Republic's thirty-six years. To that end, his budget proposals have been contractionary, despite unemployment that remains at 10.5 percent. The criticism of this approach was summed up by Kevyan Sheikhi, head of the Securities and Exchange Organization of Iran's statistics department: "Disregarding the current recession and getting preoccupied with cutting the nominal inflation rate and basking in the glory will not help the economy; rather it will dampen the investment mood." Cerisola warned about the pressures to boost spending, which run counter to Rouhani's focus on inflation: "Pent-up demands from different sectors may also pose some risks to macroeconomic stability." Indeed, this year's budget included a 30 percent uptick for military spending, despite the budget's overall contractionary stance. Presumably, in the lead-up to the elections in February 2016 for Majlis and May 2017 for president, pressure will build for more spending so as to show the nuclear deal's economic benefits. Meanwhile, another controversial Rouhani policy for containing inflation is keeping the exchange rate steady, which benefits consumers by making imports cheap but hurts producers who must compete against low-cost imports -- as well as cutting into the earnings of exporters. The negative effect on producers weighs heavily on the TSE. So far, the Rouhani team seems determined to resist pressure to change its focus on curbing inflation.

Political Impact Limited So Far

Rouhani is facing increasing discontent from his supporters about the country's poor economic situation. On September 6, 2014, Rouhani had told an audience in Mashhad, "Today, we can announce that thankfully we have passed through the recession." The expectation then that the situation would start improving markedly has not played out. On October 4, the Mehr News Agency published a September 9 letter to Rouhani from Defense Minister Hossein Dehghan and the three ministers whose portfolios relate directly to the economy: Ali Tayebnia, minister of economy and finance; Mohammad Reza Nematzadeh, minister of industries and commerce; and Ali Rabiei, minister of labor. The letter cited several reasons for what it called the "rare decline" in Iran's economy but gave the primary reason as "uncoordinated decisions and policies" of various governmental agencies.

Rouhani has limited his vulnerability to criticism about the economic situation by embracing the main policy

proposal that could have served as a critique of his policies -- namely, "the economy of resistance" approach strongly favored by Supreme Leader Khamenei. While that slogan could be read as a rejection of the greater opening to the outside world Rouhani portrays as central to growth prospects, Rouhani has emphasized the aspect of the "economy of resistance" that advocates overall diversification from reliance on oil. This has left Rouhani's domestic critics with no clear alternative to his policies.

Rouhani is also helped by the obvious fact that his team is more competent and less corrupt than that of Ahmadinejad. While the Rouhani administration has made more than a few policy mistakes and been slow to enact structural reforms, its record is stellar when compared to its predecessor. For instance, the country's new health care insurance program has drawn much praise for lowering consumer costs. This leaves critics in a poor position to exploit the souring public mood about the economy.

Given these dynamics, it is by no means clear how much the weak economy will affect Rouhani's strength relative to his critics. And the recession seems very unlikely to affect implementation of the nuclear deal in the short term. But over time, Rouhani's main explanation about why the nuclear deal was necessary -- that only sanctions relief would allow Iran to prosper, and only a nuclear deal would provide such relief -- will look less and less convincing unless the economy does begin to prosper. His standing with the new Majlis and his prospects for reelection could suffer if, as is distinctly possible, Iran's economic situation in coming years improves very slowly despite sanctions relief. Such a case would entail the oil price drop hurting the economy as much as sanctions relief helps it and policy paralysis blocking steps needed for growth.

Patrick Clawson is the Morningstar Senior Fellow and director of research at The Washington Institute. ❖

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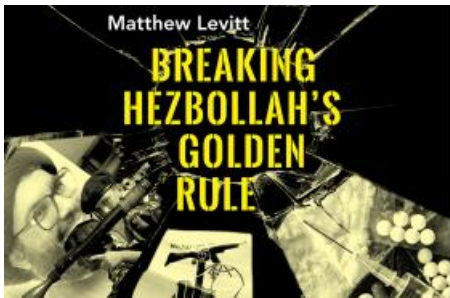
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