Iran Can Afford to Say No to a Nuclear Deal

by Patrick Clawson **(/experts/patrick-clawson)**

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ABOUT THE AUTHORS

Patrick Clawson (/experts/patrick-clawson)

Patrick Clawson is Morningstar senior fellow and director of research at the Washington Institute for Near East Policy.

Brief Analysis

The Islamic Republic has taken tough measures to adjust to the new sanctions, and its economy is now positioned to grow modestly even if the sanctions remain in place.

The firm stance Tehran has taken in the nuclear negotiations seems out of step with the image of a country desperate to achieve sanctions relief. That raises the question of just how crippling the sanctions imposed on Iran have been. The answer? No longer so much.

PROFOUND IMPACT OF THE 2012 SANCTIONS

The intensified U.S. and European sanctions in the Iranian year 2012/13 hit the Islamic Republic's economy hard, to the considerable surprise of the country's elite. As an April 2014 International Monetary Fund (IMF) report details, oil export proceeds fell the equivalent of 15% of gross domestic product during that period. A comparable shock to the U.S. economy would be a $2.5 trillion annual loss. Similarly, real GDP fell by 8.5% over 2012/13 and 2013/14, or about twice as much as the 4.3% drop in U.S. output during the 2007-2009 recession. Meanwhile, inflation rose to 45% in 2012/13, and the rial lost 60% of its value on the parallel market.

Against this backdrop, the spring 2013 presidential election focused on the economy. Hassan Rouhani's candidacy took off in no small part because he hammered home the theme that improving the economy required a nuclear deal with the West -- that being the only way to obtain sanctions relief, attract foreign investment, and secure trade openings for Iran. Yet even without a comprehensive deal and major relief, the government has been able to establish a modus vivendi under sanctions.

TAKING TOUGH STEPS TO ADJUST

Iran's economy contracted sharply in part because authorities were putting in place the kind of adjustment measures the IMF often recommends when a country faces an external shock. Those measures had the impact the IMF typically predicts: pain followed by gain. Iran has already experienced the pain; now it is beginning to see the gain.

Spending cuts. The government has slashed spending since the shock hit, with 2014/15 budgeted expenditures down 37% in real terms from those in 2011/12. Looked at another way, government spending fell from 19.5% of GDP in 2011/12 to a projected 14.9% in 2014/15. A similar reduction in U.S. spending would be $800 billion per year -- meaning actual reduction, not $800 billion below the past trend line.

Those cuts meant that Iran's government debt did not rise much -- currently, its debt relative to GDP is much less than in the United States or Germany, let alone in Italy or Japan. Admittedly, Iranian government debt is difficult to evaluate. The Ahmadinejad team left public finances in a mess by ordering banks to make loans that cannot possibly be repaid, running large deficits in the "Targeted Subsidy Organization," and raiding the accounts of the two development funds that supposedly receive a considerable portion of oil revenue (the Oil Stabilization Fund and the National Development Fund of Iran). According to IMF data, government arrears in 2013/14 were equal 10% of GDP, which presumably is a rough estimate of what will be needed to clean up the past mess. If one adds in those arrears and assumes that the two development funds are effectively broke, Iran's government debt would be 21% of GDP, which is vastly below the 60-100% typical of industrialized countries. The IMF also forecasts that by 2018, this figure will have increased by only a further 8% of GDP.

Exchange rate adjustment. In another impressive move, Tehran permitted the rial to depreciate in effect by about 60% within a few months. Coupled with the restraint in spending, this depreciation caused imports to fall by $22 billion and exports to increase by $11 billion, making up for half the loss in oil export earnings caused by sanctions. Iran started out with a $60 billion annual current account surplus -- the new sanctions wiped that surplus out, but the adjustment measures restored $30 billion of it.

Today, Iran's foreign trade position is strong despite sanctions. The April 2014 IMF report showed that in 2013/14, the country imported $73 billion in goods and services and exported $46 billion in non-oil goods and services, meaning it would have needed only $27 billion in oil and gas exports to balance its current account -- the equivalent of 740,000 barrels of oil per day (b/d) at $100 a barrel. In fact, Iran exported more crude than that in 2103/14; adding in sales of other petroleum products, it totaled $56 billion in oil and gas exports, giving it a $29 billion current account surplus. Looking at future years, the IMF forecasts that Iran would need only $28 billion in oil and gas exports to balance its account in 2019/20, which it could earn even if such exports fall considerably from their current level.

It is instructive to compare these figures with the sanctions relief provided earlier this year by the interim nuclear deal known as the Joint Plan of Action (JPOA). Even if one assumes that there is no leakage in the sanctions regime, the agreement allows Iran to export 1 million b/d of crude oil worth about $35 billion a year -- an amount more than sufficient to meet its foreign exchange needs for the foreseeable future. Of course, this assumes that Tehran has access to the proceeds from these sales. Because of U.S. banking restrictions, most such proceeds are tied up in the countries to which the oil was exported, meaning Iran can use the funds only to import from those countries. While that is a problem, Iran's situation under the JPOA is actually better than the 1 million b/d target cited by the State Department. This is largely due to its substantial exports of non-crude oil -- especially the $10 billion it receives annually from 300,000 b/d of condensates exports that the department insists are not counted in the 1 million b/d target.

Tighter monetary policy under Rouhani has also brought inflation down sharply, from a rate of over 40% in spring 2013 to around 17% today. This trend will help restore confidence and encourage investment.

In short, Iran has brought its economy into line with the resources available under the new sanctions regime. And it has done so without running up the kind of huge government debt seen in many developed economies.

LEARNING TO LIVE WITH THE NEW SANCTIONS

Having taken the tough measures to adjust to the sanctions shock, Iran is relatively well positioned to resume growth even if the current sanctions remain in place. The IMF forecasts that growth in 2014/15 will be 1.5%, rising to 2.3% per year afterward if oil sales do not pick up and sanctions persist. And that is absent any substantial reform in the government's various growth-inhibiting policies, which are at least as much a burden on the economy as are sanctions. Put another way, Iran's economy under sanctions is poised to grow at about the same pace as the U.S. economy.

Of course, the country remains much poorer than it would be without sanctions, and the position of many Iranian families is precarious. One political problem for the regime is that real household incomes have been squeezed enormously in the past three years, and unrecorded unemployment appears to have risen significantly. The forecasted growth would do little to address this problem. On one hand, although the country is well positioned to leap forward if it receives substantial sanctions relief, it may be difficult to get the people excited about what could be. On the other hand, if public opinion concentrates on the government's clear improvement from an admittedly bad starting point, then the solid if unspectacular economic growth looks pretty good, especially compared to the mess next door in Iraq and Afghanistan.

Another concern for Tehran is that the country remains vulnerable to additional sanctions. Having already implemented substantial adjustment measures, the regime has less room for maneuver in the event of a new shock. Yet Iranian officials may believe that the United States would face great difficulty securing broad international cooperation with expanded sanctions. They may also calculate -- wrongly, in all likelihood -- that sanctions targeting more Iranian oil exports would drive up global prices to a degree unacceptable to oil-consuming countries.

In short, sanctions brought Iran to the table, but the regime may be willing to pay the price rather than agreeing to the steps the P5+1 are demanding. Sanctions hobbled the country, but Iran is still walking, and that may be good enough for its leaders.

Patrick Clawson is director of research at The Washington Institute. ❖

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