Tehran Adds to the Pressure on Iran's Economy

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

Sep 17, 2012

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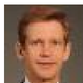

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Brief Analysis

Iran's economy has taken a turn for the worse, primarily due to poor domestic policies as well as international sanctions. But it would be unduly optimistic to think this will change the regime's nuclear stance.

Three weeks ago, Iranian Supreme Leader Ali Khamenei called for an "economy of resistance," which he described as "using the country's full potential...[to] break the illusions of the arrogant powers" that Tehran will change its policies. Since then, the country's currency has lost 27 percent of its value on the free market. Yet these and other deteriorating economic circumstances are due not just to ongoing international sanctions, but also to the accumulating impact of inappropriate Iranian government policies. And although the situation may eventually spill over into the nuclear impasse, there are no signs of that at present.

THE COLLAPSING RIAL AND STAGFLATION

Until recently, Iran's economy had been doing rather well -- its growth was higher than that of either the United States or the European Union every year since 2008. But that may be changing.

The Iranian rial has been nose-diving since September 2010, when for the first time since the 2002 currency reform, the free market rate fell appreciably below the official rate of about 10,000 rials per dollar (the official rate was periodically adjusted by small amounts). The Central Bank of Iran vainly tried to close the gap, but after the free market rate fell to 11,800 rials per dollar in June 2011, Tehran gave in and devalued the official rate from 10,590 to 11,740. Although that brought a unified rate for five months, the free rate plummeted again in November 2011 to 13,300 rials per dollar. That sparked a two-month free fall, with the rial dropping to 22,100 per dollar in late January 2012.

In response, the government panicked, adopting coercive measures (e.g., closing currency dealers, blocking websites quoting exchange rates), allowing interest rates to rise, feeding large amounts of dollars into the market, and providing dollars at the official rate of 12,260 to import basic goods. The free rate soon recovered to about

19,000, where it stayed until late August. Since then, however, it has headed sharply downward again, reaching 26,000 on September 12. That figure represents 38 percent of what it was worth two years ago, and 73 percent of what it was worth in August.

As the rial has fallen, the cost of imported goods has gone up. The official consumer price index in August was 23.9 percent higher than a year earlier, with the increase being sharpest for foodstuffs (e.g., 74 percent for fresh fruit, 81 percent for vegetables, 74 percent for chicken). As is typical in such situations elsewhere, the popular perception among Iranians is that the inflation rate is even higher than the government figures show. At these rates, Iranians are all the more likely to flee the rial, accelerating the downward spiral. For instance, in the first seven months of 2012, Turkey reported exporting $6.2 billion worth of gold to Iran, up 500 percent over the previous year; this made Iran Turkey's largest export destination.

Tehran's decreasing export earnings have placed additional pressure on the rial. As U.S. Treasury undersecretary David Cohen noted on September 12, "Last year, Iran exported approximately 2.4 million barrels of oil per day...earning it about $100 billion," but since then, its "crude exports have plummeted to approximately one million barrels a day...costing Iran up to $5 billion a month."

The government's response has apparently included administrative measures to cut imports. In early August, Central Bank governor Mahmoud Bahmani warned, "There is no reason to spend our money [on imports] when we are under sanctions. We should remember that we might need to manage our country for a long time with this money." What this means for Iranian importers is illustrated by a quote one gave in mid-July to PBS reporter Kelly Niknejad: "Before the sanctions, it took two days to get an import permit from the Ministry of Commerce or a letter of credit from the Iranian bank that pays the exporter. Now it takes two weeks for the import permit and 15-20 days for the letter. Customs is blocked up too. Last week we had a shipment that was held at Bandar Abbas [Iran's largest port] for two months."

The difficulties in acquiring imported parts and materials are hitting Iranian industry hard. The automobile sector, which employs 150,000 people directly and indirectly, is scrambling to get a hold of parts from key French and Korean suppliers, in the face of financial sanctions imposed by those two governments and the reluctance of Peugeot and Kia to risk angering Washington or losing American customers. Meanwhile, the official unemployment rate is 17 percent overall and 29 percent for youths, with most Iranians believing it is much higher.

DOMESTIC POLICY ERRORS MAGNIFY SANCTIONS

In early September, Central Bank governor Bahmani stated, "Our situation is one of war. We are fighting an economic war with the world." Much as Washington may wish to claim full credit for Iran's economic problems, however, Majlis speaker Ali Larijani may have been closer to the truth when he said in late July, "The country's economic problems are only 20 percent due to sanctions. Unfortunately, the main origin of inflation comes from the maladroit application of the plan to suppress subsidies." Whatever the exact distribution of blame may be, both internal and external factors underlie Iran's current economic quandary.

In December 2011, Tehran raised the country's highly subsidized energy prices to market levels, giving families monthly cash payments to compensate. That move had much to recommend it -- in particular, gasoline consumption dropped, partly due to lower domestic demand but also because of a drop-off in the rampant smuggling of gas to neighboring countries where prices were much higher. Yet the quadrupling of energy prices ran the obvious risk that businesses would simply increase prices to cover the higher costs, setting off high inflation. The announced plan was to direct considerable funds to businesses to help them adjust to the new situation (e.g., by investing in energy-saving technology). Instead, the government used all of the additional revenue from higher-price energy sales to provide checks to households, leaving businesses to struggle. Many turned to bank loans to finance their losses, a

route made all the more attractive by interest rates that were well below the inflation rate. Those loans, plus government borrowing to finance the payments to households, expanded the money supply, which only further fed inflation.

Indeed, loose monetary policy has been a major reason for accelerating inflation and the rial's declining value. From March 2007 (in the middle of President Mahmoud Ahmadinejad’s first term) to March 2012, the broad money supply went from 1,383 trillion rials to 3,720 trillion, a 169 percent increase. During the same period, the real gross domestic product increased by 21 percent. When 169 percent more money chases 21 percent more goods, the result is inflation -- indeed, Iran's consumer price index increased 18 percent annually over that period. With prices increasing less than 3 percent annually in the countries with which Iran trades, one would expect the rial to lose value. To keep pace with rising costs, the rial should have fallen from 10,000 per dollar in 2007 to 20,000 in 2012. The actual, far steeper drop to 26,000 is a crude indicator of how much the economy has been affected by concerns about the international situation and flaws in the regime's fiscal policies.

POTENTIAL IMPACT ON THE NUCLEAR IMPASSE

At present, it would be optimistic at best to hope that the deteriorating economic circumstances will spur Iran's leaders to shift their nuclear stance. They do not seem to know or care much about the country's economic situation -- their own income has been hurt only a little, if at all, and they appear unconcerned about the prospect of popular unrest given their past success at repressing opposition. For now, they are likely to stay the course on both domestic economic policy and the nuclear issue. If they do so, the economy will deteriorate at an even faster rate, with perceptions of runaway inflation leading Iranians to take more desperate actions to get out of the rial just at the time when low oil exports and tightening financial sanctions reduce Iran's access to foreign exchange.

Unless the regime's policies change, the economic situation could become so bad over the next year or two that Iran's leaders find themselves facing strong business pressure (including from the Islamic Revolutionary Guard Corps) and popular grumbling to do something dramatic. At that point, all of the policy options available to them will be terrible. Sharply raising interest rates to attract money back into banks (and therefore available for lending to the government) would slow the economy, worsening unemployment and hurting politically well-connected borrowers in particular. Imposing foreign exchange controls and multiple exchange rates would exacerbate already-rampant corruption (the leading popular complaint against the government) and lead to shortages or price increases for the cheap imported goods to which consumers have become accustomed. And slicing government spending in the short term so that more dollars can be directed into the free market would be a tough step to take with a presidential election looming in 2013.

If any of these dire scenarios comes to pass, Tehran may be more open to a nuclear deal that leads to relaxation of sanctions, increased oil sales, and greater public confidence in the country's economic prospects. To date, however, there are no indications that such a shift is in the cards, and it would be an act of faith to base U.S. policy on this prospect.

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

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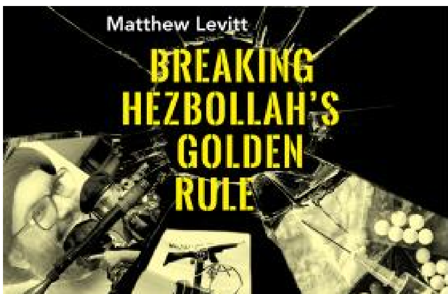

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