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LEADING INDEPENDENT ANALYSIS OF IRAN'S ECONOMY

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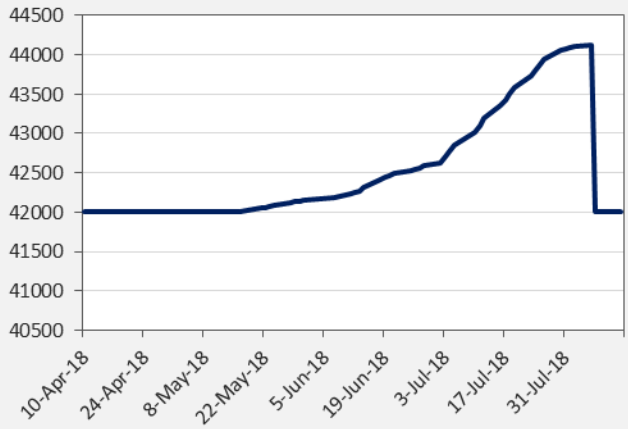
The Iranian economy: Back to black

Economic commentators predicted the latest round of US sanctions would be less severe than in 2011 due to a lack of international consensus – many are revising their assessment. The US has signalled its intention to enforce its powers strictly and confidence in the Iranian economy has plummeted. Having spent much of the gains from the JCPOA on military expenditures, Iran now enters another period of austerity and credit-crunch. The best strategy is to ride out the pressure, maintain compliance on the terms of the nuclear deal and keep the channels open for a reversal of fortunes.

One week after the US sanctions snapped back into place on Iran, there is an unfortunately familiar sense of economic crisis in the air. With businesses and individuals rushing to convert their assets into safer currencies, the Iranian rial has lost almost 20% in value since January at the official rate. The black market rate has dropped by almost 60 percent in the same period and the Central Bank of Iran (CBI) has reverted to strict capital controls. This collapse in the currency has already begun to feed through into prices, particularly in food and consumer goods, and risks jeopardising the Rouhani administration's achievement of stabilising inflation.

Fig 1. Rial to USD official exchange rate
(April 2018 to present)



More businesses have joined the roll-call of European partners pulling out of Iranian ventures due to commercial practicalities. German car manufacturer, Daimler followed Peugeot in announcing a halt to their investment plans. A major airline (Dutch KLM), railway company (Swiss Stadler Rail), and shipping firm (French CMA CGM) also decided to cease operations. There is no absence of appetite amongst these European partners to invest in the Iran: to work with Iranian partners and serve the Iranian market. But for many global enterprises an Iranian play has become untenable.

The European Union has vowed to counter US sanctions and fight to preserve the JCPOA, in a bid to persuade Iran to continue complying with the terms of the deal. But a lack of clarity over the EU's ability to protect European businesses is sapping investor confidence. The European Union has enacted a blocking statute into legislation, but its teeth are untested.

When it comes to oil sanctions, European governments are limited in what they can do. Whatever the motivations of European politicians and government officials, it is companies that calculate the risks and make the decisions. For firms buying it, shipping it or insuring it, oil is an international business in which it is difficult to avoid the US dollar. In July, Iran's crude shipments were down by over 400,000 barrels per day compared to April – a 15 percent drop. The EU, Japan and South Korea, together accounting for more than one third of Iran's exports only months ago, are expected to drop off to zero. India and China have mopped up some of that surplus in recent months, but market experts do not expect that trend to continue (Fig 3). All signs suggest that for these countries to secure a waiver from the US Treasury they will likely have to commit to reducing imports. Bloomberg oil analysts have predicted a bigger and faster drop off in Iranian crude exports than in the run up to the JCPOA deal, with up to 1.5 million barrels of exports falling away within the next six months.

Many Iranian businesses and households are facing a rather dismal near and medium term future. The threat of stagflation looms (a stagnating economy in parallel with inflationary pressures), with slow jobs growth, a squeeze on public finances and a potential credit crunch. Iran's policy makers will lament not having achieved a more stable footing in the short window of economic recovery the JCPOA allowed. GDP growth was positive but predominantly constrained to the non-labour intensive oil and gas sector, which is now set to be reversed. Steps were taken to clean up the banking sector, but the banks remain undercapitalised and will come under pressure from defaulted loans.

Iran recouped much of its stranded foreign exchange reserves since the JCPOA, but has spent profligately on its military capabilities and regional conflicts. Ultimately, it was precisely this expenditure that provoked hawks in the US administration to take the extreme step of withdrawing from the JCPOA, despite Iran's compliance with the terms. With billions spent overseas, ordinary Iranian households will doubtless suffer in the years to come.

Fig 2. TEDPIX All Shares stock index
(April 2018 to present)

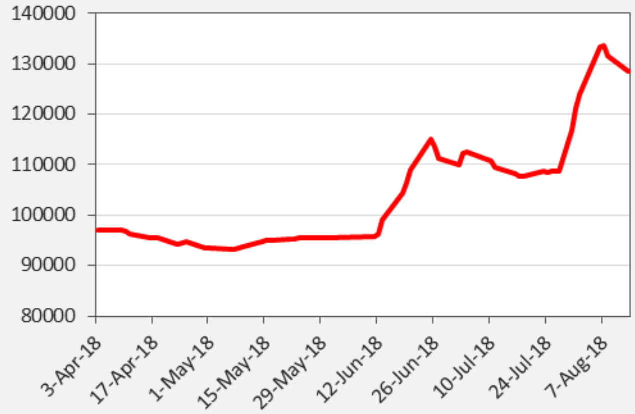
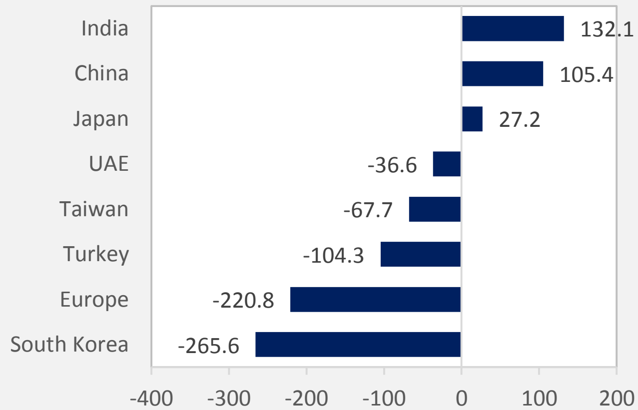


Fig 3. Change in purchases of Iranian crude exports
(Thousands of barrels per day, April to July 2018)



From the perspective of Iranian businesses, the best strategy is to ride out the pressure and continue to make the case for sanctions removal. Many international partners want the JCPOA to succeed, with compliance on the nuclear deal, peaceful solutions to regional tensions and a thriving Iranian economy. Whilst this administration has demonstrated its willingness to upend the deal, the next US administration, potentially only two and a half years away, could potentially revert course. On the other hand, if Iran were to itself renege on the terms of the nuclear agreement, block the Strait of Hormuz or provoke any kind of military conflict, it may well find its return to the global financial system more permanently on ice.

In the meantime, entering a tense period, it will be important for the Iranian authorities to avoid the pitfalls of bad governance and the abuse of power. Exploiting privileged access to subsidised currency rates is a growing source of public anger, and was widely recognised as a criminal drain on public finances during the pre-JCPOA economic crisis. The prospects for currency exploitation are now raised again under the CBI's capital controls and a highly volatile currency. The CBI tried to ease public concerns by publicising a transparent list of recipients of US dollars at the subsidised rate – a rate only intended for strategically imperative imports. But the list is not complete. As one parliamentarian highlighted, only $2.5 billion has been accounted for, of the more than $11 billion that is ring-fenced. That leaves $9 billion in the dark. As the reality of life under sanctions bites for ordinary Iranian citizens, this level of corruption amongst the best connected and wealthiest Iranians will be destabilising.

On a positive note, despite the pipeline of foreign investment seemingly drying up, the Majles passed four bills to bring the country further into line with global money-laundering and anti-terrorist financing norms. Iran has been working with the Financial Action Task Force (FATF) for the past two years to bolster its reputation amongst foreign investors and raise the transparency of its financial flows. In spite of US sanctions, these steps – if Iran proves its ability to properly enforce them – will help Iran attract foreign investors in what is otherwise a high risk environment.