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Iran Faces an Economic Crisis: Structural Issues More Problematic Than Sanctions

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President Donald Trump's decision to withdraw the U.S. from the nuclear agreement (JCPOA) with Iran has impacted the Iranian economy, contributing to the weakening of the currency and the decline in GDP. However, the most important challenges for Iran's economy are structural problems, including bad governance, corruption, and excessive public sector participation. Attempts to solve these issues have been criticised by ultra-conservatives in Iran who are interested in maintaining the status quo. If reforms were to be successful though, that would create an opportunity for the EU to implement a wider trade mechanism with Iran while stifling the U.S. objections.

Economic and Political Consequences of the Sanctions. Trump's announcement on 8 May 2018, to withdraw the U.S. from the JCPOA was tantamount to restoring American sanctions. It quickly deepened the problems with the Iranian currency, the rial, which from March to September 2018 lost nearly 70% of its value against the dollar (from 47,000 to 190,000 rials per dollar, though later the rate moderately stabilised and in January this year on the black market it was hovering around 110,000 to 1). The U.S. decision also contributed to the deterioration of economic forecasts. The International Monetary Fund (IMF) had to revise its calculations. Before the sanctions were reinstated, it had estimated that from March 2018 to March 2019 (the Iranian fiscal year), Iran's GDP would increase by about 4%. The IMF then claimed that in the current year the country's GDP will decrease by 1.5% and in the next year by nearly 4%. The sanctions also have meant problems for the Iranian labour market. In August 2018, then Labour Minister Ali Rabiei pointed out that by March 2019 they will result in the loss of about one million jobs. This is a big challenge for a state whose official unemployment rate is already 12% and among young people, who constitute about 60% of Iranian society, it reaches 25%.

The re-imposition of sanctions scrapped modernisation plans for the Iranian economy devised by President Hassan Rouhani. They were based on foreign investment and technological upgrades. The prime example was the plan for the oil sector announced by Oil Minister Bijan Namdar Zangeneh in August 2017. It included an increase in oil production and modernisation, yet it needed significant financial spending (around $200 billion over five years) and know-how. Iran was supposed to gain both elements through cooperation with Western companies. Fear of the U.S. sanctions has made that impossible as the firms leave Iran. The turmoil of Rouhani's economic projects has given fire to his critics, in particular ultra-conservatives. They have repeatedly stressed that the U.S. is not a reliable partner and therefore negotiating with it and building political and economic strategies based on the outcome of the nuclear talks would have negative consequences for Iran.

Dangerous Structural Problems. The sanctions, however, would not have hit the Iranian economy to such a degree if not for its structural problems. One of the most important flaws is bad management. This was particularly visible during the currency crisis. Although the U.S. decision contributed to deepening this crisis, it largely was the result of negligence and mistakes by Iranian decision-makers. In 2012–2018, the government had artificially inflated the official exchange rate and had not been adjusting it to the rising inflation, which increased the panic after the initial declines. Then, Iranian politicians, instead of assuring investors and Iranians in advance that the government was aware of the risks associated with the change in U.S. policy and had a plan for the economy if the sanctions were re-imposed, were reactive. When the rial began to fall, they blamed speculators and foreign "enemies" and stated that the currency was not reflecting the state of the economy. It tried to remind Iranians of the events of 2012 when such assurances were followed by the rial's significant devaluation. This was another factor that contributed to selling the currency, which exacerbated its exchange rate. Also, in the first half of 2018—so before the U.S. sanctions came into effect—the Rouhani administration first decided to increase the availability of the dollar on the market and then prohibited the sale of foreign currencies at exchange offices. This empowered the black market and hit foreign trade. Another example of bad management is the continual postponement of banking sector reform. Economists had warned about a deep crisis in this sector even before the restoration of sanctions based on bad loans. In the least optimistic calculations, about 50% of loans granted by Iranian banks were threatened by a lack of repayment.

The efficiency of the Iranian economy has also been hampered by corruption and a lack of transparency (130th in the Transparency International ranking) and the high share of the state sector in the economy. Most of the 377 state-owned enterprises in Iran are unprofitable, which reduces tax revenues and increases debt. In addition, a large part of the economy—around 30% according to the most careful estimates—is under the control of the Revolutionary Guard. This hinders pro-market reforms. For example, Rouhani has repeatedly argued for "real privatisation" in Iran, claiming that many privatised enterprises are in fact in the hands of groups associated with the regime. A recent example of the obstructive influence of non-governmental factors on the economy is the dispute over reforms proposed by the FATF (The Financial Action Task Force). This international organisation develops global standards on, among others, counteracting money laundering and terrorism financing. In 2016, it conditionally suspended its restrictions on Iran, which had been on its "blacklist." Iran was given until February 2018 to implement the FATF recommendations, otherwise it would again be covered by the counter-measures, affecting the banking and financial sector. Although reforms would improve the investment conditions in Iran and, in Rouhani's view, even rendering the U.S. sanctions ineffective, the ultra-conservatives have been blocking their introduction. They argue that the FATF reforms will hinder Iran's opportunities to finance regional allies such as Hezbollah, which would negatively affect Iran's international position.

Conclusions. The currency crisis and hobbled banking sector in Iran show that the U.S. sanctions have only exacerbated problems stemming from the structural inefficiency of Iran's economy. The lack of necessary economic reforms rather than sanctions is what could lead to a deeper economic crisis.

Trump's policy on Iran poses a threefold economic risk for the latter. Above all, it gives Iranian decision-makers an excuse not to carry out the economic reforms. In addition, attempts to circumvent the sanctions may lead them to make decisions that will even increase the existing problems. It is already visible that the enthusiasm for Rouhani's reforms has been weakened, as seen in calls for more state involvement in economic processes. Moreover, further attempts to circumvent the sanctions may intensify corruption and increase certain actors' influence on the economy, for example, that of the Revolutionary Guard. The synergy of these factors may ultimately persuade Iranians that Rouhani is economic incompetent and that his previous plans were inadequate. This will further weaken his political position and strengthen that of his ultra-conservative critics. As a result, the declared goal of the Trump administration—a change in the behaviour of the Iranian regime—appears less likely.

In this situation, the EU's role in helping persuade Rouhani and Iranians that their current administration's political-economic plans are accurate, is growing. This could be facilitated by broadening the INSTEX trade mechanism—initiated by Germany, France and the UK at the end of January—so that it encompasses more products than initially planned (so far, medicine and food). However, this should be done only when Iran accepts the FATF recommendations. When it does, the EU will gain an argument that it has contributed to a change in Iran's regional policy. This would strengthen Rouhani's position, important in the light of the intra-Iranian rivalry for the position of supreme leader. It would also mean at least a partial achievement of the Trump administration's goals. All these factors, when combined, could help in finding a transatlantic compromise on Iran. The details could be the subject of a debate between the U.S. and its European allies during the upcoming Middle East Summit in Warsaw.