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Iran's Economic Challenges in the New Year: Problems with(out) Solutions?

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Introduction

In order to ensure its survival under the US sanctions, Tehran will have to harmonize the goals of the economic development with necessity to secure social stability.

On 21 March, 2019, Iran celebrated the beginning of the new 1398 year of the Solar Hijri calendar adopted as the official one in the Islamic republic. The last days of 1397, new year celebrations and subsequent holidays were marked by serious socio-economic problems including consumer prices growth, high inflation rates, volatility of the national currency as well as falling real incomes of the population. Occasional disruptions in the imports of raw materials, spare parts and equipment led to productions stops in a number of industries including automobile and petrochemical sectors. The situation was aggravated by the negative role of the gray economy in the daily life of Iran. The black market's masters were obviously profiting from illegal activities such as smuggling, foreign exchange and goods speculation. This, in turn, mitigated the positive effect from measures taken by Iran's government to handle the economic challenges.

The Roots of Troubles

The economic problems of Iran are determined by two main reasons. On the one hand, those structural problems of the country's economy that have been accumulating for years and decades have finally hit Iran hard. The dominance of the public sector over the Iranian economy, intensive involvement of the government in economic activities, high administrative costs, low labor effectiveness, weakness of the private sector, underdevelopment of the market mechanisms accompanied by protectionist policies that created artificial favorable conditions for Iranian producers are just few among those problems that predetermined the conditions for the current crisis. The inflow of petrodollars that increased after the JCPOA was signed in 2015 allowed the leadership of Iran to camouflage some of these issues. Yet, in 2018, sanctions reintroduced by the US deprived the government of this option by limiting Tehran's capacities to sell its oil abroad. On the other hand, the US sanctions played the role of the catalyst of the economic crisis. The sanctions largely closed Iran for foreign investors, limited its access to international financial system, created problems with imports and also sparked panics among regular consumers that additionally destabilized Iran's market.

Further expectations for Iran's economy are not positive. In 2019, the country's GDP will be shrinking. Its growth rates might potentially reach to -5.5%. Under the current US sanctions, Iran will be able to export no more than 1 – 1.1 million barrels of oil a day (mln bpd). The oil sector's growth rates are predicted to be between -26% – -31%. Petrochemical, automobile and construction sectors will also suffer from sanctions as a result of their dependence on imported equipment, spare parts and row materials, and also due to the fall of consumer demand determined by the decrease in the purchasing power of the population. The exchange rates of Iran's national currency, Rial, might avoid new drastic falls as it was in the autumn 2018. Prior to September 2018, Rial's exchange rate to US dollar or other international currencies was much higher than its real cost. However, the current price of 120 – 140 thousand Rials for 1 US Dollar is considered a fair value. Consequently, any potential further falls of Rial's exchange rate will be caused by either psychological or speculative factors rather than by economic drivers. As a result, these drops will be short-term and marked by the subsequent return of the Rial exchange rate to the corridor of 120 – 140 thousands Rials for 1 US dollar. However, consumer prices are yet to adjust to the rapid depreciation of rail in September – November 2018 and existing inflation rates that are estimated in 34 – 42 %. This naturally means the continuation of the consumer prices growth.

Possible solutions

The government of Iran clearly understands the scope of problems faced by the country and tries not to be passive. However, , the Iranian leadership seems to believe in old measures that were used by Iran previously to cope with the negative impact of sanctions and tries to focus on their use without adopting new strategies. Thus, it plans to increase current expenditures in order to cover emerging deficit. As of the beginning of April 2019, the Iranian government was still determined to maintain the system of multiple exchange rates in order to provide cheaper foreign currency to the importers of goods essential for consumers and producers. It expects to regulate domestic prices by holding off their growth administratively as well as through the provision of indirect subsidies and additional imports of consumer goods (usually food products) to be distributed at cheaper prices at the domestic market. The outflow of foreign currency as well as its circulation inside Iran are taken under the government control. The re-introduction of the coupon system existed in Iran in the 1980s is also actively considered by the authorities. These steps are likely to be accompanied by the number of psychological measures such as public persecution of economic criminals to scare those who plan to profit from the country's misfortunes or the hypothetical denomination of Iranian Rial in order to create the false perception regarding the tempos of depreciation of the national currency.

Existing problems

Yet, these measures do not seem to work properly. First of all, these efforts require the investments of substantial financial resources, but Iran capacities are already overstretched. Subsidies and ambitious social programs annually consume up to USD80 bln of budget money that becomes a heavy burden for Iran to carry in the conditions of the falling petrodollar incomes. Consequently, Tehran has to choose between its priorities, as its current incomes do not allow funding all measures necessary to handle the current crisis. For example, in mid-March 2019, the Iranian authorities failed to provide 20% of loans promised to the automakers to support them in these difficult times. They also had to cancel one of the programs to support bred producers in order to allocate more money to cover the guaranteed purchases of grain from local producers. By April 2019, the Iranian authorities also had problems with paying debts to the social insurance system.

Finally, in 1398, the increase in current expenditures necessary to handle emerging issues (for instance, drop down in the real value of salaries) will largely be secured at the expense of very limited increase in development expenditures and preservation of the decreased volume of financial allocations at the National Development Fund. For instance, according to the budget of 1398, the current spending of the government will nominally increase to 16% whereas the increase in developmental spending will be just around 2% that will not be enough to compensate the actual financial losses of development programs from the depreciation of the national currency in 2018. Moreover, 31% (according to other estimates – up to 35%) of the new year budget are still supposed to be funded by oil revenues. However, even officially the government will be able to accumulate expected volume of oil incomes only if Tehran retains options to export more than 1.5 mln bpd at the barrel price standing beyond USD54 (according to unofficial calculations – beyond USD70). Given existing oil sanctions limiting Iran's exports to 1.1 mln bpd and market conditions this will be hardly feasible and the government will have to further cut its development spending. Little to be achieved in other sectors. As demonstrated by the recent experience of the automobile spare part makers or agricultural producers, government's attempts to control consumer prices are only discouraging the producers from doing business: they are dissatisfied with the falling net incomes consumed by raising cost of raw materials. In addition to that, low prices at the domestic market encourages the excessive exports of goods abroad adding to the market deficit and growth of consumer prices in Iran. Periodical export bans on selected items such as poultry, certain type of fruit, agricultural products and other consumer goods whose prices in Iran substantially differ from that of abroad only encourage their smuggling. Thus, Iran's media report about huge volumes of fuel and grain illegally exported from the country. Meanwhile, the distribution of cheap products in Iran do not also ensure lower prices but rather encouraging speculations on price differences by retailers. Under these circumstances, the allocation of USD14.5 bln at the low exchange rate to the importers of the goods that have strategic importance for economic security and stability of the country is believed to be the most controversial decision by the Iranian government for 2019. Initially, this decision was supposed to slow down the growth of consumer prices and, thus, ease the inflation pressure on the poor layers of the population. Nevertheless, in January 2019, the research centre of the Iranian parliament came to a conclusion that, in 2018, the provision of cheap currency to the importers had little effect on the growth of consumer prices and inflation. The massive violations of the law by the recipients of cheap foreign exchange currency were among the main reasons that made the use of subsidized currency ineffective. Thus, Iranian companies instead of using cheap foreign currency to import goods were just selling US dollars received from the government at the domestic free market to gain additional income. In other cases, they were distributing imported goods at higher prices, thus, 'forgetting' that the cost of the imported goods were to be lower as they were bought on US dollars whose exchange rate was subsidized by the authorities. There are little doubts that these stories repeat in 2019.

The government attempts to fight with economic crimes with the use of coercive methods are also proven to be ineffective: while existing illegal opportunities offer high incomes even the danger of capital sentences for them (as it was in the case of Vahid

Mazloumin who was accused of massive financial speculations with gold coins in 2018) cannot prevent people from doing criminal business. This situation illustrates another specifics of Iran's economic policies: they largely deal with the consequences of the economic problems (high inflation rates, economic prices growth, illegal activities and etc) rather than with the sources of the problem. To cope with them, Tehran will need to conduct deep structural economic reforms including the cuts or, at least, optimization of unjustifiably large social programs and indirect subsidies.[1] Thus, it would be much more logical to the Iranian government to accept one of the initiatives emerged during the discussions of the current budget bill that implied the additional direct payments of money to low-income layers of population instead of allocating them to the provision of subsidized foreign exchange to importers. This could heave bigger positive impact on the social situation.

Why is it all so difficult?

Yet, the Iranian leadership is cautious about making steps that can questioned its status of the social-oriented government such as the cuts of indirect subsidies or refusal to push employers to raise the salaries in accordance with the inflation rates. There are, at least, three reasons for this.

First, declaring the protection of the interests of the low-income layers of population –named as 'oppressed' (*mostazafin*) by the official propaganda-as one of the main tasks of the Islamic republic in 1979, the ayatollah Khomeini and his followers turned populist programs in one of the key elements of their domestic policies. They also made the Islamic authorities eternally dependent on the support of the lower classes. This decision made the ruling regime in Iran extremely durable. At the same time, such social policy had a number of negative economic implications. The Iranian authorities were compelled to buy the loyalty of their supporters, and, since 1979, one of the main measures used by the government to ensure the support of the lower layers of urban population was consumer subsidies and cheap basic products. As a result, during the last four decades, the Iranian authorities created an intricate system, which allowed them to influence and control the process of importing, production and distribution of main consumer goods. However, the price of the creation of this system was high: the Iranian government is to maintain the complex system of social programs that lies a heavy burden on the budget of the country. It substantially increases the current expenditures of the state and massively consumes those financial assets that could be used to develop the economy instead. Nevertheless, any attempts to change this system implies the growth of consumer prices and services provided to the population. This, in turn, might fire back at the stability of the regime.

Second, some of potential reforms might touch the ideological tenants of the regime, a very sensitive topic for the ruling elite. For instance, the ban of the Western models of banking in Iran, as it was demanded by the principles of the Islamic economics, have turned Iran's banks into financial structures oriented to financing mainly those commercial films that are affiliated with them. Due to the Islamic

[1] Mohammad Reza Abdallahi, Tahlil-e Tahavvolat-e Akhir-e Eqtesad-e Iran (Tehran: Markaz-e pazhukheshkha-ye majles-e shoura-ye eslami, 1397). P. 4 – 6.

principle of risk sharing and ban on pro cent taking Iranian banks do not demonstrate enough initiative to find and retain customers and they are actually involved in economic rather than financial activities. Consequently, in order to revitalize the Iranian financial system it is important to reconsider these approaches to the pro cent taking and risk sharing. However, this will put under the question some principles laying in the ideological basis of the Iranian political system. Thirdly, structural reforms might face the active resistance of those who profit from existing structural misbalances. The latter could be illustrated by the case of the FATF accession issue: in 2018, the attempts of the Iranian authorities to join the FATF faced heavy resistance. Certain groupings among political and economic elite of the country were concerned that the new standards of financial accountability might disclose some of their incomes and spending these people would like to keep away from public eyes. At the end, as of March 2019, Iran's association with the FATF was de facto put on hold, although this was one of the informal conditions posed by the EU members to ensure increase in European assistance provided to Iran in its struggle against the US sanctions.[2]

What's next?

Under these circumstances, the Iranian economic perspectives for 2019 remain gloomy. In order to cope with existing problems, Tehran has to conduct deep and effective economic reforms. Yet, given that these measures might negatively affect the social stability of Iran, the current leadership of the country is cautious about choosing this way. Consequently, the Iranian government will still be trying to deal with the consequences of the problems rather than with their source. For instance, in spite of all warnings, shortly before the beginning of 1398, the Iranian authorities managed to persuade the private sector to raise the minimal wages of workers by about 40% and decided to increase the salaries of government workers by approximately USD95. This decision will positively affect public moods and improve government's image in the short run, but it will have a negative consequence such as the further growth of inflation from the mid-term perspective. Nevertheless, to keep people loyal, the Iranian leadership had to make this very controversial step.

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[2] Interviews with the representatives of German business. Berlin. November 2018.