An Analysis of the Iranian Economy

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Introduction

“If the Plan to redirect subsidies is implemented efficiently, Iran will be one of the top 10 world economies by 2015!” – these were President Ahmadinejad’s ambitious words in a meeting between the cabinet and Parliamentarians on 10 November 2009. Considering Iran’s current state of affairs, this seems to be a far-fetched objective, especially considering that Iran’s resource-rich economy is heavily burdened by the country’s political realities.

In fact, economic indicators need to be assessed more carefully to understand the interrelationship between economic realities and domestic as well as foreign policy developments. While purely quantitative indicators have indicated that the Iranian economy is on a path of “inflationary growth”, the overall economic picture has produced very mixed signals. On the one side, it has grown at an average annual pace of about 5% which is partly explained through high oil prices from 2006 to 2008, but also a consequence of the growth of private sector activity. On the other side it has suffered from a long host of populist policies by the Ahmadinejad administration as well as international sanctions. This article will look at the most significant economic trends in Iran and will examine issues such as the effect of sanctions, the planned redirection of subsidies, the significance of privatization policies as well as the political consequences of a growing private sector.

The Current Economic Picture

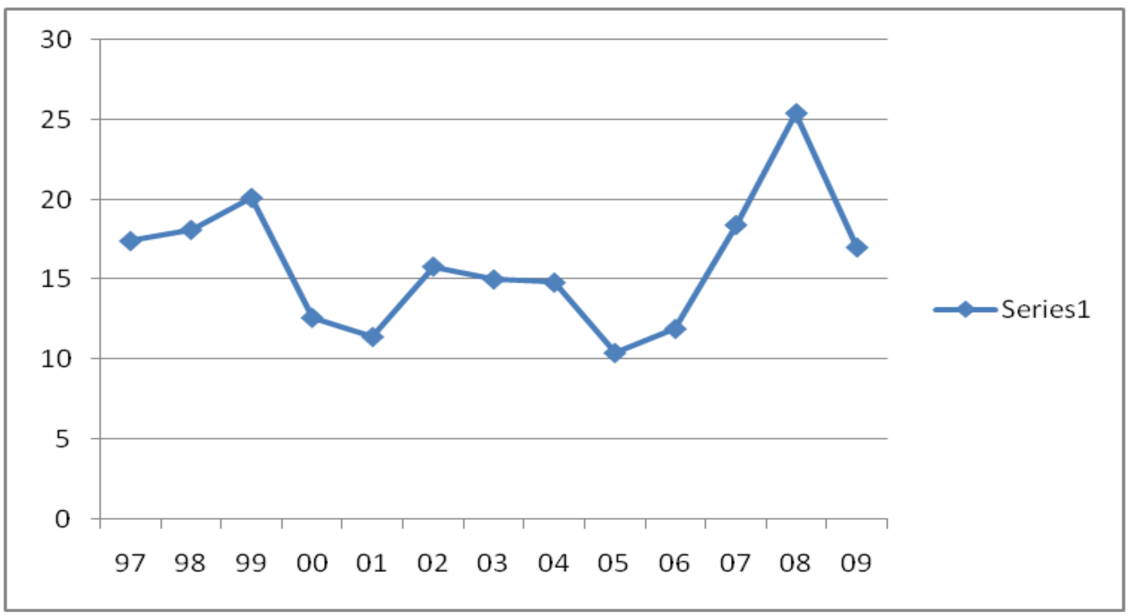
A look at the current economic phenomena underlines the following facts:

- High inflation has led to major dissatisfaction among the lower and middle class citizens – the relatively lower inflation figures of the past few months do not alter the overall negative performance of the Ahmadinejad government compared to the previous administration (see Graph 1). It should be noted that “unofficial inflation” is higher than the official figures, mainly due to the inclusion of subsidized prices in the official calculation (see Table of economic indicators below);
- The gradual lifting of subsidies is an irritating phenomenon both for consumers, but also for businesses – based on a bill entitled the “Redirecting of Subsidies” the government is planning to discontinue the current blanket subsidies and to commence direct cash handouts to lower income classes. Even though the bill is still under review in Parliament, some steps have been taken, e.g. gasoline has been rationed and a non-subsidized price established for this product. The development surrounding subsidies will be discussed in more detail below;
- Experts agree that the government’s populist policies have been the main cause of high inflation, especially in the field of massive distributive policies with handouts in the form of loans and shares of government companies to the lower income classes – these policies will be discussed in more detail below;
- Official UN as well as unofficial US sanctions have had a negative impact on economic performance – the impacts have been direct and indirect, but they need to be seen as an important parameter in business development as well as in the

country's foreign policy orientation in the next few months – this aspect will also be discussed in more detail;

- The relative decline in oil prices has undermined the government's financial position leading to a decline in infrastructure investment in the country – in fact, in the Iranian year that ended on 20 March 2009, a significant portion of the infrastructure budget was dedicated to current expenditures to fill the budget deficit;
- Despite all negative developments, the country's Gross Domestic Product (GDP) has been on the rise – projected to reach $440bn in the year current Iranian year (ending on 20 March 2010). Using the Purchasing Power Parity (PPP) calculations for the GDP, it would hit $850bn in the same period[1], i.e. a PPP per capita income of $11,600 – this means that despite all problems, Iran is becoming a large and significant economy. However, it is important to note that this is an "inflationary growth" mainly derived from a tightly controlled exchange rate.

Graph 1: Official Inflation Figures 1997 to 2009 (in %)



Source: Central Bank of Iran (CBI)

The following table summarizes the key economic indicators where three items stand out and need some further clarification:

- Inflation: The reason that unofficial inflation is much higher than official inflation is that a number of items in the basket of goods used by the CBI rely on subsidized prices, whereas the calculation of unofficial inflation mainly relies on non-subsidized goods and services;
- Unemployment: This is one of the most challenging socio-economic phenomena in Iran. It is mainly driven by the country's demographic profile (with the age groups between 15 and 30 representing almost 40% of the population). In

[1] For PPP figures, please see the World Fact Book at https://www.cia.gov/library/publications/the-world-factbook/geos/ir.html

fact, youth unemployment currently stands at 27%[2]. The level of unofficial unemployment relates to the prevalence of "underemployment", i.e. the mismatch between university graduates and job opportunities. In fact, the Iranian economy has failed to produce jobs in line with the emerging university graduates;

- Per capita GDP: Despite all problems, per capita GDP has been growing consistently. This is reflective of an indigenous, but inflationary economic growth that needs to be analyzed carefully.

Table 1: Key Economic Indicators[3]

Indicators	1386 (2007/08)	1387 (2008/09)	1388* (2009/10)
GDP growth	4.6%	4.0%	3.5%
GDP – in billion US$ (GDP per capita in US$)	$280.2b ($3,647)	$350.0b ($4,730)	$440.0b ($5,980)
Inflation Official (Unofficial)	19.1% (21.4%)	22% (30.0%)	17% (27.0%)
Liquidity growth	42.3%	40.0%	30.0%
Population (million)	71.5	72.5	73.6
Active work force	42.6%	44%	46%
Unemployment Official (Unofficial)	11.2% (14.5%)	12.5% (15.0%)	12.0% (15.0%)
Oil & gas exports	$78.8bn	$77.0bn	$55.0bn
Non-oil export (incl. services)	$18.0bn	$22.0bn	$25.0bn
Imports	$55.7bn	$57.0bn	$60.0bn
Trade balance (incl. crude)	$30.9bn	$39.0bn	$20.0bn
Budget deficit	$13.5bn**	$45.0bn**	$30.0bn**
Foreign Reserves (hard currency and gold)	$100bn	$86bn	$70bn
Exchange rate (IRR/US$)	$1=IRR9,420	$1=IRR10,000	$1=IRR10,500

** Projected until the end of the current Iranian year 1388 (21 March 2009-20 March 2010)*

Impact of the Ahmadinejad Policies

President Ahmadinejad's main economic campaign pledge in 2005 was that he would "bring the oil money to the people's dinner tables". In practice, his economic policies focused on two interrelated pillars:

a) Rejection of technocratic planning for economic development which led to the dissolution of the Management and Planning Organization (MPO) at a very early stage of his presidency; and

b) Distributive policies with a focus on lower income classes which took shape in the form of providing an easy access to loan facilities for lower income levels as well as direct cash payments to rural families.

The first initiative deprived the country of a comprehensive approach to economic planning and decisions were shifted to provincial trips during which the President accompanied by the entire cabinet would make decisions about infrastructure

[2] Source: Ministry of Labor and Social Affairs.

[3] Main sources: Population and employment statistics are based on the report of Statistical Center of Iran (SCI). The rest of the figures are based on statistics prepared by Iran Economics Magazine (Eghtesad-e Iran), October 2009 as well as Atieh Bahar Consulting (www.atiehbahar.com).

spending, out of budget allocations to provinces, regions as well as social groups. As a result, a significant segment of the government resources was allocated to provinces in populist initiatives which lacked any serious cost-benefit analysis. As an example, major resources were allocated to asphalting all rural roads in the country - a populist project which eventually had high socio-economic costs for rural communities[4].

The downside of the aggressive distributive policy under Ahmadinejad was the emergence of an imbalance in the availability of resources for the country's large-scale industries. By allocating more and more loan facilities to the lower income classes, banks were unable to provide the needed loan facilities to trade and industry. President Ahmadinejad's direct interventions in the banking sector have been another example of failed policies. By imposing interest rates in the level of 12% for state banks and 13% for private banks, the government has produced an upside-down financial reality in the economy: Essentially, banks are forced to offer risky loan facilities at the mentioned rates, while the government itself is selling risk-free participation bonds offering an interest rate of 15%.

Furthermore, the country's trade policies have encountered major criticism. Experts highlight that over the course of Ahmadinejad's first term presidency, the volume of consumer goods imported has increased significantly while the import of investment and intermediate goods has fallen. (Please see table below). This has been as part of the administration's attempt to curb hard currency liquidity – liquidity that emerged as a result of record crude export revenue[5]. The phenomenon has prompted the President's opponents to accuse him of squandering oil windfalls to import consumer goods, ranging from fruit, rice and other staples, to gasoline. The following table demonstrates the import trend of the country over the past six years:

Table 2: Trend of imports over the past six years

Year*	Total Value of Imports ($bn)	Share of Total (%)	
		Intermediary & Capital Goods	Consumer Goods
2002/03	22.28	87.24	12.76
2003/04	26.60	88.03	11.97
2004/05	35.39	89.2	10.8
2005/06	39.76	86.89	12.98
2006/07	41.72	85.54	14.46
2007/08	48.33	81.8	18.2
2008**	38.30	80	20

*: Iranian year starts 21 March

**: Shows the amount of imports till 20 November 2008

Source: Sarmayeh Economic Daily

[4] According to one critique, the paving of rural roads led to huge costs as a result of car accidents, mainly as the local communities were culturally not prepared for fast pace vehicle traffic through their villages.

[5] Official statistics underline that Iran's oil export revenue between 21 March 2006 and 20 March 2009 amounted to $269 billion which was unprecedented in Iran's history.

In addition to the above issues, high budget deficit has been one of the most critical elements in the country's economic performance and it has led to major inflationary impacts. Poor budget management has also led to the fact that the government has not been able to repay its debts to the banking sector rendering Iran's major state-owned banks towards a financial collapse.

The Plan to Redirect Subsidies

The Islamic Republic has long been contemplating removing subsidies, as they constitute an unsustainable burden on the state budget. Subsidies have been a legacy of the 1979 Islamic Revolution which ingrained the government responsibility to "distribute the oil wealth" into the state system. Offering unrealistically low consumer prices for energy and food products has been the Islamic government's approach to distributing the oil wealth among the people. However, the policy has failed and it is clear that the current approach is working against the interests of lower income classes.

It is very difficult to estimate the actual volume of energy subsidies as there is no accurate costing of domestically produced fuels. However, if one calculates the "opportunity cost" of the energy subsidies, i.e. their value based on international prices, the Iranian Treasury spent some $ 86 billion on energy subsidies in 2008 alone.

The basic idea of the plan is to achieve the following objective: Ease the financial burden of subsidies on the Treasury and then utilize the released funds according to the following breakdown: 60% of the released funds are paid directly to the lower income classes[6], 30% goes to the industries that will be affected through the price shifts and 10% goes back to the Treasury. Obviously, there will be some relaxation on the government finances, but the plan will help iron out some of the current distortions in the Iranian economy, though there will be significant inflationary impacts. Parliamentarians are still discussing the bill but according to the Iranian media, they have so far voted for an upward adjustment of electricity and natural gas prices by the end of the Fifth Five Year Development Plan (March 2015). Article Four of the bill orders subsidies on food items such as wheat, rice, oil, milk and sugar as well as subsidies on postal and transportation services to be gradually eliminated over the next five years. Apart from financial benefits to the Treasury, the proponents of the plan believe that a more realistic pricing will moderate consumption in Iran, which is high both in the fields of energy and also foodstuffs.

In spite of potential benefits, the bill has been widely criticized and its approval has raised great concern. Negative consequences of the plan can be summarized as below:

- Parliamentarians and economic experts fear that the inflation rate could rise to as much as 60% to 75%. A leading MP, Ahmad Tavakkoli, has stated that subsidies on bread and pharmaceuticals alone will add 19% to the current inflation rate.

[6] Based on the latest estimates, a total population of 36 million (50% of the population) will receive direct cash handouts.

According to Tavakkoli, once energy subsidies are also lifted, the inflation rate could rise up to 60% to 75%[7];

- Furthermore, although the government contends that the removal of subsidies will stimulate employment and create jobs, critics warn that the plan will have a negative impact on employment, arguing that increasing the price of energy will cause a number of manufacturing units to shut down, resulting in job losses.
- The plan will also have a dramatic impact on liquidity. Basically, the large sums that will be paid out to the lower income classes will explode the money supply leading to even higher inflation.
- Although the government has scheduled to redirect subsidies through paying cash handouts to the lower income families (target groups), the removal of subsidies will result in some uncertain social consequences which vary according to their type. The fact is that only a segment of the existing subsidies actually reached the lower income classes. Hence, it is more likely that we will see a very gradual shift, potentially distributed over five years, as opposed to the original idea of implementing the plan in 3 years.
- All in all, the initiative will have its own challenges. The rapid price appreciation is expected to spark widespread discontent and protests across Iran. However, as was the case in 2007 with the government's gasoline rationing plan, the initial public outcry is not expected to last too long, especially, if cash handouts kick in efficiently.
- Another risk of the emergence of cash handouts in Iran is the risk of corruption, i.e. the payment of handouts to families who do not fall into the targeted brackets. It is not clear from the current plan how the government intends to avoid such distortions and past experience shows that there will be high potential for corruption which would undermine the prospects of the subsidy shifts.

Impact of External Developments

Parallel to the policy shifts that the Ahmadinejad administration has introduced in the past four years, the Iranian economy has also dealt with a number of external sanctions. While Iranians have been subject to economic and technology sanctions for the past three decades, a number of new phenomena have emerged in the past few years, mainly in the light of western pressure on Iran due to the country's nuclear program. The more recent sanctions that the Iranian companies have to deal with are:

☐ There are some UN sanctions targeting military and nuclear sector equipment including areas that are considered "dual use" – these sanctions mean that access to many products and equipment needed in the petroleum sector, in utilities and other industries has been limited. Iran's response to these limitations has been threefold:

☐ In some areas, the country has moved to produce some equipment domestically – for example, Iran is now in the top ten producers of turbines that are needed in the petroleum and power generation sectors;

☐ In other cases, Iranian buyers have moved to Asian and Russian providers of the needed equipment which has increased Iran's trade with the East

[7] Sarmayeh Newspaper, 24 October 2009

– in fact, 2007 was the first year in Iranian modern history that the country's trade with eastern partners exceeded the trade with western trade partners;

- Finally, some equipment is resourced through third countries whether through Iran's southern neighbors or through other close trading partners (Venezuela, Turkey, Syria etc.);
- In addition to the UN sanctions, there are US-imposed banking sanctions that have led to limited interaction of all major international banks with Iran – this has had a negative impact on many levels:
- It has limited access to international finance and loans for Iranian projects – in the petroleum sector this limitation has led to a decision to issue a total of $12 billion in domestic participation bonds to fill the financing gap in the industry;
- It has impeded the operation of many international companies in Iran; and
- It has worked against the interest of Iran's international traders who have had to find alternative banking solutions for their growing business into and out of Iran;
- In the meantime, 2nd and 3rd tier international banks are active in dealing with Iran and there will always be routes to transfer money to and from Iran, though at a higher expense.

While the banking sanctions have been a major thorn in the side of Iranian business for the past few years, they led to two positive phenomena in the country, i.e.:

- The closing down of Iranian accounts by international banks in the course of 2006 and 2007 led to the flow of a considerable amount of foreign capital back to Iran. These were funds held by Iranians in their external accounts which were injected back into the Iranian economy. Some analysts argue that the sudden growth in housing prices in that period were related to this major capital injection which was mainly invested in properties; and
- The relative isolation of Iran's banks and financial sectors (i.e. stock exchange) meant that Iran was not hit hard by the international financial meltdown. In fact, the net immediate effect of the financial crisis was negligible in Iran. What had a negative impact on the Iranian economy were the consequences of the meltdown, i.e. lower oil prices, lower commodity prices which then in turn led to lower government revenue and a partial collapse of the shares of major companies active in export of commodities.

A Look at the Privatization Campaign

Privatization has been on the agenda of the Iranian governments ever since the very first post-revolutionary 5-year plan was drafted in 1989. However, the privatization effort remained relatively fruitless until the Expediency Council offered a new interpretation of Article 44 in November 2004 (i.e. before President Ahmadinejad's first term). According to that decree which was approved by Ayatollah Khamenei, the government was instructed to withdraw from all areas where private sector can participate by the end of the 4th Plan (March 2010). Essentially, the decree obliged the government to sell off 80% of the shares of government companies with the exception of the National Iranian Oil Company, Bank Melli Iran, Central Insurance Company and a few smaller sectors of government monopoly (such as tobacco). In the meantime, the government and the Parliament have been passing regulations and laws to implement the mentioned decree. However, the full implementation is hampered by the reluctance of the true private sector to acquire government companies. In fact, there are 2 parallel trends which are of significance:

a) The real private sector is avoiding government assets and is investing in new private sector initiatives and is enjoying the new opportunities which have emerged as a result of the new interpretation of Article 44. This has led to the creation of private banks, private insurance companies etc. which do have a positive impact on their respective sectors;

b) Government companies are being transferred to a large host of semi-governmental entities such as pension funds, revolutionary and religious foundations and regional cooperatives. Furthermore, some shares of government entities are being transferred to the vulnerable social classes in a scheme entitled "Justice Shares" introduced by President Ahmadinejad.

In the meantime, the privatization process of many key companies including major banks, the Iran Telecom Company and some major steel factories is in full swing. However, if one looks at the privatization process as a tool to liberalize the economy and to ease some of the economic tensions in the country, one can conclude the following:

- The current privatization program will have a limited impact on Treasury revenues as most companies are being sold to semi-governmental entities with whom the government has a financial relationship - in other words, proceeds from privatization in many cases flow back to the buyers to whom the government owes money (i.e. the Social Security Organization, various pension funds, various foundations etc.);
- The impact of the privatization program on unemployment will be negative, as most companies that change hands are more likely to make employees redundant in the light of the fact that most state entities are overstaffed and inefficient;
- The privatization program could eventually have a positive impact on efficiency in the Iranian economy, mainly due to the gradual growth of the true private sector, however, the potential efficiency gain will be far below the planned efficiency-based growth of 2.5% which has been envisaged in the current 4th Five Year Plan.

All in all, it is valid to argue that the privatization campaign will have very limited net impact on the Iranian economy. There will be small gains in some areas, but also new challenges in other fields. It will basically make the governmental sector smaller and the semi-governmental sector larger – i.e. a cosmetic change in an economy where the government has been dominant for decades. However, there will be a political impact, i.e. the actual government will become smaller and the semi-governmental institutions, especially entities affiliated with military organizations such as the Islamic Revolutionary Guards Corps (IRGC) will become economically more powerful. This new balance in the political power landscape is irritating many observer who believe that the IRGC is becoming a dominant economic and hence political player in the country.

The Significance of the Private Sector

As explained above, the private sector has benefited from the privatization process, not because it has secured investment opportunities, but rather because the new interpretation of Article 44 has provided private sector investors with more security about the country's economic structure. The growth of private sector activity in banking, insurance, light industries, telecommunications and even industries can be considered the most significant driver of economic growth in the past few years.

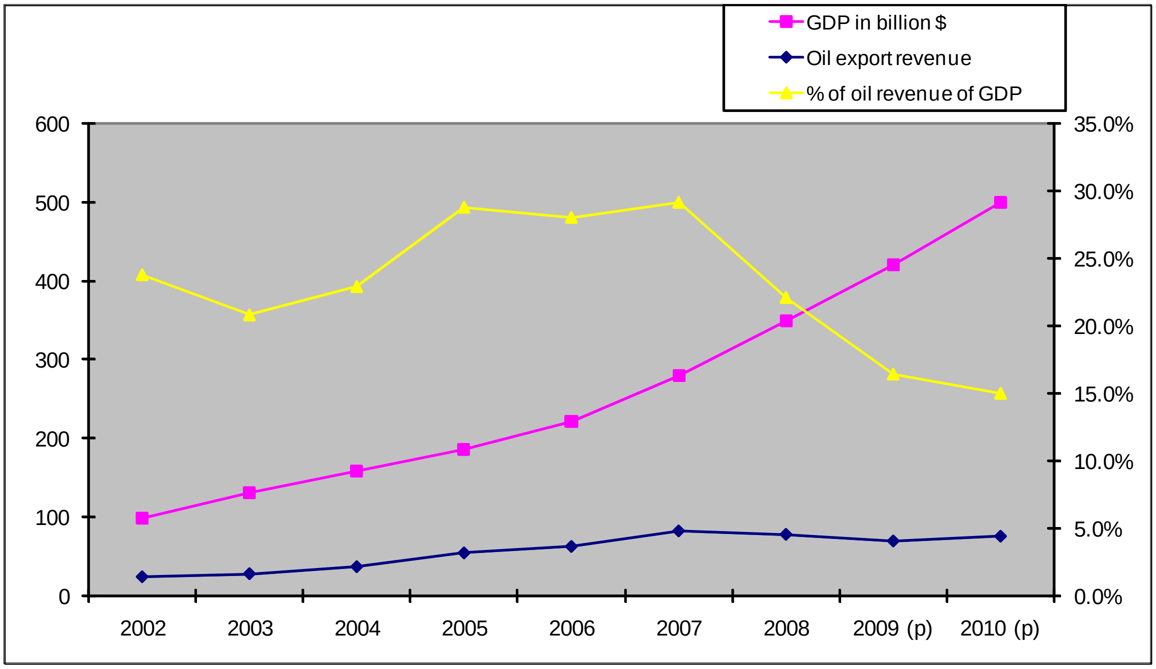
According to the latest statistics presented by the Ministry of Labor and Social Affairs 81% of the Iranian employment opportunities are to be found in the private sector. However, in terms of share in the country's GDP, the private sector makes up only 28% of the overall GDP. This fact underlines that most capital intensive sectors remain in government control and the private sector is focused on labor-intensive sector activities. However, the more significant statement at this stage is that the needed employment opportunities in the economy[8] will be provided by the private sector. It should also be noted that the economy will continue to be behind in terms of job creation – populist government schemes will produce short-term occupations through loans, but sustainable jobs will fall short of the actual needs in the society. One economic indicator that contributes to lower than needed job creation is Gross Capital Formation (GCF) which has been around 15 to 20% of the GDP over the past few years, whereas a GCF of 25% of the GDP would be required for a solid economic development and job creation.

Another area of significance for the private sector relates to the Total Factor Productivity (TFP) which is very low in Iran. Based on official estimates, HR efficiency has grown at a rate of about 1% in the past few years, while capital efficiency has declined by about 1 to 2% leading to a negative TFP growth rate. This has happened while Iranian planners had hoped to achieve a 2.5% TFP growth annually between 2005 and 2010. Lack of TFP efficiency will remain the central challenge and it can only be addressed through significant growth in private sector and foreign investment.

Analysts agree that the growing role of the private sector will eventually also have constructive political consequences. With oil export revenues falling, tax revenues will become more significant for the government, introducing greater interaction between the government and the private sector (as key tax payers) and it will offer new instruments to the civil society to lobby with the government. The graph below indicates the declining role of the oil export revenues in the overall GDP of Iran.

[8] As a result of the country's young demography, Iran needs to generate some 1 million new jobs every year.

Graph 2: GDP and Oil Export Revenues



Source: Central Bank of Iran (CBI) – projections from the Iran Economic Magazine (October 2009)

Conclusions

The main objective of this article has been to present an analysis of the Iranian economy and how it is fairing in the light of internal and external political developments. However, it is impossible to include all key aspects in one such paper. For example, issues such as "brain drain" and other socio-economic developments have been neglected to focus on key economic indicators.

There is no doubt that the real potential of the Iranian economy is much higher than its current performance, but it is also fair to say that the economy is growing despite all tensions, failed policies and political uncertainties. Though the growth can be described as "inflationary growth", it has led to new economic opportunities for Iranian companies. At the same time, Ahmadinejad's distributive economic policies have attracted many lower income classes, but they have also undermined the overall economic development in the country.

In the medium term, the Iranian economy will also be affected through the following developments:

- **Plan to redirect subsidies and the anticipated price hikes over the next 5 years:** Over the next few years, the plan to shift subsidies will be the core process to influence the country's economic realities. Essentially, the original revolutionary objective of "social justice" was never achieved through blanket subsidies and it was clear at a very early stage. However, state inertia and bureaucratic and legal burden stood in the way of correcting the subsidy structure. Now that the political will is in place, Iran will have to overcome the practical obstacles in implementing this plan. Undoubtedly, there will be short to medium-term inflationary as well as negative social consequences, however, in the long term, there will be a new balance in the Iranian economy. In the medium term, the country will experience regular price hikes through the gradual lifting of subsidies. This will affect the purchasing power of middle class which in turn will have implications for the socio-political development;

- **Changing economic and political dynamics through privatization**: The current process is making the governmental sector smaller and the semi-governmental sector larger. The emergence of a new balance of power between government on the one side and the semi-governmental entities on the other side will have a direct impact on medium-term economic as well as political developments.

In the meantime, the economic performance will continue to be influenced by internal and external political events and developments. The main domestic impetus will be the implementation of the Economic Recovery Plan which includes many other dimensions beside the subsidy shifts (including liberalization of trade policies). Furthermore, external developments will influence the overall economic balance: A resolution of Iran's external challenges (Iran-US relations as well as the nuclear issue) could certainly unleash new potentials in the Iranian economy, but it won't undo some of the structural issues, especially the growing role of the semi-governmental sector in the economy. Evidently, the economy will continue to be carried by its enormous resources (not just oil and gas but also human resources, mines and other potentials), but economic imbalances will continue to plague overall economic performance.