SANCTIONS WERE NOT THE ONLY PROBLEM

While they have no doubt harmed the Iranian economy, the damage is small compared to that caused by years of economic mismanagement.
The nuclear agreement between Iran and P5+1 signed in Vienna on July 14, 2015 opens a range of economic opportunities both for Iran and its traditional trading partners in Asia and Europe. Already a number of delegations from many countries have been travelling to Iran in the hope of taking advantage of those opportunities. But the economic potential of this agreement will depend on choices made by Iran, such as how it reforms its ailing economy and how it spends new foreign exchange revenues, and the choices made by the rest of the world, including how rapidly sanctions are removed.

Iran is a large market with a young, educated population, relatively high per capita income and great technical and absorptive capacity. With a population of over 78 million, it has one of the lowest dependency ratios (the ratio of young and old to working age population) in the world. In 2014, its dependency ratio stood at 41% as compared to 51% in India, 60% in Pakistan and 55% in the UK.

There is considerable demand for foreign capital equipment and expertise. Old commercial airplanes need replacing, the manufacturing sector requires modernisation, automobile production needs to become internationally more competitive in price and quality, the oil and gas sectors require considerable capital investment, and hotel construction and management needs foreign capital and expertise.

With the lifting of sanctions, Iran will recover funds frozen in foreign banks. A central issue will be how this money is used. US Treasury estimate $100bn, but liquid assets that can be realised may only be a quarter of that; the governor of the central bank of Iran estimated $29bn readily available. Other money is already obligated or subject to restrictions even when sanctions are removed. The final figure may be about $50bn.

Sanctions, particularly when prolonged as in the case of Iran, introduce huge distortions in the economy with important income and wealth distributional implications. Removal of sanctions will increase government revenue from oil and gas exports and from unfreezing of Iran’s foreign exchange reserves. This, in turn, could reduce the urgency for reforms and encourage continuation of past and current populist poli-
cies. Initially, the economy will grow quite fast, but this could bring about further inflation, and inefficiencies leading to another foreign exchange crisis. It is important to resist fast economic expansion without the necessary reforms and the policy adjustments needed in response to sanction removal.

While sanctions have no doubt harmed the Iranian economy, the damage they have done is small compared to that done by years of economic mismanagement. The Iranian economy had begun to decline even with high oil prices during the period 2010-2012, which led to the currency collapse in 2012, triggered by the intensification of sanctions, but largely due to Ahmadinejad’s populist economic policies. With the election of Rouhani in 2013, inflation fell from 45% in mid-2013 to 16% in March 2015, the economy diversified and oil is now a smaller part of Iran’s exports. After two years of negative real output growth, -6.6% in 2012/2013 and -2.6% in 2013/2014, output growth is now estimated to have become positive (4% in 2014/2015), and is expected to be around 3% in 2015/2016.

In the aftermath of the 2012 sanctions, oil production fell from 4.3 to 3.2 mb/d, and crude oil exports from 2.1 to 1.1 mb/d, although production and exports have since somewhat recovered to 3.6 and 1.2, plus 0.4 mb/d of exports of petroleum products. But domestic consumption of oil (due to relative subsidies rising as a result of increased inflation) has continued to rise and now stands at 1.8 mb/d, exceeding Iran’s crude oil exports. Despite having the largest gas reserves, Iran remains a marginal player in international gas trade. Some like the IEA think production could return to its 2011 level quite quickly, but many others are sceptical and think any recovery in production will depend on using foreign expertise and investment.

Attracting foreign investment in the oil industry will depend on the terms of the new Iran Petroleum Contract (IPC) revising the traditional contractual terms, which have not been very attractive to foreign operators. Iran has been very sensitive to oil price volatility and, over the longer term, needs a sovereign wealth fund to smooth the impact of the volatility of oil revenues. A key issue is to insulate the economy against large variations in oil revenues — specific legislation is needed for this purpose.

Under recent sanctions, household consumption, smoothed by a range of subsidies, hardly fell and the main impact was on investment. Over the two years 2012/13-2013/14, real private consumption expenditure declined by around 1.4% as compared to an average decline of 15.4% in total real gross domestic investment. The priority should now be to boost investment in infrastructure, in oil and gas production, petrochemicals, tourism (e.g. hotel building and management) and car manufacturing, where there is already a successful industry.

In the past, there have been successions of episodes, in 1990-92, 2004-2005 and 2012-2013 where high and persistent inflation has been associated with foreign exchange crises. It is important that this pattern is not repeated. This will require management of inflation expectations by building confidence in the government and the monetary authorities; unification of exchange rates; a degree of central...
bank independence; public sector fiscal balance and banking reforms. The role of semi-government agencies in initiating politically motivated expenses, and having priority over access to bank loans and credits must also be curtailed.

Another important element in the fight against inflation is the interest rate policy. The nominal interest rates should be set above the level of prevailing inflation expectations. Otherwise, there will be excess demand for loans (primarily destined for speculative purposes). In the case of Iran, following such a policy is particularly important, due to the presence of politically strong semi-government agencies with access to bank loans.

It will be important to reform the economic structure, increase transparency and openness to private sector initiatives and foreign investment. This may be very threatening to existing economic vested interests. Removal of price controls and subsidies may also be politically difficult.

Urgent reforms are needed in the area of energy subsidy – which results in waste, economic distortions and air pollution. Under Ahmadinejad, the reforms were enacted, but failed to produce the desired result. Energy prices were increased and large cash payments were made ($34 billion) in compensation. But with high inflation and the collapse of the rial, the domestic energy prices in terms of international benchmark prices ended up at the same level as they were before the reforms, namely 22% of the benchmark prices.

The economic priorities of the Iranian government should be to balance the growth of resources with the growth of claims on them; set interest rates above inflation expectations; prioritise investment; reform the economic structure and build better relations with its neighbours in the middle east and central Asia. This should not only boost trade and tourism; it will also have geopolitical implications. Economic isolation means that it costs Iran little to support revolutionary groups abroad; economic engagement means that there is a very obvious cost to providing an incentive to collaborate. It may be able to contribute more positively to resolving the crises in Iraq, Libya, Syria and Yemen.

Hashem Pesaran is Distinguished John Eliot Chair of Economics, University of Southern California, an Emeritus Professor of Economics at Cambridge University, and a Fellow of Trinity College, Cambridge. He is a Fellow of the British Academy, and has written extensively on the Iranian economy.

Ron Smith is Professor of Applied Economics at Birkbeck, University of London, an Associate Fellow of the Royal United Services Institute and author of Military Economics, Palgrave 2009.