



The Impacts of internal and external tensions on the Iranian Economy

Bijan Khajehpour

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Contents

- Briefly recap the key domestic and external developments that have had an impact on the Iranian economy;
- Discuss the current economic picture and indicators;
- Focus on key indicators to gauge the health of the economy;
- Discuss prospects for the next 12 months;



Relationship between Iranian Politics and Economy

- The developments surrounding the largest bank embezzlement involving 8 banks, has already led to the resignation and sacking of 3 managing directors (Khavari, Jahromi and Zarrabieh);
- These are the first 3 heads to roll, but others will emerge, especially in the field of politics;
- The embezzlement case is proof of the existence of a network of complex business webs that operate across business sectors with the aim of monopolizing key opportunities in the Iranian economy (more later).



Sources of Irritation

Domestic Irritations

- Ahmadinejad's Agenda;
- Empowerment of the government circles through economic interests (privatization, licenses etc.);
- Subsidy Reforms;
- Corruption and embezzlements;

External Irritations

- Sanctions;
- Regional developments and uncertainties;
- Financial crisis;



Ahmadinejad's Agenda

- Ahmadinejad's main domestic agenda in recent years has been to enhance the power base and influence of the government and to try to sustain his faction in the government;
- To achieve his goal, he has used:
 - Institutional restructuring (dissolution of MPO ...);
 - Undermining other state organs (such as the Majles);
 - Providing his trusted network with economic interests (which could then come back to his faction's help at the next elections);



Empowerment of trusted Circles

- In the past 6 years, the administration has pushed out those companies and business circles who benefitted from the Rafsanjani and Khatami governments;
- Government projects now mainly go to companies and entities that are closer to the administration;
- More importantly, new licenses are mainly issued to trusted individuals;
- Unique and potentially corrupt approach to privatization through the promotion of "cooperatives";



Subsidy Reforms

- Potentially a political suicide, but the subsidy reforms were necessary to explode the volume of the Iranian economy and unleash the real potential;
- These reforms will eventually ease the financial burden on the government;
- The economy will experience a period of inflationary growth – by 2015, Iran's GDP could go beyond \$900 billion, notwithstanding, the middle class and a large number of Iranian companies will suffer as a result;
- However, the cake of "economic interests" will become much larger both domestically and internationally;
- (More on subsidy reforms later).



Corruption and Mismanagement

- The focus on monopolizing economic interests has led to the creation of a complex web consisting of businesspersons, security officials and politicians;
- The recent bank embezzlement case is only the tip of the iceberg and many more such cases will be exposed, especially as the factions will try to undermine each other ahead of emerging elections;
- The heavy presence of the above structure has marginalized honest businesspeople and created a negative business atmosphere;
- Unprofessional approach to development projects has led to massive wastage of government resources with costly socio-economic side effects;



"I am opposed to the trend of the entrance of military officials into the area of politics, and regard it as harmful to the country's interests . . . The appointment of a military official to the post of oil minister will increase the IRGC's political power, and the possession of great economic and political power may lead to corruption."



Current Economic Picture

- The Iranian economy continues to produce mixed signals. High unemployment and inflation figures continue, while other indicators (such as trade balance and non-oil exports) are in positive territory (see table on next page);
- The economy is heavily affected by domestic issues such as the subsidy reforms, inflation as well as by external issues such as sanctions;
- In the last Iranian year (ended March 2011), Iran's real GDP grew by **3.2%** ; but for the current year, Iran will experience a growth of about **2.5%** – both figures are considerably lower than the planned growth of **8.0%**. This means that unemployment will continue to rise in the absence of the needed economic growth and job creation;
- Youth unemployment is considered Iran's main socio-economic issue which won't go away for some time;
- Based on the UN's Purchasing Power Parity (PPP) calculations, in 2011 Iran's GDP stands at **\$848 billion**, i.e. a PPP based per capita GDP of **\$10,917**;

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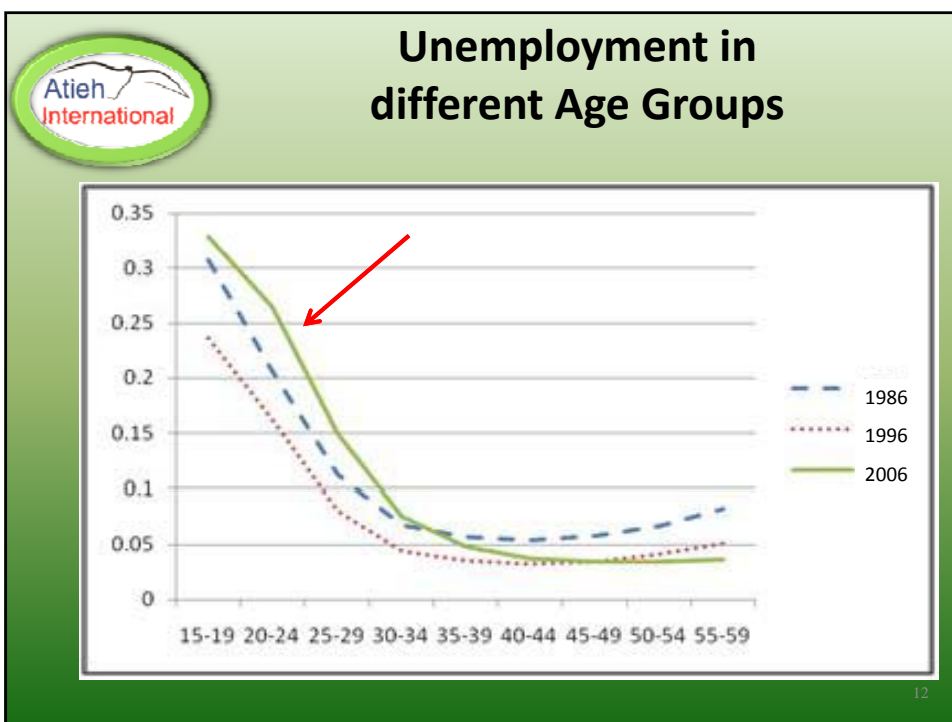
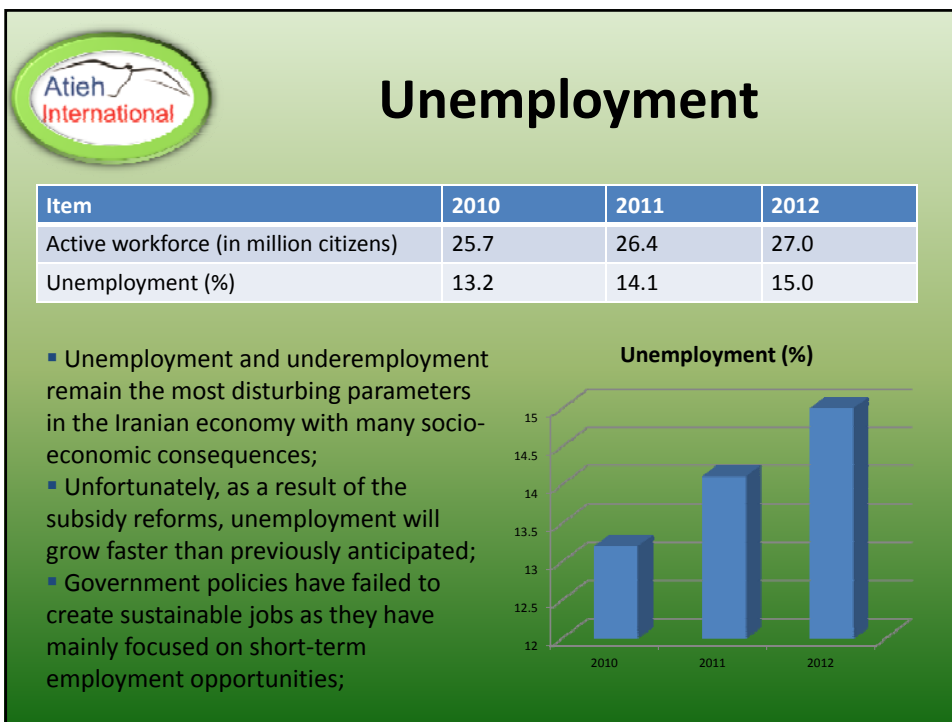
Latest IMF Report


In June 2011, the International Monetary Fund (IMF) sent an expert team to Iran to review the country's economic performance and subsequently, IMF revised some of its figures on Iran for the years 2008 to 2010.

Index	Year		
	2009	2010	2011 (p)
	Revised IMF Report		IMF projection
GDP Growth Rate (%)	3.5	3.2	2.5
Inflation Rate (%)	10.8	12.4	22.5
Unemployment Rate (%)	11.9	14.6	14.9
Liquidity Growth (%)	23.5	26.7	26.7
Reserves (\$ bn)	78.0	78.9	80.0
Foreign Debts/ GDP Ratio (%)	5.9	5.4	5.0

Table: IMF report of Iran's economy Source: International Monetary Fund (2011)

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Subsidy Reforms

<p>Original Plan:</p> <ul style="list-style-type: none"> – Remove existing subsidies and redirect revenues based on the following breakdown: <ul style="list-style-type: none"> • 50% directly to the lower income classes (about 36 million citizens), • 30% goes to the industries that will be affected through the price shifts; and • 20% goes back to the Treasury. • Over 5 years, a minimum of \$100 billion of new cash transactions would have been injected into the economy. 	<p>Actual Implementation:</p> <ul style="list-style-type: none"> – Subsidies have been partly removed, but new revenues have not been achieved; – The redistribution plan has been corrected as follows: <ul style="list-style-type: none"> • 80% directly to the recipients (about 63 million citizens), • 20% to the industries (not materialized on top of \$14 b debt to the domestic industry) • No allocation for the Treasury. • The plan has improved purchasing power of the lowest income classes (lowest 30%), but undermined everyone else.
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Short-term consequences of Subsidy Reforms on Society

Assuming a 20% inflation in 2011, the purchasing power of the various social groups will be influenced as follows:

<p>Top 20% income groups</p>	<ul style="list-style-type: none"> • Lose about 10% of their purchasing power • This leads to lower savings and investments, i.e. an eventual loss of investments and jobs;
<p>Middle Class</p>	<ul style="list-style-type: none"> • Lose some of their purchasing power; • The psychological impact of the reforms will lead to a general sense of dissatisfaction and economic disadvantage;
<p>Lowest 30% income groups</p>	<ul style="list-style-type: none"> • Gain between 10 to 30% purchasing power; • The new purchasing power will be spent on higher consumption of basic commodities (again inflationary in itself);

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Medium-term Consequences of Subsidy Reforms

- The absence of a liberalized economic structure increases the possibility of a failure of the main economic objective, i.e. better distribution of wealth;
- The main losers will be the urban middle class and limited social backlash (such as strikes) could be expected in those social classes, however, the lower income classes won't join the protests;
- The government will continue to engage in fire-fighting on various fronts and will react with short-term corrections depending on the emerging tensions and bottlenecks;
- The new pricing of fuels will create an imbalance in the mix of fuels consumed in Iran and will undermine some industries;
- In the absence of an exchange rate correction, the competitiveness of the Iranian industry, especially Iranian exporters will be undermined, as low energy cost has acted as a competitive advantage;
- Many industrial outlets will close down as a consequence of subsidy reforms which in turn will lead to further unemployment and economic decline;



Interim Audit Report on Subsidy Reforms

Though the correction in energy prices have led to energy savings, the State Audit Organization has already charged the government with a number of unlawful acts, including:

- (1) The program was to be self-financing which it is not - from the total \$23 b paid to recipients, only about \$9.63 b was supplied through cutting subsidies (less than 42%). The remaining amount was provided through the CBI resources, oil revenues and public budget.
- (2) Only 50% of the adjustment revenue was to be used as financial aid to families, whereas now 80% has been earmarked for that purpose and there is no formula on how to curb the numbers;
- (3) The cash handouts should have been allocated for 5 years, whereas now the recipients consider this payment as a permanent in fact expect it to be doubled (as promised by the president);



Inflation Outlook

- The inflationary pressures of subsidy reforms will lead to an inflation of about 20% by the end of the current Iranian year (20 March 2012). Unofficial inflation figures will be higher (about 25%).
- Though the subsidy reforms have marginally improved the purchasing power of the lower income classes, the net effect of that additional purchasing power is also inflationary (higher demand for basic goods);
- The middle class will continue to suffer as a result of the subsidy reforms which will translate into a relative decline in spending;
- The government will have no choice but to reduce the amount of cash subsidies;
- Time lagged inflationary effects will appear on the horizon, i.e.:
 - High inflation in the housing sector;
 - Increase in telecom fees and other utilities etc.
- The industry will suffer as a result of higher energy prices which will also lead to unemployment;

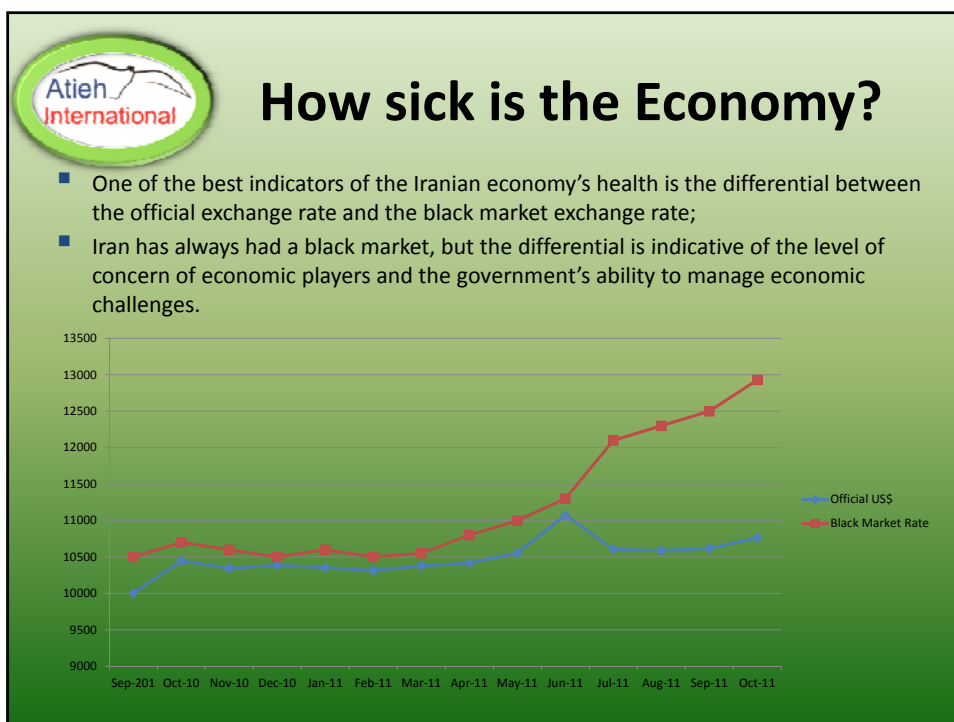
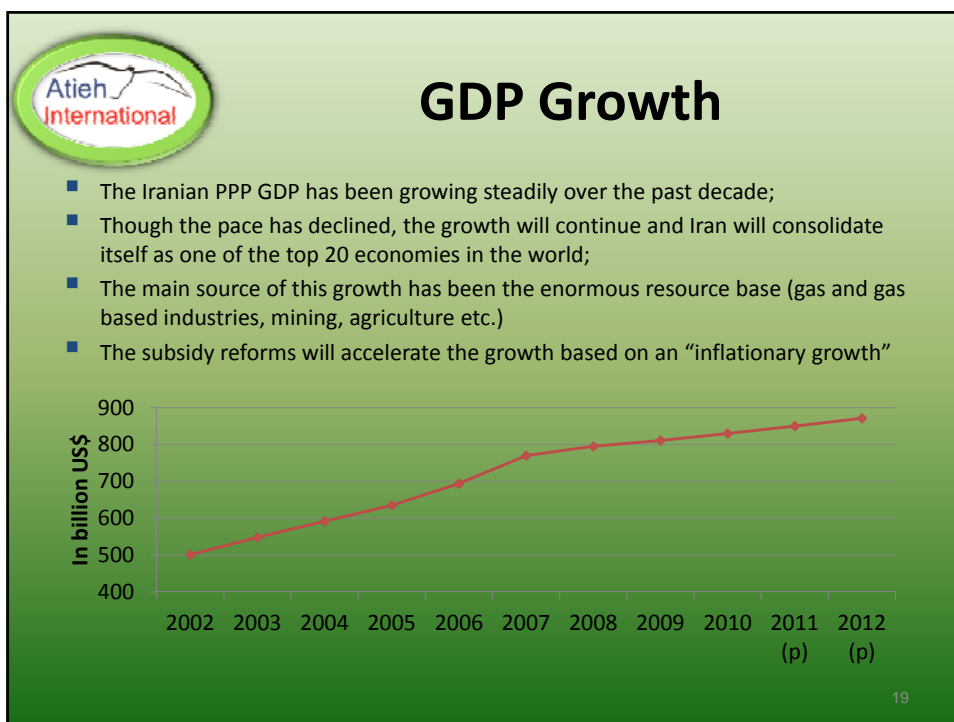
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Privatization Issues

- Iranian privatization is mainly targeted at the semi-governmental entities such as revolutionary foundations, pension funds, military organizations;
- The composition of the economy is undergoing a strong shift away from the government moving towards the semi-governmental sector.

	Year 2000	Year 2005	Year 2010 (estimate)	Year 2015 (projected)
Government	60%	50%	35%	25%
Semi-governmental entities	20%	25%	30%	35%
Private sector	17%	20%	28%	30%
Cooperatives	3%	5%	7%	10%





Other signs of sickness

- Volume of bounced checks in the last 12 months: \$ 25 billion, i.e. 4.5% of the total volume of checks and 7.5% of the country's money supply volume;
- Despite higher than expected oil revenue, the oil surplus fund and the national reserve fund are empty (mainly as funds have been diverted and partly used for the subsidy reform against the law);
- Unemployment is sharply on the rise (official reports indicate that 81% of new job opportunities are created by the private sector which could be further undermined through government policies)



Impact of Sanctions

- Banking relations have become strained, in some cases impossible;
- Imports have become about 5 to 10% more expensive for the economy;
- Iran has faced difficulties retrieving its proceeds from oil exports;
- However, banking sanctions have also led to the fact that more and more Iranian money has returned to the Iranian economy (hence the high level of luxury consumption and property investments in the country);
- Iranian businesses have no choice but to look for export opportunities to create a payment balance between their exports and their imports (i.e. proceeds from exports are used for importation of goods avoiding banking issues);
- Trade patterns are strongly moving towards regional and Asian trading partners (China and Turkey being Iran's most significant trading partners);
- Projects like the Oil Bourse have failed completely.



Other Impacts of Sanctions

- **Upside: Gold reserves** – as a result of sanctions, Iranian authorities converted large sums of Iran's hard currency reserves to gold. The appreciation of international gold prices has created a windfall for Iran in the sum of tens of billion dollars;
- Oil swap deals (e.g. with Syria)
- Slowdown in oil and gas investments (even Chinese firms have withdrawn)
- Government looking for domestic investors in the energy sector;
- Opaque external banking relations are justified through the banking sanctions;

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Economic Outlook

- Sanctions, subsidy reforms and continued budget deficit will all undermine the economic performance in the next 12 months – the Iranian economy will remain behind its actual potential;
- The higher than expected oil price will offer some leverage to the government, but short-term adjustment pains are inevitable;
- Real economic growth in the next decade will be around 3% per annum, excluding the inflationary growth fueled by the subsidy reforms;
- The Rial will have to officially be devalued sooner or later;
- The economy will continue its mixed signals, but it will mainly be driven by the resource base, as well as by the increased activity of the private sector (The main source of entrepreneurship for new jobs);
- Political infighting will expose many corruption cases, but it won't stop future corrupt dealings;

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Conclusions

- The Islamic Republic of Iran has undergone two important transformations, i.e.:
 - The political culture has changed and moved towards one in which the aim is to completely eliminate your opponents from the political scene; and
 - The sphere of interests has moved from ideological-revolutionary to a more pragmatic-economic nature, however, the common language of factions has remained a revolutionary one;
- Today's competition in Iran is for economic (and hence political) power and not for ideological control;
- The upcoming Majles elections will further intensify the power struggle – exposure of information about embezzlement may push economic interests further into the forefront;
- The role of the semi-state institutions will continue to rise;
- Economic and political power will be influenced by the shady networks that have engaged in corrupt business dealings;
- The Iranian middle class will be the main losers having to deal with negative phenomena like inflation, unemployment and their socio-political consequences;