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Exploring the Transformative Potential of the E3+3 Joint Comprehensive Plan of Action with Iran for Improving the Iranian Economy and Its Reintegration into the Global System

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Background on the macroeconomic effects of sanctions on Iran

According to the World Bank, there was a dramatic fall in GDP per head in 2014, of 17% (from \$6376 in 2013 to \$5293 in 2014), the most serious since the end of the Iran–Iraq war (1980–88). (During the later years of the war with Iraq, GDP per head dropped by 12.6% in 1986, and by 9.5% in 1988.) This significant contraction in GDP per head is the chiefly the result of the imposition of sanctions affecting the energy, banking and financial sectors, especially since 2012. The sanctions have targeted the main funding source of the Iranian economy, namely oil exports. According to the Organization of the Petroleum Exporting Countries (OPEC), Iran's revenues from oil exports fell significantly in 2012, by 12%, compared with earnings in 2011. This mainly reflects the reduction in oil output arising from the sanctions, and not negative changes in oil prices. According to BP data, Iran's oil production dropped from 4,358,000 barrels per day (b/d) in 2011 to 3,751,000 b/d in 2012, and further, to 3,614,000 b/d, in 2014. International banking embargoes have amplified the impact of oil sanctions on the Iranian economy. This negative trend can be also seen in the overall growth rate, with GDP falling by 11% in 2013 and 16% in 2014¹.

Inflation, meanwhile, increased continuously, from 10.7% in 2009/10 to almost 39.3 % in 2013/14², pushing more people beneath the poverty line and also increasing the size of the 'shadow' economy. One factor underlying this high growth rate in consumer prices has been subsidy reform and associated direct cash payments since 2010. Furthermore, sanctions have increased the costs associated with importing and exporting goods and services. According to the World Bank's *Doing Business 2014* report, the import cost per container in Iran had increased from US \$1,330 in 2007 to \$2,100 in 2013, while the export cost per container increased from \$860 to \$1,470. As a result, trade openness has decreased in recent years: as a share of GDP, merchandise trade fell from 52% in 2006 to 30% in 2012. However, after the Iran's nuke deal, the cost of import decreased to \$ 1,555 and cost of export to \$1,350 per container in 2015³. The increase in inflation has accompanied the depreciation of the Iranian rial against the US dollar and other hard currencies. For example, the official exchange rate (rials per US dollar, period average) increased from IR 8,963 = \$1 in 2005 to IR 29,830 = \$1 in 2015⁴. The rate of depreciation was particularly significant in 2013: one year after the implementation of oil sanctions, the Iranian currency lost some 51% of its value against the US dollar, falling from IR 12,175 = \$1 in 2012.

Poor economic performance in conjunction with demographic transition can be a risky combination for political stability. Currently, around 70% of the total population of Iran are of working age (i.e. aged 15–64 years). The youth unemployment rate has notably been increasing in recent years. Male youth unemployment (% of male labor force ages 15-24) increased from 19.8% in 2007 to 26.4% in 2013⁵. The situation for women is even more difficult: female youth unemployment (% of female labor force ages 15-24) grew from 29.8% in 2007 to 41.7% in 2013⁶.

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¹ <http://data.worldbank.org/indicator/NY.GDP.MKTP.CD>

² <http://data.worldbank.org/indicator/FP.CPI.TOTL.ZG>

³ <http://www.doingbusiness.org/data/exploreeconomies/iran?topic=trading-across-borders>

⁴ http://www.cbi.ir/default_en.aspx

⁵ <http://data.worldbank.org/indicator/SL.UEM.1524.MA.ZS>

⁶ <http://data.worldbank.org/indicator/SL.UEM.1524.FE.ZS>

How political economy of Iran can get affected by lifting sanctions?

Increasing oil export revenues is an expected proxy to capture the lifting sanctions in Iran. Interesting case is the response of key economic indicators such as income per capita, investment, inflation, government spending in different functions.

Positive shocks in Iran oil export revenues following lifting sanctions increases government spending and demand for both tradable and non-tradable goods in market. Increased demand for tradable goods such as manufacturing and agriculture can be met by increasing their imports at international prices. The supply of such goods is highly elastic. Thus, their prices in domestic market will not shift. By contrast, higher demand for non tradable good (such as government services, construction...) cannot be covered by increasing their supply by imports. As a result their prices will shift upward. If we assume the mobility of labour and capital within the economy, increasing prices in non-tradable part of economy absorbs economic agents from tradable sector, leading to higher wages in latter sector. Given the exogenous prices in the tradable sector, this means lower profit margin for this section which in long run can lead to marginalization of manufacturing and agriculture in economy, the so-called de-industrialization following Dutch disease. Increasing real exchange rate following positive oil rents shocks in post sanction period increases the costs of Iranian non-oil goods in international markets, affecting their competitiveness and market share negatively. However, it also means the imports of products such as machineries and intermediary goods become cheaper which can also reduce the cost of production in industries which are dependent on imported inputs and equipment. Farzanegan and Markwardt (2009) investigate the response of Iranian economy to positive oil shocks (which in current analysis can be due to lifting energy and economic sanctions).

What will happen to government budget allocation in post-sanction period? In another study, Farzanegan (2011) examines this issue. According to his analysis, the response of military spending of Iranian government to positive shocks in Iranian oil export revenues is positive and statistically significant. By contrast, the response of spending on education and health to similar shock is insignificant. This highlights the influence of powerful groups such as military elites in winning the larger share of increased oil rents which could eventually happen after lifting sanctions. Such findings show that lifting sanctions per se is not great news for Iranian political economy. In order to capture the potential dividend following elimination of economic sanctions, Iran should invest and improve its economic and political institutions (such as control of corruption, rule of law and transparency). Investing in political institutions in Iran can be a key for benefiting from lifting sanctions. In a recent study, Dizaji, Farzanegan and Naghavi (2015) develop a model which shows “democracy can shift government expenditure from national defense (military) to productivity-enhancing public spending (e.g., education).” Their empirical analysis suggests that positive shocks in quality of Iran political institutions lead to negative response of military spending and positive response of spending on education. Transparency matters. In order to deal with the Dutch disease Iran established oil stabilization fund in 2000 that is now changed to Iran National Development Fund. It aims to reduce the volatility effects of oil revenues on macroeconomy and investing for future generation. Such initiatives however require free flow of information and political independence from centres of power as well as qualified board of management. Based on the 2013 Resource Governance Index (RGI) from total of 58 investigated countries, Iran is ranked 53. This index assesses the quality of four key governance components with respect to natural resource management: Institutional and Legal Setting; Reporting Practices; Safeguards and Quality Controls; and Enabling Environment.⁷

References

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⁷ <http://www.resourcegovernance.org/rgi>