Restoring Economic Sanctions: The Impact on Iran

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Immediately following President Donald Trump's announcement of the United States' withdrawal from the nuclear agreement, the US Treasury Department posted a document on its website detailing the sanctions on Iran the United States intends to reinstitute. The document indicates that in practice, all the sanctions that the United States had imposed on the eve of the JCPOA are expected to be restored. To enable the business sector in the United States and around the world to adapt to this change in policy, it was stipulated that some of the sanctions would go back into effect within 90 days, and the remaining sanctions would be resumed within 180 days.[1]

Although Iran has scored a number of economic goals in the past two years, since the sanctions were lifted in 2015 Iran has not seen the onset of any processes that will spur a fundamental boost to its current economic strength in comparison to its economic strength in 2012. On the contrary, in a number of major realms, its situation has even worsened, in part because large international banks and foreign companies feared the re-imposition of sanctions. Renewed sanctions are expected to exacerbate Iran's already difficult economic situation further, even if the US administration does not receive full international cooperation.

Inflation and the Foreign Currency Market

The sanctions that are expected to enter into force on August 6, 2018 include a ban on selling dollars to the Iranian government and a ban on supplying financial services for the purchase, sale, or substantial holdings of rials.[2] These measures, which are intended to block the Iranian financial system's access to dollar transactions, will deepen Iran's current foreign currency crisis and accelerate the increase in inflation.

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In the initial months of 2018, public expectations in Iran regarding the re-imposition of sanctions caused the value of the rial to fall sharply in trade on the free market. This sharp dive in the value of the rial resulted in the emergence of a gap of dozens of percent between the market-determined exchange rate and the official exchange rate, indicating a loss of public faith in the local economy. To arrest this trend, on April 11, 2018 the Central Bank of Iran announced the unification of the official rate and the market rate, and set a rate of 42,000 rials to the dollar.[3] Since the announcement on the unified exchange rates, the Central Bank of Iran devalued its currency twice during the month of May. It also instituted a series of restrictions on movements.[4] The re-imposition of sanctions will obligate the Central Bank to continue updating the exchange rate quickly and tighten the restrictions on the movement of capital even further. The expected continuation of the rial's downward spiral will result in increased prices for imports and, as a result, a rise in inflation.

Inflation is one of the Iranian economy's structural problems. Except for two years, the country experienced double-digit inflation every year between the Islamic Revolution in 1979 and 2015. In 2013, during Mahmoud Ahmadinejad's presidency, Iran's annual inflation rate rose to 34.7 percent, in part due to the sanctions on the Iranian financial system that resulted in an increase in the cost of imports. President Hassan Rouhani succeeded in lowering inflation to 9.1 percent in 2016 and to 9.7 percent in 2017.[5] The trend of decreasing inflation that began in 2014, even before the sanctions were lifted, is to a significant extent the product of a restrained monetary policy. The lifting of sanctions helped lower inflation due to the immediate reduction of import prices and the creation of budgetary space, which allowed the government to slow the pace of loans from the Central Bank (financing the debt using loans from the Central Bank is one of the structural factors causing inflation in Iran).

The sanctions that will go into effect in August also include a list of bans on the provision of financial services to the government bond market, which Iran recently began to develop in an effort to reduce the linkage between debt and inflation. The Iranian government hoped to implement various reforms that would enable it to continue to lower inflation and at the same time encourage local and foreign investment. The re-imposition of sanctions will prevent the government from realizing this goal.

Unemployment and Local and Foreign Investments

Although the Iranian economy grew by 12.5 percent in 2016 and 4.3 percent in 2017, the past two years did not witness a steady, meaningful decline in unemployment, which in 2017 stood at just under 12 percent.[6] The government's failure to create new jobs, despite economic growth, can be explained in part by the energy sector's centrality to the economy. The Iranian government hoped that in parallel to the attraction of foreign direct investments (FDI), which would enable it to introduce efficiency enhancing measures to oil and natural gas production, the lifting of sanctions would lead to growth in FDI in non-energy related sectors, and in turn, lower unemployment.

Nonetheless, and even prior to President Trump's decision to withdraw from the agreement, concerns among foreign companies regarding investment in Iran – against the background of political and economic uncertainty, the impact of US sanctions that had not been lifted, and structural economic failings – prevented rehabilitation of the labor market by means of FDI. Although the lifting of sanctions resulted in a 66 percent jump in investments between 2015 and 2016, the scope of the investments totaled less than $4 billion.[7] This amount is the equivalent of less than one percent of the Iranian product, and many times lower the scope of the annual foreign investment that Iran set as a major aim for the period 2016-2021 in its sixth five-year development plan.[8] The re-imposition of sanctions can be expected to delay Western companies' return to the Iranian market further. Many companies that in the past two years decided to invest in Iran are now expected to suspend their business there.

The sanctions that will take effect on November 4, 2018 include a number of sanctions on foreign companies that provide insurance services to Iranian shipping and port companies and Iranian oil companies. The United States also intends to renew sanctions on private and government financial bodies that enter into contractual agreements with the Central Bank of Iran, as well as with certain other Iranian financial institutions that hope to clear payments for transactions in different areas, including oil sales. The prohibition on contractual agreements with such principal entities in the realms of Iranian energy, industry, and banking will make it difficult for foreign companies to invest in Iran without violating the American sanctions.

In May 2018, Total announced that it would be unable to continue its project for the development of Stage 11 of the South Pars gas field, which it signed in July 2017 – clear evidence of concern regarding the effect of the sanctions over Iran's efforts to establish relationships with companies exposed to the US financial system. Total's announcement to the media emphasized that without the receipt of a waiver from the US sanctions, it would encounter economic difficulties, given that American banks are responsible for 90 percent of the financing of its activity.[9] Similar claims have been advanced by various European companies such as Simmons of Germany, ENI and Danieli of Italy, and PGNiG of Poland, which have already announced their intentions to end their relationships with Iran once the sanctions go into effect.[10] These decisions were taken despite EU leaders' statements regarding their intention to take measures to reduce the damage to business between European companies and Iran caused by secondary sanctions. Such measures include the reinstitution of a blocking statute prohibiting European companies from abiding by the American sanctions, the financing of business activity in Iran through the European Investment Bank, and financial activity with Iran via a number of financial institutions that have the ability to work around the prohibition on contractual relations with the Iranian Central Bank.[11]

European companies not involved in direct business activity with the United States have also been concerned by the sanctions, as violating US law could make it difficult for them to enter the American market in the future, and as the very use of the dollar links them to the US financial system. French auto giant PSA, which does not sell automobiles in the United States, announced in June that it has started suspending Peugeot's investment in the joint venture with Iranian automobile companies, based on its desire to avoid violating the US sanctions.[12] French competitor Renault, which also does not engage in direct activity in the United States, announced that it would remain in Iran and that "we have a future in Iran." However, it also clarified that it would significantly reduce its activity Iran, and that it would contact the United States directly in order to examine actions that could entangle it in difficult situations.[13]

The departure of large European companies from Iran could lead to an increase in the activity of companies from Russia and China. However, even if this occurs, Iran will have difficulty compensating for the loss of European investments, which, it hoped, would improve the labor market.

Banking

Since the sanctions were lifted, there has been an increase in the number of connections between Iranian banks and international banks (correspondent banking) and in their willingness to provide letters of credit for export transactions. At the same time, most contractual agreements do not involve the leading banks, and the number of contractual agreements in 2017, which stood at 238, was lower than the 633 concluded in 2006.[14] In 2006, US sanctions on the Iranian banking system were already resulting in a steady decline in the connections between Iranian banks and banks around the world. Presumably increasing the pressure on the financial system will have similar results this time as well.

In 2016, Iran was reconnected to the SWIFT network, making it easier for it to clear international payments. In light of the European opposition to the American measures, it is still unclear how the sanctions will affect Iran's ability to continue clearing payments through SWIFT, which is headquartered in Brussels. The most recent report of the International Monetary Fund, published before it was announced that sanctions would be re-imposed, raised the possibility that Iran would be cut off from the system due to its violation of regulations pertaining to money laundering. In recent months, difficulties were revealed regarding contractual agreements with various international banks, and the collection of payments for exports has also encountered difficulties.[15]

Over the past two years, as part of attempts to abide by international regulations pertaining to the prohibition on financing terrorism and money laundering, Iran has started to increase the transparency of its banking system. The increased transparency revealed the depth of the hardship facing the banks in Iran, many of whose balance sheets contain double-digit rates of nonperforming loans.[16] Iran has started to examine the possibility of rehabilitating the banking system by means of debt arrangements, which require significant budgetary outlays. The economic uncertainty will likely prevent the government from committing to unnecessary budgetary expenditures anytime soon, meaning that the weak state of the Iranian banking system will go unrectified in the near future. The flaws in the banking system constitute another obstacle to the attempts to rehabilitate local investment and to encourage employment in the private sector.

Trade and Dependence on Oil Exports

In recent months, Iran has resumed a pace of oil production and export comparable to its pace in 2011, with oil exports reaching approximately 2.5 million barrels per day, in comparison to only 1.4 million barrels per day in 2015. Although Iran has somewhat decreased its dependence on oil in recent years, its economy remains extremely vulnerable to measures that would make energy exports difficult. Oil revenues constitute 35 percent of total government revenues, and the export of oil and natural gas account for some 64 percent of Iran's total exports.[17]

The thrust of the US effort to damage Iranian oil exports focuses on the renewal of sanctions on parties that interact with the Central Bank of Iran in order to clear payments for oil transactions. Under the Obama administration, the United States distributed waivers regarding these sanctions to financial institutions of countries that reduced their rate of purchase of oil from Iran by 20 percent every six months. Countries of the European Union did not take advantage of this option in 2012, and the sharp decline in the purchase of Iranian oil on the part of EU member states stemmed from the EU's decision to join in increasing the pressure on Iran.[18]

It is still unclear what will be the exemption and waiver policy of the US administration regarding financial interactions pertaining to oil this time around. The Treasury Department recommended that countries considering future relief and exclusions from sanctions pertaining to oil already begin reducing their purchase of oil from Iran within the next 180 days. If the administration does indeed award these waivers, presumably the rate of decline in Iranian oil exports will be less than in 2012. Similarly, the cold shoulder that Europe turned to the latest American action is of clear importance and has the potential to temper one of the measures that during the last round of sanctions did the most damage to Iran. At the same time, it is quite possible that the statement by the Secretary of State regarding the implementation of additional sanctions indicates that the United States will attempt to focus its effort on Iranian oil exports by hardening its policy pertaining to the clearance of oil transactions.

It is difficult to assess the number of barrels that will be subtracted from the world market due to the sanctions on Iran. However, trends indicating anticipated difficulties in exports are already discernible. The Danish company Maersk, which holds the largest fleet of oil tankers in the world, has announced its intention to cease its oil shipments from Iran beginning on November 4, 2018.[19] The difficulty of clearing transactions in dollars is expected to spur efforts by the Iranian government to carry out transactions in other currencies. Even before Trump's declaration, the Iranian government announced that the euro would replace the dollar as the unit of measure in government reports. The Central Bank of Iran even signed a currency swap deal with the Central Bank of Turkey and declared its intention to sign similar agreements with other central banks.[20] The planned sanctions prohibit all significant trade with Iran in gold and rials in a manner that will leave many of Iran's trade partners unenthusiastic about signing currency swap agreements or replacing Iranian oil with gold.

In the past, Iran relied on its connection with financial institutions in a number of countries in the region in order to bypass the ban on purchasing dollars. In 2015, it was reported that more than $1 billion in cash had been smuggled into Iran using corporate fronts, which purchased dollars in Dubai and Iraq at the encouragement of the Central Bank of Iran.[21] Although the United States will likely be unable to completely prevent the smuggling of dollars into Iran, increased US pressure on institutions with connections to these fronts could reduce the flow of dollars that will ultimately be smuggled into Iran.

Iran's $120 billion in foreign currency reserves, enough for 15 months of imports,[22] provides it with a degree of room to breathe, which will allow it to engage in imports even in the event of a significant reduction in exports. In the short term, Iran will likely not suffer from a crisis leading to a shortage of basic imported goods. However, the desire to prevent rapid erosion of its foreign currency reserves will lead to increased supervision over imports, which could well be felt in the Tehran markets.

Political Effects

The effects of the sanctions will not be limited to the economic realm, and their effectiveness must also be examined with regard to regime policy and public opinion.

It is difficult to assess the possible effects of the renewed economic sanctions on regime policy. The Iranian regime, under the leadership of Supreme Leader Ali Khamenei, views President Trump's decision to withdraw from the nuclear agreement as proof of its fundamental conviction that the nuclear program was only an excuse for the West to pressure, isolate, and weaken Iran in order to lay the groundwork for regime change in Tehran. In an address marking the thirty-fifth anniversary of the Islamic Revolution, Khamenei maintained that the United States is continuing its efforts to bring about regime change in Iran: "American officials publicly say they do not seek regime change in Iran. That's a lie. They wouldn't hesitate a moment if they could do it."[23] On another occasion, he emphasized that the West's efforts to play up the threat of a nuclear Iran are based on a lie, as the West is frightened of an Islamic Iran, not a nuclear Iran.[24]

However, Iran is not immune to pressure. Its agreement in the past to return to the negotiating table under the influence of the sanctions and to accept restrictions pertaining to its nuclear program are indicative of its willingness to moderate its positions in response to pressure. The sanctions that did serious damage to the Iranian economy and increased frustration among the population also increased the pressure on the regime to agree to concessions, out of fear that a continuation of the economic crisis could undermine its stability over time.

At the same time, the regime's willingness to deviate from its policy will depend on its subjective assessment regarding the dangers and opportunities it faces. This assessment can change in accordance with the worldviews of the different factions in the Iranian elite. Radical elements are likely to respond to increased external pressure with heightened defiance, in order to neutralize potential threats to the stability of the regime and deter the enemies of the Islamic Republic. On the other hand, more pragmatic elements within the leadership could display a willingness to temper the regime's positions and adopt a more moderate policy.

At least in the short term, the United States' withdrawal from the agreement can be expected to strengthen the opponents of President Rouhani, who opposed the nuclear agreement from the outset and argued that the government's conciliatory policy had resulted in an agreement of surrender, in which Iran agreed to painful concessions without receiving anything in return. The economic sanctions could also further strengthen the Revolutionary Guards, whose involvement in economic projects increased in the past due to the cessation of the activity of Western companies in Iran.

Although the economic pressure is expected to increase, it is still too early to assess whether it will be sufficient to moderate the regime's policy on issues it perceives as essential to its national security and its very survival. Khamenei, whose approach to the negotiations over the nuclear issue was suspicious from the outset, views the difficulties of implementing the agreement as proof of his claim that the West, and especially the United States, cannot be trusted. He also views it as evidence that economic improvement can be achieved only through an "economy of resistance," based primarily on the reduction of Iranian dependence on foreign elements. It is no coincidence that the Supreme Leader declared the new Iranian year (which began on March 21) "the year of support for Iranian products."[25] Moreover, from Khamenei's perspective, military nuclear threshold capacity is a necessary insurance policy for the regime's survival. It is therefore possible that under heavy economic pressure, the regime would be willing to conduct renewed negotiations on specific sections of the nuclear agreement (for example, how long the restrictions on Iran's nuclear program will be in effect) or on certain aspects of its policy (for example, the range of the missiles it can develop, or Iranian involvement in geographical arenas it regards as less important, such as Yemen). However, it is highly doubtful that it will agree to concede assets it regards as essential to its national interests, and especially to its survival, such as the option of a military nuclear program, its long range missile capacity, and its influence in Syria and Iraq.

The impact of sanctions on Iranian public opinion is mixed. The increased economic pressure resulting from stronger sanctions could intensify the ongoing popular protest that has been underway in Iran in recent months, and it could strengthen the public criticism of the regime's policy. At the same time, it is also likely to make it easier for the regime to mobilize public support against the West. The Iranian public is not monolithic and does not espouse a uniform view on the issues that are currently on the national agenda. Despite the mounting alienation between different segments of the population and the regime, the Iranian public often expresses its willingness to fall into line behind the regime in the event of cases that it believes could harm essential interests or national dignity, such as, for example, challenges to Iran's territorial integrity or threats of a military attack. Many citizens harbor a hostile attitude toward all expressions of Western condescension and pressure exerted in an effort to force it to come to terms with Western dictates. The economic sanctions that the international community imposed on Iran have already been used by Tehran to mobilize public support against the West with a degree of success. Although Iranians have objected to the high price of continued sanctions, many have adopted a critical approach toward the West, which is perceived largely as responsible for their difficult situation. A Gallup poll in December 2012 indicated that 47 percent of Iranian citizens blamed the United States for their difficult economic situation, whereas only 10 percent believed that their own government was responsible.[26] A poll published in July 2017 by the University of Maryland found that the Iranian public continued to oppose giving in to the dictates of the West. The results of the poll also indicated that a clear majority of the Iranian public supports Iranian retaliatory measures in the event of violation of the nuclear agreement on the part of the United States. Fifty-five percent of respondents said that if the United States annuls the agreement, Iran should resume its nuclear program and not limit itself to an appeal to the United Nations, although the decisive majority of Iranian citizens (76 percent) continue to support the agreement.[27]

Furthermore, despite the sanctions' potential as a means of pressuring the Iranian regime, they might also delay the advancement of significant political changes. This is the result of the severely detrimental impact they have on civil society and the Iranian middle class, which is considered one of the main agents of change in Iranian society. Erosion of the Iranian middle class under the sanctions regime did serious injury to one of the main power centers of the reformist camp. The economic crisis has forced the middle class to focus on the struggle for everyday survival and has kept it too busy to continue the struggle to promote political liberties and political change. Moreover, the economic crisis has intensified middle class dependence on the government, as most middle class Iranians are employed by the public sector. As a result, there is a less of a chance that they will endanger their economic and employment security through political and civil involvement.[28]

Conclusion

The initial demands on Iran, as well as the fact that within a relatively short time the United States intends to reinstitute all the sanctions that were gradually imposed on Iran in the past and is also threatening to impose more severe sanctions, suggests that even without international cooperation, the economic damage of the sanctions will already be felt in the short term. Even before the sanctions go into effect, they are expected to intensify Iran's foreign currency crisis, accelerate inflation, and damage the scope of foreign investment. The need to prepare for the sanctions will force the Iranian government to deviate from necessary reforms that have already achieved early signs of success and impose a restrained fiscal and monetary policy.

The anticipated decline in the flow of foreign investments will make it difficult to create new jobs. However, it will not result in a rapid rise in unemployment or an immediate decline in the scope of energy production. On the other hand, the success of measures meant to do damage to the banking system and strike at Iranian oil exports could find quick expression in increased unemployment, a sharp decline in government income, and additional inflationary pressures. American resolve remains the most important variable that will determine the extent to which these measures are successful. Although European Union and other countries will be able to delay the sanctions' impact, increased efforts to bypass the sanctions will actually result in their intensification on the part of the United States, as well as a rescinding of the possibility of waivers, including waivers for the ban on contractual engagements with the Central Bank of Iran for the clearance of oil transactions. Intensified measures on the part of the United States could cause considerable shocks and propel the Iranian economy back to the position it was in on the eve of the nuclear agreement. However, even under the current sanctions, the Iranian government will be forced to revert to the restrained policy it implemented between 2013 and 2015. In the past, this policy helped curb inflation to some extent, and maintain a reasonable budgetary framework. However, it required the leadership to take unpopular measures and had a detrimental impact on economic activity. Beyond the political difficulties posed by such a policy, its success in preventing a slide into hyperinflation and detrimental impact on budgetary stability will depend on the intensity of the shock produced by the sanctions.

In conclusion, Iran has faced significant economic challenges in the past. Moreover, over the years the Iranian public has developed the ability to adapt to the economic crisis, and the regime still possesses many means of suppression in the event that the protests spread. The sanctions' impact on the political and public realms will depend not only on the intensity of the sanctions but also on the success aimed for: the lower the aspirations, the greater the chances of achievement. If the US administration strives to topple the Iranian regime, the likelihood of this happening will be weak even under heavy economic pressure. Regime change will depend on a large number of factors that are not necessarily influenced by external intervention, such as the interaction between centers of political and security power in Iran, the regime's willingness to use means of suppression against acts of protest, and the public's ability to organize itself for effective protest. On the other hand, if the achievement aimed for is limited to an Iranian agreement to conduct negotiations regarding specific issues that do not require it to concede its strategic assets or essential interests – such as the nuclear option and the development of surface-to-surface missiles – it is more likely to be realized, even if only due to the fact that Iran appears to aspire to bide its time, through negotiations, until, inter alia, there is a new president in Washington.

Notes

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15 "IMF Executive Board Concludes 2018," International Monetary Fund.

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17 The above figures are based on a calculation relying on data published in the above quoted report of the International Monetary Fund. Other reports of the International Monetary Fund present a slightly lower figure for energy exports as a percentage of total exports.

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