Iran's Year Under Maximum Pressure
The Political Limits of Economic Resilience
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1. Introduction

Since the Trump administration reimposed secondary sanctions on Iran on November 5, 2018 as part of its campaign of “economic war” on the Islamic Republic, there has been a great deal of speculation as to whether unilateral sanctions would prove sufficient to bring Iran’s economy “to its knees.” One year later, the serious impacts of the Trump administration’s “maximum pressure” policy are impossible to deny. The International Monetary Fund (IMF) projects that Iran’s economy will contract by 9.5 percent this year, the largest contraction since the height of the Iran-Iraq War in 1984. However, there are already signs of readjustment in the Iranian economy. The IMF’s also projects that Iran will return to zero growth in 2020—a rebound that would parallel Iran’s experience in 2012-2013, in which Iran rebounded from a 7.4 percent contraction to minor 0.2 percent contraction the following year.

In the second half of 2019, marked improvements in several areas of Iran’s economy suggest that the country may emerge from its recession in 2020. Foreign exchange markets have largely stabilized, manufacturing activity is expanding, and non-oil sectors of the economy are beginning to generate new jobs. However, significant risks remain. A recent move by the Supreme National Security Council to reduce a long-standing fuel subsidy, which effectively tripled the price of gasoline, triggered widespread protests beginning in the nighttime of November 15. The subsequent violent crackdown, which led to more than 300 deaths and thousands of arrests, not only gave rise to a crisis in state-society relations in Iran, but has also threatened to undo much of the progress in the government’s efforts to stabilize the economy. The Iranian rial lost 10 percent of its value in the weeks following the protests. Events at the outset of 2020, including the airstrike that killed Qods Force commander Qassem Soleimani and the accidental downing of Ukrainian International Airlines Flight 752 by Iranian air defense, have further contributed to political and social instability in Iran, which may have a bearing on economic resiliency moving forward.

Trump administration officials have pointed to the unrest in Iran to argue that their maximum pressure campaign is working, and have warned that Iran’s government is poised to collapse. These prognostications are premature, despite the seriousness of the recent protests and the strain in state-society relations. Macroeconomic indicators point to a considerable ability among Iranian government institutions and economic operators to adapt to the headwinds. This report will present a narrative analysis of the Iranian economy in order to describe both the factors that continue to stave Iran’s economic collapse as well as areas of ongoing vulnerability.

2. Oil Exports

Lost oil revenue has put a strain on government budgets, but China continues to purchase Iranian crude.

The most significant impact of the reimposition of U.S. secondary sanctions has been the significant reduction in Iran’s oil exports. Despite the Trump administration’s vows to drive Iran’s exports to “zero,” Iran continues to export oil to China, which is purchasing Iranian crude in direct defiance of U.S. sanctions. Since the revocation of the sanctions waivers
permitting imports of Iranian oil at the beginning of May 2019, China customs data has shown a monthly average of $357 million in oil imports.

However, the declared value of these imports is lower than the observed exports of Iranian oil as tabulated by tanker tracking services. Since May 2019, observed exports have averaged between 300,000 to 500,000 barrels-per-day (bpd) per month (down from 2.8 million bpd), with a market value of over $800 million (although Iran is likely offering China a significant discount). This suggests that some oil observed in transport from Iran is being delivered into bonded storage in China, meaning it has yet to be sold to a Chinese buyer. Moreover, reports suggest that Iranian oil is being delivered to China via ship-to-ship transfers off the coast of Malaysia. Indeed, the fall in China’s declared imports of Iranian oil coincided with a marked increase in declared imports from Malaysia, a marginal oil producer. The use of such ship-to-ship transfers may enable Chinese buyers to use smaller tankers to conduct the trade, mitigating risks associated with possible U.S. sanctions on major shipping firms such as COSCO, which was targeted with a designation in September of this year.4

CHART 1: China’s Declared Imports of Iranian and Malaysian Oil
USD Thousands, Oil Imports Based on HS 27 Category

While the oil industry only accounted for 13.5 percent of Iran’s GDP in 2018, oil revenues have been a crucial part of government budgets for decades. The loss of oil revenues in 2019 has compelled a significant redesign of government budgets. The proposed budget
for the next Iranian year calls for around $40 billion of expenditures, around one-third of the total budget for the current Iranian year in dollar terms at the unofficial free market rate.

In the current iteration of the budget, oil revenues are expected to cover just 9 percent of expenditures, a historic low. Fundamentally, Iran’s government will be far more dependent on tax revenues, bond issuances, and privatization of state enterprises. While there have been significant improvements in the collection of tax revenues over the last decade, the new budget presents both a challenge and an opportunity. In order for tax revenues to cover the planned 35 percent of expenditures, the government is projecting growth of 13 percent in tax revenues—an ambitious target. Iran is weaning itself off dependence on oil rents for its core budget spending, but it also finds itself navigating a period of great economic uncertainty with a severely constrained ability to spur growth through development spending or expanded welfare transfers.

3. Foreign Exchange

Iran has stabilized its currency markets, but risks of further devaluations loom large.

Lost oil revenue also has a direct bearing on Iran’s foreign exchange markets. Since the imposition of financial sanctions on 2012, Iran has struggled to reliably access its extensive foreign exchange reserves. These impediments were never fully removed in the aftermath of sanctions relief in 2016, but the related pressures came to a head at the end of 2017, when the Iranian rial underwent a significant episode of devaluation. Over the course of 2018, the currency had lost 60 percent of its value relative to the dollar, stoking inflation.

In the latter half of 2018 and first half of 2019, the Rouhani administration working to regain control over the foreign exchange market, principally by giving the Central Bank of Iran new oversight powers, including the establishment of a centralized exchange called NIMA through which the bank manages the repatriation and allocation of currency between Iranian exporters and importers. These efforts began to pay dividends at the beginning of 2019 and the rial regained value as foreign exchange markets stabilized. But significant concerns remain for the stability of the currency in the medium term.

Treasury managers at major European multinationals tell Bourse & Bazaar that their customers in Iran are struggling to find euros with which to pay for imports. Increasingly, the euros used to pay for goods in Europe-Iran bilateral trade are being purchased in the United Arab Emirates or China and are often sourced with significant delays, increasing the transaction costs associated with even routine trade.

These additional costs are then passed on to the importers and subsequently to customers and consumers in Iran. The most dramatic manifestation of this issue can be seen in Iran’s imports of key agricultural commodities. Over the last year, cargo ships carrying soybeans and maize have been anchored off Iran’s coast for weeks as traders await payment from Iranian customers. The delays mean that the Iranian importers incur demurrage costs, placing upward pressure on food prices in Iran.
Iranian policymakers will also be concerned that new volatility in foreign exchange markets will undo months of progress in restoring the value of the rial. After several months of relative calm in foreign exchange markets, the Iranian rial slid nearly 2 percent against the dollar on November 13, the final full-working day before the announcement of the fuel subsidy reform. This movement in the price of the rial, which was among the largest since the beginning of August, suggests that some economic operators had prior knowledge of the pending announcement. The rial has continued to lose value in the days following the protests losing 10 percent of its value.

**CHART 2:** New Volatility in Iran’s FX Market  
Percentage Change in USD/IRR Sell Prices

A new and prolonged devaluation episode remains one of the most significant risks for the Iranian economy and its nascent recovery from the 2019 contraction. A weaker rial will increase costs of imports, and the pass-through effects can help stoke inflation. It is therefore possible that the volatility in foreign exchange markets spurred by the recent unrest will undercut the Rouhani administration’s recourse to expanded cash transfers to try and ease the hardship of the poorest families in Iran.

In an interview with the *Wall Street Journal*, the Trump administration’s Iran envoy, Brian Hook, disclosed that the Iranian government is assessed to retain free access to just 10 percent of its overall foreign exchange reserves. Hook’s interview provides insight into the Trump administration’s efforts to use sanctions designations to limit Iran’s access to
foreign exchange, for example by designating Iran’s central bank under a terrorism authority.

4. Inflation

_Inflation continues to rise, but at a slower pace, reducing some pressure on ordinary Iranians._

Inflation surged over the course of 2018, driven largely by the rapid devaluation of the Iranian rial, but prices have risen at a slower pace in recent months. In September 2019, CPI increased by an annual rate of just 6.1 percent. However, ordinary Iranians continue to encounter stickiness in prices, and wages have not kept up with inflation. This means that while there is greater price stability—an important precursor to economic recovery—many Iranians continue to struggle to reconcile their incomes with the new, higher prices.

**CHART 3:** Iran Consumer Price Index

3-month moving average

Encouragingly, the government has resisted the urge to “print money” in order to try and boost household consumption and ease the impact of high prices. Rather, as demonstrated by the move to retarget expenditures on the fuel subsidy towards cash handouts, the government is seeking to find new fiscal space through the more efficient use of state resources. The question is whether this discipline will be sustainable as Iran enters an election period.
5. Trade

*Trade with Europe and China has stabilized at a low base.*

In an October 21 interview with *Al Monitor*, the governor of Iran’s central bank, Abdolnasser Hemmati, suggested that Iran’s high inflation was principally related to the increased cost of imports. Hemmati’s explanation is in some sense a deflection—disruptions in the currency markets, such as interrupted supply of foreign exchange, were the precedent cause of the higher cost of imported goods—but it is true that price stability is dependent on stability in trade flows. While Iran has a significant manufacturing base, meaning that most of the final goods consumed in Iran are produced in Iran, these manufacturing processes are nonetheless dependent on a wide range of industrial intermediate goods—setting aside the significant demand for pharmaceutical and food products that can be classified as “humanitarian trade.”

**CHART 4:** Chinese and European Exports of Machinery and Electrical Equipment

Total exports for HS Section XVI - US Dollars

The first half of 2019 was a challenging period for Iranian importers and their foreign suppliers. The reimposition of secondary sanctions led to the cessation of services from many banks and logistics companies, meaning that it was more difficult to both pay for and transport goods to Iran. However, companies were able to adjust, drawing on the lessons of the previous sanctions period. It was also helpful that there had been a long lead-up to the reimposition of secondary sanctions as the Trump administration laid the groundwork for its withdrawal from the JCPOA with “decertification” of the deal in 2017.
Iran continues to source around $500 million of machinery and electrical equipment each month from its two primary trading partners: China and the European Union. While most attention has been on the decline in European trade with Iran due to the impact of U.S. secondary sanctions, there has also been a significant decline in Chinese exports to Iran across categories, but particularly in the category of machinery and electrical equipment. However, exports to Iran do appear to have reached a floor over the last few months.

**CHART 5: China-Iran Bilateral Trade Under Sanctions**
USD Thousands, Oil Imports Based on HS 27 Category

Chinese authorities have been largely silent about their reduced trade with Iran perhaps because of their ongoing “trade war” with the United States. However, Iran’s bilateral trade with China remains a pillar of Iran’s economic resiliency in the face of the Trump administration’s “maximum pressure” sanctions campaign. Bilateral trade totaled $23 billion last year. While this annual total has fallen 34.5 percent, Iran has sustained significant oil and non-oil exports to China, totaling just over $13.2 billion. The earnings from this trade have enabled Iran to afford continued imports of Chinese raw materials, parts, and machinery that support Iran’s manufacturing sector—total imports were $9.7 billion in 2019.
European policymakers have been more vocal about the central role that bilateral trade plays in Iran’s economic resiliency and have sought to safeguard trade in the face of U.S. sanctions pressures. The launch of INSTEX, a company intended to providing a netting mechanism to support European trade with Iran, should help address the fact that Europe-Iran trade remains vulnerable to disruptions in foreign exchange markets and in banking channels. INSTEX will eliminate the need for cross-border financial transactions to facilitate Iran trade. Founded by France, Germany, and the United Kingdom, the mechanism recently welcomed six further state shareholders (Denmark, Sweden, Finland, Norway, Belgium, and Netherlands) and over the last few months of 2019 has expanded its staff. Despite significant and politically costly delays, a first transaction is expected in the first quarter of 2020.

The fact that Chinese and European exports continue at these levels one year after the reimposition of U.S. secondary sanctions suggests that unilateral sanctions are an imperfect tool for imposing an out-and-out embargo on Iran. However, there are other sanctions-related risks on the horizon. On the one hand, the United States may have sought concessions regarding the continued activities of Chinese state enterprises in Iran as part of the recently concluded first phase of its trade deal with Beijing.

On the other hand, the European parties to the JCPOA have determined that Iran’s reduced compliance with the nuclear deal required triggering the “dispute resolution mechanism” (DRM) enshrined in the agreement. While the DRM may offer a framework to address both European concerns around Iranian compliance with the deal as well as Iranian frustrations at European failures to defend its trade in the face of U.S. sanctions, the failure of the DRM negotiations—perhaps triggered by unrelated escalation in the region—could lead to the snapback of UN and EU sanctions on Iran. In such a scenario, many European exporters will likely consider it reputationally and operationally untenable to maintain their sales to Iran.

6. Manufacturing

Manufacturing has rebounded after a difficult start to the year.

Stability in foreign exchange markets and a more reliable supply of intermediate goods has helped Iran’s manufacturing sector—which accounts for nearly a third of the country’s employment—to return to expansion. In October 2018, the Iran Chamber of Commerce launched a new Purchasing Manager’s Index (PMI) report, which draws on input from over 400 manufacturing enterprises in Iran. Iran’s PMI reflects expansion in manufacturing activity in seven of the last nine months, although, with the exception of December 2019, the scores remain only just above the threshold of 50, suggesting a degree of delicacy in the manufacturing recovery.

Executives in Iran tell Bourse & Bazaar that the economic contraction of the last year has had a positive impact for many of Iran’s larger manufacturers. European competitors have dropped out of the market, reducing the competition posed by imports for domestic-made products. At the same time, many smaller Iranian manufacturers have had to mothball operations due to the increased costs of intermediate goods. For those larger manufacturers that were able to weather the initial economic storm, the rewards of greater market share and pricing power has helped pad profit margins. This is one reason why
Iran’s stock market has performed so well over the past year despite the overall contraction of the economy.

**CHART 6:** Iran Purchasing Manager’s Index  
Corresponds to period from Mehr 1387 to Aban 1398

![Graph of Iran Purchasing Manager’s Index](image)

Strength in the manufacturing sector is also crucial to Iran’s ability to grow non-oil exports, which are expected to reach $42 billion this year, having averaged around $3.5 billion per month in the first half of the current Iranian year.11

7. Unemployment

*Led by the services sector, the Iranian economy is adding jobs.*

A key source of Iran’s economic resiliency is the large size of its services sector. The services sector has created new employment every year since 2015. Last year, as the Iranian economy contracted 4.9 percent, the services sector actually managed to grow a small, but remarkable, 0.02 percent.

The underlying drivers include the modernization of the Iranian economy, particularly through the adoption of new digital technology. But the growth also reflects an increase in self-employment, particularly among the lower classes, as individuals adapt to job losses in manufacturing and construction. The manufacturing sector has also contributed to the more positive outlook for job creation. In the same period in which PMI substantiates a
recovery in manufacturing, data from the Statistical Center of Iran shows that the manufacturing sector has added around 450,000 jobs.\textsuperscript{12} Overall, the growth in services sector employment means that 2019 marks a new record for the number of Iranians in employment at just under 25 million. Nonetheless, chronic employment remains high and the economy is not producing enough jobs, particularly high-quality jobs, to address the country’s demographic burden.

**CHART 7:** Iran Employment by Sector

8. Poverty

*Increased poverty rate strains state-society relations, as shown in recent protests.*

Despite the resiliency being shown in key areas of the economy, the significant economic contraction over the last two years has had a marked impact on Iran’s poverty rate. Last year, 1.6 million Iranians fell into poverty as inflation eroded household purchasing power, undoing several years of progress under the Rouhani administration in lifting households out of poverty.

The controversial decision to reduce fuel subsidies is best understood as a measure to counteract these trends. The move is part of a decades-long effort in Iran to reform the welfare state, and the specific proposition of reducing oil subsidies was earmarked in the current five-year development plan and also recommended as part of the IMF’s Article IV
consultations which concluded earlier this year. Irrespective of the controversial implementation of the policy and the tragic, violent response to the subsequent protests, the economic logic of the fuel subsidy move is sound. Projections by economist Djavad Salehi-Isfahani suggest that the new cash transfers could meaningfully impact Iran’s poverty rates.  

**CHART 8: Estimated Impact of Cash Transfers on Poverty Rates**

The elimination of the fuel subsidy in favor of more targeted cash transfers is projected to decrease the poverty rate in Iran by 2.6 percentage points—the equivalent of raising 2 million Iranians out of poverty. The cash transfers are to be distributed to around 70 percent of Iranian households, covering approximately 60 million individuals. For the middle class, the cash handout will mostly nullify the welfare loss related to the increased price of petrol. But for the poor and working classes, representing 40 percent of all households, the cash transfer should actually increase per capita expenditures.

Notably, nearly all of the fiscal space created by the reduction of the fuel subsidy will be used to fund the new cash transfers. This lends credence to the idea that the move was principally about poverty reduction, and not about finding savings, which the government could apply to other areas of the budget.
9. Conclusion

In recent remarks, Iran’s First Vice President, Eshaq Jahangiri acknowledged that “The Americans have in the true sense blocked the key bottlenecks of our country’s economy.”\(^{14}\) Iranian officials have increasingly admitted the immense difficulties they face as they seek to insulate the Iranian public from the Trump administration’s “maximum pressure” sanctions campaign while also seeking to address widespread frustrations over economic mismanagement and corruption.

As sociologist Kevan Harris has observed, Iran is a “developmental state.” It is an overlooked fact of state-society relations in Iran that the economy is the fundamental issue around which the Islamic Republic has accrued legitimacy—it’s economic model has successfully improved the living standards of Iranians over the last four decades.

This legacy of progress is now threatened. In the short-term, should trends from the last six months hold, Iran’s economy is poised to rebound from this year’s sharp contraction. But in the medium-term, years of economic stagnation will still prove politically problematic for the leadership of the Islamic Republic. Political resiliency will require a viable model for economic development—even in the face of U.S. sanctions. That model remains unclear, even if large sections of the economy, such as the services and manufacturing sectors increasingly driven by private sector firms, continue to strive towards greater economic productivity. The interplay between oil sales, foreign exchange earnings, inflation, trade, manufacturing activity, unemployment rates, and poverty described in this report point to the fundamental dilemma of economic development in Iran. What the events of the last year show us is that the dilemma facing Iran’s leadership is not whether they can ensure Iran’s economy will survive, but whether it can thrive.

Works Cited

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