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ROBERT MOGIELNICKI *Comment*

Stagflation and high unemployment have led Iran to raise fuel prices – resulting in violent protests. But while US sanctions are not helping, Iran must tackle serious economic reforms, says the resident scholar of the Arab Gulf States Institute.

Protests in Iran over new fuel pricing measures introduced in November 2019 quickly evolved into violent confrontations between the regime and Iranian protesters. According to some observers, the unrest reached levels not witnessed since the Islamic Revolution in 1979. Officials from US president Donald Trump's administration viewed these protests as evidence that the 'maximum pressure' campaign against Iran is weakening the regime. The US strategy to inflict a heavy economic and political toll on the Iran through a coordinated sanctions policy is unlikely to change during the early months of 2020.

Although US sanctions on Iran have exacerbated the country's deteriorating economic situation, the precise objective of the sanctions policy remains unclear. Iran's decision to resume uranium enrichment at its underground Fordow nuclear plant further obscures a pathway out of the crisis between the two countries. With Mr Trump potentially remaining in office until 2024, the prospects for a durable agreement between the US and Iran appear remote.

The Iranian economy therefore faces more risks than opportunities in both the short and the medium term. Moreover, the Iranian regime will struggle to contain the impact of long-term, structural issues on immediate political and economic dynamics within the country.

THE IMPACT OF SANCTIONS

Since November 2018, US sanctions on Iran have predominantly targeted the country's crude oil exports, which account for about 30% of the government's fiscal budget for 2019-20. Iran's public sector has worked hard to become less dependent on oil revenues: the petroleum sector accounted for about 60% of government revenue in 2009. Iranian officials assert that the country continues to sell crude oil. However, with fewer countries willing to import Iranian crude, Iran adopted more desperate measures, such as storing oil in Chinese bonded zones and opaque oil transfers through illicit trading channels.

Iranian crude oil and condensate exports peaked at 2.7 million barrels per day in June 2018. More recent estimates of Iranian crude oil exports range from just 200,000 barrels to 500,000 barrels per day, according to assessments by the International Energy Agency and the US Treasury Department. The country's budget for 2020-21, announced mid-December, envisages a 40% drop in oil, gas and condensates revenue compared with the previous 12-month period. The expanding scope of sanctions covers other important industries, such as petrochemicals and steel, with new measures announced in December 2019 against the country's biggest shipping firm and largest airline.

Most attempts to mitigate the negative impact of sanctions on the economy have flopped. In 2018, Iran banned about 1400 non-essential goods in an effort to boost domestic manufacturing and shore up foreign exchange reserves. The government plans to manufacture $11bn-worth of cars and electronic products as part of an import substitution scheme, in addition to doubling exports to 15 neighbouring countries. The European-led Instrument in Support of Trade Exchanges and its Iranian counterpart, the Special Trade and Finance Instrument, have done little to boost trade between Iran and Europe.

Russia, meanwhile, has offered to share its knowledge of sanctions circumvention and corresponding technical expertise with Iran. The Russian Association of Cryptoindustry and Blockchain and Iran Blockchain Labs, a research centre connected to the Sharif University of Technology and the Central Bank of Iran, signed an agreement in 2018 for Russian developers to help build Iran's emerging crypto sector. Though part of a broader, long-term strategy to combat US sanctions, the initiative offers no immediately viable path to global financial integration.

ECONOMIC GRIEVANCES

Meanwhile, economic conditions continue to deteriorate. Iran's economy is beset by stagflation – a combination of low growth, rising prices and high unemployment. The International Monetary Fund (IMF) projects that Iran's economy will contract by 9.5% and that the

inflation rate will reach 35.7% in 2019. Price increases for essential items are often even higher.

Beyond high inflation, political instability and risk aversion have led to the precipitous depreciation of the Iranian rial. The Iranian currency's value fell from IR43,000 against the dollar in early 2018 to a low of IR190,000 in September 2018.

Other socioeconomic issues pose future challenges to the regime. Unemployment, for example, may be reaching a tipping point. The World Bank measured youth unemployment at 28.3% in June 2018, and unemployment among university graduates is even higher. These figures, along with protests, are likely to increase as long as US sanctions are in place. The country's unemployment rate reached 16.8% in October 2019 and may exceed 20% by 2024, according to the IMF.

Skilled Iranians with the means to travel internationally seek opportunities in more robust labour markets, leading to labour shortages in strategic segments of Iran's economy, such as the healthcare industry. Older Iranians worry about their pensions and retirement funds becoming insolvent in the absence of government support. Iran's vice-president noted that the government pays for between 70% and 80% of the country's retirement funds and that armed forces pensions funds are financed entirely by the government.

THE WEIGHT OF SUBSIDIES

While the November unrest emerged during a sensitive economic period, it is important to note that public opposition to energy subsidy reform is a familiar feature of Iran's political landscape. Protests broke out in 2017 and 2010 when respective presidents Hassan Rouhani and Mahmoud Ahmadinejad attempted to restructure the country's system of blanket subsidies.

Reform to such programmes has been badly needed for some time. Fossil-fuel consumption subsidies in Iran reached 15% of gross domestic product during 2018, with subsidies for oil costing $26.6bn, according to the International Energy Agency.

The Iranian regime responded to the November 2019 protests with a combination of repressive tactics and financial incentives. On the one hand, the government detained thousands of people, used lethal force against hundreds of protesters, and shut down the internet for five days – a move that placed further constraints upon an ailing economy. On the other hand, the government initiated the implementation of cash transfers to Iranian households and promised additional transfers to millions of Iranians in the coming months.

FRAGILE FINANCIAL SECTOR

The sustainability of this and other Iranian government spending initiatives depends on a stable financial system. Yet Iran's banking sector is fragile – partly because of the heavy state involvement in the country's lenders – and faces a host of inward-oriented risks. The non-performing loan ratio of the country's banks reached an estimated 11.4% in 2017. Meanwhile, estimates of capital adequacy ratios of Iranian banks average 4.9%, significantly lower than recommended levels.

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While there has not yet been a run on the country's banks, it is unclear how long the Central Bank of Iran (CBI) can continue to supply debt to lenders. The CBI has limited tools at its disposal for conducting monetary policy, and is itself subject to US sanctions.

Yet comprehensive reforms to Iran's financial system are unlikely to occur amid the current economic crisis. The country's foreign exchange reserves are dwindling, further complicating the government's ability to pay off trade debt and stabilise the rial. The IMF estimates the gross international reserves held by the central bank to be about $85bn, significantly lower than the $118bn held in 2013. The central bank has proposed a redenomination to tackle rising inflation and the depreciation of the national currency, and the government is in the process of determining how this financial reform might unfold.

Given the lack of confidence in local lenders, Iranians have experimented with other avenues for protecting their savings. Domestic investors have pumped capital into Iran's stock market, which consequently outperformed many global counterparts in 2019. A smaller group of Iranians have experimented with crypto assets as a vehicle for facilitating payments and storing domestic savings. The Iranian government and central bank, however, are sceptical of crypto activities, and consequently the legality of domestic transactions in foreign cryptocurrencies and cryptocurrency mining remain in flux.

A POST-TRUMP ERA

Mr Trump's eventual departure from office (whether in 2020 or 2024) may ease the immediate fiscal constraints facing the Iranian regime. However, a temporary change in US sanctions policy is not going to address underlying weaknesses and distortions in Iran's government programmes, labour market and financial system. The removal of sanctions would be a positive step toward better integration into the global trading system, but well-founded concerns over Iranian banks and other commercial entities will not simply disappear overnight.

The Trump administration's withdrawal from the Iran nuclear deal demonstrated the fragility of international agreements under the current administration. Iran should do its best to prepare for a post-Trump era by getting its house in order. Nevertheless, Mr Trump and hawkish officials in his administration will do their best to frustrate any such efforts. TB

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