Iran Adapts to Sanctions in the Absence of New Measures

by Patrick Clawson

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Over time, Iran adapts to any level of sanctions. And Iranian authorities have repeatedly persuaded themselves that the United States is "sanctioned out," i.e., that Washington cannot step up the pressure. Continuously adopting new measures is the best way sanctions can effectively move Iran's leaders to resolve the nuclear impasse.

Iran's Plan A is No Nuclear Deal

Iran's new budget shows that the authorities see no urgent need for relief from the current sanctions. They correctly feel that they have learned to live with those sanctions. The 2015/16 budget submitted to the Majlis by President Hassan Rouhani is based on 1.3 million barrels a day in oil exports, only slightly above the average level in 2014 – a rise which is consistent with the Joint Plan of Action as interpreted by the Administration, in that Iran expects to increase its exports of oil condensates which the Administration does not consider to be crude oil. Iran's proposed 2015/16 budget also does not assume any sharp pickup in economic activity, such as some have forecast would occur in the aftermath of a nuclear deal.

Instead of assuming sanctions relief, the new budget proposes a range of painful measures to live with the existing situation, such as increased taxes and continuing erosion of both government salaries and the monthly payment to families introduced when subsidies were slashed in 2011. These will be painful measures, hitting hard at Iran's middle and lower classes. They would come on top of several years of impressive adjustments which go far beyond anything the International Monetary Fund has recommended to hard-hit countries like Greece. In effect, the 2015/16 budget continues the path of recent policy: do what is needed to reduce vulnerability to external pressure, even if that imposes great pain.

And the budget-balancing measures are not paper solutions like those favored by former president Mahmoud Ahmadinejad. Instead, the Rouhani government has been implementing real steps to improve tax collection and has announced plans to increase tax rates. It has also been getting tougher about those (mostly industrial firms) not paying the higher electricity and natural gas rates adopted in 2012. Another sign that the budget is a serious document is that rather than unrealistically underestimating spending, the government has left room for priority expenditure increases, which in this case means dramatically higher spending for the military and intelligence apparatus.

The budget made what seemed when it was proposed in early December the conservative assumption that the price of oil in April 2015 to March 2016 would average $72 per barrel oil. For 474 million barrels of oil exports (1.3 million barrels a day), that would generate $34 billion. When the price of oil declines, that hits Iran's budget hard. That is true irrespective of sanctions which complicate Iran's access to its oil export earnings. Those sanctions impact how Iran manages its foreign exchange, which is an entirely different manner from budget revenue. When the National Iranian Oil Company (NIOC) sells oil abroad, it earns dollars which it then hands over to the Central Bank of Iran (CBI) in return for Iranian rials. The CBI faces the challenge of how to manage those dollars, that is, how to ensure that Iranians wishing to import goods have access to the dollars they need. Meanwhile, NIOC takes the rials provided by CBI and, as provided by law, deducts 14.5% for its expenses, and hands the rest to the government. The government, by law, deposits 20% of the total export earnings in the National Development Fund of Iran (NDFI), directs 2% to the provinces, and uses 63.5% for the budget. Under that formula, the budget's share of 1.3 million barrels a day at $72 a barrel is $21.7 billion.

Faced with the oil price decline, Iran is preparing to take additional measures. **On January 15, Economic and Finance Minister Ali Tayeb Nia announced that a revised budget would be based on $40 per barrel oil** – which is well below what the U.S. Department of Energy and most observers predict will be the average price in the period April 2015 - March 2016. Iran has many alternatives available for adjusting to such a price level. Besides reducing expenditures and raising taxes, the two most obvious are:

Suspending payments into the NDFI. The NDFI is partly a rainy day fund, which was the explicit purpose of its predecessor, the now effectively defunct Oil Stabilization Fund (the NDFI is also partly a reserve fund for the post-oil future). If the government suspended payments into the NDFI, then in order to produce budget revenue of $21.7 billion, NIOC would have to sell only $26 billion in oil, which means an oil price of $55.

Depreciating the currency, which would generate more Iranian rials for each dollar of oil exports. The Rouhani government has kept the dollar/rial rate more or less constant. That is inappropriate given that Iran's high inflation rate drives up costs for Iranian producers. A constant exchange rate makes domestic products more expensive relative to imports and makes exporting less attractive. A better policy would be to let the rial depreciate in line with inflation. The budget assumes a very modest decline in the exchange rate to IR28,500 per dollar compared to IR26,500 now. At that level, the $21.7 billion in oil export revenue for the budget produces IR618 trillion.[1] If instead the exchange rate declined to reflect the inflation of the last two years, the rate would be at least IR40,000 per dollar. That would stimulate production in Iran, both for exports and to replace imports. It would also generate the IR618 trillion for the budget from $15.5 billion, which would be the equivalent of an oil price of $52 per barrel if the government continues payments into the NDFI or $39 if it suspends those payments. In the likely situation that the oil price were higher than $52 (or $39), then the government would have room to increase spending a bit to accommodate the higher prices post-depreciation.

In addition, the government could draw down the balance in the NDFI, though it is not clear how much remains in that account. Or it could simply borrow more at home (it claims the current

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[1] Among the many complications in analyzing Iran's budget, the oil and gas revenue figure it shows is partly from sales at home. So not all of the projected IR711 trillion comes from oil exports.

budget is balanced, but that is by using creative accounting). Iran's government has much room to borrow. Iran's government debt is low. Rouhani's finance minister, in his complaints about what a terrible situation he inherited, has claimed that the government debt was run up to 25 percent of GDP, which is probably an exaggeration, but even if true is only a third of the U.S. level. Vast sums sit in the various public pension plans, all of which have been and could be again drawn on to fund government programs (usually off-budget programs). And if that is not enough, Tehran can rely on the banking system – almost all government-owned – to carry out what is in reality government spending loans, much as the Ahmadinejad administration did with the massive Mehr social housing program.

So Iran can finance its government despite sanctions and low oil prices. It can also generate the foreign exchange it needs to pay for imports, so long as it can access that foreign exchange. The last year for which we have solid numbers, thanks to the International Monetary Fund, is 2013/14. In that year, non-oil exports of goods and services generated $46 billion, when imports of goods and services were $73 billion. That left a gap of $27 billion, while Iran's foreign exchange reserves at the start of the year were $104 billion. With modest oil exports, Iran was able to increase its reserves in 2013/14. Iran's statistics for what is happening in 2014/15 show that non-oil exports are up, imports are down, and reserves are up – all of which fits well with what we know about how Iran's economy is performing. So Iran has less and less need for oil export earnings to pay for imports. And if Iran can export 474 million barrels of oil even at a price as low as $40 per barrel, that would produce $19 billion, which – if available for Iran to use – would probably be close to enough to fill the gap between imports and non-oil exports. Or looked at another way, Iran's reserves are enough to fill that gap for about five years even without any oil exports, if Iran has access to those reserves.

Of course, the foreign exchange problem Iran faces is that it has only limited access to its oil export proceeds and to its foreign exchange reserves, thanks to restrictions by the United States and its allies on Iran's access to international financial markets. Iran's excellent trade balance and substantial reserves show how the restrictions on its access to financial markets are the most effective pressure point on the Iranian economy. Those restrictions have remained effective only because new measures are continuously being taken – both enforcement steps aimed at new shadow entities and extension measures blocking channels Iran is using to evade restrictions on the usual paths for financial transactions. Iran has shown great creativity at evading financial restrictions. Standing still means falling behind: constantly taking new steps is the only way to keep up with Iran's latest evasions.

Resistance Economy?

Convincing Supreme Leader Ali Khamenei to pay attention to sanctions is not easy. He does not care much about the economic well-being of Iranians, especially when his closest supporters are doing well. That is part of the reason he has supported tough adjustment measures, despite the pain they inflict on the lower and middle classes. But he firmly believes that Iran would be better advised to adopt what he calls a "resistance economy."

Khamenei's call for a "resistance economy" is mostly nonsense but partly good advice. The nonsense is that Iran should, or can, cut itself off from the world economy. The pursuit of self-sufficiency has led into one dead-end after another. High barriers to imports has protected inefficient Iranian producers, raising prices for consumers and creating opportunities for corruption by those who can use political ties to get imported goods at a fraction of the price at which those goods are selling on the local market. Those who benefits from the barriers to imports form an important, politically well-connected group which are scared at the prospect of Iran opening up to the world. They fear that lessened political tensions with the West will mean a more open economy in which they will do poorly. Because of the political strength of this group, it is not easy to make sanctions painful enough to overcome hardline objections to resolving the nuclear impasse.

The good advice in Khamenei's call for a "resistance economy" is his call for Iran to rely less on oil income. Iran is richly endowed with many resources, not least its talented and increasingly well-educated work force. To a considerable extent, Iran used the last decade's oil windfall to expand its non-oil economy, including substantial export-oriented activities from iron mining to high-value fruit agriculture, petrochemicals, and light industry. Iran now has a better-rounded middle-income economy in which oil is important but by no means all-important, with oil's role dropping by the year. That is a sound economic policy for many reasons: it creates jobs, it makes the economy less vulnerable to oil price swings, it rewards productive economic activity instead of influence-peddling, and it makes Tehran less and less vulnerable to oil-centered economic sanctions. Of course, the transition has only gone part-way: government revenue and export earnings are still oil-intensive, and oil income still fuels breath-taking corruption. But the Islamic Republic looks more and more like the Shah's economy: a vibrant non-oil economy with oil providing the lubrication for a corrupt government bent on regional domination.

The "resistance economy" strategy – both the parts that hurts Iran's economic development and the parts that help it – reduces the impact sanctions have on the thinking of Iran's leaders. That fact should cause us to redouble our efforts, not to give up.

Ratchet Up the Pressure

Sanctions are more likely to have impact, both on Iran's economy and more importantly on its political leadership if they continuously get tougher. We need to convince Iran's leaders that the longer the nuclear impasse persists, the worse the pain will be.

Like many of us, Iran's leaders are naturally optimistic. Frequently, they have thought that the United States was "sanctioned out," that there were no new measures that Washington could apply on Tehran. The early Obama administration well understood how constant tightening of sanctions sent a clear message that the nuclear impasse would get costlier and costlier. Their approach was to use three simultaneous avenues for tightening sanctions:

First and foremost was tougher enforcement of the measures nominally in place. The Obama administration continued and intensified the Bush-era initiatives to vigorously pursue financial institutions which were ignoring U.S. sanctions regulations. The resulting billions of dollars in fines collected from banks has had a dramatic impact on the attitudes in the financial community, which have decided that transactions with Iran are not worth the risk.

In addition, the Obama team pushed hard for allies to step up their sanctions on Iran, helped by the outrageous rhetoric from the Ahmadinejad administration. The careful incorporation into the 2010 UN Security Council Resolution 1929, building on the 2008 Resolution 1803, of language about "exercising vigilance" about a range of Iranian activities provided a way to present the complementary measures by allies, especially the European Union (EU), as being within the framework of Security Council actions, something important for many of those allies. The quiet support from many other governments to U.S. restrictions on financial transactions strongly influenced financial institutions to fall in line with those restrictions rather than to complain about U.S. perceived extraterritorial action.

And new sanctions were adopted that built on and extended existing sanctions. Repeatedly, the Administration complained about new sanctions measures being considered by Congress only to proclaim, months after similar measures were enacted into law, that such steps had been important contributions to Iran's leaders' reconsideration of their previous stance.

We can debate the relative contribution of each of these approaches. In any case, the end result was to shock Iran's leaders at our ability to turn up the heat, as well as to feed popular discontent with a hardline nuclear stance perceived correctly as standing in the way of Iran taking advantage of the many opportunities that greater integration into the world economy offers it.

Our challenge now is to find a new mix of policies that will once again shock the Iranian leaders. A powerful assist to this end has come from an unexpected direction, namely, the ample supply conditions in world oil markets. To a person, Iranian leaders are convinced that the recent oil price decline has been a deliberate Saudi-American plot to harm the Islamic Republic. Saudi Oil Minister Naimi's several interviews proclaiming that oil prices may have to go much lower and stay there for a prolonged period, irrespective of the impact on Iran among others, is read as proof of the political motivations behind the price decline. Khamenei's extended January 24 remarks on how the oil price decline was an American-sponsored plot against the Islamic Republic drew his usual policy recommendation: "blows will be met with blows."

The historical analogy which resonates with the current generation of Iranian leaders is the 1986 price collapse (when the Dubai spot crude price fell from $27.53 per barrel in 1985 to $13.10 in 1986 and stayed at about that level for years). The resulting loss of revenue was a central element in Iran's decision that it could not afford to pursue the war with Iraq, which had to be abandoned with little show for 150,000 Iranian dead. Iranian leaders have always thought that the Saudi decision to step up oil production from 3.6 million barrels per day in 1985 to 5.2 million in 1986, which was the main reason for the price collapse, was aimed at the Islamic Republic, as part of the multifaceted Saudi effort to stave off Iran's battlefield successes against Iraq.

It is no secret that the Saudi leadership wants to see Iran pressed harder, both to resolve the nuclear impasse and to pull back from Iran's active role supporting Shia fighters in Syria, Iraq, and Yemen (and the Saudis would add, Bahrain). That fact and their reading of the 1980s history only contributes to the Iranian leaders' conviction that the Saudis are doing what they would do

were they in the Saudis' shoes, namely, driving oil prices lower to press Iran. We may doubt that this is an accurate reading, but both in public and in discussion with Tehran, the U.S. government should hint that low oil prices are part of Washington's plan. Since people in the Middle East are often ready to see the United States as all-powerful, we should find ways to make that work to our advantage. If we can get credit for the sun rising in the east, take it.

Just as the years of high oil income were a good time to shock Iran by showing the high price it paid for not being able to export much of its oil, now is a good time to shock Iran by showing that since the world economy does not need their oil, we are prepared to take tougher measures against Iran unless the nuclear impasse is resolved. The impact of the last rounds of sanctions has faded; a new round is needed to show that the United States is not "sanctioned out." My intent today is not to address what should be the character of that new round of sanctions; my role instead is to point out why it is needed.

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