

FPC Briefing: Iran's Economic Crisis-On the Verge of Change?

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Economic conditions in Iran have brought the people out into the streets of Tehran once more, and in doing so have raised questions about the government's ability to stave off continued internal and international pressure. However, the current crisis has been building for some time as a combination of stultifying economic sanctions, inefficient economic policies, reliance upon the rent received from oil², and the addition of non transparent actors have weakened the financial infrastructure. A tipping point was reached after January 2012 when the EU announced further sanctions, stopping its members from buying Iranian oil, a considerable source of revenue for Iran and a means to obtaining foreign currency.

The failing economy is in part then a symptom of the international sanctions, and therefore they could be considered as fulfilling their objective. However, the humanitarian conditions are also worsening and caution should be aired in regards to tightening the noose. It is the Iranian people after all who are most affected by these circumstances, but we cannot predict which way popular momentum will shift after a suggested period of chaos. Further intervention (militarily or economically) could therefore paradoxically galvanise the regimes relationship with its people or promote a more hard line approach, when at present a degree of disaffection already exists. It is in the best interest of the international community then to adopt a 'watch and wait' strategy during this precarious time, as allowing sufficient space for the Iranian people to recognise their financial plight would create a more local interactive response.

As this paper will highlight, irrespective of sanctions the Iranian government has mismanaged its economy for over three decades which has culminated in the imposition of irregular financial mechanisms plus non transparent activity. So while relations with Iran are currently predetermined by the continued presence of its nuclear programme and the rhetoric it uses towards the West and Israel in particular, we should be reminded that the economic policies it has established do not support long term sustainability or good relations with its own people.

Financial Background

In trying to avoid the Washington consensus, Iran has instead implemented a series of rigid policies that have failed to maintain a balance between banking sector growth and society's needs. To understand this, we can pinpoint three events after the 1979 revolution that have been particularly significant for Iran's financial sector; nationalisation, Islamisation and privatisation.

Firstly, in response to the Western orientated policies of the Shah, the banking sector was nationalised which led to the number of banks being reduced from thirty six to nine³ and subsequently divided into two areas, commercial and specialised (specialised banks attend to industrial needs such as agriculture, mining etc.).

¹ Stephen Royle is a PhD candidate at Lancaster University. Some of this research stems from a working paper titled '*Islamic development thinking after the global financial crisis: Shaking the 'consensus' or mimicking it?*', (S. Royle, R. Geyer, 2012).

² In 2008 accounted for almost 80% of the total. Not only has this exposed Iran to price fluctuations leaving the government with reported deficits of up to US\$30 billion and foreign debt of US\$28 billion, its export has been seriously affected by international sanctions (see K. Katzman, 2010, Iran Sanctions, Congressional Research Service, Feb 2nd 2010, <http://fpc.state.gov/documents/organization/138727.pdf>, Rahigh-Ashan, A. and Jakobsen, P. V. 'The Rise of Iran: How Durable, How Dangerous?', Middle East Journal, Vol 64, No 3, 2010, pp 559-573).

³ Khan, M. S. and Mirakhor, A. (eds) (1987) *Theoretical Studies in Islamic Banking and Finance*, Houston-Texas: The Institute for Research and Islamic Studies, 1-13)



Secondly, Iran's version of 'Islamisation' saw the creation of the 'Law of Usury Free Banking' (1983) which led to the establishing of Islamic banking in 1984⁴ and permitted depositing and crediting without the payment of interest, promoted through the method *qard al Hasan*⁵. However, in what Ibrahim Warde⁶ describes as a '*curious element of the official banking system*', depositors are offered incentives in the form of prizes, gifts, lottery draws and even preferential treatment when seeking a loan, as a replacement for interest payments.

The Central Bank of Iran (Bank *Markazi*)⁷ is controlled by the government and holds precedence over the rate of charge, rate of minimum profit and the percentage share of profits a bank can take from an agreement. In the latter case, this means that whilst a bank may have contributed capital of up to 95% for a given project it may only be able to claim 50% of this as profit. And while Ehsan Zarrokh⁸ believes this enables '*policy makers in setting the economic priorities of the country*', akin to separating the macro from the micro, it has also reduced the profit making mechanisms of the banking sector. For Amir Naghshineh-Pour⁹ the ignoring of free market supply, demand and inflation (maintenance of low interest charges in the face of high inflation for example) has resulted in structural irregularities within the banking system. Customers therefore have had little incentive to invest or save in the face of an overt 'borrowing market' and with deposit accounting failing to attract significant numbers to cover costs, debt has begun to spiral. By 2008 non-performing loans reached US\$17.8 billion, a situation that Iranian economic advisor Massoud Rad stated could '*make most banks bankrupt if there was an effective auditing system*'¹⁰. By 2009, the Iranian Labour News Agency (ILNA) reported that the total debt of state run banks had exceeded US\$32 billion, with Commercial bank 'Bank Melli' accumulating US\$9 billion of this¹¹.

In view of this potential banking sector collapse the third and final significant event aimed to recapitalise the banks under the Privatisation Law of 2008. While inefficiency and debt accumulation were heralded as reasons for this change, the process has not occurred without issues. As Central Bank Governor Mahmoud Bahmani stated;

*"Of course, the reality must be accepted that the opening up of the banking system's resources sack in the past few years has brought them (the banks) to the brink of crisis."*¹²

The Reality

Regardless of the restrictive international sanctions, efforts to increase efficiency have remained limited and as of yet there is a general reluctance to allow all banks to be 'privatised' (commercial or special). Also, attempts by the Central Bank to increase charge rates as a way of stymieing inflation resulted in the removal of two governors between 2008 and 2010¹³. By October 2012, failure to attend to this trend was made evident when Iran's rial lost approximately 40% of its value against the US dollar¹⁴.

⁴ (See Zarrokh, E. 'Iranian Islamic Banking', *European Journal of Law Economics*, 29, 2010, pp188)

⁵ Non interest and mostly free of charges but sometimes with a small administrative charge attached.

⁶ Warde, I. (2000), *Islamic Finance in the Global Economy*. Edinburgh University Press: Edinburgh, pp120.

⁷ Its general role is the design and implementation of monetary and credit policies. In doing this it also has the responsibility of; issuing notes and coins, supervising banks and credit institutions, regulation of foreign exchange and transactions, regulation of gold transactions and the regulation of domestic currency transactions (Central Bank of Iran, 2011, http://www.cbi.ir/default_en.aspx).

⁸ Zarrokh, E. (2010), 29, pp 189.

⁹ Naghshineh-Pour, A. 'Iran's Banking and Monetary Problems', MPRA Paper No, 15790, June, 2009, pp 3, <http://mpra.ub.uni-muenchen.de/15790/>.

¹⁰ Financial Times, 4th May 2008, <http://www.ft.com/cms/s/0/0d4f774a-aa9e-11dd-897c-000077b07658.html#axzz28ndeQop3>.

¹¹ Press TV, September 27th 2009, <http://edition.presstv.ir/detail/107273.html>.

¹² Reuters, January 25th, 2010, *Iran banks have \$48 bln in bad loans -cbank*. Taken from [http://www.dailystar.com.lb/Business/Middle-East/Jan/26/Iran-banks-have-\\$48-billion-in-bad-loans-report.ashx#axzz20nCIBKAS](http://www.dailystar.com.lb/Business/Middle-East/Jan/26/Iran-banks-have-$48-billion-in-bad-loans-report.ashx#axzz20nCIBKAS).

¹³ Fielding-Smith, A. (2009) Iran's credit crunch, *New Statesman*, 138(4944).

¹⁴ Gulf in the Media, 5th October 2012, http://gitm.kcorp.net/index.php?id=617767&news_type=Top&lang=en.



In Iran's case, apathy towards change and a preference for nationalisation under an Islamic pretext is not solely related to social responsibility. In truth, the infrastructural issue has been aided in part by the 'Bonyads' and the Revolutionary Guard Corps (IRGC) whose control over aspects of power and money would decline without the status quo¹⁵. The Bonyads in particular, or as Ilias refers to them as '*semi-private charitable Islamic Foundations or trusts*'¹⁶, have an interesting role in the economic development of Iran. Although they report to the Supreme Leader they are not accountable to parliament or any financial regulatory body, but have nevertheless gained from the 'privatisation' process, significantly more than private enterprises¹⁷.

Instead of confronting these issues, President Ahmadinejad and his government have chosen to limit credit supply and maintain low charges, a potentially hazardous move considering poverty levels¹⁸ and the need for credit access. As a way of improving cash flow, foreign investment would provide stimulus to help the economy recover and as of 2009 the financial sector was opened up to foreign banks, but with sanctions ever present this area of potential growth remains unlikely at present.

Conclusion

Iranian society suffers because of both international and internal policies that apply a high degree of rigidity, which in turn imposes upon the freedom of the people and therefore their ability to interact within the changing economic climate. Nonetheless, the Iranian government's unwillingness to address its financial shortcomings and commit to sustained dialogue at the international level will continue to affect its relationship with the Iranian people. We cannot be certain that this will lead to change but there is enough evidence to suggest that waiting and watching these developments may prove fruitful in the long term as the economic situation shows few signs of improving within the country.

¹⁵ Rahigh-Ashan, A. and Jakobsen, P. V. Vol 64, No 3, 2010, pp 568.

¹⁶ Ilias, S. (2010) Iran's Economic Conditions: U. S. Policy Issues, DIANE Publishing, pp7.

¹⁷ Ibid, pp 8.

¹⁸ According to Iran's Department of Statistics (2010), ten million people (approximately 8%) live under the 'absolute' poverty line and 30 million (approximately 24%) under the 'relative' poverty line (see <http://www.payvand.com/news/10/may/1316.html>).