



LEGATUM
INSTITUTE

GLOBAL
TRANSITIONS

www.li.com
www.prosperity.com

FUTURE OF IRAN | ECONOMY | SEPTEMBER 2013

Curing Iran's Sick Economy: An Investor's Vantage Point

by Shahriar Ahy



Curing Iran's Sick Economy: An Investor's Vantage Point

ABOUT THE AUTHOR: Shahriar Ahy

Shahriar Ahy is an organiser of Unity for Democracy in Iran. Together with Kambise Rousta, an intellectual father of the Iranian Left, Shahriar was a co-founder of Solidarity Iran.

Shahriar was the Chief Executive and the Chairman of the Executive Committee of ARA Group International ("AGI"), a media holding company whose daughter companies included United Press International. Shahriar was the co-founder of the Baltic Fund, the first private sector investment fund set up for the Baltic States. Alongside the Baltic Fund, Shahriar was also on the Board of the US-Baltic Foundation.

Shahriar holds a PhD from MIT; his thesis was based on a regression model that predicted the pricing policies of the members of the Organization of Petroleum Exporting Countries.

This working paper was produced for the Legatum Institute's workshop on Economic Reform in October 2013. The workshop was part of 'The Future of Iran' project, which is designed to encourage Iranians to begin thinking about the challenges they will face if, or when, they suddenly find themselves in a position to carry out major political, social and economic reforms.

You will know Iran's economy is on the road to recovery when the first international Iran investment fund is set up. Why? Because launching a "country fund" is predicated on answering a list of questions that best describe the risks and rewards of having a productive enterprise there. If the risk/reward calculus does not add up, it is groundless to expect increased production. What follows is a framework for analysing those questions and their systemic interrelationship.

Critics

Before proceeding, however, two angles of attack against the approach here must be acknowledged: One comes from unreconstructed socialists who have an allergic reaction to investors' views. But they do not seem to live in a world where the largest communist economy, China, has based its planning on attracting foreign investors, without whom modern management and productive technology transfer would have been impossible. Though unrealistic and effete, critics of foreign investment are not without political success in Iran. Their misguided notions underpin the idea of a "Resistance Economy" touted by Ayatollah Khamenei.

The second angle of attack comes from those who say all we need is the removal of sanctions and the generation of more oil income. Their math is weak. For if Iran was like Saudi Arabia, with a third of its population and five times its oil export capacity, perhaps it could afford an unproductive economy. But even Abu Dhabi, with higher oil income, an even higher sovereign wealth fund and a native population one ninth of Iran's, does not believe it can afford an unproductive economy. Witness its leading investments in zero-carbon productivity in Masdar City.

Many of those who drive the second angle of attack are less innocent and more insidious than they seem. They are Putinists, to borrow from Anne Applebaum. They want a strong state in control of a weak private sector, with all of the latter's uncertainties and correlation with independent civil society. Oil income has been the most effective

economic instrument of Putinism, not just to control potentially independent domestic centres of economic power, but also to purchase international influence.

If the enigmatic architect of the Islamic Republic's Intelligence organisation, Saeed Emami, died too early to become Iran's Andropov, his students are succeeding in sidelining cruder totalitarians. Their success in the recent Iranian Presidential elections was in no small measure due to convincing Khamenei that the proponents of the Resistance Economy, the wild and unruly "Baseejis", whose style imbued the Ahmadinejad era, were too shaky a foundation for stable control in the Islamic Republic.

Having defeated their unruly radical rivals, the Putinists have now turned their attention to rivals who want to liberalise the economy and external relations. For their obsession is control, their fear is freedom.

The Framework

The framework for Iran's economic recovery has four sides. Ignoring any one of them will undermine the effect of improvement in others.

1. Macroeconomic Management

There is a bomb ticking in the Iranian economy. It is the bursting money supply - about seven times what it was when Ahmadinejad became president. In other words he added six times the money supply created since the beginning of history. Since gross domestic production (including oil) has not increased, prices have to grow by about 100% of the levels at the time of his inauguration, every year for six years, in order to return to equilibrium. Should domestic production continue to fall and oil exports reduce further, the bomb may explode in the form of Argentinian-like inflation where no one would want to hang on to the massive overhang of the domestic currency.

There is a common misconception that the money supply growth was due to cash subsidies distributed to all Iranians. However, money supply growth in the years after the subsidies was less than before the subsidies. In the first two years after the subsidies, money supply grew by 12 and 16 %, respectively. Whereas before the subsidies, in the year after pseudo-banks such as "Fast Return Funds" and "Mehr Housing" were introduced early in Ahmadinejad's presidency, money supply grew by 41%.

Clearly it was breaking elementary rules of monetary policy, such as the elimination of normal reserve requirements and mandatory central bank deposits for pseudo-banks, which removed the theoretical upward limit of monetary growth. Actual money supply growth depended on the demand for borrowing, which ran rampant because of negative real interest rates: Ahmadinejad's policies indicate that he believed lower interest rates reduce inflation.

The floodgates of money supply were now wide open. The only factor that absorbed short-term inflationary pressures was the massive import of cheap foreign goods, made possible by unprecedented oil income (as much under Ahmadinejad as Iran's oil export income since the beginning of history, albeit in nominal terms.) Controlling illegal trade ports by the Revolutionary Guards was a driver for these cheap imports that decimated domestic production. Even Ahmadinejad came to call the Guards the "Smuggling Brothers."

With the new round of sanctions, Iran's oil export has fallen from above two to under one million barrels a day. There is no longer a cushion against the stagflation vice of falling domestic production and monetary overhang. Senior economic appointments early-on in Rouhani's Government show an awareness of the problem. But the solutions they dare to announce are like trying to kill the elephant of inflationary pressures with mosquito bites of fiscal discipline. In Ahmadinejad's last submitted budget the deficit was about half the projected government revenue. It is politically impossible to close that huge gap at a time of falling production and rising unemployment.

Conclusion: Any solution needs massive foreign investment as well as sanctions relief.

2. International Economic Relations

Iran is not North Korea, or even Burma. For the better part of a century, its infrastructure and industries have depended on imported intermediate goods and production factors. Iran's economy cannot survive in international isolation. It will take a long period of healthy growth to wean Iran's economy from energy export dependence. A precipitous fall in imports of intermediate goods has decimated Iranian industrial production - from oil and gas to auto manufacturing.

Some of this shortfall is directly due to sanctions. A license to export a pump for injecting gas into tired oil wells, for example, would have been issued for a year in Germany. Fear of retaliatory US sanctions shortened that period to three months. By the time the increasingly difficult letter of credit is in place, often the license has expired. Some of the Chinese substitutes have proven so inadequate that even the Revolutionary Guards' companies maintaining the oil wells refuse to accept them. If there were eight pumps at a wellhead during the Khatami administration, five working and three in reserve, there may be only five left today, ready to break down anytime.

At its peak before the Revolution, Iran's oil production capacity reached 6.7 million barrels a day, with a domestic consumption of seven hundred thousand and an export potential of 6 million. Even with ten times the nominal net income from a barrel, today Iran's production capacity has dipped to four million barrels per day, with an export potential of only 2.5 million barrels. So Iran has well under half the oil export capacity and well over twice the population of a year before the Revolution.

Many other industries were already ill with the "Dutch Disease", contracted in a period of ultra-high oil income that was injected indiscriminately into the domestic economy,

causing inflation and a free fall of competitiveness of domestic production. Scarcity of raw materials and intermediate goods that must be imported has compounded the problems of industrial production. The exit of important foreign partners has added to the problem of choking technology transfer, making it more difficult to keep up with the world. Renault, for example, recently left Iran and took a huge loss by writing off the entire value of its business there.

Impoverishing as they are, none of the factors above have had the devastating impact of severing Iran's banking transactions and finance abroad. Clearing dollar-denominated Iran-related trade has virtually stopped at the Federal Reserve. The EU has placed severe restrictions on euro transactions. As the normal universal method of bank transfers, SWIFT has cut Iran off. Since February 2013, new unilateral US sanctions force major importers of Iran's oil to block their income in a special account, to be expended only in that importing country. Since the EU has banned oil imports from Iran altogether, that means Iran cannot sell oil to India, for example, and use the proceeds to buy in Germany. But even Iran's previously earned euro-denominated foreign exchange holdings are not left untouched. In March 2013, the US Senate approved funding to constrict Iran's use of Target2, the euro-clearing counterpart of the US Fedwire. In short Iran is thrown into the stone age of banking, forced to use barter or move physical gold as payment for much of its foreign trade.

Conclusion: Any solution must include a massive reform of banking, transparency and the restoration of access to foreign trade and international financial institutions. In turn this means the normalisation of Iran's foreign relations.

3. The Judiciary

Any investment in productive activity is in the expectation of a right to future income and limits on liability. Due diligence requires knowledge of the legal environment in which those rights are realised and liabilities incurred.

Contract law and company law are of course an investor's first hurdles for realising a commercial opportunity. Next, financial regulations, including banking, taxation and labour laws, competition law, licensing and intellectual property laws could make or break an otherwise sound commercial undertaking. Finally, equity, profit repatriation and negotiable instrument laws on the up side, and adjudication and arbitration laws on the other side, affect decisions to invest.

Two added wrinkles of doing business in Iran involve agency law and Shiite Sharia courts. Prejudicial exercise of agency laws could change jurisdiction and introduce uncertainty in legal opinions that might have seemed sound at contract time. The lack of standards in Sharia courts stem from the principle of independence of *ijtihad*, where no hierarchical authority could question the judgment of a *Mojtahid*-Judge, no matter how contradictory with another similar judgment. In a notorious case, Ayatollah Khalkhali

who was chastised by Ayatollah Khomeini for excessive executions (just imagine how far he had gone) told Iran's undisputed ruler that he had used his own *ijtihad*, not Khomeini's. There was no appeal and Khomeini's serial executions continued.

Later firmer control on Sharia courts by Khomeini's judiciary has rendered judicial process more political and arbitrary, rather than increase standardisation and uniformity in the judicial process. The politicisation of the judiciary has an obstinate logic in late-stage totalitarian regimes, where popular support has waned. Here, security of the state becomes insecurity of the people and vice versa. As a guarantor of the security of law-abiding citizens, a fair and independent judiciary makes the totalitarian state less secure. So the question is can the Islamic Republic afford such a judiciary?

Conclusion: If commercial relations inside Iran, and between Iranian and foreign entities are to become attractive for investors, a modern standardised commercial code and a professional, independent judiciary must be firmly in place.

4. Ownership

More than seventy percent of Iran's economy is controlled by governmental or semi-governmental institutions, such as the Revolutionary Guards, and idiosyncratic para-state foundations, controlled directly or indirectly by the Supreme Leader. No sizable successful business is safe from their take-over hunger and no government contract, national resource or public asset is put to commercial use without them standing first in line. The astronomically high-value disputes in the labyrinth of entities controlled by these institutions are resolved by a shadowy hierarchy capped in the House of the Leader. Disputes that spill out of this behind-the-scenes resolution mechanism are stifled, at times by the Leader's injunction to the judiciary or parliamentary committees not to "stretch" the case.

This "ownership" pattern does not damage Iran's economy only through an unfair distribution of resources and profits, reducing fair competition and starving deserving projects from internal investment. It has also brought monumental managerial incompetence. The most glaring example is the oil industry. While the lavishly funded oil and gas development mega projects have gone to the Revolutionary Guards, Iran, with the world's second largest gas reserves and fifty times Qatar's population is producing one twentieth of the gas produced by Qatar from their common gas fields.

Such gross incompetence is not surprising where talent, creativity and competitiveness do not pay compared to having special relations with the Islamist nomenclature. Why would an entrepreneur waste his life building businesses that will be taken over as soon as he achieves great success, or persevere in reinvesting and building up significant capital that paints a target on one's head?

Conclusion: For Iran to become investible, it needs free and fair competition in its internal and external economic relations.

Postscript

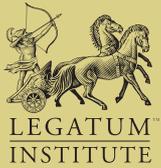
Many analysts would say it is impossible for the Islamic Republic to implement all four conclusions and remain an Islamic Republic. All totalitarian states come to power on a wave of popularity, but eventually lose majority support, because most people do not want all aspects of their lives governed by an all-encompassing ideology. The problem catches up even faster if that ideology is inalterably anchored in a book revealed 1400 hundred years ago.

As popular support dissipates, a regime must increasingly rely on force to remain in power. That force turns into a class with its own interests. Going against them is sawing off the branch on which the regime is perched. Here was the blind spot of communists who thought glasnost and perestroika can save them from slow economic demise. Khamenei has said he would not repeat that mistake. His first line of defence was the Ahmadinejad “Cultural Revolution” atmosphere that roused the rabble against the thinking men of the Islamic Republic. But then the economic suffering got too much to be anesthetized by the fog of radicalism.

The thinking men came back with an idea. Let’s bypass the fall of totalitarianism and go straight to Putinism. But the reforms required by the bypass are far more fundamental than Khamenei has bargained for, not the least of which is a wholesale transformation of foreign relations and strategic nuclear cooperation with the West, the price Russia paid for demilitarising its conflict with advanced democracies.

This is where the fault line lies between Putinists and radicals in Iran. This is the fight ahead. If the former win, expect a loyal ally of Russia which will manage economic underperformance in an authoritarian, but less militaristic state. If the latter win, Islamic Putinism will have proved more short-lived than the real one. Chaos and economic free fall will follow.

Iran’s road to economic recovery opens if both sides lose.



BUILDING A MORE PROSPEROUS WORLD THROUGH LIBERTY AND RESPONSIBILITY

LEGATUM INSTITUTE
11 Charles Street
Mayfair
London W1J 5DW
United Kingdom
t: +44 (0) 20 7148 5400

Twitter: @LegatumInst
www.li.com
www.prosperity.com

SEPTEMBER 2013