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The Sanctioned States: Economic Crises in Iran and Turkey

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Until recently it was accepted wisdom that the non-Arab states in the Middle East were becoming more powerful as the Arab world went into massive decline. For instance, the population of Iran and Turkey equaled 39 percent of that of all the Arab states, while their combined national income (GDP) was almost 50 percent. If Israel is included, then the figures are 41 percent for population and 61 percent for GDP (See Table 1).

Table 1: Middle East Basic Data, 2017

	GDP ($billions)	Population (millions)	GDP per capita ($)
Iran	440	80.6	5,459
Turkey	851	80.3	10,592
Israel	351	8.7	40,345
Arab states	2,591	414.5	6,251

Source: World Bank and Israel Central Bureau of Statistics

In recent months, however, this perception has changed with the emergence of severe economic crises in Turkey and Iran. Ostensibly these crises were the result of sanctions imposed or re-imposed by the United States. In fact, they are due to very serious internal problems exacerbated by sanctions or the announcement of sanctions.

The severity of the crises facing Turkey and Iran is demonstrated by the collapse of the exchange rates of the Turkish lira and the Iranian rial in the year to mid-August (see Table 2). The collapse of a currency reflects the loss of confidence in the management of the economy that, in turn, reflects underlying realities.

In July 2018, President Trump abruptly announced that the United States would impose “large sanctions” on Turkey for detaining an American pastor accused of aiding the failed coup attempt 2016.[1] Then, in August, the US re-imposed economic sanctions on Iran that had been lifted under the 2015 Joint Comprehensive Plan of Action (JCPOA).[2] This followed the US withdrawal from the nuclear agreement in May 2018. In both cases, the announcement of sanctions led to a collapse of the exchange rate.

Table 2: Exchange Rates to $1 USD, 2017-2018

	Mid-August 2017	Mid-August 2018	% Change
Turkish lira	3.54	6.28	80
Iranian rial (offical)	32,860	42,015	28
Iranian rial (market)	36,300	97,000-100,000	167-175

Source: IMF, Reuters

The US withdrawal from the JCPOA, signed by Iran and the permanent members of the United Nations Security Council—the United States, the United Kingdom, Russia, France, and China—plus Germany and the European Union signaled trouble ahead for Iran. It increased the pressure on an economy that was only just beginning to recover from sanctions.

In autumn 2017, the World Bank reported that Iran’s GDP growth had grown rapidly in 2016. This 25-year high was mainly due to the rapid recovery in oil production, with exports increasing by 41.3 percent that year thanks to the sanctions relief implemented in January 2016. However, this occurred after the economy had experienced four years of negative growth. Moreover, non-oil GDP growth has not been fast enough to reduce unemployment. Between 2005 to 2011, almost two percent of overall annual non-oil growth was attributed to industry and mining sector. Since 2011, the sector’s contribution has been negative. As a result, in 2016 this sector was almost the same size as it had been in 2013. In 2016, the surge in oil exports led to growth in demand, but investment and domestic consumption did not fully recover.

Investment in Iran contracted for the sixth consecutive year as the effect of sanctions relief was not strong enough to overcome structural constraints that in turn resulted from years of economic mismanagement and sanctions. Despite anticipation of an inflow of funds after the signing of the JCPOA, investment did not increase in 2016 due to political uncertainties including the presidential elections in Iran and the US, and the persistent effects of previous boom-bust cycles.

Inflation rates decelerated to nine percent in 2016, the lowest level in 25 years, but this achievement has also been reversed. The Central Bank of Iran has reported that the consumer price index in urban areas grew to 18 percent in the year to June-July 2018 while food prices rose by 25 percent. Rising prices for food and other basic goods and services have been a major source of social and political tensions.

The banking sector remains fragile, after a long period of being largely cut off from foreign capital, credit lines, correspondent banking facilities and know-how. Iranian banks operate with numerous restrictions on deposit and lending terms that affect resilience and performance. As a result, with limited capital or liquidity reserves, many banks are vulnerable to external shocks, and in 2016 sharply increased their borrowing from the central bank.

In 2016, unemployment among women aged over ten years was 20.7 percent and among those aged 15 to 29 years it was 42.3 percent. Among men the comparable figures were 10.5 percent and 21.4 percent. Between 2008 and 2015, the share of women with higher education who were economically active women rose rapidly. However, educated women were largely unemployed: high skilled job creation was not enough to absorb the increased number of women with college and graduate degrees.[3]

The Supreme Leader of Iran, Ali Khamenei, has blamed the government of President Hassan Rouhani for economic mismanagement, and in August parliament impeached the Minister of Finance, Masoud Karbasian,[4] The deteriorating economy has resulted in a series of strikes. In June, the Grand Bazaar in Teheran closed, and protests have taken place in cities throughout the country.[5]

The regime, including the Supreme Leader, is under unprecedented internal pressure and does not appear to have any solutions. The depth of the crisis is manifested by protests in the streets that include calls for Iran to end its involvements in Syria, Iraq, Lebanon and Gaza. Iranians see the huge expense of those campaigns as a cause of their own plight. Iran's activity in the Middle East is directed by the Supreme Leader and carried out by the Revolutionary Guards with little support from more moderate forces in the government. This reflects an element of the power struggle that dominates Iran's politics. Given this economic and political crisis, US sanctions pose a serious threat to the regime.

There are two phases to the re-imposition of US sanctions. The first came into effect on August 6 and included sanctions on the purchase of US dollar by the Iranian government. The second will begin on November 4, targeting oil exports, ports and shipping sectors and transactions with Central Bank of Iran including the SWIFT payment system. One of the most significant aspects of the sanctions regime is that companies or banks in third countries trading with Iran will not be able to trade with the US.

In August 2018, along with the US announcement on the resumption of sanctions, record temperatures, power outages, and water shortages, a 50 percent rise in the price of some food items, triggered scattered protests. The new sanctions ban purchases of U.S. dollars by Iran and prevent the trade of gold, metals, and automobiles. This resulted in the crash in the value of the rial despite government attempts to stabilize the currency. Economic pressures have prompted protest that began with teachers in Yazd, were followed by the protests of steelworkers in Ahvaz and railway workers near Tabriz. Protesters objected to military expenditures in Syria, Yemen, and Iraq as well as rising prices, corruption and other local issues. The protests emerged in June led by bazaar merchants who were affected badly by the sharp decline of the exchange rate and U.S. dollar shortage, causing prices to rise and demand to fall.[6]

The Iranian economy has rapidly lost the few gains reaped in the past two years. International firms working announced that they will leave Iran within the 180-day deadline set by the United States, so as to avoid paying fines under the U.S. sanctions and jeopardizing their US sales. Most of them operate in key sectors such as oil and gas, aviation, banks, maritime transport, and the automobile industry. The latter directly and indirectly employs 1-1.5 million peoples and all these jobs are threatened by sanction because the automobile industry is totally reliant on imports. The U.S. aircraft giant, Boeing, has canceled deals worth $16 billion with Iran.

The European signatories of the JCPOA vowed to continue trading with Iran, thus insuring the latter's compliance with the agreement and access to its markets. The EU therefore issued a "blocking statute" which will allow European firms to sue the US government for compensation if they are affected by sanctions. The likelihood of the statute being used is slim as most European companies that had dealings in Iran have decided that their relations with the US are far more important and have already announced plans to quit. Germany's Daimler and France's Peugeot and Renault have cancelled plans to produce in Iran. Total, the only oil major to plan to invest in Iran following the nuclear deal, has said that it will pull out of a $4.8bn program to develop Iran's phase 11 of the South Pars gas project.[7]

Crude oil production and exports have fallen. Production which rose from 3.15 million barrels a day (mb/d) in 2015 to 3.87 mb/d in 2017, declined to 3.74 mb/d in

July 2018. Exports fell more rapidly from 2.7 mb/d in May 2018 to 1.68 mb/d in the first half of August or by 27 percent.[8] Capital flight in the Iranian year 1396 (March 2017 / March 2018) reached about $ 13 billion according to the Research Center of the Iranian Parliament. Other sources have reported it at $ 30 billion.

Criticism of President Rouhani and other members of the government has increased in and outside parliament. In August the supreme leader, Ali Khomeini, made his sharpest criticism yet of the president, faulting him for having crossed "red lines" in nuclear negotiations with the United States and other failures that have created an economic crisis. He called on the government to return to a "resistance" economy and urged the people to be patient.[9]

Turkey's economy is nearly twice the size of Iran's and its involvement in the international economy is much larger. It is therefore more exposed to international developments than Iran and its economic fate is of greater concern to the international community. Along with other so-called emerging economies, the increase in US dollar interest rates has led to an outflow of short- term funds from Turkey. This has been one of the factors undermining the exchange rate of the Turkish lira.

Turkey has a very low domestic savings rate and has therefore borrowed large sums abroad to finance the construction of public-private sector infrastructure projects worth some $140 billion. In addition, the private sector has borrowed heavily abroad. The total debt of non-financial companies rose from nearly $32 billion in 2002 to $176 billion in 2010 and to $331 billion in mid-2018. The net debt rose from $6.5 billion in 2002 to $89.4 billion in 2010 and to $216 billion in mid-2018. Loans from abroad rose from $26 billion in 2002 to $76 billion in 2010 and to $107 billion in mid-2018.[10] These have also become more expensive to finance in local currency because of devaluation.

Private-sector short-term borrowing in dollars is a major source of macroeconomic vulnerability. The vulnerability of Turkish companies has made lenders less willing to roll over their debt. Furthermore, the rise in interest rates in the United States and Europe, as well as the prospect of further rate hikes, have made emerging market debt, including Turkey's, relatively less attractive. The boom in credit has come not from foreign currency lending to firms, but rather from lira lending to households (for mortgages and for loans to buy household appliances). That borrowing boom in turn supported domestic demand, raised imports, and led to a persistent current account deficit.[11]

The standard response to this type of crisis is a rise in interest rates, but this has not happened in Turkey. Conventionally, central banks attempt to reduce the outflow of funds and keep the currency from falling by raising interest rates and making domestic debt more attractive. This also helps to demonstrate the independence of the central bank, which gives investors confidence that the currency will not continue to fall. Higher interest rates also raise the cost of borrowing to firms and reduce economic activity. Monetary policy in Turkey has, however, been quite expansionary, as rapid inflation suggests. Foreign investors had reason to believe that the Central Bank of Turkey will not raise rates, or only do so minimally.

In May 2018, President Erdogan called for lower interest rates and described them as the “mother and father of all evil,” triggering a further fall in the exchange rate of the lira as investors worried about the central bank’s ability to rein in high inflation.[12] Standard & Poor’s, the credit rating agency, gave the extreme volatility of the lira and the forecast of a recession in 2019 as the reasons for lowering Turkey’s rating from B+ from BB.[13] Moody's Investors Service also downgraded the government of Turkey's long-term ratings to Ba3 from Ba2 and changed its rating outlook to negative. The main reason was the further weakening of Turkey's public institutions and the reduction in the predictability of Turkish policy making.

Since June, financial stress has increased further, most visibly with the sharp depreciation of the lira, Domestic funding conditions have deteriorated with bond yields on the government's domestic securities reaching above 20 percent in mid-August. While Turkish banks have so far managed to maintain access to the international inter-bank markets for funding, the tightening financing conditions and the weakening lira increased pressure on domestic borrowers with foreign-currency debt.[14]

On 13 September, the Central Bank of Turkey increased interest rates from 17.75 percent to 24 percent. It cited inflationary pressures as the main reason for this massive rise. Initial reaction was positive with a sharp strengthening of the lira’s exchange rate. Sceptics noted that the problems of Turkish economy were political and related to Erdogan’s dominant position.

Turkey is better placed to get out of the crisis than Iran. The crisis over US sanctions could be easily resolved and Turkey has some bargaining power in Europe over Syrian refugees. The central bank’s decision on interest rates could be first step towards financial repair. This is, however, too narrow a view. Turkey’s crisis is systemic and results from the fact that so much power has been concentrated in the hands of the President. The government has been less transparent, and its decisions are not based on improving the economy but on maintaining the political status quo.
Iran suffers deep political splits within the regime and between it and large sections of the public. Its economy is totally dependent on oil, exports of which are being increasingly restricted. The regime sees its involvement in conflicts in Iraq, Syria, Lebanon and Yemen as the front line of its defense of the Islamic Revolution despite the fact that there are ever fewer resources to fund them. Most importantly, the

regime retains the monopoly of force and a willingness to use it against its opponents at home as well those abroad.

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[1] Julie Herschfeld Davis, "Trump Threatens Sanctions Against Turkey over Detained Pastor," *The New York Times*, July 26, 2018. Trump ultimately did impose sanctions in early August and threatened even more sanctions later that month when Turkey refused to release the US citizen. The American minister Andrew Brunson was finally convicted in Turkish courts on charges of aiding Kurdish separatists and was concurrently allowed to return to America after having been held for two years on October 12th, 2018.

[2] Gardiner Harris and Jack Ewing, "U.S. to Restore Sanctions on Iran, Deeping Divide with Europe," *The New York Times*, August 6, 2018.

[3] *The World Bank*, "Iran Economic Monitor: Sustaining Growth: the Challenge of Job Creation," Fall 2017, public document.

[4] Parisa Hafezi, "Iran's Khamenei rejects Trump offer of talks, chides government on economy," *Reuters*, August 13, 2018; Kozar Nawzad, "Iran impeaches Finance Minister over economic mismanagement charges," *Kurdistan 24*, August 26, 2018.

[5] Khrishnadev Calamur, "Iran's People Keep Getting Poorer," *The Atlantic*, June 27, 2018.

[6] Ladane Nasseri, Golnar Motevalli, and Arsalan Sarhala, "After Sanctions, Iran's Economy is Nearing a Crisis," *Bloomberg Businessweek*, August 9, 2018.

[7] *Middle East Economic Survey*, "US Slaps Back Iran Sanctions, With More to Come," Vol. 61, No. 32, August 10, 2018 [Paywall].

[8] Ariel Cohen, "Iran's Oil Exports Plummet 600,000 b/d As U.S. Sanctions Force Key Buyers To Seek Alternatives," *Forbes*, August 29, 2018.

[9] Rick Gladstone, "Iran's Top Leader Faults Rouhani for Crisis, Saying He Crossed 'Red Lines'," *The New York Times*, August 13, 2018.

[10] Paul Rivlin, "Turkey's Economy is Paying the Price," *Iqtisadi*, Vol. 7, No. 3, March 30, 2017; also see CBRT Statistics on the Financial Exchange Assets and Liabilities of Non-Financial Companies, report 2018-6.

[11] Brad W. Setzer, "Framing Turkey's Financial Vulnerabilities: Some Rhymes with the Asian Crisis, but Not a Repeat," *CFR*, August 20, 2018.

[12] Ali Kucukgocmen, Behiye Selin Taner, "Turkey's Erdogan calls interest rates "mother of all evil"; lira slides," *Reuters*, May 18, 2018.

[13] *Reuters*, "S&P lowers Turkey's credit rating deeper into junk territory," August 17, 2018.

[14] *Moody's*, "Rating Action: Moody's downgrades Turkey's ratings to Ba3 and assigns negative outlook," August 17, 2018.