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## **CESD Paper**

# **Iran's Economy: On the Background of the New Sanctions**

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## Introduction

Before analyzing Iran's economy we will look at the overall state of the country. Iran is one of the largest countries in the Middle East. The territory of Iran is 1.6 million square meters, while the population is more than 80 million people. The territory of the country is divided into districts (ostans). The biggest ostans are located in the south of the country: Balajustan, Kirman, Isfahan, Fars, and Khorasan. The territory of Iran and its natural resources bring plentiful of advantages to this country. First of all these advantages exhibit themselves in the production of agricultural goods. Due to the changing seasons in various parts of the country, food supplement is not a problem. In this sense, one of the world's cheapest food supplements is in Iran. In spite of all these advantages, Iran's government bases its political and economic system on a particular ideology and by practicing this ideology in its domestic and foreign policy Iran diminishes the full potential of its economy. In order to better understand the level of this ideological approach, it is enough to examine the trade relations of Iran with its close neighbor, Turkey. Only 8% of Iran's exports and 4.8% of its imports fall on Turkey<sup>1</sup>. In comparison, the largest trading partner of Iran is China. The share of the total trade overturn of China is 22%. Hence, Iran's total trade turnover in 2011

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<sup>1</sup> <https://www.cia.gov/library/publications/the-world-factbook/geos/ir.html>

was 207 billion USD, of which 45 billion USD fell on China.

Obviously, Iran's poor relations with its close neighbors have had a negative impact on its economic relations. Turkey's secularism and close alliance with Western countries—all of which don't match with Iranian regime's ideology—contributed to the cold relations between the two countries. In spite of temporary rapprochements, the government of Iran still mistrusts Turkey. According to all of the above mentioned, we can come to the conclusion that the criteria which prevents the development of Iran's economy consists of both internal and external factors. The internal factors, as noted above, encompass Iran's approach to its neighboring and other countries due to its ideology. The external factors, on the other hand, are heavily influenced by the sanctions imposed on Iran's economy by Western countries. As a result, Iran's economy is almost completely isolated from the world economy.

Basically, Iran would like to trench sanctions with assistance from Russia and China. These two countries are considered to be the caretakers of Iran in the international arena. It is of no coincidence that China and Russia have repeatedly voted against sanctions on Iran.

According to the International Monetary Fund, in terms of nominal GDP Iran's economy is ranked 26<sup>th</sup>. The volume of nominal GDP is 482 billion 445 million<sup>2</sup> USD. In comparison, according to this potential (in terms of population and area) which is approximately the same size with that of Iran, the volume of Turkey's nominal GDP is 296 billion USD or 1.7% more. Taking into account the richer natural resources of Iran (in comparison to Turkey), the discrepancy between the potential and current economy of Iran becomes obvious. As noted above, the reliance of Iran's economy on ideology and its isolation from the international community prevents it from reaching its full potential.

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<sup>2</sup> [http://en.wikipedia.org/wiki/List\\_of\\_countries\\_by\\_GDP\\_\(nominal\)](http://en.wikipedia.org/wiki/List_of_countries_by_GDP_(nominal))

### **Income sources of Iranian economy**

The leading areas of Iran's economy include the hydrocarbon sector as well as small-scale agriculture and service sectors<sup>3</sup>. Despite the fact that the main income-generating sector is hydrocarbon production, in recent years the role of the service sector in Iran's economy has strengthened gradually. According to the data of 2011, the GDP of the service sector constitutes 48.2%<sup>4</sup>.

However, the role of the service sector in Iran's economy is ambiguous. Some experts<sup>5</sup> consider this role as either a traditional or a modern approach. They note that according to the traditional approach, energy and other fundamental sectors are the leading divisions in Iran's economy. However, in terms of the modern approach, Iran is capable to improve in the service sector. Thus, the income from the energy sector, directly or indirectly contributes to the development of other sectors as well.

Iran's industry includes petro-chemistry, oil and gas, steel, textile, and engineering.

The oil and gas sector continues to occupy the dominant position in the country's economy. Hence, a major part of government revenues and exports comes from oil

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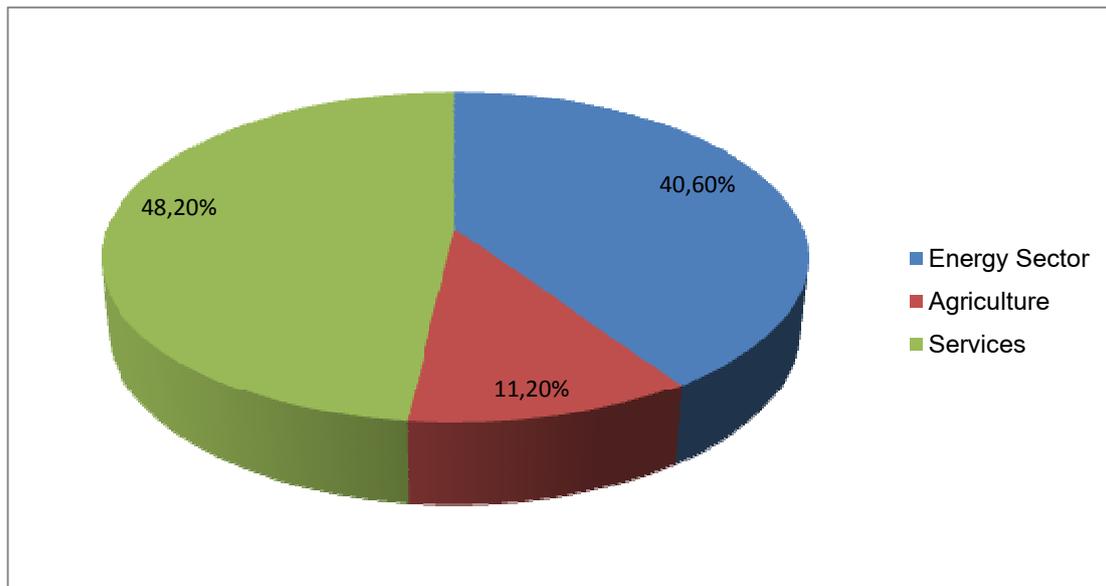
<sup>3</sup> <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/MENAEXT/IRANEXTN/0,,contentMDK:20146413~menuPK:312964~pagePK:141137~piPK:141127~theSitePK:312943,00.html>

<sup>4</sup> <https://www.cia.gov/library/publications/the-world-factbook/geos/ir.html>

<sup>5</sup> "Quantitative Analysis of Services and Sub-service sectors in the Iranian Economy" Seyed Iman Azad, Ali Asghar Banouei PHD, Narges Moradkhani

and gas income. The main reason for this is Iran's large oil and gas reserves. In fact, Iran possesses the third largest oil reserves after Saudi Arabia and Canada. Some 10% of the world's discovered oil reserves are in Iran. Among the members of OPEC, Iran is the second largest oil producer after Saudi Arabia. Currently, Iran produces 4 million barrels of oil, which constitutes 5% of the world's oil production. 15% of the world's gas reserves are in Iran. In addition, Iran attains the second largest gas reserves after Russia.

**Diagram 1. The dispensation of Iran's GDP according to the sectors**



**Source;** Central Bank of Iran, 2011

One of the most important income-generating sectors besides oil is the agricultural sector. In the agricultural sector—the main division of Iran's economy—11% of the Iranian population is employed. According to the data of 1991, one-fifth of the total working places are in this sector.

Iran has a large landmass and a favorable climate for agricultural development. It is of no coincidence that the agricultural sector depends less on oil production. Although this factor is small, it increases the importance of agriculture in Iran's economy. While agronomy is the main part of Iran's economy, other areas such as livestock, forestry and fishing are also included.

**The essential changes between 1980 and 2004 in the structure of agriculture**

Share of agriculture	1980	1988	1990	1995	2000	2004
Farming and gardening	62	58.3	58.3	61.1	60.8	61.8
Livestock	29.8	34.5	33.9	31.1	32.4	30.3
Forestry	1.4	1.2	1.1	1.2	1.2	1.3
Fishing	2.5	21.1	2.8	2.7	2.7	2.4

**Source:** The Central Bank of Iran, 2011

As shown in the table above, farming and gardening are also important parts of Iran's agricultural sector. However, these sectors are the most vulnerable divisions of agriculture as they are susceptible to drought and other natural disasters.

The main agricultural products are wheat, barley and rice. Other products are beans, lentils, fruits, vegetables, almonds, pistachios, and walnuts. However, such a large share of the agricultural sector can't meet domestic demands.

Although the arable land area in Iran is 51 million hectares, only 15 million hectares are used. The main problem in farming is irrigation.

Among the most profitable sectors in the rural area is fishing. This is due to the large income from the caviar export.

The service sector is the largest area in Iran's economy. The service sector made up for 51.8% of the GDP in 2011; some 45% of the workforce is in this sector. The main service areas are public services (education, health, etc.), non-commercial services, personal services and tourism.

According to Iran's state budget for 2012, tax revenues and reform subsidies are expected to be the main sources of income. Iran is planning to get 37 billion USD in the form of tax revenues, 54 billion USD from reforms, and 50 billion USD from oil production.

### **Main characteristics of Iran's economy**

As in many other areas, the Islamic revolution has had a great impact on Iran's economy and has contributed to Iran's Islamic economy.

With this, Iran's economy gives the impression of a mixed economy to the public sector. Up to 50% of its economy is centrally planned. Otherwise, in the financial and management sectors, the share of the state is high.

According to the 44<sup>th</sup> law in the Constitution, Iran's economy focuses on three sectors: public, corporate, and private sectors. Among these, the most important is the public sector.

Thus, the main areas of industry in the public sector are electro-energy, banking, aviation, railway and sea transport, as well as foreign trade. The public share is also high in media and communication.

In a word, private property is limited by the constitution and private business activity is not prohibited. However, conditions such as obeying Islamic laws against private property and not harming society are still pursued.

At first, the private sector was mainly held by subjects of small entrepreneurship.

However, because in reality this idea was not possible to implement, the government had to abandon it.

Thus, even if in the 80s, the regime's activities had distinctly responded to the interests of small business, they significantly changed their direction of interest. After the 80s, many of Iran's private industries and commercial banks were taken over by state and half-state institutions.

At present, even though agriculture, trade, small-scale mining, and other industrial areas belong to private companies, their activities remain weak in the country's economy.

One of the unique features of Iran's economic system is its major religious organizations and institutions. The total budget expenditure of these institutions is 30% more than that of the central government. In Iran, these organizations are called Bonyadlar and function as charitable organizations. In particular, the organizations play an important role in Iran's non-oil sector and control 20% of Iran's GDP. However, these organizations receive ample subsidies from the government and provide inadequate help to the poor. One of the worst impacts of these organizations on Iran's economy is the increase of the volume of trade in the black market. As a rule, the victory of these organizations also prevents the participation of foreign companies in Iran's market. On the other hand, some international organizations and states accuse Bonyadlar for financing terrorism and other illegal activities.

One of the other non-traditional organizations in Iran's economy is the Islamic Revolutionary Corps. The institution is a nationalistic organization, established in 1979.

The organization's first participation in the economy was during its post-war reconstruction and infrastructure projects. However, because of the organization's strong connections, it creates difficulties for the private sector. Due to these connections, the organization has captured many business contracts and in comparison to the private sector, attains an unfair advantage. Mainly, this organization, like Bonyadlar is known for its involvement in smuggling, contraband and in other illegal activities in Iran.

The World Bank characterizes Iran's economy as transforming into a market-oriented economy. However, with this, the Bank notes that Iran plays a huge role in world economy; and companies in trade and industrial sectors are mostly state or semi-state companies. According to the Bank's estimates, more than 60% of the products in the manufacturing sector are produced by state organs.

The Bank also notes that in spite of that, the government has announced a large-scale privatization program and intends to annually privatize 20% of the state-owned enterprises.

State-owned banks also play a dominant role in the financial sector. Thus, Iran's banking system is comprised of financial institutions called Central Bank and Banks and Credit.

Banks and Credit institutions, in turn, consist of the following 5 categories:

- State-owned commercial banks
- Specialized state-owned banks
- Non-state-owned banks
- Gharzolhasaneh Banks
- Near banks or credit institutions for development

State commercial banks include Bank Melli Iran, Iran Post Bank and Bank Sepah. Although, Bank Melli Iran was the first commercial bank in the country, it is now state-owned.

Bank Sepah is also one of the oldest banks in Iran. It has served Iran's workers in the first years of its banking activity. This bank has functioned in the form of a joint-stock bank until the 1953 revolution and has been nationalized by the state in the aftermath of the revolution.

In spite of the fact that Post Bank is a commercial bank in Iran, it is under state control.

Specialized state banks include Iran Export Development Bank, Industrial and Mining Bank, Bank Maskan, Bank Keshavarazi, and the Corporate Development Bank.

Export Development Bank was established in 1991 and as implied by its name, its main mission is to finance export and import operations. The main mission of the Industrial and Mining Bank is to support economic growth.

Bank Keshavarazi is Iran's first agro-credit bank. Its main mission is to finance rural economics. After the revolution, this bank was also nationalized under the "Bank Nationalization law" and acquired the title of Agriculture Bank of Iran.

Bank Maskan is one of the banks engaged in civil participation. This bank provides services such as the opening of housing accounts, and the construction of houses for the youth.

The Corporation Development Bank was established to pay for the industrial and social needs of citizens based on their wills.

Non-state banks include City Bank, Tourism Bank and other such 17 banks. All of these banks are considered to be private.

Near Bank is not a small bank credit organization.

As seen, the main owner of the banks in Iran is the state and in this system there is strong state control. In addition, Iran's participation in the legislation of the foreign capital in the banking system is restricted.

Iran Money and Credit Council have adopted an Act covering the "rules regulating the participation of foreigners in the bank's capital." According to the Act, if the share of foreign capital in Iran's banking system is equal to 40% or if it exceeds this limit, then the Central Bank of Iran must obtain the consent of the Credit Committee and must have it approved by the Chairman of the Central Bank.

One of the unique features of the banking sector is that it must comply with Sharia principles and pursue other related obligations. In contrast to the banking sectors of other Islamic countries, Iran's banking sector is governed by the law on usury adopted in 1983.

According to International Monetary Fund's report, "Iran-selected issues," there are two forms of credits that are ascribed to Islam in Iran: participatory and non-participatory tools. The share of lending to investment banks is funded based on participation fees and income level. Lending on the basis of non-participation is similar to leasing loans and the rent given by equipment leasing on the basis of the banks' earnings or rental of property rights. Credit based on overdraft and credit cards is not prohibited.

In general, all over the world, Islamic banking is based on profit and loss sharing. The profit and loss sharing paradigm considers Islam in law and economic literature as the basis of Islamic financing. The Islamic banking that is based on this paradigm is established in accordance to two contracts.

## **Joint Venture and Profit-sharing**

- Joint venture agreements are similar to other venture contracts; these contracts include capital investment in the bank as well as the joint participation of business management.

- Profit-sharing contracts are agreements based on the income distribution of all equity transactions and these agreements are formulated by the entire capital bank, entrepreneur or a client only in labor; and expertise and management are provided. Income from projects previously agreed between the parties (fixed ratio) is divided, and the bank undertakes all the losses.

As for the tax system, it could be said that Iran's tax system is based on an indirect system. In general, taxes should be based on the salary and wages of employees. In Iran, taxes are mainly divided into 5 categories:

1. Taxes imposed on companies
2. Labor based taxes
3. Consumption and sales taxes
4. Occupational (special taxes)
5. Import taxes

Company taxes: taxes that cover income and interests of state and non-state legal entities. The amount of these taxes and discounts applied to these taxes vary by company type and characteristics.

For example, according to the 131st Tax Law, state companies must pay 10% tax, but tax amounts differ in private companies by joint-stock, mixed and corporate companies.

Occupational Tax—is one of the sections of tax. This tax is comprised of many activities including those in commerce, restaurant, hotel, and finance. According to the 93rd Tax Law, certain deductions from the income earned by the concrete entity's occupation are considered before the tax is applied.

The share of tax revenues from such taxpayers is low. This is due to the prevalence of many tax privileges and also depends on tax evasion.

Salary taxes—According to the 82<sup>nd</sup> Tax Law, the object of this tax are incomes of entities with labor privileges, car rentals, and etc.

Consumption and sales Taxes—The object of these taxes are the prices and quantity of goods sold.

Import taxes—taxes based on the quantity of imported goods; in other words, the capacity of imported goods taxed.

Despite the small number of taxes in Iran, tax privileges and tax evasion is extensive. However, the impact of sanctions is expected to decrease tax privileges and as a result, such will further be observed.

Despite the apparent activity of Tehran Stock Exchange (TSE)—one of the main elements of Iran's market infrastructure—its real economic profits are low.

Even though TSE encompasses a high volume of market capitalization, its volume of trade is low. One of the reasons for this low volume of trade is the ban on interest on bonds. In order to remove this ban, TSE Malaysia and other Islamic countries are planning to enforce the Islamic loan, Sukuk. Sukuk loans are appropriate for Islamic laws. In general, there are 3 types of exchange activities in Iran. Along with these and the Tehran Stock Exchange, small and medium-sized enterprises are intended for the OTC. Liquid shares and strong companies are listed to the Tehran Stock Exchange; however, in the second market, smaller companies are permitted to participate and shares with smaller liquidity are sold.

In addition, the Iran Mercantile Exchange shows productivity in conducting business on spot contracts related to agricultural products, metals, gold and petrochemical products.

As can be seen, Iran has a mixed economy. All of these factors, together yielding a mixed economic system, weaken the country's transition into a market-oriented economy.

## **Iran Economics and the Energy Factor**

While the energy factor yields importance to Iran's economy, it is also one of the most vulnerable points. It is true that the share of GDP in the energy sector decreased from year to year. While the oil sector's share in GDP was 40% in 1960, it decreased to 10.5% in 2011.

However, in budget revenues and subsidies, oil revenues play a dominate role. In this regard, Iran's economy depends on the critical changes in world oil prices. In 2008, the price of 1 barrel of oil, fell from 140 USD to 40 USD and remained at this level for a period of 6 months. As a result, unemployment increased from 9.9% in 2008 to 15% in 2011. To fully comprehend the role of the energy sector in Iran's economy, we must look at figures. The energy sector holds for 80% of the exports and constitutes 60-70% of the state revenues.

In this regard, it could be said that almost all of the economic problems inherent in the oil exporting countries, hold true for Iran's economy. The fact that Iran is one of the main oil exporting countries increases the role of the oil factor in Iran's income sources. The sale of crude oil is the core of the country's foreign revenues.

According to OPEC, Iran accumulated 95 billion USD from its sale of oil in 2011.

In 2012 (January-April), Iran accumulated 29 million USD from its sale of oil.

Among the oil exporting countries, Iran following Saudi Arabia and UAE, is the third country that receives the most revenues from the sale of oil.

According to the Revenue Watch Institute, from 2005 to the present day, oil and gas production has earned Iran revenues of more than 500 billion USD.

According to the Central Bank of Iran, state budget revenues in 2011 totaled 505 trillion 269 billion rial of which 434 trillion 485 million rial or 86% of the revenues were accumulated from the sale of oil. This in turn, increases the impact of the energy factor on Iran's fiscal policy and serves as a potential source of instability. Although the current world market price for a barrel of oil is expensive (85 USD), sharp price fluctuations may have a negative impact on budget revenues and fiscal stability.

In addition, the energy sector is one of the aspects in Iran's economy that receives the most demand for reform. Efforts to attain cheap energy prices have created problems for the economy such as, smuggling and wastefulness. To understand this, it is enough to look at energy prices. Until the recent years, the price of gasoline was 10 cents for a liter. This in turn, provoked the public and business to use more energy, in other words it stimulated wastefulness.

With the abolition of subsidies and an increase in government budget revenues, it was planned for Iran to switch from a wasteful economy to a more frugal and productive economy. Due to price increases in its first years of reform, Iran

accumulated a net income of 200 trillion rial. However, the removal of subsidies also created some difficulties. That is, even though the revenues increased, 50% of the revenues were spent on the dividends given to the public. On the other hand, due to the increase in prices, businesses faced problems in increasing their productivity. The corporate sector faced problems in the implementation of new technology—a problem that requires additional investment.

If considering the decrease in foreign investment due to sanctions, it could be assumed that the corporate sector will experience difficulties in this transformation.

As can be seen above, the energy factor is of great significance to Iran's economy and with the new sanctions, reforms in this sector are essential. Thus, reforms in this sector are not limited, and have the capacity to impact the entire economy. This makes the energy factor one of the most vulnerable points in Iran's economy.

**The modern state of Iran’s foreign economic relations and the changing trends**

International trade is one of the priorities of Iran’s foreign economic relations. In the last five years, Iran’s foreign trade significantly increased. According to the International Monetary Fund (in comparison to the turnover in 2005) in 2010 Iran’s foreign trade turnover increased by 83% or 78 billion 426 million USD. Compared to its 2005 share of trade in the world, Iran’s trade increased from 0.44% to 0.61% in 2010. The relevant indicators can be found in the following table.

**Table 2: Iran’s trade with the world**

In millions of U.S. dollars	2005	2006	2007	2008	2009	2010
Export	55,232	75,801	89,025	116,940	68,681	102,263
Import	38,904	40,686	45,168	70,115	60,069	70,300
Trade turnover	94,136	116,487	134,193	187,055	128,750	172,562

Trade balace	16,328	35,115	43,857	46,825	8,612	31,962
World trading(in millions of U.S dollars)	21,058	24,294	27,845	32,215	24,948	28,143
The share of Iran in world trade	0.44%	0.47%	0.48%	0.58%	0.51%	0.61%

**Source:** IMF and International Financial Statistics, 2011

Some 60% or 64 billion 271 million USD of Iran's exports consists of mineral fuel and oil products. Other major export products include machinery and equipment, organic chemical products, iron and steel, fruit, vegetables, citrus fruits, carpets and other products. Iran's five main export partner countries are China, Japan, South Korea, Turkey and Italy. It should be noted that Iran's trade turnover with these five countries constitutes 56.3% of the total turnover. While in 2005 Iran's exports to countries such as China, South Korea, and Turkey have increased, its exports to Italy and Japan have decreased. One of the main reasons for this is that the sanctions imposed on Iran's trade relations with Italy and Japan are harsher. On

the contrary, sanctions imposed on Iran's trade relations with China, South Korea and Turkey are limited.

**Table 3: Iran's main export partners (in percentage)**

	2005	2006	2007	2008	2009	2010
China	10.2	22.5	14.5	20.6	18.5	19.2
Japan	28.4	23.9	13.3	18.2	15.3	16.7
South Korea	0.2	0.3	6.2	5.2	7.1	7.5
Turkey	0.6	0.5	7.7	4.3	6.9	7.5
Italy	10.3	10.7	6.6	5.2	4.9	5.4
Others	39.4	42.1	51.7	46.5	47.3	43.7

**Source:** International Trade Center ,2011

As can be seen in the table above, in comparison to 2005, in 2010 the share of exports to China, Turkey, and South Korea increased to 9%, 6.9% and 7.3% respectively. However, the share of exports to Italy and Japan decreased by 4.9% and 11.7% respectively.

However, Iran's top five import partners are different. Following China—Germany, United Arab Emirates (UAE), South Korea, and Russia respectively are the main import partners of Iran.

**Table 4. Iran's main import partners (percent)**

	2005	2006	2007	2008	2009	2010
China	10.2	12.4	14.3	14.0	13.3	13.8
Germany	9.0	9.2	9.8	9.8	9.6	9.3
The United Arab Emirates	8.2	8.4	8.4	8.5	8.9	8.6
South Korea	5.2	5.5	5.9	6.0	6.4	6.5

Russia	4.3	5.0	5.4	5.4	5.6	5.5
Others	63.1	59.5	56.2	56.3	56.2	56.3

**Source:** International Trade Center , 2011

Historically Germany has always been one of the main trading partners of Iran .

However, due to sanctions the relations between the two countries continue to weaken.

Despite the unstable political relations between Iran and the UAE, the latter's share of trade with Iran is high due to the fact that the products exported from third-world countries are packaged in the UAE, from where they are imported to Iran.

Due to sanctions, some countries export their products to Iran through the UAE.

According to Dubai Chamber of Commerce, UAE's export to Iran totaled 6.8 billion USD, of which 60 % is re-exported. The remaining trade turnover is left as part of the share of UAE's free trade zones.

As can be seen above, Iran's foreign trade growth marked over the past five years is continuing. However, as a result of the impact of sanctions in the previous periods, major trading partners have begun to reduce purchases of crude oil from Iran. Thus, China, India, Japan, South Korea and Turkey decreased their import of

Iranian oil to 22%, 38%, 28%, 22% and 11% respectively. If this trend continues, the influx of foreign exchange and trade can have negative consequences. This in turn will affect most of the country's balance of payment and trade. Sanctions on Iran in the coming years will depend on the dynamics of foreign economic relations.

## **New sanctions on the background of the Iranian economy**

The sanctions caused both the decline of Iran's national currency and inflation. On the other hand, as a result of sanctions, trade has become one of the most affected sectors. Thus, many of Iran's companies that participated in the import and export trade have closed their offices in Dubai. In addition, one of the biggest difficulties is the lack of foreign currency. This doesn't allow Iran to import goods from its trade partners. For instance, currently Iran is not capable of paying its debt to Ukraine for the imported grain.

As noted above, the sanctions had a negative impact on the sale of crude oil, which is the primary part of Iran's exports. In this regard, Iran's oil production has already started to decrease. Sanctions also have a significant impact on Iran's financial and banking sector. Ordinary citizens are affected too. As a result of price increases due to inflation, 20% of the population lives below the poverty line. However, according to independent sources, 40 % of the population faces extreme poverty.

The reduction of subsidies for the energy sector presented by the President has increased the impact of sanctions on the poor population. Because of the insufficient compensations granted in response to the reduced sanctions, the overall quality of life has worsened.

### **Iran's economic system in the period of post-sanctions**

Sanctions are expected to have an impact on Iran's foreign trade turnover. According to the International Monetary Fund, the energy export makes up to 78-80% of the total export.

This means that due to sanctions, the country may be deprived of large foreign currency inflows. It is estimated that Iran's income from its energy exports will decrease by some 24 billion USD. Moreover, the International Monetary Fund states that due to sanctions, Iran's non-oil exports may decrease by some 7 billion USD. Hence, Iran's total export loss is expected to be about 31 billion USD. Another area that will be most affected by sanctions is the budget income. Due to the fact that two-thirds of the budget income comes from the sale of oil, the state budget is expected to be most affected. According to the International Monetary Fund, tax collections may decrease by 10% due to sanctions; this in turn, may lead to an annual deficit of 2% of GDP in 2013.

Nevertheless, Iran's foreign debt does not exceed 9 percent of its GDP, which enables Iran to cope with sudden budget deficits.

The weak sides of Iran's economy are due to high inflation and a balance of payment. Despite the fact that Iran's balance of payments profit, it is expected for

the balance of payments to be imperfect due to a reduction in income from exports. This may lead to the strengthening of Iran's inflation.

Due to the reduction of subsidies in energy and food industries, inflation rose to 20% by the end of 2010. However, according to independent experts the real inflation rate is even higher. Amidst sanctions, one of Iran's greatest advantages is its foreign currency reserves. According to the International Monetary Fund, the foreign currency reserves are expected to reach 104 billion USD in the current fiscal year. However, EU states claim to freeze Iran's currency resources. According to the World Bank, Iran's economy will fall by 1% in 2012 due to sanctions. The probability for the sanctions to influence the banking and tax system is very high. Thus, Iran's banking system has diverged away from the SWIFT system and Iran's banks experience difficulties in carrying out the functions of foreign banks.

In addition to this, unofficial money transfer systems in Iran like the havala system are also the cause for the reduction in bank income. This system based on confidence and trust, and on banks created by different individuals is outside of the transfer system.

Evidently, it is expected that sanctions will have a serious impact on the banking system and that bank profits will decrease. The tax system is also one of the sectors sensitive to the impact of sanctions. Thus, currently private and legal entities in Iran are granted many tax privileges and large amounts of tax funds are diverted. If

the income from oil decreases because of sanctions, income from Iran's state budget may be affected. As a result, the state will have to abolish tax privileges and harshen tax control. This will upset businessmen and companies. From a corporate point of view, the unstable economy will make it difficult for tradespeople and businessmen to deal with commerce. Already some businessmen complain about the hourly changing currency rates. This in turn will obstruct business and will cause unemployment and the closure of companies. As a result of all of these, the capacity of black markets and illegal activities such as, smuggling will increase. As seen, future sanctions may create surprises for Iran's economy. From a macroeconomic point of view, this may contract Iran's economy and cause it to halt into recession. At the same time, high unemployment and inflation are among other surprises that could be brought about by sanctions.

## **Economic relationship between Azerbaijan and Iran**

Iran's influence on Azerbaijan's economy has exceedingly improved after the collapse of the USSR. The main reasons for this are: Iran being a geographic neighbor of Azerbaijan, the weakening of Azerbaijan's economy due to the loss of its connections in its old economic system, and the withdrawal of the country's industry.

The similarity of the Azerbaijanian and Iranian languages has also had a positive effect on the amount of trade turnover. But it is possible to say that economic relations between these two countries have always been below their potential. Thus, despite the fact that Azerbaijan borders Iran by a large area of land and water, trade turnover and other economic relations between the two countries were comparatively lower than their relations with distant countries. There have been objective and subjective reasons for this. The objective reason is that both of these countries export oil; hence, their main partners are distant countries.

As for the subjective reasons, the cold relationship between the two countries was a contributing factor. Iran does not want western companies to function in Azerbaijan and it especially does not want Azerbaijan to strengthen as an independent country.

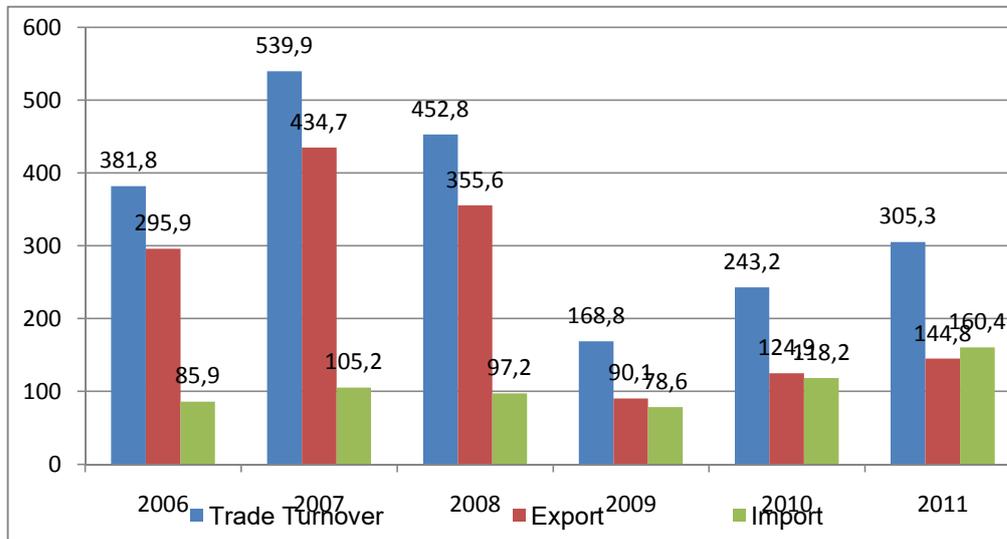
However after the restoration of stability in Azerbaijan there has been an unwavering relationship between Azerbaijan and Iran. The main factor for the

establishment of this stable relationship was Azerbaijan's neutral attitude towards Iran and that it didn't fully impose its sanctions against Iran. On the other hand, Iran approves its banks to work independently in Azerbaijan. But in recent periods, the tightening of Azerbaijan's sanctions against Iran, the change in attitude towards Iranian banks in Azerbaijan, and other reasons have again contributed to a problematic relationship.

The main economic relationship between Azerbaijan and Iran is trade. However it is difficult to continuously assess the trade relations between these two countries.

These relations depend on the concrete state political relations.

**Diagram 2. The trade turnover between Azerbaijan and Iran, export and import from Azerbaijan to Iran (by millions of US dollars)**



**Source: Government Statistic Committee, 2012**

During the period up to 1995, the trade turnover between Azerbaijan and Iran began to increase rapidly. This is mainly due to the local and Iranian merchants who could easily and cheaply take out their goods from the country.

During 1995-2000 the volume of trade exchange between the two countries began to stabilize. In this period, cheap industry and agricultural goods were exported to Iran. The main reason for that was a sharp decline in manufacture (except in oil production). As a result, a profitable market was created for exporting goods to Iran. Due to the fact that Iranian companies do not face serious competition in the Azerbaijani market, they can produce their products in a short period of time.

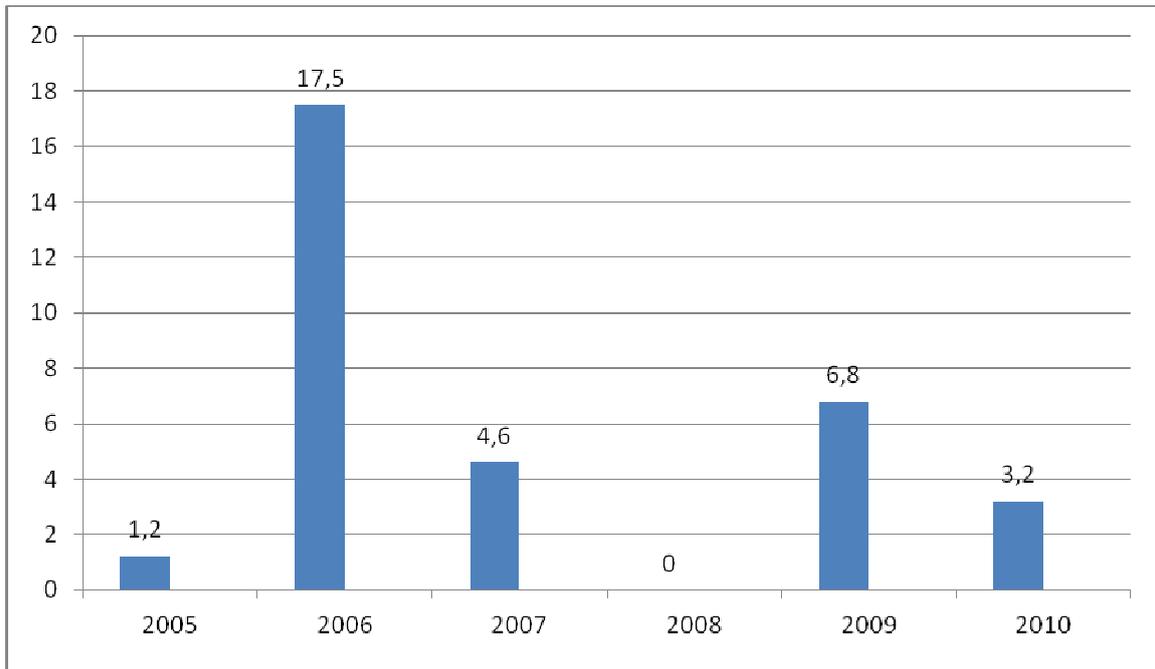
From 2000 to 2007, the trade relationship has been dynamically improving. As a result of this, (in comparison with the turnover in 2000) the turnover trade volume between Azerbaijan and Iran grew by more than eight times.

The volume of trade turnover decreased again in other years. This is connected to the strengthening of internal production in Azerbaijan as well as the decrease in demand for Iranian products and the unofficial challenges in the customs system.

As the trade relations, the investment capacity between the two are also low. According to the State Statistics Committee, Iran invested some 93,3 million USD in Azerbaijan in the period of 1995-2010; this makes up for 2% of the total investments.

In recent years, Iran has repeatedly reduced the volume of its investment in Azerbaijan. Hence, if Iran invested 17.5 million USD in 2006, in 2010 this figure fell to 3.2 million USD.

**Diagram 3. The Iranian investments to Azerbaijan economy during 2005-2012**  
**(in millions of US dollars)**



**Source: State Statistics Committee of Azerbaijan, 2011**

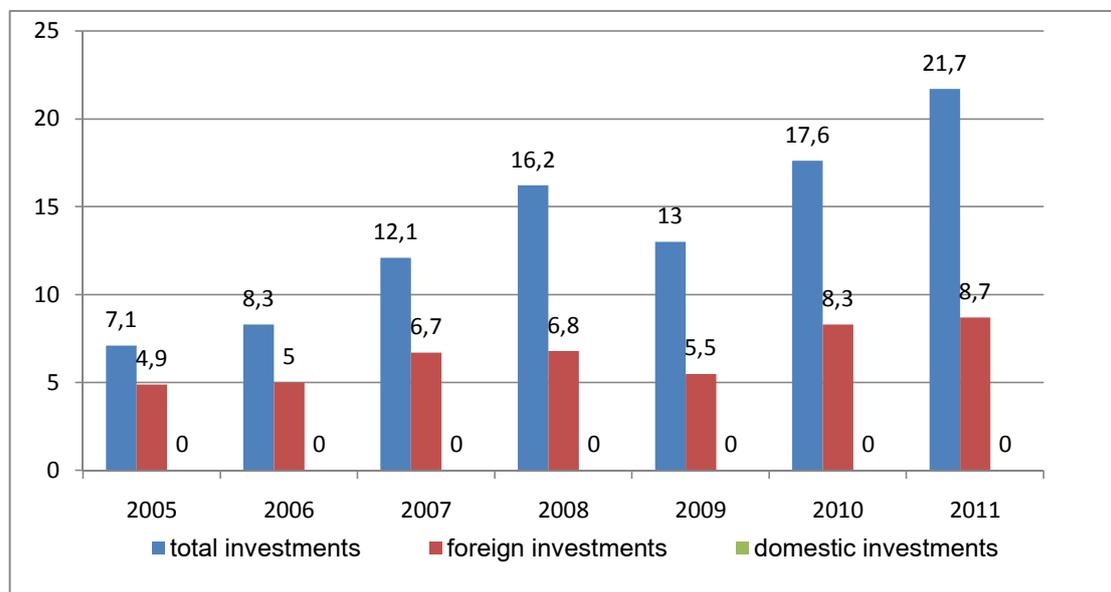
As shown in the diagram above, the volume of Iran's investment in Azerbaijan is not extremely big. For comparison, in 2010 the amount of Iran's investment among other foreign countries was only 0.04%.

Because of the small volume of Iranian investments in Azerbaijan and in the overall oil sector, the sanctions imposed on Iran will not have a serious impact on Azerbaijan's economy.

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On other hand, because Azerbaijan attains plentiful of financial resources, it can compensate for such losses. Hence, starting from 2008, internal investments have overwhelmed foreign investments in Azerbaijan's economy.

**Diagram 4. The structure of investment towards Azerbaijan's economy during 2005-2011 ( in millions of US dollars)**



**Source:** State Statistics Committee of Azerbaijan, 2011

In case of a spontaneous crisis in the suburbs, Azerbaijan's possession of big strategic currency reserves ensures the economic security of the country.

But if there is a critical situation in Iran, millions of Azerbaijanis who live there will immigrate to Azerbaijan. This in turn can lead to a humanitarian catastrophe in the country. Even though the political instability between the two countries does

not have a serious impact on the economic relationship between Azerbaijan and Iran, it creates problems in some other areas of the custom system.

As a result of sanctions in the coming years, it is not expected that the economic relationship will become worse. This will especially have a negative impact on Iranian banks operating in Azerbaijan. However the devaluation of the Iranian rial occurred along with the valuation of the Azerbaijanian AZN in the country. This also increased Iran's interest in Azerbaijani goods and merchants. In this context, in the short-term or mid-term the volume of import from Iran to Azerbaijan can increase. On the other hand, if the situation around Iran becomes problematic, this can affect oil prices in the world market and thus, can affect Azerbaijan's economy. This is because the bulk of the foreign currency inflows come from oil revenues.

In general, Azerbaijan's economy mainly depends on oil and any alteration in this sector can sharply change Azerbaijan's economy. However, the long-term economic relations between the two countries will depend on political relations and on Iranian sanctions.

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## Conclusion

Even if Iran is trying to transform its economy into a market-oriented economy, a serious effect is still not observed. The transformation of the country's economy into the latter is impeded by the accepted five-year development plans. The negative effects of this are mostly felt among the socially weak groups of people. Thus, in order to achieve the goals under the framework of these plans, Iran mostly uses the monetary-credit policy, which gives an opposite effect caused by inflation and unemployment.

Taking into account the pressure of sanctions on Iran, we can expect that the coming years will be difficult for its economy. In general, because economy policy and political policy in Iran are very mixed, the economic reforms there are very weak and their effectiveness is also low.

Thus, despite more than 30 years since the Islamic revolution, it could be said that before the 90-s none of the reforms have been carried out and only under the pressure of sanctions did the government decide to reduce the inefficient subsidies to the country's economy. All of these started producing a contrary effect.

Significant state ownership of the economy is another big problem. Many religious foundations take big amounts of subsidies from the government, increasing the pressure on the state budget; and the main income of the budget consists of oil

revenues. Fiscal sustainability in Iran depends on oil prices in the international market and therefore, is very sensitive.

The tension around Iran may cause an increase in oil prices in the world market. This in turn can have a negative impact on the economy of both world and regional countries.

Thus, the world's oil consumption in 2010 reached the amount of 85 million barrels a day. Some 5% of it was provided by Iran: USA is the largest oil consumer in the world and its daily oil consumption reaches 19 million barrels; this accounts for 22% of the world's daily consumption. The UN is second to USA with its 16% consumption. China with its 10%, Japan with its 5% and India with its 3.6% follow respectively.

Besides the UN, Russia with its 3.5% holds the first place among the top five most oil consuming countries; Russia's daily oil consumption is 2.9 million barrels. If considering that the USA and Russia are only two countries among all of the oil consuming countries and are also oil producers, we can say that the increase in oil prices will mostly affect Asian countries. This includes China with its oil consumption rising daily at 7.5% and Japan, whose import consists of 10% of Iranian oil.

Thus, China meets 60% of the demand for oil from the Middle East. Iran is China's third biggest oil supplier after Saudi Arabia and Angola. Iran has already

repeatedly threatened many countries by blocking the Strait of Hormuz. If this happens, most of the damage may be to China's economy.

The increase in oil prices can also affect the European Union countries. Because EU countries meet 20-30% of their oil needs from Iranian oil. If huge countries such as China, Japan, India and Turkey will refuse Iranian oil because of sanctions and start to find other sources, the demand for oil will increase. This will cause an increase in oil prices, the deepening of the Euro zone crisis, and also will lead to the decline of the economic growth rate in countries such as China and India.

However, it should be noted that the European Union in terms of meeting their energy resource issues, mostly depend on Russia and the North African countries. Also, the European Union's import includes only 4% of the Iranian crude oil.

In 2012, OPEC decreased the forecast for the world's daily oil consumption by 0.2 million barrels. The consumption forecast has been reduced from the previous forecast of 1.3 to the 1.1 million. According to OPEC's forecast the world's oil consumption this year will be 88.9 million barrels a day.

As for the tension around Iran, which influences Azerbaijan, there may be some positive as well as negative causes. As a result of the growth in oil prices, Azerbaijan's economy can get additional income in a short-term period of time. However, in the long-term, the high prices are expected to affect internal prices. Thus, as a result of the increase in the prices of products imported from foreign countries, an imported inflation may occur. This, in turn, can lead to the

deterioration of the population's living standards. On the other hand, this may damage the real sector and the banking system in Azerbaijan.

In general, the factors that affect Iran's economy can be divided into the internal and external factors. External factors include international sanctions. As a result of international sanctions, the volume of foreign investments into Iran is small. Also, due to sanctions, Iran is not able to improve its oil and gas infrastructure and therefore, these sectors cannot be fully developed. It is not accidental that Iran imports gasoline from abroad for not being able to recycle oil-gas products. There are also difficulties in finding the means to finance the trade sector in Iran.

As mentioned above, the dependence on the energy sector, the futility of economic management, and the flawed economic policy can be related to the internal factors. In addition, Iran relied on ideology even in its treatment of its neighboring Muslim countries, contributing to the weak economic relationship among them. The rapid economic development of Iran can only be achieved through reforms and a renewed openness to the world.

Although the country has extensive natural resources, there are few opportunities to use these resources effectively. Signs of a crisis in Iran's economy are not yet felt, as oil prices remain high. Some experts affirm that the country's income from oil covers the gaps present in its economic sphere.

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