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Sanctions, Economic Mismanagement, and Interpreting the Iranian Currency Crisis, 2010 - 2012

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1 Introduction

In October 2012, the Iranian rial earned the unwelcome distinction of the world's least valued currency. It had lost more than 80% of its open market value in the previous two years, crashing from 9,800 to 37,000 rials (IRR) per U.S. dollar (USD). As the rial lost value, demand for more reliable hard currencies surged until it far exceeded the Central Bank of Iran's (CBI) official supply. The widening spread between the official and black market rates reinforced loss of public confidence in the rial and perpetuated the cycle of devaluation.

Many western analysts, taking their cue from U.S. officials, claimed this devaluation proved the efficacy of international sanctions.[1] The Bloomberg editorial board heralded the rial's "death spiral" as "the first clear sign that we're on a path to victory."[2] The Cato Institute proclaimed the arrival of hyperinflation and projected the rate to double every 38 days.[3] Forbes termed this imminent hyperinflation "a weapon of mass destruction" and likened Iran to Zimbabwe and Weimar Germany.[4] Such reputable outlets as CNN, the Boston Globe, BBC News, the New York Times, and the Wall Street Journal offered variations on the same theme: because of sanctions, Iran wavered on the brink of financial collapse.[5]

These analysts badly misjudged the currency crisis. Two years later, the rial has stabilized, albeit at a devalued rate. Inflation has dropped 50% in the last year, and the economy has pulled out of recession, with estimates of economic growth between 2.9% and 4.6%.[6] Iran may be feeling the pain of sanctions, but it has not collapsed into the hyperinflationary death spiral that so many analysts confidently predicted. Their errors derived from superficial analysis, classic confirmation bias, and a misunderstanding of the dynamics of the Iranian foreign exchange market.

In reality, the complex interplay of several related factors prompted the crisis: economic mismanagement under President Mahmoud Ahmadinejad, public loss of confidence in the rial, and the impact of the 2012 sanctions on inflationary expectations. Furthermore, because of the particular relationship between Iranian state structures and its isolated economy, the impact of the currency crisis was restricted to a very small segment of the economy. This

[1] It is important to note that not all analysts fell into the same errors. Both the Washington Post and the Christian Science Monitor, for example, published articles that acknowledged the role of domestic economic policy in the rial's devaluation. Several Iranian economists and policy analysts directly rebutted the misleading analyses in editorials and blog posts. However, the prevailing narrative remained focused primarily, if not exclusively, on sanctions. See Joby Warrick and James Ball, "Food prices, inflation rise sharply in Iran," Washington Post, 5 Oct 2012, www.washingtonpost.com/world/national-security/food-prices-inflation-rise-sharply-in-iran/2012/10/04/44521436-0e69-11e2-bb5e-492c0d30bff6_story.html.

[2] "Turning Iran's Currency Crisis into a Revolution," 7 Oct 2012, Bloomberg, www.bloomberg.com/news/2012-10-07/turning-iran-s-currency-crisis-into-a-revolution.html

[3] Steve H. Hanke, "Hyperinflation Has Arrived in Iran," Cato Institute, 3 Oct 2012, www.cato.org/blog/hyperinflation-has-arrived-iran

[4] Addison Wiggin, "In Terms of Hyperinflation, Iran Going the Way of Weimar," Forbes, 10 Oct 2012, www.forbes.com/sites/greatspeculations/2012/10/10/in-terms-of-hyperinflation-iran-going-the-way-of-weimar/

[5] "As Iran's economy crashes, sanctions could yet bear fruit," Boston Globe, 6 Oct 2012, www.bostonglobe.com/opinion/editorials/2012/10/05/iran-economic-crash-shows-sanctions-are-working/4uPWcHe4JE9PWiof2dtaeN/story.html; Steve Hargreaves, "Behind Iran's Currency Crash," 5 Oct 2012, money.cnn.com/2012/10/05/news/economy/iran-currency/; "Iran's rial hits an all-time low against the US dollar," BBC News, 1 Oct 2012, www.bbc.com/news/business-19786662; Alen Mattich, "Lessons from Iran's Hyperinflation," Wall Street Journal, 5 Oct 2012, online.wsj.com/articles/SB10000872396390444223104578038070985468966; Rick Gladstone, "Iran Sanctions May Cut Supply of Currency," New York Times, 16 Oct 2012, www.nytimes.com/2012/10/17/world/middleeast/irans-supply-of-currency-may-be-at-risk-in-sanctions.html.

[6] Bijan Khajepour, "Decoding Iran's Economic Indicators," Al Monitor, 22 Oct 2014, www.al-monitor.com/pulse/originals/2014/10/economic-indicators-iran.html

allowed the government to resurrect its multiple exchange rate system to subsidize essential goods.

Despite drastic reactive measures, the government quickly stabilized the rial and adapted the new situation to its advantage. Iran does not seem to have been at any immediate risk of financial collapse. In fact, the ruling elite has strengthened its economic and political positions as a result of the devaluation.

2 Historical Development of the Currency Crisis

The rial's abrupt depreciation from 2010-2012 overshadowed a long history of currency decline. In 1980, the nascent Islamic Republic plunged into economic travail during its ruinous eight-year war against Saddam Hussein. Military imports and capital flight propelled high demand for foreign exchange, despite a wartime drop in dollar-denominated oil exports. In response, the government instituted a system of multiple exchange rates and intense capital controls. By the end of the war, Iran had twelve different IRR/USD exchange rates, all overvalued. This abstruse system stabilized the rial but, over time, led to macroeconomic distortions, budget deficits, pressure on foreign exchange reserves, and corruption.

The postwar administration of Ali Akbar Hashemi Rafsanjani (1989-1997) gradually reduced the number of exchange rates, but unification carried high transition costs for the fragile economy. For example, in March 1993, Iran briefly eliminated all but one official exchange rate that coexisted with a parallel open market rate (legal, but outside the banking system). The official rate was a managed float based on the open market; however, by December, unexpectedly low global oil prices and expansionist fiscal policy rendered it unsustainable. Inflation skyrocketed from 22.9% in 1993 to a high of 58.8% in 1995, and Iran subsequently reverted to multiple rates.[7]

Lasting exchange rate unification was not feasible until 2002, under reformist president Mohammad Khatami (1997-2005). The CBI adopted a managed float at IRR 7,900 per USD 1. This reflected the rial's steady depreciation since the revolution: between 1978 and 2001, the official rate fell from IRR 70 to IRR 1,750 per USD 1, while the open market rate dropped more drastically from IRR 100 to IRR 7,920.[8]

The CBI could maintain this managed float at relatively low cost because it controlled the flow of dollars into Iran. The rial was not fully convertible: it held no value on global exchange markets, and it was used almost exclusively inside Iran. Crude oil exports were the primary mechanism by which dollars entered the Iranian economy. The petroleum industry is state-owned and operated, with the CBI acting as a clearinghouse for almost all transactions. As a result, the CBI controlled the domestic supply of dollars and effectively manipulated it to prop up the rial.

Traditionally only individuals and import companies that dealt in "essential goods" or had government connections (often these were the same entities) could readily access large sums of dollars. A thriving black market for dollars emerged in the Tehran bazaar to handle excess demand. Black market demand derived primarily from other private sector entities

[7] V. Sundararajan, Michel Lazare, and Sherwyn Williams, "Exchange Rate Unification, the Equilibrium Real Exchange Rate, and Choice of Exchange Rate Regime: The Case of the Islamic Republic of Iran," Middle Eastern Department, International Monetary Fund, Jan 1999, www.imf.org/external/pubs/ft/wp/1999/wp9915.pdf.

[8] Jahangir Amuzegar, "Iran: The Rial Saga," Middle East Economic Survey, Vol 55, No 32, 6 Aug 2012, archives.mees.com/issues/1435/articles/49192

and anyone wishing to travel or pay tuition abroad – not nearly enough to exert significant pressure on the rial. As long as the spread between the official and black market rates remained negligible, the government tolerated unofficial currency trading in the bazaar.

However, the turn of the decade saw rising volatility in Iranian currency markets. September 2010 marked the first time since the 2002 currency reform that the black market rate dipped markedly below the official rate. Between September 2010 and October 2012, the low point of the crisis, the Iranian rial lost almost 80% of its open market value, falling from around IRR 9,800 to IRR 37,000 per USD 1 (see Figure 1).

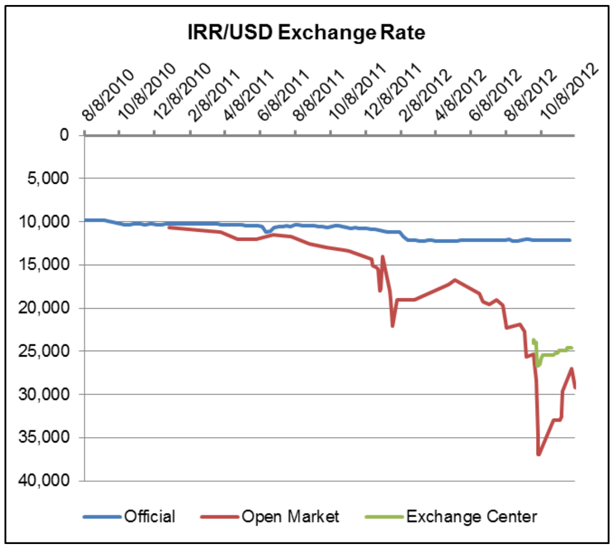

Figure 1: Sourced from author calculations and various open source reports.

In late September 2012, the CBI abandoned the managed float and resurrected a version of the old postwar multiple exchange rate system. The CBI categorized goods by relative economic importance and assigned different exchange rates to each category:

1. Official (Reference) Rate: a peg against the dollar at IRR 12,260 per USD 1. The most privileged rate applied only to essential goods, such as food and medicine.
2. Exchange Center (Non-Reference) Rate: purportedly a managed float against the dollar, set daily by the CBI at 2% below open market.[9] It was used to import other priority goods, such as livestock, metals, and minerals.[10]
3. Open Market (Black Market) Rate: free float against the dollar.

[9]This rate, called either the "non-reference" or "exchange center" rate, was administered through a new Foreign Exchange Center that opened on 23 September 2012. The initial exchange center rate of IRR 24,040 per USD 1 was approximately 2% below the open market rate that day, and, by the end of the month, its rate had stabilized around IRR 24,000-25,000 per USD 1. However, this was clearly far more than 2% below the open market. Empirical data suggests that, during its first two months of operation, on average the exchange center rate actually was about 18% below the open market.

[10]Najmeh Bozorgmehr, "Iran struggles to curb currency crisis," Financial Times, 27 Sep 2012.

3 Causes of the Crisis

At the height of the crisis in early October 2012, President Mahmoud Ahmadinejad blamed sanctions for the chaotic currency markets. "Are these currency fluctuations because of [domestic] economic problems?" he asked reporters in Tehran. "The answer is no. Is this because of government policies? Never… it's due to psychological pressure. It's a psychological battle."[11] U.S. officials gladly accepted the blame. A U.S. State Department spokesman claimed that month: "[The rial's devaluation] speaks to the unrelenting and increasingly successful international pressure that we are all bringing to bear on the Iranian economy."[12]

This expedient causal line from sanctions to currency collapse does not stand up to scrutiny. No single factor caused the currency crisis. Rather, it was the interplay of three related factors: economic mismanagement; loss of public confidence in the rial; and the indirect impact of sanctions on inflationary expectations.

3.1 Economic Mismanagement

When Ahmadinejad ran for president in 2005 and 2009, he promised a welfare-oriented economic plan that included an overvalued rial, expansionist fiscal policy, and low interest rates. In essence, his philosophy was to focus Iran's considerable oil revenue on the poor. But these policies reflected his populist agenda rather than sound economic principles. Ahmadinejad brazenly disdains economics; he has stated publicly, "I pray to God I never know about economics," and claimed to take economic policy advice from his local butcher.[13] His fiscal profligacy directly undermined the Iranian economy.

Iran experienced record inflation from 2005 to 2012. Official reports comparing food prices show year-on-year increases of 42% for dairy products, 47.5% for red meat, 29% for rice, and 92% for vegetables from 2011-2012.[14] The owner of a chicken shop in southern Tehran recounted this price volatility:

> Yesterday, I had some orders from some regular customers. So I sold them chickens for 50,000 rials each, but when I went to buy the chickens today, the price had spiked 5,000 rials overnight. I had to pay 55,000 rials for each chicken, so I lost some money. It would be fine if this was a one-time thing, but it keeps happening. The prices, they've fluctuated so much the last couple of months.[15]

Iran's inflation stands out even more starkly when compared with the economies of its major trading partners, which only saw year-on-year increases of 2-4%. These inflation differentials alone indicate that the rial should have lost nearly 90% of its value between 2005 and 2011.[16] Instead, the government continued its practice of overvaluing the rial to benefit importers and symbolize strength against the West. This defied not only economic prudence but also the

[11] Saeed Kamali Dehghan, "Mahmoud Ahmadinejad: Iran's currency crisis due to psychological war," The Guardian, 2 Oct 2012.

[12] Sasan Fayazmanesh, "The Forces Behind Iran's Currency Crisis," Counterpunch, 11 Oct 2012.

[13] Quoted in "The Populist's Problem," The Economist, 5 May 2009, www.economist.com/node/13580307; and Robert Tait, "It's the economy, Mr Ahmadinejad," The Guardian, 19 September 2007, www.theguardian.com/world/2007/sep/19/iran.roberttait.

[14] Najmeh Bozorgmehr, "Subsidy dispute adds to Iran's woes," Financial Times, 25 Apr 2012, www.ft.com/intl/cms/s/0/a6ac4438-8ebe-11e1-ac13-00144feab49a.html.

[15] Jay Newton-Small, "The Iranian Currency Crisis: Three Possible Scenarios," TIME Swampland, 4 Oct 2012.

[16] Amuzegar, "Iran: The Rial Saga."

explicit terms of Iran's Fourth Economic Development Plan (2005-2010), which mandated exchange rate adjustments to account for foreign inflation.[17]

Ahmadinejad exacerbated the problem by holding nominal interest rates artificially low – well below the rate of inflation. In 2008 Tahmasb Mazaheri, the second CBI governor under Ahmadinejad, cautioned that this policy could spark hyperinflation, but Ahmadinejad dismissed his warnings.[18] When the rial began its steep descent in late 2010, interest rates were dangerously low (around 13% annually on short term deposits). In April 2011, the CBI inexplicably lowered rates even further (to about 12%). Then-CBI Governor Mahmoud Bahmani promised the cut would "decrease the final prices of products and control and manage imports," over the furious protest of many private banks.[19]

Into this chaos, Ahmadinejad introduced several ill-conceived populist programs. The massive Maskan-e Mehr (Goodwill Housing) project was, in many ways, the signature program of Ahmadinejad's administration. Introduced in 2007, the Mehr housing project targeted a severe shortage of housing for Iran's working class. Ahmadinejad provided free government land to developers in order to build two million affordable housing units. Eligible first-time homeowners who could not otherwise access necessary credit were granted 99-year mortgages guaranteed by the state.

As a populist program, the Mehr housing project backfired. Iranian banks had granted loans worth over IRR 100 trillion (USD 10.2 billion) to first-time homeowners by January 2011, and the government itself borrowed upwards of IRR 400 trillion from the CBI to finance the program.[20] Granting extended lines of credit had the added effect of fueling inflation. As rising prices made these ventures unprofitable for developers, many were abandoned mid-construction, without access to clean water, heating, and sewage. The government loans could only partially cover the cost of a mortgage. Homeowners failed to make payments, and the government was left holding all the bad debt.[21]

Subsidy reform, though prudent in concept, fell victim to flawed implementation. The Targeted Subsidies Reform Act, passed in March 2010, phased out Iran's extensive system of indirect subsidies on energy and other basic goods. The high cost of these subsidies had become unsustainable, estimated at 25% of total GDP in 2009 (USD 335 billion).[22] Ahmadinejad decided to compensate the population for soaring post-reform prices with monthly direct cash transfers of IRR 455,000, which totaled nearly USD 2.7 billion per month.[23]

The Majlis (Iranian parliament) proposed using half the revenue from subsidy cuts for these compensatory payments and half to support domestic producers. Instead, Ahmadinejad dropped the producer support and increased the cash transfers in a misguided attempt to mitigate political backlash. The abrupt switch to non-subsidized prices, combined with excess

[17] Jahangir Amuzegar, "Iran's Fourth Plan: A Partial Assessment," Middle East Policy Council Journal, Vol. XVII, No. 4, Winter 2010, www.mepc.org/journal/middle-east-policy-archives/irans-fourth-plan-partial-assessment.

[18] "The Populist's Problem," The Economist, 5 May 2009, www.economist.com/node/13580307.

[19] Amiri, "Iran cuts interest rates on savings, loans"; Amuzegar, "Iran: The Rial Saga."

[20] "$10b Allocated for Mehr Housing," Iran Daily, 13 January 2011, old.iran-daily.com/1389/10/23/MainPaper/3870/Page/4/Index.htm.

[21] "Iran's economy struggles to support Ahmadinejad's ill-conceived housing vision," The Guardian, 30 January 2014, www.theguardian.com/world/iran-blog/2014/jan/30/irans-economy-struggles-to-support-ahmadinejads-ill-conceived-housing-vision.

[22] Semira Nikou, "The Subsidies Conundrum," United States Institute of Peace, Iran Primer, iranprimer.usip.org/resource/subsidies-conundrum.

[23] Farnaz Fassihi, "Iranians, Given No Choice, Adjust to Soaring Prices," Wall Street Journal, 20 Jan 2011, online.wsj.com/article/SB10001424052748704637704576081990207590326.html; Bozorgmehr, "Subsidy dispute adds to Iran's woes"; Najmeh Bozorgmehr, "Iranian parliament revises budget law," Financial Times, 21 Oct 2012, search.proquest.com/docview/1113986184/13ACF248F176119E6AE/13 ?accountid=14026.

liquidity from the cash transfers, skyrocketed inflation to 30-45%.[24]

Beyond inflation, expansionist programs like these cash transfers and the Mehr housing program also drove up the budget deficit. The cost of the cash transfers far outstripped any government savings from subsidy reform. During Iranian year 1391 alone (March 2012 – March 2013), the government saved IRR 280 trillion but paid out IRR 420 trillion in these transfers.[25] This shortfall had to be financed out of the general budget. According to Minister of Economy Ali Tayeb-Nia, Iran had accrued a budget deficit of IRR 160 trillion by February 2012. Government expenditures in the preceding year exceeded revenue by a staggering IRR 96 trillion, which amounted to 45% of the total budget.[26]

The government turned to a number of questionable sources to fill this gap: funds previously allocated to other uses, holdings of the Oil Development Fund and National Development Fund, and CBI loans. The CBI provided the necessary rials for these loans by selling foreign exchange on the black market. This arbitrage provided greater numbers of rials for increasingly fewer petrodollars. According to Ahmad Tavakkoli, Majlis representative from Tehran and head of the Majlis Research Center, the administration had earned IRR 110 billion in this way by September 2012.[27]

Arbitrage on a government scale has precedent in Iran. The CBI admitted to selling hard currency on the black market in the early 1990s under similar circumstances: multiple exchange rates, high inflation, and a mounting deficit. That likely accounts for the unexplained increase in the share of "other revenue" in the annual budget from an average of 14% during the years preceding and during the Iran-Iraq War (1978-1988) to an average of 36.2% in the four years after the war ended (1989-1992).[28] But debt monetization is shortsighted, especially in times of fiscal turmoil. It increases the money supply and perpetuates the cycle of devaluation.[29]

3.2 Loss of Confidence

The cumulative result was a loss of public confidence in the rial. As rial accounts paid interest far below inflation, Iranians rushed to move their savings into non-rial assets, such as gold, foreign exchange, and real estate. Public anxiety steadily weakened the rial, so that the new round of sanctions in 2012 fell on a vulnerable environment of high inflationary expectations and low confidence in the currency.

Government mishandling of the crisis only confirmed fears and further eroded confidence, especially after the low point in 2012. The CBI's initial response was characterized by empty promises, insufficient action, and coercion. For example, the CBI expected the new Exchange

[24] Bozorgmehr, "Subsidy dispute adds to Iran's woes."

[25] "State of Economy in Iran," Uskowi on Iran, 10 March 2013, www.uskowioniran.com/2014/03/state-of-economy-in-iran.html.

[26] Ahmad Tavakkoli, "Parliament critical of government's handling of subsidies," Radio Zamaneh, 22 Apr 2012, archive.radiozamaneh.com/english/content/parliament-critical-governments-handling-subsidies; "State of Economy in Iran," Uskowi on Iran, 10 March 2013, www.uskowioniran.com/2014/03/state-of-economy-in-iran.html.

[27] Hamid Mafi, "Overt and covert hands in Iran's foreign currency market," Payvand News, 13 Sep 2012, www.payvand.com/news/12/sep/1111.html; Tavakkoli, "Parliament critical of government's handling of subsidies."

[28] Abbas Valadkhani, "An Empirical Analysis of the Black Market Exchange Rate in Iran," Asian-African Journal of Economics and Econometrics, 4(2), 2004, 141-52.

[29] In this case, it was not only shortsighted but also illegal. The Majlis passed a law in 2012 prohibiting the use of oil revenues or arbitrage in currency markets to fund the targeted subsidies. However, the enforcement mechanisms for this law were never clear, and it seems that the practice continued regardless.

Center not only to provide a mid-tier rate for essential goods, but to stabilize the open market rate as well. It had the opposite effect. The rial lost nearly 40% of its value in the three months preceding the opening of the Exchange Center; it lost that much again in the week after.[30]

To a wary public, the creation of the Exchange Center confirmed that the CBI lacked sufficient hard currency reserves to meet rising demand. Suspicion trumped the CBI's promise to sell 14.5% of oil export proceeds and 20% of its sovereign wealth fund at the Exchange Center.[31] Further, the Exchange Center rate was fixed at 2% below the open market rate. With this privileged second tier now linked to the free-falling market rate, importers of affected goods anticipated future price increases.[32]

The government soon turned to more heavy-handed tactics. In early January 2012, all non-official currency trading was banned.[33] Iranian security forces shut down the Tehran bazaar multiple times over the next several months. Currency speculators were arrested for trading dollars at less than the official rate, accused of "acting in line with the nation's enemies," and threatened with execution.[34] SMS text messages with the words "dollar" in English or Farsi or "foreign currency" in Farsi were censored.[35] By September 2012, the CBI had stopped reporting the value of the rial and forced the handful of private Iranian currency-tracking websites to do the same.[36] Far from calming the markets, however, coercion and censorship further undermined public confidence by suggesting the government had something to hide.

Contradictory and confusing statements by Iranian officials compounded the sense of uncertainty. On the same day that Ali Larijani, speaker of the Majlis, said foreign exchange reserves were low, his deputy, Mohammad Reza Bahonar, claimed that reserves were more than sufficient to support the rial.[37] Mehdi Ghazanfari, the Minister of Industry, Mines, and Commerce, blamed "non-economic perpetrators" for the currency fluctuations and publicly called for the intervention of Iranian security forces.[38] Ahmadinejad himself bizarrely hinted at currency sabotage by a cabal of 22 unnamed internal enemies.[39]

3.3 International Sanctions

Thus, by 2010 Iran had a grossly overvalued rial and expanding domestic liquidity, thanks to years of economic mismanagement. The Iranian people were rapidly losing confidence in their currency. The rial was vulnerable, and international sanctions provided the catalyst for swift devaluation. The first sharp drop, when the rial declined 20% against the dollar in one

[30]"Open Letter to the President's foreign exchange / currency market would correct policy (Title Translated from Original Persian)," Mehr News, 5 Oct 2012; "Dollar prices increased by Rs 300 to Rs 3620 reached (Title Translated from Original Persian)," ILNA, 7 Nov 2012.

[31]"Iran Investment Monthly," Vol. 6 No. 73, Turquoise Partners.

[32]Yeganeh Torbati, "Iran rial plunges as Western Sanctions bite," Reuters, 1 Oct 2012.

[33]Bill Spindle, Benoit Faucon, and Farnaz Fassihi, "Iran Cracks Down on Dollar Trades," Wall Street Journal, 17 Jan 2012.

[34]Thomas Erdbrink, "Iran warns currency speculators as rial continues to fall," Washington Post, 1 Feb 2012; Spindle, et. al., "Iran Cracks Down on Dollar Trades"; Andrew Torchia, "Analysis: Iran government likely to win battle of wills over currency," Reuters, 9 Oct 2012.

[35]"Iran censors news of currency plunge," AFP, 11 Sep 2012.

[36]"Iran Censors Currency Rates as Rial Suffers," Wall Street Journal, 9 Oct 2012.

[37]Nazanin Kamdar, "The Foreign Currency Crisis is Causing Mayhem in Iran," Payvand, 4 Oct 2012, www.payvand.com/news/12/oct/1028.html

[38]Kamdar, "The Foreign Currency Crisis is Causing Mayhem in Iran."

[39]Thomas Erdbrink, "Iran's President Ties Recent Drop in Currency to U.S.-led Sanctions," New York Times, 2 Oct 2012, www.nytimes.com/2012/10/03/world/middleeast/iran-president-mahmoud-ahmadinejad-ties-currency-drop-to-sanctions.html?_r=2&

week in September 2010, coincided with news that banks in the United Arab Emirates had stopped processing financial transfers to Iran.[40] Then, three major sanctions-related events occurred in the first half of 2012:

1. In January, the United States intensified sanctions against the Iranian banking sector, targeting the CBI and all financial institutions that transacted with it.[41] This impeded the export of oil, because foreign importers usually dealt directly with the CBI.[42]

2. Also in January, the European Union (EU) announced new sanctions that prohibited the import of Iranian oil and insurance of Iranian tankers. This prevented the purchase and transport of Iranian crude by Asian oil refiners (e.g. in South Korea, Singapore, Turkey), which were otherwise willing to defy sanctions.[43] Shipments could continue only if importing governments offered sovereign insurance guarantees, as China and Japan proceeded to do, or if Iranian exporters used their own tankers and insurance. However, neither of those workarounds could handle the volume of previous oil sales, especially since a number of Iran's largest tankers already were in use as floating storage units.[44]

3. In March, Belgium-based financial clearinghouse SWIFT stopped service to Iranian banks, including the CBI.[45] SWIFT, the world's largest interbank electronic payment system, plays a crucial role in efficient international trade. In 2010 alone, Iranian banks had used SWIFT to make more than two million cross-border payments, most of which were remittances of payment for oil and other exports.[46] Iran's exclusion from SWIFT was an unprecedented blow to its ability to conduct international trade, and it imposed large additional transaction costs.

The effect of sanctions on inflationary expectations is undeniable. Iranians scrambled to sell their rials; in an environment of rapidly fluctuating prices and general economic uncertainty, even ordinary Iranians read further sanctions as a danger to their currency. But those same sanctions, imposed on a well-managed Iran, would not have had such a devastating effect. Iran could have worked much earlier to curb inflation by raising interest rates and exercising fiscal restraint. Leaders could have harnessed the benefits of subsidy reform. Recognizing the dangers in an overvalued rial, they could have prepared for an orderly realignment of the exchange rate. Any of these measures would have mitigated the impact of sanctions on the currency in 2012.

Absent sanctions, the rial would not have fallen as far or as fast. But the underlying vulnerabilities took root in decades of ill-conceived economic policy and Ahmadinejad's blinding populist agenda.

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[40] Acil Tabbara, "Most UAE Banks stop transfers to Iran after sanctions," AFP, 5 Sep 2010, www.google.com/hostednews/afp/article/ALeqM5jyh0qPCQrAQNBg0rOOVUJizbCQJA.

[41] "U.S. Targets Iran's Central Bank," Wall Street Journal, 4 Jan 2012, online.wsj.com/article/SB10001424052970204720204577132923798499772.html.

[42] Moustafa al-Labbad, "Iran Economic Crisis May Provide Rafsanjani With Re-Entry," Al-Monitor, 10 Oct 2012, www.al-monitor.com/pulse/politics/2012/10/irans-economic-crisis-may-be-an-opportunity-for-former-president-rafsanjani.html.

[43] Najmeh Bozorgmehr, "Sanctions threaten weak Iranian economy," Financial Times, 27 Jun 2012, search.proquest.com/docview/1022451542/13ACF5C1BEA1C08504D /11?accountid=14026.

[44] Javier Blas, "Insurance ban hits Iranian oil sales," Financial Times, 18 Jun 2012.

[45] "Swift to Cut Ties With Iran Banks After EU Ban," Wall Street Journal, 15 Mar 2012, online.wsj.com/article/SB10001424052702303863404577283532862521716.html.

[46] Rick Gladstone and Stephen Castle, "Global Network Expels as Many as 30 of Iran's Banks in Move to Isolate Its Economy," New York Times, 15 Mar 2012, www.nytimes.com/2012/03/16/world/middleeast/crucial-communication-network-expelling-iranian-banks.html?_r=0.

4 Severity of the Crisis

Most contemporary analysis not only attributed far more to the potency of sanctions than was warranted but also wrongly predicted total financial devastation. Iran certainly experienced a major currency devaluation starting in 2010, and the government was forced to adopt drastic reactive measures. But the economy was not in imminent danger of collapse.

Part of the fallacy derived from faulty historical comparisons. The Iranian experience in 2010-2012 differed from the dramatic devaluations that preceded financial crises across Asia in the late 1990s or in Argentina in 2001. In Thailand, for example, devaluation of the baht affected all prices because foreign trade and investment played a significant role in the economy and all foreign exchange traded at the same rate. Compounding the problem foreign debt repayments. Western countries had invested heavily in Asia through the 1990s. As a result, Thailand amassed substantial dollar-denominated debt, which it was forced to repay using the free-falling local currency. This led to default and plunged Thailand into deep economic crisis.

In contrast, a devalued rial impacted a relatively small sector because of the isolation of the Iranian economy. Ahmadinejad addressed this phenomenon in a 2012 speech: "Everyone is aware that foreign trade and commerce don't have a very high share in the Iranian economy... the number of U.S. dollars being exchanged in our country is not that big."[47] Crucially, the government already controlled almost all foreign exchange through the state-owned petroleum industry. The CBI did not need to print or buy foreign exchange at crippling cost to finance its expenses. It simply could sell part of its dollar holdings at a much lower rate, as it did through the multiple exchange rate system.

Most Iranians lived well below the median income level and could only afford to buy essential goods (e.g. food, fuel, medicine) using rials. Under the multiple rate system, these goods were imported at the official rate – that is, implicitly subsidized. In this way, most Iranians were protected from the full deleterious effects of the crisis. Hardship was concentrated in Iran's upper-middle class, composed of people working in the marginalized private sector who had built up savings and could afford to travel or educate their children abroad. These nonessential goods and activities felt the full effect of devaluation because they were relegated to the open market – that is, implicitly taxed.

Furthermore, Thailand in 1997 had essentially zero foreign exchange reserves to defend the baht. It was forced to shift abruptly from a fixed rate to a free float against the dollar, triggering a drastic fall in the baht's value. Iran, on the other hand, held extensive reserves to defend the official rate until the situation stabilized.[48] Iran earned around 47% of its total oil income of the last 103 years between 2005-2012 and, according to official figures, pulled in USD 166 billion in 2011 alone.[49] Even with a healthy skepticism of self-reported economic

[47] Quoted in "Iran's Rial: Bad policy or Western sanctions?" Inside Story, Al Jazeera, Video, 5 Oct 2012, www.aljazeera.com/programmes/insidestory/2012/10/20121056470377 845.html.

[48] There has been much recent scholarly debate on how to assess the adequacy of foreign reserve holdings. The IMF released a 2011 paper on the subject – but these are guidelines, at best. In this case, the vastness of Iran's foreign exchange holdings stands in stark contrast to Thailand's nonexistent reserves. Adopting multiple exchange rates rationed those holdings, so that Iran only needed to defend the exchange rate for a small segment of goods (i.e. official rate). Taken together, these features of the Iranian system suggest that Iran possessed ample foreign exchange to avert a full-blown currency collapse, at least in the short term. And, after all, the multiple exchange rates were intended as a short-term stabilization tool – a band-aid on a wound. See "Assessing Reserve Adequacy," International Monetary Fund, 14 February 2011, www.imf.org/external/np/pp/eng/2011/021411b.pdf.

[49] "A comeback for the reformers?" The Economist, 13 Oct 2012, www.economist.com/node/21564607; Mohammad Ali Shabani, "Iran's Currency Faces Pressures Beyond the US-led Sanctions," Al Monitor, 15 Sep

data, the International Monetary Fund estimated that Iran had over USD 100 billion in foreign exchange reserves in 2012.

Far from heralding financial collapse, the currency devaluation ushered in a new era of government control of the economy. The government tightened its grip on prices and foreign exchange supply through the multiple rate system. Ruling elements, especially in Ahmadinejad's inner circle and the Islamic Revolutionary Guards Corps (IRGC), enriched themselves. Arbitrage between the official and open market exchange rates earned vast sums for individuals, as well as banks and government entities.

For example, the IRGC used its access to privileged currency rates to purchase high-demand nonessential goods at a discount, which it smuggled into Iran and resold for a significant profit. The IRGC manages security along borders, at international airports (e.g. Imam Khomeini) and seaports (e.g. Qeshm and Kish), which grant control over major trade centers. It also operates so-called "invisible jetties" along the Persian Gulf and Indian Ocean coastlines to facilitate the import and export of smuggled goods.[50]

By design, the shift to multiple exchange rates in September 2012 drastically increased the cost of nonessential imports, including cars. The resulting scarcity fueled black market demand, driving up potential profits for smugglers. For this reason, the number of luxury cars imported in Mehr 1391 (22 September – 21 October 2012) skyrocketed almost 2000%, from 200 to 3,900.[51] The average price of each car sold that month rose 60%, from USD 21-23,000 to USD 35,000.[52]

To maximize profits, smugglers illegally purchased the cars at the official rate, using subsidized dollars earmarked for essential goods. The scale of this corruption is astounding. Iranian importers had misused around IRR 117 billion in this way as early as 4 November 2012 – less than two months after the introduction of the multiple exchange rate system.[53] According to Nader Ghazipour, a Majlis representative from Urumiyeh and member of an investigatory committee, the list of companies and officials involved was several pages long and implicated "high-ranking government officials" from the Ahmadinejad administration and several "quasi-governmental" companies – most likely IRGC-owned.[54]

Furthermore, the subsidized dollars used to purchase these cars appear to have been designated for medical imports. Through 2011-2012, Iran experienced a shortage of critical medical supplies, including both drugs and equipment. The official regime line was to blame the shortages and resulting hardships on sanctions.[55] However, in August 2013, CBI governor Mahmoud Bahmani confirmed that unnamed organizations "received currency at the

2012, www.al-monitor.com/pulse/originals/2012/al-monitor/more-than-sanctions-depressing-i.html.

[50]"Tejarat-e siah dar eskeleh-ha-ye namar-i," Quds Online, 6 Jul 2011, http://tinyurl.com/ooerxeb; Ali Alfoneh, Iran Unveiled: How the Revolutionary Guards Is Transforming Iran from Theocracy into Military Dictatorship, AEI Press, 18 Apr 2013.

[51]"Su estefade-e vared konandegan-e khodro az bohran-e arz-e keshvar," Donya-e Eqtesad, 18 Mar 2014, http://www.donya-e-eqtesad.com/news/792301.

[52]"Gozarash-e tekan dahande az fesad dar varedat-e khodro," Iran Briefing, 17 Mar 2014, http://tinyurl.com/ohfceu2.

[53]"'Su estefade 118 miliard tomani' bahzi az vared konandegan-e kala dar Iran," BBC Persian, 4 Nov 2012, www.bbc.co.uk/persian/iran/2012/11/121104_l31_iran_currency_misuse.shtml.

[54]"Esami sherkatha-ye vared konande 'khodro-ye luks' ba arz moraje," Tadbir Khabar, 18 Mar 2014, tadbirkhabar.com/news/economy/25243.

[55]Sanctions undoubtedly contributed to medical shortages, despite official exemptions for trade in medical and other humanitarian supplies. Anecdotal evidence suggests that Western suppliers are reluctant to sell medicine to Iran, despite the exemptions, because of their fear of unintentionally falling afoul of the sanctions. Even so, the regime's characterization of sanctions "killing" Iranian civilians is overblown and clearly designed for political effect. Much like the currency crisis, the medical shortage is primarily the result of misguided and corrupt practices by Iran's ruling elite – though no doubt then exacerbated by sanctions.

[reference] rate for importing 83 ships loaded with medicine and essential goods, but only eight of them were loaded with medicine and essential goods. The other 75 contained luxury items [i.e. cars]."[56]

In other words, not only had corrupt actors seized the chance to smuggle high-demand expensive cars at the official rate, but their actions contributed to the scarcity of medicine and other essential goods needed for a desperate population. This is just one way the IRGC and others exploited the currency system to tighten their economic grip and generate enormous personal and institutional profits.

Such centralized economic control further translated to enhanced political power. Corrupt and questionable practices – such as arbitrage in exchange markets to fund budget deficits – helped the Ahmadinejad administration avoid catastrophic financial problems and even mitigate some of the pressure of sanctions. Profits from these schemes helped offset revenue losses from sanctions on the petroleum industry. The middle class, weakened economically and politically by the crisis, would be even less able to protest the regime than during the brief Green Movement of 2009. Wealth begets influence, especially in a corrupt, opaque political system; thus, the IRGC in particular shored up its position against domestic challengers, such as current President Hassan Rouhani.

5 Conclusion

The rial depreciated significantly in the open market between 2010 and 2012, culminating in an abrupt drop to an all-time low of IRR 37,000 per USD 1. To many Western observers, this indicated that sanctions had caused a full-blown financial crisis and foretold economic collapse. This myth held a powerful appeal for those opposed to Iran's nuclear ambitions. It offered irresistible hope that Iran would soon be forced, out of sheer desperation, back to the negotiating table.

The true story was more complex and much less auspicious. Since the 2002 currency unification, a succession of Iranian administrations had deliberately overvalued the rial. Under Ahmadinejad, this combined with a number of other populist policies to severely weaken the economy and stoke massive inflation. Iranians rapidly lost confidence in their currency and began to move their wealth into non-rial safe havens, further driving down its value. The announcement of additional trade and banking sanctions triggered a precipitous currency devaluation in the open market. While the value of the rial would not have fallen so suddenly absent sanctions, it is not accurate to consider sanctions the cause of the plunge. As an Iranian economics professor put it, "I do not deny the effect of sanctions, but the weight of mismanagement is heavier."[57]

Because of the particular relationship between Iranian state structures and its isolated economy, the impact of the currency crisis was restricted to a very small segment of the economy. The government resurrected its postwar system of multiple exchange rates to subsidize essential goods. As a result, the brunt of the devaluation was felt only by those fortunate enough to want to conduct business outside Iran or send their children to school abroad.

[56] "Esami sherkatha-ye vared konande 'khodro-ye luks' ba arz moraje"; "Iran: Mullahs import luxury goods under guise of medicine," National Council of Resistance of Iran, 11 Aug 2013, www.ncr-iran.org/en/news/economy/14332-iran-mullahs-import-luxury-goods-under-guise-of-medicine.

[57] David Ignatius, "Iran Copes With Sanctions But Wants to Bloom," Washington Post, 20 Dec 2013, www.washingtonpost.com/opinions/david-ignatius-iran-copes-with-sanctions-but-wants-to-bloom/2013/12/20/76382bee-691b-11e3-a0b9-249bbb34602c_story.html

Government actors may have had to scramble in the initial aftermath of the currency drop, but they quickly stabilized the rial and adapted the new situation to their personal gain.

For many Iranians, the election of Hassan Rouhani as president in June 2013 represented hope of escape from this downward economic spiral. Rouhani presented himself as a rational leader, whose government of "hope and prudence" would take the necessary steps to restore stability. His early policies sought to combat Ahmadinejad's legacy of corruption, economic mismanagement, and abrasive foreign policy – but this is easier said than done. Even if Rouhani develops sound economic plans for reform, he will face significant political challenges to their implementation. Powerful domestic actors, including the IRGC and some of his own ministers, have both financial and political interests in opposing broad reform.

Rouhani's standing in the government is increasingly tenuous, as he fields criticism from both conservatives and frustrated reformers. Supreme Leader Ali Khamenei is giving him space to explore the potential for sanctions relief through negotiations and, so far, has reigned in the challenges from the right. Yet Khamenei's support for the president is neither unreserved nor guaranteed to continue indefinitely.[58] By permitting the negotiations but voicing pessimism about their efficacy, Khamenei has carefully positioned himself to claim credit (in case of success) or to abandon Rouhani to his fate (in case of failure). In many ways, Rouhani has staked his presidency on the success of these negotiations in propping up the economy.

The prospects for lasting reform in the currency markets are bleak. In a lecture last March, economist Mohsen Renani of the University of Isfahan argued that the Iranian economy has reached "a point of singularity," brought about by more than forty years of continued double-digit inflation, weak growth, high unemployment, and an atmosphere of extreme uncertainty.[59] Unless the Rouhani administration can transcend severe political pressure and develop wise, conservative economic policies, Iran might face yet another perilous crisis.

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[58]Khamenei holds himself at arm's length from the nuclear talks, granting Rouhani latitude to pursue a negotiated solution but clearly stating that he would prefer the domestic economic solution advocated by the IRGC. In a speech last February, Khamenei said: "But we also insist that the officials rely on domestic forces. We also want the officials to trust the people, to trust the domestic forces." Ali Khamenei, "Bianat dar didar mardom-e Azerbaijan," Speech, 17 Feb 2014, farsi.khamenei.ir/speech-content?id=25363.

[59]"Eghtesad-e Iran Asir-e Adam-e Eteminan," Iran Emrooz, 13 Apr 2014, www.iran-emrooz.net/index.php/politic/more/50238.