Study

Iran's Central Bank Struggles to Regulate Markets

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Abstract

The Central Bank of Iran (CBI), a financial arm for Iran's government, faces a tough battle ahead as it attempts to introduce policies to tackle the country's faltering economy. Under the 2015 Iran nuclear deal with world powers, known as the Joint Comprehensive Plan of Action (JCPOA), Iran limited its disputed nuclear program in exchange for sanctions relief. But in 2018, the Trump administration revived the sanctions regime against Iran by withdrawing from the nuclear deal. Iran's modest economic success was reversed, and the government dismissed the Governor of the CBI Valiollah Seif. He was replaced by Abdolnaser Hemmati. In October 2020, the United States imposed sanctions on major banks operating under CBI regulations in Iran.

In the midst of tight US sanctions, the CBI is operating increasingly as an extension of the Iranian government rather than functioning independently from the government by adopting policies to plug the country's budget deficit and to lend money to the government. Sanctions against the CBI, imposed after it was charged with supplying billions of dollars to Iran's Islamic Revolutionary Guard Corps (IRGC) following attacks on Aramco's oil facilities in Saudi Arabia in 2019, pushed it to undertake tasks to enable Iran's government and armed forces to function.

Assuming that sanctions will continue indefinitely, the CBI has addressed Iran's immediate market needs by expanding formal and informal options to trade internationally. The latest CBI policies have left much to be desired, considering Iran's volatile financial and trade markets, the non-transparent financial practices taking place between the CBI and black-market dealers, and conflicting state-led market policies. In the sections below, the paper reviews the CBI's policy challenges and the opportunities available to it as it regulates Iran's financial and trade markets in the months ahead.

Introduction

The CBI designs and implements monetary and credit policies to maintain the value of the Iranian national currency, the rial. The CBI has spent $280 billion to maintain the value of the rial since the start of a tight sanctions regime imposed by the United Nations against Iran in 2006. The CBI was sanctioned by the United States in September 2019 for maintaining financial ties with Iran's government and the IRGC.[1] Since the latest sanctions, the International Monetary Fund's (IMF) forecast shows that the CBI foreign reserves, estimated at around $130 billion in recent years, dropped to around $69 billion.[2] The rial could convert to the predominant market currency in Iran known as the toman, pending an approval from Iran's Parliament, in light of the rapid currency devaluation.

The Iranian government has tasked the CBI with maintaining the country's balance of payments and the monetary policies related to its five-year development plan, mainly through trade finance and letters of credit. Due to sanctions, the CBI was forced to initiate plans to liberalize the banking sector, which led to a large number of private banks emerging in Iran and challenges arising in relation to generating money for the country's banking and financial systems. Along with the sanctions, the liberalization process challenged the CBI's policies to support trade transactions, and ensure the overall growth of Iran's financial, economic and trade markets.

Despite the challenges, the CBI continues to issue notes and coins, supervise national banks and credit institutions in Iran, formulate foreign exchange policies and transactions, and regulate transactions in gold and other precious metals. Furthermore, as the government's banker, the CBI manages government financial accounts, grants loans and credits to state enterprises, banks and agencies, and purchases and sells government participatory papers.[3]

US sanctions and the coronavirus pandemic temporarily halted Iran's exports and led to the shutdown of its borders, forcing the CBI to think of new policies to stabilize Iran's financial and trade markets. But the policies failed to address Iran's monetary needs, fix its severe budget deficit, and halt hyper-inflation. As a result, Iran's economy shrunk between 7.5 percent and 11 percent in 2020. Sanctions alone led to a drastic decline in Iran's oil revenues, which dropped from

$100 billion resulting from the sale of $2.8 million barrels of crude oil daily and other oil byproducts after the nuclear deal was concluded, to $8 billion in 2019. It is estimated that the total cut in Iran's annual revenues when the US-led sanctions resumed in 2018 was roughly 50 percent.[4] The coronavirus pandemic led to the loss of nearly 6.5 million jobs. As a result, the CBI has been unable to fix the severe budget deficit, and stabilize the shrinking economy, which have caused higher inflation rates.[5]

The CBI is now mainly entrusted with protecting consumers by addressing the massive budget deficit crisis. The CBI has vowed to take an active role in regulating foreign currency exchange rates and financial market fluctuations. But its operations are only partly transparent. In fact, part of the capital generated by the CBI could have been sourced from irregular or illicit market practices in Iran.

Furthermore, Iran's blacklisting by the Financial Action Task Force (FATF), an inter-governmental body that sets international standards to prevent illegal financial activities, hampers the operations of the CBI by restricting Iran's international monetary transactions. This encourages the CBI and Iran's government to operate financial and trade markets in an increasingly non-transparent manner.

The following sections examine the challenges that the CBI faces to regulate Iran's financial and trade markets and review the options available to the CBI to regulate markets in the months ahead.

I-The Challenge of Regulating Volatile Financial and Trade Markets

1- *FATF Regulations*

The Iranian economy's future prospects to improve rests on its ability to abide by the terms of the nuclear deal and meet FATF regulatory requirements. The FATF demands that Iran ends money laundering, black market international profiteering, and terrorist financing.

In 2018, the Financial Crimes Enforcement Network (FinCEN), a bureau of the US Department of the Treasury, reviewed the methods that the Iranian government used to access international financial systems. FinCEN cautioned that Iran, and by extension the CBI, used illicit means to exploit financial systems including money laundering, broker deals, and other deceptive schemes. Masking illicit transactions through the CBI involves the misuse of domestic and third-country exchange houses and trading companies, running procurement networks that use front or shell companies, engaging in illicit shipments, and using precious metals and virtual currency to evade sanctions. Some of these activities helped fund the IRGC, as a result of which the United States sanctioned the former Governor of the CBI Valiollah Seif.[6]

The CBI continues to use several trading companies to conceal financial transfers for Iran's military purchases, according to the US Department of the Treasury. Since Iran's oil export revenues are usually deposited in its central bank, and the bank holds overseas accounts, monitoring the CBI's cash flows has demanded global scrutiny to fight its financial crimes.[7]

In February 2020, according to the FATF, Iran will remain on the FATF statement on High-Risk Jurisdictions Subject to a Call for Action due to the country's failure to enact the Palermo and Terrorist Financing conventions. To date, Iran's Parliament has approved only two out of the four required FATF bills, one on Iran's accession to the United Nations Convention against Transnational Organized Crime and the other related to amending Iran's Counter-Terrorist Financing Act.

Iran designated by the FATF as 'high-risk' means that the country will be excluded from international financial banking systems and other systems needed to facilitate low-risk foreign investments. Under these circumstances, even Iran's long-standing trade partners including Turkey, India, China and Russia have refused to offer Tehran major investment opportunities. As a result, experts have warned that Iran's blacklisting by the FATF in addition to the tight US sanctions could hasten the collapse of the Iranian economy.[8]

Although Iran claims to have implemented a domestic anti-money laundering law required by the FATF, the country is involved in international money laundering operations. Although the measure undertaken by the FATF falls short of sanctioning Iran, it enables the FATF to urge all jurisdictions to apply effective counter-measures in line with FATF recommendations to restrict Iran's access to international financial markets and banks.[9]

The aforementioned discourages Iran to comply with all FATF regulations, although it maintains contact with the body to address Iranian compliance deficiencies. In addition, Iran continues to fund armed militias such as Hezbollah. In February 2020, the FATF placed Iran on its terrorism financing blacklist after prematurely suspending it from the blacklist following the nuclear deal in 2016.[10] The move came a few months after the CBI made the case before Iran's Parliament for the country to join the FATF. This was in response to signals from Iran's key trading partners China and Russia to the effect that Iranian non-compliance with FATF regulations would carry dire trade consequences.[11]

The new CBI Governor Abdolnasser Hemmati dismissed the FATF blacklisting, and argued that it would not impact Iran's foreign currency exchange market given that 90 percent of its trade transactions are conducted through non-sanctionable financial channels that the country has set up to enable foreign trade.[12] While the FATF cannot impose sanctions on Iran or other individual states, its heavy extraterritorial regulations and penalties involved in trading with Iran and collective punitive measures by its member countries including the United States and European powers could prevent future investments in Iran.[13]

2-*Foreign Currency Fluctuations, Currency Decline, and Foreign Trade Irregularities*

The CBI insists that it can control Iran's rapid currency fluctuations after the US dollar sold for 19,000 tomans following the passing of a resolution by the International Atomic Energy Agency (IAEA) that called for the inspection of Iran's suspicious nuclear sites in July 2020.[14] The value of the US dollar in Iranian markets fluctuated in the following two months, reaching nearly 30,000 tomans to the dollar in open markets, a rapid rise from the special government rates given to exporters at 4,200 tomans against the US dollar. By October, the CBI vowed to return some $19 billion of its foreign currency held in third countries to control the ongoing currency fluctuation.[15] In addition, the CBI uses affiliated exchange bureaus to infuse currency into Iran's markets. Meanwhile, there is some speculation that Iran's government allowed foreign currency rates to surge in order to make money out of currency conversions through the black market, causing an artificial rise in Iran's stock market prices and increased foreign trade irregularities.[16]

What is clear is that the sudden surge results from the government's decision to infuse cash into the local stock market, through a combination of legal and illicit policies, which led to ballooning liquidity and higher inflation rates due to higher demands for foreign currencies and local cash. Iran's government justifies its policies and says they are necessary to plug the severe budget deficit caused by sanctions and the coronavirus pandemic.[17]

Simultaneously, the CBI summoned Iran's exporters to recycle foreign currencies given to them at lower conversion rates into Iran's economy. The CBI has called on all entities that have profited from the recent rapid market fluctuations in Iran to reinvest their profits into the local stock exchange to boost its value. It insists that the stock market needs small and large investors to save the Iranian economy and to ensure cash flows in domestic markets during the sanctions.[18]

But Iranian exporters are refusing to return export currencies given to them at favorable rates, once profits on exports are made. According to the CBI, the coronavirus pandemic was the main reason why the currency returns to Iran by exporters did not take place.[19] However, in reality, the sudden rise in foreign currency rates in Iran made it attractive for exporters to keep currency profits. When exporters receive low foreign currency rates to export goods, they either keep their profits in foreign bank accounts or sell the profit at higher currency rates in local black markets.[20]

As a result of this pervasive practice, some $20 billion in export currency was not returned to the CBI.[21] Before the latest round of sanctions, Iranian exporters were given 30 days to return foreign currency to Iran after export profits came in, in order to enjoy tax exemptions. Difficulties involved in transferring profits to Iran due to the sanctions led to the period increasing to four months. Still, out of a total value of $40 billion in non-oil exports only $10 billion returned to Iran. The remaining $30 billion never returned to Iran, either as product imports or cash.[22]

3- ***Ballooning Liquidity and Budget Deficit***

The Iranian government has borrowed money from the CBI to make up for a severe budget deficit. The borrowing has compelled the CBI to enforce new market regulations in order to generate money, however, without sufficient economic backing. By moving money around, the CBI and the Iranian government have infused cash into Iran's financial cycles, which in turn has caused high inflation rates without creating economic growth. By most estimates, Iran's liquidity growth was 12 percent higher in the first five months of the current Iranian calendar year beginning in March 2020, compared to the same period in the last five years.[23]

Subsequently, the local stock market saw some growth, despite a poor stock market performance earlier this year. Experts warned that Iran's stock market rates possibly represent fake figures, and that without government intervention, the market would collapse.[24] What is clear is that generating liquidity is essential to fight sanctions. The CBI has justified the policy by arguing that it will enable money to flow through Iran's regulated markets rather than through unregulated economic activities. But market psychology in Iran does not trust the CBI argument. While official inflation rates given by the CBI are less than 18 percent, unofficial rates of inflation are much higher, at 43 percent. This was despite earlier CBI projections of a maximum inflation rate of 22 percent.[25]

Iran's inflation rate is expected to increase even more, after the recent collapse of government plans to unveil a new economic opening package by pre-selling oil in the stock market, a move that would increase Iran's national debt and force the CBI to bankroll the debt.[26] In 2019, the CBI announced that Iran faced an unprecedented budget deficit of roughly $10.73 billion, as both oil and tax revenues decreased. The CBI figures showed that only 71 percent of expected tax income was actually realized, making it difficult for the CBI to save any accrued oil revenue.[27]

II-Options to Regulate Financial and Trade Markets

1- *Managing the National Debt*

Iran is seeking to reclaim assets held in foreign countries to better manage its national debt. Iran's assets abroad are roughly worth $85 billion since the US sanctions resumed in 2018, only 10 percent of which is accessible to Tehran according to a US Congressional Report published in 2020.[28] Recently, the CBI has been negotiating with South Korea's Chamber of Commerce for the return of some $6.5 billion to $9 billion in money owed to Iran.[29] In a separate move, the CBI is taking legal action to prevent Washington from seizing its assets at Deutsche Boerse, and has assessed the feasibility of a Swiss-proposed payment channel to facilitate humanitarian aid to Iran.[30] Still, the German Central Bank blocked Iran's withdrawal of $400 million in cash from Europaische-Iranische Handlesbank (EIH), partly owned byIran.[31]

To increase its limited foreign cash reserves, the CBI engages in smuggling illegal money, gold and other valuable cash or in-kind payments into Iran from other countries including from Afghanistan. In 2019, the outgoing head of Afghanistan's Central Bank Khalil Sediq revealed the transfer of tens of thousands of dollars to Iran on a daily basis through air and ground routes.[32] In 2020, Iran took gold bars equaling approximately $500 million from Venezuela, transferred by the sanctioned airline Mahan Air.[33] The United States has imposed pressure on other countries like Pakistan, Armenia, Qatar and Turkey to halt transferring cash or gold to Iran. Armenia attempted to but failed to resist US pressure to cut ties between Armenian private banks and Iran.[34] At least one Pakistani national, a member of an organization known as "Islamic Pulse" was charged in a US court with moving cash collected as a religious tax (*khums*) to Iran.[35]

Since the UAE closed down banking and money transfer channels with Iran in 2018, Tehran hoped to use Qatar and Turkey for cash and gold transfer purposes. Iranian banks including Parsian and Melli opened accounts with Qatar National Bank.[36] But in 2020, a major US indictment against the Turkish state-owned Halbank, and sanctions on two UAE-based companies, halted money laundering and gold scheme operations with Iran through third countries. These schemes previously involved Iranian registered businesses in the UAE before the United States took measures to shut those businesses down. The CBI also attempts to move cash around through other banks or businesses registered in the Middle East, China, Canada and Central Asia.[37]

To address the debt crisis, the CBI has extended a law approved by Iran's Parliament last year to enable local producers to repay government loans. The law encourages some 9,000 local debtors to pay money back to the CBI.[38] In June 2020, the CBI held an auction to sell $588 million in government Murabeha bonds on the Iran inter-bank trading platform. The bank vowed to sell more bonds valued at $8.8 billion. The measure aimed to raise $6.4 billion, via the debt market.[39] Over the course of the summer, the CBI also issued promissory notes to prevent further currency devaluation, and to boost the confidence of account holders to deposit money into local banks. In exchange, the money remains in banks and cannot be withdrawn until the end of a designated period. However, a withdrawal could take place along with an additional payment by the CBI to account holders in the event of a currency devaluation in accordance with the inflation rate.[40]

2- ***Developing Monetary Plans to Encourage Trade***

The CBI monetary and banking plans aim to evade sanctions. They include setting up a bartering system together with the Ministry of Industries and Customs Administration to facilitate trade at a time when almost all major foreign monetary channels are closed to Iran. In addition, the CBI has stepped up efforts to build financial mechanisms with neighbors and friendly countries, and is in talks with trade partners and regional and non-regional states to find ways to bypass existing restrictions.[41] Some 80 percent of Iran's borders, and 75 percent of border markets, have reopened since the coronavirus pandemic struck, to enable cross-border monetary transactions and trade.[42]

Other CBI monetary plans involve managing the fluctuating foreign currency market through a regulated local forex market known as NIMA, which serves as a platform for exporters to sell currency earnings at prices lower than open market rates. The platform aims to improve trade in non-oil exports, and the return of export earnings to Iran's economic cycle.[43]

The CBI says that NIMA should become the central financial hub for Iran and its stock market and has adopted measures to boost trade in NIMA. Bazarsaz is one arm of these measures, which infuses bills into NIMA to prevent profiteering and to provide much-needed foreign currency to customers. The CBI is also expanding the network of government licensed exchange rate offices across Iran to support more transparent transactions in NIMA. In September 2020, trade in NIMA exceeded 1 million euros, reflecting foreign exchange cash infusions by exporters into the forex system. Stocks recently exchanged at NIMA are at higher rates equaling almost $100 million per month.[44]

Iran's current currency needs are met both by the CBI and NIMA.[45] The aforementioned measures are designed to ensure that Iran's medical supply demands are met during the sanctions and coronavirus pandemic, and that local factories can access raw materials to boost the production of much-needed medical supplies. To this end, the CBI allocated $15 billion to ensure imports this year.[46] To help raise capital for manufacturers and trading companies, the CBI allocated an additional $30.31 billion in 2018-2019.[47] In addition, the CBI increased bank interest rates, although the rates dropped three months earlier due to the government's instruction.[48] In the stock market, this measure enabled the CBI to help raise industrial stock growth by 1.5 percent to 2.7 percent in July.[49]

The European Instrument for Supporting Trade Exchanges (INSTEX) designed to preserve the JCPOA in the face of the US maximum pressure strategy against Iran was revived in 2020. INSTEX aims to preserve economic engagement with Iran while upholding the US sanctions regime, by focusing on sending Iran humanitarian aid and gradually expanding trade with the country in the oil and consumer goods sectors. The European Union (EU) "blocking statute" in force since 1996 will protect some EU firms from US sanctions, however, European compliance with the United States' strict sanctions regime only permits a gradual activation of INSTEX. In April 2019, Iran set up the Special Trade and Finance Instrument (STFI) to facilitate banking and financial transactions with INSTEX. In March 2020, INSTEX completed its first transaction of approximately $540,000 by sending medical supplies to Iran.[50] The latest US sanctions on Iranian banks enforced in October 2020 will lead the CBI to seek alternative financial channels to meet Iran's medical needs, some of which will continue to be received through INSTEX financial humanitarian channels that are exempt from the sanctions.[51]

3-*Generating Liquidity and Containing High Inflation Rates*

The CBI reinforced policies to infuse liquidity into Iran's markets by re-regulating the stock exchange market in late summer. Measures included the infusion of cash into the economic cycle, and stock brokerage houses returning segments of their profits to Iran's bourse. The CBI also issued government bonds with varying profit incentives and they were sold to buyers in auctions in midsummer. In addition, an over-supply of government bonds deposited into three major banks, Mellat, Tejarat, and Saderat, helped ensure liquidity flows.[52] As a result, Iranian banks made no additional demands to receive government bonds in September, meaning that current levels of liquidity were sufficient to meet market needs. Otherwise, selling bonds could reduce the CBI cash reserves and increase inter-banking lending rates.[53]

The CBI promissory notes issued this year intended to maintain consumer purchasing power despite the high 17.8 percent inflation rate according to official figures.[54] In addition, the CBI has launched Open Market Operations (OMO) to enable it to buy and sell securities in the open market in order to expand or contract the supply of money, to control inflation, and to eliminate inter-banking lending rates. As a result, the CBI was able to control liquidity levels by 12 percent to prevent a so-called liquidity explosion, by forming an internal committee to manage liquidity levels and address concerns about hyperinflation.[55]

Conclusion

Predicting the full scope of Iran's pending financial disaster or the ramifications of CBI policies to address this is a major challenge given widespread market irregularities, corruption, and under-developed banking systems in Iran. The IAEA and the FATF have increased compliance pressures on Iran which could cause further market instability in the country. As a result of Iran's enrichment of uranium exceeding JCPOA limits, and the country's ongoing financing of terrorist operations outside its borders, it is unlikely that financial markets can heal anytime soon.

The CBI is left with fewer options to optimize the performance of Iran's financial markets, but it will continue to build up assets domestically, and invite trade and investments from willing international partners. But it remains to be seen how much longer Iran can withstand the pressure of sanctions. The extent of Iran's budget deficit is not clear. Iran's economy is expected to grow only by 1.7 percent without oil revenues, and with some oil revenues it could grow by 3.5 percent this current year. But these official forecasts do not reflect the reality on the ground. In reality, the CBI has been reluctant to present accurate inflation rates in order to avoid causing market panic. But the price of basic goods in Iran indicates that the inflation rate is uncontrollable.[56]

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