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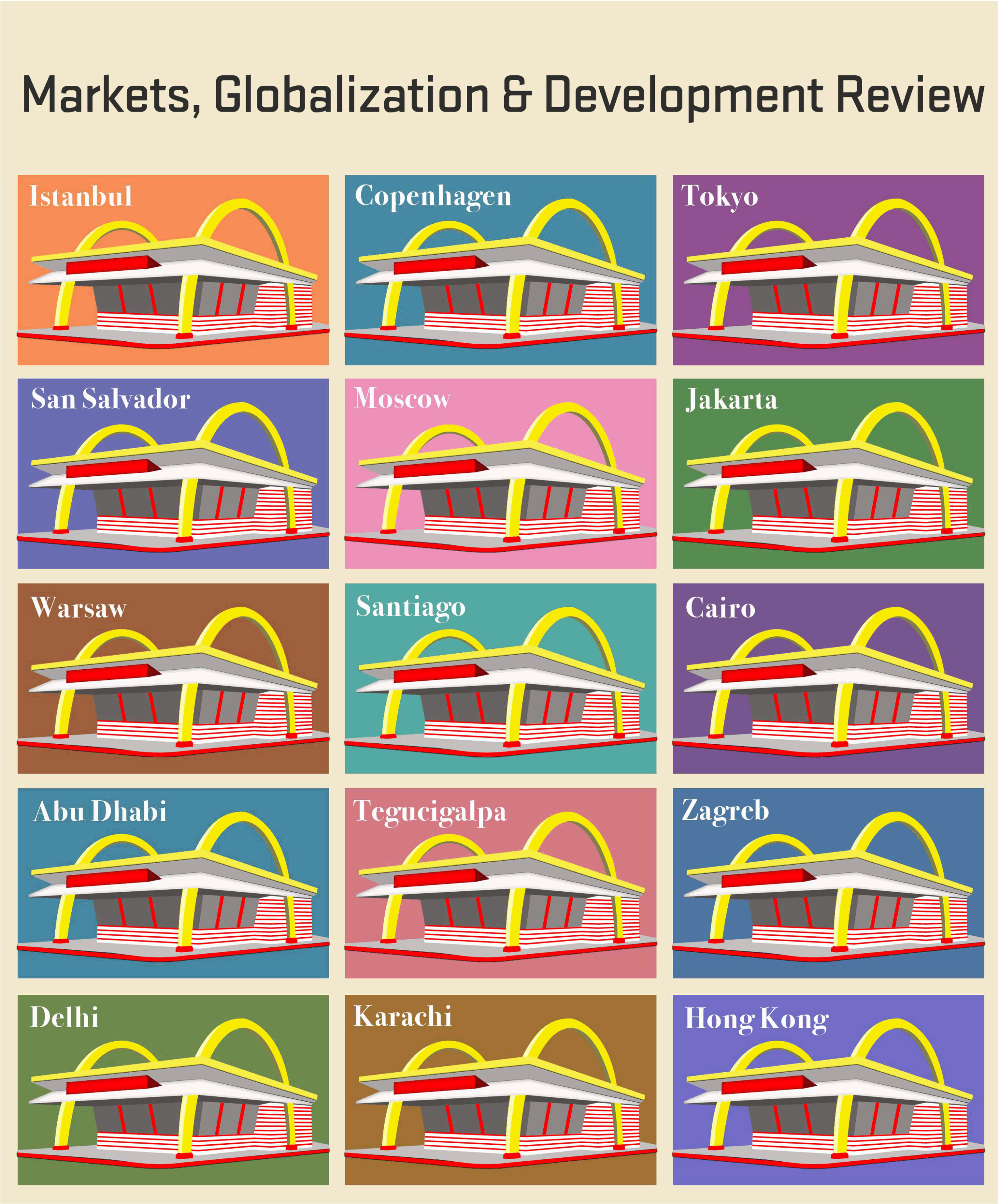
Cover Page Footnote

We would like to thank the editors Nik Dholakia and Deniz Atik for their speedy review and helpful comments. The views expressed in this paper are personal to Bahadori and do not represent the stance of any affiliated organizations, including PwC.



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How to Make Everything About Sanctions? Review of "How Sanctions Work, Iran and the Impact of Economic Warfare" by Bajoghli, Nasr, Salehi-Isfahani, and Vaez (2024)

Overview

A 2024 book titled "How Sanctions Work, Iran and the Impact of Economic Warfare" by Narges Bajoghli, Vali Nasr, Djavad Salehi-Isfahani, and Ali Vaez argues that sanctions have had no impact on the behavior of the Islamic Republic in Iran (IR hereafter) and have instead inflicted pain on the ordinary Iranians. While the book (Bajoghli et al. 2024) does offer a useful description of the evolution of the sanctions against the IR, it fails in its analysis and conclusions.

Critical Review

Let us begin by examining their methodology. The authors use a qualitative approach in the first three chapters, relying on interviews conducted in Iran without any discussion on the methodology used. Notably two indispensable and related points are left out. First, Iran has a vastly documented track record of violating freedom of expression, and imprisonment of dissidents and individuals whose (political) opinions are not aligned with the regime's propaganda. A case in point would be Hossein Shanbeh-Zadeh, a journalist, who was sentenced to serve 12 years in prison in late August 2024 for commenting just a "dot" under the supreme leader post on X (formerly known as Twitter). Given this context and the fact that interview participants may fear the consequences if they express a view contrary to those of the IR's propaganda, the authors fail to explain how their collected responses are not biased. Second, and related to the first, is the violation of researcher neutrality principle. Among respondents, we see active Islamic Revolutionary Guard Corps (IRGC hereafter) members, Hezbollah terrorists during training in Iran, a professor of Imam Sadegh University (a university widely known for its close connection to the Iranian intelligence services and hardliner government officials), and a former IRGC member who is currently an importer of pharmaceuticals from Cuba. Just the ability to access this group alone requires close relationship and established trust between the authorities and researchers, violating the researcher neutrality principle, and hence disqualifying the whole study and its conclusions. Anyone familiar with the IR's politics knows that these types of individuals would not participate in an interview related to such a sensitive topic, unless the message and the outcome of the interview is already determined and engineered. Therefore, the book's analysis and its results are as reliable as those from research funded by the tobacco industry that finds smoking cigarettes does not cause cancer.

Furthermore, establishing causality in economics is a daunting task. The significance of establishing causality using scientific approaches is reflected in the Royal Swedish Academy of Sciences decision to award the 2021 Nobel Prize in Economic Sciences to Professors Joshua Angrist (MIT) and Guido Imbens (Stanford) "for their methodological contributions to the analysis of causal relationships".[1] An entire field in economics is devoted to studying scientific approaches to identify causality in economic settings, and the qualitative approach followed by the authors is unequivocally not one of them. Indeed, in numerous instances, the authors commit the cardinal sin in economics by conflating correlation with causation, and worse, they fail to remain intellectually consistent even in their own approach. If we were to follow the authors' own flawed metric, it is easy to show that they cherry-picked the evidence and that the sanctions did in fact influence IR's behavior. Based on Figure 1 we could easily argue that reducing sanctions (Joint Comprehensive Plan of Action or JCPOA) or not enforcing them (Biden Administration since 2020) has *caused* more executions, larger military expenditure, more installed centrifuges, and generally more harm to the Iranian people. In contrast, these statistics are the lowest during Trump's Maximum Pressure policy which substantially reduced oil exports to less than 500,000 barrels per day.

In addition, the authors make two fatal assumptions in their analysis. First, the underlying theme in their analysis is that the IR has no agency in setting its economic policies. Second, and perhaps more importantly, the entire analysis is built under the assumption that the Iranian economy would have thrived without the US sanctions, and that Iran's economy and its growth are among the top priorities of the IR. These assumptions are critical in shifting the responsibility for more than four decades of Iran's consistent poor economic performance from the IR and its mismanagement of the economy to the US and the sanctions. Facts, however, are not on the authors' side.

1. https://www.nobelprize.org/prizes/economic-sciences/2021/press-release/

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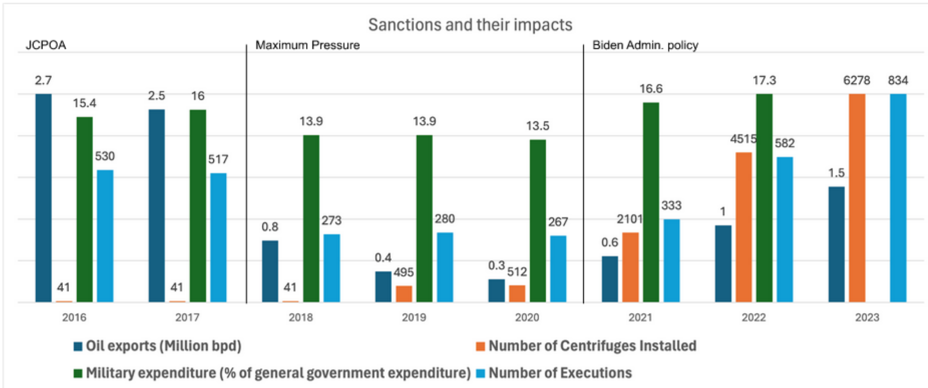

Figure 1 - Sanctions and their impact in terms of government oil revenues, military expenditure, number of executions, and nuclear centrifuges installed.

Sources: World Bank Data, Institute for Science and International Security, Iran Human Rights (IHRNGO), and IEA.I

Throughout the entire analysis in the book the notion of “sanctions” refers to those started by the multilateral sanctions in 2011. In contrast, all economic indicators clearly demonstrate that the Iranian economy has been on a decline since the 1979 revolution. Figure 2 depicts that the Iranian economy has been stagnating since 1980 whereas GDP per capita has increased by multiple folds in other countries. Sanctions cannot explain such a consistent poor economic performance for over four decades. In fact, a recent study by Laudati and Pesaran (2023, p. 292) concludes that “Iran’s low output growth relative to its potential, high inflation and excess output growth volatility cannot all be traced to sanctions and have domestic roots stemming from prolonged periods of economic mismanagement, distorted relative prices, rent seeking, a weak banking system and under-developed financial institutions.”

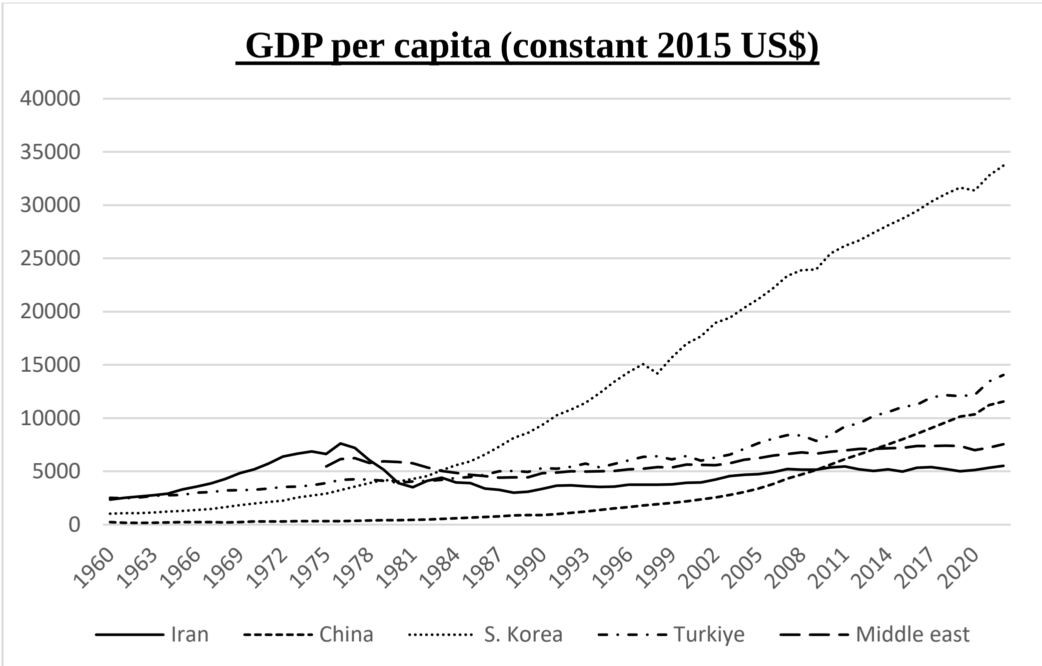

Figure 2 – GDP per capita of Iran, China, South Korea, Türkiye, and the Middle East region expressed in constant 2015 USD.

Source: World Bank.

The authors' overarching argument implies that we should observe signs of improvements in Iran's economy when oil revenue is high, and the IR can access the proceeds. With about $700 billion in oil revenue thanks to the oil price boom of the 2000s, Ahmadinejad's presidency was the quintessential opportunity for economic growth. Instead, his presidency marks one of the darkest economic periods in Iran whose effects are still felt to this day. Ill-conceived economic policies, lack of planning, and systemic corruption are hallmarks of his presidency. By the time he left office, the economy had entered stagflation, GDP per capita was almost the same as when he took office, the currency had lost half of its value, and inflation was about 40%. How can sanctions explain this performance?

Furthermore, the book argues that since 2011 economic sanctions have contributed to spikes in the currency exchange rate in Iran, which led to increased liquidity, thus further raising inflation. The authors, however, chose not to show earlier years in their graphs. But if they did, it would have been clear, as Figure 3A demonstrates, that high levels of double-digit inflation, rising money supply, economic fluctuations, and a currency on a free fall (Figure 3B) have been the norm in Iran long before the first wave of economic sanctions in 2011. These issues are predominantly rooted in IR's chronic budget deficit, lack of fiscal discipline, and systemic corruption among other structural issues rather than sanctions. Sanctions have just amplified the effect of existing issues; they did not cause them. This view is consistent with the results of the study by Laudati and Pesaran (2023). As mentioned above, this 2023 study attributes Iran's economic peril to IR's prolonged periods of economic mismanagement rather than to sanctions. For instance, among other findings, their results indicate that the high and persistent inflation in Iran is hardly affected by sanctions and that its root must be found in IR's economic mismanagement. They further argue that the Iranian economy would have still suffered from IR's economic mismanagement, their poor governance, and systemic corruption – even in the absence of any sanctions and, for these reasons, lifting sanctions is unlikely to lead to sustained economic growth.

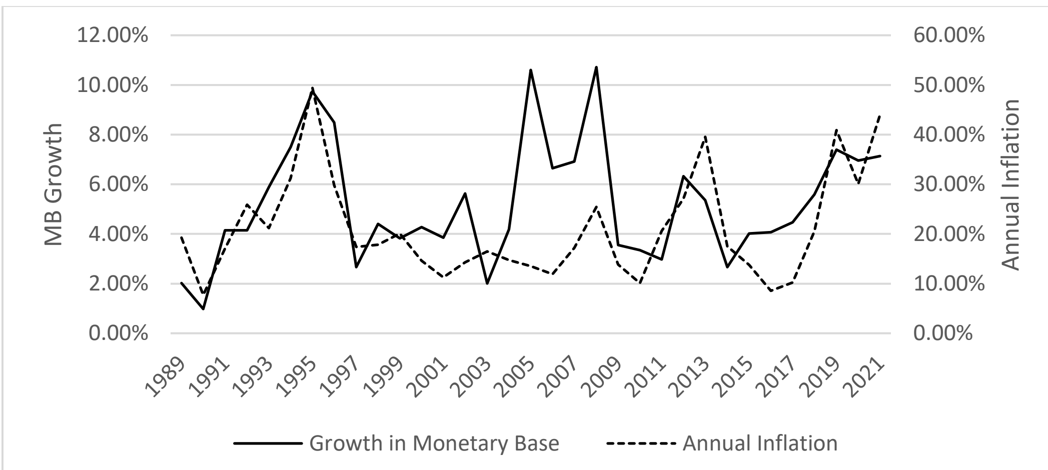

Figure 3A: Inflation in Iran

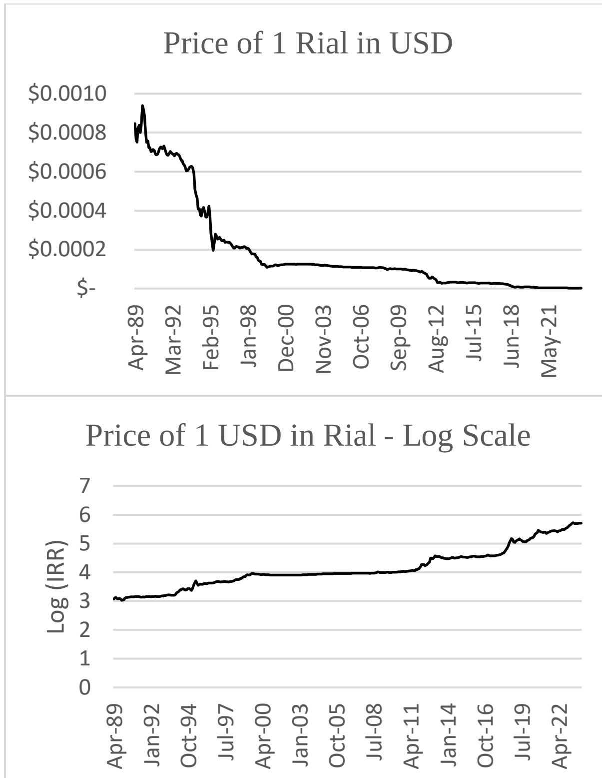

Figure 3B – USD and Rial Exchange Rates

Source: Central Bank of Iran.

Such a poor economic performance over such a long period is rooted in the political identity and structure of the IR, rather than the sanctions. In fact, the sanctions themselves are the consequence of the political identity and structure of the IR, the same variable that plays the main role in mismanaging the Iranian economy for over four decades. It is crucial to remember that these sanctions have not been imposed in a vacuum. They are the response of the international community to the IR's aggressions which themselves are a reflection of its political identity. Thus, there is a variable, the IR's political identity and structure, that drives both economic mismanagement and imposing sanctions on the country. This is a well-known endogeneity issue in economics – called omitted variable bias – that, if not addressed, completely distorts any causal inference (See Angrist & Pischke 2009 for more details).

The case of Russia is helpful to better see how authors' negligence of this critical endogeneity issue has distorted their conclusions. Following the invasion of Ukraine, several packages of sanctions were imposed on

Russia, targeting various entities ranging from individuals to organizations, making Russia the most sanctioned country in the world at the time of this writing. Despite all these sanctions and contrary to the expectation of the US and its allies, however, the Russian economy has shown noticeable resilience to sanctions. For example, GDP rose by 3.6% in 2023, real wages by 7.8%, construction sector by 8%, auto industry by 19%, and the IMF raised its 2024 GDP growth forecast to 3.2% last April.[2] The primary reason for this resilience is the structural reforms in the Russian economy that started in 2006 and were later expanded and accelerated in 2013 when Elvira Nabiullina was appointed the governor of the Central Bank of the Russian Federation. Her team implemented many structural and fundamental reforms in the Russian Economy. For instance, they rooted out corruption and rent-seeking, put a stop to connected lending in the banking system, convinced the Russian government to have fiscal discipline and balanced the budget, and shutdown over 600 banks between 2011 and 2020 that were risky and not in compliance with the Basel Accord capital adequacy requirements. Russia's fiscal discipline can be observed by the fact that an oil price of $114 per barrel would have balanced their fiscal deficit in 2013 which subsequently dropped to $48 in 2019. In contrast, for Iran, this figure was $81.5 in 2011 and steadily rose to $194 in 2019, and $352 in 2023, reflecting a consistent and chronic lack of fiscal discipline. The example of the Russian economy showcases how prudent economic management can create a resilient economy that absorbs the adverse shock of economic sanctions and reduces their effects on ordinary people's livelihood.[3]

The root of the economic peril in Iran is IR's political ideology which is manifested in their adventurous foreign policy, poor governance, and systemic corruption. To provide context, we briefly examine the consequences of systemic corruption for the Iranian economy so that it becomes clearer why the Bajoghli et al. (2024) thesis on attributing Iran's current economic devastation to sanctions is misleading. The adverse impact of corruption on economic development is widely documented and a heavily researched area and in parallel there is mounting evidence suggesting that separation of power, rule of law, a system of checks and balances, along with strong organizations, and transparency are necessary

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2. Teurtrie, D. (2024, July). Russia: Why the sanctions failed to bite. Le Monde diplomatique, English Edition. https://mondediplo.com/2024/07/11russia-sanctions
3. Dolgin, D. (2021, October 12). Russian budget consolidation may face obstacles in 2022. ING. https://think.ing.com/articles/russian-budget-consolidation-may-face-obstacles-in-2022/

prerequisite for sustained economic development (for instance, see Shleifer and Vishny 1993; Murphy, Shleifer and Vishny 1993; Shleifer and Vishny 1997; La Porta, Lopez-de-Silanies, Shleifer and Vishny 1998).

Iran has one of the most corrupt economies according to different institutions across the world that employ various methodologies to measure corruption. In particular, the Corruption Perception Index (CPI) by Transparency International is helpful in our case, since its methodology focuses on public sector corruption, alleviating the concerns that sanctions could decrease overall transparency and amplify corruption.[4] Since its inclusion in the CPI in 2003, Iran has been consistently scoring poorly. In the latest annual report of Transparency International in 2023, Iran marked its worst CPI score of 24/100 in the last decade, taking the 149th place among 180 countries/territories, remaining one of the most corrupt countries in the world. For context, the least corrupt countries in 2023 were Denmark, Finland, and New Zealand, with scores ranging from 90 to 85, while the most corrupt countries were Somalia, Venezuela, and Syria, with scores as low as 11-13. One of the implications of this systemic corruption has been connected lending in the banking system. People close to the circle of power and access to economic rent would take out massive loans without ever repaying the loan. This connected lending practice has severely deteriorated the banking system, leading to an accumulation of non-cash flow generating assets, a sharp increase in non-performing loans, and substantial rollover losses. Consequently, these problems have pushed the banking system to the brink of a full-fledged banking and financial crisis. Banks have no option but to continuously borrow from Iran's Central Bank and the Central Bank itself has no choice but to increase liquidity and money

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4. Countries targeted by sanctions may employ sanctions circumvention schemes to mitigate the impacts of the restrictions on their countries. In this regard, depending on the scope and nature of sanctions, sanctions evasion schemes may involve trade in informal markets — such as black markets, as the authors suggest — money laundering, illicit trade of goods, illicit financial flows, banking fraud such as invoice manipulation, an increase in shell and foreign companies, manipulation of beneficial ownerships, etc. Sanctions thus may indirectly — following the employment of such schemes — decrease the overall level of transparency in the targeted countries and amplify certain types of corruption. The CPI index, however, follows a narrow and specific methodology, and does not measure any of these aspects such as informal economies and markets, private sector corruption, money laundering, illicit financial flows, illicit trading, etc. Rather, it focuses on other various aspects of public sector corruption, representing no direct link between such practices and the CPI score as they are outside of its methodological scope.

supply to avoid financial catastrophe. Of course, ultimately, the public pays the price of this systemic corruption by facing ever-rising inflation. And worse, this rising inflation only benefits those who took out those massive loans since the real value of their debt declines as inflation rises. Sanctions cannot explain this dynamic.

The book's one-sided analysis and cherry-picking the evidence become even more apparent when we focus on the Biden Administration. Conflating sanctions existing on the books with sanction enforcement, authors characterize sanctions during the Biden Administration as a continuation of the Trump's. In contrast to their mischaracterization, however, the data from the World Bank and IMF clearly show that the Biden Administration has chosen not to enforce sanctions as firmly. As Figure 4 illustrates, since President Biden took office, IR's oil export has been rising steadily, reaching over 1.5 million barrels per day last March, a six-year high. IR's total oil revenue has reached over $100 billion. And yet exactly during this period, IR just recorded the highest inflation in 80 years (about 52.3%), doubled its money supply, while the currency nosedived.

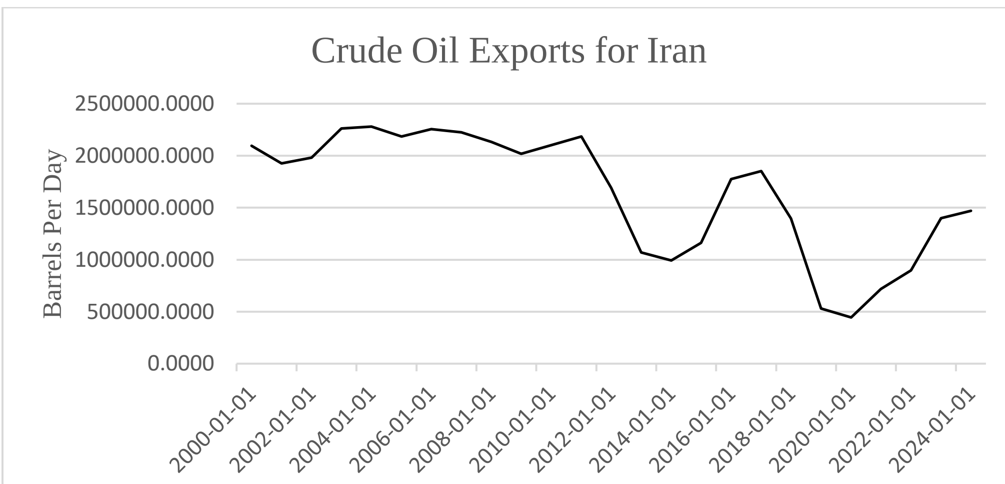

Figure 4 – Iran's crude oil export expressed in barrels per day
Source: IMF

Moreover, from a political economy standpoint, sanctions might have had a silver lining for the civil society of Iran. The political identity of the IR displays characteristics that are only observed among totalitarian regimes, notably (1) an official ideology, (2) exclusive control over mass media, (3) organized armed groups structured for protection and expansion of the official ideology and (4) exclusive control over the economy (Arendt 1973; Friedrich and Brzezinski 1965). One distinguishing factor of totalitarian regimes compared to other types of dictatorships is their power maximization desire. That is, they want to maximize their influence over as many aspects of their citizens' lives as possible. As Ronald Wintrobe explains in his book, the dictators in totalitarian contexts perceive enhanced economic conditions as a signal to gain more power by increasing repression of civil society and distribution of rents to shore up more loyalty. He further explains (p. 71):

> ... from the point of view of democracies, which are considering whether to expand economic relations with such a regime, there is no substitute for the principle of insistence on a long-term binding human rights constraint if their objective is to minimize the repressiveness of the dictator's regime.

Conclusion

To blame everything on sanctions does not overshadow over four decades of malpractices by the IR with its dire consequences for ordinary Iranians, nor does it provide a justification to lift them while the threat of terrorism and destabilization by the regime persists. The plight of ordinary Iranians stems from IR itself and its policies, not the sanctions. The economy and people's livelihood are demonstrably secondary to IR's ideological objectives and its foreign policy adventures that have isolated the country, its people, and the economy.

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