IRAN'S VULNERABILITY TO FOREIGN ECONOMIC PRESSURE

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For several years, Iran's economy was cushioned from foreign pressure by the high price of oil. That has changed as oil prices have declined and Tehran's poor policies have exacerbated serious structural weaknesses. The most likely prospect is that during the next few years, Iran's economy will face serious problems. Foreign economic pressure could add to those problems. Furthermore, Iranian public opinion is likely to exaggerate the impact of the foreign pressure and to blame the Ahmadinejad government's hardline stance for the country's economic difficulties. Let me expand on these points, after making a few remarks about Iran's structural economic problems.

Background on Iran's Structural Economic Problems

No country in the Middle East has suffered more from the "oil curse" than Iran. Iran had spectacular economic growth while its oil income was modest; indeed, the oil revenue fueled that growth. But after the 1973 oil price rises, Iran became addicted to oil while the rest of the economy suffered. Through the many political changes Iran has experienced since 1973–Islamic revolution, eight-year war, reform/hard-line confrontation–one constant has been over-reliance on oil income. Had oil income been more limited, Iran would have long ago been forced to undertake far-reaching structural reforms, much as the Shah was forced to do in the early 1960s; as then, the result would have been rapid growth. Instead, policymakers have either ignored the economy or let their ideologies prevail over common sense, convinced that in the end, high oil income would sustain the country.

The Shah used the windfall oil income after 1973 to force-step growth at an unachievable pace. The economy stalled and social problems mounted, setting the scene for the 1979 Islamic Revolution. The Islamic Republic's leaders cared little about the economy and were suspicious of capitalist markets, plus they were preoccupied by the war with Iraq. Adding to Iran's problems, the world oil industry went into deep decline, and Iran suffered as much as any OPEC producer. As the world oil industry recovered in the 1990s and as Iran emerged from the 1981-88 war with Iraq, Ali Akbar Hashemi Rafsanjani became president. The first Iranian revolutionary leader to put priority on economic development, he forced through the Majlis (the legislature) a plan to downsize state control. Under the limited reforms he introduced, the economy recovered nicely, with gross domestic product rising 8 percent per annum in real terms during 1988/89–1992/93. Iran increased its oil production from 2.6 million barrels per day in 1988/89 to 3.9 million in 1992/93. That should have provided the means to fuel the growth the government wanted to promote. But the oil curse hit again. For all of Rafsanjani's hopes, at the end of the day, reforms did not progress very far. The entrenched revolutionary interests fought back to protect their sinecures, and Rafsanjani was unwilling to risk a confrontation. The hopes of continued reliance on oil income provided the excuse to avoid making difficult choices.

In the mid-1990s, the economy was hit hard by the combination of stalled reforms and the exaggerated boom since the war's end. In 1993 when the oil market weakened, Iran was no longer able to service the substantial foreign debt it had run up. In this atmosphere of mounting economic problems came the U.S. economic sanctions, first imposed in a vigorous manner by the Clinton administration. Iran's economy would have faced serious problems without the U.S. sanctions, but the U.S. pressure was perfectly timed to add to the Islamic Republic's burden. The Rafsanjani government had little choice but to throttle back on imports so that Iran's oil income could be used to repay its foreign debt. The debt crisis, which lasted five years, brought an end to the postwar boom. The popular mood was sour, and the blame was put firmly on hard-line policies, especially the isolation from the United States.

The deep discontent that led to the surprising 1997 election of reformist Mohammed Khatami led to little change in economic policy. Furthermore, Khatami had no clear economic ideas, unlike his well-formed and articulated-stated views on political and social reform. The different political factions all agreed the economy was in bad shape and that drastic steps were needed–indeed, this has been a favorite theme of Supreme Leader Ali Khamenei, who has argued the government's priority should be fixing the economy rather than making political reforms. But no one was willing to tackle the entrenched interests, be it the subsidies for consumer goods that drained the public coffers or the rampant corruption that enriched the politically well-connected but scared away foreign investors and embittered ordinary Iranians.

High Oil Prices Cushioned Iran from Foreign Economic Pressure

In the 1990s, oil prices were quite moderate; the price of benchmark Dubai oil averaged $17 per barrel from 1991 to 1999. With the new millennium, the price rose by half, averaging $25 per barrel from 2000 to 2003. That price rice gave the Iranian economy a boost, fueling modest growth.

In the last five year, things got even better for Tehran. Oil prices rose 30 percent a year on average. Dubai oil went to $34 per barrel in 2004, $49 in 2005, $61 in 2006, $68 in 2007, and $94 in 2008 – ending up more than 3 ½ times where it had been in 2003. The Islamic Republic's oil and gas exports in its fiscal year 2007/08 were higher than the combined total for all four years of the first Khatami term (1997/98-2000/01). Preliminary figures suggest that they stayed at almost the same level in 2008/09.

With this windfall, Iran's economy has grown at 6 percent a year on average, faster than that of the United States or the other industrial countries. Consumption has grown handily at 7 percent per year. Unemployment has fallen.

The additional oil income since 2004 swamped the impact of increased foreign economic pressure. Iran could readily afford the higher price that such pressure imposed on its imports. Iran's spending on imports tripled from 2003/04 to 2008/09, rising from $28 billion to $85 billion. Given such a spectacular increase in availability of foreign goods, it was hard to make the case that foreign sanctions were holding back growth. And the sanctions-induced higher cost of doing business did not necessarily look like such a burden when business was growing so briskly. In short, the last few years have been a particularly difficult time for foreign economic pressure to have much impact on Iran.

But Poor Policies Wasted the Opportunity

The oil windfall has allowed President Mahmoud Ahmadinejad (who came to power in 2005) to engage in populist policies designed to secure short-term popularity at the expense of exacerbating fundamental economic problems. In particular, his government has spent huge amounts on subsidies, on grants, and on social benefits, which for many people – especially the lower social classes – have offset much of the pain from unemployment and inflation. These subsidies, grants, and social benefits had a budgetary cost of 98 trillion rials (about $11 billion) in 2005/06, which then mushroomed to 252 trillion rials (about $25 billion) in 2008/09, according to the IMF. That is an increase of $14 billion in three years. That increase is equal to about 4 percent of GDP; an equivalent increase in the United States would be $550 billion. In 2008/09, the subsidies, grants, and social benefits made up 28 percent of all government spending.

This extra $14 billion for subsidizing consumption vastly exceeded the modest $4 billion in government investment during the same period (government capital expenditures went from 118 billion rials, or about $13 billion, in 2005/06, to 170 billion rials, or about $17 billion, in 2008/09). While the policy of using the oil windfall to boost consumption may give a temporary boost to the government's popularity, the country's economic development would have benefitted much more if the windfall had been used to fund investment.

Under Iranian law, oil windfalls are supposed to be set aside in the Oil Stabilization Fund, which meant to accumulate a reserve when prices are high, as at present, for use when prices drop. Statutory provisions dictate that it is to receive the excess between the budget's estimated oil income (traditionally set conservatively) and actual revenue. However, the fund's balance has actually decreased since March 2006, when the fund should have received tens of billions of dollars. The Ahmadinejad government has repeatedly raided the Oil Stabilization Fund. The money was used partly to fund government spending but mostly for politically motivated loans that offer poor prospects of being repaid. Annoyed at the few constraints he faced in such raids, Ahmadinejad simply dissolved the board charged with administering the fund. Information about the fund balances since then has been hard to obtain.

In addition to the explicit subsidies in the budget and the wasted loans from the Oil Stabilization Fund, another huge drain on government resources came from the "implicit subsidy" which comes from pricing oil and natural gas well below world market rates. Continuing energy subsidies cost Iran $45 billion a year, according to former Central Bank governor Mohammed Hossein Adeli. The IMF's estimates are higher; it places the cost of the energy subsidies at more like $85 billion a year. Even at the lower figure, the energy subsidies are the equivalent of 15 percent of GDP. The equivalent for the United States would be a $2.1 trillion a year subsidy. Not only are the subsidies an impressive waste of resources, but they add to environmental problems. Due to excessive use of gasoline, the air pollution in Tehran is so bad that it kills more than 5,000 people a year–a number which is growing alarmingly.

Ahmadinejad has implemented some economic reforms but only halfheartedly. Consider the long-debated move to ration gasoline supplies, a policy recommended by Iranian economists and their World Bank colleagues because of the lack of political will to raise gasoline prices to their actual cost. Rationing began in June 2007 but has been steadily undermined by periodic announcements of extra rations for populist reasons, such as summer and New Year's vacations. In addition to the monthly 25-gallon ration at $.43 per gallon, motorists can purchase extra amounts at $1.65 per gallon. While these measures may have slowed the growth of gasoline consumption, the total amount of gasoline sold in Iran has risen steadily despite the rationing—hardly surprising given that the Islamic Republic is proudly pushing automobile production.

Iran Faces Poor Economic Prospects

Let us not exaggerate Iran's economic problems; its economy has grown faster than that of the United States each year for more than a decade. But that is little comfort to the Iranian people, who are profoundly unhappy at the missed opportunity for much faster growth. Their standard of reference is the spectacular economic boom on the south side of the Persian Gulf. Iranians are well aware of how Dubai has gone from being a backwater to a world-class city, even though its oil output is limited. From the gas field they share in the waters of the Persian Gulf – the world's largest field--Qatar produces twice as much gas as does Iran. Iran had the potential to have double-digit growth rates over the last decade, but instead it has modest growth. Iranians think of themselves as a great civilization, and it is galling to them to see their country miss the opportunity to achieve the prosperity which they think should be their natural state.

Official statistics show the country's deep problems, especially inflation and unemployment. Inflation in 2008/09 as reported by the Central Bank was about 20 percent; it peaked mid-year at nearly 30 percent but has since "moderated" to15 percent – a level which Iranians still find intolerable. In mid-2008, Iran's Statistics Center estimated unemployment at 11.9 percent with the rate for those aged 15 to 24 reaching 25.6 percent. And these official statistics may understate the problem. Under the Ahmadinejad government, economic data have become increasingly untrustworthy. For instance, in 2009, the Iranian government acknowledged that it changed its definition of who counts as employed to include anyone working two or more hours a week. Evidently this change accounted for much of 2009's reported modest reduction in unemployment. And there may be even more blatant manipulation of data. Ahmadinejad's first minister of industry and mining, Eshaq Jahangari, reported that Ahmadinejad once ordered him to falsely double the reported economic growth rate.

Emblematic of the Islamic Republic's deep-seated economic problems is its inability to guarantee its citizens a secure energy supply, despite massive expenditures. Electricity outages have become everyday occurrences in Iranian cities, especially during the hot summers. Natural gas consumption, on which most Iranians depend for heating and cooking, continues to be highly subsidized with the result that consumption is booming, forcing Iran to import more gas than it exports even though Iran has the world's second largest reserves. The government has difficulty paying for imports. When in 2008 Turkmenistan cut off supplies in the midst of one of the coldest spells of weather Iran had experienced in decades in order to pressure Tehran to pay higher prices, the Iranian government had to shut off gas supplies to at least 1.4 million people.

If the story of the last few years was that Iran's economic situation has not lived up to popular expectations, the prospect for the next few years is that the authorities will face serious problems avoiding catastrophe unless oil prices are well above current levels. Until the financial crisis hit in October 2008, oil prices had been rising 30 percent a year for four years. Even if the world economy continues to recover, oil prices are very unlikely to continue that steep rate of increase. Indeed, oil prices are likely to be well below the 2008 level of $94 for Dubai's high-quality oil (Note that Iran's less desirable oil sells at a considerable discount to the Dubai price). Perhaps oil prices this year will average $70, the price at which oil has recently been trading. If so, that is 25 percent below the 2008 price.

With oil revenue declining instead of rising, Iran will face serious problems funding its imports and its government budget. These are two distinct but interrelated problems. To start with the import problem. Iran's imports have been growing rapidly, from $43 billion in 2005/06 to $67 billion in 2008/09. That is an average of 16 percent growth a year. In its August 2008 report on Iran's economy, the IMF forecast that imports would continue to grow a brisk pace, by more than $8 billion each year. Indeed, the IMF predicted that even if oil prices remained at their 2008 level, Iran's imports of goods and services would exceed its exports by 2011/12 (that is, Iran would run a deficit on the balance of payments current account).

But if oil prices are down 25 percent from the lofty 2008 level, Iran runs into problems more quickly. A 25 percent drop translates into $20 billion less export earnings each year. At first, Iran could use its ample foreign exchange reserves to make up for the shortfall. But if spending plans continue on the path forecast by the IMF, then oil prices at their current level would mean that Iran's reserves would be at a dangerously low level within three years. That may understate the problem, because if Iran starts running down its reserves, businessmen may lose confidence and so start transferring their money abroad one way or another.

Note that if oil prices were to stabilize at half their 2008 level – that is, with Dubai marker crude at $47 per barrel – then Iran's oil export earnings would be $40 billion a year less than at the high price level. At that price level, Iran's foreign exchange reserves would be dangerously low within 18 months.

Financing imports are one problem caused by lower oil prices; financing the government budget is the other problem. Government spending has been increasing at a brisk pace under Ahmadinejad. The IMF forecast was that even with oil prices steady at their 2008 level, the government budget would slip into a deficit by 2010/11. If oil prices are at their current level, then the budget will run a significant deficit already this year. And the problem appears to have been made worse by substantial increases in government spending. Already by October 2008, the IMF had revised its August forecast, saying that Iran needed a $90 price in marker crude to balance its budget. The pattern of increasing spending seems to have accelerated since then. the runup to the June presidential election saw large increases in pensions and government salaries, as well as grants handed out to the poor.

In theory, a government budget deficit could be financed by borrowing from the local banks, or more precisely by reducing the substantial deposits the government has with the banking system. But that may be hard to do in practice, because the Ahmadinejad government has ordered the banks to lend huge amounts for politically favored but uneconomical projects. The banks are in precarious shape, and they may have grave difficulties were the government to reduce the substantial support it provides banks at present.

Faced with changed circumstances in world oil markets, a wise government would begin to adjust immediately, using its reserves as a cushion for a "soft landing." This would imply reducing government spending, raising interest rates, and allowing the exchange rate to depreciate. All of these are measures which Ahmadinejad has vigorously refused, despite insistent urging by the technocrats in his own government and by Iran's economists. The most likely prospect is that he will continue to resist until reality faces Iran with a "hard landing." That is, Iran is likely to retain its current policy stance until reserves are exhausted. That is what Iran did when faced with impeding economic disaster in the early 1980s and again in the early 1990s. On both those occasions, the government resisted change until the last minute and then had to make dramatic and painful adjustments. That could include freezing government salaries while inflation rages at double-digit rates. It could also include administrative measures, such as restrictions on access to foreign exchange, to sharply restrict imports.

Taking Credit for Making the Sun Rise in the East

If Iran is forced to make the kind of dramatic retrenchment it did after the 1993 debt crisis, the popular mood will be even more sour than at present. Furthermore, there is every reason to expect public opinion to lay the blame for the economic problems on the Ahamdinejad government. Already, reform politicians blame that government for isolating Iran from the world. If Iran is forced to reduce imports substantially, the most likely popular reaction will be to blame hardliners for the problems. That was certainly the pattern after the 1993 debt crisis, when the retrenchment measures were widely blamed on hardliners who had made relations with the United States so bad.

Indeed, the experience of the 1990s suggests that Iranians will attribute more power to international economic sanctions than is merited. Most of Iran's economic problems during that decade were due to the government's poor policies, exacerbated by the stagnation in the world oil markets. But Iranians were in no mood to accept such a mundane explanation for their country's economic problems. Much more appealing for popular sentiment was to blame the economic restrictions on the same hardliners whose social and political restrictions were so resented.

As an economist, I would say Iran's economic problems now and in the future have more to do with poor government policies than with international pressure. But if asked what advice I would give the U.S. government, I would say: grab credit for Iran's economic problems even if that credit is not due. Washington should be delighted if Iranian public opinion thinks that foreign economic pressure is all-powerful. It is a good political principle to figure out what is about to happen and then to announce policies which one claims are responsible for what is in fact inevitable. Why not take credit for making the sun rise in the east, if one can get it?

In some, the current situation, in which Iran's economy is likely to do poorly in the next few years, is a perfect moment for the international community to impose additional sanctions on Iran. No longer can Iran offset the impact of those sanctions with a flood of higher oil income. On the contrary, the sanctions will come at a time of looming economic hardship, and there is excellent reason to expect that Iranian public opinion will blame the economic problems on hardliners' isolation of Iran from the international community.

Foreign pressure cannot cause Iran's economy to collapse, nor should that be our goal. But such pressure may well be able to contribute to what is becoming an intense debate inside Iran about the wisdom of a confrontational and isolationist policy towards the international community. That debate offers the best prospect for a fruitful resolution of the nuclear impasse, because those who want Iran to join the world are not willing to pay a high price for a nuclear program which they increasingly see as part of the Ahmadinejad agenda, not part of a national project.