

Iran's Fragile Economy:

Problems and Prospects

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Brief Analysis

When he came into office, Iranian President Hashemi Rafsanjani promised a "new Iran" that would be prosperous and powerful; he continued to blame the West -- America, in particular -- rather than recognizing Iran's economic failings. Today, none of this vision has been fulfilled. Instead, the regime faces a deepening economic crisis, yet still its only explanation is to blame the West. Ayatollahs preach that "blood-sucking capitalists should be whipped," that the United States is the enemy, and the defeat of the United States and its policies is the solution to Iran's economic problems.

The system of multiple exchange rates, instituted in the 1980s, is responsible for a large part of Iran's current economic woes. As the gap between the official exchange rate and the free market rate (the black market) widened, the government became deprived of foreign exchange revenue. This subsequently eroded public confidence and encouraged capital flight and corruption.

Abroad, private Iranians reportedly hold about \$180 billion. If just one-tenth of these funds were invested in Iran, there would be a boom of prosperity. However, rather than offering incentives that would generate positive activity within the economy and attract the return of this capital, the government has chosen to maintain its repressive policies.

Historically, Iran has enjoyed a diversified economy rich in handicrafts, agriculture, and industry. Currently, though, the economy has become as dependent on oil income as Saudi Arabia. Despite this, the government capped food and gasoline prices at ridiculously low rates (gasoline has sold for as low as eleven cents a gallon); these implicit subsidies are counterproductive, because domestic consumption increases exponentially and shrinks the supply of exportable oil. And while its oil-producing neighbors have made some progress at diversifying their economies in the past few years, Iran's has actually shrank.

Another fundamental problem is the role of Bonyads. These are huge Islamic charitable institutions, employing up to 350,000 people, established with the assets and possessions abandoned by the Shah, his entourage, and others who fled from the revolution. They are totally unregulated by the government, giving rise to vast corruption by the clerical hierarchy.

Flight of Quality Management

Iran has not recovered from the flight of the management elite of the labor force. Those who fled from the revolution were, for the most part, the core of a healthy economy. Most were entrepreneurs, managers, industrialists, and so forth. Their absence is sorely felt today.

The situation is aggravated by unwritten university admission policies that evaluate students more on the basis of political/religious affiliations or social/familial contacts than on academic merit. These policies explain the lower standards that characterize today's professional and industrial sectors.

Ideologically, the revolutionaries sought to eradicate the corruption that was common practice among the higher echelons of the Shah's regime. Currently, however, corruption plagues not only the government, but nearly every level of the private sector as well. It has made it virtually impossible to do business "by the book." Consequently, the thriving black market is a major source of government revenue leakage.

External Debt

The Iranian government boasted that, despite the costly eight-year war with Iraq, it had reduced the external debt inherited from the Shah's regime. Since Rafsanjani's election in 1989, however, the external debt has mushroomed to \$23 billion. The amount of the external debt loans was not the main problem; rather, it was the type of loans: as short-term loans, the government was burdened with sizable payments that it was unable to meet. To relieve this problem, the debts were restructured with the lenders -- primarily western European countries and Japan. Currently, one-quarter of Iran's annual revenue pays off this debt.

Military Expenditures

The Shah maintained a sizable military budget -- much of which was spent purchasing American weapons and military equipment -- and immediately after the revolution, the government substantially cut defense spending. Once the war with Iraq broke out, however, that was reversed and the military budget rose again.

The military budget shrank after the 1988 cease-fire, and was cut even more after Iraq's defeat in the Gulf War. In recent years, economic problems forced the regime to scale back a significant rearmament program.

Of course, Iran still retains adequate resources for a range of military activities as well as support to terrorist groups outside the country.

Considerable attention has focused on Iran's nuclear ambitions. From an economic viewpoint, all that can be said is that Iran has absolutely no economic rationale for developing nuclear power. After all, Iran has one of the world's largest supplies of natural gas.

The Effectiveness of U.S. Sanctions

The sanctions imposed by the United States in April 1995 did not, by any means, create the current economic situation, but they have made a bad situation worse. The embargo would be more effective if it was a total embargo rather than just an American effort; however, the United States remains a powerful international economic actor and the embargo's effect is widely felt. For example, most oil companies -- American or foreign -- do not make a practice of confronting or dismissing the U.S. government in matters of international commerce. The "confidence" of the companies still considering conducting business with Iran has been shaken and many have chosen not to risk their relations with the United States. In this respect, the sanctions have been useful in denying Iran access to technology and capital that it would otherwise have acquired much more readily.

This Special Policy Forum Report was prepared by Eden Bossom.

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