Iran Beyond Oil?

by Patrick Clawson **(/experts/patrick-clawson)**

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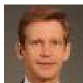

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Brief Analysis

The role of oil in Iran's economy is declining, undercutting Western efforts to press the regime by reducing its oil export revenue.

The image of Iran's economy as oil, carpets, and pistachios was always flawed, but has now become badly dated. The Islamic Republic is in the midst of a non-oil export boom -- it has the potential to remain a middle-income country even with no oil exports, and the reserves to finance the transition in the meantime. For years, Iran's leaders called for reduced reliance on oil but did little to meet that goal. Western sanctions have seemingly spurred them to action -- in his annual Nowruz address on March 21, Supreme Leader Ali Khamenei acknowledged for the first time that restrictions on the country's oil exports had made a serious impact: "The sanctions have had an effect, which is because of an essential flaw that we are suffering from. The flaw that our economy is suffering from is that it is dependent on oil." He also acknowledged that Iran's "economic weakness" had led to "harsh conditions for certain groups of people." Rather than change Iranian nuclear policy, however, he argued, "We can turn every threat into an opportunity...The sanctions caused the massive domestic capacities of the Iranian nation to become activated."

TRADE BECOMING MORE BALANCED

While still important, oil is becoming a smaller part of Iran's trade. In 2012, the country imported $57 billion in goods and exported $34 billion in non-oil products, meaning that non-oil exports covered 60% of the import bill, compared to 24% in 2002 and 14% in 1992. It produced this shift in part by converting more of its oil into industrial products for export; according to the Iranian Customs Administration, the $29.2 billion in non-oil exports over the first eleven months of fiscal 2012/2013 included $9.0 billion in chemical products (mostly petrochemicals such as urea fertilizer and polyethylene) and $3.2 billion in plastics made from oil. But other products are also being exported at high rates, including $8.2 billion in minerals, stone, cement, and related products, $5.3 billion in agricultural products, and $800 million in carpets. The country's largest market is Iraq, which took $5.6 billion in goods over the same period, including much of Iran's manufactured exports (e.g., more than $300 million in automobiles). The next-largest customers were China ($4.8 billion), the United Arab Emirates ($3.9 billion),

Afghanistan ($2.5 billion), India ($2.4 billion), and Turkey ($1.3 billion).

With the rial plunging and the dollar becoming more valuable in comparison, Iranian merchants are moving from their traditional role as solely importers to seeking export opportunities as well. This shift is reviving any Iranian production that can find an export market. For example, Mohsen Jalalpour, the head of Iran's pistachio association, recently told the *Financial Times*, "Many pistachio farmers feared their farms would go bust a year and a half ago, but the strengthening of the U.S. dollar had led to a boom." The effect has been to price Iranian pistachios beyond the reach of most Iranian consumers, but the national economy benefits from the higher exports.

The non-oil trade deficit is also shrinking because of declining imports. Higher prices and direct administrative measures are responsible for this reduction. Last November, Tehran banned the import of seventy-five goods described as "nonessential," which Industry and Business Ministry official Sasan Khodaei said accounted for $4 billion in imports the previous year (other estimates are higher). The government is also vigorously substituting oil for natural gas at home, reversing decades of policy that had made Iran the most gas-dependent economy in the world (e.g., gas constituted 60% of domestic energy use in 2011, according to the *BP Statistical Review of World Energy*). Iran has long been a net importer of gas, but the oil substitution will allow it to reduce its gas imports from Turkmenistan and increase its gas exports to Turkey.

Overall, Iran's 179-page monthly customs report shows in great detail how the balance of trade is steadily improving, with category after category of exports headed up and category after category of imports headed down. To be sure, the country still has a large non-oil trade deficit, a problem exacerbated by the deficit in services and on the capital account. But its capital outflow also appears to be decreasing -- Central Bank data reported in Tehran's *Donya-e Eqtesad* newspaper pegged this outflow at $2.4 billion in April-May 2012 compared to $11.4 billion the previous year, in no small part because international banks cut their exposure to Iran. If the declining deficits continue, Iran could use its ample reserves to finance a moderately smooth transition to an economy without oil exports.

The West has sought to hamper Iran's trade through banking restrictions, but Minister of Industry, Mines, and Commerce Mehdi Ghazanfari recently claimed that "41% of the hard currency needed for imports in the first half of the year were provided by non-banking sources." Although that may be a considerable exaggeration, Iranian officials perceive themselves as masters of evading rules, so it will be difficult to persuade them that they cannot find a way around any Western restrictions.

BUDGETARY PROBLEMS NOT INSURMOUNTABLE

Replacing oil in foreign trade is easier than replacing it in government finances, but Tehran is making progress on that front too. President Mahmoud Ahmadinejad's proposed budget for March 2013/March 2014 assumes oil revenue will fund 40% of expenditures. Although the official budget documents are not very informative, the Majlis Research Center (MRC) -- the parliament's research arm -- has prepared dozens of detailed reports on the subject. As these reports explain, the budget assumes Iran will export around $45 billion in oil in 2013/2014, based on an average price of $91 per barrel and a volume of 1.33 million barrels per day (b/d). This includes natural gas liquids; like the United States, much of Iran's oil exports are from such liquids rather than crude oil. After deductions for the National Development Fund (NDF) and National Iranian Oil Company costs, that translates into around $26 billion for the government. The budget's assumptions are largely reasonable: it will be difficult for the West to reduce Iran's exports below the current 1.3 million b/d or drive its earnings below $91 per barrel.

How much revenue the oil exports bring depends on the exchange rate used: the higher the rate, the higher the rial revenue. The budget assumes that oil exports will be converted at the current exchange office rate of 24,500 rials per dollar -- about twice the official rate of 12,260, but only three-fourths the black market rate of around 34,000.

This implies that vital imports will be shifted to the exchange office rate, doubling their price in rials and requiring either more cash subsidies from the budget or higher prices on consumers. At that rate, the government's share of oil exports would be 644 trillion rials (though the MRC reports it as 659 trillion elsewhere). That is about 40% of the government's proposed 1,669 trillion rials in expenditures.

While oil revenue is headed down, non-oil revenue is headed up. The budget claims that Iran will raise 530 trillion rials from taxes over the next year, while the MRC estimates 448 trillion (for comparison, the center estimated 2012/2013 tax revenue at 352 trillion rials, or 78% of the budget forecast). Even less realistically, the government forecasts 480 trillion rials from other revenue sources, compared to 305 trillion in the previous year's budget. Evidently, much of this figure is derived from privatization of state holdings. The MRC estimates that 180 trillion rials in shares were transferred in 2012/2013, mostly to state-controlled institutions such as banks and pension funds; the government took in only 45 trillion rials in cash. Given past experience, a significant shortfall from the 480 trillion target for nontax revenue seems likely.

Yet various reports suggest that Tehran has found ways to cover some of its expenses by drawing on the NDF, which is supposed to receive 20% of oil revenue for use in developing the economy. The 2013/2014 budget allocates about $11.7 billion to the fund, equivalent to 284 trillion rials at the exchange office rate -- money that could be diverted to cover budget expenses. So all in all, the government may find a way to put its hands on something close to the 1,010 trillion rials in non-oil revenues it forecasts, even if a chunk of that funding actually comes from oil revenues deposited in the NDF.

The new budget also seeks to reduce reliance on oil revenue by keeping a lid on expenses. The 1,669 trillion rials in budgeted expenditures for 2013/2014 represent a 16% increase over 2012/2013 (1,443 trillion), which is much lower than inflation (the Statistical Center of Iran reports that prices in March 2013 were 40.6% higher than in March 2012). The share of the budget allocated for investment (373 trillion rials) is well below what is needed for growth and continues to decline, from 28% last year to 22% this year. As for current expenditures, the budget proposes 502 trillion rials for salaries, including a 20% raise, well below inflation. Subsidies -- mostly cash payments to individuals -- would rise to 233 trillion rials, 71% more than last year. Yet that could still leave the poor worse off, since the proposed second round of subsidy reforms may raise their cost of living by more than the additional payment.

To be sure, falling oil income has almost certainly led to budget deficits. Although no official estimates are available, Abdolreza Rahmani Fazli -- the head of the Supreme Audit Court and no friend of Ahmadinejad -- estimated that 2012/2013 revenue will cover only 50% of costs, based on results for the first nine months of the year. That would imply a budget deficit of about 12% of national income, compared to the U.S. government's peak of 10% during the recent recession (in fiscal year 2009). Tehran is in a good position to finance a large deficit, however. Rather than having a national debt, the government is a significant net creditor to the banking system, both at home and abroad. And NDF managing director Mohammad-Reza Farzin reported in December that the fund's balance was $42.8 billion, which could be drawn on in a pinch.

In short, even with reduced oil income due to sanctions, Iran's government finances are doing as well as (or better) than those of the United States and most other industrial countries.

POLICY IMPLICATIONS

Thus far, international sanctions have focused on decreasing Iran's oil income, but Tehran has apparently decided to accept the immediate pain while promoting a smaller role for oil, undercutting the West's strategy. In fact, the regime's approach is good for Iran in the long term. To quote OPEC founder Juan Pablo Perez Alfonzo, oil has often been the devil's curse, encouraging a windfall mentality that impedes growth.

Exploring alternative Western strategies requires a fuller study, but a few implications of this analysis merit

mention. One is that extending sanctions to cover all Iranian exports would be very difficult. Getting Turkey, China, India, and others to give up Iranian oil was hard enough; persuading them not to buy Iranian fertilizer would be even tougher. One reason they will be reluctant to take that extra step is because revenue from non-oil exports does not go directly to the government, but to private firms (though many of these are largely owned by government-related entities). Iran is therefore unlikely to be crippled by any sanctions the West could impose.

Another point is that the increasing non-oil exports enrich the middle class and reduce the government's weight in the economy. Fears that sanctions might hollow out the modern middle class, as happened in Iraq during the Saddam era, are misplaced. Instead, all those Iranian merchants scrambling to become exporters portend a stronger civil society -- one that might someday convince Tehran to abandon its isolationist policies. Yet it would be imprudent to rest one's hopes for resolution of the nuclear impasse on such a possibility.

Patrick Clawson, an economist by training, is The Washington Institute's director of research and coauthor of the forthcoming book History of Money in Iran 1500-1925 *(I.B. Tauris, 2013).* ❖

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