

Will Iran Weather the Economic Storm?

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Articles & Testimony

The depreciation of the rial is unlikely to change Iran's foreign-policy calculations.

The conventional wisdom that the collapse of the Iranian rial will have disastrous consequences for the Islamic Republic has it wrong: On the contrary, it could be the best thing that has happened to the Iranian economy in years.

Iran is a classic case of the resource curse. OPEC founder Juan Pablo Pérez Alfonso, who served as Venezuela's oil minister, called oil "the devil's excrement" for the pernicious impact petroleum revenues had on his country's economy. The same is true for Iran, which faces the challenge of becoming a country that produces goods, not merely consumes them. Unfortunately, the current Iranian government shows few indications it will meet this challenge. Rather, history suggests that Tehran will instead persist in its populist policies, including its confrontation with the international community about its nuclear program.

From mistake to mistake

Iran's economy has historically been distorted and sluggish when oil prices have been high. The same is true this time around: Booming oil revenues have led to a rush of imports rather than higher domestic output. The IMF calculated that from 2005 to 2010 imports soared 50 percent -- from \$43 billion to \$67 billion -- while Iran's national output grew at the much more modest pace of 18 percent.

Iranian industry, meanwhile, has been hard hit by rising costs from domestic inflation, while competing imports were kept cheap by the government policy -- successful until late 2010 -- of keeping the rial steady. Propping up the rial may have fed national pride, and it certainly meant cheap consumer goods -- important factors for the populist Islamic Republic -- but it hurt domestic producers.

For years, the key factor that kept Iranian industry alive despite competition from cheap imports was the low cost of energy. With electricity and natural gas practically free, Iranian manufacturers had an important advantage over

their foreign competitors. And many Iranian companies benefited from the low cost of shipping and travel -- byproducts of the low gasoline costs.

These advantages weren't cheap: The Iranian Central Bank concluded that, by 2007, the subsidies were costing Iran \$88 billion a year, with Iran's energy costs at 10 percent or less of the international price. Using high oil revenues to subsidize energy was an expensive and inefficient way to help Iranians. A sounder policy would have been to invest in infrastructure, improve education, and make loans available for small businesses -- all policies followed by the Shah of Iran before the 1970s oil boom gave him grandiose ideas. As a result, Iran's economy in the 1960s grew as fast as China's has in the last decade.

As world oil prices rose after 2007, the burden of energy subsidies rose sharply. President Mahmoud Ahmadinejad, meanwhile, saw an opportunity to use these rising prices to his benefit. He made a shrewd political calculation: Rather than subsidizing gasoline and electricity used most heavily by the middle class, who detested him, he would raise energy prices to the global market price and use the money to send checks to the poor, who supported him.

That was his plan, but after the middle class rose in revolt after his contested 2009 reelection, he revised the scheme to send the checks to them too. And instead of phasing in the reform, he did it all at once in late 2010 by depositing rials in each household's bank account each month. To keep the cost of the subsidy reform within the bounds of what the government could afford, Ahmadinejad effectively jettisoned the substantial payments that were to have gone to industry to pay for shifting to more energy-efficient technology.

Iranian producers were now in a bind: The low energy prices that had been their competitive edge disappeared overnight. The government's response was a looser monetary policy, including providing easy credit to firms in no position to pay. According to Iran's Central Bank, the bank credit to the private sector went from 2.3 quadrillion rials in March 2010 (then worth about \$250 billion) to 4 quadrillion in August 2012. Not entirely by coincidence, bank deposits (by far the biggest component of the money supply) rose over the same period from 2.1 quadrillion rials to 3.8 quadrillion. That was an 80 percent increase in bank deposits -- while over a similar period, the IMF says, real GDP rose 7 percent.

It does not take a genius to figure out what happens when 80 percent more money is chasing 7 percent more goods: price soar. The government reports that consumer prices rose 43 percent from March 2010 to April 2012; it has not published data for recent months, presumably because they show a further rise. If one accepts the official inflation figures, this means costs in Iran would have gotten ridiculously out of line with costs in competitor countries had the rial not lost value.

The rial's collapse means that Iranian firms may finally have a fighting chance against their foreign competitors. The wise policy would be to encourage the rial to fall even further, while tightening up on monetary policy to tamp down inflation. Of course, that would mean imposing pain on consumers, which goes against every instinct of the populists who run Iran's economic policy. Therefore, such a sound policy is unlikely. Indeed, there are no signs that the loose monetary policy is going to change. Even the ever optimistic IMF expects Iran's inflation to remain above 20 percent next year.

The irony is that the falling rial benefits the government more than anyone else. Most of Iran's exports are in the government's hands. With each dollar of exported oil now worth more rials, the government's rial revenue rises, offsetting at least in part the lower volume of exports. That extra revenue would put the authorities in a good position to help businesses invest in more energy-efficient technology and to create more jobs.

But that is not likely to happen. The government is much more likely to insist on selling dollars at an artificially low rate, on the theory that this keeps prices down. The real effect, however, is to generate high profits for the politically well-connected, who get access to foreign exchange at the preferential rates.

With low export volumes and an artificially low exchange rate, the government will face the worst of two worlds: low revenue and high costs. That could force budget cuts -- and those could have serious political consequences. On Oct. 9, Ahmadinejad spoke of cutting some items 25 percent and zeroing out others, and Chief of the Joint Staff Seyyed Hasan Firuzabadi warned that the military budget could be cut 10 percent. Soaring prices, rising unemployment, budget cutbacks, and rampant corruption are a recipe for popular anger, though the Islamic Republic's vigorous repressive apparatus may prevent it from translating into popular protest.

History suggests Iran will learn the wrong lesson

Iran's economic problems are made much worse by the public's worry that war is coming. Fear of war keeps investors from committing to new projects and leads consumers to seek safe havens for their assets, such as dollars. An obvious step to improve the economy would be to re-energize the negotiations over the nuclear impasse. And that may well happen. But history offers a word of caution.

Twice before, the Islamic Republic of Iran faced serious foreign exchange problems, arguably as bad as the current one. The first was when the price of oil collapsed in the mid-1980s. Iran's oil export earnings went from \$21 billion in the 1983-1984 fiscal year to \$6 billion in 1986-1987. Iran's response was to adopt draconian measures that cut imports from \$18 billion to \$11 billion. This was at a time when Iran was throwing waves of its own citizens at Iraqi forces in a vain effort to overrun that country -- we remember the Iraqi invasion of Iran in September 1980, but we often forget that Iraqi forces withdrew in June 1982 and Iran invaded Iraq the next month. Because war-related imports could not be cut, Iran appears to have taken the ax to civilian imports -- slashing them by more than 50 percent.

The loss of oil revenue was not enough to get Iran to accept a cease-fire. That came only later, when Iranian leaders feared the United States was joining the war and Iraq would fire chemical-tipped missiles at Iranian cities. In other words, difficult economic times did not bring a change in security policy -- the threat of much greater military force did.

The Islamic Republic faced its next severe economic challenge in the mid-1990s. After running up \$14 billion in debts in a postwar burst from 1991 to 1994, Iran's bills were coming due just as U.S. President Bill Clinton's administration stepped up pressure on its allies not to lend to Iran, and then in 1995 it imposed comprehensive U.S. sanctions. Iran could have solved this problem by scaling back its support for terrorism and ending its vigorous efforts to undercut the then-vibrant Arab-Israeli peace talks. Instead, Tehran tightened its belt over the next three years to repay \$8 billion in loans and leaned on Europe and Japan to reschedule \$16 billion in loans coming due.

The austerity measures cut imports from \$23 billion in the 1992-1993 fiscal year to \$13 billion in 1994-1995, and they stayed at that level for the next fiscal year. In short, Iran preferred to cut imports almost in half rather than change its foreign policy.

Historical analogies are imperfect: Situations are different, the actors have changed, and so on. Nevertheless, the record suggests tempering one's optimism that economic pressure will bring Iran to change its populist policy stances -- either its pernicious domestic economic policy or its adventurist nuclear stance.

Patrick Clawson is director of research at The Washington Institute and heads its Iran Security Initiative.



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