Impact of World Bank Loans to Iran

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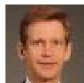

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Articles & Testimony

Testimony before the House Committee on Financial Services, Subcommittee on Domestic and International Monetary Policy, Trade, and Technology

Two important considerations in judging U.S. reaction to World Bank lending to Iran are: how important is World Bank lending be to Iran, and how would lending to Iran fit with World Bank practice? Let me address those two issues in turn.

How Important is World Bank Lending to Iran?

Iran faces difficult economic times for the next decade, because its "baby boom" after the 1979 revolution is entering the labor market. To prevent mushrooming youth unemployment -- and the attendant risk that youth will take to the streets against the Islamic Republic -- Iran needs to create at least 700,000 jobs a year. Despite growth averaging 5.8 percent per year in the last three years[1], job growth has been well under that level; the last available data show that job creation averaged 255,000 a year in 1997-2000.[2] Youth unemployment has been contained only by expansion of university education and a wave of emigration (by some estimates, 180,000 a year) -- neither of which are sustainable solutions over the next decade. Job creation could in theory come from economic reform, especially lessening the heavy weight of corruption, but there is no stomach among Iran's rulers to take that route. Their preferred approach is to secure sufficient foreign funds to meet the job creation challenge.

A recent International Monetary Fund (IMF) report on the Iranian economy predicted that Iran needs to mobilize $4 billion a year in foreign loans and direct investment if it is to achieve a level of growth which stabilizes unemployment, that is 5.4 percent per annum on average.[3] The report assumes that Iran will secure significant foreign investment in the oil industry and that Iran will borrow $3 billion a year. If Iran did not have access to that kind of foreign capital, it would suffer directly from the $4 billion a year shortfall and it would suffer further from the loss of the expanded oil exports that those funds would finance. In particular, the IMF forecasts that the foreign funds will allow Iran to expand its oil exports from 2.3 million barrels per day in 2002/03 to 3.9 million in 2008/09. If oil exports stagnated at the 2002/03 level, Iran would have $11 billion a year less by 2008/09. In other words, the foreign funds and the expansion in oil exports they make possible are central to Iran's economic plans -- and could be key to preventing youth unrest that could threaten the current hardline government.

Lending by the World Bank would under any circumstances be a small part of the $4 billion a year Iran needs to raise from abroad. After all, since lending resumed in May 2000, the World Bank has approved loans totaling $432 million, or less than $150 million a year. It will be interesting to see what the World Bank staff proposes as a lending program for Iran for the next few years in the Country Assistance Strategy (CAS) report to be presented to the World Bank Executive Board by June 2004. However, the magnitude of World Bank lending understates its impact. As the World Bank correctly emphasizes, its lending has a catalytic effect on other lenders and investors, that is, lenders and investors are more likely to place their funds in a country where the World Bank has found that the business climate and economic policies are sufficient to merit World Bank lending. In other words, World Bank lending could have a significant impact on Iran's ability to raise international capital and therefore on its economic prospects.

That said, it is by no means clear that restricted access to international capital would lead Iran to reduce its military spending, including spending on its nuclear program. The record of the last few years is discouraging in the regard. Iran faced a real problem in the mid- and late-1990s due to the imposition of U.S. sanctions in 1995 and the U.S. pressure on lenders and investors not to put their funds in Iran. Not only was Iran's access to new lending and investment reduced, but it also had to make large payments on the foreign debt it incurred in the heady days after the end of the Iran-Iraq war in 1989, when more than $30 billion flowed into Iran over four years on the false expectation that the Iranian economy would boom. Iran's response to this tough situation was to restrict civilian spending enough to repay the debt, while at the same time devoting enough resources to make unexpected progress in its nuclear program. From this experience, it is quite possible that Iran would respond to any new shortfall in expected foreign loans and investment by cinching in its belt further.

An additional complication is that Iran's international economic situation is highly dependent on the price of oil. Oil prices were quite a bit higher the last few years than they were in the mid- and late-1990s. The spot price for Dubai oil averaged $24.30 in 2000-02 compared to $15.99 in 1993-99.[4] That difference meant an extra $7 billion a year for Iran. With that money, Iran was able to repay most of its foreign debt and build up a cushion of $21.8 billion in foreign exchange reserves as of March 2003.[5] In other words, Iran used the extra income from the high oil prices to reduce its vulnerability to economic pressure and to build up a substantial cushion. This makes Iran much less susceptible to economic pressure. And if the price of oil were to stay at the average 2002/03 export price of $27.10 per barrel instead of declining to $19.70 by 2006/07 as assumed by the IMF, Iran would earn an extra $9 billion a year in revenue. Indeed, relatively small swings in world oil prices are as important to Iran's economic prospects as are its access to international capital.

In short, World Bank lending will matter much more to Iran if oil prices decline faster than expected. If Iran faces tough economic times due to low oil prices and lack of access to international capital, that could strengthen popular protests against the hardline government; at the same time, that government could well decide to make whatever sacrifices are needed to keep the nuclear program on track.

How Would Lending to Iran Fit With World Bank Practice?

Iran's highly distorted economy makes it a poor candidate for World Bank lending. The revolutionary foundations ("bonyads") control up to 70 percent of the non-oil economy, and they are dens of corruption and special dealing. The entire economy is distorted by the heavy subsidies on domestic energy, which the Iranian government estimate cost $11 billion a year, or nearly 10 percent of national income. The pernicious effects of the energy subsidy include excessive consumption of electricity, which is one reason Iran is investing in so many new power plants.

As it does in other countries with such poor economic policies, World Bank lending to Iran should be confined to social services and semi-humanitarian loans, such as the present Bank loan for earthquake reconstruction, sewage, and environmental protection. The United States should press hard to ensure that the World Bank does not bend its usual procedures, which are to insist on economic reforms and appropriate policies before the Bank can lend to a

sector. It would be particular scandalous were the Bank to lend to the electricity sector in Iran, given that Iran is wasting more than a billion dollars on the construction of a nuclear power plant when the electricity could be much more economically produced using Iran's ample natural gas. For more than twenty years, the World Bank has had a policy of avoiding loans for the electricity sector in any country building a nuclear power plant. The economic stupidity of the Bushehr nuclear power plant is ample reason for the World Bank to stay away from electricity loans to Iran; one need not raise the many proliferation concerns which Bushehr entails.

It would be entirely consistent with World Bank procedures for the U.S. government to vigorously lobby the Bank's management and Executive Board about the inappropriateness of lending to a country with as poor economic policies as those of Iran. Raising explicitly political objections is a different matter. The ethos of the World Bank, reflected in its charter, is that loans should be decided on economic and financial criteria. It would be difficult to gain international consensus to change this approach. Furthermore, there are grave risks to U.S. interests if foreign policy considerations dominate decisions about World Bank lending. Many governments oppose aspects of U.S. foreign policy, and they could be tempted to bloc World Bank loans to U.S. allies. An important case in point is the World Bank's announced intention to lend $5 billion to Iraq by 2007. Were foreign policy considerations to weigh heavily in World Bank calculations, gaining approval for that lending to Iraq could be problematic.

There is one circumstance in which the World Bank would almost certainly let politics determine its lending to Iran, and that is if the UN Security Council were to order action. In the event Iran is found by the International Atomic Energy Agency (IAEA) to be out of compliance with the Treaty on Non-Proliferation of Nuclear Weapons (NPT), the Security Council will face the question of what actions to take to press Iran. The Security Council is likely to be reluctant to start with far-reaching steps such as comprehensive economic sanctions. In the search for more measured restrictions on Iran, surely banning access to lending by international financial institutions such as the World Bank deserves consideration.

In short, the U.S. government can vigorously press against World Bank lending to Iran because of its poor economic policies. Raising more explicitly political objections is more problematic, but should be considered through the Security Council if Iran is found in violation of its NPT obligations.

Notes

1. International Monetary Fund, "Islamic Republic of Iran: Staff Report for the 2003 Article IV Consultation," August 1, 2003, p 6. 2. IMF 2003 Staff Report, p 17. 3. IMF 2003 Staff Report, p 34, which is the "baseline medium-term scenario under current policies" through 2008/09. 4. BP Statistical Review of World Energy, June 2003, p 14. 5. IMF 2003 Staff Report, p 34. ❖

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