

IRAN'S MOTIVES AND STRATEGIES: THE ROLE OF THE ECONOMY

Patrick Clawson

Statement for Senate Foreign Relations Committee May 17, 2006 Hearing

If Iran saw its nuclear program as essential to defending the country's very existence – the way Israel and Pakistan view their nuclear programs – then economic considerations would make little difference to Iran's calculations. But defense is not the principal factor behind the Iranian nuclear program. Rather, Iran's principal motives for its nuclear program are the pursuit of prestige and influence. Iranian leaders consistently present the nuclear program as an accomplishment of Iranian science and as evidence that Iran is an advanced modern industrial power. They also argue that Western opposition to Iran's nuclear ambitions are an effort to keep Iran down, to prevent the country from assuming its rightful place as a leader in the region and the broader Muslim world. They play to Iranians' national pride, to their sense that Iran is naturally a great power – not to any sense that Iran is so threatened that it must take desperate steps to defend itself.

The challenge for the West is to persuade Iran's power-holders that the nuclear program will not advance Iran's prestige and influence. Economic instruments can play a role in this regard, though they are most unlikely to be sufficient by themselves.

Iranian Self-Assurance

Unfortunately, the West's ability to press Iran has eroded in recent years. Iran's leaders are now remarkably self-assured, given the conjunction of favorable circumstances, including the end to threats to Iran from Iraq and Afghanistan; the United States being tied down in Iraq; and victories by pro-Iranian forces in Iraqi and Palestinian elections. Economic factors play no small part in this self-assurance, as documented by the recent International Monetary Fund report (the source of all the economic figures I cite, unless otherwise noted). Oil and gas exports have shot up from \$23 billion in 2002/03 to \$55 billion this year, driven entirely by higher prices (Iran got \$23 per barrel in 2002/03 and will get \$55 this year). The oil exports have swelled government coffers allowing an explosion of off-budget spending that has sent economic growth shooting up to an average of 6.2 percent a year (discounting for inflation) from 2002/03 to this year. Foreign exchange reserves have shot up to \$47 billion, more than twice the size of all foreign debt, and are expected to rise further to \$62 billion by the end of this year.

In light of the favorable strategic situation, many in the Iranian leadership are no longer convinced that it must maintain strong ties with Russia and Europe, nor do they think that these relationships have brought Iran any benefits to date. To the extent that this self-reliant attitude prevails, it will be harder to persuade Iran to cooperate with the international community. However, if the great powers can remind Iran about the true danger of isolation, the terms of the nuclear debate in Iran will change. Conceding will be difficult for Iran, but the Islamic Republic has in the past made difficult compromises with its revolutionary principles, such as ending the Iran-Iraq War.

Complicating the situation is that Iranian President Mahmoud Ahmadinezhad seems to welcome the prospect of an attack on Iran as a means to rekindle the lost fervor of the early revolutionary days.

While he represents a dangerous and growing element in the Iranian elite, the real power holder has been the Supreme Leader (who is exactly what the title suggests), Ayatollah Ali Khamenei. For the last 18 years, Khamenei has preferred low-level confrontation with the West -- just enough to keep the revolutionary spirit alive, but not enough to risk open hostilities. For now, Khamenei seems to think that the West, despite its tough rhetoric, will do nothing to stop Ahmadinezhad, so why not let him push ahead.

Economic Vulnerability

Having pegged his reputation on his ability to help the ordinary man, Ahmadinezhad faces serious problems: the economy is a mess, his policies are disastrous, and Iranians' expectations are sky-high. The World Bank's 2003 report about Iran noted, "Despite the growth in the 1990s, GDP per capita in 2000 is still 30 percent below what it was in the mid 1970s, compared with a near doubling for the rest of the world." Iranians are galled to find that their country has slipped badly behind the Arabs on the south side of the Persian Gulf, whom they traditionally have regarded as their social inferiors. Thanks to the tens of thousands of Iranians living in Dubai, Iranians know full well that Dubai is booming because it has embraced globalization, while their country falls ever farther behind, trapped by its suspicion of the West.

Ahmadinezhad's policy is based on producing everything at home and creating barriers to trade -- he has no use for globalization. His government has been discouraging foreign investors, for instance, refusing to allow Renault to use the billion-dollar facility it built in Iran to build an inexpensive car for the Asian market. The recent Iranian boom has been based almost entirely on profligate government spending which cannot last forever. Despite the flood of oil money, government policies are such that the IMF warns the budget will fall back into deficit again within two years even if oil prices remain sky-high.

The recent massive government spending has led to several years of solid growth, yet it has barely dented the country's long-term economic problems. While reported unemployment fell to an eight-year low of 10.3 percent last year, job creation remains insufficient to absorb the 700,000 young people entering the job market each year. The IMF forecasts that even if oil prices remain at their present high level, unemployment will steadily increase in years to come. In its 2003 report, the usually sober and understated World Bank summed up the "daunting unemployment challenge" with strong words: "Unless the country moves quickly to a faster path of growth with employment, discontent and disenchantment could threaten its economic, social, and political system."

Economic and political frustration is feeding social problems. One is chronic drug problem, with the Iranian government acknowledging that two million people use narcotics, mainly opium; other estimates are higher. Divorce is on the rise; one study found that 30 percent of newlyweds got divorced within three years. Another is increasing prostitution; the official estimate is 300,000 prostitutes. There have been a number of corruption scandals involving judges and government social workers involved in prostituting young girls. Instead of making reforms that would allow entrepreneurs to create jobs, the political elite is more comfortable with the "solution" of rising emigration rates, especially among the well educated. In sum, many of Iran's best and brightest are leaving the country, and a growing number of those remaining are at risk of becoming an underclass.

Business Confidence: The Achilles' Heel

Given that inappropriate government policies are already making the Iranian business community nervous, international pressure on the economy could have a major impact on business confidence.

“The [Tehran] stock market has shown to be hypersensitive to political issues (such as the course of the nuclear enrichment negotiations), as well as domestic economic policy uncertainties,” writes the state-owned Karafarin Bank in its *Survey of the Iranian Economy* for October-December 2005. In 2005, the stock market index fell 26%. At the same time, the banking system was hit by a crisis from dishonored promissory notes, primarily by big firms unable to pay their debts.

With even Iranian firms nervous about business conditions, there are excellent opportunities to press foreign firms to reduce their presence in Iran. There have already been some notable successes in this regard. Strict U.S. Treasury application of existing rules about fund transfers – such as those to prevent transfer of funds to terrorists and weapons of mass destruction (WMD) proliferators – led the two largest Swiss banks (UBS and Credit Swiss) and a large British bank (HSBC) to decide recently that Iran was not an attractive place to do business, so they stopped taking new business. The impact that this is having was well described by the state-owned Karafarin Bank in its *Survey of the Iranian Economy* for October-December 2005:

“Most probably, the fear of imposition of sanctions by the UN against Iran, in connection with the nuclear enrichment issue, has reduced the reliability of Iranian banks as international trading partners. In other words, despite [an] important balance of payments surplus, Iranian banks have been facing difficulties dealing with their otherwise cooperative correspondents. This may prove to be for the banks and the country as a whole, [sic] one of the most important obstacles to hurdle in the months to come.”

There is much scope for working with U.S. allies to more vigorously apply restrictions on financial transactions and trade with Iran. UN Security Council Resolutions 1373 and 1540 call on countries to adopt and enforce effective controls on funds and services that would contribute to terrorism and WMD proliferation respectively. The United States and its allies can approach countries to ask what are they doing to implement these resolutions regarding Iran, especially in light of the International Atomic Energy Agency (IAEA) decisions finding Iran has violated its safeguards agreements with the IAEA. Industrial firms can be warned about the many items which could be diverted from their declared peaceful intentions to be used instead in the nuclear program. Banks can be cautioned about the negative publicity as well as regulatory complications if they were found to be facilitating shady businesses. European governments excel at using such quiet warnings, which can be very effective at persuading firms that the Iran market is not worth the risks; indeed, a number of European governments seem already to be passing such warnings. The U.S. Treasury has a well-oiled machinery for implementing restrictions, and its warnings to banks can be particularly effective since few banks in the world are willing to risk being cut off from dealings with the U.S. financial system. That same machinery could be extended to press firms considering investments in the Iranian oil and gas industry.

Tighter restrictions are “de facto sanctions” which have many advantages over formal sanctions imposed by the UN Security Council. Russia and China have no veto over tightening restrictions. In the best of cases, obtaining Security Council consensus for action takes a long time, whereas tightening restrictions can be done much more quickly. Action by the Security Council provides Ahmadinezhad with a banner around which he can rally nationalist reaction, claiming that the country is under attack. By contrast, tighter restrictions operate under the public’s radar screen, while their impact is fully felt by the business community – which in Iran means first and foremost the

revolutionary elite which behind the scenes controls the economy as fully as it does the political system.

Oil's Mixed Role

Given that Iran's goal is to use its nuclear program to achieve influence and prestige, fewer instruments would seem better suited to that task than its oil exports. It has been suggested that were Iran to make good on threats to cut off its oil exports of 2.5 million barrels/day, this action would hurt the West so much it might have to back off on its pressure against Iran's nuclear program.

Perhaps – but perhaps not. The present tight world oil market will not last forever. Production outside of OPEC is increasing, not least under the stimulus of high prices, and the return of Katrina-damaged facilities will only add to the higher output. Despite the red-hot Chinese and Indian economies, world demand is growing more slowly as price influences consumption. It is not beyond the realm of possibility that within the next few years, oil markets could become much more slack. After all, that was the experience after both the 1973-74 and 1980-81 price increases: within four years, the oil market got soft. In short, the more time that passes, the less may be Iran's strategic leverage regarding oil.

Indeed, the world oil situation is already changing, though that fact is obscured by the fears of consumers and speculation of traders. In April 2006, world oil production was 1 million barrels/day higher than demand, according to the prestigious *Petroleum Intelligence Weekly*. Plus OPEC countries – principally Saudi Arabia – had excess production capacity of about 1.5 million barrels/day, and the world refinery situation is changing such that the heavier Saudi crude oils could be more readily absorbed (last year when Saudi Arabia wanted to sell additional oil to offset post-Katrina price spikes, refineries were unable to take advantage of the exceptionally low prices offered). Those two factors alone could have made up for a cutoff in Iranian oil exports, even without the use of the West's approximately 1.4 billion barrels in strategic reserves, which are the equivalent of 560 days of Iranian exports (figures from the International Energy Agency).

Were Iran to cut off its oil exports, the impact on the Iranian economy would be considerable. To be sure, Iran's ample foreign exchange reserves would cushion the impact, but those reserves would only be sufficient to pay for a year's imports (or, if Iran cut back imports to the bone, for two year's imports at that low level). And the Iranian government relies on oil revenue to fund 75% of its expenditures, according to Karafarin Bank (the IMF reports are not much help on this issue, because the government has taken to conducting so many of its operations outside the budget through various shady accounts).

Perhaps the most immediate Iranian vulnerability regarding oil is its dependence on imported gasoline, which provide about 40 percent of the 350,000 barrels of gasoline sold daily. However, this vulnerability is less than meets the eye. The price of gasoline at the pump is 800 rials per liter, or about 35 cents a gallon. Such a ridiculously cheap price encourages rampant smuggling of gasoline to neighboring countries, such as Turkey and Pakistan, where gasoline prices are more than ten times higher than in Iran. Plus the low pump price leads to excessive gasoline consumption that gives Tehran some of the world's most polluted air; schools frequently have to close because it would be unhealthy for children to go outside. And the low gasoline price results in a massive loss of government revenue; just the cost of distributing the fuel after it leaves the refinery gate is more than what the customer pays. The IMF and World Bank have spent years documenting in great detail the pernicious economic and health impact of the excessive gasoline consumption. In

short, there are few steps which would help the Iranian economy more than forcing a reduction in gasoline consumption. And the Iranian government is well along with plans to ration gasoline from September 2006 – plans which would allow a quick response in the event of a gasoline import cutoff.

A final word about the role of oil in thinking about Iran's nuclear program. It is tempting to assume that Iran can use its oil riches to influence the decisions of other governments. However, there is remarkably little evidence that Iran has successfully used oil to induce other countries to turn a blind eye to its nuclear violations. Consider for instance that the great power most reluctant to press Iran has been Russia, which is a fellow oil exporter and could therefore benefit if Iranian oil were kept off the market. Indeed, there is little reason to think that Moscow's approach has been affected by any economic consideration, which is not surprising given the remarkably favorable economic circumstances Russia finds itself in, with the main dilemma facing the government being how much of the vast budget surplus to spend and how much to save. As for Iranian efforts to use oil projects to influence China, Japan, or India, they seem to have had little impact, in part perhaps because Iran has been unwilling to offer particularly attractive terms to foreign investors. The eye-poppingly large deals announced with great fan-fare have all run into serious difficulties over the terms and conditions.

The Limitations of Economic Instruments

Economic instruments alone are unlikely to be sufficient to persuade Iran to freeze its nuclear program. The principal levers of power in Iran are in the hands of revolutionaries who are not motivated primarily by economic concerns, while those who care about the state of the economy do not have sufficient influence on their own to persuade the real power-holders to change policies. Success at influencing Iranian policy is much more likely if action on the economic front is combined with action on other fronts. In particular, the security apparatus – especially the Revolutionary Guards – are a vital power center in Iran. They need to be convinced that the current nuclear policies are threatening Iran's security, because Iran's neighbors and the great powers will react in ways that will hurt Iran. If Iran makes the Gulf a more dangerous place, then the United States and other powers will need to deploy more powerful military assets to the region, if for no other reason to protect shipping from Iranian threats to close the Strait of Hormuz. And Iran's nuclear program could start an arms race, which the Gulf Arab monarchies and Turkey would win, since compared to Iran they are both richer and have better ties with the world's principal arms suppliers.

Much as pressure should be applied on several fronts rather than just on the economy, so inducements offered Iran should take multiple forms rather than only being trade and investment incentives. Indeed, economic inducements look suspiciously like bribes paid for bad behavior. Besides being odious, such bribes give the impression that bad behavior is more profitable than good behavior. Pro-Western reformers were unable to secure a trade agreement with Europe or substantial U.S. relaxation of its economic sanctions despite their obvious interest in improving relations, but now it appears that anti-Western hardliners may achieve those objectives – which suggests that Iran would be well advised to be obnoxious rather than cooperative. No matter how creatively one designs or packages economic inducements, they will inevitably look like reward for bad behavior.

A much more appropriate form of inducement would be security inducements. Such security inducements should be designed to counter the argument that Iran needs nuclear weapons for its defense. There are many confidence-and security-building measures and arms control measures that would provide gains for both Iran and the West, similar to the way such steps reduced tensions

between the old Warsaw Pact and NATO during the Cold War. One example would be an agreement to reduce the risk of incidents at sea between the U.S. and Iranian navies.

A further security inducement which the United States could offer would be to address the reported concern that the Bush administration's real goal is regime change in Iran and that the Bush administration will use force to that end. Such complaints sound peculiar coming from an Iranian government whose president lectures President Bush on why the United States should abandon its liberal democracy and who sponsored a conference last fall on theme "The World Without Zionism and America" – a government which regularly organizes mass demonstrations filled with the chant "Death to America." Perhaps we should take as a compliment that Iran's hardliners expect the United States to be more restrained than they are; we certainly do not organize terror attacks to blow up their barracks the way they did at Khobar Towers in 1996 or in Beirut in 1983.

It would of course be inappropriate for the U.S. government to offer any security guarantees to the Iranian or any other government; what government is in power in another country is up to the people of that country to decide. But what Washington could offer Tehran would be a "conditional security assurance" – jargon for the simple proposition, "**We will not attack you if you do not attack us.**" To clarify what that means, the U.S. government should spell out:

* "Just as you criticize us for our liberal democracy, we will remain free to criticize you for your undemocratic violations of human rights.

* "Just as you spend tens of millions on radio and television broadcasting to our country to propagate your views, so we will remain free to support broadcasts to Iran.

* "Just as you tightly restrict trade with America, we will remain free to restrict trade with Iran."

Such a conditional security assurance might not be all that Iranian hardliners want, but at the very least, it would help in the battle to influence European and Middle Eastern opinion that the United States is being reasonable and Iran is not. Since Iran's main objective in pursuing its nuclear program is to gain influence and prestige, Washington's strategy should be to show that Tehran's obstinate nuclear stance is undermining Iran's influence.

Patrick Clawson (pclawson@washingtongroup.org) is deputy director for research at The Washington Institute for Near East Policy.