THE ECONOMICS OF CONFRONTING IRAN

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Chairman Saxton, Vice-Chairman Bennett, distinguished members of the Committee:

It is a privilege to appear before you today to discuss the subject of the Iranian economy and U.S. policy options.

There is no greater foreign policy challenge facing the United States today than the one posed by the Islamic Republic of Iran. The Iranian regime's persistent work on its nuclear program, and its intransigence in the face of international demands, has catalyzed a growing crisis that threatens international peace and security. So far, however, there has been little public discussion about the economic dimension of the current crisis, or of the financial levers available to the United States and its international partners to alter Iranian behavior.

WHAT FUELS IRANIAN INTRANSIGENCE?

More than any other factor, Iran's defiance in the current stand-off with the West over its nuclear program has been made possible by energy.

Over the past several years, the Islamic Republic has emerged as a *bona fide* energy superpower. Home to approximately 10 percent of world oil, Iran is the second largest exporter in the Organization of Petroleum Exporting Countries (OPEC), producing an average of 3.9 million barrels of oil per day. At the same time, Iran sits atop the world's second-largest reserves of natural gas (some 940 trillion cubic feet). As a result, Iran's economy is overwhelmingly energy-based. Today, the vast majority (80 to 90 percent) of Iran's export earnings, as well as about one half of its budget and a quarter of its gross domestic product, is derived from energy exports to the international community.[1]

In the past, this energy-dominated economy has led to wild fluctuations in Iran's financial fortunes. During the late 1990s, plummeting world oil prices left the Iranian regime nearly bankrupt.[2] Today, however, quite the opposite is true; the rising price of world oil generated by political instability associated with the War on Terror has provided Iran with a staggering fiscal windfall. As of March 2006 (the end of Iranian calendar year 1384), officials in Tehran were publicly estimating their country's hard currency reserves at some $50 billion.[3] These added resources and financial cushion can be expected to dramatically increase the Iranian regime's willingness to engage in risky regional behavior, as well as to accelerate the pace and scope of its strategic programs, in the months and years to come.

Iranian officials have attempted to solidify this economic status through a major expansion of their country's international energy profile. Over the past two years, Iran has signed two massive exploration and development accords, worth an estimated $100 billion over the next twenty-five years, with China alone.[4] A growing number of other nations, including France, Malaysia, Japan, Canada, and Italy, are now engaged in the development of existing oil fields within the country, and this involvement is expected to increase as recent discoveries—including the Azadegan field and Bangestan reservoirs in southern Iran, as well as the offshore Dasht-e-Abadan site near the southwestern port city of Abadan—begin to come online.

Iran has also commenced efforts to become a major global exporter of natural gas. Since 2002, it has supplied Turkey with substantial natural gas deliveries via a bilateral pipeline link and, according to official Turkish government statistics, could provide roughly 20 percent of total Turkish natural gas consumption by the end of the decade.[5] A similar arrangement is emerging between Iran and Armenia as part of a pipeline, currently under construction, that could supply Armenia with up to 47 billion cubic meters over a period of 20 to 25 years, beginning in 2007.[6] Iran has opened similar discussions with Georgia, and has even taken steps to coordinate natural gas policy with Moscow as part of a Russia-led natural gas cartel now emerging in the post-Soviet space.[7]

At the same time, the Iranian regime has dramatically increased its ability to leverage its strategic location in the Strait of Hormuz, the principal passageway for roughly two-fifths of world oil trade. According to U.S. intelligence estimates, a sustained national military rearmament over the past several years has provided Iran with the ability to temporarily shut off the flow of oil from the Persian Gulf, even with a Western military presence in the region.[8]

It is a testament to this energy clout that, as the international crisis over Iran's runaway nuclear ambitions has deepened, Iranian officials have repeatedly raised the specter of a disruption of energy trade in the Persian Gulf. Regime officials such as

Mohammed-Nabi Rudaki, deputy chairman of the Iranian parliament's national security committee, have warned that the Islamic Republic has the power to "to halt oil supply to the last drop from the shores of the Persian Gulf via the Straits of Hormuz" should serious measures be undertaken against the Islamic Republic at the United Nations.[9] Similarly, Iranian president Mahmoud Ahmadinejad has warned the United States and Europe that the global price of crude has not yet reached its "real value."[10] Even Iran's Supreme Leader, the Ayatollah Ali Khamenei, has threatened the West with disruptions in fuel shipments from the Persian Gulf in the event of a "wrong move" against Iran.[11] And regime officials have concretely demonstrated their capacity to do so, holding a week-long series of aerial, naval and ground maneuvers in the Persian Gulf in April 2006 to showcase the force-projection capabilities of their elite clerical army, the *Pasdaran*.

ASSESSING IRANIAN VULNERABILITIES

Given such posturing, it is not surprising that some analysts have concluded that energy is Iran's "trump card" in its dealings with the West.[12] This economic leverage, however, is a two-way street—and on at least three fronts, Islamic Republic is susceptible to economic pressure from the international community.

Commodity shortages

Despite massive oil exports of some 2.5 million barrels a day, Iran currently imports more than a third of its annual consumption of over 64.5 million liters of gasoline from a variety of foreign sources (among them India, France, Turkey and China) at an estimated cost of more than $3 billion annually.[13] These imports are not surplus; Iran reportedly maintains just 45 days worth of gasoline domestically, and requires steady supplies of refined petroleum products from abroad for the continued functioning of its economy.[14] Mounting international pressure, moreover, is already raising the costs of these deliveries. One leading Iranian policymaker has predicted that the regime will need to spend an extra $5 billion this year alone to maintain its established policy of deep subsidies on the sales of gasoline and avoid domestic rationing.[15] This suggests that the imposition of an embargo on foreign gasoline supplies to Iran could achieve rapid results—ranging from the depletion of hard currency reserves to a work stoppage in many of Iran's industrial sectors.

Centralized economic hierarchy

Today, the vast majority of regime wealth is concentrated in the hands of a very small number of people, whose associates and relatives dominate the Iranian economy. The extended family of former Iranian president (and current Expediency Council chairman) Ali Akbar Hashemi Rafsanjani, for example, now virtually controls copper mining in Iran, the regime's lucrative pistachio trade, and a number of profitable industrial and export-import businesses.[16] A related economic power center is Iran's *bonyads*, the sprawling, largely-unregulated religious/social foundations overseen by Iran's Supreme Leader, which account for between 10 and 20 percent of Iranian national GDP.[17] Given this economic hierarchy, targeted financial measures that restrict the ability of these individuals and organizations to access international markets—and curtail their capacity to engage in commerce—are likely to have an immediate and pronounced effect on regime decision-making.

<u>Foreign direct investment</u>

The dozens of billions of surplus dollars collected by the Iranian government over the past two years as a result of the rising price of world oil have done little to diminish Iran's need for foreign direct investment. According to authoritative estimates, Iran's energy sector still requires some $1 billion annually to maintain current production levels, and $1.5 billion a year to increase capacity.[18] Without such sustained capital, studies say, Iran could revert from an energy powerhouse to a net energy importer in the span of very few years.[19] Given the scope of current investment in Iran, it is unrealistic for the U.S. and its allies to expect to be able to achieve a comprehensive economic isolation. However, if broad and forceful enough, multilateral sanctions may complicate Iran's access to foreign funding, and/or force a depletion of the hard currency reserves that the regime has amassed over the past several years.

THINKING BEYOND THE UNITED NATIONS

Today, the United States has the ability to capitalize upon these vulnerabilities. International economic sanctions can help to slow Iran's nuclear progress and signal the international community's opposition to an Iranian bomb. If coupled with effective public diplomacy, such measures can also drive a wedge between the Iranian government and its people over the prudence of nuclear acquisition. Moreover, history has shown that the effectiveness of sanctions can be enhanced by the speed and scope with which they are applied.[20]

It is becoming exceedingly clear, however, that the United Nations is not the optimal vehicle by which to apply such pressure. Already, protracted diplomatic wrangling has provided Iran with valuable time to reduce its economic vulnerabilities. In recent months, Iran has carried out large-scale transfers of assets from Europe to financial institutions in China and Southeast Asia,[21] as well as initiating a major privatization of governmental funds.[22] Most recently, Iran's parliament has approved a new fiscal budget that calls for a halt to imports of refined petroleum products and the institution of gasoline rationing starting this Fall.[23] The goal of these efforts is clear: to limit Western economic leverage over Iranian behavior.

Timing should also be a major consideration. In late May, Secretary of State Condoleezza Rice signaled a sea change in American policy toward Iran when she announced that the United States would join Europe in proffering a "package" of incentives aimed at bringing the Islamic Republic back to the nuclear negotiating table. Iran, in turn, has maintained that it is studying the offer and will provide a formal reply in late August.[24] It is unclear whether the international community will wait until then to seek Security Council action against Iran, but it is reasonable to expect that forceful international action still remains some weeks or months away—allowing Iran to continue minimizing economic vulnerabilities and forging ahead with its nuclear effort. All of this means that, if and when economic sanctions are again on the table, their stated task—to alter the regime's behavior with relation to its nuclear program—will be even more difficult to achieve than it is today.

Moreover, if and when United Nations sanctions do materialize, they are likely to be deeply influenced by politics. Russia and China both wield veto power over Security Council action against Iran, and while Moscow and Beijing appear to have endorsed more robust measures against Iran should the current negotiations fail, any steps taken will need to be carefully calibrated so as to preserve the support of those states. As a practical matter, this means that the economic pressure applied against Iran will be both gradual and limited in scope.

Given these difficulties, Washington would be far better served by the establishment of an economic coalition outside of the confines of the United Nations. Through such a construct, the United States would have far greater ability to control the timing, extent and application of economic pressure on Iran, without Security Council-imposed constraints. It would also provide the U.S. and its coalition partners with greater political flexibility to apply those specific measures most likely to alter Iranian behavior.

THE LIMITS OF IRANIAN OIL POWER

Today, Iran holds the ability to exert a high price from the world if it is stymied in its nuclear efforts. But political and economic realities suggest that Iran's oil power is far more limited than commonly understood.

Iran could indeed curb oil exports, as regime officials have repeatedly threatened. However, if the Islamic Republic withdraws oil from world markets, it faces the prospect of losing much-needed long-term energy clients, such as China and India, which can be expected to quickly seek replacement suppliers. Moreover, the resulting perceptions that Iran is an "unreliable" energy partner are likely to reduce foreign direct investment flowing into the country—thereby placing Iran's current status as a global energy player in jeopardy.[25]

By the same token, a cut-off of oil exports is likely to reverse Iran's recent political gains abroad. Simply put, should Iran's energy brinksmanship hurt the economies of its political allies, those countries are far less likely to unconditionally support Iran on the perceived source of the economic turbulence: Iran's nuclear program. This change will be true in spades for major investors into Iran's energy sector (such as Japan, China and France).

Most of all, Iranian officials—despite official bluster—understand that actual use of the "oil weapon" is likely to carry dire consequences for their regime. The international community's current diplomatic overtures toward Tehran have been generated in no small part by problems attaining consensus on more robust measures. Substantial Iranian interference with the global energy market could change all that, galvanizing a consensus for aggressive containment—or even regime change—on the part of numerous energy-hungry nations.

Is there a guarantee that sanctions will succeed in altering Iranian behavior and curbing its nuclear efforts? The answer is no. On the contrary, American policymakers should refrain from seeing economic sanctions as an isolated measure; historically, a strong correlation exists between the imposition of sanctions and the subsequent escalation to the use of force (e.g., Panama in 1989, Iraq in 1991, and the Balkans during the mid-1990s). However, what is clear is that a failure by the international community to promptly utilize its existing economic leverage vis-à-vis Iran will make other, less attractive solutions—chief among them the use of force—much more likely.

Ultimately, the United States must make a choice. Is it, and the world, willing to pay the political and economic price associated with a serious strategy to confront Iran? The alternative is to internalize a permanent hike in the cost of doing business with a region dominated by an atomic Islamic Republic.

NOTES:

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