



# BULLETIN

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## Internal and International Implications of Iran's Economic Crisis

by Piotr Krawczyk

*The oil price slump—exacerbated as it is by the current global economic crisis, the sanctions, and the government's misguided economic policy—could threaten the stability of Iran's political system and undermine its international position. As the country's economic situation deteriorates, new opportunities arise for the international community to influence Iran's stance on its nuclear program. If the Barack Obama administration's diplomatic overtures towards Iran fail, the U.S. will in all probability focus on making the regime of economic and financial sanctions leak-proof and on tightening cooperation to that end with European countries.*

The Iranian economy has been going steadily into a crisis. Three factors have been at work here: the drop in oil prices fuelled by the global economic-financial turmoil; the sanctions imposed by the U.S., the EU states and international organizations (including the U.N.); and the ineffectual and incohesive economic policy of the administration of President Mahmoud Ahmadinejad. In the past year Iran's inflation doubled, to reach 26%. In 2007 Iran had already featured one of highest inflation rates among the Central Asian and Middle Eastern countries and one of highest unemployment ratios.

**Impact of International Economic Situation.** Iran's links with the global economy are limited. Even so, as they are determined by oil exports as the key prop of the country's economy, the effective impact of the global economic situation on Iran is meaningful. Oil sales being the source of close to 70% of the country's budget revenue, fluctuations of prices of this resource on global exchanges have a strong bearing on the functioning of the Iranian economy. With oil price down from US\$150 to about US\$60 per barrel since July 2008, the state budget's capacity for subsidizing the economy (80% of job-holding Iranians are employed in administration and in state-run entities) has been considerably reduced.

As a result of plummeting oil prices Iran could run up a budget deficit of as much as tens of billion U.S. dollars this year, which would necessitate reaching out for external deficit-financing sources (bonds, loans). So far, Iran's problems in this area have resulted chiefly from the sanctions, but at this crisis time the limited availability of funds on international financial markets and the resulting increased cost of borrowing are also of consequence. Moreover, Iran needs funds to modernize and develop its industry, in particular the ageing energy sector (one-third of refined petroleum products consumed in Iran, including gasoline, are imported at the cost of some US\$10bn a year).

**Impact of Sanctions.** The sanctions are commonly believed to have been unproductive so far, yet with their character modified and their enforcement regime made more leak-proof since 2006 they have been affecting the Iranian economy to a meaningfully higher extent. The U.S.- and EU-imposed sanctions have been increasingly targeted at the energy sector and at related fund transfers and the isolation of Iranian banks and financial institutions has increased the costs of foreign trade and borrowing by some 15%.

The tightening of regulations which restrict commercial dealings with Iran has influenced corporate business decisions worldwide in a major way. With persistently high investment risks arising from the political tension over the Iranian nuclear program and with difficult fund transfers, European energy companies have refrained since 2006 from entering into agreements on the exploitation of Iranian

energy deposits. Admittedly, Chinese companies did sign agreements with Iran (e.g. the 2007 SINOPEC contract for the development of the Yadavaran oil field), as did Malaysian companies (SKS signed in 2007 a US\$16bn contract for the exploitation of gas deposits), yet none of these agreements has yet been fulfilled and no work has yet commenced to bring the deposits concerned on stream. While the Iranian authorities have succeeded in capitalizing on the documents signed to make the sanctions appear futile, yet oil production—which for several years now has been static at about 4.2m barrels a day, while domestic consumption has been rising—could confront Iran with the challenge of maintaining high exports and meeting the domestic demand at the same time.

**Government Policy.** The populist policy of President Ahmadinejad who was elected in 2005 has contributed importantly to the deterioration of Iran's situation. In his four years in office oil export revenues have totaled about US\$270bn. However, despite these huge revenues, with the incumbent administration's rampant spending on subsidizing basic goods and services (electricity, water, gasoline, food) Iran has failed to accumulate savings and, on top of this, inflation has doubled in the wake of a large inflow of money to the domestic market. Neither have the present authorities continued the much-needed reforms which former administrations of presidents Rafsanjani and Khatami launched in spite of their more limited resources.

In the fiscal year 2008/2009 Iran's budget revenues totaled about US\$95bn, of which over US\$60bn comes from oil sales. Despite the significant decline of global prices of this resource (a drop likely to slash budget revenues by one-third this year) the Iranian government has not decided to cut state expenditures. This reluctance has much to do with the June election: unless subsidies remain in effect, the incumbent president will not retain public support, in particular of voters from the poorest strata of society who in 2005 swung the election in his favor. Unless the oil price goes up to at least US\$90 by the end of this year, the Iranian budget will be incapable of funding some 30% of planned spending. The lack of money for these purposes in the second half of the year could bring about a sudden deterioration of the social situation in the country.

**Relations with USA.** From the outset of its term, the new U.S. administration has signaled its desire to establish a diplomatic dialogue with Iran. So far, these efforts have been unsuccessful. Secretary of State Hillary Clinton's 22 April statement before the U.S. House Committee on Foreign Affairs implies that failing modification by Iran of its nuclear program-related activity, in particular regarding uranium enrichment, U.S. offers of diplomatic talks will be replaced by new proposals for economic sanctions. In view of Iran's mounting economic problems, the imposition of sterner sanctions could succeed in modifying Iran's stance not only on the nuclear program, but also on its regional activities, which include contacts with terrorist organizations.

**Conclusions.** As the economic downturn deepens, the society's resentment of and discontent with the present government and the political elites is mounting. Not only does the bad economic situation make Ahmadinejad's re-election chances questionable, but its continued deterioration could trigger social and political processes uncontrollable by the authorities. Economic protests could destabilize the country and confront the present government with a grave challenge. The collapse of oil prices could render the government incapable of propping up the economy, maintaining public support, and carrying out long-planned economic and social reforms.

Also, the international isolation of Iran has been increasingly apparent. So far, with its high oil sales revenues, Iran has been able to strengthen its position in the region—much to the unease of the Arab states and others. Yet the lack of funds will severely restrict Iran's international impact potential and its influence in the neighboring countries.

The incumbent Iranian administration is unlikely to relax its stance on the nuclear program before the 12 June presidential election. Neither will the victory (should it happen) of a moderate candidate open to relations with the Western states ensure an immediate policy shift. One of the problems is that Iranian institutions (including the Ministry of Foreign Affairs) are staffed with people who identify themselves with the extreme version of the political-religious ideology of the Islamic Republic. Their replacement with the pragmatic diplomats dismissed from the Ministry in the recent four years is unlikely any time soon. Accordingly, the U.S. might not receive, in the months immediately ahead, the expected signal of the Iranian administration's will to establish diplomatic dialogue. For this reason it seems likely that in the second half of this year President Obama will focus on economic sanctions against Iran.