IRAN'S ECONOMY AND THE US SANCTIONS

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Since the early 1980s, Iran's Islamic Republic has been under various US economic sanctions as a punishment for alleged international transgressions. During this period, the theocratic regime has moved forward on many economic fronts, but has been effectively held back in its efforts to reach the pre-revolution level of national prosperity. US sanctions have had a part in the setback, but not a decisive role. While the regime may survive the enhanced sanctions, the economy is not likely to prosper without American and Western support.

Since January 1984, Iran's economy has been under various US economic sanctions of increasing scope and intensity. Starting with a ban on the sale of American arms and dual-use technology, the sanctions gradually expanded to the present level with a total embargo on all bilateral trade and investment, and were even extended to secondary boycotts, penalizing foreign companies investing in Iran's oil and gas sector.

The economy's performance during the 13-year period has included some successes and many setbacks. Opposition groups have aggrandized the failures and blamed them on the regime's ineptitude, mismanagement, malfeasance, and corruption.[1] Government officials, in turn, have accentuated their positive achievements, and attributed their shortfalls to matters beyond their control. Topping the list of the reasons for the regime's problems has been the "imposed" war with Iraq (1980–88), which was allegedly

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1. For a sample of these charges, see "The Persistence of Economic Paralysis," *Focus on Iran* 3, no. 7 (July 1996), p. 1.

instigated by Washington. During that war, Baghdad is said to have been helped by American arms, intelligence information, and financial credit, while Iran was denied spare parts for its largely American-equipped armed forces. *Global arrogance*—a code phrase for the Washington-Tel Aviv axis against Iran—was repeatedly singled out as the root cause of Iran's economic difficulties.[2]

The purpose of this article is to review Iran's economic record and to examine the impact of US sanctions on the Iranian economy. There is no intention here to delve into several related but tangential issues[3] such as the true global significance of the Iranian challenge and the appropriateness of the US response; the legality of US unilateral sanctions under the World Trade Organization's charter; the application of US jurisdiction to foreign companies outside America under international law; or the extent of Washington's rift with its allies and partners on the effectiveness of *containment* vs. *dialogue*.[4] The focus here is on the sanctions' target and impact.

WHY SANCTIONS?

US coercive measures against the Islamic Republic have been advocated as a punishment for Tehran's alleged misbehavior. Washington has accused the Islamic Republic of attempting to export the Islamic revolution to other Muslim countries and promoting Islamic radicalism in such secular nations in the Middle East and North Africa as Algeria, Bahrain, Egypt, Jordan, Kuwait, Tunisia, Turkey, and others, through direct and indirect assistance to local militant Islamic elements. HAMAS (Islamic Resistance Movement) and the Islamic Jihad (Struggle) in the Palestinian Territories, Hizballah (Party of God) in Lebanon, the Shi'ites Freedom Movement in Bahrain, Al-Jama'a al-Islamiyya (Islamic Group) in Egypt, the Islamic Salvation Front (FIS) in Algeria, Hizb al-Mujahidin (The Party of Islamic Fighters) in Kashmir, Hizb al-Da'wa (The Call) in Iraq, and other assorted groups from West China and Central Asia to Morocco, Tunisia, Turkey and Saudi Arabia have been mentioned in the press as alleged beneficiaries. Tehran has also been accused of sponsoring or supporting international terrorism and subversion against its enemies and opponents.[5] There have been blunt charges or dark hints in Washington's official circles regarding the Islamic regime's involvement in terrorist acts in Bangkok, Buenos Aires, Dhahran, Jerusalem, London, Paris, Tel-Aviv and

2. For the latest annual ritual of these arguments, see the "Statements of President Rafsanjani before the Majlis," *Kayhan Havai* (Tehran), 4 December 1996, p. 18.

3. For a discussion of these issues, see Hooshang Amirahmadi and Eric Hoogland, eds., *U.S.-Iran Relations: Areas of Tension and Mutual Interest* (Washington, DC: The Middle East Institute, 1994); and *Revisiting Iran's Strategic Significance in the Emerging Regional Order* (New Brunswick: US-Iran Conference, Inc., 1995). Papers presented at the conference "Economic Sanctions" sponsored by the Middle East Institute (MEI) and the Petroleum Industry Research Foundation (PIRF) in April 1996, held at the National Press Club, Washington, DC, and another called "Iran in Transition" organized by Petro-Hunt Corporation in May 1996 in Dallas, Texas have also dealt with various aspects of the subject.

4. See "Europeans Skeptical of Isolating Iran," *The Washington Post*, 15 March 1996; and "Allies Angered by U.S. Boycott Policy," *The Washington Post*, 10 May 1996.

5. See, for example, US Department of State, *Patterns of Global Terrorism, 1993* (Washington, DC: 1994).

elsewhere.[6] Tehran's refusal to condemn HAMAS suicide bombers as "terrorists" has been cited as evidence of Iran's support for terrorism.

The Islamic government is presumed to be seeking a hegemonic position in the region by importing sophisticated arms, such as Scud and Rodong ballistic missiles from North Korea, Silkworm cruise missiles from China, or Kilo-class submarines from Russia. The continued claim by Iran of exclusive sovereignty over the Abu Musa island in the Persian Gulf is seen as proof of Iran's aggressive intent in the region. Iranian clerics are said to be seeking the production of non-conventional weapons of mass destruction, including nuclear, chemical and biological weapons. The agreement with Moscow to rebuild and finish the nuclear plant at Bushehr (abandoned by the Siemens company of Germany after the 1979 revolution) is seen as a prelude to converting Iran's enhanced nuclear technology capability to military usage.[7]

Opposition to the Middle East peace process has been another bone of contention between Iran and the United States. Tehran is blamed for having organized a rejectionist conference of Arab groups, in October 1991 (coinciding with the Madrid peace overture), presumably to scuttle the Arab-Israeli negotiations. Denunciation, by Iranian officials, of the 1993 Israel-PLO peace accord as a "shame" and "treachery" was seen as further proof of Tehran's attempt to sabotage the on-going peace negotiations.[8] Finally, the regime has been charged with human-rights abuses at home, eliminating Iranian dissidents abroad,[9] and challenging the basic principles of national sovereignty (as well as free speech) by placing a bounty on the head of Salman Rushdie, a British subject and the author of *The Satanic Verses*.[10]

Depicting Iran as a menace to the international order and claiming that the Islamic government had refused to abandon its unacceptable behavior, Washington placed Iran on the list of states supporting international terrorism, as of January 1984, and made the Iranian economy subject to various US sanctions under a number of general and specific US laws.[11]

The real objectives of Washington's sanctions policy, and the motives behind the enhanced sanctions strategy, have been the subject of considerable speculation. Iranian officials have matter-of-factly attributed these motives to Washington's hostility towards

6. See Thomas R. Mattair, "Interview with UN Ambassador Kamal Kharrazi of Iran," *Middle East Policy* 3, no. 3, December 1994.

7. For a brief reference to some of these charges, see Elaine Sciolino, "Christopher Signals a Tougher US Line Toward Iran," *The New York Times*, 31 March 1993.

8. See "Tehran Hosts a Predators' Ball," *US News and World Report* 111, no. 19, 4 November 1991. See also "Khomeini's Son Denounces Mideast Accord, Calling it Treachery," *The New York Times*, 13 September 1993; and "Iranian Leader Denounces Peace Pact," *The New York Times*, 16 September 1993.

9. For the latest of these accusations, see US Department of State, *Iran Report on Human Rights Practices for 1996* (Washington, DC: January 1997).

10. For a brief discussion of some of these issues, see David Newsom, "U.S. Iran Relations: A Washington Perspective," in Amirahmadi and Hoogland, eds., *U.S. Iran Relations: Areas of Tension and Mutual Interest*. See also Shawn L. Twing, "Is Iran's Military Build-Up Purely Defensive or Potentially Destabilizing?" *The Washington Report on Middle East Affairs* 14, no. 8 (April 1996), p. 80.

11. For the list and content of these sanctions, see *Comprehensive U.S. Sanctions Against Iran* (Washington, DC: American Israeli Political Action Committee [AIPAC], 1995); "Sanctions," *The Middle East Economic Digest (MEED)* 40, 9 August 1996 and 30 August 1996; and Lewis M. Johnson, "Iran Sanctions Program under U.S. Regulations," *Middle East Executive Reports* 19, no. 5 (May 1996).

the Islamic Republic of Iran, its desire to establish a hegemonic position in the Gulf region, and the pressure to satisfy the domestic Jewish lobby.[12] Some American analysts contend that US sanctions have been motivated more by US domestic politics than by a genuine resolve to influence Iran's policies.[13]

Whatever the real motives may be, the declared goal of the "dual containment" and trade embargo policies has been the protection of the US national interest, defined as the development of a stable, peaceful, and productive environment in the Gulf region. Iran's political behavior has been portrayed as a threat to American interests and to those of the international community. To address this threat, Washington is working closely with other countries to prevent Iran from acquiring military equipment or dual-use goods and technology, by means of international agreements and sanctions; imposing economic costs and pressures on Iran; and providing the Islamic government with a compelling incentive to abandon its unacceptable policies.[14] The ultimate aim has been to present the Islamic government with a tradeoff between its economic needs and its political deeds. In other words, Iran's access to foreign credit, technology, and markets has been made contingent on its clear and unequivocal denunciation of international terrorism, observance of universally accepted human rights principles at home and abroad, abandonment of nuclear arms pursuits, and neutrality in the Middle East peace process.[15]

THE ECONOMY'S PERFORMANCE

For the last 13 years, the Iranian economy has operated under US economic and political pressures of one kind or another. Between the imposition of sanctions in 1984 and the Iran-Iraq cease-fire in 1988, the country endured war-time conditions that overshadowed the effects of US measures. The period also coincided with the collapse of the price of oil on the world market and a drastic reduction in annual oil revenues which were independent of the US embargo. The average rate of decline in real GDP between 1984/85 and 1988/89 was about two percent a year, but this decline was mainly due to the 42 percent fall in the annual value of oil exports during that period rather than any other factor, including the limited sanctions.

The period since the end of the eight-year war with Iraq covers Iran's First Five-Year Development Plan (1989–93) and half of its Second Plan (1995–99). The period also

12. See "Interview with Kamal Kharrazi, Iranian Ambassador to the United Nations," *Middle East Insight* 8, no. 3 (January-February 1992). See also the statement by Ali Akbar Velayati, Minister of Foreign Affairs of Iran, before the 50th Session of the UN General Assembly, 25 September 1995.

13. See Gary Sick, "A Sensible Policy Toward Iran," *Middle East Insight* 11, no. 5 (July-August 1995); and Marvin Zonis, "U.S. Economic Coercion of Iran," a paper presented at the Petro-Hunt conference. Zonis also said several other motives, not specifically related to Iran, were behind the sanctions (e.g., to demonstrate America's global moral leadership, enhance domestic partisan politics, raise the voters' esteem for the President, or win the support of special-interest lobbies). For the role of special lobbies see "Progress of Iran-Sanctions Measures in Congress Signals Comeback for Pro-Israel Lobbying Group," *The Wall Street Journal*, 18 June 1996, p. A24.

14. See Robert S. Deutsch, "U.S. Sanctions Policy Towards Iran," a paper presented at the Petro-Hunt conference.

15. See statements by Ellen Laipson in "Symposium: U.S. Policy Toward Iran," *Middle East Policy* 4, nos. 1 & 2, September 1995, pp. 1–5.

coincides with the intensification of US sanctions, culminating in the comprehensive secondary boycott legislation of 1996. In a preliminary mid-term appraisal of the First Plan in 1992, its ultimate success was seen as depending, in part, on the fate of the country's on-going structural adjustment program (SAP)—the so-called 'Rafsanjani's perestroika'.[16] The SAP included an orderly exchange-rate unification, increased fiscal and monetary disciplines, trade and business deregulation, streamlining of the state bureaucracy, privatization of money-losing public enterprises, attraction of foreign private investments, and the establishment of budgetary control over the semi-independent, parastatal *bonyads* (foundations). Without these sorely needed economic reforms, and without the resolution of certain external disputes with the United States and Europe, further inflation, slower growth, and larger unemployment were to be expected.

The doubts raised in the mid-term review regarding the fate of these reforms were later justified. The *Majlis* (Assembly), which was widely (and optimistically) expected to support the president's pragmatic economic policies, turned out to be resistant to his plans. Rafsanjani's own highly-praised economic team also badly miscalculated both its own professional prowess and the response of ordinary people. The exchange-rate unification and foreign currency management were badly botched. Bank credits to debt-ridden public enterprises were imprudently increased. Widening the tax base never came to pass. Price decontrol was partly reversed. Interest-rate rationalization proved impossible to achieve. Meaningful subsidy cuts on consumer goods were effectively resisted by the Majlis as were the privatization efforts. Extremely low prices on public goods and services were increased later, but still remained low and, in many cases, still below cost. Bonyads continued their free-wheeling exercises and pursued their unfettered control over some crucial aspects of the private economy. Imports were allowed to double within two years, paid for by short-term suppliers' credit, and favoring consumer goods. Public investments were stepped up in projects of questionable value. External debt, which had been skillfully kept low during the eight-year war, suddenly skyrocketed.[17]

None of these setbacks, however, could be attributed to the US limited sanctions at the time, although friendly relations with Washington, and larger Western economic assistance, could have significantly helped the country's trade and exchange positions. By the end of its term, the First Five-Year Development Plan was successful in achieving some of its quantitative objectives, but not all. Output growth at an average real annual rate of 7.2 percent was not far from the 8.1 percent goal, and quite respectable for a country at Iran's income level. But, the annual real growth rate fell each year from 11.5 percent in 1990/91 to 4.8 percent in 1993/94. Sectoral performance was also rather erratic. Yearly increases in output in such areas as water, power, and services were slightly higher than the target rates. Results in the agriculture and petroleum sectors, on the other hand, fell short of the targets, but again not by much. Manufacturing and construction, however,

16. Jahangir Amuzegar, "The Iranian Economy Before and After the Revolution," *The Middle East Journal* 46, no. 3 (Summer 1992). Please note that 1990/91 refers to only one (Iranian) year, but 1990–91 signifies two calendar years.

17. For details and primary references, see "Supplement" in Jahangir Amuzegar, *Iran's Economy Under the Islamic Republic*, paperback edition (London: I.B. Tauris, 1997).

showed annual growth rates of only about half and one-third, respectively, of planned goals. Total oil export revenues, during the 1989–93 period, were only 90 percent of the projected level, and non-oil exports, only 65 percent. Industrial exports were less than one-third of their targets.[18]

In other projections, also, the First Five-Year Plan showed significant shortfalls. Annual investment grew half as fast as planned. Budget balance was ultimately achieved for one year, but only by selling petrodollar earnings at the free-market rates and replacing subsidies to public enterprises with bank loans. Total liquidity and inflation numbers rose at twice the planned rates. The jobless rate was reduced by increasing underemployment in the inefficient informal economy. Foreign exchange deficits were made up by obtaining short-term suppliers' credit. In short, the 1989–93 plan, which started with a detailed list of quantitative objectives, ended up with a different set of figures that bore little resemblance to the initial targets. Here, again, deviations from original objectives had nothing to do with the US sanctions and were the legacy of Iran's long-standing planning problems inherited from the past.

Despite the costly futility of such non-coordinated and non-enforceable planning, the vast (and vested) planning establishment within the Iranian government embarked on the preparation of the Second Five-Year Development Plan (1995–99) in roughly the same manner. But due to some confusion stemming from the reversal of several reform measures, and under the pretext of evaluating the performance of the First Five-Year Plan, the Majlis postponed the finalization of the Second Five-Year Plan for a year until March 1995.

The new plan for 1995–99 was a continuation of the previous one except that it had more realistic aspirations. The targeted annual growth rate was brought down to 5.1 percent a year, with corresponding downward revisions in sectoral goals. In regard to public policies, the new plan again dutifully reiterated the promises of the earlier plan for a unified floating exchange rate, trade liberalization, tax reforms, greater transparency in subsidies and transfers, rationalizing interest rate structure, reductions in cost/price distortions, and the reform of the bureaucracy.[19] In reality, however, the second plan carried the imprint of a more conservative, more cautious, and largely inward-oriented scheme that was more social welfare-directed than that of the first plan. The SAP under the new plan became more of a slogan than a serious strategy. Should the Rafsanjani government be replaced in the May 1997 presidential elections by a more *bazaar*-oriented administration, or by a pre-1989 statist-interventionist type of government, there is little chance those reforms will be implemented.

The performance record of the 1995–99 plan in the first two years of operation was not up to par. The GDP growth rate for 1995 and 1996 averaged about three percent a year against the 5.1 percent target. Both oil and non-oil sectors also fell considerably short of their targets. Inflation, targeted at an annual rate of 12.4 percent, averaged 42.6 percent.

18. For the source of all figures in this section, see *Gozaresh-e Eqtesadi Sal-e 1373* (Annual Economic Report for 1994–95) (Tehran: Plan and Budget Organization, 1996).

19. For details, see *Qanun-e Barnameh-e Dovvom* (The Second Plan Law) (Tehran: Plan and Budget Organization, 1374H [1995–96]).

Total liquidity expanded 33 percent a year against a 12.5 percent goal. Imports, oil and non-oil exports, and the budget all deviated from their targets.[20]

While sanctions' advocates among Iran's hawkish critics in the United States, and the inveterate monarchists in the Iranian exile community, may wish to relate these economic setbacks to the US-enhanced sanctions since June 1995, the evidence is not convincing. The relatively slow growth of the economy and the relatively high rate of inflation, in 1995–96, are more easily traceable to the very tight import compression dictated by the debt-service obligations, and the settlement of the 1992–93 payment arrears. The latter, too, were the clear by-products of earlier monetary imprudence, mishandling of foreign exchange reserves, the speculative surge of imports ahead of officially announced government intention to devalue the rial, and the inexcusable lack of central bank supervision.

The surprisingly improved turnout of most macroeconomic indicators in 1996/97—when US sanctions actually became most comprehensive and stringent—does not support the claim that the sanctions had a negative impact on the Iranian economy. The third year of the plan has shown notable improvement, with GDP growth expected to reach five percent; inflation reduced to less than 30 percent; trade balance in comfortable surplus; foreign exchange reserves rising; the budget deficit falling; import shortages eased; application and authorization of foreign private investment escalating; and the external debt serviced as scheduled.[21] The significant (and unexpected) strength of the global oil market, of course, has had a large part in the upturn, as has the appreciation of the US dollar.

THE SANCTIONS' EFFECTIVENESS

The efficacy of economic sanctions can be gauged by two simple yardsticks: Do they decisively hurt the intended target? And, if so, are they likely to achieve their stated objectives? The answers to these questions in the US-Iran case are not conclusive. In some views, the costs to Iran of US economic coercion has been "immense," and the sanctions have worked "better than expected."[22] To others, the unilateral boycott has been short-sighted and counterproductive to US commercial interests; hurting US companies and US credibility; and making things worse for all.[23] The Iranian leadership, on the other hand, while admitting some temporary "difficulties," has denied any suggestions that the sanctions have had a significant or lasting effect.[24] An impartial evaluation is made difficult by the lack of data and insufficient transparency in information coming from Iran.

20. See *Economic Trends*, no. 5 (Tehran: Bank Markazi, 2nd Quarter, 1375H [1996]).

21. Reuter news agency, quoting IMF officials in Washington, DC, 17 December 1996. See also *MEED* 41, no. 1, 3 January 1997, p. 27.

22. Zonis, "U.S. Economic Coercion of Iran," and Patrick Clawson, "The Impact of U.S. Sanctions on Iran," a paper presented at the MEI "Economic Sanctions" conference, 29 April 1996. See also his "Western Policy Options Toward Iran," (New York: The American Jewish Committee, 1995).

23. See *Iran Business Monitor*, May 1995, pp. 3–4; see also Thomas R. Mattair, "Containment or Collision," *Middle East Insight* 11, no. 5 (July-August 1995).

24. Statements by President Rafsanjani, quoted in *Kayhan Havai* (Tehran), 6 December 1995, p. 1.

Extensive reports from the International Monetary Fund (IMF), the World Bank, the United Nations Development Program (UNDP), and the European press speak of an active, if not actually vibrant, Iranian economy, and describe some noteworthy improvements in social conditions in Iran.[25] These reports, and others emanating from Iranian official sources, indicate that, despite the prevailing sanctions, the economy has been only marginally affected. There is evidence, corroborated by foreign visitors, that war damage to the country's infrastructure, oil facilities, farmland, manufacturing plants, and electric power stations is being repaired. New air and sea ports are being built and put to use. Roads, railways and inter-city highways are being constructed or extended with a view to linking the new Central Asian and Transcaucasian republics to the Persian Gulf. Oil and gas installations and sustainable production capacity are being expanded. Telecommunication lines (including state-of-the-art faxes, e-mail, and mobile telephones) are becoming commonplace in urban centers. Multi-purpose dams and modern irrigation networks are being built, and land reclamation projects are being undertaken. Rural reconstruction is advancing with the help of improved infrastructural services including better roads, and water, gas, electricity, and telephone connections. Metallurgical industries are now exporting steel, aluminium and copper. Petrochemicals promise to replace pistachios as the second largest "non-oil" export after carpets.[26] Self-reliance has been achieved in many areas of weapons production. The Iranian press—fed and briefed by the public relations departments of government agencies—is replete with reports about locally built military training airplanes, helicopters, marine hovercrafts, gliders, frigates, and others. Civilian manufactures range from consumer durables and modern household appliances to heavy machinery and basic industrial products. In education, computer-literate youngsters are reportedly winning prizes in global scientific competitions. In health, open-heart surgery and organ transplants are reportedly performed in modern hospitals. Iranian scientists and specialists are exporting their technical expertise to other developing countries.[27]

To be sure, a good deal of the official and press reports from Iran are embellished, overstated, and even essentially flawed. Many of the positive accomplishments appear to be concrete and solid, but their true cost and profitability are not always apparent. No official audits of public projects are published. Some of the publicized successes may simply consist of a few show-case projects that are crude in essence, and copied from foreign models with little domestic value added. Others may be over-emphasized in presentation, limited in their application, and not subject to close examination as to their

25. See The World Bank, *Islamic Republic of Iran: Economic Management and Prospects* (Washington, DC: The World Bank, November 1995); The International Monetary Fund (IMF), *Islamic Republic of Iran: Statistical Appendix* (Washington, DC: IMF, October 1996); and The UN Development Program (UNDP), *Human Development Report 1996* (New York: UNDP, 1996).

26. All of these developments are reported in the weekly issues of *Keyhan Havai* for the years 1994–97 on which this section is based. The weekly issues of *MEED* for the same years also dutifully report them for English speaking readers.

27. For samples of these claims in 1996 alone, see "Iran to Manufacture Passenger Planes in 1988," *Keyhan Havai*, 28 August 1996; "Iran Has Largest Shipping Fleet in the Region," *Keyhan Havai*, 9 October 1996; "Iran to Help Muslim Countries Improve their Technology," *Keyhan Havai*, 19 October 1996; and "Iranian-made Helicopter To Go into Operation Next Year," *Keyhan Havai*, 30 October 1996.

impact. But reconstruction and development projects are visible and underway everywhere. They are frequently detailed in the Friday *khutba* (sermons) by the prayer leaders.

Despite official denials, the economy's adjustment to the post-1995 enhanced US pressures has also not been cost-free. The immediate effect of US president Bill Clinton's Executive Order of 8 May 1995 banning trade and investment with Iran[28] was a sudden plunge in the value of the Iranian currency, and a subsequent formal devaluation of the rial. Since then, sales contracts with non-American oil customers, including the Chinese, French, Italian, Portugese, and Spanish have been signed, but only by offering some discounts. In mid-1995, the temporary storing of Iranian crude in large oil tankers in search of new buyers involved storage costs. Replacing imports from the United States (including crucial oil-drilling and other equipment) has had to be done at higher prices, or with less desirable substitutes, in third-party markets. And renovating the aging, American-based, oil infrastructure has been expensive. The ambitious post-1989 defense build-up has been cut back, and arms purchases from abroad have been curtailed. There has been an indirect cost to the ban on the sale of Boeing airplanes to Iran, although Iran Air needs have reportedly been met by European and Russian sources.

There has also been a considerable indirect negative impact. Bilateral rescheduling of Iranian short-term debts and arrears with individual creditors was concluded under less favorable terms than if Tehran had been treated like other debtors who receive the IMF's blessing and undergo multilateral negotiations with all creditors simultaneously under the Paris Club process. Although the French oil company, Total, SA, replaced CONOCO for the development of the Sirri offshore oil fields in the Persian Gulf (after CONOCO's deal was cancelled under the May 1995 embargo), the new agreement was more limited and less lucrative for Tehran. US pressures have had some impact in other areas as well. Azerbaijan's withdrawal of its offer of a five percent participation by the National Iranian Oil Company in an American-led international consortium for the development of Caspian Sea oil fields, was admittedly due to US pressure. The Dutch/Shell Group, anxious to get a foothold in the development of Iran's offshore South Pars gas field, has reportedly indicated it will not risk its vast US interests by signing an agreement with Tehran against US opposition.

The Japanese decision, in 1995, to freeze the second tranche of its promised loan to Iran (amounting to $450 million) for the construction of the Godar-e Landar dam on the Karun river was clearly taken to avoid antagonizing Washington. US objections to the construction of several oil and gas pipelines and oil swap projects from Kazakhstan and Turkmenistan to Europe via Iran have significantly reduced their scope, and deprived other countries of the most economical route for such energy deliveries. China, in September 1995, suspended an agreement in principle to provide Iran with two 300-MW nuclear reactors and, in November 1996, announced the cancellation of the sale of a uranium conversion facility to Iran in order to gain favors from Washington, although claiming to act for "reasons of its own." Tehran's deal with South Africa to store some 15 million barrels of Iranian crude oil at Saldanha Bay was, under US pressure, indefinitely

28. See "Iran Fighting US Sanctions," *MEED* 40, no. 4, 26 January 1996.

postponed pending an environmental impact study. Australia's BHP Corporation and Japan's JGC also reportedly reconsidered their participation in several Iranian natural gas projects after being threatened with retaliation by Washington. In short, the overwhelming majority of bilateral oil and gas deals involving capital investment or transfer of technology have been effectively blocked by Washington. A senior Iranian official is reported to have said: "Everywhere we try to go, we see the Americans there first, trying to convince people not to deal with us."[29]

Multilateral financial organizations, enjoined by the United States, have become reluctant to extend credit to Iran. The World Bank's extensive lending programs to Iran have been effectively suspended since 1993 due to Washington's objections,[30] despite Bank president James Wolfensohn's officially declared opposition to "political intervention in bank decisions."[31] Renewed access to generous export credit guarantees by European state agencies in France, Germany, Italy, and other countries has been reduced even though Iran's trade arrears have been rescheduled, and subsequently honored. Borrowing from international commercial banks for medium- or long-term durations has been cut back. US sanctions have also changed the international climate for Iranian business by adversely affecting the country's terms of trade, and raising the cost of foreign capital for development financing. In the oil business, which provides Iran's economic lifeblood and where American experience and expertise are unmatched, the Iranian regime has encountered its most formidable stumbling block towards capacity expansion.

Altogether, the first test of the sanctions' effectiveness, i.e., hurting the intended target, indicates some positive results. But, the second test, namely, achieving stated objectives, has so far been unsuccessful. There has been no notable change in the behavior of the Islamic Republic on any of the issues of major concern to Washington. And whatever flexibility has been evident in the regime's overall policies has been due to purely expedient reasons of self-interest and not to US containment pressures. Washington may have made its point, but it has not achieved its objectives.

PROSPECTS FOR THE US SANCTIONS

Views regarding the prospects of US sanctions achieving their ultimate objectives are conflicting and contradictory. Principal advocates of the US boycott, in and out of the US Congress and the White House, vigorously argue that given sufficient time and persistence, the comprehensive sanctions will work and the regime will be tamed.[32] The royalist press, within the Iranian exile community in Europe and the United States, also strongly

29. See *Christian Science Monitor*, 20 March 1996, p. 8.
30. Robert S. Greenberger, "World Bank to Suspend Lending to Iran," *The New York Times*, 10 September 1993.
31. "Showdown at the World Bank," *MEED* 39, no. 37, 15 September 1995, p. 5.
32. *Comprehensive U.S. Sanctions Against Iran* (Washington, DC: AIPAC, 1995), Ch. 4.

supports the sanctions in the belief that US pressure will eventually help overthrow the revolutionary regime and restore the monarchy.[33]

Some US officials, while expecting no imminent radical upheaval, hope that once Iran finds itself the odd-man-out in the region, its behavior will change.[34] Other Clinton administration officials, however, have been less sanguine. In testimony before the US Senate Banking Committee, in October 1995, senior State Department and Central Intelligence Agency (CIA) officials foresaw a serious impact on the economy if other industrial nations joined the United States, but they found that scenario rather unlikely. Undersecretary of State, Peter Tarnoff, believed Iran's "sophisticated marketing tactics" and "good quality" oil would enable the country to maintain its oil sales. And, John Gannon, Deputy Director of the CIA, predicted that "over the longer term, tightened sanctions are unlikely to have a major impact . . . without strong international backing [which] will be difficult to obtain."[35]

The optimistic view regarding the sanctions' prospects have not been widely shared by a number of outside observers sympathetic to the Islamic Republic, or critical of US policy towards Iran. They believe that the ultimate effect of the sanctions on Iranian political behavior would at best be uncertain and minimal, and at worst be injurious to long-term American business and political interests.[36] The press has been equally skeptical of the sanctions' ability to achieve their intended outcome. An editorial in *The Washington Post* found the "net benefits of trying to contain Iran unilaterally . . . wearing thin."[37] "Treating Iran as an economic outcast," concluded the London *Economist*, "with the resultant economic penalties, will not make the place nicer or safer."[38] Echoing these sentiments, some Western diplomats stationed in Tehran believe that sanctions will deepen anti-Western sentiment in the country, and will reduce what little remaining influence Europe and Japan may have over Tehran's foreign policy. Furthermore, by blocking the oil and gas pipeline projects from central Asia to international markets through Iran, Washington is believed to have inflicted a triple blow to its broad global interests: It has denied these newly independent countries a significant source of income; given Russia a continued stranglehold on some enormous Commonwealth of Independent States energy reserves; and deprived its Asian and European allies of the most logical and cost effective transport routes for their energy needs.[39] Finally, it is often argued that by

33. See *Rahe Ayandeh* (Washington), June 1995 and September 1996; and *Nimrooz* (London), 30 August 1996.

34. Laipson, "Symposium: U.S. Policy Toward Iran," p. 4.

35. Both testimonies are quoted in "Embargo," *Iran Business Monitor*, November 1995.

36. See statements by Gary Sick and Richard Cottam in, "Symposium: U.S. Policy Toward Iran," and Richard Murphy in *Iran Business Monitor*, May 1995, p. 4. The sanctions' costs for the United States have been estimated to be the loss of several thousand jobs and billions of dollars in exports. Officialdom in Washington has acknowledged that sanctions involve "some costs" for the United States, and are likely to inflict some "short-term dislocations" to some American interests. But these adverse effects are deemed justifiable and tolerable in the context of the threat posed by Iran's behavior.

37. "Containing Iraq and Iran," *The Washington Post*, 22 March 1996; see also "Loner," *The Washington Post*, 12 May 1996.

38. "Handling Iran," *The Economist* 338, no. 7957, 16 March 1996, p. 17.

39. John R. West, "How to Avert a New Oil Crisis," *The New York Times*, 30 November 1996. See also Robert D. Kaplan, "Why the U.S. and Iran Will Be Friends Again," *The Wall Street Journal*, 10 February 1997.

pushing the current, relatively pragmatic, leadership into a corner, enhanced sanctions are bound to weaken the hand of those "moderates" who look for an opening to the world community.

The gist of these observations is that the US containment policy and the sanctions strategy are likely to work against their stated objectives. Instead of forcing Iran to transform itself from a revolutionary, hostile and repressive regime to a "normal" state, any pressure to contain and isolate it will backfire by making the leaders more belligerent, uncompromising, and more prone to jeopardizing regional stability.[40] Even analysts who believe that sanctions may have hurt Iran badly in the oil sector, argue against blanket sanctions because the latter leave Tehran with little room to maneuver. The consensus among Iran's friends and supporters in the West is that while Washington has incessantly railed against that country's bad behavior, it has not offered a credible, focused, and realistic proposal for changing it.[41]

WHAT DOES THE FUTURE HOLD?

The widespread belief in Europe and Japan that the policy of "critical dialogue," rather than Washington's "containment" policy, is the right approach because it helps Iranian "moderates" come out on top, may be a sincere conviction devoid of selfish commercial interests. But it misses the very essence of the regime's theocratic legitimacy. Categories such as radicals and moderates, traditionalists and pragmatists, ideologues and technocrats within the Iranian state hierarchy are largely inventions of the Western media and their kindred national intellectuals. In reality, no such groups exist in Iran. To be sure, there are various tendencies in Iranian political inner circles, but these factions differ mainly about domestic economic philosophy (e.g., output growth vs. social justice), and public policy (e.g., state control vs. the free market). In their less emphasized external outlook, too, they differ about self reliant independence vs. integration into the world market. But, when it comes to the supremacy of the *velayat-e faqih* (governance of the jurist), there are no radicals or moderates within the establishment: they are all cut from the same cloth.

Is there any realistic chance that Tehran's clerical leadership will modify its political posture under the US containment policy? The answer will depend on the outcome of the balance between two countervailing forces: (a) increasing economic hardships and deprivation caused by US pressure, which could weaken the regime's hold on power; and (b) rising nationalist fervor and religious solidarity that could strengthen that regime's legitimacy and political bases of power.

The Iranian economy, like that of other oil-based developing economies, embodies a bulit-in capacity for survival. This capacity emboldens and encourages a religious

40. For an impassioned expression of these views, see H. Amir Ahmadi, "Dual Containment Policy Rests on Faulty Grounds," *Iran Business Monitor*, December 1995.

41. See Alon Ben-Meir, "Why It's Time for a New Policy on Iran," *Christian Science Monitor*, 27 February 1996, p. 19; see also Colin MacKinon, "Iran Sanctions," *The Washington Report on Middle East Affairs* 14, no. 8 (April 1996), p. 91.

oligarchy, constituted on seventh century Islamic theology, to seek political and strategic parity with the United States. The regime can be defiant of US sanctions for the time being simply because its considerable oil income ensures its economic survival for years to come. But, beneath the veneer of normality, and officially proclaimed uninterrupted progress, lies an economy mired in serious macroeconomic imbalances, deep-rooted structural deficiencies, and an uncertain external environment.

The imbalances include relatively heavy external debt service obligations between now and the year 2000; double-digit domestic inflation; immense cost/price distortions (particularly in domestic public utilities and petroleum products where sale prices lag behind production costs); and an effective official exchange rate that trails the free-market rate. Structural deficiencies include a growing domestic resource gap where national savings barely cover depreciation of physical assets, and add little to net fixed capital investment. Non-oil tax ratio to gross domestic product (at four percent) is one of the lowest among middle-income developing countries; public sector deficits (i.e., budget shortfalls in the central government budget and those of state enterprises) amount to about 10 percent of GDP; and domestic private investors are hesitant to commit their capital to domestic projects except for trade and non-productive services.[42] There is no effective "social safety net" to take care of the poor who get hurt by economic reforms, and current subsidies on goods and services are least enjoyed by poor consumers and are frequently squandered on the rich. The gap between jobs created each year through reconstruction and development projects and the new job-seekers entering the labor market for the first time translates into rising unemployment. The uncertain international environment, in addition to enhanced US trade sanctions, includes volatile crude oil prices; a lingering reluctance on the part of foreign private investors to invest adequately in Iran's non-energy sector due to a maze of cumbersome regulations and red tape; and Iranian businessmen's inadequate access to the global long-term capital market due partly to Iran's recent experience with payment arrears.

These internal and external challenges are known to Iran's Islamic leaders, and are a matter of unspoken but grave concern to them.[43] The problem lies in the painful trade-offs that necessary corrective political measures entail. For example, the country's external debt can be readily serviced out of annual oil and non-oil exports earnings. But, the roughly 25 percent of foreign exchange receipts that is currently earmarked for debt repayment each year requires a reduction in imports or increased non-energy exports unless oil prices continue to remain above OPEC's $21 per barrel target. Without a reliable rise in oil export receipts, both of these decisions are likely to keep down the rate of economic growth, and keep up domestic inflation. Growth is affected because of reduced output in import-dependent industries; and domestic inflation is spiked due to reduced domestic supply, stemming from increased non-oil exports.

Cost/price disparities of public goods and services can be lessened or eliminated by raising prices and fares to near international levels, or by further reducing government

42. See IMF, *Islamic Republic of Iran: Statistical Appendix*, for sources of data.
43. See Farhad Kazemi, "The Iranian Enigma," *Current History* 96, no. 606 (January 1997).

subsidies. But such rapid structural adjustments can lead to popular disaffection and social unrest, as experienced both before and after the revolution in Iran. The Majlis is also likely to put up strong political resistance to such moves.

Domestic resources can be more fully mobilized through higher taxes on income, consumer goods, and capital gains. The treasury's fiscal position can also be improved by levying taxes on the 60 percent of the economy that is currently tax exempt, and by better tax collection from the middle classes and the rich who are evading any meaningful contribution to the public coffer. Asking these groups to pay their dues, however, would involve a *quid pro quo*, namely, giving them a greater voice in deciding national public expenditures, which the present regime is not ready to do.

Semi-independent "charitable" bonyads and semi-public foundations can be brought under fiscal and managerial scrutiny and made accountable to the Majlis laws. Any such course of action towards greater institutional transparency and accountability, however, is bound to threaten certain influential clerics' fiscal fiefdoms and independent sources of revenue, which none is yet prepared to give up.

Finally, public sector deficits can be reduced through the privatization of money-losing state enterprises. But privatization in the recent past was associated with widespread corruption, and now faces many formidable obstacles including enterprise managers' resistance, a labor law that protects redundant workers, and depreciated equipment that is worth little. Statist ideology that still prevails in some clerical and bureaucratic circles and old-fashioned political patronage present additional impediments.

These dilemmas are home-grown and self-induced, independent of US sanctions and, so far, impervious to them. They are the product of wrong policies, managerial incompetence, administrative turf protection, and pernicious rent-seeking activities. They pose a latent threat to the regime's survival because, in the race between population and economic growth, the gap between national savings and required investments steadily widens and the rising socio-political tensions stemming from a decline in living standards grow rapidly. Although the gradual worsening of living conditions seldom triggers sudden political upheaval, increasing austerity and income inequities pose a threat to the regime's survival in the long run.

If other major industrialized countries adopt a similar policy to that of the United States and apply their sanctions to oil, that may hurt the Iranian economy and even accelerate the downfall of the regime. But such a unified policy, apart from its improbability, may ironically serve to keep the regime in power beyond its time. Universal enmity may have the unintended consequence of rousing the Iranian people's sense of patriotism, and creating a "blitz mentality" under which survival at any cost may become a stronger instinct.[44] Any declared intention to destabilize and isolate Iran may play into the clerics' hands, and strengthen nationalist sentiments and domestic solidarity.

Economic hardships, in the twin forms of falling per capita income and rising inflation, may thus become a deciding factor in changing the regime's behavior or leading

44. See Karen Dabrowska, "Iran Balances Dogma With Pragmatism," *Middle East International*, no. 519, 16 February 1996, p. 18.

to its downfall, only when the nationalist elements within the politically active population are convinced that Iran's territorial integrity and sovereignty will not be jeopardized by Washington's enmity toward the *mullahs* (clerics). Only when the fate of Iran, as a political entity with several thousand years of history, is separated from the fortune of an anachronistic 18-year-old religious oligarchy can one expect Washington's containment and enhanced sanctions policy to achieve its intended objectives.