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Iran's Economic Slide



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An Intelligence Assessment

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*NESA 85-10110
June 1985*

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An Intelligence Assessment

This paper was prepared by  Office of
Near Eastern and South Asian Analysis. Comments
and queries are welcome and may be directed to
the Chief, Persian Gulf Division, NESAs, on 



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Scope Note

This Intelligence Assessment focuses on Iran's current economic problems and highlights the political and economic implications of these problems.

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Iran's Economic Slide

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Key Judgments

*Information available
as of 1 May 1985
was used in this report.*

Iran's economy is sputtering as war-related disruptions, ideological rigidity, massive corruption, and mismanagement stifle production. Iran's troubles worsened in 1984 as the soft world oil market and Iraqi air attacks depressed export earnings. Economic problems are adding to popular unrest, and, in conjunction with recent battlefield defeats and power struggles within the government, they pose the most serious threat to the regime since it consolidated power in 1981.

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Iran's exports slipped sharply in the second half of 1984 and helped generate the largest current account deficit—\$3.9 billion—since the revolution. Oil revenues fell from \$19.5 billion in 1983 to \$16.5 billion last year. Rather than trim imports, Iran drew down accessible foreign exchange reserves to only about two months of imports, significantly reducing Tehran's financial flexibility. This makes the economy vulnerable to further disruption because Iran imports a significant portion of its food as well as materials to support the war effort.

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The domestic economy showed some improvement in 1982 and 1983 following the chaos of the revolution, but the war and lower oil revenues have reversed the trend. Unemployment, shortages of consumer goods, and inflation are undermining confidence in the regime and causing antigovernment grumbling among a war-weary populace. In recent months there has been an increasing number of strikes and antigovernment demonstrations.

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We expect Iran's foreign trade and financial situation to worsen this year. Even with small increases in export volumes compared with the last half of 1984 and stable oil prices, oil revenues are likely to fall by another \$1.8 billion. With foreign exchange reserves already low, imports almost certainly will be cut by at least 15 percent, further depressing consumption and domestic output. This will be a bitter pill to a regime that a year ago was still building expectations of oil-financed development. Should oil prices drop, Iran would have to institute even sharper import reductions.


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Iran's economic difficulties present potential hazards as well as opportunities for the United States. Iran's desperate need for foreign exchange will continue to push Tehran to lower its oil prices to spur exports and could precipitate an oil price war. Although Iran's relations with the United States will remain poor, moderate factions within the regime advocating

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stronger ties with Western Europe and Japan are likely to be strengthened by Iran's dismal economic performance. On the other hand, financial troubles are encouraging the regime to strengthen trade relations with Eastern Europe, and this could push Tehran closer to Moscow. If the regime believes its hold on power is threatened by economic and other problems, it could initiate actions against US interests, such as increased terrorism, to divert public attention and rally the populace. 

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Figure 1
Recent Workers' Strikes



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Iran's Economic Slide

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Oil remains the foundation of Iran's economy. Despite extensive rhetoric about economic diversification, oil accounts for about 98 percent of Iran's foreign exchange earnings and about 30 percent of gross domestic product. Between 1981 and 1983, aggressive marketing caused a near doubling of oil revenues to \$19.5 billion. The increased earnings were used to boost imports, shore up living standards for the war-weary and increasingly cynical populace, and provide substance to regime promises of better days ahead. Over the past year, however, oil revenues and foreign exchange reserves have declined, and Tehran faces rising economic discontent that is adding to other pressures confronting the regime.

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Pressure on Oil Revenues

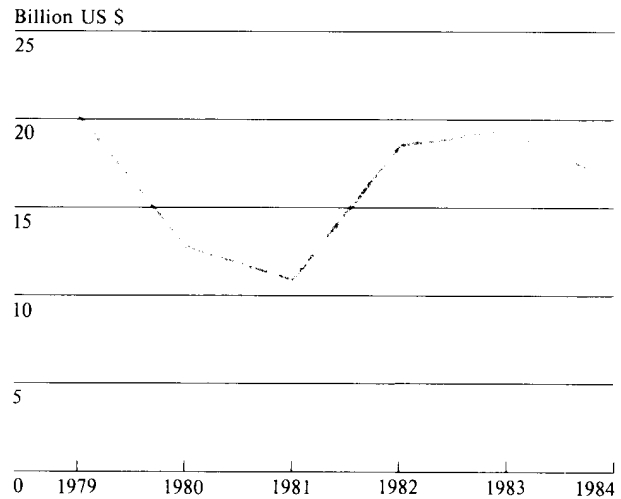
A chronically weak world oil market and Iraq's campaign against Persian Gulf shipping caused Iran's oil revenues to decline 15 percent to an estimated \$16.5 billion in 1984. Lower revenues were mostly the result of smaller export volumes in the last five months of 1984—averaging 30 percent less than during the previous 18 months. In August 1984, Iran's Petroleum Minister Qarazi announced that Tehran would reduce oil export volumes by 50 percent to support OPEC price levels. Iran subsequently toughened its pricing policy, and exports declined to about 1.2 million barrels per day (b/d) from August through October after averaging 2 million b/d in the first seven months of the year. Most of the drop in export volume resulted from the refusal of Japanese firms to pay Iran's asking price.

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Faced with sharply falling revenues, Tehran reversed course in November and began to offer price discounts of up to \$1.70 a barrel on top of war-related discounts of up to \$3.00 per barrel. As a result, exports rose to 1.6 million b/d in the last two months of the year as Japan resumed lifting Iranian crude. In January 1985, exports again fell as Iraq stepped up tanker attacks and Iran held back discounts to support its hardline position on prices at the January OPEC meeting. Exports increased again in February, March, and April as Iran aggressively marketed its oil at substantial discounts.

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Figure 2
Iran Oil Revenues, 1979-84



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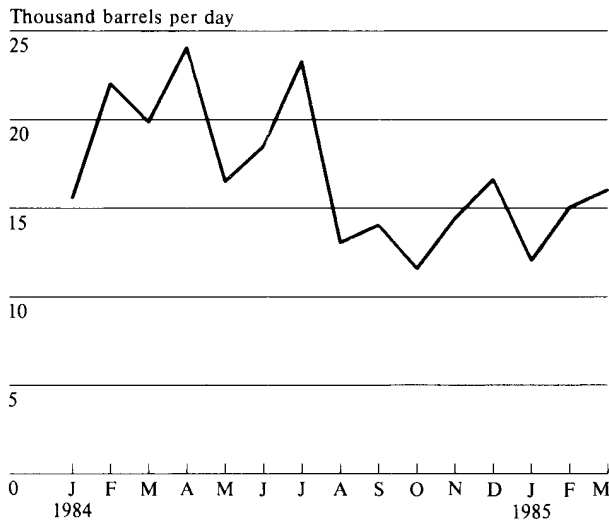
Tehran's shifting oil policy is the result of its conflicting goals of boosting foreign earnings and avoiding measures that would destabilize the world oil market. In an oil price war, Iran would probably end up a loser. Ideological concerns play a role as well. According to public statements by senior officials, Tehran believes that low oil prices help Western enemies of the Iranian revolution and that the current soft oil market is a Western plot to break OPEC.

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The war with Iraq has contributed to lower Iranian oil earnings because Iraqi airstrikes on oil tankers have forced Tehran to discount prices to offset the added costs of transportation and insurance. Uncertainty over delivery schedules has been another adverse

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Figure 3
Iran: Monthly Oil Exports,
January 1984-March 1985



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Current Account in the Red

Low oil revenues and an unwillingness to slash imports left Iran with a current account deficit of about \$3.9 billion in 1984—nearly five times the 1983 deficit and the largest since the revolution. Lacking access to long-term credit, Tehran drew down foreign exchange reserves to dangerously low levels. We estimate Iran's foreign assets were only \$5-6 billion by the end of 1984. Only about \$2.5 billion of these reserves, however, were readily accessible.¹ This represents about two months of import coverage, only one-third of the government's target. The regime, wary of the serious currency crunch that occurred in 1981, has repeatedly stated in the Western and local press a desire to maintain reserves sufficient to cover at least six months' worth of imports. [redacted]

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Despite the drawdown of foreign reserves, Iran still faces substantial foreign obligations, mostly in the form of delayed letters of credit. According to press reports, these outstanding letters of credit amount to \$6 billion. Iran's failure to make timely payments to foreign firms has caused some to discontinue or reduce business in Iran. For example, an Italian firm refused to start the second phase of a planned port expansion project at Bandar-e Abbas because of problems obtaining payments for the first phase, according to Western press reports. [redacted]

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The shortage of foreign exchange has caused the government to place severe restrictions on its expenditures. In May 1984 and again in January 1985, Iran's central bank temporarily stopped issuing letters of credit because of difficulties meeting its obligations, according to press reports. There have also been reports of drastic cutbacks in foreign exchange allocations. [redacted]

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¹ About \$1.1 billion is held in an escrow account to meet US claims to be settled by the claims tribunal at The Hague; much of the rest are loans to Third World nations. [redacted]

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factor as buyers became aware of the potential for delays caused by Iraqi attacks or the refusal of crews to enter the war zone. Delays can be especially costly for Third World buyers, because the late arrival of even a single tanker can cause fuel shortages. According to press reports, for example, Bangladesh's only oil refinery shut down in January 1985 after a shipment of Iranian oil did not arrive. So far, Iran's efforts to neutralize the effects of Iraq's shipping attacks have been unsuccessful. [redacted]

Oil assistance to compensate for Syria's support against Iraq cost Iran about \$700 million in lost revenue last year. Tehran has provided Damascus with about 120,000 b/d of oil since early 1982 in exchange for the closure of Iraq's 1.2-million-b/d pipeline through Syria. According to press reports, the terms of the agreement call for the sale of oil to Syria at what amounts to a 25-percent discount. Damascus has made few payments, however, and almost all outstanding debt has been forgiven or converted into interest-free loans, which are unlikely to be repaid soon, according to the US Embassy in Damascus. [redacted]

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Iran's Response to Iraqi Attacks

Price discounting and the Sirri shuttle operation have been Iran's most effective responses to Iraqi tanker attacks. Other measures have had little success. For example, Iran offered to underwrite insurance at below market prices, but the scheme failed when Tehran subsequently refused to pay damage claims. Similarly, Iranian offers to absorb the financial losses resulting from Iraqi attacks have not reduced pressure for war discounts on oil lifted at Khark.

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[redacted]

In February 1985 Iran started shuttling oil from Jazireh-ye Khark (Khark Island) in chartered tankers to two large storage tankers anchored near Jazireh-ye Sirri (Sirri Island) in the southern Persian Gulf. Technical problems plagued the startup of the operation, and we believe export volumes through March were only half the 1-million-b/d target.

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[redacted] in April Tehran had expanded the shuttle and was successfully exporting at least 1 million b/d through Sirri. Iran hopes to avoid paying war discounts associated with lifting at Khark, but the costs of the shuttle operation will offset part of the higher prices obtained for crude from the operation. Iran is still vulnerable to attacks on the shuttle tankers or Khark itself.

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[redacted] the shuttle was temporarily disrupted in March when two shuttle tankers were hit by Iraqi missiles.

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To reduce its dependence on Khark Island terminal, Iran is considering pipeline alternatives. Currently, about 90 percent of Iran's oil production is onshore and is exported through Khark. Press reports indicate Iran is seriously considering building an oil

pipeline to the Gulf of Oman. The line could take as long as five years to build and cost an estimated \$5 billion, [redacted]

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[redacted] According to press reports, Iran is also discussing plans with Turkey for a pipeline through that country. We believe both lines, especially the Turkish line, would be prohibitively expensive, given Iran's shortage of foreign exchange and lack of access to foreign credit. We suspect Iran's pipeline overtures to Turkey were made to further political relations and will not advance beyond the planning stage.

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[redacted]

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Tehran has beefed up defensive measures around Khark Island. Loading procedures have been changed to afford more protection to tankers berthing at Khark.

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There are indications that defensive preparations, probably connected with the shuttle, are also under way at Sirri.

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Iran has responded to Iraqi attacks on tankers with its own strikes against ships in the Gulf. Although far fewer in number than Iraqi attacks, Iran hopes they can put pressure on the Gulf states or the West to intercede and stop the Iraqi strikes. Tehran has limited its attacks to the southern Gulf after the Saudi Air Force shot down at least one Iranian F-4 fighter over its territorial waters last June. Moreover, by raising the general level of danger to Gulf shipping—and occasionally hitting, by accident, tankers going to Khark—has probably raised insurance rates for ships calling on its own ports as well as those for other Gulf states.

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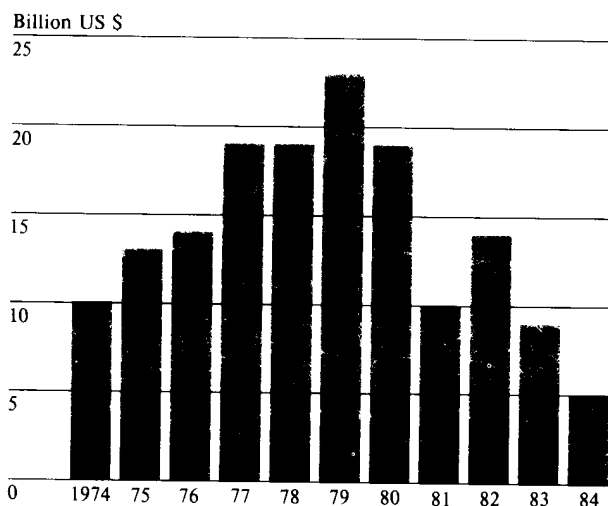
Despite drastic cutbacks in nonessential imports and efforts to raise domestic production, Iran still has significant import requirements. We estimate Iran imported about \$2.5 billion worth of food and \$1.4 billion in military equipment last year. Iran also relies on imports of capital goods, raw materials, and technical expertise to keep its major industries operating. Iran imported \$2.4 billion in raw materials last year, according to press reports.

Rising service payments, especially transportation and insurance charges, have also contributed to the large current account deficit. The war has closed or rendered less useful a large portion of Iran's port capacity. This has forced Iran to rely more heavily on

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Figure 4
Iran: Official Foreign Exchange Assets,
Yearend, 1974-84



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expensive overland alternatives and has resulted in large demurrage charges at clogged entry points. Iran has lost many merchant vessels during the war, forcing it to use scarce hard currency to charter ships. War risks have raised insurance for cargo and ships calling at Iranian ports. [redacted]

Iran's diplomatic isolation has left it without benefactors willing to finance its current account deficits. Tehran's only allies, Syria and Libya, have their own cash-flow problems. Tehran has been unable to obtain medium- and long-term loans from international money markets, for potential lenders are reluctant to offer unsecured credit because of the war and revolutionary turmoil inside the country. [redacted]

Tehran has responded to its financial squeeze by expanding barter and other forms of countertrade. Iran has used countertrade since the revolution, but in January 1985 it began pushing to conduct all trade on a barter basis. Barter has spurred Iran's oil sales, but only through implicit oil price discounts built into the

Military Procurement: A Special Case^a

The embargo on arms shipments to Iran by many Western suppliers and Soviet backing of Iraq have denied Tehran access to most weapons from major world suppliers and practically eliminated its ability to obtain technologically advanced weapons. International pressure has also tended to restrict Iran's purchases from smaller European and Third World suppliers. Arms deliveries since the start of the war have favored Iraq by 4 to 1. In 1984 arms sales to Iran totaled about \$1.4 billion compared with \$3.2 billion for Iraq. [redacted]

Nevertheless, Tehran's willingness to pay high prices in both the legal and gray arms markets has undercut efforts to prevent Iranian purchases. For example, Iraqi and Egyptian attempts to dissuade North Korea—Iran's biggest arms supplier—from selling weapons failed when P'yongyang refused to suspend a \$250 million sale. Similarly, non-Communist suppliers have been lured by Iran's willingness to pay high prices. Often these weapons are shipped to Iran through third countries. [redacted]

Iran's principal arms suppliers in 1984 were North Korea, Greece, Portugal, and Eastern Europe. Syria and Libya have provided limited supplies of weapons, primarily of Soviet origin. China currently supplies limited quantities of small arms and ammunition and, according to press reports, is negotiating to sell large weapon systems worth \$1.5 billion. [redacted]

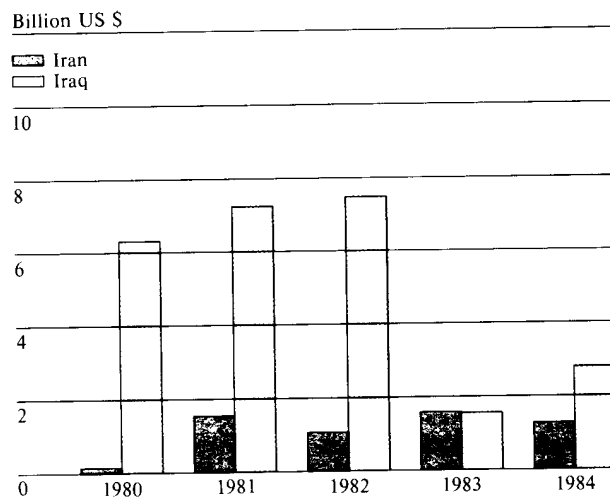
Tehran has been able to purchase or manufacture small arms and munitions for its combat forces, which are mostly composed of light infantry. Although we believe Iran will continue to make or buy sufficient small arms to carry on the war, Tehran will probably not be able to alter appreciably the numerical and technological superiority Iraq enjoys in airplanes, armored vehicles, and artillery. [redacted]

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Figure 5
Arms Sales to Iran and Iraq, 1980-84



Note: 1980 data only for September through December.

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agreements. These discounts range between 8 and 20 percent, or \$2 to \$6 per barrel. For example, [redacted] firms involved in barter have raised the price of their goods to make up for high "official" oil prices and that traders who arrange the deals have assessed large commissions. [redacted]

Domestic Economic Problems

Tehran's inability to handle its financial problems is increasing economic misery and popular dissatisfaction with the regime. Aggravating these problems are ideological conflicts over economic policy, corruption, rapid urbanization, and a shortage of skilled labor. [redacted]

Ideological Conflicts. Economic policy differences between radicals and conservatives have even appeared in the Iranian press and have almost paralyzed policymaking. The radicals advocate strong government direction of the economy including land reform, nationalization of industry, and government control of investment and foreign trade. The conservative faction draws its support from clerics and merchants who

favor a limited government role in the economy and oppose the rapid development plans advocated by radicals. [redacted]

Neither faction is powerful enough to push through its programs, and this has produced divergent policies or stalemate. Inaction on land reform has created uncertainty over land ownership, stifled private agricultural investment, and encouraged migration of rural laborers to the cities. Uncertainty over nationalization and import policies has depressed private business investment and caused hoarding. [redacted]

Efforts to construct an economy based on Islamic doctrines are taking a toll. According to press reports, even Prime Minister Musavi has complained of difficulties organizing an Islamic economy because a specific model does not exist. For example, fixed interest payments have been replaced under Islamic

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Transportation Problems

The war has gnarled Iran's transportation network, worsening shortages and impairing industrial output. The conflict has cost Iran approximately 60 percent of its prewar port capacity. Closure of the Shatt al Arab has shut off the ports at Khorramshahr and Abadan, and Iraqi bombing has reduced the use of Iran's largest prewar port at Bandar-e Khomeini by about 30 percent. [redacted]

banking statutes by a form of uncertain dividend, and this has caused bank deposits and loanable funds to drop, [redacted] Questions over the government's right to tax have touched off a raging religious dispute. Two grand ayatollahs support the *bazaaris* or merchants who contend that only religious taxes paid to the mosques are legitimate in an Islamic republic. Most regime officials, on the other hand, claim that payments to the government as well as to the mosques are proper under Islamic law because Iran is a religious state. [redacted]

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Iran now depends on its southern ports, primarily Bandar-e Abbas, for the bulk of its seaborne imports. Bandar-e Abbas, however, has been strained by the increased use. Despite efforts to speed offloading, ships are experiencing delays of up to two months, [redacted] Using average delays and charges, we estimate demurrage costs and spoilage probably totaled several hundred million dollars last year. [redacted]

Corruption. Abuse of office, a time-honored practice in Iran, has not been eliminated by the revolution. Government rationing and foreign exchange controls have opened more extensive opportunities for illicit activities. Moreover, erosion in government pay by rapid inflation has fostered more corruption. For example, the Iranian press reports that textileworkers in Qazvin went on strike last fall to protest the embezzlement of \$2 million in wages and bonuses by government managers. Businessmen complain they must resort to bribery just to sustain operations, according to press reports. [redacted]

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More costly overland routes through Turkey, Pakistan, and the Soviet Union have become more important since the war began. We estimate these routes handled about 7 million tons of goods last year compared with less than 2 million tons in the peak import year of 1977. In 1984 we estimate the Soviet Union transshipped about 20 percent of Iran's imports; Turkey transshipped about 15 percent; and Pakistan, slightly less than 5 percent. [redacted]

[redacted] most Iranians believe corruption is responsible for shortages and rising prices, and this has undermined support for the regime. Concern over this public perception has prompted the regime to launch an anticorruption campaign, including the prosecution of corrupt officials. The campaign, however, has been limited to low-level officials and has not reduced the level of public complaints. [redacted]

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[redacted] substantial delays exist at border crossings with Turkey and the Soviet Union. [redacted]

Iran's domestic transportation system was not designed to handle the large flow of goods through Bandar-e Abbas and across the Soviet and Turkish borders. None of Iran's southern ports is linked by rail to the major population centers, although a line is being built to Bandar-e Abbas. Inadequate maintenance of roads and railroads also hampers internal transportation. Moreover, [redacted] shortages of tires and spare parts plague an already overworked truck fleet. Delays in shipping raw materials and spare parts to factories have caused lower capacity utilization and in some cases even shut-downs. [redacted]

Rapid Urbanization. Government policies such as food distributions to the urban poor have encouraged migration to the cities by peasants from the countryside. This migration and refugees from Afghanistan and border areas affected by the war have contributed to rapid urbanization. The populations of many Iranian cities have doubled since 1979. For example, press

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reports indicate that Tehran has doubled in size to 7-8 million residents, and the population of Karaj, west of Tehran, has shot up from 100,000 to well over 1 million. We estimate Iran has received 1.2 million Afghan refugees since the Soviet invasion. Most have settled in cities. [redacted]

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Rapid urbanization has strained public services and worsened social problems. For example, Tehran experienced daily power cuts lasting several hours at a time last summer, and the deteriorating water system threatens the city with a water shortage, according to press reports. [redacted] there is an acute housing shortage in Tehran and other cities.

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There has also been an upsurge in crime, which many Iranians blame on Afghan refugees, [redacted]

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Skilled Labor Shortages. The regime is especially short of trained technical and managerial talent to run industries and provide government services. Emigration of members of the middle class seeking economic opportunities and political freedom and to avoid military duty has aggravated a shortage of skilled manpower. War-related demands also strain the limited pool of skilled labor. [redacted]

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[redacted] a lack of trained personnel prevents Iran from constructing multistoried buildings and other complex projects. The departure of skilled foreigners from the aircraft industry has reduced Iran's ability to maintain its aircraft, [redacted]

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[redacted] A shortage of physicians has prompted Tehran to restrict foreign travel by doctors and to have them leave behind family members to ensure their return. [redacted]

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Effects of the Deteriorating Economy

The cost of the war, lower oil revenues, and depleted foreign exchange reserves have caused inflation, shortages, cuts in development programs, and unemployment. Sorely needed industrial development is being reduced at a time of high unemployment and stagnant production. With minimal foreign exchange reserves and no source of long-term credit, the regime is being forced to make additional import reductions that are worsening shortages and inflation. [redacted]

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Budget Austerity. The government depends on oil receipts for a little more than half of its revenues, and depressed oil earnings have led to cuts in government spending. This has a widespread influence on the economy because government spending accounts for about 40 percent of the gross domestic product, and the state directly or indirectly controls basic industries and accounts for most investment. The state also runs large make-work projects to reduce unemployment. [redacted]

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The government scaled back original budget allocations for the 1985 fiscal year that ended in March by about \$2 billion—to \$44.5 billion—to close the revenue shortfall.² Oil receipts, however, fell short of budget targets by at least \$5 billion, according to press reports, and left an even larger-than-expected deficit of at least \$5.7 billion. Almost all of the spending cuts came from the development budget, which was reduced by 13 percent. [redacted]

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The downward trend will continue in the 1986 budget, which calls for a 13-percent decline in spending. Most cuts again come from the development budget, but the budget also projects a 4-percent drop in direct military expenditures, which dominate the budget. Prime Minister Musavi highlighted the impact of the war by publicly acknowledging that almost one-third of the government's \$38.7 billion FY 1986 spending will be directly or indirectly related to the war. Lower projected oil revenues prompted the government to increase taxes by 30 percent. Proposals to double the price of heating fuel and gasoline are also under consideration. [redacted]

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The government expects a deficit of \$2 billion in FY 1986, but we believe it will be closer to \$7 billion because Tehran is likely to fall far short of its oil and tax revenue forecasts. The regime claims it will finance the deficit with domestic borrowing, but we believe the government is unlikely to attract the necessary savings and will resort to money creation, adding to inflationary pressures. [redacted]

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² Iran's fiscal year is based on a solar calendar that begins 21 or 22 March. [redacted]

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Inflation and Shortages. The official inflation rate of 13.5 percent is misleading because it measures only the rise in government-regulated prices. Many goods are available only on the black market for four to eight times official prices, and press reports indicate the actual inflation rate may be as high as 40 percent. In addition to shortages and high prices, the quality of most goods, especially those sold at government prices, has declined dramatically. For example, a loaf of rationed bread has shrunk in size by about 30 percent since 1979, [redacted]

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The rationing system and shortages have hurt productivity. [redacted] government employees and military officers often spend working hours standing in line for rationed goods. [redacted] three- to four-hour waits for meat were common last summer. [redacted] inflation has eroded military wages and contributed to morale problems. [redacted]

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Stifled Production and Delayed Development. Lack of hard currency and transportation problems have made it difficult to obtain spare parts and raw materials. As a result, many factories operate at far below capacity, and industrial and infrastructure projects are being delayed. According to press reports, Iran has had to cut raw material imports to only 40 percent of the amount Iranian officials have deemed necessary to keep domestic industry running at capacity. For example, a shortage of raw materials caused output in Iran's auto industry to fall in 1984, and a shortage of bitumen has held up road construction throughout Iran, [redacted]

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An ambitious \$169 billion five-year development plan adopted in August 1983 is being revamped in accordance with more realistic assessments of financial and skilled manpower resources and because of war risks, according to Iranian press reports. For example, construction of a \$4 billion petrochemical project at Bandar-e Khomeini—the largest industrial project

under way in Iran—has been suspended because of Iraqi bombing. Many other projects still under way are experiencing long delays because of resource shortages. [redacted]

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Unemployment. With industry operating at low rates and development programs cut, unemployment has worsened. [redacted] with the jobless rate as high as 35 percent in some cities. [redacted]

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**Popular Reaction to Economic Decline:
Growing Disenchantment**

[redacted] growing war-weariness and disenchantment with the government's handling of the economy. [redacted] labor unrest and protests over prices, shortages, and working conditions. Lack of progress in the war—a main cause of economic hardships—has led to frustration. Recently, persistent Iraqi air attacks on cities have lowered morale, sparked antiwar demonstrations, and further disrupted the economy. The middle class, which has never had much affinity for the revolution, is especially vocal in its grumbling, [redacted] More important, there have been increasing numbers of demonstrations among the working class—the backbone of the revolution. [redacted]

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[redacted] over the past 12 months strikes have occurred in cities throughout Iran. [redacted] 18,000 workers went on strike at Iran's largest steel mill in Esfahan during November 1984. [redacted] despite efforts by the regime to contain the story, sympathy strikes were held in many cities. The government eventually gave in to most worker demands, [redacted]

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[redacted] refinery workers in Shiraz, Tabriz, and Esfahan held strikes this winter in the midst of fuel shortages. The workers were disgruntled over the lack of pay increases despite rising prices and shortages. They may also have been protesting government efforts to increase domestic production and thus offset cuts in imported fuels made to conserve hard currency. In addition, there have been [redacted] strikes in Arak, Karaj, Mashhad, Kermanshah, Mobarakeh, Kerman, and at the Khark Island oil terminal. Some of the strikes appear to have been coordinated, and the Iranian exile press reports the existence of a secret national labor organization.

Government Statements on the Economy

Ayatollah Khomeini on economic hardships, March 1985:

"At times calamity becomes a blessing. At other times what we consider blessing is in fact a calamity. The great God wants to groom the people. It is under pressure that the spirits soar to the higher world. Therefore, we can say that, by the grace of God, our nation is also like this. They are not afraid of hardships. If we Muslims, in fact all Muslims, were like other nations and had been running after wealth, status, and such things, or they were running for bread or sex, many would have been disappointed. But the nation who goes to war for martyrdom, a nation whose men are lovers of martyrdom and wish for martyrdom, such a nation can hardly think of anything else. As for its economy, it does not matter. These matters are for those who are tied to economies. The people who work for anything, that the prices be less or more, are very different from the nation that wishes for martyrdom. When one is determined to attain martyrdom, he is not supposed to worry about price. He does not go to collect booty, because through martyrdom he gains a booty that never dwindles. I hope all are of such mind." [redacted]

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We believe the regime will attempt to prevent a unified labor threat by giving in to workers in essential industries, while suppressing those in other fields. [redacted] the opposition press abroad report several cases in which strikes have resulted in the use of force by the government. For example, [redacted] last December Revolutionary Guards killed 10 demonstrators and wounded many others at a rally in support of striking cement workers in Shiraz. Four strikers were killed and 15 to 18 others wounded in a tobacco workers' strike in 1984, [redacted]

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Popular dissatisfaction has not coalesced into a cohesive opposition movement. Indeed, some demonstrations have had the tacit approval of senior clerics representing different sides in the continuing debate over economic policy, according to Western press reports. To head off a coordinated opposition, the government has attempted to buy the support of the middle class and *bazaaris* by allowing them greater economic freedom and wealth without giving them significant political power. This is likely to prove increasingly difficult, however, because of the shrinking economic pie. [redacted]

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Ayatollah Montazeri, Khomeini's heir apparent, on lower public consumption, January 1985:

"In my view, as we eliminate excessive expenditures and formalities in the ministries and organizations, we must spread and promote a policy of thrift and contentment in all matters and an anticonsumption ethic among the people. Our nation is definitely not satisfied to see the government spending more than is necessary to subsidize unnecessary items and formalities. If we impress upon the people the consequences of consumerism and waste in certain affairs, the people themselves will certainly take the initiative in the fight against consumerism and waste in the effort to be content with establishing Islamic ethics." [redacted]

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Outlook and Vulnerabilities

Iran's economy will continue to worsen. The soft oil market and continued Iraqi attacks will drive oil revenues down this year. We estimate oil revenues will be \$14.7 billion in 1985, assuming exports average 1.55 million b/d. To maintain this level, Iran will

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Iran: Current Account

Billion US \$

	1978	1979	1980	1981	1982	1983	1984	1985 ^a
Exports (f.o.b.)	21.9	20.6	13.6	11.7	18.9	19.8	16.9	15.1
Oil	21.2	20.2	12.8	10.9	18.6	19.5	16.5	14.7
Nonoil	0.7	0.4	0.8	0.8	0.4	0.3	0.4	0.4
Imports (f.o.b.)	17.8	7.8	10.7	10.8	9.7	15.3	15.0	12.5
Services (net)	-3.4	-1.0	-2.4	-3.3	-3.0	-5.3	-5.8	-5.1
Balance	0.7	11.8	0.5	-2.4	6.2	-0.8	-3.9	-2.5

^a 1985 projection assumes oil exports for the year average about 1.55 million b/d. This projection also assumes oil prices remain at current levels and Iraq continues attacks on shipping at the same level as the first two months of 1985.

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have to price its oil competitively and yet not precipitate a sharp decline in oil prices. Imports will have to be cut at least 15 percent, but the cuts could go even deeper if Tehran is unwilling to further reduce foreign exchange holdings or unable to arrange some credits to fund a current account deficit on the order of \$2.5 billion. Lower imports will cause further declines in industrial production and more delays in development.

We believe that, after years of hardship, further declines in living standards will lead to greater domestic unrest. Higher taxes and fuel prices in the new budget are potential rallying points for opposition groups. The poor health of Ayatollah Khomeini and the struggle for political power in Iran will continue to prevent decisive action on domestic economic problems. The regime is warning the populace that it must become self-reliant and lower its expectations in contrast with earlier advice that the public should endure sacrifices in expectation of better times.

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Iran's economic problems would go from bad to worse if there were a major fall in oil prices. If prices fell to \$20 per barrel and Iran maintained its current export levels, oil revenues would drop to about \$10 billion. This fall in earnings would force cutbacks in war-related imports and popular government programs. Iran could soften the impact of a severe crisis by using the estimated \$2-3 billion in gold and jewels the regime has kept as a last resort.

Iraqi attacks against oil shipping will not significantly change Iran's economic outlook unless Iraq either becomes far more effective or stops its attacks. Baghdad sees the present level of attacks as part of a strategy to bring Iran to accept a comprehensive peace settlement. Iraq, however, appears unwilling to risk the losses or possible Iranian retaliation that could result from more widespread attacks against Iranian production facilities or tankers.

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In the unlikely event that the oil market firms and Iran can raise oil export volumes to 1983 levels, 1985 revenues would only reach the 1984 level. By matching last year's earnings, however, Tehran would still face import cuts because it lacks the reserves to finance a current account deficit as large as in 1984.

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Iran's Oil Policy and Potential To Break Global Prices

Iran's increasingly desperate financial condition is moving Tehran toward a strategy of price cutting to spur sales that could precipitate a fall in global oil prices. The Petroleum Ministry has been criticized for past pricing policies and its inability to maintain revenues. Moreover, Tehran is unlikely to sit by idly as new oil pipelines give Iraq additional export capacity early next year.

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There are indications from public statements that Tehran regards its OPEC quota of 2.3 million b/d as a limit on exports rather than a production quota—a calculation that would permit exports 600,000 to 700,000 b/d greater than OPEC intended. These statements may be intended to warn other OPEC producers that Iran will match, or anticipate, future Iraqi production increases. We estimate Iran can bring production up to 3.2 million b/d in a matter of months, whereas recent production has been some 2.2 million b/d.

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Iran has allowed its oilfields to deteriorate seriously over the past year and that considerable work may be required before higher production levels can be achieved.

Iran's weak economy and low foreign exchange reserves will continue to make it vulnerable to Iraqi attacks on other economic targets. Tehran is ill prepared to offset lost output or repair damage to factories, power generators, and other economic facilities.

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An end to the war would reduce some of Iran's economic problems, but it would not provide a dramatic turnaround. Oil revenues would rise as the war risks of lifting Iranian crude were eliminated, and substantial financial and manpower resources would be freed for development. The regime, however, would still face a host of problems, including a weak oil market and ideological conflict over domestic policies.

Rising postwar expectations and the return of soldiers from the front could make the government's inability to deal with economic problems an even more serious threat to stability.

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Implications for the United States

Tehran's economic misfortunes provide both opportunities and hazards for US interests:

- We believe Tehran's continued efforts to price its oil competitively will help maintain downward pressure on world oil prices. Aggressive price cutting by Iran to climb out of its economic morass could start an oil price war and contribute to a sharp fall in prices.
- The depth of Iranian opposition to the United States is so great that it is highly unlikely there will be a significant improvement in relations any time soon. Relations with other Western countries, however, may improve if moderates in the regime who favor stronger ties with the West succeed in using economic issues to discredit radicals. Moderates also oppose strong ties with the Soviet Union.
- Economic difficulties increase the likelihood that Iran will improve relations with the Communist nations. A weakened financial position makes Tehran more wary of renewed economic sanctions by the West and encourages it to seek stronger trade links with nonaligned and Communist countries. Tehran's push for countertrade agreements to balance trade on a country-by-country basis can be more easily handled by centrally planned economies. The Soviet Union probably will benefit unless opposition within the Iranian regime to warming ties with Moscow intensifies.
- Tehran has publicly threatened to blockade Persian Gulf oil exports if Iraq cripples Iran's ability to export oil or if there is a collapse of the oil market. The latter threat is a relatively recent occurrence highlighted by Majles Speaker Rafsanjani's warning that Iran would "stop the flow of oil to the plundering countries" in the event of a large price fall, according to press reports. We believe Tehran

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would attempt to close the Strait of Hormuz only as a last resort, and the closure would last no more than a few days if Western countries react. Attacks against oil facilities in Iraq, Saudi Arabia, or Kuwait are slightly more likely options should Iran conclude that it was in dire circumstances, although this would still risk military and diplomatic retaliation.

- If the regime believes that its power is threatened by economic as well as other difficulties, it may support increased acts of terrorism against US and other Western interests in the region and in Western Europe. Such action would be used to rally the populace and divert attention from domestic problems.

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