The Revolutionary Economy
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- Iran has a strong foundation for rapid growth and development, with the world's second largest petroleum reserves, a young, well-educated population and a well-developed industrial and commercial infrastructure.

- But revolution, war, mismanagement and factional feuds over economic policy have undercut potential since the Islamic Republic's birth in 1979.

- The economy has been a central factor in shaping Iran's political evolution. Since the revolution, it has also been the primary target of U.S. sanctions and other international measures trying to influence Iranian policy.

Overview

Iran's revolutionaries inherited an economy in the throes of massive change and epic growth. In less than one century, Iran had been transformed from a small, predominantly agricultural economy run by a fading tribal dynasty into a modern centralized state with a booming manufacturing sector and a central role in international oil markets. Much of this transformation occurred during the reign of the Pahlavi monarchy, which sought state-led modernization modeled after the policies of Turkey's Kemal Ataturk.

Since the 1979 revolution, the Iranian economy has been beset by a costly eight-year war, unremitting international pressure and isolation, and ideological conflict. The revolutionaries clashed over what constituted an Islamic economy—and whether growth or social justice should be the top priority. Iran's reliance on oil revenues put the state at the mercy of energy market fluctuations, with prices below $10 per barrel in 1999 and above $145 per barrel in 2008. The Islamic Republic's approach to the economy is illustrated by the policies adopted during four distinct periods.

Revolution and economics

In the 1960s, Mohammad Reza Shah Pahlavi launched a far-reaching program that included sweeping land reforms, infrastructure development and huge investments in the country's industrial base. Iran's fortunes surged even more dramatically after the explosive rise in oil prices in the 1970s, helping fuel the shah's grandiose ambitions to overtake the French and German economies.

The Pahlavi economic program generated rapid growth, but the reforms also alienated influential constituencies, including the clergy, landlords and merchants or bazaaris. In addition, inflation and other problems spawned by the scope and pace of development created hardships for many Iranians. Economic grievances helped galvanize opposition to the monarchy, and revolutionary leaders such as Ayatollah Ruhollah Khomeini appealed to Iran's poor and its increasingly squeezed middle class.

Still, the economy was not the primary factor that mobilized opposition to the shah. After the monarchy's collapse, Khomeini dismissed its importance in the new order, remarking that, "Iran's Islamic Revolution was not about the price of melons." Consistent with Shiite tradition, Khomeini was a staunch defender of property rights and the role of the private sector, a view shared widely among clerics and reinforced by their alliance with the bazaar.

The clergy's economic conservatism unraveled during the chaos and competition that emerged as the Pahlavi regime imploded. Labor strikes and elite emigration paralyzed the industrial sector, and informal expropriations proliferated. Squatters were provoked by radicals hoping to accelerate the transfer of power and undercut the moderate provisional government. Iran's constraints intensified after the November 1979 seizure of the U.S. Embassy in Tehran, when Washington froze approximately $11 billion in Iranian assets and imposed other sanctions. After two years of disruptions to the economy, the post-revolutionary turmoil put the country on the brink of economic collapse.

Internal debate

The second factor that shaped the Islamic Republic's early approach to the economy was the fierce philosophical dispute within the revolutionary coalition itself. The powerful leftist component of the anti-shah movement, and even some clerics, had adopted 1960s-era Marxist dogma that sought an economy centered on "social justice."

Differences between Islamic leftists and traditional clerics roiled the policy debate throughout the 1980s, but the leftist influence won at the outset. Most major sectors of the economy were nationalized. The assets of the Pahlavis and other elite families were absorbed by newly-created semi-governmental organizations, broadly known as *bonyad*s or foundations. They evolved into important and often unaccountable economic actors over the next 30 years.

The theocracy's enlargement of the state's economic role was to some extent an improvised response to circumstances. Yet the shift proved as consequential as any of its political, social and cultural changes. The state's economic takeover could not blunt the impact of the revolutionary unrest and uncertainty in the short term. All sectors of the Iranian economy experienced a marked decline during the first several years of the revolution.

The war years

Economic policies established during the revolution were strengthened after Iraq's 1980 invasion. The eight-year conflict provided a convenient excuse for expansion of the state sector and the precipitous decline in general living standards. Meeting the demands of major combat initially boosted Iran's manufacturing output. But the oil sector never fully recovered from the revolutionary turmoil. The 1985 collapse in oil prices severely constrained Iran's capacity to import goods required to maintain industrial production.

Throughout the war, sharp divisions persisted between the "Islamic socialists" and traditional conservatives. Proposals to nationalize foreign trade, expand land reform and establish new labor protections sparked fierce conflicts between the parliament and the oversight body empowered to vet all legislation. Iran's Guardian Council consistently favored a more conservative interpretation of Islamic law, and rejected radically statist measures advanced by the Islamic leftists who dominated parliament.

Khomeini initially tried to balance the two camps. He eventually took steps that appeared to help the radicals, but yet ultimately paved the way for greater pragmatism. In a decision with sweeping long-term political implications, he mandated that the interests of the state take precedence over either the constitution or Islamic law. This principle was institutionalized in 1988, with the establishment of the Expediency Council, which was empowered to mediate between parliament and the Guardian Council. Khomeini also sanctioned a wholesale reversal of his early pro-natalist policies that had boosted Iran's birth rate to the highest world.

The 1988 decision to accept a cease-fire with Iraq also reflected recognition that the country could not afford the war's toll on the economy or society. The costs were enormous: Productivity plummeted. Urban poverty doubled. Real per capita income dropped by 45 percent since the revolution. And price controls and strict rationing of basic consumer goods failed to prevent rampant inflation. Meanwhile, the factional battles over the economy polarized the political environment and eroded what was left of the private sector.

Rafsanjani and reconstruction

The cease-fire and Khomeini's 1989 death facilitated a major shift in the Islamic Republic's economic approach. Newly elected President Akbar Hashemi Rafsanjani sought to rebuild a country battered by a decade of revolution and a war with approximately $1 trillion in direct and indirect costs. Rafsanjani advocated a fundamental reorientation and liberalization of Iran's economy, along with efforts to reverse Iran's international isolation.

Rafsanjani's agenda included:

- Infrastructure development
- Privatization of state enterprises
- Foreign exchange liberalization
- Establishment of free-trade zones
- And elimination of subsidies and price controls.

To accomplish this ambitious program, he sought to utilize foreign lending as well as efforts to attract private domestic and foreign investment.

Reconstruction was initially strong. Post-war investment and relaxation of government restrictions helped generate robust growth in gross domestic product, government revenues and employment. The progress ran aground, however, as a result of policy miscalculations and political tensions. Massive increases in government spending and private consumption fanned inflation, prompting riots in a number of Iranian cities throughout this period. Iran's private sector proved hesitant to invest.

Foreign partners also remained deterred by political uncertainty and, after 1995, intensified U.S. sanctions. Meanwhile, soft oil prices from 1992 onward prompted a debilitating debt and currency crisis. Rafsanjani responded by rescheduling some external debt, reinstituting foreign exchange restrictions and shelving infrastructure plans, as well as any move to rationalize subsidies.

Rafsanjani also had to deal with opposition at home, first from Islamic leftists who remained wedded to the state-centric economic model. They viewed any embrace of the free market as a betrayal of the revolution's ideals. After three years of tensions, Rafsanjani engineered their ouster from the parliament. But then his second term was stymied by traditional conservatives opposed to his relaxation of Islamic social and cultural restrictions. Reconstruction redressed some after-effects of the Islamic Republic's first decade. Yet the leadership's ambivalence toward market-based reforms hampered Iran's competitiveness.

The reform era

Leftists sidelined by Rafsanjani regrouped and reassessed the state they had helped create. Their efforts eventually helped produce the 1997 election of President Mohammad Khatami, and an ultimately ineffectual effort to reform the power structure. From the outset, this movement focused on social, cultural and political issues. It argued that strengthening the rule of law and regional détente represented necessary preconditions for growth and development. This strategy reflected the reformists' discomfort with the free market, a legacy of their leftist origins, as well as their frustration with the failings and repression of the

Rafsanjani era. They also feared that the destabilizing impact of real economic liberalization might cost public support, which was their most powerful asset.

Once in office, however, Khatami found himself confronted with the onset of a global recession and a deep slump in oil prices. He also faced persistent inflation, unemployment, and mismanagement. His response was a typically cautious array of small-scale economic initiatives that bore modest fruit.

During his two terms, Khatami achieved a solid beginning to serious economic restructuring. Among his accomplishments:

- Unifying the exchange rate
- Establishing an Oil Stabilization Fund as a cushion against market volatility
- Authorizing the first post-revolutionary private banks
- Pushing through some improvements to the framework for foreign investment
- Stewarding the economy through a tumultuous period of unprecedented low oil revenues
- And luring new interest and investment from the West.

More ambitious plans, including efforts to reduce the costly energy subsidies, met opposition from conservative parliamentarians. They adopted an obstructionist approach to Khatami's economic agenda, as a means of subverting his political and cultural reforms.

Khatami and the reform movement can be credited with some stepping-stone economic reforms, but they failed to build and maintain public support for their agenda. Their political tribulations persuaded much of the Iranian public that press freedom ranked higher than job creation on their priority list. This strategic blunder left them vulnerable to a populist challenge, as the surprise 2005 election of Tehran mayor Mahmoud Ahmadinejad demonstrated.

Ahmadinejad's economy

Ahmadinejad's 2005 presidential campaign emphasized economic themes with populist appeal. He pledged to distribute oil revenues to the entire population, and pointed to his modest lifestyle compared with his rivals. He assumed office at the height of a substantial increase in oil prices, which sustained illusory growth rates and brought an epic influx of revenues and foreign exchange. The other factor working in Ahmadinejad's favor was the rise of Asia as a commercial counterweight to Iran's historic trade partners in Europe, which enabled Tehran to blunt the impact of U.S. and U. N. sanctions. After the United Arab Emirates, China became the largest source of Iran's imports. And Asia purchased more Iranian oil than any other region.

Ahmadinejad took an assertive and problematic role on policy by:

- Expanding credit and spending in a freewheeling fashion
- Feuding openly with a series of cabinet ministers and Central Bank chiefs
- Dismantling the planning bureaucracy
- Disempowering government technocrats
- And reveling in the reverberations of the global economic meltdown.

His provocative rhetoric on Israel and the regime's continuing defiance of U. N. Security Council resolutions on its nuclear program heightened the sense of political risk and persuaded some foreign investors to leave voluntarily.

Ahmadinejad did move boldly, however, to address longstanding distortions plaguing Iran's economy, such as subsidies and state dominance, but in a counterproductive way. Privatization benefited mainly state-affiliated companies, particularly those associated with the Revolutionary Guards, whose retirement funds took a majority stake in the state telecommunications firm in 2009.

Ahmadinejad's assiduous use of economic issues made him especially vulnerable. The mood inside Iran soured as the global economic slowdown began to impact Iran and the price of oil crashed to less than one-third of its 2008 high. Senior political figures and renowned economists were sharply critical of Ahmadinejad's spending and interventionist approach, while strikes by bazaaris in 2008 and 2010 forced the government to delay or abandon planned tax hikes.

The economy featured prominently in the 2009 presidential campaign. Ahmadinejad countered withering attacks on his record with misleading statistics and corruption allegations against his rivals. The post-election unrest aggravated Iran's economic dilemmas, intensifying the brain drain and capital flight. It also fueled European support for vigorous economic pressure. New U.N. sanctions in mid-2010 boosted the U.S. effort to cut off Iran's access to the international financial system. They also provided a platform for surprisingly robust measures by the European Union.

Paradoxically, the 2010 sanctions also provided a modest, temporary boost. The departure of foreign investors opened opportunities for domestic firms, particularly those with Revolutionary Guard connections, and boosted the Tehran Stock Exchange. Sanctions also generated new pragmatism on economic liberalization. They galvanized support for previously unattainable reforms to the subsidies and even the investment framework. Yet early evidence suggests the 2010 sanctions may have hurt the regime, forcing costly and time-consuming shifts in banking and trade relations.

Factoids: IMF projections for 2010/2011:

Gross Domestic Product (GDP)	$353.7 billion
Real GDP growth	3%
Unemployment	9.8%
Inflation (average CPI)	10.3%
Current account balance	$8.6 billion
Exports	$92.9 billion
Imports	$85.2 billion
Current account balance	$8.6 billion
External debt	$14.2 billion
Oil revenues	$64.4 billion
Oil production	3.7 million barrels per day (bpd)

The future

- The key uncertainty affecting Iran's economic future is the leadership's capacity to circumvent and mitigate sanctions, particularly restricting its banking relationships with Europe.

- Declining production from aging oil fields, together with political and logistical constraints on Iran's ability to monetize its gas resources, will begin to take a steeper toll on Iran's revenues and hard currency reserves.

- The government might be able to lure back some foreign investors by offering more attractive contracts. But changing the current 'buy-back' system would likely entail a bruising internal battle.

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