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Iran-Iraq: The Economic Balance [redacted] 25X1

Summary

Iran and Iraq face severe economic hardships in the months ahead. The prospects for the two countries were gloomy even before the recent fall in oil prices and the shrinking value of the dollar cut their real earnings nearly in half. Sustained economic pressure will increase the danger of Saddam Husayn's ouster in Iraq and strengthen opposition to the war in Iran. Absent more aggressive Iraqi attacks on Iranian economic targets, we believe the oil price decline poses a relatively greater political danger for Baghdad than Tehran. In addition to Iraq's greater dependence on oil-financed imports, Baghdad, unlike Tehran, is saddled with large foreign debts and is unable to significantly increase oil exports. Although discontent in both countries will increase over the coming months, the Iraqi leadership is more vulnerable because of its greater reliance on domestic spending to maintain support. Financial

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This paper was prepared by [redacted] the Persian Gulf Division, Office of Near Eastern and South Asian Analysis. Comments and queries are welcome and may be directed to the Chief, Persian Gulf Division, NESA [redacted] 25X1 25X1

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constraints alone, however, will not prevent either side from continuing the war in the short term. [redacted] 25X1

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Iran's Economic Outlook

The recent collapse in oil prices and the depreciation of the dollar are staggering blows to an already weak Iranian economy. Assuming Tehran maintains last year's average oil export level of about 1.6 million b/d, the price of oil is $13 per barrel, and the value of the dollar does not rise significantly, we estimate Iran faces a 50-55 percent drop in real foreign exchange earnings this year. We believe Iran intends to increase oil exports to between 2 and 2.8 million b/d--exports for the first four months of 1986 averaged 1.5 million b/d. Tehran will have trouble sustaining higher production and exports because of shortages of skilled personnel and the deterioration of oil facilities. [redacted] 25X1

Oil revenues are critical to Iran's economy, constituting over 90 percent of foreign exchange earnings. Oil-funded imports provide 20-25 percent of Iran's food requirements, the vast bulk of its war materiel, and essential supplies for industry, transportation and construction. To maintain recent import levels of food and military goods, Iran would have to use almost three-fourths of the $8.5 billion in foreign exchange revenues that we estimate it will earn in 1986. This would leave little room for anything else. In particular, it will be virtually impossible to raise military outlays significantly to help offset Iraq's superiority in weapons. [redacted] 25X1

We expect Iran to secure some foreign loans from Japan and West European trading partners despite its strong aversion to borrowing, but Tehran will need to slash imports by one-third this year. This would represent about a 50 percent decline in imports since 1984. Tehran probably will avoid drawing down its limited foreign exchange assets, which amount to about three months of imports and serve as a cushion in case of a complete cut-off of oil exports. [redacted] 25X1

Import cuts will be a harsh blow to Iran's hobbled civilian industrial sector. A lack of imported raw materials and spare parts has already caused industry to operate far below capacity. [redacted] 25X1 additional factories will have to be closed in the coming months. Even the oil sector has not been spared. Cancellation of development projects and stretched-out maintenance will further reduce Iran's oil production capacity and cause irreversible damage to some fields. [redacted] 25X1

There has been a steady deterioration in the standard of living in Iran [redacted] and conditions will worsen 25X1 over the next several months. Even imports of high priority items such as food and medicine reportedly have been delayed or cancelled. Lower imports and reduced domestic production will aggravate inflation and shortages--consumers will turn increasingly to the high-priced black market to satisfy basic needs. Cancelled development projects leave no hope of alleviating housing shortages in major cities or improving public services. [redacted] daily power outages in Tehran and other cities. [redacted] 25X1

Unemployment is becoming a serious problem despite the war. [redacted] 25X1 [redacted] factory closings have caused layoffs even at 25X1 government-owned factories. Official estimates place unemployment at 15 percent or about 2 million. The former head of the Planning and Budget Ministry complained in April that "false employment"--government make-work projects--and unemployment account for 39 percent of Iran's 12.3 million labor force, according to press reports. [redacted] 25X1

Economic problems probably will not translate into active opposition to the regime in the immediate future. [redacted] 25X1 The regime can still find enthusiastic volunteers willing to martyr themselves at the front. Subsidies for food and other necessities will limit the impact upon the poor who form the backbone of support for the Islamic Republic. Many of the poor are not much worse off than they were under the Shah and believe the regime attempts to act in their best interest. Moreover, there is no effectively organized opposition within Iran to rally the people. [redacted] 25X1

If oil prices remain depressed over the next two years, however, Iran will face tougher choices and could decide to scale down its war effort. Economic problems will encourage dissatisfaction with the government's war policy, especially if Iran is unable to make significant military gains against Iraq. Iran's leaders might become more concerned about guaranteeing a tolerable level of long-run economic development. Nevertheless, the regime is likely to end the war only if its continuation threatens the survival of the Islamic Republic. [redacted] 25X1

Iraqi Economic Outlook

Iraq has accumulated large foreign debts over the past four years while trying to insulate its population from the economic effects of war. This has complicated Baghdad's efforts to deal with the sharp decline in oil prices. We estimate Iraqi foreign exchange earnings will fall to $7.4 billion this year from $11.7 billion in 1985. Moreover, the lower value of the US dollar will make the real impact even greater since oil is priced in dollars while most Iraqi imports and debts are valued in other currencies. We believe Baghdad will need to cut imports by 30-35 percent. In the unlikely event Saudi Arabia and Kuwait do not provide additional cash assistance this year, cuts will be even deeper. Baghdad cannot raise revenues appreciably since oil exports, which represent 98 percent of foreign exchange earnings, are already near capacity. [redacted] 25X1

Baghdad's crumbling financial position probably will necessitate even larger import cuts because foreign banks are restricting trade credit to Iraq and the number of foreign suppliers willing to do business with the country is dwindling. [redacted] Baghdad's failure to 25X1 honor up to $1 billion in letters of credit (L/Cs)--the principal manner of conducting trade--has caused many banks to refuse to handle Iraqi L/Cs. The US Embassy in Baghdad reports that Iraq failed for the first time to make a $120 million payment to France--Baghdad's major creditor and an important arms supplier. We believe that Paris has suspended short- and medium-term credit as a result of the missed payment. In addition, Iraq has missed payments to Germany, Japan, Turkey, Italy, and several smaller creditors. [redacted] 25X1

Iraq reportedly is seeking to reschedule at least $3 billion in debt payments due this year. Creditors have little choice but to accept rescheduling, but Baghdad is unlikely to find desperately needed additional credit, especially from commercial banks. Even a bank in Bahrain, partly owned by Iraq, is unwilling to increase its lending limit. [redacted] 25X1

Baghdad has little recourse but to reduce spending and the Iraqi people will suffer a significant decline in living standards over the next 12 months. Defense expenditures will not be cut, in our view, especially given the heightened level of fighting this year. To maintain recent import levels of military goods and food, Iraq would have to use almost 90 percent of its estimated 1986 foreign exchange revenues. The full weight of lower spending will fall on remaining development projects, goods for domestic industry, and consumer items. We believe Iraq has banned imports of luxury goods and also will reduce imports of semi-finished products. Many goods are already in short supply and inflation is rising rapidly, yet the full effect of the austerity measures will not be felt for a few more months. [redacted] 25X1

Iraq is also likely to cut government wages, benefits to families of war dead, and subsidies for food and other necessities. We believe a comprehensive rationing of selected food items will be implemented for the first time. [redacted] the government will raise taxes and 25X1 issue long-term state bonds to offset plummeting government revenues. In addition, the regime is trying to reduce the number of foreign workers in Iraq, about 1.2 million in 1985, despite a war-intensified labor shortage. [redacted] 25X1

Iraq's economic crisis poses potentially serious risks for the regime. According to the US Embassy, the leadership in Baghdad is more concerned with falling oil prices than with Iraq's military position. Much of the dissatisfaction with the new austerity will focus on Saddam Husayn's leadership. Efforts to blame foreign powers or several Iraqi officials for the country's economic problems will not shift blame from Saddam for starting the war that has brought economic and human hardships. The loss of perquisites could encourage military officers--already upset by mismanagement of the war--as well as government officials to become even more unhappy with Saddam's leadership. Potential dissidents from within the establishment, however, will be restrained by fear that radical change could hurt Iraq's war-effort and play into Iran's hands. [redacted] 25X1

Effect on Military Options and Balance

Financial constraints alone will not prevent either side from continuing the war in the short-term. Iran is conducting a "labor-intensive" war effort and Arab aid to Iraq should ensure that it does not find itself critically short of military supplies in the next several months. Over the longer term, however, Iran will probably find it difficult to increase the scale of its military operations. Iraq will need to cancel most of its ambitious plans to modernize its forces in favor of replacing lost equipment and used munitions. [redacted] 25X1

The economic problems confronting both countries, moreover, are forcing them to adopt more aggressive policies. Recently, Iraq has increased its attacks on Iran's infrastructure--hitting oil refineries, pumping stations, and bridges--in an effort to aggravate Iran's economic woes and force Tehran to the bargaining table. Although Iraq has the capability to bring much of Iran's economy to a standstill by destroying its electrical system and oil refineries, it has not shown the determination to sustain an effective campaign. This lack of resolve has been evident in Baghdad's sporadic attacks on tankers in the Gulf and on the Khark Island oil terminal that have been little more than an expensive annoyance for Iran. [redacted] 25X1

Falling oil prices have clearly pushed Tehran to assume a more bellicose position toward its Gulf neighbors. Iran has warned Saudi Arabia and Kuwait to restrain oil production in order to bolster prices and to discontinue their massive economic support for Iraq. To underscore the warning, Iran in early May attacked three Saudi tankers in the Gulf and probably will resume such attacks if Riyadh does not cut its oil production. [redacted] 25X1

Economic Balance

Over the next 12 months, we believe continued low oil prices will be more harmful to Iraq than to Iran. Therefore, sustained Saudi and Kuwaiti aid will be crucial if Iraq is to offset Iran's greater economic resilience and better financial position. Since the beginning of the year, however, Arab financial support for Baghdad has fallen short of the 1985 level, rather than risen. Moreover, although discontent in both nations will increase, we believe the Iranian populace is probably more willing to make sacrifices than the Iraqis. [redacted] 25X1

We also believe Iraq will suffer relatively greater economic problems in the coming months. Iraq has less flexibility to raise export revenues. Tehran's larger foreign exchange assets and access to loans give it more options than Baghdad in dealing with falling oil prices. Moreover, the Iranian economy is less dependent on imports and thus less vulnerable to fluctuations in the oil market. [redacted] 25X1

-- Tehran has about $3 billion in readily accessible foreign exchange assets; Baghdad has almost none.

-- Iraq owes $9-10 billion to non-Arab debtors and has virtually no access to further credit. Iran has negligible foreign debts and could probably find lenders willing to provide substantial credit. Japan, West Germany, Italy, and others are likely to be willing to extend at least as much credit to Iran as they have to Iraq--several billion dollars--to maintain their position in the larger Iranian market.

-- Iraqi oil exports are near capacity, with no prospects for significant increase until a new pipeline through Turkey is completed in May 1987. On the other hand Iran might be able to raise oil exports by several hundred thousand b/d within a few months by devoting sufficient resources to its oil sector. Recent price concessions probably indicate Tehran hopes to increase exports in the coming months.

-- The Iraqi economy is more dependent on oil-financed imports.

-- Two-thirds of domestic output in Iraq is directly linked to oil while the oil sector contributes only about one-third in Iran.

-- The large "black economy" and less rigid government direction of the economy in Iran allows for greater efficiency and private provision of many goods. [redacted] 25X1

About $25 billion in financial support from Saudi Arabia and Kuwait since the beginning of the war has helped maintain Iraqi living standards, but current aid levels will probably fall far short of Baghdad's growing needs. Total aid this year is unlikely to offset the $4.3 billion decline in oil revenues unless substantial additional cash payments are made. Without such payments, financial assistance from Saudi Arabia and Kuwait for 1986 will probably be even less than last year's $2.0-2.5 billion. At current prices, aid in the form of oil sales on Iraq's behalf will be worth less than half what it was last year. Moreover, the 300,000 b/d oil aid figure announced by Baghdad may be high because of low production in the Neutral Zone, which accounts for 80 percent of such oil aid. Saudi Arabia has also restricted the flow of Iraqi crude through the Iraq-Saudi pipeline to about 150,000 b/d below its 500,000 b/d capacity, depriving Baghdad of several hundred million dollars in revenues since last November. [redacted] 25X1