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Iran's Economy

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Iran's Economy

Summary

The Islamic Republic of Iran, a resource-rich and labor-rich country in the Middle East, is a central focus of the U.S. national security policy. The United States asserts that Iran is a state sponsor of terrorism and that Iran's uranium enrichment activities are for the development of nuclear weapons. To the extent that U.S. sanctions and other efforts to change Iranian state policy target aspects of Iran's economy as a means of influence, it is important to evaluate Iran's economic structure, strengths, and vulnerabilities.

In terms of external challenge, Iran has long been subject to U.S. economic sanctions and, more recently, to United Nations sanctions. Partly due to the sanctions, some foreign countries and companies, particularly in Europe, have curbed trade and business with Iran. Iran also has faced challenges in obtaining foreign investment for development of its energy sector. Iran has turned to new trading partners, such as China and Russia, and has focused more heavily on regional trade opportunities.

A significant internal challenge is domestic economic mismanagement. With the election of President Mahmoud Ahmadinejad in 2005, Iran's economic policies have worked to reduce regional and class disparities through oil wealth redistribution. Mr. Ahmadinejad has tried to reduce unemployment and poverty through expansionary monetary and fiscal policies, including large energy subsidies and subsidized lending. However, some criticize these policies for contributing to unemployment and inflation and not reducing poverty.

Another domestic vulnerability is Iran's dependence on its oil sector; the government's chief source of revenue is from oil exports. Iran has experienced strong economic growth in recent years due to the rise in international oil prices, but remains susceptible to oil price volatility. Iran has taken steps to diversify its economy, such as through building up its non-oil industry sectors.

Because Iran does not have sufficient refining capacity, the country is highly dependent on gasoline imports to meet domestic consumption needs. To reduce this dependency, the country is seeking foreign investment to develop its petroleum sector. While some deals have been finalized, reputational and financial risks may have limited other foreign companies' willingness to finalize deals.

While some analysts maintain that Iran's economy is performing robustly, others suggest that the economy is underperforming, given the country's vast resources. Despite the challenges faced by Iran, most analysts believe that the economy is not in immediate crisis, given the continued highs in oil prices.

Members of Congress are divided about the proper course of action respect to Iran. Some advocate a hard line, while others contend that sanctions are ineffective at promoting policy change in Iran and hurt the U.S. economy. In the 110th Congress, several bills have been introduced that reflect both perspectives. This report will be updated as warranted by events.

Contents

List of Figures

List of Tables

Iran's Economy

Introduction

The Islamic Republic of Iran, a resource-rich and labor-rich country in the Middle East, is a central focus of the U.S. national security policy. The United States has designated the Iranian government as a state sponsor of terrorism. The Administration's 2006 U.S. National Security Strategy argues that the United States "may face no greater challenge from a single country than from Iran."[1] The United States contends that Iran is a destabilizing force in the Middle East and expresses concern about its growing influence in the region and internationally. The Bush Administration has accused Iran of arming Shiite militias in Iraq, providing support to Hezbollah and Hamas, and inflaming sectarian strife in the Middle East. The Administration also has decried Iran's uranium enrichment activities, which it alleges are being used to develop nuclear weapons.

This report provides a general overview of Iran's economy, addresses related U.S. policy concerns, and discusses policy options for Congress. The purpose of this report is two-fold. First, it provides insight into important macroeconomic trends, policy reforms and objectives, key economic sectors, international trade patterns, and sources of foreign exchange. Secondly, in the context of U.S. economic sanctions imposed for national security and foreign policy reasons, it evaluates Iran's economic structure, strengths, and vulnerabilities and discusses U.S. policy concerns.

While some analysts maintain that Iran's economy is performing robustly, others suggest that the economy is underperforming, given the country's vast resources. External challenges faced by Iran's economy include U.S. and United Nations (U.N.) sanctions and other forms of U.S.-led pressure. Internal challenges include high inflation and unemployment levels, domestic economic mismanagement, dependence on the oil sector for export revenues, and dependence on gasoline imports. Despite the challenges faced by Iran, most analysts believe that the economy is not in immediate crisis, given the current highs in oil prices. This report will be updated as warranted by events.

Background

The 1979 Islamic revolution changed Iran's modern political and economic history. Ayatollah Ruhollah Khomeini and his supporters transformed Iran into an Islamic state with a public sector-dominated economy. Iran's economy subsequently was dealt a hard blow by the protracted, eight-year Iran-Iraq war (1980-1988). In the

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[1] "The National Security Strategy of the United States of America - 2006," March 2006.

post-war era, Iran has strive to rebuild war-torn local production, attract international investment, enhance foreign relations, liberalize trade, and, more recently, redistribute wealth under a series of a five-year economic plans.

Iran is the second largest oil producer in the Organization of the Petroleum Exporting Countries (OPEC) and its oil and gas reserves rank among the world's largest. Iran's economy is largely dependent on oil and is highly susceptible to oil price shocks. The 1973 oil price bust sent the economy spiraling into crisis, while recent oil price surges have increased Iran's export revenue and reserves.

Since the 1979 U.S. embassy hostage crisis in Tehran, Iran has been subject to various U.S. economic sanctions. Such actions have been motivated over time by concerns regarding Iran's nuclear program and support for terrorist organizations. More recently, the United States increasingly has focused on targeted financial measures to isolate Iran from the U.S. financial and commercial system. Sanctions have been imposed in order to change the Iranian government's policies with respect to its nuclear program and support to terrorist organizations. To that end, the United States has imposed sanctions to curtail the development of Iran's petroleum sector and constrain Iran's financial resources in a way that motivates policy change in Iran. The United States also has applied diplomatic pressure on foreign countries and companies to limit business with Iran.[2] In addition to the United States, some European Union states and other countries also have imposed sanctions on Iran in line with the U.N. moves.

The United States also has pushed for stronger international sanctions against Iran in the United Nations. Most recently, in March 2008, the United Nations Security Council passed a third round of sanctions against Iran through Resolution 1803, calling for the inspection of suspicious international shipping to and from Iran that are suspected of carrying prohibited goods. It encourages greater monitoring of named Iranian financial institutions, travel bans for named Iranians, and freezes additional assets related to Iran's nuclear program.

Iran has opposed U.S. and United Nations sanctions vehemently. It has long maintained that the purpose of its uranium enrichment program is to produce fuel for nuclear power reactors, rather than fissile material for nuclear weapons. The government asserts its right to develop nuclear energy for peaceful purposes. Iran increasingly has questioned the justification of the sanctions in light of some recent positive reports on its nuclear activities. A November 2007 U.S. National Intelligence Estimate (NIE) assesses that Iran stopped its nuclear activities for weapons proliferation in 2003. Iran and the IAEA agreed in August on a work program that would clarify the outstanding questions regarding Tehran's nuclear program. Iran has clarified some questions, but a May 2008 IAEA report raised major new questions about Iran's nuclear intentions.

[2] For more information on U.S. sanctions against Iran, see Kenneth Katzman, CRS Report RL32048, "Iran: U.S. Concerns and Policy Responses."

Overview of Iran's Economy

Macroeconomic indicators for Iran provide a mixed picture of the country's economic situation. While the Iranian government asserts that its economy is performing robustly, there are elements of Iranian society that express concern about economic conditions. Some analysts raise questions about the economy's long-term viability and contend that currently rising international oil prices mask vulnerabilities in the economy. The following section discusses certain macroeconomic indicators of Iran's economy.[3]

Iran Overview

Land Area: 1.6 million square kilometers (slightly larger than Alaska)
Population: 65.9 million
Median Age: 26.4 years
Population Growth Rate: 0.8%
Head of State: Mahmoud Ahmadinejad, elected as President in August 2005
Capital: Tehran
Life Expectancy: 70.9 years
GDP: $852.6 billion (purchasing power parity); $278.1 billion (official exchange rate) (2007 estimate)
GDP Real Growth Rate: 4.3% (2007 estimate)
GDP Per Capita: $12,300 (2007 estimate)
GDP Composition: Agriculture, 11%; industry, 45.3%; services: 43.7% (2007 estimate)
Unemployment rate: 11%, reported by Iranian government (June 2007 estimate)
Population below poverty line: 18%
Inflation rate (consumer prices): 17% (July 2007 estimate)
Exports: $76.5 billion f.o.b. (2007 estimate)
Export Commodities: Petroleum, chemical and petrochemical products, fruits and nuts, carpets
Imports: $61.3 billion f.o.b. (2007 estimate)
Import Commodities: Industrial raw materials and intermediate goods, capital goods, foodstuff and other consumer goods, technical services

Source: Central Intelligence Agency (CIA) Factbook, 2008 estimates

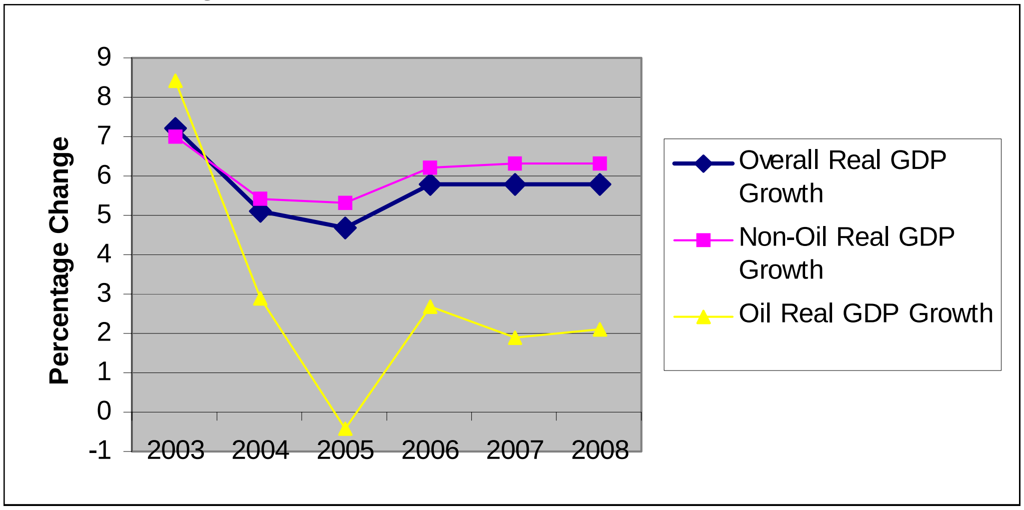
Economic Growth

Since 2000, Iran has experienced positive rates of real economic growth (percentage change GDP). According to the IMF, the annual change in GDP

[3] Economic data for this report is largely based on data from the International Monetary Fund (IMF). As a member of the IMF, Iran reports on its economy to the IMF. The economic data is limited in its means of independent verification by the IMF. In addition, this report relies on data from the Economist Intelligence Unit and Global Insights, international economic research and forecasting agencies. U.S. government sources of data include the Central Intelligence Agency for general economic indicators and the Census Bureau for trade data.

registered at 5.8% for 2006 and was projected to stay level for 2007. Iran's recent economic growth can be attributed largely to rising international oil prices. In addition, positive growth also has been associated with expansionary monetary and fiscal policy reforms under President Ahmadinejad and weather-related agricultural recovery.[4] Iran's non-oil real GDP growth was strong, above 6% for both 2006 and 2007. In comparison, oil real GDP growth has been less, at 2.7% for 2006 and 2.1% for 2007. Oil-related economic growth has been modest partly due to OPEC oil production capacity constraints (see **Figure 1**).[5]

Figure 1. Real GDP Growth in Iran, 2003-2008



Source: International Monetary Fund (IMF), Regional Economic Outlook, May 2008.
Notes: 2007 data are estimated and 2008 data are projected. Oil real GDP growth represents economic growth from the oil and gas sectors. Non-oil real GDP growth represents economic growth from other sectors.

In the past, Iran's economic health has fluctuated, attributed in part to external shocks. During the 1960s and 1970s, Iran's economy experienced real economic growth rates nearing 10%, one of the world's highest. With the 1979 revolution, the Iran-Iraq war, and growing international isolation, Iran faced negative rates of real economic growth during the 1980s. Throughout the early 1990s, Iran experienced post-war recovery. However, the country faced a severe economic downturn in the latter part of the decade due to a drop in international oil prices.[6]

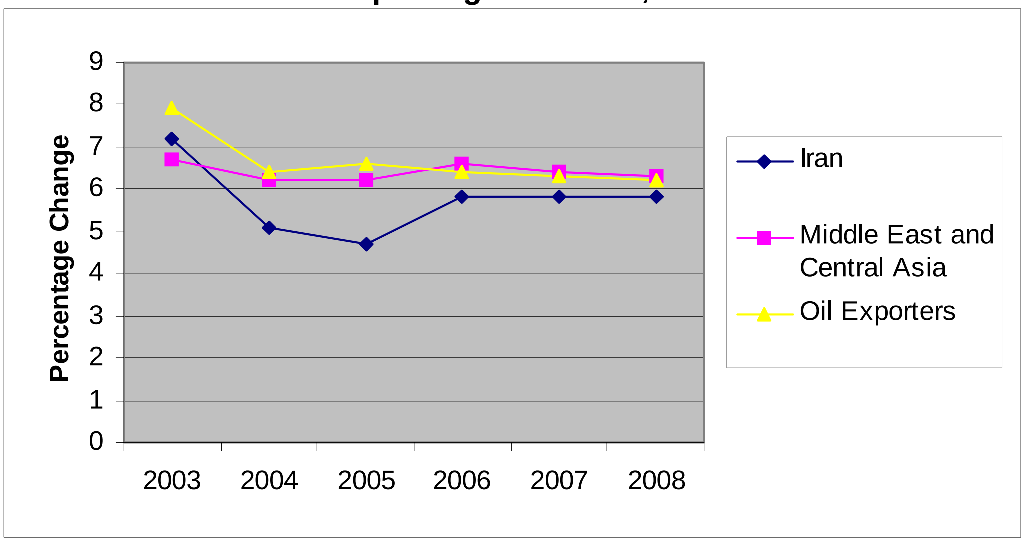
[4] IMF, "Islamic Republic of Iran: 2006 Article IV Consultation ," IMF Country Report No. 07/100, March 2007, p. 7.

[5] The CIA estimated a lower real GDP growth rate estimate of 4.7% for 2007.

[6] Abdelali Jbili, Vitali Kramarenko, and José Bailén, "Islamic Republic of Iran: Managing the Transition to a Market Economy, IMF, 2007, pp.1-5.

Although Iran's economic growth appears to be on the upswing currently, it continues to fall short of average economic growth of the Middle East and Central Asia overall and for oil exporting countries in general (see **Figure 2**).[7]

Figure 2. Real GDP Growth in Iran, Middle East and Central Asia, and Oil Exporting Countries, 2003-2008



Source: International Monetary Fund (IMF), Regional Economic Outlook, October 2007
Notes: 2007 data are estimated and 2008 data are projected. Oil-exporters consist of Algeria, Azerbaijan, Bahrain, Iran, Iraq, Kazakhstan, Kuwait, Libya, Oman, Qatar, Saudi Arabia, Syria, Turkmenistan, and the United Arab Emirates.

Inflation

Other macroeconomic indicators suggest Iran faces some challenges. Inflation levels consistently have been in the double-digits. The Iranian government official estimate for consumer price inflation was 11.7% in 2006. The IMF estimated that inflation reached 17.2% in 2007 and is projected to surpass 20% in 2008.[8] High inflation is widespread among the oil-exporting countries in the Middle East and Central Asia, where inflation averaged an estimated 10.0% in 2007. Among the oil-exporters, Iran's inflation level was second only to Iraq (30.8%) in 2007.[9] Because of inflation, Iran's currency, the *rial*, has been appreciating in real terms against the U.S. dollar.

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[7] IMF, "Regional Economic Outlook: Middle East and Central Asia," *World Economic and Financial Surveys*, May 2008, p. 44.

[8] Ibid.

[9] IMF, "Regional Economic Outlook: Middle East and Central Asia," *World Economic and Financial Surveys*, May 2008, p. 49.

Iranians struggle with the rising cost of basic foods, such as rice, chicken, and eggs, and housing prices,[10] which have eroded real wages. The poor are hit hardest by inflation; it is the poor, mainly from rural areas, who also supported President Ahmadinejad in the 2005 presidential election. Support for President Ahmadinejad weakened marginally during the March 14, 2008 parliamentary elections, despite Iran's economic difficulties.

Inflation levels have been associated with Ahmadinejad's efforts to curb the interest rate. In May 2007, the interest rate for loans was capped at 12% for private and state-owned banks, although the Central Bank proposes interest rate hikes. High levels of inflation also have been associated with a growth in Iran's money supply. The Central Bank figures suggest that the money supply growth has been about 40% annually.

Unemployment

Unemployment levels remain high, reaching 11.5% in 2005/06.[11] At least one-fifth of Iranians lived below the poverty line in 2002.[12] Iran has a young population[13] and each year, about 750,000 Iranians enter the labor market for the first time, placing pressure on the government to generate new jobs.[14] The emigration of young skilled and educated people continues to pose a problem for Iran. The International Monetary Fund (IMF) reports that Iran has the highest "brain drain" rate in the world.[15]

Economic Policy and Reform Efforts

Over the past few decades, Iran has engaged in a series of five-year economic plans in order to shift its state-dominated economy into an economy that is market-oriented, private sector led, and economically diversified. Recent efforts toward economic reform has been mixed because of the stop-and-start nature of reforms and resistance from various elements of Iran's political establishment.

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[10] Anne Penketh, "Iran enters new year in sombre mood as economic crisis bites," *The Independent*, March 24, 2008.

[11] IMF, "Islamic Republic of Iran: 2006 Article IV Consultation ," IMF Country Report No. 07/100, March 2007, p. 7.

[12] EIU, "Iran: Country Profile 2007," p. 33.

[13] About 30% of the population estimated to be under age 15 and less than 5% above age 64 in 2004.

[14] EIU, "Iran: Country Profile 2007," p. 33.

[15] Anne Penketh, "Iran enters new year in sombre mood as economic crisis bites," *The Independent*, March 24, 2008.

Third Five-Year Plan (2000-2004)

Significant attempts at economic reform took place under the third five-year plan (2000-2004), which advocated greater trade liberalization, diversification of economic sectors, and movement toward privatization. The government introduced some structural reforms such as tax policy changes and adoption of new foreign investment laws to promote Iran's global market integration and attract investment. Under former President Mohammed Khatami, Iran shifted to a unified managed float exchange rate system in March 2002.[16] Iran previously maintained a multi-tiered exchange rate system. Iran has had various combinations of exchange rates, including official, export, parallel market, and Tehran stock market versions, at various times. The exchange rate reform is considered to have improved Iran's trading environment and to have enhanced public sector transparency modestly.[17]

Fourth Five-Year Plan (2005-2009)

Iran is currently in its fourth five-year plan (2005-2009), which has taken a largely populist approach. President Ahmadinejad came to office in 2005 with promises to redistribute oil wealth toward poorer segments of the population through social programs and subsidies.[18]

Redistribution Policies. The Ahmadinejad government has engaged in a number of expansionary fiscal and monetary policies aimed at reducing poverty and creating jobs. The government provides extensive public subsidies on gasoline, food, and housing. Energy subsidies alone represent about 12% of Iran's GDP, while total subsidies are estimated to reach over 25% of GDP. When including implicit subsidies, the government's spending on subsidies may be even higher. In addition to subsidies, President Ahmadinejad has handed out cash to the needy.

The government has provided low-interest loans for agriculture, tourism, and industry and has instituted loan forgiveness policies. Other activities include the creation of a number of social programs to assist farmer and rural residents.[19] President Ahmadinejad's cabinet established the $1.3 billion Imam Reza Mehr Fund (Imam Reza Compassion Fund) to assist youth with marriage, housing, and education in 2006.[20] As in other Middle Eastern countries, the rising cost of marriage is

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[16] Abdelali Jbili, Vitali Kramarenko, and José Bailénm "Islamic Republic of Iran: Managing the Transition to a Market Economy," IMF, 2007.

[17] EIU, "Iran rank: Macroeconoimc risk," January 22, 2008.

[18] Ali Alfoneh, "Ahmadinejad versus the Technocrats," AEI, *Middle Eastern Outlook,* May 8, 2008.

[19] Gareth Smyth, "Middle East: Iran cuts farm lending rate in populist 'social justice' move," *Financial Times,* November 15, 2005. Najmeh Bozorgmehr and Roula Khalaf, "World News - Iran: Bank chief takes a realistic tack," *Financial Times,* March 6, 2008.

[20] Najmeh Bozorgmehr and Gareth Smyth, "Coping with the rising cost of marriage, Iranian-style: The new president is to set up a fund to deal with rising expectations of the good life," *Financial Times,* November 8, 2005.

financially prohibitive to many young Iranians. Interest-free loans are available to youth for marriage through the fund.

The government has used oil export revenues from the Oil Stabilization Fund (OSF) to pay for social spending. The OSF was created by Iran's Central Bank, the Bank Markazi, in 2001 to store surplus oil revenue and to smooth economic vulnerabilities associated with oil price fluctuations.[21] The Ahmadinejad government has been criticized by some analysts for using the OSF for handouts and current spending rather than storing for future generations.

Economic Mismanagement Concerns. Some critics maintain that policies under President Ahmadinejad have been a major contributor to budget deficits and are ineffective tools for combating inflation and unemployment.[22] Subsidies and cash handouts are considered by many to un-targeted and ineffective at helping the poor. The IMF has encouraged Iran to reduce its subsidies.[23]

Some economists contend that President Ahmadinejad's efforts to lower the interest rate may lead to excessive liquidity and inflation. Critics, including the recently dismissed Iranian finance mister, Davoud Danesh-Jaafari, express concern about the inflationary risks of uncurbed growth in the money supply.[24]

Economic concerns continued to erode President Ahmadinejad's political support base in the weeks before the March 2008 parliamentary elections.[25] Ahmadinejad's party appeared to emerge from the elections with significant continued support, but some allege that this is because many reformist candidates were disqualified from running. Others say that Ahmadinejad's faction successfully painted Iran's economic difficulties as caused by U.S. pressure.

Analysts debate the extent to which Iran's economic policies are a result of poor decisions by the Iranian government and sub-optimal choices taken by the government in response to U.S. and international sanctions. Some economists believe that the sanctions augment the government's tendency toward state-led rather than private sector-oriented market policies.[26] Given Iran's vast oil wealth, some contend that Iran should be experiencing an economic boom at the present time instead of mediocre economic performance.

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[21] "Iran: Ahmadi-Nejad populism damages economy," Oxford Analytica, February 19, 2008.

[22] Fredrik Dahl, "Iranians worry about high food prices before vote," Reuters, March 6, 2008.

[23] IMF Country Report No. 07/100, "Islamic Republic of Iran: 2006 Article IV Consultation-Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Islamic Republic of Iran," March 2007, [http://www.imf.org/external/pubs/ft/scr/2007/cr07100.pdf].

[24] EIU, "Iran: Monetary shrinkage," April 1, 2008.

[25] EIU, "Business outlook: Iran," March 1, 2008.

[26] Gareth Smyth, "Sanctions fail to fuel dissent on Iran's streets," *Financial Times*, July 24, 2007.

Economic Stakeholders

Iran's economy is still dominated by the state, which is the recipient of revenues from crude oil exports, and quasi-state actors, such as the *bonyads* and the commercial entities of the Islamic Revolutionary Guard Corp (IRGC). Private sector activity is limited, although the government is engaged in some privatization efforts.

Bonyads

Sometimes referred to as "Islamic congolomerates," *bonyads* (Persian for "foundation") are semi-private charitable Islamic foundations or trusts that are believed to wield enormous political and economic power in Iran. They were among the institutions used by the regime to help nationalize Iran's economy after the 1979 revolution. *Bonyads* are not subject to the Iranian government's checks and balances. *Bonyads* report directly to the Supreme Leader and are not subject to parliamentary supervision. They do not fall under Iran's General Accounting Law and, consequently, are not subject to financial audits. Because *bonyads* are not required to disclose their financial activities, it is not known exactly the magnitude of their wealth.

The largest Iranian charitable trust is the Foundation of the Oppressed and War Veterans (*Bonyad e-Mostazafan va Janbazan*, MJF). With over 200,000 employees and 350 subsidiaries, the MJF has an estimated value of more than $3 billion, at least 10% of Iran's gross domestic budget (GDP). The MJF provides financial assistance, medical care, and recreational opportunities to Iran's poor and individuals wounded or disabled from the Iran-Iraq war. Through its company affiliates, the MJF is involved in both Iran's domestic economy and foreign economies. The MJF's domestic economic scope is expansive, with affiliates involved in economic areas such as agriculture, construction, industries, mining, transportation, commerce, and tourism. Since 1991, the MJF has invested in energy, business, engineering, and agricultural activities in Europe, Russia, Asia, the Middle East, and Africa. Some allege that the MJF is used for Iranian intelligence activities for buying dual-use products for proliferation of weapons of mass destruction (WMDs).[27]

Many believe that *bonyads* enjoy a significant advantage over private companies. Prior to the unification of Iran's exchange rate system, the *bonyads* were able to access foreign exchange at deep discounts compared to private enterprises. Presently, *bonyad* officials have longstanding connections with politicians, and frequently get special access to credit at state-owned banks.[28] In addition, *bonyads* get privileges on taxation and import duties. Some critics contend that economic and political reform in Iran will not be significant unless *bonyads* are reformed. Some also contend that they contribute to political corruption and limit the funneling of oil wealth to the poor. *Bonyads* also may limit privatization, because shares for many

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[27] "Iran: Mostzafan va Janzaban Supports Veterans, Covert Activities," Open Source Center report, May 2, 2006.

[28] EIU, "Iran risk: Legal and regulatory risk," January 22, 2008.

of Iran's national companies undergoing privatization are given to *bonyads*, rather than wholly private enterprises.

Islamic Revolutionary Guard Corps

The Islamic Revolutionary Guard Corps (IRGC) was founded in 1979 by the Ayatollah Khomeini and is a branch of the Iranian government's military. The IRGC is comprised of five branches: the Grounds Force, Air Force, Navy, Basij militia, and Qods Force special operations.[29]

The Islamic Revolutionary Guard Corps increasingly is becoming an important player in the Iranian economy. The IRGC's initial economic involvement consisted of postwar reconstruction activities, largely infrastructure projects. More recently, the IRGC has become involved in commercial activity in the construction, oil and gas, and telecommunications sector.[30] Elements of the Iranian private sector have expressed displeasure with the IRGC. Through its powerful connections, the IRGC frequently acquires business contracts for new projects at the expense of private sector businesses. The IRGC also serves as a leading investment tool for many of Iran's leaders.

Some Iranians express concern that the IRGC is involved in Iran's underground economy. The IRGC has significant control over Iran's borders and airports. The IRGC is allegedly involved in smuggling alcohol and other low-level contraband into Iran. Some report that the IRGC smuggles gasoline, which is heavily subsidized in Iran, to other countries for profit.[31]

Some analysts believe that the Revolutionary Guard benefits from Iran's economic isolation. With foreign businesses unwilling or unable to enter into deals, the Revolutionary Guard faces less competition for acquiring new contracts. However, because the IRGC frequently does not have the technical expertise that many international companies do, the IRGC sometimes subcontracts to international companies, making a profit as an intermediary in the transaction.[32]

The United States contends that the IRGC is involved in WMD proliferation activities. Under Executive Order 13382, the United States can sanction entities for proliferation concerns. The sanctions prohibit all transactions between U.S. persons and the sanctioned entity and freeze any assets that the sanctioned entity has in the United States.[33] On October 25, 2007, under E.O. 13382, the U.S. Department of State designated the IRGC for proliferation concerns. The U.S. embargo on the IRGC

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[29] For more information on the IRGC, see Kenneth Katzman, "The Warriors of Islam: Iran's Revolutionary Guard," Westlaw Press, 1993.

[30] Ali Alfoneh, "How Intertwined Are the Revolutionary Guards in Iran's Economy?", American Enterprise Institute, October 22, 2007.

[31] Ibid.

[32] Ibid.

[33] E.O. 13382, "Blocking Property of Weapons of Mass Destruction Proliferators and Their Supporters," June 28, 2005.

represented the first time that the United States has sanctioned a foreign country's military. Also on the same day and under the same executive order, the U.S. Treasury identified nine companies either owned or controlled by the IRGC and five individuals associated with IRGC for proliferation concerns.[34] These companies all are reportedly tied to Iran's energy sector.[35] They are listed below:

Companies:

- Khatam al-Anbya Construction Headquarters: Main engineering headquarters of the IRGC; secured deals of at least $7 billion in oil, gas, transportation, and other sectors[36]; owned or controlled by the IRGC
- Oriental Oil Kish: Drilling company; owned or controlled by the IRGC
- Ghorb Nooh: Owned or controlled by the IRGC
- Sahel Consultant Engineering: Owned or controlled by the IRGC
- Sepasad Engineering Company: Owned or controlled by the IRGC
- Omran Sahel: Owned or controlled by the IRGC
- Hara Company: Engineering firm associated with Khatam al-Anbya; owned or controlled by the IRGC
- Gharagahe Sazandegi Ghaem: Business services company owned or controlled by the IRGC

Individuals:

- General Hosein Salimi: Commander of the Air Force, IRGC
- Brigadier General Morteza Rezaie: Deputy Commander, IRGC
- Vice Admiral Ali Akhbar Ahmadian: Former Chief of the IRGC Joint Staff
- Brigadier General Mohammad Hejazi: Former Commander of Bassij resistance force
- Brigadier General Qasem Soleimani: Commander of the Qods Force

In addition to WMD proliferation concerns, the United States asserts that the IRGC is involved in terrorist activities. E.O. 13224 permits the President to freeze the assets of terrorists and their supporters.[37] On October 25, 2007, the United States

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[34] Treasury press release, "Statement by Secretary Paulson on Iran Designations," October 25, 2007, [http://www.treas.gov/press/releases/hp645.htm].
Treasury press release, "Factsheet: Designation of Iranian Entities and Individuals for Proliferation Activities and Support for Terrorism," October 25, 2007, [http://www.treas.gov/press/releases/hp644.htm].

[35] "U.S. dilemma: Targeting Iran's oil industry could hurt Iran more," *International Herald Tribune*, November 5, 2007.

[36] Treasury press release, "Factsheet: Designation of Iranian Entities and Individuals for Proliferation Activities and Support for Terrorism," October 25, 2007, [http://www.treas.gov/press/releases/hp644.htm].

[37] E.O. 13224, "Blocking Property and Prohibiting Transactions With Persons Who Commit,
(continued...)

sanctioned the IRGC-Qods Force under E.O. 133224. The United States asserts that the Qods Force provides to Hezbollah's military and terrorist activities, with assistance ranging between $100 to $200 million a year.[38]

Private Sector

Prior to the 1979 revolution, Iran boasted a vibrant, significant private sector. However, under the leadership of the Ayatollah Khomeini, the bulk of private sector companies, including commercial banks, were taken over by state and quasi-state institutions. Foreign participation in Iran's economy was prohibited.

Currently, wholly private enterprises are present in agriculture, trade, small-scale manufacturing, and mining, but play a minimal role in large-scale economic activity.[39] In an effort toward more private sector development, Iran began a major privatization initiative in July 2006. It allowed issuances of up to 80% of shares in strategic industries through the stock market, including downstream oil sector businesses, banks, insurance, utilities, and transportation.[40] Iran is also working to privatize state-run oil and gas companies.

Iranian officials have encouraged foreign companies to enter into the Iranian market. However, many business contracts have been won by quasi-state actors, such as the *bonyads* and commercial entities of the IRGC. Some observers are critical of the Iranian government's continued strong involvement in the country's economy. Some Iranians believe that the government needs to invest oil export revenues in Iran's private sector rather than spending revenues on imports[41] and socially minded programs.

Historically, Iran has been a society of trade merchants, the *bazaari* class. As manufacturing in Iran is limited (see below), the merchants import goods, mark up the goods for profit, and then sell. In order to be economically viable, the *bazaaris* need low employment costs, low rents, free trade, and low regulation. The *bazaaris* tend to be skeptical of a large government role in the economy. They are supportive of Iranian trade with foreign countries. However, they tend to be critical of foreign investment because it would open up their companies to foreign competition.[42]

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[37] (...continued)
Threaten to Commit, or Support Terrorism," September 23, 2001.

[38] Treasury press release, "Factsheet: Designation of Iranian Entities and Individuals for Proliferation Activities and Support for Terrorism," October 25, 2007, [http://www.treas.gov/press/releases/hp644.htm].

[39] IMF, "Islamic Republic of Iran: 2006 Article IV Consultation ," IMF Country Report No. 07/100, March 2007, p. 12.

[40] IMF, "Islamic Republic of Iran: 2006 Article IV Consultation ," IMF Country Report No. 07/100, March 2007, p. 12.

[41] Ibid.

[42] Kenneth Katzman, Specialist in Middle Eastern Affairs, Congressional Research Service,
(continued...)

Economic Sectors

Iran's economy is dominated by its industrial sector, which represents about 45% of the country's GDP and includes oil and gas, petrochemicals, steel, textile, and automotive manufacturing. The services sector accounts for another 43% of Iran's economy, while agriculture about 11%.[43] Agriculture continues to be one of the economy's largest employers, representing one-fifth of all jobs based on a 1991 census.[44]

Oil and Gas

Iran boasts the world's third largest proven petroleum reserves following Saudi Arabia and Canada and the second largest gas reserves after Russia. Oil and gas undoubtedly constitute the most important industrial sector to Iran's economy. The oil sector's share of nominal GDP has declined from 30-40% in the 1970s to 10-20%, largely due to destruction of production facilities during the war and OPEC output ceilings. Nevertheless, oil revenue accounts for the majority of export earnings and presents the bulk of government revenue (about 40%). This sector also receives the majority of domestic and foreign investment. Some analysts have expressed concern that excessive focus on the hydrocarbon sector is crowding out investment and expansion opportunities in other sectors and opportunities for economic diversification.[45]

The oil and gas sector is heavily state-dominated. Oil and gas production and exploration are handled by the state-owned National Iranian Oil Company (NIOC). A NIOC subsidiary, the National Iranian South Oil Company (NISOC), represents the majority of local oil production.

Oil. Iran accounts for an estimated 10% of global proven oil reserves (approximately 136 billion barrels). Most of the crude oil reserves are in the southwestern region near the Iraqi border. Among the Organization of the Petroleum Exporting Countries (OPEC) members, Iran is the second largest oil producer following Saudi Arabia. In 2006, Iran produced about 4.2 million barrels per day (mbd), approximately 5% of total global production. Iran also is the fourth largest exporter of crude oil worldwide, after Saudi Arabia, Russia, and Norway.[46] Net crude and product exports in 2006 totaled 2.5 million barrels per day and $54 billion revenues. Top export markets for Iran are Japan, China, India, South Korea, and Italy. More than 40% of the world's oil traded goes through the Strait of Hormuz, a channel along Iran's border. The Strait of Hormuz is considered a global "chokepoint" because of its importance to global energy security. It is a narrow

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[42] (...continued)
Joint Economic Committee Hearing on Iran, July 25, 2006.

[43] CIA Factbook, 2007 estimates.

[44] EIU, "Country Profile 2007: Iran," 2007, p. 27.

[45] EIU, "Country Profile 2007: Iran," 2007, pp. 26-27.

[46] Ibid.

channel with a width of only 21 miles at its widest point through which large volumes of oil are shipped.[47]

While oil export revenues have spiked in recent years due to a surge in oil prices, Iran's oil output has remained essentially flat. The government has set a goal of 5 mbd, which is still below the 6 mbd pre-revolution capacity. Oil production has been hindered by a number of factors. First, the oil industry faces the high rate of natural decline of mature oil fields; the decline rate is 8% for onshore fields and even greater at 10% for offshore fields. Second, oil recovery rates in Iran average between 24% and 27%, much less than the world average. It is believed that millions of barrels of oil are lost annually because of damage to reservoirs and these natural declines. Additionally, structural upgrades and access to new technologies, such as natural gas injections and other enhanced oil recovery efforts, have been limited by a lack of investment and access to new technology, due in part to U.S. sanctions.[48] The United States is restricted from oil development investments in Iran, but other countries, until recently, have actively invested in Iran's oil and gas sector development.

Internally, oil export revenues are used to finance government subsidies and cash handouts to the poor. Of primary concern to the United States and the international community is the use of oil export revenues to finance Iran's nuclear program and support for terrorist groups. Surplus oil earnings are directed to the Oil Stabilization Fund.

Oil Sector Dependence. Iran's dependence on oil export revenues makes the country highly susceptible to the volatility of international oil prices. The quadrupling of global oil prices since 2002 has given Iran enormous economic and political leverage. Steadily rising oil export revenues provide a cushion to the extent to which Iran's economy is affected by international sanctions.

Economic forecasts suggest that in the near-term, oil prices will not drop, but any unexpected future drop could cripple Iran's economy, reducing government revenue and spending and potentially increasing Iran's vulnerability to sanctions. An unanticipated drop in oil prices to below $40 per barrel for more than one quarter could pose fiscal pressure.[49] Oil price drops also would affect the private sector, as Iran imports a significant portion of its capital and machinery goods from abroad. A fall in oil prices and subsequent economic downturn may increase political dissent among Iranians, already facing high unemployment and inflation levels.

A dramatic, unexpected drop in oil prices may be cushioned by a number of factors. Iran may be able to draw from its Oil Stabilization Fund to cushion an oil price bust. However, observers warn that this means Iran would have to restrict its current spending from the OSF to fund imports.

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[47] Energy Information Administration (EIA), "World Transit Oil Chokepoints," January 2008.

[48] EIA, "Country Analysis Briefs: Iran," October 2007.

[49] Global Insight, "Iran: Global Risk Service," April 1, 2008 update.

Iran also has been working to reduce its dependence on oil export revenues by building up other sectors of its economy. In an attempt to diversify its exports, Iran also is building up its petrochemicals industry.[50] The industry reportedly faces some challenges from state intervention and price-fixing. Additionally, international sanctions have reduced commercial banks' willingness to finance international deals to build the petrochemical sector.[51] According to Iranian Oil Minister Gholam-Hossein Nozari, Iran's petrochemical industry needs an estimated $30 billion in investment.[52]

Iran's non-oil exports have increased dramatically, which the government cites as a testament to its increased diversification. Non-oil exports, thus, may be able to alleviate economic harm from a future drop in oil prices, although the economy likely would still suffer.

Iran's economy would be threatened if there was a widespread embargo on its oil exports. This prospect is unlikely, given the fact that Iran is the second largest oil-producer in OPEC and other oil-producing countries do not have the excess capacity to make up for a loss of oil supply from Iran.

Because Iran's economy is largely dependent on oil export revenues, Iran is developing its natural gas sector in an effort to diversify its economy. In addition, natural gas production would help increase export earnings and help to meet growing domestic consumption demands for electricity.

Natural Gas and Gasoline. With an estimated 15% of the world's gas reserves, Iran has the second largest natural gas reserves globally, following Russia. Despite its vast gas resources, Iran has been unable to become a major international gas exporter. In fact, Iran was a net importer of natural gas as late as 2005.

Iran is the world's second largest gasoline importer after the United States. Iranian gasoline imports in 2006 totaled about $5 billion. About 40% of Iran's domestic consumption of gasoline is met by imports.

Extensive government subsidies on gasoline have contributed to high gasoline consumption rates. Many analysts contend that high subsidies do not give Iranians an incentive to conserve. In addition, there has been an increase in vehicle sales, particularly of fuel-inefficient older models. Import levels are also high because Iran has limited domestic refinery capacity to produce light fuels. However, gasoline's share of imports has fallen recently, from 18% in 2005 to 6% during the first eleven months of FY2007-08, according to Iran's Customs Administration. In June 2007, the government implemented a gasoline rationing system to reduce gasoline consumption. This policy was extremely unpopular and led to public riots, but has led to a drop in gasoline consumption. Oil consumption also is declining as consumers are moving more toward natural gas use.

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[50] EIU, "Country Profile 2007: Iran," 2007, p. 44.

[51] "Iran Petrochemicals Report Q1 2008," *Business Monitor International*, February 20, 2008.

[52] "Iran calls for foreign investments in petrochemical projects," IRNA, May 17, 2008.

Gasoline Supplies. Major gasoline suppliers to Iran historically have been India, Turkmenistan, Azerbaijan, the Netherlands, France, Singapore, and the United Arab Emirates. Iran also imports gasoline from multinational companies (MNCs), particularly Europe-based wholesalers. Based on data from 2005 through 2006, Turkmenistan was Iran's only supplier of natural gas.[53] In 2006, Vitol, a MNC based in Switzerland, supplied Iran with 60% of its total gasoline cargo imports. In December 2007, Vitol reportedly declined to renew long-term contracts with Iran, but still provides gasoline to Iran on the spot market. Major gasoline suppliers to Iran include BP, Royal Dutch/Shell (Netherlands), Total (France), Lukoil (Russia), and Sinopec (China). In addition, Venezuela supplies small quantities of gasoline from time to time in a show of political solidarity with Iran. Iran and Venezuela have sought to counter U.S. global influence and strengthen their own international standing and reputation through strategic alliances.[54]

Iran would be threatened if it was cutoff from imports of gasoline and natural gas, as the economy is highly dependent on such imports to meet its domestic consumption demands. This vulnerability was highlighted in December 2007, when Turkmenistan halted natural gas supplies to Iran in a pricing dispute. Millions of Iranians suffered from the bitter cold with lack of gasoline for heating during one of the coldest winters in recent Iranian history. Turkmenistan has since resumed supplying gasoline to Iran.

Foreign Involvement in Oil and Gas Development. Iran has sought foreign investment in the development of its gas fields and has sought to increase its export market of natural gas as well. In the near-term, the petroleum sector appears to be healthy, but is plagued with aging infrastructure and old technology. In order to boost oil production to levels to pre-Iran-Iraq war levels and develop refining capacity, Iran needs international investment.

Foreign activity in the hydrocarbon sector is conducted under a buy-back system, under which international oil companies contract with an Iranian affiliate, who receives a fee - such as an "entitlement to oil or gas from development operation." In 2006, buybacks were projected to reach $500 million.[55] The buyback system is unpopular and is believed by some analysts to contribute to the lack of foreign investment and activity in Iran's hydrocarbon sector.

Among some more recent deals, Switzerland's energy company EGL, signed a 25-year LNG export deal with Iran's National Iranian Gas Export Company on March 17, 2007, reportedly valued at €18 billion. Switzerland will buy 5.5 billion cubic meters of Iranian natural gas each year, beginning in 2011. This would be

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[53] Telephone conversation with EIA official, April 29, 2008.

[54] Energy Information Administration, "Country Analysis Briefs: Iran," October 2007. Telephone conversation with EIA official, April 29, 2008.
Power and Interest News Report (PINR), "Iran Looks for Allies through Asian and Latin American Partnerships," May 27, 2007.

[55] IMF, "Islamic Republic of Iran: 2006 Article IV Consultation ," IMF Country Report No. 07/100, March 2007, p. 29.

Europe's second largest gas deal.[56] There is some skepticism that Iran will not be able to supply gas to Switzerland for the foreseeable future because no pipeline connects Iran to Europe at present.

In April 2007, OMV, the Austrian partially state-owned energy company, signed letters of intent with Iran, worth an estimated $22.8 billion (22 billion euros), for Iran to supply Europe with gas.[57] The United States has expressed strong opposition to both the Swiss and Austrian deals with Iran. The State Department is evaluating the deals for possible violations of the Iran Sanctions Act.[58]

Other notable petroleum sector development deals include those with Russia and China. On February 19, 2008, Russian state gas company Gazprom announced a deal to establish a joint venture company to develop the offshore Iranian South Pars gas field. Iran would benefit from a build-up of its gas export infrastructure.[59]

A China National Offshore Oil Corporation (CNOOC) investment deal, valued at $16 billion, to develop Iran's North Pars gas field and to build a liquid natural gas (LNG) plant, was supposed to be signed on February 27, 2008 but has been delayed. Some analysts believe that China has been hesitant to finalize the deal because of international reaction to Iran's nuclear program and the tightening of United Nations sanctions. The state-operated National Iranian Oil Company (NIOC) and CNOOC signed a memorandum of understanding in December 2006 for the project, under which CNOOC would purchase 10 million metric tons per year of LNG for 25 years.[60] The United States has criticized China's pursuit of the deal with Iran. China has also looked into alternate suppliers, such as Qatar and Australia.[61]

The National Iranian Gas Company (NIGC) is expected to finalize a natural gas export deal with Pakistan in April 2008, with exports set to begin in 2011. The gas would be transported through a "Peace Pipeline," worth about $7.4 billion. The plan initially also included exporting gas to India, but negotiations have stalled over pricing. The United States has strongly opposed the pipeline and pressured India and Pakistan to halt the project.[62]

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[56] Benjamin Weinthal, "Switzerland to sign second-largest Iran gas deal today," *The Jerusalem Post*, March 17, 2008.

[57] Benjamin Weinthal, "Switzerland to sign second-largest Iran gas deal today," *The Jerusalem Post*, March 17, 2008.

[58] Eli Lake, "State Department Looks to Sanction Law," *The New York Sun*, March 21, 2008.

[59] "Gazprom announces gas deals with Iran and Nigeria," *Energy Economist*, March 1, 2008.

[60] "Chinese delegation to sign major gas deal soon: source," Platts Commodity News, March 5, 2008.

[61] David Winning and Renya Peng, "Update: CNOOC, Iran to Ink Deal for 10 Mln Tons LNG-Sources," Dow Jones Newswires, January 21, 2008.

[62] "Project News - Iran Finalizing Pakistan Gas Deal," *BMI Industry Insights - Oil & Gas, Middle East & Africa*, March 12, 2008.

Iran also is discussing a gas production and export deal with Turkey. Under the plan, Turkey would assist in developing Iran's South Pars field in exchange for cash or natural gas. Gas would be shipped from Iran to Turkey and other parts of the world via a new pipeline that Turkey plans to build.[63]

International Sanctions on Oil and Gas Sector Development. The oil and gas sectors' susceptibility to international sanctions is debatable. U.N. and some U.S. sanctions are targeted toward obstructing Iran's development of its oil and gas sectors in order to constrain Iran's resources for uranium enrichment and alleged terrorist financing.[64]

U.S. sanctions have limited Iran's access to technologies from abroad that are necessary for developing liquid natural gas plants. The intellectual property for these technologies belong to a small network of U.S. and Japanese companies. Providing such technologies to Iran would violate the U.S. trade ban on Iran.[65]

Foreign investment in Iran's oil and gas sectors is a mixed picture. Foreign investment has been limited. In part, this is because foreign companies have had difficulty obtaining financing due to U.S. Treasury Department pressure on international banks to cut off ties with Iran,[66] and in part, it is due to the hesitancy of foreign companies to incur U.S. opposition. Additionally, many U.S. allies are wary of how their business deals with Iran may affect their relations with the United States. International sanctions have reduced foreign investment to some extent, particularly by Western countries, but Iran appears to be successfully negotiating deals with some Asian countries. While new agreements have been negotiated, their successful completion has been slow. According to a GAO report, State and Treasury officials assert that U.S. sanctions have contributed to a delay in foreign investment in Iran's hydrocarbon sector.[67] Others point out that LNG contracts with Asian and Eastern European countries may not be able to deliver the same quality as Western contracts. For instance, despite the possible termination of Shells' LNG project with Iran, Iran appears to be "keep[ing] open the option of enlisting Shell's technical and marketing know-how and financial input for an LNG project linked to a future phase of South Pars."[68]

Iran is engaging in efforts to privatize nearly 50 state-run oil and gas companies, estimated to be worth $90 billion, by 2014 through the Tehran Stock Exchange. Both domestic and foreign investors would be able to buy shares. Privatization of these energy companies may make it easier for investors to circumvent U.S. sanctions,

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[63] Turkish Daily News, "Iran, Turkey to Discuss Gas Projects," May 5, 2008.

[64] See Kenneth Katzman, CRS Report RS20871, "The Iran Sanctions Act."

[65] Samuel Ciszuk, "Tightened Iran Sanctions Introduced by UN Security Council in Anticipation of IAEA Report," February 22, 2008.

[66] "Iran economy: Oil breakthrough?", Economist Intelligence Unit, December 10, 2007.

[67] GAO-08-58, "Iran Sanctions: Impact in Furthering U.S. Objectives Is Unclear and Should Be Reviewed," p. 18, December 2007.

[68] EIU, "Iran economy: Au revoir LNG? - Country Briefing," ViewsWire, May 12, 2008.

which complicate investors' ability to engage in business transactions with Iran directly.[69]

Agriculture

Iran's agriculture sector is substantial. Iran is a major source of caviar and pistachio nuts, which constitute significant non-oil exports for Iran. Iran's climate and terrain also support tobacco, tea, wheat and barley, among other food commodities.

Iran's agriculture sector is vulnerable to climate change. For instance, a severe drought period from 1998 to 2001 was highly damaging to production. Subsequently, Iran became a major importer of wheat; major suppliers were Canada, Australia, Argentina, and France. In 2004, Iran did not import wheat for the first time in years. In addition to climate change, the agricultural sector faced setbacks in production during the 1979 revolution and the war with Iraq.[70] Overfishing and environmental degradation also threaten the agriculture sector.

Iran typically has used oil export revenues to pay for agricultural imports. However, rising international food commodity prices combined with a large population increase have placed pressure on Iran's economy, despite high international oil prices. Other Middle Eastern countries are experiencing similar economic strains.[71]

Manufacturing

Iran is working to build up various industries within its manufacturing sector. There is some concern that Iran's manufacturing sector has declined because oil export revenues have increased Iran's exchange rate, making the manufacturing sector less competitive. This theory was coined the "Dutch Disease" by *The Economist* in 1977 to describe Netherlands' manufacturing sector in the 1960s following the discovery of natural gas.[72]

Iran is the largest producer of steel in the Middle East.[73] In 2006, Iran ranked as the 20th largest producer of crude steel globally, with an output of 9.8 million metric tons. Despite Iran's high production levels, the country is a net importer of steel. Based on most recently available data from the International Iron and Steel

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[69] "Tehran opens energy sector to overseas investment," *Middle East Economic Digest*, February 8, 2008.

[70] EIU, "Country Profile 2007: Iran," 2007, pp. 35-36.

[71] Javier Blas, "Mideast reels as hunger outgrows oil earnings," *Financial Times*, May 7, 2008.

[72] "Economy & Dutch Disease," *Iran Daily*, *Islamic Republic News Agency*, April 24, 2007. Lionel Beehner, "What Sanctions Mean for Iran's Economy," Council on Foreign Relations, May 5, 2006.

[73] EIU, "Country Profile 2007: Iran," 2007, p. 45.

Institute, Iran was the 14th largest importer of steel in 2005, with net imports reaching 6.9 million metric tons.[74] There has been a ramp up of growth in demand for steel in the Middle East, fueled by the need for investments in energy project infrastructure and expansion of construction activity. Due to rising demand, Iran plans to double its steel production by 2010.

Iran is the 15th largest motor vehicle producer in the world and the largest automaker among the Middle Eastern countries. Motor vehicle production ramped up by 10.3% to 997,240 units in 2007. Iran produces both light and heavy vehicles.[75] Its two biggest automakers are Iran Khodro and Sapia.[76] Auto plants frequently have outdated technology and parts must be imported through third countries. Cars frequently are not fuel-efficient, contributing to pollution.[77]

Despite Iran's high level of automotive production, domestic demand for motor vehicles exceeds supply. Iran imports a variety of vehicles, including basic models, luxury vehicles, and vehicles for construction and mining. Iran reduced the tariff rate on auto imports in 2006.

Iran recently began joint ventures with foreign companies for auto production, including Peugeot and Citroen (France), Volkswagen (Germany), Nissan and Toyota (Japan), Kia Motors (South Korea), Proton (Malaysia), and Chery (China).[78] Foreign companies have entered the Iranian auto market with some caution in light of concerns about U.S. reaction and reputational risks.

Additionally, there has been a growth in agriculture-related manufacturing, such as rice milling and manufacturing of canned food and concentrates, fruit juices, and confectionary. Foreign companies, such as Nestle, Coca Cola, and Pepsi have signed deals for production with local Iranian businesses.[79] Under U.S. sanctions regulations, foreign subsidiaries of American companies are able to trade or engage in business in Iran.

Finance

Following the 1979 revolution, all of Iran's banks were nationalized and foreign banks were banned. Over the past couple of decades, Iran has engaged in some privatization and liberalization of its financial sector. In 2001, Iran's Central Bank approved licenses for three full functioning private banks. Efforts toward

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[74] International Iron and Steel Institute, "Major importers and exporters of steel, 2005," [http://www.worldsteel.org/].

[75] International Organization of Motor Vehicles (OICA), "World Motor Vehicle Production by Country and Type: 2006-2007," [http://oica.net/category/production-statistics/].

[76] Eric Ellis, "Made in Iran," *Fortune Magazine*, September 12, 2006.

[77] Eric Ellis, "Made in Iran," *Fortune Magazine*, September 12, 2006.

[78] EIU, "Country Profile 2007: Iran," 2007, p. 45. Prime Vista Research and Consulting, "Automotive Industry and Marketing of Iran 2007," June 2007.

[79] EIU, "Country Profile 2007: Iran," 2007, p. 46.

privatization have been thwarted frequently by the Guardian Council. Iran's financial sector continues to be heavily dominated by large state-owned banks.

State-owned banks are considered by many to be poorly functioning as financial intermediaries. Extensive regulations are in place, including controls on rates of return and subsidized credit for specific regions. In May 2007, President Ahmadinejad capped lending rates to 12% for state-owned banks and 13% for commercial banks, despite strong opposition from the Central Bank. Most of the financial intermediaries' loan portfolios are comprised of low-return loans to state-owned enterprises and quasi-government agencies, such as the *bonyads*. Some believe that the financial system has stifled domestic business and has lowered Iran's attractiveness to foreign businesses.

The Bank Markazi, Iran's Central Bank, is not able to conduct a "proactive" monetary policy and has no control over the government's fiscal policy. In addition, the Central Bank is limited in its ability to issue direct instruments to combat inflationary pressures. The Central Bank must obtain approval from the *Majlis* in order to issue participation papers.[80]

Tehran Stock Exchange. In 1967, Iran began operating its stock exchange - the Tehran Stock Exchange (TSE). With initially only six companies, the TSE now lists over 300 companies. Capitalization through the TSE is permitted for the automotive, mining, petrochemical, and financial sector. Since 2005, foreign investors have been able to participate in the TSE. Foreign investors are permitted to hold a maximum of 10% of shares of each company listed and are not allowed to withdraw their capital for three years after purchases.

The Tehran Stock Exchange has fluctuated in recent years. The TSE index performed strongly between 2000 and 2004, rising by more than tripling, but declined following President Ahmadinejad's election in 2005. During the 2007, the TSE market stabilized, but was still 20% lower than before Ahmadinejad came into power.[81] It is hoped by the Ahmadinejad government that privatization plans will help to revive the stock market.

Foreign activity in the TSE is low. Aside from concerns about the international tensions associated with Iran's nuclear standoff, this may reflect concerns about liquidity, transparency, and the poor legal environment protecting foreign holdings.[82]

Financial Sanctions. The U.S. Department of Treasury recently has employed targeted financial measures against Iran. The United States is attempting to isolate Iran from the international financial and commercial system in an effort to promote policy change in Iran regarding its nuclear program and purported terror financing. The United States also hopes that financial isolation will limit Iran's

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[80] EIU, "Iran economy: Quick View - Monetary strife - Country Briefing," ViewsWire, April 21, 2008.

[81] EIU, "Iran risk: Financial risk," April 23, 2008.

[82] Ibid.

resources for its nuclear program and its alleged support for terrorist organizations. In recent congressional testimony, the Treasury Deputy Assistant Secretary for Terrorist Financing and Financial Crimes stated, "Iran utilizes the international financial system as a vehicle to fund these terrorist organizations... the Iranian regime operates as the central banker of terrorism, spending hundreds of millions of dollars each year to fund terrorism."[83]

Several major Iranian banks are under U.S. and U.N. sanctions. Under Executive Order (E.O.) 13224,[84] the Treasury has designated several Iranian entities for supporting terrorism. On October 25, 2007, the Treasury designated Bank Saderat, a major Iranian state-owned financial institution, for terrorism support. Iranian authorities contend that two external audits of Bank Saderat conducted in Lebanon and London found no evidence of such allegations.[85]

On January 9, 2007, the Treasury sanctioned Bank Sepah, another major Iranian financial enterprise, under E.O. 13382[86] for assisting with Iran's missile program.[87] U.N. Security Council Resolution 1747 named Bank Sepah and Bank Sepah International as financial institutions involved in financing nuclear or ballistic missile activities. Subsequently, on October 25, 2007, under E.O. 13382, the Treasury Department sanctioned Bank Melli and Bank Mellat, other major Iranian financial institutes, as WMD proliferators or supporters.[88]

In a signal to Arab countries, the United States sanctioned the Bahraini Future Bank B.S.C. in March 2008 under E.O. 13382 for reportedly assisting in Iran's nuclear and missile programs. The United States contends that Future Bank B.S.C. is controlled by the embargoed Bank Melli.[89]

Money Laundering. Iran's financial system may be vulnerable to money laundering. Since 2002, the Central Bank of Iran has engaged in efforts to combat

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[83] Daniel Glaser, Testimony before the House Committee on Foreign Affairs Subcommittee on the Middle East and South Asia and the Subcommittee on Terrorism, Nonproliferation, and Trade, April 17, 2008, HP-933.

[84] E.O. 13224, "Blocking Property and Prohibiting Transactions With Persons Who Commit, Threaten to Commit, or Support Terrorism," September 23, 2001.

[85] IMF, "Islamic Republic of Iran: 2006 Article IV Consultation ," IMF Country Report No. 07/100, March 2007, p. 17.

[86] E.O. 13382, "Blocking Property of Weapons of Mass Destruction Proliferators and Their Supporters," June 28, 2005.

[87] Treasury press release, "Iran's Bank Sepah Designated By Treasury," January 9, 2007, [http://www.treas.gov/press/releases/hp219.htm].

[88] Treasury press release, "Statement by Secretary Paulson on Iran Designations," October 25, 2007, [http://www.treas.gov/press/releases/hp645.htm]. Treasury press release, "Factsheet: Designation of Iranian Entities and Individuals for Proliferation Activities and Support for Terrorism," October 25, 2007, [http://www.treas.gov/press/releases/hp644.htm].

[89] Treasury press release, "Treasury Designates Iran-Controlled Bank for Proliferation: Future Bank Controlled by Iran's Bank Melli," March 12, 2008, [http://www.treas.gov/press/releases/hp869.htm].

money laundering. In February 2008, Iran passed its first anti-money laundering law, which criminalized money laundering. Critics contend that Iran's money laundering framework is not adequate to combat the terrorist financing through Iran's financial system. There is international concern that these vulnerabilities pose a threat to the international financial system.

On March 3, 2008, the U.S. Treasury's Financial Crime Enforcement Network issued a statement emphasizing concern about ongoing deficiencies in Iran's efforts to combat money laundering and the financing of terrorism through its financial system. The U.S. Treasury advisory stated that, using state-owned banks, Iran "disguises its involvement in proliferation and terrorism activities through an array of deceptive practices specifically designed to evade detection." Of particular concern to the U.S. Treasury is that Iran's central bank and commercial banks have requested their names to be removed from international transactions in order to make it more difficult to track their involvement.

The Treasury advisory noted 59 major Iranian banks or their branches in international financial cities that pose threats, including Iran's central bank. None of the banks listed currently face United Nations or U.S. sanctions.[90] The advisory encouraged all financial institutions to consider the risks associated with doing with the specified Iranian financial institutions.[91] Additionally, the Financial Action Task Force (FATF), a Paris-based "international financial watchdog," called on its 34 member states to encourage banks to monitor their financial interactions with Iran. The FATF alleges that Iran has not taken adequate actions to combat money laundering and terror financing.[92] Iranian officials assert that Iran's central bank complies with international best practices and that it vigilantly regulates domestic financial institutions.

Informal Finance Sector. Many Iranian businesses and individuals also rely on *hawala*, an informal trust-based money transfer system that exists in the Middle East and other Muslim countries. *Hawala* transactions are based on an honor system, with no promissory instruments exchanged between the parties and no records of the transactions. Some analysts consider the *hawala* system as particularly susceptible to terrorist financial transactions.

Since the imposition of recent U.S. and U.N. financial sanctions on Iran, the use of *hawala* by Iranians reportedly has increased. It is considered by many Iranians as a more cost-effective way to transfer money in light of the added expenses incurred through working through the formal financial system in light of the sanctions. According to a Iranian merchant, "If we wanted to send money through the banking system it would cost a small fortune, so we move money to dealers and they send the

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[90] Robin Wright, "Iran a Nuclear Threat, Bush Insists; Experts Say President Is Wrong and Is Escalating Tensions," *The Washington Post*, March 22, 2008.

[91] Daniel Dombey and Stephani Kirchgaessner, "Steer clear of Iran central bank, says US," *Financial Times*, March 21, 2008. Jeannine Aversa, "Treasury warns banks that Iran is engaging in deceptive practices to skirt sanctions," Associated Press, March 20, 2008.

[92] Jeannine Aversa, "Treasury warns banks that Iran is engaging in deceptive practices to skirt sanctions," Associated Press, March 20, 2008.

money through Dubai to China." While some assert that the use of *hawala* shows that Iran is able to successfully circumvent international sanctions, others suggest that the increased use of *hawala* is a sign of the sanctions' effectiveness in making it more difficult for Iran to finance transactions.[93]

International Trade

International trade contributes significantly to Iran's economy and has increased dramatically over the past few years. Total trade in merchandise (exports plus imports) reached nearly $140 billion in 2007. Similar to other countries in the Middle East and North Africa region benefitting from high world oil prices, Iran enjoyed a trade surplus in goods, registering at $15.2 billion in 2007. Exports totaled about $76.5 billion, while imports reached about $58.0 billion that same year (see **Table 1**).

Table 1. Iran Merchandise Trade, 2003-2007
(millions of U.S. dollars)

Merchandise	2004	2005	2006	2007
Exports	44,364	60,013	70,514	76,498
Oil and gas	36,827	48,824	55,579	57,956
Non-oil and gas	7,537	11,189	14,935	18,542
Imports	38,199	48,824	53,984	61,336
Gasoline	2,639	4,190	5,745	6,135
Trade Balance	6,165	11,189	16,530	15,162
Total Trade	82,563	108,837	124,498	137,834

Source: IMF
Notes: Iran's fiscal year starts March 21st. Data for 2005 are preliminary. Data for 2006 and 2007 are projected.

Oil and gas exports dominate Iran's export revenues, constituting about 80% of total exports and are the most important source of foreign exchange earnings for the country. Other major export commodities are petrochemicals, carpets, and fresh and dried fruits. Top destinations for Iran's non-oil exports, including natural gas liquids, are the United Arab Emirates (UAE), Iraq, China, Japan, and India.

Major Trading Partners

Important export markets for Iran are Japan, China, Turkey, and Italy. Major merchandise suppliers for Iran include Germany, China, the United Arab Emirates, and South Korea (see **Table 2**).

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[93] Anna Fifield, "No problem," *Financial Times*, April 14, 2008.

Table 2. Major Export Markets and Sources of Imports for Iran, 2006
(millions of U.S. dollars)

Country	Exports	Imports	Trade Balance	Total Trade
China	9,042	4,927	4,115	13,969
Germany	412	5,674	-5,262	6,086
Italy	4,451	2,537	1,914	6,988
Japan	9,887	1,291	8,596	11,178
Russia	216	2,085	-1,869	2,301
South Korea	4,260	2,534	1,726	6,794
Turkey	5,115	1,173	3,942	6,288
United Arab Emirates	633	4,381	-3,748	5,014

Source: IMF, Direction of Trade Statistics

Germany. Historically, Germany has been one of Iran's most important trading partners. However, Germany-Iran trade has declined in recent years, as Iran's trade with other countries, particularly the United Arab Emirates and China, has grown. In 2007, German imports from Iran rose by close to 50% in 2007, while German exports to Iran fell by about 15%.

United Arab Emirates and Transshipment Trade. The UAE is a major trading partner for Iran, with trade largely dominated by UAE exports to Iran. According to the UAE Ministry of Economy, total non-oil trade between UAE and Iran was upwards of $6 billion in 2006. The bulk of merchandise supplied to Iran by the UAE is believed to be products imported into the UAE from foreign markets, including the United States, European Union, China, and India, and subsequently repackaged for shipment to Iran. Iran represents about 14% of the UAE's total exports, including re-exports. According to the Dubai Chamber of Commerce and Industry, re-exports accounted for about 60% of the UAE's $6.8 billion trade with Iran in 2006. The rest of the trade came from the UAE's free trade zones. Iran's foreign investments in Dubai are more difficult to verify, but may have neared $300 billion, about a quarter of Iran's total foreign investments.[94]

The UAE thrives as a central re-exporting and distribution center in the Persian Gulf because of its low tax rates, free trade zones, lower delivery times, enhanced handling and service capacity, and a perception of lax export controls. Dubai, in particular, is Iran's economic lifeline to the rest of the world. Through Dubai, Iran is able to import goods that the country cannot import directly due to international and U.S. sanctions. Although U.S. businesses are outlawed from operating in Iran, many reportedly can circumvent U.S. sanctions by sending their investments through Dubai.

The United States increasingly has pressured the UAE to make its export controls more stringent. Generally speaking, the UAE has resisted such pressure. In recent months, the UAE appears to be taking actions to regulate trade and investment

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[94] Ibid.

relations with Iran in a more stringent manner. In September 2007, the UAE passed a law permitting it to place restrictions on dual-use technologies, chemical and biological weaponry, and military equipment. The UAE recently used the new law for the first time to impound a vessel at Jebel Ali that was delivering merchandise to be transshipped to Iran.[95] About 40 Iranian companies were closed in 2007 based on UAE efforts to reduce trade in goods with potential "dual use."[96]

While UAE-owned banks continue to open letters of credit to back exports from Iran, some say that it is becoming harder for Iranian-based businesses to obtain letters of credits from UAE or foreign banks based in Dubai in order to fund imports of goods into Iran. In particular, some Iranian businesses have witnessed foreign banks' hesitancy in honoring letters of credit issued by Iranian banks under U.S. sanctions. UAE-based banks sometimes are wary of how such transactions may be viewed internationally and presumably concerned about funds being frozen. Consequently, Iranian businesses have had to shift to other regional banks or have had to engage in cash-based transactions. Either route has raised the costs of goods on the end-user.[97] On the whole, these actions have not hindered transshipment of Iranian products to the rest of the world or Iranian imports from the rest of the world through Dubai. Still, some parts of the Iranian business community are concerned about the potential implications of a more stringent UAE approach to commercial ties with Iran. There is a possibility that trade diversion to Iran may take place through other countries if the UAE is perceived as a hostile business environment.[98]

New Trading Partners. Facing challenges in trading with Western countries, Iran has pursued increased integration with its neighbors in the Middle East. Merchandise trade with the Middle East has ballooned. Arab nations may be weary of Iran's nuclear ambitions, but they appear to see the value of trade and investment relations with Iran. Many are hoping that positive economic engagement with Iran will mitigate international tensions over Iran's nuclear ambitions. Iran also has sought to strengthen ties with China and other Asian countries. While official data is not yet available, some analysts expect that China may have been Iran's biggest exporter in 2007; major exports to Iran include mechanical and electrical equipment and arms, as noted above. Furthermore, several countries in central Asia have declared their interest in boosting economic engagement with Iran, including Tajikistan.[99] Iran, Turkey, and Azerbaijan have held discussions on building a joint railway through the three countries in order to enhance relations, trade, and travel.[100]

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[95] Barbara Surk, "Dubai at center of US efforts to pressure Iran, "Associated Press Newswires, October 26, 2007.

[96] "UAE/Iran: Trade squeeze, or business as usual?", EIU - Business Middle East, January 16, 2008.

[97] Ibid.

[98] Ibid.

[99] "Tajik speaker says Tahikistan keen on active cooperation with Iran," ASIA-Plus Information Agency, March 27, 2008.

[100] "Iran, Azerbaijan, Turkey to build joint railway," BBC Monitoring Caucasus, March 27,

(continued...)

U.S.-Iranian Trade. U.S. trade with Iran is limited, receding drastically with the 1987 U.S. ban on imports from Iran and the 1995 ban on U.S. exports to and investments in Iran. Before 1995, major U.S. exports to Iran included machinery and industrial equipment. U.S. exports virtually came to a standstill with the 1995 embargo on U.S. trade and new investment in Iran. Sanctions were relaxed to a certain extent in 2000, with the election of President Khatami in Iran. Since then, U.S. trade with Iran has grown somewhat, but still remains low (see **Table 3**).

Table 3. U.S.-Iranian Trade, 2000-2006

(millions of U.S. dollars)

Year	U.S. Exports	U.S. Imports	Balance
2000	17	169	-152
2001	7	143	-136
2002	32	156	-124
2003	99	161	-62
2004	85	152	-67
2005	92	167	-75
2006	83	157	-74

Source: U.S. Census Bureau

Currently, the primary U.S. exports to Iran are pharmaceuticals, tobacco products, wood pulp, and optical and medical instruments. The top U.S. imports from Iran are textile and floor coverings, art and antiques, fish and seafood (caviar), prepared meat and fish, and edible nuts and foods (pistachios). There is evidence that Iran is able to obtain embargoed U.S. goods through the re-export trade, mainly through Dubai.[101]

In general, entities targeted by U.S. sanctions do little business with the United States. Thus, the United States must rely on its trading partners to not do business with Iran. According to U.S. Secretary of State Condoleezza Rice, the targeted financial sanctions are a "powerful deterrent to every international bank and company that thinks of doing business with the Iranian government."[102] Such sanctions would have little effect on U.S.-Iran trade since such trade is already limited. However, the action would send a strong signal to foreign countries and may hurt Iran's trade with major trading partners.[103]

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[100] (...continued)
2008.

[101] GAO-08-58, "Iran Sanctions: Impact in Furthering U.S. Objectives Is Unclear and Should Be Reviewed," p. 18, December 2007.

[102] "Iran sanctions put west's unity at risk," *Financial Times*, October 26, 2007.

[103] Glenn R. Simpson, "Democrats Urge Sanctions on Iran's Central Bank," *The Wall Street Journal*, March 5, 2008.

International Sanctions and Trade Financing

The impact of international sanctions on trade financing in Iran is difficult to gauge. Since 2006, European Union countries, including France, Germany, and Britain, have curtailed export credits to companies doing business in Iran.[104] For example, in 2007, German export credits backing trade with Iran totaled about $730 million, about half the value of German export credits in 2006 and one-fifth that in 2004.[105] Germany does not actively dissuade companies from doing business in Iran, but it is conducting extra scrutiny of export authorizations requests and evaluating the financial risks of doing business with Iran more closely.[106]

Some large European banks have reduced businesses with sanctioned Iranian bodies. For instance, Germany's Commerzbank and Deutsche Bank, have been reducing or stopping business with Iran. The United Kingdom's HSBC and Standard Chartered have also reduced business with Iran.[107] Many European banks that have curtailed business with Iran are leaving offices open on a minimal basis in case there is a change in the international climate towards Iran.[108]

The merchant class has particularly been hurt by the international sanctions. Iranian businessmen reportedly have increased difficulty opening bank accounts abroad and getting foreign banks to honor letters of credit. According to Iranian officials, over half of the banks in Dubai no longer provide credit to businesses based in Iran.[109]

As Iranian businesses experience setbacks in obtaining trade financing from international banking partners, they may turn to lesser known banks or to other banking partners not susceptible to international pressure, but potentially raising the cost of business. In particular, the Islamic Republic has turned toward banks in Gulf Cooperation Council (GCC) countries. Bahrain, Qatar, and Dubai in UAE are viewed as especially critical in propping up Iran's economy.

Trade Liberalization

In 1995, Iran became a WTO observer state and, since then, has repeatedly put forth applications to become a permanent WTO member. Accession to the WTO is a stated priority of the Iranian government. Iran cites the more favorable treatment that WTO members give to one another and competition from Asian countries in

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[104] Danielle Pletka, "Congress's Ill-Timed Iran Bills," *Washington Post*, August 28, 2007.

[105] Ibid.

[106] Bertrand Benoit, "Berlin hardens trade stance with Iran," *Financial Times*, February 11, 2008.

[107] "German imports from Iran up despite nuclear row-paper," *Reuters News*, January 8, 2008.

[108] Samuel Ciszuk, "UN Security Council Tightens Iran Sanctions, Complicating Oil and Gas Developments and Trade," Global Insight Daily Analysis, March 4, 2008.

[109] Anna Fifield, "No problem," *Financial Times*, April 14, 2008.

textiles and manufactures as important challenges to Iranian exports.[110] The United States repeatedly blocked Iran's bids to join the WTO over concerns about Iran's nuclear program and support for terrorist activities. On the other hand, many European Union countries and developing countries have supported Iran's accession. Iran and many other countries maintain that WTO membership should not be based on political reasons, but rather, on economic and business grounds.[111] In a significant policy shift toward Iran in May 2005, the United States agreed to stop blocking Iran's attempts to join the WTO as part of economic incentives to Iran to resolve the nuclear program issue.

Iran is not currently a member of the WTO and the most recent negotiations for accession have ceased because of political reasons.[112] The WTO accession process is lengthy and some Iranians have expressed concern that domestic momentum for the reforms necessary for accession has waned. Iran, along with Russia, now remain the two largest economies outside of the WTO.

Iran and the Gulf Cooperation Council (GCC) countries[113] reportedly have agreed to engage in trade negotiations. Such talks are notable given the history of tensions between the Sunni-based GCC countries and the Shia-dominated Islamic Republic. A trade agreement may help mitigate the trade impact of international sanctions.[114]

Sources of Foreign Exchange

Foreign Exchange Reserves

Iran's foreign exchange reserves tend to depend on international oil prices. In recent years, reserves have strengthened, reaching about $58.5 billion in 2006. The EIU estimates that this would cover over a year's worth of imports.[115] Foreign reserves include the foreign assets held in Iran's Oil Stabilization Fund.

U.S. efforts to limit Iran's access to the international finance system and access to the dollar have contributed to a change in Iran's composition of foreign reserves. Iran now refuses to accept payment for oil exports in dollars, and is shifting to other

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[110] IMF, "Islamic Republic of Iran: 2006 Article IV Consultation ," IMF Country Report No. 07/100, March 2007, p. 18.

[111] Fiona Fleck, "Iraq Is Granted Observer Status at the WTO," *The New York Times*, February 12, 2004.

[112] IMF, "Islamic Republic of Iran: 2006 Article IV Consultation ," IMF Country Report No. 07/100, March 2007, p. 18.

[113] GCC members are Saudi Arabia, Kuwait, the United Arab Emirates, Oman, Qatar, and Bahrain.

[114] Simeon Kerr and Najmeh Bozorgmehr, "Gulf states plan trade talks with Iran," *Financial Times*, September 17, 2007.

[115] EIU, "Iran: Country Profile 2007," pp. 54-55.

currencies, such as the euro and the yen. The Central Bank is also reducing the proportion of dollars in its foreign reserves and diversifying to other currencies.[116] Iran reportedly still has a solid external reserves position.

International Investment

As the most populous country in the Middle East, Iran has a significant market for foreign investment. However, foreign direct investment (FDI) in Iran historically has been low. In 2005, FDI and portfolio equity in Iran was expected to reach $1.2 billion, up from $776 million in 2004 and $1.1 billion in 2003.[117] In contrast, Turkey, a country of comparable size, was expected to attain FDI of $11 billion in 2006.[118]

After decades of financial isolation, Iran is slowly letting investors into the country, despite some widespread resistance within the Iranian parliament (the *Majlis*) and other parts of government. FDI has been thwarted to some extent because of Iran's international relations and uncertain political environment. A stringent domestic regulatory environment and government reluctance to allow foreign investment also have contributed to low levels of FDI. Iran faces a problem of significant domestic capital flight abroad, particularly to the UAE.

Political uncertainty has been a cloud over Iran's economy and has made foreign business and investors wary about economic involvement in Iran. Capital flight remains a serious concern for Iranian policy makers. A U.S. military attack on Iran may not be completely discounted, but the threat appears less likely after the release of the December 2007 U.S. National Intelligence Estimate Report. With the risk of U.S. military action lessened in the eyes of the government, the Ahmadinejad administration has shifted gears somewhat away from international politics toward boosting the domestic economy and enhancing trade relations.

In the United States, there has been a growing grassroots movement to divest from Iran. Divestment is a decision to not hold stock in a company or bank that does business with Iran. There is a call to remove current stock from such companies. States such as Louisiana and California recently have passed measures to divest from Iran.[119]

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[116] Najmeh Bozorgmehr and Roula Khalaf, "World News - Iran: Bank chief takes a realistic tack," *Financial Times*, March 6, 2008.

[117] IMF, "Islamic Republic of Iran: 2006 Article IV Consultation ," IMF Country Report No. 07/100, March 2007, p. 29.

[118] David J. Lynch, "Geopolitics casts pall on hobbled Iranian economy," *USA Today*, September 5, 2006.

[119] "Divesting from Iran: State-by-State Update," Israel Project news release, accessed via US Fed News, February 21, 2008.

International Loans and Assistance

World Bank. Iran receives loans from the World Bank. As of February 29, 2008, the World Bank had loaned Iran $3.163 billion, of which $2.450 billion had been distributed.[120] The World Bank currently has nine active portfolios in Iran, focused on reconstruction efforts. The World Bank's activity in Iran restarted in 2000, following a seven year halt. World Bank loans to Iran come only from the International Bank for Reconstruction and Development (IBRD), the Bank's market-rate lending facility. Iran is unable to borrow from the Bank's International Development Agency (IDA), a concessional lending and grant-making fund, because of its per capita GDP. The United States has not made any contributions to the IBRD, which lends to Iran, since 1996. Some lawmakers call for reducing U.S. contributions to the IDA in protest of IBRD lending to Iran. However, some question the merits of penalizing other countries that receive loans from the IDA.

In addition, the World Bank's International Finance Corporation (IFC) recently invested in Iran, providing a $5 million joint venture among a Iranian private bank, a French bank, and the IFC. In addition, Iran has joined the World Bank's Multilateral Investment Guarantee Agency (MIGA), which offers political risk insurance to foreign and domestic investors in Iran.[121]

Bilateral Official Development Assistance. In terms of bilateral official development assistance (ODA), major donor countries to Iran are Germany, France, the Netherlands, Norway, and Japan (see **Table 4**). On the whole, the United States does not provide foreign assistance, but does provide some humanitarian assistance, to Iran. For instance, USAID has provided disaster relief assistance following the earthquake that struck near the Iranian city of Bam on December 26, 2003.

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[120] World Bank data accessed February 29, 2008.

[121] For more information on World Bank lending to Iran, see Martin A. Weiss and Jonathan E. Sanford, CRS Report RS22704, "The World Bank and Iran."

Table 4. Net ODA to Iran from OECD DAC Members, 2001-2005
(millions of U.S. dollars)

Donor	2001	2002	2003	2004	2005
Austria	3.5	3.4	5.7	6.4	4.4
Germany	32.6	31.8	38.8	41.2	40.6
France	6.8	7.9	9.5	15.7	14.8
Japan	34.4	17.5	11.3	19.8	-2.5[a]
Netherlands	3.8	3.8	7.7	11.1	6.8
Norway	3.7	5.3	9.7	11.5	4.3
United States	---	0.2	0.5	4.8	3.8
Total DAC Countries[b]	90.8	81.5	102.1	138.9	78.2

Source: OECD, "Geographical Distribution of Financial Flows to Aid Recipients, 2001-2005."

a. Negative grants may be due to the return to the owner of unspent balances that were previously disbursed as grants.
b. OECD DAC members for which data is reported for are Australia, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

Iran has the lowest foreign debt ratio of any country in the Middle East and reportedly maintains solid external reserves. During the last oil windfall, Iran paid off a significant portion of its international debt.

Assessment of Iran's Economy

External and internal factors affect Iran's economy, and analysts differ over which affect the economy most significantly. Based on the above discussion and analysis, this section reviews some of the major issues facing Iran's economy.

The main external factors affecting Iran's economy are international sanctions. There is considerable debate on the impact of U.S. and United Nations sanctions on Iran's economy. According to a recent GAO report, U.S. economic sanctions on Iran have had affected Iran, but the extent of these effects on Iran's economy and behavior are difficult to gauge. The GAO notes that assessment of the impact of sanctions is challenging because of a lack of data collection by the U.S. government and baseline information for comparability.[122]

The international tensions associated with Iran's nuclear program and alleged financing for terrorist organizations undoubtedly have complicated Iran's business

[122] GAO-08-58, "Iran Sanctions: Impact in Furthering U.S. Objectives Is Unclear and Should Be Reviewed," p. 18, December 2007.

environment. Some analysts point to Iran's low levels of foreign investment, difficulties obtaining trade finance, and challenges in developing its oil and gas sectors as evidence of the impact of sanctions. Others suggest that a variety of other factors, primarily internal, may also affect Iran's economy. Meanwhile, the Iranian government maintains that financial isolation efforts have not affected Iran's economy. Ayatollah Khamenei recently stated, "We have transformed these threats and sanctions into opportunities and even according to our enemies we have become the number one power in the region."[123]

Sanctions may not raise the costs to the point that they are crippling to the Iranian's trade and financial interactions with the rest of the world. Iran reportedly is able to circumvent the trade ban by transshipment of U.S. exports through other countries, such as the UAE. In addition to transshipment, analysts also note that international sanctions may simply divert Iran's trade with sanctions enforcers to other countries.

Iran's economy also faces major internal challenges. A significant challenge is domestic economic mismanagement. With the election of President Mahmoud Ahmadinejad in 2005, Iran's economic policies have worked to reduce regional and class disparities. Mr. Ahmadinejad has focused on redistributing oil wealth and to reduce unemployment and poverty through expansionary monetary and fiscal policies, including large energy subsidies and subsidized lending. However, some criticize these policies for contributing to unemployment and inflation and not reducing poverty.

A second internal challenge is Iran's dependence on its energy sector, which is the government's chief source of revenue. Iran has experienced strong economic growth in recent years due to the rise in international oil prices, but remains susceptible to oil price volatility. Iran has taken steps to diversify its economy, such as through building up its non-oil industry sectors.

Because Iran does not have sufficient refining capacity, the country is highly dependent on gasoline imports to meet domestic consumption needs. To remedy this dependency, the country is seeking foreign investment to build its gas fields. While some deals have been finalized, others have been met with limited success. Some analysts contend reputational and financial risks have limited foreign countries' willingness to finalize deals.

While some analysts maintain that Iran's economy is performing robustly, others suggest that the economy is underperforming, given the country's vast resources. Despite the challenges faced by Iran, most analysts believe that the economy is not in immediate crisis, given the continued highs in oil prices. However, high inflation and unemployment levels may eventually translate into serious political dissent in the country.

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[123] "Khamenei says Iran unafraid of nuclear sanctions," Agence France Presse, April 30, 2008.

U.S. Policy Concerns

Susceptibility of Iran's Trading Partners to U.S. Pressure

Because the United States does not trade significantly with Iran now, it must depend on other countries to reduce trade with Iran in an effort to change Iran's policies. In December 2005, President Bush remarked, "We are relying on others because we have sanctioned ourselves out of influence with Iran."[124]

There is considerable debate on the extent to which Iran's trading partners are susceptible to U.S. pressure to limit economic engagement with Iran. According to one Asian diplomat in Iran, "The situation over sanctions is a huge opportunity for China, former Soviet republics and regional countries."[125]

President Ahmadinejad asserts that foreign interference would not affect expanding economic relations between Iran and the UAE, Iran's most important trading partner. While bilateral trade between the United States and the UAE is significant, UAE trade with Iran is far greater.[126] Both Iran and UAE officials maintain that they would protect their relations from foreign pressure.[127] Despite or because of U.S. sanctions, Iran has been able to negotiate oil and gas investment deals with developing countries. However, while new deals have been signed, many countries are hesitating to finalize them. While various reasons are given as to why the deals have not been finalized, many speculate that the deals are not closed because of international concerns over Iran's nuclear enrichment program and the specter of sanctions.[128] The Iranian government contends that sanctions and international pressure have not slowed down foreign investment in Iran's gas sector.

China and India and other developing countries have been highly resistant to multilateral efforts to widen sanctions on Iran. The United Nations successfully passed the third round of sanctions against Iran only after watering them down to satisfy Chinese and Indian concerns. As industrializing countries with increasing energy demands and insufficient supplies, China and India view Iran as a critical energy supplier for their needs. Such short-term national interest priorities may override international long-term security concerns about Iranian alleged terrorist financing or nuclear technology development. Others suggest that to the extent to which China and India engage in economic transactions with Iran may be muted somewhat by the two countries' ties with the United States.

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[124] Daniel Dombey and Stephanie Kirchgaessner, "Fresh ways of turning the screw on Iran," *Financial Times,* October 22, 2007.

[125] Gareth Smyth, "Sanctions fail to fuel dissent on Iran's streets," *Financial Times,* July 24, 2007.

[126] Oxford Analytica, "United Arab Emirates: Dubai/Iran trade defies US moves," April 29, 2008.

[127] "Iran president says no third party can harm Iran-UAE ties," BBC Monitoring Middle East, February 18, 2008.

[128] "Iran: Sanctions and threats damage economy," Oxford Analytica, June 15, 2007.

Middle Eastern countries may be wary of Iran's alleged nuclear ambitions, but they value regional stability and assert that economic engagement with Iran may be the most appropriate means to reduce any belligerent Iranian ambitions. Arab diplomats note that while they would respect U.N. sanctions against business with Iran, it is difficult to comply with unilateral U.S. sanctions in light of growing trade relations with Iran.[129]

Additionally, there is concern about how U.S. pressure on European and Asian banks and countries is affecting U.S. international relations. The United States has derided other countries for not complying with international sanctions against Iran in order to advance their own economic interests. At an international security conference in Munich in February 2008, Senator Joseph Lieberman said, "It is outrageous when Germany makes the principled decision to curtail its exports to Iran to watch as the People's Republic of China moves in and exploits that decision for its own commercial advantage."[130]

Impact of Iranian Sanctions on U.S. Economy

The international nuclear standoff with Iran is one of a number of geopolitical events contributing to higher global oil prices.[131] Combined with the subprime housing crisis, and the cost of the U.S. combative operations in Iraq and Afghanistan, high oil prices may be fueling an economic recession in the United States. There is concern that if Iran were cut off from the world market - either because Iran chose to as a counter-sanctions measure or if there was a general embargo on oil trade with Iran - oil prices could skyrocket.

In December 2007, Iran stopped accepting payments in U.S. dollars for oil export purchases by foreign countries. Iran also called upon other OPEC members to shift away from the dollar in favor of other currencies during a November 2007 OPEC summit. Aside from Venezuela, all other member states opposed the switch.[132]

Iran claims that this move away from dollars is in response to the recent slide of the U.S. dollar, and cited the dollar as an unreliable currency. However, others contend that this is a retaliatory measure. Iran's diversification also may be an effort to seek independence from the dollar in light of punitive U.S. measures against Iran. This may mitigate U.S. ability to pressure other countries to follow along with sanctions against Iran.[133] For the United States, these recent events may raise questions about the long-term viability of the U.S. dollar as the global oil currency and have potential implications for the U.S. economy. U.S. massive current account

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[129] Jay Solomon, "U.S. Sanctions Bahrain Bank Over Iran," *The Wall Street Journal*, March 13, 2008.

[130] "Prominent US senator raps China over Iran trade," Xinhua Financial Network (XFN) News, February 9, 2008.

[131] Steve Hargreaves, "Who's to blame for $4 gas?," CNNMoney, May 20, 2008.

[132] "Iran stops accepting U.S. dollars for oil, " RIA Novosti, December 8, 2007.

[133] "Iranian oil no longer available for U.S. dollars," RIA Novosti, December 11, 2007.

deficits are financed by foreign countries' purchase of U.S. dollar denominated assets.

U.S. sanctions curtail U.S. economic activity, imposing costs on American workers and businesses and reducing U.S. exports.[134] U.S. businesses have expressed concerns about U.S. measures against companies that are unable to control re-exports of high-technology goods to Iran and other targeted countries. Others have noted that U.S. policies in Iran may deprive the United States of significant business opportunities in Iran. Europe, China, India, and Russia are stepping in and taking advantage of Iran's sizeable market and untapped potential. However, even new countries that are stepping into Iran are proceeding with caution. Undersecretary of the Treasury Stuart Levey said, "It is clear that many businesses are taking it upon themselves to scale back [on business with Iran]. At first glance, this may appear to present a tempting business opportunity for other corporations to step in. However, there is a reason that these other companies are pulling back: they have decided that the risks of business with Iran outweigh any potential gain."[135]

U.S. Policy Options

Members of Congress appear to be divided about the United States' course of action with respect to Iran. Some contend that the United States should pursue harsher measures against Iran, given the gravity of the real and potential threats posed by Iran's uranium enrichment program and terrorism financing. Some Members of Congress are strongly encouraging the imposition of sanctions on Iran's Central Bank. The Administration maintains that Iran is a threat, and continues to push for more punitive U.S. and international action.

There is debate about whether or not the United States should pursue more sanctions against Iran unilaterally or work through the United Nations. Some lawmakers assert that U.S. unilateral efforts to pressure Iran may detract from building multilateral consensus to widen punitive measures against Iran through the United Nations. Some maintain that unilateral efforts also might reduce Iran's willingness to cooperate with the United Nations. Additionally, foreign countries, such as the Persian Gulf states, may not be as responsive to unilateral action by the United States as they would be to multilateral action, given the growing trade ties between the Gulf states and Iran.

Others note that pursuing multilateral action can be a lengthy process and that it is difficult to find consensus among foreign countries with various competing interests, such as promoting international security and promoting economic growth through trade with Iran. They note that recent U.N. sanctions have been "watered

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[134] Jeffrey J. Schott, "The Iran and Libya Sanctions Act of 1996: Results to Date," Peterson Institute for International Economics, Testimony before the Committee on International Relations, U.S. House of Representatives, July 23, 1997.

[135] Matthew Levitt, "Pulling Tehran's Purse Strings: Leveraging Sanctions and Market Forces to Alter Iranian Behavior," The Washington Institute for New East Policy, March 15, 2007.

down" and took a long time to pass. There is concern about how long it would take to come to agreement for future sanctions and that, meanwhile, Iran will be uninhibited in its uranium enrichment activities. Still, many lawmakers consider the recently-passed third United Nations resolution a good first step and support pushing for more punitive action through the United Nations Security Council.

Some lawmakers question the effectiveness of sanctions, noting that despite thirty years of sanctions, the United States has not been able to significantly shift the Iranian government's policies. Iran contends that its economy is robust and can withstand the sanctions. According to the GAO report, "Iran's global trade ties and leading role in energy production make it difficult for the United States to isolate Iran and pressure it to reduce proliferation activities and support for terrorism." The Peterson Institute for International Economics (IIE) writes that sanctions increasingly have been unsuccessful as globalization has allowed embargoed countries to find other suppliers and export destinations for trade and investment.[136]

Previous studies have found that sanctions have little impact on government policy. Rather, they tend to hurt the population of a country. In congressional testimony, William A. Reinsch stated, "In a broader sense, sanctions often end up hurting ordinary people while having little impact on the government leaders we are trying to influence."[137] While the United States recently has focused on applying targeted financial sanctions to Iran, the effects of these sanctions may spill over to the broader Iranian populace. There is uncertainty about how sanctions affect the elite, and how elite views may spillover into government policy.[138] Congress may choose to follow with GAO's assessment and require the U.S. Treasury and State to collect data to assess the economic impact of sanctions on Iran. The enforcement of targeted financial measures appears to signal an effort to avoid the drawbacks of past sanctions efforts and to concentrate pressure on key negative actors.

Some lawmakers question the sincerity of the Administration's willingness to apply economic pressure on Iran in a way that harms U.S. commercial interests. They note that the United States has yet to sanction any U.S. multinational corporations that do not comply with sanctions laws.

Still others suggest that perhaps the United States should consider more positive engagement with Iran through rebuilding diplomatic ties and pursuing economic engagement with Iran, such as through Iran's accession to the World Trade Organization. They suggest that the Iranian state would be receptive to sincere positive engagement on the part of the United States. Some analysts suggest that the Iranian government is not going to pursue any drastic policy changes currently and

[136] Jeffrey J. Schott, "The Iran and Libya Sanctions Act of 1996: Results to Date," Peterson Institute of International Economics, Testimony before the Committee on International Relations, U.S. House of Representatives, July 23, 1997.

[137] William A. Reinsch, President of National Foreign Trade Council and Co-Chairman of USA*Engage, Testimony before the U.S. Senate Committee on Finance, Regarding S. 970, The Iran Counter-Proliferation Act of 2007," April 8, 2008.

[138] "Iran: Sanctions and threats damage economy," Oxford Analytica, June 15, 2007.

is waiting for a new U.S. Administration, in hopes that it will be more willing to engage positively with Iran in order to resolve longstanding and outstanding issues.

Recent Congressional Action

In the 110th Congress, several bills have been passed in the House related to Iran. House-passed bills encourage tighter sanctions against Iran, but note that such action does not indicate congressional support for U.S. military action against Iran. The following are some of the major pieces of legislation proposed by lawmakers:

- H.R. 957, "To amend the Iran Sanctions Act of 1996 to expand and clarify the entities against which sanctions would be imposed," would stiffen existing sanctions against Iran. The bill was passed by the House on July 31, 2007.

- H.R. 2347, "Iran Sanctions Enabling Act of 2007," and the corresponding Senate version of the bill (S. 1430) would encourage divestment from companies that conduct business with Iran. The Administration has opposed H.R. 2347 on the grounds that it may interfere with Administration's foreign policy efforts. The bill would allow for sanctions against countries such as China, Russia, and France for conducting business with Iran.[139] H.R. 2347 was passed by the House on July 31, 2007.

- H.R. 1400, "The Iran Counter-Proliferation Act of 2007," and its companion bill, S. 970, would expand economic sanctions against Iran and remove the presidential waiver in the Iran-Libya Sanctions Act. H.R. 1400 was passed by the House on September 25, 2007.

- H.R. 2798 is a more narrowly targeted measure against Iran. It would be prohibit any assistance by the Overseas Private Investment Corporation (OPIC) to individuals who have finance or investment ties to countries that are state sponsors of terror. The bill would target Iran, North Korea, and Sudan. The bill was passed by the House on July 23, 2007 and was ordered to be reported out to the Senate Committee on Foreign Relations on March 4, 2008.

- H.R. 1357, "To require divestiture of current investments in Iran, to prohibit future investments in Iran, and to require disclosure to investors of information relating to such investments." The bill remains in Committee.

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[139] Adam Graham-Silverman, "Despite Flurry of Action in House, Congress Unlikely to Act Against Iran," *Congress Quarterly Today*, September 12, 2007.