

## Saudi Oil Power Keeping Iran's Economy in Check

By Mamdouh G. Salameh\*

With its economy in free fall, growing popular alienation, a political system facing a crisis of legitimacy, and problems with the outside world, the Islamic Republic of Iran (IRI) is at a crossroads. The economy is stagnant and severely burdened with debt repayments to foreign creditors – a source of extreme humiliation – that consume almost \$8 bn annually, over half of the country's oil revenue.<sup>1</sup>

Whether it survives the crisis is open to question. The 'unwarranted' optimism of a number of Iranian technocrats – who foresee Iran successfully meeting its obligations to its creditors in the short term, and transforming into an economic powerhouse in the long term – is not universally shared. Even the clerics are increasingly worried. The economic and political crisis of the Iranian state has been further exacerbated by Saudi oil power which has frustrated Iran's oil policies inside the Organization of Petroleum Exporting Countries (OPEC) and also by the United States total trade embargo on Iran.

Economic issues, including oil, are of great importance both to Iran and Saudi Arabia, although in different ways. In Iran, initially, Islamic leaders attempted to deny that the revolution would be judged by its economic performance. However, years of war and destruction, rapid population growth, corruption and economic mismanagement have sapped Iranians' support for further sacrifice. The population is simply unwilling to accept more hardship. With the pressing needs of reconstruction, the demands of a burgeoning population and the decline in fervor among the revolution's faithful, the political salience of economic development has grown. Underscoring this is the number of scattered protests and riots over economic conditions in the country since 1992.<sup>2</sup>

Saudi leaders have never been under any illusion about the importance of economic resources. They have learned in the past decade or so that the role of the state as universal provider of goods and services may have to be reduced. Even with massive funds at its disposal, the state has found that it cannot at a time of depressed oil revenues meet all of its commitments as easily as once it could. Instead, it must make choices and priorities. This has had an impact on the expectations of a population used to a lavish scale of public subsidies and well aware of the ruling family's conspicuous wealth. This process has been particularly marked since the 1991 Gulf War, with the enormous costs of that effort and a continuing softness of oil prices.

The Saudi strategy has been to maximize oil revenues by maintaining production at a high level. Saudi Arabia is determined that its own oil production should not fall below 8 million barrels per day (mbd) and that it should retain its 35 percent share of OPEC production. At the same time it is unwilling to press for dramatic increases in the price of oil.

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<sup>1</sup> See footnotes at end of text.

This is partly because of Saudi concern about the effect of this on the West's industrialized economies, the consequences for future oil demand (and Saudi revenues), and the U.S.-Saudi relationship. However, its unwillingness is also due to the Saudi government's awareness that a significant rise in oil prices could only be achieved by a dramatic reduction in its own oil production, given the poor discipline of some OPEC members and the growing volume of non-OPEC production.

The Iranian regime, determined to reduce its reliance on oil income, has been unable to provide a political environment conducive to developing the private sector, and has thus been unable to realize this reduction. Oil revenues have fluctuated dramatically over the past decade, with a steady downward trend. In real terms, oil was cheaper in 1995 than in 1973. In constant terms, the price of oil in 1994 was \$20 per barrel; in 1995 it had fallen to \$15-\$17 per barrel (versus \$40 in 1983-84).<sup>3</sup> For Iran, this situation posed serious problems. Inflation in 1995 ran at 58 percent.<sup>4</sup> Per capita GDP has fallen 50 percent and per capita earnings from oil, in real terms, are no more than one-quarter of the pre-Revolutionary level. The hardest period for Iran's economy, which is trying to service a short term debt of roughly \$5-7 bn a year until 2000, coincides with the anticipated period of relatively low oil prices.

### Iran's Economic and Social Failures

One of the greatest structural economic problems that Iran has faced is its overwhelming dependence on oil-export revenue accounting for 85-90 percent of its total revenue. The Islamic Republic's goal was a long-term strategy to reduce this chronic dependence on oil revenue. Yet, today Iran is still highly dependent on oil revenue.

Consequently, its budget remains subject to the volatile fluctuations of the oil market. While the oil slump of 1986 seriously affected Iran's ability to wage war with Iraq, the sudden jump in oil prices in 1990-91 following the Gulf crisis netted Iran income of \$18 bn. The subsequent drop in oil prices has had a catastrophic effect on economic reconstruction programs. In 1992-93 Iran earned \$16 bn in oil-export revenue, while in 1994 it barely made \$12 bn. Compounding its falling income is the decline in the productive capacities of its major oil fields, poor maintenance of equipment and lack of sufficient technical and managerial expertise, all of which have hindered Iran's ability to reach its maximum production capacity of 4.2 mbd. Such fluctuations and structural weaknesses within Iran's oil industry have made it very difficult for the government to implement economic reconstruction plans.<sup>5</sup>

Foreign borrowing proved to be controversial. Iran emerged from the war with Iraq with virtually no debt problem, unlike Iraq. But from 1989 onwards, it became clear that the economic reconstruction and recovery program required access to Western capital. The government did not have any significant budget surplus and private investors in Iran were reluctant to invest in productive enterprises, preferring to put their money into dormant savings or property speculation.

In order to maintain a political consensus the government eschewed long-term debt obligations – the Western states were also reluctant to lend to Iran on a long-term basis and settled on short-term loans to finance its recovery program. The sudden surge in oil prices following Iraq's invasion of

Kuwait and the subsequent disappearance of both Iraq and Kuwait from the oil market, tempted the Iranian government into a spending spree. The government's inability to control spending caused a severe debt crisis by 1993, with the country acknowledging short-term debts of \$30-40 bn. By early 1994 the country was \$10 bn in arrears to its Western creditors.<sup>6</sup> This crisis has had a ripple effect on the rest of the economy.

#### Iran's Ailing Oil Industry

Problems compound one another; Iran has barely maintained its oil fields well enough to sustain a high level of production. To maximize its production capacity or even to maintain it, Iran needs cash, yet the current situation does not allow for such vital investments. These either have to be postponed or paid for by committing Iran's future oil production. Equally grave are the political constraints that prevent Iran from cutting its profligate domestic oil subsidies that lead to waste, smuggling and substantial loss of income. At current rates of domestic consumption, Iran may not have much oil available for export by the year 2000.<sup>7</sup> Low oil prices have forced cutbacks, but the prospect of Iraq's return to the market hangs over and depresses the market, which would be further affected if it occurs before demand rises. This was confirmed by the lowering effect on prices after Iraq's acceptance of UN Security Council Resolution 986 in mid-1996, allowing it to export \$2 bn of oil. Furthermore, the economic embargo imposed on Iran by the United States in April 1995 has forced Iran to find alternative markets for its crude oil. Despite initial bravado, there are signs (such as the renting of South African storage facilities) that Iran has experienced difficulties adjusting to the embargo. U.S. oil companies were the largest purchasers of Iranian crude oil, buying about 30 percent of Iranian oil exports or over \$4 bn-worth on the open market in the early 1990s.<sup>8</sup>

Iran's claims to a share of any increases in OPEC's output ceiling, or its ability to resist a reduction in its quota when Iraq returns to world markets, may live or die by its offshore development plans. According to Iran's oil minister Gholamreza Aghazadeh, offshore output, currently 465,000 barrels per day (b/d), will account for nearly all future increases in production capacity. Aghazadeh claims Iran's sustainable capacity is 4.1 mbd. However, many Western oil observers assert that Iran is hard-pressed even to meet its 3.6 mbd OPEC quota on a sustainable basis.<sup>9</sup>

One major reason why Iran is looking offshore may be the anticipated near-term decline in onshore output. The National Iranian Oil Company (NIOC) claims that the future of the Iranian oil industry is in the Persian Gulf, rather than onshore. This is at least the theory. Unfortunately, the figures available don't seem to bear out this theory. The portion of Iran's total oil reserves that are to be found offshore, and the relatively high cost of developing them, do not appear to justify their being given such a high priority. Only 5-6 billion barrels (bb) of Iran's claimed 93 bb of proven recoverable reserves lie offshore.

Iran is thus facing a five-year period of austerity which could become a major economic crisis with political repercussions. How Iran responds to this, whether by increased cooperation in OPEC or by a more belligerent attitude toward its neighbors, remains to be seen. For price and revenue stability, cooperative relations with Saudi Arabia would appear to be imperative. This will have to include agreement

on how to accommodate Iraq's full re-entry to the oil market, and will involve an agreement on how to allocate cuts in production. Yet this will not be easy to achieve.

#### Saudi Oil Power Versus Iran

In 1990-91 Saudi Arabia, with the largest spare production capacity, quickly stepped into the gap created by the absence of Iraq and Kuwait from the market, and softened the shock effect on prices. Since the mid-1980s, the Kingdom has otherwise refused to act as the swing producer, reducing or increasing its production to suit OPEC or the market. It now insists that production levels be decided not according to historic levels, or income need, but by production capacity. The Saudi argument was fortified by its uniquely strong position during 1991-92. It devoted considerable resources to expanding its production capacity to ensure that it could produce 10 mbd by 1995 versus the 8 mbd it produced, thus allowing it a spare capacity unmatched by any other OPEC member.<sup>10</sup> With bargaining power inside OPEC flowing from oil production capacity, the Saudis, producing one third of OPEC's output, need OPEC less than the other members.

Iran, with large revenue needs, little sympathy for the West, insufficient reserves to take a long-term view of the market and production at maximum capacity, saw Saudi oil policy as an extension of its alliance with the United States. There are some grounds for this interpretation. There is at least an implicit understanding that Saudi Arabia will keep oil prices low in exchange for U.S. protection.<sup>11</sup> To Iran, this represents (ideology apart) a real problem. Iran cannot match Saudi influence within OPEC and needs cooperation. Whether it can generate any compensating leverage that does not alienate Saudi Arabia is doubtful.

Since 1991, Saudi Arabia has assumed a dominant role in oil politics. Iran's attempts to match this by increasing its production capacity in order to recapture its pre-Revolutionary role as an OPEC leader, have been to no avail. Simply put, without Saudi cooperation Iran has been unable to achieve its economic and political goals, which are not necessarily compatible with those of Saudi Arabia.

In 1993, when prices slid to a five year low and Iran's much-needed oil revenues melted away, Tehran sought to pressure Saudi Arabia to cut production in order to force prices up. Iran accused Saudi Arabia of over-production, Saudi Arabia in turn accused Iran (and Nigeria) of 'chronic' large-scale cheating on quotas. OPEC's divisions accelerated the price slide. By autumn 1993, Iran took a different tack.

Reflecting sensitivity to the free fall in prices and revenues, Iran sought to avoid further quarrels which would continue to weaken the market. Iranian president Rafsanjani contacted King Fahd directly before the September 1993 OPEC meeting to arrange a compromise. The outcome was an agreement which presented a solid OPEC front, strengthening prices while boosting Iran's quota from 3.3 mbd to 3.6 mbd.<sup>12</sup> It was reportedly achieved because Saudi Arabia agreed to give up some of its market share to Iran, although it refused any suggestion that its production should fall below 8 mbd. It further agreed that Iran's quota should thenceforth be close to what it is already producing, thereby legitimizing Iran's *de facto* rule breaking. The Iranian decision to seek

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accommodation with the Saudis bore the hallmarks of Iran's President Rafsanjani's pragmatism. Isolating Iran's need to cooperate with Saudi Arabia on oil from differences on other matters was not easy. Nevertheless, the September 1993 OPEC meeting demonstrated that cooperation, when tried, could be beneficial to all.

Saudi Arabia's willingness to cut its own production enough both to placate Iran and to increase prices did not appear to harm it economically, since the small rise in prices tended to cover the small cut in Saudi production. For Iran, however, there was an advantage on both counts and this consideration appears to have weighed most heavily with the Saudi authorities. It is possible that the concession to Iran at OPEC was intended to create an atmosphere in which compromise over other regional issues could be achieved, dangling in front of the Iranians enticing possibilities of what might be gained in the realm of oil production and prices if cooperation and goodwill existed between Iran and Saudi Arabia.<sup>13</sup>

Goodwill was evident in January 1994 when the *Tehran Times* called for further cooperation by the two states in OPEC and on regional matters. The honeymoon was not to last. Within a month, Iran was criticizing Saudi Arabia for extravagant purchases in the United States, suggesting that Saudi Arabia had embarked on overproduction in order to appease the United States.<sup>14</sup> The Saudis, in turn, refuted Iranian allegations, stating that the Kingdom adheres to its allotted OPEC quota and to all the agreements it signs and that it is Iran that adheres to its quota only when it is incapable of production and that the untrustworthy Iranian policy has become a source of annoyance inside OPEC and helped prices to fall.<sup>15</sup>

The record of the past few years has tended to demonstrate that Saudi Arabia is capable of and willing to cooperate with Iran on questions of oil pricing and production only if it believes that this cooperation is producing beneficial effects in other areas as well. This is because such cooperation is usually a Saudi commitment either to cut production or not to raise it at certain times, thereby risking a fall in revenue. However, the scale of these cuts has not been seen as adequate to fulfill Iran's desperate need for revenue. Iran will remain sensitive to economic conditions, vulnerable to weakness in the oil market and factors reducing the country's oil revenue unless it can devise a promising, alternative strategy for influencing the oil market. Those Iranian officials who can negotiate a cooperative agreement with Saudi Arabia on oil production and pricing may be in no position to offer Saudi Arabia the pragmatic quid pro quo that it seeks in other areas. If pragmatism prevails, Tehran will try to keep a cooperative relationship with Saudi Arabia in this area insulated from other areas of rivalry. Whether Saudi Arabia will accept this compartmentalization is an altogether different question.

### Prospects for Iran-Saudi Relations

Iran's revolution and its accompanying foreign policy have made an always difficult relationship with Saudi Arabia worse. To competition for influence in the Gulf region has been added rivalry over competing conceptions of Islam and influence in other areas, such as the Palestinian territories. Hostility towards the United States and its presence in the

region exacerbates the situation. The experience of the past 17 years has increased Iran's sense of grievance, making it oblivious to the degree to which its actions have increased its neighbors' sense of insecurity. Yet, in the case of Saudi Arabia at least, that very sense of insecurity has led its government to an increasingly close military relationship with the United States, which Iran perceives as a direct threat to its own interests.

Economically and militarily weaker than in the past, Iran is not equipped to compete commercially in the post Cold War world. Its claim to represent a correct, authentic, caring, activist and independent Islam puts it in direct competition with Saudi Arabia. Iran is under pressure to perpetuate this role for two reasons. First, as the only Shi'i state it has to work hard to authenticate its Islamic credentials and to have any influence beyond its small sectarian constituency. Second, strong positions on Islamic issues are important for the regime's legitimacy.<sup>16</sup>

The legacy of the past decade and a half has made reconciliation harder, but there are no signs that Iran wants an appreciably different approach to regional relations. The struggle for power in Iran, together with the regime's essentially decentralized nature, make for erratic policies. Contradictory statements and actions make it harder for neighbors to assess Iran's intentions, consequently they judge its deeds. Growing economic problems do little to increase confidence that the Iranian leadership will change course, except perhaps to accommodate radicals by diversionary forays. There is, in short, no sign that its distinctive Islamic ideology or its volatility will diminish.

For Saudi Arabia, this is a worrying prospect. It realizes that it is at the forefront of much of the ideologically motivated criticism that surfaces in Iranian public life, including questions about the monarchy and privilege, the claim to Islamic virtue or the evils of U.S. intervention in the region. Furthermore, political volatility in Iran will keep the Saudi government guessing about Iran's true intentions at any particular moment and will cloud any agreement reached, suggesting that the slightest appearance of amity or cooperation will simply be transient.

In light of the ambiguous messages Iran has sent out over the years, there is little doubt that a U.S. security guarantee has become more than simply desirable; in the eyes of many Saudi policymakers it has become a necessity. For this visible and reassuring short-term security presence the Saudi government is willing to incur continuing Iranian wrath (as well as violent opposition within the Kingdom).

In the Saudi experience, conciliatory initiatives towards Iran have tended to end in one of two ways. They have come up against a series of unacceptable demands about larger issues, such as breaking the Saudi alliance with the United States, which the Iranian government says are necessary preconditions for any initiative. Alternatively, they have fallen victim to the ideological debate within Iranian politics which can seize small issues and turn them into questions of great symbolic power.

That said, under what conditions might there be scope for change in Iran-Saudi relations? On Iran's side a significant change in the dynamics of domestic politics or a marked departure in relations with the United States could precipitate such a change.

De-Islamization or the secularization of foreign policy,

with greater emphasis on national interest, diminished activism and less posturing in foreign relations, would be elements in this change. The most likely cause of this change would come from domestic transformations, such as increased centralization of power or a new national consensus resulting from widespread recognition of and reaction to the economic penalties of continuing current policies, perhaps generated by a sudden economic shock and its political consequences.

With the largely reactive and frequently defensive attitude that currently characterizes Saudi policy towards Iran, Saudi Arabia would respond to such a change. It is unlikely to take any initiative itself to change the current nature of Iran-Saudi relations, principally because of its inability to effect the kind of changes that would make a difference. As far as the security relationship with the United States is concerned, a marked improvement in Iran-U.S. relations would change the context of Saudi-U.S. relations. However, it is unlikely to change the perceived need in Saudi Arabia to continue close relations with the United States, since that need does not derive simply from the perceived Iranian threat.

#### Iran's Iraqi Option

Distrust is the common element in the triangular relations between the three major Gulf states. None trusts the other and each seeks to widen its area of influence and enhance its leverage against the others. With Iraq practically excluded from Gulf politics since 1991, Iran's rivalry with Saudi Arabia has been more direct. Iran has used the threat of a reconciliation with Iraq to increase its leverage with Saudi Arabia, the United States and the Gulf Cooperation Council (GCC) states. How real the *Iraqi option* is, and how much Iran will retain control over it, are also uncertain.

Iran has certain potentially overlapping interests with Iraq, but these are not weighty enough to dictate a decisive opening to Baghdad. Divergences are at least as significant as areas of common interest. An additional consideration is Iran's relationship with Syria which may be strained if Iran collaborates too closely with Iraq. Furthermore, if overlapping interests are a consideration, Iran may have many, if not more, in common with Saudi Arabia. A policy of equidistance between Iraq and Saudi Arabia might give Iran more options than an alliance with Baghdad. Opening up to Iraq in any case is not without risks. It may increase Iraq's leverage and give it new options, perhaps leading eventually to an Iraq-Saudi rapprochement. For example, Iraq might seek to exploit the insecurity of the GCC states vis-à-vis Iran by reviving its role as 'defender of the Arab East.' Hence, Iran risks a renewed polarization of the Gulf on Arab-Persian lines.

Iran's diplomacy towards Iraq is an uncertain venture; tilting towards Iraq promises increased leverage, but at the risk of diminishing Iran's current influence which has been achieved by Iraq's enforced absence. Iran sees Iraq as an asset in its difficulties with the United States. Less clear is how Iran views Iraq in terms of Gulf politics, and how it sees the presence or absence of that state affecting Iran's position with the other Gulf states.

Iran and Saudi Arabia both want a weakened, though intact, Iraq. Both Iran and Saudi Arabia have reason to feel threatened by a militarily revived Iraq, which could be a potential threat to each of them that neither poses, in the same way, to the other. A weak Iraq intensifies Iran-Saudi rivalry;

a revived or stronger Iraq would moderate it, while complicating the balance for both parties.

Not only does the existence of a perceived Iraqi military threat continue to excite U.S. policymakers, but it also underlines the importance of the continued U.S. military commitment to protect Saudi Arabia. This has two beneficial consequences for the Saudi regime. First, it allows Saudi Arabia to order the advanced American weapons systems which it might otherwise have had difficulty in acquiring. Second, the blatant military threat represented by Iraq reinforces U.S. determination to organize the military defense of the Saudi oil fields, and thus of the Kingdom.

An additional and critical question is whether Iran's strategic interests in the Gulf are served by Iraq's return to regional politics. It could be argued that a weak, isolated Iraq serves Iran better, it enhances Iran's role in the Gulf, it poses no military threat and, if excluded from the oil market it allows a revenue-hungry Iran to sell more oil. A revived Iraq in alliance with Iran would certainly challenge the United States, but in the process it would reduce Iran's weight in the Gulf and gravely complicate the oil market, which would have to adapt to Iraq's need to sell (more rather than less) oil.

Above all, if Iran engineered an alliance with Iraq, how would that fit in with its other Gulf interests – influence over Saudi Arabia and the GCC, an increased regional role, and the reduction or elimination of the U.S. presence and influence in the region? Iran would run the risk of both driving the GCC closer together and, under the Saudi wing, closer to the United States, as well as justifying the U.S. presence in the region. In brief, the 'Iraqi card' holds risks as well as opportunities for Iranian diplomacy. It may be more effective as an implicit threat than as a serious strategy.

#### Conclusions

Since the Iranian revolution, Riyadh has been alone in seeking privileged relations with Washington. Before 1979, Iran was the United States' favorite ally; it may be again one day. Although that day is not yet in sight, the idea of good Iran-U.S. relations must be considered in Riyadh with mixed feelings. On the one hand, it would mean a diminution in the threat from Iran; on the other the beginning of diplomatic rivalry for Washington's ear and the loss of Saudi influence. That preconditions for such a shift do not currently exist does not alter the belief among most of the Saudi ruling elite that it is in their interest to keep Iran and the United States apart.

The conclusion drawn from this is that the future of Saudi-Iranian relations and of regional security must depend on the state of the U.S.-Iranian relations, which in turn will be affected by domestic politics in Iran and by perceptions of Iran in the United States. It is unlikely, in the present atmosphere, that the United States will see beyond its peculiarly intimate animosity towards Iran to encourage rather than delay Saudi-Iranian dialogue and participate in its terms and aims.

#### Footnotes

<sup>1</sup> Ahmed Hashim, "The Crisis of the Iranian State," Adelphi Paper 296 (Oxford: Oxford University Press for the IISS, 1995), pp. 11-14.

<sup>2</sup> Shahrar Chubin & Charles Tripp, "Iran-Saudi Arabia Relations & Regional Order," Adelphi Paper 304 (Oxford: Oxford University

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