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The Economic Consequences of U.S.—Iran Relations

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The price of a barrel of crude oil dropped from about $140 in mid-July to about $120 by the end of July, 2008. This sharp decline coincided with two pieces of news that signaled a potential easing of tensions between the United States and Iran. The first was the U.S. decision to send Undersecretary of State William Burns to attend the talks between European and Iranian nuclear negotiators in Switzerland. The other was confirmation that the U.S. Department of State was considering establishing a limited American diplomatic presence in Iran in the form of an "interest section," almost 30 years after relations between the two countries were severed because of occupation of the American Embassy in Tehran. While the price decline may have had other causes as well, its timing indicates a likely connection between the two pieces of news.

This was not the only time that news about Iran—U.S. relations coincided with tangible changes in oil prices. News of the U.S. backed negotiation of European countries with Iran over its nuclear program in September 2006 and a number of other occasions have been followed shortly thereafter by declines in oil prices. On the other hand, escalation of tensions often has contributed to increased oil prices. For example, earlier in July when Iran tested missiles capable of reaching Israel and other corners of the Middle East, the price of oil jumped to a new high of over $147 per barrel. In fact, some analysts see the impact of U.S.—Iran relations on the oil market as so important as to suggest the best way to give quick relief to energy consumers around the world is a declaration by the U.S. that military force is not an acceptable option in its dispute with Iran (see, for example, Klare, 2008). Conversely, a military attack on Iran could substantially raise the price of oil, raising inflation and lowering gross domestic price (GDP) in the U.S. and most of the world economies. Judging by the magnitude of responses to the past news, an oil price increase as a result of a military attack, even if it does not turn into a broader war, could exceed 50 percent and keep prices over $200 per barrel for some time.

How large are the effects of oil price changes on inflation and GDP? In a carefully done study, Blanchard and Gali (2007) estimate that in the 1984-2005 period, a 10 percent increase in the price of crude oil tended to lower the U.S. consumer price index (CPI) by about 0.27 percent and lower GDP by about 0.32 percent. These effects may seem relatively small. In fact, they are less than one half of the corresponding effects before 1984, when the share of oil in production was larger, labor markets were less flexible, and monetary policy was less sophisticated. However, the economic impact still is not trivial.

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For example, based on Blanchard and Gali's estimate, the 60 to 70 percent per annum price rises over the past two years are responsible for about 2 percentage points decline in U.S. GDP growth, which has taken the economy to the verge of recession this year. Another 50 percent price increase in case of a military attack (assuming it remained contained) could reduce the GDP by a further 1.6 percent and make a recession virtually unavoidable. The dollar equivalent of this reduction in GDP is almost $230 billion dollars—not at all a trivial amount. This is, of course, only the cost to the U.S. economy and does not include the cost to other countries or the cost of a military action itself. More importantly, it does not include the human and economic cost to ordinary Iranians.

The effects of oil price rises on other oil importing economies in terms of percentage change in CPI and GDP are generally in the same range of the impact on the U.S. economy (Kilian, 2008). But, for oil exporting countries, the effect of an increase in oil prices is in fact positive, unless the price hike reflects a cost push rather than a demand rise. Iran, for example, stands to earn almost $1 billion dollars more for every dollar increase in the price of oil. However, when aggravation of tension between Iran and the Western powers raises the oil price, it entails substantial costs for Iran as well. Insurance costs rise for the country's imports and exports, including both oil and non-oil trade. Also, the U.S. and its allies are more likely to extend and intensify their economic sanctions on Iran.

The exact costs of sanctions are difficult to measure, but they are certainly non-trivial. One detailed study of the unilateral U.S. sanction on Iran estimates the cost in the 1990s and early 2000s to be about one percent of GDP, or the equivalent of U.S. $6 billion (Torbat, 2005). Intensified sanctions that are supported by the EU can entail much higher costs, perhaps as much as 3 to 5 times. In addition, if tensions lead to a military attack on Iran, then Iran may not be able to export its oil for a while and the costs in terms of economic resources and human life could be enormous. The economic costs could reach about 5-10 percent of GDP, or $30 to $60 billion, which is a huge sum for a middle income country like Iran.[1] For Iran, put together, these costs are likely to far outweigh the benefits of an increase in oil prices induced by an increase in U.S.—Iran tensions.

The high costs of tensions and sanctions show that it would be best for everyone involved if U.S.—Iran relations were to take a less confrontational direction. But, the question is whether there are any feasible alternatives of this kind. If there are good alternatives, what are the costs and risks for each country? Should the U.S. initiate détente policies with Iran, or should it continue its tough stance until the Islamic Republic modifies its behavior or shows willingness to take the first steps?

Addressing these questions requires a perspective on the nature of tensions between the U.S. and Iran. The issues most highlighted in the news are the U.S. claims that Tehran supports terrorism and has been trying to obtain nuclear weapons, thus threatening the vital interests of the U.S. and its allies, especially Israel, in the Middle East and elsewhere. However, as many analysts have argued convincingly, the regime in Iran is a rational actor and there are

1. In the aftermath of the 1979 Islamic Revolution and Iran-Iraq war, Iran's per capita GDP fell by about 37 percent. By the late 1980s, the per capita income was about 50 percent of the level that it would have been if Iran had grown at the average rate for developing countries. The estimated 5-10 percent decline in Iran's GDP in case of a military attack assumes that the attack will not turn into a major or prolonged war.

deeper motives behind its policy decisions (see, for example, Takeyh, 2006). The leaders of Iran ultimately want to preserve their regime and enhance its influence internally and externally, especially in the Middle East. It is precisely the latter objective of the Iranian regime that has come into conflict with the economic and geopolitical interests of the U.S. to maintain its hegemonic reach in the region. The nature of this conflict and the two sides' responses to it are largely shaped by the history of U.S. interventions in Iran and the region, and by the process through which the Islamic Republic was established (Kinzer, 2008).

Since its inception, the Islamic Republic has been under attack internally and externally and has sought to defend itself, sometimes using excessive means. At the same time, the extreme security concerns and the excesses of the early years after the Islamic Revolution curtailed the regime's access to high-quality human resources and restricted its policy options. Under those circumstances, the rulers of Iran used the external conflicts with Iraq and the U.S. as a means of regimenting internal political actors and marshalling public support for the government. They also sought to build their military power and form alliances with opponents of the U.S. outside the country. In recent years, the institutions of the Islamic Republic have taken stronger root, but the regime also has come under greater security threats from the U.S.. In response, the Islamic Republic has found it imperative to assert its interests in the region more aggressively.

Acquiring nuclear technology also has become an important means of enhancing internal confidence and rallying Iranians behind the regime.[2] This would not necessarily lead to a build up of a nuclear arsenal. In fact, most Iranian leaders seem to understand full well that the arms race that a nuclear Iran might trigger in the region could destabilize the country's neighborhood and ultimately cost them heavily. Rather, their objective seems to be developing the Islamic Republic's capabilities as a regional power in order to gain respect at external negotiating tables as well as in internal politics.

In this context, as McFaul, Milani, and Diamond (2006-2007) argue, further threats and sanctions are likely to be counter-productive in curbing the Islamic Republic's use of unconventional means to ensure its security and enhance its power. A more fruitful approach seems to be a move in the opposite direction: full engagement of the regime and recognition of its strengths, while demanding that it moves away from policies that threaten the security of other countries in the Middle East. The offer could consist of U.S. assistance in the economic and technological development of the country and recognition of Iran as a power that can help guarantee the security of the region in cooperation with its neighbors and the U.S.. Some variation of this approach could be initiated by the U.S. and would very likely be feasible and acceptable to Iran, given the potentially significant economic and political gains to both sides.

2. A similar obsession developed in Iran in the mid-twentieth century with regard to iron and steel technology. Even the Shah, who was wholeheartedly pro-West, seemed to believe Iran was being denied the "mother technology" and its economic development was suffering as a result. So, he made a deal with the Soviets, whom he viewed as enemies, to build a steel mill in Esfahan. The steel mill came at a high cost and was based on outdated and inefficient technology, but it quelled the Iranians' thirst for the technology. The parallel with the policy of acquiring nuclear technology in recent decades is difficult to miss.

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