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**Testimony before the Senate Committee on Banking, Housing, and Urban Affairs  
“Minimizing Potential Threats from Iran: Assessing Sanctions and Other U.S. Policy Options”  
July 30, 2009**

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Mr. Chairman and members of the Committee, I’m very grateful for the opportunity to discuss recent developments in Iran and the policy tools available to the United States for tempering Tehran’s nuclear and regional ambitions.

With turmoil on the streets and in the corridors of power, Iran’s perennially unpredictable politics have moved into uncharted territory in the wake of the shameless manipulation of last month’s presidential elections. Unrest within Iran is hardly unprecedented; Iran has experienced ethnic rebellions, labor actions, student protests, economic riots, and a range of other political agitation with a surprising regularity over the past 30 years.

However, the current turbulence stands apart from any past instability within Iran in the scope of popular engagement and the severity of divisions among the political elite. As a result, the Islamic Republic today is now forced to contend with an almost unprecedented array of internal challenges, including the emergence of an embryonic opposition movement and profound fissures within the inner circles of power. The persistence of street skirmishes and passive resistance on the streets, the increasingly uneasy straddling of the broader array of conservative politicians, the mutiny against the supreme leader’s unfettered authority by a quartet of veteran revolutionary leaders as well as senior clerics – all this clearly marks the opening salvos of a new phase of existential competition for power in Iran.

At this stage, it is beyond the capabilities of any external observer to predict precisely where, when and how Iran’s current power struggle will end. In the immediate term, the Islamic Republic will likely survive this crisis with its governing system and leadership largely intact, thanks to the same tactics that have preserved it for the past 30 years: behind-the-scenes deals and mass repression. However, the regime’s internal challenges have already intensified beyond what most analysts anticipated a mere six weeks ago, and at some point the discord may begin to transcend Tehran’s capacity to navigate.

***Iran’s Economy***

Among the most important factors shaping both Iran’s future trajectory and the tools available to the international community for influencing that course are those related to the Iranian economy. As even the most cursory review of the press coverage of Iran would suggest, its economy has experienced perennial problems of mismanagement that have been exacerbated by the ideological and interventionist approach of President Ahmadinejad. In the past four years, every meaningful economic indicator has suggested serious trouble for Iran – alarms that were sounded well before the global economic crisis. Iranians must contend with double-digit inflation, power shortages, a tumbling stock market, stubbornly high unemployment rates particularly among

young people, increasing dependence on volatile resource revenues, and perhaps most ominously for Iran's leaders a rising tide of popular indignation spawned by individual hardship and the broader national predicament.

Ironically, Ahmadinejad owes his unlikely ascent from administrative obscurity to the pinnacle of power in Iran in part to his successful exploitation of Iranians' frustration with their living standards and economic opportunities. While Ahmadinejad's original 2005 election surely benefited from no small amount of electoral manipulation, his election was accepted as a credible outcome by many if not most Iranians because he waged an unexpectedly effective campaign. His messages emphasized the economic hardships and inequities that afflict the average Iranian, and he spoke bitterly about the indignities of Iran's grinding poverty and pointedly contrasted his lifestyle with that of his chief rival, the profiteering former president Akbar Hashemi Rafsanjani. Ultimately, Ahmadinejad's initial election reflected the frustrations of an electorate more concerned with jobs and the cost of living than with slick campaigns or implausible pledges of political change.

Despite this apparent mandate, however, Ahmadinejad governed on the basis of ideology rather than performance. As a result, the president himself bears much direct responsibility for the current state of Iran's economic affairs; his heavy-handed interference with monetary policy and freewheeling spending contributed the spiraling inflation rates, and his provocative foreign policy and reprehensible rhetoric has done more to dissuade prospective investors than any U.S. or United Nations actions. His personal disdain for the technocracy and quixotic economic notions has undermined much of the progress that has been made in recent years to liberalize the Iranian economy and address its underlying distortions. The president has boasted of his instinctive grasp of economic policy, reveled in the reverberations of the global economic meltdown, and scoffed that his government could withstand even a drop in oil prices to a mere \$5 per barrel. And he spent – taking full advantage of an epic oil boom that reaped more than \$250 billion in his first three and a half years as president. Ahmadinejad traversed the country with his full cabinet in tow, and taking evident enjoyment from a paternalistic process of doling out funds large and small for picayune provincial projects and even individual appeals.

The senselessness of his policies has provoked an intensifying firestorm of criticism from across the political spectrum. At first the critiques were light-hearted. When he once boasted about the bargain price of tomatoes in his low-rent Tehran neighborhood, the president sparked a flurry of popular jokes at his expense and grumbling among the political elite. However, as the ripple effects of the global economic slowdown began to impact Iran and the price of oil crashed to less than one-third of its stratospheric 2008 high, the mood soured both among the regime's veteran personalities and its population at large. In three successive letters, panoply of the country's most respected economists detailed the dangers of the president's policies. Notably, the critiques were not limited to the president's factional adversaries; much of the disquiet voiced in recent years over the state of the economy emerged from sources ideologically inclined to support Ahmadinejad and his patron the supreme leader, including traditional conservatives with longstanding links to the powerful *bazaar* and the centers of clerical learning.

Thanks to his assiduous deployment of economic grievances during his original campaign and his copious and public spending throughout his first term, Ahmadinejad made himself

particularly vulnerable to the regime's stumbling in this arena. What particularly galled so many Iranian political figures was the opportunity sacrificed by the malfeasance of the past few years. Iran's oil revenues under Ahmadinejad's first term exceeded eight years' of income during both the Khatami and Rafsanjani presidencies; indeed of the more than \$700 billion that Iran has earned through oil exports in the past thirty years, nearly 40 percent came in during the past four years. Adding fuel to the fire was the lack of transparency over its allocation; having decimated the economic planning bureaucracy and attempted to classify the details of the nation's oil reserve fund, Ahmadinejad left vast ambiguity as to the destination of tens of billions of dollars of his government's spending. The presumption is much of it has financed record consumption, with a disturbingly high import quotient, rather than creating jobs, attracting investors, or taking advantage of Iran's large, well-educated baby boom as it comes of age.

During the presidential campaign, this particular issue and the state of the economy more broadly were hot-button issues for Ahmadinejad's opponents. Musavi, who had pressed for statist policies through his tenure as prime minister during the 1980s, embraced a relentlessly technocratic message centered on the incumbent's failure to manage the economy effectively. Musavi and his rivals pitched the economy as the primary issue in their attempt to connect with voters, equating economic grievances with threats to the country's security. As is his wont, Ahmadinejad was not cowed, and brandished shocking allegations of corruption and patronage as well as misleading statistics in the riveting televised campaign debates with each of his rivals.

The unrest of the past six weeks will only aggravate Iran's economic dilemmas and put durable solutions to the perpetual problems of uncontrollable subsidies, unaccountable spending that much further out of reach. The crisis will likely persuade more Iranians who have the means and/or ability to leave the country to do so, exacerbating the persistent problem of the brain drain and related capital flight. Even in advance of any multilateral action on sanctions, the political risks and generally unpalatable nature of the new power structure will dissuade some investors and reduce the competitiveness of Iran's external links. Should the political situation degenerate further, economic actions by the opposition such as strikes and mass boycotts could further paralyze the Iranian economy as a means of applying pressure to current decision-makers.

However, one caveat regarding assumptions on the state of the Iranian economy: Particularly over the past four years, the media as well as policymakers have routinely speculated on the prospect for economic grievances to spark turmoil that might threaten the Islamic Republic. The longstanding distortions that plagued the Iranian economy have been greatly exacerbated by Ahmadinejad's spendthrift, interventionist policies, and in recent years Iranians have had to contend with double-digit inflation and unemployment rates. Analysts often pointed to small-scale labor actions as well as the short-lived protests against the gasoline rationing program, launched in 2007, and other poorly-designed efforts to revamp the government's vast subsidies as the harbingers of mass unrest. They were repeatedly wrong on this count; Iranians grumbled and routinely vented their outrage over the economic conditions, but largely resigned themselves to making do.

Instead, what drove the Iranian people into the streets in record numbers and established the nascent stirrings of a popular opposition to the creeping totalitarianism of the Islamic Republic was a purely political issue – the brazen abrogation of their limited democratic rights. This

should not imply that Iranians view their economic interests as somehow secondary to their political aspirations, but rather that three decades of Islamic rule have generated the conviction that Iran's representative institutions and its citizens' limited democratic rights represent the most effective tools for advancing their overall quality of life. With the brazen manipulation of the election, Iranians saw not simply the abrogation of their voice but the continuing hijacking of their nation's potential wealth and their individual opportunities for a better quality of life.

This reflects a remarkable transformation in the way that Iranians view their leadership; although Ahmadinejad, like Ayatollah Khomeini before him, prefers to emphasize the regime's ideological mandate, the population as well as much of the political elite have come to identify the responsibilities of their leaders as primarily oriented toward the provision of opportunities and a conducive environment for the nation's growth and development. Neither Ahmadinejad nor Khamenei can meet this test; their functioning frame of reference remains the fierce passions of religion and nationalism.

### *US Policy*

The events since the June 12<sup>th</sup> elections have changed Iran in profound and irreversible fashion, and it would be fruitless and even counterproductive to proceed as though this were not the case. The United States must adjust both its assumptions about Iran and its approach to dealing with our concerns about Iranian policies to address the hardening of its leadership, the narrowing of the regime's base of support, the broadening of popular alienation from the state, and the inevitability that further change will come to Iran, most likely in erratic and capricious fashion.

But the turmoil within Iran has not altered America's core interests vis-à-vis Iran, nor has it manifestly strengthened the case for alternatives to the Obama Administration's stated policy of diplomacy. The worst of these prospective alternatives, military action, remains fraught with negative consequences for all of our interests across the region, including the revitalization of the peace process and the establishment of secure, independent states in Iraq and Afghanistan. Even as an option of last resort, military action would leave us and our allies in the Middle East markedly less secure and would likely strengthen rather than derail Iran's nuclear ambitions.

There may be some who see the past six weeks as a vindication for the prospects of regime change in Iran. This is precisely the wrong lesson to take from the recent unrest. Every element of the past six weeks of drama in Iran has been wholly internally generated, and even the whiff of any external orchestration or support would have doomed its prospects. Even today, with a burgeoning opposition movement, America's instruments and influence for effecting regime change are almost nonexistent.

As a result, I remain support the Obama Administration's continuing interest in utilizing direct diplomacy with Tehran to address the nuclear program and the broader array of concerns about Iranian policies. As profound as recent events have been in splintering the Iranian leadership and creating the seeds of an opposition movement, engagement remains the only path forward for Washington. Engagement will require an effort to negotiate with a particularly unpleasant and paranoid array of Iranian leaders. Still, the Administration's interest in diplomacy was never predicated on the palatability of the Iranian leadership – indeed, until very recently the

conventional American wisdom tended to presume a second Ahmadinejad term – but on the urgency of the world’s concerns and the even less promising prospects for the array of alternative U.S. policy options.

The upheaval in Iran does not inherently alter that calculus, but it does seem likely to exacerbate the potential pitfalls of implementing engagement. One of the lines floated by the administration – that the consolidation of power under Iranian hard-liners will create incentives for a quick resolution of the nuclear standoff – is certainly conceivable, but given Tehran’s uncompromising rhetoric and resort to violence, it sounds suspiciously like wishful thinking. More probable is the opposing scenario – that the United States is going to have to deal with an increasingly hard-line, suspicious Iranian regime, one that is preoccupied by a low-level popular insurgency and a schism among its longstanding power brokers.

Among American policymakers and citizens, sincere trepidations have emerged about the impact that any direct bilateral negotiations might have on the seemingly precarious stability of the Islamic regime and on the prospects and mood of the opposition. However, conducting the business of diplomacy does not confer an official American seal of approval on our interlocutors, as evidenced by our ongoing capability to maintain a formal dialogue with a wide range of authoritarian leaders across the world.

To the contrary, the Iranian regime in fact derives its scant remaining legitimacy from its revolutionary ideology that remains steeped in anti-Americanism. If we can successfully draw Iran’s current leadership into serious discussion about the urgent concerns for our own security interests, negotiations with Washington would only undercut Tehran’s attempts to stoke revolutionary passions at home and rejectionist sentiment across the region. Negotiations could also play a powerful role in exacerbating the divisions within the regime and clarifying the prospective path forward available to Iranian leaders who are capable of compromise.

How can Washington draw an even more thuggish theocracy to the bargaining table? What incentives might possibly persuade a leadership that distrusts its own population to make meaningful concessions to its historical adversary? How can the international community structure an agreement so that the commitments of a regime that would invalidate its own institutions are in fact credible and durable? Finally, what mechanisms can be put in place to hedge against shifts in the Iranian power structure, an outcome that seems almost inevitable given the current volatility of the situation?

These hurdles are not insurmountable; the context for the successful 1980-81 diplomacy that led to the release of the American hostage was at least as challenging as that of today. Most of the tentative American relationships with the revolutionary regime had evaporated with the demise of Iran’s Provisional Government, and instead U.S. negotiators faced an implacably anti-American array of Iranian interlocutors, whose authority, credibility, and interest in resolving the crisis remained an open question throughout the dialogue. Moreover, Tehran’s ultimate goals seemed unclear, possibly even unknown to its leadership, who often employed the negotiating process as a means of prolonging the crisis rather than resolving it.

A successful agreement to end the hostage crisis entailed months of intense work and many false starts, but a variety of tools – including secret negotiations and the involvement of a third-party mediator and guarantor for the eventual agreement – helped facilitate an outcome that both sides abided by. There are no guarantees that the hard-won success of the negotiations that ended the hostage crisis can be replicated today; if anything, the stakes are higher and the Iranian political dynamics are less promising at least in the very short term.

Perhaps the critical factor in the success of the 1981 conclusion to hostage negotiations was the Iraqi invasion and Iran's desperate need for economic and diplomatic options to sustain the defense of the country. In a similar respect, any U.S. effort to negotiate with Tehran would benefit from the identification of incentives and counterincentives that can similarly focus the minds of leaders and expedite the path for negotiators.

In this respect, there is a direct and mutually reinforcing relationship between the act of engagement and the identification of potential sanctions to be applied by the international community if Iran chooses to persist with noncooperation. The threat of sanctions may be the only effective means of persuading Iran's increasingly hard-line leadership that their interests lie in restraining their nuclear ambitions and cooperating with their old adversary in Washington.

In addition, the offer and the act of dialogue with Tehran represent the most important factors for creating a framework for long-term economic pressure if negotiations fail. The historical experience of prior U.S. administrations makes clear that international willingness to apply rigorous sanctions is inherently limited. The critical actors – Russia and China, as well as the Gulf states – have generally proven averse to steps that would severely constrain their economic interests and/or strategic relationships with Tehran. The minimum price for achieving their support for and participation in significantly intensified economic pressure will entail a serious American endeavor at direct diplomacy with the Islamic Republic.

Recognizing the currently hostile context for diplomacy, we should be coordinating our next steps as closely as possible with those states that can still bring greater political and economic pressure to bear on Tehran. In particular, we need to step up our dialogue with Beijing, whose interests with respect to Iran diverge substantially from those of the Russians and whose investments in Iran reflect a long-run effort to secure prospective opportunities rather than a short-term calculus of maximizing profit.

Still, we should be careful to presume too much with respect to the efficacy of sanctions. The conventional wisdom in Washington appears to be shifting toward the need to identify “crippling” sanctions that can force Tehran to capitulate on enrichment. Unfortunately, this policy pronouncement overlooks the reality that Iran's multifaceted economy and, in particular, its petroleum exports offer a significant degree of insulation from sanctions. History has demonstrated that there simply are no silver bullets with respect to Iran.

While Tehran is certainly capable of change, economic pressures alone have only rarely generated substantive modifications to Iranian policy, particularly on issues that the leadership perceives as central to the security of the state and the perpetuation of the regime. In general, external pressure tends to encourage the coalescence of the regime and even consolidation of its

public support, and past episodes of economic constraint have generated enhanced cooperation among Iran's bickering factions and greater preparedness to absorb the costs of perpetuating problematic policies.

Specifically, the debate within the Iranian leadership at the height of the war with Iraq during the mid-1980s offers an illuminating case in point. Tehran was confronted with mounting frustration with the increasing human, political, and financial toll of the war as well as a collapse in the oil markets which cut prices by half. Iran's prime minister at the time, Mir Husayn Musavi, had the thorny task of persuading its feuding parliament to pass an austerity budget, which entailed persuading traditionalists with ties to Iran's *bazaar* merchant community to accept new taxes and left-wing radicals to endorse cuts in state spending, particularly on social welfare. Musavi succeeded by presenting both factions with a choice – either accept the harsh budget measures or end the war. The regime's ideological commitment to the 'sacred defense' and the conviction, even among growing misgivings about war strategy, that this was an existential struggle meant that this was no choice at all; Iranian leaders undertook the painful political and economic steps that Musavi proposed.

Much has changed in Iran over the past two decades. The diminution of revolutionary fervor and the arguably less compelling public interest in the nuclear program would surely complicate any effort to persuade Iranians that economic deprivation is an acceptable price to pay for defending what the leadership has portrayed as its national right to technology. However, the global context differs as well; Iran today is not nearly as isolated as it was in the 1980s, the considerable economic opportunities offered by Europe and conceivably by the U.S. are no longer irreplaceable.

As a result, sanctions, while nominally successful in raising the costs to Tehran of its provocative policies, could fail in their ultimate goal of gaining Tehran's adherence to international nonproliferation norms and agreements. Equally importantly, the time horizon for sanctions to revise the calculus of the Iranian elite may be more protracted than the world is prepared to wait.

In retrospect, the rare cases where economic pressures have produced changes to Iranian security policies relate less to the actual financial cost to the Iranian leadership, which have ultimately proven manageable even during periods of low oil prices, than to the perceptions, timing, and utility in swaying critical constituencies within the Iranian political elite. Efforts to deter the import of refined gasoline are unlikely to have such an impact; they will be mitigated by Iran's porous borders, long history of smuggling petroleum products, and ongoing efforts to upgrade its refining capabilities. And to the extent that sanctions aimed at refined products penalize third-country governments and entities, trying to exploit Iran's gasoline vulnerability may cost more in terms of international influence than it is worth.

Finally and perhaps most importantly, any forward-looking U.S. policy needs sufficient dexterity to adjust to the inevitable changes that will buffet Iran over the forthcoming months. Iran is in a period of great flux, and there simply can be no certainty about the final outcome of the current dynamics. As events inside Iran shift toward either compromise or confrontation, Washington must be ready to respond accordingly.