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The global financial crisis is set to depress oil producing economies. As the crisis is already pushing down oil prices, a firm response to the fallout of the crisis from governments and central banks is expected. Oil prices have tumbled more than 70% since their July peak and there are fears they could continue their plunge because of diminishing demand caused by the current financial meltdown. Though, the Iranian government does not seem to be greatly concerned about the ongoing global situation, although many Iranian economists believe that sanctions and the international financial crisis will soon be taking their toll on Iran's economy by unfavorably affecting oil, trade, and trade financing. Even if the relative isolation from the world's economy may seem to protect Iran from the negative impact of the global financial crisis to a certain extend at least for now, plunging oil prices and a massive credit deterioration suggest otherwise.

A few weeks ago sixty prominent economists in Iran warned Ahmadinejad in a public letter that his unfriendly behavior toward the rest of the world has cost Iran lost opportunities and investment in addition to imposed U.N. Security Council sanctions. The letter criticized the government for spending too much of the oil revenues and for its policies that the economists said had deprived the country of foreign investment. They also pointed out to continuing high inflation and unemployment as well as unsystematic economic policies that the government has been implementing for the past three years.[1 & 2]

Iran needs higher crude prices than in the past in order to break even as spending at home rises and as the government may have to cut output to meet OPEC quotas. There is not considerable room for using the surpluses accumulated during the oil boom to support economic activity in the event of continued weakness. The majority of oil revenues have been spent on subsidized lending, massive bank credits, imprudent social spending, substantial imports, aids to other countries, and huge energy and food subsidies.[3] For years governments in Iran have depleted vast amounts of money to keep national energy prices artificially bellow international rates to instigate their populist agenda. As a result, no significant savings have been accumulated. This is particularly recognized during the tenure of the Ahmadinejad administration. It seemed that the system was functioning properly when the energy prices were rising. Today, there are no clear information and data on the balance of Iran's Oil Stabilization Fund (OSF). The balance according to the central bank is approximately $24 billion, while the expectation is a figure between $80 and $100 billion.[4] Certainly these figures do not indicate a sufficient amount of reserve for grimmer rainy days that are becoming more likely. Simply put, the government squandered and mismanaged billions of dollars that could have saved in the OSF by proper planning and adopting systematic economic policies.

At the beginning of November, deputy Central Bank governor for economic affairs Ramin Pashaeifam quoted that Iran needed oil prices to average $60 per barrel until March, the end of the current Iranian year, to avoid big economic problems.[5] For oil prices lower than $75 per barrel, the IMF signifies that the current account will fall into a deficit. The estimated amount of the current account by year end is $82 billion excluding the short-term and long-term liabilities.[6] This estimate will be valid only if the average oil price lives up to the IMF's assessment for the year, which seems dubious. For the present Iranian year (March 20th 2008 – March 20th 2009) the annual budget was derived from an oil price of $56 per barrel. However, the government submitted additional legislation to the Majles (Iranian parliament) for supplementary budget amendments. Thus, for this year the budget's dependency on oil is estimated to be $80 per barrel.[7] On the other hand, an IMF report predicts that Iran's break-even point is $90 per barrel for the next year. This figure shows that Iran is much more dependent on petrodollars in comparison to other oil producing countries are, except for Venezuela and Iraq.[8]

As one of the biggest oil producing countries, Iran has become increasingly dependent on oil earnings since the 2005 election of Ahmadinejad. In average, oil revenues are 80% of Iran's foreign income and their share in the fiscal budget is over 50%. Therefore, if the existing condition persists, it is broadly expected that the government will encounter huge budget deficits in the future. In order for the government to cope with these budget deficits, there will be no other ways but to borrow from the Central Bank, which will result in an increase in the money supply and hence an increase in the base money and inflation even further. The economy is already experiencing a 26% inflation rate, and the government has shown no plans to curb its spending and expansionary policy so far, although because of past policies banks have encountered considerable liquidity problems. On the contrary, the administration is still insisting on continuing to offer credit and loans to applicants openhandedly as well as preparing an economic evolutionary plan. Both plans have received much criticism from economists and experts for not being in accordance with economic principles and thereby worsening the economic situation at these critical times, if executed. Ahmadinejad sacked the former governor of the Central Bank Tahmasb Mazaheri a few weeks ago, because he had opposed expansionary policy of the government. Mazaheri had prevented the banks to offer loans and credit to production units and real estate investors as a result of over injection of capital to the economy and uncurbed inflation.

For the past few years statesmen and policymakers in Iran placed their bets on increasing petro prices; therefore, they paid less attention to declining economic activity and increasing inflation. But, at least for the next few months that all bets in relation to higher oil prices are off, it seems that the economy will experience fresh shocks. Iran's economy is already suffering from Dutch Disease, an economic phenomenon that is caused by overspending of the capital income from exploiting natural resources. The aftermath of this economic disease is a decline in production, overvaluation of the currency or the exchange rate, and an increase in imports.[9] All these signs are quite observable in Iran. What dangerously threatens the Iranian economy is, unlike other troubled economies any accommodative monetary and fiscal course of action to revive the economy in the current inflationary environment will even worsen the economic circumstances. Bearing in mind, ongoing inflation coupled with additional inflation due to any future budget deficits because of much lower oil profits in a recessionary environment, will compel economic stagflation to become practically imminent. Stagflation is an economic situation in which inflation and economic stagnation occur simultaneously and remain unchecked for a period of time.[10] Hence, many industries and production units that are already going through a slowdown will encounter more trouble in selling their products and consequently will retain even smaller profit margins in the future, if any. Furthermore, it will impose higher monetary pressure on the people who are already in a financial hardship.

Since 1999, when oil prices began their ascent, both the governments of Khatami and Ahmadinejad kept the exchange rate in a narrow range with the US dollar (T850 to T950), while domestic expenses have increased many times and the inflation rate has been above US and global inflation rates by at least 15% per annum. That is because Iran's oil income was rising. In parallel to that, for the past three years the government also considerably increased its annual budget. In order to provide the needed tomans (Iranian currency) for its budget, the government has been injecting the petrodollars to the economy and currency market. In return, it has also been able to maintain the exchange rate within a certain range. By doing so, the government not only has kept the toman grossly overvalued, but also has made the Iranian products much more expensive than their foreign counterparts. It would have been prudent for Iranian policymakers to either allow the toman to float freely against other currencies or at least devaluate it against the U.S. dollar or the euro by the amount equal to the annual difference between the inflation rate in Iran and that of the U.S. or Europe to prevent potential economic shocks in the form of a currency crash at the times of foreign currency shortages as well as to make Iranian products more competitive in the international markets to boost exports.

Iran was not the only country that adopted this approach, Russia and Arab countries of the Persian Gulf have their currencies pegged to the U.S. dollar as well. However, those countries never experienced such high inflation as Iran has. In addition, they have piled up billions of dollars in their Sovereign Wealth Funds (SWF) from their oil earnings in order to manage their foreign currency fluctuations at the times of economic distress. For instance, Russia and the Emirate of Abu Dhabi (U.A.E.) had accumulated $500 and $900 billion in their funds, respectively. For the past few months Russia has drained some of its reserves to defend the ruble in order to avoid a repeat of the 1998 financial crisis when the ruble crashed, as tumbling oil prices and the war in Georgia caused ruble holders to lose faith in the ruble and therefore to remove billions of dollars from the country. At the same time, it is now abandoning the illogical protection of the ruble and letting the currency devalue to prevent a sudden collapse. In addition, Abu Dhabi maintains enough reserves to supply any currency demand to uphold its currency peg, although the emirate has lost over $100 billion in the ongoing crisis.

Of course, this is not the case for Iran. It is widely expected that with the falling oil prices, the demand for foreign currencies to increase in the future coupled with a shortfall in the current account. In return, the government may encounter difficulties to supply sufficient foreign currencies for the seekers. This will certainly impel a sudden devaluation of the toman against other foreign currencies. Even if the government adopts right economic policies today, there are doubts that it will be able to weather the highly possible upcoming currency crash. Simply put, the current hyped rates of the toman against other currencies are living on borrowed time. On the other hand, there are fears that if the government encounters foreign currency shortages and hence high exchange rate fluctuations, it will likely resort to mandate foreign exchange rate controls or implement a multi-exchange rate system. The past experience in Iran; however, indicates to rampant corruption and establishment of black markets in addition to a much worse condition for the already ailing business environment, if such plans are put into practice.

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