

**Studying rentier states over time: the political
economy of macroeconomic policymaking in pre-
Revolutionary Iran**

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Abstract

This thesis attempts to explain why the Pahlavi regime chose imprudent macroeconomic policies in response to the 1973 oil boom. It argues that the macroeconomic policies that were selected by this regime after 1973 were shaped by the economic policies that it had been pursuing in the 1960s.

In 1963, the Pahlavi regime initiated the policy of import substitution industrialisation (ISI). The economic success of this policy in the 1960s generated spillover effects on the ideology, geopolitical standing and class coalition of the Pahlavi state. As this state moved from the first phase of ISI (1963-1967) to the second stage (1968-1972), its developmentalist ideology became stronger, its geopolitical standing in the Gulf was elevated and its economic alliance with the industrial elite grew deeper. A combination of these spillover effects generated a self-reinforcing process, whereby the political elite constantly sought to maximise oil prices in OPEC and use the resulting oil revenues domestically to push the ISI process deeper towards heavy and intermediate industries. Importantly however, this self-reinforcing process of ISI deepening set the stage for imprudent macroeconomic policymaking at the time of the 1973 oil boom. After the boom, the elite accelerated ISI to an extreme through a massive fiscal and monetary expansion and refused to reverse this policy despite its macroeconomic consequences. This indicates that it was the *interaction* of the 1973 oil boom with the self-reinforcing process of ISI deepening (which had been underway since 1963) that led to poor macroeconomic policymaking in the 1970s.

Theoretically, this case study shows that, once chosen, an economic policy can possibly become self-reinforcing over time (by generating spillover effects) and shape future policy choices. This thesis, therefore, introduces the element of path dependency and dynamic analysis into the study of rentier states.

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List of abbreviations

BI	Bank Indonesia
CB	Central Bank
CBB	Central Bank Bulletin
CPO	Central Planning Office
FCO	Foreign Commonwealth Office (UK Public Record Office)
FO	Foreign Office (UK Public Record Office)
FRUS	Foreign Relations of United States
ICB	Industrial Credit Bank
IMDBI	Industrial and Mining Development Bank of Iran
IOHCHU	Iranian Oral History Collection, Harvard University
ISI	Import Substitution Industrialisation
ME	Ministry of Economy
MEFA	Ministry of Economy & Financial Affairs
NIOC	National Iranian Oil Company
OHCFIS	Oral History Collection of the Foundation for Iranian Studies
OPEC	Organisation for Petroleum Exporting Countries
PO	Plan Organisation

PBO	Plan & Budget Organisation
SAMA	Saudi Arabian Monetary Agency
WDI	World Development Indicators

Introduction

It is well known that the quadrupling of oil prices in 1973 was more a curse than a blessing for most oil-rich countries, due to their imprudent policy responses to this external shock. Iran stands out as one of the economies worst hit by the 1973 oil shock due to her failure in macroeconomic policymaking (Ross, 2012; Karl, 1997; Gelb, 1988). This thesis investigates why the Pahlavi state reacted so badly to the 1973 oil boom. More specifically, it explores why, despite its remarkable economic performance in the 1960s, the Pahlavi state failed to effectively manage the boom.

Before being derailed by the 1973 oil shock, Iran was among the best performing developing economies. Table 1 shows that Iran's growth rate between 1960 and 1972 was higher than that of South Korea, Taiwan, Brazil or Mexico, which were the fastest growing economies in East Asia and Latin America. Thanks to this "economic miracle", Iran's per capita income doubled in this period (IBRD, 1974). The main engine behind this miracle in Iran was rapid industrialisation, which was spurred by an import-substitution policy from 1963 onwards (Karshenas, 1990, Alizadeh, 1984). As indicated by Table 1, Iran's manufacturing output growth not only surpassed Brazil's and Mexico's but was even comparable to that of South Korea and Taiwan- the two well-known cases of "East Asian Miracle".

Table 1: GDP and manufacturing growth between 1960 and 1972					
Country	Iran	Brazil	Mexico	Korea	Taiwan
GDP Growth	10.6%	7.6%	6.8%	8.2%	9.1%
Manufacturing Growth	12.2%	8.4%	8.8%	16.9%	17.1%

Source: World Bank (2015) & Karshenas (1990)

Importantly, Iran's impressive economic drive, which was achieved under the autocratic rule of Mohammad Reza Shah (henceforth the Shah), was accomplished with price stability as inflation averaged 2.7% for the period between 1960 and 1972 (Razavi & Vakil, 1984). One crucial factor that contributed to this price stability was the low volatility of oil revenues in the 1960s (Salehi-Esfahani & Pesaran, 2008). Thank to this impressive economic performance, Iran was hailed by the World Bank as *the* success story of the 1960s, which was named as the "development decade". The US administration regarded Iran as a role model for economic development; for instance, President Johnson considered Iran's progress as "one of the notable success stories of the period" (Popp, 2011: p86) and urged his economic advisor, Walt Rostow, to look into ways of "translating Iran's experience to Vietnam" (Saunders, FRUS, 1967). Accordingly, the young Western-educated technocrats who were officially put in charge of economic policymaking by the Shah were praised by the World Bank and the US advisors. The main institutions that were responsible for designing Iran's economic policies in this period were: the Plan Organisation, the Central Bank and the Ministry of Economy. The first two institutions set the macroeconomic policies while the latter managed the process of state-led industrialisation. Among this trio of policymaking institutions, Ministry of Economy enjoyed a higher degree of influence in decision-making than the Central Bank and the Plan Organisation (Nasr, 2000).

However, with the quadrupling of oil prices in 1973, the process of economic policymaking took a new turn inside the Pahlavi state. After the boom, the macroeconomic policymaking institutions were *completely* marginalised from decision-making by the Shah. Subsequently, against the advice of these institutions, all the windfall oil revenue was injected into the economy and the policy of import substitution was driven to an extreme. This "Big Push" ISI drive translated into a massive fiscal and

monetary expansion: the state's five-year development plan for the 1973-1977 period was suddenly doubled in size and the money supply grew by fourfold. At the same time, the value of the domestic currency was artificially kept at a high level (i.e. an overvalued exchange rate). Moreover, in a drastic move, Iran's capital account was liberalised in a single step in 1973. As will be outlined later, these inappropriate macroeconomic policies produced soaring prices, widening income inequality, capital flight and unprecedented corruption after the boom (Pesaran, 1982).

However, despite those negative outcomes, the Shah refused to empower the Plan Organisation and Central Bank in the post-boom period to restore stability via monetary and fiscal discipline. Instead he relied on a set of radical microeconomic policy tools to address the twin problems of rising prices and growing income inequality. Accordingly, to control inflation, the state engaged in a harsh "anti-profiteering" campaign in 1975, which ended up in the mass arrests of merchants and the jailing of several prominent industrialists. Simultaneously, to counteract the widening income inequality, private industrialists were obliged to transfer a large part of their company shares to their workers. Predictably, these radical policies severely damaged the trust between the state and businesses.

Considering these inappropriate macro and micro policy choices, it can be argued that the Pahlavi state reacted far more imprudently to the oil boom than any other petro-state. To be sure, some of the policy mistakes of the Pahlavi state were widely shared among petro-states; for instance, Saudi Arabia, Venezuela and Mexico also engaged in massive fiscal and monetary expansion after the boom while keeping an overvalued exchange rate (Gelb, 1988). But the Pahlavi regime went further than these common macro policy errors and embarked on a premature capital account liberalisation, a harsh price control campaign on businesses and a wholesale industrial ownership reform. This

inappropriate policy mix clearly distinguishes the Pahlavi state from other petro-states in terms of responding to the 1973 oil boom.

Unsurprisingly, this policy mix led to adverse economic outcomes after the boom: inflation jumped to an average of 15% for 1973-1978 and the annual capital outflows amounted to 10% of foreign exchange reserves on average (Mehran, 2013). In terms of inequality, the Gini Index rose from 42% in 1970 to its peak at 50% in 1975 (Salehi-Esfahani & Pesaran, 2008). Most importantly, the economy experienced a very volatile growth rate (Figure 1), exhibiting a drastic standard deviation of 8.3% for the post-boom period. Accordingly, Iran was transformed from one of the most stable and fastest growing economies in the 1960s into one of the most unstable and unequal economies in the 1973-1978 period. Only a small number of oil-rich countries experienced this magnitude of economic derailment after the oil boom. This economic failure, in turn, sowed the seeds of the eventual downfall of the Pahlavi regime in the 1979 Revolution.



Now the puzzling question is *why did the Pahlavi state react so badly to the 1973 oil boom in terms of macroeconomic policymaking, given its remarkable economic performance in the 1960s?* Relatedly, the deeper puzzle is *why did technocratic macroeconomic policymaking institutions in Iran turn out to be so politically vulnerable after the boom, given their impressive achievements in the previous decade?* This research attempts to answer these two questions. However, before outlining the thesis of this research, it is fruitful to briefly review the explanations offered in the literature for these questions and highlight their shortcomings.

Explanations in the literature

So far, two explanations have been offered for why the Pahlavi state mishandled the oil boom. The first explanation is inspired by the “rentier state” theory and more broadly the “resource curse” literature. The second answer is more rooted in the “Iranian studies” literature and is informed more by the particular history of pre-revolutionary Iran. As will be explained these two answers are not mutually exclusive.

The first answer implicitly relies on “petro-mania” hypothesis developed in the resource curse literature (Karl, 1997). According to this explanation, the oil boom inflamed the Shah’s grand ambitions to turn Iran into one of the most powerful nations in the world in a short span of time through implementing a series of grandiose economic and military projects. Consequently, he ignored the warnings given by the technocrats about the drastic macroeconomic consequences of these projects and marginalised the Central Bank and Plan Organisation in policymaking. This explanation is very popular among Iranian economists and historians. To substantiate this argument, they frequently refer to the famous “Great Civilisation” speeches made by the Shah after the boom, in which he boldly claimed that Iran was on an unstoppable march towards joining the industrial

nations in less than two decades (Milani, 2009, 2011; Afkhami, 2009; Keddie, 2006). For instance, Razavi and Vakil (1984: p66) explicitly link the downfall of policymaking institutions after the boom to the Shah's excessive confidence:

“Given the confidence factor, the Shah's character and experience, the management response was to further centralise decision making, even though the increased complexity of the economy required increasing delegation of authority at all levels. The Shah's response, as noted, was in line with the rapid fulfilment of his vision of Great Civilisation. The dream was announced, expectations were raised and thus the stage was set for the contradictions to work themselves out”.

Former officials of the Pahlavi regime also rely on a similar explanation. For instance, Khodadad Farmanfarmaian, the former Governor of the Central Bank and Director of the Plan Organisation, stresses that the Shah was “drunk” by the inflow of petrodollars (Farmanfarmaian, personal interview, July 2010). Likewise, Alinaghi Alikhani, the former Minister of Economy, points that that “the Shah was seduced by oil revenues” (Alikhani, Tejarat Farda, 2013a). Reza Niazmand, the former Deputy of Minister of Economy, also believes that high “oil revenues made the Shah an autocrat” in policymaking (Niazmand, Tejarat Farda, 2013b). Analytically, this explanation divides Iran's economic history into two periods of “before” and “after” the 1973 oil boom. Accordingly, in the first period, the technocrats were in charge of economic policymaking and, therefore, Iran achieved an impressive economic miracle. However, with quadrupling of oil prices, the Shah became overconfident and, consequently, marginalised the technocrats from policymaking. This then led to the mishandling of the boom and the resulting economic instability.

At first glance, Iran's case perfectly fits into the “petro-mania” hypothesis and approves the claims made in the resource curse literature and rentier state theory about the negative effects of oil booms on institutions and policymaking. However, a brief

comparison between Iran and other oil-rich countries show that, *on its own*, the oil boom fails to explain the Pahlavi state's imprudent policymaking and institutional failure after 1973. This is because other petro-states that experienced a similar boom followed a different path from the Pahlavi state in terms of policy selection and institutional development. In his thorough study of OPEC countries, Amouzegar (2001) shows that, notwithstanding some common policy choices, oil-rich countries reacted differently to the 1973 boom. This means that, contrary to the petro-mania argument, we cannot reduce the Pahlavi state's poor policymaking and institutional weakening in the 1970s solely to the sudden upsurge in oil revenues. In fact, the main shortcoming of the petro-mania argument and, more generally the resource curse literature, is that it treats oil as a structural variable that has a uniform negative effect on institutions and policies across countries (Torvik, 2009; Rosser, 2006). Naturally, this deterministic theory is unable to explain the wide variation witnessed across oil-rich countries in terms of economic and political development in the long run (ibid). For the same reason, it falls short of explaining why the Pahlavi state reacted worse than other petro-states to the 1973 oil shock. However, this point is often missed in the literature since most of the studies conducted on this topic only focus on Iran and lack a comparative lens.

Most importantly, the petro-mania argument wrongly assumes that the 1973 oil boom was exogenous to the Shah's behaviour. In this conceptualisation, the quadrupling of oil prices is seen as an external factor that caused a change in the behaviour of the Shah. However, ample historical evidence reveals that the oil boom, *itself*, was the outcome of a series of deliberate decisions made by Saudi Arabia and Iran in 1973. At first, in reaction to 1973 Arab-Israel war, the Gulf countries, headed by Saudi Arabia, imposed an oil embargo on Western countries and pushed up oil prices from \$3.12 per barrel to \$5.12 per barrel on October 16. Capitalising on this opportunity, the Shah started to

lobby for a second round of price increases in OPEC. His goal was to increase Iran's oil revenues to hasten the on-going process of industrialisation. Thanks to effective lobbying, he then managed to push oil prices up from \$5.12 per barrel to \$11.65 in the next OPEC meeting held in Tehran in December 1973 (Amouzegar, 2001). In this way, Iran played a major role in *creating* the oil shock. This indicates that the oil boom was the outcome of the Shah's behaviour, not the other way around.

The second explanation, which is put forward by historians in the "Iranian Studies" literature, links the mismanagement of the boom to the unique "despotism" of the Pahlavi regime (Katouzian, 1998, 2009). It argues that the Pahlavi state was a "Sultanistic" petro-regime where the Shah enjoyed absolute power both inside the state and also in relation to social classes. This power structure, in turn, allowed the Shah to rule arbitrarily and select radical policies at will. Consequently, when the oil shock happened, the Shah was not obliged to listen to economic experts. On the contrary, he selected a series of grandiose development projects to realise his "Great Civilisation" dream. The main shortcoming of this argument is that it relies on historical "exceptionalism" to explain the mishandling of the boom in Iran, without showing that Pahlavi' autocratic rule was actually "different" from other oil-rich autocracies such as Saudi Arabia, Libya, Iraq, Nigeria and Indonesia. Instead, Pahlavi's unique "Sultanism" or "despotism" is traced back by Katouzian (2009) to Iran's long-term history; in a way, the author argues that despotism has been in the DNA of Iran's political trajectory throughout the centuries. Obviously, this overtly deterministic explanation clings to political and cultural essentialism and stretches the historical analysis too far. The other shortcoming of this theory is that it assumes autocracy is bad for economic policymaking, while empirical research conducted by Collier and Hoeffler (2008) reveals that, on average, oil-rich dictatorships tend to outperform oil-rich democracies

in terms of economic growth due to having a longer political horizon. Thus, dictatorship and oil still fail to explain Pahlavi's poor economic reaction to the boom.

A new explanation

This research offers a novel explanation for mismanagement of the boom in Iran by treating the performance of Pahlavi regime in the 1960s and 1970s as two *interrelated* periods rather than two separate periods of “success” and “failure”. This thesis argues that the success of the ISI policy had generated a self-reinforcing process of rapid industrialisation in the 1960s, which *set the stage* for imprudent macroeconomic policymaking after 1973. This self-reinforcing process of industrialisation was formed in the following way. In 1963, the Pahlavi state started the first phase of ISI, which involved development of light industries. More than any factor, this policy decision was informed by the developmentalist ideology of the state, which fetishised rapid industrialisation and “catch up” development. The economic success of the first phase of ISI policy (1963-1967) created a series of spillover effects on the Pahlavi regime, which are outlined below:

1. Ideological: The remarkable industrial growth that accompanied ISI solidified the developmentalist discourse of the regime. In effect, the elite started to rely on high economic growth as the main source of legitimacy for their rule.
2. Geopolitical: alongside the development of light industries, ISI led to creation of industries such as steel, aluminium, metallurgy and automobile, that had high geopolitical importance for the state. Therefore, ISI strengthened the geopolitical status of Iran in the Gulf region.
3. Social: ISI entailed a drastic change in the state-business relationship; in 1963, the Pahlavi state cut its link with the conservative social classes, namely the Bazaaris and

landowners, who were involved in the trade and exports of agricultural and manufactured goods and formed a coalition with a new-born industrialist class that was engaged in development of consumer goods for the internal market. This meant a change of coalition from “outward looking” classes that attached high importance to external competitiveness to an “inward looking” class that had little interest in macroeconomic adjustments. This latter class was focused on gaining access to economic rents (tax breaks, cheap loans and tariff protection) via the ISI policy rather than improving its external competitiveness.

A combination of these effects motivated the political elite to follow “more of the same” policy and therefore, push the ISI forward towards heavy and intermediate industries, hence creating a self-reinforcing path of ISI acceleration. To borrow the utilitarian language of rational choice theory, the spillover effects mentioned above, increased the political utility of ISI for the elite over time, and in tandem, increased the cost of policy reversal. This means that the decision to embark on ISI in 1963 (after coming out of a balance of payments crisis), proved to be a critical juncture for the Pahlavi state since it directed that regime into a self-reinforcing path that made it resistant to any policy change in time. Crucially, the main negative by-product of this policy path was the gradual political marginalisation of macroeconomic policymaking institutions (CB and POB) as these institutions were the only actors inside the state that opposed ISI deepening due to its negative implications for macroeconomic discipline. The other negative side effect of this path was the relative economic and political decline of outward-oriented social classes (Bazaaris and the landlords), which were against protectionism.

As the Pahlavi state moved down the ISI path in the 1960s, its developmentalist ideology became stronger, its geopolitical standing in the Gulf was elevated and its

economic alliance with the industrial elite grew deeper. These factors made Iran's conditions fertile for a petro-mania at the time of the boom. Accordingly, when the price of oil quadrupled in 1973, the political elite engaged in a "big push" industrialisation program and pushed the ISI process to extremes and then stuck with this policy, despite its consequences for macroeconomic stability. Indeed, the oil boom, itself, had been partly instigated by Iran in the first place to acquire sufficient funds for this domestic industrial leap. Naturally, this ISI leap led to the further political marginalisation of the CB and PO and resulted in poor fiscal and monetary policies in the 1970s. In short, the oil boom did not generate a petro-mania in Iran on its own, however, it was the *interaction* of this boom with the self-reinforcing process of ISI deepening, which had been underway since 1963, that led to poor macroeconomic policymaking in the 1970s.

This is not to say that the mishandling of the boom was unavoidable in Iran. This research refrains from employing the strong version of path dependence, where a decision made in the past "locks" the country into a particular path. In contrast, path dependence used here claims that, once a country chooses a path, it tends to stick with it despite the presence of alternative options. Following this version of path dependence, this research shows that the elite *did* have the option to slowdown the "big push" industrialisation between 1975 and 1977 and shift towards fiscal and monetary prudence. However, they refused to do so because the entrenchment of the ISI path had increased the political cost of such a policy shift. Slowing down the ISI would involve the reduction of economic growth and the cancelation of many grand industrial projects that were of high geopolitical importance for Iran. This in turn, would entail large legitimacy and geopolitical costs for the regime as the Shah had already promised to turn Iran into

the fifth largest industrial nation in the world and the dominant military power in the Gulf region in less than a decade.

As its main theoretical contribution, this thesis uses the story of Iran to show how certain critical policy decisions can send petro-states into resilient paths and therefore, shape their subsequent economic and political trajectories. As a result, it introduces the role of path dependency into the analysis of petro-states and, in doing so, it offers a more *dynamic* and historical framework for studying these states.

Comparative lens

To substantiate the argument presented above, this research compares Iran with two similar oil-rich countries, Saudi Arabia and Indonesia, which reacted differently to the 1973 oil boom in terms of empowering technocratic institutions and choosing macroeconomic policies. This case selection is informed by Mill's "difference method", where similar cases that have experienced different outcomes are compared with each other. In this study, divergent outcomes (dependent variables) are (a) macroeconomic policy choices and (b) power of macroeconomic policymaking institutions.

Indonesia is often known as the "least-hit" country by the oil shock, due to her relatively good macroeconomic policy responses in the 1970s. Unlike in Iran, macroeconomic policymaking in Indonesia remained in the hands of the technocrats after the boom (except for a brief period), resulting in prudent fiscal, monetary and exchange rate policies (Gleb, 1988; Temple, 2003). In a way, Indonesia represents the most contrasting case to Iran in the literature (Karl, 1997).

The case of Saudi Arabia lies in between Iran and Indonesia in terms of macroeconomic and institutional responses to the boom. To be sure, like Iran, Saudi Arabia did choose excessively expansionist fiscal and monetary policies after the boom and experienced

high rates of inflation and instability as a consequence (Amouzegar, 2001). Importantly however, the Saudi Kingdom behaved differently from the Pahlavi regime in a significant respect: saving petrodollars abroad. After the upsurge in oil revenues, the Saudi Kingdom recycled a large share of its petrodollars to Western economies while Iran refrained from doing so. Accordingly, in contrast to Iran, the Saudi Kingdom empowered its central bank and placed it in charge of recycling petrodollars to the West. This build-up of savings provided a fiscal cushion for the Kingdom to counterbalance the negative effect of future oil price falls which the Pahlavi regime lacked.

This study shows that the reason that Indonesia and Saudi Arabia reacted differently from Iran to the oil boom was rooted in the policy path that they had been pursuing before the boom. Unlike Iran, Indonesia and Saudi Arabia had been following a non-interventionist development model since the early 1960s, in which the state gave priority to ensuring economic stability rather than to “catch-up” industrialisation. This economic model had become politically entrenched in these countries by 1973, hence reducing the incentive of the political elite at the time of the oil boom to radically change their economic policies and engage in a “Big Push” industrialisation. This comparison further highlights the importance of policy choices made in the past for the future policy trajectory of petro-states.

Process tracing

In order to provide supporting evidence for the claims made about Iran, Saudi Arabia and Indonesia, this thesis engages in “process tracing” (Pierson, 2004). This historical methodology, which is becoming popular among social scientists, empirically traces the chain of events that connects an event in the past to a distant outcome in the future. Ontologically, this methodologically is based on the assumption that certain important

events or decisions in the past can generate a *cumulative process* that can influence future policy decisions. This process involves three stages: 1. Identifying an important decision in the past 2. Tracing the cumulative process that follows from that decision 3. Relating that process to the final outcome under study. Following these steps, in the case of Iran, this research identifies the ISI policy chosen by the Pahlavi state in 1963 as a critical decision. Then, it traces how this decision directed Pahlavi regime into a self-reinforcing path of ISI deepening in the 1960s by having spillover effects on its (a) ideology, (b) geopolitical relations and (c) class coalitions. Finally, it shows that how this self-reinforcing path encouraged the Pahlavi regime to engage in a “big push” industrialisation drive after the boom and choose catastrophic macroeconomic policies. On the other hand, for Saudi Arabia and Indonesia, their deliberate decisions to avoid ISI policy in the early 1960s are considered as crucial events. The effects of these crucial decisions are then traced on their subsequent macro policy choices in the 1970s in the same manner. Therefore, the analytical narrative presented in all the three cases has a similar structure: path selection, path entrenchment and implication of that path for macroeconomic policymaking after 1973.

Plan of the thesis

Chapter one identifies the gap that this research fills in the literature. Chapter two outlines the research methodology and the various sources of historical data that are employed in this thesis. Chapter three explores the adoption of ISI in Iran in 1963. Chapters four and five track the entrenchment of ISI between 1963 and 1972 by exploring its spill-over effects on the characteristics of the Pahlavi regime. Chapter six focuses on 1973 oil boom and relates the mishandling of this boom to the self-reinforcing process of ISI that had been underway since 1963. Chapter seven and eight

contrast the experience of Iran with Indonesia and Saudi Arabia respectively. Chapter nine concludes and discusses the theoretical implication of this study.

Chapter One: Literature Review

At the broad level, the study of the 1973 oil shock and its effect on policymaking in Iran relates to two different strands of literature. The first strand is the resource curse literature and the rentier state theory. This literature, which has been dominated by economists and political scientists, is concerned with the detrimental effects of oil and other natural resources for economic and political development. The second strand is Iranian studies literature, more particularly the political economy research produced on economic development during the late-Pahlavi era. This literature is predominantly focused on explaining the economic causes of 1979 Revolution. This chapter reviews each of these literature strands and identify the gap that this research aims to fill.

1.1 The resource curse literature/ rentier state theory

The counter-intuitive idea that natural resource wealth is harmful for economic prosperity has been around since the days of Adam Smith. However, this idea has been theoretically and empirically developed in the last three decades by two separate, but interrelated, literature streams: the resource curse literature and rentier state theory. The main factor that separates the two streams is methodology; the “resource curse” literature, which has been mainly dominated by economists, relies on large-N quantitative studies, while the rentier state theory, which has been mostly developed by political scientists and sociologists, employs small-N qualitative studies. Both of these literature strands have undergone a process of ‘creative destruction’ in the last three decades, thanks to the falsification of some theories and emerging methodological criticism. This section reviews these two bodies of literature and situates the current study within them.

1.1.1 Resource curse literature

Prior to the 1980s, natural resources were considered as a blessing by the economics profession. For instance, most development economists such as Arthur Lewis, Jacob Viner and Benjamin Higgins believed that favourable natural endowments could help poor countries break out of the poverty trap by providing the necessary capital (Rosser, 2006). Similarly, Walt Rostow, who was the most influential figure in development policymaking in the 1960s, argued in his famous book “Stages of economic development” that natural resources would facilitate the economic transition of developing countries towards industrialisation, just as they had done for countries such as Australia, the United States, Canada and Britain (Rostow, 1961). The neoliberal economists later expressed similar views in the 1980s. To be sure, some development economists such as Albert Hirschman, Hans Singer and Raul Prebisch questioned the “blessing” of natural resources by highlighting the “declining terms of trade” and “enclave nature” of primary sector, but they did not go so far as to argue that natural resources were harmful for growth (Rosser, 2006).

However, this trend changed in the 1990s, particularly with the cross-country study conducted by Sachs and Warner (1995). Covering the period between 1970 and 1989 for 97 developing countries, they showed that resource-rich countries grew on average about one percent less than other countries between 1970 and 1989. This empirical paper, which was later developed by the same authors (Sachs & Warner, 1999, 2000), popularised the idea of the “resource curse” in the economics profession. This research triggered a new wave of large-N studies on the link between resource-abundance and economic growth. Most of this empirical research found supporting evidence for the resource curse (Gylfason, 2001; Gylfason & Zoega, 2003; Gylfason *et al*, 1999; Auty, 2001, 1993; Sala-i-Martin & Subramanian, 2003; Collier & Goderis, 2008; Cordon &

Neary, 1982; Stijns, 2003). This literature held Iran, Saudi Arabia, Venezuela, Nigeria and Algeria as prime examples of the resource curse. Going further, a new wave of studies showed that resource wealth has a detrimental effect on political institutions including democracy, the rule of law, public bureaucracy and corruption (Collier, P & Hoeffler, 2008, 2005; Jensen & Wantchekon 2004; Ross, 2004, 2001a, 2001b, 1999; Wantchekon, 2004; Vincente, 2007). Moreover, developing a sub-literature, a body of statistical research showed that natural resources are associated with a higher likelihood of civil conflict (Ross, 2012, 2004, 2002; Collier & Hoeffler, 2000).

Many of these empirical studies have now come under various methodological criticisms¹. In particular, Sachs (1995) is criticised for using inappropriate measures to capture resource abundance and also for relying solely on cross-country analysis (Rosser, 2006). Indeed, as argued by Rosser (2006), many proxies that are used to capture resource abundance in the literature such as production, exports, reserves and value are not truly exogenous as they are one way or another correlated with other economic or political variables. Therefore, many of these studies suffer from “endogeneity bias”. Indeed, a new body of empirical research has emerged in reaction to the resource curse literature (Lederman & Maloney, 2007; Brunnschweiler, 2008; Alexeev and Conrad, 2009; Sala-i-Martin *et al*, 2004); these studies show that actually natural wealth has a positive impact on growth. Specifically in the case of Iran, the econometrics research conducted by Mohades and Pesaran (2013) clearly demonstrates that oil has had a positive net effect on growth. However, despite these pieces of refuting evidence the idea of the resources curse has remained influential in the economics profession and policy circles, especially in the context of Iran. The following paragraphs review the theoretical explanations that have been forward for the curse.

¹ See Frankel (2012), Van der Ploeg (2010) and Rosser (2006) for a complete survey of empirical studies conducted on the resource curse literature and the methodological shortcomings of those studies.

The economic explanations

The Sachs and Warner (1995) study has encouraged economists to come up with several economic explanations for the curse. These explanations claim that natural resources directly harmed economic growth by affecting economic variables such as the real exchange rate, output volatility, foreign borrowings and domestic investment.

The Dutch disease is the most popular economic theory used for describing the curse (Sachs, 2007; Ebrahim-Zadeh, 2003). According to this theory, resource booms lead to an increase in the relative price of non-tradable to tradable goods (i.e real exchange rate appreciation). This real exchange rate appreciation can reduce the competitiveness (i.e. profitability) of the manufacturing sector in resource-abundant countries and as a result encourage labour and capital to move out of this sector (Cordon & Neary, 1982). However, this process of de-industrialisation can have consequences for economic growth in resource-rich countries (Chang 2006; UNIDO, 2009). This is because the manufacturing sector is often considered as the vital sector for the process of long-term economic development mainly due to the learning-by-doing and knowledge spillovers that happen in this sector (Lall, 1994; Wade, 2004).

The high volatility of commodity prices is the other economic explanation put forward. Humphreys *et al* (2007) and Davis *et al* (2003) point out that large fluctuations associated with the price of natural resources can lead to increases in output volatility and fuel “boom-bust” cycles in the overall economy. Hausmann and Rigobon (2003) highlight that for a country where oil accounted for 20% of GDP, a one-standard-deviation shock to the price of oil represented an income shock equivalent to 6% of GDP. Moreover, Mansoorian (1991) and Manzano and Rigobon (2001) add that resource wealth encouraged excessive borrowings in resource-abundant countries;

Humphreys *et al* (2007) show that during the commodity booms, resource-rich countries tend to engage in a borrowing binge as the international financial markets consider their resources as high-value collaterals. This process can lead to a debt default and a financial crisis when the price of natural resources subsequently falls. In addition, it is claimed that natural resources led to the over-expansion of the state and the “crowding out” of the private sector as typically revenues derived from these resources go directly to the state (Gylfason & Zoega, 2006). Finally, Auty (1994) argues that access to resource rents encourages countries to engage in an inward-looking industrial strategy and continuously postpone their shift to export promotion. This, in time, results in low productivity in the economy as domestic firms are not exposed to international competition.

Interestingly, many of the economic explanations that are outlined above fit the case of Iran in the 1970s. When the 1973 oil boom occurred, Iran experienced real exchange appreciation, output volatility, foreign borrowing (although on a small scale), state expansion and the lack of export promotion in the industrial sector. However, economists have argued that these problems can be easily avoided if appropriate macro and micro economic policies are adopted. For instance, an effective industrial policy together with public investments in infrastructures can allow resource-rich countries to strengthen their domestic manufacturing sectors and mitigate the de-industrialisation effects of the Dutch disease (Sachs, 2007; UNIDO, 2009). Similarly, fiscal savings can help these countries insulate themselves from positive and negative commodity shocks and avoid the problem of output volatility and exchange rate appreciation (Devlin & Titman, 2004). Moreover, prudent macroeconomic policies can discourage foreign borrowings in these countries at the time of the boom. In short, the economic explanations automatically imply that the resource curse can be avoided with prudent

macroeconomic policies and appropriate industrial policy at the micro level. Therefore, the economic explanations view the problem of the curse as a technical problem that can easily be fixed with the right economic policies.

However, the main problem is that usually resource-rich countries do not adopt these “right” economic policies in reaction to the booms. Instead, in most cases they engage in fiscal and monetary expansion and adopt a highly overvalued exchange rate (Collier & Goderis, 2008). Now the question that economic explanations fail to address is that if the curse can be easily avoided with prudent economic policies then why is it that most resource-rich states do not follow these policies? For instance in the case of Iran, a large body of archival evidence shows that the policymakers were aware of the economic consequences of spending all the oil revenues domestically after 1973 (see chapter six). Yet, they embarked on a massive “big push” investment. In other words, the economic theories cannot explain the persistence of bad economic policymaking in many resource-rich countries. To address this problem, advocates of the resource curse have moved towards political explanations.

Political explanations

It is now widely claimed that resource rents indirectly harm economic growth by influencing political factors such as the mentality of the political elite, the quality of institutions and the state-business relationships. For instance, relying on a behaviouralist approach, Mitra (1994) and Krause (1995) argue that resource booms make the political elite myopic, over-exuberant and irrational. Therefore, they tend to spend their resources on “White Elephant” projects and grandiose industrial plans and raise social expectations to an excessive level. This explanation is often applied to explain the mishandling of the 1973 oil boom in Iran. In fact, there is a consensus among specialists

of the Pahlavi era that the boom turned the Shah into a “megalomaniac” and encouraged him to spend all the petrodollars on a series of grandiose industrial projects, against the advice of economic experts (Milani, 2011, 2009; Afkhami, 2009; Katouzian, 1998). However, the problem with this behaviouralist explanation is that it reduces bad economic policymaking to the mentality of the elite and neglects the economic, social, institutional and geopolitical factors that made Pahlavi regime susceptible to myopic behaviour after the boom.

The second political explanation put forward for the curse focuses on the role of institutions. It argues that external rents provide governments with ample revenues and decrease their financial reliance on domestic tax revenues. This financial independence, in turn, reduces the incentive of the rulers to (a) be accountable to their citizens (democracy), (b) uphold the rule of law and (c) build a well-functioning public bureaucracy to provide public goods and collect taxes in return. Therefore, in such a situation, the political elite does not have the incentive, or the capacity, to manage the resource revenues prudently and transparently. Alternatively, they engage in patronage to maintain their grip on power. This patronage involves direct or indirect transfers of resources to specific social groups in the form of public sector jobs, welfare support, cheap loans, import monopolies and energy subsidies (Tornell & Lane, 1999; Lane & Tornell, 1996). This political explanation has been backed by a large body of empirical research that employs large-N studies. For instance, Ross (2012), Ramsey (2007) and Jensen and Wantchekon (2004) found a negative correlation between resources, oil in particular, and democracy². Also, Haber and Menaldo (2007) demonstrate that oil

² It is important to add that many of these studies have been criticised in the literature. For instance, cross-country studies done by Ross (2001) and Jensen and Wantchekon (2004) have been criticised for using an inappropriate proxy for measuring resource abundance and also failing to take into account counterfactual scenarios. In fact, the recent cross-country econometric analysis conducted by Haber and Menaldo (2009), Hourichi and Wagle (2008) and Herb (2005) do not find a negative link between natural resources and

prolongs authoritarianism. Specifically, Vincente (2007) illustrates that resource rents fuel corruption, rent seeking and patronage. More generally, Sala-i-Martin & Subramanian (2003) and Collier and Goderis (2008) shows that natural resources erode the quality of institutions, including democracy, the rule of law and public administration. Finally, the third political explanation for the curse concentrates on the state-business relationship. Torvik (2002) argues that windfall revenues encourage the private sector to divert its attention from productivity and innovation to rent seeking. In this way commodity booms crowd-out entrepreneurship and corrupt the state-business relationship.

All of the political explanations listed above argue that natural resources have an *unconditional* negative effect on institutions, policies and economic performance. As a result, they treat resource rents as destiny. This deterministic framework is informed by aforementioned large-N studies that have found a negative link between resources and economic prosperity. However, the main problem with these studies is that they focus on the *average effects* of resource rents. This focus on average effects automatically masks the large variation in economic policies and outcomes that are found among resource-rich countries. As argued by Torvik (2009: p242): “The most interesting aspect of resource-abundant countries is not their average performance, but their huge variation. Resource-abundant countries constitute some of the richest and some of the poorest countries in the world”. He highlights (p:241): “for every Nigeria or Venezuela there is a Norway or a Botswana”. Indeed, even excluding rich countries, we still see a wide variation in economic policies and outcomes among developing countries that are blessed with natural resources. Amouzegar (2011: p190) empirically supports this claim

democracy. For example, Haber and Menaldo (2009) point out that several resource-rich countries such as Mexico, Chile and Ecuador transitioned from autocracy to democracy during resource booms.

by studying the economic performance of OPEC countries in the last decade and points out the inadequacy of “resource curse” framework for the analysis of those countries:

“In the case of OPEC countries, however, the finding of this study fails to confirm this hypothesis [Sachs and Warner analysis]. Based on the volume of oil deposits as a relative indicator of natural wealth, Saudi Arabia and UAE, for example, which had the highest ratio of oil exports to GDP in 1974, did in fact grow more sluggishly than Indonesia, Ecuador, Algeria, and Iran which were not as richly endowed. But Kuwait and Iran achieved higher growth rates than Nigeria and Venezuela, which were less abundantly blessed. The large endowment with oil (and other natural resources in the case of Iran) also did not uniformly retard growth. And there were reasons for poor performance in other group members unrelated to oil reserves. The wealth thesis did not thus hold true in an intra-group comparison”.

Therefore, the main shortcoming the resource curse literature is that it fails to explain the large variation in economic policies and outcomes across resource-rich countries. For instance, so far this literature has not been able to explain why the oil-rich countries of Latin America have followed an entirely different economic and political trajectory from the oil-rich countries of the Middle East and Sub-Saharan Africa (Torvik, 2009). Additionally, this literature cannot explain the change in economic policies and performances of resource-rich countries *over time*. For instance, Di John (2009) highlights this theoretical shortcoming in the case of Venezuela: “...after allowing for selection bias, the *historical* relationship between non-oil growth and mineral resource abundance in Venezuela does not support the rentier state argument. Oil abundance has co-existed with periods of rapid growth, stagnation and growth implosions since 1920” (Di John, 2009 : p86). This argument can also be extended to the case of Iran; the large difference in growth rates before and after the revolution suggests that oil has not exerted a similar effect in Iran over time. In order to address this problem, the resource curse literature has moved to a new direction in the last decade, as pointed out by Torvik (2009: p42): “Recently we have seen a shift in the resource-curse literature.

Rather than investigating the average economic effects of resources, researchers have turned to the perhaps more important question: why do some resource-abundant countries succeed while others do not?" In line with this research agenda, scholars have been searching for potential factors that *interact* with resource rents and shape the effect of these rents on policies and economic performance. This research fits into this strand since it attempts to explain the different economic policies that were pursued in Iran, Indonesia and Saudi Arabia after the 1973 boom.

1.1.2 Rentier state theory

This theory was first presented by Mahdavy (1970) through studying the role of oil in Iran during the early 1960s and it was later applied to the Middle Eastern countries by Beblawi and Luciani (1987). Since then, this theory has been refined and developed mainly by political scientists and sociologists out of qualitative case studies conducted on a small sample of countries, including Iran, Saudi Arabia, Algeria, Nigeria and Congo. In many ways, this theory bundles together the political explanations put forward in the resource curse literature and constructs an encompassing framework for the economic and political analysis of resource-rich countries. Beblawi and Luciani (1987) define a rentier state as one that derives most of its revenues (more than 50%) from external rents such as oil and foreign aid. They argue this access to external rents shapes the nature of those states. Relaxed from the need to collect tax, the rentier states become authoritarian and weak in institutional capacity. More importantly, they claim that external rents transform the rentier states into "distribution states". Their idea is that access to external rents encourages rulers to focus only on the distribution of the rents to different social classes in order to buy their support (i.e. patronage). Consequently, the rulers have a weak incentive to follow economic policies that are aimed at economic growth and wealth creation. Instead, they focus on transferring rents to different

segments of society (i.e. patronage) to maintain their monopoly on power. Accordingly, the authors observed, rentier states tend to provide ample subsidies on “necessary” goods, establish inefficient state-owned enterprises that function as the “employer of last resort” for citizens and supply generous welfare services. However, this transfer of rents, they argued, hampers economic growth as it leads to economic inefficiencies and dead-weight losses for the society. It also encourages budget deficits, macroeconomic instability and expansion of inefficient state-owned enterprises that act as budget-maximisers instead of profit-maximisers.

The main shortcoming of the standard rentier state theory is that, like the resource curse literature, it clings to oil determinism. This theory assumes that petro-states tend to behave the same economically and politically, *irrespective* of their different class coalitions, geopolitical standings, ideology, internal power structure and histories (Rosser, 2004). Therefore, the rentier state theory neglects the role of country-specific factors in shaping policy choices and economic outcomes. This neglect of contextual factors automatically makes the theory insensitive to the timing of resource discoveries (or the timing of resource booms); in this static theoretical framework, resource booms tend to generate the same economic and political effects, no matter *where* or *when* they happen. In other words, irrespective of *prior* conditions, the resource discovery (or resource booms) produces the same effects across countries. Again, such a static and deterministic framework fails to account for the wide variation that is witnessed in the economic and political behaviour of resource-rich states over time and across countries (Mohades & Pesaran, 2013; Torvik, 2009; Brunnschweiler, 2009; Lederman & Maloney, 2007). Amouzegar (2001: p198) highlights this theoretical shortcoming specifically for the economic analysis of OPEC countries:

“The argument [rentier state theory], simply put, is that the origins of state’s chief revenues and especially the character of the revenue-producing sector, determine the nature of the state as predatory or developmental. The findings of this study show that such a deterministic approach lacks both strong non-Marxian theoretical underpinnings and empirically representative example. While similar boom-generated irrational euphoria, irresistible temptations to profligacy, personal rather than institutional power relations and weak and inept bureaucracies can all be detected in all member countries, differences in the choice of development path and the adoption of policy alternative among members cast doubt on the existence any omnipotent “over deterministic dynamic”.

To address these empirical challenges, the rentier state theory is now undergoing a process of refinement, similar to the resource curse literature. As mentioned in the previous section, the research on this topic has moved towards explaining the economic and political variations among resource-rich countries. The current study fits into to this new strand of research as it aims to explain why Iran reacted to the oil boom differently to Saudi Arabia and Indonesia. The next section reviews the studies that have focused on explaining the divergence among resource-rich countries and highlights how some of those studies have influenced the current research.

1.1.3 Explaining the divergence among rentier countries

The main preoccupation of the recent strand of research in the resource curse literature and the rentier state theory is to find factors that *interact* with natural resources and shape the developmental effect of those resources (Rosser, 2006). This means that the literature is moving towards a conditional theory of the resource curse (or resource blessing). So far, scholars have identified various factors (both at the time of resource discovery and during the inflow of resource rents) that mediate the economic and political effect of natural resources. The following paragraphs review these factors.

(a) Economic policy choices during the inflow of resource rents: many scholars argue that the reason that some resource-rich countries have been able to escape the “curse”

while others have failed to do so has been due to their better economic policies (Sachs, 2007; Humphreys *et al*, 2007; Lederman & Maloney, 2007; Davis *et al*, 2003). This literature highlights the importance of prudent macroeconomic policymaking and economic diversification for turning natural resources into a blessing. For instance, the economic success of Chile, Botswana, Indonesia, Malaysia and Thailand is often related to their “sound diversification policies” and counter-cyclical macroeconomic policies (Humphreys *et al*, 2007; Davis *et al*, 2003). In particular, much has been written on the importance of “stabilisation fund” in the proper management of copper resources in Chile or the pivotal role of technocratic economic policymaking in Indonesia in smoothing out the effect of positive and negative oil shocks in the economy (*ibid*). The main problem with these studies is that they offer only a technical explanation for why some countries have escaped the resource curse; they do not explore why governments in those countries followed prudent policies in the first place. Therefore, this literature cannot explain why, for instance, Indonesia went for technocratic economic policymaking after the 1973 oil boom while Iran, Venezuela and Nigeria did not. In short, these studies ignore the role of politics.

(b) The quality of institutions during resource inflows: several scholars (Robinson *et al*, 2006; Melhum *et al*, 2006) claim that the reasons that many resource-rich countries have a poor economic performance is because of the poor quality of their institutions (i.e the rule of law, democracy, protection of private property, checks and balances). In other words, they claim that the interaction of resource rents with weak institutions (or “grabber-friendly” institutions to use their label) lead to development disasters. This is because when institutions are weak, rulers enjoy the autonomy to use resource rents for patronage and self-enrichment. Nigeria, Congo, Algeria, Sierra Leone, Sudan, Liberia and Chad are often cited as prime examples of such development disasters. On the other

hand, when institutions are strong and effective checks and balances are in place, as in the case of Norway, Canada and New Zealand, the political elite is forced to manage the resource rents effectively and transparently. The problem with these explanations is that they ignore the fact that institutions, themselves, may be *endogenous* to resource rents. Indeed, as mentioned, a large body of theoretical and empirical literature supports this claim. For instance, the qualitative study conducted by Ross (2011b) on a number of Southeast Asian countries show that resource booms enable politicians to slowly dismantle checks and balances on their power through the promise of patronage or populist policies. Another shortcoming of this institutionalist explanation for the curse is that it assumes that public accountability forces political elite to follow sound economic policies at the time of the resource booms. However, there is no reason to assume that the public would demand prudent fiscal and monetary policies at boom times. As Collier (2013) argues, democracy and transparency does not necessarily create a social demand for the proper management of resource wealth. Finally, this institutionalist explanation is unable to account for the successful growth stories achieved despite the poor quality of institutions. Indonesia represents the prime of example of such growth stories. This country managed to escape the “curse” despite dictatorship, high levels of corruption, a lack of transparency and weak protection of property rights (Rosser, 2004).

(c) The quality of institutions prior to resource discovery: in her seminal book, “Paradox of plenty”, Karl (1997) argues that to explain the divergence between resource-rich countries we need to go back to the time of resource discovery. She highlights that natural resources were discovered in the US, Canada, Britain and Norway at a time when these countries had already undergone the process of state-building and as a result they had strong political institutions. This favourable initial condition enabled these

countries to use their natural endowments effectively and industrialise their countries, hence following a virtuous circle of economic growth and institutional development. On the other, she mentions that resource discovery in the developing world coincided with the period of state-building; therefore, when countries such as Iran, Saudi Arabia, Nigeria, Venezuela and Indonesia found their resources, they had weak and underdeveloped states. This unfavourable political condition, in turn, pushed these countries into a vicious circle of institutional decay and bad economic policymaking. Karl (1997) exclusively focuses on Venezuela as a representative case to empirically substantiate this point. Her argument emphasises the timing of resource discovery and, in effect, takes the role of history and initial conditions seriously. Similarly, Acemoglu *et al* (2003) highlight the role of favourable initial conditions at the time of the diamond discovery in Botswana to explain the subsequent economic success of that country. They mention that when mineral wealth was found, the county had strong tribal institutions that constrained the power of elites and encouraged broad-based political participation. They note that these “inclusive” political institutions, which had been in place since the pre-colonial era, forced the elite to guarantee the protection of property rights, uphold “producer friendly” economic institutions, and use the diamond resources transparently and efficiently in the post-colonial era. In this way, they implicitly confirm the validity of Karl’s argument for the case of Botswana.

However, the main flaw of Karl’s theoretical claims is that, in a way, it still suffers from the oil determinism of standard rentier state theory. According to her argument, if resources are discovered in a country at a bad time, then that country will be locked into a vicious circle of economic and political deterioration. Again, this argument cannot explain why countries such as Chile, Malaysia, Indonesia and Thailand have managed to escape the curse because all of these countries had very weak political institutions at

the time of resource discovery (Torvik, 2009). This is while many countries that are often considered as “typical” examples of the resource curse had relatively developed states at the time of resource discovery. For instance, in the case of Iran, the country had a strong army and an efficient tax-collecting public bureaucracy in the 1930s (Katouzian, 1981), which was the period when oil revenues start to flow into the coffers of the government in significant amounts. Additionally, due to its implicit determinism, Karl’s (1997) argument is unable to explain the ups and downs in economic performance of resource-rich countries over time. For instance, Di John (2009) challenges her argument in the case of Venezuela by pointing out the highly varied economic performance of the country from the period of oil discovery to 2005.

(d) Class coalitions in boom times: as mentioned, so far, the standard rentier state theory and resource curse literature have completely ignored the role of social classes in institution-building and economic policymaking in resource-rich countries. Indeed, by definition, rentier states are assumed to be “autonomous” from social classes because of their low dependence on tax revenues. This assumption is informed by the history of state-formation and democratisation in European countries. As pointed out by Tilly (1992), under the threat of external wars, European states were forced to rely on tax revenues to build strong armies in the 18th century and, it is argued, that this very process of tax collection gradually encouraged institution building and democratisation (Ross, 2012) as citizens started to demand accountability and checks and balances in return for their tax payments. These Western-centric theories of state formation echo the well-known proposition of “no representation without taxation”. However, arguing against this proposition, Herb (2005) mentions that there is no reason to assume taxation is the only mechanism through which citizens can pressure the political elite in institution building and economic policymaking. He points out that social classes can

still exert pressure on the rentier states through the threat of violence or civil disobedience. Indeed, the 1979 revolution in Iran was a vivid example of a pressure exerted from “below” on the state. In that case, the Bazaar and Ulemma were able to mobilise social opposition to the state by virtue of being deeply rooted in society, both economically and ideologically. Similarly, in the realm of economic policymaking, several studies have shown that state-society links matter in the way resource rents are spent. For instance, Bevan *et al* (1999) shows that deep-rooted differences in the structures of interest groups in Nigeria and Indonesia have played a major role in the adoption of vastly different economic policies in these countries in the last five decades. Similarly, studying the process of economic liberalisation in Saudi Arabia in the 1980s, Chaudhry (1994) shows that the private sector did not play a passive role in this process. These studies suggest that class analysis should be systematically incorporated into the rentier state theory and resource curse literature.

Perhaps Saylor (2012) is perhaps the only study that has moved in this direction. He explores the effect of commodity booms in state-building and the provision of public goods in Latin American countries during the 19th century. He argues that depending on state-society coalitions, resource booms can produce different effects. If the state is in a coalition with an export-oriented class such as commodity producers or traders, then resource booms induce those classes to push for the supply of public goods, such as infrastructure, to overcome the economic bottlenecks that emerge during the booms. Additionally, to ensure the marginalisation of rival social classes during the boom time, the export-oriented classes demand that the state expand its control at local levels through institution-building. This latter effect is realised especially when the political elite and export-oriented social classes feel threatened by the rival classes. Saylor (2012) summarises his argument in the following way (p321):

“Whether commodity booms result in new state capacity seems to hinge on the type of political coalition that prevails in any given country. Sometimes actors with direct stakes in exporting are in charge of a country’s ruling coalition, as was the case in Chile and Argentina. Commodity booms promote state building in these situations because of the close alliance between exporters and government officials, though whether state building projects germinate is also conditioned by contextual factors, such as public goods preferences and the political threats faced by ruling coalition members. Other times, actors without a direct stake in exporting lead ruling coalitions, as in Colombia, which dispose these countries to missing the state building opportunities associated with commodity booms. In short, it appears that commodity booms create conditions ripe for state building, but coalitional politics ultimately determines if the windows of opportunity opened by commodity booms will result in the growth of state capacity”.

Evidently, this study places emphasis on the economic-orientation of social classes (outward-looking versus inward-looking) to analysis the effect of booms on institutions. Inspired by this study, this research pays attention to the state’s class coalition, particularly the economic orientation of the allied class, to analyse the politics of macroeconomic policymaking after the oil boom. My assumption is that if the state is in a coalition with an export-oriented class at the time of the boom, then that class has an incentive to push for prudent macroeconomic policies, especially in the realm of exchange rate policy, to protect its external competitiveness (i.e. to avoid the Dutch disease). However, if the state is a coalition with an inward-looking class, then that class has little incentive to protect the economy from the Dutch disease and therefore, has no interest in upholding macroeconomic discipline. Of course, this is not to say that having a coalition with an outward-looking class is a sufficient factor for prudent macroeconomic policymaking at the boom times; rather, it is suggest that the economic orientation of social classes can potentially matter in policy choices.

(e) Decisions made at “critical times”: none of the explanations reviewed so far incorporate the role of choice in their analysis; they all claim that the political and

economic trajectory of resource-rich countries is determined by the interaction of resource rents with a structural variable (quality of institutions or economic orientation of influential social classes) that is very hard to change in the short term. In other words, they focused on “deep” economic, political or social forces to explain the divergence between rentier economies. However, going against this trend, some scholars (Smith, 2007; Hertog, 2010) have emphasised the role of “decisions made at critical times” to explain the variation between resource-rich countries. The idea here is that a decision made at a “critical juncture” can send countries into a self-reinforcing economic (or political) path and, in effect, incrementally limit their future options.

Hertog (2010) applies this form of causal reasoning (cumulative causation) to explain the lacklustre economic performance of Saudi Arabia in the 1980s and 1990s. He starts his analysis from the early 1960s, when oil revenues were flowing into the coffers of the state on a large scale for the first time. He highlights that at that time, King Faisal formed a cabinet that distributed power among different factions of the family. This balance of power then shaped the expansion of the Saudi bureaucracy as the oil revenues steadily increased. According to Hertog (2010) this led to the emergence of a highly fragmented state in the 1960s, where each agency or ministry ended up in the hands of a particular faction of the family. Becoming entrenched in time, this fragmented bureaucracy, in turn, made it difficult for Saudi Arabia to engage in institutional reforms or state-led development in the 1980s and 1990s. Thus, the author shows that a decision made by King Faisal in the early 1960s had lasting influence on the future choices of the political elite. This form of path-dependent analysis suggests that the behaviour of rentier states is dynamic, in a sense that their actions during one period of time may affect their actions during a different time period.

Similarly, this research employs path-dependence analysis to explain the divergence in macroeconomic policymaking between Iran and the two selected cases. It claims that the economic policies that were selected by these countries in the early 1960s became entrenched over time with the steady inflow of oil revenues and, in turn, shaped their subsequent economic reactions to the 1973 oil boom.

To summarise, the so-called “new generation” of rentier state/resource curse literature has so far focused on economic policymaking, the quality of institutions, timing of resource discovery, economic orientation of dominant social classes and “critical decisions” to explain why some countries have escaped the curse while others have failed to do so.

This literature, however, has ignored the role of two important factors in the analysis of resource-rich states. The first factor is ideology; the standard rentier state theory does not take into account the power of ideas in shaping the preferences of decision makers. Indeed, this neglect of ideology as an important explanatory factor in fact applies more generally to the discipline of “modern political economy” as argued by Rodrik (2013). However, the very fact that economic policies of developing countries tend to shift to certain economic paradigms at the same time suggest that ideas play an important role in economic policymaking; for instance, in the 1960s and 1970s most countries in the South (resource-rich or resource-poor) followed state-led development and then they simultaneously shifted to neoliberal policies in the 1980s and 1990s. Bevan *et al* (1999) offers perhaps the only study that acknowledges the importance of ideology in the behaviour of resource-rich governments. Comparing Indonesia and Nigeria over five decades, they show that the popularity of free market ideology in the former led to more prudent macroeconomic policymaking. Similarly, this research incorporates ideology as an important explanatory factor in economic policymaking. The other factor that has

been ignored in the study of rentier countries is geopolitics. As pointed out by Rosser (2006): “Much of the literature on the resource curse focuses on the effect of *domestic political variables*, particularly the nature of the state and the behaviour of political elites, on development outcomes” (emphasis added, p:561). To be sure, there are studies conducted on how natural resources impact civil and international conflicts (Colgan, 2013; Ross, 2004; Collier & Hoeffler, 2000), but little research has been done on how geopolitical factors impact the pricing and spending of natural resources in countries, while historians (Yergin, 1991) have shown that, in case of OPEC countries for instance, the pricing of oil and recycling of petrodollars have been highly influenced by geopolitical considerations. This research fills this gap by incorporating geopolitics into its analysis.

Overall, the main contribution of this study to the so-called “new generation” of rentier state/resource curse literature is that it focuses on the 1973 oil shock, which is considered as the “mother of all” oil shocks in terms of magnitude (Ross, 2012; Amouzegar, 2001), and attempts to explain why Iran behaved differently to this shock in terms of macroeconomic policymaking from Saudi Arabia and Indonesia. The main advantage of such a small-N analysis is that it allows us to “dig deep” and identify contextual factors that can *condition* the effect of resource booms on economic and political behaviour of rentier states. In other words, it helps us better capture the interaction effects between oil and other variables (i.e. multifactor causation). Methodologically, this requires studying every aspect of rentier states in detail including their ideology, policymaking institutions, internal power structure, class coalitions and geopolitical relations. Another strength of small-N analysis is that it can explore the possibility of path dependency (i.e. cumulative causation) in the behaviour of rentier states. In terms of methodology, this demands studying rentier states over time. For this

purpose, this research adopts “historical institutionalism” as its theoretical framework. This framework, which is widely used in comparative politics, offers a holistic and dynamic approach for studying states.

However, small-N analysis suffers from a major disadvantage; its findings have low external validity. Due to the importance of country-specific factors, analytical narratives generated by small-N studies do not have a high applicability for other cases. Therefore, the ideal is to combine this approach with a large-N quantitative analysis, but this thesis leaves the complementary quantitative analysis for future research.

1.2 Iranian studies literature

A large body of literature in “Iranian studies” is devoted to the study of economic development before the revolution. This historical episode is often conceptualised as the “golden age” of rapid growth in the economic history of the country (Hakimian, 2008; Salehi-Esfahani & Pesaran, 2008). The research conducted on this topic can be divided into two categories. The first category comprises studies that focus on the economic policies of the government in that period and the economic, social and political effects of those policies. These studies consider government policies as “taken” (exogenous) and do not explain how those policies were shaped in the first place. In other words, they do not focus on the political economy of policymaking in that period. The second category of studies deals with the political economy of the Pahlavi regime and seeks to explain how politics shaped economic choices. This section reviews these two streams of literature.

1.2.1 The economic analysis of policies

Scholars often divide Iran's economic development before the revolution into two period of "before" and "after" the 1973 oil boom. The first period is often characterised as a period of stability, high growth and rapid industrialisation while the latter is known as the period of economic instability, volatile growth and widening income inequality. Therefore, the 1973 oil boom is known as a crucial turning point in Iran's economic development. Indeed, there is a consensus among historians that the mismanagement of this boom was one of the prime factors behind the subsequent downfall of the Pahlavi regime in 1979. The economic policies of the two periods have been analysed in detail in the literature (Amouzegar, 1992, 1991; Walton, 1980; Pesaran, 1982; Looney, 1992; Mofid, 1987; Razavi & Vakil, 1984; Rahnema, 1990; Fatehi & Veliyath, 2008; Mohatdi, 1987; Nowshiravani & Bildner, 1973).

Specifically, Hasanali Mehran, the former Governor of the Central Bank, offers a comprehensive review of monetary policy in Iran from 1960 to 1978 in his latest book (Mehran, 2013). He shows that the government was relatively successful at upholding monetary discipline in the 1960s, but then, this discipline gave way to excessively loose monetary policy when the oil revenues hiked in the 1970s. Salehi-Esfahani (1989) points out that this loose monetary policy led to rent seeking and corruption in the banking system. Similarly, Walton (1980) and Pesaran and Salehi-Esfahani (2008) contrast Iran's fiscal policy in the two periods. They show that that in the first period, the steady growth of oil revenues enabled the policymakers to effectively plan for their future spending and follow a relatively prudent fiscal policy, but when the oil revenues jumped in the second period, the government followed a highly expansionary spending policy. In effect, the government increased its spending far beyond the "absorptive capacity" of the economy (i.e the exiting infrastructure and manpower) and this resulted

in severe supply bottlenecks and soaring inflation. Walton (1980) and Pesaran and Ghahvary (1976) highlight that the main beneficiaries of these expansionary policies turned out to be top income groups in the society. Overall, these studies show that the imprudent macroeconomic policies of the 1970s had grave social and political consequences.

Iran's sectional policies are also analysed thoroughly in the literature. The Pahlavi regime has often been criticised for favouring industrial development at the expense of agricultural growth. For instance, Katouzian (1978) highlights that the state relied more on food imports than domestic supply to keep the food prices low in urban areas and make sure that wages would remain low. At the same time, an overvalued exchange rate was adopted to indirectly subsidise food imports. He also adds that agriculture received a smaller share of development expenditures than industry in the 1960s and 1970s while that sector accounted for a large share of GDP and employment. This neglect of agriculture, according to the author, led to "uneven development" in the country and, in effect, triggered mass rural-urban migration. Katouzian argues that the root cause of this "heavy bias against agriculture" was oil because it provided the necessary foreign exchange and capital to fund industrial development and therefore, eliminated the state's dependence on taxing agricultural surplus. Many historians also agree with this assessment (Halliday, 1979; Keddie, 2006, 1979). In fact, they dismiss Pahlavi's land reform of the early 1960s as just a political attempt to crush the power of landed elite and the Ulemma (who owned land in the form of "vaqf") rather than a genuine reform aimed at improving agricultural production. Going further, they argue that "economic failure" of this reform, which resulted in a "rural exodus", was one of the prime factors behind the revolution. However, the research conducted by Majid (1992), Karshenas (1990) and Amouzegar (1991) pose a serious challenge to these claims. In particular,

drawing on several data sources, Majid (1992) reveals that, contrary to the popular belief, agricultural output, productivity and employment increased at a relatively high rate during the 1960s and 1970s. He also adds by 1971, 85% of agricultural lands was transferred to peasants thanks to the land reform (ibid). So, he shows that by international standards, Iran's land reform was a success and the mass rural-urban migration that followed it was a normal phenomenon given the rapid growth of the economy. This argument suggests that it was not failure of land reform that caused the revolution, but it was the failure of large cities to absorb the large wave of migrant workers. This reading of the revolution automatically shifts the spotlight to the analysis of the industrial sector as a potential destination for the migrants.

Among the studies conducted on industrialisation in pre-revolutionary Iran, Karshenas (1990) and Alizadeh (1984) offer the most comprehensive empirical and theoretical analyses. Theoretically, the main pre-occupation of Karshenas (1990) is to explore the link between oil and economic diversification; its main empirical focus is to assess the economic effects of the ISI process in Iran during the 1960s and 1970s at the general level. On the other hand, Alizadeh (1984) focuses more narrowly on the economic analysis of the automobile sector. The current research heavily relies on Karshenas (1990) to provide a general picture of different stages of ISI. The following two paragraphs provide a brief summary of Karshenas' assessment of ISI in Iran.

According to that study, the 1960 balance of payments crisis and the subsequent austerity period provided the main impetus for the government to shift towards protectionism and adopt an activist industrial policy from 1963 onwards. At that time, Iran's industrial sector lagged behind that of similar countries like Turkey and Egypt. In the first stage of ISI (1963-1967), the government focused on the development of light industries behind high tariff barriers by supporting private investment. For this purpose,

it gave ample credit subsidies and tax breaks to large-scale industrial firms in order to motivate them to diversify their economic activities towards the production of various consumer goods. In parallel to this business-oriented strategy, the government focused on investing in heavy industries such as steel and basic metals. These investments, however, did not “crowd out” private investment as they were funded by external sources (oil). In the second stage (1968-1972), the focus of ISI was shifted to the development of intermediate and heavy industries such as aluminium, petrochemicals and machine building. At the same time, various policy measures such as financial rewards and credit subsidies were devised to promote manufacturing exports in the private sector.

Thanks to these measures, Iran’s industrial output, productivity and employment respectively grew by 14.3%, 6.7% and 7.2% from 1963 to 1972. However, Karshenas identifies two sets of problems in Iran’s industrialisation process in this period. The first problem was that the credit subsidies pushed industrial firms towards adopting capital-intensive production systems. As evidence, the incremental ratio of capital to labour rose from 815 million rials per worker in the first stage of ISI to 2671 million rials per worker in the second stage. Due to this capital-intensive structure, large firms, which produced about 65% of industrial output, accounted for only 32% of employment in the industrial sector. This indicates that the modern industrial sector contributed little to employment generation, despite experiencing a high rate of growth. The second problem was that ISI resulted in a high degree of import dependency in the industrial sector (15% of non-oil GDP). This is because the industrial sector absorbed about 70% of total imports while generating less than 10% of export earnings. This means that this sector was extremely reliant on foreign exchange revenues earned out of oil exports. According to Karshenas, these two problems then became magnified after the 1973 oil

boom as the government decided to inject its petrodollars into the economy and make a large leap into the third stage of ISI, which involved the substitution of capital goods. During this stage, the ratio of capital to labour jumped to 6473 million rials per worker. At the same time, the rapid appreciation of the exchange rate further reduced the ability of domestic firms to compete internationally and contribute to export earnings. In short, Karshenas highlights that in the 1960s the ISI process gave rise to a modern inward-looking industrial sector, which was (a) highly reliant on oil revenues for its import needs and (b) unable to contribute effectively to job creation due to its highly capital-intensive production system. These problems were then amplified with the massive domestic injection of oil revenues into the industrial sector after the boom. Finally, it is crucial to add that Karshenas stresses that these problems, which are often presented as confirming evidence for the resource curse in Iran, were *not* unavoidable. On the contrary, he argues that oil could potentially foster a sustainable process of economic diversification in Iran if appropriate industrial and macroeconomic policies were chosen.

Other studies conducted on Iran's industrialisation confirm Karshenas' findings. For instance, in the case of the automobile sector, Alizadeh (1984) similarly finds that the external competitiveness of this sector fell sharply in the post-boom period. Moreover, Hakimian (1998) assesses the impact of ISI on the working class and concludes that the benefits of this process did not "trickle down", due to the highly capital-intensive structure of production in the modern industrial sector.

To recapitulate, the studies reviewed above show that in the 1960s, when the oil revenues were increasing at a steady pace, the Pahlavi state initiated economic diversification through ISI. For most of this period, the state managed to uphold macroeconomic discipline. This industrialisation program resulted in an "economic miracle", but by creating a modern industrial sector that contributed little to export

earnings and employment. Subsequently, when the oil revenues hiked in the 1970s, the state pushed the ISI process to an extreme and sacrificed macroeconomic discipline for rapid industrialisation. This “big push” policy not only exacerbated the existing structural imbalances in the industrial sector but also bred economic instability, income inequality and corruption.

1.2.2 The political economy literature

The literature on the political economy of pre-Revolutionary Iran can be divided into two categories. The first category focuses on the “Pahlavi state” as its unit of analysis and seeks to conceptualise the characteristics of this state to explain its economic and political behaviour. The main pre-occupation of this category is to uncover the root causes of the 1979 Revolution. The second category takes a more focused approach and concentrates on certain policymaking institutions inside the state (the Plan Organisation, Central Bank and the Ministry of Economy). This category is mainly concerned with explaining Pahlavi’s economic mismanagement in the 1970s. Reviewing these two categories, this research argues that neither is able to provide a satisfactory explanation for the Pahlavi regime’s mishandling of the 1973 oil boom.

Conceptualisation of the Pahlavi state

The Pahlavi state has been conceptualised in various ways by different schools of thought in political economy. The theoretical framework that proved to be very influential at the beginning was the “dependency theory”. Perhaps, this is because the first wave of political economy research conducted on this topic, which was during the 1970s, coincided with the ascendancy of this theory. Advocates of this theory argue that the Pahlavi state was a typical “dependent state” that heavily relied on multinationals for both extraction of its oil and the diversification of its economy (Haliday, 1979;

Imam-Jomeh, 1985). Accordingly, this dependent relationship reduced the autonomy of the state to regulate foreign capital according to the national interest. Therefore, the state devised very loose regulations when it came to encouraging the transfer of technology and know-how from foreign firms to domestic ones (Rahnema, 1990; Nowshiravani & Bildner, 1973). For instance, it placed a weak local content rules and technology transfer requirements on foreign firms in return for giving them access to the protected domestic market (ibid). It is argued that this lax regulation encouraged the rise of an “enclave” modern sector that had little backward and forward linkage with the rest of the economy. This form of “dependent capitalism” not only failed in industrial upgrading, but led to a growing polarisation of wealth, which in turn, set the stage for the 1979 Revolution.

These dependency arguments, however, have been heavily criticised in the literature. The main critique is that this school exaggerates the role and influence of foreign capital in the economy. As evidence, Mofid (1987) outlines that FDI only accounted for 10% of fixed capital formation in the industrial sector in 1969. This percentage later dropped to 1.5% by 1975 as the state became increasingly involved in industrialisation. In addition to these economic critiques, a recent wave of revisionist history (Alvandi, 2014; Afkhami, 2009; Milani, 2011, 2009) reveals that the Pahlavi state managed to incrementally increase its autonomy from foreign powers, especially from the US, during the 1960s and 1970s and operate as an active agent in the international economic and political order rather than just as a passive “peripheral” actor. To support their argument, the revisionist historians highlight Iran’s independence in the pricing of oil and recycling of petrodollars in the 1970s (ibid). The dependency theory fails to explain why the Pahlavi state refused to lower oil prices or invest its petrodollars abroad in that period, despite pressures exerted by the US.

Going against the dependency school, some scholars have conceptualised the Pahlavi regime as a “developmental state” (Milani, 2011, 2009; Afkhami, 2009; Nasr, 2000). According to them, the Pahlavi state shared many characteristics of East Asian states in South Korea and Taiwan; it had (a) a developmentalist ideology that gave priority to “catch-up development”, (b) a high degree of autonomy from social classes and foreign powers and (c) a set of technocratic policymaking institutions. It is argued that these characteristics allowed the Pahlavi state to effectively manage a business-oriented industrial strategy and achieve an “economic miracle” in the 1960s and 1970s.

The concept of the “developmental state” has a high explanatory power when it comes to explaining rapid economic growth in Iran in the 1960s (Alizadeh, 2000). However, this concept cannot explain the collapse of technocratic policymaking in Iran in the 1970s. This is because the East Asian developmental states are often praised as success stories of rational and prudent economic policymaking (Woo-Cumings, 1990). So, in terms of macroeconomic policymaking, the behaviour of the Pahlavi state clearly diverged from that of the typical East Asian cases.

Finally, the most best-known conceptualisation of the Pahlavi state is offered by Katouzian (1998, 1981). He argues that Pahlavi was a “despotic” regime, where the Shah enjoyed absolute power both inside the state and in relation to social classes. This power structure allowed him to rule arbitrarily without any limits. Specifically, in the realm of economic policymaking, this meant that the Shah could set economic policies according to his personal wish. Relying on this conceptualisation, Katouzian criticises Iran’s economic strategy in the 1960s and 1970s. He states that the Shah’s reforms aimed at emulating only the façade of modernity (large dams, large industrial plans and modern shopping malls) and accordingly, he sought to modernise the country from the “top” by spending oil revenues on large-scale infrastructure and industrial projects

while neglecting other sectors of the economy, most notably agriculture. This “pseudo-modernism” only benefited a small fraction of society and led to “uneven development”. Subsequently, when the oil revenues jumped in the 1970s, the Shah introduced a series of grandiose industrial projects according to his personal vision of modernity. In this way, Katouzian links the mismanagement of the oil boom to Pahlavi’s extreme level of autocracy, which he conceptualises as “despotism” or “Sultanism”.

The main shortcoming of this argument is that it relies on historical “exceptionalism” to explain the mishandling of the boom in Iran, without empirically showing that Pahlavi’s autocratic rule was actually “different” from other oil-rich autocracies such as Saudi Arabia, Libya, Iraq, Nigeria and Indonesia. Instead, Pahlavi’s unique “Sultanism” or “despotism” is traced back by Katouzian (2009) to Iran’s long-term history; in a way, the author argues that despotism has been in the DNA of Iran’s political trajectory throughout the centuries. Obviously, this overtly deterministic explanation clings to political and cultural essentialism and stretches the historical analysis too far. The other shortcoming of this theory is that it assumes autocracy is bad for economic policymaking, while empirical research conducted by Collier and Hoeffler (2008), reveals that, on average, oil-rich dictatorships tend to outperform oil-rich democracies in terms of economic growth, due to having a longer political horizon.

To summarise, the Pahlavi state has so far been conceptualised by different schools of thought as a “dependent state”, a “developmental state” and a “despotic state”. However, none of these concepts are able to adequately explain Iran’s adverse macroeconomic responses to the boom.

Literature on policymaking institutions

Within the literature generated on pre-Revolutionary Iran, there is a sub-literature that narrowly focuses on economic policymaking institutions inside the state. This sub-literature is mainly produced by Iranian technocrats or foreign advisors, who were closely involved in the process of institution building and policymaking. Some of these studies are descriptive in nature and focus only on technical issues while others also attempt to uncover the politics of economic policymaking. This sub-literature mainly concentrates on the Plan Organisation, the Ministry of Economy and the Central Bank, as key economic policymaking institutions.

Most of this sub-literature has concentrated on the Plan Organisation as the key policymaking institution. This institution, which was responsible for developing planning and fiscal policymaking, has been studied by Bostock and Jones (1989), Baldwin (1967) and Razavi & Vakil (1989). Following a business history perspective, Bostock and Jones (1989) tell the story of the PO's creation and ascendancy in the 1950s by relying on archival documents. They particularly focus on the pioneer of economic planning in Iran, Ebtehaaj. They argue that Ebtehaaj's personality, technical knowledge and reputation in the international banking community played a major role in the development and political empowerment of the PO. To put in differently, they claim that Ebtehaaj acted as an "institutional entrepreneur" (Guard & Maguire, 2007), who laid the foundations of economic planning in Iran. However, eventually, he clashed with the Shah over the growing share of oil revenues going to military spending instead of development expenditures. This clash reached its peak in the late 1950s and, in the end, Ebtehaaj was dismissed from the PO in 1959. After this dismissal, the PO lost its political clout according to the authors. This study, however, does not go forward to explore the PO's trajectory in the crucial periods of the 1960s and 1970s.

In contrast, the study conducted by Baldwin (1967) extends the analysis of the PO into the early 1960s. As a member of the Harvard Advisory Group sent to Iran, he offers a survey of the PO from the First Seven-Year Development Plan to the Third Five-Year Development Plan. His study is mainly focused on the technicalities of economic planning including surveying, budgeting and monitoring. But he also touches on political issues pointing out that practice of development planning was not institutionalised in the country. Invoking Orientalist clichés, the author relates the weakness of the PO to a lack of respect for rational economic planning in Iranian culture.

The best-known and the most influential study of the PO is conducted by Razavi and Vakil (1984). This study explores the technicalities and politics of economic planning from 1971 to 1983. Both authors held senior positions in the PO in that period. Hosein Razavi was the PO's Bureau Director from 1976 to 1981 and Firouz Vakil was Under Secretary for Informatics from 1973 to 1979. Importantly, this study lays out the important events that took place in the process of economic planning at the time of the 1973 oil boom. Specifically, it provides valuable information about the two crucial meetings at Gajereh and Ramsar, when decisions were made about the allocation of windfall oil revenues. The main message of this study is that the oil boom made the Shah "over-confident" and "euphoric" about his desire to transform Iran into one of the richest nations in the world in a short span of time and realise his "Great civilisation" vision for the country. The authors stress that the technocrats warned the Shah about the economic consequences of injecting all the oil revenues into the domestic economy, but under the spell of "oil euphoria", the Shah dismissed those warnings and declared that "it would be an unforgivable sin to waste this unique opportunity" (Razavi & Vakil, 1984: p75). The study portrays these events in the following manner (ibid: p70):

“In a nutshell, it was almost as if the government officials had been called in to hear the gospel of the Great Civilisation and then sent back to their offices to the urgent task of implementation. To repeat: there was no dialogue, only a set of directives. The question of feasibility almost did not enter the equation. The report on Iran’s economic long-term prospects was placed on the Shelf and, for all practical purposes, never referred to again. In his solitary confidence, the Shah had already decided what to do with the 287 per cent increase in oil revenues- if not in detail, at least in the broad truest”.

In short, applying the “petro-mania” argument, the authors conclude: “the overconfident Shah of the post-1973 period launched the overspending spree with his dream of Great Civilisation” (ibid: p96).

Similarly, Nasr (2000) uses the petro-mania argument in his study of the Ministry of Economy in the 1960s. The main purpose of his study is to explain the politics of industrial policymaking within the Pahlavi regime during that period. He claims that the balance of payments crisis of the early 1960s motivated the Shah to put in place a strong technocratic institution that could diversify the economy and initiate an “industrial take-off”. In this line, he established the Ministry of Economy and gave the leadership of this ministry to Alikhani, who was a young and competent technocrat. According to the author, in the beginning the Shah threw his full support behind Alikhani and allowed him to bring his own team of technocrats to the ministry. More importantly, the Shah gave Alikhani full autonomy in industrial policymaking and shielded his ministry from interference and rent-seeking. The Shah even prevented the members of the royal family from interfering in industrial policymaking. However, according to Nasr, this situation began to change as oil revenues started to steadily rise in the 1960s. In time, the Shah came to believe that the protection of the Ministry of the Economy was not necessary for economic growth. As a result, he gradually relaxed his support for Alikhani and eventually replaced him in 1969. The following paragraph perfectly captures Nasr’s narrative about economic policymaking in the Pahlavi regime (Nar, 2000: p112):

“After 1966-67, when the growth of the preceding four years had relieved economic pressures on the state, and after 1971, when the price of oil would begin to enrich the state, the Shah's attitude toward economic growth and its institutional foundations changed drastically. He began to view growth as self-sustaining and confused oil wealth with development (especially in the heady years of the 1970s). He then concluded that growth, as well as revenue and employment generation, did not need a private sector-which is why Alikhani's attempts to protect it were deemed overzealous. In the 1970s, these conclusions would lead the Shah to question the wisdom of his economic planners”.

As outlined above, the Iranian studies literature mainly relies on the petro-mania argument to explain the collapse of technocratic policymaking after the 1973 oil boom. This explanation divides the economic history of Iran into two separate period of “before” and after the “boom”. In the first period, the Shah allowed the technocrats to take control of policymaking and manage the “industrial take-off” but after 1973 this behaviour changed; “drunk” on windfall oil revenues, he was no longer willing to listen to the technocrats. This, in turn, resulted in the mishandling of the oil revenues.

However, the petro-mania argument suffers from a number of serious flaws. Firstly, echoing the determinism of the resource curse literature, it relates the Shah’s reaction to a single factor: the rise in oil revenues. Placed in comparative perspective, this argument fails to explain why other similar oil-rich countries did not react the same way as Iran. In other words, it cannot explain why the Pahlavi regime was much more prone to petro-mania than other similar oil-rich autocracies. Nor does it explain why it took so long for the Pahlavi regime to “wake up” from this mania and correct its policies, compared with similar countries like Saudi Arabia and Indonesia. The main challenge for scholars is to explain why the Pahlavi regime was so susceptible to petro-mania in the first place. This requires studying Iran’s conditions before the boom and identifying additional economic and political factors that interacted with oil and led to bad economic policymaking after 1973. The current study aims to fill this gap.

Secondly, and most importantly, the underlying assumption behind the petro-mania argument is that the 1973 oil boom was *exogenous* to the Shah's behaviour. This assumption is very questionable because the quadrupling of oil prices in 1973 was, *itself*, instigated by a series of deliberate decisions made by Saudi Arabia and Iran. At first, in reaction to 1973 Arab-Israel war, the Gulf countries, headed by Saudi Arabia, devised an oil embargo on Western countries and pushed up oil prices from \$3.12 per barrel to \$5.12 per barrel on October 16. The motivation behind this price increase, which intended to be *temporary*, was to pressure the US and other Western countries to drop their support for Israel. However, as will be explained in chapter six, the Shah capitalised on this opportunity and started to lobby for a second round of price increase. His goal was to increase Iran's oil revenues to hasten the on-going process of industrialisation. Thanks to effective lobbying, the Shah then managed to orchestrate a massive price increase at the next OPEC meeting in Tehran in December 1973. In the end of that meeting, OPEC countries increased their posted prices from \$5.12 per barrel to \$11.65. In effect, Iran played a major role in creating the 1973 oil boom. In a nutshell, the 1973 oil boom was the outcome of the Shah's behaviour, not the other way around. Indeed, the Shah was portrayed in the Western media as the main instigator of the upsurge in oil prices.

This thesis clearly shows the oil boom was *endogenous* to the Shah's aspiration to hasten the process of ISI deepening in the economy. Therefore, it argues that Iran's oil strategy and macroeconomic policies after 1973 were shaped by the cumulative process of ISI that had been in motion from the early 1960s. In this way, it offers a novel explanation for why Iran mishandled the oil boom.

Chapter Two: Methodology

This research aims to explain why the Pahlavi state reacted badly to the 1973 oil boom, given its remarkable economic performance in the 1960s. This topic entails studying the economic behaviour of the Pahlavi state through time. The theoretical framework suitable for this task is Historical Institutionalism (HI) (Thelen, 1999; Steinmo, 2008, 2001; Hall & Taylor, 1996). This framework, which is widely used in comparative politics, takes a holistic and dynamic approach to the study of states and their economic policies. It traces various features of the states over time and explores how these features influence their economic policies. Relatedly, this approach takes the role of contingency and path dependency seriously in explaining stability or change in the economic behaviour of states.

The first section of this chapter outlines the ontological assumptions and epistemological approach of this school of thought and explains how this framework has been applied in this research. The second section outlines the reason behind selecting Saudi Arabia and Indonesia for comparison with Iran. The final section lists the data sources.

2.1. Ontology and epistemology of “historical institutionalism”

HI is one of the main schools of thought in political economy, alongside rational choice theory. As its name suggests, this school stresses the importance of institutions and history in explaining economic development. This section explains how the ontological and epistemological approach of this school has shaped the methodology of this research.

2.1.1 The state as the main actor in economic policymaking

Following the German Historical School, HI places its emphasis on the state as the primary actor in explaining policy choices and economic outcomes. To be sure, this paradigm does take into account the role of external factors such as social classes and international forces in economic policymaking, but its main emphasis is on the state as an independent actor in its own right. In other words, it holds that even within most rigid social and geopolitical structures, the state still has room to manoeuvre. This paradigm therefore, relates the economic variation between developing countries to the contrasting characteristics of their states. To capture the characteristics of the states, HI looks at their internal and external attributes.

In terms of internal attributes, HI follows Max Weber and attaches high importance to the public bureaucracy, especially key economic policymaking institutions such as central banks and planning agencies (Kohli, 2004). Its assumption is that the technical competence of central banks and planning institutions can have a major influence on policy selection (ibid). HI also puts much emphasis on ideology as another important internal attribute of the state. It argues that ideas not only form the preferences of political and economic actors, but also determine the way in which they *perceive* their interests (Steinmo, 2008, 2001). The fact that we often witness the sudden adoption of similar policies and institutions across a diverse group of countries underlines the power of ideology. The spread of Keynesianism after World War II or the abrupt shift towards neoliberalism across developed and developing countries in the 1980s can be seen as supporting examples of the above claim. Economic and political crises play a major role in the emergence and diffusion of ideologies (Hall, 1989; Rodrik, 2013); ideas tend to evolve over time in response to their historical context and accordingly, they should be ontologically seen as a process rather than an object. This attention to ideology as a

powerful force in history stems from the lineage of German Idealism in HI. Finally, HI pays attention to the internal power structure of the state. The assumption is that the distribution of power inside the state between different factions can have major implications for economic policymaking.

Moving on to external attributes, HI views the state as embedded in the wider social and geopolitical environment in which it operates (Morgan *et al*, 2010). Accordingly, it focuses on the state's relationship with social classes and foreign powers. In this lens, the states are characterised depending on the manner in which they engage with the society and international community. The underlying assumption here is that coalitions that the states form with foreign powers and domestic social groups have an influence in their policy choices.

As outlined above, to characterise the state, HI looks into their economic policymaking institutions, ideology, internal power structure, class coalitions and geopolitical relations. This research explores the same aspects of the Pahlavi state through time to explain its policy choices. Epistemologically, this view requires that we study the states in a holistic manner, which involves employing the historical method. This method enables us to study both inside the Pahlavi state and also its relations with social classes and foreign powers in depth.

2.1.2 Role of individuals

So far, we have established that HI considers economic policies as *endogenous* to the institutional arrangement of the state. However, regarding how and why economic policies change and evolve over time, HI does not have a unified stand. As reviewed by Morgan *et al* (2010), some scholars within the school put the emphasis on “deep” characteristics of the state, such as the internal power structure, ideology and

geopolitical relations in determining policy choices, while others, following Max Weber, leave a conceptual space for the role of individuals and personalities. The latter group claims that even within the most confined institutional settings, individual actors can still play an important role in shaping policy choices (ibid). It, therefore, assumes that actors have an embedded agency. This attention to the role of individuals introduces the element of contingency (i.e. chance) into economic policymaking³ (Shapiro, 2007).

This research attaches high importance to individuals as this assumption helps to capture the process of economic policymaking in the Pahlavi case. It is well known that the Shah personally exerted tremendous influence on policymaking within the state (Katouzian, 1998; Milani, 2011). This suggests that if Iran's leader had been someone else or if the Shah had not enjoyed absolute power inside the state, then the Pahlavi state might have chosen completely different economic policies at critical times, hence the role of contingency. Due to this reason, it is necessary to take into account the role of agency and personality of the Shah when analysing the economic behaviour of the Pahlavi state over time.

In terms of epistemology, the historical method again provides us with an appropriate tool to highlight the influence of leaders on crucial events; orthodox historians are often known for stressing the importance of individuals in determining the course of history. Following this approach, this research explores the role of individuals, particularly the Shah, in economic policymaking through studying the available historical material.

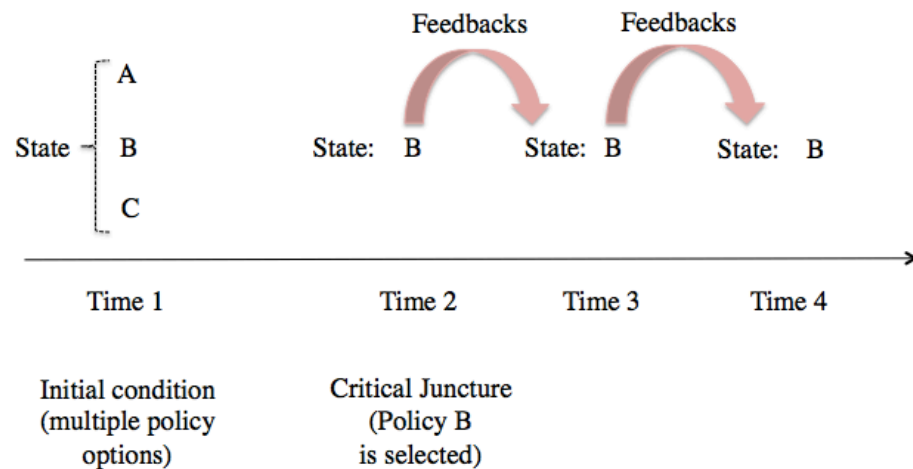
³ It is worth mentioning that commitment to agency and methodological individualism does not necessarily mean that policy or institutional outcomes are always contingent. Indeed, the entire paradigm of Rational Choice theory is based on the notion that, under certain conditions, agents interact in a predictable manner and reach an equilibrium in policymaking or institutional formation.

Initial conditions, critical junctures and path dependence

As its name suggests, HI takes the role of time and history seriously in analysing the emergence and persistence of policies. It assumes that a certain policy decision made at a critical time can push the process of policymaking in different directions (Pierson, 2004). This is because a particular policy adopted at an important time may generate self-reinforcing processes that make policy reversal increasingly difficult in the future. This ontological assumption invites to think that perhaps the policies that we have today, and the available changes that we can make to them, are to a great degree shaped by the choices (or accidents) made in the past. In other words, policymaking can exhibit path dependency and persistency.

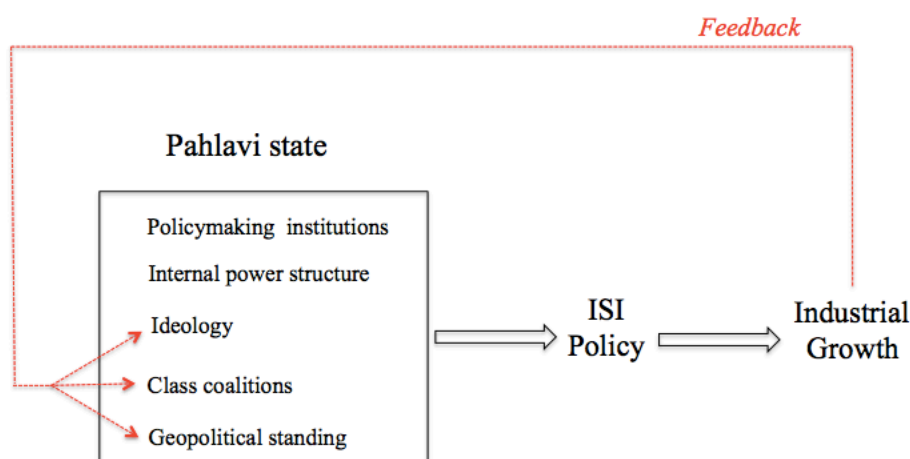
According to Mahoney (2000), every path-dependent process starts with a “critical juncture” and is preceded by an “initial condition”. To explain these concepts, let us assume a state is hit by a balance of payments crisis (like the Pahlavi regime was in 1960). This event is conceptualised as an initial condition. After this event, the political rulers have a menu of policy options: let us say A, B and C. If, for instance, option B is selected, then this policy choice may become self-reinforcing in time by generating spillover effects on the characteristics of the state. These spillover effects can be ideological, geopolitical or social. The point at which a self-reinforcing policy choice is selected is referred to as “critical juncture”. That choice can be due to an accident or a deliberate decision made by a political leader. Graph 2-1 captures these concepts. The depicted process of policy reproduction can continue until an external shock occurs.

Graph 2-1: Self-reinforcing policy



Applying path dependency, this research will show that, once chosen in 1963, the policy of import substitution industrialisation became self-reinforcing in Iran because of the generation of spillover effects on the ideology, geopolitical standing and class coalition of the Pahlavi regime. The underlying mechanism behind these spillover effects was as follows: the initial success of ISI in realising rapid industrial growth (a) strengthened the regime's developmentalist ideology (b) elevated its geopolitical standing in the Gulf and (c) solidified its alliance with the inward-looking industrial class. These effects, in turn, increased the demand among the political elite (and in the business community) for further accelerating the process of import substitution towards heavy and intermediate industries. Hence, the ISI process became self-reinforcing in time. Graph 2-2 depicts this dynamic process.

Graph 2-2: Self-reinforcing effects of ISI



It is crucial to stress that path dependency does *not* entail determinism or the unavoidability of certain outcomes. Here, path dependence means that initial moves in a particular direction increase the cost of shifting to another option in time. Thus path dependent processes are not irreversible, but they are resistant to change. As pointed out by Douglas North (1990, p:98-99): path dependence is “not a story of inevitability in which the past neatly predicts the future”. Similarly, Paul Pierson (2004, p:52) mentions: “Nothing in path dependent analyses implies that a particular alternative is permanently “locked in” following the move to a self-reinforcing path. Identifying self-reinforcing processes does help us to understand why organisational and institutional practices are often extremely persistent”. In this line, Margaret Levi stresses (cited in Pierson, 2004: p20):

“Path dependence has to mean, if it is meant to anything, that once a country or a region has started down a track, the costs of reversal are very high. There will be other choice points, but the entrenchment of certain institutional arrangements obstruct an easy reversal of the initial choice. Perhaps, the better metaphor is a tree, rather than a path. From the same trunk, there are many branches and smaller branches. Although it is possible to turn around or to clamber from one to the other- and essential if the chosen branch dies- the branch on which a climber begins is the one she tends to follow”.

Theoretically, this stipulates that once a policy option is chosen, then in time, the reversal of that option become less likely, if it generates self-reinforcing feedback effects. Here, this argument is applied to explain the persistency of economic policy in oil-rich countries.

Epistemologically, the study of path dependence requires the use of “process tracing” or “analytical narratives” (Pierson, 2004). This means that the researcher has to provide empirical evidence on the sequence of events (intervening variables) that connects a selected option in the past to an outcome in the future. Specifically, the researcher has to show empirically that the selected option generated intended or unintended economic, social, geopolitical or ideological effects that further reinforced the desirability of that option. At the heart of this approach lies a commitment to epistemological realism, meaning that the causal processes or mechanisms that link the independent variable to the intervening variables, and finally, to the outcome should be empirically substantiated. This approach, therefore, entails an in-depth study of different historical sources.

Using “process tracing” or “analytical narrative”, HI aims to produce middle-range theories⁴ (Morgan *et al*, 2010). It claims that the causal processes that are witnessed in a certain period of time in a country may be found in another country at a different period of time. In other words, contrary to orthodox historians, HI scholars argue that causal processes are *not* entirely unique or specific in time and space; they can be applied to other similar cases. As a result, the narratives that are offered by HI are *analytical* in a

⁴ Middle-range theories are developed out of the qualitative comparative study of a small number of cases. They are “middle range” in a sense that they sensitive to particular characteristics of their selected case studies but at the same time, offer theoretical insights that go beyond the context of their study (Morgan *et al*, 2010).

sense that they can potentially “go beyond” the case under the study. This ambition to bring history and social science together has been one of the main goals of HI.

2.2. Selection criteria for the case studies

Using analytical narrative, this research compares the Iran's economic reaction to the boom with that of Saudi Arabia and Indonesia. This section outlines the similarities and differences that existed among these cases at the time of the boom and lays out the logic behind selecting these countries as "similar cases" for comparison.

First, it is helpful to list the notable differences between these countries at the onset of the oil shock. In 1974, the year that oil revenues started to flow into these countries on a massive scale⁵, Iran's GDP was two times larger than that of Saudi Arabia and Indonesia (Amouzegar, 2011). As illustrated in table 2-1, the three countries also differed from each other in terms of level of education and infrastructure development (access to safe water used as the indicator). However, the most drastic difference between the countries was the size of population, which in turn, translated into a large variation in income per capita levels.

Table 2-1: Key economic & social indicators for Iran, Saudi Arabia & Indonesia in 1974

	Adult literacy rate (as % of total population)	GDP per capita (\$ Million current market prices)	Access to safe water (% of population)	Population (Millions)	Infant mortality rate (per 1000)
Iran	50%	1,429	51	32	120
Saudi Arabia	15%	3,977	64	7	119
Indonesia	62%	195	11	132	118

*Source: Amouzegar (2001)

However, despite these differences the three countries shared an important factor: they all were governed by states that relied on natural resource rents, especially oil, for their finances (table 2-2). Also, they all relied on oil exports for a large share of their foreign exchange earnings. To be sure, the oil sector did not play a major role in Indonesia's economy and also this country was not as richly endowed with oil reserves as Iran and

⁵ The oil prices were raised by OPEC countries in the last months of 1973. Therefore, their effects on oil revenues became realised in the following year (Amouzegar, 2001).

Saudi Arabia. However, it is important to bear in mind that other than oil, Indonesia was endowed with other natural resources such as tin, copper, timber, palm oil and rubber. The prices of these resources also jumped in tandem with oil prices in 1973. If we add the revenues derived from these sources, then the contribution of natural resource rents to Indonesia's GDP and government revenues in 1974 jumps to approximately 39% and 68% respectively (Bevan *et al*, 1999). Therefore, this country can be analytically considered as resource-rich and more importantly, its state can be certainly categorised as a rentier state, if not an oil-rich state.

Table 2-2: Role of oil in Iran, Saudi Arabia & Indonesia in 1974

	Oil exports as % of total exports	Oil revenues as % of total government revenues	Oil exports as % of GDP
Iran	92%	85%	46%
Saudi Arabia	99%	93%	95%
Indonesia	71%	55%	20%

*Source: Amouzegar (2001) & Bank Indonesia, annual report (1978), Niblock & Malik (2007), CB, annual report (1978).

The fact that all three selected three countries had states that derived most of their public revenues and foreign exchange earnings from external rents makes the comparison of these countries theoretically fruitful. According to the standard resource curse/rentier state theory literature, resource booms (on average) should produce the same negative effect on institutions and policies across countries controlling for social and economic variables such as education, population and infrastructure. This is because resource booms induce actors inside and outside the state to weaken policymaking institutions that are in charge of spending and managing resource revenues in order to maximise their access to rents. This institutional deterioration, in turn, leads to imprudent macroeconomic policymaking.

However, in practice, the 1973 oil boom did not have the same effect on policymaking institutions and macroeconomic policies in the three countries. In Iran, the macroeconomic policymaking institutions completely collapsed and as a result, the government followed a highly pro-cyclical fiscal and monetary policy (against the advice of experts in the CB and PO). However, the boom did not translate into the downfall of macroeconomic policymaking in Indonesia and Saudi Arabia and so these countries came up with far better macroeconomic responses to the boom than Iran. Hence, in this research design, we focus on three resource-rich states that should have acted similarly to the boom according to the standard rentier state theory, but they *did not*.⁶ The theoretical aim of this “similar case” design is to explain the divergence in (a) the power of macroeconomic policymaking institutions and (b) the macroeconomic policy choices between Iran on the one hand, and Saudi Arabia and Indonesia on the other hand. This comparison helps us refine the standard rentier state theory and resource curse literature by finding other factors that interact with oil and lead to a divergence in the economic behaviour of resource-rich states.

⁶ See chapters seven and eight (sections 7.1 and 8.1) for a detailed comparison of the macroeconomic responses of the three selected countries to the boom.

2.3. Research sources

Using HI as its framework, this research engaged in the holistic study of economic policymaking institutions in Iran over time through historical method to explain why the Pahlavi state mismanaged the 1973 oil boom. Here, historical method refers to the “reconstruction” of the past through the cross-checking of historical sources. This approach assumes that it is possible to objectively study the past and attempt to re-create it through careful examination of the available sources (Munslow, 2006). This epistemological tendency towards realism, which idealises the Rankean project of “reconstructing the past”, is rooted in HI’s background in the German Historical School (Morgan *et al*, 2010). To be sure, not every follower of this school has been committed to realism; for instance, inspired by Kant’s sceptical philosophy, Max Weber questioned the realist assumption between reality and concepts (ibid) and accordingly, he employed “ideal types” as mental constructs to describe and provide causal explanations for social phenomena (ibid). This research, however, remains committed to realism like most HI scholars and utilises analytical narratives rather than “ideal types” for explanation. The reason behind this choice is that “ideal types” tend to provide a “snap shot” view of institutions and are not able to provide a dynamic analysis over time like analytical narratives.

In general, the application of HI in this research entailed “re-creating” the politics of economic policymaking inside the Pahlavi regime over time, through investigations of various archival sources. These sources were:

2.3.1 UK Foreign Office documents

These documents were comprised of correspondence between officials of the Foreign Office in London and at the UK Embassy at Tehran. For the period between 1945 and 1966, this correspondence is referred to as FO 371 in the text and for the period after 1966, they are referred to as FCO 8. These references correspond to the titles of these documents in the UK National Archives. These files outline the crucial meetings and negotiations that took place between the Iranian and British diplomats. Specifically, they supply details of the meetings held between the embassy staff and the Shah and ministers. Similarly, they provide reports on any trip made by Iranian diplomats to London (and sometimes to Washington). Moreover, they include local policy documents and newspaper articles that were considered as important or topical in Iran at the time. Details of trade agreements made between Iran and other countries, especially communist ones, can also be found in these files.

These documents provided valuable information on almost every aspect of economic policymaking inside the Pahlavi state, including the political status of the PO, CB and ME, the dominant economic ideology of the elite, the relationship of the state with the business community, the role of foreign advisors in economic management and the Shah's interference in economic affairs.

2.3.2 US Foreign Relations documents

These documents gather the correspondence between the State Department and US embassies in Iran, Saudi Arabia and Indonesia between 1950 and 1980 concerning the political and economic matters in these countries, including macroeconomic policymaking and building policymaking institutions. This source, which is referred to

as FRUS (Foreign Relations of the United States) in the text, is accessible online at the State Department's Office of the Historian website⁷.

This source gave useful insight into the Pahlavi regime's geopolitical relations with foreign powers, especially the US and UK. It also specifically shed light on the relationship between the IMF and World Bank advisors and Iranian policymakers, especially the technocrats of the PO, CB and ME.

2.3.3 Minutes of High Economic Council Meetings

The general economic policies of the Pahlavi regime were discussed and finalised during High Economic Council meetings, which were held on a weekly basis. This council was comprised of the Shah, the prime minister, minister of finance, minister of economy, minister of industry and mines, minister of commerce, minister of agriculture, the Director of the Plan Organisation and the Governor of the Central Bank. The minutes of these meetings held between 1973 and 1977 are available in Farsi in the National Library and Archives of the Islamic Republic of Iran. These files are sorted according to the subject of the meetings. This research mainly studied the meetings where the crucial policies of "anti-profiteering" campaign and "inflation fighting" were discussed. A part of these minutes is also available in the book published by Planning and Budget Organisation after the revolution under the title of "Minutes of High Economic Council (1973-1986): prices and inflation" (PBO, 1990). These minutes document in detail the comments made by the Shah and officials regarding economic policies, hence shedding light on the influence of each actor in policymaking.

⁷ This website can be accessed at: <http://history.state.gov/historicaldocuments>

2.3.4 Central Bank Bulletins

These monthly bulletins, which are referred to as CBB in the text, were published from 1961. They document the new policies that were introduced at the time and provide frequent reports on the economy. They also include any speech given at the Central Bank by the Governor of the bank, the Minister of Economy, the Minister of Finance, the Director of the Planning and Budget Organisation and the head of the Chamber of Commerce. In addition, they outline the academic papers presented at the bank by internal staff or academics. These bulletins shed light on the economic ideology of policymakers, especially on their opinion about sources of inflation, private sector promotion and import-substitution industrialisation. These documents are accessible online in Farsi⁸ and their English versions are also available at London School of Economics Library.

2.3.5 Chamber of Commerce Bulletins

These bulletins, which are referred to as CCB in the text, were published by the Chamber of Commerce from 1955 until 1967. This Chamber functioned as the main lobby group for merchants and industrialists at the time. Its bulletins document the elections held at the Chamber as well as the meetings that took place with policymakers and international counterparts. In addition, they include interviews conducted with major industrialists as well as speeches given at the chamber by policymakers or foreign delegates. Information on joint country chambers can also be found in these bulletins. This source, which is accessible online in Farsi⁹, sheds light on the state-business relationship in Iran.

⁸ The Central Bank Bulletin can be accessed at: <http://www.noormags.ir/view/fa/default>

⁹ The Chamber of Commerce Bulletin can be assessed at: <http://www.noormags.ir/view/fa/default>

In 1969, the Chamber of Commerce was merged with the Chamber of Industry and Mines -another lobby group for industrialists- to form the Chamber of Commerce, Industry and Mine. This research also examined some of the bulletins published by that chamber. These bulletins were available in Farsi at National Library and Archives of Islamic Republic of Iran.

In addition to these sources, this research relied on the book published by National Iranian Library entitled “From council of merchant representatives to Iran’s Chamber” (Torabi-Farsaani, 2013). This book supplies primary sources, mainly summaries of newspaper headlines, on the evolution of private sector lobby groups in Iran from the 19th century up to the 1979 Revolution. It provides a wealth of information on the composition of private sector chambers over time and also highlights their reaction to government policies. Thanks to these sources, this research managed to explore the state-business relationship in detail.

2.3.6 World Bank reports

This research also investigated World Bank reports published on Iran’s economy between 1953 and 1978. These reports, which are referred to IRBD in the text, reflect the views of World Bank advisors on Iran’s development projects, agricultural policy and industrial policy. They also reveal IMF’s views about macroeconomic issues in Iran such as fiscal, monetary and exchange rate policy. In addition, they sometimes discuss the technical capacity of Iran’s economic policymaking institutions.

Moreover, World Bank archives have a series of reports on IMDBI- Iran’s privately owned development bank that was formed with the assistance of the World Bank in the late 1950s. This bank assumed a crucial role in Iran’s state-led industrialisation project. The World Bank reports document the performance of this bank during the 1960s and

1970s by providing valuable information on the size and composition of its credit portfolio. Further, the reports track the changes in the ownership of the bank, while also following its progress in improving technical capacity and human capital. Overall, this source sheds light on the government's credit policy and its relationship with the private sector. The World Bank reports on Iran's economy and IMDBI are available online at the World Bank's website¹⁰.

This research also explored World Bank reports on Indonesian economy in the 1960s and 1970s. Similarly, these reports, which are accessible online¹¹, reveal the views of World Bank and IMF advisors on macro and micro economic policies in Indonesia.

2.3.7 Oral history collections

Two Oral History collections were used in this research: the Iranian Oral History Collection of Harvard University (IOHCHU)¹² and the Oral History Collection of the Foundation for Iranian Studies (OHCFIS)¹³. The first collection has been gathered by Dr Habib Lajevardi during the 1980s with the financial support of the Harvard Middle East Centre. It is worth mentioning that Dr Lajevardi's father was the founder of Behshar Industrial Group, which was one of the successful private conglomerates of the Pahlavi era. The second collection has been assembled by Dr Gholam Reza Afkhami of the Foundation for Iranian Studies during the 1990s and 2000s. This foundation was created with the financial support of Princess Ashraf Pahlavi, the Shah's twin sister, during her exile. Together these two collections comprise interviews with more than sixty individuals including members of the royal family, army generals, ministers,

10 These reports are accessible at <http://documents.worldbank.org/curated/en/docsearch/country/82604>.

11 These reports are accessible at: <http://documents.worldbank.org/curated/en/docsearch?query=indonesia>

12 To view the Iranian History Collection gathered by Harvard University (IOHCHU) visit the website of Harvard University Iranian Oral History Project at: http://ted.lib.harvard.edu/ted/deliver/home?_collection=iohp

13 To view Oral History of Iran Collection gathered by the Foundation for Iranian Studies (OHCFIS) visit: <http://www.fis-iran.org/en/oralhistory/browse?page=2>

deputy ministers, MPs, technocrats, businessmen, foreign ambassadors, embassy staffs, leaders of opposition and intellectuals. This research specifically drew on the interviews conducted with the following:

1. Alinaghi Alikhani: the Minister of Economy (1963-1969)
2. Dr Khodadad Farmanfarmaian: the head of the Economic Bureau in the Plan Organisation (1958-1962), Deputy Governor of the Central Bank of Iran (1962-1968), the Governor of the Central Bank (1968-1970) and Director of the Plan Organisation (1970-1973).
3. Mohammad-Mehdi Samiee: Governor of the Central Bank (1962-68), Director of the Plan Organisation (1968-70), Governor of the Central Bank (1970-73).
4. Bahman Abadian: member of the Economic Bureau of the Plan Organisation (1957-64), the head of the Economic Research Department of the Central Bank (1964), and Deputy Director of the Plan Organisation (1965-1969).
5. Abolghasem Kheradjou: the Managing Director of the Industrial and Mining Bank of Iran during the 1960 and the 1970s.
6. Mahmoud Lajevardi: Founder and Chairman of Behshahr Industrial Group, head of the Chamber of Commerce and Industries (1963-1977).
7. Abdolmadjid Majidi: Director of the Budget Bureau in the Plan Organisation (1962-1967), Minister of Agricultural Products & Consumer Affairs (1967-68), Minister of Labour & Social Affairs (1968-73), Director of the Plan Organisation (1973-77).
8. Fereidoun Mahdavi: Deputy Managing Director of the Industrial and Mining Development Bank of Iran during the 1960s.

9. Gholamreza Moghadam- Deputy Governor of the Central Bank of Iran (1961-63), Deputy Director of the Plan Organisation (1969-73).
10. Mohamad Yeganeh- Vice Minister of Economy (1963-69), Minister of Development and Housing (1969-70), Governor of the Central Bank (1973-75).
11. Reza Niazmand: Executive Director of the Industrial Management Institute, 1962-1969; President of the Industrial Development and Renovation Organisation and Deputy Minister of Economy for Industrial Affairs, 1969-1971.
12. Mohammad Baheri: the Minister of Justice (1963-1964) and the Deputy Minister of the Imperial Court (1964-1977).
13. William Lehfeltdt: Economic Officer at the U.S. Embassy in Tehran, 1969-1974; Vice President, General Electric Corporation in Iran, 1974-1979.

2.3.8 Autobiographies, diaries and speeches

The research also examined the official books written by the Shah: *Mission for My Country* (Pahlavi, 1960), *The White Revolution* (Pahlavi, 1967), *Toward the Great Civilization* (Pahlavi, 1977); and *Answer to History* (Pahlavi, 1980). These books outline the Shah's ideology and his aims for the country. In addition, the diaries of Alam (2008), who was close confidant of the Shah and prime minister (1962-1964) and minister of the Royal Court (1967-1977), were explored. This source provides valuable details on the Shah's private life and the politics of his court.

In the case of Indonesia, the thesis explored the collection of speeches given by Widjojo Nitisastro, who was the chairman of the Indonesian National Development Planning Agency (Bappenas) from 1967 to 1983 (Nitisastro, 2011). In addition, for studying the

important economic debates that were taking place in Indonesia, the research relied on collection of newspaper articles gathered by Chalmers and Hadiz (1997).

2.3.9 Secondary literature

The research also drew on the secondary literature on Iran, Saudi Arabia and Indonesia. In the case of Iran, it particularly relied on Abbas Milani's (1990) "Prominent Persians", which discusses the lives of notable politicians, ministers, entrepreneurs and technocrats of the Pahlavi era. It also used the recent biographies of the Shah written by Milani (2011) and Afkhami (2009). Finally, this research frequently refers to Karshenas (1990) and Alizadeh (1984) for the analysis of Iran's state-led industrialisation.

For Saudi Arabia, the research heavily drew on Steffan Hertog's (2010) "Oil and the state in Saudi Arabia: Princes, brokers and bureaucrats". This book traces state formation in Saudi Arabia and uncovers the politics of economic policymaking inside the country. For analysing oil policy in Saudi Arabia and other OPEC countries, Skeet's (1991) book "OPEC: Twenty years of prices and politics" was used. For Indonesia, the research heavily relied on Bevan *et al* (1999) to sketch out the political economy of Suharto's regime.

2.3.10 Elite interviews

In addition to collecting archival material, a series of unstructured interviews were conducted with several prominent economic policymakers of the Pahlavi regime. These policymakers were:

1. Dr Khodadad Farmanfarmaian: the head of the Economic Bureau in the Plan Organisation (1958-1962), Deputy Governor of the Central Bank of Iran (1962-1968), the Governor of the Central Bank (1968-1970) and Director of the Plan Organisation (1970-1973). I interviewed Dr Farmanfarmaian twice in person in London in July 2010 and February 2013. The first interview was used for my MPhil thesis.
2. Alinaghi Alikhani: the Minister of Economy (1963-1969). This interview was conducted over the phone in February 2013.
3. Abdolmadjid Majidi: Director of the Budget Bureau in the Plan Organisation (1962-1967), Minister of Agricultural Products & Consumer Affairs (1967-68), Minister of Labour & Social Affairs (1968-73), Director of the Plan Organisation (1973-77). This interview was conducted over the phone in February 2013.
4. Dr Gholamreza Moghadam- Deputy Governor of the Central Bank of Iran (1961-63), Deputy Director of the Plan Organisation (1969-73). This interview was conducted in person in London in March 2013.
5. Mr Farokhnajm Najmabadi: Deputy Minister of Economy, 1967-1974, Minister of Industry and Mines 1974-1977. Two rounds of interviews were conducted over the phone with Dr Najmabadi in August 2013 and May 2014. Also, several email exchanges were later made between the author and the interviewee, in which he answered additional questions.

6. Dr Hasanali Mehran- Deputy Minister of Economy (1967-1975). Governor of the Central Bank (1975-1978), Minister of Economy & Finance (1978-1979). Two rounds of interviews were conducted over the phone with Dr Mehran in November 2013 and May 2014. He also kindly addressed additional questions through subsequent email exchanges.

7. Dr Firouz Vakil- Undersecretary of Informatics at the Plan Organisation (1972-1979). This interview was conducted over the phone in June 2013.

8. Professor Hashem Pesaran- Assistant to the Vice Governor of the Central Bank (1973-1974), Head of the Economic Research Department of the Central Bank (1974-1976), Undersecretary in the Ministry of Education (1977-1978). This interview was conducted in person in Cambridge in June 2014.

As outlined above, this research has employed a large variety of sources that represent different perspectives (the Shah, royal family, ministers, technocrats, foreign embassy staff, and businessmen). This diversity of sources allows us to fully capture *the process* of policy and institutional evolution in Iran from 1960 to 1978. In other words, through these sources, this research re-constructs how the ideology, policymaking institutions, internal power structure, geopolitical status and class coalitions of the Pahlavi state changed over time and how this changed influenced the macroeconomic policymaking. The reconstruction of this historical process is conducted through cross-examination of the historical sources listed above. This cross-examination is demonstrated along the analytical narrative of the thesis, in a sense that the research presents a variety of empirical evidence from the listed sources to support the crucial parts of its narrative.

Chapter Three: Path Selection

This thesis treats the advent of ISI in 1963 as a critical juncture since it directed the Pahlavi regime into a self-reinforcing policy path. However, before explaining the self-reinforcing effects of this policy, it is necessary to understand why the Pahlavi state chose this policy in the first place. This chapter uncovers the initial motivation behind the selecting of ISI in Iran, and in doing so it sets the background for us to later explain the path-dependent nature of this policy in the 1960s and 1970s.

This chapter traces the evolution of the Pahlavi state from 1953 to 1962 in the light of crucial economic and political events that took place in this period and explain how this process of state evolution paved the way for a policy shift to ISI in 1963. Section one explores state-building in Iran after the 1953 coup. Section two discusses the 1960 balance of payments crisis and its impacts on the Pahlavi regime. Finally, section three highlights the motivation of the Pahlavi state to switch to ISI in 1963.

3.1 State-building (1953-1960)

The 1953 coup is without a doubt a critical point in Iran's trajectory in the 20th century. This CIA-engineered coup that successfully toppled the democratically elected Prime Minister Mosaddeq had a drastic implication for state-formation in Iran (Milani, 2009).

3.1.1 Geopolitical standing

By ousting a popular nationalist leader, the 1953 coup killed off postcolonial aspirations in Iran and turned the country into a "patron state" of the US in the Cold War (Alvandi, 2014). Soon after the coup, Iran officially joined the CENTO agreement to signal her pro-Western stance in the Cold War. At the same time, Iran entered into a new oil agreement with a consortium of foreign firms including the British Petroleum Company,

Royal Dutch-Shell, Standard Oil, Socony, Socal, Texas, Gulf and Compagnie Française des Pétroles (CFP). Under this agreement, half of the oil profits would go to the National Iranian Oil Company (NIOC) and the other half would go to the foreign firms. However, this 50-50 agreement still placed the production and pricing of Iran's oil revenues under the full control of foreign firms (Afkhami, 2009). Thanks to this deal, Iran's oil revenues started to increase substantially from 1955 (Table 3-1); the total oil revenues that accrued to the Pahlavi regime between 1954 and 1960 (\$707 million) was larger than the entire oil revenues received since the discovery of oil in 1913. This unprecedented inflow of oil revenues transformed the Iranian state into a "rentier state" for the first time. Correspondingly, the share of oil revenues in total government expenditure rose from 22% in 1954 to 40% in 1962 (Karshenas, 1990).

In addition to oil revenues, Iran received substantial military and development aid from Washington as a patron state. Between 1953 and 1960, Washington supplied about \$900 million of aid to the Shah (Karshenas, 1990), turning Iran into one of the largest recipients of American aid (except Turkey) (Baldwin, 1967). Interestingly, the size of the aid inflows to Iran in this period almost matched the country's total oil revenues.

Table 3-1	
Year	Oil revenues (\$ Million)
1954	-
1955	22.5
1956	92.2
1957	140.5
1958	207.8
1959	244.9
1960	258.7

Source: Karshenas (1990)

Washington's aid policy in this period was more or less influenced by advocates of the Modernisation School, especially by Walt Rostow (Latham, 2000). Cheerleaders of this school argued that the American empire had to rely more on development aid rather than military aid to prevent the penetration of communism in developing countries (Engerman *et al*, 2003). They believed that by supplying aid and technical knowledge to developing countries, the US could help these countries escape their "poverty trap" and embark on economic and social modernisation, hence minimising the chance of a communist revolution (ibid). Accordingly, during the Eisenhower administration, the US began to promote economic development in countries like Iran through the provision of aid as part of its broader Cold War doctrine.

3.1.2 Internal power structure

Domestically, the 1953 coup allowed the Shah to consolidate his rule and take control of every political institution inside the state including the army, judiciary, bureaucracy and parliament (Milani, 2009). The US administration helped the Shah to suppress internal dissent by developing the army and building a notorious security service called SAVAK (ibid). Other than repression, the Shah also relied on patronage (i.e giving economic favours) to "buy" the support of individuals on whom he depended for his power. This patronage network was comprised of the royal family, especially the Shah's siblings, as well as military and SAVAK officers. The main source of patronage was government contracts and monopoly rights for imports (Baldwin, 1967). Thus, overall the 1953 coup enabled the Shah to assume absolute power inside the state through patronage and oppression.

3.1.3 Class coalitions

The two social groups that supported the 1953 coup were merchants (Bazaar) and landlords. Accordingly, when the Shah seized power he built an alliance with these two social classes by including them in the parliament and giving them key administrative positions. Accordingly, the parliament was dominated by the landlords between 1953 and 1960 (Abrahamian, 1982). Similarly, the Bazaaris were closely tied with the state; in addition to being represented in the parliament, they were able to voice their preferences through the Chamber of Commerce¹⁴, which was a powerful and independent interest group (ibid). Further, the Ulemma, who were the spiritual leaders of the Bazaaris, enjoyed frequent access to the Shah.

Economically, the landlords and merchants were active in the import and export of agricultural and manufactured goods. Therefore, they shared an interest in free trade and maintaining the competitiveness of tradable sectors. It is worth mentioning that through non-oil exports, these classes supplied 30% of the country's foreign exchange reserves from 1953 to 1960 (Baldwin, 1967).

3.1.4 Policymaking institutions

When the Shah assumed full power in 1953, the economy was in shambles due to the sanctions imposed on Iran during Mosaddeq's rule (Baldwin, 1967). The state's economic policymaking institutions, namely the Plan Organisation, Ministry of Finance, Ministry of Commerce and Ministry of Industry and Mines, were also in a very bad shape (ibid). However, as already mentioned, Iran started to receive large inflows of aid from Washington after the coup. To make sure that this aid would be spent on economic

¹⁴ Between 1953 and 1963, the Chamber of Commerce was filled with influential members of the Bazaar who were active in retailing, small-scale manufacturing and imports of consumer goods (Abrahamian, 2008).

development, the US administration started to promote economic planning in Iran. At the same time, as the oil revenues started to increase many politicians and bureaucrats inside the state called for the rationalisation of economic policymaking (Ebtehaaj, 1996a). Thanks to these internal and external demands, in 1954 the Shah selected a capable banker named Abdol Hasan Ebtehaaj to revitalise Iran's economic planning organisation and also build new economic institutions with the assistance of the US administration and the World Bank. Naturally, this process of institution building was guided by modernisation theory, which was the prevailing development ideology in the US. Thus, to fully understand the evolution of policymaking institutions in Iran, first it is necessary to explain this theory in detail.

Modernisation theory

Modernisation theory first made inroads to US foreign policy circles in the mid-1950s by becoming influential among powerful philanthropic organisations such as the Ford Foundation and Rockefeller Foundation (Gilman, 2007). These foundations established a number of academic centres in Harvard and MIT that actively championed this school of thought (ibid). This theory reached its peak of influence in the Kennedy and Johnson administrations as it became officially incorporated into the US foreign policy and functioned as the Cold War ideology of the American empire (Latham, 2000). In a nutshell, modernisation theorists argued that through the provision of aid and technical expertise, rich countries could help poor countries develop.

They viewed economic development as a universal process that involved capital accumulation and structural change away from low-productivity sectors (agriculture) to high-productivity sectors (industry). However, they claimed that this process would not take place automatically in poor countries due to the prevalence of market failures.

Their reason was that in poor countries private investment in a new industry depended on complementary investment in other sectors, thus, the private sector ended being crippled by a “coordination problem” (Meier, 2004). This market failure, therefore, trapped poor countries in a vicious cycle of low growth and low capital accumulation. Accordingly, to break this cycle, poor countries had to embark on top-down planning and state-led investment. Such a policy would “crowd in” private investment and capital accumulation in high productivity sectors and help these counties “take-off” into a virtuous of economic development (ibid). Inferring from this argument, modernisation theorists concluded that the US could kick-start development in poor countries by giving them financial aid and planning expertise (Gilman, 2007). It is important to add that the modernisation school borrowed these ideas from development economics, especially from Lewis, Rosenstein-Rodan, Nurkse, Myrdal and Hirschman, who were pioneers of Anglo-Saxon Structuralism (Meier, 2004).

However, modernisation theorists did not confine their argument to the realm of economics. Inspired by Talcott Parson’s sociology, they saw economic growth as interrelated with social, cultural and political change in poor countries (Engerman *et al*, 2003). They argued that in the long term economic growth and industrialisation would lead to spread of liberal values and democratisation by giving birth to a growing middle class and a new capitalist elite. In other words, these classes would act as the agent of modernisation in the society (ibid). Following this deterministic paradigm, champions of this school considered the promotion of economic growth as the panacea for all the social, political and cultural ills in developing countries and hence, the best strategy to save these countries from the spread of communism (ibid).

Revitalisation of the Plan Organisation

The process of reviving economic planning in Iran happened at the time when the modernisation doctrine was taking hold in Washington. Ebtehaaj was the person who was at the heart of this institution building. It is possible to consider him as “Iran’s first technocrat” (Katouzian, 1999) and the instigator of economic planning in the country. In terms of ideology, Ebtehaaj shared many beliefs of the modernisation theorists in Washington; he considered economic development as a magic bullet for Iran’s social, political and cultural problems (Farmanfarmaian, tape three, IOHCHU). He also believed that by utilising Western technical expertise and domestic oil money, a group of “elite planners” in Iran would be able to kick-start the process of modernisation (Bostock & Jones, 1989). Finally, as a fervent anti-communist, he was a firm believer in private sector promotion (Ebtehaaj, 1996b). Other than sharing a similar ideology, Ebtehaaj was also highly respected by foreign technocrats for his competence, especially by Eugene Black, then head of the World Bank. Likewise, the British embassy considered him as “by far the strongest and ablest of all Persians and perhaps indeed the ablest Government Official in the Middle East” (FO 371/91462, 1951). This admiration was shared by the US embassy (Bostock & Jones, 1989). He was also praised as “the symbol of incorruptibility” due to his financial honesty (Bostock & Jones, 1989; P1, FO 371/133023, 1958; Milani, 2009).

As a first step to revive the PO, Ebtehaaj recruited several World Bank advisors and placed them in key positions (Ebtehaaj, 1996a) and, at the same time, he sacked most of the employees, who had previously entered this organisation through patronage (Ebtehaaj, 1996a; Bostock & Jones, 1989; Dr Farmanfarmaian, personal interview, 2013). Subsequently, the Technical Bureau was set up as the executive arm of the PO in development projects. This Bureau, which was filled mostly with engineers, dealt with

the allocation of government contracts to the private sector (Ebtehaaj, 1996a, Baldwin, 1967). The technical capacity of the Budget Bureau was also developed (ibid). Further, the Economic Bureau was created through the financial grant given by the Ford Foundation. This grant was provided on the condition that the recruitment of the Bureau's staff would be conducted by a team of advisors from the Harvard School of Government (ibid). Ebtehaaj used the grant to offer high salaries¹⁵ to potential applicants in order to attract best Iranian and foreign talents. Through these arrangements, the PO managed to gather a young team of Iranians who had acquired economics or engineering degrees from top American and British universities. This team, which had a good reputation for financial honesty, was highly praised by Washington (Milani, 2009). In addition to recruiting a new team, Ebtehaaj improved the technical capacity of the PO by gathering information about the economy by commissioning surveys of foreign firms (Bostock & Jones, 1989). Overall, he managed to build a competent and technocratic planning institution, which employed about 500 staff (FO 248/1544, 1954), through the support of the World Bank and the Ford Foundation.

Once revitalised, the Shah threw his personal support behind the PO and gave special powers to this institution (FO 371/120710, 1956). The organisation was made responsible for formulating the development expenditures of the state, while the Ministry of Finance retained the responsibility for budgeting the current expenditures. More importantly, the PO assumed the task of *implementing* the development projects as well. For this purpose, it officially operated as a “bureaucratic enclave” within the government and the Prime Minister had little control over it. This is because, according to the PO and foreign advisors, the government ministries did not have the required technical competence and financial transparency to implement the planned projects

¹⁵ The higher-than-normal salaries were partly financed by the grant (\$1million) given by the Ford Foundation (FO 371/133023, 1958).

(Milani, 2009; FO 248/1544, 1954). According to the law, the government had to allocate 60% of oil revenues to the PO to be expended on infrastructure projects (Razavi & Vakil, 1984; FO 371/133022, 1958; FO 371/127095, 1957). This law highlighted the commitment of the Pahlavi regime to economic development and the Shah's strong support for the PO.

It is important to add that the Shah eventually withdrew his personal support for Ebtehaaj in 1959 because of a dispute over military expenditures (Bostock & Jones, 1989). Although Ebtehaaj's departure was a serious blow to the PO's political status, nevertheless, the organisation still continued to retain its technocratic character (ibid).

Industrial development banks

Another legacy of Ebtehaaj in institution building was the creation of the Industrial and Mining Development Bank of Iran (IMDBI) in 1959. The rationale behind this bank was to promote "domestic and foreign investments in private industrial enterprises in Iran" (IBRD, 1959a: p1). Again, Ebtehaaj built this institution with the support of the World Bank that had already established similar banks in other developing countries. During the tenure of Eugene Black in the 1950s, the World Bank aimed to ameliorate the problem of market failure for private investment in industry by creating specialised development banks in countries such as Turkey, India and Ethiopia (Mason & Asher, 1973). Importantly, the World Bank insisted on the private ownership of these development banks to reduce the risk of government interference in the distribution of credit subsidies (ibid). The idea was that governments would financially support the

development banks, but at the same time, leave the allocation of loans in the hands of private owners¹⁶.

Accordingly, Iran followed the World Bank's blueprint in creating the IMDBI. Initially, through Black, Ebtehaaj attracted two Wall Street investment banks, Lazard Frères & Co. and Chase International Investment Corporation, to invest in the IMDBI. He engaged a group of domestic private investors at the same time. Correspondingly, the bank was set up with a dual equity structure; forty percent of its shares were owned by a group of multinationals from the US, UK, France, Belgium, Germany, Holland and Italy (class "B" shares) and the rest of its equity was owned by a limited number of domestic private firms (class "A" shares) (Benedick, 1964). It was agreed, however, that for the purpose of training a competent managerial staff, the management of the bank would be entrusted to foreign firms for a five-year period. Then, after this period, the Iranian owners would take control of the bank (IBRD, 1959b).

The IMDBI started its operation by obtaining long-term loans from the Iranian government, the World Bank and the US Treasury and specialised in giving credit subsidies to large-scale manufacturing firms. Inspired by the modernisation doctrine, the idea behind this bank was to help a new class of industrialists to emerge in Iran to act as the agent of modernisation for the country.

The Industrial Credit Bank (ICB) was another development bank formed by Ebtehaaj. Established in 1955, the ICB was completely owned by the Plan Organisation and specialised in allocating credit subsidies to small and medium-sized manufacturing firms (Benedick, 1964).

¹⁶ As will be explained in the following chapters, this model proved very costly in countries that followed ISI policies as the demand in domestic protected markets started to guide the allocation of credit subsidies rather than the comparative advantage of countries. However, the World Bank was not alarmed by this matter until the late 1960s (Mason & Asher, 1973).

Overall, from 1953 to 1960, the Pahlavi regime established the necessary institutional infrastructure for economic planning and private sector promotion through foreign support.

3.1.5 Ideology

Assuming power after the 1953 coup, the Shah's regime did not have any particular ideology. However, with the revitalisation of the PO and the emergence of a new class of foreign educated technocrats, the prevalent ideas of development economics and the modernisation school started to make inroads in Iran. This is not surprising given that these technocrats were mainly recruited through foreign institutions (the Ford Foundation and the Harvard School of Government) that championed these ideas (Gilman, 2007). Khodadad Farmanfarmaian, an Iranian economist who was hired by the Harvard School of Government to recruit new members for PO, admits that this process was affected by ideological considerations, especially by his personal preference for candidates who were trained in the Anglo-Saxon School of development economics (Farmanfarmaian, HUIHOP, tape two, November 1982):

“..it was very difficult to find Iranians who were being trained as economists and [we] were looking for economists. We weren't looking for the sort of people in the softer science. And in recent years, when some people accuse me of being prejudice in favour of Anglo-Saxon educated people, I've reasoned that from their curriculum or from the knowledge that I had about, let's say, German training or French training, those people were not the hard type of economists and planners that one wanted...we wanted more people who had grounding in hard theory”.

This remark shows that, in the spirit of the modernisation school, Iranian technocrats viewed themselves as a group of “elite modernisers” who were going to promote economic development by application of their scientific knowledge and expertise. Of course, this is not to suggest that these technocrats believed in every aspect of the

modernisation doctrine as passive agents. On the contrary, they picked aspects of development economics and modernisation theory that they found suitable for Iran and constructed their own brand of developmentalist ideology. Overall, it is possible to trace three attributes in their ideology.

Firstly, they were all “deeply enamoured of economic growth” as described by a prominent member and the main question for them was “how to increase the size of the pie” (Farmanfarmaian, tape two, IOHCHU). They considered economic development as the panacea for Iran’s social, cultural and political ills; they believed that, with economic growth, the Shah’s dictatorship would automatically fade away in time (Mehran, 2013). For example, one of Ebtehaaj’s protégés stresses (Farmanfarmaian, tape three, IOHCHU):

“And at that time he [Ebtehaaj] introduced me to a basic tenet of his thought which was that once you raised the standard of living of people through deliberate economic development, all these political problems -- corruption, inefficiencies, jealousies, etc., he was referring to them -- will be wiped out from their awareness, from their conscience, from their character if you will. And as the standard of living went up, people would become more straightforward, more cooperative, and that you would get true social, political change from the development of the country”.

Secondly, the technocrats prioritised industrialisation above agricultural development. This bias for industrialisation ran deep in the Plan Organisation as pointed out by a member of Technical Bureau at the time: “we were either manufacturing engineers or economists; we didn’t know anything about agriculture...they even hadn’t sent a single member of us to study agricultural development” (Niazmand, Tejarat Farda, 2013c).

Thirdly, they believed that Iran’s economic modernisation had to be driven by private sector. In line with Rostow, they considered that the main job of the state was to “solve the problem of entrepreneurship in the take-off stage”. This required the state to support

the emergence of a new class of “modern” capitalists in Iran, who were willing to take risks and import new technologies from the West. The technocrats reasoned that the enrichment of such a class would benefit the whole society because it would push the economy through the “take-off” stage and generate a self-reinforcing cycle of private capital accumulation and economic growth. They sought to propel the economy from merchant capitalism to industrial capitalism by nurturing a new industrial elite. The following remark by the former head of the Economic Bureau highlights the allure of this “trickle-down” ideology among the technocrats: “we were firm believers in the need for growth and cited the greatest world economic authorities in the defence of this thesis that once you have growth, slowly, slowly things begin to trickle down to the other levels and in the long term, income distribution will improve” (Farmanfarmaian, IOHPHU, tape 2). Similarly, another technocrat recalls: “our job was to make people millionaires. Without millionaires the country would not develop” (Niazmand, Tejarat Farda, 2013b). Therefore, like most development economists at the time, the Iranian planners assumed that income inequality was necessary for the preliminary stages of development.

The above analysis shows that between 1953 and 1960, a particular form of developmentalist ideology started to take root among Iran’s technocratic elite.

3.1.6 Policy choices (1953-1960)

Overall, the Pahlavi state followed a liberal economic strategy in the above period by narrowing its focus on investment in infrastructure and making little interference in the economy. As part of the Second Seven-Year Development Plan (1954-1962), the PO implemented a series of infrastructure projects such as roads, dams and electricity (Baldwin, 1967). Public investment grew at 26% per year from 1953 to 1960 with the

PO accounting for more than half of this investment. As intended, this strong commitment to building public infrastructure paved the way for the private sector; private investment grew by 39.3% per year, mostly going to construction, transportation and light manufacturing (ibid). In line with this liberal strategy, the government followed a free trade policy mainly to serve the economic interests of its allied classes (merchants and landlords), who were engaged in tradable sectors. As result of these policies, Iran's economy grew by approximately 8% annually in this period (Baldwin, 1967).

However, the government suffered from a lack of macroeconomic discipline in this period (Mehran, 2013). In the realm of fiscal policy, the Ministry of Finance was responsible for current expenditures while the PO focused on implementing development projects rather than synchronising fiscal expenditures across the ministries. Similarly, in the realm of monetary policy, Iran had no functioning central bank that could discipline the banking sector. These institutional weaknesses led to uncontrolled fiscal and monetary expansion, which in turn, produced growing internal demand and inflation (ibid). To meet the growing internal demand, the government encouraged imports through foreign borrowing with the hope that the foreign loans would be repaid through rising oil prices in the future. This trend sowed the seeds of a balance of payments crisis as shown in table 3-2.

Table 3-2 (\$ Million)				
Year	Exports	Imports	Loans	Repayment
1955	117.4	200.2	72.6	4.5
1956	162.3	279.1	83.4	6.0
1957	194.1	345.4	106.7	16.9
1958	306.2	371.4	116.6	31.0
1959	331.2	479.7	61.3	43.4
1960	353.4	495.2	103.0	62.2

Source: Karshenas (1990)

3.2 The austerity years (1960-1963)

Eventually, the lack of macroeconomic discipline in Iran culminated in a balance of payments crisis in 1960 (FO 371/149779, 1960). The trigger for this crisis was the decision of foreign oil companies (Esso in particular) to reduce oil prices by 14 cents from \$1.90 to \$1.76 (Skeet, 1991). As a result, Iran's economy was bailed out by the IMF on July 1960. In return, a set of austerity policies labelled as a "stabilisation package" was imposed on the policymakers. This package included drastic fiscal cuts and credit contraction as well as import tariffs and restrictions (Karshenas, 1990; Mehran, 2013). Specifically, the government had to turn the 0.9 billion rial deficit in the annual budget into a 1.8 billion rial surplus in 1960. This harsh austerity package, which lasted until 1962, led to a recession (ibid). This austerity period dramatically influenced certain aspects of the Pahlavi state.

3.2.1 Geopolitical standing

The austerity period severely limited Iran's autonomy from the US. Naturally, the IMF bail-out increased the leverage of the US administration over the Pahlavi regime. This episode coincided with the election of Kennedy in the US. This new administration was highly influenced by modernisation theory in terms of its foreign policy towards developing countries (Latham, 2000); indeed, the main cheerleader of this theory, Walt Rostow, was selected as the National Security Advisor. Kennedy believed that to save his regime, the Shah had to engage in economic, social and political modernisation. For many years the CIA had been predicting a revolution in Iran (Milani, 2009). Thus, to pre-empt this possibility, a series of reforms was imposed on the Pahlavi regime by the Kennedy administration under the banner of a "Controlled Revolution". The hallmark of this revolution was a land reform, which was inspired by the modernisation doctrine.

Rostow's famous theory of "stages of economic growth" claimed that agricultural development was the precondition for industrialisation and economic "take-off", hence, the urgency of land reform (Latham, 2000). Geopolitically, the imposition of such reforms indicated the patron-client relationship between the US and the Pahlavi regime.

The other notable geopolitical development of this period was the formation of OPEC in 1960 by Iraq, Iran, Kuwait, Saudi Arabia and Venezuela (Skeet, 1991). The event that gathered these countries together was the unilateral decision of foreign oil companies to reduce oil prices in August 1960 without even informing the host countries. This decision pushed these countries into balance of payments problems (ibid). The rationale behind this organisation was to fight for the economic independence of oil-rich countries and limit the control of foreign companies in the production and pricing of oil.

3.2.2 Internal power structure

The austerity period and the recession that accompanied it threatened the Shah's grip on power domestically. In August 1960, at the onset of the crisis, the Shah appointed a new Prime Minister, Sharif Emami, who was previously Minister of Industry and Mines, to stabilise the economy (Milani, 2009). However, that cabinet collapsed less than a year later, when public sector teachers and civil servants protested against wage cuts introduced by the government (ibid). Afterwards, under the pressure from the Kennedy administration, the Shah appointed Ali Amini, a reformist politician, as the new Prime Minister in May 1961 (ibid). The US administration was hopeful that Amini could lead the "Controlled Revolution" and implement the necessary social, economic and political reforms. Accordingly, the Shah was pressured to give autonomy to Amini to select his own cabinet and allow him to rule by decree for six months in order to give him a free hand for reforms (FO 371/170372, 1962; FO 371/164179, 1962).

Using this autonomy, Amini loosened press control and lifted the ban on political activities. In terms of economic reforms, however, Amini's government had to execute the harshest phase of the austerity package in 1962. His government attempted to balance the budget primarily by cutting the military expenditure and SAVAK's finances (Milani, 2011). Unsurprisingly, the Shah successfully resisted these reforms as these two institutions constituted the main pillars of his power. As a consequence, Amini had to resort to cutting non-military expenditures and public investment (ibid).

In time, these reforms took their toll on the economy as output declined and unemployment rose (Mehran, 2013), triggering a series of social unrest in 1962. At the same time, the loosening of controls over the press and political activities encouraged more opposition to the government, hence weakening Amini and fuelling internal conflicts within his cabinet. Gradually, a combination of these factors destabilised Amini's government and pushed the US administration to revise its views on Iran (Milani, 2011). Finally, the US advisor, Edward Mason, who previously led the Harvard Advisory Group in the PO, concluded in his report that the Shah was more capable than Amini in managing the country in austerity times (ibid). Highly influenced by this report, the Kennedy Administration then decided to throw its support behind the Shah on the condition that he would continue the reforms that had been initiated by Amini. Following this policy reversal, Amini's government resigned and the Shah appointed one of his close confidants, Assadollah Alam, as the new Prime Minister in July 1962 (ibid). In this way, the Shah regained his absolute authority inside the state.

3.2.3 Class coalitions

The austerity period disturbed the existing alliance between the state and its allied classes. Firstly, the land reform introduced by Amini's government fuelled the conflict between the landlords and the regime. In fact, to ensure that the landlords were not able to block this reform in the parliament, the Shah enabled Amini to rule by decree. Secondly, the austerity packaged introduced by the IMF had a negative impact on the merchants as it shifted Iran's policies from free trade to protectionism for the purpose of saving foreign exchange reserves. Right after the crisis a series of strict import restrictions was put in place by the Ministry of Commerce to limit the import of consumer and luxury goods (FO 371/149780, 1960). The merchants expressed anger at these restrictions, as they were highly active in the import of such goods. The anecdotal evidence offered by the then Deputy Minister of Commerce, who was responsible for imposing the import quotas, captures this anger perfectly. He mentions that a few days after the introduction of restrictions, Tayyib Haj Riziai- a mob leader who had helped the Shah in the 1953 Coup and was later awarded with the monopoly rights to import bananas- came to his office with a knife threatening him over the quotas (Moghadam, February 2012, personal interview). Similarly, the Chamber of Commerce that represented the interest of merchants opposed the import restrictions. Yet, notwithstanding such attacks, the government stood firm on its tariff policy (FO 371/149774, 1960). Eventually, this policy took its toll on the Bazaar and produced several bankruptcies (FO 371/157627, 1961; FO 371/164179, 1962).

On the other hand, this protectionist policy accidentally served the interests of domestic industrialists who were engaged in the production of consumer goods. These industrialists constituted a small but emerging economic class in Iran and their interests were opposed to those of the Bazaar. In 1962, these industrialists managed to form their

own lobby group, the Chamber of Industry and Mines, despite fierce opposition from the Bazaar (Asharf, 1991).

Overall, the above analysis indicates that the austerity years destabilised the previous state-elite coalitions in Iran.

3.2.4 Policymaking institutions

The 1960 balance of payment crisis forced a series of institutional reforms on the Pahlavi state. Firstly, the PO underwent radical transformation from an “enclave” organisation that focused on the implementation of development projects to a planning institution that concentrated on harmonising capital expenditures across the ministries (while the budgeting of current expenditures remained in the hands of the Ministry of Finance). Accordingly, the PO was placed under the control of government and lost its privilege status of being a “state within a state” while the responsibility of executing development projects was transferred to the ministries (Razavi & Vakil, 1984). In this way, this organisation was transformed into an institution that specialised solely in designing development plans and supervising their implementation. Moreover, the duration of planning was reduced from seven to five years in the Third Plan in order to make the budgeting process more realistic (FO 371/157626, 1961; FO 371/157598, 1960). Under the law, the PO retained its 60% share of oil revenues to spend on development expenditures. Overall, these institutional changes considerably improved the foundations of planning in Iran.

Secondly, and more importantly, the crisis gave birth to the Central Bank of Iran (CB). To be sure, the need for such an institution had become evident in the late 1950s. During that period, Iran’s banking sector expanded at a rapid pace and, as a result, the authorities became concerned about the supervision and regulation of this sector

(Mehran, 2013). At that time, the Bank Meilli, which was a commercial bank, acted both as a profit-seeking entity and a *de facto* central bank in charge of regulating the banking sector and controlling the money supply (ibid). Naturally, this arrangement created a conflict of interest, hence the need for creation of a modern central bank.

However, it was the 1960 balance of payments crisis that provided the main impetus for forming the CB; the political elite then realised the urgency of building a central bank to manage the crisis (Mehran, 2013). Accordingly, the CB was established in 1961, together with the Council of Money and Credit. This council amounted to a “parliament” that had to decide monetary and banking policies, while the CB operated as an “executive” branch that had to implement those policies (ibid). The council was initially comprised of fifteen members including the governor of the CB, the Minister of Industry and Mines, the Minister of Commerce, the Minister of Agriculture, the State Prosecutor, the governor of the Bank Melli, representatives of the Chamber of Commerce and representatives of private banks. Also, the minimum tenure for the CB’s governor was set at three years (ibid). Since the CB had to implement the decisions taken by the Council, it did not enjoy the independence that most central banks have today. In short, this institution was formed as part of the government.

The initial technical help for creating the CB came from the PO, specifically from Francis Craco, a Belgian expert, who had been employed by Ebtehaaj. Subsequently, Bank Meilli became heavily involved in building this institution. Indeed, many competent employees of the Bank Meilli were transferred to the CB to lay the foundation of a modern technocratic institution (ibid). As a result, similar to the experience of many rich countries, a modern central bank was born in Iran out of a private bank that had been acting as a “proto central bank” (Epstein, 2007).

One of the main responsibilities of the CB upon its establishment was defined as the “stabilisation of foreign exchange accounts” (Mehran, 2013). The emphasis on this responsibility was a by-product of the 1960 crisis. The CB soon took over the management of the crisis as the political elite, especially the Shah, threw their support behind this institution. It used various tools such as credit limits, restricting the use of trade credit and high interest rates to shrink the internal demand through monetary contraction (FO 371/149774, 1960; Mehran, 2013; Moghadam, IOHCHU, Tape one; Moghadam, February 2012, Personal interview). These measures proved to be successful at reducing the current account deficit, but at the expense of creating an economic recession. By March 1962, the CB managed to fully implement the stabilisation package and restore confidence in the balance of payments (ibid).

Interestingly, that episode of crisis management hastened the CB’s institutional development. For instance, under pressure from the IMF, the CB started to gather data about the banking sector and publish frequent reports about the health of this sector (ibid). Correspondingly, its first annual report was published in 1960, which was in effect, the first reliable piece of macroeconomic statistics generated in the country. The CB started its operation with around four hundred personnel (ibid). Soon, it invested heavily in personnel training and human capital development, creating one of the most technocratic institutions within the state (ibid).

Overall, the IMF’s stabilisation package forced the Pahlavi state to reform and develop its macroeconomic policymaking institutions to stabilise the economy.

3.2.5 Ideology

The 1960 crisis and the IMF stabilisation program had a profound ideological impact on Iran's political and technocratic elite. Firstly, this period instilled a fear of austerity among the elite because this policy resulted in a recession that threatened the regime's stability (Mehran, 2013). Secondly, and relatedly, the crisis and the recession made the technocrats more convinced that Iran needed economic growth more than anything else. Similarly, like the modernisation theorists, the Shah came to view economic development as a tool to pre-empt the possibility of communist revolution in the country and a source of legitimacy for his regime (Milani, 2011). This motivation for economic growth is evident from the ambitious target the regime set for its next economic plan; while designing the Third Five-Year Development Plan (1963-1967) during the recession, the technocrats aimed to achieve the growth rate of 6% annually, which would entail a 40% increase in GDP in the span of five years (FO 371/157626, 1961). In effect, the crisis strengthened the ideology of developmentalism inside the regime.

The other impact of the crisis was that it made the ideas of the Latin American Structuralist School, especially the "terms of trade" hypothesis and import substitution, popular among the elite. As argued by Rodrik (2013), the economic crises provide the fertile moment for new ideas to gain popularity. In moments of uncertainty, policymakers need a "mental model" to tell them "what has gone wrong" and "what should be done about it" (North, 2010). In the case of Iran, the "terms of trade" hypothesis developed by Raul Prebisch in the early 1950s provided this mental model for the elite.

Prebisch claimed that in the long term the relative price of commodities to industrial goods tends to fall, hence pushing countries that specialise in commodity exports into a balance of payments crisis. The solution according him was import substitution; developing countries had to produce industrial goods domestically rather than importing them from abroad. In this way, they could save their foreign exchange reserves and avoid a balance of payments crisis. Finally, after developing their infant industries, they could engage in the export of industrial goods. This nationalist economic theory became extremely influential among developing countries during the decolonisation period after WWII. This theory later became the intellectual foundation of Marxist theories of centre-periphery” proposed by Dependency School.

Some of the Iranian policymakers were familiar with these ideas even before the crisis. For instance, the Minister of Commerce had previously argued that “freedom of enterprise and competition, as well as free foreign trade does not exist in the real sense of the word, even in big industrial countries like the USA, the UK, Germany or Japan....experience gained after the two World Wars and the economic crises on the one hand, as well as rapid industrial and technical development of great magnitude all over the world on the other hand, have led to the rejection of the classical theories of economy and the law of supply and demand. It is only under the protection of a nationally directed economy that countries like Iran may preserve their entity and provide the prosperity of their people” (FO 371/140821, 1959). However, the 1960 crisis greatly increased the allure of these protectionist ideas. Accordingly, the elite started to blame the crisis on Iran’s overreliance on oil and lack of a domestic industrial strategy. Echoing Prebisch’s terms of trade argument at Tehran’s Economic Conference in 1963, the Shah mentioned that “raw materials were becoming cheaper each year while manufactured goods supplied by the countries buying these raw materials were

becoming more expensive: thus the more advanced and industrial nations were exploiting the backward countries producing only agricultural and raw materials” (FO 371.172359, 1963). As a response, he urged economic diversification. At the same time, the Shah became determined to fight the exploitative behaviour of the foreign oil consortium in regards to the pricing and production of Iran’s oil.

Overall, the above analysis shows that like most developing countries that undergo a balance of payments crisis, the Pahlavi regime experienced an ideological slide towards protectionism and import substitution and also became more motivated to promote economic growth.

3.3 The policy shift towards ISI (1963)

As mentioned, the IMF stabilisation package forced a shift towards protectionism in Iran during the 1960-1962 period to restore balance of payment confidence by saving foreign exchange reserves. However, after successfully completing the package, Iran had to choose whether to go back to its liberal model, which it had previously followed in the 1950s, or maintain its protectionist policies and start the ISI process. Ultimately, due to the growing popularity of economic nationalism and import-substitution ideas among the Shah and technocratic elite, the Pahlavi regime chose the latter option. Accordingly, the Third Five-Year Development Plan (1963-1967) was designed to promote the development of domestic consumer goods industries in collaboration with the private sector (the first stage of ISI). In this way, the Pahlavi regime decided to embark on a business-friendly ISI policy in 1963.

Of course, this policy change entailed a serious political risk for the regime. In effect, the state had to break ties with its traditional allies (merchants and landlords) and enter into an alliance with a new-born industrial elite. Yet, as the ultimate decision maker inside the state, the Shah decided to take this political risk and shift to ISI.

More importantly, alongside this economic shift, the Shah introduced a series of radical social reforms under the banner of the “White Revolution”. These reforms included: 1. Land reform; 2. the nationalisation of forests 3. The sale of state-owned enterprises to the public 4. Workers’ profit sharing in 20% of net corporate earnings 5. Voting and political rights for women 6. Formation of a Literacy Crops to tackle illiteracy in poor areas (Afkhami, 2009). The purpose of these reforms, many of which were inspired by

the modernisation doctrine, was to transform Iran from a “backward” society into a “modern one” and in this way, limit the prospect of a “Red Revolution” in the country¹⁷.

Naturally, these modernising reforms were against the economic interests and cultural values of the landed elite, merchants and clergy (Milani, 2011). For instance, the clergy was against the growing penetration of government into education, a realm that had been traditionally regulated by this class. Also, they had vast landholdings in the form of “vaqf” that would be threatened by the land reform (ibid). The combination of these factors urged the traditional classes to oppose the “White Revolution”. Eventually, this opposition resulted in a widespread social protest in 1963 that was brutally crushed by the government. This bloody conflict marked the transition to a new economic and political era in Iran.

¹⁷ It should be stressed that the “White Revolution” was not simply imposed by the US on the Shah. The recent revisionist history offered by Milani (2011) on late-Pahlavi era indicates that the Shah, himself, had considerable incentive to engage in these reforms to save his regime. For instance, the Shah had already discussed the prospect of a land reform several times in the 1950s (FO 371/149804, 1960, Milani, 2011).

Conclusions

This chapter traced the evolution of the Pahlavi state's geopolitical status, internal power structure, ideology, policymaking institutions and class coalitions from 1953 to 1962 in the light of important economic and political events that took place in this period. It showed how this process of state evolution paved the way for a policy shift to ISI in 1963.

Undisputedly, the event that precipitated this policy shift was the 1960 balance of payments crisis. Due to this crisis, the Pahlavi state experienced an ideological slide towards protectionism and import-substitution as these ideas supplied the “mental model” through which the elite could interpret the crisis. In line with the “terms of trade” hypothesis, the political elite believed that the root cause of the crisis was Iran's overreliance on oil and the lack of economic diversification rather than macroeconomic indiscipline. This interpretation of the crisis provided the rationale for a switch towards ISI after the recovery.

However, we should *not* consider the selection of ISI in 1963 as an unavoidable outcome of the ideological overhaul inside the Pahlavi regime. Surely, shift to ISI would not have taken place if it was not for the leadership of the Shah. His agency played a pivotal role in propelling the Pahlavi regime to take the political risks involved in the policy change. This means that Pahlavi's policy overhaul in 1963 was the outcome of ideology and the Shah's agency. In other words, the Pahlavi regime would not have necessarily chosen ISI if the Shah had not been willing to do so or had he not possessed absolute power inside the regime. In this regard, the selection of ISI can be conceptualised as a *contingent* policy choice since it highly depended on a single actor (Sharipo, 2007).

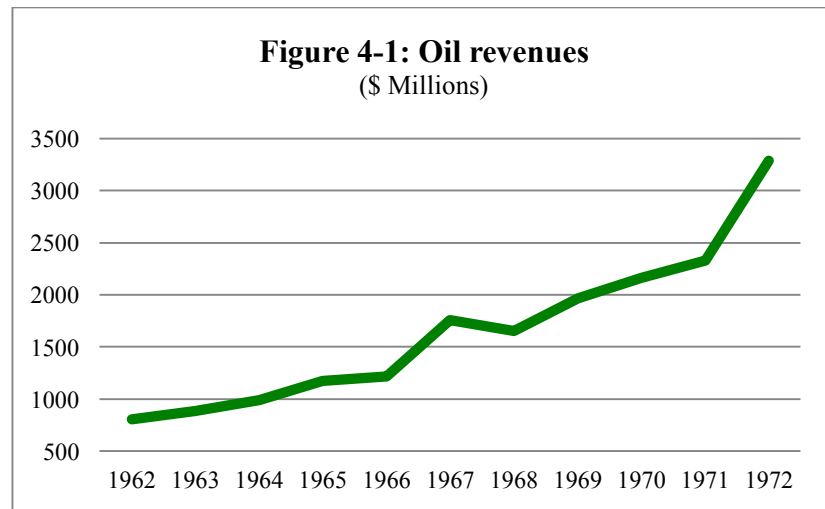
Finally, the Pahlavi regime started the ISI while it had these characteristics: 1. Geopolitically, it did not enjoy much autonomy in relation to the US 2. It had a cohesive internal power structure in which all the power was centralised in the hands of a single actor 3. It had two competent macroeconomic policymaking institutions (PO and CB) 4. It followed a developmentalist ideology, which was a mixture of modernisation theory and Latin American Structuralism (import substitution) 5. It had a newly formed alliance with the nascent industrial elite. These characteristics laid the foundations of a new economic era in Iran.

Chapter Four: Path Entrenchment (I)

This chapter focuses on Third Five-Year Development Plan (1963-1967), which marked the first stage of ISI in Iran. This chapter first looks at the politics of economic policymaking during this plan. The subsequent sections investigate the spillover effects of ISI on the Pahlavi regime's internal power structure, ideology, class coalitions and geopolitical status during the course of the Third Plan. In doing so, they demonstrates that the success of ISI's first stage created a self-reinforcing dynamic that motivated the Pahlavi regime to push this policy further in the Fourth Plan. Hence, the entrenchment of the ISI path.

4.1 Overview of the Third Plan

This plan focused mainly on the development of consumer goods industries through supporting the private sector. However, alongside private sector promotion, the government also engaged in establishing a number of strategic and heavy industries such as steel mills. Thanks to the rising oil revenues (Figure 4-1), this ISI strategy produced remarkable economic results; the economy grew by 9.8%, while inflation remained below 2% (IBRD, 1974a). Manufacturing output increased by 11% annually and, in effect, employment in this sector expanded by 70% over the span of five years (ibid). The private sector accounted for more than 60% of investment in the industrial sector during the plan, hence assuming the leading role in the country's industrial take-off. Most of these investments went to the production of consumer goods, which constituted about 63% of total industrial output (Alizadeh, 1984).



Source: IBRD (1974)

In terms of macroeconomic stability, the government managed to contain fiscal and current account deficits at low levels (table 4-1). Overall, the plan achieved a remarkable economic performance in terms of growth and stability.

Table 4-1: Macroeconomic indicators

	Current Account balance (% of imports)	Budget Balance (% of GDP)	Inflation
1963	12%	-2.2%	1.0%
1964	-8%	-3.3%	4.5%
1965	-12%	-1.8%	0.3%
1966	-13%	0.28%	0.8%
1967	-15%	-2.7%	0.8%

Source: Karshenas (1990), Salehi-Esfahani & Taheripour (2002), Pesaran (1982).

4.2 The politics of economic policymaking

The Third Plan marked the rise of a technocratic elite inside the Pahlavi regime. During this period, the Shah not only empowered the existing policymaking institutions but also supported the creation of new technocratic institutions. The following CIA report reveals this gradual change inside the state (CIA, FRUS, 1964):

“One aspect of social change in Iran, which holds considerable significance for the future has been the rise of the technically trained managerial and administrative class who now have reached the upper levels of the bureaucracy in substantial numbers. This new breed of foreign-educated intellectual first became prominent in the late 1950's in the Plan Organization which, being independent of the traditional bureaucracy, provided quick advancement. They are now gradually being distributed throughout the bureaucracy. While many are not enthusiastic about the Shah's style of government, they are sympathetic with much of his reform program and are helping to implement it.”

The head of the Economic Bureau in the PO similarly proves this claim by pointing out (Farmanfarmaian, IOHCHU, tape 8):

“the Shah would show us great favour in receiving us, listening to our arguments ... So we naturally came to the conclusion that he believed in some of these matters, that he thought that the country needed all of these [economic] reforms”.

This section traces the process of industrial policymaking, macroeconomic policymaking and the oil strategy setting during the Third Plan.

4.2.1 *Industrial policymaking*

When the Third Plan was initiated, the Pahlavi regime had two competent macroeconomic institutions: the CB and PO. However, to effectively manage the process of ISI at the micro level, the regime needed a new ministry to specialise in industrial policymaking and private sector promotion. The Ministry of Economy (ME) was created for this purpose. The Ministry of Economy was established in 1963 by

merging the Ministry of Commerce with the Ministry of Industry and Mines. The rationale behind this merger was to harmonise industrial policy with tariff policy, which was a necessary move under the ISI model. Once established, the ME was made responsible for managing the relationship between the state and private sector through setting tariff rates, credit subsidies, tax breaks, foreign investment regulations and licencing requirements. The management of state-owned industries was also placed under this ministry.

To lead the ME, the Shah appointed a 32-year old Sorbonne-educated economist, Alinaghi Alikhani, who was a firm believer in developmentalism and protectionism (Moghdam, personal interview, March 2013). Once in power, Alikhani started to build a technocratic institution with the support of foreign advisors and also the expertise of the CB and PO (Nasr, 2000). In a short span of time, he managed to fill his ministry with a team of competent technocrats, many of whom had a background in the PO (ibid). In terms of institution building, he firstly established the Centre for Economic research and asked the United Nations to conduct various industrial surveys to help the ME improve the quality of its data (FO 371/170388, 1963). The Industrial Management Institute was then formed to help the private industrial firms to find their needed managerial cadres (ibid). At the same time, the Organisation for Industrial Development and Renovation was created to improve the management of state-owned industries (Afkhami, 2009). This process of institution building paved the way for effective industrial policymaking.

In terms of policy autonomy, the Shah threw his personal support behind the ME to allow this institution to manage the ISI with little interference from actors inside the state, as indicated by Alikhani (Radio Farda, 2010): “the Shah was convinced that if we wanted to have a dynamic economy we needed to separate economic policymaking from politics ... thus, he gave his full support for the Ministry of Economy, Plan

Organisation and the Central Bank. He allowed us to do whatever we thought is right to do for the economy. He showed a lot of flexibility and tolerance towards us”. He adds: “the Shah’s support was critical for us, we wouldn’t have been able to work without his backing”.

Enjoying this political support, the ME engaged in private sector promotion. As the first step, he invited the major industrialists to an economic conference in 1963 and laid out the government’s industrial strategy (FO 371/172359, 1963). He warned that the country needed to diversify away from oil through industrialisation. Thus, the government’s plan was to protect infant industries first and then promote manufacturing exports. Accordingly, Alikhani encouraged the industrialists to take part in the first stage of ISI and invest their money in new consumer goods industries. He explained that the government would primarily focus on heavy and strategic industries and leave other industries in the hands of the private sector (ibid).

This pro-business attitude shaped the direction of the ME’s industrial policy during the course of the Third Plan. In terms of trade policy, the ME devised high tariff rates for consumer goods to encourage the domestic production of these goods by infant industries (the first phase of ISI) and at the same time, lowered the tariff rates for imports of intermediate and capital goods (Karshenas, 1990). In terms of tax policy, it gave generous tax breaks to industrialists who were willing to invest in new sectors. Finally, it indirectly supplied large-scale industrial firms with credit subsidies via IMDBI¹⁸.

¹⁸ In addition to the IMDBI, the government used the state-owned ICB to channel credit subsidies to small-scale industrial firms. However, the bulk of the subsidies in the Third Plan (about 70%) were supplied through the IMDBI due to its superior technical capacity, especially in managerial skills, and also, the preference of policymakers to promote large-scale industries (Karshenas, 1990; Benedick, 1964).

Importantly however, in return for these economic favours, the ME monitored the price of consumer goods to make sure that the industrialists would not engage in opportunistic behaviour and set high prices for their products (Najmabadi, personal interview, May 2014). Thus, this policy was used by the ME as a mechanism for disciplining the domestic firms that were receiving credit subsidies, tax breaks and tariff barriers.

Moreover, the ME showed a green light to foreign firms to enter the Iranian market by forming 49% joint ventures with domestic counterparts (Karshenas, 1990). This was to facilitate the transfer of the necessary knowledge and knowhow for the development of consumer and intermediate industries. To further facilitate this process, the ME devised local content rules in 1965 to promote linkages between foreign and domestic firms (FO 371/180780, 1965).

Finally, while protecting domestic industries, the ME aspired to promote manufacturing exports (Karshenas, 1990). Accordingly, it devoted a budget for export promotion and created a research bureau to help domestic producers to market their products for external markets (ibid). More importantly, it signed a series of trade deals to spur non-oil exports, first with the European Common Market in 1963, and then, against the US administration's wish, with a number of communist countries: the Soviet Union (in 1964 and 1967), Poland (in 1965), Hungary (in 1966), Czechoslovakia (in 1966), Bulgaria (in 1967) and Romania (in 1967) (FO 371/180780, 1965; FO 371/170388, 1963; FCO 17/351, 1967).

Alongside private sector promotion, the ME also directly invested in a number of strategic and heavy industries. The most notable of these investments was the building of a steel industry in collaboration with the Soviet Union (see section 4.6).

Overall, this policy mix resulted in a remarkable industrial take-off, hence turning the ME into one of the most powerful institutions inside the state as a result. In time, this ministry started to be considered as a political platform for assuming the post of the premiership. Accordingly, Prime Minister Hoveyda considered Alikhani as a potential political contender by the end of the Third Plan, (Nasr, 2000).

4.2.2 Macroeconomic policymaking

The CB was another policymaking institution that played a major role in the success of the Third Plan. In 1962, this bank was placed under the control of Mehdi Samiee, who was one of the most able and financially honest bankers in the Pahlavi regime (Milani, 2009). The Shah gave him full autonomy in monetary and banking policies from the beginning (ibid). The following remark by Samiee captures the essence of this autonomy (Samiee, IOHCHU, tape one):

“..those first five years [1963-1968] was a very good period. We had really managed to build an independent Central Bank, which was respected by the business community with the exception of few banks. We really made good decisions, we never dreamt of asking permission from the Shah or the prime minister. Not a lot of people could do such a thing in those days. At most, we would talk about these policies in High Economic Council or the Planning council...but we felt to a great extent that we could do many things without asking for any permission”.

Like most Pahlavi technocrats, Samiee was ideologically pro-business and considered the government as a “bad entrepreneurs”. One of his first speeches given as the director of the Bank clearly reveals this belief (CBB, No 16, 1962: p427):

“it is evident that governments have announced their inability [in generating economic profits] one after another. It is said that “governments are not good entrepreneurs”. It is true, given that, so far, our governments have not been good entrepreneurs”.

Also, like the rest of the technocrats, he placed a high priority on achieving economic growth. Accordingly, the CB operated as a “development bank” under his directorship by indirectly facilitating the flow of credit from the banking system towards the industries that the Third Plan intended to develop. This function was not unusual at the time; many central banks in rich and developing countries implicitly assumed such a role during the 1960s and 1970s, before “inflation targeting” became the main function of central banking in the 1990s (Epstein, 2007).

More importantly, like many economists at the time, the CB’s experts saw no conflict between supporting ISI and ensuring macroeconomic stability. In terms of stability, the main preoccupation of the CB was to make sure that Iran would never again experience a balance of payments crisis (Mehran, 2013; FO 371/175728, 1964); for this purpose, the experts in the bank embraced the import substitution policy because they believed that eventually this policy would reduce Iran’s import requirements and therefore, improve the balance of payments¹⁹ (CBB, No 49, 1965). Thanks to this viewpoint, the CB held that it was possible to simultaneously promote economic growth and ensure macroeconomic stability through the ISI.

During the Third Plan, the CB managed to greatly improve the supervision of the banking sector and facilitate the flow of credit to import substituting industries. It also fixed the value of the dollar against the rial at 75.7 (IBRD, 1974) to eliminate exchange rate risk for the private sector. Thanks to these policies, the bank established an effective relationship with private bankers and industrialists (Samiee, IOHCHU, tape one; Mehran, 2013). Most importantly, the CB managed to keep a low rate of inflation and balance of payment deficit (table 4-1) during the Third Plan despite its preoccupation with promoting economic growth through credit allocation. This

¹⁹ Interestingly, this belief was also shared by the IMF and World Bank advisors (FO 371/186690, 1966).

achievement greatly enhanced the credibility and authority of the bank in the business community (Farmanfarmaian, Tejarat Farda, 2014).

Moreover, the CB successfully managed to keep monetary policy independent from fiscal policy *in practice*. During the Third Plan, the Ministry of Finance constantly pressured the bank to finance the deficit in current expenditures, but notwithstanding these pressures, Samiee kept insisting on “the right of the Central Bank to continue to have its own policy separate from the Ministry of Finance” (FO 371/170390, 1963).

Overall, due to a high degree of policy autonomy and a pro-business developmentalist ideology, the CB managed to propel the ISI policy in collaboration with the ME and PO, while maintaining macroeconomic stability. This success, in turn, made the CB a powerful and independent institution inside the state (Farmanfarmaian, Tejarat Farda, 2014; Mehran, 2013).

Unlike the ME and CB, the PO did not experience an upsurge during the course of the Third Plan, but as will be explained, this institution still managed to perform well in terms of fiscal policymaking.

When the Third Plan began, fiscal policymaking was not centralised within the Pahlavi regime; the PO was responsible for budgeting and supervision of development expenditures while the Ministry of Finance had to budget and monitor current expenditures. However, after lobbying by the PO, the entire task of budgeting was transferred to this institution in 1964 (Majidi, OHCFIS, tape two; Ian Sadr, 2013), hence, leaving the Ministry of Finance responsible for the collection of taxes and the

disbursement of funds to ministries²⁰. In effect, this institutional change harmonized the process of fiscal policymaking inside the state.

However, the PO did not have the policy autonomy that the CB and ME possessed due to the Shah's support. To be sure, the Shah allowed the PO to set the development plans in isolation from the parliament, as indicated by one of its members (Farmanfarmaian, IOHCHU, tape fourteen):

“we didn't really feel answerable to them [the MPs], this is the truth .. don't forget! we were technocrats. In our heart, we believed that they knew nothing about economic development and the less they interfered with us, the better it was”.

However, the PO did not enjoy such political protection against more powerful institutions such as the army. Indeed, this organisation had little say in setting military expenditures, as pointed out by a senior member (Farmanfarmaian, IOHCHU, tape eleven):

“..it was very simple. Once the Shah had approved [the military budgets], they would be formally sent to the Plan Organisation, and they would say on the paper, the budget has been approved by His Imperial Majesty, the Shah-hanshah, the Commander-in-Chief of the Armed Forces. It would come to us. We would examine them, to be sure, we would read them, to be sure, but we knew we couldn't do much about it”.

Most importantly, the PO did not have access to accurate information about future oil revenues (FO 371/186690, 1966; FCO 17/381, 1968; Majidi, OHCFIS, tape two). This is because the Shah treated the issue of future oil revenues as a security issue and, therefore, did not let the NIOC to share information about this matter.

²⁰ The PO also lobbied to take control of the disbursement of funds in order to “give the organisation more political teeth” to enforce discipline on the ministries in the execution of development projects (Farmanfarmaian, February 2013, personal interview). However, the Ministry of Finance fiercely opposed this reform unsurprisingly.

However, despite these political weaknesses, the PO managed to uphold fiscal discipline during the course of the Third Plan (Table 4-1). One important factor that helped this organisation in achieving this end was the stability of oil revenues (Figure 4-1). This stability enabled the technocrats to estimate the future oil revenues with good precision and plan accordingly, despite not having access to information about the oil negotiations that were taking place by NIOC (Majidi, OHCFIS, tape two).

Overall, the PO succeeded in ensuring macroeconomic stability during the third plan while satisfying the development needs of the ISI project such as investment in infrastructure, the building of state-owned industries and credit subsidies to private sector via the IMDBI.

Based on the analysis presented in this section, we can describe the Third Plan as a period where macroeconomic policymaking institutions (the CB and PO) worked effectively with the ME to propel the ISI while maintaining macroeconomic stability. The following remarks by the Minister of Economy capture this cooperation in policymaking (Afkhami, 2009: p323):

“Samiee [CB’s Governor], Asfia [PO’s Director] and I understood each other. We kept each other informed of what we did and sought each other’s advice. Consequently, we were almost always in agreement not only about general policy but often also about what went on in our individual bailiwicks”.

Thanks to this cooperation, these technocrats even managed to achieve a higher rate of growth (9%) than the ambitious target originally set in the Third Plan (6%). This economic miracle made these institutions, especially the ME and CB, politically powerful. The empowerment of these policymaking institutions, in turn, provided the needed institutional infrastructure for the transition to the next stage of ISI in the Fourth Development Plan.

4.2.3 Oil strategy setting

During the Third Plan, Iran financed the import needs of ISI through her oil revenues. Naturally, this translated into the growing dependence of Iran's industrial sector on oil revenues over time, as indicated by the widening trade deficit of this sector from 10% to 15% of non-oil GDP between 1963 and 1967 (Karshenas, 1990). Correspondingly, in 1967, industry absorbed 55% of total imports while generating only 10% of export revenues (IBRD, 1974). This meant that in order to drive ISI forward, Iran had to continuously increase her oil revenues. As a result, the maximisation of short-term revenues became the guiding principle of Iran's oil policy in the 1960s²¹ (as opposed to maximising oil revenues in the long term). Beside ISI, Iran's growing military investment also required the maximisation of short-term oil revenues.

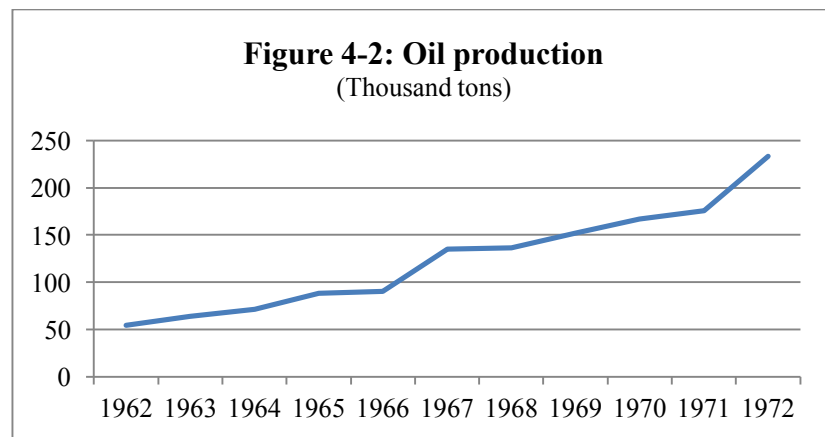
In line with this goal, NIOC started to press the oil Consortium to increase Iran's oil production. Since the foreign oil companies operated as cartel, an increase in Iran's production entailed a decrease in production elsewhere. Accordingly, Iran reasoned that due to having a larger population, she had to produce more oil than small Gulf countries. Therefore, during the Third Plan, Iran followed a unilateral strategy to increase her petroleum production at the expense of other oil-rich countries. In addition, Iran also demanded higher royalties from the Consortium. Interestingly, due to the reasons outlined in section 4-6, the Johnson administration was sympathetic with Iran in this oil battle since it generally believed that higher oil revenues would help economic development and the stability of its oil-rich allies (Rusk, FRUS, 1968). At the same time, higher oil revenues would help the US administration to cut foreign aid to Iran

²¹ In other words, the ISI's success made current oil revenues increasingly more important than future oil revenues for the Pahlavi regime, hence shortening its horizon in the global oil market.

(FO 371/186696, 1966). A British Foreign Office report (FCO 17/351, 1967) describes Iran's battle with the Consortium in this way:

“He [the Shah] argued that Iran's political stability, her attachment to the West, and her large population by comparison with other oil-producing countries (over 25 million according to the November census), fully justified Iranian demands for increased oil revenue...Unfortunately, the oil Consortium did not take these demands seriously enough, some of the American companies being particularly guilty in this respect...When this was refused, the Shah and Prime Minister publicly threatened unilateral action against Consortium; Press, Parliament, inspired from above, attacked the Consortium and a dangerous situation, reminiscent of Mosaddeq's days, had suddenly been created. But once again wiser counsels prevailed and the Shah stepped back at the last minute; the oil companies were given a month's grace in which to produce counter-proposals. By this time, the companies were themselves convinced that the Shah was not bluffing and, when their negotiators, led by Mr Howard Page of Standard Oil Company of New Jersey (who had been the chief negotiator of the 1954 oil agreement establishing the Consortium), came to Tehran in November, they were able to offer an acceptable “package deal” whereby oil production would be increased in 1967 and again in 1968 by between 12 and 13 per cent, 25 per cent of concession area would be relinquished immediately and some 20 million tons of crude oil made available between 1967 and 1971 at a special price for barter deals with East European countries. The Shah, at long last aware of Dr Eqlbal's limitations as a negotiator, personally played a key role in the final round of negotiations and was well satisfied with the final outcomes”.

In the end, in order to pressure the Consortium to submission, the Pahlavi regime cleverly exploited the Cold War environment by threatening to give oil concessions to the Soviet Union in case its demands were not met (FO 371/186690, 1966; FO 371/186693, 1966, FO 371/186691, 1966). At that time, the oil companies were worried about the prospect of the Soviet Union exporting oil to the Western markets, hence threatening their share in those markets (ibid). As a result, through extensive negotiations, Iran finally managed to increase her oil production (Figure 4-2) and revenues (Figure 4-1) during the Third Plan. Thanks to this increase in oil revenues, Iran became financially independent from US foreign aid in 1967 (Johns, 2007).



Source: IBRD (1974)

In summary, the analysis presented above shows that in synchrony with the ISI strategy Iran directed its oil policy towards the constant maximisation of short-term revenues.

4.3 Effect on the internal power structure

The Third Plan was initiated by the Shah while he enjoyed absolute power inside the state. To ensure the effective implementation of the Plan and the White Revolution reforms, he accordingly started a “house cleaning” inside his regime. He encouraged the formation of a new political party called Iran Novin, which was comprised of a young generation of Western-educated Iranians, who shared the Shah’s belief in top-down modernisation. This party assumed power in 1963 at the behest of the Shah, with the People’s Party acting as its main opposition in parliament. This party functioned as a group of “elite modernisers”, rather than a political party with organic roots in the society, as indicated by a CIA report (CIA, FRUS, 1964):

“In constituting his most recent cabinet, that of Hasan Ali Mansur in March 1964, the Shah once again turned to the managerial and administrative class. Although Mansur's experience in government affairs is limited, he has a reputation for being a capable administrator. In 1959 he became head of the Progressive Center, a group of pro-government technicians, businessmen, and intellectuals which formed the nucleus of the New Iran Party, founded at the Shah's behest in 1963. Though this party now has about 140 of the 189 deputies in the Majlis, it is an artificial creation without a popular base”.

Initially, Hasan Ali Mansour was selected as Prime Minister from the New Iran Party in 1964. He was, however, assassinated in 1965 by a militant Islamic group in retaliation for passing the controversial Capitulation Law²² and also, the bloody suppression of the clergy and the Bazaar in 1963 (ibid). Mansour was succeeded by Amir Abbas Hoveyda, who continued to serve as Prime Minister until 1977, setting the record for the longest premiership in the history of Iran (ibid).

²² The Capitulation Law gave protection to American soldiers within Iran. This law was viewed by many, especially Ayatollah Khomeini, as a regression towards to the colonial era (Milani, 2009).

Thanks to the remarkable economic success of ISI, Iran experienced a high degree of political stability during the course of the Third Plan. This stabilisation effect of ISI was noted by the US ambassador (Meyer, FRUS, 1966):

“It has been years since the political atmosphere has been as sluggish, as self-satisfied, or as resigned to the status quo. This...is in large measure attributable to economic prosperity....A rising new middle class is on the march economically and, in the short run at least, appears to be developing an interest in political stability”.

This observation was also approved by another State Department Paper (Newberry and Mulligan, FRUS, 1967):

“The internal Iranian political scene has not been as stable as it is today since World War II....[The Shah’s] programs for economic development, land reform, health and education and many other improvements have engaged the cooperation of most Iranians and have outdone the slogans and proposals of the opposition to his rule”.

These papers suggest that, in many ways, the Third Plan fulfilled its political function in terms of ensuring political stability and allowing the Shah to maintain his monopoly on power. This positive political impact therefore, further increased the desirability of ISI for the Shah.

4.4 Ideological effect

Naturally, the economic success of the Third Plan and its positive effect on political stability strengthened the developmentalist ideology of the Pahlavi regime. The political and technocratic elite became more convinced that increasing economic growth should be the main priority of the state. In effect, economic development started to occupy centre stage in political discourse and functioned as the prime source of legitimacy for the regime. Correspondingly, while preparing the Fourth Development Plan from 1966

onwards, the Shah set even a more ambitious growth target (10%) than the Third Plan for the technocrats (FO 371/186690, 1966; FCO 17/381, 1968).

Also, Iran's remarkable industrial performance in this period reinforced the technocrats belief in the economic merits of ISI. Since this performance had been accomplished with few macroeconomic problems, the technocrats continued to believe that pursuing ISI posed no serious risk to macroeconomic stability (Alikhani, personal interview, February 2013). Like many development economists at the time, they argued that pushing ISI further towards intermediate and heavy industries would save foreign exchange reserves for the country in the long term by reducing import needs for steel and petrochemical goods (FO 371/186690; 1966 & FCO 17/381, 1968).

Overall, Iran's economic miracle in the Third Plan amplified the Pahlavi regime's developmentalist discourse and also reinforced the elite's belief in economic merits of ISI.

4.5 Class coalition effect

This section maps out the evolution of the state-business relationship in the Third Plan. As mentioned, the Pahlavi regime started the ISI in alliance with the nascent industrialist elite. The regime sought to expand and enrich this class during the Third Plan, thinking that rest of the society would benefit from this phenomenon ("trickle down economics"). Inspired by the modernisation doctrine and the prevalent theories of development economics, the technocrats aimed to build a modern sector that could disseminate the use of modern technology and management techniques to the wider economy (i.e. spill-over effects) and also instigate progressive social, cultural and political change. They considered traditional sectors such as the Bazaar as Iran's symbol

of backwardness. Particularly, the Shah shared an ideological disdain for the Bazaar (Keshavarzian, 2007: p133):

“It remains my conviction that their time is past. The Bazaar consists of a cluster of small shops. There is usually little sunshine or ventilation so that they are basically unhealthy environs. The Bazaaris are a fanatic lot, highly resistant to change because their locations afford a lucrative monopoly”.

In this regard, the Pahlavi regime attempted to propel Iran’s economy from merchant capitalism to industrial capitalism through top-down development. For this purpose, policymakers encouraged the landed elite and merchants to transform their businesses and invest their money in industry, as recalled by Deputy Minister of Economy (Niazmand, Tejarat Farda, 2013b):

“we used to turn Bazaaris into industrialists; that was our job... for instance, we would say to a merchant, who had been importing textile, to produce textile in Iran... we would say to Haji²³ Barkhordar that instead of importing TVs, produce TVs inside your country. If you don’t do this, we will increase the tariff rates for TVs, then you will not make any profit...this was our tool!...I had to invite importers and convince them to produce the same good inside...we decided to choose policies that facilitate the business environment for the industrialists. The first thing we decided was to let industrialists become rich...we believed that the country would not develop unless some people became millionaires”.

Following this goal, the ME gave a large number of entry licenses in the Third Plan to pave the way for new factories, as highlighted by a World Bank report (IBRD, 1970: p20):

“the government authorities appear concerned that individual firms, after obtaining protection or after the import ban has been introduced, might exploit the situation of being a de facto monopolistic seller. In order to avoid this possibility, the practice seemed to have been to issue licences to several firms for almost every product. The number of licences issued can in some cases become very large (e.g. TV sets)”.

²³ “Haji” is a prefix used in Iran for anyone who has made the pilgrimage to Mecca. Many Bazaaris at the time were Hajis and enjoyed close relations with the clergy.

The IMDBI also played an instrumental role in this process by giving cheap loans to large-scale manufacturing firms. This private bank was the dominant supplier of industrial credit (15% of total) in the Third Plan and operated as a facilitator in joint ventures between domestic and foreign firms (IBRD, 1971).

Thanks to these policies, a series of conglomerates such as Arj, Bishahr, Shahriyar, Sudavar and Sabet Industrial Groups were formed from 1963 onwards. Almost all of these family conglomerates had four common features. Firstly, they were established by an entrepreneur who had a background in the Bazaar; Milani's (2009) analysis reveals that among top twenty industrialists only three came from outside the Bazaar. Secondly, they were involved in a large number of businesses, thanks to their high number of horizontal linkages. Karshenas (1990) shows that the limited size of the internal market, together with the high income inequality, motivated large-scale firms to penetrate into various markets rather than "deepening" their activities in their initial market by generating vertical linkages. Thirdly, they had capital-intensive production structures, therefore generating few employment opportunities (*ibid*). This is normal given the heavy subsidisation of credit for these businesses. Finally, and most importantly, they focused mainly on serving the domestic protected market rather than competing in the global economy (inward-looking). To be sure, Iran's manufacturing exports grew threefold during the Third Plan, thanks to the ME's promotional policies, but this increase started from a very low base (Alizadeh, 1984). Overall, family conglomerates exported less than 5% of their outputs (*ibid*).

Politically, these conglomerates voiced their demands through the Chamber of Commerce and the Chamber of Industry and Mine. However, these chambers were more instruments of state power rather than independent lobby groups as the government implicitly supervised the selection of their members and board of directors (Ashraf,

1991). This indicates that despite the rise of new family conglomerates, the industrialist class remained small and failed to exercise significant political power.

As a response, many industrialists involved members of the royal family in their business to gain leverage over policymaking. This alliance allowed the industrialists to attain influence in the policymaking institutions at the middle and low levels of management (Farmanfarmaian, IOHCHU, tape fifteen). However, the evidence suggests that this influence never reached the top management level. The Foreign Office documents, Oral History interviews and SAVAK papers point to many occasions where the high-ranking experts in the ME, the CB and, to a lesser extent, the PO successfully resisted the pressures of the royal family regarding the allocation of credit, entry permits or employment opportunities. For instance, in the case of the Minister of Economy, the IMDBI's director remarks: "at that time, people at the [Imperial] Court wanted to use their influence to get industrial licences. But, Alikhani stood against all those pressures" (Kheradju, IOHCHU, tape two). Similarly, Farmanfarmaian recalls: "Alikhani was tough; he resisted the Court's pressures" (Farmanfarmaian, personal interview, 2010). These findings are also consistent with the claims put forward by Nasr (2000) and Milani (2009).

The above analysis shows that the success of ISI gave rise to a new group of "inward looking" family conglomerates that had little leverage over the Pahlavi regime.

4.6 Geopolitical effect

The Third Plan's success profoundly changed Iran's relationship with the Cold War superpowers and marked a new era in the Pahlavi regime's foreign policy. When starting the Third Plan, the regime still operated under the direct influence of the US. As evidence, Iran provided complete legal immunity to the American military staff in 1964,

fuelling anti-imperialist sentiments in the society in response. This foreign influence placed serious constraints on the economic and geopolitical ambitions of the Pahlavi regime. In terms of geopolitics, the Pahlavi regime aspired to gain supremacy in the Gulf by replacing the British forces as the guarantor of stability in the region after their withdrawal in late 1960s. For this purpose, the Shah continually lobbied the Johnson administration to sell Iran the latest military equipment. Also, in harmony with this geopolitical aspiration, the Pahlavi regime sought to invest in strategic and heavy industries such as steel, while simultaneously supporting private sector investment in consumer goods industries. Importantly however, the Johnson administration was opposed to Iran's military and heavy industry plans for ideological and geopolitical reasons.

As mentioned in the previous chapter, the Johnson administration was ideologically influenced by modernisation theorists, especially by Walt Rostow, who served as an advisor to the president. In line with the modernisation doctrine, Rostow argued that Iran had to prioritise economic development over military advancement as he considered economic growth as a more effective weapon against the "communist disease" in the Third World than military might (Engerman *et al*, 2003). Therefore, he believed that investment in heavy industries and military would divert economic resources away from sectors in which Iran had a comparative advantage such as labour-intensive industries and petroleum related industries. Following on from this view, he insisted on "getting industry to develop in such a way as to support and complement the agricultural development" (Eckhardt, FRUS, 1964). He also stressed the importance of developing petrochemical industries in Iran: "The important principle will be for Iran to reap the profits of value added to its raw materials rather than to let these profits go to processors outside Iran" (Saunders, 1968a). Accordingly, the US and World Bank

advisors rejected Iran's proposal for building a steel factory on the grounds that it did not conform to the country's comparative advantage (FO371/172359, 1963). Also, the US administration made military sales to Iran conditional on meeting certain economic goals to make sure that military investment would not "crowd out" economic development (Johns, 2007). The following remark by Rostow clearly reveals this intention (Rostow, FRUS, 1966a): "Most of us believe the Shah is foolish to spend his money this way. AID forecasts a rapidly growing balance of payments deficit if he pushes both development and heavy arms purchases too hard. His oil revenues will not rise as sharply as he hopes, and AID fears he will end up asking us to bail him out of a foreign exchange bind just when we are phasing out of economic aid". He then concludes: "We're walking a tightrope between bowing to his intention to be master in his own house and keeping his military spending within reason" (Rostow, FRUS, 1966b).

However, the US opposition to Iran's military build-up and heavy industry plans was motivated by factors other than ideology. During the early 1960s, the US followed a "balance of power" policy in relation to Iran and Saudi Arabia to exercise maximum power over its two important allies to prevent either of these countries from dominating the Middle East region (Alvandi, 2014). Therefore, the Johnson administration was weary of favouring Iran over Saudi Arabia in the region. On this ground, it constantly rejected the Shah's demand for sales credits for military equipment. Washington secretly held that "Iran's armament should not be so augmented as to frighten our riparian states and thus, endanger prospects for Arab-Iranian cooperation" (Alvandi, 2014: p37).

However, in response to these constraints imposed by the US, Iran started to approach the USSR. The main rationale behind this move was to follow an "independent line in

foreign affairs” (FO 371/180780, 1965) and gain policy space against Washington by exploiting the Cold War environment. At that time, the Shah perceived Arab nationalism and Nasserism as the main revolutionary threat to his regime rather than the Soviet Union. Therefore, Iran took the initial step to normalise relations with the USSR in 1963 by promising not to allow the US to station missiles on her soil (Alvandi, 2014). As the next step, the ME entered established a series of trade deals with communist countries: the Soviet Union (in 1964 and 1967), Poland (in 1965), Hungary (in 1966), Czechoslovakia (in 1966), Bulgaria (in 1967) and Romania (in 1967) (FO 371/180780, 1965; FO 371/170388, 1963; FCO 17/351, 1967). The economic logic behind these deals was to encourage manufacturing exports to these countries. More importantly, the ME entered into negotiations with the Soviets to help Iran build a domestic steel industry. Unsurprisingly, Washington lobbied hard against this policy (FO 371/180780, 1967), but the two countries progressed with the deal and finalised it on January 1966 (FCO 17/351, 1967): the Soviet Union agreed to provide the capital and technology for the steel mill in Estefan in return for receiving piped gas from the Southern Iranian oil field. The technocrats hailed this deal as a national triumph and a major step towards economic independence (Nasr, 2000). Emboldened by the ISI’s economic success, the technocrats encouraged the further involvement of the communist countries in the construction of heavy industries in Iran. As a result, the Soviet Union signed a protocol in 1967 to help deepen Iran’s ISI project in the Fourth Development Plan (FCO 17/351, 1967; FCO 17/382, 1967). Specifically, they agreed to develop Iran’s machine-building industry in Tabriz. Soon after this deal, the US administration dropped its opposition to ISI deepening in Iran and welcomed American investment in heavy industries. In effect, the Iranian government entered into a joint venture with US Reynolds Metals in 1967 to pioneer aluminium industry in Arak.

The above analysis shows that Pahlavi's determination to create domestic heavy industries pushed the regime towards the Soviet Union. This relationship expanded in time with the ISI's progress, resulting in the growing autonomy of Iran from the US. Of course, Iran remained "essentially in the Western Camp" despite this close economic relationship (FO 371/180780, 1965). However, her growing economic relations with the Soviet Union put pressure on Washington to consider Iran more as a partner in foreign policy rather than a client.

In addition to this geopolitical effect, ISI's success had a direct impact on Iran's image in Washington. By the end of the Third Plan, Iran was praised as the success story of the 1960s (the so-called "development decade") by the World Bank and Washington (Popp, 2011). According to Rostow's assessment in 1968, Iran was at the "point on the development ladder where the "take off" is just about finished and the nation is beginning to diffuse its resources and technology into a broad range of new industries" (Saunders, FRUS, 1968a). Similarly, Johnson praised the Shah for his effective economic leadership by mentioning that "he did not know any country...where the leadership has been wiser or more effective. Some people talk about development. Some people do it" (Saunders, 1968b). Therefore, viewing Iran as a role model for economic development, President Johnson looked to "translating Iran's experience to Vietnam" (Saunders, FRUS, 1967).

In the end, the combination of ISI's economic effect and geopolitical impact (i.e. the Iran-Soviet ties) encouraged the Johnson administration to gradually change its foreign relations with Iran towards a partnership of equals and, therefore, consider the Pahlavi regime's military needs and heavy industrial plans (Johns, 2007). In short, the ISI's success during the Third Plan increased the autonomy of Pahlavi regime from the US.

Conclusions

The Third Plan marked the rise of technocratic elite inside the Pahlavi regime. In this period, the Shah empowered the existing macroeconomic policymaking institutions and established the ME to manage the process of ISI. This new ministry worked effectively with the CB and PO and successfully launched the first stage of ISI, which involved development of light industries. Thanks to this cooperation between the technocrats, Iran experienced a high rate of economic growth and macroeconomic stability in the third plan.

This economic success, in turn, had spill over effects on the characteristics of Pahlavi regime. Firstly, relating to internal power structure of the state, it drastically improved Iran's political stability and, in effect, let the Shah maintain his absolute power inside the state. Secondly, it strengthened the developmentalist discourse of the regime. Thirdly, it led to an alliance between the state and a nascent class of industrialists, who were primarily concentrated on producing consumer goods for the internal market (inward-looking). The government nurtured this class with economic favours, but in return, it introduced price-monitoring measures on consumer goods to discipline the economic behaviour of this class. Finally, in terms of geopolitics, it enhanced the autonomy of Pahlavi regime from the US.

Combination of these effects resulted in growing demand among the political elite (and industrialists) to drive the ISI to its next stage in the coming Fourth Development Plan (1968-1972). In other words, the Third Plan's success directed the Pahlavi regime into a self-reinforcing path of ISI deepening.

Chapter Five: Path Entrenchment (II)

This chapter focuses on the Fourth Five-Year Development Plan (1968-1972), which marked the deepening of Iran's import substitution strategy towards the development of heavy and intermediate industries, alongside the promotion of light industries. Similar to the previous chapter, it first explores the politics of economic policymaking inside the state during this plan. Then, it assesses the spillover effects of this plan on different aspects of the Pahlavi regime. In doing so, it shows that the ISI policy continued to influence the characteristics of Pahlavi regime in a way that motivated the elite to stick with this policy and even push it further into its next stage. Thus, the further entrenchment of the ISI path. The final section contrast Iran's ISI in the 1963-1972 period with other rapidly growing developing economies to highlight its distinctive features.

5.1 Overview of the Fourth Plan (1968-1972)

The main goal of the Fourth Plan was industrial development as this sector absorbed the highest share of expenditures (20%). This plan propelled Iran's ISI strategy to its second stage, which involved public investment in heavy and intermediate industries. Accordingly, the government accounted for most of the capital formation (60%) in industry during the Fourth Plan. Notably, the government built the Isfahan's steel mill, the Tabriz and Arak machine-making plants, the Tabriz tractor building plant and the Arak Aluminium smelting plant. Thanks to these investments, Iran slowly started to produce intermediate goods such as basic metals, chemicals, rubber and paper in addition to consumer goods. By the end of the Plan, consumer and intermediate goods accounted for 64% and 22% of total industrial output respectively (Alizadeh, 1984). As outlined in the Fourth Plan, the policymakers expected that this push towards heavy and

intermediate industries would reduce the import the country's needs in the long term (Daneshkhu, 2004: p138):

“The Fourth Plan is the first stage of a long-term programme to industrialise the country and the objective of which is to make country independent of consumer goods and to manufacture capital and intermediate goods inside the country so as to minimise the volume of imports and to diversify the export of locally manufactured goods to foreign countries”.

Like the Third Plan, the Fourth Plan generated an economic miracle; the economy grew by 11% per year and industrial output rose by 13% (IBRD, 1974). However, ISI deepening entailed a large increase in government spending and growing import requirements (capital and intermediate goods). This resulted in rising inflation and widening current account and budget deficits from 1968 (table 5-1). Therefore, typical of developing countries that undergo the second phase of ISI, Iran started to experience macroeconomic imbalances.

The empirical evidence reveals that ISI deepening was the main driver behind Iran's widening current account deficit. During the Fourth Plan, 55% of foreign exchange earnings were used to finance the import requirements of the industrial sector, while the export earnings of this sector accounted for less than 10% of foreign exchange earnings. This means that the industrial sector was a major net absorber of the foreign exchange²⁴.

Table 5-1: Macroeconomic indicators

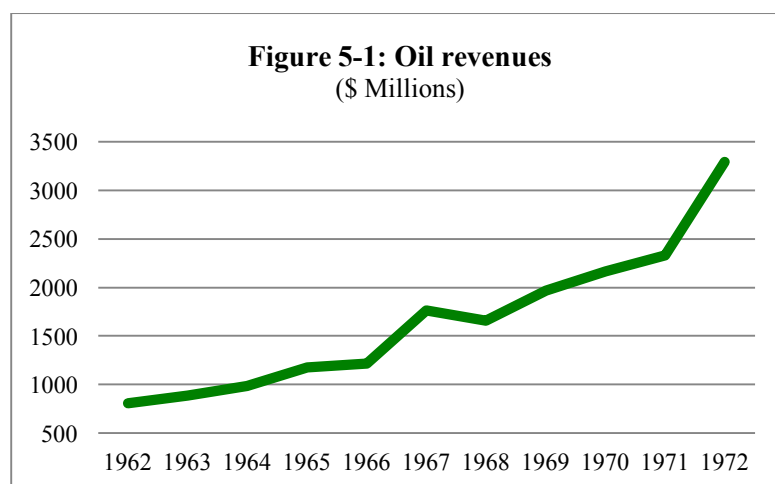
	Current Account balance (% of imports)	Budget Balance (% of GDP)	Inflation
1963	12%	-2.2%	1.0%
1964	-8%	-3.3%	4.5%
1965	-12%	-1.8%	0.3%
1966	-13%	0.2%	0.8%
1967	-15%	-2.7%	0.8%
1968	-25%	-4.2%	1.6%
1969	-27%	-5.5%	3.5%

²⁴ To be sure, the growing military expenditures also contributed to the current account deficit. However, this item accounted for only 15% of imports in the Fourth Plan on average (Mofid, 1987). Therefore, its effect on the external imbalance was not on the same scale as the ISI.

1970	-28%	-4.9%	1.5%
1971	-9%	-5.8%	5.5%
1972	-5%	-9.2%	6.3%

Source: Karshenas (1990), IBRD (1974), Salehi-Esfahani & Taheripour (2002)

As illustrated in the above table, Iran's current account deficit peaked in 1970. According to a CIA report, Iran's foreign exchange reserves had "fallen to a six-year low, or less than two months' imports" at the end of that year (cited in Cooper, 2011: p53). However, as will be explained, these macroeconomic risks did not deter the Pahlavi regime from carrying on with the Fourth Plan. Instead of cutting down the planned expenditures to control inflation and eliminate the balance of payments deficit, the regime stuck with its usual policy of ISI deepening. To support this policy financially, Iran intensified her pressures on the Consortium to acquire a new oil deal for the country. Finally, after years of lobbying through OPEC, Iran managed to reach a more favourable agreement with the oil companies in 1971. This new deal, known as the Tehran Agreement, raised Iran's oil revenues (Figure 5-1) and eased the pressure on the balance of payments, thus financially allowing the country to continue to drive ISI deepening and achieve a higher rate of growth (11%) than the ambitious target originally set in the Fourth Plan (10%).



Source: IBRD (1974)

5.2 The politics of economic policymaking

As Iran transitioned to the second stage of ISI, a conflict started to emerge among the technocrats over economic policymaking. The main root of this conflict was the negative impact of ISI on macroeconomic stability, which was becoming increasingly apparent to the experts by the late 1960s.

In the one camp, the macroeconomic policymaking institutions (CB and PO) started to question the compatibility of ISI deepening (and maximising economic growth) with maintaining stability in the price levels and the external payments. They argued that this policy was pushing the government further towards fiscal expansion and deficit financing, hence lifting the aggregate demand in the economy and causing inflation and trade deficits (Ian Sadr, 2013). Their solution, therefore, was to reduce inflation and current account deficit by slowing down the ISI project (ibid). This camp viewed inflation as a macro phenomenon, which was rooted in fiscal and monetary policy. On the other hand, the ME and other ministries argued for the acceleration of ISI. According to them, this policy would automatically solve the problem of inflation by increasing the domestic supply of goods (Mehran, 2013) and also, in the long term, would ease the pressure on the balance of payments by reducing import demands for intermediate and capital goods. This camp viewed inflation as a micro phenomenon that was rooted in the behaviour of industrialists, since this class had total control over the production of consumer goods. In line with this perception, this camp proposed imposing new price monitoring measures on the private sector to control inflation, alongside encouraging domestic production (Ian Sadr, 2013). In a nutshell, the CB and PO saw a conflict between macroeconomic stability and ISI deepening and gave priority

to the former, while the second camp saw no such conflict and continued to empathise maximising economic growth.

The Shah sided with the second camp because a switch to fiscal and monetary prudence entailed large political costs for his regime. In order to restore macroeconomic discipline, the authorities had to cancel or postpone many of the government's heavy industry projects. This policy would hurt Iran's chance to amass enough industrial power to fill the geopolitical vacuum that was going to be created by the British withdrawal from the region. Additionally, the Shah was not willing to restore macroeconomic discipline at the expense of reducing the growth momentum because such a move would hurt the legitimacy of his regime. At the same, the state faced little pressure from the private sector to reverse its expansionary policies because the dominant players in this sector were focused on serving the internal market and therefore, had little interest in lobbying for macroeconomic corrections. A combination of these political factors urged the Shah to insist on ISI deepening. The following paragraphs trace the effect of this decision on macroeconomic policymaking and oil strategy setting during the course of the fourth plan.

5.2.1 Macroeconomic policymaking

The Fourth Plan was a period of mounting opposition to the CB and PO. From the onset of the Plan, these institutions started to advocate unpopular fiscal and monetary cuts to control inflation and reduce the chance of a balance of payments crisis. However, instead of slowing down the ISI, the Shah preferred to deal with the problem of the current account deficit by increasing Iran's oil revenues through exerting more pressure on the consortium. Nevertheless, while the oil negotiations were in progress, the Shah was forced to support the PO and CB to improve fiscal and monetary discipline in order to avert the possibility of a foreign exchange crisis. Even then, he did not go very far in his support for these institutions; instead of letting them introduce serious fiscal and monetary cuts and devalue the currency, he only allowed them to *contain the growth* of expenditures and credit between 1968 and 1970. Subsequently, when the oil negotiations succeeded in 1971 and the pressures on balance of payments were removed, the Shah completely withdrew his support for the CB and PO. The following paragraphs trace the gradual decline of these institutions in the Fourth Plan.

Retaining its technocratic prestige and political power, the CB had survived as a competent institution upon the start of the Fourth Plan. As mentioned in the previous chapter, this institution had ensured macroeconomic stability during the Third Plan by insulating monetary policymaking from outside interference, thanks to the powerful leadership of Mehdi Samiee, the CB's Governor, and his able deputy, Khodadad Farmanfarmaian. The latter describes Samiee's insistence on the CB's independence in the following manner (Farmanfarmaian, IOHCHU, tape ten):

“Now Mehdi, among other lectures, among other things that he told me, he said, "Do you know central banking?" I said, "yes, I do," because that was one of my fields, central banking, monetary policy. He said, "But you must remember the art of central banking as

against the science of central banking." To which I said, "What do you mean by the art of central banking?" He said, "While I fully recognize that the Central Bank is a place where there is money and everybody naturally has their eye on the Central Bank and the government constantly presses the Central Bank for money, we as individuals, as governor and deputy governor, not only must keep out of politics ourselves, but we must keep the institution totally out of politics. And that we must pave, create, continue a tradition, a non-political tradition for the Central Bank. Keep it out of politics. Money should not, the currency of the country should not become a political football. It should not be subject to political games. And if you or I as individuals are involved in politics, then automatically Central Bank is put into politics and money supply and the value of money becomes subject of political caprice of various governments."

He then continues:

"During this period of about 8 years [1960-1968], the Central Bank was held in great regard by the government and the public at large. It was a period of constructive support for development activity with price and balance of payment stability. We used to have bloody wars, of course, within the government of Hoveyda. As all governments, they were always thirsty for funds and we would refuse to do so uncritically. We couldn't just open the door of the bank. We would delay, we would negotiate, we would fight, we would refuse, we would take the fight right up to the Shah, you know. At the end of the day, we had done rather well. Prices kept their levels, foreign exchange reserves slowly built up, and steady economic growth was maintained".

Unlike the CB, the PO did not have much political clout at the onset of the Fourth Plan. Accordingly, as an immediate response to the looming threat of balance of payments crisis, the Shah decided to place a powerful leader in the PO to stabilise expenditures. As a result, he asked Samiee, the CB's powerful governor, to take over the leadership of this organisation in 1968. Samiee's deputy, Farmanfarmaian, then replaced him as the CB's governor. Like Samiee, Farmanfarmaian had a good reputation among the business community and foreign experts; the US embassy considered him as a "brilliant, aggressive, and development-minded economist" (Ian Sadr, 2013: p83).

As mentioned, the growing fiscal and current account deficit after 1968 gave rise to a conflict between macroeconomic policymaking institutions and the rest of the ministries. The CB was mainly pressed by the Ministry of Finance, which was responsible for the disbursement of funds to ministries, to engage in deficit financing (Farmanfarmaian, personal interview, August 2009, Mehran, 2013). This inevitably led to a severe personality clash between Jamishid Amouzegar, the powerful Minister of Finance, and the CB's new governor. The latter described this clash as follows (Farmanfarmaian, IOHCHU, tape ten):

“Amouzegar didn't get along with us all that well, with none of us. He admired us, but he didn't get along with us -- let's be honest. We admired him for some of his great qualities, but we just didn't see eye to eye. That's all there was to it, there was an honest fight constantly between Amouzegar and the two of us [Farmanfarmaian and Samiee]”.

Similarly, the PO was under pressure from rest of the ministries not to curtail their investment projects. As pointed out in the previous chapter, this institution was already weak at the time; it lacked access to information about the oil revenues and had little control over the military budget. Samiee mentions that when he took over the PO, the institution was in “complete disarray and had no strong man” (Samiee, IOHCHU, tape three). This made it very difficult for him to revitalise the organisation. But the Shah let Samiee to bring his own team to the organisation and supported him to limit the growth of expenditures (ibid). This translated into a declining rate of growth for fiscal spending between 1968 and 1970 (table 5-2). Similarly, the Shah supported the CB to constrain the expansion of credit as well.

Table 5-2: Growth in spending & credit

	1968	1969	1970	1971	1972
Growth of fiscal spending	24%	16%	17%	22%	26%
Growth of credit to government	23%	30%	27%	20%	25%
Growth of credit to private sector	17%	18%	16%	20%	30%

Source: Mehran (2013)

Naturally, these trends increased the opposition to the macroeconomic policymaking institutions. For instance, the CB's governor at the time describes the mounting opposition to the PO in this manner (Farmanfarmaian, IOHCHU, tape ten):

“...now the Plan had become so political, every minister was attacking the Plan Organization. He [Samiee] had trouble with the oil company, he had trouble with the Minister of Agriculture, I remember. In spite of his soft personality, Mehdi had the hardness to insist on accountability. He wouldn't approve funds just because the minister wanted it. He wouldn't approve quit-tenders just because the ministers pressed for them. Anyway, there was a great deal of opposition to Mehdi...”.

Crucially, however, by 1970 the Shah decided to relax his support for macroeconomic institutions as the oil negotiations with the Consortium started to look promising. This led to resignation of Samiee from the PO in 1970 and his return to the CB. However, he found the CB to be a powerless institution as well in the absence of the Shah's support. He mentions: “in my second tenure at the Central Bank, I was no longer able to fight with the government” (Samiee, IOHCHU, tape one). Thus, he resigned after ten months, marking the shortest tenure for a Central Bank governor in the history of Iran²⁵ (Mehran, 2013). In this way, one of the most powerful technocrats of the CB and PO was sidelined by the Shah.

²⁵ The Shah then made Samiee an advisor to the Prime Minister Hoveyda (Milani, 2009). Subsequently, he became the head of Agricultural Development Bank until the 1979 Revolution.

The Shah's withdrawal of support for the CB gave an opportunity to the ministries to increase their control over this institution. This resulted in the growth of credit by the bank to the government and private sector between 1970 and 1972 (table 6-2), despite the rising rate of inflation. The Central Bank was also formally weakened in 1971. In that year, the Monetary Banking Law, which had originally gave birth to the CB, was revised by the government. In effect, the CB was stripped of its semi-independent status, thus giving power to the ministries and state-owned companies to ask for "sufficient funds" from this institution (Mehran, 2013). Equally important, this legislation increased the control of the Ministry of Finance over the Central Bank by including two representatives from this ministry on the Monetary and Credit Council (Mehran, personal interview, November 2013). In short, the change in the law turned the CB into a money-printing machine for the government, both *de jure* and *de facto*.

The PO suffered a similar fate after a short period of time. The organisation was placed under the leadership of Farmanfarmaian from 1970 onwards. However, like his predecessor, Farmanfarmaian was unable to defend the PO against the ministries during his tenure, as he explained: "when I went back to the PO, this organisation was not the same as before. It had become so weak and political" (Farmanfarmaian, personal interview, August 2009). He adds: "The PO was turned into a place where all the ministers gathered frequently, about 13 or 14 ministers, and fought for their share of money" (Farmanfarmaian, OHCFIS, Tape two). This resulted in a growing increase in expenditures between 1970 and 1972 (table 6-2). Due to this lack of fiscal discipline, the actual expenditures of the government surpassed the planned expenditures of the Fourth Plan by more than 30% in the end (CB, 1974).

Meanwhile, other ministers sought to officially weaken the PO as well. In particular, Hoveyda wanted to take full control of the PO and place it under the complete authority

of the Prime Minister's Office, thus officially turning the PO's Director into a Deputy Prime Minister (Majidi, OHCFIS, tape two). Naturally, Farmanfarmaian opposed this reform, as he believed that such a restructuring would totally strip the PO of its independence and reduce the power of its director to sub-ministerial level (ibid). However, ultimately, he lost the battle to Hoveyda in 1972.

In that year, the PO represented its first draft of the Fifth Plan to the Shah at a large ministerial meeting in Shiraz. In that draft, the PO urged the government to cut down its spending to control inflation, as described by the PO's Director (Farmanfarmaian, IOHCHU, tape fifteen):

“...in the case of the Fifth Plan, we felt that the country was slowly, slowly beginning to develop inflationary tendencies within it. Our estimate of inflation during the Fifth Plan, if we were to carry out the Fifth Plan, was about eight percent, as it were. That's before, of course, the oil price was increased [the 1973 oil boom]. So we presented as an argument that we should perhaps spend less, we should control certain types of expenditures and shift from, let's say, long-term investment to the type of projects that would have short-term fruition or short-term gestation period, so that we would increase the flow of goods and services faster than the other alternatives would have allowed, and thus decrease the pressure of inflation within the system”.

However, being fixated on rising economic growth, the Shah did not like this conservative proposal and later dismissed it as some “theoretical nonsense” (Samiee, IOHCHU, tape two). As will be explained in detail in the next chapter, the Shah also believed that the problem of inflation could be easily solved by price controls and increasing domestic production rather than fiscal cuts.

Capitalising on this meeting, Prime Minister Hoveyda managed to successfully lobby against the PO's Director and forced him to resign. That resignation enabled Hoveyda to press for his proposed reform and take full control of the PO. Accordingly, in 1973, the PO was placed under the complete authority of the Prime Minister's Office and its

director was made Deputy Prime Minister. The name of the institution was also changed to the Planning and Budget Organisation (PBO henceforth). Subsequently, Hoveyda selected one of his close confidants, Abdol-Majid Majidi, as the Director of the organisation. This official restructuring in 1973 signalled the total breakdown of the PO's autonomy.

The analysis presented in this section shows that Iran's macroeconomic policymaking experienced a severe political decline during the Fourth Plan, as they opposed the ISI acceleration. On the other hand, the institution that ran this popular policy, that is the ME, continued to remain powerful.

5.2.2 Oil strategy setting

Iran's battle with foreign oil companies became more intense during the Fourth Plan as the process of ISI deepening greatly increased the import needs and put a lot of pressure on the balance of payments in the late 1960s. This adverse economic effect forced the Pahlavi regime to pursue its strategy of maximising short-term oil revenue more aggressively. As a result, it constantly pressed the Oil Consortium to increase Iran's profit share and raise oil prices (Skeet, 1991). Interestingly, Nixon backed Iran in this battle, since he was keen on helping the Pahlavi regime to progress with its oil-fuelled industrialisation project and military build-up (see section 5-6). Following this position he stressed that "Tell, the Shah you can push [us] as much as you want [on oil prices]...As long as you make this money for the good of the Iranian people and the progress of Iran, [then] I will back you" (Cooper, 2001: p 42). At that time, the energy prices had not yet turned into a foreign policy issue for the US.

Instead of pursuing a unilateral negotiation strategy as before, Iran increasingly joined forces with other OPEC countries to multilaterally exert pressure on oil companies

(Skeet, 1991). Accordingly, in the late 1960s, OPEC gained strength as the oil-producing countries moved towards cooperation instead of competing with each other over the existing market share. Yet, as the two major oil producers in the world, Iran and Saudi Arabia still competed with each other over OPEC's leadership.

In the end, these multilateral negotiations bore fruit under Iran's leadership at the 1971 OPEC conference at Tehran. Under this agreement, which was officially known as the "Tehran Agreement", the oil companies agreed to a 55% tax rate on their profits, an immediate raise of oil prices by 35 cents to \$2.15 a barrel and further successive price increases in the future (ibid). This agreement, which marked OPEC's first major victory against the oil companies, lifted Iran's position among oil-producing nations. As a result of this agreement, Iran's oil revenues jumped by 60% in 1971, relieving pressures on the balance of payments (Mehran, 2013).

The above analysis shows that by the intensification of ISI, the Pahlavi regime became more aggressive in its quest to maximise Iran's current oil revenues. Following this aggressive strategy, Iran mobilised OPEC members and succeeded in negotiating a more favourable agreement with the oil companies in 1971. This victory, in turn, solidified Iran's position as an "oil hawk" in OPEC.

5.3 Effect on the internal power structure

The impressive economic achievements of the Fourth Plan helped the Shah continue his absolute rule in political stability. The Iran Novin party was re-elected in 1968 with a majority in the Parliament and Hoveyda remained as the Prime Minister (Afkhami, 2009). Due to its weak social base, this party continued to operate as a circle of elite modernisers for the Shah, while the Mardom Party acted as the opposition party (Abrahamian, 2008). Overall, the Shah experienced no opposition from forces inside or outside the state during the Fourth Plan (ibid). Politically therefore, this was the most stable era of the Pahlavi regime (Milani, 2011, 2009, Halliday, 1979).

5.4 Ideological effect

The high growth of the Fourth Plan greatly solidified the developmentalist discourse of the regime because the government achieved an even higher rate of growth than its ambitious original target in the end. Thus, at the final stage of the plan, the Shah declared that Iran's rapid economic and social progress had become unstoppable, echoing the language of modernisation theory. He firmly claimed in 1971 that Iran would become an industrial country within twelve years and famously envisioned an era of Great Civilisation for the country (Cited in Ansari, 2007:P239):

“If all of our efforts continue as at present, and if no foreseeable situation outside our control arises, we shall construct during next 12 years a solid industrial, agricultural and technological structure for the country's development and will reach the present level of progress of Western Europe. At that time, our country will have a population of 40 to 50 million, i.e. comparable to the populations of larger countries of Europe and the era of the “Great Civilisation” will have begun”.

As outlined above, the elite had greatly raised social expectations regarding Iran's industrial program by the end of the Fourth Plan.

5.5 Class coalition effect

During the Fourth Development Plan significant changes took place in the relationship between the state and the private sector. This section outlines the elements of continuity and change in this relationship from 1968 to 1972.

5.5.1 Credit policy and export promotion

As before, the government continued to give generous credit subsidies to the industrial sector and protect domestic firms behind high tariff barriers in the Fourth Plan. Indeed, the credit subsidies provided under this plan were three times larger than under the previous plan (Karshenas, 1990). Again, most of these subsidies (66%) were channelled towards family conglomerates via IMDBI (ibid).

It is worth mentioning that the PO made an attempt in this period to widen government support to small and medium-sized enterprises by proposing to increase the budget of ICB, which specialised in giving credit subsidies to such enterprises. The PO's Director explained the rationale behind his proposal in the following manner (Farmanfarman, IOHCHU, tape fifteen):

“Look, I pointed out, so far we have sustained, supported the concessionary funds through the IMDBI (that is, the Industrial Mining Development Bank of Iran) and we have created a few industrial giants, to be sure. But, now we must be sure that this money does not go back to these industrial giants, since these industrial giants now have excellent credit ratings -- they can on their own, on their own signature borrow in the market all the money they need. Therefore, IMDBI must be directed not to give concessionary funds to these big industrialists. Rather, these funds must be reserved for the purpose of newcomers into the industrial sector, to give possibility of development to the, let's say, young engineers who have just come back from Europe or the United States in order to establish an industry and get started. Or people, for example, in the south of Tehran who had already begun, shall we say, an intermediate technological revolution. It was a very, very interesting phenomenon; where, you remember, Darvazeh Ghazvin for example,

there were these small shops that could reproduce any part of, let's say, a Mercedes-Benz. All they needed was a lathe, which would have cost \$30,000, \$40,000. I was arguing that funds should be going to these people. And they would have used it twenty-four hours a day in the sense that they would have shared the lathe with other shops around; and slowly, slowly this would have developed to become a great industrial base. And from out of them maybe we would have got some major industrialists also. My argument was that Iran should not be satisfied with ten major industrialists. It's a feudal form of development in industry. That we must begin to push and create five hundred large industrialists, then we have a real industrial base in the country”.

Yet, this proposal was rejected outright by Ansari, the new Minister of Economy²⁶, and more importantly, by the Shah. This rejection could be linked to the Shah's ideological disdain and political reluctance for involving small-scale enterprises, which were generally rooted in the Bazaar, in his modernisation project (Moghadam, personal interview, March 2013). As a result, the government retained its focus on supporting industrial conglomerates throughout the Fourth Plan.

In addition, the anecdotal evidence suggests that in the above period the royal family and the Pahlavi Foundation became more active in the industrial sector and developed closer ties to the new industrial class, especially after the selection of Houshang Ansari as Minister of Economy in 1969. Given his strong political ambitions, it is often claimed that Ansari actively cultivated the link between the royal court and the industrialist class. However, it is very difficult to verify such claims systematically.

Moreover, like the Third Plan, the government induced family conglomerates to export their products. Indeed, the widening current account deficits in the late 1960s forced the government to follow this policy more aggressively. As a response, the ME established a centre for export promotion in 1969 and reduced port charges and commercial profit

²⁶ It is important to add that ICB was under the direct control of PO. Therefore, given the growing conflict between the ME and PO in the Fourth Plan, it is not surprising that Ansari was not keen on empowering the ICB.

tax for exports (CBB, 1968). It also devised new financial rewards for export-oriented firms. In harmony with this policy, the CB increased the export credit facilities from 4.4 billion rials to 5.3 billion rials between 1970 and 1972 (CB, 1973). Thanks to these measures, manufacturing exports more than doubled during the Fourth Plan (Alizadeh, 1984). However, despite this impressive growth, the conglomerates remained dominantly inward-looking by the end of the Plan and only exported 10% of their output.

In summary, Pahlavi's industrial strategy remained committed to supporting large-scale industrial conglomerates in the Fourth Plan and these conglomerates remained mostly inward-looking, despite the remarkable expansion of manufacturing exports.

5.5.2 Price controls

The most important change that took place in the state-business relationship in the Fourth Plan was the introduction of price controls. As inflation rose from 1968, the ME started to attach pricing conditions to the transfer of credit and tax subsidies to the private sector. This ministry obliged industrialists to keep their product prices low in return for receiving economic favours from the government. For this purpose, it extended its supervision on prices and quality of consumer goods. It also started to compare domestic product prices with international ones as a yardstick for measuring the competitiveness of domestic industries (Najmabadi, personal interview, November 2013, IBRD, 1970).

This shows that instead of relying on the CB and PO to tackle inflation through macroeconomic instruments, the Pahlavi regime relied on the ME to control prices at the micro level. Unsurprisingly, the industrialists objected to this policy, but not in an explicit manner. As an example, Khosrowshahi, a major industrialist who headed the

Chamber of Commerce, offered a very conservative critique of price monitoring in his 1969 speech at the CB (CBB, 1969a):

“although every industrial company is owned by an individual or a group of people, it is still part of the wider society and tries to serve the economic needs of that society in a responsible manner. Here, balancing the conflict of interest is important; on the one hand, producers need to add their production costs and credit costs into their product prices, on the other hand, consumers want to pay the cheapest price possible. Meanwhile, let’s not forget that these private producers have been eagerly acting as the engine of the government’s economic plans. As a result, balancing the interest of the producers and consumers is best managed when it is left at the hands of industrial unions. These unions would automatically take care of the production and distribution of goods by paying careful attention to the rights of consumers. In this way, they would protect their members from social criticism and discard any member who acts differently”.

This implicit and cautious criticism of the government’s attitude towards the price monitoring is indicative of the weakness of the industrialists towards the state during the Fourth Plan. However, with the rise of inflation in the 1970s, the Pahlavi regime extended its price control measures and adopted a very harsh tone towards the industrialists (CBB, 1968, 1969a, 1969b, 1970a, 1970b). In this regard, the Shah clearly warned the private sector in 1972 that the state was “going to fight inflation with any means” (CBB, 1972b). He even threatened to use the army for this means (FCO 8/2261, 1974).

5.5.3 Integration of chambers

The other significant change in the state-business relation that took place in the Fourth Plan was the integration of Tehran’s Chamber of Commerce with Iran’s Chamber of Industry and Mines in 1970, hence creating Tehran’s Chamber of Commerce, Industry and Mines. Importantly, this integration was mainly introduced by the new Minister of Economy, Houshang Ansari, in a top-down manner in order to streamline the dealings

of the state with the industrialists; there is little evidence to suggest that the industrialists or the merchants made any initiative towards this integration. In fact, the statute of the new Chamber was entirely prepared by the ME and Houshang Ansari played a major role in its first board election (Torabi-Farsaani, 2013). Again, this top-down transformation of the chambers confirms the passivity of the industrialist class in relation to the state. As will be explained in the next chapter, the government would eventually take full control of the new Chamber with the help of the SAVAK by the mid-1970s and, ironically, use this institution to discipline the private sector.

The evidence provided in this section shows that during the Fourth Plan the industrialist class remained economically inward-looking and politically weak. Importantly, this class was blamed for the growing inflation in this period, since the production of consumer goods was entirely in its hands. Therefore, the Pahlavi regime intensified its pressure on this class as it drove the process of ISI forward through fiscal and monetary expansion.

5.6 Geopolitical effect

By moving towards the development of strategic and heavy industries, Iran's industrialisation strategy became more geopolitically oriented in the Fourth Plan. In other words, this plan increased the synergy between Pahlavi's industrialisation project and its geopolitical ambition to become the dominant power in the Middle East. This section assesses the impact of Iran's transition to the second stage of ISI on her relations with foreign powers.

Iran's economic partnership with the Soviet Union became deeper with the movement of ISI towards development of heavy and strategic industries during the Fourth Plan. Indeed, the most notable industrial projects of this plan such as the Arak and Tabriz

machine building factories were built in collaboration with the Soviet Union. Also, Iran signed a new round of trade agreements with the Communist countries during this period to promote her manufacturing exports (CBB, 1970b; CBB, 1972a, 1972b). Thanks to these trade deals, the Communist countries became the main destination for Iran's non-oil exports (CB, 1973). Yet, in spite of these growing links, Iran's relationship with the Communist block remained strictly economic as before.

However, on the other hand, Iran-US relations underwent a considerable change during the Fourth Plan. The main reason behind this change was the election of Nixon in 1968. This election had important implications for US foreign policy towards developing countries. Under the "Nixon Doctrine", Washington had decided to militarily empower her allies in the Third World to defend themselves, instead of providing them with direct combat support. This doctrine, therefore, sought to transfer the responsibility of upholding security in the Third World to regional powers. This new foreign policy intensified the rivalry between Iran and Saudi Arabia to become the dominant power in the Gulf after the planned British withdrawal from that region (Alvandi, 2014). However, when Nixon came to power, Saudi Arabia lagged behind Iran both economically and militarily. Thanks to the ISI's success, Iran's GDP was twice as large as Saudi Arabia's in 1968 and the country was actively investing in strategic industries such as steel, aluminium and machine building (Halliday, 1979). Also, Iran's armed forces were three times larger than Saudi Arabia, due to the aggressive militarisation strategy that Pahlavi had been pursuing from the early 1960s. Therefore, due to Iran's superior military power and her impressive track record in industrialisation, Nixon decided to rely on the Pahlavi regime to uphold the stability of Gulf region and end Washington's balance of power strategy between Iran and Saudi Arabia (Alvandi, 2014). In this way, the Iran-US relationship moved closer towards a partnership of equals.

As a result, Nixon lifted the restrictions that the Johnson administration had placed on arms sales to Iran and gave the green light to the Pahlavi regime to embark on a military spending spree (Cooper, 2011). Correspondingly, Iran's defence expenditures jumped from \$557 million in 1969 to more than \$1billion in 1972 (Alvandi, 2014).

By the end of the Fourth Plan, Iran became the dominant military power in the region and actively fought against the spread of Nasserism and Maoism (Alvandi, 2014). Between 1968 and 1972, the Shah showcased his military force on various occasions; he supplied Pakistan with weapons during her war with India in 1971 and sent troops to Oman in 1972 to crush the leftist rebellion (ibid). He also supplied the Saudi regime with weapons when the South Yemeni rebel groups attacked the Kingdom (ibid). These developments show that by the end of the Fourth Plan, Iran operated as an autonomous Cold War actor in the Middle East region.

In summary, Iran's interdependent strategy of ISI deepening and military build-up helped Pahlavi regime to push its relations with the US closer to a partnership of equals and pave the way for Iran's military supremacy in the Gulf region.

5.7 Comparison with other countries

Before moving on to the next stage of ISI, it is helpful to adopt a comparative lens and contrast Iran's "catch-up" development during 1960-1972 period with other industrialising economies in the South such as South Korea, Taiwan, Mexico, Brazil and India. This comparison aims to highlight the similarities and differences between Iran and other developing countries in terms of industrial policy and economic outcomes.

Iran started its catch-up industrialisation later than Brazil, India, Taiwan and South Korea; these countries were already engaged in ISI during the 1950s when Iran was following a non-interventionist development model. To be sure, Iran did experience a protectionist phase in the 1930s under Reza Shah's rule but the main purpose of this policy was to raise fiscal revenue and counteract the adverse effects of the Great Depression on Iran's commodity exports (Alizadeh, 1984). Indeed, Iran followed no *deliberate* industrial policy until being hit by balance of payment crisis in 1960.

Comparing to South Korea, Brazil and India, Iran embarked on its state-led development with a weak industrialist class. Of course, the country had experienced an industrial expansion in consumer goods industries in the 1950s, but this expansion was not sizeable enough to propel the economy from merchant capitalism to industrial capitalism. The underdevelopment of Iran's industrial bourgeoisie had deep historical reasons, one of which being the colonial history of the country. During the 19th century, Iran was *de facto* colonised by Russian and British forces. This form of foreign domination, which was "extractive" in nature, did not provided a conducive environment for capital accumulation and emergence of a modern private sector (ibid). In contrast, colonialism in Korea, Brazil and India provided a fertile ground for the rise of big businesses that were willing to proactively imitate foreign technologies. The other historical reason for the weakness of Iran's modern industrialist class was the backwardness of the agricultural sector (ibid). Due to the country's poor climate and unproductive land tenure system, this sector had not able to produce sufficient surplus for capital accumulation in the industrial sector during the late 19th century and the early 20th century. Due to these historical factors, Iran started its ISI in the early 1960s with a nascent industrialist class that had much less experience and knowledge in manufacturing compared to countries such as Brazil, India and South Korea. However,

on the upside, this enabled the Pahlavi state to discipline the behaviour of industrialists and act autonomously in economic policymaking. In this regard, the experience of Iran differed from most Latin American countries, where the state tended to be “captured” by well-established big businesses (Evans, 1979).

Coincidentally, Iran’s “catch-up” development was initiated during the decade when oil-rich countries in the South gradually took full control of production and pricing of their oil, thanks to OPEC’s ascendancy. This translated into increasing oil revenues for Iran in the 1960s, which in turn, had dramatic implications for the selection of industrial policy and pattern of industrialisation in the economy. Due to the windfall oil revenues, Iran’s ISI during the 1960s and especially the 1970s deviated from the “normal pattern” of industrialisation observed in other developing countries in important ways.

Firstly, access to oil rents meant that Iranian policymakers did not have to rely on taxing the agricultural sector to fund the investments in ISI program, unlike their counterparts in South Korea and Brazil (Kay, 2001). On the positive side, this reduced the possibility of “agricultural squeeze” and “crowding out” of private investment in Iran (Karshenas, 1990). However, on the negative side, it divorced the process of industrialisation from agricultural development and consequently reduced the incentive of policymakers to foster agricultural productivity. This had a negative implication for Iran’s land reform in the early 1960s; in contrast to South Korea and Taiwan, where agrarian reforms were aimed at raising agricultural surplus and extracting funds for industrial development (Kay, 2001), the agrarian reform in Iran followed a political purpose (i.e. crushing the power of landed elite).

Secondly, oil inflows discouraged manufacturing exports during 1960-1972 period. As evidence, the manufacturing exports accounted for only 2% of the total manufacturing

output in this period (Alizadeh, 1984). Thus, unlike South Korea, Taiwan and Brazil, Iran did not develop any thriving export processing zone. To be sure, the Iranian manufacturing exports did grow by 15% per year in this period, which was above the average rate in developing countries (Karshenas, 1990). However, these exports started from a very low base and most of them went to uncompetitive markets such as Eastern European countries on the basis of barter agreements (ibid). The manufacturing exports, which included detergents, clothing, soap, motor vehicles and basic chemicals, constituted a very small percentage of non-oil exports; even in their peak year (1972), they only accounted for 23% of total non-oil exports (Alizadeh, 1984). Most of the non-oil exports were comprised of traditional goods such as carpets, cotton and dried fruit. Even put together, the traditional and manufactured exports only generated less than 20% of total foreign exchange earnings during the 1960-1972 period (ibid). This reveals Iran's dismal performance in export diversification²⁷.

The growing oil revenues discouraged manufacturing exports through various channels. First of all, they expanded the size of the domestic market as the income per capita hiked from \$168 in 1960 (constant 1959 prices) to \$366 in 1972 (ibid). Secondly, and more importantly, they reduced the incentives of the policymakers to encourage industrial exports. As argued by Alizadeh (1984), the government had no coherent export promotion policy. For instance, the subsidies supplied to private firms were not tied to any export target or performance standard (ibid). Specifically, the cheap loans given by the IMDBI were not conditioned on any export performance. To be sure, there were informal pressures by the World Bank on the IMDBI to promote exports, but these

²⁷ Of course, one might argue that the manufacturing sector was not mature enough to be able to compete globally. But the research conducted by the World Bank in 1970 shows that there was no major difference between the domestic prices and international prices for the manufactured goods, thanks to the price controls imposed by the ME (IBRD, 1972). This suggests that the industrial sector did have high export potential.

pressures did not lead to any tangible policy change. The only exception was the 1970-1973 period, when the central bank started to provide credit facilities for export promotion. But according to the World Bank these measures did not “adequately offset either the costs of the protection system or the incentives given to manufacturers to produce for the sheltered internal market” (IBRD, 1972: p31). So to use the framework developed by Bela Balassa (1980, 1979, 1975), the government’s industrial policy remained “inward-oriented” as it gave a *net* incentive to industrial firms to produce for the domestic market.

Specifically, in terms of credit policy, Iran’s experience was in marked contrast to most rapidly growing East Asian and Latin American countries. For example, the Korean Development Bank conditioned the provision of credit subsidies to Chaebols on meeting various export targets (Amsden, 2001). A similar credit policy was followed by the Brazilian Development Bank (BENDES) in the 1960s and the 1970s (ibid). It is important to add that unlike Brazilian and Korean development banks, the IMDBI was privately owned. Given the high degree of cross-ownership between this development bank and major domestic industrial conglomerates in Iran, the IMDBI was naturally reluctant to push domestic firms to export their products as long as the domestic market was growing. Accordingly, it can be argued that if the IMDBI had been publicly owned, then the government would have been in a better position to use credit subsidies as a tool for promoting manufacturing exports.

As will be mentioned, the 1973 oil shock further reduced the incentive of policymakers to pursue export promotion. This is because the injection of windfall oil revenues into the economy led to the sudden expansion of the domestic market as income per capita jumped from \$336 in 1972 (at constant 1959 prices) to \$798 in 1977. At the same time, the real exchange rate appreciated due to the soaring domestic inflation and resulted in a

drastic decline in competitiveness of the tradable sectors. Instead of counteracting these Dutch Diseases effects, the central bank withdrew its credit subsidies for manufacturing exports after 1973 (Alizadeh, 1984). Combination of these factors heavily discouraged export diversification in the 1973-1977 period. Of course, in absolute terms, the manufacturing exports still grew from 14 billion rials in 1972 to 18 billion rials in 1977, but the share of manufacturing exports from the total manufacturing output declined from 2.8% to 1.1% in the same period (ibid). To put this in a comparative perspective, Mexico and Brazil, which similarly experienced a commodity boom, respectively exported 13.7% and 15.5% of their manufacturing outputs in 1975 (Alizadeh, 1984). Indeed, the share of manufacturing exports from total export revenues was only 1% in Iran in 1975, compared to 25% and 31% in Brazil and Mexico (WDI, 2015). These comparisons highlight the degree in which mismanagement of the 1973 oil boom hindered Iran's export diversification.

In addition, access to oil discouraged vertical integration in Iran's industrial sector, especially formation of backward linkages. As emphasised originally by Albert Hirschman and later by New Trade Theorists, vertical integration has important implication for long-term productivity of industrial sector as it encourages knowledge spillovers and positive externalities (Meier, 2004). However, Karshenas (1990) shows that compared to a "typical" developing country undergoing ISI, Iran was slow at industrial deepening. To support his argument, he puts the spotlight on the high import ratios of capital and intermediate goods in Iran (table 5-3). These ratios indicate that the manufacturing sector imported most of its needed machinery and intermediate goods instead of producing those goods domestically. This high degree of import dependency, together with dismal manufacturing exports, meant that the ongoing industrial miracle was not sustainable in the long-term (i.e. beyond the exhaustion of oil).

Table 5-3: Share of imports in total supplies

	Iran		“Typical country”	
	1963	1972	1963	1972
Total	30.9%	31.7%	19.5%	9.6%
Textiles	12.4%	10.6%	21.1%	7.2%
Clothing	1%	0.2%	4.9%	1.6%
Wood and paper	18.2%	19.9%	26%	9.8%
Rubber & leather	30.4%	23.3%	22.9%	10.3%
Chemicals	57.5%	36%	26.5%	12.6%
Minerals	12.3%	10.3%	12.7%	5.8%
Metals	48.4%	45.7%	31.8%	12.5%
Machinery	89.7%	71.0%	73.4%	27.8%
Transport equip	26.8%	32%	54.0%	12.8%

Source: Karshenas (1990)

To be sure, there was a notable reduction in the import ratios of certain intermediate goods such as chemicals and basic metals between 1963 and 1972, but comparing to the international norm, Iran’s import ratio still stood at a high level in 1972 (table 5-3). This indicated that the growth elasticity of imports for Iran’s manufacturing sector was very high as this sector was more focused on production of consumer goods instead of intermediate and capital goods. At the level of firms, this meant that family-owned conglomerates concentrated more on building horizontal linkages rather than vertical ones²⁸.

Similar to Karshenas, Alizadeh (1984) highlights the lack of industrial deepening in Iran by focusing exclusively on the capital goods sector. She stresses that Iran started its ISI in the virtual absence of any machinery industry. Thus, the country severely lagged behind other rapidly growing developing economies in terms of capital goods production; for instance, the share of electric and non-electric machinery in the total

²⁸ Normally, family conglomerates diversify into different sectors (i.e. horizontal linkages) as they grew in size. Such an expansion strategy facilitates the distribution of power between different branches of the family and minimise the chance of future intra-family conflicts. This process is then accompanied by building backward linkages. In the case of Iran, the first phase of horizontal expansion happened quickly in the 1960s, but the subsequent vertical expansion followed so slowly.

manufacturing value added was only 2.9% in Iran in mid-1960s, compared to 11.2% and 10.3% in India and Brazil. Of course, Iran did manage to undergo a rapid growth in these sectors and increase the share of machinery in the manufacturing output to 9.8% in 1974. However, despite this growth, Iran still lagged behind many developing countries inducing India, Brazil and Mexico in terms of diversification towards capital goods sector in the mid 1970s (table 5-4).

Table 5-4: Share of machinery in manufacturing value added	
Iran (1974)	9.8%
India (1976)	15.7%
Brazil (1973)	14.4%
Mexico (1975)	10.9%
S.Korea (1973)	8.9%
Turkey (1973)	6.6%
Colombia (1973)	5%
Hungary	18.6%

Source: Alizadeh (1984)

As argued by Karshenas (1990) the main reason behind Iran's lagging performance in ISI deepening was the increasing inflow of oil revenues during the 1960s and 1970s. He highlights that these inflows generated a high degree of income inequality²⁹, which in turn, prevented the emergence of mass markets for consumer goods. In the absence of mass consumer markets, the businesses had little incentive to engage in production of intermediate and capital goods as these sectors had to operate at scale economies to generate profit. Instead, the businesses focused on serving top income classes by increasing the variety of their consumer goods. This gave rise to a "branch economy", where firms focused on setting up numerous small assembly plants to cater for the

²⁹ Iran's Gini index stood at 46% in 1973, which was higher than almost all countries in East Asia and the Middle East (Alizadeh, 1984).

increasing variety of goods targeted for high-income classes. Such a production method also inhibited the emergence of economies of scale in production of consumer goods, hence limiting their capacity for exports (Karshenas, 1990).

Finally, it is helpful to compare Iran's experience with other developing countries in terms of relying on multinational companies for industrialisation. Similar to East Asian countries, Iran did not depend heavily on multinational companies for her "catch-up" development. As evidence, foreign firms only accounted for 5.1% of gross fixed capital formation in Iran from 1963 to 1977 (Alizadeh, 1984). This is because Iran's industrial structure was heavily geared towards consumer goods sector, where the technologies were relatively easy to assimilate; the private sector could easily purchase the necessary machinery for these industries from independent suppliers, hence there was not a strong business demand for FDI and joint ventures (Alizadeh, 1984). Correspondingly, foreign capital participation in the manufacturing sector was mainly in the form of minority shareholding as opposed to majority or wholly-owned subsidiaries. As evidence, of the total number of foreign firms investing in the manufacturing sector from 1956 to 1978, more than 48% had shareholding between 10% and 35%. Another 39% had capital equity ranging between 35% to 50% and only 11.7% had majority shareholding above 51% (ibid). As claimed, this low involvement of foreign capital stemmed from Iran's lagging performance in industrial deepening and vertical integration. Furthermore, in terms of technology policy, the Iranian policymakers made little effort to push foreign firms towards technology transfers, unlike their counterparts in South Korea, Taiwan and Mexico (ibid). The only government regulation concerning joint ventures was the "local content rule" in certain industries that was aimed at reducing the import dependence of the manufacturing sector (ibid).

Generally, the comparative analysis presented in this section shows that Iran's ISI deviated from the "typical" path of industrialisation observed in other developing countries in two important respects. Firstly, Iran had a very disappointing performance in terms of promoting manufacturing exports. Secondly, the country progressed to the next stages of ISI at a much slower pace than other developing countries. As argued, both of these "anomalies" were due to Iran's increasing access to windfall oil revenues in the 1960s and the early 1970s.

Conclusions

Typically, with the movement of ISI towards the development of heavy industries, Iran started to experience widening budget and current account deficits and rising inflation at the beginning of the Fourth Plan. However, despite this macroeconomic instability, the Pahlavi regime refused to slow down the ISI and, therefore, subordinated macroeconomic policymaking to industrial policymaking. This was because the cost of policy reversal would have been high for the Pahlavi regime; a slowdown in ISI would entail the cancelation or postponement of government's heavy industry projects and this, in turn, would hurt Iran's chance to amass enough industrial power to fill the geopolitical vacuum that was going to be created by the British withdrawal from the region. Additionally, the Shah was not willing to restore macroeconomic discipline at the expense of reducing the growth momentum. This is because such a move would hurt the legitimacy of Pahlavi's developmentalist discourse. Moreover, the business elite did not favour a policy reversal either; indeed, they did not have the incentive (or the power) to lobby for fiscal and monetary discipline as they were mainly engaged in serving the internal market and had little interest in macroeconomic corrections. Due to these reasons, the Pahlavi regime insisted on ISI deepening and, along this line, it intensified its pressures on foreign companies to maximise its short-term oil revenues. This aggressive oil strategy resulted in the Tehran Agreement in 1971 and financially empowered the Pahlavi state to continue its policy path and achieve another economic miracle.

In the end, the success of ISI deepening in accomplishing high economic growth in the Fourth Plan had several impacts. Firstly, it ensured domestic political stability as before and therefore let the Shah maintain his full grip on power. Secondly, geopolitically, it allowed Iran to move towards a more equal relationship with the US and enlist the full

military support of this superpower, hence paving the way for Iran's military supremacy in the Gulf region. Thirdly, it solidified the developmentalist discourse of the regime. Finally, it continued to enhance the rise of family conglomerates in the private sector at the expense of outward-looking traditional classes (Bazaar and landlords); the state lifted its economic support for these conglomerates in the Fourth Plan, but in return, it imposed additional price control measures on them to discipline their behaviour. However, in spite of this support, this class remained economically inward-looking and politically weak.

As will be explained in the next chapter, these effects, in turn, fuelled the demand for further ISI acceleration inside the state and in the business community, thus setting the stage for a "Big Push" industrial drive at the time of the 1973 oil boom.

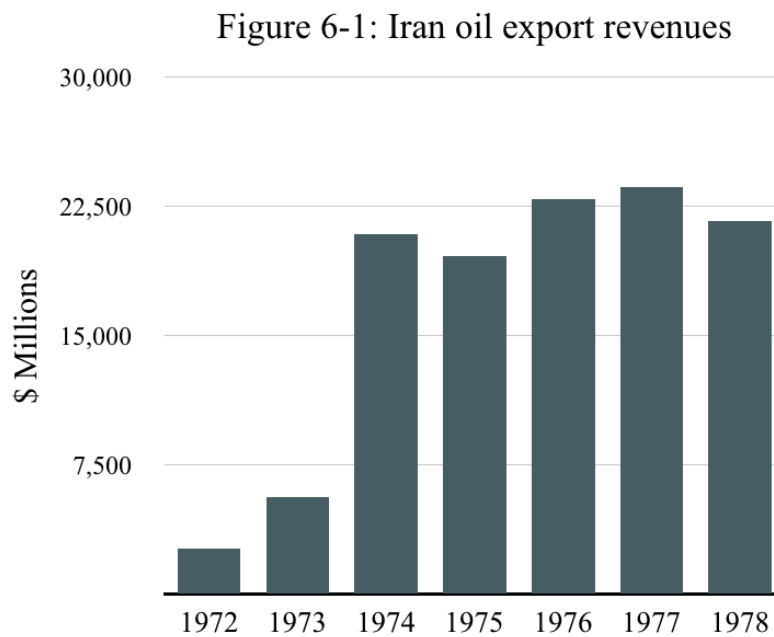
Chapter Six: Mismanagement of the oil boom

This chapter seeks to explain why and how the Pahlavi regime mishandled the 1973 oil boom. This boom, which was itself partly created by Iran, coincided with the commencement of Fifth Five-Year Development Plan (1973-1977). This chapter shows that quadrupling of oil prices in 1973 motivated the Pahlavi regime to jump to the third phase of ISI to materialise its “Great Civilisation” promise, hence making macroeconomic policymaking more subordinate to industrial policymaking. This process led to highly expansionary and volatile fiscal and monetary policies after the boom and, fuelled economic instability as a consequence. Thus, this chapter demonstrates that the oil boom destabilised the economy by greatly amplifying the regime’s previous policy path instead of causing a radical break in it.

This chapter first provides an overview of Fifth Development Plan in section one. Then, section two discusses the politics of economic policymaking inside the state during this plan. The following sections deal with the influence of this plan on the state’s internal power structure, geopolitical relations and class coalitions.

6.1 Overview of the Fifth Plan (1973-1977)

Unlike the previous two plans, the Fifth Plan was implemented in the face of major external economic shocks. Eight months into the plan, the price of oil quadrupled and generated a sudden windfall for Iran (Figure 6-1). The oil revenues continued to stay high for the rest of the plan, but they exhibited a high degree of volatility.



Source: Central Bank of Iran, Annual reports, various issues

Encouraged by the windfall oil revenues, the Pahlavi elite revised the original Fifth Plan. The result was a colossal economic plan, which was four times larger than the Fourth Plan in total expenditures (Karshenas, 1990). As before, the highest share of expenditures (20%) was devoted to the industrial sector. This sectoral preference was justified on the basis of supposed increasing returns and positive externalities of the industrial sector as pointed in the Plan document (Daneshkhu, 2004: p124):

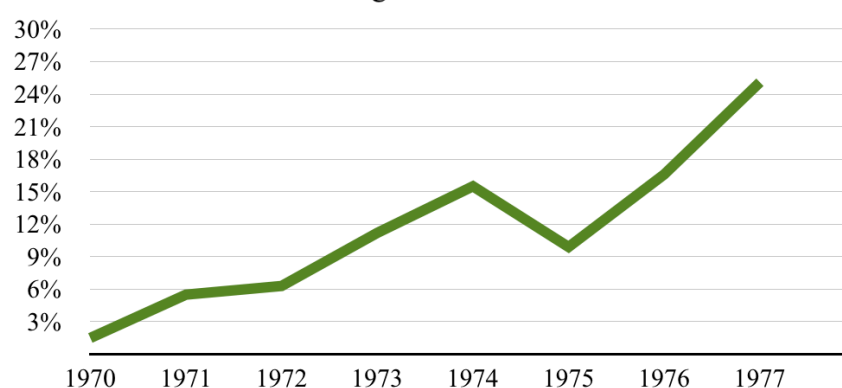
“Industrial development is of particular importance in view of the fact it provides protection and incentive for the progress of other sectors of the economy, and is a most important factor in raising the national income and providing opportunities for productive employment. At this stage of the country’s economic development, industrialisation is considered important as an element of sustained, long-term economic growth, not just because industrial units established during the Plan period will continue to operate in the years to come but rather because the measure taken or postponed in this field will determine the country’s future. Industrial development not only results in the supply of industrial goods required by society but also facilitates increased productivity and innovation in other sectors of the economy and leads to the introduction of new and improved methods of management and higher level of technical skills. In the Fifth Development Plan the country’s industrial development is regarded as the basic measure in laying the groundwork of an advanced economy, which will pave the way for the Great Civilisation”.

In line with this rationale, the total size of public investment in industry was increased from 94 billion rials in the Fourth Plan to 288 billion rials in the Fifth Plan. As an important step, the government moved towards developing military and nuclear industries after the boom, hence making its industrialisation program more geopolitically oriented. In harmony with this policy, the Pahlavi regime engaged in a military spending spree by increasing its defence expenditures from 145 billion rials in 1973 to 561 billion rials in 1977 to consolidate its dominance in the Gulf region (Mofid, 1987). In parallel with these policies, the government showered the private sector with cheap credit to prevent the “crowding out” of this sector. As a result, credit transfers to the private sector jumped from 31 billion rials in the Fourth Plan to 225 billion rials in the Fifth (Karshenas, 1990). As before, the bulk of these subsidies (65%) were supplied through the IMDBI.

Naturally, this “Big Push” industrial drive translated into excessively expansionary fiscal and monetary policies during the Fifth Plan. Annual fiscal expenditures rose from 176 billion rials in 1973 to 2,442 billion rials in 1977 (CB, 1978). Importantly, the

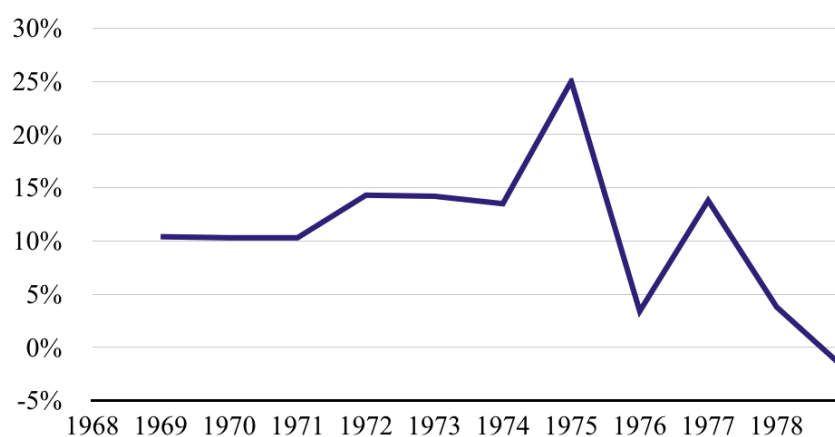
government made little fiscal savings in this period (less than 11% of its annual oil revenues), despite the windfall revenues. Similarly, liquidity expanded by four fold throughout the plan (ibid). The government accompanied this expansionary monetary policy with a sudden opening of the capital account in 1974. The rationale behind this policy was to encourage growth by facilitating the inflow of foreign capital into the economy. Thanks to this policy, foreign inflows into the banking system rose by fivefold during the plan, hence fuelling domestic credit growth. Unsurprisingly, the combination of capital account liberalisation and expansionary policies of government led to high rates of inflation during the Fifth Plan (Figure 6-2). However, as will be explained, this problem did not force Pahlavi regime to change its policy path.

Figure 6-2: Inflation



Source: Central Bank of Iran, annual reports.

Figure 6-3: GDP growth



Source: Central Bank of Iran, Annual reports.

In addition to being expansionary, Iran's fiscal and monetary policy exhibited a high degree of volatility due to the large fluctuations in oil revenues (Mohades & Pesaran, 2013). As shown in table 6-1, the growth rate of fiscal expenditures and money supply was very unsteady during the Fifth Plan. This volatile expansionary policy, in turn, translated into an unstable inflation and growth rate (figure 6-3) in the economy. Overall, due to economic instability, Iran experienced much lower growth during the Fifth Plan (7%), than during the two previous plans.

Table 6-1: Changes in

	Fiscal spending	Money Supply
1970	17%	7%
1971	22%	20%
1972	26%	35%
1973	33%	27%
1974	125%	61%
1975	35%	36%
1976	12%	36%
1977	30%	29%
1978	-15%	56%

Source: Mehran (2013)

Table 6-2: Budget balance (% of GDP)

1970	-4.9%
1971	-5.8%
1972	-9.2%
1973	-3.8%
1974	-3.8%
1975	-5.7%
1976	-3.7%
1977	-6.8%
1978	-9.6%

Source: Salehi Esfahani & Taheripour (2002)

Path disruption

However, Iran's ISI deepening was finally disrupted as a result of a negative external oil shock in 1977. At the end of that year, Saudi Arabia decided to go against OPEC countries and flood the market with supply at a lower price (10%) than the other cartel members. This unilateral action by Saudi Arabia, which aimed at increasing the country's market share, resulted in a 20% decrease in Iran's oil revenues. Given Iran's low level of petrodollar savings, this negative shock produced a very large budget deficit (table 6-2) and forced a painful policy reversal on Pahlavi regime as a consequence (Mehran, 2013). Accordingly, the government cut its fiscal expenditures by 15% and caused an economic recession in 1978. Naturally, this recession generated social instability and sowed the seeds of the subsequent collapse of the Pahlavi regime in 1979.

6.2 The politics of economic policymaking

In order to understand the politics of economic policymaking in the Fifth Plan, first we need to look at the origins of the oil boom and its immediate effects on the policymaking institutions. Accordingly, this section first explores the reason behind the quadrupling of oil prices in 1973 and outlines Pahlavi's immediate institutional responses to this price change. Then, it traces the process of macroeconomic policymaking and oil strategy setting during the Fifth Plan.

6.2.1. The oil shock and Pahlavi's institutional responses

The origins of the 1973 oil shock go back to the third Arab-Israel war in October 1973. In response to this war, the Gulf countries, headed by Saudi Arabia, raised their posted price of crude oil from \$3.12 per barrel to \$5.12 per barrel and placed an oil embargo on Israel's allies including the US (Amouzegar, 2001). Hence, Arab countries started to use oil as a diplomatic weapon to pressure the US. But, the Pahlavi regime refused to take part in this embargo due to its close relations with Israel and continued to sell oil to the US. Nevertheless, this embargo changed Iran's oil policy; capitalising on this opportunity, the Pahlavi regime sought to use its position in OPEC to push for even higher oil prices in order to hasten the pace of its ambitious domestic industrial and military plans further. Adopting this hawkish oil stance, Iran sought to orchestrate a massive price increase at the next OPEC meeting in Tehran. Thanks to Iran's effective lobbying, OPEC countries increased their posted prices from \$5.12 to \$11.65 per barrel in the December meeting in Tehran in a bold gesture³⁰. In this way, Iran played a direct

³⁰ Iran's proposal was to increase the price of oil to \$17. This proposal was based on the calculations made by OPEC's Economic Commission Board regarding the "real cost of an alternative energy" (Amouzegar, 2001). However, this proposed price was in the end discounted by OPEC's ministerial committee to \$11.65 (ibid).

role in *creating* the 1973 oil shock. The following remark by the “Financial Times” captures the Shah’s mood at the Tehran meeting (Graham, 1978: p1):

“It was a performance to match the occasion. On 23 December 1973, while the Ministers representing the Gulf members of OPEC were still in formal session, Mohammad Reza Pahlavi, Shah of Iran, called a press conference. His announcement was a staggering new increase in the price of oil. The Shah displayed his usual mannered polish but his tone had a new confidence- the confidence of a man who knew that his country’s financial resources had quadrupled in just over two months”.

This clearly indicates that the quadrupling of oil prices in 1973 was *endogenous* to the Shah’s industrial and military aspirations. Following this oil windfall, the Shah started to make some institutional changes to prepare the state for a massive industrialisation push. Most significantly, he empowered the ME as this ministry was in charge of managing the ISI. This ministry was merged with the Ministry of Finance to create the Ministry of Economic and Financial Affairs (henceforth MEFA). At the same time, two “sub-ministries” were born out this integrated ministry: the Ministry of Commerce and the Ministry of Industry and Mines. These ministries were placed under *de facto* control of MEFA. The whole idea behind these changes was to transform the Ministry of Economy into a “Super Ministry” that could manage the government’s overall economic strategy by harmonising different policy areas including industrial policy, trade policy, tax policy, private sector promotion and bilateral economic relations (Mehran, personal interview, May 2014). The Financial Times described the political implications behind the creation of MEFA in the following way (Housego, 1974):

“The man who is seen to have emerged far stronger from the reshuffle is Mr Hushang Ansary, the Minister of Economy, who has now taken over the Ministry of Finance as well...The sweep of his power now covers: foreign trade; bilateral agreements involving exchanges of oil, commodities and technology; domestic industrial development; overall supervision of the Central Bank; and

determining the level of taxes and tariffs. Largely working under his directions are two new Ministries of Industry and Commerce”.

The MEFA also took some important fiscal policy tools away from the PBO such as the authority to acquire foreign loans (Majidi, OHCFIS, tape two, FCO 8/2744, 1976). Also, the responsibility of saving Iran’s oil revenues abroad was given to this ministry, instead of the PBO. Moreover, the MEFA became the main supervising body of the CB (Mehran, Tejarat Farda, 2015). Overall, these *de jure* changes translated into simultaneous strengthening of the ME and weakening of the CB and PBO.

6.2.2. Macroeconomic policymaking

As mentioned, by the start of the Fifth Plan, Iran’s macroeconomic policymaking institutions had already been weakened, due to the insistence of the authorities to sacrifice fiscal and monetary discipline for the sake of rapid industrialisation. Under the Shah’s pressure, the PBO’s technocrats had designed a highly expansionary plan for the 1973-1977 period. This plan was 120% larger than the Fourth Plan in size and had the annual growth target of 11%.

However, a few months after the plan started the Arab-Israeli war broke out and oil prices soared in response. Alarmed by this positive external shock, the technocrats of CB and PBO started to express concern about Iran’s macroeconomic stability in the future. This anxiety was best expressed in a speech from Majidi, the then Director of the PBO (CBB, 1973):

“At the moment, the gravest danger threatening us is that, because oil prices have gone up, we might think that constraints have now been lifted and we must start to rapidly spend our money and press for our development projects to be implemented at high speed. It might sound rational for us to rapidly develop our economy, now that we have a lot of money. But we have to remember that every economy has an absorptive capacity and if this capacity is ignored

we will get adverse results out of our spending and waste this opportunity”.

However, the Shah ignored such views presented by the technocrats and called for an upward revision of the Fifth Plan. He also instructed the PBO to prepare a “twenty-year perspective” for the Iranian economy as a blueprint for becoming the fifth largest industrial country in the world. The Shah gave these orders while he was secretly lobbying for future price increases in OPEC. However, as before, the PBO officials had been kept in the dark regarding the details of these oil negotiations and they were asked to revise the Fifth Plan and also formulate a long-term blueprint for the economy without any accurate information about future oil revenues (Majidi, personal interview, February 2013, Mehran, 2013).

Subsequently, the “twenty-year perspective” was formulated and presented to the Shah by the PBO on March 1974. In that meeting, the PBO officials clearly declared that even on the basis of the most optimistic assumptions, Iran would not be able to become the world’s fifth largest industrial power in twenty years (Razavi & Vakil, 1984). Angered by this dismal view, the Shah dismissed the technocrats’ warnings as pessimistic and short-sighted and pressed for a massive industrialisation drive for the revision of the Fifth Plan. The final decision regarding the revision of the Fifth Plan was then made in two crucial meetings held in Gajereh (July 1974) and Ramsar (August 1974).

The Economic Council meeting at Gajereh

The function of this meeting, which was attended by the ministers, the CB’s Governor and PBO’s director, was to prepare a draft of the revised the Fifth Plan to be later presented to the Shah at the High Economic Council meeting. Therefore, this meeting reflected in-fighting between the ministers and PBO over the size of total expenditures.

As a framework, the PBO officials provided three scenarios, which had been based on the “back of the envelope estimates”, for the increase in public spending: (1) a “modest” increase of 30% (b) a “medium” increase of 98% and (3) a “high” increase of 141% (Vakil, personal interview, June 2013). In parallel, the ministers had provided their own proposed expenditures and their aggregates even exceeded the third scenario (ibid).

Most of the PBO officials lobbied for the first scenario. Specifically, the experts of the Planning Division represented by Firouz Vakil advocated the first scenario and pressed for saving the surplus oil revenues abroad in the form of a sovereign wealth fund (Vakil, personal interview, June 2013). This division opposed the other scenarios for their inflationary consequences, highlighting the limited absorptive capacity of the economy (i.e. infrastructure and manpower). However, seeking to maximise their budgets, most of the ministers opposed the first scenario. In the end, after three days of lobbying by various ministers, a middle position was reached: a figure close to the second scenario was selected. This scenario, which set aside about 11% of the oil revenues for foreign investment, still translated into an over-ambitious revised plan that was in line with the Shah’s high-flying developmental goals. In the end, the sole success of the PBO in the Gajereh meeting was to prevent the adoption of the Third scenario (Vakil, Personal interview, June 2013).

The High Economic Council meeting at Ramsar

The purpose of the High Economic Council meeting at Ramsar was to seek the Shah’s approval for the draft agreed upon at the Gajereh meeting. Again, in the meeting, two PBO Officials expressed their concerns about the severe inflationary impacts of increasing public expenditures by 98%, emphasising the infrastructure and manpower constraints. However, the Shah quickly dismissed these views as before (FCO 8/2744,

1976a; Graham, 1978; Milani 2011; Amouzegar 1991; Walton 1980 and Pesaran, 1982) and even ordered a slight upward revision for the proposed scenario. He also personally added a series of grand industrial projects such as investment in nuclear energy and military industries to the plan (Yeganeh, IOHCHU, tape twelve). The outcome was a 100% increase in the fiscal expenditures with the aim of achieving 25% economic growth per year, as opposed to 11% per year set in the original Plan. Needless to say, this plan was based on the optimistic assumption that oil prices would stay high in the future. Summarising the meeting, the Shah confidently declared in a press conference that “the Great Civilisation we promise you is not a utopia either. We will reach the gates in 12 years: but in some fields we have already crossed its frontiers” (Cited in Graham (1978): P80).

The economic turmoil (1974-1978)

The immediate outcome of the revised plan was a fiscal and monetary explosion; spending and liquidity grew by 125% and 56% respectively in 1974 (Mehran, 2013). This expansionary policy was accompanied by a sudden opening up of the capital account. The rationale behind this policy was to further encourage economic growth by inflow of foreign capital. Due to this policy and the sudden expansion in spending and credit, inflation soared to 15% in 1974. The most important turning point, however, came in 1975, when the global demand for oil dropped due to the recession in the West and Iran’s oil revenues fell (Figure 6-1), generating a wide fiscal deficit (5.5% of GDP) in that year (Table 6-2). Hence, the Fifth Plan ran into financial difficulties.

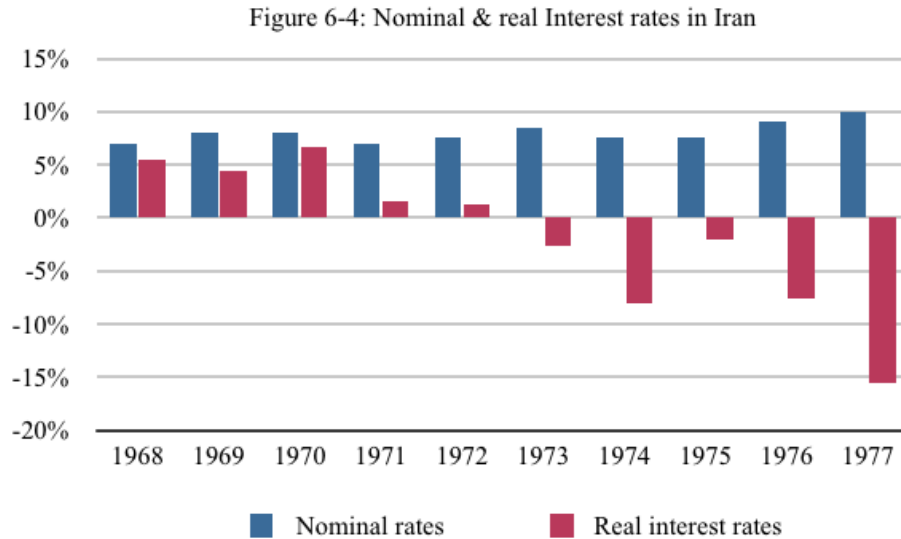
Yet, despite the large budget deficit and growing inflation, the Shah refused to empower the PBO and CB to restore fiscal and monetary discipline. This is because the cost of policy reversal had become even higher than before for the Pahlavi regime. Slowing the

ISI would entail a reduction in economic growth and cancellation of many large-scale industrial projects that were of high geopolitical importance for Iran such as building nuclear and military industries. This is while the Shah had already promised to turn Iran into an industrial country by the end of the 1970s and, at the same time, he was determined to ensure Iran's regional supremacy against Saudi Arabia's military rise after the oil boom. Based on these reasons, a switch to fiscal and monetary discipline would entail large geopolitical and legitimacy costs for the regime. In addition, there was no demand for policy reversal in the business community; indeed, the industrialists had neither the power nor the incentive to lobby for macroeconomic corrections as they were not export-oriented in their economic outlook. Finally, beside these political reasons, the Shah did not believe that macroeconomic discipline was the right remedy for controlling inflation anyway (PBO, 1990); in contrast to the experts in the PBO and CB, he perceived inflation as a micro phenomenon that was rooted in the "opportunistic" price setting behaviour of industrialists. Following this view, he believed that inflation should be tamed through micro means such as price controls and increasing supply through imports or production (ibid). In the end, the combination of the political and ideological factors listed above urged the Pahlavi regime not to engage in a policy reversal (i.e. slowing down the pace of ISI). Alternatively, Iran continued to cling on to its usual aggressive oil strategy to raise prices in OPEC in order to acquire sufficient funds to continue the Fifth Plan. In parallel to this growth-oriented strategy, a new series of harsh price controlling measures were imposed on the private sector with the aim of decreasing inflation.

Subsequently, thanks to Iran's aggressive strategy in OPEC, her oil revenues increased in 1976 and 1977 (Figure 6-1). Following from this upsurge, the Shah pressured the PBO to lift the growth rate of fiscal expenditures in 1976 and 1977 (Table 6-1). Again,

this translated into a high inflation rate and a growing budget deficit (Table 6-2). Commenting on this macroeconomic instability in an interview, the Shah boasted that “We are even further ahead than what we planned...We will have a 17 per cent growth rate this year. Is this bad?” (Ian Sadr, 2013: p102). Similarly, Prime Minister Hoveyda contended that “We overspent with open eyes. We took the occasion of more income at one time to make a jump, and I don’t shed any tears about a miserable couple of billions of dollars’ deficit” (ibid). These remarks clearly show that the elite were willingly sacrificing fiscal discipline for rapid industrialisation. Indeed, the PBO was ultimately made redundant in 1977 as the Shah declared that the state no longer needed Five-Year Development Plans.

The CB also experienced a similar political trajectory. Throughout the 1974-1977 period, this bank sought to control inflation by limiting liquidity growth in the economy through increasing credit quotas on the banks (Pesaran, personal interview, June 2013). However, the Shah did not fully support the enforcement of these quotas in many cases as he believed that reduction in credit would harm production (Mehran, 2013). Following the same logic, he also did not allow the technocrats to increase interest rates (discount rates) in tandem with inflation. This policy produced negative real interest rates (Figure 6-4) and fuelled corruption in the banking sector (Salehi-Esfahani, 1989). These policies clearly indicate that the Shah had no desire to restore monetary discipline at the expense of slowing down the growth momentum.



Source: Mehran (2013).

Overall, the evidence provided in this section reveals that the 1973 oil boom emboldened the Pahlavi regime to push the ISI to an extreme level in the Fifth Plan; hence making macroeconomic policymaking more subordinate to industrial policymaking. This decision led to the further political decline of the CB and PBO and the postponement of necessary macroeconomic corrections.

Finally, this steady trend of institutional deterioration was disrupted by the sudden drop in oil revenues in 1977. As mentioned, this negative external shock widened Iran's fiscal deficit and forced a painful policy reversal on the elite. As a result, after many years of postponement, the Shah had to (re)empower the CB and PBO to engage in large monetary and fiscal cuts. These painful adjustments led to economic decline and social unrest in a very short span of time, threatening the very survival of the Pahlavi regime in the end.

6.2.3. Oil strategy setting

This subsection shows that, as before, Iran's oil strategy between 1973 and 1977 focused on maximising short-term revenues in order to drive the state's industrialisation project and military build-up at full speed.

Pahlavi started the Fifth Plan with an important oil victory at home; on March 1973, Iran finally gained control of the production and pricing of her oil after many years of negotiation with the Consortium. This agreement, which amounted to the partial nationalisation of the oil industry, transformed the Consortium into the "privileged" buyer of Iranian oil for twenty years. The Shah announced a total victory over the oil companies after this event and celebrated Iran's full economic independence from the West.

This home victory was followed by the Arab oil embargo on October 1973, which, as mentioned, gave Iran the opportunity to orchestrate a massive multilateral price rise in OPEC in December 1973 to acquire ample funds for her ambitious domestic industrial and military plans. Among the OPEC countries, Saudi Arabia was the least receptive to this strategy. Unlike Iran, the Saudi Kingdom had a long-term horizon on the oil market, due to reasons that will be discussed in chapter eight. The Saudi elite believed that high oil prices would create an economic downturn in rich countries and reduce the demand for oil in the future. Following this logic, Zaki Yamani, the Saudi Oil Minister argued in favour of taxing the oil companies rather than raising oil prices: "Saudi Arabia believes that rising oil prices at this time will reduce demand and consequently, weaken the relative position of the oil-producing countries because, clearly, increasing demand is the foundation of the latter's ability to maintain price stability" (Afkhami, 2009: P282). Also, more importantly, the Saudi elite argued that high oil prices would encourage

supply from non-OPEC members and therefore, threaten the dominance of OPEC in the oil market in the long term (Amouzegar, 2001). In addition to these long-term concerns about the future conditions of the oil market, Saudi Arabia worried about high oil prices feeding further military developments in Iran, as claimed by William Simon, the Treasury Secretary in the Nixon Administration (Cooper, 2011, P:176) : “[the Shah] wants to be a superpower. He is putting all his oil profit into domestic investment, mostly military hardware...it is crazy from their [Saudi Arabia] point of view. The Saudis keeping oil prices high is making Iran, their natural rival, strong”. A combination of the factors mentioned above persuaded Saudi Arabia not to support Iran’s hawkish oil policy. This created a divide between Iran and Saudi Arabia in terms of pricing of oil between 1975 and 1977. On the one hand, Iran desperately lobbied for high oil prices in OPEC to close the fiscal gap of the Fifth Plan, while on the other hand, Saudi Arabia supported price constraint. This divide reached its peak at the December 1976 meeting in Doha (Graham, 1978). Ultimately, Saudi Arabia decided to break away from OPEC in 1977 and unilaterally flood the market with supply by exceeding its production quotas (ibid). The Pahlavi regime immediately condemned this move in its state media: “the Third world and all progressive nations everywhere are angry and detest Yamani [Saudi oil minister] for having sold the real interests of his country and of OPEC to imperialism” (Cooper, 2011: p360). Unlike Saudi Arabia, Iran had little petrodollar savings abroad and, therefore, it was highly vulnerable to a sudden drop in oil revenues. Consequently, after losing the oil battle with Saudi Arabia, the Pahlavi regime was forced to halt its ambitious development and military programs at home and undergo painful fiscal cuts in 1978.

6.3 Class coalition effect

This section shows that with intensification of ISI in the Fifth Plan, the Pahlavi regime greatly amplified both its supporting role and disciplining role towards the private sector. On the one hand, it showered the family conglomerates with credit subsidies, but on the other hand, it imposed harsher price controls on these firms to discipline their pricing behaviour. The first policy led to an explosion in corruption and income inequality and the second policy fuelled instability in the business community, particularly during the later stages of the plan. In this way, the Fifth Plan greatly aggravated the twin problems of growing corruption and instability that had *already* surrounded the state-business relationship since the middle of the Fourth Plan. The following subsections explain how the “Big Push” industrial drive worsened these twin problems.

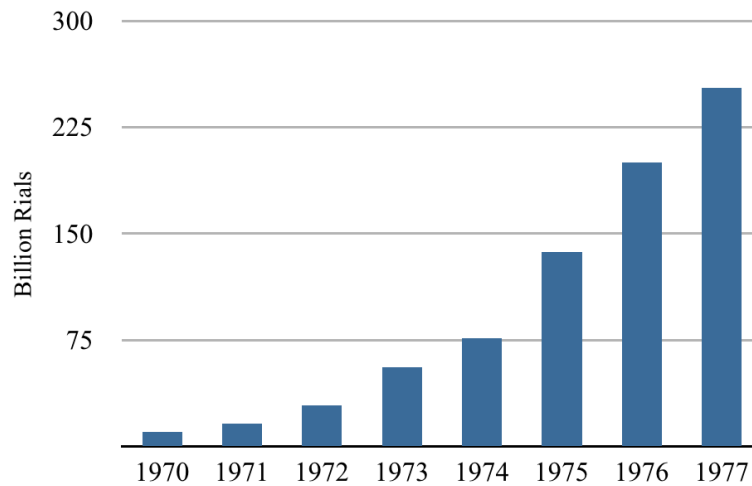
6.3.1 *Rent seeking in credit allocation*

As mentioned, in response to the oil boom, the government massively increased the credit subsidies to the IMDBI and followed a loose monetary policy while opening up the capital account. This policy mix soon generated inflation and negative interest rates. Importantly, these negative interest rates persisted throughout the Fifth Plan (Figure 6-4) as the Shah was not eager to let the CB increase nominal rates in tandem with inflation and, in effect, slowdown the ISI project. The Shah also did not allow the CB to control inflation via non-market instruments such as reserve ratios and credit limits. Therefore, the combination of negative real interest rates and loose credit restrictions fuelled corruption and rent seeking in the banking sector during the Fifth Plan as industrialists sought to maximise their access to cheap loans.

For instance, in violation of the banking regulations, the private commercial banks and IMDBI started to give large loans to companies that were connected to their directors and shareholders, thus increasing the concentration of risk in the banking sector (Mehran, 2013). In line with this view, the 1974 World Bank report estimates that about 25% of IMDBI loans were given to the firms related to the directors of this bank (IBRD, 1974). At that time, 49% of this bank was owned by the ten largest industrial corporations (ibid). The Pahlavi Foundation was also among the major shareholders of IMDBI, with its director being also the chairman of the bank (ibid).

Similarly, many commercial banks, which were owned by the industrialists, started to give loans to their own conglomerates. To be sure, practices like the transfer of loans to bank directors or the cross-ownership of banks and conglomerates had the implicit approval of the technocrats in the CB from the onset of the industrialisation project, as they were seen as “necessary policies” for fostering capital accumulation in an environment where the financial markets were incomplete and search costs were high (Farmanfarmaian, personal interview, July 2010, Mehran, 2013). However, these practices were disproportionately reinforced during the fifth plan. Crucially, capital account liberalisation exacerbated this corruption as it facilitated sudden inflows of foreign capital into the banking system (Figure 6-5). Accordingly, the ratio of foreign to total debt in the banking sector rose from 4% in 1970 to 10% in 1977 (Mehran, 2013).

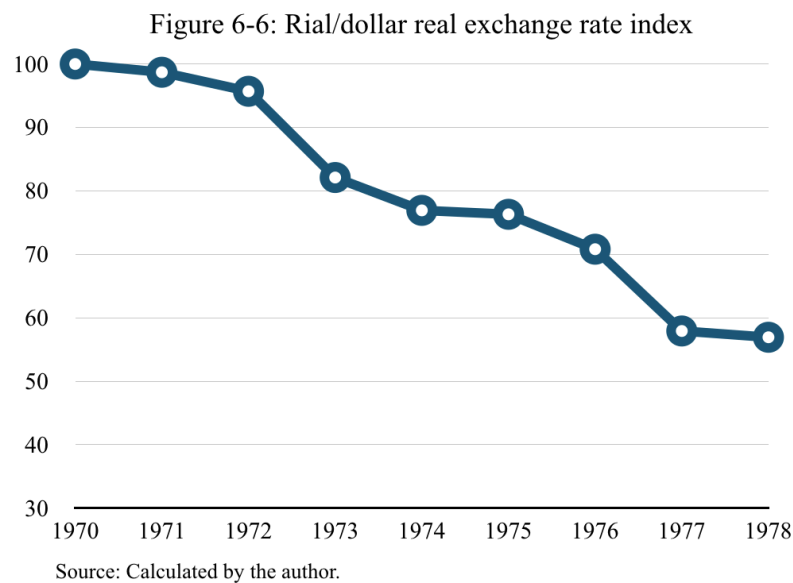
Figure 6-5: Foreign Debt in Banking Sector



Source: Mehran (2013)

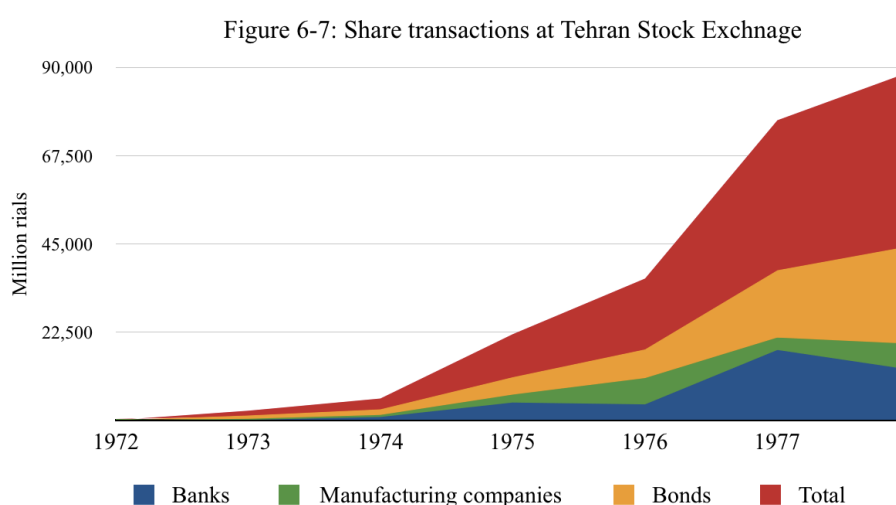
In addition to negative real interest rates, Iran experienced real exchange rate appreciation during the Fifth Plan (Figure 6-6), thanks to the high rate of inflation and a fixed nominal exchange rate. This appreciation had three effects on the private sector. Firstly, it lowered the price of technology imports for industrialists. Secondly, it made it cheaper for banks to borrow from abroad, hence further fuelling domestic credit growth. Thirdly, it reduced the economic competitiveness of outward-oriented classes (the Bazaar and landed elite). The second and third effects pushed the CB to lobby for an exchange rate correction (i.e a nominal depreciation of the rial). However, the Shah and cabinet members not only opposed this policy but they pressured the CB to even increase the value of the rial in order to hasten the ISI process by facilitating the import of technology and capital goods. This pressure came mostly from the MEFA, the Ministry of Commerce and the Ministry of Industry and Mines as these ministries were directly involved in the industrialisation project (Yeganeh, OHCFIS, tape four). Needless to say, industrialists supported such a policy as it would shrink the real value of their external loans and also lower the cost of importing machinery for them. However, the CB governor opposed these demands, stressing the harmful effects of rial overvaluation on the budget deficit and also on the competitiveness of the domestic tradable sectors (i.e.

the Dutch disease argument) (ibid). In the end, the Shah supported the CB as he believed that revaluation of rial would hamper the progress of the Fifth Plan by increasing the budget deficit (Mehran, 2013). Therefore, as its maximum achievement, the CB managed to prevent further revaluation of rial in the end, let alone making a necessary devaluation.



The combination of negative real interest rates and an overvalued exchange rate ignited competition among the industrialists to gain control over the existing banks in the mid-1970s. The growing popularity of the banks' shares on the Tehran Exchange reflected this trend (figure 6-7). This thirst for "bank grabbing" was most evident in the case of Hozhabr Yazdani- a businessman who had become rich by exploiting his relationship with the Shah's personal physician, Dr Ayadi. He targeted eight different banks and finally managed to buy the Iranian Bank through corrupt practices, as recalled by the then Governor of the Central Bank (Yeganeh, OHCFIS, tape ten). The factors mentioned above also increased the demand for creating new banks (Mehran, 2013). In particular, many foreign banks became eager to enter into the Iranian market, reassured by the high foreign exchange reserves of the country (ibid). However, the CB's technocrats were reluctant to give permits for new banks, given the excessive expansion

of credit and build-up of risk in the banking sector. Yet, determined to turn Tehran into a financial hub, the Shah ignored the technocrats' arguments. As a result, seven new banks acquired permits in the post-oil boom era (ibid). This was a significant change since no new bank had been established since 1963. Consequently, the CB found it more difficult to supervise the banking sector effectively and enforce regulations and credit limits (ibid).



This lack of governance by the CB ultimately resulted in a number of bank failures (“Bank Saderat”, “Bank Bime Bazarganan”, “Bank Shahriyar” and “Bank Asnaf”) according to the then CB governor (Yeganeh, OHCFIS, tape sixteen). These banks were later secretly bailed out by the CB due to being “too big to fail”³¹ (Yeganeh, OHCFIS, tape sixteen, Mehran, 2013).

³¹ Allegedly, in many of these cases, the bank directors kept their control and shares even after the bail-outs due to the pressures exerted by the Minister of Economic and Financial Affairs on the CB’s governor (Yeganeh, OHCFIS, tape sixteen).

6.3.2 The anti-profiteering campaign and industrial ownership reform

The relationship between the state and the industrialists went through a dramatic upheaval when inflation started to soar after the revision of the Fifth Plan. As mentioned, instead of controlling inflation through fiscal and monetary cuts, the Shah preferred to place harsher price controls on industrialists. This is because he considered inflation as a micro phenomenon that had been caused by the hoarding behaviour of the industrialists and Bazaaris.

Naturally, the price controls set by the government in the early 1970s had generated black markets for certain goods. The then Deputy Governor of Central Bank outlined the Shah's view regarding this matter: "when the inflation rose as a result of the economic policies of that time, the Shah believed that outcome had political roots rather than economic ones. In other words, the Shah said that prices have increased because of profiteering by merchants, rather than inflation. While [ironically] all these new Baazaris [the industrialists] were nurtured by the Shah....in a meeting the Shah expressed that the inflation has been caused by hoarding in the Bazaar and had nothing to do with demand and supply" (Jalil Shoraka, Tejarat Farda, 2013d). The minutes of High Economic Council meetings also clearly confirm this picture (PBO, 1990).

Consequently, the Shah embarked on a harsh anti-profiteering campaign aimed at the industrialists and Bazaar in July 1975. The Ministry of Commerce became responsible for this campaign and acquired the authority to arrest any merchant or industrialist who violated the prices set by the government. In September 1975, the Shah officially made "Price stabilisation and the campaign against anti-profiteering" the 14th principle of the White Revolution (Afkhami, 2009). In this vein, the Ministry of Commerce mobilised the student wing of newly created Resurrection Party (see subsection 6.4) to intimidate

and arrest suspects. In the words of the US embassy's Economic Officer, this created a Chinese-style harassment campaign that was reminiscent of Mao's Cultural Revolution (Lehfeldt, OHCFIS, tape two).

Subsequently, 7,700 suspects were arrested and, more importantly, two major industrialists, Habib Elqanian and Hamid Akhavan Kashani, who were members the Board of the Chamber of Commerce, Industry and Mines, were put in jail (Torabi-Farsaani, 2013). Moreover, Habib Sabet, another major industrialist who was among the major shareholders of IMDBI and also a Board member of the Chamber of Commerce, Industry and Mine, was threatened with arrest (Milani, 2009). These arrests created a panic among the industrialists. Nonetheless, the head of the Chamber of Commerce, Industry and Mines, Senator Taher Ziyai, supported the campaign and promised to oust any member who did not respect the price controls (Torabi-Farsaani, 2013). This remark clearly reflects the weakness of the private sector in relation to the state in that era³².

Foreign companies also did not protest against the campaign because, unlike the industrialists, they were mainly engaged in the second phase of ISI, which focused on developing intermediate and heavy industries, and were not involved in consumer goods industries (Mehran, personal interview, May 2014; Lehfeldt, OHCFIS, tape three). To be sure, the industrialists made several attempts to express their grievances about the campaign through foreign companies, especially via the US-Iranian Chamber of Commerce (Lehfeldt, OHCFIS, tape three). However, the government was not responsive to this chamber either (ibid).

³² The only industrialist who protested against the campaign was Senator Ghasem Lajevardi, who was among the few capitalists who had been allowed a political seat by the Shah. He criticised the price controls and regular government interference in the economy in a Senate speech in 1976 (Milani, 2009).

Alongside the anti-profiteering campaign, the government launched another private sector reform to address the problem of income inequality (Yeganeh, IOHCHU, tape eleven), which had been ballooning³³. On August 1975, the Shah formally declared that industrial corporations had to sell 49% of their shares to their workers and made this program the 13th principle of the White Revolution. This program entailed the restriction of foreign companies' share ownership to 25% in joint-stock companies (FCO 8/2511, 1975). Although this reform was never fully implemented due to the practical problems surrounding it (Yeganeh, IOHCHU, tape eleven), it created confusion among foreign firms (FCO 8/2728 1975). In consequence, for instance, GM withheld its program for investments in the country (Graham, 1978). Likewise, the program reinforced the panic among the industrialists. Nonetheless, the Chamber of Commerce, Industry and Mines fully supported it as a redistribution measure (Torabi-Farsaani, 2013).

Overall, the anti-profiteering campaign and the industrial share ownership reform resulted in a collapse of confidence among the industrialist class during the later stages of the Fifth Plan and triggered capital outflows from the country. These outflows, which were facilitated by the overvalued exchange rate, averaged around 10% of Iran's foreign exchange earnings during the 1973-1977 period (Mehran, 2013). This capital flight reached its climax during the political instabilities of 1977-1978 as many of the industrialists started to escape from the country.

³³ The Gini coefficient had risen from 47% in 1969 to 53% in 1975 (Karshenas, 1990).

6.4 Effects on the internal power structure

When starting the Fifth Plan, the Shah was at the pinnacle of his power, thanks to the positive impact of Iran's economic miracle on social stability in the preceding decade (FCO 8/2261, 1974). As before, the Iran Novin party was in control of the government and Hoveyda was the prime minister, while the Mardom Party was functioning as the opposition party. However, this political equilibrium was soon disrupted when the revised Fifth Plan started to aggravate inflation, corruption and income inequality (FCO 8/2981, 1977; FCO 8/2743, 1976). As a response to this economic turmoil, the Shah personally abolished the two-party system on March 1975 and established a single party called the "Resurrection Party". As the Prime Minister, Hoveyda became the General Secretary of the party and, to generate the facade of competition, the party was then split into two wings: "Progressive Liberals", headed by Jamshid Amouzegar, the Interior Minister and Iran's representative in OPEC, and "Constructive Liberals", headed by Houshang Ansari, the Minister of Economic and Financial Affairs.

This political change was arguably inspired by ideas of the Harvard political scientist, Samuel Huntington (Abrahamian, 2008). In his famous book "Political Order in Changing Societies" (1968), Huntington argued that rapid economic modernisation unavoidably breeds political instability due to the sudden social transformations it entails. Accordingly, he called for establishment of a strong unified political party in modernising countries to mobilise mass social support behind the state. This idea gained popularity among the political elite and the Shah as soon as the Fifth Plan's "Big Push" industrialisation drive propagated economic and social instability. Once established, the Resurrection Party was utilised as a tool for disciplining the economic behaviour of the Bazaaris and industrialists. For instance, the student wing of the party was mobilised to

harass producers who violated the prices set by government during the anti-profiteering campaign. This new political arrangement remained in place during the post-boom instability years. However, in 1977, the drop in oil revenues and the subsequent austerity reforms pressed the Shah to bring a new government in power. Accordingly, he appointed Jamshid Amouzegar, the leader of the “Progressive Liberal” wing of the Resurrection Party, as the Prime Minister on August 1977, dismissing Hoveyda after twelve years. This new government, which in a way signalled a slight shift of power back towards the pro-austerity technocrats, embarked on deep fiscal and monetary cuts. However, these cuts soon generated an economic downturn and social instability, leading to the collapse of Amouzegar’s government in a year. Ultimately, a series of poor political decisions by the Shah in 1978, culminated in a popular revolution and the collapse of the Pahlavi regime in February 1979.

6.5 Geopolitical effect

Iran’s geopolitical relations underwent considerable change during the Fifth Plan. Mostly importantly, the plan caused serious tensions in Iran’s relationship with the US because it entailed policy choices that were not in the interest of the latter. This section describes these contentious policy choices and explains how they influenced US-Iran relations.

At the onset of the Fifth Plan, Iran’s relationship with the US was at its peak. Standing as the successful example of the “Nixon Doctrine”, Iran had become the guarantor of stability in the Gulf region. Subsequently, when the Arab-Israel war broke out in October 1973, Iran did not support the Arab embargo against the US. Naturally, this move drew the Nixon administration closer to the Pahlavi regime. Thus, as before, this administration supported the Shah’s moves to increase oil prices for the sake of

speeding up Iran's domestic industrialisation and military programs. Importantly however, Nixon began to reconsider this position after the second round of price increase instigated by Iran in December 1973. This oil shock ended the "Golden Age" of economic growth in the Western countries by plunging their economies into macroeconomic instability, rising inflation and widening balance of payments deficits. As a reaction, Nixon pressed Iran to reduce oil prices in 1974, but the Shah refused to do so (Milani, 2011; Cooper, 2011). The then US Treasury described the Shah's position in this manner: "The Shah is a nut and maximisation of the oil prices is in his best interest as he sees it" (cited from Copper, 2011, p. 176).

In the meantime, the Shah continuously justified the high oil prices of the mid 1970s on the basis of rising import prices for developing countries: "...this year of terrible world inflation [1974] has already eroded our purchasing power. So as a matter of fact the price of oil has come down as far as we are concerned because we have not augmented in OPEC as much as we have lost" (FCO 8/2283, 1974). It is worth remembering that the 1973 oil shock was preceded by the abandonment of the Bretton Woods system by the Nixon administration in 1971. That breakdown, which had been caused by the excessive deficit financing by the US, had resulted in rising global prices since 1971. Following this reasoning, the Shah argued in 1974 that "Well, we have been witnessing inflation in the world before the increase of the oil price. We have had inflation in the world when oil was so cheap. How do they answer this?" (ibid). Along this line, he suggested OPEC should index oil prices to the prices of thirty commodities. Further, he mentioned in a famous interview³⁴ that it was time for the Westerners to learn to live within their means:

³⁴ This interview can be accessed online at: <http://www.youtube.com/watch?v=imil1ilpIYA>

“Q: Have you got anything in principle against the system in Britain or other Western countries [in reference to the high oil prices]?”

A: Not really against. But! I must tell you my opinion. If you continue this way; a permissive and undisciplined society, you are going to blow up...you will go bankrupt. You work not enough; trying to get too much money for the little work you are putting up and this cannot continue”.

Of course, the Shah made these statements while still remaining in the Western camp in his general foreign policy outlook (FCO 8/2492, 1975), as evident, for instance, from his full support for the US during the Vietnam War or his backdoor assistance to Israel in the midst of the 1973 War (Lehfelddt, OHCFIS, tape one). At the same time, the US administration continued its military support for Iran as before; in fact, US weapon sales to Iran ballooned from \$682 million in 1974 to more than \$2.5 billion in 1977 (Alvandi, 2014).

As an alternative strategy to reducing oil prices, the Western powers, especially the US, lobbied the Shah to recycle Iran’s petrodollars to rich countries through foreign investments and loans. Yet again, the Shah refused to do so, as he wanted to spend most of the oil revenues domestically. The data shows that, on average, Iran recycled only 11% of its oil revenues abroad in the 1973-1977 period (CB, 1978). These foreign outflows were comprised of multilateral loans to the World Bank and the IMF, bilateral loans to rich countries such as France and the UK, foreign assistance to poor countries and stock investments in foreign companies. Most of these investment decisions were made personally by the Shah in an “ad hoc” manner (FCO 8/2283, 1974, Yeganeh; IOHCHU, tape eight; Pesaran, personal interview, June 2014). The then Economic Officer in the US Embassy recalls this episode in the following manner (Lehfelddt, OHCFIS, tape one):

“..after the oil price increases and money started rolling in, one of the preoccupations of the US government naturally was to the recycling of petrodollars. It fell to my lot, on instructions from Washington, to go over to see the then head of the Central Bank, Dr Mohammed Yeganeh, to break the news that the US government was not going to support a couple of World Bank loans to Iran that they had in the process, and that indeed we would like to suggest to the Iranian government that they start putting their oil money in places where it would whirl around the world and help some of those nations especially that had no oil and were badly off and could use some funds somehow. Well this upset him greatly. He rushed to the palace to tell the Shah all about it, and the Shah got all over Helms [the US Ambassador]. But, after venting his spleen a little bit, the next thing we knew the Shah had announced a grandiose scheme to loan money with low interest to developing nations and so forth and so on...”.

Accordingly, the joint Iran-US Economic Commission was established to facilitate the recycling of petrodollars to the West (Lehfeltdt, OHCFIS, tape one). Iran also proposed to create an OPEC fund to help poor countries deal with the adverse effects of the oil hike. However, these policies were mere friendly gestures by the Shah to the West; in the end, the US failed to pressure Iran to recycle its petrodollars, as pointed out by the US Economic Officer (Lehfeltdt, OHCFIS, tape one): “...we were studying what we were going to do, who was going to fund what, how much money the Iranians were gonna put up. But it was not a reality by the time I left [summer of 1974]. In the event the Iranians didn’t want to put up any money. Unlike the Saudis”. Indeed, the US embassy warned about the potential dangers of injecting all the petrodollars into the domestic economy but to no avail, as remembered by the US Economic Officer (Lehfeltdt, OHCFIS, tape two):

“ ...he [the Shah] was bound and determined he was going to get whatever he wanted. And I will say this. I’ve talked about this with Ambassador Helms afterwards, in the vein that while he and I can be faulted for not cautioning the Shah to go a little more slowly, and he said: “Bill, there was absolutely no way you could have hung on to his coat-tails. He [the Shah] was flying high. There was no way you could tell him it was going to be bad for him”.

The post-oil shock economic upheaval in Iran further increased the tension between Tehran and Washington. This is because the growing fiscal gap during the Fifth Plan forced the Shah to follow a more hawkish oil strategy during the 1975 OPEC meetings and go against the economic interests of the US. Accordingly, the Shah received a letter from President Ford in September 1975 urging him to change his oil policy (Afkhami, 2009: p283):

“As you can appreciate, the support of the American public for the new United States position must be based on awareness of the concern of the oil producers and other developing countries and the need to seek cooperative solutions to our common problems. I am concerned, however, that this necessary support will be jeopardised should the member countries of OPEC increase the price of oil this fall.

I am also concerned that such action could raise serious questions among the American public regarding the close cooperation we seek and are actively developing with your country in several fields of our bilateral relationship. I value this relationship greatly and sincerely wish to continue to broaden it...[Another oil price increase] would have a significant negative impact on the economies of all the oil importing nations-both developed and developing...and would impose shocks on the United States economy, on the more vulnerable economies of Europe and Japan, and finally on the highly fragile economies of the developing world...It is because I am aware, Your Majesty, of your sensitivity to the interdependence of the world economy and your commitment to successful economic dialogue that I am asking you to weigh heavily the adverse effects- both psychological and real- which a price increase would have. It is my hope that you will use your considerable influence among the producing countries to urge restraint on oil prices and to argue that our long-term mutual interest in a more rational global economic structure should prevail over short-term economic advantage”.

However, the Shah remained defiant and continued to lobby for high oil prices in OPEC (Afkhami, 2009; Milani, 2011). This growing tension between Tehran and Washington, in turn, gave an opportunity to Saudi Arabia to divert the support of the US administration away from Iran towards herself. Unlike the Pahlavi regime, the Saudi elite had already recycled a large chunk of their petrodollars to the West. They also did

not seek to maximise oil prices at the expense of jeopardising their market share in the long term. These factors persuaded the US administration to approach Saudi Arabia to lower the oil prices and break the OPEC cartel (Milani, 2011, Afkhami, 2009). Subsequently, by flooding the market oil market with extra production in 1977, Saudi Arabia managed to replace Iran as the principal partner of the US in the Gulf region.

The above analysis reveals that the Shah's refusal to lower oil prices and recycle petrodollars to the West during the Fifth Plan created serious frictions in the US-Iran relations and gave the opportunity to Saudi Arabia to divert US support away from Iran towards herself.

Conclusions

This chapter shows that 1973 oil boom, which was partly instigated by Iran, motivated the Pahlavi elite to leap further down the path of ISI deepening, hence following an excessively expansionary macroeconomic policy. This policy generated inflation and a large fiscal deficit from 1974. Despite this instability, the Pahlavi elite refused to empower the macroeconomic policymaking institutions and shift towards fiscal and monetary prudence. This was because the geopolitical and legitimacy costs of slowing the ISI had become so high; the Shah had already promised to turn Iran into an industrial nation in less than a decade and he had also started a series of grandiose industrial projects that were of high geopolitical importance such as military and nuclear industries. At the same time, the state faced no pressure from the private sector for a policy reversal since the industrialists neither had the power, nor the incentive, to lobby for macroeconomic corrections. Due to these reasons, the Pahlavi regime decided to stick with its policy of ISI deepening and, accordingly, focused on raising oil prices in OPEC to close the fiscal gap during the Fifth Plan. This policy persistence resulted in the further political marginalisation of the CB and PBO and poor fiscal and monetary choices throughout the Fifth Plan.

In addition to breeding macroeconomic indiscipline, Pahlavi's policy rigidity had a negative impact on Iran's geopolitical relations. The continuation of the Fifth Plan required Iran to follow a hawkish stance in OPEC and also spend her petrodollars domestically rather than recycling them abroad. These policies created tension between Iran and the US as they were against the economic interests of the latter. Moreover, the elite's insistence on the industrialisation push also created a tension in the state-business relationship. The state massively increased its economic support for family conglomerates as part of its "Big Push" drive, but in return, it imposed harsher price

controls on them to discipline their behaviour more than before. This policy damaged the confidence of the private sector and resulted in capital flight at the later stages of the Fifth Plan. However, despite these domestic and geopolitical tensions, the political elite preferred not to slowdown the growth momentum and finish their vast industrial projects. Ultimately, this path of ISI deepening was disrupted in 1977 due to a drop in Iran's oil revenues. This path disruption led to economic decline and social instability in 1978 and set the stage for the eventual downfall of the Pahlavi regime in 1979.

Overall, the analysis provided in chapters four, five and six reveals that as the political elite moved further down the path of ISI deepening, they became more reluctant to change this policy despite its negative side effects on macroeconomic stability. This insistence on ISI deepening, in turn, led to the increasing subordination of macroeconomic policymaking to industrial policymaking over time and resulted in growing fiscal and monetary indiscipline. This shows that Iran's poor macroeconomic choices after the boom were caused by the self-reinforcing process of ISI deepening that had been underway since 1963.

Chapter Seven: Indonesia

Indonesia is often known as the country that came up with best macroeconomic responses to the 1973 oil boom (Gelb, 1988; Usui, 1997; Warr, 1986; Pinto, 1987; Temple, 2003). This chapter argues that those policy responses were to a great extent shaped by the economic path that the New Order regime had been following in the 1960s. The first section of the chapter outlines the logic behind choosing Indonesia as a comparative case for Iran. Section two provides a brief historical background on state evolution in Indonesia. Section three concentrates on the period between 1960 and 1965, when the Indonesian economy was destabilised by a growing balance of payments deficit. As will be explained, this economic crisis led to a major political upheaval and gave birth to the “New Order” regime. Section four then examines the politics of economic policymaking inside this regime from 1965 to 1972 (the pre-boom period). Finally, section five explores the politics of economic policymaking after the 1973 oil shock.

7.1. Comparing two similar cases with different policy choices

When the oil prices hiked in 1973, both Iran and Indonesia had autocratic rentier states that were OPEC members and shared close geopolitical ties with the US. However, despite these similarities, the two regimes reacted differently to the 1973 oil shock, especially in terms of their macroeconomic policy choices.

To be sure, the magnitude of oil windfall was very different in the two countries; in Iran, oil exports amounted to 46% of GDP in 1974, compared with 20% in Indonesia (Amouzegar, 2001). Also, Indonesia’s petroleum exports in 1974 were four times

smaller than Iran while her population was four times bigger³⁵ (ibid). Nevertheless, as motioned in the methodology chapter (section 2-2), the quadrupling of oil prices in 1973 *still* amounted to a big shock to the Indonesian economy; by the peak of the boom (1974), oil accounted for 71% of export earnings and more than 50% of the government revenues (Warr, 1986).

Like Iran, Indonesia embarked on a massive fiscal spending program in the immediate aftermath of the shock. This translated into sudden hikes in expenditures in 1973 and 1974. Importantly however, from 1975 onwards, Indonesian policymakers steadily reduced the growth of expenditures both in nominal and real terms, while as previously mentioned the Iranian policymakers followed a very volatile pattern of expenditures (Table 7-1 & Table 7-2). In addition, unlike their Iranian counterparts, the Indonesian technocrats refrained from deficit spending and ran budget surpluses during the 1973-1977 period (Table 7-3). Accordingly, they managed to increase the government savings from 3.2% of GDP in 1973 to 6.1% in 1978 (Bevan et al, 1999).

³⁵ One might argue that the reason Indonesia came up with relatively prudent macroeconomic responses to the boom was because the size of her oil revenues was very small in relation to the size of her population. In such a situation, it can be claimed that social actors have a lower incentive to form interest groups and engage in rent seeking because the size of external revenues is not large when divided among group members. However, the problem with this argument is that it only focuses on actors that are operating outside of the state. Indeed, as argued by Ross (2001b), the resource booms can still give a lot of incentive to the limited number of actors who are operating inside the state to engage in rent seeking and weaken policymaking institutions that are responsible for allocation of resource rents.

Table 7-1: Nominal increase in government expenditures

	Iran	Indonesia
1971	22%	17%
1972	26%	36%
1973	33%	57%
1974	125%	70%
1975	35%	38%
1976	12%	34%
1977	30%	16%
1978	-25%	18%

Source: Central Bank of Iran, Bank Indonesia, Annual reports, various issues.

Table 7-2: Real increase in government expenditures

	Iran	Indonesia
1971	17%	13%
1972	20%	29%
1973	22%	26%
1974	110%	30%
1975	25%	19%
1976	-4%	30%
1977	21%	6%
1978	-15%	10%

Source: Central Bank of Iran, Bank Indonesia, Annual reports, various issues.

Table 7-3: Public revenues & expenditures in Indonesia

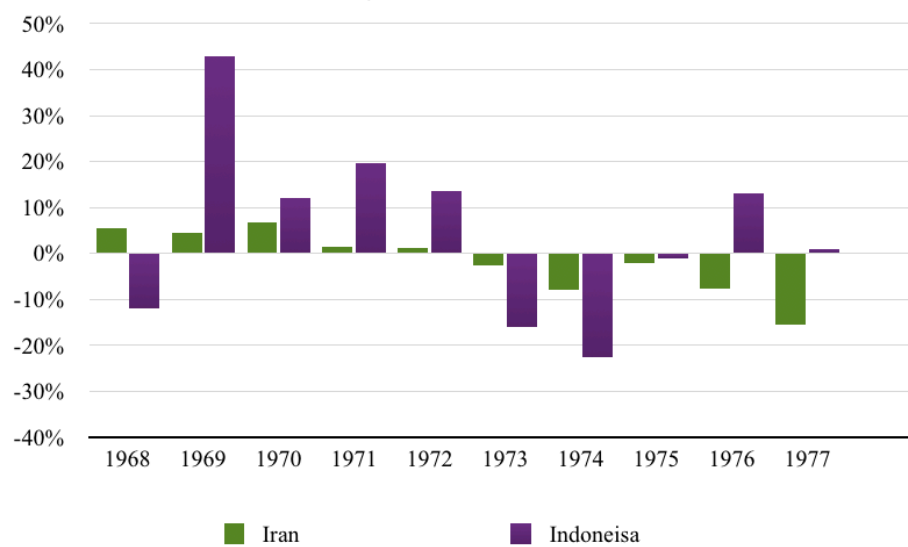
	1970	1971	1972	1973	1974	1975	1976	1977
Revenues	464	557	748	1170	1986	2734	3690	4309
Expenditures	457	539	736	1163	1978	2731	3684	4306
Balance	7	18	12	7	8	3	6	3

(Billion rupiahs)

Source: Bank Indonesia, Annual reports, various issues.

In monetary policy, due to the underdevelopment of their money markets and banking sector, both Iran and Indonesia relied on non-market instruments such as reserve requirements, rate ceilings and lending quotas to control the liquidity in the economy (Booth, 1992; Mehran, 2013). At the same time, they followed an open capital account and a fixed exchange rate policy (the rupiah and the rial were both pegged to the dollar). After the shock, initially, the two countries followed a similar monetary policy by engaging in the excessive expansion of credit. Crucially however, from 1975, the Indonesian technocrats employed aggressive credit quotas on their banks and increased interest rates to limit liquidity growth and avoid the emergence of real negative interest rates (Figure 7-1). In contrast, as pointed out in the previous chapter, the Iranian policymakers did not wholeheartedly apply credit limits on their banks and failed to increase the interest rate in par with inflation. Overall, unlike their Iranian counterparts, the Indonesian technocrats showed a firm commitment to taming the liquidity growth, as illustrated in Table 7-4. Thanks to this commitment, between 1973 and 1977, liquidity increased by a much smaller magnitude in Indonesia (285%) than in Iran (400%) (Central Bank of Iran, 1978; Bank Indonesia, 1978).

Figure 7-1: Real interest rates



Source: Central Bank of Iran, Bank Indonesia, Annual reports, various issues.

Table 7-4: Liquidity growth

	Iran	Indonesia
1970	14%	37%
1971	25%	50%
1972	35%	40%
1973	29%	56%
1974	56%	31%
1975	39%	42%
1976	31%	25%
1977	23%	15%

Source: Central Bank of Iran, Bank Indonesia, Annual reports, various issues.

Moreover, the two regimes also reacted differently in terms of exchange rate policy. Figures 7-2 and figure 7-3 capture the real value of the rupiah and rial respectively against the dollar. Initially, both countries experienced real exchange rate appreciation between 1973 and 1976 due to growing inflation and a fixed nominal exchange rate. This entailed a decline in the competitiveness of their tradable sectors ('Dutch disease'). However, in 1977, Indonesian policymakers decided to reverse this trend by depreciating the rupiah by 50% against the dollar to protect the competitiveness of their domestic tradable sector, while the Iranian technocrats failed to make any adjustments to their currency and, as a result, the rial remained overvalued. The more advanced empirical research conducted by Amouzegar (1991), Salehi-Esfahani and Pesaran (2008), Warr (1986) and Usi (1997) on real exchange rates in Indonesia and Iran also confirms this policy divergence.

To summarise, both the Pahlavi and New Order regimes initially reacted in a similar manner to the shock by conducting excessively expansionary fiscal and monetary policies. However from 1975, the New Order Regime reversed its policies and promptly made necessary fiscal, monetary and exchange rate adjustments to stabilise Indonesia's economy while the Pahlavi regime failed to do so.

This policy divergence, in turn, led to notable differences in economic outcomes: Indonesia managed to tame inflation more quickly than Iran (figure 7-4) and more importantly, achieve a stable economic growth, while Iran experienced a very volatile growth rate in the 1973-1977 period (figure 7-5). The purpose of this chapter is to explain the Indonesia's macroeconomic policy responses to the boom.

Figure 7-2: Rupiah/dollar Real Exchange Rate Index

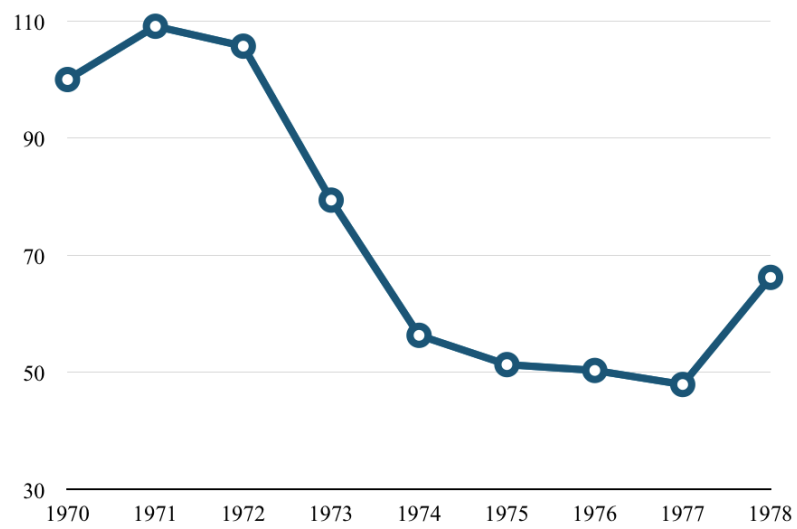


Figure 7-3: Rial/dollar real exchange rate index

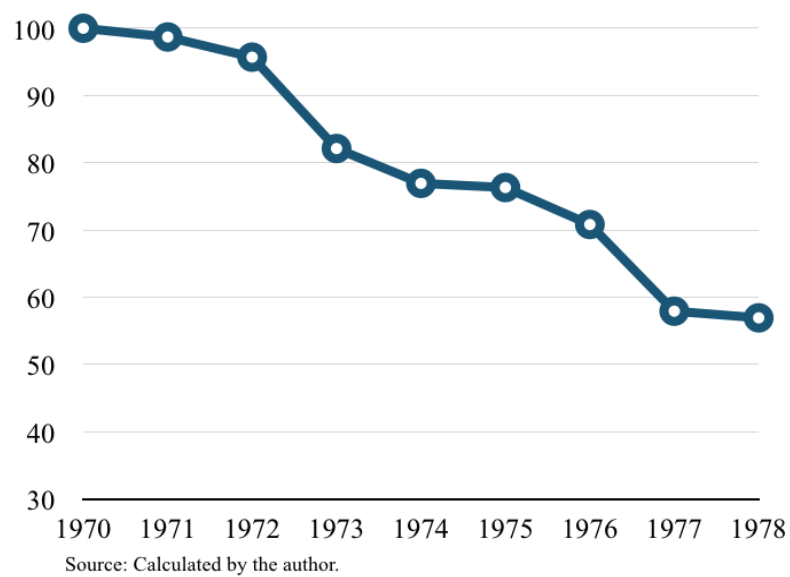
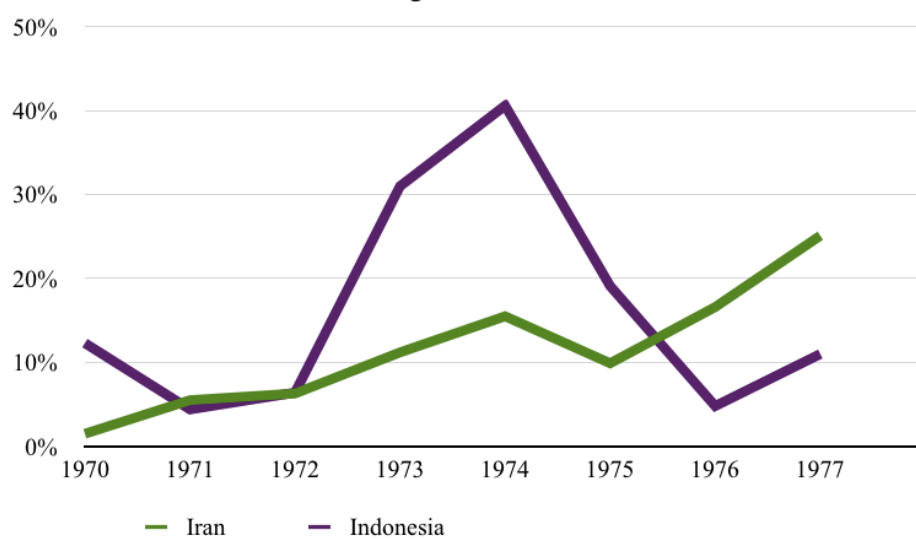
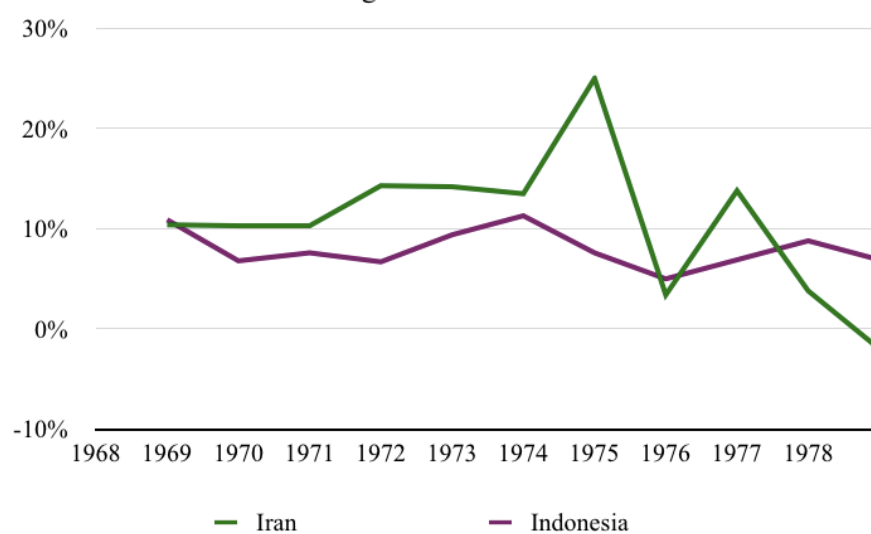


Figure 7-4: Inflation



Source: Central Bank of Iran & Bank Indonesia, annual reports & WDI (2015).

Figure 7-5: GDP Growth



Source: Central Bank of Iran and Bank Indonesia, Annual reports, various issues.

7.2. State formation

This section offers a descriptive history of state formation in Indonesia. The aim of this history is to help us better understand the economic behaviour of the New Order regime in the 1960s and 1970s.

Unlike Iran, the emergence of modern state in Indonesia was highly influenced by colonialism. The country was known as the Dutch East Indies when it was a colony of the Netherlands. The main goal of this colonialism was the extraction of raw materials. Accordingly, the Dutch controlled plantations, agricultural estates, trade and shipping in the country (Bevan *et al*, 1992) and established commercial relations with the local merchant class, which was mainly composed of Chinese settlers, and the landed elite. Subsequently, oil was discovered in 1880 and its export monopoly was eventually given to Royal Dutch Shell. Naturally, this “extractive” form of colonialism (Acemolgu *et al*, 2001), reduced the incentive of the Dutch to heavily engage in state-building. Their institutional development focused on military training and rudimentary educational reforms.

This colonial order was disrupted by World War II. After the war, the pro-independence forces inside the country gained the opportunity to mobilise mass support. The Indonesian National Party (PNI) and the Indonesia Communist Party (PKI) were at the heart of this mobilisation (Rosser, 2007). Eventually, this anti-colonial movement, which was headed by the nationalist leader Sukarno, resulted in Indonesia’s independence in 1949. After independence, a fragile democracy was born in 1950 and Sukarno was elected as president (Bevan *et al*, 1992). Upon assuming power, he projected a unified national identity to bridge the ethnic, religious and regional divides that existed in the country. At the time of independence, landlords and Chinese

merchants, who controlled trade and the production of consumer goods, represented the most economically established social classes (ibid). To counteract these social forces, the communist party (PKI) started to mobilise support among the peasantry and urban poor. Thanks to this strategy, this party soon became a powerful player in the new democratic system (ibid). However, this system proved to be very fragile as no single party could take hold of power because of the high level of ethnic and regional diversity in the country. Frustrated by this political impasse, Sukarno proclaimed emergency rule in 1957 with the support of the army and PKI and established an autocracy under the banner of “Guided Democracy” (ibid).

7.2.1 “Guided Democracy” (1957-1965)

This autocracy was formed out of an uneasy political coalition between the army on the one hand and nationalist and communist forces on the other hand (ibid). In terms of foreign policy, this regime established relationships with both the East and the West in the Cold War; the army received economic and military aid from the US while communist and nationalist forces relied more on the support of Soviet Union.

Other than supporting the army, the US trained the first generation of Indonesian technocrats during this period to shape the development thinking in the country and “win the long-term struggle for Indonesian mind”, to use the words of American ambassador (Simpson, 2008: p18). At that time, the country was in dire need of economic experts; in 1956 only fifteen Indonesians had pursued advanced economic studies. Accordingly, with the financial support of the Ford Foundation, various exchange programs were established between the Faculty of Economics at the University of Indonesia and economics departments at Harvard, Berkley, MIT and Cornell (Booth, 2005; McIntyre, 2000). Also, various research centres were created in

these universities to study Indonesia's economic problems (ibid). These efforts gave rise to a young group of technocrats, who were highly influenced by the modernisation doctrine (Simpson, 2008). Viewing this training policy as a long-term investment, the President of the Ford Foundation's International Division noted that "you cannot have a modernising country without a modernising elite" (Simpson, 2008: p227). These technocrats were described by the US diplomats as "first rate", "capable", "energetic" and with a "clear sense of urgency" (Simpson, 2008: p219). Subsequently, the National Development Planning Agency (BAPPENAS) was formed in 1959 with the US technical support (ibid). This agency became one of the main destinations for the young technocrats. The Central Bank of Indonesia (BI) was the other destination for the technocrats; this bank was created in 1953 out of a commercial bank that had been set up in the colonial era (Bevan *et al*, 1999). Overall, thanks to the technical assistance supplied by the US, two technocratic institutions were built in Indonesia.

Importantly however, these institutions enjoyed little influence over policymaking as they ideologically and politically clashed with Sukarno (Simpson, 2008). Following the modernisation theory, the technocrats believed in the role of the private sector and free trade in economic development, while as a nationalist, Sukarno was a firm believer in heavy state intervention and import-substitution industrialisation (ibid). Also, the technocrats were politically associated with the army and the US whereas Sukarno was more inclined towards the PKI and the Soviet Union. These factors urged Sukarno to politically marginalise the technocrats.

Alternatively, Sukarno followed a radical nationalist economic policy. As a first step, he nationalised almost every foreign firm, especially the Dutch ones, which were active in trade and agricultural production (Bevan *et al*, 1999). This policy resulted in the transfer of ownership of 90% of plantation output, 60% of trade, some 246 factors and mining

enterprises from foreign firms to the state (Robison, 1986). The Dutch oil companies were also nationalised and three state enterprises were created out of them (Pertamin, Permina and Permigan) (ibid). However unlike other sectors, the petroleum sector was not entirely closed off to foreign companies. Overall, this nationalisation policy encouraged the widespread entry of the army into the economy; the generals even took control of the state-owned oil company. Alongside this policy, Indonesia started protectionism and investment in heavy industry from the late 1950s; state enterprises, rather than private ones, were the main agents of this industrialisation projects (ibid). Similar to Iran, Indonesia sought technical help from the Soviet Union to build a steel mill and other state investment projects that included shipbuilding and fertiliser production (ibid). Naturally, the World Bank advisors were opposed to these projects as they did not conform to the country's comparative advantage (Simpson, 2008). Alongside this industrialisation project, the state attempted to create an indigenous merchant class through the transfer of import monopolies and credit subsidies. The main goal behind this policy, which was labelled as the "Benteng Program", was to eventually replace the Chinese businessmen with an "Indonesian" merchant class (Bevan *et al*, 1999). Finally, Sukarno and the PKI made several attempts to introduce a large-scale land reform in the country to enlist the support of the peasantry. However, the landed elite managed to block this reform during the later 1950s and early 1960s (Robison, 1986).

To summarise, Sukarno's regime followed a highly nationalist and statist economic policy that gave priority to economic self-sufficiency. The main losers of this policy were multinational companies as well as the landlords and Chinese merchants, who constituted two of the most entrenched classes in the society (ibid).

7.3. The crisis period (1960-1965)

Typically, Indonesia's drive towards heavy industries caused a large fiscal and current account deficit from 1960. As a response, the government resorted to deficit financing, which in turn generated runaway inflation. As a response, very restrictive price controls were introduced on agricultural and consumer goods (Bevan *et al*, 1999). This situation created an internal conflict over economic policymaking. On the one hand, the technocrats and US advisors emphasised the need for austerity, devaluation and the removal of price controls (Simpson, 2008). The army also moved towards this camp to ensure the continuation of aid flows from Washington. On the other hand, Sukarno and the PKI stressed further support for domestic production and self-sufficiency as a long-term solution for the crisis (*ibid*). As the economic situation worsened, the fiscal deficit reached 62% of revenues in 1962 and, in effect, the IMF bailed out the Indonesian government (Bevan *et al*, 1999). This bail out, which was linked to a harsh austerity package, polarised Indonesian politics. This package became under attack from nationalists and communist for inflicting unnecessary pain on the poor.

Importantly, Sukarno started to move further away from the army and get closer to the PKI. This leftward slide was motivated by geopolitical events in the region; during that period, diplomatic tensions arose between Indonesia, the UK and Netherlands over the independence of Malaysia. Capitalising on this diplomatic crisis, Sukarno, like the PKI, adopted a very anti-Western and nationalist foreign policy to gather support at home. Subsequently, as a reaction to the UN's support for Malaysia, Sukarno withdrew Indonesia from this organisation (Simpson, 2008). This policy convinced Washington to reduce its aid flows to the country and lift its economic support for the on-going austerity package. Expressing his frustration about these events, Walt Rostow

emphasised “that Sukarno could not bring himself to settle down on modernisation of Indonesia and let the matter of Malaysia be dealt with peacefully” (Simpson, 2008: p123). Amidst these diplomatic tensions, Indonesia also experienced a severe negative terms of trade shock as commodity prices fell in global markets. The combination of this shock and dwindling aid flows worsened the fiscal deficits between 1962 and 1965 and forced the government to print even more money. Accordingly, inflation rose from 156% in 1962 to 594% in 1965 (Hill, 1996).

This hyperinflation caused riots and food shortages across the country and further destabilised the political coalition inside the state. Reacting to this social and political instability, the army, headed by General Suharto, staged a successful military coup against Sukarno and the PKI in 1965 and seized power. This military coup gave birth to the New Order Regime. Once in power, the army started to brutally suppress the PKI and nationalist forces (Liddle, 1985). This led to the massacre of more than 500,000 communists and opposition figures (Simpson, 2008). After the consolidation of power, the new regime immediately ended the hostility with Malaysia and adopted a pro-Western foreign policy. Also, the radical nationalist rhetoric of Sukarno was pushed aside in favour of pragmatism (ibid). Naturally, as counter-revolutionary classes, the landed elite and Chinese merchants welcomed this political change (Rosser, 2007). Therefore, in a way, the rise of the New Order regime marked the change of political and economic power from communist and nationalist forces to counterrevolutionary forces, namely the army, landlords and Chinese merchants. As will be explained, this political change entailed a dramatic shift in Indonesia’s economic policies.

7.4. The politics of economic policymaking before the boom (1965-1972)

When Suharto seized power, Indonesia's economy was crippled with hyperinflation, food shortages and a high level of foreign debt. In this situation, Suharto gave priority to combatting inflation to consolidate his regime and accordingly empowered the technocrats to manage the economy. The main technocrat, who assumed the leadership of economic policymaking was the Director of Bappenas, Widjojo Nitisastro. He attributed Indonesia's soaring inflation and widening current account deficit to the lack of macroeconomic discipline and excessive intervention in the economy. In a speech given at University Of Indonesia, he mentioned (Nitisastro, 2011: p28):

“For years, the government expenditure has always exceeded its revenues. The gap has been plugged with printing money...for years, the government's foreign exchange expenditures has far exceeded its export earnings. The gap has been closed by foreign debts. Denial of this simple principle will clearly have logical consequences. And we are currently suffering from these consequences...if we don't pay attention to our economy, if we let our expenditures swell without harmonising it with comparable revenue, and if the flow of money gets bigger everyday, but the flow of goods cannot cope with a corresponding speed, sooner or later people will suffer”.

Correspondingly, he prescribed a shift towards macroeconomic prudence and a free market economy. In 1966, the technocrats went “from one meeting to another...with the same message. The economy is in really bad shape and strong measures need to be taken to rescue it” (Simpson, 2008, p: 219). They sought to create a consensus around the urgency of austerity and free market reforms. At the same time, the US embassy sent clear signals to the army generals that “Indonesia would not get aid until they went the way the economists advised” (Simpson, 2008: p219). This external pressure together with rising inflation, urged Suharto to shift economic policies towards a new path.

7.4.1 Macroeconomic policymaking

From 1966 onwards, under the guidance of technocrats, Indonesia followed a harsh austerity package and removed many of its trade restrictions and price controls (Bevan *et al*, 1999). In terms of fiscal policy, major cuts were introduced and many grand industrial projects of the previous regime were cancelled. More importantly, a “balance budget rule” rule was devised (Booth, 2005; Hill, 1996; Liddle, 1991). This rule, which strictly banned the government from running a budget deficit, signalled the commitment of the New Order regime to fiscal discipline. In terms of monetary policy, interest rates were raised from 6% to 9% and a reserve requirement of 30% was enforced on banks together with severe credit restrictions (Bevan *et al*, 1999). Some of the state-owned banks were also dismantled to clean up the banking sector. Multiple currency rates were removed and the rupiah was floated, which resulted in a depreciation from 85 per dollar in 1966 to 325 in 1968 (*ibid*). These macro policies were accompanied by removal of price controls at the micro level.

In the meantime, Walt Rostow lobbied the Johnson administration for increased aid to the New Order regime in order to financially support the stabilisation program. He wrote to the president that the Indonesian government was “working hard for the people...by pursuing a pragmatic policy” (Simpson, 2008: p238). Subsequently, an Inter Governmental Group on Indonesia was formed by the US and other Western countries to supply aid to the new regime. In parallel to this group, the US provided ample food assistance to prevent possible rice riots in the country. Thanks to these policies, the supply of aid to Indonesia resumed. Praising the impact of these aid flows on the stabilisation policy, the US ambassador wrote: “Our timely economic assistance has strengthened the hands of Indonesia's “modernizers”” (Green, FRUS, 1968).

Moreover, in order to attract foreign capital and improve the country's foreign exchange position, the New Order regime followed a very liberal attitude towards foreign investment. As a first step, it returned some of the foreign companies that were nationalised under Sukarno to their original owners (Robison, 1986). Secondly, and more importantly, it introduced the Foreign Capital Investment Law No1 in January 1967 (ibid). This law made it clear that the government had no intention to nationalise foreign assets and guaranteed compensation payments to investors in case of such an event. It also gave full authority to foreign firms to select their own management staff and freely transfer their profits out of the country (ibid). This liberal investment regulation was then followed by the Domestic Capital Investment Law of July 1968. This law gave similar concessions to domestic investors and signalled that the army was willing to rely on the domestic private sector, which was primarily composed of the Chinese merchant class, for economic development (ibid). While passing this law, Suharto also gave a green light to the army to form business alliances with the merchant class and become involved in trade and production. Expressing his pro-business attitude, he announced (Chalmers and Hadiz, 1997: p54):

“I feel it necessary now to speak with you directly about the policies that have been adopted by the government, because I know that development is not something that happens just because of a “command”. Development can only succeed if the people work enthusiastically and participate in implementing development. Greater freedom for business means that society will develop more initiative, creativity and responsibility... The government emphasises market forces, but will not surrender to the free play of such forces. The government feels that it is responsible for constantly supervising and controlling the factors and circumstances, which influence market forces”.

Unsurprisingly, Suharto's economic team was criticised by a fraction of the army for introducing harsh fiscal cuts and also for favouring foreign capital. Despite these criticisms, Suharto did not lift his support for the technocrats and their economic

policies (Hughes, FRUS, 1968). As reported by the US ambassador, by 1967 Suharto “had come to accept the need for foreign investment as principal means for developing outer islands, and, by that time, he had come to subscribe fully to stabilization program as backbone of national economic policy” (Green, FRUS, 1967). Accordingly, he protected the economists from any influence peddling from the army, especially from his personal inner circle. Reflecting on this support, the US embassy reported “A further earnest of the government's interest in economic development and its willingness to seek popular support is the curtailment of some of the powers of President Suharto's much-criticized private staff” (Hughes, FRUS, 1968). Additionally, the technocrats enjoyed the full support of the US; Ambassador Green believed that the US had to “continue to promote the modernizer-staffed Bappenas as the agency most directly responsible for economic development” (Green, FRUS, 1968). He added:

“perhaps the best single way of ensuring that an American program will be adjusted to the Indonesian environment is to work through the so-called “third culture,” that is Indonesians who have gained a broad knowledge of our culture and yet retain accredited membership in their own. This type of person, most prominently represented by General Suharto's team of economic advisors, can serve as invaluable mediators between the two cultures”.

In time, the monetary and fiscal cuts introduced by the technocrats bore fruit as the current account deficit was brought under control and inflation fell from 635% in 1966 to 84% in 1968 and then to 17% in 1969 (Bevan et al, 1999, Hill, 1996). This fall in inflation was a great political victory for the macroeconomic policymaking institutions (Bank Indonesia and Bappenas). Importantly, after the termination of stabilisation program, the New Order regime remained committed to macroeconomic prudence and continued to consider price stability rather than “catch-up development” as its main priority. This is because the hyperinflation years of the Sukarno era had instilled a fear of inflation among the political elite; they worried that in case of high inflation, their

regime would be similarly toppled (Temple, 2003; Bevan *et al*, 1999; Smith, 2007). As a result, they let the macroeconomic policymaking institutions to retain their power and ensure fiscal and monetary discipline. This continuing commitment of the regime to macroeconomic stability was clearly expressed by the Director of Bappenas in a Financial Times article (Nitisastro, Financial Times, 1968):

“...the revival of confidence has been one of the chief objectives of the Suharto government. In order to achieve this object the Government has itself the following four tasks: 1. To control inflation and restore confidence in Rupiah 2. To restore Indonesia productive capacity 3. To re-establish sound “rules of the game” in the domestic economy. The new policies place more reliance on market forces, although the government still directs the economy, it prefers to do so indirectly, relying mainly on private initiative in the various sectors”.

Accordingly, in terms of fiscal policy, Bappenas followed the “balance budget rule” and avoided deficit spending between 1968 and 1972³⁶. This was mainly due to growing revenues from oil and aid, which together constituted about than 50% of total revenues (Hill, 1996). In the realm of oil policy, the government strictly focused on increasing its production and accordingly experienced a steady growth in its revenues from \$298 million in 1966 to \$913 million in 1972 (Booth, 1992). Although a member of OPEC, the country had no influence over the pricing of oil due to its tiny market share. In terms of monetary policy, Bank Indonesia liberalised the capital account and pegged the rupiah against the dollar. The rationale behind this liberalisation was to enforce macroeconomic discipline on the government through freeing up inflows and outflows of foreign capital (Hill, 1996). It was believed that the threat of capital outflows would pressure the political elite not to print too much money or accumulate a lot of foreign debt (ibid).

³⁶ The fiscal surplus accounted for 3% of GDP on average between 1968 and 1972 (IBRD, 1973).

Overall, considering economic stability as its main priority, the New Order regime gave a lot of authority to macroeconomic policymaking institutions between 1966 and 1972.

7.4.2 Sectorial policy

In 1969, the policymakers introduced the First Five-Year Development Plan (Repelita 1969-1973). The main goal of this plan was agricultural development and promoting self-sufficiency in food, especially in rice production³⁷ (Anonymous, FRUS, 1968; Connally, FRUS, 1971). At that time, the agricultural sector dominated the economy. Table 7-5 outlines the sectorial composition of GDP in Indonesia and Iran in 1968. Indonesia was a predominantly agrarian economy that enjoyed a much lower income per capita (\$299) than Iran³⁸ (\$2,788) (WDI, 2015). Her industrial production was also heavily geared towards agriculture-related sectors; for instance, the 1964 Industrial Census indicates food, beverages and tobacco accounted for 53% and 44% of total industrial output and employment respectively (Hall, 1997). This shows the high reliance of industrial sector on agricultural development.

Table 7-5: Sectorial composition of GDP in 1968

Sectors	Indonesia	Iran
Agriculture	51.4%	20%
Oil	4.6%*	24.4%
Manufacturing	8.2%	13.9%*
Construction	1.8%	4.4%
Trans & communication	3.2%	6.3%
Domestic trade	15%	7.2%
Banking & insurance	0.8%	3.1%
Services	5.9%	13.3%
Rest	9.1%	7.4%

Source: IBRD (1974, 1973).

*Includes mining

³⁷ The government set the goal to become self-sufficient in rice production by 1975 (IBRD, 1973).

³⁸ The income per capita figures are in constant 2005 prices.

So given this economic structure, the Indonesian policymakers naturally put a lot of emphasis on agricultural development. Accordingly, in his 1968 speech at University of Indonesia, the Director of Bappenas stressed that “Agricultural sector will play a central role in Repelita, with primary attention being paid to food production” (Nitisastro, 2011: p106). He then spelled out the reasons behind this priority by talking about structural features of the Indonesian economy and experiences of other countries (Nitisastro, 2011: p106):

“(1) Indonesia’s production is for the greater part agricultural production, so that promotion of this sector will greatly contribute to an increase in overall production nationally. (2) The majority of Indonesian people work in the agricultural sector, so that improvement of this sector will promote the livelihood of most of the population. (3) Any increase in agricultural production also constitutes one of the important sources of export promotion”. In the end, he added “Development experiences in other countries have taught us prioritising industry- as in India and the People’s Republic of China (when they undertook their first five-year development plans)- does not live up to expectations, whereas the prioritisation of agriculture- as in Pakistan and other countries- has been fruitful”.

As intended, the agricultural sector absorbed the largest share of development expenditures (19%) in Repelita I, with fertiliser subsidies accounting for the bulk of these expenditures (IBRD, 1973, 1971b). In line with this policy, export restrictions on agricultural goods were removed. Politically, this sectorial preference signalled the new alliance formed between the regime and the landed elite; in fact, one of the objectives of this pro-agricultural policy was to contain the influence of communist forces in rural areas and block the resurgence of the PKI³⁹. The technocrats also favoured the development of light manufacturing such as textiles and handicrafts and industries that were related to agriculture, such as fertiliser production and timber and rubber

³⁹ The Indonesian Foreign Minister explained the political rationale behind the five-year plan to the US Secretary in the following way: “In the three years of the new government, the GOI has broken the hold of the PKI on the country and [if] the five-year plan is successfully achieved, this will lessen substantially the capability of the PKI to return to power” (Anonymous, FRUS, 1969).

processing, because these sectors conformed to the country's comparative advantage (ibid). Although no growth target was specified for the plan, the planners hoped that the growth rate would be in the order of 5%- slightly ahead of the projected population increase (Dicks, Financial Times, 1969). Also as firm advocates of free trade, the technocrats believed that Indonesia had to follow its comparative advantage and avoid diversification into heavy industries.

However, it is critical to add that the authority of the technocrats in economic policymaking was not uncontested in this period. As mentioned, the planners had many opponents inside the state due to their influence. Pertamina⁴⁰, the state-owned oil company, was their main opponent (Robison, 1986). The economic activities of this company, which was packed with generals, went far beyond the petroleum sector. Operating as a giant industrial conglomerate, Pertamina was involved in the steel, cement, chemicals and aluminium industries as well as in construction and the hotel industry (ibid). In contrast to the technocrats, the Pertamina generals advocated economic nationalism and, on this basis, they lobbied for diversification towards heavy and strategic industries. To accommodate the economic interest of these generals, Suharto allowed Pertamina to follow its desired economic policies in a limited scale. For instance, he let the company borrow from abroad and expand its domestic economic activities without the supervision of Bappenas and Bank Indonesia. However, these economic activities were kept marginal in Repelita I, as indicated by the small share of expenditures (7%) devoted to the industrial sector (IBRD, 1973).

⁴⁰ Pertamina was created in 1968 out of the merger of three state-owned companies (Pertamin, Permina and Permigan). Headed by General Ibnu Sutowo, this company acted as "state within a state" and did not share information about oil revenues with ministers or the public (Robison, 1986). To be sure, several attempts were made to improve its transparency and accountability in the early 1970s. For instance, in May 1972, the economic activities of this company were officially placed under the supervision of a committee that included the Ministry of Finance, Ministry of Mining and Bappenas. But in practice this reform did not produce any tangible change (ibid). Later, under pressure from the IMF, its long-term foreign borrowing was put under the supervision of Bank Indonesia. However, Pertamina bypassed this reform by switching to short-term foreign borrowing and roll-over loans (ibid).

Overall, between 1966 and 1972, the New Order followed a non-interventionist economic policy that prioritised price stability and agricultural development rather than “catch-up industrialisation”. Thanks to this policy, the government was able to reduce inflation from 635% in 1966 to 9.4% in 1972 (Hill, 1996). At the same time, the economy grew by 6.8% annually in this period, which was 2% above the intended target (IBRD, 1973). Agricultural output expanded by 6.4% and specifically, rice production increased by 4.5% annually, which was in tune with population growth (IBRD, 1973; Bevan *et al*, 1999). Industrial output increased by 9%, with consumer goods accounting for 80% of total production (IBRD, 1973). These results amounted to an economic success for the New Order regime⁴¹.

⁴¹ After assessing Repelita I, the World Bank concluded: “The government's efforts during the First Five-Year Plan period were highly successful in putting the economy on the road towards development. Most physical objectives were achieved or nearly so, and there was very substantial rehabilitation of run-down infrastructure, and of government enterprises in agriculture and manufacturing” (IBRD, 1975: pi).

7.4.3 Spillover effects

This subsection shows that the success of the economic path chosen by the army in 1966 led to the further entrenchment of this path by having spillover effects on the internal power structure, class coalitions and geopolitical relations of the New Order regime.

Most importantly, the success of the stabilisation program and Repelita I enabled the army to keep its monopoly on power inside the state and avoid a resurgence of the nationalist and communist forces (Rosser, 2007). In effect, the quick and steady reduction in inflation together with high agricultural growth allowed the New Order regime to consolidate its power and brutally suppress the opposition groups, especially PKI (ibid). Secondly, the recovery in trade together with improvements in agricultural and industrial production solidified the political and business alliance created between the army on the one hand and the Chinese merchants and landlords on the other hand (Robison, 1986). During this period, several conglomerates flourished out of ventures made between the army and Chinese businessmen. These military-private conglomerates included Diponegoro Associated Companies, TUB Group (Tri Usaha Bhakti), Kostrad Business Group and P.T Propelat Group. They were active in agricultural estate, forestry, logging and light industries (ibid). The management of these companies was in the hands of Chinese businessmen (ibid). However, the main side effect of this flourishing alliance between the Chinese capitalists and the generals was the growing disenchantment of the indigenous merchants and capitalists, who were less economically competitive than their Chinese counterparts. This neglect of indigenous capitalists by the government fanned criticisms of the technocrats from various social circles. For instance, inspired by economic nationalism, student activist groups accused Suharto's economic team of "selling the country" to non-indigenous

business groups and foreign firms, especially Japanese ones (Hansen, 1975). These nationalist sentiments were also echoed by many academics and intellectuals. Notwithstanding these criticisms, the technocrats and the army continued to favour Chinese capitalists and foreign firms because of their access to technology and management skills and superior economic efficiency.

Finally, the stabilisation of the economy had important geopolitical implications for Indonesia and the American empire. The rise and consolidation of the New Order regime amounted to one of the few Cold War victories of the US in Southeast Asian front, which in the 1960s and early 1970s was the most important battleground for the superpowers. Although officially a member of the non-aligned movement, in practice, Indonesia was a US ally and a fiercely anti-Communist regime.

Once in power, the New Order regime proved to be an economically competent regime in a very unstable region (thanks to the crucial role played by the technocrats in economic policymaking). This resulted in growing inflows of aid from the Western donors. The archival documents show that by 1968 Indonesia had managed to gain credibility in the donor community due to its competent economic team (Galbraith, FRUS, 1968).

For instance, a State Department report mentioned (Katzenbach, FRUS, 1967):

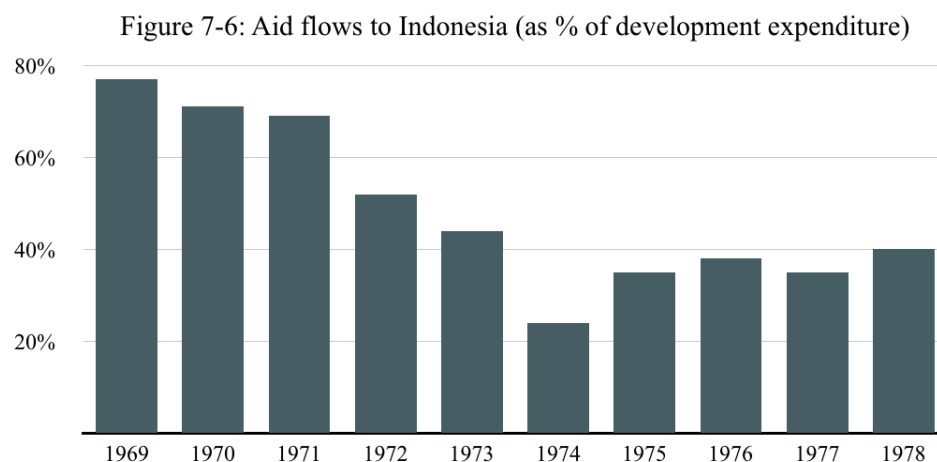
“Indonesia's primary asset in dealing with international community is support of International Monetary Fund. This support stems in turn from confidence this international organization has in economic team that developed and is now executing New Order economic policy. Performance Indonesian team at Scheveningen meeting continued very high standard established by this group at previous meetings, and continuing support of Suharto and Presidium to this highly competent group of economic advisers is best way, in our judgment, maintain and expand flow of foreign assistance to Indonesia”.

Similarly, strongly affirming the ideology behind Indonesia's economic policies, the US ambassador stressed: (Green, FRUS 1968):

“...the US has become closely identified with the goals and efforts of the Suharto government. Such an identification is in fact inevitable since we have a heavy stake in the success of the “New Order” not only for obvious reasons related to Indonesia's size, strategic importance, resources and potential strength but also because it is the latest test case of whether liberal economic policies combined with free world assistance offer a more solid path to modernization than communism or other totalitarian solutions”.

Likewise, Secretary Rogers expressed “high regard” for the economic competence of the New Order regime due to the fact that it had “checked a virtually runaway inflation” (Anonymous, FRUS, 1969). Following from these praises, the US, Japan, the IMF and the World Bank showered Indonesia with aid (figure 7-6). These aid flows financed 58% of expenditures in Repelita I (IBRD, 1975).

In summary, the economic path chosen by the military elite in 1966 became entrenched because of the positive spillover effects on political stability, state-society relations and foreign aid flows. As will be explained, the entrenchment of this economic path came to play a major role in the policy choices of Indonesia after the 1973 oil boom.



Source: Bank Indonesia, Annual reports, various issues.

7.5. The politics of economic policymaking after the boom (1973-1979)

This subsection shows that immediately after the 1973 oil shock, the military elite diverted Indonesia's economic policies to a new path. However, this policy diversion turned out to be short-lived because foreign powers, together with the Chinese merchants and landlords, forced the military elite to revert back to their original policies by 1975. This shows that the economic model that had been chosen in 1966 proved to be well-entrenched, both socially and geopolitically.

7.5.1 Path diversion

When the 1973 boom occurred, Indonesia was in the final year of its first Five-Year Development Plan. Thanks to this boom, the oil revenues jumped by 77% and 225% respectively in 1973 and 1974⁴² (Bank Indonesia, 1978). Naturally, this positive external shock greatly increased the influence of the state-owned oil company inside the state. Capitalising on this opportunity, the Pertamina generals started to lobby for a “big push” investment in heavy industries, particularly in sectors in which they were economically active such as steel, cement and aluminium. This “big push” industrialisation policy was justified on the grounds of economic nationalism. To further push this nationalist agenda, the Pertamina generals allied themselves with the indigenous merchants/capitalist class, which had been economically side-lined⁴³ by Chinese merchants. At the same time, the oil boom fanned the demand for economic nationalism among the student activist groups and the intellectual class. As evidence,

⁴² In addition to a positive oil shock, the country experienced a commodity boom in timber, rubber, palm oil and tin.

⁴³ In 1972, it was reported that only 10% of importers were indigenous. Also, in the textile industry, which accounted for most of the industrial output, the indigenous class only owned one in seven firms. These factors indicate the relative economic weakness of the indigenous merchants (Bevan *et al*, 1999).

favouring a shift towards state-led development, B.M Diah, the famous journalist wrote (Robison, 1986: p155):

“Two trends are now clear. One leads via Bappenas technocrats to a “free fight” and laissez-faire pattern of development in the Western and American fashion. Another trend takes the form of cooperation with Japan on the basis of *one’s own strength* without loans from IGGI, the IMF and the World Bank with Pertamina as guarantee” [emphasis added by the author].

During this period, the students made several protests against the widespread presence of foreign companies in the economy and also the joint ventures formed between the army and Chinese capitalists. Following on from this resentment, they attacked the offices of Chinese and foreign companies (especially Japanese multinationals) in Jakarta and Bandung. In support of these protests, “Indonesia Raya”, the daily newspaper, wrote (Chalmers & Hadiz, 1997: p64):

“Just look at the questions asked by university students “who went into the streets” to demonstrate against foreign loans, foreign investment and misuse of bank credits. It is now a public secret that those who benefit from these activities are the big-shots and members of their families- wives, relatives, children, nephews, close friends and cliques. Children and wives have been made directors, members of the board and shareholders in all sorts of foreign and domestic joint ventures with non-indigenous [i.e. Chinese, ed.]. People are also talking about the startling figure of almost Rp 200 billion of credit being given to a number of non-indigenous business groups intimately connected to these New Order big-shots. Indigenous [pribumi] business groups, by contrast, do not obtain such credit; nor do they enjoy special facilities from the government”.

Thanks to this growing nationalist sentiment in the society after the boom, the Pertamina generals managed to marginalise the technocrats and change the economic policies in their favour. As a result, the New Order regime embarked on a “big push” industrialisation by increasing its fiscal expenditures by 57% and 70% respectively in

1973 and 1974 (Bank Indonesia, 1978). This is while the technocrats had originally planned a large surplus for these years, as reported by the World Bank:

“Initially, when the large increase in oil revenues became apparent, the Government planned a substantial overall budgetary surplus. In the course of the year [1974], however, budgetary oil revenues fell short, while more and more decisions were taken to increase Government expenditures”.

This fiscal expansion was divided almost equally between routine and development expenditures (Hill, 1996). Importantly, the industrial sector absorbed 60% of development expenditures in 1973 and 1974, which implied a transfer of resources towards projects that had been proposed by Pertamina. During this period, large investments were planned in the steel, cement, fertiliser, aluminium and paper industries (IBRD, 1975). This was while the second Five-Year development plan (1974-1978) which had been designed by the technocrats, placed its emphasis on agricultural development (IBRD, 1973). Reflecting on this poor planning discipline, the World Bank reported (IBRD, 1975: p42):

“So far as the Mission has been able to ascertain, the investments now foreseen for the public capital-intensive industrial sector are several times as large as those included in the Plan; several major commitments of this kind planned -- and, in fact, under execution by government enterprises -- are not included in the development budget, as has already been noted. Recently, large commitments have been made for telecommunications, and are being planned in the transport and power sectors. It appears, therefore, that substantially more investment of a capital-intensive nature is now being implemented or planned than was indicated in the Plan”.

Going further, the World Bank mission expressed scepticism about the economic efficiency of the planned industrial projects (IBRD, 1975: p71):

“There is a danger that these projects might absorb resources on such a scale that the accomplishment of a more balanced growth strategy, in industry as well as other sectors, could be jeopardized. The projects are lumpy as well as capital-intensive; once started,

their execution cannot readily be stopped or slowed...Major investments to expand capacity in the fertilizer, cement and steel industries seem to justified, but the aggregate scale of the expansions that are currently under consideration seems open to question in the above context”.

In parallel to these projects, Pertamina generals increased their foreign borrowings and engaged in various off-budget economic activities. Meanwhile, they refused to share accurate information about future oil revenues with the technocrats.

On the monetary front, the government also followed a highly expansionary policy in 1973 and 1974, as outlined in table 7-1. To respond to the growing nationalist sentiments in society, the government adopted two new credit schemes (KIK and KMKP) to improve the access of indigenous merchant/capitalists to loans. Two specialised credit institutions (P.T Askrindo and P.T Bahana) were also set up to financially support the indigenous companies. However, while introducing these reforms, Suharto assured the Chinese business class that he was not planning to break his alliance with them (Bevan *et al*, 1999: p248):

“The policy measures being prepared are designed to enlarge the ability of the economically weak group to participate in the process of development. This does not mean that we are to wipe or kill the economically strong group. It would be very detrimental if we neglect domestic capital, skills and economic potential only because they belong to a non-indigenous group”.

In summary, after the oil boom, the alliance made between the Pertamina generals and the indigenous capitalist class compelled Suharto to divert the government’s policies towards “big push” industrialisation and economic nationalism by conducting a massive fiscal and monetary expansion.

7.5.2 Return to the original path

Unsurprisingly, the highly expansionary macroeconomic policies that were introduced resulted in soaring rates of inflation in 1973 and 1974. This inflation led to the real appreciation of the exchange rate and eroded the competitiveness of the agricultural sector, hence causing disenchantment among the landlords and peasants (Robison, 1986). Alarmed by this trend, foreign donors, especially the US, expressed concern about economic policymaking in Indonesia (ibid). In addition to these adverse social and geopolitical effects, the ensuing inflation refreshed the memories of hyperinflation (and its political consequences for the previous regime) among the military elite (Bevan *et al*, 1999). The combinations of these factors gradually weakened the support for “big push” industrialisation and economic nationalism among the military elite. However, the main turning point for policy reversal came in late 1974, when Pertamina defaulted on its foreign loans due to poor management by the generals.

The default of this company in the midst of the oil boom changed the balance of power between the technocrats and the advocates of economic nationalism in favour of the former group (Glassburner, 1976). At the same time, utilising their financial leverage over the Indonesian state, the Western donors pressured Suharto to bring the technocrats back into power and place the management of oil revenues and macroeconomic policymaking in their hands (ibid). Ultimately, in 1975, due to the growing fear of the political elite regarding the soaring prices and the pressures exerted by the Western donors, Suharto decided to re-delegate authority to the technocrats to conduct necessary macroeconomic adjustments to control inflation.

After regaining power, the economic planners took control of Pertamina. As a first step, they announced to the parliament that “to ensure, order and coordination, the

government has decided that Pertamina and other state-owned companies should not apply for loans by themselves. All foreign loans for state-owned companies will now be decided solely by the government” (Nitisastro, 2011:p 183). Secondly, they slashed various capital-intensive projects that had been initiated by the company such as the expansion of the Krakatau steel project (ibid). In his address to the parliament, the Director of Bappenas explained the rationale behind this policy (Nitisastro, 2011:p 183):

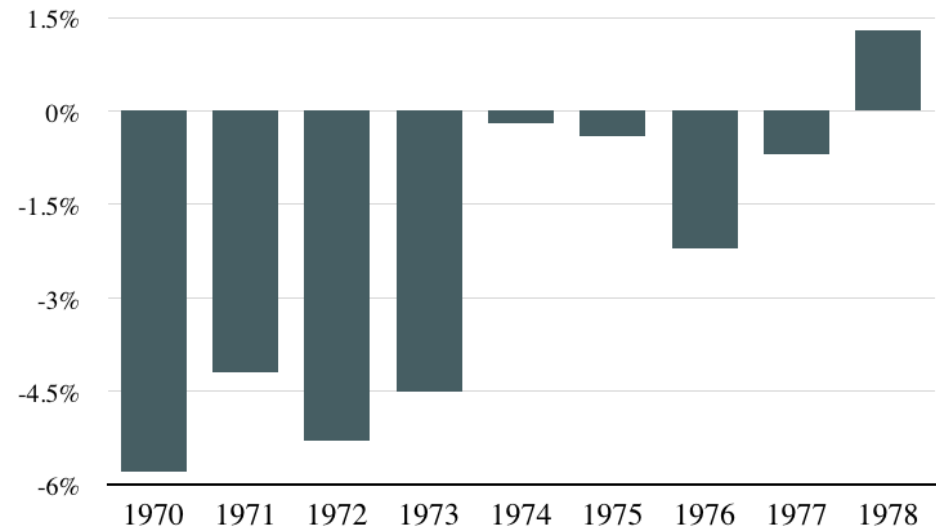
“One of the recent problems has arisen from Pertamina’s grandiose investment plans, both for ongoing work and for projects yet to be carried out. Therefore, the government considers it important to reevaluate all of Pertamina’s investment plans. A distinction is being made in the evaluation between the gas and oil projects on one hand and projects in other sector on the other. This evaluation is currently being carried out. Basically, some projects will be continued, some others will be carried out on a more limited scale, while some will be postponed, and some other will be halted”.

Thanks to these early adjustments, the planners were able to steadily slowdown the growth of fiscal spending from 1975 onwards in both real and nominal terms (Tables 7-1 and Table 7-2). In parallel, in the domain of monetary policymaking, Bank Indonesia’s technocrats curbed the expansion of domestic credit and foreign borrowing from 1975 onwards by introducing credit quotas on banks (Bevan *et al*, 1999). They also set the nominal interest rates in a way to prevent negative real interest rates to emerge (Figure 7-1). Moreover, they engaged in the restructuring of troubled state-owned banks mainly through mergers to reduce the risk in the banking sector (Bank Indonesia, 1978).

It is critical to stress that the restoration of fiscal and monetary discipline was *not* solely forced by the balance of payments problems that loomed after the Pertamina default. As illustrated in figure 7-7, Indonesia’s current account deficit never reached alarming

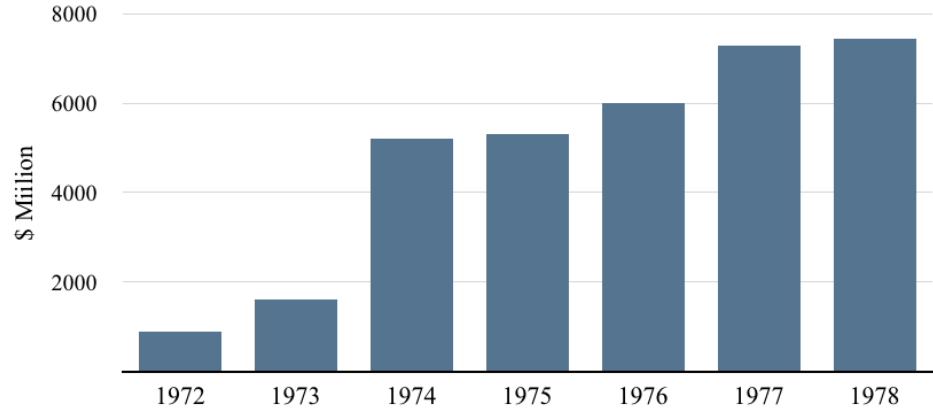
levels after that default; in fact, at the height of the Pertamina crisis, foreign debt amounted to only 36% of GDP (WDI, 2015). Indeed, one year after this crisis, the government signed a new 45% profit sharing contract with the foreign oil companies, which resulted in a steady rise in the oil revenues for the country (Figure 7-8) and therefore, eased the pressure on the balance of payments (ibid).

Figure 7-7: Indonesia's Current Account Balance (% of GDP)



Source: WDI (2015).

Figure 7-8: Indonesia oil export revenues



Source: Bank Indonesia, Annual Reports, Various issues.

These economic facts show that the elite's shift towards macroeconomic discipline between 1975 and 1979 was not forced by debt problems or a drop in oil revenues. Rather, this policy change was motivated by ideological and political factors such as the fear of inflation and external pressures from foreign powers and domestic social groups. The following quote extracted from Suharto's autobiography suggests that the Pertamina crisis acted as a warning for the military elite not to jeopardise macroeconomic prudence for economic development (cited in Nitisastro, 2011: p193):

“In sum total, this episode constituted more than a financial hurdle. The Pertamina crisis was a bitter experience and had to become a lesson for all of us; the government apparatus, as well as, the state-owned companies. Even if we had wanted to speed up development, in the absence of prudent execution, such an action would end up in trouble or even in failure”.

Thanks to the policy change outlined above, the technocrats managed to reduce inflation quickly from 1975 onwards (figure 7-5). It is important to highlight that, since Indonesia was a labour-exporting economy, the country was less prone to wage/price spiral inflation. This structural feature greatly assisted the policymakers in fighting inflation. In contrast, as a labour-importing country, Iran faced manpower shortage and wage inflation after 1973. Thus, factor endowment differences played an important role in shaping the policy choices and economic outcomes in the two countries.

After controlling inflation, the Indonesian policymakers sought to restore the competitiveness of the tradable sector to avoid the Dutch diseases. This was mainly to improve the performance of agricultural sector because this sector still accounted for the lion share of aggregate output and employment in the economy. Table 7-6 and table 7-7 compare the sectorial composition of GDP and labour force in Indonesia and Iran in the mid 1970s.

		Table 7-6: Composition of GDP in 1974			
		Oil	Agriculture	Industry*	Services
		12%	38%	19%	31%
Indoneisa	Iran	43%	11%	12%	34%

Source: Amouzegar (2001)

* Includes mining & construction

		Table 7-7: Composition of labour force in 1974		
		Agriculture	Industry*	Services
		70%	9%	21%
Indoneisa	Iran	49%	26%	25%

Source: Amouzegar (2001)

* Includes oil, mining & construction

Given the economic dominance of agriculture in Indonesia, there, the policymakers were much more worried about the economic and political consequences of Dutch Diseases. Accordingly, they devalued the rupiah by 50% in 1978 to offset the real exchange rate appreciation that had been underway since the 1973 oil shock (Booth, 1992). The main political goal of this policy was to protect the commercial interests of the landed aristocracy and the peasantry through restoring competitiveness of the agriculture sector (Robison, 1986, Karl, 1997, Bevan *et al*, 1999). In a television interview, the director of Bappenas spelled out the benefit of this policy for the agricultural sector (Nitisastro, 2011: p197):

“We have often heard that the goods produced domestically are struggling to compete with the imported ones. So we have to create a market for our own goods, it is imperative that we create a viable domestic market...There are similar issues with our export goods, whether that would be natural rubber, tea or other commodities that we sell abroad. Our goods have to be able to compete with other goods produced by other countries on the international market. In reality, what our exporters- and also our farmers who are the producers of those export goods- get in rupiah is undervalued. This is because they export the goods in foreign currencies (the yen, dollar, gulden, and so on) while the value of those currencies in rupiah is too low. The results of our exports are then below expectations”.

Restoring the competitiveness of agricultural sector was also indirectly helpful for the industrial sector as most of the output in this sector was related to processing of agricultural goods; for instance, in 1975, food processing together with wood and paper products accounted for half of the total manufacturing output (Hall, 1997). Accordingly, the Governor of Bank Indonesia reflected on the importance of devaluation for the industrial sector, which was mainly controlled by the Chinese merchants (cited in Bevan *et al*, 1999: p257):

“[Devaluation] was carried out with a view to improve Indonesia’s international competitiveness and thus to stimulate the development export-import-substitution industries, which had been under increasing cost pressure because of faster rate of inflation in Indonesia in the recent years than the rate abroad”.

While devaluing the rupiah, the government relaxed the import duties and tariffs on raw materials and also directly increased the domestic supply of rice in order to minimise the inflationary impacts of the devaluation. As assessed by Gleb (1988), Pinto (1987), Warr (1986) and Usui (1997), thanks to this devaluation, Indonesia avoided the Dutch diseases in the late 1970s and the early 1980s. As claimed, this exchange rate reform was to a large extent linked to the structural features of Indonesian economy, mainly the dominance of agriculture.

In summary, after the boom, Indonesia switched to “catch-up” industrialisation under pressure from the advocates of economic nationalism inside and outside the state, namely the Pertamina generals, indigenous merchants, intellectuals and student activist groups. This policy diversion, however, proved to be politically costly for several reasons. Firstly, it went against the economic interests of counter-revolutionary social classes (Chinese merchants and landlords). Secondly, it caused a high degree of inflation, which was perceived by the military elite as a grave threat to the survival of

their regime. This inflation also caused concern among foreign donors about the new economic path chosen by the elite. Combination of these three factors increased the internal and external demands for a return to the previous non-interventionist model, where economic stability and agricultural development were considered as the main priorities instead of “catch up” development. These forces gathered momentum after the Pertamina crisis in late 1975 and managed to return the economic policies to their original path in the subsequent period (1975-1979). This shows that the advocates of economic nationalism were not strong enough to cause a permanent change in economic policymaking; in the end, Indonesia’s non-interventionist model proved to be enduring and well entrenched due to the social and geopolitical relations that had been formed around it since 1965.

7.4.3 Spillover effects

The technocrats' success in bringing inflation down between 1975 and 1979 and avoiding the Dutch disease had spillover effects on Indonesian politics. Firstly, it assured the foreign donors about the stability of the New Order regime and therefore, it secured the continuation of aid inflows (Robison, 1986). Secondly, it led to the permanent marginalisation of the Pertamina generals from power; in 1976, Pertamina's Director General Sutowo along with the entire top-level management were dismissed (Housego, Financial Times, 1978; Robison, 1986). After "cleaning up" this company, Suharto announced to the parliament (cited in Nitisastro, 2011: p190):

“... as soon as the government found out about the difficulties Pertamina was in, it took the necessary measures to save the state finances, to rescue Pertamina from bankruptcy and to reform the *entire* management and administration of Pertamina. These efforts have so far produced satisfactory results. Pertamina's debt- their reimbursement is assisted by the government- have been reduced to minimum, so that Pertamina can continue its function properly”.

In terms of class alliances, a switch back to agricultural development and promotion of light industries restored the relationship between the state and the landlords and the Chinese merchants. To be sure, the government maintained the populist credit policies that were introduced to help the indigenous merchants. But these policies were put under the supervision of Bank Indonesia to ensure that they would not jeopardise monetary stability in the future. Finally, the return to a policy of agricultural development and self-sufficiency in food allowed the government to realise an equitable growth in the 1970s and 1980s and drastically reduce poverty (Bevan *et al*, 1999). It can be argued that these economic outcomes contributed to the survival of Suharto's regime in the subsequent decades.

Conclusions

This chapter argues that in order to understand Indonesia's economic policies after the boom, it is necessary to follow the political and economic trajectory of the country from the previous decade. In the early 1960s, Indonesia was ruled by unstable political coalitions between the army on the one hand and the nationalist and communist forces on the other hand. During this period, the country aggressively followed state-led industrialisation and attached high importance to economic independence from the West. These policies produced high budget and current account deficit and led to hyperinflation. In reaction to this economic disarray, the army executed a coup in 1965 and seized power. The new military regime adopted a pro-Western foreign policy and entered into an economic alliance with counter-revolutionary social classes (Chinese merchants and landlords). Once in power, the military elite chose a non-interventionist economic model that gave priority to ensuring economic stability and promoting self-sufficiency in food. In short, the rise of the New Order entailed a deep change in the state's internal power structure, class coalitions, geopolitical relations and economic policies.

Thanks to the new policy path selected by the elite, Indonesia experienced a declining rate of inflation and positive economic growth between 1966 and 1972. These economic outcomes, in turn, led to social stability, a growing supply of foreign aid and closer relations between the state and counter-revolutionary classes. However, when the 1973 oil boom occurred, nationalist sentiments resurfaced in the country. Emboldened by the boom, advocates of economic nationalism, notably the Pertamina generals, indigenous merchants, student activist groups and the intellectual class, demanded a shift towards "catch up" industrialisation. Accordingly, to accommodate the growing nationalist sentiments in society, the government engaged in a "big push" industrialisation and

subordinated macroeconomic policymaking to industrial policymaking. However, this deviation from the non-interventionist model proved to be politically costly for the elite as it caused a high degree of inflation. This inflation refreshed the memories of Sukarno's downfall for the elite and therefore caused great concerns about the survival of the regime. This inflation also reduced the economic credibility of the regime for foreign donors, which financed a considerable portion of government spending. Finally, the new policies went against the economic interest of the counter-revolutionary classes, which constituted the main social base of the regime. The combination of these factors increased the internal and external demand for a return to the original policies. Finally, these demands gained momentum after the Pertamina crisis in late 1974 and caused a return to macroeconomic prudence and agricultural promotion between 1975 and 1979. This shows that the advocates of economic nationalism were not strong enough to cause a permanent change in economic policymaking after the boom; in the end, Indonesia's non-interventionist model proved to be enduring and well entrenched due to the social and geopolitical relations that had been formed around it since 1965. Therefore, more generally, the case of Indonesia confirms the theoretical claim that the economic reaction of rentier states to the 1973 oil shock was mediated by their previous economic path.

Chapter Eight: Saudi Arabia

This chapter focuses on the political economy of macroeconomic policymaking in Saudi Arabia after the 1973 boom. It argues that the macroeconomic policies that the Saudi elite followed after the boom were to a great extent influenced by their previous policy path. The first section of the chapter outlines the logic behind selecting Saudi Arabia as a comparative case for Iran. Section two provides a brief historical background on state formation in Saudi Arabia. Section three focuses on the balance of payments crisis of the late 1950s as an important turning point in the economic and political trajectory of Saudi Arabia. Section four then examines the politics of economic policymaking inside the Kingdom after the crisis until the 1973 oil boom. Finally, section five explores the politics of economic policymaking after the boom.

8.1. Comparing two similar cases with different policy choices

Among the oil-rich countries, Saudi Arabia represents the “most similar case” to Iran at the time of the 1973 oil shock. Firstly, both countries were among the dominant oil producers in the world and the two major players in OPEC; in 1973, Iran and Saudi Arabia respectively accounted for 10% and 12% of total oil production (Central Bank of Iran, 1978). Secondly, both countries had dictatorial regimes that banned political parties, restricted press freedom, outlawed independent labour unions and suppressed all social opposition. Finally, these two regimes enjoyed a high degree of autonomy in their foreign policy while being a close ally of the US in the Cold War.

When the oil price quadrupled in late 1973, the two regimes were showered with windfall revenues and adopted economic policies that were similar in many respects; at the broad level, both massively expanded their fiscal expenditures on infrastructure, the

military, social welfare and industry and loosened monetary policy. Importantly, however, in one crucial aspect the two regimes responded differently to the shock; Saudi Arabia saved a considerable proportion of its oil revenues abroad in the form of portfolio investments (i.e. bonds and stocks) by running a large budget surplus (Table 8-1) while Iran saved very little of its oil revenues. This policy divergence, in turn, produced a large gap between the investment incomes of the two countries between 1973 and 1978 (table 8-2). As indicated in Figure 8-1, Saudi Arabia's investment income, in time, turned into a major source of foreign exchange, even becoming comparable to her oil revenues. This income source later helped the Saudi regime when the oil prices dropped in the mid-1980s. In contrast, the lack of major foreign investment by Iran in the early 1970s kept the Pahlavi state increasingly reliant on oil revenues and, in consequence, made it vulnerable to any price drop (or strikes in the oil industry) in the late 1970s.

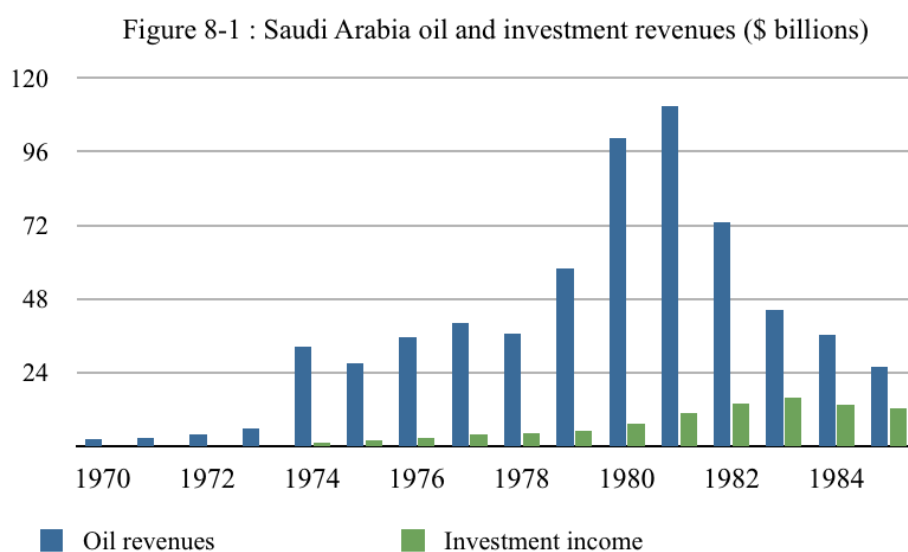
Table 8-1: Fiscal balance (as % of GDP)

1970	6%
1971	9%
1972	13%
1973	40%
1974	40%
1975	13%
1976	3%
1977	-2%
1978	-5%

Source: Nilbock & Malik (2007)

Table 8-2: Investment income (\$ millions)					
Country	1973	1974	1975	1976	1977
Saudi Arabia	200	1,200	1,900	2,900	4,000
Iran	63	507	766	611	796

Source: Central Bank of Iran (1978), annual report and Niblock and Malik (2007)



Source: Niblock & Malik (2007)

According to Spiro (1999), Saudi Arabia was responsible for half of all the petrodollars that were saved by OPEC countries in the West in the 1970s. Thanks to this saving strategy, the country's foreign assets swelled from \$1 billion to \$80 billion between 1970 and 1980 (ibid). These reserves were held primarily in the form of treasury bonds and short-term deposits in the US banks.

Other than saving their petrodollars abroad, the Saudi royal family also recycled a considerable portion of their oil revenues in the form of aid to developing countries, while Iran refrained from doing so. Between 1974 and 1978, the total aid outflows from Saudi Arabia accounted for 6.4% of GDP in contrast to 0.5% of GDP in Iran (Amouzegar, 2001). Again, this difference shows that Saudi Arabia was more

committed to the recycling of oil revenues than Iran. Finally, in addition to petrodollar recycling, the two countries diverged from each other in terms of oil strategy; Saudi Arabia advocated modest price increases in OPEC from 1973 to 1977, whereas Iran constantly lobbied for large price increases.

This chapter seeks to offer a novel explanation for the policy differences listed above. Scholars of OPEC economics often relate these policy differences to the different factor endowments of the two countries at the time of the shock. They point out that Saudi Arabia's oil revenue per capita (\$5,000) was much larger than Iran's (\$625) in 1973. Therefore, they argue that, given the much bigger size of the boom in Saudi Arabia, this country naturally saved a much larger portion of its oil revenues while Iran refrained from doing so. However, the main flaw of this argument is that it naively assumes that when the political rulers receive windfall revenues, they have an incentive to follow the optimal economic policy, which in this case entailed saving surplus oil revenues. But this argument does not clarify why the political elite should have this incentive in the first place; if anything, large windfall rents should encourage rent seeking and budget maximisation among actors who are operating inside or outside the state (Olson, 1982, 1965). As a defence, advocates of the explanation mention above point out that the Saudi policymakers were wary of the dangers of spending beyond "the absorptive capacity" of their economy and, therefore, they had an incentive not to inject all the oil revenues domestically. However, the empirical evidence refutes this claim because, as described by Mallakh (1982), the Saudi policymakers spent well beyond the absorptive capacity of their economy in the 1970s anyway. The total expenditures of the government increased by 83% and 72% respectively in 1973 and 1974 and, like Iran, this massive fiscal expansion led to severe bottlenecks in ports, roads and manpower (Nilbock & Malik, 2007). This outcome is inconsistent with the supposed concern of

the Saudi elite for the limited absorptive capacity of their economy. Alternatively, this research goes beyond these economic explanations reviewed above and relates the policy divergence between Saudi Arabia and Iran to the contrasting characteristics of their states.

8.2 State formation

This section offers a descriptive history of state formation in Saudi Arabia. The purpose of this history is to help us better understand the economic behaviour of the Saudi state in the 1960s and 1970s. Interestingly, it is possible to trace back many features of this state in those periods to the manner in which it was born in the first place.

The modern Kingdom of Saudi Arabia was pioneered by King Abdul Aziz Ibn Saud in 1932 after consolidating his rule over Riyadh, Najd and Hijaz by defeating rival tribes, notably the Hashemite family who traditionally had control of Hijaz (Halliday, 1974). The main social base of the Kingdom was formed by the merchants of Najd, the region where the Saudi tribe had originated from. The Wahhabis Ulemma, followers of a religious movement that aimed at the purification of Islam, comprised the other social pillar of the Kingdom (ibid). As a conservative ruler, Abdul Aziz did not engage in the modernisation of the Saudi state or the economy throughout his reign until 1953 and preserved its ties with the Ulemma and the merchants (ibid).

Upon creating the Saudi state, he gave exploration rights to the Standard Oil Company, which later merged with Esso, Texaco and Mobil to form the Arabian American Oil Company (ARAMCO), in 1933. Oil was discovered one year later and its production began in 1938, laying the foundations of the US-Saudi relations in the 20th century (ibid). However, the oil production remained low until World War II; between 1941 and 1946, the Kingdom's oil output only amounted to 1% of output in the US. With the rise

of Third World nationalism and de-colonisation after WWII, the Saudi state and Aramco agreed to a 50-50 profit-sharing agreement in 1950- and this remained in place until 1973 (ibid). In 1951, the US established a permanent US Military Training Mission in the country and agreed to train the Saudi army.

The distinctive feature of the Saudi state was that it had been established by a large tribal family that had deep historical roots in the Arabian Peninsula. From the beginning, this large dynasty generated an intense internal competition for power among the Saudi princes, especially among the sons of Abdul Aziz (Hertog, 2010). This dynastic politics, in turn, shaped the formation of the public bureaucracy as Abdul Aziz gave control of each public agency to specific factions among his sons, in effect, turning the institutions into personal “fiefdoms” of Saudi princes (ibid). This initial set-up later shaped the pattern of institution building in the 1950s, 1960s and 1970s (ibid).

After Aziz’s death in 1953, his second son, Saud assumed power. As a new ruler, he faced many hurdles to the consolidation of his power due to competition from other princes, most notably his younger brother Faisal. The rivalry between the princes continued to shape the process of state building for the rest of the 1950s. Saud inherited an underdeveloped state thanks to the legacy of his father’s conservative and patrimonial style of rule; at the time when he assumed power, the country had only three ministries of Finance, Interior and Foreign Affairs, which acted with little coordination with each other (Niblock & Malik, 2007). The army was also unorganised and in disarray (Halliday, 1974). However, with the growth of oil revenues after 1953, the Kingdom came under pressure from the US administration and Aramco to create modern institutions to administer the allocation of petrodollars to the economy; in that period, oil accounted for 80% of the government’s revenues (Yizraeli, 1997).

The most thorough account of institution building in this period is provided by Hertog (2010). He shows that in the 1950s the design of institutions continued to be shaped by family politics rather than rational functions and, accordingly, the administrative posts were allocated on the basis of family ties. In this period, the Saudi state expanded at a rapid pace as new ministries and agencies were established and the army was strengthened. This gave rise to a “divided bureaucracy” with many parallel and overlapping institutions, where each ministry or agency was controlled by a prince. Naturally, this patrimonial institutional arrangement impeded the rationalisation of public administration and made the coordination of policy very difficult. As a consequence, fiscal policy and economic planning were not centralised in the hands of a single institution in this period. This lack of rationalisation in the budgeting process in turn led to cancellation of the American Point Four assistance program (Hertog, 2007). In terms of monetary policy, the Saudi Arabian Monetary Agency (SAMA henceforth), which was established by US advisors in 1952 to function as a central bank, lacked authority. When designing SAMA’s charter, the US advisors had banned this institution from lending money to the government. Yet, under pressure from Saud and the ministry of finance, this charter was later modified in 1955 to open the way for deficit financing (Yizraeli, 1997). This action blocked the rise of SAMA as the only technocratic institution inside the state.

In terms of economic policy, the Saudi state followed a liberal trade policy and intervened little in the economy due to the lack of technical capacity, hence functioning as a “minimal state”. This non-interventionist model served the economic interests of merchants and the Ulemma. On foreign policy, the main challenge that faced the kingdom under Saud’s rule was the rise of Gamal Abdul Nasser in Egypt in the early

1950s. As a conservative regime, the Saudi state aggressively focused on containing the growing popularity of Arab nationalism in the region.

In summary, this descriptive history shows that by the mid-1950s, the Saudi state had the following characteristics; firstly, it had a divided internal power structure and a conservative ideology. Secondly, it had an alliance with conservative social classes (merchants and the Ulemma), which were outward-oriented in their economic outlook. Thirdly, it had close geopolitical relations with the US. Finally, and most importantly, its economic policymaking institutions were technically and politically weak.

8.3 The crisis period (1957-1960)

Naturally, the lack of macroeconomic discipline under Saud's rule resulted in growing deficit financing, foreign borrowing and corruption from 1953 onwards. Ultimately, this trend culminated in a balance of payment crisis in 1957 (Hertog, 2010). In response, the IMF bailed out the Kingdom and imposed an austerity package on the government that included fiscal cuts and import restrictions. This crisis had an immediate effect on institution building and the balance of power between conservative and reformist factions of the ruling family.

After the crisis, Saud was forced by the reformist faction of the family to appoint Faisal, who was ideologically in favour of modernisation, as prime minister in 1958 and give him the authority to manage the stabilisation of the economy (ibid). Upon assuming this post, Faisal followed the IMF's recommendation and re-empowered SAMA by appointing an able Pakistani IMF economist, Anwar Ali as its Governor and gave him policy autonomy (Mallakh, 1982). Faisal also helped this institution build its technical capacity by hiring technocrats and improving its data gathering. This institutional improvement allowed the government to publish its first detailed budget in 1958. By 1960, SAMA managed to stabilise the economy and emerge as a technocratic institution. Officially, this institution was unauthorised to give loans to the government. Therefore, overall, the balance of payments crisis led to the rationalisation of monetary policymaking to a reasonable degree.

After the crisis, a conflict emerged between the reformist and conservative factions of the family over the economic model that the kingdom should pursue in the future. On the one hand, the reformists, headed by Faisal, favoured a shift towards active intervention in the economy and lobbied for the creation of a strong planning institution

to discipline fiscal policy and create a framework for economic development. On the other hand, the conservative faction argued for the maintenance of the status quo and opposed the idea of building a strong planning institution. Ideologically, this faction prioritised stability over economic development and change. Naturally, this intra-elite conflict had a direct effect on the evolution of economic planning inside the state.

At the behest of the reformist faction and the technocrats of the SAMA, the World Bank mission sent a mission to the country in 1960 to study its economic problems and make recommendations. This led to the formation of the first Supreme Planning Board in 1961, which consisted of the Prime Minister (as chairman), and the ministries of Finance (deputy chairman), Communications, Petroleum, Commerce, Agriculture and Health (Mallakh, 1982). The World Bank was insistent that the executive secretary of this body had to have ministerial ranking (i.e. the board being administered by the Ministry of Planning). However, the conservative faction of the royal family fiercely opposed the idea of creating such a strong institution. Therefore, the first attempt to create a planning framework failed (ibid).

8.3.1 Path creation

The intra-elite conflict over the country's overall economic strategy finally ended in 1964; in that year, Saud stood down due to his deteriorating health and Faisal was appointed as the new king. Upon assuming power, Faisal unified the prime minister's office with that of the king, and more importantly, formed a cabinet that reflected a coalition between different factions of the family (Hertog, 2007). Naturally, this implicit power agreement did not allow Faisal to shift the country's overall economic strategy towards active development planning and economic diversification. Instead, he chose to stick with the non-interventionist economic model of the Kingdom and prioritise

stability over economic development. As will be explained, this decision gave rise to an enduring policy path in the 1960s.

The analysis provided in this section shows that like in Iran, the Saudi elite had the option of embarking on state-led development or returning to their non-interventionist model after recovering from the balance of payments crisis. In the end, due to the Kingdom's conservative ideology and fragmented internal power structure, Faisal decided *not* to shift towards economic intervention and “catch-up” development.

8.4 The politics of economic policymaking before the boom (1964-1972)

This section first looks at the overall economic model of the Kingdom in the 1960s and focuses on the actors and institutions that implemented this model. It then assesses the spillover effects of this model on the characteristics of the Saudi state in the same period.

8.4.1 Macroeconomic policymaking

The period after 1964 coincided with the large increase in oil revenues for the state. This made it necessary for Faisal to finally lay the foundations of economic planning in the country. As a result, he formed the Central Planning Office (henceforth CPO) in 1965 with the assistance of the Ford Foundation and made it responsible for preparing periodic economic reports and drafting five-year plans (Niblock & Malik, 2007). He also defined and expanded the supervisory power of SAMA over the banking sector by passing the 1966 Banking Control Law (ibid). This law also enabled SAMA to place reserve requirements on banks as a policy tool to control money supply (Mallakh, 1982). With Anwar Ali remaining as its governor, SAMA continued to operate as a technocratic institution in the 1960s and produce reliable statistics, surveys and reports (Hertog, 2010). Defending its policy autonomy, this institution resisted deficit financing in this period (Mallakh, 1982). In contrast, however, the CPO remained weak in terms of technical capacity and political power due to continuing opposition from other ministries. In effect, the segmented internal power structure of the state made it difficult for Faisal to centralise economic planning in the hands of a single institution (Hertog, 2010). As evidence, the CPO did not produce any economic plan for the first five years of its existence. Ultimately, the first economic plan was produced in 1970 after an able technocrat, Hisham Nazer, was appointed as the director of this organisation. However,

even after this appointment, the CPO could not overcome the opposition from other ministries and remained politically weak in the 1970s (ibid).

The main focus of economic policy in the 1964-1972 period was heavy investment in infrastructure mainly roads, hospitals, schools, ports and dams (Niblock & Malik, 2007). In parallel with this policy, the government massively increased its defence expenditures from 243 million riyals in 1961 to 925 million riyals in 1970 (ibid). Overall, fiscal expenditures steadily grew from 1.2 billion riyals in 1964 to 5 billion riyals in 1972 with transport, communication, education and health accounting for the highest share of expenditures (30%) (ibid). However despite this gradual fiscal expansion, the policymakers kept the budget almost in balance and mostly avoided deficit financing during the 1964-1972 period to minimise the possibility of another crisis (Mallakh, 1982). This is because the main priority of the elite in this period was to maintain economic stability rather than rapid economic growth. Moreover, policymakers followed no active diversification or industrial strategy. Alternatively, following the comparative advantage of the country, they made considerable investments in oil and petrochemical sector (ibid). For this purpose, the state-owned firm Petromin was established. Overall, in line with “minimal state” model, the Saudi elite followed a liberal trade policy and focused their economic activities on building infrastructure and defence.

8.4.2 Oil strategy setting

The main goal of Saudi oil strategy in the 1964-1972 period was to preserve the position of the country as the dominant supplier in the market in order to ensure the maximisation of revenues in the *long-term*. Therefore, unlike Iran, the Kingdom did not advocate massive price increases in OPEC, because the Saudi elite believed that such a

policy would encourage oil supply from non-OPEC countries and jeopardise their position as the dominant oil supplier in the long term. In addition, they believed that high oil prices would push the consumer countries into economic trouble and reduce the demand for oil in the long term; in effect, they perceived the long-term economic prosperity of Saudi Arabia as linked to the pace of growth in rich countries, which were the main consumers of oil. Therefore, instead of favouring multilateral price increases in OPEC, the Saudi elite focused on increasing their oil revenues through other means such as raising their oil production and increasing royalties and taxation on foreign oil companies. Following this strategy, oil production in the country soared from half a million barrels a day in 1962 to 1.3 million in 1970 while the price of the “Arabia Light” was kept at \$1.8. This strategy led to a steady increase in oil revenues from 1.9 billion riyals in 1962 to 7.1 billion riyals in 1970 (Niblock & Malik, 2007). This steady stream of oil rents, in turn, enabled the government to finance its infrastructure projects and defence expenditures; in fact, more than 70% of the expenditure in the 1964-1972 period was financed out of petrodollars. However, it is important to stress that, unlike Iran, the Saudi elite did not seek to maximise their short-term oil revenues to accelerate their domestic development project. Indeed, they gave the priority to preserving their dominant position in the oil market rather than speeding up their economic modernisation at home.

The analysis provided in this section shows that between 1964 and 1972, Saudi Arabia pursued a non-interventionist economic model that gave priority to ensuring domestic economic stability at home and preserving the country’s dominance in the global oil market. Thanks to the steady increase in the oil revenues, this policy path proved to be economically successful; the country experienced an annual growth rate of 9% between 1964 and 1972 with inflation averaging 2.6% (Niblock & Malik, 2007; WDI, 2015).

8.4.3 Spillover effects

This subsection shows that the economic success of the policy path chosen by Faisal in 1964 led to further entrenchment of this path by having spillover effects on the internal power structure, class coalitions and geopolitical relations of the Saudi state.

Firstly, the high economic growth resulting from the non-interventionist model solidified the coalition formed by Faisal among different factions of the family by allowing the princes to hold on to their personal institutional “fiefdoms”⁴⁴ (i.e. ministries or public agencies) (Hertog, 2007). As a result, the public bureaucracy remained segmented as before and became even more entrenched as the total number of government employees increased from 52,000 in 1960 to 124,000 in 1970 (ibid). Hence, the success of the liberal policy path strengthened the prevailing balance of power formed within the family. Secondly, this path tightened the alliance between the state and merchant classes as the authorities followed a free trade policy and invested heavily in infrastructure; naturally, these policies led to economic empowerment of the merchants (Niblock & Malik, 2007). Finally, and most importantly, the non-interventionist model gave ample autonomy to the elite to use oil as a geopolitical weapon rather than a purely economic resource. This means that since rapid economic development was not the main priority for the elite, they enjoyed a high degree of freedom to use their petrodollars for geopolitical purposes. For instance, they could recycle a considerable portion of their oil revenues to different countries and, in this way, gain geopolitical influence over the host countries. Saudi Arabia used this strategy

⁴⁴ It is worth mentioning that Faisal attempted to introduce limited reforms in this period with US help to rationalise public administration. For example, he established the Institute of Public Administration in Riyadh and asked a Ford Foundation consultancy mission to create a merit-based bureaucracy. But, as documented by Hertog (2007), these reforms achieved little success.

to fight against the spread of Arab nationalism and communism in the Middle East region. Between 1960 and 1972, these revolutionary forces destabilised North Yemen, South Yemen and Oman, hence threatening the survival of the Kingdom as well. As a response to this geopolitical threat, Saudi Arabia started to inject her petrodollars through foreign investment and aid into Oman, Jordan, Lebanon, Pakistan, Sudan and Algeria to contain the spread of revolution in these countries⁴⁵ (Mallakh, 1982). The non-interventionist model also left the elite with a high degree of flexibility in the pricing of oil, as they were not pressed to maximise their short-term revenues for development projects at home. This flexibility gave them the option to *temporarily* exploit their dominant position in the global oil market (in the form of an embargo for example) to exert pressure on consumer countries to behave according to the geopolitical interest of the Kingdom. For instance, Faisal threatened to use this temporary option against Israel's allies following the 1967 Arab-Israel war (Yizraeli, 1997). As will be mentioned, Saudi Arabia later utilised this tool in the form of an oil embargo during next Arab-Israel war in 1973.

The above analysis shows that the non-interventionist policy path chosen by Faisal in 1964 had a positive spillover effect on the internal power structure, class coalitions and geopolitical relations of the Kingdom. These effects, in turn, led to the entrenchment of this policy path as it served the interest of prominent actors inside and outside the state.

⁴⁵ Beside this strategy, the Kingdom actively promoted Islam as an alternative ideology to communism and secular nationalism (Mallakh, 1982).

8.5 The politics of economic policymaking after the boom (1973-1979)

This section first provides an overview of the 1973 oil shock. Then, it discusses how the oil boom affected the politics of economic policymaking inside the Kingdom. Finally, it investigates the spillover effects of the economic policies that were selected after the boom on the characteristics of the Saudi state.

8.5.1 The 1973 oil shock

The fourth Israel-Arab war in October 1973 was the most important geopolitical event of the 1970s in the Middle East. In response to this war the Arab countries, headed by Saudi Arabia, raised their posted price of crude oil from \$3.12 per barrel to \$5.12 per barrel in OPEC and placed an oil embargo on Israel's allies including the US. Hence, they started to use oil as a diplomatic weapon to pressure the US. This move was indicative of Saudi Arabia's growing independence from the US and the increasing tendency of the country to occasionally use oil as a foreign policy weapon to put temporary pressure on other states. Ultimately, the embargo was lifted in March 1974 when the US pressured Israel to enter negotiations with the Arab countries. As already mentioned, Iran capitalised on this oil attack and, in December 1973, engineered a subsequent price hike on from \$5.12 per barrel to \$11.65 to speed up her domestic industrialisation and military programs (Skeet, 1991). However, the Saudi princes did not perceive this move to be in their long term economic interest (ibid), because they believed that a *permanent* price rise would (a) push consumer countries into recession and reduce the demand for oil in the long-term and (b) encourage oil supply from countries outside OPEC and threaten the dominance of this cartel in the long term. Therefore, as the two major oil suppliers in OPEC, Iran and Saudi Arabia started to battle with each other over the pricing of oil from 1974.

8.5.2 Macroeconomic policymaking

When the oil boom occurred, Saudi Arabia was in the middle of its first five-year development plan (1970-1974). Following the non-interventionist model, this plan had focused on massive investments in infrastructure, education, healthcare and defence and followed a simple “project approach”, meaning that the CPO had formulated a series of projects that were going to be implemented by ministries (Niblock & Malik, 2007). As in the 1960s, no sectoral policy had been devised in the plan. In the middle of the plan, the country’s oil fortune jumped suddenly (Figure 8-1). In response, the Saudis massively increased their spending in 1973 and 1974 (table 8-3) and loosened the monetary policy.

Table 8-3: Changes in fiscal spending

1971	53%
1972	22%
1973	83%
1974	72%
1975	155%
1976	56%
1977	7%
1978	7%
1979	22%

Source: Nilbock & Malik (2007)

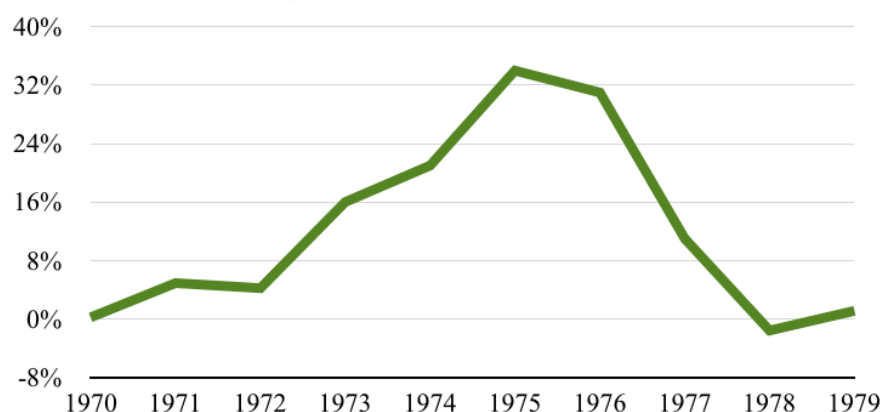
Importantly however, despite this massive increase in domestic spending, they ran a large budget surplus and invested a considerable share of their petrodollars in rich countries (Table 8-1). Interestingly, this petrodollar recycling was conducted by SAMA, as this institution was more technically capable than the Ministry of Finance or the CPO. The purpose of this recycling was to make sure that rich countries would not plunge into

crisis, and therefore, the demand for oil would not drop in the long term. This fiscal strategy shows that, as before, Saudi princes attached more importance to the maximisation of their oil revenues in the long term than the acceleration of economic development at home. This means that the massive increase in spending after the boom represented a “bounded change” *within* the previous conservative policy path of the Kingdom rather than a fundamental policy shift.

This fiscal expansion continued after the completion of the first plan. The Second Five Development Plan (1975-1979) was a highly ambitious one that continued the first plan’s focus on building infrastructure and defence, but on a much larger scale⁴⁶. Accordingly, the government increased its spending by 155% in the first year of this plan. Naturally, after this fiscal explosion, inflation reached 34% (Figure 8-2) and, like in Iran, large infrastructure bottlenecks emerged in the economy. For instance, ports were mired in chaos as large numbers of ships were queuing to offloads imported goods. Worried by this economic instability, the princes immediately agreed to slow the pace of the second plan. As a result, they empowered SAMA and the CPO to restore fiscal and monetary discipline from 1976 onwards. This resulted in a sudden decrease in the growth of fiscal spending (table 8-3). Thanks to this policy, inflation dropped from 34% in 1975 to 1.1% in 1979.

⁴⁶ The total expenditures set out in the second plan were six times larger than in the first plan (Hertog, 2010).

Figure 8-2: Inflation in Saudi Arabia



Source: WDI (2015)

The macroeconomic responses listed above show that after the boom the Saudi state remained in its conservative policy path, despite embarking on a fiscal expansion between 1973 and 1975, and gave priority to ensuring economic stability at home and preserving the long-term demand for oil through petrodollar recycling.

8.5.3 Oil strategy setting

Between 1973 and 1979, Saudi Arabia focused on lifting oil production and increasing royalties from foreign companies to increase her revenues rather than forcing up oil prices in OPEC. Implementing this strategy, the authorities successfully renegotiated the Aramco joint-venture and increased the national share in the company from 25% to 60% in 1974 (Skeet, 1991). In a way, this move amounted to a partial nationalisation of the oil industry. They also expanded their oil supply from 2.7 million barrels per day in 1973 to 3.3 million barrels in 1977 (Niblock & Malik, 2007). From 1973 to 1976, Saudi Arabia preached price moderation in OPEC and opposed Iran's hawkish position, as before. The outcome of this battle was a 6% annual increase in oil prices in the above period (Mallakh, 1982). However, the main turning point in this oil battle was the December 1976 meeting in Doha, where Saudi Arabia (along with the UAE) proposed a 5% rise in oil prices as opposed to a gradual 15% rise advocated by other members

(ibid). At the end of that conference, Saudi Arabia decided to oppose the cartel and increases the price of her oil by 5%. This in effect, gave rise to a dual pricing system within OPEC. Then, in 1977, the Saudis flooded the market at their own price by raising their production by 6% to gain market share from other producers (ibid). As mentioned in the previous chapters, this move led to a reduction in Iran's oil revenues and derailed her economy.

Overall, the macroeconomic policies and oil strategy outlined in this section reveals that after the boom, the Saudi state continued to behave as a conservative rentier state and accordingly sacrificed rapid economic development for economic stability, and all along, focused on preserving the country's dominance in the global oil market.

8.5.4 Spillover effects

The non-interventionist model after the boom continued to have the same spillover effects on the characteristics of the Saudi state, but to a much larger degree. The segmented internal power structure of the state remained the same and the institutional fiefdoms formed in the previous decade expanded at a rapid pace as the total number of government employees increased from 124,000 in 1970 to 175,000 in 1980 (Hertog, 2010). Six new ministries were created in 1975 including the Ministry of Planning (by upgrading the CPO) and the Ministry of Industry and Electricity (ibid). Also numerous agencies and funds were set up such as the Saudi Industrial Development Fund, the Real Estate Development Fund, the Saudi Port Authority and the Saudi Basic Industry Corporation (ibid). Like before, these ministries were placed under the control of a prince as an instrument of power to cement the coalition shaped within the family. However, amid these continuities an important political incident took place in 1975; in that year, Faisal was shot and killed by a hard line member of the family for initiating

various modernisation reforms. Despite this assassination, the political coalition formed by Faisal within the family proved to be resilient. Therefore, this incident failed to shake the state's internal power structure. Also, in terms of class coalitions, the merchant classes became closer than before to the state as policymakers invested heavily in the infrastructure and maintained an overvalued exchange rate to encourage the import of consumer goods; in effect, imports jumped from 8,272 million riyals in 1973 to 81,856 million riyals in 1978 (Mallakh, 1982). Most importantly, the conservative policies chosen in the realm of petrodollar recycling and oil pricing had significant spillover effects on the geopolitical relations of the Kingdom. After the boom, the Saudi elite massively increased aid flows to their neighbouring countries to combat the spread of revolutionary forces in those countries. Correspondingly, the Kingdom gave \$3.5 billion in aid and grants, more than any of the OPEC countries by a wide margin⁴⁷ (Amouzegar, 2001). More crucially, by offering to invest a large proportion of her oil revenues in the US and other Western countries, Saudi Arabia gained an opportunity to redefine her geopolitical relationship with the US. The following paragraph describes how the Kingdom utilised its surplus oil revenues to gain geopolitical influence.

In the early 1970s, the US administration was crippled by widening fiscal and current account deficits due to the rising costs of the Vietnam War. Naturally, this situation was made worse after the 1973 oil boom, as the US faced a colossal negative terms of trade shock overnight. Subsequently, the US started to exert pressure on oil-rich countries to reduce the price of oil and also invest their petrodollars in American assets. As pointed out in chapter six, the Pahlavi regime resisted against this pressure and instead insisted

⁴⁷ In comparison, Iran only gave \$345 million in aid (Amouzegar, 2011).

on driving its domestic industrialisation project forward by spending its oil revenues domestically and increasing the oil price in OPEC. In contrast, the Saudi elite were not adamant in accelerating development at home; instead, they worried that prevailing high oil prices would plunge rich countries into recession and reduce the long-term demand for oil, hence jeopardising the economic situation of the Kingdom in the future (Mallakh, 1982; Amouzegar, 2001). Therefore, their economic worries happened to be much more aligned with the economic interests of the Western countries. The Saudi royal family capitalised on this opportunity to redefine its geopolitical relations with the US to enlist the military support of this superpower in the Gulf region at the expense of Iran. Subsequently, from 1974, Saudi Arabia entered into secret negotiations with the US regarding their petrodollar recycling (Spiro, 1999). During these negotiations, the Saudi royal family agreed to invest their oil surplus in US government bonds and oppose drastic price increases in OPEC and, in return, Washington agreed to supply the Kingdom with arms and security training to help them catch up with Iran militarily (Cooper, 2011; Spiro, 1999). Accordingly, an agreement was signed between the US and Saudi Arabia on June 1974 announcing that “[they] are prepared to expand and give more concrete expression to cooperation in the field of economics ...and in the supply of the Kingdom’s requirements for defensive purposes” (Spiro, 1999: p 107). Meanwhile, the US treasury made a secret offer to SAMA to sell them treasury bonds at a discount price outside of the normal auctioning process (Spiro, 1999). The details of this deal were finalised by 1975 and from then onwards, SAMA started to diversify its portfolio away from short-term dollar deposits to treasury bills. Accordingly, by 1977, 30% of SAMA’s portfolio was invested in US treasury bonds and 80% of its total investment was held in dollars⁴⁸ (ibid). In effect, by 1977, Saudi Arabia held 20% of all

⁴⁸ SAMA kept 70% its dollar assets in New York Federal reserves (Spiro, 1999).

the T-bills held by foreign central banks and accounted for 90% of the total Middle East investment in US treasury bonds (ibid). This heavy concentration of SAMA's portfolio in US bonds reveals the geopolitical nature of the Kingdom's oil savings in the 1970s. Throughout this period, the Kingdom pressured the US administration to ensure the secrecy of SAMA's portfolio (ibid). In return for this recycling, the Saudi state received ample military support from the US in the form of personnel training and arms deals (ibid).

Overall, the above analysis shows that by accident the conservative policy path chosen in the 1960s proved to be economically and politically optimal for the elite after the 1973 boom. By sticking to this policy path, they not only avoided economic and political instability at home, but gained geopolitical influence abroad.

Conclusions

Like Iran, Saudi Arabia experienced a balance of payment crisis in the 1950s. However, in contrast to the Pahlavi regime, the Saudi elite did not switch to state-led industrialisation after the crisis. Instead, they followed a non-interventionist economic policy that gave priority to economic stability and preserving the country's dominance in the global oil market. This policy choice was influenced by the conservative ideology and segmented internal power structure of the Saudi state (such features hindered the possibility of a shift towards “catch up” development”). Thanks to this policy and the steady rising oil revenues, the country experienced a high degree of economic stability and growth in the 1960s. This economic success, in turn, produced positive spillover effects on the internal power structure, class coalitions and geopolitical status of the state, hence further increasing the incentive of Saudi princes to stick with their chosen economic path. Therefore, at the time the 1973 oil boom occurred, the non-interventionist path had become politically entrenched and, as a result, the political elite had little incentive to shift to state-led development and embark on a “big push” industrialisation like Iran. Accordingly, instead of spending all their oil revenues on domestic development projects, they saved a large portion of their petrodollars in rich countries. This was to make sure that Western countries would not plunge into recession and, thus, the future demand for oil would stay the same. This fiscal strategy clearly shows that, as before, the elite attached more importance to ensuring the long-term stability of their oil revenues than to accelerating economic development at home. To be sure, the government did increase its expenditures after the boom and followed a very ambitious development program. But, once this program resulted in a high rate of inflation and bottlenecks in the economy, the political elite slowed down their expansionist policies and restored fiscal and macroeconomic prudence by empowering

SAMA and the CPO. This again reveals that the authorities were not willing to sacrifice macroeconomic stability for economic development. Overall, thanks to the conservative policies listed above, Saudi Arabia was able to contain the macroeconomic damages of the 1973 oil boom and avoid the political trajectory of the Pahlavi regime.

The case of Saudi Arabia further supports the claim that the reaction of rentier states to the 1973 oil boom was dependent on their previous policy path. Like Iran, Saudi Arabia showed little variation in its policy direction after the boom. The major difference was that Saudi Arabia was on a conservative policy path that gave priority to stability instead of “catch-up development”. Ironically, this policy path, which resulted in an industrial performance far inferior to that of Iran in the 1960s, helped the Saudis to manage the oil boom more effectively in the 1970s.

Chapter Nine: Conclusions

The 1973 oil shock is considered a pivotal factor in the historiography of the 1979 Revolution in Iran. The mismanagement of this positive shock by the Pahlavi regime is widely acknowledged as one of the main causes of the revolution (Milani, 2011; Graham, 1978; Razavi & Vakil, 1984). This research attempted to explain why the Pahlavi regime made major macroeconomic policy mistakes after the 1973 oil boom, given its remarkable economic performance in the 1960s. The central argument of this thesis is that the regime's inappropriate economic reaction to the boom was *conditioned* by the economic strategy that it had been previously pursuing. In other words, the very economic strategy that had enabled Iran to grow at a phenomenal rate in the 1960s set the stage for bad macroeconomic policymaking after the boom. To substantiate this argument, the thesis employed an analytical narrative that related Iran's economic responses to the boom to the cumulative process of ISI that had been underway since 1963. This analytical narrative is summarised below.

In 1960, Iran was hit by a balance of payments crisis that plunged the economy into a recession that lasted until 1962. After overcoming the crisis, the Pahlavi elite, particularly the Shah, decided to embark on state-led industrialisation to diversify the economy away from oil and maximise economic growth. This policy shift, which entailed a brutal confrontation between the state and conservative social classes, was made possible by the Shah's absolute grip on power and his ideological preferences for "catch-up" development. As this policy path was created, Iran's economy started to grow at a high pace due to the rapid accumulation of capital. More importantly, this path exhibited self-reinforcing features in a sense that, over time, the benefits of

pursuing import substitution increased for the elite. This is because of spillover effects of this policy that are outlined below:

(1) The ideological effect: The rapid economic growth that accompanied ISI from the early 1960s solidified the developmentalist discourse of the Pahlavi regime. In time, the elite relied more on industrialisation and economic modernisation as a source of legitimacy for the regime.

(2) The geopolitical effect: from the beginning ISI in Iran entailed the development of domestic strategic industries such as steel, aluminium, metallurgy and automobiles, which had a high complementarity with the Pahlavi's military ambition to dominate the Persian Gulf.

(3) The social effect: ISI entailed a drastic change in the state-business relationship; in 1963, the Pahlavi regime cut its link with the conservative social classes, namely the Bazaaris and landowners, who were involved in trading and exports of agriculture and manufacturing goods and formed a coalition with a new-born industrialist class that was engaged in development of consumer goods for the internal market. This meant a change of coalition from "outward looking" classes that attached high importance to external competitiveness to an "inward looking" class that had little interest in macroeconomic adjustments. This latter class was primarily focused on getting access to economic rents (tax breaks, cheap loans and tariff protection) via ISI policy rather than improving its external competitiveness.

Over time, combinations of these spillover effects fuelled the demand for further movement down the path of ISI within the state and in the business community. Crucially, this growing demand for ISI deepening led to the political marginalisation of macroeconomic policymaking institutions (CB and POB) as these institutions were the

only actors inside the state that opposed this policy due to its negative implications for macroeconomic discipline. Accordingly, due to the self-reinforcing effects of ISI, Iran rapidly moved from the development of light industries to building heavy industries from 1963 to 1972, despite the negative effects of this policy on macroeconomic stability. The entrenchment of ISI in this period resulted in the gradual subordination of macroeconomic policymaking to industrial policymaking and consequently, set the stage for poor macroeconomic policymaking after 1972.

The quadrupling of oil prices in 1973, which was partly instigated by Iran, eliminated the country's foreign exchange constraint for "catch up" development overnight. This positive financial shock motivated the Shah to make a large leap down the ISI path and engage in a massive fiscal and monetary expansion. This policy generated soaring inflation and crippling bottlenecks in the economy from 1974. However, despite this instability, the Shah refused to empower the macroeconomic policymaking institutions and shift towards fiscal and monetary prudence. This is because the geopolitical and legitimacy costs of such a policy reversal had become so high (path entrenchment); the Shah had already promised to turn Iran into an industrial nation in less than a decade and he had also started a series of large-scale industrial projects that were of high geopolitical importance such as military and nuclear industries. Due to these reasons, the Pahlavi regime decided to stick with its policy of ISI deepening and, meanwhile, resort to harsher price controls to tackle inflation. This policy persistence resulted in further political marginalisation of the CB and PBO and poor fiscal and monetary choices throughout the fifth plan.

This analytical narrative reveals it was not the oil boom on its own that led to bad economic policymaking in Iran. Rather, it was the *conjuncture* of this boom with the on-going process of state-led industrialisation that produced a "petro-mania" among the

elite. In other words, Iran's reaction to the boom was conditioned by its previous policy path.

To substantiate the above claim, this thesis contrasted Iran with Saudi Arabia as a similar oil-rich country that reacted differently to the boom. Unlike the Pahlavi regime, the Saudi Kingdom did not follow ISI after coming out of its balance of payments crisis in 1960. Instead, it reverted to its non-interventionist model and maintained its coalition with conservative social classes. The main priorities of this model were to ensure economic stability at home and safeguard the country's dominance in the global oil market. Therefore, it did not entail the subordination of macroeconomic policymaking and oil strategy setting to industrial policymaking. This policy path became entrenched in the 1960s, as the coalitions surrounding it (both inside the royal family and also between the state and private sector) became stronger with the inflow of oil revenues. As a result, this conservative policy path proved to be resilient in the face of the oil shock. Although the oil boom opened the possibility of "big push" industrialisation for Saudi Arabia, the political elite did not shift to this path. Alternatively, they saved a large part of their petrodollars abroad and exercised price moderation in OPEC to ensure stable inflows of oil revenues for their regime in the long-term. To be sure, like Iran, Saudi Arabia did introduce an ambitious development plan after the boom, yet alongside this plan, they recycled their petrodollars abroad to make sure that the demand for oil would not drop in the long-term. This shows that, as before, the Saudi princes attached more importance to the maximisation of their oil revenues in the long term than to the acceleration of economic development at home. This means that the massive increase in spending after the boom represented a "bounded change" within the previous conservative policy path of the Kingdom rather than the abandonment of that path. In addition, once this fiscal expansion started to produce inflation and supply

bottlenecks in the economy, the authorities slowed down their development plan and restored fiscal and monetary prudence. This again proves that, as before, the royal family placed economic stability above “catch up” development. Overall, the case of Saudi Arabia supports the claim that the economic trajectories of the rentier states after the 1973 oil shock were shaped by their previous trajectories.

The case of Indonesia also illuminates the above thesis. Like Iran and Saudi Arabia, Indonesia experienced a severe balance of payments crisis in the early 1960s, which paved the ground for a successful military coup in 1965 and gave birth to the New Order regime. Once in power, Suharto followed a non-interventionist economic model and gave priority to economic stability and agricultural development. Thanks to this model, he managed to stabilise the economy in a short period of time and, in effect, solidify the intra-elite coalitions and state-society links formed around this model. However, when the oil boom occurred, Suharto switched from this model and engaged in a “big push” industrialisation. But this policy shift proved to be short lived since the new path caused a high degree of economic instability and mobilised opposition from the beneficiaries of the old path. Given that the new path was not socially, ideologically and geopolitically entrenched enough, the growing opposition to it led to a shift back to the original non-intervention model in 1975. Subsequently, Suharto re-empowered the “technocrats of Bappenas and Bank Indonesia to engage in fiscal and monetary contraction and depreciate the exchange rate. Therefore, in the end, Indonesia’s original policy path survived after the boom.

The main message of this comparative study is that the reaction of petro-states to the 1973 oil boom was conditioned by the policy path that they had been pursuing in the 1960s. In all three cases, the political elite stuck with their original policy paths and followed “more of the same” after the boom; Iran pushed its ISI policy to extreme by

injecting all of its petrodollars into the domestic ISI process, while Saudi Arabia and Indonesia increased their foreign savings. The main difference was that the path that Iran had chosen proved to be sub-optimal for the post-oil boom period since it not only caused a high degree of economic instability, but also left the country with few financial savings. Due to this lack of savings, Iran was hit hard by the drop in her oil revenues in 1978 and was forced to make painful macroeconomic corrections. Therefore, ironically, the very path that had led Iran to rapid economic development in the 1960s, proved to be destabilising for the post-boom period.

Theoretical contributions:

This study offers two interrelated theoretical contributions to the rentier state literature. Firstly, it shows that policy choices of petro-states are influenced by their ideology, internal power structure, geopolitical standing and class coalitions. Secondly, it demonstrates that once a policy is selected it can become entrenched in time by producing spillover effects on the characteristics of petro-states. This means that a policy decision made at a critical time can send rentier states into different resilient economic paths and therefore, influence their future economic and political trajectory. The following paragraphs substantiate these claims in turn.

Contextual factors matter

Economic ideology: one of the factors that encouraged the Shah to choose import-substitution in 1963 was the growing allure of developmentalist ideology among the technocratic and political elite during the crisis period of 1960-1962. As argued by Rodrik (2013) the economic crises provide the fertile moment for new ideas to gain popularity. In moments of uncertainty, policymakers need a “mental model” to tell them “what has gone wrong” and “what should be done about it” (North, 2010). In the case

of Iran, “modernisation theory” and “Latin American Structuralism” provided this mental model for the elite. The combination of these ideas created a unique brand of developmentalist ideology among the elite; which considered economic growth and diversification as the panacea for Iran’s economic, social and political problems. This ideology facilitated a policy shift towards state-led industrialisation in 1963. In contrast, the Saudi elite were not influenced by “modernisation theory” or Latin American structuralism. As a conservative monarchy, they valued stability and continuity, instead of radical economic and social reforms. This conservatism made them choose a different policy path to that of Iran in the 1960s. Ideas also played an important role in policymaking in Indonesia; there, the elite were ideologically divided between economic nationalism and market orientation. This ideological rift resulted in important policy swings in the 1970s.

Thus, following Weberian economic sociology, this study invites us to take the role of ideology seriously when studying rentier states. So far, the resource curse literature has ignored economic ideology as an important interacting factor with oil. Unfortunately, this neglect of ideology also extends to the “modern political economy” as a discipline in general (Rodrik, 2013).

Internal power structure: due to its structuralist inclination, the “rentier state” theory neglects the role of leaders while analysing the economic and political trajectory of oil-rich countries. However, this research shows that in cases such as Iran, where political power is concentrated in the hands of a strong leader, then the role of personalities and individuals becomes very important. For example, the empirical evidence presented in this research demonstrates that as an individual the Shah played a major role in economic policymaking in Iran in the 1960s and 1970s. In particular, he played a critical role in directing economic policy towards ISI in 1963. Even in cases such as

Saudi Arabia, where a family instead of single person has the power, the role of individuals still matters. For instance, Hertog (2007) demonstrates that Faisal played an indispensable role in building a lasting political coalition within the Kingdom in the 1960s. These findings suggest that the rentier state theory should incorporate the role of agency and move away from its rigid deterministic framework.

Class coalitions: the rentier state theory/resource curse literature largely ignores the role of social classes for wrongly assuming that, due to enjoying access to external rents, petro-states are completely “autonomous” from their society. However, this comparative study reveals that class coalitions at the time of the boom matter for economic policymaking; in particular, the orientation of allied classes to the global economy (inward-looking versus outward-looking). When the 1973 oil shock occurred, the Pahlavi regime had a coalition with a new-born “inward-looking” industrial class that had little interest in external competitiveness. Accordingly, the private sector had neither the influence nor the motivation to push for macroeconomic correction. Instead, this sector lobbied for the further extension of credit and appreciation of the nominal exchange rate. In contrast, the New Order regime had a coalition with landlords and merchant classes, which were engaged in the export of agricultural and industrial goods, hence creating social pressures for macroeconomic corrections after the boom, especially for exchange rate depreciation. Similarly, the Saudi Kingdom’s coalition was with a merchant class that was engaged in external trading and had an interest in macroeconomic adjustments after the boom. This finding calls for the integration of class analysis into the political economy of macroeconomic policymaking in resource-rich countries.

Geopolitical standing: as mentioned already, the resource curse literature only focuses on domestic political variables when analysing the economic and political behaviour of

petro-states and ignore the influence of geopolitical factors. However, this research shows that, in the case of Iran and Saudi Arabia, the pricing of oil and recycling of petrodollars in the 1970s were influenced by the geopolitical position of these countries in the Gulf region. As a far more superior economic and military power, the Pahlavi regime had the incentive to constantly push for high oil prices in the 1970s to spend the resulting oil revenues on its ambitious industrialisation and military projects in order to ultimately seal its position as the dominant power in the Gulf region. On the other hand, to make up for its inferior military position in the Gulf, the Saudi state preferred to use its surplus petrodollars and influence in OPEC on the pricing of oil as a geopolitical tool in its foreign relations. The geopolitical factors also played a major role in economic policymaking in the case of Indonesia; the proximity of this country to the Vietnam War increased her aid dependency on Western powers, hence influencing the economic decisions of the political elite, both before and after the boom. These findings help this research take a small step towards bridging the existing gap between the resource curse literature and the Cold War studies.

Overall, this comparative study shows that, other than oil, the policies of rentier states are shaped by their ideology, internal power structure, class coalitions and geopolitical standing. In other words, the economic behaviour of rentier states is determined by the interaction of oil with a bundle of contextual factors. This means that important policy choices made by rentier states are often contingent, in a sense they are determined by interaction of *multiple factors* at a particular time and space. Epistemologically, this invites us to adopt a historical approach towards studying rentier states as this approach allows us to “dig deep” and capture the important contextual factors that can interact with oil.

Studying rentier states over time

By adapting a historical approach, this thesis also highlights that once a policy path is selected by a rentier state, it can become entrenched in time by having spillover effects on the characteristics of that state. Hence, a policy decision made at a certain point can have lasting influence on the future economic and political trajectory of a petro-state. Epistemologically, this necessitates the study of rentier states *over time* (a dynamic approach). At its heart, this approach encourages us to search for cumulative causes (or causal processes) to explain the economic and political divergence among oil-rich countries. Also, this approach opens the door for counterfactual analysis. For instance, the relevant counterfactual question in the case of Iran is what would have happened if the Shah had decided to return to a liberal economic model in 1963 and maintain his alliance with the Bazaar rather than embarking on ISI? The other interesting question is what would have happened if the Shah had decided to follow ISI upon assuming absolute power in 1953 rather than in 1963 (as by the time of the 1973 oil boom the economic diversification would have already shifted towards export promotion and, as a result, the private sector would have an interest in lobbying for macroeconomic corrections)? Posing such questions helps us clarify the nature of causal claims put forward in this thesis, but addressing them requires an analysis that goes beyond the scope of this research.

Overall, at the broad level, this research calls for studying rentier states both in depth and over time. Such an approach allows us to identify the role of contextual variables that interact with oil and influence the long-term economic and political trajectory of petro-states. By following this approach, this thesis has taken a novel step towards bringing the rentier state theory closer to history.

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