The Iranian Economy in the Shadow of Economic Sanctions

Prof. Nader Habibi

Iran’s refusal to freeze its uranium enrichment program, reiterated in the wake of receiving a new economic incentive package from 5+1 nations in June 2008, quickly led to the approval of additional economic sanctions by the European Union and the United States. These new sanctions will follow a number of existing sanctions which go as far back as 1996. The emerging tensions between Russia and the United States, however, will make it more difficult for the U.S. to obtain more effective international sanctions through the United Nations. Instead, the U.S. and the European Union are expected to concentrate on additional unilateral trade and financial sanctions. So far these external economic pressures have had only a moderate impact on Iran’s nuclear policy, but there are many indications that they have had an impact on Iran’s economy and commerce. Even some Iranian public officials have acknowledged the adverse impact of these sanctions.

Indeed, the government of Iran has been very mindful of these sanctions and has taken every possible step to neutralize them—including offering trade concessions to countries and foreign firms that are willing to do business with Iran. The government has essentially politicized Iran’s international trade and foreign investment policies, and as a result, the sanctions have evolved into a process of dynamic and complex economic warfare between Iran and major Western nations, particularly the United States.

In this Brief, I try to analyze how the recent economic sanctions have affected Iran’s economy. To this end I will look at the sanctions as one of four major
forces—along with the fluctuations in oil revenues, the deeply rooted structural and institutional weaknesses in Iran’s economy, and the current Iranian government’s economic policies—that have influenced the performance of the Iranian economy. As will be shown in the sections that follow, these three factors have played a key role in determining the impact of economic sanctions on the Iranian economy. I begin the analysis with an overview of current economic conditions in Iran. Then I analyze the present strengths of the Iranian economy, and its vulnerabilities to external economic pressures such as sanctions in the context of the three factors mentioned above.

Current Economic Conditions in Iran

Various economic indicators suggest a mixed performance on the part of the Iranian economy in recent years. While annual economic growth has exceeded 5% on average and high oil revenues have led to large current account surpluses, inflation has worsened and unemployment is still in double digits. Based on the latest economic data, the annual rate of inflation has exceeded 20% in recent months, compared with 11% and 14% in 2006 and 2007, respectively. Real estate prices, in particular, have risen sharply, resulting in a dangerous real estate price bubble.

The most important driver of Iranian economy is oil, and Iran has benefited from the high price of oil since 2002; the last time Iran experienced a current account deficit was 1998. Since then, its annual current account surpluses have ranged between a meager $860 million in 2003 and a record $20.65 billion in 2006. Iran’s oil revenues rose to $81 billion in 2007 and are projected to exceed $100 billion in 2008. These revenues have led to a sharp increase in public spending.

Economic Growth

High oil revenues and strong government spending have led to higher and less volatile economic growth in recent years. From 1992 to 1999, the Iranian economy grew by an average of 2.5% and was very volatile: Thus, economic growth declined eight percent from 4.1% in 1992 to -2.1% in 1993; conditions improved slowly and the annual growth rate rose to 6.7% in 1996. By contrast, the average economic growth over the succeeding eight years (2000–2007) was 5.2%, and annual economic growth never declined below 4.7% in this period. The latest economic figures from the Central Bank of Iran put the 2007 economic growth rate at 6.9%.

Exchange Rate

Strong oil revenues have also enabled the Iranian government to stabilize the exchange rate. Traditionally, Iranian policy makers have viewed the rial-dollar exchange rate as an anchor for stabilizing the domestic inflation rate. After several trials and errors in the 1990s, and after imposing severe restrictions on imports, the Iranian government was finally able to stabilize the rial-dollar exchange rate in 2000. Currently Iran has enough hard currency reserves to preserve the value of the rial.

Inflation

Worsening inflation is by far the most important source of economic discontent in Iran. The annual inflation rate has remained in double digits throughout the past eight years; averaging 14.4% per year; the latest estimates put the annual inflation rate for 2007 at 18.2%, compared with 11.2% in 2006. And inflationary pressures have intensified since the last quarter of 2007. The main force behind the high inflation rates of recent years is the sharp increase in liquidity (money supply) caused by President Ahmadinejad’s economic policies (see below).

Unemployment

Another visible long-term weakness of the Iranian economy is the persistence of high unemployment rates. Every year the government spends billions of dollars in
job creation, but the unemployment rate has remained in double digits. The latest official population and employment census, conducted in the fall of 2006, revealed that the unemployment rate increased from 9.8% in 1996 to 12.75% in 2006.5

The unemployment rate is higher among younger workers, and the 2006 data also show a sharp increase in joblessness among college graduates. As the share of college graduates in the labor force rose from 9.96% in 1996 to 16.2% in 2006, the unemployment rate for this group of workers increased from 4.0% to 10.1%. More recent semi-official statements by government officials put the unemployment rate at 10.3% during the latest Iranian fiscal year (April 2007–March 2008), indicating a moderate improvement compared with the previous fiscal year.

Investment

Iran's savings and investment performance offers a mixed picture. The long-term investment trends are positive and indicate a significant increase in the flow of resources to investment as opposed to consumption since 1995. Iran's national accounts data show that the share of investment in GDP (measured in inflation-adjusted prices) has increased from 26% in 1995 to a peak of 40% in 2004. Furthermore, there was a gradual shift from investment in construction to investment in machinery during this period. The share of machinery in total gross investment rose from 41% in 1995 to 61% in 2004.8

As noticed by Salehi-Esfahani, the rapid increase in machinery investment is an indication of investors' growing confidence in the long-term prospects of the Iranian economy. He also points out that most of the growth in machinery investment in recent years is attributable to private investors rather than to the government. The increase in investment and the growing share of private sector investment are both consequences of active government policies that were intended to promote manufacturing and industrial activity—including a variety of producer subsidies and subsidized government loans for industrial projects.

This positive long-term trend has been disrupted by the moderate decline in investment during more recent years. During 2003–6 the share of investment in Iran’s GDP suffered a steady decline, from 40% (2003) to 35% (2006). The fact that Iran earned record oil revenues in this four-year interval suggests that the decline in investment was not due to a shortage of liquidity or financial capital. Rather, the main causes of this decline were political uncertainty and economic mismanagement.

Sources of Vulnerability and Strength

The mixed economic performance of the Iranian economy described above has resulted from several domestic and external factors. The main external factors have been oil and economic sanctions. In recent years, oil prices and international sanctions have exerted opposite influences on the Iranian economy, with high oil revenues partially offsetting the impact of the economic sanctions. The major domestic forces can be divided into deeply rooted economic and commercial institutions that have changed slowly over the past three decades, and economic policies that have undergone noticeable and sometimes inconsistent changes in recent years.

Institutional and Structural Issues in the Iranian Economy

As in most oil-exporting developing countries, Iran's ruling elite and intellectuals have adhered to a statist ideology that calls for an active economic role for the government. This mindset has led to the growth of rent-seeking activities at the expense of economic competition. The statist mentality was prevalent before the Islamic Revolution and became even more popular afterwards. Hostility toward private sector and market institutions led to the nationalization of banks, and of many industrial units whose owners had fled the country during the Revolution.

A large portion of these nationalized assets were transferred to religious charitable foundations—such as Bonyad-e Mostazaafan (Foundation of the Oppressed) and Bonyad-e Shahid (Foundation of the Martyrs)—which, as a result, enjoy a significant amount of economic and financial power. They function as semi-autonomous conglomerates, and in addition to controlling large assets they enjoy exclusive import privileges with respect to a variety of imported products, including consumer goods and manufacturing parts. They enhance the government’s economic and political influence even as they stifle competition in the economy.

Another institutional weakness of the Iranian economy is judicial inefficiency and corruption. Although the constitution of the Islamic Republic respects private property ownership, the enforcement of property ownership was highly politicized in the early years of the Islamic republic. The enforcement of property rights has improved in the past two decades, but the judiciary is still inefficient and resolution of business disputes is often vulnerable to corruption and nepotism. Concerns about the legal environment have had an adverse effect on investor confidence, particularly in the case of foreign investment.

The Challenge of Economic Reform

Another source of Iran’s economic vulnerability is the lack of coherence and coordination in economic policies. This weakness has been more visible in the past two years, but it has been a recurrent phenomenon for more than two decades. Iran has followed the path of many other developing nations in the adoption of market-oriented economic reforms—but it was only after a severe economic decline in the 1980s that the ruling policy makers were ready to entertain any proposals for reform. The economy (as measured by the GDP) had declined by nearly one-third during the years 1978–87 as a result of political instability, low oil revenues, and eight years of war with Iraq. By 1988, Iran’s Budget and Planning Organization had raised the
alarm about this severe decline. The calls for economic reform were slowly passed up to the more pragmatic political leaders such as Hashemi Rafsanjani, who was elected president in August 1989.

Under Rafsanjani’s leadership, Iran initiated a series of economic reforms during the 1990s. These reforms were supported by everyone from bazaar merchants to the new generation of Western-trained economists who had filled the ranks of the economics departments in Iranian universities in the 1980s and 1990s. Proposed reforms included some of the prevailing IMF recommendations for privatization, deregulation, and exchange rate unification.

In the past two decades, Iran has experienced an intense political struggle between the proponents and opponents of economic reform—a struggle that has led to an erratic course of economic policy. In the case of some reform initiatives, such as privatization, the government has moved back and forth several times as the balance of power has shifted among opposing factions. The resulting inconsistent economic policies have created an uncertain business environment and reduced investors’ interest in long-term investment in Iran. They have also intensified the adverse effect of external economic pressures on Iran’s investment climate.

Privatization is not the only area of economic reform with which Iran’s ruling regime has had difficulties. The attempts to reduce consumer subsidies and liberalize commodity prices have also faced strong political resistance, as was seen in several failed attempts to liberalize the price of gasoline despite the heavy fiscal burden of gasoline subsidies. (Iran imports one-third of its domestic gasoline consumption, owing to inadequate domestic refining capacity.)

During Mohammad Khatami’s presidency (August 1997–July 2005), the lack of consensus over economic policy continued. Khatami supported a series of privatization programs and took the first steps toward the promotion of private banks and the privatization of a small number of state-owned banks. He also took some actions to promote foreign investment.

During the final years of Khatami’s presidency, his conservative opponents gained the upper hand in the parliament (partly by disqualifying and purging reformist politicians) and blocked many of his economic policy proposals. Some of his foreign investment agreements with foreign firms were also undermined by the parliament in 2005, which resulted in significant confusion on the part of international investors regarding economic stability in Iran and the enforceability of Iran’s foreign investment regulations.

Mahmoud Ahmadinejad’s presidential campaign in the spring of 2005 featured promises of economic justice and a reduction in poverty. In this context, Ahmadinejad was sharply critical of the privatization program that was already underway. He accused the public officials in charge of privatization of nepotism, and of selling privatized enterprises at unfairly low values. Ahmadinejad’s candid criticism of government officials for corruption and economic mismanagement helped him win the election.

Ahmadinejad’s economic ideology was driven by four principles. First, he believed in an active economic role for the government and did not have much faith in privatization or deregulation. Second, he believed that government must redistribute wealth and income in favor of low-income families and the poor. Third, he expressed little appreciation for fiscal conservatism and believed that the Iranian government should spend its oil revenues aggressively on development projects, particularly in underdeveloped regions of the country. Finally, he viewed Iranian financial institutions, particularly the state-owned banks, as instruments of government policy and had little appreciation for their commercial or monetary role.

This perspective resulted in a number of radical economic policies that contradicted the previous economic reforms and resulted in higher inflation rates. Anticipating resistance to his programs, Ahmadinejad began his presidency by replacing the directors of Iran’s state-owned banks with his close supporters—the beginning of a broad policy of replacing the top-ranking public sector managers who had been appointed by President Khatami (or by former President Rafsanjani). At that time the parliament was already dominated by a large group of conservative MPs who supported Ahmadinejad and generally approved his economic programs in the first two years of his presidency.

Ahmadinejad did not waste any time expressing his disapproval of the previous government’s privatization program. He initially froze privatization sales but came under pressure from the Supreme Leader and the Expediency Council—which reaffirmed the constitutional legitimacy of the privatization initiative—to proceed with the approved sales.

Strong support for Ahmadinejad’s economic policies did not last for long. Soon there was a division within the conservative faction of the Islamic regime, and the more pragmatic conservatives joined the reformists in voicing opposition to his policies. They were particularly worried about Ahmadinejad’s attempts to undermine previous reforms.

If Western sanctions undermined Iran’s privatization initiative by deterring foreign investors, the lack of clarity and consensus among the ruling elite discouraged domestic and foreign investors alike. Fractional disagreements over the wisdom and implementation of privatization created an uncertain environment up until early 2007, when the Supreme Leader, Ayatollah Ali Khamenei finally intervened and called for acceleration of the privatization program. Consequently, privatization sales revenues, which had declined sharply to $180 million during the 2005–6 fiscal year—the first years of Ahmadinejad’s presidency—enjoyed a huge increase, to a record $4.97 billion, in 2006–7.
President Ahmadinejad also tried to introduce significant changes in banking and monetary policies. Soon after coming to power he called for a reduction in state-controlled interest rates. The average lending rate was subsequently reduced from 16% in the 2004–5 fiscal year to 14% in 2005–6 and to 12% in 2006–7. These reductions were enforced with the backing of the parliament and despite objections by the minister of Economic Affairs and Finance, and by central bank officials who warned about the inflationary consequences of this policy. Indeed, these bank rate reductions led to excess liquidity and higher inflation rates—and forced many banks to accept heavy financial losses, which had to be covered by large government subsidies.

Ahmadinejad’s fiscal policies also contributed to a rise in inflation: Government spending rose by 25% during the 2005–6 fiscal year, according to Iran’s Central Bank fiscal statistics. While the approved 2006–7 budget did not show a significant increase over the previous fiscal year, in practice Ahmadinejad repeatedly requested and received parliamentary approval for supplemental spending. Hence it is estimated that public spending growth in 2006–7 was even larger than during the previous year. The additional spending was mainly allocated to development projects in underdeveloped areas and distant provinces.17

While the economy has continued to grow in the past two years, inflation has taken a toll on the quality of life for most segments of Iranian society, and opposition to Ahmadinejad’s economic policies has intensified, even among a significant number of the newly elected parliament members. Specifically, in the March 2008 parliamentary elections, one of Ahmadinejad’s political rivals, Ali Larijani, not only won a parliamentary seat but was also elected speaker of the parliament. Larijani represents a more pragmatic faction of the conservative camp, and under his leadership the parliament is likely to take a more active role in the formulation of economic policy. Hence, Ahmadinejad will be on the defensive in the remaining months of his first term (until August 2009). In the past six months, several of his economic policies, including an attempt to restructure the banking system and further reduce interest rates, have been frustrated. He has also been forced to accelerate the privatization program despite his personal reservations.

Unsatisfied with these limited UN sanctions, the U.S. has intensified its own. American firms have been barred from doing business with Iran ever since the adoption of the 1996 Iran-Libya Sanctions Act (ILSA). In recent years the U.S. has also been able to discourage many foreign firms from engaging in trade and investment activities in Iran.

The American effort in this direction has primarily focused on the financial sector. In the past three years, several major European banks have terminated their business relationships with Iran—which has had an adverse effect on Iran’s trade and investment ties with Europe. Up until 2005 the volume of trade between Iran and the European Union was on the rise, but the latest data show a decline in 2006 and 2007. In recent months, and particularly after Iran rejected the latest economic incentive offer of the 6+1 group in August 2008, European governments have escalated their own economic and financial sanctions against Iran.

In response to the difficulties of trading with Europe and in anticipation of deteriorating conditions, Iran has shifted its economic orientation toward Russia, Asia, and the GCC countries. Iran’s volume of trade with Asia and the GCC has steadily increased in the past decade, and Asia has captured a large share of Iran’s import market at the expense of Europe.

This development, however, has not escaped the attention of the United States. The U.S. Treasury Department has put increasing pressure on financial institutions in both Asia and the GCC to sever their business transactions with Iranian entities. Various news reports indicate that several banks in both regions have cut back on their dealings with Iran, and this has already created difficulties for Iranian importers.18

These financial sanctions have also had an adverse effect on Iran’s manufacturing sector—particularly its automobile industry, which has traditionally relied on European suppliers for parts and machinery. As trade with Europe has become more difficult, Iran has increasingly turned to Korean and Chinese automakers. Now even the success of these deals is in doubt because of U.S. pressure on Asian countries.19

Equally troubling for Iran is the potential spread of financial sanctions to GCC countries—particularly the United Arab Emirates, which has emerged as one of Iran’s largest trade partners. The geographic proximity of the two countries and the presence of a large expatriate Iranian community in Dubai have led to a significant increase in bilateral trade. In particular, Dubai serves as an important re-export center for the sale of industrial and electronic goods from Asia to Iran.

The United States maintains close relations with the federal government of the UAE, and has requested it to improve its cooperation with the financial sanctions applied against Iran. Iran’s main trade partner in the UAE, however, is the Emirate of Dubai, which benefits heavily from its economic

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**Coping with Economic Sanctions**

At present, Iran is subject to two types of sanctions: the official United Nations economic sanctions and the unilateral sanctions of the United States (and more recently the European Union). The UN sanctions have a limited scope and focus on exports of goods and services that can directly contribute to Iran’s nuclear program. The United States tried very hard to make these international sanctions more comprehensive, but it faced strong resistance from Russia, China, and to a lesser extent the European Union. As a result of their limited scope, the UN sanctions have not imposed any severe costs on the Iranian economy.
ties with Iran and so far has been reluctant to sever those ties. Trade with Dubai has played a key role in allowing Iran to bypass the U.S. sanctions. A cutoff of Iran-Dubai economic ties would be a severe blow to the Iranian economy, and the United States is well aware of this vulnerability.

In recent years the United States has tried very hard to convince China and Russia to join the sanctions against Iran, but it has had only limited success. And recent tensions between Russia and the U.S. over Russian military intervention in Georgia may further reduce the likelihood of Russian cooperation in the near future. This may offer only partial relief to Iran, however, as the lack of progress with respect to UN-sponsored sanctions will likely encourage the United States and the European Union to intensify their unilateral sanctions.

Oil to the Rescue

If in spite of economic mismanagement and worsening economic sanctions the Iranian economy has managed to grow by an average of 5.8% per year in the past three years, the reason is the high oil revenues that have enabled the government to finance its fiscal expansion. The latest data from the Iran Central Bank show that Iran's oil export revenues have increased from $36 billion in the 2004–5 fiscal year (ending in March) to $81 billion in the 2007–8 fiscal year. Overall, Iran has earned a total of $197 billion from oil sales from April 2005 to March 2008.

One visible negative consequence of Iran's larger than expected oil revenues is the sharp increase in the inflation rate, which has angered large segments of the Iranian population in recent months. At the same time, abundant oil revenues have helped the government shield the population from some of the adverse consequences of the sanctions. There is no doubt that sanctions have kept foreign investment in the country's manufacturing and energy sectors far below its potential. Oil revenues, however, have enabled the Iranian government to partially offset the shortfall in foreign investment by increasing domestic investment. The government, in addition to increasing investment by public enterprises, has used a portion of the country's oil revenues to provide investment loans to domestic private investors.

Abundant oil revenues have also made it possible for Iran to sharply increase imports of basic necessities and consumer goods in the past three years. Thus, while the sanctions have slowed down the development of Iran's manufacturing and energy sectors, which are crucial for the long-term growth of the Iranian economy, oil revenues have allowed the government to shield households and consumers from the effects of stagnation in these sectors. For example, gasoline imports have made up for the shortage in domestic refining capacity, which is partly due to the sanctions.

Oil revenues have also enabled the ruling regime to offer economic rewards to its political support base. President Ahmadinejad has used oil revenues to finance development projects in underdeveloped regions of the country. These expenditures have proven highly popular at the local level and have strengthened the Islamic regime's political base in these areas.

Oil revenues have been used by the government to support the exchange rate and prevent financial panic. Iranians are highly sensitive to the stability of the exchange rate because it has a direct impact on price of imports and people's confidence in the economy. Any fears regarding the foreign reserves of the country's central bank could easily spark a currency run and encourage people to hoard foreign currency. Had it not been for the large currency reserves accumulated in recent years thanks to oil revenues, the economic and financial sanctions imposed on Iran could easily have led to currency runs and financial panic. Yet the currency has been stable, and most of the excess liquidity has been directed to real estate speculation instead of hording foreign currencies.

Conclusion

The economic mismanagement and institutional inefficiencies of the Iranian economy have made it more vulnerable to the economic sanctions that have been applied against Iran in recent years. Had the sanctions been imposed on Iran during a period of low oil revenues, they would have had far more severe consequences. In the past three years, however, abundant oil revenues have helped Iran cope with the sanctions without subjecting its citizens to a significant decline in their economic well-being.

In the near future, the continuation and effectiveness of the UN-sponsored sanctions will remain hostage to the state of U.S.-Russia and U.S.-China relations. In the aftermath of the recent Russian maneuvers in Georgia, Russian cooperation with respect to international sanctions against Iran remains uncertain. Unilateral sanctions applied by Europe and the United States are likely to continue and intensify, however, unless the dispute over Iran's nuclear program is resolved. At the same time, as long as oil markets remain tight, the U.S. is unlikely to impose sanctions on Iran's oil exports, and Iran will be able to earn sufficient oil revenues to enable it to cope, at least partially, with the remaining sanctions.

This is not to say that economic sanctions, particularly the unilateral financial sanctions applied by the United States and the European Union, will not take any toll on the Iranian economy: They have already cost that economy billions of dollars in lost trade and investment, and these costs have already led to an internal debate within the regime about the wisdom of its current nuclear program. Yet so far the proponents of the nuclear program have had the upper hand, and they believe that pursuing it is well worth the sanctions, particularly since oil revenues in recent years have far exceeded the costs of the sanctions.
In the first two years of his presidency, President Ahmadinejad undertook more than 300 provincial visits outside Tehran and even held several cabinet meetings in provincial capitals to emphasize the priority of rural and provincial development in his administration. These visits and the delivery of developmental funding have boosted his popularity among rural voters. See Ahmad Rafat, “Iran: Sanctions Continue to Batter the Economy,” AKI—Adnkronos International, April 11, 2008.

Top-ranking managers of the oil ministry and of energy sector public enterprises were also replaced during the first year of Ahmadinejad’s presidency; some were removed after expressing opposition to the president’s policies. This purge led to a loss of experienced managers in the oil sector. By implementing this purge Ahmadinejad wanted to make sure that oil ministry and its main subsidiaries were controlled by his close allies and confidants so that there will be no internal resistance to his policies. He was also trying to eliminate the corruption and financial abuse of foreign contracts that, in his view, were rampant in that ministry.

The Expediency Council is a high-ranking appointed body that is responsible for resolving constitutional disputes between the branches of the Iranian government and the Guardian Council.

According to article 44 of the Iranian Constitution, three types of economic ownership are recognized: private, public and cooperative. The leftist interpretation of article 44 paved the way for the expansion of the public sector (state ownership) during the first decade of the revolution (1979–88). Internal debates over the boundaries of private and public ownership began after 1988, and there has been a gradual increase in support for privatization over time. The Third and Fourth five-year development plans included extensive privatization projects, which have been only partially implemented. In reaction to the ongoing disagreements on privatization policy, the Supreme Leader of Iran issued a ruling in early 2006 that supported the privatization of state-owned enterprises in many sectors of the economy. The detailed interpretation of this ruling was left to the Expediency Council.


President Ahmadinejad frequently visits the provinces, and during these visits delivers funding for development projects. In the first two years of his presidency he undertook more than 300 provincial visits outside Tehran and even held several cabinet meetings in provincial capitals to emphasize the priority of rural and provincial development in his administration. These visits and the delivery of developmental funding have boosted his popularity among rural voters. See Scott Peterson, “Ahmadinejad: Rock Star in Rural Iran,” Christian Science Monitor, December 7, 2007.

Iran was counting on trade and investment relations with China to bypass the sanctions, but even Chinese firms are now hesitant to trade with Iran. Since January 2008, four Chinese banks have frozen their ties with Iranian financial institutions, resulting in the termination or postponement of several important business contracts. Some Chinese contractors are also withdrawing from existing agreements. The rationale offered by these firms is that access to the U.S. market is more valuable to them than access to the Iranian market. For more details, see Ahmad Rafat, “Iran: Sanctions Continue to Batter the Economy,” AKI—Adnkronos International, April 11, 2008.

Rent-seeking refers to the efforts of an individual to increase its profit by influencing the government policies and altering the business regulations as opposed to engaging in trade or productive activities. For example, when members of an industry lobby their government to raise the tariffs on their foreign competitors they are engaged in a rent seeking activity.

As a compromise solution, the government finally introduced gasoline rationing in 2007.
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