

# WEEKLY GEOPOLITICAL REPORT

## DOES IRAN WANT WAR?

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Since his election in June 2005, Iranian President Mahmoud Ahmadinejad has upset both the domestic and international political order. Within Iran, Ahmadinejad has replaced hundreds of liberal and moderate bureaucrats with members of the conservative Revolutionary Guard and has purged 40 ambassadors from the diplomatic corps. To the world, the new president has made inflammatory statements, suggesting that Israel should be “wiped off the map” and pushing ahead with a nuclear program despite opposition from Europe, the United States and most of the Middle East — opposition strong enough to, perhaps, bring additional United Nations sanctions.

The United States and Israel have both indicated they would not tolerate Iran joining the nuclear weapons club. Despite repeated threats, Iran loudly continues along the path of acquiring the bomb.

### Why is Iran so belligerent?

#### Iran's problem ...

Iran, the world's premier Shiite power, is caught in a demographic and economic vise that, if not resolved, could bring a catastrophe. There are two basic problems:

First, Iran has an unusual demographic profile. In the aftermath of the Iranian revolution in 1979, a “baby boom” ensued, as Ayatollah Khomeini encouraged large families. This has led to a very young population; in 2005, 27.1% of Iran's population was 14 years old or younger, compared with 20.6% in the United States. Young populations tend to carry two risks. First, the economy needs to expand at a rapid pace to generate enough jobs to employ all these young people. If growth fails to create enough jobs, turmoil can develop. Second, young people tend to be more radical; young population “bulges” can bring social unrest. As a historical parallel, we note the United States in the 1960s during the flowering of the baby boom and the student turbulence that occurred in that decade.

The flip side is that, at present, Iran's population aged 65 years old or greater is 4.9%, compared with 12.4% for the United States. However, with a sharp decline in birth rates in the aftermath of the Iran/Iraq war, by 2050, 30% of the Iranian population will be of pensioner age in a nation that lacks a social safety net to meet the needs of the elderly. Such demographic “time bombs” are not unique; nearly every nation in the world will face something like this, or worse, by mid-century. But Western nations can meet this crisis by improved productivity and immigration. Iran has net emigration and falling productivity. Thus, over time, Iran faces collapsing living standards.

Second, although Iran claims to have 132 bb of oil reserves, the lack of investment, international sanctions and poor field management has led to stagnant output. At the same time, its internal consumption is growing at 5.2%. Due to the combination of rising demand and falling production growth, Iran will be a net oil importer by 2020. Already, due to the lack of refining capacity, Iran imports oil products.

Thus, Iran is staring at the following crisis. Due to its demographics, it needs robust growth now to maintain political stability. Over the next 50 years, it needs enough wealth to meet the needs of a rapidly aging population. And it must do this with an energy-based economy with a steadily deteriorating oil industry.

#### A fork in the road ...

It seems highly unlikely that Iran, within its current borders and under its existing political system, can avert a crisis. There are two different directions that Iran can take to solve its present and future problems.

#### The way of peace ...

To attract foreign investment, Iran needs to make peace with the United States, which would likely end economic sanctions. For the Bush administration to agree to ease sanctions, it would need proof that Iran was no longer supporting Islamic terrorist groups, including Hezbollah.

Given Iran's huge oil reserves, Western oil companies would be very interested in developing these assets. Most likely, Iran would be able to boost its oil production and revenue and improve its financial situation.

So what's the downside? Iran is a totalitarian theocracy, a nation ruled by clerics. Although there are elections and a parliament, a council of clerics, known as the Council of Guardians, can overrule any laws passed by the legislature. It can also decide which candidates can run for office. Liberalizing the economy and allowing foreign investment into the country will open the social system to outside influences. That could undermine the control of the mullahs; given the current demographic youth “bubble,” the odds of revolution would increase. We note that in the 1980s another totalitarian state, the Soviet Union, attempted to improve its economic growth via liberalization. The result was an end of the Soviet system. And so to maintain political and social control, the current Iranian government will be wary of liberalization of the economy and improved relations with the United States.

## The way of war ...

The other option for Iran is to expand its resources through conquest or influence. There are significant oil reserves near the Iranian/Iraqi border in southern Iraq. Conveniently, this region of Iraq is heavily Shiite. Iran has exercised influence over the most important clerical figures in this region of Iraq. Ayatollah Ali al-Sistani, the spiritual leader of Iraq's Shiites, spent years in exile in Iran. And the firebrand Muqtada al-Sadr is thought to be controlled by Iran. One of the great fears of a divided Iraq is that Iran would either heavily influence, or eventually annex, the southern Iraq region. The second potential target is eastern Saudi Arabia. Not only is this the heart of the Saudi oil industry, but it is heavily Shiite as well. There are fears that if Iran controlled southern Iraq, it could eventually take over the Saudi oil fields as well.

Of course, military adventurism requires resources and military prowess that Iran probably doesn't possess. Although Iran could probably prove formidable enough to attack Iraq's depleted military, and may even have enough military resources to invade Saudi Arabia, its military would be no match for NATO or the United States. Because the West probably won't tolerate a "greater Iran," Iran needs a "force multiplier."

Nuclear weapons could be just that multiplier. They could give Iran the ability to use "nuclear blackmail" to either gain control of these two oil-rich regions or force Iraq and Saudi Arabia to kowtow to Iranian desires for OPEC production powers, all this without firing a shot. If Iran decides to maintain its totalitarian system by acquiring oil resources, having the "bomb" could be the most cost-efficient way to become powerful enough to win these resources.

## Which path will Iran take?

Most Middle East analysts seem to assume that Iran will take the "way of peace." Neo-conservatives have suggested that clerical rulers in Iran, like the Soviets before them, will crumble once even faint liberalization occurs. And they see this liberalization as inevitable. But the last presidential election has increased the odds that a more violent outcome is possible.

The presidential runoff election in June was between the former president and erstwhile pragmatist, Akbar Hashemi Rafsanjani, and the eventual winner, Mahmoud Ahmadinejad. Since little happens in Iran by chance, it appears enough of the clerical establishment wanted the radical mayor of Tehran to win.

Most analysts consider Ahmadinejad something of a fool; not only does he make repeated inflammatory statements, discussed above, he often exposes beliefs that a messianic figure in Shiite Islam, the "12th Imam," will arrive at any time. He has, in fact, allocated some \$17

million to a mosque in the small Iranian town of Jamkaran to remodel for his return. The return of this figure is expected to set off the "end times," a world battle of good against evil. Ahmadinejad may be driven by religious beliefs that a secular, Western mind couldn't comprehend. Unfortunately, a zealot like Ahmadinejad may be more open to using weapons of mass destruction, given his apocalyptic worldview.

In other words, calculated, rational negotiations with this guy might not work.

## Is war inevitable?

War isn't inevitable, but the odds of some sort of conflict are increasing. As the European experience of Adolph Hitler showed, appeasing a madman who is running a totalitarian state doesn't work out very well. The Middle East Newline reports that the Bush administration is quietly negotiating with Turkey and the other Gulf states to try to garner support in case military action is required. Unlike with the situation in Iraq, the Europeans will likely be on board for this one, especially if Iran continues to rebuff France, United Kingdom and Germany in nuclear negotiations.

The primary difference between the Iraq War and a conflict with Iran is our aims will be limited to simply thwarting the country's progress toward developing a nuclear weapon. Given the demographic and economic nightmare facing Iran over the next 15 years, the West has time on its side. Thus, limited airstrikes and Special Forces operations are liable to be the extent of any conflict. Because there won't be attempts to rebuild Iran, the costs will be less. And America will have greater support.

## In conclusion ...

Hostilities with Iran are not a sure thing, but the odds are increasing. Any conflict would probably be of limited scope with a broad base of allies. Thus, the probability of success is higher. The outset of hostilities would likely cause the usual market behavior — a lift in gold prices, a spike in oil, a pop in Treasuries. But if our analysis is correct, and the war is limited, these will likely reverse quickly. Often such events turn out to create buying opportunities in equities.

Of course, whenever ordinance is in the air, there is always the chance that things don't go as planned. If war looks more likely later this year, it will have the market impact of boosting flight-to-safety instruments and hurting assets that require investor confidence.

But, just perhaps, a small conflict now avoids a much bigger one later. If hostilities with Iran are going to occur, it makes sense to attack before it acquires nuclear weapons. And so, it may not be as worrisome as it appears at first glance and, in fact, could be a prudent course of action.



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