The political economy of macroeconomic policymaking in Iran and Indonesia after the 1973 oil shock

Abstract

Using comparative historical method, this study seeks to explain why after the 1973 oil shock, technocrats were marginalised in macroeconomic policymaking in Iran, while in Indonesia, technocrats continued to retain their power. It relates this divergence in macroeconomic policymaking to the contrasting economic ideology, class coalitions and geopolitical standings of the Pahlavi regime and New Order regime. Generally, this paper highlights the importance of contextual factors (history at the broad level) in explaining the behaviour of oil-rich states, hence arguing against the implicit oil determinism of "rentier state" theory and "resource curse" literature.

Introduction

Among oil-rich countries, Iran and Indonesia represent the two "extreme cases" in terms of being affected by the 1973 oil shock; the former is usually held as the hardest-hit economy by the shock, while the latter is often considered as the most positively influenced (or the least-damaged economy) (Karl, 1997). This divergent performance is related to the power of technocratic policymaking institutions in the two regimes and the different macroeconomic policies that were selected in response to the shock.

In the case of Iran, when the oil shock occurred, the technocrats of Central Bank (CB) and Planning and Budget Organisation (PBO) were marginalised by the Shah and, as a consequence, a series of adverse economic responses such as doubling of fiscal expenditures, loosening of monetary policy and premature capital account liberalisation were chosen. These policies produced soaring inflation, widening income inequality, capital flight and unprecedented corruption in the 1973-1977 period (Pesaran, 1982, Salehi-Esfahani & Pesaran, 2008). In addition, at the micro level, a harsh "anti-profiteering" campaign was introduced against the private sector along with an outright industrial ownership reform, which generated a panic among the new-born industrialist class. Combination of these policies turned Iran from one of the best performing and stable economies in the 1960s into a highly unstable and unequal economy in the 1973-1978 period (Hakimian, 2008), sowing the seeds of the subsequent downfall of the Pahlavi regime in 1979.

While in the case of Indonesia, the competent technocrats of "Berkley Group" retained their control over macroeconomic policymaking after the shock (except a brief period) and made necessary fiscal and monetary adjustments to offset the negative effects of the oil boom (Gleb, 1989, Temple, 2003, Bevan *et al*, 1999). Moreover, at the micro-level, the large chunk of oil revenues were directed to agriculture, the sector in which the country enjoyed a comparative advantage and where most of the population was employed. This policy ensured poverty reduction and equitable growth and, in effect, strengthened the social base of the New Order regime (Temple, 2003). Thus, this regime continued to survive for the next two decades and managed to achieve a high and steady growth rate (7% per year) until 1997; relatedly, the World Bank named Indonesia as an "East Asian miracle" in the early 1990s (Rosser, 2004).

This research aims to explain why the Iranian technocrats lost their control over policymaking after the shock, whereas the Indonesian technocrats retained their power. In other words, why Iran experienced an *institutional deterioration* in policymaking as opposed to Indonesia? This paper particularly focuses on macroeconomic policymaking, an area where the performance of the technocrats differed in the two cases.

To answer the above question, the paper compares macroeconomic policymaking before and after the shock in the two countries. Specifically, it maps out the broad political environment in which the technocrats were operating and links their power to the contrasting economic ideology, class coalitions and geopolitical status of the two states.

Section one of the paper explains the logic behind the case selection, while section two identifies the research gap that this comparative study seeks to fill. The method employed in the paper is outlined in section three. Section four and five compare and contrast the politics of macroeconomic policymaking before and after the shock in the two cases. Finally, section six concludes and discusses the potentials of comparative historical method for studying economic and political development in resource-rich countries.

1. Two "similar cases" with divergent macroeconomic policy choices

When the oil prices hiked in 1973, both Iran and Indonesia had central banks and planning institutions that were staffed with highly competent technocrats. Similarly, these institutions were operating within patrimonial states where all the power was centralised in the hands of an autocrat. Also, both states 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[1].

In fiscal policy, both countries embarked on a massive spending program in the immediate aftermath of the shock. The Pahlavi regime emphasised the development of heavy and capital-intensive industries while the New Order Regime concentrated on agricultural development. This translated into sudden hikes in expenditures in 1973 and 1974 (table 1). Importantly however, from 1975 onwards, the Indonesian policymakers steadily reduced the growth of expenditures both in nominal and real terms, while the Iranian policymakers followed a very volatile pattern of expenditures (table 1 & 2). In addition, unlike their Iranian counterparts, the Indonesian technocrats refrained from deficit spending and ran budget surpluses during the 1973-1977 period

[1] 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, comparing to 20% in Indonesia (Amouzegar, 2001). Also, Iran's petroleum exports were four times as Indonesia in the same year (ibid). Accordingly, Iran enjoyed considerable influence in OPEC as a major oil producer, unlike Indonesia which was a marginal producer. Nevertheless, the quadrupling of oil prices in 1973 *still* amounted to a big shock to the Indonesian economy; by the peak of the boom, oil accounted for three-quarters of the export earnings and more than 60% of the government revenues[1] (Warr, 1986). Hence, it is theoretically fruitful to compare macroeconomic policy responses of Indonesia and Iran with each other, irrespective of the magnitude of the shock in the two countries.

(table 3 & 4). Accordingly, they managed to increase the government savings from 3.2% of GDP in 1973 to 6.1% in 1978 (Bevan *et al*, 1999).

In monetary policy, due to the underdevelopment of their money markets and banking sector, both countries 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 (rupiah was pegged to dollar and rial was linked to SDR). After the shock, initially, the two countries followed a similar monetary policy by engaging in excessive expansion of credit. Crucially however, from 1975, the Indonesian technocrats employed aggressive credit quotas on their banks and increased the interest rates to limit the liquidity growth and avoid the emergence of real negative interest rates (figure 1). In contrast, the Iranian policymakers did not wholeheartedly devise credit limits on their banks and failed to increase the interest rate in par with inflation (figure 2). Overall, they showed less commitment to tame the liquidity growth than their Indonesian counterparts, as illustrated in table 5. Correspondingly, between 1973 and 1977, liquidity increased by 400% in Iran comparing to 285% in Indonesia.

Moreover, the two regimes also reacted differently in exchange rate policy. Figure 3 and 4 capture the real value of rupiah and rial against the dollar, respectively. As shown, initially, both countries experienced real exchange rate appreciation between 1973 and 1976 due to the growing inflation and a fixed nominal exchange rate. This entailed a decline in the competitiveness of their tradable sectors (the Dutch disease). However, in 1977, the Indonesian policymakers decided to reverse this trend by depreciating 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, rial continued to remain overvalued. The more advanced empirical research conducted by Amouzegar (1991), Salehi-Esfahani and Pesaran (2008), Warr (1986) and Usi (1997) on the real exchange rates in Indonesia and Iran also confirms this policy divergence.

To summarise, both Pahlavi and New Order regimes initially reacted in a similar manner to the shock by conducting excessively expansionary fiscal and monetary policies. But 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 quicker than Iran (figure 5) and more importantly, achieve a stable economic growth, while Iran experienced a very volatile growth rate in the 1973-1977 period (figure 6). This high growth volatility is captured by the large difference in the standard deviation of growth in Iran (8.3%) and Indonesia (1.9%).

As outlined above, this study selects two similar rentier dictatorial regimes that had competent technocratic institutions but followed different policies after the oil boom, and accordingly, achieved different economic outcomes. The main goal of this comparison is to explain the *policy divergence* between the two regimes by focusing on their technocratic institutions and process of policymaking.

2. Literature review

The main contribution of this paper is to the political economy of oil, particularly to "rentier state" theory. The main shortcoming of this theory is that it treats oil as destiny and defines the universal concept of "rentier state" to explain the behaviour of all oil-rich states, irrespective of their different class coalitions, geopolitical standings, ideology, internal power structure and histories (Rosser, 2004). Naturally, this deterministic framework fails to explain the wide variation that is witnessed in the behaviour of resource-rich states (Mohades & Pesaran, 2013, Torvik, 2009, Brunnschweiler, 2009, Lederman & Maloney, 2007).

More specifically, in the case of pre-revolutionary Iran, the rentier state theory is unable to explain why the Pahlavi state reacted so poorly to the 1973 oil shock, comparing to other oil-rich countries. The large magnitude of oil windfall in Iran cannot provide a satisfactory answer on its own, since other major oil producers such as Saudi Arabia were not as badly damaged as Iran by the shock.

The Iranian studies literature often links the mismanagement of oil windfall in Iran to the personal despotism of the Shah (Katouzian, 1981, Milani, 2011). Again, a brief comparison with Indonesia or other "high-growth" autocracies of East Asia shows that dictatorship cannot sufficiently explain bad policymaking. The research conducted by Collier and Hoeffler (2008) even suggests that autocracies tend to be better at managing oil revenues due to their long-term political horizons.

Finally, Karl (1997) proposes "petro mania" hypothesis to explain the behaviour of Pahlavi state. According to this hypothesis, the Shah became over-confident after orchestrating several rounds of price increases in OPEC in the 1970s and, henceforth stopped listening to the advice of economic experts. The problem with this psychological hypothesis is that it neglects the role of structural variables such as Iran's strong geopolitical standing and the state-society relations in shaping the Shah's behaviour.

To address the above gap in the literature, this study has engaged in a holistic comparative study of Iran with a similar case that reacted differently to the shock. Generally, this kind of in-depth analysis helps us discover new causal factors for explaining the different trajectories of oil-rich states.

3. Research methods

This paper employs the historical method and engages with a wide variety of primary and secondary sources to uncover the politics of policymaking in the two countries. In the case of Iran, these sources include:

(a) The UK Foreign Office and Foreign and Commonwealth Office archival documents between 1963 and 1977, referred to as FO or FCO in the text.

(b) Minutes of the High Economic Council meetings held between 1973 and 1977, documented by PBO (1990).

(c) Monthly magazines published by Tehran's Chamber of Commerce and Iran's Chamber of Commerce, Industry and Mine between 1963 and 1977.

(d) Central Bank of Iran's Bulletins between 1963 and 1977. This source includes speeches given by major policymakers at the Central Bank.

(e) Oral History Collections gathered by Harvard University and Foundation for Iranian Studies, respectively referred to as IOHCHU and OHCFIS in the text.

(f) A series of unstructured interviews conducted with several high-ranking officials: 1. Dr Khodadad Farmanfarmaian 2. Dr Alinaghi Alikhani 3. Dr Abdolmadjid Majidi 4. Dr Gholamreza Moghadam 5. Mr Farokh Najmabadi 6. Dr Hasanali Mehran 7. Dr Firouz Vakil. These individuals were at the heart of economic policymaking in Iran, holding governorship, ministerial or sub-ministerial positions in the Central Bank, Planning and Budget Organisation and Ministry of Economy. In addition, Professor Hashem Pesaran, who headed the Central Bank's Research Department, were interviewed.

In the case of Indonesia, the paper relies on:

(a) The UK Foreign Office or Foreign & Commonwealth Office archival documents between 1963 and 1977.

(b) The World Bank policy documents for the 1970-1978 period. These documents reflect the views of foreign advisors regarding the policy choices in Indonesia.

(c) Secondary sources, particularly Bevan *et al* (1999), Hill (1996), Booth (1992), Liddle (1991), MacIntyre (2000). These studies primarily focus on the political economy of macroeconomic policymaking in Indonesia during Suharto's rule.

The arguments put forward in the paper are the outcome of careful cross-examination of these sources with each other. This method provides high empirical richness to the proposed theoretical claims.

4. Macroeconomic policymaking before the 1973 oil shock

This section sheds light on the politics of macroeconomic policymaking in the pre-boom period. As argued in this paper, this background comparison enables us to better understand the divergent performance of the two countries *after* the shock.

The following paragraphs focus on the technocratic institutions in the two countries and compare the broad political environment in which these institutions were operating. This comparison pays particular attention to internal power structure, prevalent economic ideology, class coalitions and geopolitical standing of the two states as important explanatory factors for macroeconomic policymaking.

4.1 Internal power structure

Both, Pahlavi and New Order regimes had a "patrimonial" character in the 1960s, as one individual held absolute power over every state institution and appointed the administrative officials, ministers, MPs, army commanders on the basis of personal loyalty (Katouzian, 1998, Smith, 2007). Likewise, these regimes were born out of military coups against nationalist and communist forces. In the case of Iran, the Shah had come to power as a result of the 1953 coup against the nationalist leader Mohammad Mossaddeq; in Indonesia, the 1966 coup orchestrated by General Suharto had ousted Sukarno, the charismatic figure who had guided Indonesia's independence from the Dutch in the 1940s. Upon assuming power, these leaders had quickly consolidated their power by outlawing the communist parties and purging the army from leftist sympathiser with the aid of their vicious security services.

4.2 Technocratic institutions

Similarly, Pahlavi and New Order regimes supported the rise of technocratic policymaking institutions in the 1960s. In both cases, an economic crisis had provided the initial impetus for institution building.

In the case of Iran, a balance of payment crisis in 1960 encouraged the Shah to delegate authority to the newly established Central Bank (CB) to stabilise the economy (Mehran, 2013). This institution, which had originated out of a commercial bank, was formed as part of the government (rather than an independent organisation) and it was staffed with competent technocrats (ibid). Throughout the 1960s, it enjoyed a considerable autonomy over monetary policy and managed to discipline the banking sector and keep the inflation at a very low rate (1.6% on average) (FO 371/170390, 1966, Mehran, 2013).

Planning and Budget Organisation (PBO) was another technocratic institution that operated alongside the Central Bank. This organisation was responsible for formulating development expenditures of the state and, by 1973, it took full control of fiscal policy. Like the CB, the PBO was mostly staffed with able economic experts, who had been educated in the best Western universities. However, this institution lacked the CB's clout in terms of policymaking. For instance, it did not have access to correct information about oil revenues (FCO 17/381, 1968, Majidi, personal interview, February 2013) and also, had no authority over defence spending (Farmanfarmaian, IOHCHU, tape eleven). Nevertheless, the stability of Iran’s oil revenues in the 1960s, allowed this organisation to effectively formulate two Five-Year Development Plans between 1963 and 1972.

In the case of Indonesia, the rise of technocratic institutions went back to the hyperinflation years of the early 1960s, which had been caused by the excessive deficit financings of Sukarno’s regime. This crisis provided an opportunity to General Suharto to stage a military coup in 1966 and form the New Order regime. Once in power, Suharto brought a new team of economists, who were mostly educated at University of Berkeley, to restore macroeconomic stability. These economists, known as “Berkley Group”, took control of State Ministry of National Development Planning (*Bappenas*), the central bank of Indonesia (Bank Indonesia) and Ministry of Treasury and were given free hand in appointing their staff (ibid). Immediately, the technocrats devised the “balanced Budget Rule”, which signalled *de facto* commitment of the New Order regime to fiscal discipline. At the same time, with the help of the IMF and the World Bank, Bank Indonesia managed to bring inflation down from 635% in 1966 to 4.4% in 1971, primarily through non-market instruments such as reserve requirements and lending quotas. In this process, it allowed the rupiah to depreciate from 85 per dollar to 325 between 1966 and 1968, as a necessary exchange rate adjustment (ibid). It also fully liberalised the capital account in 1971 after restoring confidence in the balance of payments. The rational behind this liberalisation was to force monetary discipline on the state through freeing up inflows and outflows of foreign capital (ibid).

Naturally, the "Berkley Group" had many opponents inside the state due to its high authority in policymaking; PERTAMINA, the state-owned oil company, was the main opponent of this group in policymaking (ibid). Yet this company, which was mainly packed with military generals, did not pose a serious challenge to the authority of the "Berkley Group" over macroeconomic policymaking between 1966 and 1972 mainly due to the unstable condition of the economy.

4.3 Economic ideology

The prevalent economic ideology of Pahlavi and New Order regimes was different from each other in the 1960s. The former was committed to state-led industrialisation while the latter followed free market orthodoxy, thanks to the intellectual influence of "Berkley Group". More importantly, the Pahlavi regime held maximisation of economic growth as its main priority, whereas New Order regime prioritised price stability.

This difference stemmed from the contrasting historical experiences of the two countries. Iran had experienced a depression in the 1960-1962 period due to a balance of payment crisis that had been caused by excessive foreign borrowing and liberal import policies of the 1950s (Karshenas, 1990). After that event, the Iranian policymakers moved towards import-substitution industrialisation to avoid future balance of payment crises (ISI) and focused on rapid economic growth. Accordingly, the CB acted more as a development bank in the 1960s by actively directing credit to import-substituting industries, with the belief that these industries would reduce future imports and ensure stability in balance of payments (Mehran, 2013).

On the contrary, the New Order regime's ideology was formed by the hyperinflation of the early 1960s. The "Berkley Group" believed that that inflation had been caused by Sukarno's state-led development projects in the early 1960s, which had led to widening budget deficits and growth of money supply (Bevan *et al*, 1999). So, once in power, this group switched the state's macroeconomic policies towards free market principles and made inflation fighting its prime target. At the same time, in contrast to Iran, a consensus emerged among the Indonesian political elite about the causes of inflation (monetary roots of inflation in particular) and the adverse effects of deficit financing (ibid).

To be sure, state-led industrialisation had many advocates among the Indonesian elite, most notably among the PERTAMINA officials and various army officers, who were involved in various economic activities (Liddle, 1991). In fact, at the micro-level, Suharto counter-balanced the power of technocrats by letting PERTAMINA officials to follow their desired policies in some sectors (ibid). Nevertheless, in terms of macroeconomic policy, New Order regime remained committed to price stability and balanced budget rather than maximisation of economic growth.

Moreover, the two regimes differed from each other in terms of their sectorial preferences. In Iran, both the Shah and the technocrats favoured rapid industrialisation through promotion of private industrial conglomerates. Inspired by "trickle down" theories, they believed that enrichment of large-scale firms would automatically benefit other segments of the society (Farmanfarmaian, IOHPHU, tape two). On the contrary, Suharto and "Berkeley Group" preferred agricultural development, especially self-sufficiency in food production, through small and medium-scale farming (Temple, 2001). The "Berkley Group" rationalised this preference on the basis of comparative advantage theory (ibid).

4.4 Class coalitions

The Pahlavi and New Order regimes had very different social bases. Since 1963, the Pahlavi state had entered into a *de facto* coalition with a new-born industrialist class and had broken its ties with the landed elite and the merchants (Katouzian, 2009). This change of class coalitions had been motivated by the regime's modernisation reforms together with its shift towards import-substitution. In the 1960s, the industrialists, who had risen from the "*Bazaar*", became heavily engaged in production of consumer goods (Nasr, 2000, Milani, 2009), helping the state to rapidly advance through the first stage of import-substitution and achieve a very high economic growth (10% per year).

Crucially however, these industrialists had little influence over the state in terms of economic policymaking as they constituted a nascent class that had been born out of state intervention in the first place[2] (*Tejarat Farda*, 2013, Ashraf, 1991). Indeed, the

[2] To be sure, the industrialists enjoyed influence over low or middle ranking officials in the public administration as suggested by ample anecdotal evidence (Moghadam,

state enjoyed the upper hand in its relation with the industrialists, as reflected in the archival evidence gathered by Torabi-Farsaani (2013) on state-business relationship in that era. The state supplied the industrialists with tariff protection, tax breaks and credit subsidies, but in return, it imposed various price controls on consumer goods as a disciplinary tool (Najmabadi, personal interview, May 2014). It also regularly intervened in the broad elections held in Chamber of Commerce and Chambers of Industry and Mine to ensure loyalty of the industrialists to the regime (Lajevardi, IOHCHU, tape 1).

In the case of Indonesia, the Javanese landed aristocracy and the peasantry constituted the main social base of the state (Temple, 2001). These groups exerted strong influence over the New Order regime through direct and indirect channels (Karl, 1997). The high importance of agriculture in the economy (38% of GDP) together with Suharto's own rural background explains this class coalition.

4.5 Geopolitical status

Both Iran and Indonesia were OPEC members and close US allies in the Cold War. However, their geographical positions in the Cold War entailed different implications for the two countries. Due to proximity to Vietnam war, Indonesia received ample aid flows from the US and Japan between 1966 and 1972, hence making the New Order regime highly aid dependent. This aid dependency was most evident in the state's development expenditures, where aid flows amounted to 60% of the spending between 1968 and 1972[3] (Bank Indonesia, 1979).

On the contrary, aid flows to Iran stopped in 1967 as the Johnson administration decided to focus all its attention on the Vietnam War (Siakal, 2009). Later, when

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personal interview, March 2013). However, the minutes of High Economic Council meetings show that this influence never reached to the top level.

[3] Even after the oil boom, 35% of development expenditures was still financed out of aid (Bank Indonesia, 1979).

Nixon administration came to office in 1969, it supported[4] the Shah in his battle with the foreign oil companies (Cooper, 2011). The aim of this support was to let Iran increase its oil revenues to acquire enough funds to develop its military and take control over the security of the Persian Gulf- taking a step towards realisation of "Nixon Doctrine" (ibid). This support enabled Iran to greatly increase its influence in OPEC and also become a major military power in the Middle East. Thus, unlike Indonesia, Iran enjoyed financial independence from the West and by 1972, it gained a strong geopolitical standing in OPEC and the Middle East, thanks to the Nixon administration's support for its oil policy.

To summarise, at the onset of the oil boom, the Pahlavi regime had (a) technocratic macroeconomic policymaking institutions that were committed to rapid growth; (b) a strong geopolitical standing in OPEC and the Middle East and; (c) a coalition with a nascent industrialist class. On the other hand, the New Order regime had (a) technocratic policymaking institutions that prioritised price stability; (b) high aid dependency on the West and; (c) a close link with a powerful landed aristocracy. As will be argued, these factors (initial conditions) played a major role in shaping the macroeconomic policymaking after the oil shock.

[4] The Shah's maneuver to the Soviet Union proved vital in enlisting the supports of US administration against the private oil companies (FCO 17/382, 1967).

5. Macroeconomic policymaking after the 1973 oil shock

This section traces the process of fiscal and monetary policymaking in Iran and Indonesia after the oil boom separately to highlight their divergence.

5.1. Macroeconomic policymaking in Iran

The 1973 oil shock roughly coincided with the start of the Fifth Five-Year Development Plan (1973-1977) in Iran. When the oil prices quadrupled in late 1973, the Shah ordered the PBO to revised this plan (Majidi, personal interview, February 2013, Vakil, personal interview, June 2013). Against the advice of the technocrats, the Shah raised the Plan expenditures by a whooping 100% in 1974 and increased the annual growth target from 11% per year to 25% (CB, 1978). The main priority of this over-ambitious plan, which was based on very optimistic assumptions about future oil prices, was a big-push towards development of intermediate, heavy and military industries (the third phase of import-substitution industrialisation). Accordingly, 20% of the plan expenditures was allocated to the industrial sector (ibid).

However, soon this plan ran into financial difficulty; in 1975, the recession in the West decreased the demand for oil and as a consequence Iran's revenues started to fall. Yet, the Shah refused to delegate power to the PBO to conduct necessary fiscal adjustments, which meant slashing several inefficient and costly development projects outlined in the Fifth Plan. Instead, in defiance from the US Administration, the Shah decided to use Iran's influence in OPEC and press for high oil prices in order to acquire enough funds to finish the Fifth Plan. This strategy divided the OPEC from 1975 to 1977 into two groups of "price hawks" led by Iran and "price moderates" headed by Saudi Arabia (Graham, 1978). Importantly, this division increased the volatility of oil production and export revenues for Iran (figures 7 & 8) and translated into ups and downs in fiscal spending, which in turn, resulted in inefficiencies in the implementation of the Fifth Plan. Ultimately, Saudi Arabia won the battle with Iran (due to its higher production capacity) by considerably increasing its oil production in 1977 against OPEC's agreement and caused a large drop in petroleum prices (Cooper, 2011). This event forced an abrupt and painful fiscal adjustment on Iran. In consequence, many development projects were left incomplete and the Shah decided to discard the entire practice of Five-Year Planning altogether in 1977 (ibid). In short, in the realm of fiscal policymaking, Iran's strong geopolitical standing in OPEC reduced the Shah's incentive to delegate power to the Planning and Budget Organisation to implement necessary adjustment to the Fifth Plan at an early stage. In effect, this decision forced a painful fiscal adjustment on the economy at a later stage.

Similarly, in the domain of monetary policymaking, the Shah refused to empower the CB to tame inflation. More than any factor, the post-shock monetary policymaking in Iran was shaped by the ideological preference of the Pahlavi regime for growth maximisation. As mentioned, since the 1960s, the Shah and the technocrats had focused their effort on rapid economic growth and import-substitution industrialisation with price stability being the lesser concern (Mehran, 2013). In addition, there was no consensus among the political elite about causes of inflation, as the prices had remained mostly stable in the 1960s due to the steady stream of oil revenues[5]. Combination of these factors generated conflicting policies when inflation hiked in 1974.

Personally, the Shah (and many technocrats) believed that inflation could simply be tamed by increasing supply through encouraging domestic production and imports

[5] Inflation averaged 1.7% in the 1960s. Even in the late 1950s, when the country engaged in excessive foreign borrowing, inflation remained below 10% (Karshenas 1990).

rather than monetary contraction, as indicated by the minutes of High Economic Council meetings (PBO, 1990). Additionally, at the micro-level, he linked the price rises to the "opportunistic behaviour" of the industrialists, who were engaged in production of consumer goods (ibid). According to him, the industrialists were increasing the price of their goods despite receiving ample subsidies, hence violating the implicit pact that had existed between them and the state.

These ideas reduced the Shah's incentive to rely on the Central Bank to control inflation through contractionary monetary policy. Instead, the Shah embarked on a harsh anti-profiteering campaign in 1975 against the *Bazzar* and the industrialists. Subsequently, three major industrialists were put into jail together with thousands of retailers in the *Bazaar* (Torabi-Farsaani, 2013). Interestingly, the industrialists made not explicit protests in response to this move; in fact, the Chamber of Commerce, Industry and Mine supported the anti-profiteering campaign and even threatened to dismember any industrialist who violated the price controls (ibid). This reaction captures the dominant position of the Pahlavi state vis-à-vis the industrialists in that period.

At the same time, the CB's technocrats attempted to control inflation between 1974 and 1977 by limiting the 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 and worsen inflation (Mehran, 2013). Following the same logic, he also did not allow the technocrats to increase the interest rates (discount rates) in tandem with inflation. This policy produced negative real interest rates (figure 2) and fuelled corruption in the baking sector (Salehi-Esfahani, 1989). Not surprisingly, this situation raised the demand for establishing new banks and also encouraged the industrialists to compete with each other over buying the existing banks through corrupt practices to gain access to cheap loans (Yeganeh, IOHCHU, tape ten). Accordingly, five new banks were established in the post-shock period and the stock market became the arena where the competition for "bank grabbing" took place among the industrialists, as reflected by the growing trade volume of the banks' shares in Tehran Exchange (figure 9).

Further, as mentioned, the CB's technocrats failed to make any adjustment to the nominal exchange rate to offset the real appreciation of rial. In effect, this real exchange rate appreciation encouraged capital flight from the economy and also, harmed the competiveness of the tradable sector. However, the archival evidence shows that the technocrats were, at best, able to prevent further revaluation of rial, let alone making a necessary devaluation.

In summary, in terms of monetary policymaking, the economic ideology of the Pahlavi regime, particularly its focus on growth maximisation and lack of political consensus about sources of inflation, reduced the Shah's incentive to fully support the Central Bank to control inflation through contractionary monetary policy.

5.2. Macroeconomic policymaking in Indonesia

The 1973 oil shock approximately coincided with the start the Second Six-Year Development Plan (*Repelita II*: 1974-1979) in Indonesia. Similar to Iran, the economic planners in *Bappenas* lost their authority over fiscal policy in Indonesia once the price of oil hiked in 1973 (Bevan *et al*, 1999). Instead of them, the military generals based in PETRIMENA, who favoured state-led industrialisation, gained power and included a series of capital-intensive industrial projects in *Repelita II* (1974-1979) to be implemented by their conglomerates (ibid). This marked a drastic change in the state's industrial policy. As a result, government expenditures jumped by 60% in 1974. Yet, despite its emphasis on industrial policy, agricultural development remained the main priority of *Repelita II* due to the ideological preference of Suharto for this sector as well as his coalition with the landed elite and small scale-farmers[6] (ibid). Accordingly, agriculture absorbed 20% of the plan expenditures, which mainly included spending on fertilisers and investment in water irrigation, while industry received 9% of the expenditures (Bank Indonesia, 1979).

Not surprisingly, the first year of *Repelita II* generated soaring inflation (40%) as the public expenditures rose. This alarmed Suharto and the political elite as it refreshed the memory of 1960s hyperinflation and its political consequences for the previous regime (Bevan *et al*, 1999). However, the main turning point for policy reversal came in late 1974, when *PETRAMINA* defaulted on its foreign loans due to poor management of the military generals. Since the early 1970s, Suharto had allowed this oil company to engage in short-term borrowing from abroad and had let it diversify its business activities to shipping, petrochemicals, hotels, fertilisers and steel

[6] The rice riots of 1972 in Java, which had been caused by bad harvest, provided further impetus for promoting self-sufficiency in food production in *Repelita II*.

manufacturing (ibid). In many ways, this company had been operating as a state within the state, refusing to share information about the oil revenues with the rest of the ministries, especially with the *Bappenas* technocrats.

But crucially, the default of this company in the mist of the oil boom changed the balance of power between the technocrats and the military generals in favour of the former group. At the same time, utilising their financial leverage over the Indonesian state, the Western donors, the IMF and the World Bank pressured Suharto to bring the "Berkley Group" 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 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 returning to power, at the fiscal front, the economic planners in *Bappenas* immediately slashed various capital-intensive projects such as steel and aluminium manufacturing that had been included by the military generals in *Repelita II* (ibid). Thanks to these early adjustments, the technocrats were able to steadily slowdown the growth of fiscal spending (table 1 & 2). It is important to stress that these adjustments were motivated more by the fear of inflation rather than balance of payment problems; as illustrated in figure 10, Indonesia's current account deficit never reached to alarming levels in the post-shock period. Moreover, in contrast to Iran, the fiscal adjustments in Indonesia were implemented on the back of steady rinsing oil production and export revenues (figure 11 & 12). As a marginal actor in OPEC, Indonesia relied on taxation of foreign oil companies (Royal Dutch in this case) to increase its oil revenues between 1974 and 1977, rather than collaborating with the “price hawks” in OPEC. In this line, a 45% profit sharing scheme was introduced in 1976 to ensure a steady stream of increasing revenues for the state (ibid).

In parallel, in the domain of monetary policymaking, the technocrats of Bank Indonesia curbed the expansion of domestic credit and foreign borrowing from 1975 onwards by introducing credit quotas on banks and placing limits on state-owned firms to borrow from abroad (Bevan *et al*, 1999). Importantly, the existing consensus among the political elite regarding the monetary roots of inflation gave support to this policy reversal. Also, the technocrats set the nominal interest rates in a way to prevent negative real interest rates to emerge (figure 1). Moreover, they engaged in restructuring of troubled state-owned banks mainly through mergers to reduce the risk in the banking sector (Bank Indonesia, 1978). And finally, as mentioned, in 1978, they devalued rupiah by 50% to offset the real exchange rate appreciation that had been underway since the 1973 oil shock. It is important to stress that this adjustment was motivated by the class coalition of the Indonesian state rather than balance of payment problems (Booth, 1992). As Karl (1997) and Bevan *et al* (1999) suggest the main goal of this nominal devaluation was to protect the commercial interests of the landed aristocracy and the peasantry through restoring competiveness of the agriculture sector. At the same time, as a major foreign donor, Japan also pushed for this exchange rate adjustment due to its classical commitment to export promotion.

To summarise the comparative analysis provided in this section, the contrasting economic ideology, class coalitions and geopolitical status of Pahlavi and New Order regimes produced different trajectories for the technocrats in the two countries after the shock and, therefore, led to different policy responses.

6. Conclusions

This research sheds light on the importance of economic ideology, class coalitions and geopolitical relations in explaining the behaviour of oil-rich states. However, the "rentier state theory" and "resource curse" literature often ignore these contextual factors.

In the case of Pahlavi state, the insistence of the Shah and some technocrats in growth maximisation along with a lack of consensus about causes of inflation, discouraged the Shah to fully support the Central Bank's contractionary policies after the boom. Instead, the Shah decided to embark on anti-profiteering campaign against the new-born industrialist class that enjoyed little influence over the state. Additionally, Iran's strong standing in OPEC motivated the Shah to press for high oil prices to acquire enough funds to finish the Fifth Plan rather than empowering the Planning and Budget Organisation to conduct necessary fiscal adjustments in the Fifth Plan early on. Thus, ironically, the high strength of the Pahlavi state vis-à-vis internal social classes and foreign powers, discouraged the Shah to support the technocrats to implement macroeconomic adjustments. Accordingly, Iran experienced a highly volatile economic growth after the shock due to poor macroeconomic policymaking. Also, income inequality severely widened in the economy because of the state's ideological preference for developing capital-intensive industries.

In contrast, high aid dependency of New Order regime together with its fear of inflation, encouraged Suharto to re-delegate power to the "Berkley Group" after the shock to ensure fiscal and monetary discipline. Hence, Indonesia's economy grew at a rapid and stable rate in the 1973-1977 period. In addition, the preference of New Order regime for agricultural development, which was both product of its coalition with the landed elite and its ideological commitment to principle of comparative advantage, reduced income inequality and poverty after the boom in Indonesia (Bevan *et al*, 1999).

Generally, this study suggests that contextual factors (and history more broadly) matter in the behaviour of oil-rich countries. Hence, the literature on political economy of oil needs to engage more with history and in-depth comparative method. This method encourages us to move away from the implicit oil determinism of "resource curse" literature and helps us find new causal factors to explain the variation in economic and political development across oil-rich countries.

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Table 1: Nominal increase in goverment 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 2: Real increase in goverment 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 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.

Table 4: Public revenues & expenditures in Iran

	1970	1971	1972	1973	1974	1975	1976	1977
Revenues	173	258	302	464	1,394	1,582	1,836	2,034
Expenditures	176	218	359	478	1,254	1,569	1,874	2,442
Balance	-3	+40	-57	-14	+140	13	-38	-408

(Billion rials)

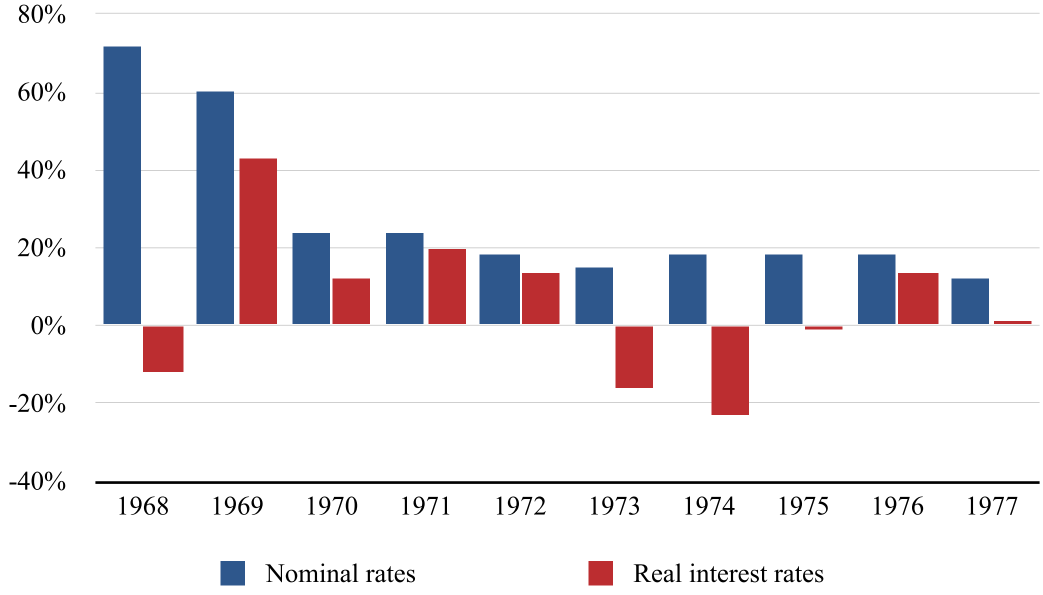
Source: Central Bank of Iran, Annual reports, various issues.

Table 5: Liqudity 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%

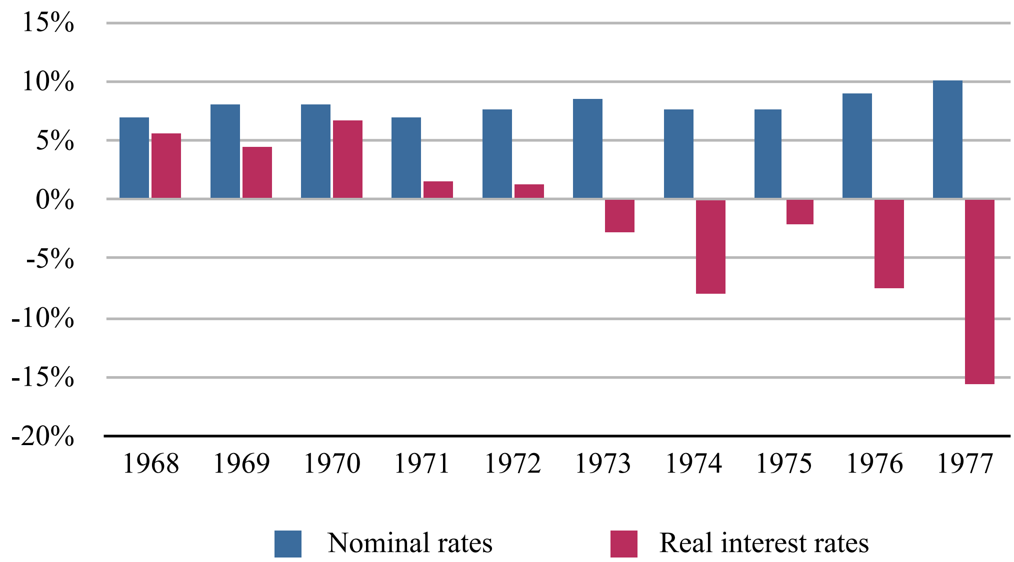
Source: Central Bank of Iran, Bank Indonesia, Annual reports, various issues.

Figure 1: Nominal & real interest rates in Indonesia



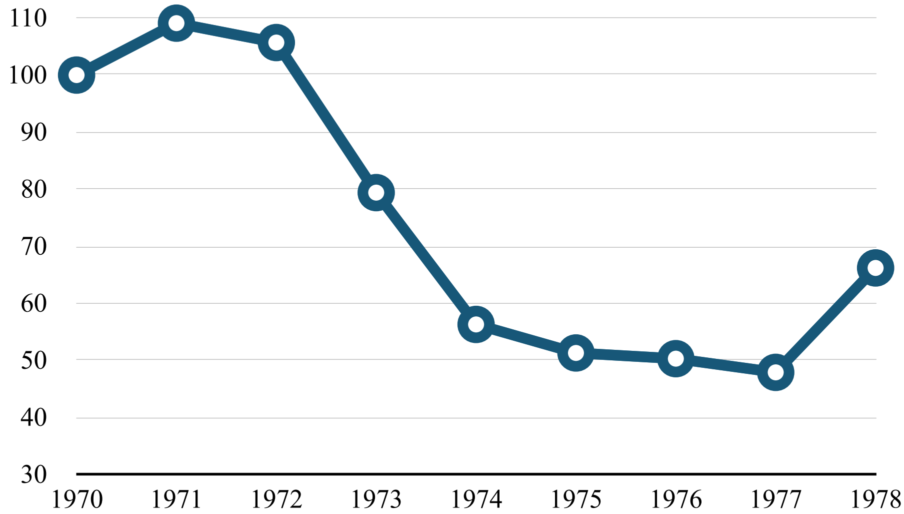
Source: Booth (1992).

Figure 2: Nominal & real Interest rates in Iran



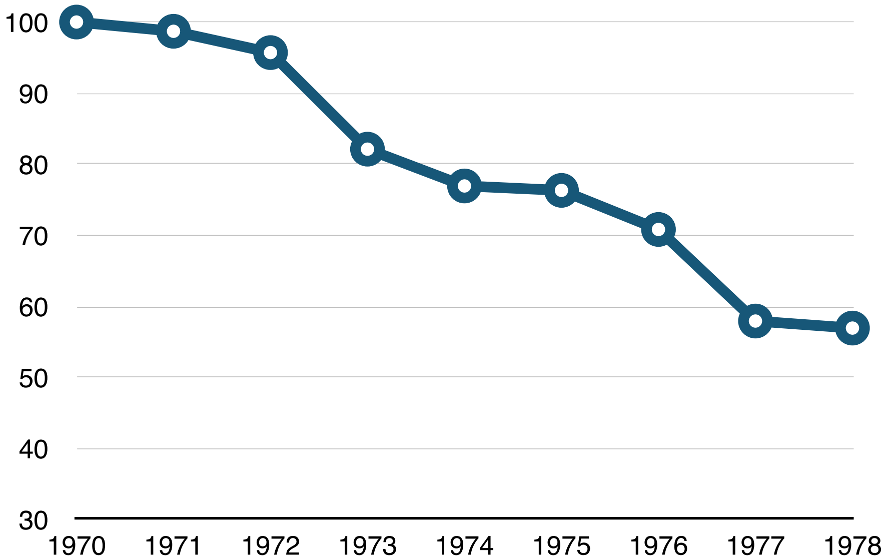
Source: Mehran (2013).

Figure 3: Rupiah/dollar real exchnage rate index



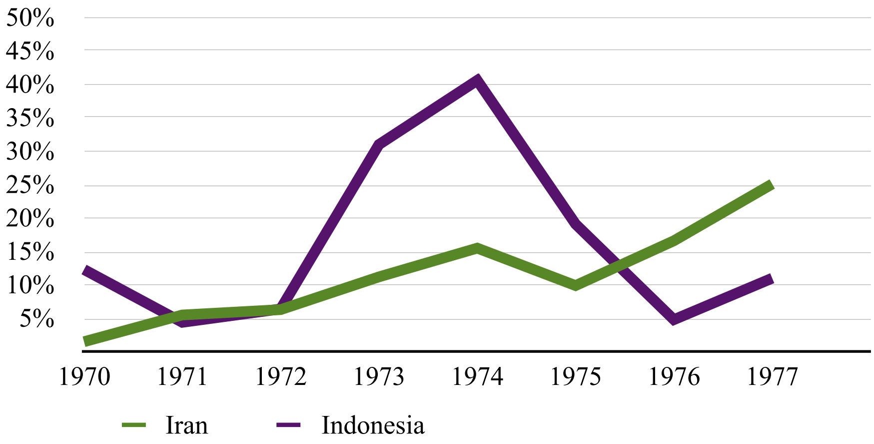
Source: Calculated by the author.

Figure 4: Rial/dollar real exchange rate index



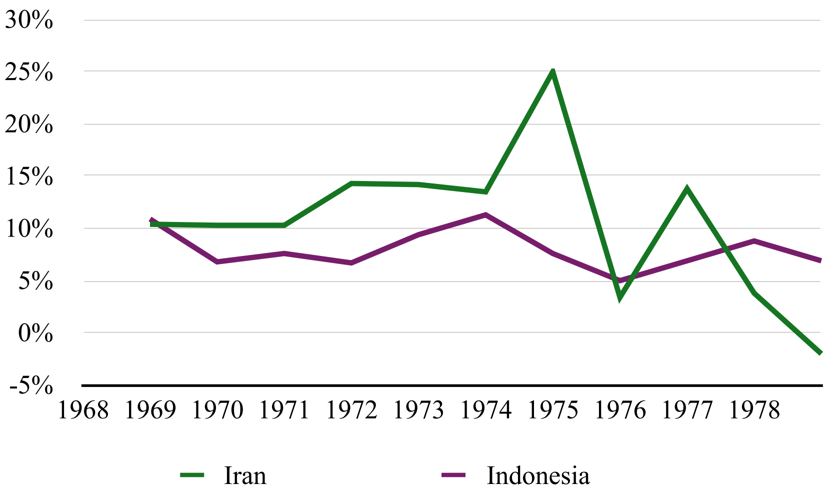
Source: Calculated by the author.

Figure 5: Inflation



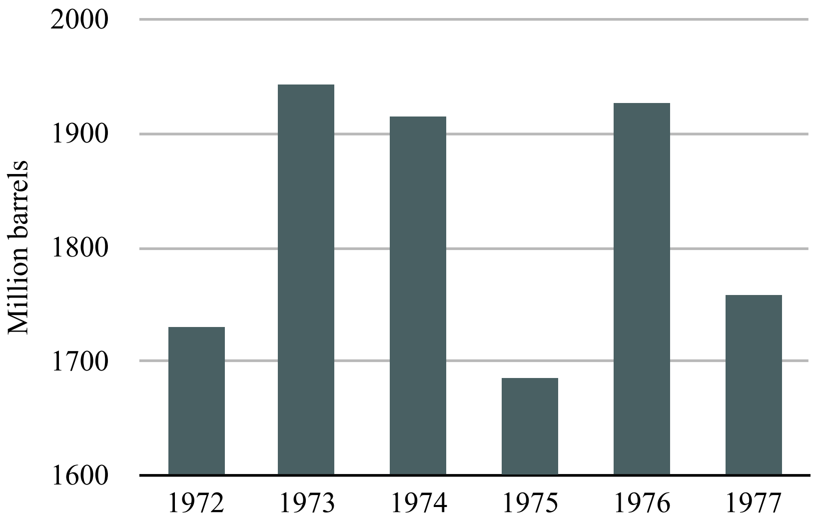
Source: Central Bank of Iran & Bank Indonesia, annual reports & World Development Indicators.

Figure 6: GDP growth



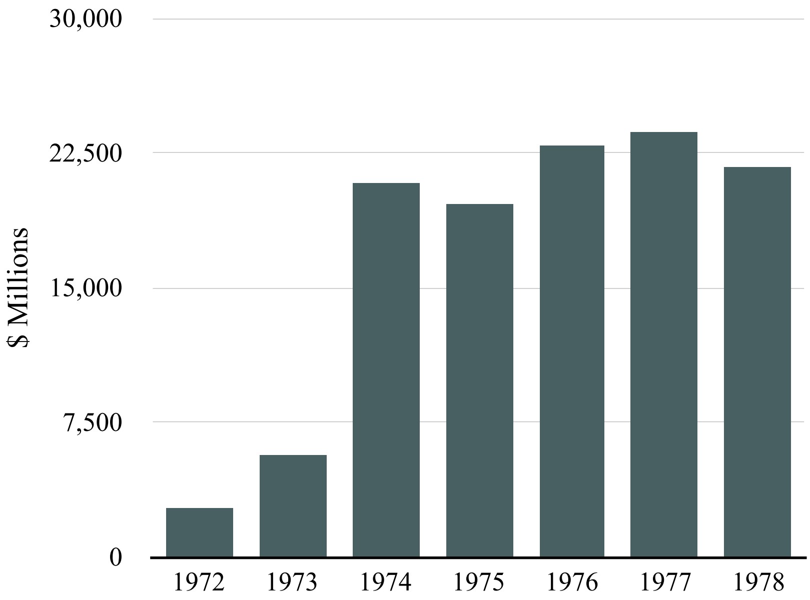
Source: Central Bank of Iran, Bank Indonesia, Annual reports, various issues.

Figure 7: Iran oil export volumes



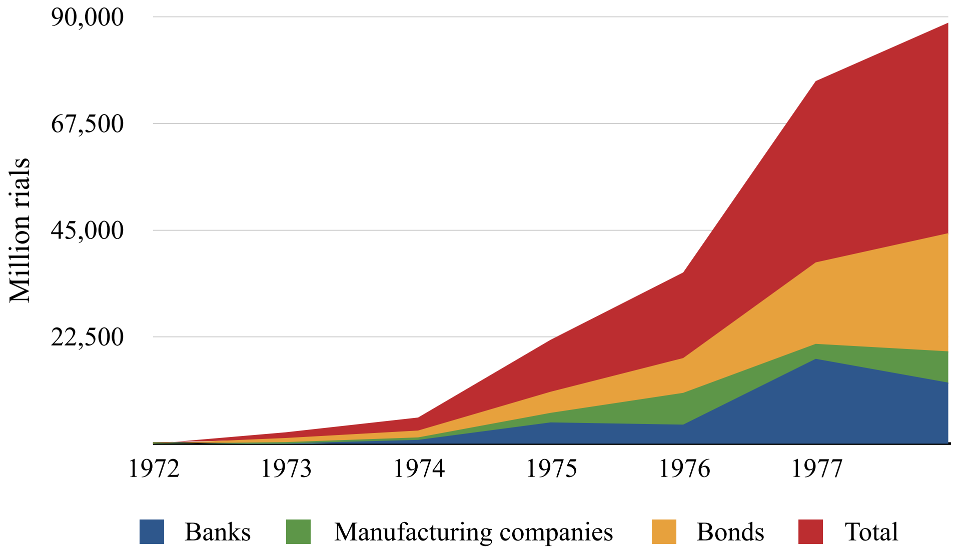
Source: Central Bank of Iran, Annual reports, various issues.

Figure 8: Iran Oil export revenues



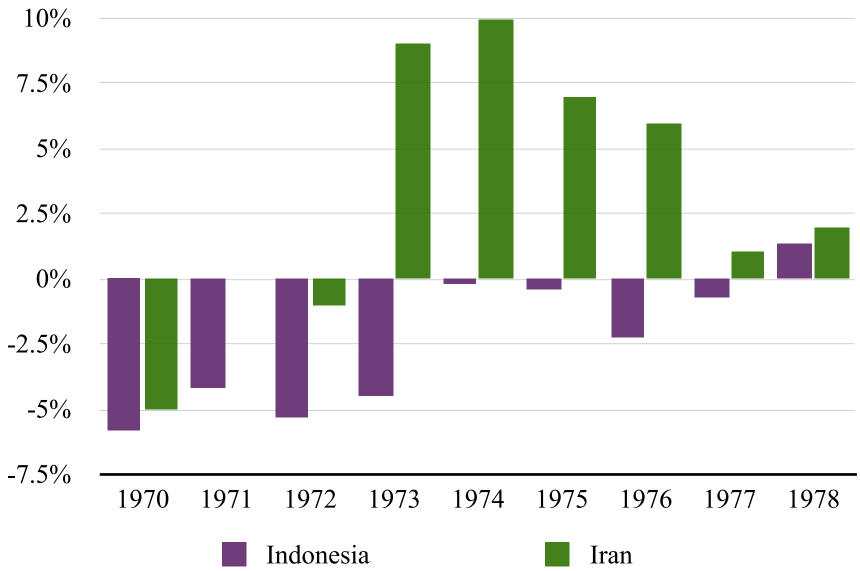
Source: Central Bank of Iran, Annual reports, various issues
& Amouzegar (2001).

Figure 9: Share transactions at Tehran Stock Exchnage



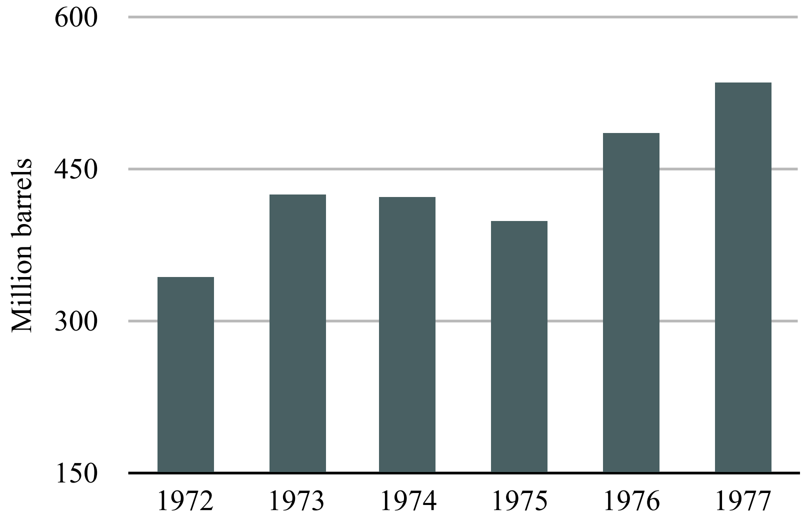
Source: Central Bank of Iran, Annual reports, various issues.

Figure 10: Current account balance (% of GDP)



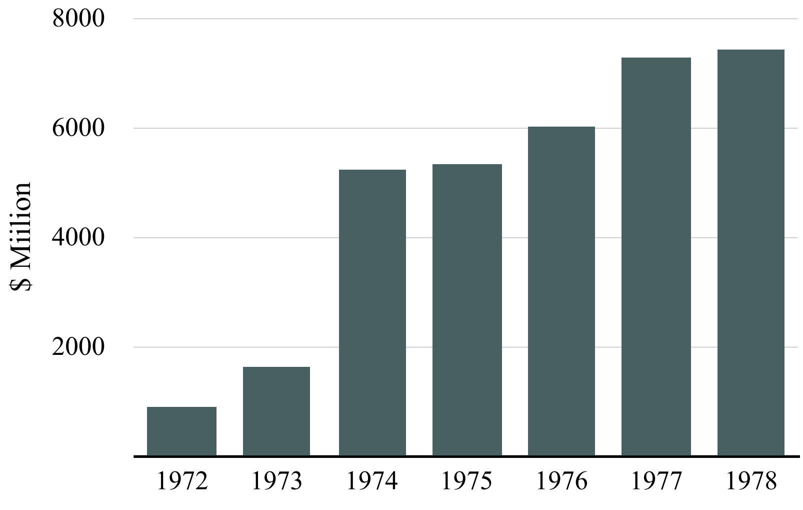
Source: World Development Indicators.

Figure 11: Indonesia oil export volumes



Source: Bevan *et al* (1999).

Figure 12: Indonesia oil export revenues



Source: Bevan *et al* (1999).