CHAPTER 4

DEVELOPMENT TRENDS OF IRAN DURING FYDP
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4.1 Introduction


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4.1 Introduction:
The period of 90's can be described as an era of reservation of economy in order to stabilize the rate of monetary expansion. In fact during this period Iran had tremendous potential to grow for which industrialization through privatization was the real solution. However there was main obstacle by the supreme authority controlled by religious leaders. An effort is made in this chapter to review the development performance of economy of Iran.

The First Five Year Economic, Social and Cultural Plan, covering the period 1989/90 to 1993/94, provided an important framework within which the government's reform and liberalization policies could be implemented. The primary aim of the Plan was to regenerate the economy, carry out the reconstruction of the war-damaged regions, promote private investment, and initiate a reform and liberalization programme. The Plans overall target was to achieve an average annual growth of 8.1% in real DGP, 11.6% in real investment, and an average annual growth of 8.1% in real DGP, 11.6% in real investment, and an average annual growth of 5.7% in real private consumer expenditures.

Another important quantitative objective of the plan was to stabilize the economy's rate of monetary expansion to an average annual rate of 9.4% and reduce the rate of inflation from 28.9% in 1988/89 to an average annual rate of 15.7% over the duration of the Plan.

However, the most significant aspect of the First Plan was in the area of foreign exchange and trade liberalization policies, attempting to reverse the autarchic and failed economic policies of the previous decade.

Under the Plan, real output increased by an average annual rate of around 7.3%, which is only slightly below the plan's overall target (at 8.1%). The average annual growth rates of values added in industries and mines, and
construction were below their target. Values, by 6.3% and 9.2% respectively, while the growth of value added in the water, electricity and gas sectors (at 12.7%) exceed in Plan's target by 3.6%. With the removal of trade and foreign exchange restrictions the private consumption expenditures at constant prices, grew by the staggering rates of 19.5 and 9.5% over the years 1990/91 and 1991/92 respectively, followed by more moderate rates of 5.1% and 2.6% for the last two years of the Plan. The last two year of the Plan real investment grew by 7.1%. The average growth of real investment was in line with the Plan's target, although once again there are important discrepancies between the actual and planned investment growth over the different year of the Plan. Public sector consumption expenditures at constant prices also grew very much in the line with their target values, and averaged to around 4.0% as compared to the planned fire of 3.8%.

The high growth of output and the excessively high private consumption growth during the first three years of the Plan were primarily achieved through increased utilization of existing capacities and increased imports, particularly final consumer goods imports. The imports of goods and services rose from 13.5 billion dollars in 1989/90 to around $25 billion in 1991/92.

The plan's implementation was, however, ultimately marred by an external debt crisis, which broke out in the latter part of the period causing service imbalances in the external accounts. Bay 1994, austerity measures were adopted to deal with the crisis, which signaled the end of the rapid growth phase. By then, the economy was virtually at a standstill and the reforms were gradually scaled back and reversed. A notable example was the case of the newly unified exchange rate system, which was thwarted in late 1993, less than a year after its introduction (Farzin, 1995). Declining oil revenues after 1992 made matters worse (falling from $18 billion in 1990 to about $14 billion in 1993 and 1994).

Despite the First Plan's mixed fortunes and the government's subsequent waving commitment to reforms, the plan was watershed in the development of Iran's postwar economy. First, it played a major part in dismantling the country's hitherto centrally administered economy in the late 1980s. Second,
it initiated-albeit slowly the beginnings of the economic adjustment and reform agenda with its ramifications continuing to the present.

The economic boom also was fueled, at least partially, by improving oil revenues in these years. This was particularly true of the early years of the Plan, when government spending was boosted by a doubling of oil revenues. For instance, foreign exchange revenues from oil sales almost doubled between 1988 and 1990: rising from $ 9.7 billion to about $ 18 billion and counting for some 60 percent of total government revenues (up form 39 percent in 1988). Oil export revenues averaged about $ 15.4 billion for the entire Plan period of 1989-93.

Another important factor in these years was Iran’s changing interaction with the rest of the world. It was in the First Plan years that external savings of pursuing seclusionist policies and relative insulation from the international economy, foreign capital (mostly bank loans) began to flow into the country soon after the reconstruction program got under way. Although foreign competition to lend to Iran was keen, Iranian appetite for foreign loans to finance its postwar reconstruction program drive was also significant. By 1992, however, it was already clear that short-term debt (mostly trade-related) had been accumulated an unsustainable manner and the country was in the throes of a gig debt crisis. Although neither the volume ($23 billion in 1993) nor the relative size of external debt (reaching at its peak one-third of GDP) should have been of direct concern, its composition was, and led to a full-blown external crisis. It was principally made of short-term trade finance (debts of less than one-year maturity averaged 80 percent of the total during the entire first plan period.) Most important, the onset of the debt crisis revealed serious gaps in Iran’s macroeconomic policy management and exposed lack of cohesion, communication, monitoring, and coordination of policy making during this period of increasing exposure to the international economy (Frazin, 1995; Hakimin and Karshenas, 2000:51-57).
4.3 Second Plan (1995 - 1996 to 1999 - 2000)\textsuperscript{2,3,4}:

The key objectives of the Second Five-Year Development Plan has been to "...set rates at levels that would ensure positive real return on bank deposits." Clearly this objective is far form being met. Iranian financial system is in need of major reforms if it is to achieve the dual objectives of price stability and financial development. Abolition of credit ceilings and other restrictions on bank credits would be desirable and effective only if accompanied by deposits and bank profit (lending) rates that are responsive to market forces and fully reflect the inflationary expectation and that are present in the economy. An effective policy of financial liberalization also requires a competitive banking system where the lending policies of the banks are based on commercial considerations rather than on political factors. Such reforms should also take account of the development in foreign exchange markets and the complicated interactions that exist between monetary and foreign exchange policies.

As a result of these large deficits Iran's external debt which was almost non-existent at the end of the Iran-Iraq War, started to grow very rapidly and according to the official statistics amounted to $23.2 billion by the end of 1993/94. The first Five Year Plan provided Mr. Rafsanjani's government with an important opportunity for regeneration of Iran's war-damaged and ailing economy. It also provided the government with a reasonably cohesive framework for the formulation and implementation of badly needed reforms of the trade and foreign exchange system. The Plan's growth objectives were, however, rather ambitious and attempts at achieving them led to substantial balance of payments deficits and, given Iran's unfavorable international position, created serious external financial difficulties for the government. These developments were further exacerbated by hasty and badly-timed moves towards unification of the exchange rate. In consequence, the pace of economic growth slowed down inflation reached new heights and the country faced the daunting task of servicing and repaying large foreign debts.

During the period 2000-01 to 2003-04, growth accelerated, external debt ratios improved, gross official reserves increased substantially, and unemployment declined (Text Table 4.1 and Figure 4.1). The proportion of the population living below the poverty line declined to 21 percent in 2002 from
26 percent in 1990. These positive achievements are in part attributable to important structural reforms implemented at the beginning of the Third Five Year Development Plan (2000-01 to 2004-05, TFYDP), including exchange rate unification, progress in trade and exchange liberalization, passage of a new foreign direct investment (FDI) law, tax reform, and the granting of licenses to private banks and insurance companies. High oil prices and expansionary fiscal and monetary policies also helped sustain domestic demand (Figure 2) and growth, but contributed to high liquidity growth and inflation.

Table 4.1. Islamic Republic of Iran: Selected Indicators, 1989-90 to 2004-05.  
(Period average percentage change, unless otherwise indicated)

Fig. 4.1: Real exchange rate trend Islamic Republic of Iran: Selected Macroeconomic Indicators, 1996/97 – 2004/05  
(Annual percentage change, unless otherwise indicated) 1/
Table 4.1: Selected Indicators during the FYDP

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<tr>
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<tr>
<td>GDP</td>
<td>7.4</td>
<td>3.3</td>
<td>5.6</td>
</tr>
<tr>
<td>M(2)</td>
<td>24.1</td>
<td>26.0</td>
<td>29.1</td>
</tr>
<tr>
<td>CPI</td>
<td>18.7</td>
<td>25.6</td>
<td>13.9</td>
</tr>
<tr>
<td>Oil prices (U.S. dollars/barrel)</td>
<td>17.2</td>
<td>16.5</td>
<td>25.5</td>
</tr>
<tr>
<td>External debt (in percent of GDP)</td>
<td>11.4</td>
<td>15.7</td>
<td>9.1</td>
</tr>
<tr>
<td>Reserves (in months of imports)</td>
<td>2.5</td>
<td>4.4</td>
<td>6.7</td>
</tr>
</tbody>
</table>

Sources: Central bank of Iran; and Fund staff estimates.

1. There was a lapse of one year between the first and the second plans.
3. At factor cost at constant 1997-98 prices.
4. End period.

In light of these policy challenges, Fund staff advice has focused on the need for restrained fiscal and monetary policies to help reduce inflation and critical structural reforms to sustain private sector investment and growth. The authorities broadly share the staff views.

Growth was driven by higher oil production following increases in Iran's OPEC oil production quota, as well as by rising private sector investment, including foreign direct investment. The non-hydrocarbon GDP growth remained strong, even though it decelerated to 6.5 percent from 7.8 percent in 2002-03.

Agricultural output growth reverted to its trend after an exceptionally good rainfall during the previous years and there was some slowdown in construction and services. Other sectors, however, such as manufacturing and most of the increase taking place in the private sector. This led to a decline in the unemployment rate to 11.2 percent in 2003-04 from 12.2 percent in 2002-03.

Domestic demand continued to grow rapidly under the impetus of an expansionary policy mix, as evidenced by the strong growth in credit and liquidity (Figures 4.2 and 4.3). As a result, average CPI inflation remained at 151/2 percent in 2003-04. Text Table 4.2 shows the decomposition of the sources of growth in
Iran during the period, drawing on a Selected Issues Paper "Economic Growth in the Islamic Republic of Iran." The negative contribution of TFP to economic growth and the relatively high rates of investment in physical capital (30 percent of GDP on average during 1960-2002) suggest that growth in Iran resulted from high savings and investment rather than from an efficient use of resources. Text Table 4.2 shows that while the investment of GDP ratio has been relatively high compared with high-growth countries, average GDP growth has been 50 percent lower.

**Figure 4.2: Islamic Republic of Iran: Breakdown of Domestic Demand Growth, 1998/99 – 2003/04**

(Annual percentage change at constant prices)
Figure 4.3: Islamic Republic of Iran: Inflation Developments, 1999-2004 1/
(Year-on-year percentage change of 12 month average index)

1/ Last observation: May 2004
2/ Excluding food, beverages and tobacco

Table 4.2: Iran Sources of Economic Growth, 1960-2002
(In percentage points)

<table>
<thead>
<tr>
<th>Period</th>
<th>Average growth rate</th>
<th>Contribution of capital</th>
<th>Contribution of human capital</th>
<th>Contribution of TFP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960-1976</td>
<td>9.8</td>
<td>3.9</td>
<td>2.7</td>
<td>3.2</td>
</tr>
<tr>
<td>1977-1988</td>
<td>-2.4</td>
<td>1.7</td>
<td>5.5</td>
<td>-9.6</td>
</tr>
<tr>
<td>1989-2002</td>
<td>4.7</td>
<td>2.3</td>
<td>4.3</td>
<td>-1.8</td>
</tr>
<tr>
<td>1960-2002</td>
<td>4.6</td>
<td>2.1</td>
<td>3.7</td>
<td>-1.2</td>
</tr>
</tbody>
</table>

Source: Central Bank of Iran; and Fund staff estimates.
In the period 1960-2002, the Iranian economy grew at an average rate of $\frac{4.1}{2}$ percent, which compares favorably with the rest of the countries in the MENA region (with average growth rates of 4.2). This growth performance, however, shows a high degree of variability; rapid growth in the 1960s and early 1970s was followed by a period of negative growth during 1979 revolution and the war with Iraq which lasted well into the 1980s. Growth rebounded following the post-war reconstruction and subsequent economic reforms.

4.4 Third Plan (2000-01 to 2004-05)\cite{5,6}:

From Table 4.2 above it is realized that annual growth rate of 5.8 percent was almost double that achieved by the Second Plan (2.8 percent only). Besides, the Third Plan managed to dent the stagflationary trap of the previous Plan by resuscitating aggregate demand while moderating persistent inflationary pressures. Both total investment and private consumption expenditure rose again, and the inflation rate was almost halved (coming down to a period average of 14.1 percent against 27.2 percent).

The Third Plan was the early stage of a number of important structural reforms in the Iranian economy. One of the earliest reforms involved the setting up of an Oil Stabilization Fund (OSF), which aimed to cushion the impact of fluctuations in oil prices on government expenditure. This reform had been necessitated by endemic fluctuations in government oil income in the past, and especially the oil price collapse of the late 1990s which had reinforced the need to reduce the dependency of public finances on oil revenues.

The setting up of OSF was accompanied by further budgetary reforms in 2002 to make transparent the exchange rate subsidies and from 2003 also the energy subsidy, which amounted to 10 percent of GDP. Until 2002, most government subsidies were provided implicitly through the subsidized exchange rate. These covered a wide range of essential household commodities (such as wheat, rice, oil, sugar, milk and cheese) as well as imports of medical equipment and pharmaceuticals, fertilizers, and debt service payments on publicly-guaranteed debt. Although the government had gradually tried to
reduce explicit subsidies on food, they were still substantial and constituted about 4 percent of GDP in 2003-04.

A number of other reforms too followed in these years. Regarding the external accounts, for instance, steps were taken to liberalize trade: the tariff structure was rationalized and non-tariff barriers were replaced with tariffs during 2000-04. Most export restrictions were eliminated too and a new legal framework for the promotion of FDI was approved in 2002 after a long and drawn-out judicial process.

A number of financial reforms were introduced to encourage savings. For instance, more flexibility was allowed in setting the rates of return for both deposits and lending and several private banks were licensed to operate. “Participation papers” (saving bonds) were introduced to finances government projects in a non-inflationary way and to mop up excess liquidity from the market. Iran also adopted a number of important fiscal reforms in these years, including the tax reforms of 2002-03, which reduced both personal and corporate tax rates (the latter were reduced from a high of 68 percent to a single rate of 25 percent).

The Third plan’s; main success was in restoring macroeconomic balance and regenerating growth. It was far less successful in achieving its more strategic goals in the areas of reducing unemployment, encouraging foreign investment, achieving large scale privatization, and reducing reliance on oil exports.

Overall, therefore, the success of this Plan came against a background of increased openness to international trade and widening economic reforms, but it also benefited form improved oil prices and sustained fiscal stimulus. Despite these, by the end of the Plan in 2004, official unemployment was still as high as 11.2 percent (against 13.4 percent at the start), foreign investment was largely absent form the Iranian economy, and the reform of ailing state-owned enterprises had hardly begun.
REFERENCES


