Chapter-IX

Conclusion

As explained in the foregoing eight chapters, Iran's economy has been experiencing severe internal and external imbalances during the period 1970-2000. These serious imbalances have been reflected in widespread price distortions, decline in the economic growth, and a host of other economic problems. Between 1970 and 2000, the Iranian economy went through apparently three distinct phases. It has been shown through these three different phases the Iranian governments had confronted specific challenges in each period: from high growth to high inflation of the 1970s; from external war to reconstruction and reform; from foreign debt to austerity and consolidation of the economy during peacetime.

The most important event of the first phase was the 1974 oil boom, when the government revenues rose sharply. In order to absorb new income, the government revised the fifth development plan (1973-78). As a result, the aggregate effective demand increased and the problems of excess demand appeared. But there were supply side bottlenecks and non-tradeable goods shortages (manpower, electricity, ports, and so on). To remedy the situation, the government started importing goods, but due to the infrastructural bottlenecks, the imported items arrived too late. So that, the shortages of tradeable and non-tradeable goods caused a sharp rise in prices. The government adopted measures such as; price control was not able to reduce inflation. Since 1977, both the GDP and
investment showed declining trends and experienced negative growth rates. So that the economic benefits of oil boom were eroded towards the end of the 1970s.

The second phase corresponds to the 1979 revolution and the Iran-Iraq war (1980-88). Despite the revolutionary government's desire to break with the past, the economy's basic character had not changed. Some of the economic problems for which the Pahlavi's regime (1926-79), was called to task, and which the revolutionary government was supposed to remedy, had actually intensified. In addition inflation, material shortages, and large budget deficit, had all exceeded the levels prevailing before the 1979 revolution. Moreover, economic diversification and the reduction of oil industry's contribution to the economy and government's budget remained a distant goal.

The third phase began in 1989. Iran embarked on its First Five year development plan of the country after the 1979 revolution. The first development plan (1989-93) was launched at the right time. The war with Iraq was finally over. The resources for reconstruction were released from the war. And Oil prices were on the rise. Why then, did these favorable factors did not produce corresponding favorable results?

There is no doubt that a combination of various factors like: unrealistic assumptions, financial miscalculations, relatively low growth rate of industry, and agriculture constraints were all partly to blame. The absence of policy coordination was another setback to the country's structural adjustment program. The government's structural reforms faced serious difficulties before they produced reasonably good results.
Although, the decision makers must have known, exchange rate unification and exchange devaluation would fail to produce significant results, without the necessary supporting policies in fiscal, monetary and trade areas. However no such coordination was achieved. The incompatible policies such as: rising exchange rate, intensification of inflation, reduced subsidies, and higher prices for public services all were added to the people's economic problems.

The experience of Iran has also shown that the achievement of rapid economic growth during the 1970s and 1990s may not by itself be sufficient to reduce economic duality overnight. The failure of the Iranian state in this regard, was not because of its wrong perception of the policies that were needed to tackle these problems or because of difficulties experienced in the implementation of its policies such as, the problems of economic duality and worsening economic situation of the poor which till date had never received serious consideration in government policy formulation.

**Emergence of Macro Imbalances**

The experience of the Iranian economy indicates that the signs and sources of imbalance were many. One of the most important sign of internal imbalance of the Iranian economy has been the inflationary pressure. Iran’s experience shows that as supply becomes more and more inelastic. In such conditions the higher effective demand is allowed to rise, the more widespread the production bottlenecks and the inflationary pressures become. Price rises so generated by the pressure of demand against productive capacity can properly be designated as demand–pull inflation. This type of inflation was observed in Iran during
the 1970s. During the 1970s and 1980s prices of manufactures and services also rose because of an increase in the prices of imported inputs into services, such as raw materials, fuels and equipment, and imported consumer goods, brought about by devaluation in the country. Basically this type of inflation is related to non-demand factors.

One of the most important sources of instability comes from the instability in export prices. As far as the effects of fluctuations in export prices on internal balance are concerned, both decreases and increases in export prices could generate inflationary pressures in a developing country like Iran. On the one hand a fall in export prices generally results in balance of payments deficits, and is often followed by such measures as import restriction and devaluation, which cause inflation. On the other hand, a rise in export prices will raise domestic income and expenditure that may not be matched by parallel increase in the supply of goods and may thus have a similar effect on prices. The growth in the supply of goods may be impeded partly by a lack of adequate internal productive capacity and partly by the time lag between the placing of new import orders and the arrival of imports in the market.

Fluctuation in oil prices are the other obvious source of instability. This not only has a major direct impact on country exports revenues, but also indirectly affects the whole economy. For a number of reasons, during the last two decades instability in oil prices and export earnings have been significantly higher than those for the period before the
OPEC action of 1973-74. Therefore, it is not surprising if oil revenues declined by 50 percent in some periods, e.g. 1975-1977 and 1996-98.

The contractionary import compression policy that has been adapted in response to loss in oil revenues by the government could easily reduce the output level in an import dependent economy like Iran. Hence, one of the steps that should have been taken by the government was careful examination of the commodity composition of the country’s imports. Since most of Iran’s import items were intermediates goods, any reduction in the level of imports affects the country’s level of output and production level. The policy of import compression also went contrary to the objective of the economic liberalization policy to expand non-oil exports.

A related problem is that the idea of substituting oil revenues by taxes on domestic products and incomes in order to reduce dependency on the outside world has remained unrealized. Iran’s tax/GDP ratio registered a sharp decline during the 1980s and 1990s. Iran has one of the lowest tax/GDP ratios. This meant that non-tax revenues acted as a substitute for tax revenue and reduced the tax effort. Further, the relatively easy access to oil revenues allowed the acceleration of the rate growth of investment and government expenditures without the need to curb the income and consumption of higher income groups. In the event the budget deficit has not yet been effectively dealt with by raising income taxes. The deficit was for decades almost totally financed by borrowing from the central bank. In addition, the substantial fall in central government expenditure after the 1979 revolution was realized almost totally at the expense of public investment since
revenues expenditures tended to be sticky. These problems were aggravated by periodic conflict. Most notably, the Iran-Iraq war (1980-1988) and decline in oil revenues precluded the allocation of funds for development purposes.

In the long run, economic development constitutes the only remedy for reducing the relatively greater vulnerability of Iran's economy to internal and external imbalances. Basically, the policy measures available to developing countries for dealing with the problems of imbalances can be divided into three broad groups: direct controls and selective measures; deflationary measures; and external borrowing. The question to be answered then is how should a developing country like Iran deal with the various types of imbalances in the short run without seriously damaging its long-term development prospects? It is clear that, because of differences in institutional and economic conditions of different countries, measures that are found suitable for dealing with certain categories of imbalance in some of them may prove to be unsuitable to others. Iran adopted selective measures rather than deflationary policies and foreign loans (except for a short period in the early 1990s). One of the first steps taken by Iran while facing external disequilibrium is tightening and restricting imports. Balance of payments pressures can be relieved by selective instruments of policy aimed at promoting and diversifying exports. The government post-revolution reconstruction plans (1989-1993 and 1994-1999) stressed the importance of the adoption of competitive real exchange rate through devaluation. To achieve balance of payment equilibrium, therefore, devaluation was required. In fact, the proponents of this view go to the extent of advocating floating exchange rates, which they argue should replace dual exchange markets. A devaluation can cause an increase in
the volume of non-oil exports because the price of these exports for foreign buyers will be reduced and each dollar earned by the exporters will bring a larger amount of domestic currency. However, the Iran experience showed that the extent of improvement in the foreign exchange earnings will depend on the elasticity of domestic supply, which depends on the removal of structural constraints and bottlenecks and sufficient supply of intermediate and capital goods.

Iran’s non-oil sector was not well integrated into domestic production and was dependent on imported goods for production. Much of export earnings generated by this sector are, therefore absorbed by its own production process, and value added is negligible. The main obstacles that constrained non-oil sectors were therefore: a) the excessive compression of imports needed to make room for external debt repayments as Iran’s access to external financing was limited; b) the extension of US financial and economic sanctions that restricted market access to Iranian exports; and c) the tightening of exchange controls, to contain the unfolding foreign exchange crisis.

A third category of selective measures that can be used to ease both inflationary pressures and balance of payments difficulties includes measures such as consumer subsidies, rationing and price controls. Pricing policy is, in fact, a part of the economic policy that is a comprehensive expression for the entire set of principles and measures governing the management of the economy, and it has to be implemented within the framework of the general economic policy being pursued. Because of the Iran-Iraq war (1980-88) and economic sanctions, the government began rationing basic goods based on the coupon
A minimum quota was allotted for each individual. The quota was equal throughout the country and was purchasable at government rates. Thus, the low-income classes enjoyed these payments more widely, though the rural populations faced troubles accessing these goods.

Following the end of Iran-Iraq war (1980-88) and the beginning of the First Development Plan, (1989-93) there was a change in the government's pricing policies. The items included under controlled pricing were gradually decreased and the procedure of gradual elimination of regulated pricing of such items started. Consequently, at the beginning of 1992 the number of items include under regulated pricing became small and the process continued until the middle of 1994. During 1991-1994, inflation reached unprecedented levels. The parliament requested for the pricing of some capital items. The Expediency Council (Majma-e Tashkhise maslahat) held a session to discuss the high inflation in the country. The Council made some decisions about the pricing policies throughout the country. Therefore, once again important organizations for pricing and controlling the prices were formed.

The government had chosen the scheme of universal direct price subsidies to deal with the inflation problem. Under the universal direct price subsidies scheme, the negative impact of exchange rate unification on the domestic prices of certain basic necessities and strategic commodities was reduced by keeping the final consumption prices of these commodities at, or close to, their pre-reform levels. Despite all its shortcomings, this
scheme was still better than the grant of implicit subsidies, because the amount and the nature of the subsidy are explicitly reflected in the government budget.

Iran's economic reforms failed to address the fundamental distortion in the real economy that developed since the second half of 1970s leading to the remarkable decline of the Iranian economy during the 1980s. In addition to this poorly conceived policies and the economic reforms intensified these distortions. The fundamental factors hindering the economic growth of Iran arise from the internal conditions that developed during the past two decades of economic stagnation. In fact the process of economic reform was not shaped by the priorities of the people, nor did it have a long term view in terms of development objectives. The enthusiasts of liberalization often pretend that Iran's basic problems of development will be solved through austerity practiced by the government coupled with the adoption of price liberalization and subsidy reduction.

The experience of some of the fast growing developing countries demonstrate that micro level reforms targeted at removing specific structural rigidities, a macro economic policy aiming for technological upgradation, a proper tax system and a stable price environment play a crucial role in achieving and sustaining high rates of growth. However, Iran's economic reforms did not recognize the difference between micro level reform and policies needed for long-run growth. The government accepted the IMF's perception of financial and fiscal reforms, but how these reforms are to be implemented and applied was not specified in the government agenda.