Chapter-I

Introduction

Iran as an oil exporting country faces a number of developmental advantages and challenges. Its advantages derive from its possession of a non-reproducible resource for which demand is high. This provides a basis for a successful development strategy. It has been convincingly argued that exports of primary commodities, which still account for a dominant share of total exports from many developing countries, cannot sustainably finance manufactured imports in the long run, because of their low income elasticity of demand. However, the advantage enjoyed by oil exporting countries like Iran is that their main export item is not subject to low elasticity of demand in the market. Thus, the development experience of countries with access to this sustainable source of export revenue is distinctive, even if not based on altogether different principles from the development process in other developing market economies. This thesis is concerned with examining the interaction between oil revenues and the domestic economy and its implications for the pace and pattern of development in the specific context of the Iranian economy.

The oil sector in Iran has been the main source of income for the government and the principal source of finance and foreign exchange for financing import-substituting industrialization in the 1970s and 1980s. The evidence shows that the accumulation of capital in Iran has been heavily dependent on oil export earnings, particularly in the period since World War II. However, despite access to oil revenues and the attendant foreign
exchange, there have been periods when growth and structural change in the Iranian economy have been less than satisfactory. This thesis addresses that question, taking the existing literature as its point of departure. In the literature, some scholars have sought to evolve a framework that links oil revenues and government expenditures and various components of aggregate growth. Others have discussed why the expansion in oil exports and the investment opportunities they have generated were not fully taken advantage of by the private sector. Both these strands in the literature have also examined how different forms of government intervention, through their demand and supply side influences, could lead to structural change of a kind that is beneficial or adverse from the point of view of growth and economic diversification in a mixed economy like that of Iran.

The early development planning literature focussed on the two principal “gaps” that developing countries needed to address when initiating a process of sustained growth: the savings gap and the foreign exchange gap. The principal argument here is that Iran is less likely to be subject to fiscal and foreign exchange gaps for a reasonable range of growth rates. Iran’s mineral resources, with some investment, provide a source of rents that can finance other investment, and can in addition form the basis for an industrialization strategy.

The immediate contribution of the oil industry to growth is that by providing access to oil revenues in the form of foreign exchange, it helps reduce imbalances between the structure of domestic supply and domestic demand that could appear during the growth
process. In other words, it facilitates a higher rate of investment and growth than in a balance of payments constrained economy. In an economy where these bottlenecks do not act as a barrier to raising the rate of growth of the economy, growth could be seen to be constrained by absorptive capacity. The concept of absorptive capacity explains the limit to the rate of growth of investment set by all domestic factors of production which either cannot be imported or faces rapidly rising supply prices; including non-tradeable factors such as, power, transport, and general infrastructure.

Whatever the cause of limited absorption, it implies that the mere availability of oil revenues does not itself ensure dynamism. Oil can be used in a short sighted manner to increase the level of consumption in the short run without generating significant dynamic effects in the production structure of the economy. The challenge which faces an oil exporting economy is to choose an appropriate path of growth and structural change from the long term perspective.

Iran's experience does suggest that a continuous expansion of oil revenues cannot be relied upon to sustain the rate of growth of the economy in the long run, unless the necessary structural changes which should accompany the growth process are achieved. Despite access to oil revenues, Iran could not reduce its heavy reliance on imported capital and intermediate goods, and ensure that its economy reduces its import dependency become competitive enough to be able to export. The rate of growth of industry was also hindered by various other factors. This thesis discusses some of the more important
factors which have played a key role in causing inflationary pressures and balance of payments difficulties in Iran during recent decades

Iran's economy was characterised by periodic infrastructural bottlenecks such as deficiencies in transport and communication facilities and shortages of skilled labour. These translated themselves into bottlenecks in production. As a result, even when there was some idle capacity in the economy, attempts to bring such capacity into use by stimulating demand was likely to lead to price rises and/or increases in tradeable imports. These price rises may in time be transmitted to the rest of the economy if they result in a noticeable increase in the cost of living index.

It should be clear that greater the level of aggregate demand, the larger will be the incidence of supply bottlenecks of non-tradeable goods and greater the number of goods subject to rising prices. Inflationary pressures will increase and or the balance of payments will deteriorate sharply if demand continues to increase. In such conditions, the economy may properly be seen as suffering from aggregate demand pressures, since the growth in demand leads primarily to a worsening of imbalances rather than to an increase in production. The need to transform the economic structure and reduce dependence on imports while spurring non-oil exports arises because there are limits to the rate of growth of oil exports and revenues in the long run. The initial advantage that oil revenues provide should be seen as a catalyst that can help create the structure necessary for sustaining growth in the longer run. However, as argued later in this thesis, even in the period after the 1979 revolution Iran has neither been able to develop or adopt an
appropriate model for the reconstruction of the economy, nor has it been successful in providing the necessary social and legal institutions required for sustaining undisrupted production. Faced with this, the Islamic republic of Iran has in recent years embarked on a neoliberal economic reform program of the kind favoured by the World Bank and the IMF.

However, in Iran as elsewhere, complete reliance on the market mechanism is neither feasible nor desirable. There are important instances of market failure associated with the existence of externalities and incomplete markets, which may entail government intervention to reduce inefficiency in these markets. The particular form that government intervention may take under these circumstances depends on the specific problems at hand and cannot be decided on the basis of some general universal prescriptions and rules. The primary aim of the liberalization program in Iran was to promote private investment, regenerate the economy and reconstruction of the country’s infrastructure.

This thesis is concerned with analysing the macroeconomic consequences of the policy regime adopted at different points of time in a country endowed with oil revenues. Towards that end it seeks to identify the sources of macroeconomic imbalance in Iran, the policies that have been adopted to deal with the imbalances, and the extent to which fiscal and monetary policies have contributed to economic stability.

It seeks to establish that two decades after the revolution, Iran’s economy is still dependent on oil revenues. Fluctuations in those revenues have resulted in volatility in
Iran’s fiscal ratios since the government’s expenditures are highly dependent on oil revenues. To deal with these fluctuations and the changed expenditure priorities of the government after the revolution, price controls and consumer subsidies were the most important measures adopted for dealing with macro imbalances.

The thesis is divided into nine chapters, including this introduction. Chapter two traces the evolution of Iran’s oil industry and oil revenues and identifies their role relative to the rest of the economy and as a source of government finance. Chapter three analyses the structure of government finances and trends in the fiscal policy of the government of Iran. While tax revenues were influenced by the structure of taxation and the rates of tax, the chapter argues that the growth in oil revenues had been a crucial determinant of trends in total government revenues. Further, the chapter notes that during the 1980s, government income tax revenue fluctuated. Along with this effective economic variables such as imports, GDP, oil revenues and tax revenues also registered negative trends.

Chapter four examines the expenditure strategy of the Iranian government, which was geared to increasing spending on developing infrastructure and diversifying the industrial base. However, though expenditures on infrastructure have experienced a high growth rate during the last three decades, the pace of expansion of the infrastructural sector was inadequate. Iran’s current expenditures had been rising continuously as a result of rising salaries, increased defense spending and larger subsidies.
Chapter five discusses the fact that the 1970s oil boom caused an enormous credit boom in Iran. It analyses the relationship between monetary policy and economic growth and development in the Iranian economy during the 1970s and 1980s.

Chapter six provides a detailed analysis of inflation during the 1970s and 1980s. It is also discussed that the inflationary build-up was attributable to the supply side bottlenecks which were inevitably associated with excess demand for agricultural commodities. In response the government intervened repeatedly to rein in prices in the post-revolutionary period. The nature and efficacy of the measures resorted to by the government, such as price control and the creation of a consumer protection fund to reduce the impact of inflation on the people, is also discussed.

Chapter seven argues that one decade after the revolution, the structural features of the Iranian economy remain relatively unchanged, a state of oil dependency had continued and the country’s balance of payments position was fragile. The government had adapted devaluation to achieve balance of payment equilibrium, because devaluation can cause an increase in the volume of non-oil exports. This chapter also argues that for a mixed developing country like Iran, it would usually be difficult to find a strong case for using devaluation, in preference to other available measures, as a means of resolving the problem of external imbalances.

Chapter eight argues that the problems of the Iranian economy during the 1990s did not develop suddenly, but in fact were accumulated over years. The origin of the economic
problems is not only directly attributable to macro economic management during the 1980s which led to macro-economic imbalances, but also the limitations of the strategy of development. This chapter also analyzes why the economic reforms plan neither be successfully implemented nor help overcome the internal and external imbalances that the economy has been suffering from since long. During the 1990s, inflation intensified and government foreign debt rose to the high levels. And the main features of the Iranian economy, oil dependency, and import dependency strongly remained.

Chapter nine draws out the conclusions relating to the macro economic performance of Iran during the last three decades. It seeks to identify the signs and sources of imbalance in the Iranian economy and analyse the efficacy of the remedial measures being adopted by the government.