Islamic Republic of Iran
Managing the Transition to a Market Economy

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and José Bailén

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Abbreviations

ADF	Augmented Dickey-Fuller
AML	anti–money laundering
CBI	Central Bank of Iran
CBPP	central bank participation paper
CPI	consumer price index
FDI	foreign direct investment
FSAP	Financial Sector Assessment Program
FYDP	five-year development plan
GPP	government participation paper
HLS	half-life of a unit shock
IFS	International Financial Statistics (IMF)
LIBOR	London interbank offered rate
MCC	Money and Credit Council
MENA	Middle East and North Africa
NEER	nominal effective exchange rate
NFPE	nonfinancial public enterprise
OLS	ordinary least squares
OSF	Oil Stabilization Fund
P/E ratio	price-earnings ratio
PPP	purchasing power parity
REER	real effective exchange rate
Rls	rials
TFP	total factor productivity
TPID	Trade Policy Information Database (Policy Development and Review Department, IMF)
TSE	Tehran Stock Exchange
VAT	value-added tax
WEO	World Economic Outlook (IMF)

Preface

Most of the chapters in this paper are based on analytical work undertaken in preparation for the IMF's 2004 Article IV consultation with the Iranian authorities. Since then, a number of changes have taken place at the domestic level and with regard to the Islamic Republic of Iran's external economic environment. These changes do not materially alter the paper's findings and conclusions, but may have implications for future economic policymaking in Iran. Without undertaking a full-fledged updating of the paper, it is useful to highlight up front key developments and policy changes and their likely effects.

First, as a major oil producer, Iran has benefited from the sharp increase in oil prices in recent years. The average export price of Iranian crude almost doubled between 2002/03 and 2005/06, rising from about $27 per barrel to almost $51 per barrel. Iran's export earnings from oil and gas reached close to $50 billion in 2005/06. Such a large positive shock has further improved an already strong external position, as reflected in the growing current account surplus, the large buildup of international reserves, and the low external debt ratio. Assuming that part of the increase in oil revenue will be permanent, Iran's external resources, if adequately managed, are sufficient to meet its development objectives and build savings for future generations.

Second, since 2002/03, Iran has made major strides in opening its economy to the rest of the world through trade liberalization, unification of the exchange rate, elimination of exchange restrictions, and attraction of foreign direct investment (FDI). These efforts have culminated in Iran's acceptance of Article VIII of the IMF's Articles of Agreement,[1] its return to international financial markets from which it had been absent for almost three decades, and its application for membership in the World Trade Organization. There is no doubt that these policies contributed to the favorable performance highlighted in this paper and that Iran would benefit from further integration into the global economy.

Third, the Iranian economy has sustained high growth for the past five years, but reducing unemployment remains a key challenge. Against the background of abundant oil revenue, real GDP growth has remained strong and broad-based. Despite some deceleration in 2004/05 owing to adverse

[1]Under Article VIII, Sections 2 (a) and 3 of the IMF's Articles of Agreement, Iran committed to eliminating all exchange restrictions on current account transactions and refraining from introducing new ones.

weather conditions and capacity constraints in the oil sector, real GDP growth was 6¼ percent a year, on average, during the period 2002/03–2005/06. Unemployment has continued to trend down but remains high at about 10 percent.

Fourth, buoyed by high oil revenue, fiscal policy has been expansionary. The non-oil fiscal deficit remained close to 24.5 percent of non-oil GDP in 2005/06, roughly unchanged from 2002/03. This, in turn, has put upward pressure on domestic liquidity and inflation. The inflation rate, as measured by the consumer price index, averaged 14 percent a year during the five years up to 2005/06. The authorities have committed to reduce inflation to a single-digit level by 2010/11, the end of the current five-year development plan (FYDP), but this objective has so far proven elusive. Recent attempts to bring down inflation through price freezes are only a temporary remedy.

Finally, the overall setting for macroeconomic policy has undergone some changes since 2003/04. In the financial sector, new private banks have been licensed, bank supervision has been strengthened, and new capital market regulations have been introduced. Banks have been given more leeway in allocating credit, but most rates of return (equivalent to interest rates) have continued to be set administratively, and little progress has been made toward developing effective and market-based monetary policy instruments. Moreover, efforts to strengthen the central bank's autonomy have been weakened by parliament's increased oversight over the use of some monetary policy instruments.

These developments highlight the need for macroeconomic policies to better focus on helping contain the growth of domestic demand, reduce fiscal dominance, curb the rapid growth of bank credit, and contain inflationary pressures. The Iranian authorities cannot rely indefinitely on fiscal and monetary expansion to boost growth and employment. Instead, there is a need to direct resources away from wasteful subsidies toward high-quality projects in infrastructure and social services. This, together with reforms aimed at improving productivity and economic efficiency, would encourage the private sector to grow and foster a sustainable increase in employment.

The Fourth Five-Year Development Plan, introduced in 2004/05, aims to raise real GDP growth to about 8 percent a year on average and calls for far-reaching structural reforms, including privatization, financial sector reform, an overhaul of the large subsidies, and development of technology- and knowledge-based activities. Although preparations for some of these reforms (such as streamlining the subsidy system) are under way, the speed and depth of implementation need to be accelerated substantially to achieve the plan's objectives.

Introduction

Iran has received much attention from a geopolitical and regional standpoint, but its economic challenges have not attracted a similar degree of interest. Yet, with a population of 69 million, considerable hydrocarbon resources, a dynamic and entrepreneurial middle class, and a relatively well-educated labor force, Iran's economic potential is considerable. Equally important is Iran's experience with economic reform, which deserves attention for several reasons:

- Iran is in transition to a market economy, and the process has been neither smooth nor supported by external conditions. An assessment of economic performance since the 1979 revolution must be viewed against the historical background of several years of political and institutional upheaval, an eight-year war with neighboring Iraq (1980–88), regional instability, trade sanctions, and two major episodes of boom and bust in oil prices. These events have left their mark on the economy—not to mention the related human cost—through a sharp contraction in real GDP, destruction of physical infrastructure and property, high inflation, and food and supply shortages. From this perspective, the Iranian experience is one of resilience.

- Significant advances have been made in recent years in opening up the economy to international trade and FDI, encouraging private sector activities, removing exchange restrictions, reforming the tax system, and enhancing macroeconomic management. These reforms have started to bear fruit, as evidenced by the pickup in growth, the improvement in other key macroeconomic indicators, increased business confidence, and Iran's renewed access to international capital markets.

- Despite the progress, major challenges remain. The economy continues to be saddled with large and inefficient subsidies, and private sector development is hindered by administrative controls and rigidities. Unemployment is high, and inflation remains in double digits. The next phase of reforms would need to strengthen the foundations of private-sector-led growth in a context of greater integration with the world economy in order to achieve higher levels of efficiency and competitiveness. The reforms would also need to address fiscal policy challenges arising from the management of Iran's large oil and gas reserves, promote diversification of the economy, and improve macroeconomic policies to reduce inflation to single-digit levels over the medium term. These reforms are critical to help sustain high growth and employment creation.

- The Iranian experience offers a remarkable example of ownership of reforms. Despite years of economic isolation, Iran has remained open to advice and technical assistance from bilateral and multilateral sources, although the solutions to its specific economic problems have been largely homegrown. This openness to external advice, in turn, has increased the confidence of the countries' economic managers and brought about further opening to the global economy, which has led to substantial improvements in transparency and the dissemination of economic and financial statistics.

This IMF Special Issue Paper takes stock of key developments in the Iranian economy in recent years, reviews the major issues and policy responses, highlights the nature of the challenges faced by Iran, and draws implications for the next phase of reforms.

Chapter 1 takes an historical view of economic growth in Iran (1960–2002), analyzing the role of capital accumulation, investment in human capital, and total factor productivity (TFP) in explaining Iran's growth performance. It also attempts to quantify the role of several other factors—such as macroeconomic stability, financial sector development, trade openness, and the terms of trade—and discusses the impact of noneconomic factors, such as political developments. The analysis highlights the fact that the Iranian economy can sustain high growth rates for an extended period, and it also provides evidence of the negative effects on growth of inflation, widespread distortions, and inward-oriented economic policies that tend to lower TFP. The lessons to be drawn from this review are relevant for the period ahead, given the expectation that about one-third of the growth rate targeted by the Fourth Five-Year Development Plan (2005/06–2010/11) is to come from higher TFP.

Chapter 2 focuses on financial sector development, which is a key building block of a high-growth strategy. Starting with a comprehensive review of the current status of the financial system and its evolution, the chapter highlights the reasons behind the low level of financial sector development in Iran. It draws on the literature and cross-country experience to show the links between financial sector reform and the performance of the real economy. Finally, the chapter points to key areas in which reform is urgently needed, including regulation and supervision, bank restructuring and management, and the development of capital markets.

This analysis sets the stage for Chapter 3, which contains an in-depth discussion of monetary policy in light of the gradual move in recent years toward market-based monetary and exchange rate policies. The discussion provides helpful insights into the complexity of the Iranian monetary policy framework, which is based on Islamic finance principles and is characterized by, among others factors, fiscal dominance, lack of market-based instruments of liquidity management, and limitations on the independence of the central bank in pursuing its monetary policy objectives.

Chapter 4 provides a brief review of the institutional setup of the foreign exchange market during 1993–2003 and examines a range of indicators that could be used to assess the exchange rate level. After a long period of multiple exchange rates, Iran unified the exchange rate and established a managed float exchange rate regime in 2002. Finding appropriate indicators to assess the exchange rate level, let alone to estimate an equilibrium real effective exchange rate (REER), presents a major challenge in the Iranian context. The difficulties stem from the large share of oil exports in trade, various distortions arising from government intervention in economic activity, and the relatively short experience with a unified market-based exchange rate. Standard approaches to assessing the exchange rate level based on the purchasing power parity (PPP) theory or on an analysis of productivity differentials and terms of trade show inconclusive results. Thus, this chapter relies on a number of indicators of performance of the tradables sector, as well as an assessment of equilibrium external balances, to provide additional insights into formulating a judgment on the current level of the exchange rate.

Chapter 5 discusses fiscal management in an oil economy, with an application to Iran, and highlights various options for developing a medium-term fiscal framework. The chapter outlines the long-term objective of preserving hydrocarbon wealth for the benefit of future generations and discusses other short-term objectives of fiscal policy, including the need to bring down inflation and reduce the economy's vulnerability to a decline in oil prices. On the basis of the prices prevailing in 2003/04 and current policies, the analysis indicates that Iran is overconsuming its oil wealth resources and that a comprehensive energy price reform could play a critical role to improving welfare and intergenerational equity.