Financial Crisis, Iranian Style

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9 February 2009

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February 2009

A steep fall in crude prices allied with lower output will decrease the Iranian government's foreign revenues significantly. The Tehran Stock Exchange (TSE) has lost 30% of its value in the last four months, which points to a sizable economic slowdown in the near future. Perhaps Iran is among a handful of countries that has not properly planned to combat any potential economic crisis in the face of lower oil prices and the global financial meltdown that began to show its visage in the middle of 2007. The substantial inflow of petrodollars to the government's account coupled with the faulty assumption that the oil prices will continue to rise triggered the government to infuse billions of dollars into the economic and banking system. Iranian officials have just begun to accept the new global circumstances and are after drafting a budget for the next Iranian year to ride out the financial turmoil. The administration is planning to eliminate energy subsidies and reduce its price controls in the new fiscal budget planning in order to reduce the massive deficit. It is indeed ironic from a government that has no belief in principles of a free market economy and denied it in the past to draw such a plan, many economists have stated. Whether the government has realized its past mistakes, is unknown and whether the new budget and policy will ease the current economic problems, remains to be seen! A more important question is whether the central bank and the administration will be able to employ the available monetary and fiscal tools to tackle the profound upcoming economic challenges, since they already tied their hands by their past mistakes and beliefs. Overall, the next few months or perhaps years will undoubtedly be very challenging times for the system.

Oil export earnings could dive considerably as crude prices are projected to average between $30 and $40 a barrel and the oil production will likely decline following OPEC's collective decision to slash supplies to offset a sharp drop in demand. The decline in petro prices has a direct impact on the financial and economic condition, since oil revenues are the core source of income for the socioeconomic development. The government forced the banks to offer billions of dollars of credit to the seekers for agricultural, production, and real estate projects without setting any sensible requirements for their economic justification. The injection of these funds into the economy formed the phenomenon of Dutch disease in the country. As a result, a large amount of borrowed funds for agricultural and production projects found their way to real estate and other more lucrative investments.[1] Many of these borrowers invested billions of dollars both in the domestic and regional property markets such as Dubai that was undergoing a boom of its own.

After a year when leading economies slid into recession, the forecasts paint an even grimmer picture for the 12 months ahead. Recession is expected for most advanced economies and a growth decrease for emerging economies; hence, many economists urged world governments to spend more to boost domestic demand to prevent this recession developing into a great depression similar to the downturn of the 1930s. Because of the downturn in economic activity and overall demand around the world that have led to much lower commodity prices today, lower inflation rates for many economies and even deflation for some other economies are coming into effect. Consequently, central banks and governments around the world have resorted to expansionary fiscal and monetary policy by deficit spending, offering stimulus packages, lowering reserve requirements, tax cuts, and lowering interest rates to boost their economies and stabilize prices.

Though, the situation in Iran is rather different. The government carried out expansionary monetary and fiscal policy conversely during the times of economic growth and increasing inflation. Ahmadinejad's extravagant spending from the oil income in combination with lowered lending interest rates less than the average inflation rate and deposit rates triggered a huge amount of demand for borrowing despite many warnings he received from Iranian experts. They stated that excessive capital injection not only would not increase economic growth, but also would place the economy in an unwanted economic situation. It is easy to throw money at the market and people. But, it's not so easy, and certainly not popular, to manage the process of taking it back without creating a whole new set of problems for the economy and investors. As a result, far too much lending went to further increase the money base and inflation and to encourage purely speculative activity in the real estate market. Therefore, it distorted the markets, inflated asset prices, increased the fragility of the financial system, and served no constructive objective in the real economy.

Imprudent expansionary economic policy during the economic growth times and the inflow of capital to real property as the result of that have encountered the government and central bank with two major challenges: 1- a substantial amount of budget deficit and exploitation of accommodative monetary and fiscal policy to revive the economy and 2- A credit crisis in the banking system.

Budget Deficit and Economic Policy

It is expected that the government's earnings be reduced via its four different sources of income: 1- oil revenues, 2- amounts of oil exports, 3- exports of petrochemical and non-oil products and services, and 4- taxes.

The government just completed planning for the next fiscal budget (March 20th 2009 – March 20th 2010) based on an oil price of $37.5 a barrel. According to its current planning, the budget will encounter a deficit of $30 billion if the average crude price remains within the range of $35 to $40 a barrel, which comprises 1/3 of the next year's fiscal budget. Even many experts believe that the deficit figure is very optimistic and the government will not be able to achieve many of its predicted earnings. In the past three years, the fiscal budget has grown significantly due to the inflow of petrodollars.[2&3]

During its tenure, the present government has poorly supervised the economy and showed little discipline in managing its finances besides its continual interference into central bank's affairs. Every year it had to submit legislation to the Majles (Iranian Parliament) several times for supplementary budget amendments to tap into the Oil Stabilization Fund as well as to borrow from the central bank. Therefore, in the upcoming Iranian year if the government continues its mismanagement and acts disorderly, the figure for the budget deficit will be much larger.

Deficit spending in a modern economy is not necessarily a bad practice if it is done correctly. It does not inevitably represent financial risk to either the government or the public. On the contrary, sometimes attempts to balance the budget can easily be counterproductive, especially during recessionary times. When the economy is sluggish or in recession, deficit spending helps support aggregate demand and production needed for recovery. Nevertheless, the question is how the money should be spent? Many economists suggest that during recessionary times with low inflation the money should be spent on infrastructure projects to increase employment, which will boost demand, when prices are falling due to deflation or disinflation.

In a modern economy to help pay for a fiscal budget deficit, the government raises capital by selling debt to the public. Also, the central bank buys securities to lower the short-term interest rate to its desired value and provide for growth of the money supply. By applying this tactic, the money base remains unchanged or changes based on the desired interest rate and therefore inflation stays in check. On the other hand, high inflation is almost due to a huge budget deficit, which the government is unwilling or unable to finance in the ordinary way by borrowing in the capital markets that maintains the money base. Instead of cutting the deficit, the government prints money or borrows it from the central bank, which amounts to the same thing. The result then leads to an increase in the money base and hence inflation.

The latter is the case for Iran. In general, the government sells the petrodollars to the central bank and instead receives tomans for its budget. For the past few years, the central bank has printed trillions of tomans to exchange with billions of dollars of the government's petro earnings. In these critical times, both the government and central bank are crippled in employing accommodative monetary and fiscal measures to revive the economy that is already experiencing a slowdown because of their past policies. The government has frantically been openhanded in exhausting petro earnings and lowering interest rates that led to higher inflation and asset prices. At present when the economy needs a lift by government spending, tax cuts, and lower interest rates, previous policies have made the situation very difficult for any easing. To cope with the budget deficit, the administration will have the choice of cutting spending (contractionary policy), reduce subsidies, increasing taxes, borrowing from the central bank (printing more money), selling participation bonds (government bonds), borrowing from foreign sources, or increasing the foreign exchange rate (currently set to 950 tomans per dollar for the new budget.)

By cutting spending, in particular for development projects, the administration will add to the fire of unemployment that is already officially around 11% but unofficially more than 15%. By reducing subsidies, the government is planning to hand out targeted cash to the people, so it will not help. By borrowing from the central bank, the monetary base will increase, and as a result it will give a boost to the already high inflation rate. By increasing taxes, businesses will undergo more liquidity pressure when they need it more. By selling participation bonds, the government will be able to collect some of the stray money and pump it back to the development projects. However, there are doubts whether the government can raise a substantial amount of capital by selling these bonds unless it increases their yield a few percentage points more than the average inflation rate. Currently, the yield for the bonds is set to 19% while the average inflation rate is about 26%. By attempting to borrow from foreign sources, because of US and UN Security Council sanctions besides the ongoing global credit crunch, it seems highly unlikely that any foreign governments will be too enthusiastic to financially support the government of Iran. By increasing the foreign exchange rate, the government will be able to receive more tomans against the dollars that it sells to the central bank. It seems that the last one is the most viable option that the government has, considering the fact that the current rate is by far undervalued.[5] Yet, it will not be easy to increase the rate suddenly as the demand to convert tomans to dollars will sharply increase.

By adopting any of these approaches, the government will face a grave challenge nonetheless. Perhaps serious stagflation is inevitable. For the government to fight inflation, it has no choice but to curb spending, increase interest rates, and reduce liquidity and hence bring the economy to a halt to kill high inflation. However, this will bring about high unemployment and deeper recession that may lead to social unrest. This is the risk that the government has to take eventually to normalize the economic condition.

Credit Crisis

Iranian banks have the credit crisis of their own. The current credit crisis in Iran has no relation with the global credit crisis whereas its roots may be found in the unsystematic interference of the government into central bank's affairs by imposing policies that were out of the scope of government's responsibility such as lowering the interest rates and forcing the banks to lend funds to loan applicants without requiring a viable business plan or conducting any supervision. The banks often had to borrow from the central bank to provide the funds. This policy has weakened the banking system considerably and made it undercapitalized. Substantial amounts of delinquent payments from the borrowers have shown on banks' balance sheets. According to central bank governor Mahmud Bahmani the total amount of delinquent payments is estimated to be $30 to $40 billion.[6] Now, these banks have tremendous difficulty lending money. As a result, many companies, businesses, and development projects that require borrowing for their operations have faced a great hurdle.

As it was previously stated, because of the formation of Dutch disease due to high oil prices and over injection of money into the system, considerable amounts of capital were funneled into the local and regional real estate markets. Thus, it made real property as a non-tradable asset heavily inflated. The regional real estate markets, particularly Dubai and Abu Dhabi were booming too. Iranian banks offered most of their capital to be invested in fast return economic units and other development projects. Many economists warned the government that the tactics of lending to achieve fast returns had been examined and failed in other countries such as Eastern bloc nations. In view of the fact that neither did the banks impose any supervision nor did any of these projects have viable business plans, the investors often initiated the plans but later redirected the capital to real estate and equity investments.[4] Besides, the unfriendly business environment due to inappropriate economic policies and over regulation aggravated the situation. In both Iran and Arab countries of the Persian Gulf, in particular the UAE (mainly Dubai), property prices skyrocketed. Property sold like hot cakes for the past few years. However, because of a decline in oil prices and the ongoing global credit crunch, demand has slumped as panicking investors and creditors fled the markets. In other words, Dutch disease started to fade away as a less amount of petro dollars entered the financial system.

Since their peaks, property prices both in Iran and Dubai have dropped nearly 20 to 30% and they are expected to continue their decline. Many sellers are even willing to sell their estate less than the market price, but there are no buyers to be found. Many of them had a plan to purchase property and then sell it in a few months later to pocket a quick profit. Now, they are trapped in big sums of loans and properties with considerable depreciated prices. Many of these investors have discontinued their monthly loan payments and thus defaulted on their loans. Furthermore, the fast return economic concept has not been able to bear fruit either. Most of the economic units have not been able to reach profitability. Currently, many of them need additional funds to continue.

Consequently, Iranian investors have encountered a significant difficulty to make their payments to the Iranian banks. There are no clear statistics that show how much the banks have exposure to the real estate mortgages. It is likely that a significant part of business and personal loans has been invested in real estate.

Some of Iranian policymakers close to the government are still making cheering statements about the Iran's non-existence exposure to subprime loans and the global credit crisis. But they have stayed hushed about heavy investments in inflated local and regional property markets as well as the increasing number of payment defaults. There are high possibilities that further economic weakness leads to more bad debts within the banking system. Furthermore, many expatriate Iranians who transferred their money from foreign banks to Iranian banks to exploit high yields that the Iranian banks offer with nearly fixed exchange rates may soon move their funds back to their foreign banks if they lose faith in the financial system. The premise is also valid for high net worth Iranians who own a business or have a stake in Iran. This will additionally put pressure on the banking system and the undervalued exchange rates.[7]

Government's economic policy of the last three years has failed. Ahmadinejad Administration's shortsightedness has cost the economy a fortune. At a time that Iran could have accumulated tens of billions of dollars in reserves, officials are pondering to borrow from foreign sources to weather the turmoil. Many Iranian economists believe that the newly drafted budget is unrealistic and contains hidden budget shortages and discrepancies in addition to its known massive deficit. It is highly unpromising that the government will be able to properly manage the new fiscal budget considering the upcoming budget deficit of $30 billion partnered with the delinquent payments of $30 to $40 billion to the banking system and the upcoming foreign debt payments. Iranian statesmen have no choice but to eventually accept the principles of free market economics and private ownership of the economy. Half baked policies and central planning have inflicted indescribable damage to the country and people. May this domestic crisis be a good lesson for the policy makers in the future.

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