A Review and Analysis of Iran's Current Economic Status

Naghshineh-Pour, Amir

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By: Amir Naghshineh-Pour

Mahmoud Ahmadinejad became Iran's sixth president after winning the 2005 presidential election by popular vote. He placed second after Ali Akbar Hashemi-Rafsanjani in the first round amid rumors surfaced that the Revolutionary Guard and the Basiij Militia had engineered his election. However, in the second round he handily defeated Rafsanjani to become president. Throughout his presidential campaign and after, he resorted to populist slogans such as equal distribution of wealth, economic justice, thoughtfulness and compassion (mehrvarzi), etc., to timely take advantage of people's emotions during a period of rapidly rising oil revenues and the potential threat of a U.S. invasion was becoming serious after Bush's notorious State of the Union speech that put Iran a part of an axis of evil.

Iran has one of the most isolated economies in the world. It is currently ranked 151 out of 162 among all countries and 16 out of 17 in the Middle East and North Africa region.[1] The government of Iran controls more than 80% of the economy, a figure more or less consistent for the past 30 years. The Khatami administration, in a major attempt to reverse such a trend, designed and planned the 4th five year economic development plan (2005 – 2010) and the twenty year economic outlook to lower the state ownership of the economy. A new interpretation of article 44 of the constitution allowed the government to privatize major industries that it had originally monopolized according to its previous interpretation by offering their shares to the public and private sectors. However, after Ahmadinejad's inauguration, the government deviated rapidly from those plans. Years of careful studies and planning became obsolete due to the administration's ideological beliefs.

Since Ahmadinejad took office, despite a considerable increase in oil revenues, the state of the economy has deteriorated. The inflation rate is reaching 30% according to Central Bank statistics, many factories operate at 50% or less of their capacity, and major cities have daily power blackouts. Real estate prices have tripled. The U.S. has implemented financial pressure on Iranian banks while the U.N. Security Council has imposed sanctions. The president has failed to make any prominent development in the nation's latest five year economic development plan. A mixture of massive subsidies, price controls, mandate interest rate controls, mismanagement, central planning, etc., have contributed to his failure. The Ahmadinejad administration has become the victim of his campaign slogans. These slogans are ineffective for solving any problems. They are only good for temporary public consumption. However, he is still going full speed. Much of his confidence is fueled by unprecedented oil revenues in combination with his ideological beliefs.

Central Planning

The Ahmadinejad's administration economic policies are directed toward a central planning system, which originate from the president's own mindset. Its main objective is to control all markets including commodities, capital, credit, and labor. Although this matter was evident in the previous governments, the current government's interference in monetary decisions, different market affairs, and setting price controls in the name of justice and Islamic economics is exceptional.

In a major attempt towards central planning, Ahmadinejad dissolved several semi-independent state entities to increase his control over fiscal and monetary policies thus enabling him to implement his populist plans. Management and Planning Organization (MPO) was one of the major entities that fell victim to Ahmadinejad's plans. Before desolation, this 60 year old state body was in charge of allocating the national budget relatively independent from the administration. The president established a new budget and planning body directly under his supervision to have complete control of budgetary policies.[2 &3] Another major victim was the Credit and Money Council (CMC). The CMC's responsibility was to study and make decisions related to the general guidelines of the Central Bank of Iran (CBI) and to supervise monetary and banking affairs. Before dissolution, the CMC had resisted Ahmadinejad's plan to reduce the lending interest rates lower than the inflation rate several times.[4] In total, 28 state councils and committees were combined into 4 bodies under the supervision of president's office.

Another attempt by Ahmadinejad was granting billions of dollars of civil contracts to the Revolutionary Guard (Sepah-e Pasdaran) Khatam Al-Anbia unit (RGKA) and Basiij Militia. These contracts were conceded without participation of other bidders and funded from the Oil Stabilization Fund (OSF). At first, many reformist members of the Majles protested and inquired explanations from Ahmadinejad. They questioned whether allocating such funds from the OSF to the RG was legal and whether participation of the RGKA in economic projects was part of its mandate. Furthermore, there were doubts whether the profits from these projects would be used for defense expenditures or other expenditures. Knowing that the RG is only responsive to the leader, nobody would ever know where the profits would be spent. Later it became apparent that the RGKA unit had hired subcontractors to execute the projects because it did not have enough expertise and recourses to implement the projects.[5] This was the original plan of Ahmadinejad to phase the private sector out of being a major economic player. He certainly wanted the RG to be the beneficiary of the new contracts, as he had specifically promised during his presidential campaign.

The independence of the Central Bank is another matter that the government of Ahmadinejad has violated more than the previous governments have. In many well managed economies, the central bank operates independently from their governments. The government and the central bank have two separate responsibilities. The former is in charge of administrating and setting the country's fiscal policy while the latter is in charge of setting country's monetary policy. Ahmadinejad has completely ignored this very important distinction and has continued his interference in Central Bank's affairs. As a result, he stood at odds with the initial Central Bank governors in his tenure and just recently appointed the third one. So far, he has managed to impose his government's views upon the Central Bank as evidenced by the reduction of the lending interest rate to 12% below the inflation rate and hence the acceptable rate in a free banking system.[6] Many in his administration have made outrageous claims denying the existence of a relationship between inflation and the interest rate. Such denial has resulted in sky rocketing inflation.

Subsidies, mandate interest rates, and high inflation

To materialize his populist promises, Ahmadinejad has tried to reduce unemployment and poverty through expansionary monetary and fiscal policies, including large energy subsidies and subsidized lending. These policies are resulting in disastrous consequences. Substantial subsidies, perhaps about four times the amounts paid during the presidency of Khatami, have produced huge budget deficits in the past three years forcing the government to borrow from the Central Bank in addition to raiding the Oil Stabilization Fund (OSF) every few months. He has adopted the worst and obsolete economic policies of the past. The results are inflation rates close to 30%.[7]

High inflation rates are the main cause of economic instability. The economy works best when the price level is stable and predictable. If the inflation rate fluctuates unpredictably, money becomes less useful as a measuring rod for conducting transactions. Borrowers, lenders, employers, and workers must take on extra risks.

While Iran's inflationary environment has worsened due to external circumstances, it is nonetheless mainly a domestic creation. The economic problems are not cyclical but structural and ideological. These inflation levels have been partially associated with Ahmadinejad's efforts to restrain the interest rate. In May 2007, the interest rate for loans was fixed at 12% for private and state-owned banks, although the Central Bank advised interest rate hikes because of higher inflation rates to prevent adding fuel to the fire of inflation. There is an incorrect perception in the administration that offering the lending rate of 12% or lower to industries increases both production and employment and hence helps the economy, while ignoring the fact that the banks also have to lower the interest rates that they pay to their clients' deposits. For instance, currently the interest rate for a one year fixed deposit is set at 18%, which is also less than the current inflation rate of 28%. It means that depositors lose 10% of their purchasing power annually. Therefore, offering the 12% lending rate comes at a cost for these depositors. These depositors are consumers. By losing 10% of their purchasing power, they will likely reduce their purchases and therefore the producers will also be affected. This is clearly evident by the massive amounts of borrowed money diverted to other investments such as real estate and gold instead of being invested in industries. Real estate prices have nearly tripled in the past three years. In addition, the difference between the interest rate the banks pay and the interest income they receive from lending activities has caused the state owned banks to be highly undercapitalized and receive huge amounts of subsidies to stay afloat. Private banks resort to other ways to compensate for their losses or simply lend their capital at higher rates. Perhaps this is the only economy in the world that the rate of interest for borrowing money is less than the rate of interest for deposits.

High levels of inflation have also been associated with a growth in Iran's money supply. The Central Bank's data suggest that the money supply growth has been about 40% annually.[8] The rapid growth of money supply came from high demands for borrowing capital at the rate of 12% the banks offer. This rate is lower than the inflation rate, which makes the cost of borrowing less than the free market cost of borrowing that would have been determined by free market supply and demand based on the inflation rate and risk. In countries that prices or rates (such as the 12% lending rate) are not determined by free market supply and demand, even if the borrowers are destined to use the low rate borrowed funds in production, the effects of lowering inflation because of lower production costs due to lower borrowing costs would be much less if the rates were determined in a free market. This is due to the fact that the allocation of resources in a free banking system would be much more optimally and efficiently done.

Furthermore, offering lending rates lower than free market rates causes high demands for bank funds and since supplies of bank funds are limited, it will eventually yield in higher market interest rates. For the past twenty years this has been the main reason for many companies to go bankrupt. These policies have already manifested themselves in high unemployment and inflation and increasing poverty.

Additionally, for the banks to fulfill the high demands for their low rate borrowing funds, they've had no choice but to borrow from the Central Bank. For the past three years the amount of borrowing from the Central Bank has increased many-fold.[9]

The government provides extensive public subsidies on gasoline, food, and housing. Energy subsidies alone represent about 12% of Iran's GDP, while total subsidies are estimated to reach over 25% of GDP. This has resulted in a wasteful system.[10] For instance, heavily subsidized gasoline has invited huge amounts of smuggling out of the country and domestic overconsumption. Furthermore, because of very low gasoline prices, automobile manufacturers have had little incentive to manufacture fuel efficient automobiles.

The Ahmadinejad government has used oil export revenues to pay for social spending contrary to the fund's original objective. Many economists and analysts have criticized the administration for using the OSF for cash aids and current spending rather than for future reserves or reinvesting in the aging oil and gas infrastructure. Billions of dollars are needed to keep the oil and gas industries in their current condition.

In principle, the aforementioned policies have been a major contributor to budget deficits and are ineffective tools for combating inflation and unemployment. Subsidies and cash aids are considered to be un-targeted and ineffective at helping the poor. Some economists contend that Ahmadinejad's efforts to lower the interest rate have led to excessive liquidity and inflation. Furthermore, critics express concern about the inflationary risks of uncurbed growth in the money supply. Considering Iran's vast oil wealth and current government spending, Iran's economy should be booming at the present time instead of average economic performance.

Dutch disease, foreign exchange policy, and imports

"Dutch disease is an economic concept that tries to explain the apparent relationship between the exploitation of natural resources and a decline in the manufacturing sector combined with moral fallout. The theory is that an increase in revenues from natural resources will de-industrialize a nation's economy by raising the exchange rate, which makes the manufacturing sector less competitive and public services entangled with business interests."[11]

Injecting sudden foreign exchange revenues in the economic system forms the phenomenon of Dutch disease in a country. There are two main consequences for a country with Dutch disease: loss of price competitiveness in its production goods, and hence the exports of those goods; and an increase in imports.[12] Both cases are clearly visible in Iran.

The flow of capital into real property instead of manufacturing and service industries is one of the clear signs of this economic disease. Real estate as a non-tradable good has increased in value many fold because of limited supply and overvaluation of the toman (Iranian currency). This has also caused some real estate owners to convert their tomans into foreign currencies and take their profits out of Iran. Furthermore, overvaluation of the toman because of rising oil prices and hence rising government expenditures has resulted in massive imports of cheaper goods (compared to the ones produced in Iran) to keep up with high demands. Investments in various industrial and service sectors have become uneconomical. Many production units and factories produce only a fraction of their capacity, because their products cannot compete with similar foreign counterparts. Simply put, Dutch disease has led Iran's economy to a real estate bubble and impeded industrial growth and competition in global markets.

One of the main factors that plays an important role in creating this condition is foreign exchange policy. Since 1999, when oil prices began their ascent, the Iranian government has stubbornly and irrationally kept the exchange rate in a narrow range with the US dollar (T850 to T950), while domestic expenses have increased many times and the inflation rate has been above US and global inflation rates by at least 15% per year.[8] Hence, as mentioned earlier, the Iranian currency is grossly overvalued thereby making Iranian products much more expensive than foreign products. Based on this fact, Iranian export products have lost their competitive power in global markets and by the same token they are unable to compete with similar imported goods. In these conditions, the government has resorted to imposing illogical and improper import tariffs to combat excessive imports and to increase domestic product competitiveness and in return has prevented both domestic and foreign investments. Currently, many of export products receive heavy subsidies from the government in order to compete with similar foreign products.

By adopting correct and rational foreign exchange policy, for example, devaluation of the toman against foreign currencies based on the inflation rate and the GDP growth, exports of many production goods will become economical and as a result many foreign products will lose their competitiveness against similar Iranian products. This will certainly lead to an increase in the country's revenue, domestic employment, foreign currency savings, and domestic and foreign investments (because domestic products will become economical) along with a decrease in real estate speculation, speculative price hikes, and capital flight to other countries. By current estimate, capital flight to other countries has been around $250 to $300 billion in the past few years.[13]

Fast return production units

One of the strategies that the Ahmadinejad administration has implemented to increase employment is the fast return economic plans. The main architect of these plans is his labor and social affairs minister Mohammad Jahromi.

In the past few years, efforts to create employment opportunities have made the government deviate from adopting correct policies. Offering small and medium size loans in order to reduce unemployment has created temporary and artificial jobs. This policy, originally initiated during the Khatami presidency, has continued and even expanded during the Ahmadinejad presidency. The Ahmadinejad administration laid out a plan to establish fast return economic units and offered loans to these units to tackle the country's unemployment problem. However, many economists believe that these units are ineffective and have turned the unemployed of the past to the indebted unemployed of today. In general, the only way to solve the unemployment problem is long-term planning and investment that is exactly the opposite of what has taken place.

To pursue this policy, the administration forced the state owned banks to offer their resources to these units. The banks lent their low interest rate funds to individuals who were involved in these units without requiring any collateral against the loans or any supervision regarding the use of the loan proceeds. Hence, liquidity increased considerably. A huge chunk of the injected liquidity diverted to more lucrative investments and spent for other purposes.[14] For instance, many of these individuals that received these funds deposited them in 1 year savings accounts that paid higher interest rates. Without any work (meaningful creation) and risks, they easily pocketed the difference. At present, a lot of bank payment delinquencies are observed, because these units have not been able to make their payments. Technically, the state owned banks are all bankrupt.

Privatization

Privatization in Iran has been a very sad tale. After the end of the Iran-Iraq war, the government of Rafsanjani decided to cede most of the state owned industries to the private sector in an effort to stimulate the economy. The effort; however, due to the opposition in the establishment did not properly materialize and most industries remained state owned.

During the presidency of Khatami, the issue attracted more supporters and hence the Tehran Stock Exchange was re-launched and a new interpretation of Article 44 of the constitution paved the way for more privatization. After Ahmadinejad took office, the privatization trend significantly slowed down, but in July 2006 after an issuance of a new decree from the leader, the privatization plan resumed.

During all these years, the authorities have missed an important fact: a successful privatization without a free market system is impossible. Iran has a command economic system based on central planning that has greatly intensified during the Ahmadinejad presidency. Simply put, the system has been the major obstacle to a thriving private sector. The intention herein is not to discuss how to lay out the requirements for a successful privatization, but to mention that without a comprehensive macroeconomic reform and adoption of proper macro and micro economic policies, the privatization plan will not be successful. The evidence is the bankruptcy of many industries after privatization.[15]

Price controls

In 2004, in opposition to the 4th five year economic development plan, the Majles prepared legislation to impose price controls on a few major commodities (water, electricity, natural gas, petroleum, diesel fuel, etc.) to prevent inflation hikes. The architect behind this legislation was Ahmad Tavakoli, who served on the Research Center Committee of the Majles. The government of Ahmadinejad wholeheartedly supported the Majles bill. Many economists and specialists warned the Majles speaker that price fixing would have no benefits for the economy, yet it would weaken the financial and production foundation of the system. They argued that by fixing these prices, the government would have to pay a substantial amount of subsidies to cover the rising costs that would have no benefits but to increase the budget deficit for the government. The increase in the budget deficit would have no advantage at this time but to increase the inflation rate.[16]

As was widely expected, the Majles-government plan that was once announced as a Norouz gift for the people, badly failed and caused huge budget deficits. In return, petrodollars were used to compensate for the shortfall. Consequently, the increase in the money supply contributed to the inflation boost. These huge budget deficits eventually began to show up on peoples' utility bills some time ago, often approximately 9 to 10 times the amounts the consumers would have had to pay, had this bill not passed (at most they would have risen at a pace a bit higher than the inflation rate.) Majles speaker, Haddad-e Adel, in a very surprising move requested Tavakoli, the very person who initiated the bill, to investigate the cause, i.e., leaving the meat with the cat. Tavakoli received much criticism afterwards.[16] At present, the government owes a large sum of money to private contractors.[17]

For a while, the price fixing provided relatively low rates for the consumers. Because of these low rates, consumers gradually increased consumption of these commodities thereby resulting in shortages of natural gas supply and electricity for industries, which caused a considerable decline in industrial growth, and power blackouts. And, of course, the ongoing drought gave the Majles and government the perfect excuse to try to cover up their failure.

In general, this mindset, while no stranger to Iranians, stems mainly from the lack of knowledge behind inflation causes and price increases. Price fixing has been carried out in many countries, including Iran, and has always failed. The price of any commodity cannot be held below its market level. Two consequences will arise from such an act.

The first is an increase in demand for the commodity. Because the commodity becomes more affordable, consumers are tempted and often do purchase more of it. The second consequence is a reduction in the supply of the commodity. Because of the increased consumption, the accumulated supply is rapidly absorbed. Furthermore, production of that commodity is discouraged. Profit margins are reduced or eliminated and hence the marginal producers become bankrupt. Even the most efficient producers may be called upon to turn out their product at a loss. This is a frequent occurrence in Iran.

Sovereign wealth funds (SWF)

SWFs are government-owned investment funds, set up for investing in various financial assets worldwide. Their funding comes from central bank reserves accumulated from budget and trade surpluses, as well as from revenue generated from the exports of natural resources.[18]

Many countries already own such funds. The funds that belong to oil rich countries have received a lot of attention recently, mainly due to large accumulations of petrodollars. In the recent financial turmoil, SWFs have demonstrated that they can have a stabilizing influence on markets. The largest of these funds is Abu Dhabi Investment Authority with assets close to $900 billion.[19]

Iran's SWF or OSF was established in 1999 during the Khatami presidency. The purpose of the fund was to balance the budget at the times of economic distress. However, the frequent unplanned withdrawals from the fund have violated its original objective. Although funds were withdrawn from the OSF during the Khatami era, in the past three years the OSF was raided for any purpose. Petrodollars have flooded the financial system without regard to its repercussions, many of which were discussed in the previous sections. Today, there is no clear information and data on the balance of the OSF. The estimated balance is between $8 and $16 billion, while the expectation is a figure between $80 and $100 billion.[20]

Other countries such as Norway, the UAE, Saudi Arabia, Kuwait, China, etc., owning such funds have fairly responsibly been able to manage them. Injecting excessive amounts of capital into the financial system in a short period of time could have severe consequences. The current administration assumes that money is the solution to any problem, whilst proper capital management is the key. SWFs' assets, and the returns they generate, are likely to have a significant impact on a country's public finances, monetary conditions, the balance of payments, and balance-sheet linkages. Hence, poor management of these funds may destabilize the economy and the entire financial system.

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The government of Iran is larger and more ambitious than ever, yet without any specific strategy or planning. There are inherent difficulties that arise when the state becomes too expensive and too ambitious and seeks to be the main player, rather than a referee, in the economy. There is no doubt that to a great extent such ambition arises from the state's considerable oil revenues and the faulty assumption that the oil prices will continue to rise. Iran, more than ever, is addicted to oil; even more than major oil consumers such as the U.S., Europe, China, etc. As a result it is overwhelmingly susceptible to oil price fluctuations. Iran has possibly suffered more than any oil rich countries from oil nuisance. High oil prices have always worked against Iran's progress, growth, and long-term interests.

With the ongoing worldwide financial crisis, the possibility of a severe global rescission is imminent. That can easily translate to lower oil prices. Since the price of oil is way off its peak, many economists believe that with the continuation of the global financial calamity, the demand for oil may considerably drop and hence the price of oil may easily go under $50 a barrel.[21]

Years of mismanagement, resorting to obsolete strategies, central planning, attributing modern economic theories to western ideologies etc. have placed Iran's economy in a crisis. This crisis has not shown itself to its full effect because of oil earnings. A great percentage of the fiscal budget comes from petrodollars. Noting that the average expenditures of the government is currently between $70 to $75 a barrel, an average annual income less than those figures would be disastrous for the country as a whole. The first upshots would be a drastic increase in the inflation rate, sudden devaluation of the toman, and a huge drop in financial exchanges.

Officials' nervousness about plummeting oil prices is becoming more evident. Their attention now is focused on OPEC to reduce production and boost prices. Reducing oil production may temporarily increase oil prices; however, with the ongoing financial turmoil and a possible deep global recession, higher prices may not last long. This is very grim news for the populist government that once pledged to put the country's oil income on peoples' tables. The social gap has widened under Ahmadinejad's leadership – the poor are poorer and the wealthy are wealthier. In the hope that with falling oil prices and hence deteriorating economic condition, he does not blame external forces rather than his own mismanagement, which has come under growing fire from both the conservative and reformist camps.

The Iranian government plunders billions of dollars each year on subsidies, uneconomical industrial activities, corruption, inefficiency, and mismanagement. The essential steps that any government in Iran should take to revive the economy are: allow the market to determine the interest rate instead of commanding it, allow the prices for products and services be determined by supply and demand instead of price controls and price fixing, adopt financial discipline, reduce budget deficits, lower government costs, prevent excessive money supply growth, prevent injection of petrodollars to the economy that has resulted in Dutch disease and stagflation, stop raiding the OSF, end artificial overvaluation of the toman against foreign currencies to increase internal production and international investments, resist changing laws frequently, lower import tariffs, build trust and improve relations with the world to increase competition, and, last but not least, privatize state owned entities to reduce government size coupled with a macroeconomic reform based on a free market economic system.

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About the Author: Amir Naghshineh-Pour (MBA) is a financial and business analyst. He works for an investment bank.