A Note on the Post-Revolution Iranian Economy and the Banking Sector

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Abstract

This note provides an analysis of Iranian economy in its post-revolution era with special emphasis on the country's banking sector and discusses the reasons for Iran's failure in reaching sustained economic growth and financial development.

1. Introduction

This note provides an analysis of Iranian economy in its post-revolution era with special emphasis on the country's banking sector and discusses the reasons for Iran's failure in reaching sustained economic growth. These problems are interesting for any Iranian and foreign researcher as Iran is a rich country with abundant natural resources. An analysis of the economic problems of Iran and the impact of government and foreign policies on economic indicators seems necessary to identify the factors which prevent economic and financial development in Iran. This note discusses that some of the government policies, which hinder the economic growth and financial development in Iran should be removed or revised, especially those policies which are known as financial repression and those that may decrease the efficiency of financial sector and consequently inhibit financial development and economic growth.

2. An Analysis of the Iranian Economy

Iran has a young population. According to the World Bank (Country Brief, June 2009), Iran has a population of 73 million. Most of these people are young people and Iran's health and education levels are one of the best in the region. At the same time, the number of women participation in the labor market force continues to increase in this society with a large number of young people with high level of education. Hence, one of the most challenging problems in Iranian economy is to facilitate and create new jobs for those who are ready to enter the labor market (see figure 2 for unemployment position in Iran).

As obvious from the Figure 1 the population growth has fluctuated until 1993 but then it has been steady around 1 % growth rate till today.

Figure 1: Population growth rate (%) in Iran, 1986-2006
Source: US Census Bureau, International Data Base, Country Data

As can be seen in Figure 2, it seems that the rate of unemployment has fluctuated from 1986 till 2007 between 10-15%, which is quite high.

Figure 2: Unemployment rate (% of total labour force) in Iran, 1981-2007
Source: World Bank World Development Indicators

With a brief review of economy of Iran, especially after 1960, we can easily identify that Iran's economy has experienced many periods of high inflation, stagnation, expansion and recession. In the period of Mohammad Reza Shah Pahlavi Kingdom, with the policy focus on the oil sector, the sale of oil was very beneficial for the government in terms of budget revenue as well as for the economy as a whole. During the 1960s, the economy of Iran has experienced almost its best time. The rate of economic growth was quite high in this decade. The IMF Country Report (2004) states that during 1960-1976, the rate of growth of Iranian economy was the fastest in the world with a real economic growth rate of 9.8 on average and a real per capita income growth of 7 percent on average.

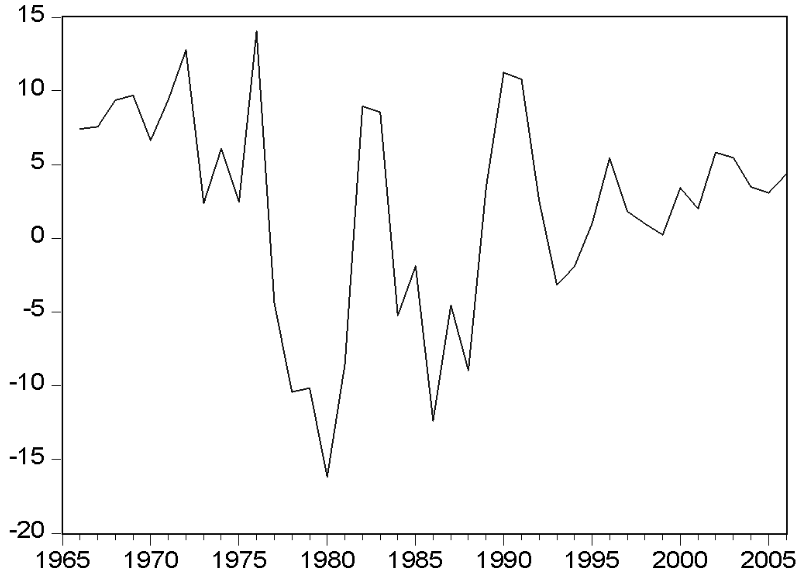

Figure 3: GDP growth rate (%) in Iran, 1965-2005
Source: International Monetary Policy and World Bank World Development Indicators

As can be seen from the graph of GDP growth in Figure 3, economic growth has fluctuated from 1966 till today. These fluctuations have been approximately between a range of -13% and 18%. As it is clear in Figure 3, economy of Iran had the lowest GDP growth rate in 1979 which was -13.29% and the highest GDP growth rate in 1976 which was 17.73%. Therefore, it is obvious that the highest GDP growth rate occurred at the end of Pahlavi regime and the lowest GDP growth occurred after Islamic revolution, during the war between Iran and Iraq.[1]

In 1973, because of a fall in international oil prices, the economy of Iran quickly plunged into a crisis.[2]

[1] As reported by Alizadeh (2000), during the 1960s and the early1970s, Iran's GDP and consumption rates were between the ranges of 10-12 percent. Also, in 1970s especially the private investment growth was even faster and the government spent much of its revenue from oil on the public investment and consumption .During the same period, the government expenditure on public investment exceeded the private investment by 50%, and the public consumption was 50% of private consumption (Alizadeh, 2000).

[2] The world faced three major oil shocks in the last three decades: 1973-1975 (the Yom Kippur-Arab-Israeli-war), 1979-1980 (Iranian revolution and ensuing Iran-Iraq war) and 1990-1991 (Iraq's invasion of Kuwait and the Gulf War) (RIS, 2004).

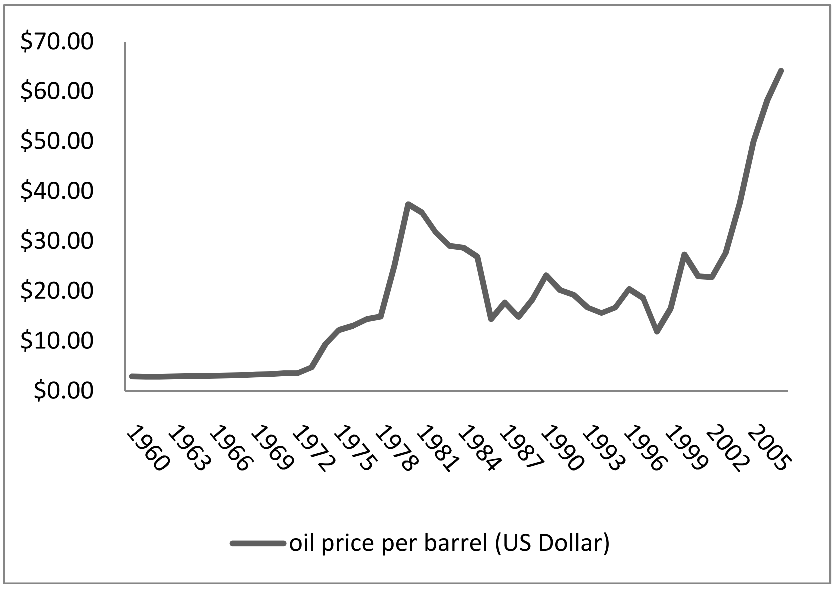

Figure 4: Oil price per barrel (US dollars) in Iran, 1960-2005
Source: www.inflationdata.com/inflation/Inflation_Rate/Historical_Oil_Prices_Table.asp

Regarding the price of oil per barrel, as shown in Figure 4, oil prices were stable starting from 1960 around $3 per barrel until 1972, and then it has fluctuated widely till 2007. These fluctuations have been between a range of $5 and $65 per barrel. This instability has not been favorable for the Iranian economy, which is an exporter of oil.

Between 1977 and 1988, Iran experienced its Islamic revolution and the Iran-Iraq war, which have had significant negative impact on the country's economy, reversing the direction of economic growth (Ilias, 2008).

Ilias (2008) states that Islamic revolution which occurred in 1979 changed the economic history of Iran and also its modern political history. She argues that Iran's economy changed into a public sector-dominated economy and, during the eight years of war between Iran and Iraq, the economy of Iran suffered to a great extent (Ilias, 2008).

After the Iran and Iraq war, the Iranian government tried to restructure and rebuild the economy, which was damaged during the war. It also tried to redistribute the wealth by a series of Five-Year Development Plans. For this purpose, they removed the allotments and subventions after 1989 through changes on the rules of the exchange rates and prices. Moreover, the size of government participation in the economy was reduced by privatization between the years 1989 and1993. As the Iranian government tried hard to reconstruct and recover the oil production, the growth reached an annual average of 4.7 percent between the years 1989-2002 (see Figure 3). Although this period was marked by frequent fluctuations in growth rate, the economy was affected by a decline during 1993-1994 when the price of oil decreased significantly due to the economic boycott (see Figure 4). The crisis of debt with improper policies had a great detrimental effect on growth by a 3.6 percent fall during the years 1995-2000 (IMF, 2004). Subsequently, in the third Five-Year Development Plan, the Iranian economy had an impressive development: By the year 2005, the government successfully smoothed the path of exports and consolidated exchange rates (Salarpour, 2007).

During 2007-2008, progress was significant and, in the face of fast expansion of the labor force, unemployment decreased (see Figure 2). Since 2005-2006, economic growth of the non-oil sector increased by 7.3 percent. The oil sector, nevertheless, registered only little development caused by inadequate foreign investment in 2007-2008 (IMF, 2008).

Parallel to these developments, inflation rate has been relatively stable in the last decade. As can be seen from the graph of inflation in Figure 5, inflation rate fluctuated widely from 1980 to 2007. This fluctuation has been approximately between a range of 4.37 percent and 49.11 percent.

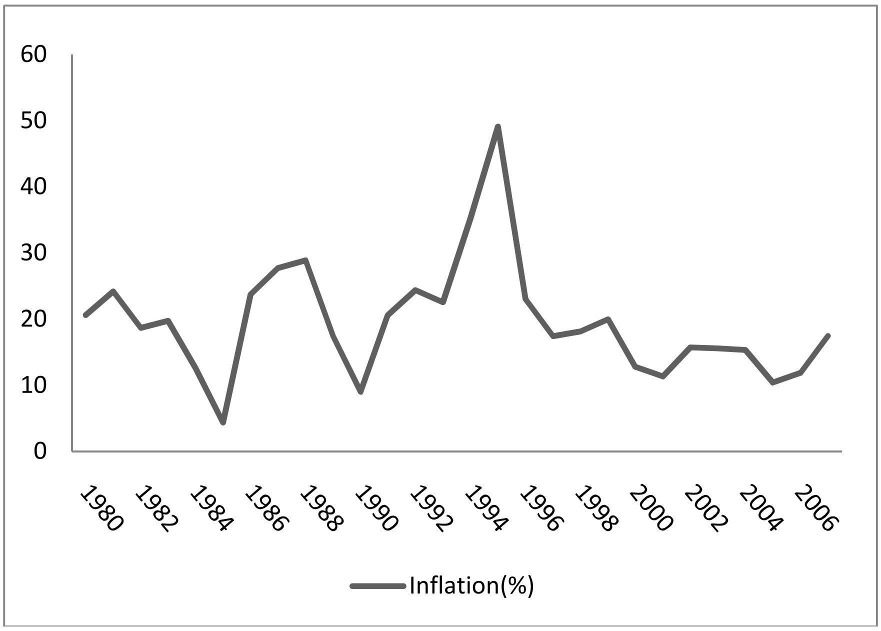

Figure 5: Inflation rate (Annual %) in Iran
Source: International Monetary Policy and World Bank Country Data's

3. Financial Development in Iran

One of the main barriers to economic and financial development in Iran is the shortage of adequate productive investment. Increasing competency of financial market and improving the position of financial growth may solve these complications. However, financial markets in Iran are not uniform and organized. Significant shares of savings are transmitted to borrowers via unauthorized market and economy. Due to financing with poor-quality loans, most of the investment projects are not profitable. Furthermore, a large volume of credits allocated to private sector are channeled by direct command of the government (Taghavi and Ismailzadeh, 2009).

One of the economic policies of the Iranian government has been to inculpate private-public proprietorship system of the banking sector of the pre-revolution period and to accomplish nationalization of the sector. As the banking system is directed by the tight control of the government, it has a number of limitations regarding interest rate and on branch expansion (Hosseini and Shabbani, 2003).

After the 1979 Islamic Revolution, financial system of Iran has developed in different periods. In early 1980s, it experienced widespread nationalization. In 1990s, it experienced a reconstruction of the financial system, concentrating on reforming the regulatory conditions (Taghipour, 2009). For instance, during the years 1995-2000, in the Second Five-Year Development Plan, the improvement concentrated on placing an interest rate on bank deposits at a position that guaranteed positive real returns, giving out investment certificates, and motivating the existence of individual credit institutions. Moreover, in the Third Five-Year Development Plan during the years 2000-2005, the reconstruction concentrated on reducing the use of executive controls on interest rates and credit apportionment, reinvestment of the state banks by issuing securities, and the establishment of private banks and non-bank credit organizations. Despite these improvements, the policies were not sufficient to loose up financial repression in Iran (Taghipour, 2009).

Table 1 presents the average data for every 10 years between the years 1960 and 2007 on leading financial and economical variables.

Table 1: Banking Sector and Macroeconomic Indicators in Iran

	Years				
	1960-1970	1970-1980	1980-1990	1990-2000	2000-2007
CPI (%)	2.55	0.00	19.82	23.71	11.39
GDP growth (annual %)	11.62	11.00	-0.31	4.64	4.69
GDP per capita growth (annual %)	8.51	2.88	-3.66	2.91	4.87
M2 as % of GDP	25.19	31.06	49.87	39.62	38.99
Deposit Money Banks: Assets (Millions US Dollars)	45.31	529.74	2003.08	3285.38	18946.31
Deposit Money Banks: Liabilities (Millions US Dollars)	22.28	776.52	885.44	3215.28	18714.94
Reserves (Billions Rials)	17.46	181.29	2966.02	22396.44	97467.76
Foreign Assets (Net)(Billions Rials)	16.53	422.51	780.10	5933.61	180179.38
Domestic Credit (Billions Rials)	119.99	975.89	10436.32	81803.45	505973.38
Cash (Billions Rials)	1.84	13.39	42.39	616.64	12199.65
Demand Deposits (Billions Rials)	4.23	30.42	127.63	1754.57	16488.95
Private Sector Deposits (Billions Rials)	2.70	11.31	125.50	1754.57	16487.95
Time And Savings Deposits (Billions Rials)	2.00	33.22	320.57	3730.76	75938.84
Deposit Rate	-	8.07	7.38	11.11	11.66
Lending Rate	-	12.07	10.43	17.40	14.66

Source: International Monetary Policy and World Bank Country Data

4. Banking Sector in Iran

According to RSM International (2008), there are approximately 17 commercial banks in Iran today. Among these banks, eleven of them are state-owned and six of them are privately owned. All of these banks have to follow the principles of Islamic banking whereby usury is not allowed and, beside to interest rates, profit rates are set on deposits and expected rates of profit on facilities are set on loans. The banking sector is dominated by Bank Melli Iran (National Bank of Iran) in terms of both capital and asset size.

Currently, six banks which are privately owned, Bank Persian, Bank Kafarin, Bank Saman, Bank Pasargad, Bank Eqtesad-e-Novin, Bank Sina and Bank Sarmaye were the first banks to start operations in Iran after the nationalization of the banking sector in 1952. Some policies have been introduced to reform the structure of financial sector by privatizing the majority of Iran's state-owned banks. Nevertheless, the privatization process is restricted to domestic investors, and the state proposes to keep a 30% stake of the overall banking sector (RSM International, 2008).

In Iran, following to the completion of landmark reforms in the financial sector, banking sector has witnessed large changes with the elimination of bureaucratic controls, encouragement to foreign private and private investment and integrating the Iran's banking systems with the international economy. The entry of new private banks constitute a challenge to the public sector bank leadership in Iran (Ahangar, 2009).

The Iranian Government obliges the Central Bank to use specific monetary policies in support of catering for their current affairs and fiscal policy. Thus, usually the money supply stays out of control of the Central Bank. In determining the quantity of money, the most significant factors are how the monetary base is controlled and the ways the money is supplied (Naghshineh-pour, 2009).[3]

Even though the mix of private and state banking in Iran may be considered as a structural problem, it is ideo-politically driven (Naghshineh-pour, 2009). There is still a big deal which supports the establishment of state banking that prevents healthy competition, although privatization of the majority of the state owned banks is on the agenda. All private banks were nationalized after the revolution. Private banking restarted its activity again only eight years ago and its growth has been considerably fast (Naghshineh-pour, 2009).

At the moment the market share of private banks is 22% (in terms of asset) of the whole market. Their performance and productivity are significantly higher than those of the state banks. Nevertheless, they are subject to anti-competitive interference in their affairs constantly by the government and the Central Bank to prevent their fast market share growth. Additionally, state owned banks can slash the private-owned banks' profitability, since they tend to care less about profits. Besides, they receive a large number of unfair benefits from the Central Bank (Naghshineh-pour, 2009). Based on international standards, Iran does not have an adequate number of private banks compared to the number of state-run banks. There are fewer private banks in Iran than that of developed countries because of the loss of a competitive state of affairs in the country (Naghshineh-pour, 2009). Recently, the average real interest rate has been either close to zero or negative. Therefore, depositors have fewer intensive to save and have more tendencies to spend. They allocate their capital in gold, real estate, and durable goods to avoid

[3] The monetary base consists of the government's debts to the Central Bank, the net amount of Central Bank's foreign assets, financial institutions' and commercial banks' debts to the Central Bank, and other assets of the Central Bank (Naghshineh-pour, 2009).

depreciation of their money. In contrast, negative real interest rates increase the demand for borrowing in the banking system (Naghshineh-pour, 2009).

Currently, under the command of the government, the banks are converted into a tool for distributing credit with no consider to economic wisdom and to the profitability of the investments. Consequently, the banks are at the risk of credit defaults. This policy has significantly decreased the level of efficiency of the banking system and has imposed on the economy high costs (Naghshineh-pour, 2009).

The Central Bank of Islamic Republic of Iran (CBI) was set up in 1960, and is in charge of formulating and implementation of the fiscal and credit policies. In line with the common economic policy of the country, four main goals of central bank of Iran are; (1) Preserving the value of national currency; (2) Preserving the stability of the balance of payments; (3) Smoothing the path of trade-related transactions; and (4) Developing the potential expansion of the country (CBI, 2009).

According to CBI (2009), the financial institutions in Iran include the following: (1) The banks which are authorized by government and the banks which are nongovernmental; (2) The credit organizations which get the permission from Central Bank of Iran; (3) Money dealers which are accredited, as well as charitable lending funds; and (4) Cooperative funds and cooperative credit firms (CBI, 2009).

In the guideline of Central Bank of Iran for banking sector, it is stated that Central Bank of Iran has the option to meddle in and control fiscal and banking affairs to ensure the performance of the fiscal system. Some of these actions have been listed as follows:

First, clearing the formal loan interest rates and rediscount rate, which may differ on the basis of the type of bill and loan or document.

Second, for different aspects of banks according to their performances or on the basis of other standards at its own, setting the ratio of the bank's liquid assets to their total assets or to their different types of liabilities.

Third, the ratios and the rates of interest should be payable on the lawful deposits of banks at the central Bank of Iran. The mentioned ratios may be different according to the formats and performances of the banks, but it will never decrease below 10 percent and increase over 30 percent.

Fourth, identifying the upper and lower rates of interest. Fifth, setting the proportion of the total amount of paid up reserves and capital of banks to their various categories of assets.

Sixth, determining the highest amount of obligation on the part of banks issuing letters of credit, and, the kind and amount of commitment for such obligations.

Seventh, setting the periods and conditions relating to hire-purchase negotiations financed by banks.

Eighth, determining the kinds and amounts of awards and other encouragements recommended by banks to absorb savings or current deposits also regulations relating to public interests in this regard.

Ninth, restraining the operations of banks to one or more specific sectors of performance either temporarily or permanently.

Tenth, determining methods in which banks savings and deposits are utilized.

Eleventh, setting the maximum amount of credits and loans granted by banks or the maximum amount of their credits and loans in particular fields. Lastly, applying these rules, which are mentioned above, to credit institutions and systematizing regulations for them.[4]

5. Conclusion

This note has provided an analysis of Iranian economy in its post-revolution era with special emphasis on the country's banking sector and has discussed the reasons for Iran's failure in reaching sustained economic growth. It also indicates that some of the government policies, which hinder the economic growth and financial development in Iran, should be removed or revised, especially those policies which are known as financial repression and those that may decrease the efficiency of financial sector and consequently inhibit financial development and economic growth.

[4] For full list see: www.cbi.ir/page/BankingStudiesRegulations_en.aspx

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