IRAN -- 1978 Consultation

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Mr. Andrew Crockett

Room 3-314 #12

Executive Board Meeting 78/153

AGENDA

10:00 a.m., Friday, October 6, 1978

1. <u>Bahamas - 1978 Article IV Consultation</u>
(SM/78/234 and Correction 1 and SM/78/236 and Correction 1)

2. <u>Iran - 1978 Article IV Consultation</u>
(SM/78/235 and SM/78/239)

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problems for maintaining technical personnel at the highest government levels. Indeed, some of the bottlenecks to which the staff referred, and which were a matter of concern to his authorities, stemmed from the shortages of skilled professionals in certain key areas in government departments. The Government was fully aware of the need for a more comprehensive development program, especially now that it had more resources to devote to public investment in infrastructure. He hoped to be able to report more progress by the time of the next consultation.

As for the need to develop open market operations, Mr. Drabble remarked that there was no question that the Central Bank, which shared Mr. Kent's concern, was fully competent and equipped to handle them. Again, it was a matter of reaching the necessary decisions at the political level.

Another point mentioned by Mr. Kent was the development of fisheries, Mr. Drabble observed. The matter was being studied, but the experts in the area, some of whom had come from international organizations, were not in full agreement on the question of how well endowed Bahamian waters actually were. The authorities were giving careful study to the possibilities of fish farming as well as to the development of ocean fisheries.

The Chairman made the following summing up:

My understanding is that Executive Directors have indicated support for the views expressed in the staff appraisal contained in the report for the 1978 Article IV consultation with the Bahamas (SM/78/235).

2. IRAN - 1978 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1978 Article IV consultation with Iran (SM/78/235, 9/5/78), together with a proposed decision pursuant to Article XIV. They also had before them a staff report on recent economic developments in Iran (SM/78/239, 9/28/78).

Mr. Amuzegar made the following statement:

A major task of the Iranian authorities in the period between the two annual consultations with the Fund has been the implementation of a new policy toward a reasonable and more sustainable rate of economic growth, as compared with the dizzying pace of the 1974/75 period.

During 1976/77, Iran continued to experience high levels of economic growth. Real GDP grew at 11.5 per cent and the non-oil sector registered a 13.0 per cent growth rate in real terms.

The level of domestic expenditures, both public and private, and fixed capital formation continued to increase, although at a much reduced rate compared with the previous buoyant years.

However, in spite of increased domestic production and the continuation of heavy imports of goods and services, inflationary pressures continued in the first half of 1977 due to a rise in domestic liquidity of some 39 per cent in 1976/77 (compared, however, with a rise of 57 per cent in 1974/75 and 41 per cent in 1975/76).

One of the reasons for the increased inflationary pressures has been the performance of the agricultural sector in recent years, which has been comparatively sluggish. The authorities have now announced their intention to give top priority to this sector. The temporary tax-exempt status of investments in the agricultural sector has been extended indefinitely. The amount of credit provided to farmers, as well as the mechanism for its distribution, is being reviewed and improved. Private investment in this sector is being further encouraged.

The authorities are relying more on the price mechanism to increase production. They have already announced an almost 17 per cent increase in the purchasing price of wheat for producers in 1978/79, and have promised a further 7 per cent increase for next year. To further help farmers close the widening gap in rural/urban incomes, the basic purchase price of certain agricultural commodities (e.g., sugar beets, tobacco and others) have been raised. The Government's policy of offering financial assistance to farmers (partly in the form of subsidized 6 per cent loans) for the purchase of farm machinery and other aspects of farming has also been intensified.

With a view to increasing agricultural production and productivity, the 1978/79 budget for fixed capital formation in agriculture was raised by 54 per cent (partly to expand farm credits and to increase the resources of agricultural banks). In a major policy declaration in May 1978, the Ministry of Agriculture also announced that the Government's involvement in agricultural activities would be limited to improving the infrastructure, expanding services to the farm sector, increasing research and promoting farm output through various incentives.

The industrial sector has in recent years assumed a leading role among non-oil activities. The percentage share of this sector in GDP has steadily increased, and in 1977/78 it reached 19 per cent. Moreover, this sector is expected to continue to play a leading role in the transformation of the economy.

The Government intends to extend various incentives to promote investments in this sector. Special attention is also being given to the development of small-scale industries and the expansion of the more traditional activities. The Bank Melli Iran has already outlined the guidelines for extension of credits to these activities. Industries that would employ domestic resources, as well as those promoting agricultural activities, will be given priority.

It should also be noted that construction activities are expected to remain strong. Housing construction is going to get the full backing of the Government. A new distribution mechanism for the allocation of building materials to actual builders rather than middlemen is being set up, and interest subsidies and other incentives are to be offered to low income house owner-builders and to corporations for workers' low cost housing.

In line with the Government's basic objectives of removing bottlenecks, increasing production and enhancing efficiency, swift action by the Ministry of Energy has nearly doubled electric power production capacity, and put an end to power failures. Through better use of production and distribution facilities, the volume of cargo discharges in Iranian ports rose by 24 per cent (as against a mere 3.8 per cent in 1975); total capacity reached 17 million tons in a span of one year.

On the fiscal front, the authorities are determined to control public expenditure, minimize budget deficits, and avoid new inflationary pressures. Total public expenditure (including foreign loans and investments), which rose by some 31 per cent in the 1977/78 budget, was brought down to 17 per cent in the 1978/79 budget. Significant shifts of resources were also allowed in the new budget in favor of increased public investments in relation to current outlays. Although total expenditure in 1977/78 grew at a faster rate than revenues, capital expenditure grew by more than double the rate of current expenditure. This was viewed by the authorities as a necessary measure to maintain economic momentum. On the revenue side, the revision of the tax structure is now under serious consideration: the Government is determined to use fiscal policy for a better distribution of income. It is already planning to offer a further tax exemption on earnings at the lower end of the incomes scale. The authorities are mindful of the potential inflationary impacts of increased government expenditure, and are seriously evaluating all current, as well as development, expenditure. In the latter group, priority is to be given to those projects which have already started. Still, the Government may face a larger deficit in 1978/79 than in the previous year, and it expects to finance this deficit by recourse to domestic borrowing and some use of external sources.

Looking toward longer run prospects, the Government has taken steps to increase direct and indirect taxes in order to reduce gradually its dependence on oil revenues. Non-oil revenues in recent years have been increasing from less than 5 per cent of GNP in 1973/74 to more than 7 per cent in 1977/78--exhibiting an annual growth of about 27-28 per cent. These revenues for the 1978/79 budget year are estimated to increase by at least 30 per cent in the next few years.

On the monetary side, the Central Bank has continued its tight credit policy. In 1977/78 the credit ceilings for the commercial banks were set at 20 per cent and for specialized banks at 35 per cent above 1976/77 figures. Similar figures for 1976/77 were 25 per cent and 42 per cent respectively. The rediscount rate was also raised from 9 per cent to 10 per cent during 1977/78. These policies have reduced the rate of increase of domestic liquidity to 32 per cent as compared with a 39 per cent increase for the 1976/77 year. As for 1978/79, the authorities have expressed their intention to continue a tight credit policy. They have already adopted similar ceilings for the expansion of credit by both the commercial and the specialized banks.

The prudent fiscal and monetary policies adopted by the authorities did indeed reduce demand pressures. These policies together with the tough new law against land speculation and the Government's all-out effort to increase the supply of housing as well as the removal of other existing bottlenecks, provided an opportunity for the authorities to remove the price control guidelines. This action, necessary for a more efficient allocation of resources, immediately caused a sharp increase in the cost of living index. Later on, however, these policies proved successful, and the cost of living index, which in August 1977 was nearly 31 per cent higher than a year earlier, was brought down to 7.9 per cent in July 1978.

Realizing that the rapid increases in housing costs (e.g., 75 per cent in June 1977 over June 1976) were a major factor in price inflation, the Government directed its main efforts to this sector. A tough new law against urban land speculation was passed by the Parliament according to which city lots were to be priced by zones, and these prices used as a base for tax assessment, collateral on bank borrowing, and value assessment by the Government in exercizing its right of eminent domain. A reported 60 per cent drop in the housing price index was the result.

The Government's other anti-inflationary measures, in addition to further restriction of overall credit creation by the banking system, have included temporary shelving of low priority projects in the public sector; tying of wage boosts and workers' share of company profits to productivity (with an appeal for a voluntary wage freeze); reduction of the number of middlemen in domestic distribution through the establishment of retail cooperatives, and increased domestic production of goods through subsidies and other incentives.

As part of the restabilization efforts, a meaningful revision was also made of the price control philosophy and apparatus. Prices of "non-strategic" items not in short supply were freed from government regulations. Emphasis was also shifted from demand controls to the expansion of supply, increased competition and more efficient distribution.

To encourage fuel conservation (and improve government revenues), oil and gas prices were raised by 25 per cent in March 1978, and are scheduled to go up in five yearly 25 per cent hikes. Other products supplied by government enterprises at subsidized prices were also given price boosts in order to bring these companies into the black within five years.

The balance of payments picture has been quite satisfactory. In 1977/78, in spite of continued stagnation of the price of oil, a 130 per cent increase in payments for net services, a poor performance of non-oil exports and a 67 per cent drop in the current account surplus, the overall BOP showed a SDR 1.9 billion surplus although a 30 per cent drop from the previous year. The capital account registered a net inflow, which was basically due to an increase in borrowing abroad, and a decline in Iran's foreign investments.

Iran's exchange rate policy has remained essentially unchanged. While continuing to be pegged to the SDR at Rls 82.2425, the rial is allowed to fluctuate within a target zone above and below that central rate. The upper and lower limits of the target zone are based on the basic underlying conditions in Iran in relation to its major trading partners. Since July 31, 1978, Iran no longer observes a 7.25 margin of rial vis-à-vis the SDR. Iran follows a liberal policy toward all external payments and transfers, and hopes to be able to continue to maintain this policy beyond current payments and transfers. Iran's international reserve position, however, while still remaining strong, is becoming increasingly small in relation to the country's basic reserves and payments requirements.

Iran is presently going through an adjustment period. The Sixth Development Plan, although not yet finalized, will most likely be more concerned with improvement of health, education and living conditions for all citizens with more attention to those living outside Tehran. It will also concentrate on a better distribution of income. Proper attention will be paid to the development of infrastructure. The rate of growth will most likely be more modest than the recent experience, but still noteworthy.

Finally, a word must be said about Iran's contributions to the international adjustment process, and her close relations with the Fund. The Iranian authorities have contributed significantly to the oil facility, and the subsidy account; they have agreed, under certain conditions, to contribute to the supplementary financing facility and the Trust Fund. Iran has also been a major contributor to OPEC's Special Fund, and the International Fund for Agricultural Development.

Mr. Dini noted that oil price increases since late 1973 had raised Iran's oil export receipts in the following years about SDR 12 billion--the equivalent of more than one fourth of GDP--over the 1973/74 level. Iran had utilized the additional resources to achieve an impressive increase in both private and public investment, especially in industry and services, as well as to improve living standards, as was demonstrated by the rapid increases in real wages and in consumption. The sharp acceleration of demand had been accompanied by an even more impressive acceleration of imports, which had grown in volume at an average annual rate of more than 60 per cent, partly as a result of import liberalization. Consequently, the large current account surplus that had emerged in 1974/75 had been rapidly reduced, and substantial official lending, especially in 1975/76 and 1976/77, had contributed to reducing the overall surplus. The current account was expected to record a small deficit in 1978/79, but such a development might not need to be viewed with concern, given Iran's comfortable foreign reserves and low foreign indebtedness.

With the explosion of domestic demand, Mr. Dini continued, the economy had inevitably come under stress, as the rate of inflation showed. Recently, a relatively large public sector deficit had emerged. The situation appeared manageable, however, and the authorities were acting on various fronts to bring the domestic economy into better balance and to ensure a sustainable rate of economic growth in the years ahead. While a good share of the adjustment might have to come from the government budget, which in the recent past had been at the origin of excessive monetary expansion, specific policies aimed at containing wage increases generally, and at removing bottlenecks and increasing the supply of domestic goods, would be equally important.

In recent years, Mr. Dini commented, the rapid development of industry and services had gone together with the slow growth of agriculture, where productivity was presumably still very low. Large wage increases in industry would place strain on the traditional sectors of the economy where only low wages could be afforded. The expansion of the services sector, which was characterized by relatively low productivity and intensive use of labor, had been very large for a country in Iran's stage of development, and some effort to moderate it seemed desirable. Indeed, the growth of services had accounted for some 60 per cent of total GDP growth during the past four years. Moreover, if fiscal policy, especially on the expenditure side, was to remain a major tool for fostering growth and the balanced distribution of oil benefits, tight control of wage dynamics would be essential. The price policy pursued by the Iranian authorities had been courageous and sensible. Direct price controls had been used only temporarily, and they had been relaxed rapidly once demand pressures had started decreasing. The success of that policy had been aided by import liberalization between 1974 and 1977; he trusted that the authorities did not intend to provide excessive protection for domestic activities in the changed circumstances.

Exchange rate policy seemed to have been reasonable, Mr. Dini considered, in view of Iran's strong balance of payments position. It had certainly helped to moderate domestic inflation by permitting a rapid increase in imports, which were largely denominated in U.S. dollars. However, the need to encourage import substituting industries as well as exports of manufactures might require exchange rate flexibility in the future if inflation and wage increases continued to be higher in Iran than among its major competitors in the dollar area. In that regard, it would have been helpful if the staff had provided more information on relative price and effective exchange rate developments. More details on the quantitative aspects and economic effects of the protection being offered to industries at present would also have been useful, not because the protection was necessarily excessive, but because of the difficulty of evaluating it.

Mr. Laske noted that, of the significant changes that had taken place in Iran since the Executive Board had last had a chance--in June 1977--to discuss policies and developments in that country, the most remarkable was the shift in the external position from a comfortable surplus on both the current account and the overall balance of payments to the deficits projected for the current year. Those deficits were not, of course, a cause for serious concern, in view of Iran's ample external reserves, its low foreign indebtedness and the high credit standing it enjoyed in international markets. A less favorable aspect of the external sector related to the effect of certain domestic developments that might become worrisome if they were allowed to continue unchecked. It seemed clear from the staff report that the Iranian authorities were fully aware of the factors involved and were willing to set their policies accordingly. Once it had become obvious that the period of overabundant surpluses had been about to come to an end, both fiscal and monetary policies had been adapted to the new circumstances. More emphasis would have to be put in future on balanced development, both in the real economy and in the financial sphere.

Apart from the strong surge of imports of capital equipment, Mr. Laske continued, Iran's current account had obviously been affected by strong inflationary tendencies over the past two to three years.

The staff had pointed out that, according to recent indications, the trend had recently been broken. It might well be that the acceleration of inflation toward the end of 1977 had been caused partly by the elimination of price controls, which had originally been meant to avoid just such a development. But excess internal demand, fed both by strongly rising public expenditure and by private consumption, had also played a significant role. The lesson to be drawn from that experience was that the expansion of demand from the public and private sectors together would have to be kept within the limits of domestic production capacity and foreign supplies. Although the industrial base of the Iranian economy had been expanded greatly in recent years, and the most troublesome bottlenecks--for instance, in port facilities and transportation--either eliminated or eased, the constraints still existing called for caution.

The authorities seemed to have concluded that the original budget plan for 1978/79 was too ambitious and that it would have to be scaled down, Mr. Laske commented. Even though current expenditure was expected to grow at only half the rate previously envisaged, they still had reason to be worried about the potential inflationary impact of the budget. The moderate pace of the shift to more vigorous fiscal restraint, which the authorities felt to be essential, should not be allowed to slip into gradualism, which would in the end be harmful to the economy as a whole.

Under the Fifth Development Plan, Mr. Laske noted, an impressive expansion of the non-oil industrial sector had been achieved. The rather scanty information available on the forthcoming Sixth Development Plan indicated that increased emphasis would be placed on further reducing bottlenecks remaining in various sectors of the economy. The shift from expansion to "intensification" was highly appropriate. It seemed especially important to give far more attention than before to agriculture, where not only adverse weather conditions but also deficiencies in infrastructure and "know-how," as well as a rigid pricing system, had apparently worked against any improvement thus far. He had been glad to learn from Mr. Amuzegar that steps in that direction were being taken.

Monetary policy had been significantly tightened over the last two years, Mr. Laske observed. The restrictive stance had affected the private sector much more than the public sector. During the discussion of the staff report for the 1977 Article XIV consultation with Iran, several speakers had noted that the private sector might well play a beneficial role in the development of the Iranian economy if it was given more room to breathe. Yet the ceiling established on bank credit to the private sector, and the financing needs of the budget for the current year, suggested that the largest part of domestic savings would again be placed at the disposal of the public sector. It was stated in the SM/78/235 that the major monetary instrument for Iran was quantitative controls. Interest rates were not mentioned at all in that document, but Table 54 in SM/78/239 seemed to indicate that real interest rates were negative to a substantial degree and that there was little, if any, differentiation in the rates according to the amounts and maturities of savings deposits. It would be helpful to have information on the role the Iranian authorities assigned to interest rates in the framework of monetary policy, especially as a vehicle to mobilize domestic savings.

It seemed appropriate to mention exchange rate policies in the discussion for an Article IV consultation, Mr. Laske commented. He had no basic difficulties with the policies followed by the Iranian authorities so far. The recent elimination of exchange rate margins, which had been very wide, seemed sensible because it would give more room for maneuver in a period when factors working on the exchange rate might not always go in the same direction as the so-called underlying factors in the economy. It was puzzling, however, that the authorities continued to maintain a dual exchange market even though the dollar rate had been the same in both markets for some time and the official rate had in effect become a floating one.

Mr. Garcés noted that the Iranian authorities had made great progress in expanding their economy's absorptive capacity, thereby easing payments imbalances in the international economy. The process had not been an easy one, of course. The economy had expanded very rapidly in 1974-75, but physical bottlenecks had become the fundamental constraint to further growth, and inflation had accelerated substantially. Lately, the authorities had concentrated their efforts on the elimination of bottlenecks so as to allow an expanded quantity of goods, including imports, to reach domestic markets, and thus to ease an important constraint on investment and future growth. The concentration of investment expenditure on ongoing projects, and power and infrastructure projects, augured well for the future. At the same time, the authorities were making determined efforts to achieve a higher degree of financial stability. Some progress had been achieved, and more was to be expected under current policies. The effort should also aid in strengthening Iran's external accounts, which had deteriorated sharply over the last two years.

There could be no doubt, Mr. Garcés continued, that the Iranian authorities were moving in the right direction, nor that their policies were producing the desired results. However, he had a few questions in his mind with regard to some areas. One related to the way in which the tightening of credit was being achieved. Apparently, in an effort to reduce domestic liquidity, the monetary authorities had chosen to restrain credit to the private sector, while the public sector had taken up most of the net domestic credit expansion. Furthermore, in 1978, the Government would borrow abroad to meet its financing requirements, thus adding to the expansion of domestic liquidity. The authorities should seek to reduce the Government's deficit, which was equivalent to about 8 per cent of GDP, and perhaps allow more room for the expansion of private sector activities through a relaxation of credit to that sector. But any such relaxation would need to be accompanied by positive real rates of interest if the available resources were to be efficiently allocated.

The second area where the Iranian authorities' intentions were not clear, Mr. Garcés observed, was the protection and subsidization of domestic industries. His impression from the staff reports was that protection was widespread and that certain industries were heavily subsidized. Moreover, he was not entirely sure what was meant by the staff statement that Iran maintained a liberal payments policy, since trade restrictions had been intensified and certain imports were barred.

His third point, Mr. Garcés noted, related to exchange rate policy. The use of dual exchange markets was one way to isolate the non-oil economy from the impact of the oil sector on the exchange rate. In Iran, the policy could be successful, since the Government obtained all foreign exchange revenues from oil exports. But to achieve the desired effect the parallel market surely should be allowed to set the price of foreign exchange with more flexibility. Then, non-oil exporters would probably have greater financial incentives to increase their sales abroad, imports of consumer goods would not be subsidized from oil revenues, and the government budget would not bear the burden of subsidizing non-oil exporters.

The issues he had touched on, Mr. Garcés concluded, had a bearing on the efficient allocation of resources. Their resolution, together with the policy measures suggested by the staff, would tend to maximize the social and economic returns of future oil and gas revenues. Of course, the Iranian authorities deserved warm commendation for the sense of international cooperation Iran had shown in its external adjustment, its aid program, and its contributions to the International Monetary Fund.

Mr. Peroz observed that the tight economic policy followed by the Iranian authorities in 1977/78 was reflected in a rate of growth of only 2 per cent of real GDP. Although in sharp contrast to the rates recorded in previous years, the rate was by no means unsatisfactory, considering the size of the overall imbalances that had resulted from recent policies designed to achieve as high a rate of growth as had seemed economically feasible. The rather large increase in the cost of living recorded in 1977/78 had come as a disappointment, although part of it could be traced to the near elimination of price controls in 1977, which reflected the courageous price policy of the Iranian authorities. The 1977/78 overall deficit in public expenditure, equivalent to about 7.5 per cent of GDP, had been financed mostly through bank borrowing; it seemed to have exerted too much pressure on the economy, as the current budget would probably also do. On the other hand, monetary and credit policies had been in line with economic circumstances, and quantitative ceilings on credit expansion had proved to be effective on the whole. The pent-up forces that still seemed to be present indicated that it was appropriate for the Iranian authorities to pursue tight policies for 1978/79. However, the ceilings on commercial bank credit for the coming period might prove to be too high, even allowing for the desirability of fostering private sector investment.

In the external field, Mr. Peroz added, a current account deficit of SDR 2 billion was projected for 1978/79, which would lead to an overall deficit of SDR 800 million. Undesirable as that would be as a permanent feature, in the short term it did not seem to be of much consequence because of Iran's present level of foreign reserves.

Mr. Cross said that he was in broad agreement with the analyses and conclusions of the staff's comprehensive report for the Article IV consultation with Iran. The authorities had contributed to the international adjustment process through a willingness to reduce substantially and then eliminate their recent current account surpluses. Liberal policies on imports and capital outflows were noted in the staff report, although it was also mentioned that there had been an intensification of trade restrictions.

As for the domestic economy, Mr. Cross continued, it could be generally agreed that the boom conditions following the oil price increase had produced some negative financial effects alongside rapid growth in the real economy. The authorities should be commended for seeking to restore financial balance by directing policies toward "absorbable growth." The decision to lift comprehensive price controls and to depend on demand management had taken courage, but it reduced the potential for major distortions in the economy. Restraint on private credit expansion was evidently having an effect, for the rate of inflation had declined. Steps had also been taken recently to lower the public sector deficit projected for 1978/79. He would urge even further steps in that direction; a reduction in current public expenditure could leave more room for longer-term private sector investments.

The development strategy of Iran appeared appropriate in general, Mr. Cross considered. Bottlenecks in transportation, energy, and building materials had been reduced, and the concentration on natural resource industries such as minerals and petrochemicals was fitting. Agriculture had not performed well, however, and he welcomed the authorities' intention, reported on page 12 of SM/78/239 to place greater emphasis on that sector. Although a number of inputs had been subsidized, higher producer prices would be beneficial and have ramifications for non-oil exports, urban congestion, and urban employment patterns. In any case, the long-term prospects for the economy were favorable. Greater external balance, to bring import demand trends in line with likely petroleum earnings, would be necessary, but Iran's reserve levels and creditworthiness did not require that that adjustment be immediate. With respect to exchange policy, given the balance of payments outturn and the rate of inflation, the decision not to peg the rial inflexibly to the SDR basket seemed appropriate.

Mr. Ruding said that the Iranian authorities deserved much praise for their ambitious efforts over several years to undertake a comprehensive development program. It was understandable that they had encountered problems, partly because of the fall in the price of oil in real terms and partly because of the domestic problems that inevitably arose when too much was attempted in a short period of time. He hoped that the authorities would be able to continue their efforts without being hampered by external constraints, particularly in the current account of the balance of payments. Mr. Amuzegar's statement that Iran would concentrate on bringing about a better distribution of income in the years ahead was also welcome.

Iran's external payments policy was for the most part liberal, Mr. Ruding noted, but it was not above criticism. As the staff had mentioned, there had been an intensification of some restrictions, so that the wording of the proposed decision seemed somewhat puzzling.

Another aspect of the external situation, Mr. Ruding remarked, was the stepping up of borrowing abroad. Iran's reserve position was still very satisfactory, although, as Mr. Amuzegar had commented, it might weaken in relative terms. The authorities were wise to establish lines of credit in order to give themselves extra security. Nevertheless, it might be unwise for Iran to step up borrowing abroad while contributing actively to multilateral support activities via the Fund. Of course, from the Fund's point of view, Iran played an intermediary role, but he wondered whether it would feel able to continue participating in international cooperative efforts in a period of increased external borrowing.

He had noted the view of the Iranian representatives, as reported on page 7 of SM/78/235, Mr. Ruding continued, that Iran's bilateral payments agreement with Romania was still considered necessary "for conducting trade with a socialist country." Many other countries that were active trading partners of Romania no longer considered such agreements necessary, however.

Finally, Mr. Ruding observed, Iran's contributions to the international adjustment process had been impressive, and its close relations with the Fund more than appreciated. But Mr. Amuzegar had made no specific reference to one form of cooperaton, namely, voluntary contributions to the Trust Fund of countries' shares of gold profits. Eight member countries had agreed to make such voluntary contributions while remaining on the list of developing countries. Six of those countries had later honored their commitments by transferring their shares of gold profits to the Trust Fund, but Iran and one other country had not.

Mr. Al-Eyd said that he also agreed with the staff analysis and appraisal. There was no doubt that Iran had utilized its revenues well since the adjustment of oil prices in 1974. The authorities' economic policies had been more or less dictated by circumstances and by the nature of the development process itself. It had been necessary to channel oil revenues into productive assets and to concentrate on the establishment of industries. The consequences had also been in a sense inevitable; the most important had been the rise in the inflation rate and the bottlenecks that had emerged due to the quick pace of development spending. The authorities' willingness both to reorient their development and investment policies and to consider a reorganization and reappraisal of projects to be included in future plans was commendable. The most significant change in policy was the new concentration on agricultural development, which was necessary for balanced growth and for a lessening of the country's dependence on oil revenues in the future. Agricultural resources were not depletable, and for that reason the policies described in the staff reports and in Mr. Amuzegar's statement were to be commended. Another valuable change in the orientation of policy would come under the Sixth Development Plan, which would emphasize education, health, and a more equitable distribution of incomes.

During the last round of consultation discussions with Iran, Mr. Al-Eyd recalled, it had been pointed out that the authorities should follow somewhat tighter fiscal and monetary policies. At that time, his chair had been in agreement with the prescription, although it had felt that the tightening should be carried out gradually. As the documentation before the Executive Board showed, an appropriate policy stance had been taken. The surge in inflation from the first half of 1977/78 had been due mainly to the lifting of price controls. The second half of the year had witnessed a slowdown in the rate of inflation, and the staff projected that the trend would continue in the coming year. As for the relative impact of credit controls on the private sector and on the public sector, he wondered whether an expansion of credit to the private sector a priori would be beneficial to the country's economic development. He had noted from the staff report that private speculation in land had added to inflationary pressures. Fortunately, there was every assurance that the public sector would use the resources at its disposal for the general benefit of the economy.

In conclusion, Mr. Al-Eyd said, like many other oil exporting countries, Iran had contributed to the adjustment process. Even after oil prices had stabilized, it had continued to import at a high rate, and it would incur a deficit in the coming year as a result. The Iranian authorities should be commended for that policy and for the generous aid and cooperation they had extended to other nations.

Mr. Whitelaw remarked that Iran was an obvious example of a country discovering the problems of rapid growth. The consensus would no doubt be that, having gone through difficult times, it was now making appropriate adjustments in its policies. Among noteworthy developments, the most significant was probably the recent slowdown in the rate of inflation.

In the monetary and fiscal fields, Mr. Whitelaw noted, the large fiscal deficit of 1977 was giving way to an even larger one in 1978/79. External borrowing was supposed to make only a small contribution to the financing of the deficits, but domestic nonbank financing had been limited, and the authorities had apparently relied on borrowing from the banking system. It might be useful for the authorities to undertake more active sales of government securities to the nonbank private sector. Regardless of whether such a system was feasible, or whether a strong market could be developed, there would presumably be a need for competitive interest rates, although the staff had had little to say on interest rate policy in general. On another aspect of credit policy, while credit to the private sector had been slowed down, it was still expected to have expanded by 22 per cent in 1977/78 and to grow somewhat more slowly in 1978/79. But the technique the authorities seemed to be using to restrain bank credit--the imposition of credit ceilings--raised the question whether restraint could not be applied more easily through an active interest rate policy, which in theory should help to ensure that credit reached the most efficient borrowers.

As for developments in the external accounts and in the exchange system, Mr. Whitelaw added, Iran's current account surplus was rapidly giving away to a prospective overall deficit, but one that could be financed through external borrowing, thanks to Iran's strong financial position. Such a swing in the balance of payments was precisely the adjustment that oil exporters had been asked to achieve, yet when it materialized, it was inevitably somewhat worrisome. Iran's external balance had gone from a surplus of over SDR 3 billion to a deficit in just a year. Obviously, if such a trend continued for long, corrective measures would be necessary. The scaling down of the growth target, which Mr. Amuzegar had stated was necessary, would in itself be helpful. But, at the same time, it raised the issue of the competitiveness of Iranian industry. Non-oil exports had not been growing strongly, and there seemed to be a fairly widespread system of export incentives on the one hand and protectionism on the other. It was unclear how competitive non-oil industry was, and more particularly what the trend was likely to be in the years ahead. Exchange rate developments in Iran had been entirely appropriate, but it might be helpful if the staff could delve a little more deeply in future reports into the country's competitive position. Given Iran's financial strength, that position was not a cause for immediate worry, but it should be watched throughout the period ahead.

Mr. Drabble observed that it might not be entirely without foundation to suggest that Iran had to some extent been a victim of the oil price increase, since before 1973 its development had been progressing at an exceptionally high rate and had been extremely well balanced. For instance, according to Table 5 of SM/78/239, gross domestic product in the five years 1968/69 to 1972/73 had averaged 12.8 per cent a year, with the non-oil sector of the economy growing at an average rate of 10.5 per cent. It was, of course, entirely understandable that the authorities had attempted to turn an already excellent development record into an even better one, setting a growth target of close to 15 per cent for the non-oil sector under the Fifth Development Plan. Further, it was not surprising that the attempt to achieve such an acceleration had produced many pressure points and bottlenecks.

It was necessary for the authorities to shift to a more cautious stance, Mr. Drabble went on. On the whole, he had been reassured by the policies outlined in the staff reports and Mr. Amuzegar's statement. The Iranian authorities were moving on the right course to correct some of the imbalances that had developed. For instance, a courageous decision had been taken to allow for corrective price adjustments and in effect to accept the end of the period for price controls, which might have helped to spread out the adjustment of inflationary pressures. It was all for the good of the future development of the economy that those adjustments had been accepted. The high rate of price increases during the transition period was an added reason to apply cautious fiscal and monetary policies. Once released, inflationary pressures could produce expectations that made it difficult to contain them. The recent marked slowing in the rate of price increases was welcome, but it underscored the need for a cautious set of policies in the immediate future.

Having accepted the importance of realistic pricing as a means of improving the allocation of resources, Mr. Drabble commented, the authorities needed to keep a close watch on other areas. As mentioned by previous speakers, those included in particular interest rates and the maintenance of exchange rate flexibility, which was needed if the exchange market was to provide a guide for further development and ensure that the allocation of resources continued to be reasonable. He would be interested to learn how the staff felt about the Iranian authorities' views on interest rates. In addition, it was difficult to determine the degree to which the non-oil sectors of the economy were shielded from the impact of oil revenue on the exchange rate. Certainly, the trend of non-oil exports was rather worrisome. More discussion of effective exchange rates and any estimates that could have been made of effective competitiveness, at least in the industrial sectors of the economy, would have been helpful and especially fitting in a staff report for an Article IV consultation. The Iranian rial was, after all, one of the 16 currencies in the SDR basket, and it would have been interesting to know to what extent the authorities had taken advantage of the spreads under which the rate had operated earlier and under the present, less constrained arrangement. A chart on the exchange rate might have been useful, too. Clearly, it was an area calling for careful attention, although the outcome would to some extent depend on the authorities' success in reducing the rates of wage increase and price inflation to levels closer to those of Iran's principal competitors.

Mr. Hollensen considered that the importance of the Iranian economy made it disappointing to find so little indication on how the staff judged the exchange rate situation and the competitiveness of the Iranian economy. Astonishing efforts had been made to diversify Iranian economic life, but the trend in exports of non-oil industrial goods raised questions about the future. There should be a clear difference between the reports for Article XIV and Article IV consultations with countries that could influence the world economy.

In the basic data in Appendix II of SM/78/235, Mr. Hollensen continued, it was surprising to note that the services sector, at constant 1974/75 prices, accounted for a larger part of GDP than the sum of the shares of the agricultural sector and the industrial sector, which had also shown large increases. Of course, there was a general tendency for the services sector to increase in importance as a country developed, but Iran was still a developing country, and such a large expansion of services might not be appropriate.

It had been recognized during the Executive Board's discussion for the 1977 Article XIV consultation with Iran, Mr. Hollensen recalled, that the key to regulating the economy was financial policy. Monetary policy had been strengthened, but its role was modest; like others, he wondered whether the ceiling system was the right approach, and whether the authorities would not be wise to use interest rate policy and perhaps other monetary instruments as well. Ceilings could be used as a temporary measure, but if they were relied on too long, the monetary system became inflexible. Nevertheless, the sectoral approach preferred in Iran might be necessary to a certain extent, even though monetary policy could play a larger and more sophisticated role in the future.

Referring to the proposed decision pursuant to Article XIV, Mr. Hollensen added that it was correct to state that Iran maintained a liberal policy relating to current payments and transfers. However, nothing was said about the intensification of trade restrictions since the 1977 Article XIV consultation, nor was it mentioned that the fiscal system, and perhaps also the monetary system, was designed to have a protectionist impact. The Article XIV decision might leave the wrong impression if it referred in such a limited way to a liberal payments and transfer policy, given the existence of protectionist tendencies in the economy. OPEC countries should be more liberal, not more restrictive. As for the reference to the Fund's hope that Iran would terminate its bilateral payments arrangement with one Fund member, he joined Mr. Ruding in noting that many other members had managed to end bilateral payments agreements with countries having socialist economies.

The Director of the Middle Eastern Department said that the staff would try to provide more information on relative prices, the level of protection, and the general competitiveness of the export sector. It might be noted, however, that it was stated in the staff report that the effective exchange rate, as measured by the import weighted index, had declined by 6 per cent in 1977/78.

A number of Executive Directors had referred to the importance of interest rate policy both in controlling the rate of credit expansion and in effectively allocating resources, the Director continued. The Iranian authorities had relied much more heavily on quantitative restrictions than on the interest rate, in the belief that those were more effective in controlling the growth in credit expansion and because the immediate policy objective over the last year or two had been to reduce the rate of inflation. The current annual rate of price increases was about 10 per cent, roughly one third of that prevailing a year earlier. Thus, the interest rate gap was narrowing sharply. However, the staff agreed that interest rate policy could play a more effective role. On the related subject of the tightening of credit to the private sector, it might be noted that in 1977/78 the private sector had not used its full allocation of credit. The reason was basically that price controls, as well as significant industrial reorganization aimed at widening the base for industrial ownership, had caused a profit squeeze, which had deterred private investment.

It was certainly correct to state in the proposed decision that Iran maintained a liberal policy relating to current payments and transfers, the Director remarked. In fact, there were no restrictions on payments and transfers. Iran had increased trade restrictions, but those were not payments restrictions. The tightening of trade restrictions had primarily taken the form of increases in import duties. It had been motivated partly by reasons of protection and partly by the authorities' desire to increase government revenue.

While Iran legally had a dual exchange market, the Director commented, in practice the system was unitary. Oil receipts accrued to the Government and were sold to the Central Bank, which then sold foreign exchange to the commercial market. In recent years, the official rate and the commercial rate had not deviated from one another.

The observation by Mr. Hollensen that the value-added in the services sector seemed to be larger than the combined net value-added in the agricultural and industrial sectors should not really come as a surprise, the Director said. With the sharp increase in government expenditure over the past few years, public services had increased substantially. Moreover, banking and insurance had also grown rapidly, and imports had reached an extremely high level.

Among the factors explaining why the budget deficit was not financed to a greater extent through the nonbanking sector, the Director explained, there was certainly the need to pay competitive interest rates. However, the staff believed that the financial markets were not well enough developed at the present time for the Government to be able to make a meaningful attempt to mobilize non-banking sector financing.

Mr. Amuzegar thanked Executive Directors for their interesting theoretical and practical questions and for the cooperative way in which they had approached Iran's present economic situation.

The services sector had always been large in Iran, Mr. Amuzegar commented. The earliest figures on national income accounting showed that services had constituted about 40 per cent of total GNP, not much less than the agricultural and industrial sectors combined. Thus, the ratios had changed little. In absolute terms, the large amount of GNP accruing directly to the Government was being spent on basic infrastructure services--education, housing, welfare, and others--and that explained why the services sector was still large. Moreover, Tehran was witnessing a proliferation of small businesses and services that had not existed ten or fifteen years previously. The small scale of those enterprises meant that productivity was not high, although it could, of course, be improved.

Reference had been made to the adverse effects of monetary policy on the private sector, Mr. Amuzegar noted. The statistics were correct, but they were misleading in the sense that the private sector itself had been reluctant to use the share of credit that had always been available to it, perhaps for fear of price controls and uncertainty about profit-sharing by workers. Banks had had more liquidity than they had needed. The relative spread of public ownership at the apparent expense of the private sector had been made impossible by fear of the law under which all large private corporations were required to share their stocks with their own workers, with peasants and with the public. There had been no real restrictions on investment in the private sector, but it had simply not taken place at the expected pace, whereas the public sector had used all the money available to it.

Mention had also been made, Mr. Amuzegar commented, of the negligible role that the structure of interest rates had played in Iranian monetary policy. Government attempts at nonbank domestic borrowing highlighted the peculiarity of the Iranian response. The rate of interest on savings deposits was about 11-13 per cent net of tax. Other than during the 18 or 24 months of high rates of inflation, the rate had always been positive. Yet financial markets had not developed, and a large number of private businessmen in small cities and villages still kept banknotes "under the mattress," or lent to no-one except their own business partners. Interestingly, only financial institutions and companies had taken advantage of public offerings, in the full knowledge that they would earn a substantial return on their money.

As to the need to emphasize agricultural development, Mr. Amuzegar remarked that for ten years long and serious discussions had been held in Iran among agricultural experts, both international and Iranian, about the course of Iran's agricultural development. In all development strategies, agriculture had always been the thorniest problem. Developing countries had oscillated between large-scale and small-scale farm centers. For many years the previous Government had been convinced that the only way to have a viable agricultural sector was to undertake agricultural development on a large scale. Iranian villages had been considered too small and scattered to be viable, and the policy advocated by many agricultural experts--including those from the World Bank--had been to relocate peasants and to give them the means of mechanization as well as fertilizer and improved seeds. Unfortunately, the results had been somewhat disappointing, not simply because large-scale agriculture was not productive, but because agribusiness in countries like Iran had encountered many problems that the experts had not anticipated. The present Government intended to offer aid to small farmers in the form of credit, cheap fertilizer, and better seeds.

It was an interesting fact, as Mr. Drabble had pointed out, Mr. Amuzegar noted, that oil countries had been somewhat the victims of the oil price increase. Even a developed country like Norway had not avoided the pitfalls, although it had been well aware of them. In Iran, everyone was better off than they had been, but raising the standard of living led to expectations that rose exponentially, not in proportion to the improvements actually taking place. Nevertheless, Iran had learned a great deal from its attempt to speed up its Five-Year Development Plan.

His authorities, were of course, concerned about the behavior of non-oil exports, Mr. Amuzegar said. The losses incurred had been to a great extent in the traditional export sector, rather than in the new sectors. The rise in incomes in Iran meant that agricultural and traditional products were being consumed by Iranians in greater amounts than in the past. Traditional exports had fallen far below their previous levels in volume terms, and Iran had become an agricultural importer because domestic consumption had increased far beyond anyone's expectations.

A number of references had been made to the protection of domestic industries, Mr. Amuzegar observed. There was no contradiction between industrial protection and a liberal payments policy, because the Fund's competence was confined to the discussion of member countries' payments policies, as distinct from trade policies. The protectionist measures that had been introduced were being used partly for revenue purposes, to reduce the Government's reliance on oil income, and partly also to meet administrative requirements peculiar to Iran. By statute, the Government could reduce but could not increase restrictions during any one year. Consequently, the Ministry of Commerce tried to raise the level of protection at the beginning of each year, because it could always be lowered; whereas if restrictions were kept low the Government would not be able to increase them in the event that the need arose. The restrictive measures were thus motivated by caution rather than by a fundamental change in policy. Protection was reduced at the discretion of various ministries, which had informed the staff that restrictions would be eased during the year as the situation warranted.

The reasons for having a dual exchange market were of great interest to him, Mr. Amuzegar said. There was a need for a study by the Fund of the situation of oil producing countries and the necessity for a dual exchange market in its true sense, one that would separate the oil sector from the non-oil sector. At present rates of exchange, oil exporting countries would never be able to develop viable industries.

Constant revaluation would destroy all domestic industry; burgeoning export industries might be helped by devaluation, but the inflationary impact made that too costly a solution. That was the essence of Iran's dilemma, to which no economic solution had yet been found. Mr. Garcés had pointed to the theoretical problem, and the Fund should offer both theoretical and practical assistance in the search for a solution.

In all fairness to the staff, Mr. Amuzegar stated, it was an exceedingly difficult task to make a satisfactory assessment of the future impact of Iran's protectionist measures. Further work would be necessary in that respect.

Finally, in response to Mr. Ruding's question about Iran's failure to contribute its gold profits to the Trust Fund, Mr. Amuzegar observed that the amount was, of course, miniscule compared with what Iran had been donating both in grant form and as aid. The issue was one of principle, as the Resolution prepared at his instigation and adopted in Manila, had explained. Iran had been waiting to know whether other developing countries in a position to do so would also contribute their share of gold profits to the Trust Fund. As long as there was any possibility that such countries, after being excluded from the list of developing countries eligible to participate in the distribution of gold profits, would come back to the Fund to ask to be included--as one already had--his authorities would not contribute as a matter of principle.

The Deputy Managing Director stated that the topic of dual exchange rate systems as they related to oil producing countries and other countries similarly placed was under study by three departments in collaboration, the Middle Eastern Department, the Exchange and Trade Relations Department, and the Research Department. It was an extremely difficult topic to deal with, and he could not predict when the study would be available or what the outcome would be.

The Chairman made the following summing up:

> In concluding this wide-ranging and interesting discussion on the 1978 Article IV consultation with Iran, I will sum up briefly by saying that the Executive Directors noted the excellent growth record achieved by Iran over many years, and have commended the Iranian authorities on the success they have attained so far in moderating inflationary pressures in the economy while at the same time lifting quite courageously price controls. The Directors, who generally agreed with the thrust of the views expressed in the staff appraisal, also viewed with satisfaction the important contribution made by Iran to the resolution of the problem of imbalances in international payments through a dynamic investment policy, and a continued liberal system of payments.

> Directors believed that as the balance of payments was entering a weakening phase, it had been prudent for the Iranian authorities to implement a new policy directed toward a more sustainable rate of growth. Some Directors believed that in that light it might be prudent for the authorities to take further steps to reduce domestic demand and inflationary pressures, in particular through appropriate fiscal and credit policies. Various Directors stressed the importance of reaching a more harmonious and balanced structure of growth.
>
> I should also note that several Directors have commented on the Iranian policy of protecting domestic industries, which should be the subject of further analytical study.

The Executive Directors then turned to the proposed decision pursuant to Article XIV.

Mr. Amuzegar wondered whether, if short decisions were to be the norm, the language would be identical for all countries and either be purely descriptive of the particular situation or contain an element of judgment or prescription of policy. He would have no objection to stating in all decisions that a country maintained either a liberal or nonliberal policy, but if it was to be mentioned in some decisions that the Fund welcomed a country's maintenance of a liberal policy, the question then arose of making the opposite judgment in the case of members that did not maintain a liberal policy. The Executive Board should decide on a general policy for recording decisions pursuant to Article XIV.

With respect to the proposed decision on Iran, Mr. Amuzegar noted that, the mention of current payments and transfers was consistent with the Fund's having jurisdiction over current payments. Again, he would have no objection to such language if it was used for all countries. However, it should be noted that Iran had no payments restrictions whatsoever at the present time.

The staff representative from the Exchange and Trade Relations Department explained that it had been the practice to "welcome" new developments during a year, when doing so was appropriate. The reference to current payments was, of course, within the Fund's jurisdiction, but the staff would have no objection to language that suggested the inclusion of all payments and transfers, especially when--as in the case of Iran--there were no restrictions on capital payments.

The Chairman suggested that there was a need to keep a certain flexibility. As far as Iran was concerned, it would be desirable to welcome, in line with the Fund's usual approach to new developments, the maintenance of a liberal policy on transfers and payments in a difficult period when the balance of payments was weakening, and deficits appearing on current account. Furthermore, it would be equally appropriate to delete the word "current." It was, after all, well known that the Fund was not exercising its authority in respect of capital payments. Of course, in the case of a country that did have capital restrictions, it would have to be specified that a decision related only to current payments restrictions.

Mr. Cross said that he had a certain preference for maintaining a little freedom. It had been unfortunate that the Fund had become encumbered with precise language with respect to GATT matters. The Chairman had suggested the right approach, which could perhaps be translated into language welcoming the continued maintenance by Iran of a liberal trade and payments system in light of its balance of payments position.

The Executive Board then approved the decision, as amended.

The decision was:

1. This decision is taken by the Executive Board in concluding the 1978 consultations with Iran pursuant to Article XIV, Section 3.

2. In light of recent developments in its balance of payments, the Fund welcomes the maintenance by Iran of a liberal policy relating to payments and transfers. The Fund hopes that this policy will be continued and that Iran will terminate its bilateral payments arrangement with one Fund member.

Decision No. 5915-(78/153), adopted
October 6, 1978

Mr. Dini then referred to the summing up, and wondered whether it would not be desirable to mention exchange rate policy, especially for a major oil exporting country like Iran. Although all the elements necessary for reaching a judgment had perhaps not been available, Iran's exchange rate policy appeared to have been reasonable so far. To omit a reference to it would suggest that no mention would be made of other countries' exchange rate policies, which raised the general question whether that was the most appropriate course.

The Chairman responded that so far a cautious attitude had been taken to either endorsing or giving a different view of a country's exchange rate policy. The earliest summings up had referred to the acceptability of specific exchange rate policies, but some Executive Directors had pointed out that the absence of a phrase of endorsement would imply that the Fund was not satisfied with a member's exchange rate policy. That in turn would lead to the need to suggest corrective measures, which might create a problem for the member and its relations with the Fund, and also possibly have an impact on exchange markets. As a result, it had been agreed to give rather indirect indications of the Fund's views, where appropriate.

As far as Iran was concerned, the Chairman added, its policy on the rial exchange rate had been explained in a way that should satisfy the Executive Board. Moreover, he had indicated in his summing up that Executive Directors had commented on the Iranian policy of protecting some industries, and he had noted that that policy would be the subject of further studies.

Mr. Cross remarked that, while there was a need to be careful not to make pronouncements that could have serious effects on the market or in other ways, the Fund could be somewhat more direct in some of its assessments of members' exchange rate policies, since its purpose was to survey those policies. A procedure would of course have to be evolved as Article IV consultations proceeded. As a general matter, he shared the concerns of Mr. Dini.

The Chairman agreed with Mr. Cross that when the Fund had a precise judgment to make on an exchange rate, it had to be able to express it, because such judgments were one of the main elements of Article IV consultations with members. What should be avoided was the use of a general phrase expressing satisfaction with a country's exchange rate policy. Either the Fund had no immediate problem with such a policy, and then it did not need to say anything--and in his view that was the case of Iran--or it had a precise view to express.

Mr. Drabble said that he shared to some extent the general view expressed by Mr. Dini and supported by Mr. Cross. With respect to Iran, however, he agreed entirely with the Chairman's feeling that the minor technical changes in the way the rial rate was set had been appropriate in Iran's circumstances, and that the exchange policy had remained essentially unchanged. It might have been possible to include such a reference in the summing up in a way that would relate the changes to specific developments since the last consultation. Where the Fund had no concerns, the easiest solution might be to say nothing. He did recall that in earlier summings up statements had been made on exchange rate developments, and he hoped that the practice had not been changed to the extent that comments on exchange rates were made in summings up only to formulate a specific concern, because they would then clearly be a signal flagging the dissatisfaction of the Fund with a member's policy.

Mr. Whitelaw said that his personal preference was to follow the procedure suggested by the Chairman, and not refer to Iran's exchange rate. Just because the Fund was conducting Article IV consultations with members, it should not feel obliged always to refer to exchange rates; on the contrary, it should be reluctant to do so unless absolutely essential. Some countries thought that exchange rate policy was a sensitive matter, and discussion of it in an international gathering was sometimes viewed as an impingement on sovereign rights.

Mr. Deshmukh said that on the whole he was in favor of a low-key approach. He could therefore agree entirely with the Chairman's exposition and also with the views expressed by Mr. Whitelaw.

Mr. Harewood noted that the Fund was obviously still evolving its procedures in the sensitive area of members' exchange rate policies. For the time being, he believed that the approach suggested by the Chairman was the correct one.

Mr. Masunaga commented that he had no strong feelings on how to deal with Iran's exchange rate policy. As a general matter, he considered that the Chairman had outlined the approach that had been generally agreed in the Executive Board. Of course, in the review of procedures that was to take place in several months' time, the Executive Directors would have an occasion to reconsider the matter, which was best left alone for the time being.

Mr. Garces stated that he agreed entirely with the Chairman's position both on Iran and on the general procedural question.

Mr. Donecker also supported the Chairman's position. It was necessary for the Fund to avoid having to single out a particular country's exchange rate policy in the Chairman's summing up.

Mr. Al-Eyd expressed agreement with the Chairman's suggestion that he should not refer to Iran's exchange rate policy. The changes that had been introduced were technical, and it might be better not to say anything. On the larger issue, he discerned no disagreement between the Chairman's position and that stated by Mr. Cross and others. When the Fund had a view, it should be free to express it; after all, it had been charged under Article IV with exercising surveillance over members' exchange rate policies.

Mr. Kent stated that he agreed with Mr. Masunaga that the Executive Board should proceed as the Chairman had suggested but that it should take the opportunity of the review of Article IV procedures, to go into the whole subject thoroughly.

Mr. Hollensen supported Mr. Kent's view.

The Chairman said that he took it that the summing up should be left as it was. The Article IV consultation procedures should be developed in a pragmatic and flexible way, according to the different situations of members. The matter would be reviewed in the early part of 1979, at which time the Executive Board could look at experience so far and consider what steps to take for the future.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adoped by the Executive Board without meeting in the period between EBM/78/152 (10/4/78) and EBM/78/153 (10/6/78).

3. GRENADA - SCHEDULE OF REPURCHASES AND POSTPONEMENT OF REPURCHASE

Grenada has proposed that repurchase in respect of the gold tranche purchase equivalent to SDR 500,000 on September 17, 1975 and the purchase equivalent to SDR 500,000 on October 6, 1975 under the stand-by arrangement of September 29, 1975 be made in five equal installments equivalent to SDR 200,000 each not later than March 20, 1979, August 20, 1979, December 20, 1979, May 20, 1980 and September 20, 1980. The Executive Board agrees to the proposal of Grenada (EBS/78/537, 10/4/78).

Decision No. 5916-(78/153), adopted
October 5, 1978

4. GRENADA - TECHNICAL ASSISTANCE

In response to a request from the Grenadian authorities for technical assistance, the Executive Board approves the proposal set forth in EBD/78/206 (10/3/78).

Adopted October 5, 1978

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/78/272 (10/4/78) and EBAP/78/273 (10/4/78) is approved.

APPROVED BY THE EXECUTIVE BOARD:
Meeting 79/52, March 30, 1979

LEO VAN HOUTVEN
Secretary

cc: Mr. Yaqub/Mr. Nsouli

OCT 13 1978

Sir:

I have pleasure in advising you that in concluding the recent consultation with Iran under Article IV, the Chairman made the attached summing up, with which the Executive Board agreed.

I also take pleasure in attaching the decision approved by the Executive Board in concluding the 1978 consultation with Iran pursuant to Article XIV, Section 3.

I should like to take this opportunity to express the Fund's appreciation for the courteous cooperation of your Government during the course of these consultations, and to say that the Fund looks forward to a continuation of this close relationship.

Very truly yours,

Leo Van Houtven
Secretary

Attachments 2

CC: ~~MED~~
ETRD
SEC

Mr. Youssef Khoshkish
Governor
Bank Markazi Iran
P.O. Box 3362
Teheran, Iran

RECEIVED
OCT 16 1978
5:00
Western Hemisphere Department

BJO BJOwen/ag 10/6/78

The Secretary October 3, 1978

S. Mookerjee and A.S. Shaalan

Iran--The Forthcoming Executive Board Discussion

The Executive Board is scheduled to consider on October 6, 1978 the 1978 Article IV consultation report on Iran. Attached for the use of the Managing Director please find a draft that may be useful in summing up the Board's discussion.

Attachment

cc: Mr. Mookerjee
Mr. Hitti
Mr. Yaqub
Mr. Nsouli

October 3, 1978

Draft Statement for the Managing Director to
Conclude the 1978 Article IV Consultation with
Iran (October 6, 1978)

In concluding the 1978 Article IV consultation with Iran, I would say that the Executive Directors commended the Iranian authorities on the success they have attained so far in moderating the inflationary pressures in the economy while at the same time lifting the price controls. The Directors also viewed with satisfaction the contribution made by Iran to the resolution of the problem of imbalances in international payments. The Directors, however, noted that the balance of payments was entering a weakening phase and believed that it would be prudent of the Iranian authorities to take further steps to reduce domestic demand and inflation in order to bring external payments in line with receipts. In general there was broad support for the views expressed in the staff appraisal.

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

Iran: 1978 Article IV Consultation

July 8-16, 1978

Teheran

List of Participants

Iranian Representatives

H.E. Mohammad Yeganeh, Minister of Economic Affairs and Finance
H.E. Manuchehr Agah, Minister of State and Director of the Plan and Budget Organization
H.E. Youssef Khoshkish, Governor, Bank Markazi Iran

Bank Markazi Iran

Mr. B. Homayoun, Vice Governor
Mr. S.M. Shirazi, Vice Governor
Mr. F. Naderi, Director General for International Affairs
Mr. G.H. Shahkarami, Director General for Economic Statistics
Mr. A. Ebtehaj, Director, Economic Statistics Department
Mr. A. Manavi-Rad, Director, International Relations and Studies Department
Mr. H. Mahdavi, Director, Economic Research Department
Mr. B. Zarringhalam, Deputy Director, Economic Research Department
Mr. M. Amini, Assistant Director, Economic Research Department
Mr. B. Tamani, Assistant Director, Economic Research Department
Mr. A. Yasseri, Assistant Director, International Relations and Studies Department
Mr. F. Rakhshani, Chief, Money and Banking Division, Economic Research Department

Fund Representatives

Mr. A.S. Shaalan
Mr. S.H. Hitti
Mr. S.M. Nsouli
Mr. Z. Iqbal
Mr. P. Boxall

Observer

H.E. J. Amuzegar, Executive Director, IMF

Ministry of Economic Affairs and Finance

Mr. A. Kooros, Vice Minister

Ministry of Commerce

Mr. Ganjei, Deputy Minister

Plan and Budget Organization

Mr. A. Mejloumian, Under-Secretary of State for Planning
Mr. F. Sarraf, Director, Bureau of Budgetary Policies, Methods and Training (BPMT)
Mr. G. Maleki, Assistant Director (BPMT)
Mr. B. Rafii, Assistant Director (BPMT)

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INTERNATIONAL MONETARY FUND

Iran: 1978 Article IV Consultation

Teheran

Minutes of Meeting with the Plan and Budget Organization

1. Production and private sector investment and consumption

Reviewing the developments in the level of economic activity during 1977/78, the mission noted that there was a sharp deceleration in the overall rate of growth of real GDP to less than 2 per cent, following an increase of 11.5 per cent in the previous year. Value added in the oil sector fell by 7 per cent while the rate of growth in the non-oil sector decelerated to 7.6 per cent, reflecting a marginal fall in value added in the agricultural sector and a marked deceleration in the rate of growth in the other two main sectors--industry (including construction) and services.

The Iranian representatives said that the data on agricultural output were subject to a wide margin of error. Nevertheless, the indications were that low rainfall in the crop growing areas had adversely affected agricultural production in 1977/78. The Government recognized, however, that there was a lack of incentives in the agricultural sector following the sharp movement in the rural-urban terms of trade against the rural sector, which had been exacerbated since the increase in oil prices in late 1973. The policy of stabilizing food prices for consumers in the cities had, along with the Government's pricing policy for agricultural output, reduced profitability in agriculture, thereby encouraging the flow of labor from rural to urban areas. Indeed, in 1977/78 the area under cultivation declined and there was a shortage of agricultural labor. In the case of some crops, such as sugar beet, the high wages paid had made it uneconomical to reap the harvest.

In the industrial sector, construction activity started to decelerate early in the year in response to specific measures adopted by the Government to eliminate speculation in land and in buildings. For the manufacturing industries the Iranian representatives stated that the price controls, coupled with a steep increase in costs, had caused a profit squeeze which contributed to the slowdown in industrial activity. In addition, the shortages of electricity adversely affected the growth in manufacturing output.

Another aspect of the slowdown in economic activity in 1977/78 was reflected in the decline of over 10 per cent in private sector investment in real terms. The Iranian representatives explained that the main reasons for the decrease in private sector investment were the legislation affecting construction and the business uncertainties generated by the price controls. The limitations imposed on the supply of commercial bank credit to the private sector was not considered an important factor as the demand for credit had remained relatively weak throughout the year. To some extent, the decrease in private sector investment in construction had resulted from the Government's policy to increase public sector investment in low- and medium-cost housing. To this end, a temporary regulation, prohibiting the construction of large houses and apartments, was in force up to end-1977/78 which, along with a law to limit the rise in the price of land to the rate to be set each year by the Government, discouraged construction activities in the private sector. The situation was complicated further by the continuation of a shortage of building materials, in particular of cement.

The Iranian representatives considered that the increases in real incomes over the last three years had led to the buildup in consumer demand which emerged in 1977/78. In addition, the Iranian representatives noted that with a fixed exchange rate, relatively stable world prices, and the rapid rate of increase in wages, the demand for imported goods and services had increased which contributed also to the growth in private consumption. The Iranian representatives cautioned, however, that the developments during 1977/78 are not necessarily indicative of a sudden change in the behavior of the private sector. They noted the very large increases in private sector investment in the two years preceding 1977/78 and suggested that, to some extent, 1977/78 was a year of consolidation. Indeed, having virtually eliminated speculation in land and real estate, some of the restrictions on private sector investment in the construction sector had been lifted and the latest data indicated a resumption of activity in this sector.

2. Prices and wages

The mission observed that Iran had experienced substantial rates of price increases in recent years in response to strong demand pressures. The implementation of rigid price controls had limited the rise in the cost of living index to about 10 per cent in 1975/76. However, starting in 1976/77 these controls were relaxed gradually and were eliminated for most goods and services by late 1977/78. The lifting of the controls, combined with continuing demand pressures, had resulted in rises in the cost of living index of 17 per cent in 1976/77 and 25 per cent in 1977/78, the latter being the highest rate of increase recorded for many years. The Iranian representatives confirmed the mission's analysis and stated that there was now official recognition that price controls would be limited to some necessities, mainly foodstuffs, some of which were subsidized by the Government. For all other goods, prices would be determined according to market forces. In the past the price controls, which were inclined to be enforced more rigorously for locally produced goods, tended to discourage local production in favor of the supply of imported goods.

In the opinion of the Iranian representatives, the gradual abolition of the price controls had become feasible in view of the substantial absorption of the excess liquidity created in the past. The Iranian representatives considered that, to a large extent, the underlying rate of inflation had fallen and that there was now little carryover from the excess demand pressures which were present in the economy over the last three years. They pointed out that the rate of price increase had decelerated starting in August 1977 and continued during the first quarter of 1978/79. The Iranian representatives observed also that the recent deceleration in the rise of the cost of living index was brought about by the substantial slowdown in the rate of increase of the sub-index for housing, which was the sub-index that had led the acceleration in prices during 1976/77. However, the rate of increase for the prices of food, beverages, and tobacco and clothing, which account for over 50 per cent of the weights in the cost of living index, remained quite high and did not decelerate as much as the other items, including housing. The mission pointed out that continuing caution was necessary until there was further evidence that the apparent reduction in inflationary pressures was more than a temporary phenomenon.

Wage rates in the manufacturing sector continued to increase, albeit at a lower rate, during 1977/78. However, after three years of substantial increases in real wages, wages in real terms probably did not rise during 1977/78, which reflected in part the Government's effort to limit wage increases largely through moral suasion. The Iranian representatives stated that the Government was not actively attempting to relate wage increases to productivity gains. With a slackening in the demand for labor, the Government had been able to limit the increase in the basic wage to about 7-8 per cent. However, the policy on wages had not been fully worked out.

3. <u>The outlook for 1978/79</u>

The Iranian representatives stated that there was not likely to be any substantial increase in the output of oil in 1978/79. In the non-oil sector, output was expected to recover and should increase at a faster rate than in 1977/78, perhaps by some 8-9 per cent in real terms. Construction starts had increased in the last quarter of 1977/78 and, with the Government embarking on a sizable construction program for public housing and the prospect of adequate supplies of cement, output was expected to improve during 1978/79. Similarly, manufacturing output should expand as plants increased output following the lifting of price controls. In the agricultural sector, output was projected to increase as the Government had revised upwards the price of agricultural products. For a number of products, a minimum guaranteed price had been set as well as a maximum price which the Government intended to maintain by selling off stocks. The Iranian representatives said that the Government's policy was to reduce the rate of inflation and to operate the economy at a more moderate rate of growth than in the past. They stated that efforts would be made to implement the budget for 1978/79 in a manner consistent with these objectives.

4. Economic planning

The fifth Five-Year Plan was completed in 1977/78. As yet, the sixth Five-Year Plan had not been published. Nevertheless, the Iranian representatives said that the development expenditures in the 1978/79 budget had been coordinated to fit into the development plan. The general aim of the Plan was to establish a reasonable balance between the different sectors with improved coordination in implementing the projects. Accordingly, priority would be given to completing the ongoing projects, before commencing new projects, and more emphasis would be placed on infrastructural projects, such as internal transportation and communications, and power, so as to remove the existing bottlenecks. In addition, the Iranian representatives stated that more concrete emphasis would be placed on the agricultural sector. Overall, the authorities viewed 1978/79 as a transitional year during which an adjustment in expectations to more normal conditions would be initiated. The authorities were now aware that once again financial constraints had become operative in Iran and there was a need to establish priorities more carefully and to eliminate waste.

The mission welcomed the realistic perspective with which the Iranian representatives viewed the medium-term outlook. This was important since if the present trends in the balance of payments continued Iran might experience serious difficulties. Import payments had increased steadily while export receipts had remained virtually constant, and a balance of payments constraint might arise soon. The Iranian representatives stated that the Government was aware of the possibility that a balance of payments problem might emerge. In the short run, the current account deficit could be financed by borrowing abroad and by running down reserves. In the meantime, more efforts would be made to promote non-oil exports while limiting the growth of domestic demand so as to dampen the demand for imports.

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INTERNATIONAL MONETARY FUND

Iran: 1978 Article IV Consultation

Teheran

Minutes of the Meeting with the Ministry of Economic Affairs and Finance

1. Government finance

The mission reviewed with the authorities recent developments in the Central Government's finances and the budget for fiscal 1978/79. It was noted that in recent years expenditures had been growing at a considerably faster rate than revenues and that, as a result, there had been a turnaround in the budgetary outcome from a surplus in 1974/75 to a substantial deficit in 1977/78. During 1977/78, revenues grew by nearly 12 per cent, slightly higher than projected in the budget, and total expenditures by almost 30 per cent, in line with budgetary allocations. On the revenue side, oil and gas revenues rose by 5.4 per cent, as the increase in oil prices effective January 1, 1977 more than offset the decline in output. Non-oil revenues increased by almost 30 per cent, reflecting in the main the rise in nominal income during 1977/78. Special revenues, which are earmarked for particular expenditure items, grew by 43 per cent. On the expenditure side, current outlays rose by about 18 per cent and were marginally below budget allocations. There was also a small shortfall in development expenditures, which grew by about 40 per cent. Contingent expenditures and advance payments, however, grew sharply, exceeding budget allocations. The overall deficit of Rls 389 billion that emerged was smaller than the deficit projected in the approved budget by some Rls 70 billion, an amount almost equal to the realized revenue increment in excess of the budget revenue forecast. The total of the financing items derived from the monetary and the balance of payments statistics (Rls 308 billion) was approximately in line with the deficit indicated in the fiscal accounts. The deficit was financed primarily by a change in the net position of the Government vis-a-vis the banking system amounting to Rls 351 billion while net foreign borrowing and net borrowing from domestic nonbank sources were relatively small.

Turning to the budget for 1978/79, the mission noted that oil revenues were projected at about the same level as in the previous year, and it inquired about the factors behind the projected sharp increase in non-oil and special revenues. As regards non-oil revenues, the authorities said that the anticipated additional increment of the increase over and above the past trend was attributable to improved collection methods. Computers were now being used to identify companies that were not filing tax returns, and the Government was taking steps to collect tax arrears from these companies. The projected large rise in special revenues was attributed mainly to the transfer of some social security receipts to certain central government agencies.

Turning to expenditures, the mission stated that the level of allocations did not seem to be in line with the Government's policy to moderate further demand pressures and to aim at growth rates in line with the absorptive capacity of the country. Current expenditures were projected to grow by 36 per cent and capital outlays by about 28 per cent. Further, the mission noted that there was no figure for contingent expenditures and advance payments, which had been substantial in 1977/78.

The Iranian representatives agreed that the budget allocations were on the high side and consequently government policy now was to implement the budget in a manner that would ensure substantial savings. Directives had been sent to all ministries to institute austerity measures; in particular, the hiring of new civil servants would be severely limited, travel of government officials would be curtailed, representation offices of various ministries abroad would be closed, and computer facilities would be shared by ministries instead of allowing each ministry to have its own computer. The Iranian representatives stated that the growth in current expenditures in the first quarter of the year had been limited to 18 per cent and anticipated limiting the growth rate in current expenditures in the year as a whole to about that level. This would reflect mainly the rise in salaries and fringe benefits granted to civil servants in mid-1977/78. With regard to capital expenditures, the authorities noted that in recent years the absorptive capacity of the economy had expanded considerably and that, as a result, development expenditures would approximate budget allocations. Capital outlays were being directed to ongoing projects and were aimed at further easing the physical bottlenecks, such as electrical power, and at industries the inputs of which were not currently subject to physical constraints. With regard to contingent expenditures and advance payments, the authorities stated that the Ministry of Finance intended to limit disbursements under this heading to a very small magnitude. The anticipated results in 1978/79 relative to the budget estimates could be seen in the attached table. With revenues approximating the budget forecast while an anticipated savings in expenditure relative to the allocation levels is expected, the overall deficit was now forecast at some Rls 420 billion as compared with Rls 436 billion implied in the budget estimates. The financing of the deficit shown in the attached table showed continued heavy reliance on net borrowing from the domestic banking system. The financing of the deficit also implied substantial net foreign borrowing as well.

The mission indicated that the budgeted level of expenditure after adjustment for the expected shortfall, remained excessively expansionary and might contribute to the rekindling of the inflationary pressures in the economy. This would continue the trend exhibited in recent years whereby the net domestic expenditures of the public sector, which included the Central Government and the government agencies, had been behind the rapid increases in domestic liquidity that led to intense inflationary pressures. The authorities responded that they were concerned about the possible inflationary impact of the budget and that every effort was being made to minimize the contribution of public expenditures to excess demand pressures in the economy. It was the policy of the Government to work toward the re-establishment of financial balance, and it would endeavour to move toward that goal to the extent feasible. The transition, however, to a more modest fiscal stance could be advanced only gradually if undesirable disruptions were to be avoided.

Iran: Summary of Government Finances

(In billions of Iranian rials)

	Budget 1978/79	Revised Proj.outcome 1978/79
Revenues	2,396.0	2,396.0
Oil	1,541.8	1,541.8
Non-oil	714.2	714.2
Special 1/	140.0	140.0
Expenditures	2,832.3	2,814.6
Current expenditures	1,750.7	1,583.0
Ordinary	(1,610.6)	(1,443.0)
Special	(140.0)	(140.0)
Development expenditures	1,231.6	1,231.6
Foreign grants	2/	
Contingent expenditures and advance payments	...	...
Unfulfilled obligation (-)	-150.0	...
Surplus (+) or deficit (-)	-436.3	-418.6
Financing items	436.3	418.6
Domestic financing	380.0	362.3
Banking system (net)		(342.3)
Nonbank sources		(20.0)
External financing	56.3	56.3
Net borrowing	(136.3)	(136.3)
Acquisition of assets	(-80.0)	(-80.0)

1/ Special revenues are primarily fees and user charges under the control of various ministries and agencies which are earmarked for particular uses. Expenditures financed from the revenues usually equal receipts.

2/ The amount for foreign grants is included in granting of loans and investment abroad (Rls 80 million), and is not available separately.

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INTERNATIONAL MONETARY FUND

Iran: 1978 Article IV Consultation

Teheran

Minutes of Meeting with Bank Markazi Iran

1. Monetary developments and policies

The mission reviewed with the authorities recent monetary developments and the prospects for 1978/79. Since the increase in oil prices in 1973/74, domestic liquidity (money plus quasi-money) in Iran had been expanding at a very fast pace. The rate of growth of domestic liquidity peaked at 57 per cent in 1975/76. In the subsequent two years the annual rate of growth of domestic liquidity slowed down to about 40 per cent. There was a further slowdown during 1977/78 to about 32 per cent, reflecting a considerable deceleration in the rate of growth of credit to the private sector while net credit to the public sector increased sharply. Within the public sector the Central Government had transferred approximately Rls 200 billion to the government agencies. While this did not affect the change in credit to the public sector as a whole, it showed a greater rise in net claims on the Government and a buildup in the net deposits of government agencies. Excluding this transfer, the net claims on the public agencies would have risen by some Rls 77 billion. Net foreign assets grew at a lower rate than the previous year, reflecting the weakening balance of payments position.

The mission noted that a more meaningful presentation of the sources of domestic liquidity would trace the injection of liquidity to the net operations of the public and private sectors. In countries like Iran, where a major proportion of government revenues was derived from the external sector, such an alternative presentation would be more appropriate than the traditional analysis based solely on the banks' balance sheets. The net injection of liquidity due to public sector operations consisted of the net domestic expenditures of the public sector, or the excess of domestic expenditures over domestic revenues. This was equivalent to the change in net credit to the public sector from the banking system plus the balance of payments outcome of the public sector. The net injection of liquidity due to private sector operations consisted of the change in claims by the banking system on that sector plus the balance of payments outcome of the private sector. A re-arrangement along these lines had been worked out with the authorities showing that in 1977/78, as in recent years, the net domestic expenditures of the public sector had had a strong expansionary impact while the net operations of the private sector had had a net contractionary effect on domestic liquidity.

The mission noted that in recent years the expansion in domestic liquidity had exceeded substantially the rate of growth in real non-oil GDP and had, as a result, exacerbated the underlying inflationary pressures in the economy. During the five-year period 1973/74-1977/78 real non-oil GDP had grown at an average annual rate of about 13 per cent while the annual growth rate of domestic liquidity had averaged about 40 per cent. This had contributed materially to the average increase in the non-oil GDP deflator of almost 17 per cent per year. Statistical analysis suggested that the excess liquidity created during the past five years had been substantially absorbed. Accordingly, while monetary policy for 1978/79 probably did not need to compensate for a significant liquidity overhang, it needed to be sufficiently tight to ensure that strong inflationary pressures would not re-emerge.

The Iranian representatives responded that they were concerned about the rate of expansion of domestic liquidity and had followed in 1977/78, and continued to follow, a tight credit policy. During 1977/78, the rate of growth of credit to the private sector was brought down to about 22 per cent as compared with 39 per cent in the preceding year. The Central Bank had taken various measures which included the imposition of ceilings on credit expansion; these ceilings were 20 per cent above the end-1976/77 level for commercial bank lending to the private sector and 35 per cent for specialized banks. In addition, the availability of rediscount facilities was limited, the rediscount rate was increased by 1 percentage point, and the interest rates on loans were raised. Commercial bank credit to the private sector had not reached the ceiling, as it increased by only 18 per cent. On the supply side, this was mainly due to the cautious stance of the commercial banks prompted by the uncertainty with regard to real estate prospects. On the demand side, the slowdown in the economic activity of the non-oil sector as well as the decline in real estate speculation tended to dampen the demand for loans. By contrast, the specialized banks, which finance mainly long-term investment, exceeded marginally their ceiling. This was caused mainly by the pick-up in economic activity during the last quarter of the year.

The growth in domestic liquidity had accelerated in the last quarter of the year manifesting an exaggerated seasonal pattern. Money and quasi-money had expanded by 14 per cent in the first three quarters as compared with 25 per cent in the same period of the previous year. However, mainly as a result of a surge in public sector expenditures and the pick-up in non-oil sector economic activity in the last quarter of 1977/78, which led to a surge in specialized banks' credit, domestic liquidity expanded by nearly 16 per cent in that quarter as compared with about 11 per cent in the same quarter of the previous year.

Turning to the policies and prospects for 1978/79, the authorities indicated that the Central Bank intended to continue pursuing a tight monetary policy and would continue to rely on quantitative credit controls. The Central Bank had set a ceiling on commercial bank private sector lending at 20 per cent and on specialized banks at 25 per cent above the end-1977/78 levels. Based on the expected budgetary and balance of payments outcomes and the monetary policy currently pursued, the following projections were made:

Factors Affecting Changes in Money and Quasi-Money

(In billions of Iranian rials)

	Revised Projections 1978/79
Foreign assets (net)	-70.0
Claims on public sector (net)	426.0
Claims on Government (net)	(342.0)
Claims on public enterprises (net)	(84.0)
Claims on the private sector	429.0
Other items (net)	-240.0
Money and quasi-money	545.0
Rate of increase (in per cent)	26.0

The mission noted that the abovementioned considerations resulted in an expected increase in domestic liquidity of 26 per cent in 1978/79. While this would constitute an improvement over the previous year, this growth rate would still considerably exceed the anticipated real growth in non-oil income and would, therefore, contribute to a rekindling of the inflationary pressures. The mission suggested that some further moderation in monetary policy be achieved mainly through a curtailment in the public sector's expansionary impact while the private sector be provided with an adequate level of credit to finance the ongoing recovery.

2. Balance of payments developments and policies

The mission noted that data on foreign exchange receipts and payments showed that Iran experienced in 1977/78 a 30 per cent decline in overall surplus from the previous year's level. Receipts from oil remained virtually unchanged as the export volume fell by about 7 per cent. Current payments, on the other hand, rose by about 15 per cent because of a doubling of net service payments and higher imports. Consequently, the current account surplus declined by over SDR 2.5 billion to SDR 1.1 billion. Reversing the pattern of the past three years, the nonmonetary capital account registered a net surplus of SDR 851 million in 1977/78 on account of a tripling of drawings on loans from abroad combined with a substantially reduced level of foreign investments and disbursements of loans by Iran. As the improvement in capital account was not sufficient to compensate for the decline in the current account surplus, the overall surplus decreased to about SDR 2 billion.

The Iranian representatives agreed with this assessment of Iran's balance of payments position during 1977/78. Regarding the sharp increase in net service payments they stated that it was difficult to pinpoint the components of this aggregate. One of the main components which appeared to have increased substantially in the recent past was the remittances of foreign workers. At present there were about 100,000 skilled foreign workers and an estimated one million unskilled foreign workers (approximately 10 per cent of the labor force) in Iran. Since these remittances were taking place through the noncommercial market, it was difficult to determine the exact amount involved. Expenditures on travel and shipping had also gone up and a large amount of demurrage charges incurred during the period of port congestion in 1976/77 were settled in 1977/78. While all these factors had contributed to the steep rise in net service payments, the Iranian representatives said that the service payments included some private capital outflows generated by a decline in profitable investment opportunities in Iran. The authorities estimated that net service payments would continue to increase in the future at rates consistent with the expansion in the economy and with the rising demand for foreign skills and other services.

The official projections for 1978/79 showed no decline in receipts from oil exports based on the assumptions of unchanged prices and volume. Import payments were expected to increase by about 17 per cent due to higher public sector imports aimed at sustaining the expansion in the Government's investment program and resurgence of private investment, and a further sharp increase in net service payments. Private import registration rose by 35 per cent during the first quarter of 1978/79 over the level of the same period in 1977/78 but this rate of expansion was considered by the Iranian representatives to be exceptional and not likely to be sustained over the year as a whole. As a result of the disparity between rising payments and stagnant receipts, the current account balance was expected to undergo a dramatic reversal to a large deficit of about SDR 1.9 billion in 1978/79 from a surplus position in 1977/78. The capital account, on the other hand, was forecast to register a 30 per cent increase in net inflows. Most of these inflows would be made under new loan commitments with maturity periods of higher than five years. The net surplus in the capital account, however, was not expected to offset fully the projected current account deficit. Consequently, an overall deficit of almost SDR 800 million was projected representing a deterioration of almost SDR 3 billion from the previous year.

The mission observed that in view of Iran's comfortable exchange reserves position, the modest external deficit projected for 1978/79 was not disturbing. However, given the fact that Iran's imports of goods and services were rising at a rate much faster than the growth rate of oil and non-oil exports, the balance of payments might experience widening deficits. Barring unusual circumstances, oil exports were not expected to rise faster than in the recent past and the competitiveness of the non-oil exports had been adversely affected as a consequence of a sharp rise in domestic costs. While it was possible for some time to finance the current account deficit through enlarged foreign borrowing, given that the debt service ratio was still quite low, and also through some drawdown on external reserves, such financing could not be sustained for long. Consequently, corrective measures were needed. The Iranian authorities agreed with this assessment and indicated that they would keep the economic situation under review and would consider what corrective measures might be required.

3. Exchange and payments system

The noncommercial exchange market expanded substantially in 1977/78 and was fed by a transfer of $2.1 billion from Bank Markazi. Without such a transfer it would not have been possible to maintain unified rial/dollar rates in the official and noncommercial markets. The mission inquired whether the authorities would continue the sale of dollars in the noncommercial market to ensure identical rates even if the demand for foreign exchange in noncommercial markets continued to increase. The authorities stated that they intended to continue sustaining the noncommercial market so long as demand in that market does not expand abnormally in which case they would have to reappraise their policy. The mission pointed out that the emergence of different rates might constitute a multiple currency practice requiring Fund approval. The authorities took note of this and stated that for the present they did not expect the emergence of multiple rates.

The mission sought the Iranian authorities' views on their experience with the current exchange rate system under which the rial was pegged to the SDR with widened margins of 7.25 per cent on either side of the fixed SDR rate. In principle, a change would be made in the rial/dollar rate in order to ensure that the actual rial/SDR rate did not exceed these margins. The staff team observed that the actual rial/SDR rate, based on the unchanged rial/dollar rate, almost hit the upper of these margins recently and continued to be very close to it. In these circumstances, the mission inquired whether the authorities intended to adjust the rial/dollar rate in order to stay within the margin. The authorities stated that they had expanded the margins in the hope of avoiding the need for an adjustment in the rial/dollar rate. However, should the U.S. dollar depreciate further, the Iranian authorities were not inclined to appreciate the rial vis-a-vis the dollar just in order to stay within the margin.

The mission was informed that there had been no change in the official policy toward Iran's bilateral payments arrangement with Romania and that no new bilateral payments arrangements had been signed since the last consultation discussions.

Concerning Iran's reserve management policy, the Iranian representatives stated that there had been no change in the official policy and thus, it continued to be guided by considerations of safety, geographical and currency distribution, and terms. In view of its balance of payments situation, Iran was keeping a large proportion of its reserves in liquid assets.

Iran: Summary of Foreign Exchange Receipts and Payments, 1976/77 - 1978/79

(In millions of SDRs) 1/

Year ended March 20	1976/77	1977/78	Revised Offic. Proj. 1978/79
A. Receipts from the oil exports 2/	17,806	17,557	17,528
B. Other goods and services	-14,179	-16,356	-19,390
Exports	569	666	762
Imports	-13,958	-15,214	-17,782
Private sector 3/	(-6,873)	(-7,240)	(-8,298)
Public sector	(-7,085)	(-7,974)	(-9,484)
Services (net)	-790	-1,808	-2,371
of which: interest payments	(-261)	(-313)	(-339)
C. Nonrecurrent transfers 4/	-14	-106	--
D. Total (A+B+C)	3,613	1,095	-1,862
E. Nonmonetary capital	-1,552	851	1,100
Official loans and credits (net)	-1,239	589	1,100
Drawings	(487)	(1,272)	(2,540)
Principal repayments from abroad	(449)	(681)	
Repayments	(-618)	(-577)	(-678)
Loans and investments	(-1,556)	(-787)	(-762)
Private capital (net)	-314	262	--
F. Errors and omissions 5/	702	2	--
G. Overall balance	2,763	1,948	-762
H. Monetary movements (increases) 6/	-2,763	-1,948	762
Foreign exchange holdings	-2,758	-2,040	...
Bank Markazi long-term loans	--	--	...
IMF account	--	--	...
Use of SDRs	-5	-7	...
Other	--	99	...

Source: Bank Markazi Iran.

1/ Values in U.S. dollars were converted into SDRs as follows: for 1976/77, US$1.15061 = SDR 1; and for 1977/78 and 1978/79, US$1.1 1037 = SDR 1.

2/ Excludes rial purchases from the Iranian Oil Service Company and the Joint Venture Company which are incorporated in services (net).

3/ Includes imports of nonmonetary gold.

4/ Includes special receipts and payments for oil sector and other grants and aid.

5/ Also include discrepancies between the balance of payments outcome and changes in the net foreign assets of the banking system arising out of the use of different conversion rates to convert monetary data from rials to SDRs.

6/ Excluding changes in the net foreign assets of the specialized banks.

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INTERNATIONAL MONETARY FUND

Iran: 1978 Article IV Consultation

Teheran

Minutes of Meeting with the Ministry of Commerce

1. Commercial policy

Since the previous consultation discussions, no changes in restrictions on current payments, which continued to be liberal, were made. For some time, Iran had pursued a commercial policy aimed at ensuring sufficient protection to domestic producers to promote import substitution while ensuring adequate supplies in the market. The main instruments used for that purpose were a system of prior approval for imports, commercial benefit taxes, state trading, and bilateral trade agreements. The list of imports subject to prior approval changed from year to year and its application through refusals resulted in quantitative restrictions. In 1978/79 the list and its application remained unchanged, except for certain cotton textiles which was made necessary by the dumping of cheaper imports.

The Iranian representatives responded that in the context of Iran's legal framework, once the annual import policy was announced it could not be made more restrictive during the course of the year. These circumstances necessitated the inclusion on the prior approval list of a large number of items. This, however, did not imply that their imports would in fact be restricted. The commercial benefit taxes were raised on a large number of commodities and lowered on some others. The increase in the application of commercial benefit tax was in part due to the fact that pursuant to the policy of more liberal import regulations a number of commodities included in the prohibited list were removed from the list, but the commercial benefit tax was levied on them to prevent unfair competititon. This, however, represents the maximum level of commercial benefit tax payable by the importer of these commodities because, according to the law, when the level of this tax is determined for the year it could not be increased but could, when deemed appropriate, be lowered. The Iranian representatives also stated that these taxes had been used for revenue as well as protection purposes. The revenue aspect had become relatively less important after the sharp increase in oil income. However, as the budget deficits had started to emerge in 1977/78, the need for higher revenues contributed to the decision to raise these taxes. At the same time there was a greater need for import protection and therefore these taxes were raised mainly on imports which had domestic substitutes. The staff indicated to the Iranian representatives that these developments constituted intensification of import restrictions.

Turning to export promotion policies, the mission pointed out that the performance of non-oil exports had been disappointing in recent years. These exports had grown in nominal terms at an annual average rate of 2.5 per cent during the last four years and in fact declined in real terms.

The weak performance of this sector had been mainly due to a sharp rise in domestic costs which reduced the competitive position of Iran's exports in the world market, coupled with strong domestic demand which decreased export availabilities. To offset the former factor, the Government was now providing various incentives. In addition to preferential provision of services and credit, and customs duties rebates, this support involved provisions of income tax reduction and exemption for local producers who export part of their products, and a subsidization amounting to 10-15 per cent of domestic cost of production for selected manufactured exports. The Iranian representatives stated that the Government was in the process of reviewing the pattern of export incentives, including the cash subsidies. A comprehensive study was underway to draw up policies to rationalize the incentives system.

Responding to the mission's query on the status of the bilateral trade and payments agreement with Romania, the Iranian representatives stated that there had been no change in the government policy toward this agreement which continued to be needed for conducting trade with socialist countries. The mission observed that such arrangements generated lack of competition and decline in the quality of exports. Therefore, the authorities were urged to terminate the bilateral arrangements currently in effect, especially the one with Romania.

To conclude the discussion, the mission stated that the recent direction of Iran's commercial policy raised important issues. The need for increased protection of domestic industry and for export subsidization, in combination with the fact that a large portion of non-oil exports were marketed through bilateral channels, suggested the desirability of a thorough review of industrial efficiency and export competitiveness in Iran.

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Iran: 1978 Article IV Consultation

Teheran

Meeting with Minister of Economy and Finance

The contents of the attached Final Statement of the mission were delivered at the meeting. The Minister responded that he was in basic agreement with the analysis of the mission. The Government, he explained, shared the mission's concern with regard to the necessity of adjusting policies during this transitory phase so as to ensure the attainment of sustainable economic growth under conditions of financial stability. To this end, the Minister stated that considerable efforts were being made to reduce the budgetary deficit during 1978/79. With respect to the oil revenues, the Minister indicated that the receipts would not fall below the budgeted level. Output was expected to expand somewhat while total receipts during 1978/79 would benefit also from the acceleration in payments resulting from the change in the date of the monthly payment. With regard to the non-oil revenues, the Government had launched a campaign to bring about a more effective collection of taxes. On the expenditure side, considerable savings vis-a-vis budget allocations were expected. Ordinary outlays were anticipated to increase by only 18 per cent as compared with about 36 per cent projected in the budget. Development expenditures would also be curtailed to the greatest extent possible; the execution of some projects was being prolonged while the Government's efforts in this regard were hampered by previous commitments. A smaller deficit would help reduce the rate of growth of domestic liquidity. In addition, the authorities were pursuing relatively tight credit policies. Ceilings on private lending had been set at 20 per cent for commercial banks and at 25 per cent for specialized banks above the end-1977/78 levels. As a result, the rate of expansion in domestic liquidity was expected to be lower than the previous year.

On the supply side, the Minister noted that during the last quarter of 1977/78 there had been a revival in the economic activity of the non-oil sector and that the rate of growth of non-oil GDP could be expected to be higher in 1978/79 than in 1977/78. Physical bottlenecks had been virtually eliminated, while there had been a resurgence of private sector confidence with the virtual elimination of price controls.

These factors, operating on the demand and supply sides, had already started to have a salutory effect. During the first quarter of 1978/79 there had been a significant deceleration in the rate of inflation and this trend was anticipated to continue. The Minister estimated that the rate of inflation for the year as a whole would be in the range of 10-15 per cent.

Turning to the foreign exchange receipts and payments projections for 1978/79, the Minister stated that he expected receipts from the oil sector to be at about the same level as in the previous year. In addition, he did not anticipate service payments to rise as sharply as projected for two major reasons. First, the increase in the exit tax had already had a negative impact on travel abroad. Second, the recent increases in net services probably included some capital outflows resulting from transactions in real estate. As these transactions had subsided, such capital outflows would be substantially reduced.

The Minister indicated that, because of the downward movement of the effective exchange rate of the U.S. dollar and because of the unchanging price of oil since January 1, 1977, the purchasing power of Iran's foreign exchange receipts had eroded and the terms of trade had moved against Iran. It was, therefore, essential to adjust the price of oil. A more realistic pricing policy for oil, he added, would also encourage the development of alternative sources of energy and would reduce the inefficient use of this valuable depletable resource.

The Minister stated that the authorities were very concerned about the performance of the non-oil export sector and that it was the policy of the Government to promote such exports in order to reduce the reliance of the economy on the oil sector. Some countries, however, were discriminating against Iran's non-oil exports, and Iran had conveyed its concern to the countries in question. In addition, Iran was looking into various ways of encouraging non-oil exports. At present, some manufacturers were receiving minor cash subsidies to enable them to compete in international markets. The most important factor, however, behind the decline in the volume of Iran's non-oil exports in recent years was the high level of demand within the country.

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

Iran: 1978 Article IV Consultation

Teheran

Final Statement

The economy of Iran has experienced rapid changes in direction in the recent past. The initial stimulus arose as a result of the attempt to absorb the vastly expanded oil revenues, and in this area Iran has made its contribution to the resolution of the imbalance in international payments arising from the sharp rise in oil prices. In the process, a substantial overheating of the economy occurred due to the steep increase in public expenditures which were financed by revenues accruing from the economy's export sector. In response, Iran endeavoured, and in fact largely succeeded, in removing the supply constraints which impeded the flow of resources from abroad and the expansion of domestic output. While this was being done a considerable demand/supply imbalance existed causing great pressures on the available resources. Under these circumstances, the Iranian authorities resorted to price controls which were strictly enforced in the first instance, but were gradually relaxed and virtually eliminated recently. Through this mechanism the authorities managed to limit the immediate price impact of the excess demand pressures that emerged and to spread it over approximately four years. Overall, the authorities operated their policies taking full advantage of the opportunities presented by an open economy and, after some delay, by permitting the market forces to come into full play.

The economy is now passing through a transitional phase toward a more normal level of activity and expectations. It is generally conceded that economic management is usually more difficult during transitional phases than in periods when a well set course is continued. In this context, the main purpose of these concluding remarks is to attempt an assessment of the appropriateness of current policies relative to the stated objectives of the Government of Iran to aim at absorbable and sustainable growth under conditions of financial stability. Needless to say, we fully support these goals. The vital questions, however, that have to be asked are whether the current financial policies are consistent with these objectives, and whether there is need for adjustment in policies.

The Iranian authorities have had considerable success in decreasing the rate of increase of domestic liquidity, from 57 per cent in 1974/75 to 32 per cent in 1977/78. Concommittently, the intensity of the inflationary pressures operating in the economy were also reduced. Data on price movements are somewhat distorted because of price controls. The strict enforcement of these controls in 1974/75 resulted in limiting the rise in the cost of living index to 10 per cent, while in 1977/78 the accumulated pentup demand was allowed expression and the index shot up by some 25 per cent. However, the data also show that a definite improvement in the price trends commenced in mid-1977/78 and appears to be continuing. While an improving trend is indicated, it cannot be taken for granted that the rate of inflation will continue to fall. A closer look at the index shows that the recent moderation was largely influenced by a steep slowdown in the sub-index for housing, while other items tended to manifest some resistence to decline.

The financial outlook for 1978/79 discussed with the Iranian authorities during the review just concluded reveals that some further progress in restoring domestic financial balance can be expected in the current fiscal year. The rate of growth in domestic liquidity is projected to decrease to about 26 per cent compared with 32 per cent attained in 1977/78. As the real expansion rate of the non-oil GDP is forecast at about 9 per cent, the potential rise in the domestic cost of living can be estimated at about 12-14 per cent. While this would be significantly lower than the average annual rate for the past four years, the mission believes that some additional effort should be made in order to realize a greater improvement. As the planned level of credit increment for the private sector is moderate and necessary for the expansion of activity in that sector, any adjustment will have to be borne by the Government's budget. While appreciating that substantial efforts are being made to contain current expenditures, the mission believes that an additional saving of about Rls 100 billion from the presently anticipated level of total expenditures is necessary for making more rapid progress toward the restoration of domestic financial balance.

A lower level of effective demand in 1978/79 and a greater reduction in the domestic rate of inflation are also needed for balance of payments management purposes. There are indications that the steep rates of inflation and wage increases experienced over the past few years have affected the domestic cost structure to the extent of causing some difficulties for the non-oil export sector and the import competing industries. The authorities' reaction has been to provide additional protection to domestic industry mainly through substantial rises in the commercial benefit taxes. The incentives to promote non-oil exports have been expanded to include cash subsidies in addition to the various rebates on imported inputs previously allowed. Moreover, the rial has been, for all practical purposes, pegged to the U.S. dollar and Iran's external sector has benefited from the downward movement that occurred as a consequence of the depreciation of the dollar in recent months. These steps indicate that the authorities in Iran are aware of the implication for the balance of payments of the relative changes in domestic and international costs. The mission believes that these tentative steps should not be used as a substitute for a comprehensive review of balance of payments policies and that it is vital that the authorities resist the temptation to suppress the emerging balance of payments problem through a tightening of administrative restrictions on imports.

Iran's external accounts are experiencing a weakening phase. The current account, which was in surplus to the extent of SDR 3.6 billion in 1976/77 is forecast to record a deficit of SDR 1.9 billion in 1978/79. This deficit could be higher if financial policies are not adjusted along the lines suggested earlier. The large turnaround in the current account is being caused by considerable increases in payments for imports of goods and services while oil receipts are not expected to increase. The performance of non-oil exports has been particularly disappointing as these exports have been falling in volume terms. In order to contain the overall balance of payments deficit in 1978/79 to manageable proportions, gross drawing on external loans of about SDR 2.5 billion are intended. Considering Iran's comfortable reserves position and a very low external debt service ratio, neither the forecast overall deficit nor the proposed borrowings abroad constitute cause for concern. Indeed, appropriate demand management policies require that the balance of payments be permitted to absorb a part of the demand pressures. Over the medium term, however, the divergent trends between receipts and payments cannot be sustained. Considering that adjustment policies require time to take hold, it is not too soon to start directing attention to the objective of attaining a sustainable balance in the external sector. An early start on adjustment policies would allow for a gradual approach that is more palatable socially and politically. Delays tend to cause an intensification of the difficulties and make more severe measures unavoidable. The emerging balance of payments deficit is almost the mirror image of the fiscal deficit and it is action in this area that constitutes the primary adjustment factor. A tightened fiscal stance in combination with a review of balance of payments policies would provide the basis for sustainable growth of the economy and for the continuation of Iran's liberal exchange and payments policies.

There remains to thank you for your cooperation and hospitality and to say that we enjoyed our stay in Iran.

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

Iran: 1978 Article IV Consultation

Teheran

Minutes of Final Meeting with Bank Markazi Iran

The Iranian representatives stated that they were in basic agreement with the contents of the Final Statement. The receipts from the oil sector in 1978/79 were now projected at about the same level as in 1977/78 because oil production and exports were anticipated to pick up during the year and as Iran would witness in 1978/79 a minor acceleration in payments due to the changeover in the timing of the monthly oil payments from the Gregorian to the Iranian year. Since the oil receipts were anticipated to be at about the same level as in the previous year, the budgetary deficit would be relative to the budget estimate, requiring less bank financing. The authorities indicated that the expected rate of inflation during 1978/79 would therefore be somewhere between 10-15 per cent as the Finance Minister had indicated.

The authorities requested the Fund staff to provide a study on the appropriate exchange rate policy for an oil-producing country. In addition, they indicated that they would be interested in the mission's views on the efficiency of the industrial sector in Iran and the implications for the long-term balance of payments prospects. The mission stated that the Middle Eastern Department, in consultation with the Exchange and Trade Relations Department and the Research Department, would undertake a study of the appropriate exchange rate policy for an oil-producing country. With regard to the question of industrial efficiency, the mission explained that, while this had a bearing on the balance of payments prospects, an analysis of the industrial sector in Iran lay more in the realm of the World Bank than the Fund.

IMMEDIATE
ATTENTION

SM/78/235
Supplement 1

CONTAINS CONFIDENTIAL
INFORMATION

October 10, 1978

To: Members of the Executive Board

From: The Secretary

Subject: Iran - 1978 Consultation

Attached is the Secretary's record of the decision taken by the Executive Board pursuant to Article XIV at Meeting 78/153, October 6, 1978, in concluding the 1978 consultation with Iran. This text will be transmitted to the member after the close of business on Wednesday, October 11, 1978.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

Iran - 1978 Consultation

Executive Board Decision - October 6, 1978

1. This decision is taken by the Executive Board in concluding the 1978 consultations with Iran pursuant to Article XIV, Section 3.

2. In light of recent developments in its balance of payments, the Fund welcomes the maintenance by Iran of a liberal policy relating to payments and transfers. The Fund hopes that this policy will be continued and that Iran will terminate its bilateral payments arrangement with one Fund member.

Phyllis.

DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

Mr. A.S. Shaalan

Room 3-314-C

(1) #11

October 10, 1978

To: Senior Staff

From: The Secretary's Department

Subject: Executive Board Meeting 78/153, October 6, 1978*

Bahamas - 1978 Article IV Consultation

Staff representative: Hardy
Discussion: 15 minutes

EDs agreed that owing to successful economic management, Bahamas had made an impressive recovery from 1975 recession, although comparatively low level of economic activity and structural problems still stood in the way of solution to unemployment problem. Some speakers emphasized need to step up investment and development effort and to place more emphasis on agriculture and infrastructure. Inflation record had been good, and continued wage moderation would help to maintain competitiveness of tourist industry, which was mainstay of economy.

EDs agreed with Chairman's summing up, to effect that Board had broadly agreed with the principal views expressed in the staff appraisal.

X Iran - 1978 Article IV Consultation and Decision Pursuant to Article XIV

Staff representatives: Shaalan, Mookerjee
Discussion: 2 hours, 15 minutes

Chairman's summing up to be circulated. EDs also approved decision pursuant to Article XIV, with amendment; text to be circulated.

There was some discussion of general procedure for summing up, relating in particular to whether or not a member's exchange rate policy should be mentioned routinely. It was agreed that practice followed so far provided room for flexibility, depending on circumstances, and could be further reviewed in light of experience as part of general review to be held early in 1979.

** ** ** **

Decisions taken since previous Board meeting to be recorded in minutes of Meeting 78/153

Grenada - Schedule of Repurchases and Postponement of Repurchases (EBS/78/537)
Grenada - Technical Assistance (EBD/78/206)
Executive Board Travel (EBAP/78/272, EBAP/78/273)

* Précis for limited distribution; not basis for official action.

Phyllis

October 11, 1978 - 78/131

The Chairman's Summing Up at the Conclusion of the
1978 Article IV Consultation with Iran
Executive Board Meeting 78/153 - October 6, 1978

In concluding this wide-ranging and interesting discussion on the 1978 Article IV consultation with Iran, I will sum up briefly by saying that the Executive Directors noted the excellent growth record achieved by Iran over many years, and have commended the Iranian authorities on the success they have attained so far in moderating inflationary pressures in the economy while at the same time lifting quite courageously price controls. The Directors, who generally agreed with the thrust of the views expressed in the staff appraisal, also viewed with satisfaction the important contribution made by Iran to the resolution of the problem of imbalances in international payments through a dynamic investment policy, and a continued liberal system of payments.

Directors believed that as the balance of payments was entering a weakening phase, it had been prudent for the Iranian authorities to implement a new policy directed toward a more sustainable rate of growth. Some Directors believed that in that light it might be prudent for the authorities to take further steps to reduce domestic demand and inflationary pressures, in particular through appropriate fiscal and credit policies. Various Directors stressed the importance of reaching a more harmonious and balanced structure of growth.

I should also note that several Directors have commented on the Iranian policy of protecting domestic industries, which should be the subject of further analytical study.

October 5, 1978 - 78/126
Corrected: 10/6/78*

Statement by Mr. Amuzegar on Iran
Executive Board Meeting 78/153
October 6, 1978

A major task of the Iranian authorities in the period between the two annual consultations with the Fund has been the implementation of a new policy toward a reasonable and more sustainable rate of economic growth as compared to the dizzying pace of the 1974/75 period.

During 1976/77, Iran continued to experience high levels of economic growth. The real GDP grew at 11.5 per cent and the non-oil sector registered a 13.0 per cent growth rate in real terms. The level of domestic expenditures, both public and private, and fixed capital formation continued to increase, although at a much reduced rate compared to the previous buoyant years. The real GDP's growth rate in 1977/78 was drastically reduced to only 1.8 per cent due to the Government's deliberate anti-inflationary policy, and also because of the stagnant behavior of the oil sector.

However, in spite of increased domestic production and continuation of heavy imports of goods and services, the inflationary pressures continued during 1976/77 due to a rise in domestic liquidity of some 39 per cent (compared, however, to a rise of 57 per cent in 1974/75 and 47 per cent in 1975/76).

One of the reasons for the increased inflationary pressures has been the performance of the agricultural sector in recent years, which compared to other activities has been relatively slow. The authorities have now announced their intention to give top priority to this sector. The temporary tax-exempt status of investments in the agricultural sector has been extended indefinitely. The amount of credit provided to farmers, as well as the mechanism of its distribution, are being reviewed and improved. Private investment in this sector is further encouraged.

The authorities are relying more on the price mechanism to increase production. They have already announced an almost 17 per cent increase in the purchasing price of wheat for producers in 1978/79, and have promised a further 7 per cent increase for next year. To further help farmers close the widening gap in rural/urban incomes, the basic purchase price of certain agricultural commodities (e.g. sugar beets, tobacco and others) have been raised. The government's policy of offering financial assistance to farmers (partly in the form of subsidized six per cent loans) for the purchase of farm machinery and other aspects of farming has also been intensified.

With a view to increasing agricultural production and productivity, the 1978/79 budget for fixed capital formation in agriculture was raised by 54 per cent (partly to expand farm credits and to increase the resources of agricultural banks). In a major policy declaration in May 1978, the Ministry of Agriculture also announced that the government's involvement

* Paragraphs 2 and 3 have been corrected.

in agricultural activities would be limited to building infrastructures, expanding services to the farm sector, increasing research and promoting farm output through various incentives.

The industrial sector has in recent years assumed a leading role among non-oil activities. The percentage share of this sector in the GDP has steadily increased and in 1977/78 reached 19 per cent. Moreover, this sector is expected to continue to play a leading role in the transformation of the economy. The government intends to extend various incentives to promote investments in this sector. Special attention is also being given to the development of small scale industries and the expansion of the more traditional activities. The Bank Melli Iran has already outlined the guidelines for extension of credits to these activities. Industries which would employ domestic resources, as well as those promoting agricultural activities, will be given priority.

It should also be noted that construction activities are expected to remain strong. Housing construction is going to get full backing of the government. A new distribution mechanism for allocation of building materials to actual builders rather than middlemen are set up, and interest subsidies and other incentives are offered to low income house owner-builders and to corporations for workers' low cost housing.

In line with the government's basic objectives of removing bottlenecks, increase production and enhance efficiency, swift actions by the Ministry of Energy has nearly doubled electric power production capacity, and put an end to power failures. Making better use of production and distribution facilities, the volume of cargo discharges in Iranian ports rose by 24 per cent (as against a mere 3.8 per cent in 1975); total capacity reached 17 million tons in a span of one year.

On the fiscal front, the authorities are determined to control public expenditures, minimize budget deficits, and avoid new inflationary pressures. Total public expenditures (including foreign loans and investments) which rose by some 31 per cent in the 1977/78 budget were brought down to 17 per cent in the 1978/79 budget. Significant shifts of resources were also allowed in the new budget in favor of increased public investments in relation to current outlays. Although total expenditures in 1977/78 grew at a faster rate than revenues, capital expenditures grew by more than double the rate of current expenditures. This was viewed by the authorities as a necessary measure to maintain the economic momentum. On the revenue side, the revision of the tax structure is now under serious consideration: the government is determined to use fiscal policy for a better distribution of income. It is already planning to offer a further tax exemption to the earnings at the lower end of incomes scale. The authorities are mindful to the potential inflationary impacts of the increased government expenditures, and are seriously evaluating all current, as well as development expenditures. In the latter group, priority is to be given to those projects which have already started. Still the government may probably face a larger deficit in 1978/79 than the previous year, and it expects to finance this deficit by recourse to domestic borrowing and some use of external sources.

Looking toward longer run prospectives, the government has taken steps to increase direct and indirect taxes in order to reduce gradually its dependence on oil revenues. Non-oil revenues in recent years have been increasing from less than five per cent of GNP in 1973/74 to more than seven per cent in 1977/78--exhibiting an annual growth of about 27-28 per cent. These revenues for the 1978/79 budget year are estimated to increase by at least 30 per cent in the next few years.

On the monetary side, the Central Bank has continued its tight credit policy. In 1977/78 the credit ceilings for the commercial banks were set at 20 per cent and for specialized banks at 35 per cent above 1976/77 figures. Similar figures for 1976/77 were 25 per cent and 42 per cent respectively. The rediscount rate was also raised from 9 to 10 per cent during 1977/78. These policies have reduced the rate of increase of domestic liquidity to 32 per cent as compared to a 39 per cent increase for the 1976/77 year. As for 1978/79, the authorities have expressed their intention to continue a tight credit policy. They have already adopted similar ceilings for the expansion of credit by both the commercial and the specialized banks.

The prudent fiscal and monetary policies adopted by the authorities did indeed reduce demand pressures. These policies together with the tough new law against land speculation and the government's all-out effort to increase the supply of housing as well as the removal of other existing bottlenecks, provided an opportunity for the authorities to remove the price control guidelines. This action, necessary for a more efficient allocation of resources, immediately caused a sharp increase in the cost of living index. Later on, however, these policies proved successful, and the cost of living index which in August 1977 stood at nearly 31 per cent higher than a year earlier, was brought down to 7.9 per cent in July 1978.

Realizing that the rapid increases in housing cost (e.g. 75 per cent in June 1977 over June 1976) were a major factor in price inflation, the government directed its main efforts to this sector. A tough new law against urban land speculation was passed by the Parliament according to which city lots were to be priced by zones, and these prices used as a base for tax assessment, collateral on bank borrowing, and value assessment by the government in exercizing its right of eminent domain. A reported 60 per cent drop in the housing price index was the result.

The government's other anti-inflationary measures, in addition to further restriction on overall credit creation by the banking system, have included temporary shelving of low-priority projects in the public sector; tying of wage boosts and workers' share of company profits to productivity (with an appeal for a voluntary wage freeze); reduction of the number of middlemen in domestic distribution through the establishment of retail cooperatives, and increased domestic production of goods through subsidies and other incentives.

As part of its restabilization efforts, a meaningful revision was also made of the price control philosophy and apparatus. Prices of "non-strategic" items not in short supply were freed from government regulations. Emphasis was also shifted from demand controls to the expansion of supply, increased competition and more efficient distribution.

To encourage fuel conservation (and improve government revenues), oil and gas prices were raised by 25 per cent in March 1978, and are scheduled to go up in five yearly 25 per cent hikes. Other products supplied by government enterprises at subsidized prices were also given price boosts in order to bring these companies into the black within five years.

In balance of payments, the picture has been quite satisfactory. In 1977/78, in spite of continued stagnation of the price of oil, a 130 per cent increase in the payments for net services, a poor performance of non-oil exports and a 67 per cent drop in the current account surplus, the overall BOP showed a SDR 1.9 billion surplus although a 30 per cent drop from the previous year. The capital account registered a net inflow which was basically due to an increase in borrowing abroad, and a decline in Iran's foreign investments.

Iran's exchange rate policy has remained essentially unchanged. While continuing to be pegged to the SDR at Rls. 82.2425, the rial is allowed to fluctuate within a target zone above and below that central rate. The upper and lower limits of the target zone are based on the basic underlying conditions in Iran in relation to its major trading partners. Since July 31, 1978 Iran no longer observes a 7.25 margin of rial vis-à-vis the SDR. Iran follows a liberal policy toward all external payments and transfers, and hopes to be able to continue to maintain this policy beyond current payments and transfers. Iran's international reserve position, however, while still remaining strong, is becoming increasingly small in relation to the country's basic reserves and payments requirements.

Iran is presently going through an adjustment period. The Sixth Development Plan, although not yet finalized, will most likely be more concerned with improvement of health, education and living conditions for all citizens with more attention to those living outside Tehran. It will also concentrate on a better distribution of income. Proper attention will be paid to the development of the infrastructures. The rate of growth will most likely be more modest than the recent experience, but still noteworthy.

Finally, a word must be said about Iran's contributions to the international adjustment process, and her close relations with the Fund. The Iranian authorities have contributed significantly to the Oil Facility, and the Subsidy Account; they have agreed, under certain conditions, to contribute to the Supplementary Financing Facility and the Trust Fund. Iran has also been a major contributor to OPEC's Special Fund, and the International Fund for Agricultural Development.

October 11, 1978 - 78/131

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Executive Board Meeting 78/153 - October 6, 1978

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During 1977/78, Iran continued to experience high levels of economic growth. The real GDP grew at 11.5 per cent and the non-oil sector registered a 13.0 per cent growth rate in real terms. The level of domestic expenditures, both public and private, and fixed capital formation continued to increase, although at a much reduced rate compared to the previous buoyant years.

However, in spite of increased domestic production and continuation of heavy imports of goods and services, the inflationary pressures continued in the first half of 1977 due to a rise in domestic liquidity of some 39 per cent (compared, however, to a rise of 57 per cent in 1974/75 and 41 per cent in 1976/77).

One of the reasons for the increased inflationary pressures has been the performance of the agricultural sector in recent years, which compared to other activities has been relatively slow. The authorities have now announced their intention to give top priority to this sector. The temporary tax-exempt status of investments in the agricultural sector has been extended indefinitely. The amount of credit provided to farmers, as well as the mechanism of its distribution, are being reviewed and improved. Private investment in this sector is further encouraged.

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With a view to increasing agricultural production and productivity, the 1978/79 budget for fixed capital formation in agriculture was raised by 54 per cent (partly to expand farm credits and to increase the resources of agricultural banks). In a major policy declaration in May 1978, the Ministry of Agriculture also announced that the government's involvement in agricultural activities would be limited to building infrastructures, expansing services to the farm sector, increasing research and promoting farm output through various incentives.

The industrial sector has in recent years assumed a leading role among non-oil activities. The percentage share of this sector in the GDP has steadily increased and in 1977/78 reached 19 per cent. Moreover, this sector is expected to continue to play a leading role in the transformation of the economy. The government intends to extend various incentives to promote investments in this sector. Special attention is also being given to the development of small scale industries and the expansion of the more traditional activities. The Bank Melli Iran has already outlined the guidelines for extension of credits to these activities. Industries which would employ domestic resources, as well as those promoting agricultural activities, will be given priority.

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Looking toward longer run prospectives, the government has taken steps to increase direct and indirect taxes in order to reduce gradually its dependence on oil revenues. Non-oil revenues in recent years have been increasing from less than five per cent of GNP in 1973/74 to more than seven per cent in 1977/78--exhibiting an annual growth of about 27-28 per cent. These revenues for the 1978/79 budget year are estimated to increase by at least 30 per cent in the next few years.

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The prudent fiscal and monetary policies adopted by the authorities did indeed reduce demand pressures. These policies together with the tough new law against land speculation and the government's all-out effort to increase the supply of housing as well as the removal of other existing bottlenecks, provided an opportunity for the authorities to remove the price control guidelines. This action, necessary for a more efficient allocation of resources, immediately caused a sharp increase in the cost of living index. Later on, however, these policies proved successful, and the cost of living index which in August 1977 stood at nearly 31 per cent higher than a year earlier, was brought down to 7.9 per cent in July 1978.

Realizing that the rapid increases in housing cost (e.g. 75 per cent in June 1977 over June 1976) were a major factor in price inflation, the government directed its main efforts to this sector. A tough new law against urban land speculation was passed by the Parliament according to which city lots were to be priced by zones, and these prices used as a base for tax assessment, collateral on bank borrowing, and value assessment by the government in exercizing its right of eminent domain. A reported 60 per cent drop in the housing price index was the result.

The government's other anti-inflationary measures, in addition to further restriction on overall credit creation by the banking system, have included temporary shelving of low-priority projects in the public sector; tying of wage boosts and workers' share of company profits to productivity (with an appeal for a voluntary wage freeze); reduction of the number of middlemen in domestic distribution through the establishment of retail cooperatives, and increased domestic production of goods through subsidies and other incentives.

As part of its restabilization efforts, a meaningful revision was also made of the price control philosophy and apparatus. Prices of "non-strategic" items not in short supply were freed from government regulations. Emphasis was also shifted from demand controls to the expansion of supply, increased competition and more efficient distribution.

To encourage fuel conservation (and improve government revenues), oil and gas prices were raised by 25 per cent in March 1978, and are scheduled to go up in five yearly 25 per cent hikes. Other products supplied by government enterprises at subsidized prices were also given price boosts in order to bring these companies into the black within five years.

In balance of payments, the picture has been quite satisfactory. In 1977/78, in spite of continued stagnation of the price of oil, a 130 per cent increase in the payments for net services, a poor performance of non-oil exports and a 67 per cent drop in the current account surplus, the overall BOP showed a SDR 1.9 billion surplus although a 30 per cent drop from the previous year. The capital account registered a net inflow which was basically due to an increase in borrowing abroad, and a decline in Iran's foreign investments.

Iran's exchange rate policy has remained essentially unchanged. While continuing to be pegged to the SDR at Rls. 82.2425, the rial is allowed to fluctuate within a target zone above and below that central rate. The upper and lower limits of the target zone are based on the basic underlying conditions in Iran in relation to its major trading partners. Since July 31, 1978 Iran no longer observes a 7.25 margin of rial vis-à-vis the SDR. Iran follows a liberal policy toward all external payments and transfers, and hopes to be able to continue to maintain this policy beyond current payments and transfers. Iran's international reserve position, however, while still remaining strong, is becoming increasingly small in relation to the country's basic reserves and payments requirements.

Iran is presently going through an adjustment period. The Sixth Development Plan, although not yet finalized, will most likely be more concerned with improvement of health, education and living conditions for all citizens with more attention to those living outside Tehran. It will also concentrate on a better distribution of income. Proper attention will be paid to the development of the infrastructures. The rate of growth will most likely be more modest than the recent experience, but still noteworthy.

Finally, a word must be said about Iran's contributions to the international adjustment process, and her close relations with the Fund. The Iranian authorities have contributed significantly to the Oil Facility, and the Subsidy Account; they have agreed, under certain conditions, to contribute to the Supplementary Financing Facility and the Trust Fund. Iran has also been a major contributor to OPEC's Special Fund, and the International Fund for Agricultural Development.

FOR AGENDA

SM/78/235

CONTAINS CONFIDENTIAL INFORMATION

September 5, 1978

To: Members of the Executive Board

From: The Secretary

Subject: Iran - Staff Report for the 1978 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1978 Article IV consultation with Iran. A draft decision pursuant to Article XIV appears on page 11.

This subject will be brought to the agenda for discussion on a date to be announced.

Att: (1)

Other Distribution:
Department Heads

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INTERNATIONAL MONETARY FUND

IRAN

Staff Report for the 1978 Article IV Consultation

Prepared by Staff Representatives for the 1978 Consultation with Iran

Approved by A. S. Shaalan and S. Mookerjee

September 1, 1978

I. Introduction

In accordance with established procedures, the 1978 Article IV consultation discussions with Iran were held in Teheran during the period July 8-16, 1978. The Iranian representatives were led by H.E. Mohammad Yeganeh, Minister of Economic Affairs and Finance, H.E. Manuchehr Agah, Minister of State and Director of the Plan and Budget Organization, and H.E. Youssef Khoshkish, Governor, Central Bank of Iran, and included senior officials of government departments and agencies. The mission was composed of Messrs. A. S. Shaalan, S. H. Hitti, S. M. Nsouli, P. Boxall (all of MED), Z. Iqbal (ETR), and Ms. P. Curtis (secretary). Mr. J. Amuzegar, Executive Director for Iran, attended some of the meetings. Iran continues to avail itself of the transitional provisions of Article XIV.

II. Background

The steep increases in oil prices in 1973-74 enabled the Government of Iran to expand sharply its expenditures for both current and development purposes. In 1974/75 (Iranian year ended March 20) the Central Government almost tripled its current expenditures and doubled its capital expenditures. This led to a considerable stimulation of private sector economic activity and a substantial expansion in private sector credit. Although the level of imports more than doubled as a result, the balance of payments current account registered a record surplus exceeding SDR 7 billion. The rate of expansion of domestic liquidity (money plus quasi-money) accelerated sharply and reached 57 per cent reflecting mainly the large increase in the Government's net domestic expenditures. With the sudden surge in aggregate demand, infrastructural bottlenecks emerged and the consequent supply/demand imbalance caused the rate of inflation to rise steeply. During 1975/76, 1976/77, and the early part of 1977/78, government policy aimed at reducing excess demand pressures and limiting the increases in prices while pursuing high growth targets with a view to diversifying the production base of the Iranian economy. The Central Government severely limited the growth of its current expenditures. Capital expenditures, however, were increased substantially with the aim of alleviating the infrastructural bottlenecks and accelerating the growth of the non-oil sector. Throughout this period, the real rate of GDP fluctuated considerably, reflecting mainly changes in oil sector output levels resulting from movements in world demand. Non-oil GDP value added at constant prices grew at a fast pace, led by the service and industrial sectors. During 1974/75-1976/77, non-oil GDP grew at an average annual rate of about 16 per cent.

Monetary policy became progressively tighter. During 1975/76 and 1976/77 the rate of growth of domestic liquidity dropped to an annual average of about 40 per cent mainly as a result of a slowdown in the injection of domestic liquidity by the public sector and as credit to the private sector decelerated in the latter year in response to the strict limitations on credit expansion imposed by the Central Bank. The restrained fiscal and monetary policies were accompanied by the introduction of comprehensive price controls in 1975. Mainly as a result of strict implementation of the controls, the rate of growth in the cost of living was reduced from 16 per cent in 1974/75 to 10 per cent in 1975/76. To avoid, however, excessive distortional forces from arising, the controls were relaxed somewhat and the cost of living was allowed to rise by almost 17 per cent in 1976/77. In 1977, the Government decided to lift the price controls almost completely. In view of the pent-up forces, this led to a sharp acceleration in the cost of living index in the earlier part of 1977/78. In the external sector, a modest deficit emerged in 1975/76. This reflected a sharp decline in the current account surplus, as substantial progress was made in alleviating the bottlenecks impeding the flow of goods from abroad, as well as net official capital outflows from Iran that peaked at around SDR 2.6 billion. The balance of payments reverted to a surplus position in 1976/77, partly due to a decline in net capital outflows.

Iran has a liberal exchange system. Since January 1974, dual exchange markets have been in operation within the banking system consisting of a commercial market (encompassing oil receipts and imports) where the official rial/U.S. dollar rate is applicable, and a noncommercial market where rates can, in theory, fluctuate freely in response to supply/demand conditions. The Central Bank of Iran, however, has intervened in the noncommercial market through sales of foreign exchange. Consequently, except for a few months after the introduction of the dual markets, the rial/U.S. dollar rate has been the same in the two markets. The size of the noncommercial market has expanded sharply and was the equivalent of US$4.2 billion in 1977/78 or about 20 per cent of the total foreign exchange transactions.

On February 12, 1975, Iran ceased pegging the rial to the U.S. dollar and linked it to the SDR on the basis of the rate of Rls 82.2425 = SDR 1, with wider margins of 2.25 per cent around that rate. The practice adopted was to change the rial/U.S. dollar rate whenever it remained outside the margins for five consecutive business days. On December 14, 1977, the Iranian authorities discontinued this practice in order to avoid appreciating against the dollar. On April 1, 1978, the margins around the rial/SDR rate were enlarged to 7.25 per cent; this permitted the authorities to avoid changing the rate for the U.S. dollar in terms of the Iranian rial despite the continuing depreciation of the U.S. currency. This margin was abolished effective July 31, 1978. A target zone above and below the central rate has been established based on the relative purchasing power of the rial vis-a-vis that of the currencies of Iran's major trading partners and on other basic underlying economic conditions. Iran maintains a number of bilateral payments agreements including one with a Fund member, Romania. Some payments are made through clearing accounts maintained with Turkey and Pakistan under the Regional Cooperation and Development Agreement. Iran also is a participant in the Asian Clearing Union. Iran's trade system, like those of a number of developing countries, accords considerable protection to domestic industry.

The pursuit of a high growth strategy made the task of re-establishing financial balance difficult. As a result, there was a shift in the Government's economic policy in mid-1977/78. The Cabinet which was formed in August 1977 declared the policy objective of re-establishing financial balance while aiming at "absorbable growth" targets. The consultation review centered on the progress made in 1977/78 or likely to be realized in 1978/79 toward achieving these objectives.

III. Report on the Discussions

1. Output, investments, prices and wages

There was a substantial slowdown in the level of economic activity in Iran during 1977/78. The overall rate of growth of real GDP fell to less than 2 per cent reflecting a 7 per cent decrease in value added in the oil sector in combination with growth in the non-oil sector decelerating to 7.6 per cent. Another aspect of the slowdown was indicated by the decline of over 10 per cent in private sector investment in real terms. The Iranian representatives said that low rainfall in the crop growing areas had adversely affected agricultural production in 1977/78. Construction activity started to decelerate early in the year in response to a temporary regulation, prohibiting the construction of large apartments and limiting the rise in the price of land to a rate to be set each year by the Government. For the manufacturing industries, the price controls, coupled with a steep increase in costs, had caused a profit squeeze which contributed to the slack in industrial activity and investment. In addition, the shortages of electricity adversely affected the growth in manufacturing output. With regard to the prospects for 1978/79, the Iranian representatives stated that there was not likely to be an increase in oil production. In the non-oil sector, however, output was expected to recover showing a growth of about 9 per cent in real terms. In the last quarter of 1977/78 private construction starts and industrial output and investments began to recover stimulated by the lifting of price controls. Public sector investment outlays were anticipated to continue exhibiting an upward trend. However, priority would be given to completing the ongoing projects before commencing new projects as the authorities were now aware that once again financial constraints had become operative in Iran and there was a need to establish priorities more carefully and to eliminate waste.

The Iranian representatives stated that price controls would be limited to a few necessities, mainly foodstuffs, while the prices of all other goods would be determined by market forces. The lifting of the controls, combined with continuing demand pressures, had resulted in the cost of living index rising by 25 per cent in 1977/78; the highest rate of increase recorded for many years. The Iranian representatives pointed out, however, that the rate of price increase had started decelerating im mid-1977/78 and had continued this trend during the first quarter of 1978/79. Despite these favorable indications, the Iranian authorities were maintaining a cautious attitude as the recent price developments were brought about mainly by the substantial slowdown in the rate of increase of the subindex for housing and further evidence was needed to ascertain that the apparent reduction in the rate of inflation was more than a temporary phenomenon. Wage rates in the manufacturing sector continued to increase, albeit at a lower rate, and wages in real terms probably did not rise during 1977/78. The policy of wage restraints was continuing and overall the rate of inflation in 1978/79 was anticipated to be significantly more moderate than in the past.

2. Fiscal policy

The trend for substantially higher growth rates in public expenditures than in revenues continued in 1977/78; revenues grew by nearly 12 per cent while total expenditures expanded by almost 30 per cent. The overall deficit of Rls 389 billion (equal to 7.5 per cent of GDP) that emerged was financed primarily by a change in the net position of the Government vis-a-vis the domestic banking system amounting to Rls 351 billion while net borrowing from domestic nonbank sources was relatively small. On a net basis, Iran continued to acquire foreign assets in 1977/78. Turning to the budget for 1978/79, the Iranian representatives indicated that the projected revenue level was realistic and would be attained. On the expenditure side, the budget provided for a 36 per cent rise in current expenditures and a 28 per cent increase in capital outlays.

Subsequent to the approval of the budget, the Iranian authorities decided that the budget allocations were on the high side and consequently government policy now was to implement the budget in a manner that would ensure substantial savings. Directives had been sent to all ministries to institute austerity measures; in particular, the hiring of new civil servants would be severely limited. The growth in current ordinary expenditures in the first quarter of the year had been limited to 18 per cent and it was anticipated that the growth rate in current expenditures for the year as a whole would be constrained to about that rate. This would reflect mainly the rise in salaries and fringe benefits granted to civil servants in mid-1977/78. With regard to capital expenditures, the authorities noted that in recent years the absorptive capacity of the economy had expanded considerably and that, as a result, development expenditures might well approximate the budget allocations. Commitments made in the past would be implemented and capital outlays were being directed to ongoing projects. With regard to contingent expenditures and advance payments, the Ministry of Finance intended to limit disbursements in 1978/79 under this heading to a very small amount. The anticipated revised overall deficit in 1978/79, at about Rls 420 billion, is somewhat lower than the deficit implied in the budget estimates but will still require continued heavy reliance on net borrowing from the domestic banking system. The financing of the deficit also implies a turnaround in the Government's net foreign operations into substantial net borrowing abroad. The authorities stated that they were concerned about the possible inflationary impact of the budget and that every effort was being made to minimize the contribution of public expenditures to excess demand pressures in the economy. The transition, however, to a more restrained fiscal policy had to be effected at a moderate pace if undesirable disruptions were to be avoided.

3. Monetary and credit policies

There was a further slowdown in the rate of growth of domestic liquidity during 1977/78 to about 32 per cent reflecting a considerable deceleration in the rate of growth of credit to the private sector while net credit to the public sector increased sharply. Net foreign assets grew by a smaller amount than in the previous year. As in recent years, the net domestic expenditures of the public sector had had a strong expansionary impact while the net operations of the private sector had had a net contractionary effect on domestic liquidity.

The Iranian representatives explained that the monetary authorities had followed a tight credit policy in 1977/78. The Central Bank had taken various measures but the principal instrument used continued to be quantitative ceilings on credit expansion. Commercial bank credit to the private sector, however, did not reach the ceiling as the slowdown in the economic activity as well as the decline in real estate speculation tended to dampen the demand for loans. By contrast, the specialized banks, which financed long-term investment, exceeded marginally their ceiling. This was caused by the pickup in activity during the last quarter of the year. Overall, credit to the private sector rose by 22 per cent in 1977/78 as compared with 39 per cent in the preceding year.

Turning to the prospects and policies for 1978/79, the authorities indicated that the Central Bank intended to continue pursuing tight policies and relying on quantitative credit controls. The Central Bank had set a ceiling on commercial bank credit to the private sector at 20 per cent, and on specialized banks at 25 per cent, above the end-1977/78 levels. Based on the expected budgetary and balance of payments outcomes and the credit policy currently pursued, a rate of increase in domestic liquidity of about 26 per cent is projected for 1978/79. The mission commented that statistical analysis suggested that the excess liquidity created during the past five years had been substantially absorbed. Accordingly, while monetary policy for 1978/79 probably did not need to compensate for a significant liquidity overhang, it needed to be sufficiently tight to ensure that inflationary pressures would not re-emerge. While the projected rate of increase in domestic liquidity for 1978/79 constituted an improvement over the previous year, it was substantially in excess of the anticipated real growth rate in non-oil income. The mission therefore suggested that some further moderation in monetary expansion be achieved mainly through a curtailment in the public sector's expansionary impact.

4. Balance of payments developments and policies

Iran experienced in 1977/78 a 30 per cent decline in the overall surplus from the previous year's level. Receipts from oil remained virtually unchanged as the export volume fell by about 7 per cent. Current payments, on the other hand, rose by about 15 per cent because of a more than doubling of net service payments and higher imports. Consequently, the current account surplus declined by over SDR 2.4 billion to SDR 1.2 billion. Reversing the pattern of the past three years, the nonmonetary capital account registered a net surplus of SDR 851 million in 1977/78 on account of a tripling of drawings on loans from abroad combined with a substantially reduced level of foreign investments and disbursements of loans by Iran. As the increase in the capital account did not compensate for the decline in the current account surplus, the overall surplus decreased to about SDR 2 billion. The Iranian representatives attributed the sharp rise in net service payments partly to a substantial increase in the remittances of foreign workers. Expenditures on travel and shipping had also gone up and a large amount of demurrage charges was settled in 1977/78. While all these factors had contributed to the steep rise in net service payments, the Iranian representatives said that service payments data included some private capital outflows generated in part by a decline in investment opportunities in Iran.

The official projections for 1978/79 showed net receipts from the oil sector remaining unchanged, import payments increasing by about 17 per cent to sustain the expansion in the Government's investment program and the resurgence of private investment and a further considerable increase in net service payments. As a result of the disparity between rising payments and stagnant receipts, the current account balance was expected to undergo a reversal to a deficit of nearly SDR 2 billion in 1978/79. The capital account, on the other hand, was forecast to register a substantial increase in net inflows. The net surplus in the capital account, however, was not expected to offset fully the projected current account deficit. Consequently an overall deficit of almost SDR 800 million was projected representing a decline of almost SDR 3 billion from the previous year's outcome.

The mission observed that in view of Iran's comfortable foreign exchange reserves position, the modest external deficit projected for 1978/79 was not disturbing. However, barring unusual circumstances, oil receipts were not expected to rise faster than in the recent past and the performance of the non-oil exports had been adversely affected as a consequence of a sharp rise in domestic costs. Imports of goods and services were expected to continue rising at a fast rate. It was possible for some time to finance a widening current account deficit through drawdowns on external reserves and through enlarged foreign borrowing as the debt service ratio was still quite low. Such financing, however, could not be sustained for long and consequently corrective measures appeared to be needed. The Iranian authorities agreed with this assessment and indicated that they would keep the economic situation under review and would consider what corrective measures might be required.

5. Exchange and trade policies

Since the previous discussions no changes have been made in the regulations governing current payments, which continue to be liberal. The noncommercial exchange market was fed in 1977/78 by a transfer of US$2.1 billion from Bank Markazi which made it possible to maintain unified rial/U.S. dollar rates in the official and noncommercial markets. The authorities stated that they intended to continue sustaining the noncommercial market so long as demand in that market does not expand abnormally in which case that policy would have to be reappraised.

The authorities stated that they had enlarged the margins to 7.25 per cent in the hope of avoiding the need for an adjustment in the rial/U.S. dollar rate. On July 6, 1978 the actual rial/SDR rate exceeded the upper margin of the expanded band, and remained outside the margins after July 24, 1978. However, in accordance with the discontinuation of the practice requiring exchange rate adjustment after five consecutive business days of the actual rate remaining outside the margins, the authorities indicated that they were not inclined to appreciate the rial vis-a-vis the U.S. dollar. As indicated above, effective July 31, 1978, Iran abolished the margins of 7.25 per cent.

The Iranian representatives stated that there had been no change in the government policy toward the bilateral payments agreement with Romania which they indicated continued to be needed for conducting trade with a socialist country. A recently concluded credit payments agreement with Turkey was necessitated by the special relationship between the two countries. The authorities were urged to terminate the bilateral arrangements currently in effect, especially the one with a Fund member.

The mission noted that since the last consultation discussions there had been an intensification in trade restrictions. Certain cotton textiles had been banned and commercial benefit taxes increased on a large number of commodities. The Iranian authorities indicated that with the exception of the cotton textiles, the list of imports subject to prior approval and its application had remained unchanged. They also stated that in some cases commercial benefit taxes had been reduced. Reflecting the intention of removing some commodities from the prior approval list this year, commercial benefit taxes were raised on a number of commodities for both revenue and protection considerations. The revenue aspect had become relatively less important after the sharp increases in oil receipts. However, as the budget deficits had re-emerged, the need for higher revenues contributed to the decision to raise these taxes. At the same time there was a greater need for import protection and therefore these taxes were raised mainly on imports which had domestic substitutes.

The weak performance of non-oil exports had been partly due to the strong domestic demand which decreased export availabilities,and the sharp rise in domestic costs. To offset the latter factor, the Government was now providing various incentives, including the preferential provision of services and credit, customs duties rebates, and income tax exemptions. The Iranian representatives stated that the Government was in the process of reviewing the pattern of export incentives. A comprehensive study was under way to draw up policies to rationalize the incentives system.

Concerning Iran's reserve management policy, the Iranian representatives stated that there had been no change in the official policy and thus, it continued to be guided by considerations of safety, currency distribution, and terms. In view of its balance of payments situation, Iran was keeping a large proportion of its reserves in liquid assets. On June 30, 1978, Iran's reserves stood at SDR 9,736 million equal to about eight months of imports at the 1977/78 level.

IV. Staff Appraisal

Iran has absorbed the vastly expanded oil revenues and thereby has made a contribution to the resolution of the imbalance in international payments arising from the sharp rise in oil prices. In the process, a substantial overheating of the economy occurred despite considerable success in removing the supply constraints which impeded the flow of resources from abroad and the expansion of domestic output. Under these circumstances, the Iranian authorities resorted to price controls which were strictly enforced in the first instance, but were gradually relaxed and virtually eliminated recently. Through this mechanism and the maintenance of a fairly liberal import policy, the authorities limited the immediate price impact of the excess demand pressures that emerged and spread it over approximately four years. The economy is now passing through a transitional phase toward a sustainable level of activity in conditions of relative financial stability.

With the virtual elimination of price controls in 1977/78, the price indices rose sharply in response to the pent-up demand. The data also show that a slowdown in the rate of inflation commenced in mid-1977/78 and appears to be continuing. The financial outlook for 1978/79 reveals that some further progress in restoring domestic financial balance can be expected. The rate of growth in domestic liquidity is projected to continue decelerating in 1978/79 and the potential rise in the domestic cost of living is forecast to be significantly lower than the average annual rate for the past four years. Despite this generally favorable outlook the staff believes that further improvement is needed. As the planned level of credit increment for the private sector is moderate in terms of the need for expansion of activity in that sector, any adjustment will have to be borne by the Government's budget.

A further reduction in effective demand and the inflation rate is also needed to strengthen Iran's external accounts which are experiencing a weakening phase. The current account, which was in substantial surplus in 1976/77, is forecast to record a sizable deficit in 1978/79. This large turnaround is being caused by considerable increases in payments for imports of goods and services while oil receipts are not expected to increase. The performance of non-oil exports has been particularly disappointing as these exports have been falling in volume terms. In order to limit reserves losses in 1978/79, substantial gross drawings on external loans are intended. Considering Iran's comfortable reserves position and a very low external debt service ratio, neither the forecast overall deficit nor the proposed borrowings abroad constitute cause for concern. Over the medium term, however, the official policy should be directed at altering the divergent trends between receipts and payments. In this regard, the authorities have indicated that Iran intends to pursue over the medium term a flexible exchange rate policy to reduce its dependence on the oil sector.

There are indications that the steep rates of inflation and wage increases experienced over the past few years have affected the domestic cost structure to the extent of causing difficulties for the non-oil export sector and import competing industries, although the rial has been, for all practical purposes, pegged to the U.S. dollar and the effective exchange rate as measured by the import weighted index has declined by about 6 per cent during 1977/78. The authorities have recently provided additional protection, through increased commercial benefit taxes, to domestic industry coupled with incentives to promote non-oil exports. The staff believes that adjustment policies, including a tightened fiscal stance, would need to be taken to strengthen the external position without recourse to restrictions.

V. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. This decision is taken by the Executive Board in concluding the 1978 consultations with Iran pursuant to Article XIV, Section 3.

2. Iran maintains a liberal policy relating to current payments and transfers. The Fund hopes that this policy will be maintained and that Iran will terminate its bilateral payments arrangement with one Fund member.

Fund Relations with Iran

Iran joined the Fund in 1945. The original quota was equivalent to SDR 25 million and the present quota is SDR 660 million. At the end of July 1978, Fund holdings of Iranian rials were equivalent to 88.8 per cent of quota. Iran has lent the Fund the equivalent of SDR 990 million for the Oil Facility (of which SDR 805.3 million was still outstanding at end-July 1978), agreed to contribute SDR 6 million to the Subsidy Account, and to lend the Fund the equivalent of SDR 685 million for the Supplementary Financing Facility. Iran has acquired 82,163 fine ounces of gold in the first two phases of distribution.

Iran is a participant in the Special Drawing Account and has received allocations totaling SDR 61.9 million. On July 31, 1978, Iran's holdings of special drawing rights were equivalent to 127.0 per cent of net cumulative allocations. Iran is included in the current (June-August) operational budget for SDR 12 million and in the current designation plan for SDR 22 million.

The Iranian rial is pegged to the SDR on the basis of the rate SDR 1 = Rls 82.2525. Fund holdings and transactions in rials are valued on the basis of a representative rate determined as the midpoint between the Central Bank of Iran's buying and selling rates for the U.S. dollar (the intervention currency) which are currently Rls 70.35 and Rls 70.60 per US$1, respectively.

Iran continues to avail itself of the transitional provisions of Article XIV.

The 1977 Article XIV discussions took place in Teheran during the period February 12-16, 1977 (SM/77/103). The Executive Board's decision (Decision No. 5440-77/83) adopted on June 10, 1977 was as follows:

> 1. This decision is taken by the Executive Directors in concluding the 1977 consultations with Iran pursuant to Article XIV, Section 4, of the Articles of Agreement.
>
> 2. The Iranian economy has continued to experience a high rate of economic growth. Real non-oil GDP increased by 18 per cent in 1975/76 and strong growth rates were recorded in the major sectors. However, an aggregate imbalance persists in the economy due to the impact of substantial public sector domestic expenditures. While expanding supply availabilities, the policy emphasis in Iran is to restore domestic equilibrium gradually through appropriate demand management policies. The successful implementation of these policies is expected to permit a relaxation of price regulations and to encourage the private sector to resume playing a role commensurate with its potential.

3. Iran made a rapid adjustment in its external position during 1975/76. Although transportation constraints resulted in a reduced growth of imports in 1976/77 and a sizable external surplus is estimated, the rationalization of port conditions will permit external resources to make an increased contribution to the elimination of domestic imbalance in the current year. The Fund believes that Iran's external policies are appropriate in present circumstances, and that, in particular, official policies toward the maintenance of Iran's foreign investment, loan and aid programs are commendable and consistent with domestic objectives. The Fund hopes that Iran will continue its policy of trade liberalization and that steps will be taken to terminate Iran's bilateral payments agreement with a Fund member.

Iran: Basic Data

Population	35.8 million (1978 mid-year estimate)
Annual population growth	2.7 per cent (estimate)
GNP per capita (current prices) 1977/78	US$2,127

IMF data (end of July 1978)	
Currency	Iranian rial, Rls 70.475 = US$1
Quota	SDR 660 million
Fund holdings of Iranian rials	88.8 per cent of quota
Lending to the Fund	SDR 805.3 million
SDR allocation	SDR 61.9 million
SDR holdings	127.0 per cent of net cumulative allocation

Year ended March 20	1974/75	1975/76	1976/77	1977/78
	(In billions of Iranian rials)			
National accounts (at constant 1974/75 prices)				
Gross domestic product (factor cost)	3,070.8	3,149.3	3,512.6	3,575.7
Rate of growth in per cent	(6.8)	(2.6)	(11.5)	(1.8)
Non-oil sector	1,629.2	1,884.8	2,128.0	2,290.8
Agriculture	(303.3)	(324.0)	(341.7)	(339.0)
Industry	(436.8)	(535.8)	(615.2)	(668.8)
Services	(889.1)	(1,025.0)	(1,171.1)	(1,283.0)
Oil sector	1,441.6	1,264.5	1,384.6	1,284.9
Consumption plus gross domestic fixed capital formation	2,347.9	2,879.1	3,102.0	3,285.6
Private sector consumption	(1,157.6)	(1,275.7)	(1,283.4)	(1,429.7)
Public sector consumption	(628.3)	(722.5)	(796.0)	(786.0)
Private sector gross domestic fixed capital formation	(225.2)	(420.9)	(490.6)	(439.0)
Public sector gross domestic fixed capital formation	(336.8)	(460.0)	(532.0)	(630.9)
	(In per cent)			
Price indices (1974/75 = 100)				
Wholesale prices	100.0	105.3	119.5	136.9
Rate of change	17.0	5.3	13.5	14.6
Cost of living	100.0	109.9	128.1	160.2
Rate of change	15.5	9.9	16.6	25.1

Iran - Basic Data (continued)

Year ended March 20	Actuals 1974/75	1975/76	1976/77	Prelim. 1977/78	Budget 1978/79	Projected Outcome 1978/79
	(In billions of Iranian rials)					
Government finances						
Revenue, of which	1,419.1	1,617.6	1,883.1	2,101.1	2,396.0	2,396.0
Oil and gas revenue	(1,205.2)	(1,246.8)	(1,421.5)	(1,497.8)	(1,541.8)	(1,541.8)
Expenditure, of which	1,279.1	1,604.9	1,920.7	2,489.6	2,832.3 1/	2,814.6
Fixed capital expenditures	(348.7)	(526.8)	(684.1)	(959.4)	(1,231.6)	(1,231.6)
Overall surplus or deficit (-) 2/	140.0	12.7	-37.6	-388.5	-436.3	-418.6
Financing	-302.0	-252.2	-149.4	308.0	436.3	418.6
External financing (net)	(-210.2)	(-180.4)	(-87.9)	(-60.5)	(56.5)	(56.5)
Domestic financing (net)	(-91.8)	(-71.8)	(-61.5)	(368.5)	(379.8)	(362.1)

	1974/75	1975/76	1976/77	1977/78	Projection 1978/79
A. Changes in: Foreign assets (net)	351.3	-49.9	104.6	118.7	-70.0
B. Changes in: Domestic assets (net)	-57.0	385.3	343.4	384.8	615.0
Claims on private sector	210.4	387.9	424.1	352.2	429.0
Claims on public sector (net)	-26.8	41.2	19.7	227.9	426.0
Central Government (net)	(-95.7)	(-80.3)	(-68.2)	(351.4)	(342.0)
Government agencies (net)	(66.9)	(121.5)	(87.9)	(-123.5)	(84.0)
Other items (net) (increase -)	-240.6	-43.8	-100.4	-195.3	-240.0
C. Changes in: Money and quasi-money (A+B=D+E+F)	294.3	335.4	448.0	503.5	545.0
Rate of increase (in per cent)	(57.1)	(41.4)	(39.1)	(31.6)	(26.0)
D. Public sector net domestic expenditure	501.2	594.2	810.3	1,017.8	--
E. Monetary impact of private sector operations	-91.0	-151.8	-214.2	-307.5	--
F. Other (net)	-115.9	-107.0	-148.1	-206.8	--

(In millions of SDRs)

	1974/75	1975/76	1976/77	1977/78	Projection 1978/79
A. Net receipts from the oil sector	15,302	15,771	17,806	17,557	17,528
B. Other goods and services	-8,256	-13,321	-14,179	-16,356	-19,390
Exports	573	543	569	666	762
Imports	-8,793	-13,410	-13,958	-15,214	-17,782
Private sector	(-4,156)	(-6,374)	(-6,873)	(-7,240)	(-8,298)
Public sector	(-4,637)	(-7,036)	(-7,085)	(-7,974)	(-9,484)
Services (net)	-36	-454	-790	-1,808	-2,371
C. Total (A+B)	7,046	2,450	3,627	1,201	-1,862
D. Nonmonetary official capital (net)	-1,636	-2,608	-1,552	851	1,100
E. Errors and omissions	-996	-672	688	-104	--
F. Overall balance	4,414	-830	2,763	1,948	-762
G. Monetary movements (increases)	-4,414	830	-2,763	-1,948	762

Iran - Basic Data (concluded)

	1974/75	1975/76	1976/77	1977/78
	(In millions of SDRs)			
Foreign assets (end of period)				
International reserves	6,679.1	6,952.2	8,933.2	10,094.0
Central Bank net foreign assets	6,534.1	6,335.1	8,340.5	9,569.3

1/ Reduced by Rls 150 billion representing the expected shortfall when the budget was approved.

2/ Overall surplus or deficit differs from total financing as derived for the monetary and balance of payments accounts due to data discrepancies.

Date: 10/11

		Rec'd	Fwd'
~~Shaalan, A.S.~~	3-314		
Ray, A.S.	3-320		
Selehdar, A.K. El	3-320		
Gerakis, A.S.	3-401		
Crockett, A.D.	3-314		
von Post, S.	3-300		
Mediterranean Div.			
Karamali, B.A.	3-300		
Abed, G.	"		
Blalock, J.	"		
Kawar, S.	"		
Red Sea Division			
~~Hitti, S.H.~~	3-300		
Al-Khuri, S.	"		
Borpujari, J.	"		
Nashashibi, K.	"		
Noursi, D.	"		
Thayanithy, S.	"		
Northern Div.			
Yaqub, M.	3-214		
Boxall, P.	"		
Kayoumy, A.	"		
Nsouli, S.	"		
Vaez-Zadeh, M. (YP)	"		
Southern Division			
Drees, F.	3-401		
Barth, R.	"		
Jakubiak, H.	"		
Niebling, M.	"		
Dahl, G. (YP)	"		
Khan, J.	"		

FILES 3-314

Remarks

J. Shaalan

Orig: Mr. Shaalan/Mr. Hitti
cc: Mr. Yaqub/Mr. Nsouli

Office Memorandum

TO : The Managing Director DATE: October 10, 1978

FROM : Leo Van Houtven

SUBJECT : Your Summing Up on the Consultation with Iran

There is attached the text of your summing up at the conclusion of the Article IV consultation with Iran, including the drafting suggestions you made to me at the end of the meeting, plus some very minor editorial points.

Mr. Shaalan has some difficulty with the text and proposes the following changes:

a) In line 3: he wishes to change "the excellent development record" to read "the high rate of growth". Mr. Shaalan believes that the proposed change more adequately describes the situation in Iran;

b) In line 6: Mr. Shaalan would wish to delete the words "quite courageously", but he added that he would not press that point;

c) Mr. Shaalan suggests the elimination of the last paragraph because he feels it does not belong in the summing up.

I have pointed out to Mr. Shaalan that thus far you have been rather successful in resisting verbal changes that Executive Directors have proposed in your summings up; that you have emphasized repeatedly to the Board and to individual Executive Directors that the summing up is, first of all, the Chairman's responsibility and, that it should not become excessively formalized lest one fall back into the "straight jacket" of decision language. I then pointed out to Mr. Shaalan that, if we now start ourselves introducing changes in your summing up this would open the door to Executive Directors to do precisely what you wish to avoid. Mr. Amuzegar has a good memory and he would note the introduction of the suggested changes.

Mr. Shaalan has requested that I bring this matter up for your decision. Perhaps you could consider changing "the excellent development record" to "the excellent growth record"; and you may wish to consider changing the last clause of the sentence in the final paragraph to read "which should be the subject of further analytical study and discussions with the authorities of Iran".

Mr. Shaalan has seen the draft of this memorandum.

Attachment

cc: Deputy Managing Director
Mr. Shaalan
Mr. Ware

INTERNATIONAL MONETARY FUND

The Chairman's Summing Up at the Conclusion of the
1978 Article IV Consultation with Iran
Executive Board Meeting 78/153 - October 6, 1978

In concluding this wide-ranging and interesting discussion on the 1978 Article IV consultation with Iran, I will sum up briefly by saying that the Executive Directors noted the excellent development record achieved by Iran over many years, and have commended the Iranian authorities on the success they have attained so far in moderating inflationary pressures in the economy while at the same time lifting quite courageously price controls. The Directors, who generally agreed with the thrust of the views expressed in the staff appraisal, also viewed with satisfaction the important contribution made by Iran to the resolution of the problem of imbalances in international payments through a dynamic investment policy, and a continued liberal system of payments.

Directors believed that as the balance of payments was entering a weakening phase, it had been prudent for the Iranian authorities to implement a new policy directed toward a more sustainable rate of growth. Some Directors believed that in that light it might be prudent for the authorities to take further steps to reduce domestic demand and inflationary pressures, in particular through appropriate fiscal and credit policies. Various Directors stressed the importance of reaching a more harmonious and balanced structure of growth.

I should also note that several Directors have commented on the Iranian policy of protecting domestic industries; it is intended that an analytical study of this problem will be carried out.

INTERNATIONAL MONETARY FUND

TO :

FROM:

June 12,

I have borrowed

this. (R.C.D. 1978 for Iran SM/78/239)

Sandy Mackenzie

FOR AGENDA

SM/78/235

CONTAINS CONFIDENTIAL
INFORMATION

September 5, 1978

To: Members of the Executive Board

From: The Secretary

Subject: Iran - Staff Report for the 1978 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1978 Article IV consultation with Iran. A draft decision pursuant to Article XIV appears on page 11.

This subject will be brought to the agenda for discussion on a date to be announced.

Att: (1)

Other Distribution:
Department Heads

CONTAINS CONFIDENTIAL INFORMATION

INTERNATIONAL MONETARY FUND

IRAN

Staff Report for the 1978 Article IV Consultation

Prepared by Staff Representatives for the 1978 Consultation with Iran

Approved by A. S. Shaalan and S. Mookerjee

September 1, 1978

I. Introduction

In accordance with established procedures, the 1978 Article IV consultation discussions with Iran were held in Teheran during the period July 8-16, 1978. The Iranian representatives were led by H.E. Mohammad Yeganeh, Minister of Economic Affairs and Finance, H.E. Manuchehr Agah, Minister of State and Director of the Plan and Budget Organization, and H.E. Youssef Khoshkish, Governor, Central Bank of Iran, and included senior officials of government departments and agencies. The mission was composed of Messrs. A. S. Shaalan, S. H. Hitti, S. M. Nsouli, P. Boxall (all of MED), Z. Iqbal (ETR), and Ms. P. Curtis (secretary). Mr. J. Amuzegar, Executive Director for Iran, attended some of the meetings. Iran continues to avail itself of the transitional provisions of Article XIV.

II. Background

The steep increases in oil prices in 1973-74 enabled the Government of Iran to expand sharply its expenditures for both current and development purposes. In 1974/75 (Iranian year ended March 20) the Central Government almost tripled its current expenditures and doubled its capital expenditures. This led to a considerable stimulation of private sector economic activity and a substantial expansion in private sector credit. Although the level of imports more than doubled as a result, the balance of payments current account registered a record surplus exceeding SDR 7 billion. The rate of expansion of domestic liquidity (money plus quasi-money) accelerated sharply and reached 57 per cent reflecting mainly the large increase in the Government's net domestic expenditures. With the sudden surge in aggregate demand, infrastructural bottlenecks emerged and the consequent supply/demand imbalance caused the rate of inflation to rise steeply. During 1975/76, 1976/77, and the early part of 1977/78, government policy aimed at reducing excess demand pressures and limiting the increases in prices while pursuing high growth targets with a view to diversifying the production base of the Iranian economy. The Central Government severely limited the growth of its current expenditures. Capital expenditures, however, were increased substantially with the aim of alleviating the infrastructural bottlenecks and accelerating the growth of the non-oil sector. Throughout this period, the real rate of GDP fluctuated considerably, reflecting mainly changes in oil sector output levels resulting from movements in world demand. Non-oil GDP value added at constant prices grew at a fast pace, led by the service and industrial sectors. During 1974/75-1976/77, non-oil GDP grew at an average annual rate of about 16 per cent.

Monetary policy became progressively tighter. During 1975/76 and 1976/77 the rate of growth of domestic liquidity dropped to an annual average of about 40 per cent mainly as a result of a slowdown in the injection of domestic liquidity by the public sector and as credit to the private sector decelerated in the latter year in response to the strict limitations on credit expansion imposed by the Central Bank. The restrained fiscal and monetary policies were accompanied by the introduction of comprehensive price controls in 1975. Mainly as a result of strict implementation of the controls, the rate of growth in the cost of living was reduced from 16 per cent in 1974/75 to 10 per cent in 1975/76. To avoid, however, excessive distortional forces from arising, the controls were relaxed somewhat and the cost of living was allowed to rise by almost 17 per cent in 1976/77. In 1977, the Government decided to lift the price controls almost completely. In view of the pent-up forces, this led to a sharp acceleration in the cost of living index in the earlier part of 1977/78. In the external sector, a modest deficit emerged in 1975/76. This reflected a sharp decline in the current account surplus, as substantial progress was made in alleviating the bottlenecks impeding the flow of goods from abroad, as well as net official capital outflows from Iran that peaked at around SDR 2.6 billion. The balance of payments reverted to a surplus position in 1976/77, partly due to a decline in net capital outflows.

Iran has a liberal exchange system. Since January 1974, dual exchange markets have been in operation within the banking system consisting of a commercial market (encompassing oil receipts and imports) where the official rial/U.S. dollar rate is applicable, and a noncommercial market where rates can, in theory, fluctuate freely in response to supply/demand conditions. The Central Bank of Iran, however, has intervened in the noncommercial market through sales of foreign exchange. Consequently, except for a few months after the introduction of the dual markets, the rial/U.S. dollar rate has been the same in the two markets. The size of the noncommercial market has expanded sharply and was the equivalent of US$4.2 billion in 1977/78 or about 20 per cent of the total foreign exchange transactions.

On February 12, 1975, Iran ceased pegging the rial to the U.S. dollar and linked it to the SDR on the basis of the rate of Rls 82.2425 = SDR 1, with wider margins of 2.25 per cent around that rate. The practice adopted was to change the rial/U.S. dollar rate whenever it remained outside the margins for five consecutive business days. On December 14, 1977, the Iranian authorities discontinued this practice in order to avoid appreciating against the dollar. On April 1, 1978, the margins around the rial/SDR rate were enlarged to 7.25 per cent; this permitted the authorities to avoid changing the rate for the U.S. dollar in terms of the Iranian rial despite the continuing depreciation of the U.S. currency. This margin was abolished effective July 31, 1978. A target zone above and below the central rate has been established based on the relative purchasing power of the rial vis-a-vis that of the currencies of Iran's major trading partners and on other basic underlying economic conditions. Iran maintains a number of bilateral payments agreements including one with a Fund member, Romania. Some payments are made through clearing accounts maintained with Turkey and Pakistan under the Regional Cooperation and Development Agreement. Iran also is a participant in the Asian Clearing Union. Iran's trade system, like those of a number of developing countries, accords considerable protection to domestic industry.

The pursuit of a high growth strategy made the task of re-establishing financial balance difficult. As a result, there was a shift in the Government's economic policy in mid-1977/78. The Cabinet which was formed in August 1977 declared the policy objective of re-establishing financial balance while aiming at "absorbable growth" targets. The consultation review centered on the progress made in 1977/78 or likely to be realized in 1978/79 toward achieving these objectives.

III. Report on the Discussions

1. Output, investments, prices and wages

There was a substantial slowdown in the level of economic activity in Iran during 1977/78. The overall rate of growth of real GDP fell to less than 2 per cent reflecting a 7 per cent decrease in value added in the oil sector in combination with growth in the non-oil sector decelerating to 7.6 per cent. Another aspect of the slowdown was indicated by the decline of over 10 per cent in private sector investment in real terms. The Iranian representatives said that low rainfall in the crop growing areas had adversely affected agricultural production in 1977/78. Construction activity started to decelerate early in the year in response to a temporary regulation, prohibiting the construction of large apartments and limiting the rise in the price of land to a rate to be set each year by the Government. For the manufacturing industries, the price controls, coupled with a steep increase in costs, had caused a profit squeeze which contributed to the slack in industrial activity and investment. In addition, the shortages of electricity adversely affected the growth in manufacturing output. With regard to the prospects for 1978/79, the Iranian representatives stated that there was not likely to be an increase in oil production. In the non-oil sector, however, output was expected to recover showing a growth of about 9 per cent in real terms. In the last quarter of 1977/78 private construction starts and industrial output and investments began to recover stimulated by the lifting of price controls. Public sector investment outlays were anticipated to continue exhibiting an upward trend. However, priority would be given to completing the ongoing projects before commencing new projects as the authorities were now aware that once again financial constraints had become operative in Iran and there was a need to establish priorities more carefully and to eliminate waste.

The Iranian representatives stated that price controls would be limited to a few necessities, mainly foodstuffs, while the prices of all other goods would be determined by market forces. The lifting of the controls, combined with continuing demand pressures, had resulted in the cost of living index rising by 25 per cent in 1977/78; the highest rate of increase recorded for many years. The Iranian representatives pointed out, however, that the rate of price increase had started decelerating im mid-1977/78 and had continued this trend during the first quarter of 1978/79. Despite these favorable indications, the Iranian authorities were maintaining a cautious attitude as the recent price developments were brought about mainly by the substantial slowdown in the rate of increase of the subindex for housing and further evidence was needed to ascertain that the apparent reduction in the rate of inflation was more than a temporary phenomenon. Wage rates in the manufacturing sector continued to increase, albeit at a lower rate, and wages in real terms probably did not rise during 1977/78. The policy of wage restraints was continuing and overall the rate of inflation in 1978/79 was anticipated to be significantly more moderate than in the past.

2. Fiscal policy

The trend for substantially higher growth rates in public expenditures than in revenues continued in 1977/78; revenues grew by nearly 12 per cent while total expenditures expanded by almost 30 per cent. The overall deficit of Rls 389 billion (equal to 7.5 per cent of GDP) that emerged was financed primarily by a change in the net position of the Government vis-a-vis the domestic banking system amounting to Rls 351 billion while net borrowing from domestic nonbank sources was relatively small. On a net basis, Iran continued to acquire foreign assets in 1977/78. Turning to the budget for 1978/79, the Iranian representatives indicated that the projected revenue level was realistic and would be attained. On the expenditure side, the budget provided for a 36 per cent rise in current expenditures and a 28 per cent increase in capital outlays.

Subsequent to the approval of the budget, the Iranian authorities decided that the budget allocations were on the high side and consequently government policy now was to implement the budget in a manner that would ensure substantial savings. Directives had been sent to all ministries to institute austerity measures; in particular, the hiring of new civil servants would be severely limited. The growth in current ordinary expenditures in the first quarter of the year had been limited to 18 per cent and it was anticipated that the growth rate in current expenditures for the year as a whole would be constrained to about that rate. This would reflect mainly the rise in salaries and fringe benefits granted to civil servants in mid-1977/78. With regard to capital expenditures, the authorities noted that in recent years the absorptive capacity of the economy had expanded considerably and that, as a result, development expenditures might well approximate the budget allocations. Commitments made in the past would be implemented and capital outlays were being directed to ongoing projects. With regard to contingent expenditures and advance payments, the Ministry of Finance intended to limit disbursements in 1978/79 under this heading to a very small amount. The anticipated revised overall deficit in 1978/79, at about Rls 420 billion, is somewhat lower than the deficit implied in the budget estimates but will still require continued heavy reliance on net borrowing from the domestic banking system. The financing of the deficit also implies a turnaround in the Government's net foreign operations into substantial net borrowing abroad. The authorities stated that they were concerned about the possible inflationary impact of the budget and that every effort was being made to minimize the contribution of public expenditures to excess demand pressures in the economy. The transition, however, to a more restrained fiscal policy had to be effected at a moderate pace if undesirable disruptions were to be avoided.

3. Monetary and credit policies

There was a further slowdown in the rate of growth of domestic liquidity during 1977/78 to about 32 per cent reflecting a considerable deceleration in the rate of growth of credit to the private sector while net credit to the public sector increased sharply. Net foreign assets grew by a smaller amount than in the previous year. As in recent years, the net domestic expenditures of the public sector had had a strong expansionary impact while the net operations of the private sector had had a net contractionary effect on domestic liquidity.

The Iranian representatives explained that the monetary authorities had followed a tight credit policy in 1977/78. The Central Bank had taken various measures but the principal instrument used continued to be quantitative ceilings on credit expansion. Commercial bank credit to the private sector, however, did not reach the ceiling as the slowdown in the economic activity as well as the decline in real estate speculation tended to dampen the demand for loans. By contrast, the specialized banks, which financed long-term investment, exceeded marginally their ceiling. This was caused by the pickup in activity during the last quarter of the year. Overall, credit to the private sector rose by 22 per cent in 1977/78 as compared with 39 per cent in the preceding year.

Turning to the prospects and policies for 1978/79, the authorities indicated that the Central Bank intended to continue pursuing tight policies and relying on quantitative credit controls. The Central Bank had set a ceiling on commercial bank credit to the private sector at 20 per cent, and on specialized banks at 25 per cent, above the end-1977/78 levels. Based on the expected budgetary and balance of payments outcomes and the credit policy currently pursued, a rate of increase in domestic liquidity of about 26 per cent is projected for 1978/79. The mission commented that statistical analysis suggested that the excess liquidity created during the past five years had been substantially absorbed. Accordingly, while monetary policy for 1978/79 probably did not need to compensate for a significant liquidity overhang, it needed to be sufficiently tight to ensure that inflationary pressures would not re-emerge. While the projected rate of increase in domestic liquidity for 1978/79 constituted an improvement over the previous year, it was substantially in excess of the anticipated real growth rate in non-oil income. The mission therefore suggested that some further moderation in monetary expansion be achieved mainly through a curtailment in the public sector's expansionary impact.

4. Balance of payments developments and policies

Iran experienced in 1977/78 a 30 per cent decline in the overall surplus from the previous year's level. Receipts from oil remained virtually unchanged as the export volume fell by about 7 per cent. Current payments, on the other hand, rose by about 15 per cent because of a more than doubling of net service payments and higher imports. Consequently, the current account surplus declined by over SDR 2.4 billion to SDR 1.2 billion. Reversing the pattern of the past three years, the nonmonetary capital account registered a net surplus of SDR 851 million in 1977/78 on account of a tripling of drawings on loans from abroad combined with a substantially reduced level of foreign investments and disbursements of loans by Iran. As the increase in the capital account did not compensate for the decline in the current account surplus, the overall surplus decreased to about SDR 2 billion. The Iranian representatives attributed the sharp rise in net service payments partly to a substantial increase in the remittances of foreign workers. Expenditures on travel and shipping had also gone up and a large amount of demurrage charges was settled in 1977/78. While all these factors had contributed to the steep rise in net service payments, the Iranian representatives said that service payments data included some private capital outflows generated in part by a decline in investment opportunities in Iran.

The official projections for 1978/79 showed net receipts from the oil sector remaining unchanged, import payments increasing by about 17 per cent to sustain the expansion in the Government's investment program and the resurgence of private investment and a further considerable increase in net service payments. As a result of the disparity between rising payments and stagnant receipts, the current account balance was expected to undergo a reversal to a deficit of nearly SDR 2 billion in 1978/79. The capital account, on the other hand, was forecast to register a substantial increase in net inflows. The net surplus in the capital account, however, was not expected to offset fully the projected current account deficit. Consequently an overall deficit of almost SDR 800 million was projected representing a decline of almost SDR 3 billion from the previous year's outcome.

The mission observed that in view of Iran's comfortable foreign exchange reserves position, the modest external deficit projected for 1978/79 was not disturbing. However, barring unusual circumstances, oil receipts were not expected to rise faster than in the recent past and the performance of the non-oil exports had been adversely affected as a consequence of a sharp rise in domestic costs. Imports of goods and services were expected to continue rising at a fast rate. It was possible for some time to finance a widening current account deficit through drawdowns on external reserves and through enlarged foreign borrowing as the debt service ratio was still quite low. Such financing, however, could not be sustained for long and consequently corrective measures appeared to be needed. The Iranian authorities agreed with this assessment and indicated that they would keep the economic situation under review and would consider what corrective measures might be required.

5. Exchange and trade policies

Since the previous discussions no changes have been made in the regulations governing current payments, which continue to be liberal. The noncommercial exchange market was fed in 1977/78 by a transfer of US$2.1 billion from Bank Markazi which made it possible to maintain unified rial/U.S. dollar rates in the official and noncommercial markets. The authorities stated that they intended to continue sustaining the noncommercial market so long as demand in that market does not expand abnormally in which case that policy would have to be reappraised.

The authorities stated that they had enlarged the margins to 7.25 per cent in the hope of avoiding the need for an adjustment in the rial/U.S. dollar rate. On July 6, 1978 the actual rial/SDR rate exceeded the upper margin of the expanded band, and remained outside the margins after July 24, 1978. However, in accordance with the discontinuation of the practice requiring exchange rate adjustment after five consecutive business days of the actual rate remaining outside the margins, the authorities indicated that they were not inclined to appreciate the rial vis-a-vis the U.S. dollar. As indicated above, effective July 31, 1978, Iran abolished the margins of 7.25 per cent.

The Iranian representatives stated that there had been no change in the government policy toward the bilateral payments agreement with Romania which they indicated continued to be needed for conducting trade with a socialist country. A recently concluded credit payments agreement with Turkey was necessitated by the special relationship between the two countries. The authorities were urged to terminate the bilateral arrangements currently in effect, especially the one with a Fund member.

The mission noted that since the last consultation discussions there had been an intensification in trade restrictions. Certain cotton textiles had been banned and commercial benefit taxes increased on a large number of commodities. The Iranian authorities indicated that with the exception of the cotton textiles, the list of imports subject to prior approval and its application had remained unchanged. They also stated that in some cases commercial benefit taxes had been reduced. Reflecting the intention of removing some commodities from the prior approval list this year, commercial benefit taxes were raised on a number of commodities for both revenue and protection considerations. The revenue aspect had become relatively less important after the sharp increases in oil receipts. However, as the budget deficits had re-emerged, the need for higher revenues contributed to the decision to raise these taxes. At the same time there was a greater need for import protection and therefore these taxes were raised mainly on imports which had domestic substitutes.

The weak performance of non-oil exports had been partly due to the strong domestic demand which decreased export availabilities, and the sharp rise in domestic costs. To offset the latter factor, the Government was now providing various incentives, including the preferential provision of services and credit, customs duties rebates, and income tax exemptions. The Iranian representatives stated that the Government was in the process of reviewing the pattern of export incentives. A comprehensive study was under way to draw up policies to rationalize the incentives system.

Concerning Iran's reserve management policy, the Iranian representatives stated that there had been no change in the official policy and thus, it continued to be guided by considerations of safety, currency distribution, and terms. In view of its balance of payments situation, Iran was keeping a large proportion of its reserves in liquid assets. On June 30, 1978, Iran's reserves stood at SDR 9,736 million equal to about eight months of imports at the 1977/78 level.

IV. Staff Appraisal

Iran has absorbed the vastly expanded oil revenues and thereby has made a contribution to the resolution of the imbalance in international payments arising from the sharp rise in oil prices. In the process, a substantial overheating of the economy occurred despite considerable success in removing the supply constraints which impeded the flow of resources from abroad and the expansion of domestic output. Under these circumstances, the Iranian authorities resorted to price controls which were strictly enforced in the first instance, but were gradually relaxed and virtually eliminated recently. Through this mechanism and the maintenance of a fairly liberal import policy, the authorities limited the immediate price impact of the excess demand pressures that emerged and spread it over approximately four years. The economy is now passing through a transitional phase toward a sustainable level of activity in conditions of relative financial stability.

With the virtual elimination of price controls in 1977/78, the price indices rose sharply in response to the pent-up demand. The data also show that a slowdown in the rate of inflation commenced in mid-1977/78 and appears to be continuing. The financial outlook for 1978/79 reveals that some further progress in restoring domestic financial balance can be expected. The rate of growth in domestic liquidity is projected to continue decelerating in 1978/79 and the potential rise in the domestic cost of living is forecast to be significantly lower than the average annual rate for the past four years. Despite this generally favorable outlook the staff believes that further improvement is needed. As the planned level of credit increment for the private sector is moderate in terms of the need for expansion of activity in that sector, any adjustment will have to be borne by the Government's budget.

A further reduction in effective demand and the inflation rate is also needed to strengthen Iran's external accounts which are experiencing a weakening phase. The current account, which was in substantial surplus in 1976/77, is forecast to record a sizable deficit in 1978/79. This large turnaround is being caused by considerable increases in payments for imports of goods and services while oil receipts are not expected to increase. The performance of non-oil exports has been particularly disappointing as these exports have been falling in volume terms. In order to limit reserves losses in 1978/79, substantial gross drawings on external loans are intended. Considering Iran's comfortable reserves position and a very low external debt service ratio, neither the forecast overall deficit nor the proposed borrowings abroad constitute cause for concern. Over the medium term, however, the official policy should be directed at altering the divergent trends between receipts and payments. In this regard, the authorities have indicated that Iran intends to pursue over the medium term a flexible exchange rate policy to reduce its dependence on the oil sector.

There are indications that the steep rates of inflation and wage increases experienced over the past few years have affected the domestic cost structure to the extent of causing difficulties for the non-oil export sector and import competing industries, although the rial has been, for all practical purposes, pegged to the U.S. dollar and the effective exchange rate as measured by the import weighted index has declined by about 6 per cent during 1977/78. The authorities have recently provided additional protection, through increased commercial benefit taxes, to domestic industry coupled with incentives to promote non-oil exports. The staff believes that adjustment policies, including a tightened fiscal stance, would need to be taken to strengthen the external position without recourse to restrictions.

V. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. This decision is taken by the Executive Board in concluding the 1978 consultations with Iran pursuant to Article XIV, Section 3.

2. Iran maintains a liberal policy relating to current payments and transfers. The Fund hopes that this policy will be maintained and that Iran will terminate its bilateral payments arrangement with one Fund member.

Fund Relations with Iran

Iran joined the Fund in 1945. The original quota was equivalent to SDR 25 million and the present quota is SDR 660 million. At the end of July 1978, Fund holdings of Iranian rials were equivalent to 88.8 per cent of quota. Iran has lent the Fund the equivalent of SDR 990 million for the Oil Facility (of which SDR 805.3 million was still outstanding at end-July 1978), agreed to contribute SDR 6 million to the Subsidy Account, and to lend the Fund the equivalent of SDR 685 million for the Supplementary Financing Facility. Iran has acquired 82,163 fine ounces of gold in the first two phases of distribution.

Iran is a participant in the Special Drawing Account and has received allocations totaling SDR 61.9 million. On July 31, 1978, Iran's holdings of special drawing rights were equivalent to 127.0 per cent of net cumulative allocations. Iran is included in the current (June-August) operational budget for SDR 12 million and in the current designation plan for SDR 22 million.

The Iranian rial is pegged to the SDR on the basis of the rate SDR 1 = Rls 82.2525. Fund holdings and transactions in rials are valued on the basis of a representative rate determined as the midpoint between the Central Bank of Iran's buying and selling rates for the U.S. dollar (the intervention currency) which are currently Rls 70.35 and Rls 70.60 per US$1, respectively.

Iran continues to avail itself of the transitional provisions of Article XIV.

The 1977 Article XIV discussions took place in Teheran during the period February 12-16, 1977 (SM/77/103). The Executive Board's decision (Decision No. 5440-77/83) adopted on June 10, 1977 was as follows:

> 1. This decision is taken by the Executive Directors in concluding the 1977 consultations with Iran pursuant to Article XIV, Section 4, of the Articles of Agreement.
>
> 2. The Iranian economy has continued to experience a high rate of economic growth. Real non-oil GDP increased by 18 per cent in 1975/76 and strong growth rates were recorded in the major sectors. However, an aggregate imbalance persists in the economy due to the impact of substantial public sector domestic expenditures. While expanding supply availabilities, the policy emphasis in Iran is to restore domestic equilibrium gradually through appropriate demand management policies. The successful implementation of these policies is expected to permit a relaxation of price regulations and to encourage the private sector to resume playing a role commensurate with its potential.

3. Iran made a rapid adjustment in its external position during 1975/76. Although transportation constraints resulted in a reduced growth of imports in 1976/77 and a sizable external surplus is estimated, the rationalization of port conditions will permit external resources to make an increased contribution to the elimination of domestic imbalance in the current year. The Fund believes that Iran's external policies are appropriate in present circumstances, and that, in particular, official policies toward the maintenance of Iran's foreign investment, loan and aid programs are commendable and consistent with domestic objectives. The Fund hopes that Iran will continue its policy of trade liberalization and that steps will be taken to terminate Iran's bilateral payments agreement with a Fund member.

Iran: Basic Data

Population	35.8 million (1978 mid-year estimate)
Annual population growth	2.7 per cent (estimate)
GNP per capita (current prices) 1977/78	US$2,127

IMF data (end of July 1978)	
Currency	Iranian rial, Rls 70.475 = US$1
Quota	SDR 660 million
Fund holdings of Iranian rials	88.8 per cent of quota
Lending to the Fund	SDR 805.3 million
SDR allocation	SDR 61.9 million
SDR holdings	127.0 per cent of net cumulative allocation

Year ended March 20	1974/75	1975/76	1976/77	1977/78
	(In billions of Iranian rials)			
National accounts (at constant 1974/75 prices)				
Gross domestic product (factor cost)	3,070.8	3,149.3	3,512.6	3,575.7
Rate of growth in per cent	(6.8)	(2.6)	(11.5)	(1.8)
Non-oil sector	1,629.2	1,884.8	2,128.0	2,290.8
Agriculture	(303.3)	(324.0)	(341.7)	(339.0)
Industry	(436.8)	(535.8)	(615.2)	(668.8)
Services	(889.1)	(1,025.0)	(1,171.1)	(1,283.0)
Oil sector	1,441.6	1,264.5	1,384.6	1,284.9
Consumption plus gross domestic fixed capital formation	2,347.9	2,879.1	3,102.0	3,285.6
Private sector consumption	(1,157.6)	(1,275.7)	(1,283.4)	(1,429.7)
Public sector consumption	(628.3)	(722.5)	(796.0)	(786.0)
Private sector gross domestic fixed capital formation	(225.2)	(420.9)	(490.6)	(439.0)
Public sector gross domestic fixed capital formation	(336.8)	(460.0)	(532.0)	(630.9)
	(In per cent)			
Price indices (1974/75 = 100)				
Wholesale prices	100.0	105.3	119.5	136.9
Rate of change	17.0	5.3	13.5	14.6
Cost of living	100.0	109.9	128.1	160.2
Rate of change	15.5	9.9	16.6	25.1

Iran - Basic Data (continued)

Year ended March 20	Actuals 1974/75	Actuals 1975/76	Actuals 1976/77	Prelim. 1977/78	Budget 1978/79	Projected Outcome 1978/79
	(In billions of Iranian rials)					
Government finances						
Revenue, of which	1,419.1	1,617.6	1,883.1	2,101.1	2,396.0	2,396.0
Oil and gas revenue	(1,205.2)	(1,246.8)	(1,421.5)	(1,497.8)	(1,541.8)	(1,541.8)
Expenditure, of which	1,279.1	1,604.9	1,920.7	2,489.6	2,832.3 1/	2,814.6
Fixed capital expenditures	(348.7)	(526.8)	(684.1)	(959.4)	(1,231.6)	(1,231.6)
Overall surplus or deficit (-) 2/	140.0	12.7	-37.6	-388.5	-436.3	-418.6
Financing	-302.0	-252.2	-149.4	308.0	436.3	418.6
External financing (net)	(-210.2)	(-180.4)	(-87.9)	(-60.5)	(56.5)	(56.5)
Domestic financing (net)	(-91.8)	(-71.8)	(-61.5)	(368.5)	(379.8)	(362.1)

	1974/75	1975/76	1976/77	1977/78	Projection 1978/79
A. Changes in: Foreign assets (net)	351.3	-49.9	104.6	118.7	-70.0
B. Changes in: Domestic assets (net)	-57.0	385.3	343.4	384.8	615.0
Claims on private sector	210.4	387.9	424.1	352.2	429.0
Claims on public sector (net)	-26.8	41.2	19.7	227.9	426.0
Central Government (net)	(-95.7)	(-80.3)	(-68.2)	(351.4)	(342.0)
Government agencies (net)	(66.9)	(121.5)	(87.9)	(-123.5)	(84.0)
Other items (net) (increase -)	-240.6	-43.8	-100.4	-195.3	-240.0
C. Changes in: Money and quasi-money (A+B=D+E+F)	294.3	335.4	448.0	503.5	545.0
Rate of increase (in per cent)	(57.1)	(41.4)	(39.1)	(31.6)	(26.0)
D. Public sector net domestic expenditure	501.2	594.2	810.3	1,017.8	--
E. Monetary impact of private sector operations	-91.0	-151.8	-214.2	-307.5	--
F. Other (net)	-115.9	-107.0	-148.1	-206.8	--

(In millions of SDRs)

	1974/75	1975/76	1976/77	1977/78	Projection 1978/79
A. Net receipts from the oil sector	15,302	15,771	17,806	17,557	17,528
B. Other goods and services	-8,256	-13,321	-14,179	-16,356	-19,390
Exports	573	543	569	666	762
Imports	-8,793	-13,410	-13,958	-15,214	-17,782
Private sector	(-4,156)	(-6,374)	(-6,873)	(-7,240)	(-8,298)
Public sector	(-4,637)	(-7,036)	(-7,085)	(-7,974)	(-9,484)
Services (net)	-36	-454	-790	-1,808	-2,371
C. Total (A+B)	7,046	2,450	3,627	1,201	-1,862
D. Nonmonetary official capital (net)	-1,636	-2,608	-1,552	851	1,100
E. Errors and omissions	-996	-672	688	-104	--
F. Overall balance	4,414	-830	2,763	1,948	-762
G. Monetary movements (increases)	-4,414	830	-2,763	-1,948	762

Iran - Basic Data (concluded)

	1974/75	1975/76	1976/77	1977/78
	(In millions of SDRs)			
Foreign assets (end of period)				
International reserves	6,679.1	6,952.2	8,933.2	10,094.0
Central Bank net foreign assets	6,534.1	6,335.1	8,340.5	9,569.3

1/ Reduced by Rls 150 billion representing the expected shortfall when the budget was approved.

2/ Overall surplus or deficit differs from total financing as derived for the monetary and balance of payments accounts due to data discrepancies.

The Acting Managing Director August 25, 1978

A. S. Shaalan

Iran - Staff Report for the 1978 Article IV Consultations

Attached herewith for your approval is the Staff Report for the 1978 Article IV consultation held with Iran. This draft has been cleared with the Exchange and Trade Relations Department (Mr. Mookerjee), the Legal Department (Mr. Effros), the Treasurer's Department (Mr. Wittich), the Research Department (Mr. Rhomberg), the Fiscal Affairs Department (Mr. Radford), and the Bureau of Statistics (Mr. Swaminathan).

Attachment

cc: Mr. de Larosiere (upon return)
Mr. Ware

Mr. Amuzegar August 16, 1978

A.S. Shaalan

<u>Iran--Minutes of Meetings with Minitry of Commerce</u>

Attached please find minutes of the meeting with the Ministry of Commerce. The changes introduced by the Iranian authorities are indicated. I am also attaching a copy of a note to the files on export subsidies written in Teheran after a meeting in the Ministry of Commerce as well as a schedule showing the increases in the commercial benefit taxes.

Attachments (3)

August 14, 1978

Memorandum for Files

Subject: Iran - Treatment of Foreign Financing Items in Staff Report

Mr. Radford's memorandum for files of August 11, 1978 correctly points out that the presentation of the Government's foreign financing transactions in the budgetary data this year is the same as in previous years, when the Fiscal Affairs Department participated in the Iranian missions. This presentation was continued this year as the transactions appearing under this heading as "acquisition of assets" were mostly for purposes of portfolio management rather than a result of policy decisions. The inclusion of transactions for the purpose of portfolio management above the line would give a misleading picture as these transactions reflect the final outcome of budgetary revenues and expenditures. However, in accordance with Mr. Radford's request, the next mission will discuss this issue with the authorities and attempt to seggregate from the aggregate figure whatever direct investment and foreign loans resulted from policy decisions.

Saleh M. Nsouli

cc: ~~Mr. Shaalan~~
Mr. Hitti
Mr. Yaqub
Mr. Radford
Mr. Levin

~~Mr. Shaalan~~ ✓

cc: Mr. Yaqub /

Mr. Nsouli

August 11, 1978

MEMORANDUM FOR FILES

Subject: Iran--Treatment of Foreign Financing Items in Staff Report and RED

A reading of the recent draft of the Staff Report on the Article IV consultation with Iran led to a discussion with Mr. Hitti and Mr. Nsouli on appropriate treatment of the Government's foreign financing transactions with particular reference to the treatment of foreign financial assets acquired by the Government. In the past this item has been treated as a financing entry, partly because of the wishes of the Iranian authorities and partly because of inadequate knowledge as to the purpose and nature of the transactions involved. Thus in the RED of May 10, 1977 (SM/77/104; Table 13) there is a line entitled "External financing - Acquisition of assets", with a footnote explaining that it represented net foreign direct investment and net foreign loans extended. On this basis, under GFS procedures it should have been classified as"lending minus repayments" shown above the line, and not as a financing item. The same course has been followed in 1978. Mr. Hitti explained that although there were some direct investment and foreign loans in this item he was satisfied that the transactions concerned were for the most part undertaken for purposes of portfolio management rather than for policy reasons. Certain transactions--notably lending for the oil facility--had been taken out of this category and appropriately ascribed to the monetary authorities, but the information needed for a complete separation of the remaining elements is still lacking. In any case the Iranian authorities would resist the inclusion of any more items above the line as this would show a larger deficit than that which had been agreed with the mission. It should be noted that these transactions are likely to unwind over the next few years.

The difficulty is an old one. For this year it was agreed that the best course would be to revise the footnote in the RED to read "Includes some direct investment and foreign loans" and to make corresponding changes in the wording of the Staff Report. It was also agreed that the next mission to Iran will reopen the question with the authorities and endeavor to obtain a proper classification.

R A Radford

R. A. Radford
Assistant Director

cc: ~~Mr. Shaalan~~ ✓
Mr. Hitti
Mr. Levin

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CABLE
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cc: Mr. Nsouli/
Mr. Boxall
Mr. Iqbal
Mr. Amuzegar

TO: MR. SHAKOUR SHAALAN DIRECTOR, MIDDLE EASTERN DEPT.
INTERFUND, WASHINGTON D.C.

FROM: BANK MARKAZI IRAN

WITH REFERENCE TO YOUR CABLE OF AUGUST 7, 1978, I WISH TO INFORM YOU THAT THE DRAFT REPORT ON IRAN WITH FEW NECESSARY MODIFICATIONS WAS AIRMAILED TO YOU ON AUGUST 2,1978. BEST REGARDS, YOUSSEF KHOSHKISH, GOVERNOR, MARKAZBANK

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ADDRESS

H.E. Mr. Yussef Khoshkish
Governor
Central Bank of Iran
Tehran, Iran.

The staff has prepared a draft of the Staff Report on Iran. In order to enable us to finalize the report, I shall be very grateful if you will let us have preferably by telex at your earliest convenience your comments on the minutes of our meetings. With best personal regards.

Shaalan
Interfund

Special Instructions

Distribution

cc: Mr.Nsouli
Rm 3-214

Mr. Amuzegar
Rm 13-315

MESSAGE MUST END HERE

Drafted by: S.Nsouli/pmd
Department: MED
Date: August 7, 1978

A.S. Shaalan
NAME (TYPE) SIGNATURE

NAME (TYPE) SIGNATURE

FOR CABLE ROOM USE ONLY

No. of words: 2 min. Log: 19591 Route: WUI Operator: FJ

SEC-17/OCR

Office Memorandum

Pakistan

TO : Mr. Shaalan

DATE: August 3, 1978

FROM : Saleh M. Nsouli

SUBJECT : Staff Report on Iran

Attached please find a draft of the Staff Report on Iran that has been cleared with Messrs. Mookerjee (ETR), Effros (Legal), Wittich (Treasurer's), Rhomberg (Research), Swaminathan (Statistics), and Radford (Fiscal Affairs). The comments of the Iranian authorities on the minutes have not yet been received.

— over the medium term Iran intends to pursue a flexible exchange rate policy —

— abolished.

att.

cc: Mr. Hitti
Mr. Yaqub

Final Statement

The economy of Iran has experienced rapid changes in direction in the recent past. The initial stimulus arose as a result of the attempt to absorb the vastly expanded oil revenues and in this area Iran has made its contribution to the resolution of the imbalance in international payments arising from the sharp rise in oil prices. In the process, a substantial overheating of the economy occurred due to the steep increase in public expenditures which were financed by revenues accruing from the economy's export sector. In response Iran endeavoured, and in fact largely succeeded, in removing the supply constraints which impeded the flow of resources from abroad and the expansion of domestic output. While this was being done a considerable demand/supply imbalance existed causing great pressures on the available resources. Under these circumstances, the Iranian authorities resorted to price controls which were strictly enforced in the first instance, but were gradually relaxed and virtually eliminated recently. Through this mechanism the authorities managed to limit the immediate price impact of the excess demand pressures that emerged and to spread it over approximately four years. Overall, the authorities operated their policies taking full advantage of the opportunities presented by an open economy and, after some delay, by permitting the market forces to come into full play.

The economy is now passing through a transitional phase toward a more normal level of activity and expectations. It is generally conceded that economic management is usually more difficult during transitional phases than in periods when a well set course is continued.

In this context, the main purpose of these concluding remarks is to attempt an assessment of the appropriateness of current policies relative to the stated objectives of the government of Iran to aim at absorbable and sustainable growth under conditions of financial stability. Needless to say, we fully support these goals. The vital questions, however, that have to be asked are whether the current financial policies are consistent with these objectives; and whether there is need for adjustment in policies.

The Iranian authorities have had considerable success in decreasing the rate of increase of domestic liquidity, from 57 per cent in 1974/75 to 32 per cent in 1977/78. Concomittently, the intensity of the inflationary pressures operating in the economy were also reduced. Data on price movements are somewhat distorted because of price controls. The strict enforcement of these controls in 1974/75 resulted in limiting the rise in the cost of living index to 10 per cent, while in 1977/78 the accumulated pent up demand was allowed expression and the index shot up by some 25 per cent. However, the data also show that a definite improvement in the price trends commenced in mid 1977/78 and appears to be continuing. While an improving trend is indicated, it cannot be taken for granted that the rate of inflation will continue to fall. A closer look at the index shows that the recent moderation was largely influenced by a steep slowdown in the sub-index for housing, while other items tended to manifest some resistence to decline.

The financial outlook for 1978/79 discussed with the Iranian authorities during the review just concluded reveals that not much progress in restoring domestic financial balance can be expected in the current fiscal year. The rate of growth in domestic liquidity is projected to decrease only marginally from the rate attained in 1977/78. As the real expansion rate of the non-oil GDP is forecast at about 9 per cent, the potential rise in the domestic cost of living cannot be expected to be substantially lower than 17 per cent which is the average annual rate for the past four years. It is not too late, however, to make some additional effort in order to realize a greater improvement. As the planned level of credit increment for the private sector is moderate and necessary for the expansion of activity in that sector, any adjustment will have to be borne by the government's budget. While appreciating that substantial efforts are being made to contain current expenditures, the mission believes that an additional saving of at least Rls 100 billion, and preferably Rls 150 billion, from the presently anticipated level of total expenditures is necessary for making further progress toward the restoration of domestic financial balance.

A lower level of effective demand in 1978/79 and a greater reduction in the domestic rate of inflation are also needed for balance of payments management purposes. These are indications that the steep rates of inflation and wage increases experienced over the past few years have affected the domestic cost structure to the extent of causing some difficulties for the non-oil export sector and the import competing industries. The authorities' reaction has been to provide additional protection to domestic industry mainly through substantial rises in the commercial benefit taxes. The incentives to promote non-oil exports have been expanded to include cash subsidies in addition to the various rebates on imported inputs previously allowed. Moreover, the rial has been, for all practical purposes, pegged to the U.S. dollar and Iran's external sector has benefitted from the downward movement that occurred as a consequence of the depreciation of the dollar in recent months. These steps indicate that the authorities in Iran are aware of the implication for the balance of payments of the relative changes in domestic and international costs. The mission believes that these tentative steps should not be used as a substitute for a comprehensive review of balance of payments policies and that it is vital that the authorities resist the temptation to suppress the emerging balance of payments problem through a tightening of administrative restrictions on imports.

Iran's external accounts are experiencing a weakening phase. The current account, which was in surplus to the extent of SDR 3.6 billion in 1976/77 is forecast to record a deficit of SDR 2.6 billion in 1978/79. This deficit could be higher if financial policies are not adjusted along the lines suggested earlier. The large turnaround in the current account is being caused by considerable increases in payments for imports of goods and services while oil receipts are not expected to increase. The performance of non-oil exports has been particularly disappointing as these exports have been falling in volume terms. In order to contain the overall balance of payments deficit in 1978/79 to manageable proportions, gross drawing on external loans of about SDR 3 billion are intended. Considering Iran's comfortable reserves position and a very low external debt service ratio, neither the forecast overall deficit nor the proposed borrowings abroad constitute cause for concern.

Indeed, appropriate demand management policies require that the balance of payments be permitted to absorb a part of the demand pressures. Over the medium term, however, the divergent trends between receipts and payments cannot be sustained. Considering that adjustment policies require time to take hold, it is not too soon to start directing attention to the objective of attaining a sustainable balance in the external sector. An early start on adjustment policies would allow for a gradual approach that is more palatable socially and politically. Delays tend to cause an intensification of the difficulties and make more severe measures unavoidable. The emerging balance of payments deficit is almost the mirror image of the fiscal deficit and it is action in this area that constitutes the primary adjustment factor. A tightened fiscal stance in combination with a review of balance of payments policies would provide the basis for sustainable growth of the economy and for the continuation of Iran's liberal exchange and payments policies.

There remains to thank you for your cooperation and hospitality and to say that we enjoyed our stay in Iran.

CONFIDENTIAL

MR. SHAALAN

INTERNATIONAL MONETARY FUND

Iran: 1978 Article IV Consultation

Teheran

List of Participants

Iranian Representatives

H.E. Mohammad Yeganeh, Minister of Economic Affairs and Finance
H.E. Manuchehr Agah, Minister of State and Director of the Plan and Budget Organization
H.E. Youssef Khoshkish, Governor, Bank Markazi Iran

Bank Markazi Iran

Mr. B. Homayoun, Vice Governor
Mr. S.M. Shirazi, Vice Governor
Mr. F. Naderi, Director General for International Affairs
Mr. G.H. Shahkarami, Director General for Economic Statistics
Mr. A Ebtehaj, Director, Economic Statistics Department
Mr. A. Manavi-Rad, Director International Relations and Studies Department
Mr. H. Mahdavi, Director, Economic Research Department
Mr. B. Zarringhalam, Deputy Director, Economic Research Department
Mr. M. Amini, Assistant Director, Economic Research Department
Mr. B. Tamani, Assistant Director, Economic Research Department
Mr. A. Yasseri, Assistant Director, International Relations and Studies Department
Mr. F. Rakhshani, Chief, Money and Banking Division, Economic Research Department

Ministry of Economic Affairs and Finance

Mr. A. Kooros, Vice Minister

Ministry of Commerce

Mr. Ganjei, Deputy Minister

Plan and Budget Organization

Mr. A. Mejloumian, Undersecretary of State for Planning
Mr. F. Sarraf, Director, Bureau for Budgetary Policies, Methods and Training (BPMT)
Mr. G. Maleki, Assistant Director, BPMT
Mr. B. Rafii, Assistant Director, BPMT

Fund Representatives

Mr. A.S. Shaalan
Mr. S.H. Hitti
Mr. S.M. Nsouli
Mr. Z. Iqbal
Mr. P. Boxall

Observer

H.E. J. Amuzegar, Executive Director, IMF

Minutes of the Meeting with the Plan and Budget Organization

Production and private sector investment and consumption

Reviewing the developments in the level of economy activity during 1977/78, the mission noted that there was a sharp deceleration in the overall real rate of growth of real GDP to less than 2 per cent, following an increase of 11.5 per cent in the previous year. Value added in the oil sector fell by 7 per cent while the rate of growth in the non-oil sector decelerated to 7.6 per cent, reflecting a marginal fall in value added in the agricultural sector and a marked deceleration in the rate of growth in the other two main sectors; industry, including construction, and services.

The Iranian representatives said that the data on agricultural output was subject to a wide margin of error. Nevertheless, the indications were that low rainfall in the crop growing areas had adversely affected agricultural production in 1977/78. The government recognized, however, that there is a lack of incentives in the agricultural sector following the sharp movement in the rural-urban terms of trade against the rural sector, which had been exacerbated since the increase in oil prices in late 1973. The policy of stabilizing food prices for consumers in the cities has, along with the government's pricing policy for agricultural output, reduced profitability in agriculture, thereby encouraging the flow of labor from rural to urban areas. Indeed, in 1977/78 the area under cultivation declined and there was a shortage of agricultural labor. In the case of some crops, such as sugar beet, the high wages paid had made it uneconomical to reap the harvest.

In the industrial sector, construction activity started to decelerate early in the year in response to specific measures adopted by the government to eliminate speculation in land and in buildings. For the manufacturing industries the Iranian representatives stated that the price controls, coupled with a steep increase in costs, had caused a profit squeeze which contributed to the slowdown in industrial activity. In addition, the shortages of electricity adversely affected the growth in manufacturing output.

Another aspect of the slowdown in economic activity in 1977/78 was reflected in the decline of over 10 per cent in private sector investment in real terms. The Iranian representatives explained that the main reasons for the decrease in private sector investment were the legislation affecting construction and the business uncertainties generated by the price controls. The limitations imposed on the supply of commercial bank credit to the private sector was not considered an important factor as the demand for credit had remained relatively weak throughout the year. To some extent, the decrease in private sector investment in construction had resulted from the government's policy to increase public sector investment in low and medium cost housing. To this end, a temporary law, prohibiting the construction of large apartments, was in force up to end 1977, which, along with a law to limit the rise in the price of land to the rate of inflation, discouraged construction in the private sector. The situation was complicated further by the continuation of a shortage of building materials, in particular of cement.

The Iranian representatives considered that the decline in investment opportunities, along with increases in real incomes over the last three years, had led to the buildup in consumer demand, which emerged in 1977/78. In addition, the Iranian representatives noted that with a fixed exchange rate, relatively stable world prices and the rapid rate of increase in wages, the demand for imported goods and services had increased which contributed also to the growth in private consumption.

The Iranian representatives cautioned, however, that the developments during 1977/78 are not necessarily indicative of a sudden change in the behavior of the private sector. They noted the very large increases in private sector investment in the two years preceding 1977/78 and suggested that, to some extent, 1977/78 was a year of consolidation. Indeed, having virtually eliminated speculation in land and real estate, some of the restrictions on private sector investment in the construction sector had been lifted and the latest data indicated a resumption of activity in this sector.

Prices and wages

The mission observed that Iran had experienced substantial rates of price increases in recent years in response to strong demand pressures. The implementation of rigid price controls had limited the rise in the cost of living index to about 10 per cent in 1975/76. However, starting in 1976/77 these controls were relaxed gradually and were virtually eliminated by late 1977/78. The lifting of the controls, combined with continuing demand pressures, had resulted in rises in the cost of living index of 17 per cent in 1976/77 and

25 per cent in 1977/78; the latter being the highest rate of increase recorded for many years. The Iranian representatives confirmed the mission's analysis and stated that there was now official recognition that price controls would be limited to a few necessities, mainly foodstuffs, some of which were subsidized by the government. For all other goods, prices would be determined according to market forces. In the past the price controls, which were inclined to be enforced more rigorously for locally produced goods, tended to discourage local production in favor of the supply of imported goods.

In the opinion of the Iranian representatives, the gradual abolition of the price controls had become feasible in view of the substantial absorption of the excess liquidity created in the past. The Iranian representatives considered that, to a large extent, the underlying rate of inflation had fallen and that there was now little carryover from the excess demand pressures which were present in the economy over the last three years. They pointed out that the rate of price increase had decelerated throughout 1977/78 and during the first quarter of 1978/79. The Iranian representatives observed also that the recent deceleration in the rise of the cost of living index was brought about by the substantial slowdown in the rate of increase of the sub-index for housing, which was the sub-index that had led the acceleration in prices during 1976/77. However, the rate of increase for the prices of food, beverages, and tobacco and clothing, which account for over 50 per cent of the weights in the cost of living index, remained quite high and did not decelerate as much as the other items, including housing. The mission pointed out that continuing caution was necessary until there was further evidence that the apparent reduction in inflationary pressures was more than a temporary phenomenon.

Wage rates in the manufacturing sector continued to increase, albeit at a lower rate, during 1977/78. However, after three years of substantial increases in real wages, wages in real terms probably did not rise during 1977/78, which reflected in part the government's effort to limit wage increases largely through moral suasion. The Iranian representatives stated that the government was not actively attempting to relate wage increases to productivity gains. With a slackening in the demand for labor, the government had been able to limit the increase in the basic wage to about 7-8 per cent. However, the policy on wages had not been fully worked out.

<u>The outlook for 1978/79</u>

The Iranian representatives stated that there was not likely to be any increase in the output of oil in 1978/79. In the non-oil sector, output was expected to recover and should increase at a faster rate than in 1977/78, perhaps by some 8-9 per cent in real terms. Construction starts had increased in the last quarter of 1977/78 and, with the government embarking on a sizeable construction program for public housing and the prospect of adequate supplies of cement, output was expected to improve during 1978/79. Similarly, manufacturing output should expand as plants increased output following the lifting of price controls. In the agricultural sector, output was projected to increase as the government had revised upwards the price of agricultural products. For a number of products, a minimum guaranteed price had been set as well as a maximum price which the government intended to maintain by selling off stocks. The Iranian representatives said that the government's policy was to reduce the rate of inflation and to operate the economy at a more moderate rate of growth than in the past. They stated that efforts would be made to implement the budget for 1978/79 in a manner consistent with these objectives.

Economic planning

The fifth Five Year Plan was completed in 1977/78. As yet, the sixth Five Year Plan had not been published. Nevertheless, the Iranian representatives said that the development expenditures in the 1978/79 budget had been coordinated to fit into the development plan. The general aim of the Plan was to establish a reasonable balance between the different sectors with improved coordination in implementing the projects. Accordingly, priority would be given to completing the on-going projects, before commencing new projects, and more emphasis would be placed on infrastructural projects, such as internal transportation and communications, and power, so as to remove the existing bottlenecks. In addition, the Iranian representatives stated that more concrete emphasis would be placed on the agricultural sector. Overall, the authorities viewed 1978/79 as a transitional year during which an adjustment in expectations to more normal conditions would be initiated. The authorities were now aware that once again financial constraints had become operative in Iran and there was a need to establish priorities more carefully and to eliminate waste.

The mission welcomed the realistic perspective with which the Iranian representatives viewed the medium-term outlook. This was important since if the present trends in the balance of payments continued, Iran might experience serious difficulties. Import payments had increased steadily while export receipts had remained virtually constant, and a constraint on the balance of payments may arise soon. The Iranian representatives stated that the government was aware of the possibility that a balance of payments problem might emerge. In the short-run, the current account deficit could be financed by borrowing abroad and by running down reserves. In the meantime, more efforts would be made to promote non-oil exports while limiting the growth of domestic prices so as to dampen the demand for imports and to enhance the competitiveness of domestic industry.

Minutes of the Meeting with the Ministry of Economic Affairs and Finance

Government finance

The mission reviewed with the authorities recent developments in the Central Government's finances and the budget for fiscal 1978/79. It was noted that in recent years expenditures had been growing at a considerably faster rate than revenues and that, as a result, there had been a turnaround in the budgetary outcome from a surplus in 1974/75 to a substantial deficit in 1977/78. During 1977/78, revenues grew by nearly 12 per cent, slightly higher than projected in the budget, and total expenditures by almost 30 per cent, in line with budgetary allocations. On the revenue side, oil and gas revenues rose by 5.4 per cent, as the increase in oil prices effective January 1, 1977 more than offset the decline in output. Non-oil revenues increased by almost 30 per cent reflecting in the main the rise in nominal income during 1977/78. Special revenues, which are earmarked for particular expenditure items, grew by 43 per cent. On the expenditure side, current outlays rose by about 18 per cent and were marginally below budget allocations. There was also a small shortfall in development expenditures, which grew by about 40 per cent. Contingent expenditures and advance payments, however, grew sharply exceeding budget allocations. The overall deficit of Rls 389 billion that emerged was smaller than the deficit projected in the approved budget by some Rls 70 billion, an amount almost equal to the realized revenue increment in excess of the budget revenue forecast. The total of the financing items derived from the monetary and the balance of payments statistics, Rls 308 billion, was approximately in line with the deficit indicated in the fiscal accounts. The deficit was financed primarily by a change in the net position of the government vis-a-vis the banking system amounting to Rls 351 billion while net foreign borrowing and net borrowing from domestic nonbank sources were relatively small.

Turning to the budget for 1978/79, the mission noted that the projected revenues were probably on the high side. In particular oil revenues were higher than the projected foreign exchange receipts from the oil sector shown in the balance of payments forecast. In addition, the mission also inquired about the factors behind the projected sharp increases in non-oil and special revenues. With regard to oil revenue, the authorities agreed that there might be a shortfall of nearly Rls 70 billion resulting from the fact that oil production was not anticipated to increase in 1978/79; this assumption was indicated by oil output during the first quarter of the current fiscal year approximating the level attained in the similar period last year. As regards non-oil revenues, the authorities said that the anticipated additional increment of the increase over and above the past trend was attributable to improved collection methods. Computers were now being used to identify companies that were not filing tax returns, and the government was taking steps to collect tax arrears from these companies. The projected large rise in special revenues was attributed mainly to the transfer of some social security receipts to certain Central Government agencies.

Turning to expenditures, the mission stated that the level of allocations did not seem to be in line with the government's policy to moderate further demand pressures and to aim at growth rates in line with the absorptive capacity of the country. Current expenditures were projected to grow by 36 per cent and capital outlays by about 28 per cent. Further, the mission noted that there was no figure for contingent expenditures and advance payments, which had been substantial in 1977/78.

The Iranian representatives agreed that the budget allocations were on the high side and consequently government policy now was to implement the budget in a manner that would ensure substantial savings. Directives had been sent to all ministries to institute austerity measures; in particular, the hiring of new civil servants would be severely limited, travel of government officials would be curtailed, representation offices of various ministries abroad would be closed, and computer facilities would be shared by ministries instead of allowing each ministry to have its own computer. The Iranian representatives stated that the growth in current expenditures in the first quarter of the year had been limited to 18 per cent and anticipated limiting the growth rate in current expenditures in the year as a whole to about that level. This would reflect mainly the rise in salaries and fringe benefits granted to civil servants in mid 1977/78. With regard to capital expenditures, the authorities noted that in recent years the absorptive capacity of the economy had expanded considerably and that, as a result, development expenditures would approximate budget allocations. Capital outlays were being directed to ongoing projects and were aimed at further easing the physical bottlenecks, such as electrical power, and at industries the inputs of which were not currently subject to physical constraints. With regard to contingent expenditures and advance payments, the authorities stated that the Ministry of Finance intended to limit disbursements under this heading to a very small magnitude. The anticipated results in 1978/79 relative to the budget estimates could be seen in the attached table. As the expected revenue shortfall was forecast to be greater than the anticipated savings in expenditure relative to the allocation levels, the overall deficit was now forecast to rise to some Rls 490 billion as compared with Rls 436 billion implied in the budget estimates. The financing of the deficit shown in the attached table showed continued heavy reliance on net borrowing from the domestic banking system. The financing of the deficit also implied a very steep rise in net foreign borrowing as well.

The mission indicated that the budgeted level of expenditure after adjustment for the expected shortfall, remained excessively expansionary and might contribute to the rekindling of the inflationary pressures in the economy. This would continue the trend exhibited in recent years whereby the net domestic expenditures of the public sector, which included the Central Government and the government agencies, had been behind the rapid increases in domestic liquidity that led to intense inflationary pressures. The authorities responded that they were concerned about the possible inflationary impact of the budget and that every effort was being made to minimize the contribution of public expenditures to excess demand pressures in the economy. It was the policy of the government to work towards the re-establishment of financial balance, and it would endeavour to move towards that goal to the extent feasible. The transition, however, to a more modest fiscal stance could be advanced only gradually if undesirable disruptions were to be avoided.

Minutes of the Meeting with Bank Markazi Iran

Monetary developments and policies

The mission reviewed with the authorities recent monetary developments and the prospects for 1978/79. Since the increase in oil prices in 1973/74, domestic liquidity (money plus quasi-money) in Iran had been expanding at a very fast pace. The rate of growth of domestic liquidity peaked at 57 per cent in 1975/76. In the subsequent two years the annual rate of growth of domestic liquidity slowed down to about 40 per cent. There was a further slowdown during 1977/78 to about 32 per cent reflecting a considerable deceleration in the rate of growth of credit to the private sector while net credit to the public sector increased sharply. Within the public sector, the Central Government had transferred approximately Rls 200 billion to the government agencies. While this did not affect the change in credit to the public sector as a whole, it showed a greater rise in net claims on the government and a buildup in the net deposits of government agencies. Excluding this transfer, the net claims on the public agencies would have risen by some Rls 77 billion. Net foreign assets grew at a lower rate than the previous year, reflecting the weakening balance of payments position.

The mission noted that a more meaningful presentation of the sources of domestic liquidity would trace the injection of liquidity to the net operations of the public and private sectors. In countries like Iran, where a major proportion of government revenues was derived from the external sector, such an alternative presentation would be more appropriate than the traditional analysis based solely on the banks' balance sheets. The net injection of liquidity due to public sector operations consisted of the net domestic expenditures of the public sector, or the excess of domestic expenditures over domestic revenues. This was equivalent to the change in net credit to the public sector from the banking system plus the balance of payments outcome of the public sector. The net injection of liquidity due to private sector operations consisted of the change in claims by the banking system on that sector plus the balance of payments outcome of the private sector.[1] A rearrangement along these lines had been worked out with the authorities showing that in 1977/78, as in recent years, the net domestic expenditures of the public sector had had a strong expansionary impact while the net operations of the private sector had had a net contractionary effect on domestic liquidity.

The mission noted that in recent years the expansion in domestic liquidity had exceeded substantially the rate of growth in real non-oil GDP and had, as a result, exacerbated the underlying inflationary pressures in the economy. During the five year period 1973/74-1977/78 real non-oil GDP had grown at an average annual rate of about 13 per cent while the annual growth rate of domestic liquidity had averaged about 40 per cent. This had contributed materially to the average increase in the non-oil GDP deflator of almost 17 per cent per year. Statistical analysis suggested that the excess liquidity created during the past five years had been substantially absorbed. Accordingly, while monetary policy for 1978/79 probably did not need to compensate for a significant liquidity overhang, it needed to be sufficiently tight to ensure that strong inflationary pressures would not re-emerge.

1/ The result for each sector should be adjusted by the amount of net lending, if any, between the two sectors.

The Iranian representatives responded that they were concerned about the rate of expansion of domestic liquidity and had followed in 1977/78, and continued to follow, a tight credit policy. During 1977/78, the rate of growth of credit to the private sector was brought down to about 22 per cent as compared with 39 per cent in the preceding year. The Central Bank had taken various measures which included the imposition of ceilings on credit expansion; these ceilings were 20 per cent above the end 1976/77 level for commercial bank lending to the private sector and 35 per cent for specialized banks. In addition, the availability of rediscount facilities was limited, the rediscount rate was increased by 1 percentage point, and the interest rates on loans were raised. Commercial bank credit to the private sector had not reached the ceiling, as it increased by only 18 per cent. On the supply side, this was mainly due to the cautious stance of the commercial banks prompted by the uncertainty with regard to real estate prospects. On the demand side, the slowdown in the economic activity of the non-oil sector as well as the decline in real estate speculation tended to dampen the demand for loans. By contrast, the specialized banks, which finance mainly long-term investment, exceeded marginally their ceiling. This was caused mainly by the pick-up in economic activity during the last quarter of the year.

The growth in domestic liquidity had accelerated in the last quarter of the year manifesting an exaggerated seasonal pattern. Money and quasi-money had expanded by 14 per cent in the first three quarters as compared with 25 per cent in the same period of the previous year. However, mainly as a result of a surge in public sector expenditures and the pick-up in non-oil sector economic activity in the last quarter of 1977/78, which led to a surge in specialized banks' credit, domestic liquidity expanded by nearly 16 per cent in that quarter as compared with about 11 per cent in the same quarter of the previous year.

Turning to the policies and prospects for 1978/79, the authorities indicated that the Central Bank intended to continue pursuing a tight monetary policy and would continue to rely on quantitative credit controls. The Central Bank had set a ceiling on commercial bank private sector lending at 20 per cent and on specialized banks at 25 per cent above the end 1977/78 levels. Based on the expected budgetary and balance of payments outcomes and the monetary policy currently pursued, the following projections were made:

Factors Affecting Changes in Money and Quasi-Money

(In billions of Iranian rials)

	Projection 1978/79
Foreign assets (net)	-70
Domestic assets (net)	674
Claims on private sector	429
Claims on public sector (net)	506
Central government (net)	(410)
Government agencies (net)	(96)
Other items (net)	-261
Import deposits	(-65)
Capital accounts	(-130)
Other	(-66)
Money and quasi-money	604
Rate of increasee(in per cent)	29

The mission noted that based on the abovementioned considerations this represented an increase in domestic liquidity of nearly 29 per cent. While this would constitute a marginal improvement over the previous year, this growth rate would still considerably exceed the anticipated real growth in non-oil income and would, therefore, contribute to a rekindling of the inflationary pressures. The mission suggested that some moderation in monetary policy be achieved mainly through a curtailment in the public sector's expansionary impact while the private sector be provided with an adequate level of credit to finance the ongoing recovery.

Balance of payments developments and policies

The mission noted that data on foreign exchange receipts and payments showed that Iran experienced in 1977/78 a 30 per cent decline in overall surplus from the previous year's level. Receipts from oil remained virtually unchanged as the export volume fell by about 7 per cent. Current payments, on the other hand, rose by about 12 per cent because of a doubling of net service payments and higher imports. Consequently the current account surplus declined by over SDR 2 billion to SDR 1.5 billion. Reversing the pattern of the past three years, the nonmonetary capital account registered a net surplus of SDR 478 million in 1977/78 on account of a tripling of drawings on loans from abroad combined with a substantially reduced level of foreign investments and disbursements of loans by Iran. As the improvement in capital account was not sufficient to compensate for the decline in the current account surplus the overall surplus decreased to about SDR 2 billion.

The Iranian representatives agreed with this assessment of Iran's balance of payments position during 1977/78. Regarding the sharp increase in net service payments they stated that it was difficult to pinpoint the components of this aggregate. One of the main components which appeared to have increased substantially in the recent past was the remittances of foreign workers. At present there were about 100,000 skilled and an estimated one million unskilled foreign workers (approximately 10 per cent of the labor force) in Iran. Since these remittances were taking place through the noncommercial market, it was difficult to determine the exact amount involved. Expenditures on travel and shipping had also gone up and a large amount of demurrage charges incurred during the period of port conjestion in 1976/77 were settled in 1977/78. While all these factors had contributed to the steep rise in net service payments, the Iranian representatives said that the service payments included some private capital outflows generated by a decline in profitable investment opportunities in Iran. The authorities estimated that net service payments would continue to increase in the future at rates consistent with the expansion in the economy and with the rising demand for foreign skills and other services.

The official projections for 1978/79 showed a small decline in receipts from oil exports based on the assumptions of unchanged prices and a 5 per cent decline in volume. Import payments were expected to increase by about 17 per cent due to higher public sector imports aimed at sustaining the expansion in the government's investment program and resurgence of private investment, and a further sharp increase in net service payments. Private import registration rose by 35 per cent during the first quarter of 1978/79 over the level of the same period in 1977/78 but this rate of expansion was considered by the Iranian representatives to be exceptional and not likely to be sustained over the year as a whole. As a result of the disparity between rising payments and stagnant receipts, the current account balance was expected to undergo a dramatic reversal to a large deficit of about SDR 2.5 billion in 1978/79 from a surplus position in 1977/78. The capital account, on the other hand, was forecast to register a threefold increase in net inflows. Most of these inflows would be made under new loan commitments with maturity periods of higher than 5 years. The net surplus in the capital account, however, was not expected to offset fully the projected current account deficit. Consequently an overall deficit of almost SDR 800 million was projected representing a deterioration of almost SDR 3 billion from the previous year.

The mission observed that in view of Iran's comfortable exchange reserves position, the modest external deficit projected for 1978/79 was not disturbing. However, given the fact that Iran's imports of goods and services were rising at a rate much faster than the growth rate of oil and non-oil exports, the balance of payments might experience widening deficits. Barring unusual circumstances, oil exports were not expected to rise faster than in the recent past and the competitiveness of the non-oil exports had been adversely affected as a consequence of a sharp rise in domestic costs. While it was possible for some time to finance the current account deficit through enlarged foreign borrowing, given that the debt service ratio was still quite low, and also through some drawdown on external reserves, such financing could not be sustained for long. Consequently corrective measures were needed. The Iranian authorities agreed with this assessment and indicated that they would keep the economic situation under review and would consider what corrective measures might be required.

Exchange and payments system

The noncommercial exchange market expanded substantially in 1977/78 and was fed by a transfer of $2.1 billion from Bank Markazi. Without such a transfer it would not have been possible to maintain unified rial/dollar rates in the official and noncommercial markets. The mission inquired whether the authorities would continue the sale of dollars in the noncommercial market to ensure identical rates even if the demand for foreign exchange in noncommercial markets continued to increase. The authorities stated that they intended to continue sustaining the noncommercial market so long as demand in that market does not expand abnormally in which case they would have to reappraise their policy. The mission pointed out that the emergence of different rates might constitute a multiple currency practice requiring Fund approval. The authorities took note of this and stated that for the present they did not expect the emergence of multiple rates.

The mission sought the Iranian authorities' views on their experience with the current exchange rate system under which the rial was pegged to the SDR with widened margins of 7.25 per cent on either side of the fixed SDR rate. In principle, a change would be made in the rial/dollar rate in order to ensure that the actual rial/SDR rate did not exceed these margins. The staff team observed that the actual rial/SDR rate, based on the unchanged rial/dollar rate, almost hit the upper of these margins recently and continued to be very close to it. In these circumstances, the mission inquired whether the authorities intended to adjust the rial/dollar rate in order to stay within the margin. The authorities stated that they had expanded the margins in the hope of avoiding the need for an adjustment in the rial/dollar rate. However, should the U.S. dollar depreciate further, the Iranian authorities were not inclined to appreciate the rial vis-a-vis the dollar just in order to stay within the margin.

The mission was informed that there had been no change in the official policy toward Iran's bilateral payments arrangement with Romania and that no new bilateral payments arrangements had been signed since the last consultation discussions.

Concerning Iran's reserve management policy, the Iranian representatives stated that there had been no change in the official policy and thus, it continued to be guided by considerations of safety, geographical and currency distribution, and terms. In view of its balance of payments situation, Iran was keeping a large proportion of its reserves in liquid assets.

Minutes of the Meeting with the Ministry of Commerce

Commercial Policy

Since the previous consultation discussions, no changes in restrictions on current payments, which continued to be liberal, were made. Trade restrictions, however, had been intensified. For some time, Iran had pursued a commercial policy aimed at ensuring sufficient protection to domestic producers to promote import substitution while ensuring adequate supplies in the market. The main instruments used for that purpose were a system of prior approval for imports, commercial benefit taxes, state trading, and bilateral trade agreements. The list of imports subject to prior approval changed from year to year and its application through refusals resulted in quantitative restrictions. While in 1978/79 the list had remained unchanged, its application had become more restrictive as indicated by the banning of imports of certain cotton textiles. At the same time, commercial benefit taxes were raised on a large number of commodities including petrochemical products, iron and steel, textiles, cement, tires, nonmetalic mineral products such as glass and ceramics, and electric cables and wires. This amounted to a reversal in the trend toward a reduction in these taxes initiated in 1974/75. The staff indicated to the Iranian representatives that these developments constituted intensification of import restrictions.

The Iranian representatives responded that in the context of Iran's legal framework, once the annual import policy was announced it could not be made more restrictive during the course of the year. These circumstances necessitated the inclusion on the prior approval list of a large number of items. This, however, did not imply that their imports would in fact be restricted. The increase in the restrictive application of the prior approval provision during the current year was so far limited to cotton textiles made necessary by the dumping of cheaper imports. The Government, however, continued to review the conditions of this sector in order to ensure the needed protection to the domestic textile industry. Concerning the increase in the commercial benefit taxes, the Iranian representatives stated that these taxes had been used for both revenue as well as protection purposes. The revenue aspect had become relatively less important after the sharp increases in oil receipts. However, as the budget deficits had started to emerge in 1977/78, the need for higher revenues contributed to the decision to raise these taxes. At the same time there was a greater need for import protection and therefore these taxes were raised mainly on imports which had domestic substitutes.

Turning to export promotion policies, the mission pointed out that the performance of non-oil exports had been disappointing in recent years. These exports had grown in nominal terms at an annual average rate of 2.5 per cent during the last four years and in fact declined in real terms. The weak performance of this sector had been mainly due to a sharp rise in domestic costs which reduced the competitive position of Iran's exports in the world market, coupled with strong domestic demand which decreased export availabilities. To offset the former factor, the Government was now providing various incentives. In addition to preferential provision of services and credit, and customs duties rebates, this support now involved cash subsidization amounting to 10 to 15 per cent of domestic cost of production for selected manufactured exports. The Iranian representatives stated that the government was in the process of reviewing the pattern of export incentives, including the cash subsidies. A comprehensive study was underway to draw up policies to rationalize the incentives system and to draw a list of exports eligible for subsidization, if any, and the extent of possible subsidies.

Responding to the mission's query on the status of the bilateral trade and payments agreement with Romania, the Iranian representatives stated that there had been no change in the Government policy toward this agreement which continued to be needed for conducting trade with socialist countries. The mission observed that such arrangements generated lack of competition and decline in the quality of exports. Therefore, the authorities were urged to terminate the bilateral arrangements currently in effect especially the one with Romania.

To conclude the discussion, the mission stated that the recent direction of Iran's commercial policy raised important issues. The need for increased protection of domestic industry and for export subsidization, in combination with the fact that a large portion of non-oil exports were marketed through bilateral channels, suggested the desirability of a thorough review of industrial efficiency and export competitiveness in Iran.

Meeting with the Minister of Economy and Finance

The contents of the attached Final Statement of the mission were delivered at the meeting. The Minister responded that he was in basic agreement with the analysis of the mission. The Government, he explained, shared the mission's concern with regard to the necessity of adjusting policies during this transitory phase so as to ensure the attainment of sustainable economic growth under conditions of financial stability. To this end, the Minister stated that considerable efforts were being made to reduce the budgetary deficit during 1978/79. With respect to the oil revenues, the Minister indicated that the receipts would not fall below the budgeted level. Output was expected to expand somewhat while total receipts during 1978/79 would benefit also from the acceleration in payments resulting from the change in the date of the monthly payment. With regard to the non-oil revenues, the Government had launched a campaign to bring about a more effective collection of taxes. On the expenditure side, considerabel savings vis-a-vis budget allocations were expected. Ordinary outlays were anticipated to increase by only 18 per cent as compared with about 36 per cent projected in the budget. Development expenditures would also be curtailed to the greatest extent possible; the execution of some projects was being prolonged while the government's efforts in this regard were hampered by previous commitments. A smaller deficit would help reduce the rate of growth of domestic liquidity. In addition, the authorities were pursuing relatively tight credit policies. Ceilings on private lending had been set at 20 per cent for commercial banks and at 25 per cent for specialized banks above the end of 1977/78 levels. As a result, the rate of expansion in domestic liquidity was expected to be lower than the previous year.

On the supply side, the Minister noted that during the last quarter of 1977/78 there had been a revival in the economic activity of the non-oil sector and that the rate of growth of non-oil GDP could be expected to be higher in 1978/79 than in 1977/78. Physical bottlenecks had been virtually eliminated, while there had been a resurgence of private sector confidence with the virtual elimination of price controls.

These factors, operating on the demand and supply sides, had already started to have a salutory effect. During the first quarter of 1978/79, there had been a significant deceleration in the rate of inflation and this trend was anticipated to continue. The Minister estimated that the rate of inflation for the year as a whole would be in the range of 10-15 per cent.

Turning to the foreign exchange receipts and payments projections for 1978/79, the Minister stated that he expected receipts from the oil sector to be at about the same level as in the previous year. In addition, he did not anticipate service payments to rise as sharply as projected for two major reasons. First, the increase in the exit tax had already had a negative impact on travel abroad. Second, the recent increases in net services probably included some capital outflows resulting from transactions in real estate. As these transactions had subsided, such capital outflows would be substantially reduced.

The Minister indicated that, because of the downward movement of the effective exchange rate of the U.S. dollar and because of the unchanging price of oil since January 1, 1977, the purchasing power of Iran's foreign exchange receipts had eroded and the terms of trade had moved against Iran. It was, therefore, essential to adjust the price of oil. A more realistic pricing policy for oil, he added, would also encourage the development of alternative sources of energy and would reduce the inefficient use of this valuable depletable resource.

The Minister stated that the authorities were very concerned about the performance of the non-oil export sector and that it was the policy of the Government to promote such exports in order to reduce the reliance of the economy on the oil sector. Some countries, however, were discriminating against Iran's non-oil exports, and Iran had conveyed its concern to the countries in question. In addition, Iran was looking into various ways of encouraging non-oil exports. At present, some manufacturers were receiving minor cash subisidies to enable them to compete in international markets. The most important factor, however, behind the decline in the volume of Iran's non-oil exports in recent years was the high level of demand within the country.

Minutes of the Final Meeting with Bank Markazi Iran

The Iranian representatives stated that they were in basic agreement with the contents of the Final Statement. However, in view of the discussions with the Minister of Finance the previous day, the staff of the Central Bank had revised the fiscal, monetary, and balance of payments projections for 1978/79. The main change was a revision in the receipts from the oil sector, which are now projected at about the same level as in 1977/78. This revision was prompted by two factors. First, oil production and exports were anticipated to pick up during the year. Second, Iran would witness in 1978/79 a minor acceleration in payments due to the changeover in the timing of the monthly oil payments from the Gregorian to the Iranian year. Since the oil receipts were anticipated to be at about the same level as in the previous year, the budgetary deficit would be reduced requiring less bank financing. The revision in the projection of foreign exchange receipts and payments, however, showed an approximately unchanged overall deficit, as net capital flows were revised downward offsetting virtually all of the increase in oil revenues. As a result of these factors, domestic liquidity was now projected to increase by 26 per cent during 1978/79 as compared with the earlier projection of 29 per cent. The authorities indicated that the expected rate of inflation during 1978/79 would therefore be reduced to somewhere between 10-15 per cent as the Finance Minister had indicated.

The mission said that these revisions would be incorporated in the tables to be attached in the minutes of the discussions. However, because of the time constraint, the changes that might be needed in the texts of the minutes would be made when the minutes were finalized in Washington. The Iranian representatives accepted the mission's suggestion.

The mission agreed with the authorities that the revised figures implied a lower rate of inflation for 1978/79 than dicussed earlier and the staff appraisal would reflect the somewhat better prospects. In order that the Final Statement would reflect the revisions, the following paragraph would replace the paragraph starting at the end of page 2 and running through the middle of page 3.

"The financial outlook for 1978/79 discussed with the Iranian authorities during the review just concluded reveals that some further progress in restoring domestic financial balance can be expected in the current fiscal year. The rate of growth in domestic liquidity is projected to decrease to about 26 per cent compared with 32 per cent attained in 1977/78. As the real expansion rate of the non-oil GDP is forecast at about 9 per cent, the potential rise in the domestic cost of living can be estimated at about 12-14 per cent. While this would be significantly lower than the average annual rate for the past four years, the mission believes that some additional effort should be made in order to realize a greater improvement. As the planned level of credit increment for the private sector is moderate and necessary for the expansion of activity in that sector, any adjustment will have to be borne by the government's budget. While appreciating that substantial efforts are being made to contain current expenditures, the mission believes that an additional saving of at about Rls 100 billion from the presently anticipated level of total expenditures is necessary for making more rapid progress toward the restoration of domestic financial balance."

Other changes in the Final Statement: Page 4, line 15, should read SDR 1.9 billion instead of SDR 2.6 billion, and line 23, should read SDR 2 billion instead of SDR 3 billion.

The authorities requested the Fund staff to provide a study on the appropriate exchange rate policy for an oil producing country. In addition, they indicated that they would be interested in the mission's views on the efficiency of the industrial sector in Iran and the implications for the long-term balance of payments prospects. The mission stated that the Middle Eastern Department, in consultation with the Exchange and Trade and Research Departments, would undertake a study of the appropriate exchange rate policy for an oil producing country. With regard to the question of industrial efficiency, the mission explained that, while this had a bearing on the balance of payments prospects, an analysis of the industrial sector in Iran lay more in the realm of the World Bank than the Fund.

Iran: Summary of Foreign Exchange Receipts and Payments, 1976/77 - 1978/79

(In millions of SDRs)[1]

Year ended March 20	1976/77	1977/78	Revised Offic. Proj. 1978/79
A. Receipts from the oil exports[2]	17,806	17,557	17,528
B. Other goods and services	-14,179	-16,356	-19,390
Exports	569	666	762
Imports	-13,958	-15,214	-17,782
Private sector[3]	(-6,873)	(-7,240)	(-8,298)
Public sector	(-7,085)	(-7,974)	(-9,484)
Services (net)	-790	-1,808	-2,371
of which: interest payments	(-261)	(-313)	(-339)
C. Nonrecurrent transfers[4]	-14	-106	--
D. Total (A+B+C)	3,613	1,095	-1,862
E. Nonmonetary capital	-1,552	851	1,100
Official loans and credits (net)	-1,239	589	1,100
Drawings	(487)	(1,272)	(1,540)
Principal repayments from abroad	(449)	(681)	
Repayments	(-618)	(-577)	(-678)
Loans and investments	(-1,556)	(-787)	(-762)
Private capital (net)	-314	262	--
F. Errors and omissions[5]	702	2	--
G. Overall balance	2,763	1,948	-762
H. Monetary movements (increases)[6]	-2,763	-1,948	762
Foreign exchange holdings	-2,758	-2,040	...
Bank Markazi long-term loans	--	--	...
IMF account	--	--	...
Use of SDRs	-5	-7	...
Other	--	99	...

Source: Bank Markazi Iran.

1/ Values in U.S. dollars were converted into SDRs as follows: for 1976/77, US$1.15061 = SDR 1; and for 1977/78 and 1978/79, US$1.1 1037 = SDR 1.

2/ Excludes rial purchases from the Iranian Oil Service Company and the Joint Venture Company which are incorporated in services (net).

3/ Includes imports of nonmonetary gold.

4/ Includes special receipts and payments for oil sector and other grants and aid.

5/ Also include discrepancies between the balance of payments outcome and changes in the net foreign assets of the banking system arising out of the use of different conversion rates to convert monetary data from rials to SDRs.

6/ Excluding changes in the net foreign assets of the specialized banks.

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6/ Excluding changes in the net foreign assets of the specialized banks.

Changes in Factors Affecting Domestic Liquidity

(In billions of rials)

	Revised Proj. 1978/79
Foreign assets (net)	-70.0
Claims on public sector (net)	426.0
Claims on Government (net)	(342.0)
Claims on public enterprises (net)	(84.0)
Claims on the private sector	429.0
Other items (net)	-240.0
Money and quasi-money	545.0
Rate of increase (in per cent)	26.0

Iran: Summary of Government Finances

(In billions of Iranian rials)

	Budget 1978/79	Revised Proj.outcome 1978/79
Revenues	2,396.0	2,396.0
Oil	1,541.8	1,541.8
Non-oil	714.2	714.2
Special 1/	140.0	140.0
Expenditures	2,832.3	2,814.6
Current expenditures	1,750.7	1,583.0
Ordinary	(1,610.6)	(1,443.0)
Special	(140.0)	(140.0)
Development expenditures	1,231.6	1,231.6
Foreign grants	2/	
Contingent expenditures and advance payments	...	...
Unfulfilled obligation (-)	-150.0	...
Surplus (+) or deficit (-)	-436.3	-418.6
Financing items	436.3	418.6
Domestic financing	380.0	362.3
Banking system (net)		(342.3)
Nonbank sources		(20.0)
External financing	56.3	56.3
Net borrowing	(136.3)	(136.3)
Acquisition of assets	(-80.0)	(-80.0)

1/ Special revenues are primarily fees and user charges under the control of various ministries and agencies which are earmarked for particular uses. Expenditures financed from the revenues usually equal receipts.

2/ The amount for foreign grants is included in granting of loans and investment abroad (Rls 80 million), and is not available separately.

Iran: Summary of Foreign Exchange Receipts and Payments
(In millions of SDRs)

Year Ended March 20		1974/75	1975/76	1976/77	Prelim. 1977/78	Offic. Proj. 1978/79
A.	Net receipts from the oil sector	15,302	15,771	17,806	17,557	17,528
B.	Other goods and services	-8,256	-13,321	-14,179	-16,356	-19,390
	Exports	573	543	569	666	762
	Imports	-8,793	-13,410	-13,958	-15,214	-17,782
	Private sector	(-4,156)	(-6,374)	(-6,873)	(-7,240)	(-8,298)
	Public sector	(-4,637)	(-7,036)	(-7,085)	(-7,974)	(-9,484)
	Services (net)	-36	-454	-790	-1,808	-2,371
C.	Total (A+B)	7,046	2,450	3,627	1,201	-1,862
D.	Nonmonetary capital	-1,636	-2,608	-1,552	851	1,100
E.	Errors and omissions	-996	-672	688	-104	--
F.	Overall balance	4,414	-830	2,763	1,948	-762
G.	Monetary movements (increases)	-4,414	830	-2,763	-1,948	762

Source: Bank Markazi Iran.

48 CONFIDENTIAL

FILE . IRAN.

Minutes of the Meeting with the Ministry of Commerce

Commercial Policy

Since the previous consultation discussions, no changes in restrictions on current payments, which continued to be liberal, were made. ~~Trade restrictions, however, had been intensified.~~ For some time, Iran had pursued a commercial policy aimed at ensuring sufficient protection to domestic producers to promote import substitution while ensuring adequate supplies in the market. The main instruments used for that purpose were a system of prior approval for imports, commercial benefit taxes, state trading, and bilateral trade agreements. The list of imports subject to prior approval changed from year to year and its application through refusals resulted in quantitative restrictions. ~~While~~ In 1978/79 the list
and its application remained unchanged, except for certain cotton
~~had remained unchanged, its application had become more restrictive~~
textiles which was made necessary by the dumping of cheaper imports.
~~as indicated by the banning of imports of certain cotton textiles.~~

~~At the same time, commercial benefit taxes were raised on a large number of commodities including petrochemical products, iron and steel, textiles, cement, tires, nonmetalic mineral products such as glass and ceramics, and electric cables and wires. This amounted to a reversal in the trend toward a reduction in these taxes initiated in 1974/75. The staff indicated to the Iranian representatives that these developments constituted intensification of import restrictions.~~

The Iranian representatives responded that in the context of Iran's legal framework, once the annual import policy was announced it could not be made more restrictive during the course of the year. These circumstances necessitated the inclusion on the prior approval import

list of a large number of items. This, however, did not imply that (A)
The commercial benefit (see reverse)
their imports would in fact be restricted. / The increase in the
commercial benefit tax was mainly due to the fact
~~restrictive~~ application of ~~/the prior approval provision during the~~
that pursuant to the policy of a more liberal import regulations a number of
~~current year was so far limited to cotton textiles made necessary~~
commodities included in the prohibited list were removed from the list, but the
~~by the dumping of cheaper imports. The Government, however, continued~~
commercial benefit tax was levied on them to prevent unfair competition.
~~to review the conditions of this sector in order to ensure~~
This, however, represents the maximum level of commercial benefit tax payable
~~the needed protection to the domestic textile industry.~~ ~~Concerning~~
by the importer of these commodities because, according to the law, when (see reverse) (B)
~~the increase in the commercial benefit taxes~~, the Iranian represent-
also
atives/ stated that these taxes had been used for both revenue as well as protection purposes. The revenue aspect had become relatively less important after the sharp increases in oil ~~receipts~~ INCOME. ~~However, as the budget deficits had started to emerge in 1977/78, the need for higher revenues contributed to the decision to raise these taxes.~~ At the same time there was a greater need for import protection and therefore these taxes were raised mainly on imports which had domestic substitutes.

clearly indicated

Turning to export promotion policies, the mission pointed out that the performance of non-oil exports had been disappointing in recent years. These exports had grown in nominal terms at an annual average rate of 2.5 per cent during the last four years and in fact declined in real terms. The weak performance of this sector had been mainly due to a sharp rise in domestic costs which reduced the competitive position of Iran's exports in the world market, coupled with strong domestic demand which decreased export availabilities. To offset the former factor, the Government was now providing various incentives. In addition to preferential provision of services and credit, and customs duties rebates, this support ~~now~~ involved ~~cash~~ provisions

A

taxes were raised on a large number of commodities and lowered on some others.

B

the level of this tax is determined for the year it could not be increased but could, when deemed appropriate, be lowered.

income tax reduction and exemption for local producers who export part of their ~~subsidization amounting to 10 to 15 per cent of domestic cost of~~ products. ~~production for selected manufactured exports.~~ The Iranian representatives stated that the government was in the process of reviewing the pattern of export incentives. ~~including the cash subsidies.~~ A comprehensive study was underway to draw up policies to rationalize the incentives system. ~~and to draw a list of exports eligible for subsidization, if any, and the extent of possible subsidies.~~

Keep

Keep

X

Responding to the mission's query on the status of the bilateral trade and payments agreement with Romania, the Iranian representatives stated that there had been no change in the Government policy toward this agreement which continued to be needed for conducting trade with socialist countries. The mission observed that such arrangements generated lack of competition and decline in the quality of exports. Therefore, the authorities were urged to terminate the bilateral arrangements currently in effect especially the one with Romania.

To conclude the discussion, the mission stated that the recent direction of Iran's commercial policy raised important issues. The need for increased protection of domestic industry and for export subsidization, in combination with the fact that a large portion of non-oil exports were marketed through bilateral channels, suggested the desirability of a thorough review of industrial efficiency and export competitiveness in Iran.

Iran--1978 Article IV Consultations

Memorandum for Files July 6, 1978

Subject: Iran--Export Promotion

I met Mr. Emami and Mrs. Mirza of the Iran Export Promotion Center on July 5, 1978 to explore steps undertaken by the Government to promote non-oil exports. Mr. Emami indicated that the Government intended to replace oil exports fully in twenty years through the promotion of non-oil exports. This would require such exports to grow at 25 per cent per annum in real terms. Since domestic consumption was expected to go on increasing at a rapid rate, output of these products will have to increase at a much faster rate.

At present Iran is following export promotion through the following steps:

(1) Reduced charges for the use of port facilities, lower freight charges and dissemination of information relating to markets abroad.

(2) Credit facilities for exports, granted by the Bank Markazi Iran at lower interest rate which have assisted the exporters to grant more favorable credit terms to buyers of Iranian goods abroad. Subsidized credit is also provided by Bank Markazi Iran for pre-export expenditures of exporters.

(3) Export guarantee scheme. Under this arrangement, a Guarantee Fund has been established to protect exporters against financial risks (excluding exchange fluctuations) which the commercial insurance companies do not cover.

(4) Customs duties drawback. Exporters of manufactured products are granted rebate of customs duties paid on imported inputs ~~imports~~ contained in exports. The rebate is effected after export has taken place.

(5) Cash subsidies. Recently the Government has started to extend cash subsidies to exporters of certain manufactured goods to the extent of 10-15 per cent of cost of production in order to make them competitive in the world market. At present, goods which are eligible for such subsidy include cars, spare parts, buses, batteries, refrigerators, ball bearings, and some textiles. The present list is ad hoc and the Government is in the process of preparing a comprehensive list of commodities which could be considered as potential exports and extend subsidies to them. One measure for determining this list would be the value added as a percentage of total cost. Currently this subsidy is extended for three years only but the policy associated with the new list could extend it for a longer period.

Zubair Iqbal

MS. JOUDREY

INTERNATIONAL MONETARY FUND
WASHINGTON, D. C. 20431

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INTERFUND

July 24, 1978

To : Mr. Hitti
Mr. Nsouli
Mr. Boxall
Mr. Iqbal

From : A. S. Shaalan

Subject : Iran--Schedule for the Preparation of Consultation Reports

Staff Report

Mr. Hitti, assisted by Mr. Nsouli, will have the responsibility for preparing the staff report. It is expected that a draft will be circulated to the committee during the week starting July 31. The report will be sent to Management, and thereafter issued, after the comments of the Iranian authorities on the minutes of the discussions are received.

RED Report

Mr. Nsouli will have overall responsibility for preparing the RED report. The sections to be drafted by Mr. Boxall (The Real Sector) and by Mr. Iqbal (The External Sector) should be submitted to Mr. Nsouli by August 18. The draft RED will be reviewed by Mr. Hitti and myself in early September and cleared with the committee by September 12.

cc: Mr. Yaqub
Ms. Joudrey
Mrs. Jimenez
Mrs. Khan
Mrs. Redman

3

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ADDRESS

The Honorable
Yussof Khoshkish
Governor, Bank Markazi
Teheran, Iran

I wish to take this opportunity to extend my sincere thanks and appreciation and that of my colleagues on the recent mission to Iran for your most cordial and generous hospitality. The cooperation of the Central Bank officials with the mission was greatly appreciated. We enjoyed our discussions and stay in Iran immensely. I look forward to seeing you during the Annual Meetings.

With best regards.

Shaalan

INTERFUND

Special Instructions

cc:

Mr. Hitti
(Room 3-300)

Mr. Yaqub
(Room 3-214)

Mr. Amuzegar
(Room 13-315)

Distribution

MESSAGE MUST END HERE

Drafted by: ASShaalan/pmj
Department: Middle Eastern
Date: July 19, 1978

A. Shakour Shaalan
NAME (TYPE) SIGNATURE

NAME (TYPE) SIGNATURE

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No. of words: 2min. Log: 416647 Route: TRT Operator: JJ

SEC-17/OCR

Int - Crockett

Office Memorandum

CONFIDENTIAL

TO : The Temporary Acting Managing Director DATE: July 19, 1978.

FROM : A. S. Shaalan

SUBJECT : Iran--1978 Article IV Consultation

A staff team consisting of Messrs. Hitti, Nsouli, Boxall, Ms Curtis, and myself (MED) and Mr. Iqbal (ETR) conducted the 1978 Article IV consultation with Iran during the period July 7-16. The discussions were frank and held in a friendly atmosphere and centered on the policy implications of the emerging balance of payments deficit and on the need for a more restrained fiscal stance both to strengthen the external sector and to create conditions conducive for a more rapid progress in reducing the domestic rate of inflation.

The declared policy of the current Government in Iran, which assumed office about a year ago, is to aim at moderate growth targets that can be attained without creating excessive strains in the economy. Performance during the past Iranian year, which ended on March 20, 1978, showed an appreciable movement in that direction. The growth rate of the non-oil GDP decelerated to about 7.5 per cent which, in combination with a sizable decrease in value added in the oil sector, resulted in an overall rate of growth of approximately 2 per cent. The rate of increase in the cost of living accelerated to 25 per cent, but to a considerable degree this reflected the easing of price controls and, in fact, starting in mid-year, the cost of living showed a substantial slowdown in the rate of increase. In the external accounts, both the current account and the overall balance remained in surplus in 1977/78, though sharply lower than in the previous year.

The prospects for 1978/79 are for an acceleration in the rate of expansion of non-oil GDP to about 9 per cent in real terms reflecting revival in private sector activity, particularly construction, while output in the oil sector is not expected to rise. The financial policies for 1978/79 are forecast to result in domestic liquidity expanding by about 26 per cent compared with 32 per cent attained last year. Consequently the rate of price increases is projected to decelerate to about 12-14 per cent compared with the annual average for the past four years of approximately 17 per cent. The mission emphasized that greater efforts were needed to achieve more rapid progress in restoring domestic financial stability in Iran. As the planned level of credit increment for the private sector is moderate and necessary for the expansion of activity in that sector, the mission recommended reducing public expenditures by some Rls 100 billion (equivalent to 5 per cent of the stock of money and quasi-money at the end of 1977/78), from the presently anticipated level of total expenditures.

Iran's external accounts are experiencing a weakening phase. The current account, which was in surplus of SDR 3.6 billion in 1976/77 is forecast to record a deficit of SDR 2 billion in 1978/79. This large turnaround is being caused by considerable increases in payments while receipts, particularly oil receipts, are not expected to increase. In order to contain the overall balance of payments deficit in 1977/78, substantial gross drawings on external loans are intended. The mission stated that in view of Iran's comfortable reserves position

and a very low external debt service ratio, neither the forecast overall deficit nor the proposed borrowings abroad constitute cause for concern. Considering, however, that adjustment policies require time to take hold, the mission advised that it was not too soon to start directing attention to the objective of attaining a sustainable balance in the external sector. In the circumstances a lower level of effective demand in 1978/79 and a greater reduction in the domestic rate of inflation are also needed for balance of payment management purposes. There are clear indications that the steep rates of inflation and wage increases experienced over the past few years have affected the domestic cost structure to the extent of causing some difficulties for the non-oil export sector and the import substituting industries. The authorities' reaction so far has been to provide additional protection to domestic industry and various incentives to promote exports, including cash subsidies for a number of export commodities. The mission cautioned the authorities on the dangers the pursuit of these policies could lead to. Moreover, the rial has been, for all practical purposes, pegged to the U.S. dollar and Iran's external sector has benefited from the downward movement that occurred as a consequence of the depreciation of the dollar in recent months. The mission discussed these steps with the authorities and recommended a comprehensive review of balance of payments policies.

Shortly, I shall be sending you another note (with limited circulation) on my private discussions with the Minister of Finance and Economy on Iran's exchange rate policy.

cc. The Managing Director
The Deputy Managing Director
Mr. Ware
Mr. Gold
Mr. Polak
Mr. Sturc
Mr. Habermeier
Mr. Goode

bcc. Mission members
Mr. Ray
Mr. Selehdar
Mr. Crockett
Mr. Gerakis
Mr. von Post
Division Chiefs

Office Memorandum

CONFIDENTIAL

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FROM : A. S. Shaalan

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The declared policy of the current Government in Iran, which assumed office about a year ago, is to aim at moderate growth targets that can be attained without creating excessive strains in the economy. Performance during the past Iranian year, which ended on March 20, 1978, showed an appreciable movement in that direction. The growth rate of the non-oil GDP decelerated to about 7.5 per cent which, in combination with a sizable decrease in value added in the oil sector, resulted in an overall rate of growth of approximately 2 per cent. The rate of increase in the cost of living accelerated to 25 per cent, but to a considerable degree this reflected the easing of price controls and, in fact, starting in mid-year, the cost of living showed a substantial slowdown in the rate of increase. In the external accounts, both the current account and the overall balance remained in surplus in 1977/78, though sharply lower than in the previous year.

The prospects for 1978/79 are for an acceleration in the rate of expansion of non-oil GDP to about 9 per cent in real terms reflecting revival in private sector activity, particularly construction, while output in the oil sector is not expected to rise. The financial policies for 1978/79 are forecast to result in domestic liquidity expanding by about 26 per cent compared with 32 per cent attained last year. Consequently the rate of price increases is projected to decelerate to about 12-14 per cent compared with the annual average for the past four years of approximately 17 per cent. The mission emphasized that greater efforts were needed to achieve more rapid progress in restoring domestic financial stability in Iran. As the planned level of credit increment for the private sector is moderate and necessary for the expansion of activity in that sector, the mission recommended reducing public expenditures by some Rls 100 billion (equivalent to 5 per cent of the stock of money and quasi-money at the end of 1977/78), from the presently anticipated level of total expenditures.

Iran's external accounts are experiencing a weakening phase. The current account, which was in surplus of SDR 3.6 billion in 1976/77 is forecast to record a deficit of SDR 2 billion in 1978/79. This large turnaround is being caused by considerable increases in payments while receipts, particularly oil receipts, are not expected to increase. In order to contain the overall balance of payments deficit in 1977/78, substantial gross drawings on external loans are intended. The mission stated that in view of Iran's comfortable reserves position

and a very low external debt service ratio, neither the forecast overall deficit nor the proposed borrowings abroad constitute cause for concern. Considering, however, that adjustment policies require time to take hold, the mission advised that it was not too soon to start directing attention to the objective of attaining a sustainable balance in the external sector. In the circumstances a lower level of effective demand in 1978/79 and a greater reduction in the domestic rate of inflation are also needed for balance of payment management purposes. There are clear indications that the steep rates of inflation and wage increases experienced over the past few years have affected the domestic cost structure to the extent of causing some difficulties for the non-oil export sector and the import substituting industries. The authorities' reaction so far has been to provide additional protection to domestic industry and various incentives to promote exports, including cash subsidies for a number of export commodities. The mission cautioned the authorities on the dangers the pursuit of these policies could lead to. Moreover, the rial has been, for all practical purposes, pegged to the U.S. dollar and Iran's external sector has benefited from the downward movement that occurred as a consequence of the depreciation of the dollar in recent months. The mission discussed these steps with the authorities and recommended a comprehensive review of balance of payments policies.

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bcc. Mission members
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Mr. Crockett
Mr. Gerakis
Mr. von Post
Division Chiefs

CONFIDENTIAL

The Temporary Acting Managing Director July 19, 1978.

A. S. Shaalan

Iran--1978 Article IV Consultation

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The declared policy of the current Government in Iran, which assumed office about a year ago, is to aim at moderate growth targets that can be attained without creating excessive strains in the economy. Performance during the past Iranian year, which ended on March 20, 1978, showed an appreciable movement in that direction. The growth rate of the non-oil GDP decelerated to about 7.5 per cent which, in combination with a sizable decrease in value added in the oil sector, resulted in an overall rate of growth of approximately 2 per cent. The rate of increase in the cost of living accelerated to 25 per cent, but to a considerable degree this reflected the easing of price controls and, in fact, starting in mid-year, the cost of living showed a substantial slowdown in the rate of increase. In the external accounts, both the current account and the overall balance remained in surplus in 1977/78, though sharply lower than in the previous year.

The prospects for 1978/79 are for an acceleration in the rate of expansion of non-oil GDP to about 9 per cent in real terms reflecting revival in private sector activity, particularly construction, while output in the oil sector is not expected to rise. The financial policies for 1978/79 are forecast to result in domestic liquidity expanding by about 26 per cent compared with 32 per cent attained last year. Consequently the rate of price increases is projected to decelerate to about 12-14 per cent compared with the annual average for the past four years of approximately 17 per cent. The mission emphasized that greater efforts were needed to achieve more rapid progress in restoring domestic financial stability in Iran. As the planned level of credit increment for the private sector is moderate and necessary for the expansion of activity in that sector, the mission recommended reducing public expenditures by some Rls 100 billion (equivalent to 5 per cent of the stock of money and quasi-money at the end of 1977/78), from the presently anticipated level of total expenditures.

Iran's external accounts are experiencing a weakening phase. The current account, which was in surplus of SDR 3.6 billion in 1976/77 is forecast to record a deficit of SDR 2 billion in 1978/79. This large turnaround is being caused by considerable increases in payments while receipts, particularly oil receipts, are not expected to increase. In order to contain the overall balance of payments deficit in 1977/78, substantial gross drawings on external loans are intended. The mission stated that in view of Iran's comfortable reserves position

and a very low external debt service ratio, neither the forecast overall deficit nor the proposed borrowings abroad constitute cause for concern. Considering, however, that adjustment policies require time to take hold, the mission advised that it was not too soon to start directing attention to the objective of attaining a sustainable balance in the external sector. In the circumstances a lower level of effective demand in 1978/79 and a greater reduction in the domestic rate of inflation are also needed for balance of payment management purposes. There are clear indications that the steep rates of inflation and wage increases experienced over the past few years have affected the domestic cost structure to the extent of causing some difficulties for the non-oil export sector and the import substituting industries. The authorities' reaction so far has been to provide additional protection to domestic industry and various incentives to promote exports, including cash subsidies for a number of export commodities. The mission cautioned the authorities on the dangers the pursuit of these policies could lead to. Moreover, the rial has been, for all practical purposes, pegged to the U.S. dollar and Iran's external sector has benefited from the downward movement that occurred as a consequence of the depreciation of the dollar in recent months. The mission discussed these steps with the authorities and recommended a comprehensive review of balance of payments policies.

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Washington, D.C. 20431

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ADDRESS

Mr. S. Nsouli
C/o Intercontinental Hotel
Teheran
Iran

Special Instructions

Very happy to accept Governor's invitation to Caspian Sea. Please extend my sincere thanks to Governor.

Shaalan

Interfund

Distribution

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Drafted by: A.S.Shaalan/pmc
Department: MED
Date: June 27, 1978

A.S. Shaalan
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PMJoudrey
July 19/78

FROM..

Room...................

Office Memorandum

Jr

TO : The Managing Director
The Deputy Managing Director

DATE: June 22, 1978

FROM : A.S. Shaalan

SUBJECT : Iran--Briefing Paper

Attached for your consideration and approval please find the briefing paper for the forthcoming consultation discussions with Iran. This draft has been cleared with the concerned departments.[1] I shall be leaving for Iran on July 5.

In order to help the Managing Director familiarise himself with the situation in Iran, the staff has prepared a very short briefing paper for his review.

Attachment

cc: Mr. Ware

1/ Mr. Mookerjee (ETR), Mr. Effros (LEG), Mr. Wittich (TRE), Mr. Rhomberg (RES), Mr. Hammoud (BUR), and Mr. Radford (FAD).

INTERNATIONAL MONETARY FUND

IRAN

Briefing Paper - 1978 Article IV Consultation

Prepared by the Middle Eastern Department and the
Exchange and Trade Relations Department

(In consultation with the Legal, Treasurer's, and Fiscal Affairs Departments)

Approved by A.S. Shaalan and S. Mookerjee

June 22, 1978

I. Introduction

A staff mission composed of Messrs. A.S. Shaalan, S.H. Hitti, P. Boxall, S. Nsouli, and Ms. P. Curtis (all from MED), and Mr. Z. Iqbal (ETR), is scheduled to hold Article IV consultation discussions in Tehran during the period July 8-16, 1978. Some members of the mission will arrive in advance to prepare for the discussions. The Executive Board discussed the 1977 Staff Report (SM/77/103) on June 10, 1977.

II. Relations with the Fund

Iran's quota in the Fund is SDR 660 million; at the end of May, 1978, Fund holdings of Iranian rials were equivalent to 90 per cent of quota. Iranian rials equivalent to SDR 12 million are included in the currency budget for the period June-August 1978. Iran has lent the Fund the equivalent of SDR 990 million for the Oil Facility (of which SDR 895 million was still outstanding at end-May 1978), contributed SDR 6 million to the Subsidy Account, and has agreed to lend the Fund the equivalent of SDR 685 million for the Supplementary Financing Facility. Iran has not yet transferred to the Trust Fund its share of profits from the Fund's gold sales.

Iran is a participant in the Special Drawing Account and has received allocations totaling SDR 61.9 million. On May 31, 1978, Iran's holdings of special drawing rights were equivalent to 119 per cent of net cumulative allocations. Iran is included in the June-August 1978 designation plan in the amount of SDR 22 million.

The Iranian rial is pegged to the SDR on the basis of the rate SDR 1 = Rls 82.2425; margins of 7.25 per cent are maintained around this rate. Fund holdings and transactions in rials are valued on the basis of a representative rate determined as the midpoint between the Central Bank of Iran's official buying and selling rates for the U.S. dollar (the intervention currency) which are currently Rls 70.35 and Rls 70.60 per US$1, respectively.

III. Background for Discussions

The steep rises in oil prices in 1973-74 enabled the Government to expand sharply its expenditures for both current and development purposes. The ensuing surge in aggregate demand exceeded substantially the growth in aggregate supply, both from domestic output and imports, because of infrastructural bottlenecks. As a result, the rate of price increases accelerated. The Government's initial response was to impose in mid-1975 comprehensive price controls followed by the adoption of policies aimed at reducing the excess demand and at alleviating supply constraints. These policies have met with some success but the underlying imbalance in the economy has persisted.

In 1977/78 (Iranian year ended March 21) the rate of increase in government expenditures tapered off to around 22 per cent as compared with about 38 per cent a year earlier. The restrained fiscal stance was accompanied by a tighter monetary policy. The Central Bank set a ceiling of 20 per cent on the increase in bank credit to the private sector, raised the rediscount rate by 1 percentage point, tightened the access to the Central Bank's rediscount facilities, and permitted higher lending interest rates by commercial banks, particularly for construction purposes. Mainly as a result of these measures, the rate of growth of domestic liquidity decelerated to 20 per cent from 39 per cent a year earlier.

The rate of growth of the non-oil sector is estimated to have declined to 8-9 per cent in 1977/78, from an average of about 16 per cent in the previous three years, partly due to a poor agricultural season and partly in response to the fiscal and monetary restraints. There were other contributory factors, including the profits squeeze caused by the price control program. Moreover, industrial investment suffered as a consequence of the share redistribution program initiated in 1975 which requires both private and public enterprises to sell to the public 49 per cent and 99 per cent of their shares, respectively.

The rate of inflation (as measured by changes in the cost of living index) accelerated to 25 per cent in 1977/78 from 17 per cent in 1976/77. This increase partly reflected the relaxation of price controls during the year, a move that unleashed the pent-up forces suppressed by the price controls during the two previous years. The large rise in prices prompted the Government to bring pressure on the merchant guilds to exercise greater restraints on price hikes.

In the external sector, the current account surplus is projected to have declined substantially in 1977/78, basically because of an increase in public sector imports and in net service payments. The deficit in the capital account is also projected to have declined mainly due to a significant rise in borrowing and capital repatriation from abroad. The overall surplus in 1977/78, at about US$2 billion, is estimated at about the same level as in the previous year.

Since February 12, 1975, the Iranian rial has been pegged to the SDR. Initially, the Iranian authorities availed themselves of 2.25 per cent margins and intended to change the U.S. dollar/rial rate when the actual rial/SDR rate moved and remained outside the margins for five consecutive days. The latest change in the dollar/rial rate occurred on December 10, 1977. The continuing depreciation of the dollar against the SDR in December would have necessitated further adjustment if the actual rial/SDR rate was to be maintained within the margins. The Iranian authorities, however, decided that from December 14, 1977 they would no longer adjust the dollar/rial rate after five consecutive working days of its falling outside the margin. The new policy is to wait before adjusting the dollar/rial rate until it is ascertained that the change in the dollar/SDR rate is enduring and not reversible during a short span of time and with effect from April 1, 1978 the margins were expanded to 7.25 per cent.

Although a dual exchange market exists in Iran, exchange rate quotations in both markets have remained virtually identical and for all practical purposes the exchange markets are unified. Iran maintains a number of bilateral payments agreements, one of which is with a Fund member, Romania. Some payments are made through clearing accounts maintained with Turkey and Pakistan. Iran also is a participant in the Asian Clearing Union. Iran's trade system is relatively liberal but accords considerable protection to domestic industry and in recent months there have been some quantitative restrictions of imports.

IV. Topics for Discussion

There are no major outstanding issues between Iran and the Fund and the forthcoming consultation discussions are, therefore, expected to be routine in character. There are, however, new policy initiatives that the mission will need to review and assess during the discussions.

The new Government that came into office a few months ago has signalled a shift in economic policy toward aiming at more moderate growth targets in line with the absorptive capacity of the economy. Consistent with the new outlook, the budget for 1978/79 projects only a modest increase in government expenditure in real terms. On the other hand, there are indications that the Government is now encouraging the private sector to resume the dynamic posture it had played in the past. The mission, therefore, will need to inform itself of the extent of the realignment in domestic economic policy and will discuss with the authorities the implications for monetary and credit policies.

In the external sector, an important departure in exchange rate policy was made in the recent past. When the rial peg was changed in 1975 from the dollar to the SDR the motive of the Iranian authorities was to avoid involuntary depreciation of their currency through its link to the dollar. Early in 1978 the substantial widening of the margins around the SDR peg may have been intended to avoid involuntary appreciation of the rial. In the context of surveillance by the Fund under the amended Articles, the mission will undertake a thorough review of Iran's exchange rate policy. The mission will also discuss with the authorities Iran's trade policy and urge the termination of the bilateral arrangement with Romania.

Office Memorandum

TO : The Managing Director
The Deputy Managing Director

DATE: June 22, 1978

FROM : A.S. Shaalan

SUBJECT : Iran--Briefing Paper

Attached for your consideration and approval please find the briefing paper for the forthcoming consultation discussions with Iran. This draft has been cleared with the concerned departments.[1] I shall be leaving for Iran on July 5.

In order to help the Managing Director familiarise himself with the situation in Iran, the staff has prepared a very short briefing paper for his review.

Attachment

cc: Mr. Ware

1/ Mr. Mookerjee (ETR), Mr. Effros (LEG), Mr. Wittich (TRE), Mr. Rhomberg (RES), Mr. Hammoud (BUR), and Mr. Radford (FAD).

INTERNATIONAL MONETARY FUND

IRAN

Briefing Paper - 1978 Article IV Consultation

Prepared by the Middle Eastern Department and the Exchange and Trade Relations Department

(In consultation with the Legal, Treasurer's, and Fiscal Affairs Departments)

Approved by A.S. Shaalan and S. Mookerjee

June 22, 1978

I. Introduction

A staff mission composed of Messrs. A.S. Shaalan, S.H. Hitti, P. Boxall, S. Nsouli, and Ms. P. Curtis (all from MED), and Mr. Z. Iqbal (ETR), is scheduled to hold Article IV consultation discussions in Tehran during the period July 8-16, 1978. Some members of the mission will arrive in advance to prepare for the discussions. The Executive Board discussed the 1977 Staff Report (SM/77/103) on June 10, 1977.

II. Relations with the Fund

Iran's quota in the Fund is SDR 660 million; at the end of May, 1978, Fund holdings of Iranian rials were equivalent to 90 per cent of quota. Iranian rials equivalent to SDR 12 million are included in the currency budget for the period June-August 1978. Iran has lent the Fund the equivalent of SDR 990 million for the Oil Facility (of which SDR 895 million was still outstanding at end-May 1978), contributed SDR 6 million to the Subsidy Account, and has agreed to lend the Fund the equivalent of SDR 685 million for the Supplementary Financing Facility. Iran has not yet transferred to the Trust Fund its share of profits from the Fund's gold sales.

Iran is a participant in the Special Drawing Account and has received allocations totaling SDR 61.9 million. On May 31, 1978, Iran's holdings of special drawing rights were equivalent to 119 per cent of net cumulative allocations. Iran is included in the June-August 1978 designation plan in the amount of SDR 22 million.

The Iranian rial is pegged to the SDR on the basis of the rate SDR 1 = Rls 82.2425; margins of 7.25 per cent are maintained around this rate. Fund holdings and transactions in rials are valued on the basis of a representative rate determined as the midpoint between the Central Bank of Iran's official buying and selling rates for the U.S. dollar (the intervention currency) which are currently Rls 70.35 and Rls 70.60 per US$1, respectively.

III. Background for Discussions

The steep rises in oil prices in 1973-74 enabled the Government to expand sharply its expenditures for both current and development purposes. The ensuing surge in aggregate demand exceeded substantially the growth in aggregate supply, both from domestic output and imports, because of infrastructural bottlenecks. As a result, the rate of price increases accelerated. The Government's initial response was to impose in mid-1975 comprehensive price controls followed by the adoption of policies aimed at reducing the excess demand and at alleviating supply constraints. These policies have met with some success but the underlying imbalance in the economy has persisted.

In 1977/78 (Iranian year ended March 21) the rate of increase in government expenditures tapered off to around 22 per cent as compared with about 38 per cent a year earlier. The restrained fiscal stance was accompanied by a tighter monetary policy. The Central Bank set a ceiling of 20 per cent on the increase in bank credit to the private sector, raised the rediscount rate by 1 percentage point, tightened the access to the Central Bank's rediscount facilities, and permitted higher lending interest rates by commercial banks, particularly for construction purposes. Mainly as a result of these measures, the rate of growth of domestic liquidity decelerated to 20 per cent from 39 per cent a year earlier.

The rate of growth of the non-oil sector is estimated to have declined to 8-9 per cent in 1977/78, from an average of about 16 per cent in the previous three years, partly due to a poor agricultural season and partly in response to the fiscal and monetary restraints. There were other contributory factors, including the profits squeeze caused by the price control program. Moreover, industrial investment suffered as a consequence of the share redistribution program initiated in 1975 which requires both private and public enterprises to sell to the public 49 per cent and 99 per cent of their shares, respectively.

The rate of inflation (as measured by changes in the cost of living index) accelerated to 25 per cent in 1977/78 from 17 per cent in 1976/77. This increase partly reflected the relaxation of price controls during the year, a move that unleashed the pent-up forces suppressed by the price controls during the two previous years. The large rise in prices prompted the Government to bring pressure on the merchant guilds to exercise greater restraints on price hikes.

In the external sector, the current account surplus is projected to have declined substantially in 1977/78, basically because of an increase in public sector imports and in net service payments. The deficit in the capital account ______________________________ is also projected to have declined mainly due to a significant rise in borrowing and capital repatriation from abroad. The overall surplus in 1977/78, at about US$2 billion, is estimated at about the same level as in the previous year.

Since February 12, 1975, the Iranian rial has been pegged to the SDR. Initially, the Iranian authorities availed themselves of 2.25 per cent margins and intended to change the U.S. dollar/rial rate when the actual rial/SDR rate moved and remained outside the margins for five consecutive days. The latest change in the dollar/rial rate occurred on December 10, 1977. The continuing depreciation of the dollar against the SDR in December would have necessitated further adjustment if the actual rial/SDR rate was to be maintained within the margins. The Iranian authorities, however, decided that from December 14, 1977 they would no longer adjust the dollar/rial rate after five consecutive working days of its falling outside the margin. The new policy is to wait before adjusting the dollar/rial rate until it is ascertained that the change in the dollar/SDR rate is enduring and not reversible during a short span of time and with effect from April 1, 1978 the margins were expanded to 7.25 per cent.

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IV. Topics for Discussion

There are no major outstanding issues between Iran and the Fund and the forthcoming consultation discussions are, therefore, expected to be routine in character. There are, however, new policy initiatives that the mission will need to review and assess during the discussions.

The new Government that came into office a few months ago has signalled a shift in economic policy toward aiming at more moderate growth targets in line with the absorptive capacity of the economy. Consistent with the new outlook, the budget for 1978/79 projects only a modest increase in government expenditure in real terms. On the other hand, there are indications that the Government is now encouraging the private sector to resume the dynamic posture it had played in the past. The mission, therefore, will need to inform itself of the extent of the realignment in domestic economic policy and will discuss with the authorities the implications for monetary and credit policies.

In the external sector, an important departure in exchange rate policy was made in the recent past. When the rial peg was changed in 1975 from the dollar to the SDR the motive of the Iranian authorities was to avoid involuntary depreciation of their currency through its link to the dollar. Early in 1978 the substantial widening of the margins around the SDR peg may have been intended to avoid involuntary appreciation of the rial. In the context of surveillance by the Fund under the amended Articles, the mission will undertake a thorough review of Iran's exchange rate policy. The mission will also discuss with the authorities Iran's trade policy and urge the termination of the bilateral arrangement with Romania.

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OFFICIAL MESSAGE

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Washington, D.C. 20431

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ADDRESS

H.E. The Honorable Yussef Khoshkish

Governor, Bank Markazi

P.O. Box 3362

Teheran, Iran

Special Instructions

With reference to the forthcoming Article IV consultations, I shall very much appreciate it if you will request your staff to update the tables in last year's Recent Economic Developments Report for Iran. Members of the advance team will arrive as follows: Messrs. Boxall and Iqbal on British Airways 201 at 22:35 June 25, Mr. Nsouli on Royal Jordanian Airways 900 at 0:35 June 26, and Mr. Hitti on British Airways 203 at 0:10 July 2.

Best personal regards

Shaalan

Interfund

Distribution

cc: Mr. Amuzegar
RM: 13-315

MESSAGE MUST END HERE

Drafted by: Mr. Nsouli

Department: MED

Date: July 2, 1978

A.S. Shaalan
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~~Shaalan, A.S.~~		3-314
~~Ray, A.S.~~		3-320
Selehdar, A.K. El		3-320
Gerakis, A.S.		3-401
Crockett, A.D.		3-314
von Post, S.		3-300
Karamali, B.A. (Mediterranean Div.)		3-300
Abed, G.		"
Blalock, J.	Sukachevin, P.	"
Kawar, S.		"
Yaqub, M. (Northern Division)		3-214
Kayoumy, A.		"
Nsouli, S.	Vaez-Zadeh, M.	"
Prust, J.		"
Hitti, S.H. (Red Sea Div.)		3-300
Al-Khuri, S.		"
Borpujari, J.	Eglin, R.	"
Nashashibi, K.		"
Noursi, D.		"
Thayanithy, S.		"
Drees, F. (Southern Div.)		3-401
Barth, R.		"
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Remarks ______________________________

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cc: Mr. Yaqub/Mr. Nsouli
Mr. Hitti
Mr. Boxall
Mr. Iqbal

MR SHAKOUR SHAALAN INTERFUND, WASHINGTON DC

REFERENCE YOUR CABLE APRIL 11 ARRANGMENTS FOR HOTEL RESERVATION AT INTERCONTINENTAL HOTEL HAVE BEEN MADE STOP PLEASE CABLE MARKAZBANK YOU AND YOUR COLLEAGUES' FLIGHT NUMBER, EXACT DATES OF ARRIVAL NAME OF THE AIRLINES AND NAMES OF YOUR COLLEAGUES AS SOON AS SUCH INFORMATION BECOME AVAILABLE STOP

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COL 11

His Excellency

The Honorable Yussof Khoshkkish, Governor

Bank Markazi

Teheran, Iran

With reference to your telex of March 29, 1978, I shall be very grateful if we can have the assistance of your staff in making the following reservations at the Intercontinental or Hilton Hotels: three single rooms from June 25 to July 17, one single room from June 29 to July 17, one single room from July 1 to July 17, and one suite from July 6 to 17.

With best personal regards.

Shaalan

Interfund

S. Nsouli

Middle Eastern
April 10, 1978

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OFFICIAL MESSAGE
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His Excellency
The Honorable Yussof Khoshkish
Governor
Bank Markazi, Iran

Special Instructions

You may recall that during my recent visit you indicated that it would be agreeable to hold the next consultation discussions during early July. Accordingly, we propose that these discussions be held during July 8 to 15, with the advance party arriving in late June to prepare for the discussions. In order to enable us to finalize our mission schedule and summer plans for our staff, I should appreciate it if you could let us know at your earliest convenience if these arrangements are agreeable to you.

With best personal regards,

Shaalan

Interfund

Distribution

cc: Mr. Amuzegar
13-315

MESSAGE MUST END HERE

Drafted by: Hitti/Nsouli
Department: MED
Date: March 22, 1978

A.S. Shaalan
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