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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 96/78

10:00 a.m., August 23, 1996

Contents

Executive Board Attendance

S. Fischer, Acting Chairman
P.R. Narvekar, Deputy Managing Director

Executive Directors	**Alternate Executive Directors**
	S.M. Al-Turki
	P. Cailleteau, Temporary
L.E. Berrizbeitia	
	C.X. O'Loghlin
	C.K. Duenwald, Temporary
	D.Z. Guti
	R. von Kleist, Temporary
	J. Shields
	N. Coumbis
	L.M. Cheong
	D. Gotz-Kozierkiewicz
A. Kafka	
W. Kiekens	
	H.A. Barro Chambrier
	B.S. Newman
	H. Ono
A. Mirakhor	M. Daïri
C. Saito	
A.S. Shaalan	
M.R. Sivaraman	H.B. Disanayaka
	B. Andersen
	A.V. Mozhin
E.L. Waterman	
J. de Beaufort Wijnholds	
Zhang Z.	

L. Van Houtven, Secretary and Counsellor
G.N. Walton, Assistant

Also Present

IBRD: L. De Wulf, Middle East and North Africa Regional Office. Staff Association Committee: J.M. Boyd, E. C. Harris, S. A. Meehan. Administration Department: A.D. Goltz. Central Asia Department: H. Neiss, Director. European I Department: L.J. Lipschitz, S.H. Samiei. European II Department: J.R. Márquez-Ruarte, M. Shadman-Valavi. External Relations Department: P.C. Hole, Deputy Director. Legal Department: F.P. Gianviti, General Counsel; W.E. Holder, Deputy General Counsel; H. Elizalde, L.E. Nordgaard, J.S. Powers, D.E. Siegel. Middle Eastern Department: M.A. El-Erian, Deputy Director; E. di Patti, A.C.A.R. Furtado, O. Liu, E. Maciejewski, K. Nashashibi, K.I. Sakr, V. Sundararajan, S.E. Williams. Monetary and Exchange Affairs Department: L. Errico, M. Farahbaksh, H. Mehran, M.R. Vaez-Zadeh. Policy Development and Review Department: J. Ferran, Deputy Director; P.N. Njoroge. Secretary's Department: R.H. Munzberg, Associate Secretary; W.S. Tseng, Deputy Secretary. Southeast Asia and Pacific Department: K. Saito, Director. Treasurer's Department: G. Wittich, Deputy Treasurer. Office of the Managing Director: J.A.P. Clément. Advisors to Executive Directors: M.A. Ahmed, T.K. Gaspard, G.M. Iradian, R. Kannan, M.-H. Mahdavian, M.F. Melhem. Assistants to Executive Directors: T. Berrihun, J.G. Borpujari, P.I. Botoucharov, M.A. Brooke, M. Cilento, S. Fukushima, A. Galicia-Escotto, B. Grikinyté, D. S. Hakura, O. Issaev, T. Issataev, H. Javaheri, T.-M. Kudiwu, B.M. Lvin, Ng C.S., G.P. Ramdas, J.N. Santos, Song J.

1. EXECUTIVE DIRECTOR

The Acting Chairman welcomed Mr. Sivaraman as Executive Director for Bangladesh, Bhutan, India, and Sri Lanka.

2. DEVELOPMENTS IN THE CASE OF MR. HONG

The Executive Directors met, in restricted session, to hear a statement by the Acting Chairman on the latest developments in the case of Mr. Hong.

3. ISLAMIC REPUBLIC OF IRAN—1996 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1996 Article IV consultation with the Islamic Republic of Iran (SM/96/208, 8/8/96; and Cor. 1, 8/19/96). They also had before them a statistical appendix (SM/96/210, 8/9/96; and Cor. 1, 8/19/96).

The staff representative from the Middle Eastern Department made the following statement:

> Following the issuance of the Board documents (SM/96/208 and SM/96/210), the staff has received additional information relating to the budget, domestic liquidity, and price developments during the first quarter of 1996/97 (March 21-June 20).
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> The general government accounts (excluding extra-budgetary foreign exchange losses) registered a surplus of Rls 876 billion (1.4 percent of GDP on an annual basis). Budgetary revenue was 18 percent higher than in the first quarter of 1995/96 on the strength of an increase in tax receipts. On the expenditure side, both current and capital outlays were contained, with total budgetary outlays exceeding by 10 percent the level registered in the first quarter of last year.
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> During the first quarter, domestic liquidity grew only marginally (by 0.3 percent), compared with an increase of 4.4 percent during the same period of the previous year. Available information indicates that bank credit to the nongovernment sector expanded by 2.3 percent of initial domestic liquidity, similar to its rate of increase in the first quarter of 1995/96.
>
> The consumer price index declined by 0.5 percent in June following a 0.1 percent decline in May. As a result, year-on-year inflation was reduced further to 42 percent (from 45 percent in May) and the twelve-month rate of inflation was lowered to 25 percent (from 26 percent).

Mr. Mirakhor made the following statement:

> Once again, my Iranian authorities express their appreciation for the hard work of the staff. They are in general agreement with the thrust of the staff report. Before turning to the discussion of specific policies in 1995/96 and beyond, some general comments maybe helpful. As indicated in my statement on the 1995 Article IV consultation discussions, my Iranian

authorities saw their immediate and most urgent task as speedy restoration of the nation's external financial credibility and the containment of inflation. They also felt that the reserve position of the country needed to be strengthened substantially, and growth resumed.

The authorities were quite successful in meeting their most important objective by continuing the import compression of 1994/95. The repayment of the rescheduled debt has been proceeding on time since the first installment began in December 1995. In the year ended March 1996, the amount of $5.7 billion of short- and medium-term debt was repaid, which brought the total repayments over two years ending in March 1996 to $11 billion. Although most of 1995/96 was a grace period for rescheduled debt, the authorities arranged maximum repayments whenever and wherever possible, including repayments of nonrescheduled debt. Additionally, the authorities were able to reprofile the external debt toward longer maturities; of the total external debt of $22 billion, about $17.5 billion, or 80 percent is now long and medium term, compared with 10 percent in 1992/93.

With an increase in the level of external reserves by $2.8 billion in 1995/96, the authorities are fully confident that they can meet all their external obligations, while allowing a degree of relaxation of the import constraint. Furthermore, owing to the fact that many of the large social overhead capital projects, that were initiated during the First Five-Year Plan (FFYP), have now been completed, and reconstruction has also restored considerable productive capacity, damaged or destroyed during the war, to the economy, it is likely that the relatively high rates of growth experienced during the FFYP period can be obtained at lower levels of imports.

A significant measure of success was also achieved on the inflation front as tight financial policies led to a deceleration of the twelve-month inflation rate to 26 percent in May 1996, compared with 59 percent a year earlier. Explicit incorporation into the budget of foreign exchange losses led to greater transparency in fiscal accounts in 1995/96. However, considerably smaller-than-anticipated amounts of fresh external financing required bank financing of foreign exchange losses on account of larger net external repayments than the annual limit of $1.6 billion. But for this factor, the otherwise tight financial policies would have reduced inflation further.

While the sharp compression in imports had an adverse impact on economic growth, the real economy performed better than expected in 1995/96. The growth rate recovered to 3.1 percent, nearly twice its level of a year earlier, illustrating the vitality and resilience of the economy. The supply response in agriculture, construction, and import-competing manufacturing industries has been particularly strong. The output of major agricultural products, especially those which have hitherto been imported in substantial amounts, increased in response to the rise in procurement prices in recent years. Finally, the pace of reconstruction of war-damaged areas of the country continued, and it is now estimated that this effort is 90 percent complete.

Turning to the evolution of policies, fiscal policy aimed at further fiscal consolidation; the overall deficit was reduced to 3.8 percent of GDP, compared with 4.5 percent in 1994/95 and 7.2 percent in 1993/94. Expenditures declined by about 2 percent of GDP, more than offsetting the fall in revenues of 1.4 percent. The improvement in the fiscal position in 1995/96 was due to a reduction of 3 percent of GDP in current spending as capital expendi-tures increased slightly. As indicated in the staff report (Table 2), 3.6 percent of the 1995/96 deficit was attributed to foreign exchange losses on account of heavier-than-programed debt repayment; otherwise, the authorities would have been right on their target of 0.2 percent of GDP, that they had set for the fiscal deficit.

Two developments regarding the structure of revenue are worth noting. First, the share of oil and gas revenue in total revenue shows a perceptible downward trend from 75 percent (Table 2, SM/96/208) in 1993/94 to 65 percent in 1995/96, and is set to decline to 55 percent in 1996/97. While it may be too soon to judge the sustainability of this trend, it is in line with the urgent national priority of reducing the reliance on this source of revenue. Secondly, the shares of tax and nontax revenue to total revenue show an upward trend; the former reflecting better tax administration, and the latter sharp increases in the fees and charges on government services as well as excises on petroleum products. However, the authorities recognize that more needs to be done in this area. Over the past several years, their efforts have been directed toward improving tax administration and collection. Given the progress that has been achieved in this area thus far, they can now address the widening of the tax base and elimination of tax exemptions. With the parliamentary elections behind them, the authorities plan to submit this year a value-added tax bill to the new parliament.

The 1996/97 budget will continue along the deficit-reduction path. Recent evidence suggests that tax revenue in the first three months of the current year (beginning March 20) increased by 58.4 percent, raising its share in total revenue from 16 percent to 22 percent. The rate of growth of current expenditures in the first three months decreased to 19.4 percent, as compared with the rate of 56.2 percent for the same period last year. Similarly, the growth in development expenditures was reduced to 21.3 percent in the first three months of this year, as compared with 42.9 percent in the previous year.

The authorities agree with the staff that the budgetary provision for foreign exchange losses may not be sufficient if the level of net external repayments again exceeds its programed annual limits by a substantial margin. However, even if the staff projection, which the authorities consider the upper bound on foreign exchange losses, materializes, the budget deficit will be limited to 1.6 percent of GDP, which still represents a sizable improvement over 1995/96.

Policy efforts at containing the growth of liquidity were burdened by the more than doubling of the net foreign assets and larger-than-targeted expansion in domestic credit on account of bank support for coverage of foreign exchange losses. The authorities realize that enhancing monetary

policy effectiveness requires the availability of indirect instruments. In this context, public entities, including some ministries, such as that of industry, are now authorized to issue profit-sharing securities to finance productive nontrade projects. This follows a model which was tried successfully by the Tehran municipality that floated similar instruments to finance a north-south highway through the city and the residential as well as commercial development alongside the highway belonging to the municipality. The effectiveness of these instruments in reducing the liquidity overhang remains to be seen, as the initiative has just begun. The authorities are quite mindful of the regulatory and supervisory issues that this kind of initiative raises, and are addressing them with assistance from international institutions, including the Fund.

As to the monetary policy stance for 1996/97 and beyond, my authorities are in agreement with the staff assessment that the broad money target, as envisaged in Second Five-Year Plan (1995/96–1999/2000), is highly ambitious and may not be achieved in light of excess liquidity resulting from insufficient amount of new financing. The monetary program for 1996/97 is based on the assumption that the growth of broad money will be contained at about 20 percent, well below the projected growth rate of nominal GDP. In this context, the authorities will maintain credit ceilings at the levels imposed last year. Recent data for the first three months of this year (beginning March 20) indicate an expansion of 0.3 percent in liquidity compared with 4.4 percent for the same period last year, reflecting the tight monetary policy stance.

As reflected in my statement of last year, the authorities were to review their foreign exchange policy in March 1996 with a view toward possible adjustment in the rate and acceleration of the unification timetable. In the event, the authorities, mindful of uncertainties that currently cloud the policy environment, decided that the balance of risks called for continuation of policies that minimize the risk of exchange market disruptions and inflationary expectations.

The authorities believe that the valuable lessons learned since the March 1993 unification dictate considerable prudence. In their view, policy changes must be put in place only when domestic financial imbalances are removed and external uncertainties reduced. Above all, they would like to ensure that once new policies are in place, they remain irreversible, and believe that any premature policy change based on an overly optimistic assessment of domestic financial constraints, and external uncertainties, can only harm policy credibility. Let me add that the unification and full convertibility of the rial is mandated by the SFYP Law and must be in place by the end of the Plan period. My authorities are open to a full discussion with the staff on the necessary preconditions for a successful exchange rate unification.

In 1995/96, further progress was achieved in liberalizing prices, particularly for government services and public utilities, and in privatization through the sales of shares of public enterprises on the Tehran Stock

Exchange. Having successfully met the challenge of normalizing relations with external creditors, the authorities are targeting a pickup in the rate of economic growth. They agree with the staff that the pace and magnitude of the progress they have made toward restoring external financial credibility, external debt reprofiling, stronger reserve position, and growth recovery provide the basis for enhancing the pace of structural adjustment and reform mandated by the SFYP. Most important among these are foreign exchange, price, and financial sector reforms, as well as further retrenchment of the government's role in the economy.

On major issues, such as energy prices, the authorities are in agreement with staff recommendations; their views differ only with respect to the pace of adjustment. Energy prices have been increased in two phases, one last year, and the other at the beginning of the current year; thus far, prices of petroleum products have been raised by more than 150 percent and further increases are planned. There is evidence that, as a result of these increases, domestic energy consumption has declined by 3.5–5 percent.

While the authorities remain concerned by the impact of a more strident price adjustment on the real sector of the economy, particularly on the energy- intensive industrial and petrochemical sector whose comparative advantage is energy based, they are aware that much more pronounced and accelerated price adjustments are needed to reduce the inefficiencies in domestic energy consumption. Moreover, they are fully cognizant of the potential financial resources that a more sustainable domestic energy policy can mobilize. The need for a more realistic energy policy is currently the subject of intense national debate that is hoped will lead to the emergence of a consensus for stronger policy response.

To enhance the soundness of the banking system, the authorities are strengthening the system's prudential, regulatory, and supervisory framework with the help of the Fund and the World Bank. They highly value the technical assistance provided by MAE in this area. Progress has been made in strengthening the technical capacity in the area of bank supervision. Efforts are now being directed toward establishing legal norms and benchmarks for more effective prudential regulation and supervision, as well as toward determining the extent of the effort needed to enhance capital adequacy in the banking system. It is hoped that a report can be made to the Board on progress in this area in the context of next year's Article IV consultation discussions.

During last year's discussions, Directors "noted deficiencies in areas of the capital account of the balance of payments and economic classification of government spending remained" and "advised further actions to remove" them. As indicated in the staff report (p. 39), the statistical issues relating to the economic classification of government spending have been resolved. The statistical issues of the capital account have proved more complicated and have consumed considerable effort to clear up. The difficulties have little to do with the availability of data than with differences of views on "proper" classification of various items in the coverage of transactions in the external

account. Reconciliation of the capital account with other statistical systems is a matter of priority, and improvements can be expected.

The economy of Iran has made important progress since the last consultation. Consistent with their objectives, and notwithstanding the difficult external environment, the authorities have regularized their external debt position and strengthened their international reserve cushion. While this has entailed a large cost in terms of import compression and forgone growth, it has placed the economy in a good position to meet the medium-term economic and financial challenges. Progress has also been made in reducing inflationary pressures and correcting some long-standing price distortions and structural rigidities.

The authorities' policy priorities are now being directed at strengthening conditions for a resumption of sustained high economic growth. The Second Five-Year Plan provides an important road map in this regard and identifies the additional structural reforms and adjustment measures that are required. My Iranian authorities look forward to continued policy dialogue with the Fund in the context of the implementation of these measures.

Mr. Shaalan made the following statement:

At the outset, I would like to commend the Iranian authorities for the many accomplishments in managing their economy during the past few years in spite of the difficult external circumstances facing the country. Worthy of note, in this connection, are the relatively high growth rates attained during the first Five Year Development Plan, the remarkable improvement in the social indicators, in particular, the significant poverty alleviation, the reduced budgetary deficits, and the generally moderating inflation rates.

To an important extent, external circumstances have dictated the priorities of the authorities. It is in this context that the focus of policy during the period and, particularly, in the past two years, was directed at normalizing relations with external creditors and improving the maturity structure of the country's foreign debt, as well as augmenting the low level of foreign reserves. The emphasis attached to this area was most appropriate as the country's balance of payments, as well as foreign arrears, were a deterrent to addressing other basic policy objectives. The accomplishments in this area are detailed in a comprehensive manner in Mr. Mirakhor's most helpful statement. Admittedly, attaining these crucial objectives did not come without costs, particularly to economic growth and the sharp increase in prices occasioned by the cut back in imports. These were reduced, to about half the level of the early 1990s. The authorities believe that this approach was necessary, and in my view rightly so, in order to restore the country's creditworthiness and lay the groundwork for sustained economic growth. Given the globalized nature of financial markets, the emphasis accorded to this area was well placed. Improved creditworthiness is reflected in what appears to be increased interest by foreign investors as indicated by the sharp rise in foreign direct investment approvals. Accordingly, it is important that the authorities continue to strengthen the pace of reforms.

Both the authorities and the staff are in agreement regarding the thrust of the policy requirements. There is agreement on the need to accord high priority to policies directed at consolidating the past gains and creating an environment conducive to higher levels of growth with reduced inflation. I will address some areas that have already been identified.

On fiscal consolidation, it is well to recall that the overall budget deficit, which resulted mainly from extrabudgetary outlays arising from exchange losses, has been on a declining trend during the past three years—from a level of 7.2 percent of GDP in 1993/94 to a projected 1.6 percent in the current fiscal year. Without these extra budgetary outlays, the budget is now near balance. In this connection, the staff proposed that the budget deficit be curtailed further as presented in the adjustment scenario. Putting aside my reservations about the value of the medium-term scenarios, particularly when they are used as a basis for policy prescriptions, further budget consolidation may well be needed. However, I would have liked to see this substantiated in a more specific manner giving the rationale for the fiscal adjustment recommended. If the objective is to address the inflationary pressures, would not monetary policy be a more appropriate tool?

In this connection, it is to be noted that the liquidity expansion in 1995/96 was occasioned in the first instance by the build-up in foreign exchange reserves. The government's recourse to the banking system declined while claims on the private sector and nonfinancial public enterprises recorded substantial increases. The rapid monetary expansion has compromised a major policy objective, namely reducing inflation. Rates of return continue to be negative and, accordingly, the associated relatively low level of lending rates could well be a factor contributing to the high demand for credit by the aforementioned nongovernment sectors. Here it is to be noted that the introduction of profit sharing security schemes, carrying higher rates of return than other instruments that exist, is a significant move in the direction of increasing rates of return. If these schemes are deemed successful, they should be broadened further.

On exchange rate policy there is no disagreement between the staff and the authorities on the importance attached to unification. The timing is however crucial to the success of the move. Mr. Mirakhor reminds us of the failed attempt at unification of 1993. Here I would lean toward the authorities' prudence in seeking to effect the move within the current Five Year Plan, and not necessarily immediately. During that period it is imperative that the authorities address the financial imbalances that exist to ensure that unification is successful. It would be unfortunate to have another failed attempt. In the meantime, acceleration of the transfer of import commodities to the more depreciated rates should continue as this would facilitate the eventual move to unification.

On structural issues I would like to highlight the question of energy prices and the banking sector. While petroleum prices have been raised sharply in the past year; the increase was from a very low base. Prices continue to be sharply out of line with international prices and are among the

lowest for oil producers in the region. The staff recommends an appropriately phased program to correct this distortion. I am encouraged by the authorities' awareness of this problem and hope that the ongoing national debate on the subject will result in the formulation of a meaningful energy policy. On the banking sector I can only echo the staff's recommendation, shared by the authorities, that the soundness of the banking system must continue to be given the highest priority. I look forward to the next Article IV consultation when, hopefully progress will be made on this important issue.

Finally, I again commend the Iranian authorities for the economic progress attained so far and wish them every success in the challenges that lie ahead.

Mrs. Cheong made the following statement:

I would like to congratulate the Iranian authorities for the great strides made in addressing their external payments difficulties and in turning the economy around. Despite an extremely difficult (and, at times, hostile) external environment, the authorities have succeeded in normalizing relations with nearly all foreign creditors. As indicated in Mr. Mirakhor's comprehensive statement, effective debt management has improved Iran's external debt profile toward longer maturities. Outstanding debt has also been reduced to a manageable level of 24 percent of GDP and is projected to improve progressively over the medium term. Developments in the domestic economy are equally impressive: GDP growth is expected to strengthen further to about 4–5 percent, supported—significantly—by higher output in the nonoil manufacturing sector. The balance of payments position is in surplus and international reserves have recovered to a comfortable level of 6 months of import cover. The inflation situation is also improving, although it remains in the high 20's.

However, as highlighted in the staff report, this improvement came at the cost of severe import compression, exchange restrictions and credit controls, which are not only distortionary, but can also undermine the authorities' efforts to promote private investment and growth. Here, I am pleased to note that the authorities share the staff's views on the need for a comprehensive package of structural reforms to ensure sustainable growth with low inflation. In particular, it is worth noting that the authorities remain fully committed to the reform process.

More importantly, the authorities' reform program, as outlined in the Second Five-Year Development Plan (SFDP), is a program which, in the staff's own assessment, meets the key ingredients of the staff's policy prescriptions. However, as in all policy matters, the timing and sequencing of reform measures is important. The staff is advocating a bolder and more comprehensive schedule of reforms, while the authorities are more inclined to adopt a gradualist approach. Here, I can understand the staff's view that the authorities should capitalize on the "present propitious economic conditions" to launch a comprehensive adjustment and reform program. The staff's preference for quick action is also based on the concern that gradualism can

cast doubt about the authorities' commitment to reform and dilute its impact. However, I can also sympathize with the authorities' desire to move cautiously. The need for caution is particularly relevant in Iran because of the special circumstances facing the authorities. In addition to an extremely difficult and uncertain external environment, the Iranian authorities also have to contend with strong domestic opposition to reform.

Notwithstanding these difficulties, the Iranian authorities have maintained their full commitment to tight financial policies, as highlighted in Mr. Mirakhor's statement. At the same time, significant progress has also been made to widen the tax base to reduce the dependence on oil and gas revenue, while efforts are under way on price and financial sector reforms.

On the exchange rate front, Mr. Mirakhor has reiterated that unification and full convertibility of the rial is mandated by the SFDP Law. I concur with Mr. Mirakhor and Mr. Shaalan on the need for prudence to ensure the right timing for unification. It would be important to ascertain that any move toward unification will work amidst a still hostile external environment. Here, I wish to seek the staff's views. In the staff report, the failure of the previous attempt to unify the exchange rate was attributed to "insufficient fiscal and monetary policy adjustment." Were other factors at play as well? For example, to what extent did the US embargo contribute to the collapse of unified rate in 1993? More importantly, I would be interested in the likely implications of the latest round of US sanctions on the Iranian economy. Some commentators have suggested that the sanctions could undermine the economic reform process in Iran. While the sanctions are targeted against foreign investments in Iran's oil and gas sector, I would appreciate staff comments on the possible spill-over implications for Iran's efforts to promote foreign trade and investment in general.

Similarly, liberalizing the import regime, amidst an external environment that constrains Iran's capacity to participate fully in world trade and the capital markets, would lead to pressures on the balance of payments. Favorable results can only be assured if liberalization of imports by Iran is matched by free access to international markets. Without this precondition, I doubt that Iran can liberalize import and exchange controls and still maintain the strong reserves cushion that the staff considers is necessary.

Given the prevailing uncertainties, I am more inclined to support the cautious approach to reform by the Iranian authorities. The authorities have reiterated their commitment to the reforms under the SFDP, as evidenced by the ongoing efforts to tighten financial policies, rationalize public finances, cut subsidies, and expedite privatization to address long-standing distortions. Past policy slippages should be viewed as temporary deviations in the face of difficult and domestic and external conditions. In the final analysis, a country would need to implement policies in a pragmatic manner in order to maintain the socio-political support for the reform process, while keeping an eye on the external environment.

Mr. Berrizbeitia made the following statement:

Like Mr. Shaalan and Mrs. Cheong, I also wish to commend the Iranian authorities for the substantial progress achieved in a relatively short period of time, without outside assistance and in spite of substantial external difficulties: the growth rate has increased, both inflation and the fiscal deficit have improved, international reserves have strengthened substantially, and the authorities have normalized relations with external creditors, while reducing overall external debt and substantially lengthening its maturity profile. Under the circumstances, these are impressive results indeed.

Although these positive macroeconomic achievements are commendable, the policy response has implied a temporary deviation from the liberalizing stance of the development plan, and has been extremely costly in terms of import compression, domestic consumption, nonoil exports, and resource allocation. The question is not whether the current policy stance is sustainable over time, for experience in many countries indicates that it isn't, but whether the progressive approach to reform favored by the authorities will achieve the desired results, or whether, as the staff suggests, the currently favorable economic conditions should be capitalized to consolidate what has been achieved so far, and place the Iranian economy on a sustainable growth path.

Since I am in broad agreement with the staff assessment, I will concentrate my remarks on exchange rate issues which, I feel, constitute the core of the persisting imbalances in the Iranian economy.

In this respect, it would seem that the most important disequilibria facing the Iranian authorities are those related to exchange controls and the multiple exchange system, and that the sooner corrective action is achieved on this front, the easier it will be to correct the other disequilibria. Indeed, the staff report makes it clear that, to a considerable extent, exchange rate deviations lie at the root of the fiscal and monetary disequilibria and are also affecting the real economy very directly. In fact, as stated by Mr. Mirakhor in his useful statement, were it not for foreign exchange losses, the fiscal accounts would have been essentially in balance during the 1995/96 fiscal year. As regards monetary policy, we are told that excess liquidity in the financial system is the result "larger than targeted expansion in domestic credit on account of bank support for coverage of exchange losses", to use Mr. Mirakhor's own words and is probably the root cause of persistent inflationary pressures as indicated by Mr. Shaalan. And, third, according to the staff, nonoil exports fell by 33 percent as a result of exchange controls, thereby affecting the real growth potential of the economy.

Clearly, therefore, the sooner exchange rate unification is achieved and a more competitive, market-related exchange rate is established, the better the effect will be on the overall economic situation in Iran. Although I am not advocating controls, this would be the case even while retaining exchange controls, if deemed necessary by the authorities due to the persistence of adverse external factors. Indeed, the fiscal accounts would improve significantly through the positive exchange rate effect on oil exports, which would more than offset the increased external debt service burden. Such a

stronger fiscal stance would facilitate the management of monetary policy, since the financial system would not need to cover foreign exchange losses; in turn, this would help attain positive real rates of return on deposits and achieve higher levels of savings and investment. Thirdly, a more competitive unified exchange rate would, at the very least, not hinder exports of nonoil goods, even if some exchange controls were to be temporarily maintained. And fourth, the initial impact of unification on relative prices could be partially offset by appropriately targeted direct subsidies and would be contained relatively quickly by the stronger fiscal and monetary stance.

The authorities are apparently moving in this direction as fast as they consider feasible without creating undue inflationary expectations. Indeed, the shift of a substantial volume of imports from the official to the export exchange rate is a step in the right direction, as is the intention to collect the full foreign exchange cost from enterprises that have the capacity to service their debts at the current exchange rate. These are, however, partial measures that do not correct the fundamental distortion to relative prices implied by a dual exchange rate system with a tendency to strong real appreciation. Also, as suggested earlier, unification would probably contribute to achieving domestic financial balance more rapidly than would otherwise be the case.

Therefore, I would advocate a more rapid unification of exchange rates, and preferably the elimination of exchange controls, than is apparently the authorities' current intention. While I understand their caution in this regard, and I am reassured by their commitment to unification and to reestablishing the full convertibility of the rial, as mandated by the Second Five-Year Plan, I tend to agree with the staff that present economic conditions are relatively favorable. This is the case particularly since the policies which the authorities have adopted have already substantially reduced the existing financial imbalances; and the positive fiscal, monetary and real effects of such policies would be reinforced by a more rapid unification of the exchange rate.

On monetary policy, I welcome Mr. Mirakhor's information regarding the lower growth in liquidity during the first quarter of the current fiscal year. It is to be hoped that such a trend will lead to higher rates of return on deposits, to increased banking intermediation and to further progress on inflation. Although the development of profit sharing security schemes may appear to be desirable as a complementary mechanism to channel private savings toward productive investments, the authorities need to be cautious regarding their potentially negative implications for the banking system itself, and the regulatory difficulties which they may generate. In this respect, I am reassured by Mr. Mirakhor's statement to the effect that the authorities are looking into such issues, including with the assistance of the Fund, and that banking supervision is being strengthened in advance of full liberalization.

Finally on structural reforms, the challenge to boost private sector activity in Iran will be facilitated by further progress in the privatization process by price liberalization and by measures to improve the allocation of financial resources. On energy prices, we recognize the significant measures already adopted by the authorities, which have involved fuel price increases of

the order of 150 percent, and encourage them to continue in this direction as rapidly as possible, at least until domestic prices cover opportunity costs.

I conclude by reiterating my congratulations on the very substantial progress achieved by the Iranian authorities under adverse external circumstances, and wish them continued success in their endeavors.

Mr. Sivaraman made the following statement:

I would like to join others in commending the Iranian authorities for the sustained efforts in pursuing proper policies, and for their achievements in many important areas. In particular, we are happy to note that the growth rate has picked up to 3.1 percent in 1995/96 from 1.6 percent in 1994/95, inflation has been reduced, and, more importantly, the fiscal deficit was contained at 3.8 percent of GDP, with the expectation of it going down further in 1996/97.

These results have been achieved by focused attention on reducing external arrears and the containment of government expenditure. But, to achieve overall stability and to reduce the current level of inflation, a more balanced policy package needs to be implemented, as is evidenced in the staff report's recommendations. As we are in broad agreement with the staff report, let me be brief in my comments.

Although in the last two years budgetary operations were in near balance, in order to have a sustained fiscal position it is important to consider (a) an expansion of the domestic tax base and improvement of the tax collection machinery, signs of which are visible with an impressive increase in tax revenues in the current year as indicated in Mr. Mirakhor's statement; (b) a gradual increase in the domestic price of gasoline to international levels, which again has been recognized in Mr. Mirakhor's statement; (c) removing the bias against nonoil exports; (d) relaxation of import controls consistent with the maintenance of external balance; and (e) exercising control over credit expansion in a selective manner so as not to jeopardize growth.

On the monetary side, the growth of broad money should be contained as targeted to bring down the inflation rate. For 1996/97, while the staff has projected broad money growth of 29 percent, we hope the authorities are able to achieve the target of 20 percent. On page 11, paragraph 1, of the staff report, it is mentioned that the instruments of monetary control usually employed by the central bank either were not implemented or were ineffective in containing liquidity expansion. The staff may like to elaborate the reasons for this situation.

While credit growth has been quite substantial in Iran over the past two years, this has not been adequately reflected in improving the investment-GDP ratio. In this context, we must recognize the need to monitor the end use of credit for which it was sanctioned. This could be achieved by strengthening banking supervision and introducing selective credit controls. With reference to interest rates, although we recognize the importance of a positive rate of

return on time and saving deposits, care has to be exercised in containing the spread between deposit and borrowing interest rates.

In the field of structural and social policies, transparent safety net mechanisms are required to support the most vulnerable sections of the population.

Table 1 of the staff report containing, inter alia, the growth of GDP and investment ratios in the years 1991–97 indicates that the incremental capital-output ratio has been fluctuating widely. Could the staff clarify the reasons behind this phenomenon.

With these comments, we wish the Iranian authorities success in their endeavors, because they have shown a determination to set right their economy and put it on a sustained growth path.

Mr. Zhang the following statement:

I would like to commend the Iranian authorities for the successful implementation of their economic adjustment program during the past year. With the determined application of program measures, the external current account was brought to surplus status in an expeditious manner. As shown by recent economic developments, along with the regularization of external arrears, the external reserves have been restored to a safe level. I am particularly pleased that the effective adjustment has enabled the authorities to normalize nearly all their external relations. As indicated by Mr. Mirakhor in his helpful statement, the authorities are fully confident that they can meet all their external obligations. Since I am in broad agreement with the staff on the main thrust of its report, I would like to offer some comments on fiscal, monetary and external policies for emphasis.

The budgetary development was in conformity with the requirements for a prudent fiscal policy over the past year when the budgetary expenditure in 1995/96 was contained within the scope of revenue collection. The restraint over the wage bill increase has certainly contributed to the improvement in the overall fiscal balances. On the attainability of the authorities' budget target for 1996/97, I tend to agree with the staff suggestion on future measures regarding the expansion of the domestic tax base and the progressive reduction of budgetary subsidies. In this connection, the authorities are encouraged to reduce their budgetary dependence on oil revenue along with domestic energy price adjustments, and I found Mr. Mirakhor's remarks on this issue promising and encouraging.

Regarding monetary policy, while the moderation of monetary expansion in the first quarter will certainly contribute to the containment of inflationary pressures, curbing the growth of broad money will continue to be a daunting challenge for the authorities as the rapid increase of net domestic assets and the recovery of net foreign assets are exerting heavy pressures on the expansion of monetary aggregates. In view of the current inflationary pressures, the authorities are encouraged to adhere to a restrictive monetary

policy in the near future. In this respect, the introduction of indirect instruments of monetary policy is conducive to attaining the authorities' policy objectives. Nevertheless, from the medium-term perspective, it is of great importance to further reform the financial sector so as to make financial resource allocation more rational and monetary policy more effective. In this respect, I appreciate the cautious policy stance as explained by Mr. Mirakhor, and I am pleased to note that the Fund has extended technical assistance to Iran, covering a wide range of areas in the country's financial transformation.

On external policy, we appreciate the measures and approach taken by the authorities in dealing with their difficulties over the past two years. It is encouraging that they have brought about the satisfactory results I mentioned at the outset. In this regard, I can also go along with the staff appraisal. However, the authorities are encouraged to capitalize on the present propitious economic conditions for working out a comprehensive and appropriate program for early realization of their reform and development objectives. On the issue of exchange rate unification, I tend to agree with the authorities' prudent position in seeking reunification of exchange rates and currency convertibility within the current Five Year Plan in order to ensure a successful implementation.

On the macroeconomic front, it is encouraging to see advances were recorded on both revenue and expenditure sides, as reflected in the increase in the surplus of the general government fiscal accounts during the first quarter of this year. Based upon this apparent progress, we fully support the authorities' policy targets for the Second Five Year Development Plan aimed at higher economic growth and lower inflation in the context of an increasing openness and liberalization of the economy.

In conclusion, we welcome the authorities' further efforts in stabilizing their macroeconomic conditions and creating the necessary environment for faster capital formation and economic growth. I would like to wish them greater success in their future endeavors.

Mr. Saito made the following statement:

I join previous speakers in commending the Iranian authorities for their remarkable progress in managing the economy over the last year despite the difficult macroeconomic conditions in the context of adverse external circumstances. Regularizing relations with external creditors and strengthening the external reserve position were probably the most significant gains accomplished in this period.

We recognize that, to achieve that objective, the authorities have been forced to temporarily deviate from the liberalizing stance of the Second Five-year Development Program (SFDP). However, since that objective has been met, it seems to us that it is convenient for the authorities to return to the original path of the Five-Year Plan as soon as possible. In this context, we share the staff's view that the policies that have been implemented over the last two years may not be beneficial over the longer term. Indeed, import

compression is hindering investment and growth and the dual exchange rate policy, which itself is highly distortive, is discouraging nonoil exports.

The main challenge ahead is to bring inflation down to a lower level while achieving a recovery in real GDP growth and maintaining an appropriate reserve cushion. The country's current comfortable foreign reserve position provides an excellent opportunity to reduce import restrictions and move toward their full elimination, thus improving resource allocation and facilitating a faster real GDP growth and a recovery in nonoil exports. We concur with the staff that, with the next budget, the authorities should implement a compre- hensive policy package for achieving a higher growth rate. This package needs to include substantial improvement in the fiscal position, prudent credit policies, measures to encourage domestic saving through the banking system, and a more competitive exchange rate. Furthermore, import liberalization and increased promotion of private sector participation in the economy are necessary. Let me briefly discuss each of these.

On the fiscal front, the staff may be right about the need for continued improvements in the budget through modernizing the tax system, reducing dependence on oil revenue, adjusting domestic energy prices to world levels and restraining expenditures. Introducing a and renewing efforts toward widening the tax base and eliminating tax exemptions are key to boosting revenue collection. As domestic petroleum prices are still too low by international standards, a more accelerated pace of price increases is of the utmost importance. This would strengthen public finances in so far as it would eliminate subsidies and allow for better resource allocation. It would also make it possible to reinforce the social safety net. On the expenditure side, continued restraint of current spending is needed, most notably in the area of the wage bill. Moreover, regarding debt service payments, it is advisable to deal with a more realistic exchange rate to avoid a continuing increase in extrabudgetary foreign exchange losses.

On the monetary front, given the level of underlying inflation, net domestic assets, (e.g., credit to public enterprises) should continue to be kept in check to avoid aggravating inflationary conditions. In this context, we are pleased to learn from the staff and Mr. Mirakhor that during the first quarter, domestic liquidity grew only marginally (by 0.3 percent) and bank credit to the nongovernment sector expanded by 2.3 percent. Also, considering the need to increase domestic savings, it seems to us that the authorities should adopt a more active interest rate policy tending toward positive rates in real terms. Moreover, improved banking supervision and prudential regulations will also be required to strengthen the soundness of the banking system and its capital base.

In the external sector, we understand the explanations provided by Mr. Mirakhor in his illustrative statement regarding the inappropriate timing for implementation of the unification of the exchange rate and the concomitant risks involved. However, we hope that these measures will be adopted as soon as the necessary preconditions are in place.

Finally, in the area of structural reforms, greater private sector participation in the economy is necessary. This can be achieved through the removal of price and trade controls, privatization of public enterprises, support for the development of the stock exchange and improvements in labor regimes.

With these remarks we wish the authorities the best in their future endeavors.

Mr. Ono made the following statement:

It is welcome that, as Mr. Mirakhor's helpful statement clearly describes, positive signs, such as the increase in real GDP growth and the decrease in both the fiscal balance deficit and in external debt, can be seen. Well-balanced and sustainable growth, with further improvement in the fiscal balance and further reduction of inflation, will be secured by accelerating the current favorable trend or momentum based on the staff's proposals. I hope that the authorities will maintain forward-looking and proactive policies in constructive cooperation with the Fund.

While it is fully recognized that the difficult macroeconomic situation caused by adverse external circumstances has necessitated a temporary deviation from the authorities' original policy stance, I would rather make the following comments, which focus on three policy-related issues.

First, on fiscal policy, as I mentioned, it is encouraging that positive signs can be seen in the reduction of the fiscal balance deficit mainly due to reduced expenditures. I support the authorities' intention to widen the tax base to reduce reliance on oil and gas revenues. It is also encouraging that progress has already been made in these areas, as Mr. Mirakhor reports in his statement. In addition, as the staff recommends, rationalization of the subsidy on petroleum consumption is also important.

Second, on monetary policy, the declining trend of consumer price index after its peak in May 1994 is of course a good sign; however, it is hard to be satisfied with the current levels of inflation. Accordingly, as the staff mentions in the report, maintaining a tight monetary policy is essential. In this context, the staff's recommendations to lower foreign exchange losses and to substantially reduce bank borrowing by the public enterprises are worth considering. In addition, the negative rates of return on bank deposits should be eliminated as soon as possible, since they could hamper the growth of savings, which is the key factor to ensure the achievement of medium- and long-term growth of the economy.

On exchange rate policy, since the informal parallel exchange rate is at the level of 4,000 rial per US dollars, I must say that the differentials between the parallel rate and the current official rates are too significant to neglect. As the staff as well as the authorities point out, the growth of the nonoil sector will be the key element for sustainable growth. In this regard, the current dual official rates, which are an excessive burden on key export-oriented industries,

should be unified in a gradual manner. It is encouraging that the authorities have committed to this unification. Concerning how to achieve the unification of exchange rates, I agree with Mr. Shaalan and Ms. Cheong and, therefore, do not intend to push for immediate unification. I would also expect that the authorities would propose a specific time frame for this during the Second Five Year Plan period, and I assume they will do so as soon as possible. Although this policy change is likely to bring some additional inflationary pressure, the authorities could respond by adopting the prudent monetary policy mentioned above, and I think this would be a desirable policy mix.

Finally, I hope that external circumstances will be normalized as soon as possible and that this will contribute to the authorities' further success.

Mr. Kiekens made the following statement:

During the ten months since the Board's discussion of the last Article IV consultations with Iran, the Iranian economy has consolidated its progress in several key areas. The difficult task of rehabilitating Iran's reputation with major international creditors and restoring its external reserves is virtually completed. In an extremely unfavorable external environment, the authorities have succeeded in eliminating almost all of Iran's very large stock of arrears, achieved a complete turnaround in the external debt maturity profile, and brought the level of external reserves back to a comfortable level.

But these remarkable achievements came at high cost. The system of tight foreign trade controls and exchange restrictions established to eliminate Iran's stock of debt inevitably acted as hindrances to investment and growth. The authorities are to be commended for making every possible effort to minimize the harm done by their debt-elimination policies. Real GDP growth has showed a strong recovery and inflation has dramatically decelerated. And most important of all, Iran's dependence on oil revenues has been sharply reduced.

Now that Iran's external debt difficulties have been effectively addressed and the economy is showing strong signs of recovery, policies are being redirected to the goal of putting the economy on a path of sustainable growth.

I am under the impression that the Iranian authorities fully agree in principle with all elements of the coherent global program suggested by the staff. The staff is pressing for rapid implementation of those reforms, arguing that advantage should be taken of favorable economic conditions. It is indeed important that the authorities do not lose the positive momentum of the reforms, but I can understand the more gradualistic approach of the authorities the arguments for which are well explained in Mr. Mirakhor's statement. The pace of the much needed reforms is, of course, a matter of difficult political judgment. However it cannot be denied that gradualism has its unavoidable costs in terms of lost growth, and every delay must therefore be fully justified in terms of the special circumstances which are making Iran's integration into the world economy much more difficult.

Let me turn now to various aspects of economic management that are highlighted both by the staff report and Mr. Mirakhor's statement.

The encouraging developments in the fiscal area provide a preview of the changes the authorities and the staff hope to accomplish. The share of oil and gas in total revenues continues to decline, and the share of tax revenues to expand, as a result of the authorities' ongoing efforts to improve tax administration and expand the tax base. Obviously, more must be done to make these improvements permanent. The long awaited introduction of the value-added tax would help secure the revenue position, as will the upward adjustment of domestic energy prices to world levels. Policies to improve the targeting of the social safety net will also alleviate pressures on the budget.

The generally promising budget situation is still being compromised by large foreign exchange losses. The need for exchange rate unification is generally accepted by the authorities. I therefore welcome the authorities' commitment to unify the exchange rate at a later stage. However, caution must be exercised in this area, but like Mr. Ono, I would advise the Iranian government to consider announcing a firm timetable. Mr. Berrizbeitia, in his well articulated statement, has clearly pointed out the many distortion resulting from the multiple exchange rate practices, as well as the advantages of an exchange rate unification. I therefore endorse his advice to unify the exchange rate as soon as feasible, as part of the measures being taken to correct the existing financial imbalances.

Faced by a sizable surge in liquidity growth, monetary policy was unable to achieve its targets, mainly for lack of effective indirect policy instruments. I believe the staff is correct in its assessment that the more conventional instruments such as reserve requirements or credit ceilings were ineffective in containing the liquidity expansion. It would be instructive if the staff could clarify, in more detail, why the Iranian monetary policy instruments are not effective.

Finally, let me again commend again the Iranian authorities for the progress they have made in rehabilitating their economy. I wish them success in accomplishing the tasks ahead.

Mr. Waterman made the following statement:

As others have noted, Iran has made some useful progress recently, including regularizing its external debt situation. But, as you read the staff papers, you cannot help but feel that the Iranian horse is still carrying a lot of lead in its saddle. Nothing might be overriding, but the various constraints combine to become a formidable barrier to better economic performance. Here, I would first mention the complicated exchange rate arrangements resulting in an uncompetitive rate, particularly for nonoil exporters; second, the subsidization of external borrowing costs of public enterprises and some private sector borrowers, although I note the full recovery from some of the stronger borrowers recently is certainly a positive step forward; third, the artificially low interest rate structure and signs of disintermediation that

clearly make monetary management very difficult; fourth, the system of fairly severe import restrictions where there are domestic substitutes, however unavoidable these restrictions might be; and finally, the continued underpricing of petroleum despite the recent price increases, which were clearly an important step in the right direction.

Given all this, it is not surprising that there are ongoing challenges on the budgetary side, which are limiting the ability to meet real social and investment needs. Private savings are being discouraged by the interest rate structure, and private investment has been lower than it might otherwise have been. The consequences of all this for ongoing growth are rather obvious.

Some useful progress has been made recently, but much more needs to be done to strengthen the framework for monetary control to put public finances on a secure footing, to encourage private savings, and to establish more favorable conditions for reasonably strong growth combined with low inflation.

I agree that there is a question of the sustainable speed of adjustment, and that is very much a matter of political judgment. But experience elsewhere generally suggests that a more radical, ambitious approach is likely to pay off.

The staff representative from the Middle Eastern Department said that the authorities had been advised to unify the exchange rate as rapidly as possible. When comparing the present situation with the previous attempt at unification in 1993, several factors needed to be borne in mind. First, in 1993, the unification had been implemented in the context of a debt structure in which the bulk of the debt was short-term with very large payments due in the period immediately after the unification. The authorities had been able to substantially restructure their debt profile to avoid the debt servicing pressures that had characterized the previous unification attempt. Second, in 1993, the unification had been implemented concurrently with the liberalization of the riyal. Under current circumstances the authorities were better equipped to react to pressures on the exchange rate and control capital outflows with the aid of exchange controls. Third, Iran now had a higher level of reserves than in 1993, which increased the room for maneuver in the context of the unification.

While it was clear that external conditions played a role in any attempt at unification, the staff had given prominence to strengthening fiscal and monetary policies, the staff representative continued. Provided the authorities attempted to unify at a rate which was sufficiently competitive, considerable resources would be generated for the fiscal system, which would in turn enable the authorities to cushion against unforseen shocks and to manage the transition to the new exchange system.

The staff had tried to estimate the impact of unification on the general government budget and on imports by the public sector, the staff representative stated. For the general government, a substantial surplus was projected, and depending on the ultimate level of the exchange rate under unification, there could be a substantial improvement in the fiscal position in comparison with the baseline scenario. However, those estimates were subject to tremendous amounts of uncertainty, and for that reason, a "fiscal cushion" was needed as an integral part of the inflation-reduction strategy. There would also have to be a deceleration in the expansion of credit to the public enterprise sector, as well as to the private sector.

There were several reasons for the apparent overshooting of credit in 1995/96, the staff representative remarked. First, the authorities were constrained by very tight targets in the context of the Second Five-Year Plan, which stipulated the amount of credit that could be extended to the private sector. Subsequent to the design of the Plan, Iran had experienced much higher rates of inflation than had been envisaged. That implied increased pressure on monetary policy. In that context, the authorities had not yet formally adjusted the targets under the Plan. The staff had encouraged the authorities to increase the degree of flexibility in the design and implementation of policies under the Plan. Second, there had been pressures resulting from foreign exchange losses in 1995/96, some of which were covered by the budget, but the remainder of which had to be covered directly by the banking system. Finally, the mechanisms for implementing monetary policy were weak and needed to be strengthened.

The impact of economic sanctions on trade flows had not been very significant, the staff representative considered. However, the intensification of those sanctions in 1995 had disrupted the functioning of the foreign exchange market. While crude oil exports were not being affected, it was very likely that the continued presence of sanctions discouraged the flow of investment to Iran, making it more difficult for the authorities to move in the direction of greater openness and greater integration in the world economy. It remained to be seen what the impact of the most recent economic sanctions would be.

With regard to the question of the capital-output ratio, statistics in Iran were very much affected by the valuation adjustments arising from multiple exchange rates, the staff representative said. Moreover, following the compression of imports in 1994/95, there had been a substantial decline in stocks that also affected the level of the capital-output ratio.

Mr. Mirakhor stated that the authorities' attitude toward unification of the exchange rate was clearly tainted by their experience in 1993. While certain conditions had improved, as the staff representative noted, other conditions had worsened. Immediately prior to the 1993 unification attempt, the fiscal deficit had been 1.2 percent of GDP. It had jumped to 7.2 percent of GDP following unification largely because of a sharp increase in expenditures. While the authorities might at present be in a better position to defend the exchange rate, because of a higher level of reserves than in 1993, external circumstances were likely to come into play, and that could affect the way in which reserves would have to be used. Sensitive policy judgments would be needed in the process of reserves management. The 1993 experience also showed how political uncertainties and economic sanctions could affect exchange market behavior. For example, when the market had become aware of the discussions on sanctions, the spread between the market and official exchange rates had widened dramatically. That made the task of unification even more difficult than anticipated. Such uncertainties were now stronger than before. In addition, there could be additional spending pressures in relation to the public enterprises that could affect the authorities' ability to achieve the fiscal targets established by the staff. However, the authorities were determined to implement an improved policy stance with the aim of reducing financial imbalances and placing public enterprises on a stronger financial footing, to ensure that there was not a major drag on the fiscal side once the exchange rate was unified.

Mr. Barro Chambrier made the following statement:

> Since our last Board discussion in October 1995, it is encouraging to note from the staff report and Mr. Mirakhor's very helpful statement that, despite the difficult external circumstances Iran confronted in the recent past

years, its economy has continued to perform well in a number of areas. Indeed, growth rate has continued to be relatively high, the fiscal and the external situation have strengthened significantly, while the social indicators have continued to improve. Also, inflation moderated, but is still very high, with two-digits.

Overall, the main objectives of the stabilization process were achieved and confidence in Iran economy has strengthened. The staff supplemental information concerning developments registered during the first quarter of 1996/97 shows encouraging results.

The Iranian authorities are to be commended for these positive achievements, including the normalization of relations with nearly all foreign creditors and the liberalization of the economy, which have resulted from the authorities' determination to place their economy on a sound footing during the implementation of the first Five Year Development Plan.

Despite these positive developments, the challenges ahead are still considerable. Therefore, there is a need to pursue the ongoing efforts, so as to secure a more stable economic and financial environment, conducive to sustained growth and development. I welcome, therefore the emphasis put on financial policies and structural reform in the Second Five-Year development plan.

Since I am in general agreement with staff's policy analysis and recommendations, I would like to touch upon four issues, namely on fiscal and monetary sectors, exchange rate policy and on structural reforms for the years ahead.

As regards the fiscal sector, it is encouraging to note the progress made to narrow the fiscal deficit over the period 1993/94 up to 1995/96, mainly as a result of a continued containment of budgetary expenditure. However, as regards revenue, in particular its structure, I fully agree with Mr. Mirakhor that in view of the downward trend shown by the share of oil and gas revenue in total revenue, it is imperative for the authorities to reduce their dependence on this source of revenue and to seek ways to broaden further the tax base. In this connection, I welcome the authorities' plan to introduce soon a value-added tax bill, as well as their intention to eliminate tax exemptions. Also, I note and welcome the reduction of the size of the government in the economy and this will provide lasting solution to the fiscal consolidation. On the expenditure side, subsidies issue should not be of permanent nature and should be well targeted to the most needed segments, as suggested by the staff.

Regarding the monetary sector, the authorities' efforts, aim at containing the growth of liquidity are welcome, as they will help to reduce further the inflation rate. However, I note the difficulty encountered by the authorities in the use of direct monetary instruments to ensure this objective. I, therefore, encourage them to intensify the efforts in the use of indirect monetary instruments in this area. In this vein, I welcome the initiative taken

by the central bank, with Fund technical assistance, in order to improve banking supervision and prudential regulations. Furthermore, I find the efforts being made to enhance the soundness of the banking system appropriate.

Like previous speakers, I consider the unification of exchange rates as a needed and a critical issue. However, I share the view that timing factor is crucial for the success of this process. I also think that it would be vital for the authorities to continue to address the financial imbalances that exist, while drawing lessons from the previous experience concerning the failed attempt at unification of 1993.

On other structural reforms, I commend the authorities for progress made in 1995/96, especially in prices liberalizing and privatization. However, the authorities will need to intensify their efforts in the areas where progress is still lagging, such as the promotion of greater private sector participation in the economy, the investment and labor regimes and the privatization of public enterprises.

Finally, with all the natural and human capital resources, Iran has the potential to improve further its economic prospects and the standards living of the population. The authorities' determination to succeed in their stabilization process is a key element in this achievement. In this process, it will be critical to increase further the openness and the liberalization of the Iranian economy.

With these remarks, I wish the authorities well in their future endeavors.

Mr. Duenwald made the following statement:

Iran has made significant progress in normalizing relations with foreign creditors and the country's foreign reserves position has become more comfortable. However, the means by which this progress was achieved has involved, as Mr. Mirakhor notes in his statement, a large cost in terms of foregone economic growth. The use of exchange restrictions and tight controls on credit and imports, combined with the existing administrative controls have distorted market signals and have reduced the efficiency of resource allocation in the economy. A rapid dismantling of the various restrictions, subsidies, and controls is urgently called for if the deep-seated imbalances characterizing the Iranian economy are to be corrected in a sustained way. Such a reorientation of policy toward allowing market mechanisms to function properly is also consistent with the authorities' shift in policy emphasis toward raising savings, investment and real growth while lowering inflation and ensuring external viability.

I would agree with the staff that a strengthening of macroeconomic management is called for. On the fiscal front, the authorities should be commended for achieving progressively lower deficits. Like some other speakers, however, we see some scope to increase tax revenues through an expansion of the domestic tax base, while improving the effectiveness of public spending so as to further enhance Iran's social indicators.

I would also urge the authorities to tighten monetary policy in order to obtain positive real rates of return, which in turn would engender a reversal in financial disintermediation. A strengthened financial system, including greater bank soundness, would also allow the introduction of indirect instruments of monetary control, and consequent improved monetary control. Overall, we would point out that the various controls and restrictions in the domestic capital market limit recourse to domestic savings and result in an inefficient allocation of credit.

With respect to external sector policies, we share the staff's recommendation that the exchange rate be unified at an appropriately competitive level. Indeed, this chair made the same suggestion last year. It is somewhat disappointing, then, that the authorities, according to Mr. Mirakhor, have decided to continue the current policy of a multiple exchange rate system, which in our view brings with it significant distortions. We are somewhat more hesitant than the staff, however, in calling for a crawling peg system to be introduced at the same time as the exchange rate is unified. For an economy frequently subject to terms-of-trade shocks, a more flexible exchange rate regime would enable the exchange rate to act as a shock absorber and facilitate external adjustment.

Concerning structural policies, I see the main priority as being the elimination of the implicit subsidy on the domestic consumption of petroleum products by raising domestic energy prices to international levels. While we recognize the difficulty in removing the subsidy, we think that this should be done as soon as possible. Not only will this reduce, and eventually eliminate, the associated fiscal burden, it would also improve resource allocation in the economy.

The adjustment scenario presented by the staff usefully outlines the possible benefits from adopting the staff's policy recommendations. We would urge the authorities to implement, at an early stage, a comprehensive economic reform program along the lines suggested by the staff.

Finally, the authorities should be encouraged to improve their statistical practice with a view to complying with the Special Data Dissemination Standard. This will be important as the Iranian economy integrates more fully into the global economy through borrowing in international capital markets.

Mrs. Guti made the following statement:

Like others, I welcome the achievements that have been made by the Iranian authorities in moving toward the goal of macroeconomic stability and sustainable growth. Over the last decade-and-a-half there has been a sizable reduction in poverty and a significant improvement in social indicators. In the course of the last two years, despite difficult external circumstances, the authorities made encouraging progress in restoring reserves to a comfortable level, lowering the rate of inflation, and significantly reducing external arrears. However, progress toward a higher sustainable rate of growth was hampered

by exchange restrictions and tight controls on credit and imports; policies which the authorities were forced to pursue to obtain the objectives of regularization of external arrears and a strengthening of the external reserve position in the face of an unfavorable external environment.

With good progress made toward normalization of relations with foreign creditors, and the strengthening of the external reserve position, there is now an opportunity to reduce reliance on import restrictions, and thereby accelerate the pace of economic growth, boost nonoil exports, and address the task of reducing the fiscal deficit to sustainable levels in the medium term. In this regard, I am encouraged to note that the authorities are ready to improve macroeconomic performance in 1996/97, and I also note their renewed commitment to economic liberalization in the medium term as set out in the Second Five-Year Plan.

It is clear that the authorities' efforts alone will not bring about the intended results. The extent of external support has an impact on the authorities' capacity to move ahead with the reform program. Progress in the medium term in improving macroeconomic performance will depend on a strengthened fiscal and monetary policy stance as well as an appropriate exchange rate policy.

As regards fiscal policy, in addition to containing expenditures, effective and permanent reductions in the fiscal imbalances would require measures aimed at improvement of the structure of revenues. In this context, it would be important to reduce the dependence of government revenues on oil and gas. The introduction of the contemplated value-added-type tax will make a positive contribution in this respect. Moreover, any upward adjustment of domestic energy prices will have a desirable impact on fiscal operations while providing incentives for more efficient energy use within the country.

In the area of monetary policy, I welcome the authorities' intention to contain the growth of broad money in line with the objective of letting inflation follow a downward path. I also welcome the recent efforts by the central bank aimed at improving banking supervision and prudential regulations. These efforts are important to counter potential risks arising from further liberalization that could affect the integrity of the financial system.

Oil and gas play a dominant role in the Iranian economy, accounting for 80 percent of total exports earnings. In this connection, it is important to note that Iran would be vulnerable to fluctuations in the international market. This makes it essential for Iran to exert a concerted effort at increasing the share of nonoil exports in total exports. I note in this respect that the authorities are cognizant of the need for establishing an exchange rate that can enhance the competitiveness of nonoil exports. We encourage them to realize this intention.

With these remarks, I wish the Iranian authorities success in their difficult endeavors to obtain a renewed period of long-term high growth and low inflation.

Mr. Shields made the following statement:

On the issue of exchange rate unification, I thought Mr. Mirakhor gave a very plausible explanation of why the authorities should proceed cautiously, but I was still more impressed by the reasons that Mr. Berrizbeitia gave us to proceed more rapidly because of the severe resource costs involved with the current system. Similar arguments apply to other aspects of structural reform. The best policy would be to speed up action. But if the authorities are not prepared to do everything at once, I think the critical issue is how to prioritize and sequence the necessary program reforms outlined by the staff. Does the staff have anything to add on the sort of sensible timetable or sequencing of reforms?

I was pleased to see that broadening the revenue base remains an urgent priority for the government. A sensible aim would be to bring the fraction of total government revenues accounted for by tax receipts nearer to one-half rather than the current ratio of one-fifth. The early introduction of a consumption tax, harmonization of oil import duties and, indeed, the unification of the exchange rate would go a long way toward achieving such an objective. I was also pleased to note Mr. Mirakhor's helpful comments on the progress that has been made in some of these areas, particularly his remarks about the prospects for some sort of a value-added tax.

On the expenditure side, I note from the staff report that the authorities acknowledge that there is a large amount of inefficiency in the wheat subsidy, so there would seem to be a good argument in favor of replacing this subsidy with a better-targeted social safety net transfer to the poor. It would also help to eliminate the adverse effects on the budget of another uncontrollable commodity price change. I presume that the authorities are following closely recent developments in Jordan in this regard.

Finally, I would like to make a few remarks on financial stability. I am concerned that the capital adequacy ratios and the provisions of commercial banks in Iran remain very low. Mr. Mirakhor's statement indicates that the authorities' long-term intention is, indeed, to make greater use of indirect monetary policy instruments. These are urgently needed, as is the achievement of positive rates of return on deposits, but a strong banking sector will be essential to ensure the successful implementation of such a switch in the choice of policy tools. Because of this, I welcome the latest initiatives to improve banking supervision, and I also strongly endorse the recommendations of the Monetary and Exchange Affairs Department's technical assistance mission which are set out in the staff report.

Mr. Newman made the following statement:

I had not originally intended to speak, but I wanted to assure Mr. Mirakhor that Mr. Abbott's departure does not imply any reduced interest by this chair in developments in Iran. It should come as no surprise to those around this table that on the issue of gradualism or acceleration of the reforms,

we would come out on the side of the acceleration of the reforms in light of the very substantial costs arising from the current controls which Mr. Berrizbeitia highlighted very clearly in his statement. In this context, I did not find the staff's adjustment scenario to be a particularly ambitious one, especially, for example, as it involved an adjustment of oil prices over a 12-year period, which is the equivalent of four EFFs. Therefore, like Mr. Shields, I would be interested in how the staff see the sequencing and pace of reforms and whether or not they had made any estimates of the impact of an even more accelerated reform process than in their own adjustment scenario.

Finally, while I understand Mr. Mirakhor's concern about vulnerabilities, and the implications of exchange rate unification given those vulnerabilities, I would note that some of those vulnerabilities , both internal and external, can be ameliorated by the government's own actions. For example, many of the revenue shortfalls he referred to could be taken care of by either the exchange rate unification or through the adjustment of oil prices. Similarly, on the expenditure side, the wide disparity between the official and the market exchange rate leads to substantial expenditure costs to cover potential losses for the various sectors of the economy. Vulnerabilities on revenue and expenditures therefore are not entirely outside the control of the authorities themselves.

Mr. Mirakhor, noting Mr. Newman's concern about the staff's adjustment scenario, stated that a much more accelerated pace of unification could be assured if the U.S. chair could support two Extended Arrangements for Iran. An Extended Arrangement would be helpful in reducing the cost of raising financial resources from the international capital markets.

Mr. Newman responded that he would have no problems with a staff-monitored Extended Arrangement.

The staff representative from the Middle Eastern Department noted that, apart from exchange rate unification, the authorities had also been advised to move quickly in the monetary policy area with the implementation of positive rates of return. One of the reasons there had been difficulties in administering the credit system was that the price for credit was very attractive. There had been high demand for credit at the prevailing prices. A more rapid change in the monetary policy stance would generate a higher degree of financial intermediation.

The movement to more indirect methods of monetary control was viewed more as a medium-term proposition by the authorities, the staff representative said. A mission from the Monetary and Exchange Affairs Department had provided recommendations in that area that could be implemented under the present legal framework. Those recommendations were designed to increase the flexibility of the environment in which the banks operated.

Regarding energy prices, a too-rapid move could introduce significant dislocations in the productive structure of Iran, the staff representative stated. The 12-year adjustment scenario that the staff had presented was merely illustrative, and did not mean that the staff

was recommending such an adjustment trajectory for energy prices. However, it did support a phased approach, in view of the current industry structure.

The Acting Chairman made the following summing up:

Executive Directors were in broad agreement with the staff appraisal. They commended the authorities for the considerable progress made over the past two years in regularizing the external debt situation, in restoring the foreign exchange reserve position to a less vulnerable level, and in reducing inflation despite an unfavorable external environment.

These positive developments put the Iranian economy in a favorable position to press ahead with the comprehensive reform effort, which should give high priority to the unification of the exchange rate at a realistic level, the abolition of exchange restrictions, and import liberalization. Other key elements of the reform effort should be a substantial strengthening of public finances and a prudent monetary policy with elimination of distortions in monetary mechanisms and credit allocation. Such a strategy should soon yield beneficial effects on investment and growth. They urged the authorities to design and implement such measures in a timely fashion.

Directors encouraged the authorities to strengthen further their fiscal stance through a reduction in the deficit and improvements in the structure of the budget with a view to significantly reducing the dependence on oil revenue. In this context, they noted that the fiscal position would benefit from a broadening of the domestic tax base through the introduction of a value-added tax together with improved tax administration, a reduction in the gap between domestic and international energy prices, and the containment of public expenditure.

Noting that rapid monetary expansion in 1995/96 had compromised a key objective of policy, namely, the lowering of inflation, Directors underscored the need for prudent credit and monetary policies based on greater use of market-based instruments of monetary control, and including positive real interest rates. They encouraged the authorities to promote sound and well-functioning money and securities markets by liberalizing the present system of credit allocation and control, and by strengthening the regulatory and prudential policy framework.

Directors noted the authorities' intention to unify the exchange rate within the time frame of the Second Five-Year Plan. They encouraged the development of a firm timetable, and recommended early unification together with liberalization of the remaining exchange restrictions and trade controls. Directors noted the caution of the Iranian authorities with regard to the exchange rate unification, but emphasized that the existing system was at the core of the current macroeconomic imbalances. Indeed, existing exchange rates were noncompetitive and distortive, and they were severely hampering investment and growth of the nonoil sector.

Directors underscored the importance of addressing long-standing distortions in the Iranian economy, particularly those arising from the heavy implicit subsidy on domestic energy consumption. They also stressed the importance of reforms that would promote private sector participation in the economy, including privatization of public enterprises, encouragement of foreign investment, and improvements in the investment and labor regimes.

It is expected that the next Article IV consultation with the Islamic Republic of Iran will be held on the standard 12-month consultation cycle.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/96/77 (8/21/96) and EBM/96/78 (8/23/96).

4. GROUP LIFE INSURANCE PLAN—CHANGES

The Managing Director is authorized to implement the following changes in the administration of the Fund's Group Life Insurance Plan with effect from September 1, 1996:

1. Reduce contribution rates and modify the rate structure by reducing the age brackets from 10-year to 5-year increments, in accordance with the contribution schedule set out in EBAP/96/84 (8/1/96);

2. Establish a Premium Stabilization Reserve from the excess premium paid in 1996 (to be initially set at 20 percent of total annual premium), which will be drawn down in the case of Plan deficits;

3. Beginning with policy year 1997, discontinue the refunding of any Plan surplus to the participants and the Fund at the end of each policy year and instead deposit such surplus as might accrue to the Premium Stabilization Reserve; and

4. Increase the minimum death benefit for retirees to $15,000. (EBAP/96/84, 8/1/96; and EBAP/96/84, Sup. 1, 8/5/96)

Decision No. 11326-(96/78), adopted
August 21, 1996

5. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director and by an Advisor to Executive Director as set forth in EBAM/96/136 (8/20/96), and by an Assistant to Executive Director as set forth in EBAM/96/135 (8/16/96) is approved.

APPROVAL: July 28, 1997

REINHARD .H. MUNZBERG
Secretary