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RFD 325

Board of Governors of the Federal Reserve System

Division of International Finance

REVIEW OF FOREIGN DEVELOPMENTS

June 23, 1959

Financial Developments in Iran

12 pages

Mary Maroney

NOT FOR PUBLICATION

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Financial Developments in Iran

Mary Maroney

Iran is in the fifth year of recovery in oil production after the 3-1/2 year hiatus which followed nationalization of the Anglo-Iranian concession in May 1951. Oil output, which was resumed in late 1954 under an agreement with a consortium of foreign oil companies, has now risen 21 per cent above the pre-nationalization peak. The increasing output, and the larger proportion of oil receipts accruing to the country under the revised terms of the concession, have provided for an economic expansion of large proportions, including capital development works going under the title of the Second Seven Year Development Plan.

The economy reflects some dislocations brought on by the sudden wealth. In the public sector, expenditures have risen more rapidly than new sources of revenue. In the private sector, investment demands are rising more rapidly than savings and bank accommodation is at a record level.

Despite a substantial growth in money supply, prices have remained relatively stable. The principal factor contributing to this stability has been the availability of foreign exchange which could be drawn upon to finance a continuing inflow of imported goods. Not only oil production but foreign aid has strengthened the reserve position so that the currency could be appreciated and a steep price rise avoided in all areas except rents.

However, with budgetary pressures increasing, the outlook seems to be deteriorating. More oil income is being diverted to financing the deficit in government operations and less to development works which represent the effort to expand production. The foreign exchange position shows some decline although it is still protected by a substantial cushion in foreign borrowing.

Oil production and oil income

In the first quarter of 1959, oil production averaged 880,000 barrels a day as compared with the peak pre-nationalization level of 727,000 barrels daily in December 1950. At the time of the oil stoppage, Iran was the ranking producer of the Middle East, accounting for 38 per cent of the area's output which, in turn, contributed almost one-fifth of the free world total. The development of world demand and the stimulating effects of the Iranian stoppage on other Middle East production has changed the regional picture. The current free world production of 17 million barrels a day is 76 per cent above the 1950 level. The Middle East share has risen from 19 per cent to 27 per cent of that total and Iran, now third in line after Kuwait and Saudi Arabia, is supplying 20 per cent of the area's output.

Iran's earnings from oil production have also changed considerably. As a result of the 50/50 profit-sharing agreement with the Consortium of foreign oil companies concluded in October 1954, direct receipts have risen from $59 million in the fiscal year ending March 1951, just prior to nationalization, to an estimated $245 million in the fiscal year ended March 20, 1959.[1/] Indirect receipts of foreign exchange from oil are also rising. In the three fiscal years ended March 20, 1958, indirect receipts, i.e., local currency purchases by the Consortium to cover wages and other local outlays averaged $45 million as compared with $56 million in the fiscal year 1950/51. However, in the fiscal year 1958/59, Consortium sales of exchange for rials are estimated at $75 million, the result of a developing policy to depend more heavily on local sources of supply. For example, furniture purchases in Iran are expected to amount to £1 million annually for several years; wheat and tea are also to be bought in large quantities from the local market for labor commissaries and canteens. Including indirect receipts, total foreign exchange realized from oil operations was in the neighborhood of $320 million in the fiscal year 1958/59 as compared with $115 million in the last pre-nationalization year.

Distribution of oil income; the Development Plan

The direct oil revenue paid by the Consortium to the Government as the latter's half share of profits is being spent by Iran in part for a program of development works. The idea of devoting oil revenue to long-term capital expansion in a 7 Year Development Plan for the economy was first launched in 1949 but activities had to be abandoned during the crisis into which nationalization plunged the country in 1951. The resumption of oil production revived the program. Thus, the story of how the oil revenue has affected the economy is not only a matter of the revenue having increased but also, in some degree, a matter of how it is being spent.

With changes from time to time, the direct oil revenue is being distributed between the Plan Organization (in charge of the 7 Year Plan), the Ministry of Finance for general budgetary purposes, and the National Iranian Oil Company, the Government agency in charge of oil exploration and production. As originally provided, the Plan Organization was to receive 60 per cent[2/] of oil revenue in the first 2-1/2 fiscal years (September 1955-March 1958), the NIOC 30 per cent, and the Ministry of Finance 10 per cent, plus any surplus developed by the NIOC. In the remaining 4-1/2 fiscal years (March 1958-September 1962), the Plan share was to increase to 80 per cent with the remaining 20 per cent, after covering NIOC expenditures, placed at the disposal of the

1/ The Iranian year is from March 21 to March 20.
2/ See footnote one on the next page.

Ministry of Finance. However, under subsequent revisions, the Plan share never has risen above 60 per cent,1/ and for the current fiscal year ending March 1960, this ratio has been superseded by a flat allocation of $130 million. The NIOC share, revised to 20 per cent of the 1958/59 fiscal year receipts,1/ also has been changed to a flat allocation of $20 million in the fiscal year ending March 1960.2/

The Development Plan

The law establishing the Second 7 Year Plan, covering the period September 1955 to September 1962, was promulgated in March 1956 and provided for expenditures of $933 million, including $223 million inherited from the first 7 Year Plan. These were to be the construction of irrigation, roads and communications projects, the improvement of agriculture and agricultural training, and the establishment of such industries as textiles, sugar, cement, steel and chemicals, mining, coal and salt. In addition to its own program, the Plan Organization was to share costs of approved municipal projects on a 50/50 basis. In December 1957, the over-all budget of expenditure was increased 20 per cent to $1,120 million in anticipation of larger oil revenue and rising costs of planned projects.

The Plan Law provided that development expenditures were to be met entirely from oil revenue over the long term. However, since expenditures were expected to rise more rapidly than the oil revenue in the initial period, the Plan Organization was given authority to raise up to $240 million to cover the deficits in the first 2-1/2 years ended March 1958. In March 1958, when a revision of the oil distribution formula reduced the share of the Plan Organization from 80 to 60 per cent, the Government's authority to borrow on behalf of the Plan was broadened, subject to Parliamentary approval of each individual borrowing operation.

Up to this time, the Plan Organization had received $196 million from oil revenue. Plan expenditures in this period (September 1955 to March 1958) totaled $291 million. The deficit was covered by a $75 million loan from the IBRD, negotiated in January 1957, and

1/ Limited to the Consortium guaranteed minimum payment of $144 million in the fiscal year March 1956/57, and $188 million in each of the fiscal years March 1957/58 and 1958/59.

2/ However, in a period of declining prices not offset by increased production, a flat allocation may be more advantageous than a percentage share. For example, the Government may have to absorb a loss in revenue of $25-28 million this year if production does not rise above the 1958 level as a result of the decline of 18 cents a barrel in the quotation for Middle East crude announced last February.

$17.5 million in a short-term loan from the IMF to the Bank Melli, the central bank.

Between March 1958 and September 1962, when the 7 Year Plan was scheduled to end, the Plan Organization estimated its receipts under the reduced formula at $592 million from oil and its disbursements at $894 million. There would be a deficit of $302 million to be financed through borrowing or, alternatively, the Plan program would have to be curtailed or slowed down.

To obtain funds abroad, a list of projects totaling some $380 million was developed for selective financing by foreign institutions including the U.S. Development Loan Fund and the IBRD. A curtailed Plan Program of selected priority projects was prepared also under which over-all expenditures were limited to $637 million. With revenues estimated at $592 million, this curtailed program would mean a deficit of only $45 million for the period March 1, 1958, through September 1962. Continuing with the larger program would mean that foreign financing would be required for approximately a third of the total Plan expenditure. Subsequently foreign loans totaling $120 million were negotiated.1/

By March 1959, the halfway point of the 7 Year Plan, the Plan Organization had received $300 million from oil and had spent $457 million. The $157 million deficit had been met by $100 million in foreign loans, $50 million in domestic bank accommodation, and the remainder from carry-over and miscellaneous funds. The budget for the current fiscal year (March 1960), shows expenditures of $242 million and oil revenue of $130 million, i.e., the amount alloted the Plan Organization under the latest revision of the oil distribution formula. The deficit of $112 million corresponds to the balance of credits available under the U.S. Development Loan Fund and IBRD loans.

Over the longer term, development activities may undergo further revision or modification. Last February, the Plan Organization lost its independent status and the authority and responsibility of the Plan's Managing Director was transferred to the Prime Minister. Implementation of development projects now is assigned to the appropriate Ministries, and the Plan Organization is to revert to the function of planning only as was the original intent of the Second Seven Year Law.

1/ In January 1959, the U.S. Development Loan Fund extended a loan of $47.6 million of which only $7.5 million had been drawn by March 20, 1959. In May 1959, the IBRD announced a second $72 million loan for Development Plan projects.

Budget demands more revenue

The fiscal background which contributed to changes in the financing of the Plan is the not unfamiliar one of budgetary pressures. The Government's outlays outside the Plan have much more than doubled in the past five years. The growth in nonoil revenues, although impressive, has been at a significantly lesser rate. The margin between income and outgo which the pre-emption of oil income has gone to cover, has been widened rapidly, so that in the fiscal year ended March 20, 1959, it approaches 10 billion rials,1/ or 34 per cent of expenditures.

Expenditures have risen to 28.8 billion rials from 12.3 billion in 1954/55. The greatest relative growth has been in the defense category which has trebled. Many other categories, however, have more than doubled, including education, health, agriculture, posts and telegraphs. The country's comparative prosperity, founded on increased oil production, has brought about larger spending programs and some increase in wages and costs. In the fiscal year 1958/59 just ended, outgo is estimated about 45 per cent higher than for 1957/58.

Revenues, which are derived in greatest part from indirect taxation, the monopoly of the sale of such essential commodities as tobacco, sugar and tea, and customs duties on imports, also reflect accelerated growth but at a less advanced level, rising from 10.0 billion rials in 1954/55 to 19.2 billion rials in 1958/59. Increased income taxation along with tightened enforcement is credited with the largest increase in yield of all categories in the 1958/59 year but it is still less than 10 per cent of total revenue.

The budget for the fiscal year which began March 21, 1959, shows expenditures of 31.2 billion rials and nonoil revenues of 21.9 billion, i.e., a deficit of 9.3 billion rials.2/ In past years, including 1955, 1956 and 1957 United States aid was available to balance out the budgetary deficit, but aid for the purpose of budgetary support is no longer available. At between 8 and 9 billion rials (in the range of $100 to $120 million) the annual budget charge on the oil revenue is some 40 per cent of the total of the latter. The growing use of oil revenue for current budget needs challenges the basic assumption of the Plan that increasing amounts of oil income are available for development purposes.

1/ U.S. $1 equals 75 rials.

2/ A clause in the bill provides that, in the event the Government realizes revenues over and above those estimated, it may authorize increases of up to 3.5 billion rials in the budgets of the Ministry of War and the Gendarmerie which have been left unchanged at the level of the previous year.

Money supply

From the monetary aspect, there is some difference in the inflationary impact of oil revenue spent by the Budget and by the Plan Organization. Since the latter is investing in long-term production projects which require capital goods not available at home, a significant portion of its foreign exchange income is spent abroad and does not enter the money stream. Budgetary expenditure of oil income, which tends to be focused more on projects of a more current impact has greater potentialities for expanding the means of payment. In this light, the recent trend toward increased use of oil income for budget support lends particular interest to the postwar history of development of the money supply.

Between March 1954 and February 1959 (the latest date for which statistics are available), the total of the currency in circulation outside the banking system, plus demand deposits, increased 83 per cent. (See Table 1.)[1/] The monetization of foreign exchange assets was an important element in the expansion. A factor of even greater significance, however, was the steadily rising level of bank credit to government-sponsored agencies and to the private sector.

In the years immediately following reactivation of the oil industry, the increase in the means of payment was of moderate proportions -- 8 per cent in fiscal 1954/55 and 4 per cent in fiscal 1955/56. In this period, the accretion to reserves from export earnings and aid was slowed by rising imports. The 70 per cent rise in bank credit to the private sector was partly offset by a net decline in government borrowing from the banks and a growth in savings and time deposits and "other" net banking liabilities.

In the ensuing two years, the money supply rose sharply. On March 20, 1957, the figure stood at 24.6 billion rials, 16.5 per cent higher than a year previous, and, in the next fiscal year, there was a further increase of 26.8 per cent to 31.0 billion on March 20, 1958. The foreign assets of the Bank Melli more than doubled, and bank credit to the private sector rose by more than one-third.

Between March 1958 and February 1959 (latest date available), the money supply increased 11 per cent to 34.6 billion rials. Bank financing of government sponsored agencies and of the private sector increased twice as much as in the fiscal year March 1957/58 but the effect was modified by a loss in reserves[1/] and higher levels of time and savings deposits and other net banking liabilities.

1/ See notes to Table 1 page 11 for limitations affecting analysis.

Demand for credit has promoted an increase in the number of banks as well as greater foreign participation in Iranian banking. The Bank Melli, in addition to lending from its own resources, is also disbursing funds from the 7.1 billion rial windfall profit that resulted from revaluation of the gold and foreign exchange holdings of the issue Department in May 1951.1/

In recognition of the inflationary potential of the introduction into the economy of funds in this magnitude, i.e., about 54 per cent of the outstanding note issue, the gold and foreign exchange requirement was raised from 40 per cent to 100 per cent for issues subsequent to revaluation.2/ The note cover requirement may be liberalized in current legislation to revise the banking and monetary system.

Prices

In the face of the large increase in the money supply, the country's price experience has been quite favorable. Between March 1954 and March 1957, the increase of 25 per cent in the cost of living was closely coordinated with the 30 per cent rise in the volume of the means of payment. Thereafter, through October 1958, the index fluctuated within a fairly narrow range while the money supply increased by a further 39 per cent. The wholesale price index rose 8 per cent in the March 1954 - March 1958 period. It then followed a generally declining trend and by October 1958 was only fractionally higher than in March 1954.

1/ The revaluation formalized a par value of 75.75 rials to the dollar which had been the commercial rate since the middle of 1955. Until then, the gold reserve had been valued at the official rate of 32.25 rials to the dollar established in 1945. (Except for the currency cover, application of this rate was limited and there was almost continuous adjustment by means of certificate supplements to the official rate. For example, at the height of the oil nationalization crisis, in May 1953, the official plus certificate rate was 107 rials to the dollar.) The legislation authorizing revaluation provided that the profit resulting therefrom was to be utilized to finance the rial requirement of agriculture and industrial projects outside the scope of the Plan Organization, the foreign exchange requirements of which were to be otherwise secured. (Through February 19, 1959, 1.2 billion in agricultural loans and 0.4 billion in industrial and mining loans had been withdrawn from the 3.5 billion rials reserved for each of these two categories.)

2/ On February 19, 1959, notes in circulation amounted to 38 per cent of the money supply.

Since October, both indices have shown increases considerably greater than the comparable period of earlier years. In the five months ending March 1959, the cost of living rose a further 18 points to stand at 143 per cent of the March 1954 level while the wholesale index also rose 6 points to 107 per cent of the level for March 1954 and March 1957. The new rise was in great part seasonal, occasioned by the relatively late winter and heavy February snows which accounted for abnormally high livestock losses. The resulting shortage of meat was aggravated by the dissatisfaction of livestock handlers with certain features of the price control and distribution system. Retail meat prices have risen 70 per cent; this has pushed up the price of meat substitutes, such as dried peas and beans. However, the increased precipitation has greatly improved prospects for the major cereals, cotton, fruit and nuts crops of 1959 production, so that there is hope that higher yields will permit prices to ease off.

Over the longer term, the relative stability of the wholesale price index is accounted for by the currency appreciation and by the availability of foreign exchange which has made possible substantial imports to augment local supplies. Even though the country is relatively self-sufficient in food, the cost-of-living index has been subject to special pressures from rising incomes. Among individual components, however, the advance in rents has been the outstanding factor of increase. At 225 per cent of the March 1954 level, it was far and away higher than any other element, a natural consequence of the investment program which has employed large numbers and attracted the agricultural population to the cities. To a much lesser extent, services have also risen.

The future of prices is conditioned by the conjuncture of events which seem to be pressing on the foreign exchange outlook. Rising foreign debt, with maturities of substantial amounts over the next few years, and the less favorable world oil situation, which may depress Iranian earnings, may complicate the maintenance of the foreign goods inflow. A recent report of the High Economic Council Secretariat refers to the increasing interest of the growing middle class in imported luxury goods in a context that may be pointing the direction of import control and sumptuary taxation.

Balance of payments

The deterioration of Iran's foreign exchange position over the period of increasing import is not accurately indicated in any information currently available. The central bank's reports of its holdings, which reflect the bulk but not the whole of transactions, show these as declining although they are still high. From the end of March 1954 to March 1959, the Bank's gross reserves increased from \$207 million to \$297 million, with 60 per cent of the increase occurring in the fiscal year March 1957-58. In 1958-59, there was a further rise to $355 million in August, and thereafter a decline to $297 million in March last, leaving a gross still $11 million greater than at the beginning of the fiscal year.

On the other hand, an estimate of the balance of payments which can be made from incomplete accounts of purchases and sales of foreign exchange suggests that there may have been a loss of as much as $25 million in reserves in 1958-59, compared with an accumulation of $60 million in 1957-58. The official estimate of the international account will not be available for several months. Factors complicating interpretation are that some government agencies, including the Plan Organization and the NIOC, may not sell immediately all the foreign exchange they acquire, and on the expenditure side, that the increasing number of smaller banking institutions may be selling foreign exchange in greater volume than in preceding years.

Whatever the precise reserve position (Table 2), a swing from accumulation to drain seems to have occurred in 1958-59. It reflected an increased merchandise import, other foreign expenditures, and reduced special financing the country has enjoyed. The last factor, however, is a matter of timing, rather than one of fact, inasmuch as fairly large amounts of foreign assistance are still available. Early in 1959, a $47 million loan from the Industrial Development Loan Fund was authorized, although only $7 million was drawn to the end of the fiscal year. A further $14 million was available also from the Export-Import Bank funds not yet drawn and $72 million has been made available by the IBRD. In these terms, the country has experienced no actual decline in availabilities.

As reported by the Ministry of Finance, the maturity dates of the Government foreign debt contracted up to October 1958. are as follows:

(In millions of dollars)

1958-59	28.4	1963-64	21.7
1959-60	65.5	1964-65	16.6
1960-61	60.5	1965-66	13.6
1961-62	49.6	1966-67	3.7
1962-63	34.2	1967-68	3.0

Some $130 million in loans, contracted since October, are not included in these figures. Even so, the extent of the debt which will come due in the near future is large, amounting in the next three years to $170 million, and in the next decade to possibly as much as $300 million. In totality, this debt is not much more than a single year's oil income at the present level of production. The beginnings of decline in the exchange reserve, however, point to the rise of the problem of year-to-year management, since increasing amounts of foreign exchange income must be diverted to debt service.

The big question in fiscal policy is whether the country is not, in a technical sense, attempting to burn the candle at both ends. Among the underdeveloped countries, Iran can be considered most fortunate, in that oil resources hold out the prospect of relatively easy financing of long range economic expansion of a substantial order of magnitude. Lush as it is, however, the oil revenue is not so great as to permit the country a real choice in economic policy. To the extent that the relatively liberal import system can be maintained, the danger of inflation growing out of development expenditure can be controlled. On the other hand, the more oil receipts are used to meet budgetary needs, without accompanying taxation, the greater will be the expansion of money income and consumption that imports will be required to satisfy. The contraction of foreign debt to meet the latter alternative is temporarily attractive but it may be piling up problems for the not too distant future.

Table 1

Iran - Money Supply and Factors in Change

(In billions of rials)

	March 1954/55	March 1955/56	March 1956/57	March 1957/58	March 1958-Feb. 1959 p/
Money supply (end of period)	20.4	21.1	24.6	31.0	34.6
Notes in circulation	10.9	10.8	11.6	13.0	13.2
Demand deposits	9.4	10.4	13.0	18.0	21.4
Change during period	1.5	0.8	3.5	6.4	3.5
Notes in circulation	0.8	-0.2	0.8	1.4	0.2
Demand deposits	0.7	0.9	2.7	5.0	3.3
Factors in change	1.5	0.8	3.5	6.4	3.5
Foreign assets (inc.+)1/	0.2	2/	0.2	7.5	-2.1
Credit to private sector (inc.+)	1.4	1.6	1.6	3.9	8.5
Credit to government (inc.+)	0.2	-0.3	1.0	-1.4	0.6
Credit to govt.-owned companies and institutions (inc.+)	0.9	0.6	0.6	1.5	2.9
Government deposits (inc.-)	-0.3	-1.3	0.2	-2.5	-1.9
Time and savings deposits (inc.-)	-0.3	-0.2	-0.8	-1.4	-2.2
Other net banking liabilities (inc.-)	-0.6	0.4	0.7	-1.3	-2.4

Note: Compiled from annual and monthly statements of Bank Melli Iran and monthly statements of "cash, deposits, and advances of all banks" reported in Bank Melli Iran monthly bulletin. The net liabilities of banks other than the Bank Melli are estimated as the difference between the sum of the reported asset and liability items.

p/ Preliminary figures compiled from International Financial Statistics data.

1/ Gold and foreign exchange assets of the Bank Melli only which are identifiable in the annual adjusted statements through March 1958 and in the less detailed unadjusted statements for the March 1958-February 1959 period. The privilege of dealing in foreign exchange was extended to the other banks in March 1956, but holdings of these institutions are not reported and therefore are not taken into account in the above analysis.

2/ Less than 500 million rials.

Table 2

Iran - Foreign Exchange Receipts and Expenditures

(In millions of dollars)

	Fiscal years ending March 20				
	1954/55	1955/56	1956/57	1957/58	1958/59 1/
A. Receipts	201	292	378	502	530
1. Oil	41	137	181	256	345
a. Direct revenue	29	90	140	208	2/ 270
b. Consortium purchase of rials	12	47	41	48	75
2. Proceeds of exports	98	72	90	98	85
3. Noncommercial purchases	12	11	19	32	50
4. Utilization of foreign aid	50	72	88	116	50
B. Expenditures	196	286	365	442	555
1. For imports 3/	187	259	324	408	485
2. For noncommercial purposes 4/	9	27	41	34	70
C. Difference (A-B)	5	6	13	60	-25
D. Reported increase in reserves	5	6	14	60	n.a.

Note: Compiled from Bank Melli Iran Annual Reports through March 1958 and estimated from incomplete accounts of foreign exchange transactions for 1958/59.

1/ Preliminary estimate.
2/ Includes $25 million new concession bonus payment.
3/ In addition to commercial sales includes expenditures by the Government, the Plan Organization, the NIOC, and the utilization of foreign aid.
4/ Includes debt repayment.
n.a. Not available.