IRAN:
An Analysis of Economic Reforms and Developments

Bijan Khajehpour

1.0) Introduction

According to a resource-based analysis of economic performance, Iran has the potential of being the world's 20th strongest economy. Its rich reserves of hydrocarbons[1] as well as other natural resources alongside the country's geo-strategic position make it a unique economy. However, it is an economy that has gone through decades of excesses caused by revolution, war and reconstruction. The aim of this paper is to analyze the country's economic conditions and assess the nature of current economic reforms which have been introduced within the framework of the Third Five-Year Plan[2]. The paper will offer some data on economic and socio-economic indicators and then conclude by dissecting the various reform initiatives of the Khatami administration.

2.0) Current Economic Conditions

Though faced with a number of structural challenges, the Iranian economy is currently standing on a positive footing, mainly due to high oil prices over the past few years. Table 1 summarizes the latest macro-economic indicators of the Iranian economy.

Table 1: Macroeconomic Data (21 March 2001 – 20 March 2002)

GDP	$107bn
GDP growth	4.8%
GDP per capita	$1,631
Inflation	11.4%
Unemployment	14.2%
Oil & gas export (growth)	$19.3bn (-20%)
Non-oil export (growth)	$4.4bn (4.7%)
Capital Formation Growth	10%
Foreign Debt	$7.2bn
Imports (growth)	$18.1bn (20.2%)
Trade balance	$5.6bn*

---

[1] Iran possesses the second largest gas reserves and the 4th largest oil reserves in the world.
[2] This Plan was introduced in 1999 and defines the overall policy framework for the 5-year period which started in March 2000.

Current account balance	3.5bn
Liquidity (growth)	$40.3bn (28.8%)

2.1) GDP Constituents

Clearly, to understand the underlying factors of the Iranian economy, one needs to look closely at the GDP constituents. Following a sharp decline in output immediately after the revolution and a significant increase in oil prices in 1979, the economy enjoyed moderate growth up to 1985. However, following the 1988 ceasefire, substantial rehabilitation and reconstruction projects, expansionist monetary policies and an overvalued exchange rate, coupled with rationing and price controls, led to economic distortions. Growth resumed in the early 1990s partially fuelled by short-term external borrowing. The consequent need for debt repayment restricted imports of crucial production inputs and contributed to weaker GDP growth in the mid-1990s. GDP growth was further affected by weak oil prices in 1997-1998 and, in 1999, by reduced oil exports to comply with OPEC quotas and the impact of drought on agricultural production before increased exports and a stable oil price stimulated GDP growth in 2000.

Iran's GDP for 2001 was about $107 billion, up 4.8% compared to the previous year. The country's GDP per capita for 2001 was $1,631. The latest statistic that were emerging in March 2003 indicated a GDP growth of 6.4% for the period ending on 20 March 2003. The following table sets out the growth rate in real terms of Iran's GDP for the five-year period ending in March 2002.

Table 2: GDP Growth[3]

	1997/98	**1998/99**	**1999/00**	**2000/01**	**2001/02**
At current prices (billion Rials)	280,908	324,358	428,298	567,591	662,514
At current prices (USD $ billions)[4]	101.0	101.2	102.7	99.0	106.9
Real GDP Growth (%)	3.4	3.9	1.6	5.7	4.8
Per Capita[5]:					
At current prices (US$)	1,635	1,575	1,599	1,565	1,631

The following table sets out GDP at current prices and real GDP growth (using the expenditure approach) and in percentage terms for the period indicated:

Table 3: GDP Breakdown

Billion Rials	**1997/98**	**1998/99**	**1999/00**	**2000/01**	**2001/02**
Private Consumption	139,969 (49.8%)	180,327 (55.5%)	219,030 (51.1%)	259,975 (45.8%)	302,264 (45.5%)

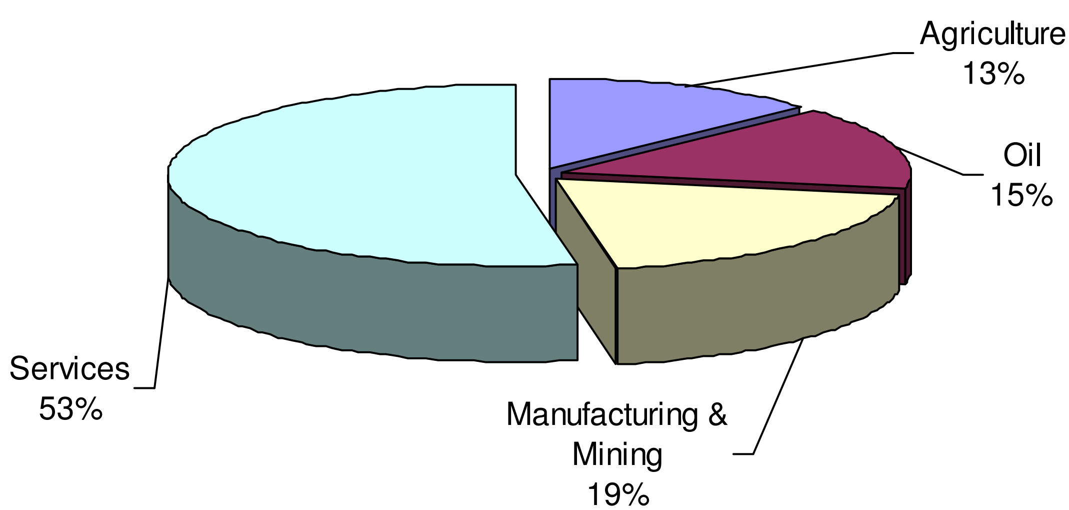
[3] Iranian years start on 21st March and end on 20th March of the following year. All annual statistics refer to these time periods.
[4] Using IMF weighted average rates of IRR 2,780 = USD $1.00 in 1997, IRR 3,206 = USD$1.00 in 1988, IRR 4,172=USD$1.00 in 1999, IRR 5,731=USD$1.00 in 2000 and IRR 6,200=USD$1.00 IN 2001.
[5] Assuming a population of 60-mn in 1995 growing at a constant 1.5% per annum (the growth rate of 1995).

Public Consumption	40,516 (14.4%)	50,166 (15.4%)	61,385 (14.3%)	79,802 (14.0%)	97,219 (14.6%)
(Gross Fixed Capital Formation	82,035 (29.2%)	98,711 (30.4%)	131,417 (30.7%)	172,089 (30.3%)	197,834 (29.8%)
Change in Stocks	12,212 (4.3%)	2,012 (0.6%)	12,991 (3.0%)	21,764 (3.8%)	56,549 (8.5%)
Domestic Demand	274,731 (97.7%)	331,216 (102.0%)	398,841 (93.0%)	533,630 (93.9%)	653,866 (98.4%)
Net Exports of Goods & Services	6,343 (2.3%)	6,420 (2.0%)	29,898 (7.0%)	34,567 (6.1%)	10,913 (1.6%)
Private Consumption	2.7%	6.8%	1.1%	4.8%	4.4%
Public Consumption	3.2%	5.6%	1.8%	1.9%	1.3%
Gross Fixed Capital Formation	0.2%	3.9%	7.8%	8.3%	9.9%

Source: Central Bank

Now turning to the country's GDP distribution, it is important to note that Iran has a relatively diversified economy, with the highest sector contribution to the GDP from the service sector. The graph below represents the breakdown of key sectors in the Iranian economy for 2001/2002.

Graph: GDP Distribution (2001/2002 economic performance)



Source: Statistical Center of Iran

The structure of Iran's GDP continues to be determined by its reliance on oil as the main source of hard currency. As the recipient of crude oil revenues, the State remains the dominant economic actor. The oil sector's share of GDP has declined from between 30-40% in the 1970s to between its more recent levels of 10 to 20%, principally as a result of policy decisions taken at the time of the revolution to reduce production and exports and diversify the production base of the country as well as a lack of investment in the oil sector. However, oil revenue still provides approximately 75% of export earnings and nearly half of government revenue. As a result, this sector is the prime recipient of foreign and domestic investment. Iran currently produces oil to the limit of its OPEC quotas.

The following table shows Iran's GDP by economic sector at current prices and by percentage contribution for the periods indicated:

Table 4: GDP Breakdown in Sectors

Billion Rials	**1997/98**	**1998/99**	**1999/00**	**2000/01**	**2001/02**
Agriculture	40,341 (14.4%)	56,364 (17.4%)	64,140 (15%)	77,159 (13.6%)	89,125 (13.5%)
Oil	40,725 (14.5%)	27,952 (8.6%)	62,839 (14.7%)	101,055 (17.8%)	100,262 (15.1%)
Manufacturing & Mining	55,900 (19.9%)	61,880 (19.1)	81,816 (19.1%)	107,615 (19.0%)	133.456 (20.1%)
Mining	1,522 (0.5%)	1,914 (0.6%)	2,398 (0.5%)	2,943 (0.5%)	3,667 (0.5%)
Manufacturing	38,951 (13.9%)	43,960 (13.5%)	57,924 (13.5%)	75,758 (13.3%)	94,773 (14.3%)
Electricity, gas & water	2,892 (1.0%)	3,401 (1.0%)	4,194 (1.0%)	7,219 (1.3%)	8,592 (1.3%)
Construction	12,625 (4.5%)	12,606 (3.9%)	17,301 (4.0%)	21,695 (3.8%)	26,424 (4.0%)
Services	147,239 (52.4%)	182,211 (56.2%)	226,083 (52.8%)	291,301 (51.3%)	352,901 (53.3%)
Trade, Restaurants & Hotels	45,888 (16.3%)	53,640 (16.5%)	67,036 (15.6%)	82,960 (14.6%)	94,787 (14.3%)
Transport, Storage & Communications	23,607 (8.4%)	26,088 (8.0%)	30,619 (7.1%)	47,385 (8.3%)	59,970 (9.0%)
Financial & Monetary Institution Services	3,140 (1.1%)	4,694 (1.4%)	7,006 (1.6%)	10,456 (1.8%)	14,502 (2.2%)
Real Estate, Specialized & Professional Services	35,701 (12.7%)	50,204 (15.5%)	62,499 (14.6%)	74,756 (13.2%)	91,875 (13.9%)
Public services	32,088 (11.4%)	39,317 (12.1%)	47,718 (11.1%)	61,740 (10.9%)	75,480 (11.4%)
Social, personal and household services	6,814 (2.4%)	8,296 (2.5%)	11,204 (2.6%)	14,005 (2.5%)	16,287 (2.5%)
Bank Service Charge	3,386 (1.2%)	4,049 (1.2%)	6,580 (1.5%)	9,539 (1.7%)	13,231 (2.0%)
Total	280,908 (100%)	324,358 (100%)	428,298 (100.0%)	567,591 (100%)	662,514 (100%)

Source: Central Bank

In 1997, real GDP rose by 3.4% reflecting a moderate increase in the non-oil sector and a substantial decline in the oil sector as a result of the decline in world oil prices. In 1998, real GDP grew by 3.9% principally as a result of growth in the agriculture and services sectors with oil recording only a small increase and manufacturing and mining recording nearly zero growth. In 1999, growth in real GDP was 1.6%. The manufacturing and mining sector grew by 10.6% as a result of increased construction activity and the services sector grew by 3.8% as a result of an increase in transportation, warehousing and communication.

The oil sector recorded a decline in growth of 6% and agriculture a decline of 9.4% as a result of a drought in that year in the east and southeast parts of the country. In 2000, real GDP grew by 5.7% with the oil sector growing by 4.8% as production increased in line with OPEC quotas and prices strengthened. Manufacturing and construction and services also recorded significant growth. In 2001, real GDP grew by 5.7% with manufacturing and construction growing by 10.0% and 12.3% respectively. Agriculture and services each grew by approximately 5%, whilst oil declined by 8.4% reflecting reduced production in line with agreed OPEC quota reductions designed to achieve price stability.

The non-oil industrial sector has suffered from uncertainties in the privatization process as well as from a suppression of imports through much of the 1990s as Iran sought to conserve foreign exchange to meet its debt repayment obligations.

In 2001, the four most significant contributors to GDP growth were construction, manufacturing, trade and transportation, which together accounted for 4.1% of GDP growth.

The following table sets forth the growth in real GDP (at constant 1990 prices) for the periods indicated:

Table 5: Growth of GDP Constituents

Real GDP Growth	1997/98	1998/99	1999/00	2000/01	2001/02
Oil	5.3	2.2	6.0	8.4	8.4
Non-Oil	4.7	4.0	2.3	5.5	6.0
Agriuclture	3.5	6.2	9.4	2.8	4.7
Manufacturing & Mining	5.4	0.1	10.6	7.4	10.4
Services	5.1	4.5	3.8	5.6	4.8
GDP	3.4	3.9	1.6	5.7	4.8

Source: Central Bank

Growth rates in the oil sector have been significantly influenced by changes in the price of oil and the level of production as Iran conforms to revised OPEC quotas from time to time. In the non-oil sector State investment in agriculture and wider production export-based items produced significant growth in this sector over much of the 1990s although successive years of drought in 1999 through to 2001 caused a contraction in real terms in 1999 and restricted growth in subsequent years. The manufacturing and mining sector has grown strongly in recent years led principally by increased construction activity and increased imports of raw material. The services sector has also seen consistent growth in recent years but has been affected by currency exchange restrictions, excessive bureaucracy and uncertain long-term planning.

2.2) Key Economic Sectors

2.2.1) Agriculture and fisheries

Iran's principal agricultural products in terms of area under production are wheat and barley. In terms of volume of production, sugar beet, potatoes, rice and onions are also significant products. Major crops include pistachio nuts (Iran is the world's largest supplier of high quality pistachios), cotton, oil seeds, green lea and tobacco. The principal farm operator and goods processor is the Bonyad-e Mostazafan & Janbazan (Foundation of the Oppressed and the War Veterans), which runs many of the private estates previously owned by the pre-revolutionary elite.

Agricultural production fell shortly after the revolution as urbanization rates increased, large landowners fled the country and the government focused on industrialization. Throughout the 1990s, however, output steadily increased and productivity improved. In 1998, a severe drought, which continued until 2001, significantly adversely affected the production of cereal products such as wheat, barley and pulses. Iran's Natural Disasters Headquarters estimated the losses from the drought at approximately $3.5 billion in 2000.

More than one-third of the value added in agriculture comes from livestock such as sheep, goats and, to a lesser extent cattle. Livestock is largely nurtured on traditional small farms and production has also been badly affected by the recent drought, which has damaged grazing land and reduced fodder supplies.

Iran possesses a variety of fishing areas with the caviar industry being by far the most developed in Iran's fisheries sector. Stocks of beluga sturgeon in the Caspian Sea have been significantly reduced over the last two decades as a result of pollution, over fishing and poaching.

2.2.2) Hydrocarbods

As mentioned before, the hydrocarbons sector is Iran's dominant industry and main foreign exchange earner. It is also the main source of government revenue. The oil and gas sector including the subcontracting sub-sectors are currently also the main sector for foreign company activity. Despite existing limitations arising from the country's Constitutional and legal framework, the country has successfully attracted international companies to invest in the hydrocarbon sector. Iran's ambitious plans in this sector, especially the plan to increase oil production capacity to a level of 8 million barrels per day by 2020, will further increase this sector's significance in the country's economic performance.

Interestingly, even within the hydrocarbon sector, Iran is witnessing a structural shift. Iran's natural gas reserves are the second largest in the world after Russia's. Currently natural gas contributes to the country's energy basket with a significant share of 45%. Slowly but surely, natural gas is gaining in significance in Iran's overall economy, gradually reducing the country's vulnerability to oil market fluctuations. Iran has a four-stage strategy for its gas reserves:

- To use reserves suitable for re-injection into ageing oil bearing structures,

- To encourage domestic industrial gas use thus freeing crude oil for export,
- To increase its gas exports and
- To use reserves in gas-related petrochemical production.

Furthermore, downstream activity both in refining as well as petrochemicals is on the rise. While the refining projects are mainly designed to respond to domestic needs, the country's petrochemical output is fully outward oriented and is generating new export potential for Iran. In fact, in the last Iranian year, the country exported nearly $1 billion in petrochemical products.

2.2.3) Manufacturing and Mining

Although manufacturing recovered strongly after the end of the Iran- Iraq war, expansion was hit in 1995 when the government re-imposed currency restrictions on imported inputs. With the exception of the mining and metals sector, the industrial sector in Iran remains dominated by inefficient state-owned companies.

In terms of value of production in 2001, iron ore, coal, decorative stones, copper and gravel and sand were the principal products mined in Iran.

In the petrochemicals sector, the state-owned National Petrochemicals Company (NPC) is undertaking an expansion program aimed at the construction of some 30 petrochemical plants by 2013. In May 2001, NPC officials estimated that total installed capacity had reached 12 million tons per year. By the end of 2001, petrochemicals overtook carpets as Iran's leading non-oil export.

Iran has invested heavily in the steel sector during the 1990s. This investment has seen production rise to 6.9 million tons per year making Iran the largest producer in the Middle East. Iran also produces aluminum (131,000 tons in 2000 and 148,000 tons in 2001) and has a reasonably well-developed agro-industrial base. The automotive sector is insulated from competition by high tariffs and quotas, which has stifled domestic innovation. The country's textiles industry is largely based on the domestic supply of cotton although comparatively high labor costs and inflexible labor laws mean that the price of Iranian produced textiles is higher than that of its regional competitors.

2.2.4) Services

The services sector grew at an average annual rate of 5.8% in real terms during 1998-2001, which exceeded the average annual GDP growth for the country over the same period. During the said period, real estate and professional services comprised 30.2% of the total service sector GDP and trade and communications and transportation services comprised 29.6 and 18.1%, respectively, of the service sector's GDP. Over the past few years, the telecommunication and tourism sectors have increased their share within the service sector's contribution to the GDP. The new growth sub-sector will most probably be the banking sector where recent privatization has boosted activity. By late 2002, the Central Bank of Iran had issued licences for four private banks and two non-bank financial institutions. Furthermore, existing governmental banks will partly be merged and also part-privatized. Also, the privatization of the insurance sector had begun in late

2002. Increased efficiencies in the service sector will facilitate the diversification of economic activity as well as the country's economic growth.

3.0) Socio-Economic Indicators

While pure economic performance has been positive, one needs to analyze the country's socio-economic indicators to identify potential challenges.

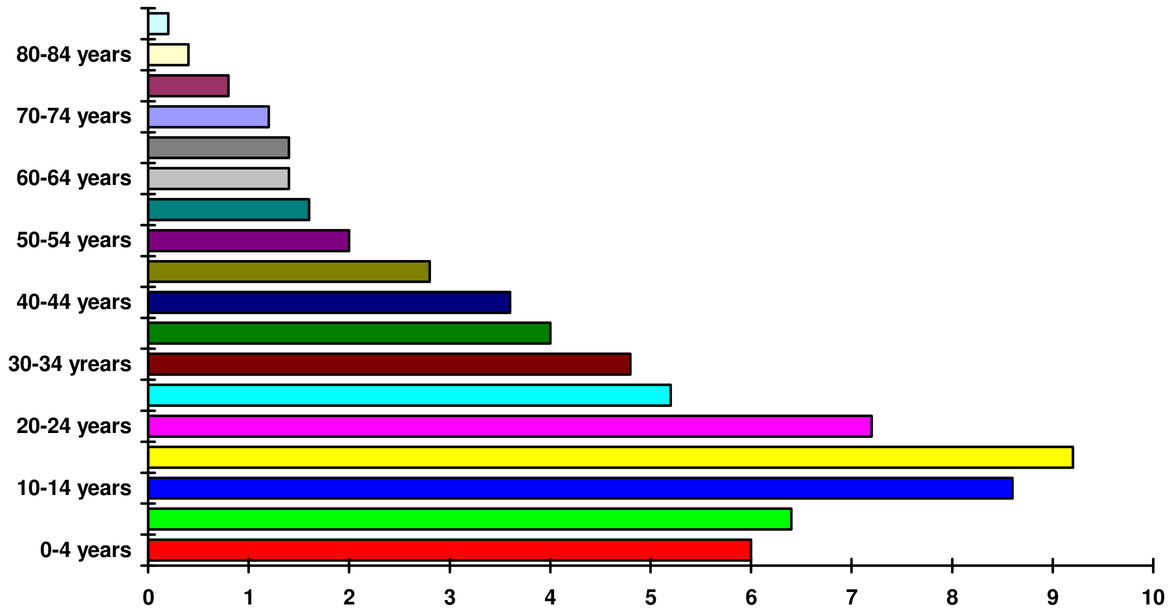
Table 6: Socio-Economic Indicators

(March 2002)	
Population (2002 estimate)	70 million
Urbanization (2002)	65%
Active population (2001)	30.0%
Employed population (2001)	16.1 million
Unemployment (2002)	14.2%
Life Expectancy (2001)	69 years
Literacy Rate (above 6 years)	84%
Number of school pupils (2002)	19 million
Number of students in university (2002)	1.7 million

It is evident from the above table that the key challenge to Iranian authorities is unemployment. Though new measures have been introduced to contain the issue, it is clear that unemployment will remain a problem for the next few years. The key factor behind unemployment is the country's young demography (see below graph). Based on projections from the latest census in 1996, some 50% of the population is below the age of 20. This fact translates to some 800,000 new entrants into the job market per annum. According to a recent statement by President Khatami[6], in the period between March 2002 and March 2003, the Iranian economy produced some 700,000 jobs. In the same speech, Khatami also announced that the unemployment rate had dropped to 12.8%, however, these figures have not been officially confirmed by state institutions. Notwithstanding the President's statement, one should point to the fact that Iran suffers from underemployment. An output of some 150,000 to 200,000 university graduates per annum is a phenomenon that the Iranian economy cannot absorb, hence leading to disturbing social phenomena such as brain drain and underemployment[7].

[6] This statement was made during President Khatami's New Year speech on 21 March, 2003.
[7] A report in the UK-based Economist published on 20 June, 2002 suggests that in the period between 1999 and 2002, some 285,000 qualified Iranians had emigrated from Iran. There is no official source of statistics on this phenomenon, but it is a fact that many educated Iranians seek job opportunities outside Iran.

Graph 1: Iranian demography (2001 estimate projected from the real census figures of 1996)



Analysts agree that the qualitative challenges relating to underemployment will remain in place for a few years. Quantitatively, the creation of 800,000 jobs per year requires a minimum 6% GDP growth and an investment ratio of 30-35% of GDP. In the past, investment ratios of the Iranian economy had peaked at 21%, meaning that the economy will require a capital formation growth higher than the actual economic growth. Iran's Management and Planning Organization has planned for a capital formation growth of 7.5% in the next few years. This, in fact, creates the most significant conflict of interest for the Iranian government: On the one side, the government is trying to reduce its role in the economy through privatization and on the other side, the government itself has to fuel capital formation growth in the absence of a vivid private sector investment growth.

Therefore, it is clear that government policies in the economic field will have to focus on promoting private sector investment activity. This is currently happening through privatization, alongside support for small and medium-sized companies in the private sector. Also, the government has introduced a number of financial schemes to promote self-employment in small-scale businesses. How sustainable and successful these policies will be, remains to be seen, however, the following factors have helped the Iranian government contain the country's unemployment to a certain extent:

a) The relative re-activation of the private sector: One of the key successes of the Khatami administration has been a genuine growth in private sector confidence in economic activity.

b) Flow of funds from Iranian Diaspora into the Iranian economy: Partly connected to the confidence and legal environment generated by the government and partly as a consequence of the post-11-September financial regulations, a number of Iranian Diaspora have returned their capital to Iran. This has mainly fueled the construction and service sectors and has also led to an enormous growth in trading at the Tehran Stock Exchange[8]. The volume of capital flowing back into the country has for the first time reversed the net flow of capital in the Iranian economy. According to the government spokesperson, Abdullah Ramezanzadeh, in the 12 months post 11 September 2001, some $7 billion of capital had been injected into the Iranian economy from the Diaspora.

4.0) Policy Objectives and Economic Reforms

Based on the above outlined challenges, the key objectives in the country's economic policy can be summarized as follows:

- Job Creation: It is evident that successful job creation policies will have to mainly rely on increased private investment. This is very critical for Iran's economic development. Interestingly, Iran's Supreme Leader, Ayatollah Khamenei, has used every opportunity to remind Iran's authorities that their main focus has to be on fighting unemployment;
- Privatization and promotion of private sector activity;
- Outward Orientation / International confidence;
- Increased efficiency in the state sector;
- Decentralization;

Before discussing the government's performance in the above policy areas, it is important to briefly mentioned the various obstacles to economic restructuring. These obstacles include:

- **Lack of consensus** among key political players: Iran's main political currents range from leftist labor unions to conservative open market favorers. The complex power structure results in continuous debates and disagreements on political and economic issues which in turn slows down a number of reforms. Table 7 depicts the level of disagreement on a number of key questions.
- **Weaknesses in the infrastructure:** The excessive experiences of the past 25 years, especially revolution, war and reconstruction have left their traces in the infrastructure as well as in the bureaucracy of the country. Disproportional infrastructure, technocratic and bureaucratic capabilities impede some of the reform processes or at least slow them down;
- **Structural problems** such as subsidies, non-application of laws, legal instability and central planning structures;
- Existence of political and economic **interest groups** who oppose reforms that would undermine their position: These interest groups have been the focus of a campaign against corruption which has the backing of the Supreme Leader.

Table 7: Disagreements on economic reforms between key political tendencies in Iran

[8] In 2002, while the majority of world bourses were hit hard by post-11 September effects, the TSE experienced the highest growth rate of all FIBV member bourses.

Policy \ Faction	Traditional Left	New Left	Center	Right	Extremist Right
Priority of Private Sector	Opposed	Opposed	Conditionally in favour	In favour	Opposed
Revision of Article 44	Opposed	Opposed	Conditionally in favour	Opposed	Opposed
Privatisation	Opposed	Ambiguous	In favour	Conditionally in favour	Conditionally in favour
Reforming subsidies	Opposed	In favour	In favour	Conditionally in favour	In favour
Lifting of price controls	Opposed	Ambiguous	In favour	Conditionally in favour	Conditionally in favour
Amending the labour law	Opposed	Opposed	Ambiguous	In favour	In favour
Reduction of gov. control	Opposed	In favour	In favour	Conditionally in favour	In favour
Foreign investment	Conditionally in favour	In favour	Conditionally in favour	Conditionally in favour	In favour
commitment to free market economy (on a 0-	1.5	5.0	5.8	6.9	3.5

Source: Iran Economic Magazine

Considering the above challenges and impediments, in the following we will dissect some of the policy areas:

4.1) Privatization [9]

Within the premises of the third five-year development plan (2000 to 2005) the government is engaged in a significant reform of the state-owned enterprise sector. In particular, the plan authorizes both foreign and domestic private sector participation in areas such as telecommunications, downstream oil and gas, power generation, banking and insurance. Previously, these were reserved exclusively to the State as provided for in the Constitution.

However, the failure of past privatization policies has alarmed many analysts who argue that Iran's political and legal reforms have not gone far enough to facilitate a successful privatization.

To avoid a repetition of old failures a High Council on Privatization has been established to set privatization policy. This organization is complemented by the new Privatization Organization which is to implement the formulated policies. Both have been established pursuant to the Third Five-Year Development Plan. The initial priority is to restructure the public manufacturing and services holdings of the government within different ministries into new holding companies established under the privatization Organization. Net privatization revenues, which are estimated to have amounted to $12 million in 2001 are budgeted at $1.875 billion in 2002 of which $1.125 billion is designated for the transfer to

[9] For a comprehensive report on Iran's privatization efforts, please see Middle East Economic Survey (MEES): VOL. XLV, No 24, 17 June 2002, *Iran's Privatization Saga* By Jahangir Amuzegar

the social security organization and $750 million for general resources of the government budget.

Consequently, the pattern of privatization at this stage can mainly be summarized in the transfer of state companies to various pension and social security funds, i.e. from the public sector to the semi-public sector.

Parallel to this process, the economy is witnessing the growth of the private sector through new initiative rather than through buying into formerly public companies. This in fact will be the dominant pattern over the next few years, i.e. a growth of new private initiative and the potential demise of some public companies over time.

4.2) Foreign Investment

In the past, attracting foreign direct investment as a means of spurring growth and economic development had not been a priority in Iran outside of the oil, gas and petrochemicals industries. In large part this reflected the post revolution constitution that prohibits the granting of concessions to foreigners for operating in the fields of trade, industry, agriculture, mines and services. However, the ratification of a new Foreign Investment Law by the Expediency Council in May 2002 can be understood as a turning point for Iran in the issue of attracting foreign investment. The new law aims to reduce the political risk of investing and allows repatriation of principal and earnings.

Within the oil sector, the use of "buy-back" contracts had circumvented these limitations and similar arrangements, such as "Build-Operate-Transfer" projects, are being applied to other sectors of the economy including power generation. Whether the new investment regime will attract foreign direct investment, remains to be seen. It should also be noted that the willingness of international companies to invest in Iran is also dampened by the current regional uncertainties.

4.3) Inflation

Inflation in Iran, measured by the consumer price index in urban areas, has been in double figures since 1991 and peaked at approximately 50% in 1995. In recent years monetary expansion due to financing the budget deficit, the depreciation of the market exchange rate, the removal of some subsidies and the suppression of imports have all contributed to rising prices. In 1997, average annual inflation was 17.4%. This increased slightly to 18.1% and 20.1% in 1998 and 1999 respectively before falling sharply to 12.6% in 2000 reflecting improved economic conditions and enhanced public confidence in the stability of economy as well as the implementation of non-expansionary monetary and fiscal policies. In 2001, the downward trend in inflation continued and at the end of the year it stood at 11.4%.

Exchange rate unification in March 2002 is has not had a major inflationary impact. This is because government financing has been made available which is designed to replace implicit subsidies with explicit ones so as to ensure that there are no price increases. In addition, there should be no significant monetary expansion as a result of the government's decision to finance the increased cost of settling existing debt obligations. At the time of exchange rate unification, tariff reductions were also implemented which offset the increased cost of imports caused by unification.

Various price indices and their breakdowns for 2000 and 2001(percentage change over previous period) are presented in the table below.

Table 8: Price Index Break Down

Description	2000 (%)	2001 (%)
Consumer Price Index	**12.6**	**11.4**
Goods	9.0	5.8
Services	17.1	20.4
Housing, Fuel & Lighting	18.4	18.8
Wholesale price Index	**14.7**	**5.1**
Domestically Produced Goods	14.8	6.8
Imported Goods	13.3	0.8
Exported Goods	19.7	-0.5
Producer Price Index	**16.3**	**10.9**
Agriculture, Forestry, Husbandry & Fishing	17.9	8.3
Industry	15.6	5.2
Mining	17.1	-4.4
Water, Electricity & Gas	14.3	10.9
Services	16.0	23.1

Source: Central Bank

It is possible, however, that budget deficit financing could increase inflation if the ambitious revenue targets set in the 2002 budget are not met.

4.4) Unemployment

Though unofficial sources put Iran's unemployment at 18%, the official unemployment rate for 2001 was 15.7%. This figure dropped in 2002 to 14.2%. The unemployment rate is relatively higher among females and, in recent years, in urban areas as opposed to rural areas. It is very likely that the official unemployment figures understate its true position as a result of the methodology used in the surveys.

Based on the most recent census, the total population aged 10 years and over in Iran numbered approximately 45 million, of which the economically active part was approximately 16 million (estimated by December 2001 to have increased to 18.6 million). The remaining 29 million were classified as students, homemakers (all men or women not being economically active or students) or income recipients (those not being economically active, students or home-makers but who received a pension or other income).

Employment among the economically active population (those aged 10 years or over who are either employed or unemployed but actively seeking work) was 86.9% in 1997. This increased to 87.5% in 1998 before falling in 1999 and 2000 to 86.5% and 85.8%, respectively. The rate of employment is marginally higher among males and, in recent years, in rural areas as opposed to urban centers. It is likely that the official figures overstate the true employment position as a result of the methodology used in the surveys.

Approximately one-half of Iran's population at the time of the last census was under 20 years of age, a fact that is expected to result in increased pressure on employment rates in the future. The government has sought to address this by financing job creation projects and implementing measures to raise production and investment. The 2002 budget law allocated $1 billion from the Oil Stabilization Fund to the private and co-operative sector in this respect as well as a further $1 billion specifically for job creation projects.

Notwithstanding these initiatives, the existing labor law makes it extremely difficult to terminate established employment contracts and the combined tax and social security costs of employment are equivalent to approximately two-thirds of each employee's wage.

4.5) Foreign Reserves and Foreign Debt

Iran's foreign reserves principally comprise its foreign exchange balances, which have grown significantly in recent years following the establishment of the Oil Stabilization Fund[10]. The country's net foreign reserves are about $12.6 billion. The reserves have grown in recent years reflecting improved oil earnings and reduced external debt repayment obligations, as rescheduled external debt has been paid.

In 2001, Iran's foreign debt was about $7.2 billion, constituting only a mere 6.7% of the GDP, confirming a healthy economy. Currently, Iran is a net creditor to the world, hence consolidating a positive financial position.

Table 10: Foreign Debt

In mln $	**1998**	**1999**	**2000**	**2001**	**June 2002**
Short-term	4,503	3,618	3,678	2,652	2,718
Medium &Long-term	9,496	6,739	4,275	4,562	4,768
Total	13,999	10,357	7,953	7,214	7,486

Source: Central Bank

Table 11: Maturity Profile

In mln $	**2002**	**2003**	**2004**	**2005**	**Later**
Amount	2,869	1,544	1,088	554	1,431

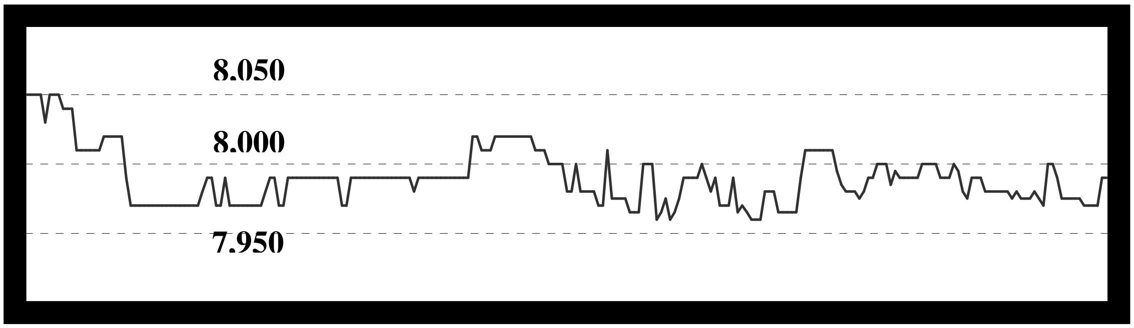
Source: Central Bank

4.6) Exchange Rate

[10] Money put aside, from the sales of higher that projected oil prices, to offset future oil price fluctuations.

Iran's exchange rate system used to be a multi-tiered system, where state and para-state enterprises would benefit from the preferred rate and hence creating an unhealthy competitive environment. However, as of March 2002, the multi-tiered system was replaced by a unified single market driven exchange rate. The official rate on 1 December 2002 was 8,000 Rials for $1. The following chart demonstrates the US dollar fluctuations from September 2001 to September 2002. The Central Bank of Iran plans with the assistance of the IMF to make the Rial fully convertible in the course of 2003.

Graph 2: Exchange Rate from 1 Sep 2001 – 1 Sep 2002



Source: Iran Financial Times

4.7) Liquidity

In general, the Iranian monetary policy has been aimed at curbing the liquidity and hence controlling the inflation. Despite a target liquidity growth of 16.4% in 2001, a range of factors, including the need to accommodate higher than expected economic growth and to finance the Rial resources of the budget, the liquidity grew by 28.8% over the mentioned year. The target liquidity growth for 2002 is 15.7%.

The following table displays the liquidity and money supply (in billion Rials) for 2000 and 2001.

Table 12: Liquidity

Description	2000	2001
Money (M1)	114,420	142,957
Notes and coins with the public	25,158	29,188
Sight deposits	89,262	133,768
Quasi money	134,690	178,000
Interest free loans savings deposit	22,014	29,848
Term invest deposits	103,346	141,066
Short-term	50,443	66,983
Long-term	52,921	74,083
Miscellaneous deposits	9,312	7,087
Liquidity (M2)	**249,111**	**320,957**

Source: Central Bank

4.8) Subsidies and Government Budget

While the government has been relatively successful in controlling prices, subsidies remain high with approximately $5.5 billion allocated to basic commodities and $10 billion to energy in 2002.

In an effort to have a more transparent monetary policy, the Central Bank of Iran in 2002, for the first time, has outlined the budget complying with many of IMF's rules and standards. Up to the 2002 budget, domestic borrowing from the banking system, the issue of participation papers and oil pre-financing largely financed deficits. The two most significant sources of financing for 2002 deficit, however, are the Oil Stabilization Fund and privatization proceeds.

Table 13 depicts the government budgets (in billion Rials) for the past three Iranian years.

Table 13: Governmental Budget

Description	2000/01 Actual	2001/02 Actual	2002/03 Planned
Revenues	121,122	148,196	218,216
Oil and Gas	59,449	74,957	100,060
Tax	33,298	38,797	62,416
Non-tax	11,895	11,726	22,752
Earmarked Revenue	16,481	22,717	32,988
Expenditure and Net Lending	123,846	148,983	243,424
Current Expenditure	83,968	102,314	155,635
Development Expenditure	23,560	24,088	54,987
Net Lending	(163)	(136)	(186)
Earmarked expenditure	16,481	22,717	32,988
Deficit	(2,724)	(787)	(25,209)[11]
Financing	2,724	787	25,209
Foreign	77	120	413
Domestic	2,648	677	24,796

Source: Central Bank

4.9) Overall Analysis

The above outline of a number of policy areas underlines that the overall performance of the Khatami government in the field of economy has been positive. Notwithstanding, a number of key challenges remain which will require courageous reform initiatives. These challenges can be summarized as follows:

[11] Does not include IRR 19,250 billions which have been earmarked by the government to compensate public sector entities which incurred external debt to fund public sector projects for the difference between the IRR 1,752 exchange rate (preferred rate that existed before 21 March 2002) at the date of contracting and the market rate at repayment in 2002 following exchange rate unification.

- **Labor Law:** As mentioned earlier, Iran's rigid labor law remains one of the main obstacles to promoting private sector activity;
- **Subsidies:** The continuation of a blanket subsidy policy by the Iranian authorities is a serious source of pressure on the government. The current subsidies represent an approximate $15 billion burden on the government annually. Analysts agree that a redistribution of subsidies and the concentration on direct subsidies to poorer classes would be more appropriate for the Iranian economy. However, the government has failed to introduce relating legal and practical initiatives.
- **Distribution of wealth:** Another challenge to the government is the efficient distribution of wealth and a reversal of the ever deepening gap between the richer and the poorer classes. The traditional instruments of state subsidies have failed. Authorities are debating a new bill called 'Poverty Eradication Law" which will address the issue of direct subsidies for poorer classes, however, serious attention will be needed to improve the economic conditions of the poorer social classes;
- **State efficiency:** Though there is a gradual improvement in the state bureaucracy, it is believed that the current state structures are not capable of responding to the needs of the Iranian economy. Increased diversification alongside the regional distribution of economic activity both require a more decentralized state structure which has not been achieved so far.

The key milestone in responding to the above challenges is the process of consensus building about the most significant bottlenecks, especially subsidies, state structure and labor law. Also, the government resolve and success in handling the issue of "vested interest groups" will be very significant.

5.0) Conclusions:

As it is evident from the set of economic policy initiatives, Iran is moving from an originally inward oriented economic structure to a more liberalized and open market structure that wants to interact with the rest of the world. In fact, the Third Five-Year Plan was the first policy document since the 1979 Revolution which declared "outward orientation" as one of the plan's objectives. However, existing disagreements and debates underline that the country's political forces are not fully prepared to pay the social and political price of this transition. Consequently, some of the related processes will remain unbalanced.

This imbalance will be further intensified by the challenges in Iran's domestic political picture as well as tensions caused by regional confrontations and crises. Therefore, the desired process of restructuring might actually take much longer than many expect. In this context, it should be underlined that the political process of democratization and its related phenomena will create short-term tensions in Iran's business environment. Notwithstanding, a sustainable democratization will have positive long-term effects on business conditions and the economic structure.

From an economic point of view, while macro-economic performance has the potential of remaining positive, current economic challenges, especially unemployment will continue to create social tensions. Therefore, one of the key signposts of economic improvement in Iran will be the government's handling of the unemployment issue. Connected to this is the need for a sustained increase in capital formation, especially from the private sector, hence the importance of attraction of investment from domestic and foreign private sectors. To achieve this, the government will further continue to put forward initiatives aimed at improving the country's overall investment climate, however, success in this field will depend on so many other political factors some of which are outside the control of the Iranian government.