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WORKING PAPER NO.26

**Institutional Change,
Policy Challenges, and
Macroeconomic Performance:
Case Study of the Islamic
Republic of Iran (1979–2004)**

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DFID Department for
International
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About the Series

The Commission on Growth and Development led by Nobel Laureate Mike Spence was established in April 2006 as a response to two insights. First, poverty cannot be reduced in isolation from economic growth—an observation that has been overlooked in the thinking and strategies of many practitioners. Second, there is growing awareness that knowledge about economic growth is much less definitive than commonly thought. Consequently, the Commission’s mandate is to “take stock of the state of theoretical and empirical knowledge on economic growth with a view to drawing implications for policy for the current and next generation of policy makers.”

To help explore the state of knowledge, the Commission invited leading academics and policy makers from developing and industrialized countries to explore and discuss economic issues it thought relevant for growth and development, including controversial ideas. Thematic papers assessed knowledge and highlighted ongoing debates in areas such as monetary and fiscal policies, climate change, and equity and growth. Additionally, 25 country case studies were commissioned to explore the dynamics of growth and change in the context of specific countries.

Working papers in this series were presented and reviewed at Commission workshops, which were held in 2007–08 in Washington, D.C., New York City, and New Haven, Connecticut. Each paper benefited from comments by workshop participants, including academics, policy makers, development practitioners, representatives of bilateral and multilateral institutions, and Commission members.

The working papers, and all thematic papers and case studies written as contributions to the work of the Commission, were made possible by support from the Australian Agency for International Development (AusAID), the Dutch Ministry of Foreign Affairs, the Swedish International Development Cooperation Agency (SIDA), the U.K. Department of International Development (DFID), the William and Flora Hewlett Foundation, and the World Bank Group.

The working paper series was produced under the general guidance of Mike Spence and Danny Leipziger, Chair and Vice Chair of the Commission, and the Commission’s Secretariat, which is based in the Poverty Reduction and Economic Management Network of the World Bank. Papers in this series represent the independent view of the authors.

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Abstract

Debates over the nature and direction of economic policy in Iran have intensified rather than abated after the tumultuous changes brought about by the Revolution in 1979. In the span of these three decades, Iran has witnessed sweeping institutional changes and has been affected by significant economic and political upheavals. At the macroeconomic level, too, there have been a number of shocks ranging from oil booms and busts, to war (with Iraq), trade sanctions, and internal political strife.

This paper uses Iran's experience to reflect on growth and development in the context of political upheaval and an uncertain institutional environment. It is a premise of the paper that Iran's recent past presents a rare, "laboratory" like, case for the study of growth and development in a broad context.

Despite Iran's manifest human and natural resource riches (as a major oil exporter), the record of the post-revolutionary period is lackluster with many Iranians experiencing setbacks to their living standards by historical, regional, and international standards. This contrasts sharply with the 1960s and 1970s, when Iran was a high-growth performer, as well with other recent success stories (notably China and India) that have combined market-friendly policies at home with liberal economic policies on the global scene. On the other hand, Iran was strongly influenced by the revolutionary ideals of social justice and economic self-sufficiency in this period. The country embarked on an inward-looking and distributionist course that was shrouded in an ambiguous institutional setting and lacked a clear commitment to achieving its high-growth potential.

Iran's ability to live off her oil rents has exacerbated the impact of institutional ambivalence in this period, arguably pushing back and delaying the agenda for economic reforms. Almost three decades after the Revolution, the structural features of the Iranian economy are remarkably unchanged: oil-dependency continues; the general investment climate is weak and beset by uncertainty; public finances are fragile; and the economy continues to be inward-looking and unsure of its position in the wider international economy.

This paper examines post-revolutionary Iran's macroeconomic policies and performance in a comparative context, appraising it against Iran's past trends and real potential. It shows how recurrent cycles of populism and pragmatism have characterized this period. The paper argues that two sets of factors have conditioned Iran's performance and will continue to taint her prospects for sustainable growth into the future. These are (i) Iran's limited economic diversification and continued dependence on the oil sector, and (ii) the institutional setting in which post-revolutionary economic policies have been formulated and implemented for much of the last three decades.

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Institutional Change, Policy Challenges, and Macroeconomic Performance: Case Study of the Islamic Republic of Iran (1979–2004)

*Hassan Hakimian*¹

1. Introduction

Iran offers unique insights and rich rewards as a case study of growth and development in the context of fast-changing economic and sociopolitical environments. Since the Revolution in 1979, Iran has witnessed important socioeconomic and institutional changes and has been affected by significant economic and political upheavals. The macroeconomic scene, in particular, has experienced a number of major shocks including oil booms and busts, war, trade sanctions, and internal political uncertainty—all affecting prospects for accumulation and growth.

Despite Iran's manifest human and natural resource riches, the record of the post-revolutionary period is lackluster, with many Iranians experiencing setbacks to their living standards by regional and international standards. It is widely recognized that, in fact, Iran's ability to live off her oil rents has pushed back and delayed the agenda for economic reforms, to the point of obstructing the largely overdue modernization of her ailing economy to date.²

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² For a broad discussion and analysis of Iran's economy in this period, see Hakimian and Karshenas (2000), Pesaran (2000), Behdad (2000), Mazarei (1996), Salehi Esfahani (2002), and Alizadeh (2003).

This paper examines post-revolutionary macroeconomic policies and performance in a comparative context, appraising it against Iran's past trends and real potential. The paper argues that two sets of factors have conditioned Iran's performance to date and are likely to continue to taint her prospects for sustainable growth into the future. These are (i) Iran's limited economic diversification and continued dependence on the oil sector, and (ii) the institutional setting in which post-revolutionary economic policies have been formulated and implemented for much of the last three decades.

The structure of the paper is as follows. First, we chart Iran's growth and development path, highlighting political economy changes before and after 1979, and explore their implications for the model of growth and development that has been pursued since then. Second, we examine a broad overview of Iran's comparative economic performance over the last few decades in both regional and historical contexts. Next, we turn to a discussion of policy challenges and responses in three subperiods after 1979: (i) 1979–88: (the heyday of revolutionary populism and war with Iraq); (ii) 1989–93 (the years of reconstruction and reform); and (iii) 1994–2004 (the decade of austerity and reform). It will be demonstrated how recurrent cycles of populism and pragmatism have characterized these two and a half decades. After this, we examine Iran's principal characteristics as an oil economy, and the way the agenda for economic policy and reform has been shaped and influenced by the institutional setting of this period.

The final section offers a summary and some concluding remarks regarding Iran's economic track record and the challenges it faces into the future.

2. Charting Iran's Growth and Development Path

Iran's recent past presents a rare—arguably a “laboratory” like—case for the study of growth and development. In the span of nearly three decades after the 1979 Revolution, Iran has experienced major economic and political upheavals followed by sweeping institutional changes. These changes offer us unique insights into, and rich rewards for, a case study of growth and development in the context of fast-changing economic and sociopolitical environments.

Two particular features of this case stand out: the fact that Iran is a large, resource-rich country, and the character of the emergent post-revolutionary institutions that infuse, atypically, religion with politics. These features no doubt add to the complexity and challenge confronting any study of Iran's recent past. Yet they also render it potentially richer and more interesting from the point of view of their wider implications for growth and development.

The 1979 Revolution overthrew one of the most stable and enduring monarchies in the Middle East and North Africa (MENA) region backed by external support and a large and modern army. This momentous event of great

international significance was also notable in at least two respects. First, the revolutionary course was driven by one of the broadest and largest mass-based movements of the twentieth century and harbored with it high expectations of change for the supporting masses. Second, by installing what is arguably the world's only theocracy in modern times, it has created an unfamiliar and unorthodox institutional and political setting, which continues to challenge conventional thinking on growth and development to date.

Prior to Revolution, Iran was led by a variant of what may be described as a "developmental state" (Alizadeh, 2000: 17–18). The state had substantial autonomy from social groups and pursued policies that were conducive to the development of the private sector.³ Moreover, as with other military dictators, the Shah had a strong commitment to growth, which he saw as the way to lifting the country out of a century of poverty and underdevelopment. To achieve this, he implemented a wide-ranging program of social and economic reforms from above in the 1960s, and pursued an active import-substitution industrialization policy to accelerate capital accumulation in the 1960s and 1970s (Karshenas, 1990). Steadily growing oil incomes and a sizeable domestic market offered Iran more of an opportunity to emerge as a semi-industrialized country by the 1970s. The advent of the oil boom in this decade, in particular, fostered this vision as it now seemed feasible to use the underground wealth to catapult Iran into a regional economic and military power.

Two obstacles, however, interfered with this course of development. First, was the weak, if not missing, domestic political legitimacy, given the Shah's strong formal dependence on Western powers.⁴ Second, and no less important, was the uneven and highly differentiating impact of economic growth in these years, which heightened social tensions especially in urban areas (Hakimian, 1988: 19).⁵ These tensions were further fueled by the 1970s' oil boom, leading to much social and economic dislocation (Graham, 1978; Hakimian, 1990). When dissent and social discontent erupted into the open, the fact that all meaningful political channels had been extinguished in the previous decades was not a tactical advantage the regime could draw on. On the contrary, it helped channel all opposition into an effective mass movement focused against the Shah.

In this context, the role of the mosques as the only organization with nationwide grassroots activity became crucial. It enabled the Shiite clergy to forge a broad, cross-class coalition that embraced the bazaar, the modern middle

³ Its industrial drive was, however, oriented towards the domestic markets, unlike in the Republic of Korea and Japan where growth was mainly export driven (Alizadeh, 2000: 18).

⁴ The Shah was restored to power in 1953 through a CIA-engineered coup that overthrew Iran's democratically elected Prime Minister—Mr. Mossadegh—following his nationalization of the oil industry (Kinzer, 2003, provides an authoritative account of this well-known external interference in Iran's affairs).

⁵ Accordingly, "as wealth poured into some urban sectors, ... its transparent lack in others ... visibly heightened growing social contrasts and a deepening image of social stratification." (Hakimian, 1988: 29)

classes, the intelligentsia, the industrial workforce, the urban poor, and other groups and social strata. The broad base from which this alliance drew from ended the state's relative autonomy from social groups and, as we shall see, has been at the base of the post-revolutionary state's popular constituency with which it has to contend.

Two further features of the Iranian Revolution have continued to play important roles in shaping the institutional landscape in this period: the twin promises of bringing about "social justice" and achieving "economic independence." Both were strong ideals of the Revolution and have made an imprint on both the vision and practice of economic policy ever since.

The strong anti-imperialist, anti-western stance and rhetoric of the Revolution reflected a rejection of the *ancien régime's* dependency on external powers in general and the United States in particular. Powerful aspirations were thus in force from the start to turn Iran into an "independent" economy. These explain broadly Iran's pursuit of a generally seclusionist development path since 1979, shunning the globalization trends that have swept developing countries in recent decades.

Moreover, despite the religious form and leadership of the Revolution, which has overshadowed somewhat its democratic and anti-dictatorial aspirations, the populist element in this process has been strong and lasting—particularly in the economic domain (Abrahamian, 1993; Behdad, 1996).⁶

As with Latin American populism, the Iranian Revolution was built around a broad coalition of the middle classes led by a strong and charismatic leadership (see Dornbusch and Edwards, 1991, on populism in Latin America). It had popular and egalitarian aspirations based on promises of fraternity, equality, and social justice—in direct contrast to the previous era's focus on growth and development. While respecting private property, it had strong connotations of class conflict between the *mostazafin* (downtrodden) and the *mostakberin* (oppressors) and promised to emancipate the former from all injustices of the monarchist era. This involved pledges to build a society "free from want and hunger, slums, drugs and inequality, and nepotism and corruption" (Abrahamian, 1993: 32).

As Acemoglu and Robinson (2006) have demonstrated, the transition from dictatorship to democracy is not necessarily a linear process with an assured outcome. In the Iranian example, too, after nearly three decades, this contradictory process seems to have resulted in a *hybrid* political form, which combines aspects of both democracy and non-democracy.

On one hand, Iran has been unique in offering universal suffrage until recently starting at the age of 15.⁷ Moreover, participation rates in most elections

⁶ According to Abrahamian (1993), characterizations of the Islamic regime as "fanatical" and "fundamentalist" have contributed to an obfuscation of its populist characteristics.

⁷ In 1997, this was raised to 18. In Cuba, Nicaragua, and Brazil, the minimum voting age is 16. Elsewhere, it is almost universally 18.

tend to be high, especially by the standards of established democracies.⁸ Yet, these “popular” elections operate on the basis of a highly limited franchise and are subject to vigorous and controversial vetting of the candidates by the Guardian Council.⁹ This system thus combines elements of “democracy” on the demand side (offering opportunities for expressions of “popular” choice) with “non-democracy,” entailing restrictions on the supply side (which limits the actual pool of candidates and political parties).¹⁰ Given the contradictory nature of the system, which, for lack of a better term, we may describe as a *participatory non-democracy*, it is not surprising that it often confounds both critics and supporters alike.

At an abstract level, Iran’s quest for democracy, as well as the upheavals leading to the Revolution in 1979, may be viewed as strategic behavior involving “conflictual social choices” between two broad opponent groups (Acemoglu and Robinson, 2006): citizens (a broad coalition of different classes and social groups) and the elite (the Shah and the Royal Court backed by higher echelons of the military, and external powers). Yet in the Iranian case, both the process and outcome of this confrontation have been distinct in a number of ways.

First, rational choice and optimal behavior would imply knowledge and information that was clearly absent in this context. There were no known blueprints for the promised type of (Islamic) Republic and much of what was on offer in the new social and economic order had to hinge on broad perceptions, if not promises and aspirations. For this reason, an element of ambiguity has permeated developments in Iran in the post-revolutionary period with far-reaching consequences, particularly in the economic policy area.

Second, Iran’s quest for democratization did not arise in the classic conditions of economic and political crises.¹¹ On the contrary, it followed the prosperity associated with the oil-boom period of the 1970s, implying that desire for revolutionary change may have had more to do with growing inequality and perceptions of (relative) poverty in these years than with actual impoverishment, hunger and crisis.

As we shall see below, oil revenues have continued to exert an undue influence over Iran’s growth and economic performance as well as shaping

⁸ The turnout in Iran’s presidential election in 2005 was 63 percent (first round) and 60 percent (second round). In the 1997 and 2001 elections, these were 80 percent and 66 percent, respectively.

⁹ This body is made of six clergymen appointed by the Supreme Leader and six laymen selected by the head of the judiciary chief. The latter are subject to parliamentary approval.

¹⁰ The Iranian Constitution permits the establishment of political parties and professional syndicates as long as “they conform to the Islamic basis of the Republic.” In the 2005 presidential elections, about 1,000 candidates were disqualified, only 8 were approved of whom 7 ran. Similarly, of the 814 candidates who declared their intention to run in the 2001 presidential election, only 10 were approved.

¹¹ Acemoglu and Robinson predict that democratizations are more likely to arise in a situation of economic and political crisis. Relevant examples are harvest failure, economic depressions, international financial or debt crises, and even wars (2006: 30–31 and 65).

popular expectations over the distribution of political space and economic resources in the post-1979 period.

In the next section, we examine the growth record of the post-revolutionary period before coming back to examine the economic policies and challenges in the period under study.

3. An Overview of Growth

Overall, Iran's economy recorded an average annual real GDP growth rate of 4.6 percent over the four and a half decades between 1961 and 2005. Although this aggregate long-term growth rate surpasses the growth rate for the MENA region as well as the world mean for this period (3.8 percent and 3.7 percent per year, respectively), it is below the rate for the group of lower-middle income economies of which Iran is part of (estimated at 5.3 percent per year).¹²

This record should, however, be qualified in at least three important ways. First, it masks gross discrepancies over time (especially after the late 1970s). Second, it needs to be studied in a comparative context to take account of Iran's relative performance in relation to her peers. Third, taking into account population growth would offer a different picture (especially after the 1980s).

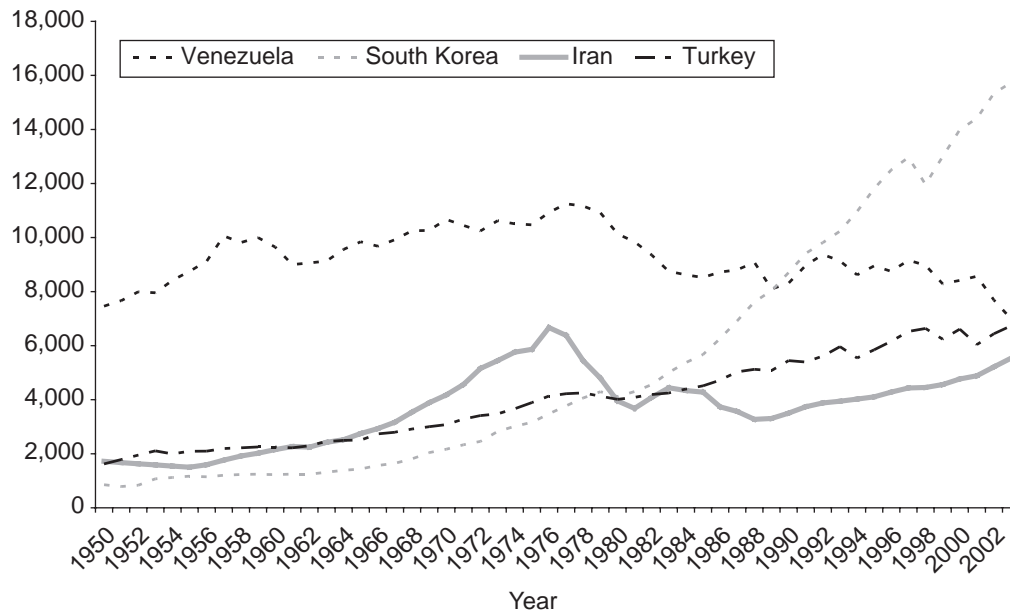
In general, evidence suggests that Iran's growth performance deteriorated after the late 1970s. This is true both in a comparative light as well as compared to the period over time (see Hakimian and Karshenas, 2000, and Karshenas and Hakimian, 2005).

Below, we offer an analysis of Iran's performance against three different comparator groups over different time periods: a select number of high-performing developing countries (LDCs), lower-middle income countries (LMCs), and the oil economies.

Comparison with a high-performing economy such as Korea highlights the sharp trend reversal in Iran's growth performance (figure 1). Between 1955 and 1975, Iran's per capita income outstripped that of Korea's. The situation was, however, reversed after the mid-1970s when Iran's growth began to falter. Korea has continued to improve its per capita GDP ever since with a wide gap separating the two countries as a consequence.

¹² Data is from the World Bank's World Development Indicators (<http://go.worldbank.org/6HAYAHG8H0>). The rates refer to average year-on-year growth rates. The MENA growth rate is for the period 1975–2005. The figure for the lower-middle income economies (5.3 percent) should, however, be treated with caution as (i) it refers to an ex-post country classification consisting of 58 countries deemed to fall in this category as of July 2006; and (ii) it embraces a heterogeneous and diverse set of countries (for instance, for republics of the former Soviet Union, data stretches back to the early 1990s only).

Figure 1: Per Capita GDP Trends in Iran, Korea, Turkey, and Venezuela, 1950–2003



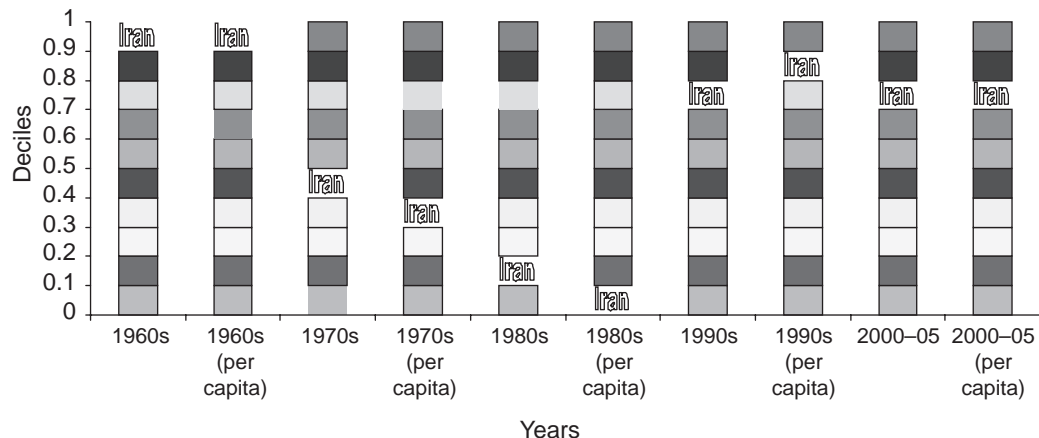
Source: Maddison (2003). Figures are in 1990 International Geary-Khamis dollars.

Turkey offers an interesting contrast too. Starting from similar per capita income levels in the early 1960s, she has followed a more steady growth path that has overtaken Iran, especially after the collapse of growth in the 1980s. It is true that much of the catching up by Turkey took place during Iran’s war with Iraq in the 1980s (from which Turkey and other neighboring countries benefited economically). However, sustained economic growth would not have been possible without far-reaching economic reforms introduced after the early 1980s resulting in a higher efficiency of investment and greater economic diversification, especially rising manufacturing exports (Karshenas and Hakimian, 2005: 71).

An examination of the Venezuelan experience shows that some of the difficulties Iran encountered in the 1980s were in fact shared by other oil economies. Also interesting is that whereas Venezuela’s growth and hence its GDP per capita has regressed, Iran’s performance has recovered—albeit gradually—after the 1990s, indicating a degree of convergence with Venezuela.

Compared with other LMCs as well as with other oil economies, Iran’s story is equally interesting. Figures 2 and 3 show another perspective of comparative growth performance based on rankings by the relevant deciles for the group of LMCs and oil economies, respectively. Figure 2 shows that Iran was a top performer in the 1960s, judged by annual real growth rates, and then sank somewhat to below the median position in the 1970s, before plunging to the bottom of the comparative growth rankings in the harsh decade of the 1980s. After that Iran improved its relative performance again both in GDP and GDP per capita terms among the LMCs, moving to the top three deciles in the 1990s and after 2000.

Figure 2: Iran's Per Capita GDP and GDP Growth Ranking among LMCs by Decile Distribution, 1960–2005

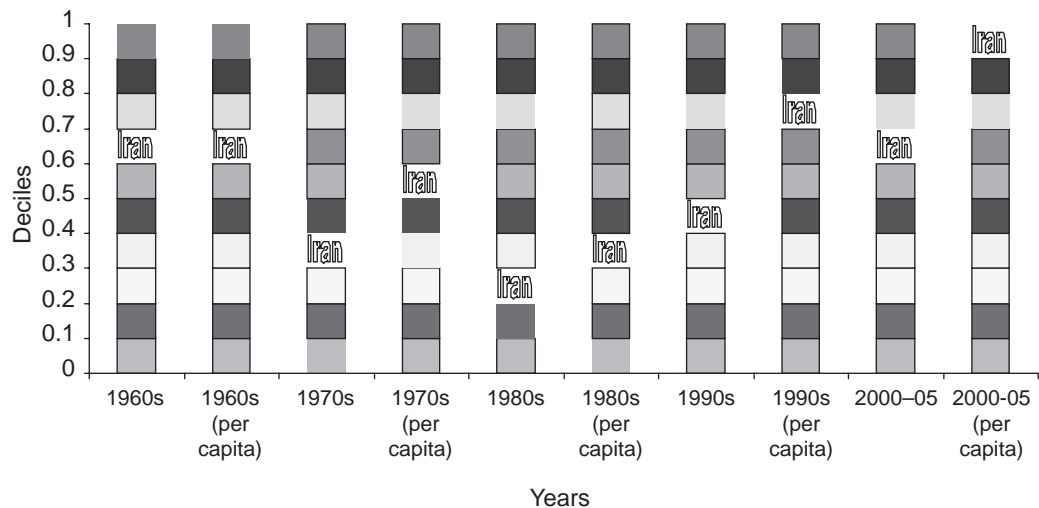


Source: Author's calculations from World Bank (2006).

Note: World Bank classification as of July 2006. LMCs comprise 58 countries, including Eastern Bloc countries and former Soviet republics for which data refer to the period after the early 1990s. The number of countries embraced by the classification here thus varies between different decades and should be treated with caution.

Figure 3 offers another useful comparison, this time against the oil economies. Here, too, we see a similar “U-shaped” trajectory whereby Iran’s about median performance (relative to oil producers) in the 1960s and 1970s drops in the 1980s before recovering later. The trough in the 1980s, however, is less severe, confirming that Iran was not alone affected by turbulence in the oil markets in this decade (see reference to the Venezuelan performance above).

Figure 3: Iran's Per Capita GDP and GDP Growth Ranking among Oil Economies by Decile Distribution, 1960–2005



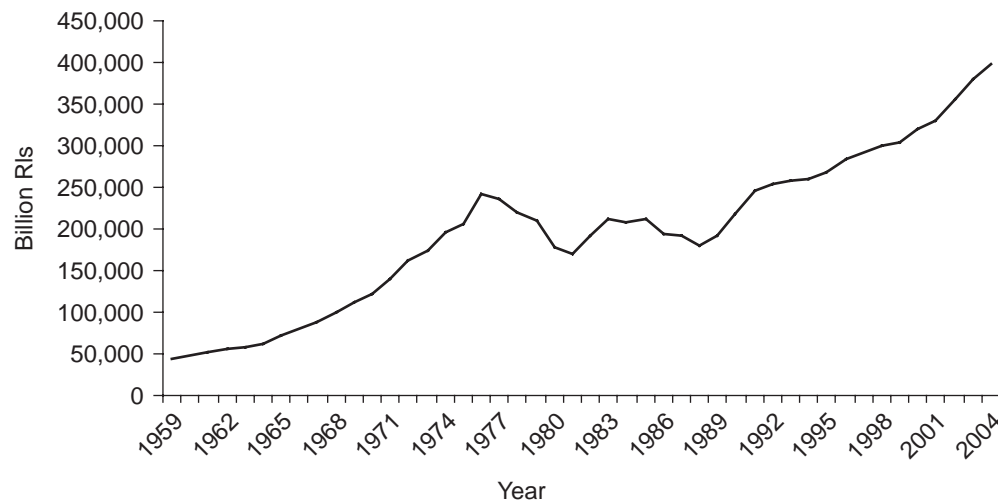
Source: Author's calculations from World Bank (2006).

Note: Oil economies included are: Algeria, Bahrain, Indonesia, Iran, Kuwait, Libya, Nigeria, Oman, Saudi Arabia, United Arab Emirates, Venezuela, and Yemen. Iraq is only included after the 1990s, and Qatar is excluded altogether due to data limitations. The number of countries embraced by the classification here thus varies between different decades reflecting data limitations and should be treated with caution.

What is further interesting is that taking into account Iran’s population growth helps rather than hinders Iran’s relative growth rankings among oil producing nations: Iran does consistently better on a *per capita* basis than its general GDP growth rankings suggest (with the moderate exception of the 1960s). This happened despite sharp sways in Iran’s demographic behavior after the 1970s (Hakimian, 2006), and is particularly surprisingly during the 1980s, when a notable fertility surge in Iran resulted in one of the fastest growing population rates in the world (reaching almost 4 percent in the 1980s; see further Section 4.1 below). This reflects indeed on the MENA region’s “demographic puzzle,” confirming that fast population growth in these decades did not affect Iran only and was more pervasive regionally and among oil producers in general for much of the period under discussion here.¹³

Figure 4 depicts Iran’s GDP in real terms since 1959 (in constant 1997/98 prices). Three general phases are readily evident from this long-term trajectory of Iran’s real income and its evolution over time. The rapid rise in two decades prior to the Revolution (the 1960s and the first half of the 1970s); the collapse and contraction period of the 1980s; and the resumption of growth after the early 1990s. This rather clear-cut and well-differentiated pattern of two GDP growth phases punctuated by one (albeit long) collapse period (the 1980s) may lead one to conclude that—bar an exceptional period of stagnation and decline itself occasioned by revolutionary upheaval and war with Iraq in the 1980s—Iran has been a high performer during most of the last four and a half decades and is now back on its “sustainable growth track.” A more detailed examination of Iran’s growth performance over time, especially when disaggregated into the relevant subperiods, however, suggests otherwise.

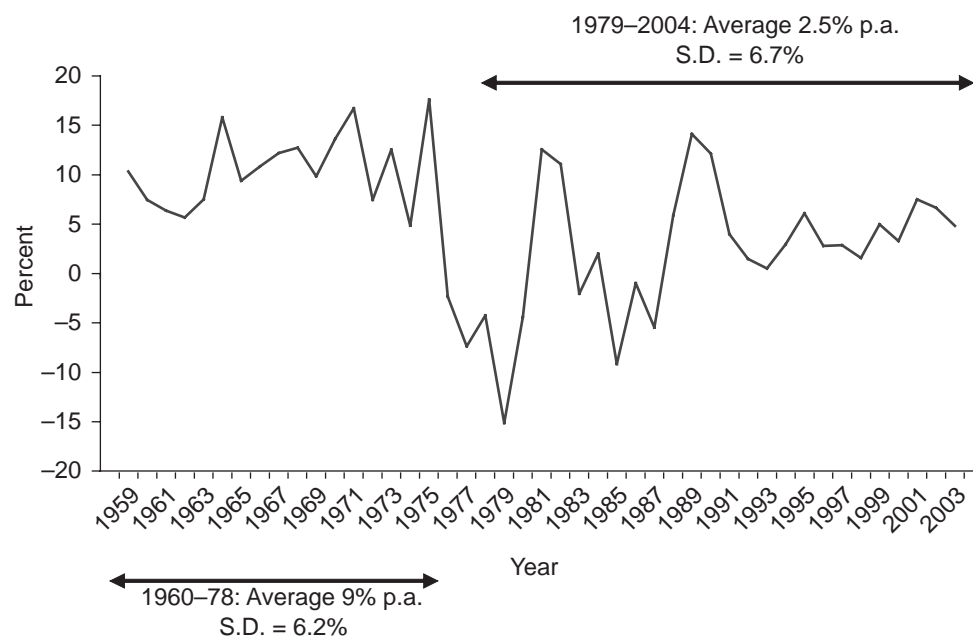
Figure 4: Iran’s Real GDP, 1959–2004 (constant 1997/98 prices)



Source: Central Bank of Iran.

¹³ For a discussion and overview of the phenomenon commonly referred to as the Middle Eastern “demographic puzzle,” see Omran and Roudi (1993).

Figure 5: Iran's Growth Rate (1960–2004)
(average annual % change in real GDP, 1997/98 prices)



Source: Central Bank of Iran.

Figure 5 depicts the GDP growth performance in Iran since 1960 and table 1 provides more detailed information on various subperiods since then. It can be seen that growth has suffered setbacks and endured heightened volatility for much of the period since the late 1970s. Whereas real GDP growth has averaged 5.3 percent per year for the four and a half decades since 1960, there has been a gross discrepancy between growth performance before and after the Revolution. Prior to 1979, Iran's economy grew at 9 percent per year in real terms—that is, more than three and a half times faster on average than after 1979 (real GDP growth averaged 2.5 percent per year during 1979–2004; see table 1). Whereas growth averaged 10.6 percent per year in the period 1960–72, the fastest growth rates ever attained were during the heyday of the oil boom in the 1970s, with growth hitting an all time high of about 17 percent in 1972 and 1976.

Different perspectives presented above thus confirm that the Iranian economy suffered the most during the 1980s—both in relative and absolute terms. Indeed, following the revolutionary upheavals of the late 1970s and a long and destructive war with Iraq, the economy contracted by 1.3 percent per year in real terms during much of the 1980s (table 1). However, even if we remove any “distortions” caused by this exceptionally difficult period from the growth picture, it is true that Iran's growth rate has underperformed compared to the period before the Revolution: the growth rate for the postwar period (1989–2004) is still only 5.1 percent, which is just over half the rate for the Shah's years (9 percent for 1960–78).

Table 1: An Overview of Iran's Growth by Subperiods, 1960–2004

| Average annual real GDP growth rate (%) ^a | | | |
|--|------------|------------|-----------------------------------|
| | Mean | STD | |
| Before the Revolution | | | |
| 1960–72 | 10.6 | 3.5 | Before the oil-boom years |
| 1973–77 | 8.0 | 7.6 | The 1970s' oil-boom years |
| 1960–78 | 9.0 | 6.2 | The Shah's years |
| After the Revolution | | | |
| 1980–88 | –1.3 | 8.9 | War years |
| 1989–93 | 7.5 | 5.4 | First Plan |
| 1994–99 | 2.8 | 1.9 | Second Plan |
| 2000–2004 | 5.4 | 1.7 | Third Plan |
| 1989–2004 | 5.1 | 3.7 | Postwar years |
| 1979–2004 | 2.5 | 6.7 | All Islamic Republic years |
| 1960–2004 | 5.3 | 5.3 | Entire period |

Source: Central Bank of Iran.

a. Constant 1997/98 prices.

The most significant episode of growth in recent years occurred during a brief period of postwar reconstruction and economic reform when growth nearly matched the pre-revolutionary record (averaging 7.5 percent per year during 1989–93 compared to 8–10 percent per year in the 1960s and 1970s). This period, however, ended abruptly amidst the debt crisis of the mid-1990s (see Section 4.2 below). More recently, growth rose again during the Third Plan years (2000–04), helped—as we shall see—by buoyant international oil prices.

Following the classifications in table 1, we shall study Iran's post-revolutionary economic growth in three specific subperiods. These are:

- **The 1979–88 period:** This period covered the early years of Revolution followed by a long war with Iraq, and was generally characterized by introduction and pursuit of economic populism in Iran. We may think of these years as the “ideological” period during which the new regime was striving to define and consolidate its grip over the economy.
- **The 1989–93 period:** Following the end of war with Iraq, these years saw a major drive at economic reconstruction and economic reform under the auspices of the First Five-Year Development Plan. Hence was ushered in a new, “pragmatist” phase in the Islamic Republic.
- **The 1994–2004 decade:** This period faced initially the twin challenges of managing an external debt crisis at the beginning of the Second Development Plan (1994–99) and restoring equilibrium in Iran's external accounts. Having emerged through this crisis, the task was then to resume macroeconomic reforms and achieve greater macro stability during the Third Plan (2000–04). The road from crisis to reform and

growth in this long decade was paved with much uncertainty over the direction of economic policy in general; and it was a time in which Iran's political economy scene was rocked by intense political strife and factional politics.¹⁴

We now offer in Section 4 a broad discussion of the challenges and policy responses in each of these subperiods. Then in Section 5 we examine the structural features of, and institutional impediments to, longer-term growth in Iran.

4. Policy Challenges and Responses

4.1. Populism and War (1979–88)

This period was characterized by the ideological fervor of the early revolutionary period and the destructive effects of an eight-year war with Iraq (1980–88). The most prominent populist themes throughout the 1980s embraced such issues as the Islamization of the economy, emphasis on social justice and redistribution, and attaining economic independence and self-sufficiency (Behdad, 1996; Mazarei, 1996). However, there was a tension between the new administration's religious idealism and the requisite economic management by the government, which lacked coherence and clarity. The result was intense debates and political scrutiny by different forces and factions in the society and within the government. The outbreak of war in 1980 provided a pretext for tactical patching up of some of these differences. However, as we shall see, many ambiguities persisted and continued to mar policy making in subsequent years (for instance, the role of interest in banking, attitudes to foreign direct investment (FDI), and more generally the boundaries between state and the private sector).

In the immediate aftermath of the Revolution a considerable portion of the large-scale modern industry as well as the entire banking and insurance systems were nationalized. These nationalizations were to some extent forced on the government, because in many cases the owners and managers of these factories had left the country and some enterprises were on the verge of collapse.

With the advent of war, the debates about the role of the private sector and markets took a new turn as the government introduced an intricate system of rationing and direct subsidies for a large number of commodities. Government controls in other economic spheres also increased significantly. Foreign exchange shortages, which became particularly acute from the mid-1980s, led to a policy of

¹⁴ Since 2005, Iran arguably has been experiencing another bout of populism under the Presidency of Mr. Ahmadinejad. In this paper, I do not cover this period, which is still unfolding, although it has similarities with the earlier 1980s' populist phase, but this period distinctly is aided by an unprecedented rise in international oil prices.

import compression and strict foreign exchange controls and rationing.¹⁵ The shortfall in oil revenues precipitated by the collapse of the international oil prices in the mid-1980s coincided with increasing demand on government resources, leading to budget deficits and heightening inflationary pressures in these years.

The government role in this period hence expanded significantly with the state now directly intervening in many aspects of the economy. Interventions included foreign exchange controls and an elaborate multiple exchange rate regime, control of interest rates and bank credits, and direct price controls in a large number of markets. By the end of the war, there had appeared an extensive network of controls embracing some 300 products that were subject to official price controls (Hakimian and Karshenas, 2000).

Despite the government's efforts to keep the economy afloat and to avert the worst consequences for the populace, the Iranian economy suffered major setbacks in this period. The resource base continued to shrink as there was a massive diversion of resources for military purposes and to sustain the ongoing war effort; the country suffered a significant international brain drain; and physical and human destruction went on a massive scale.

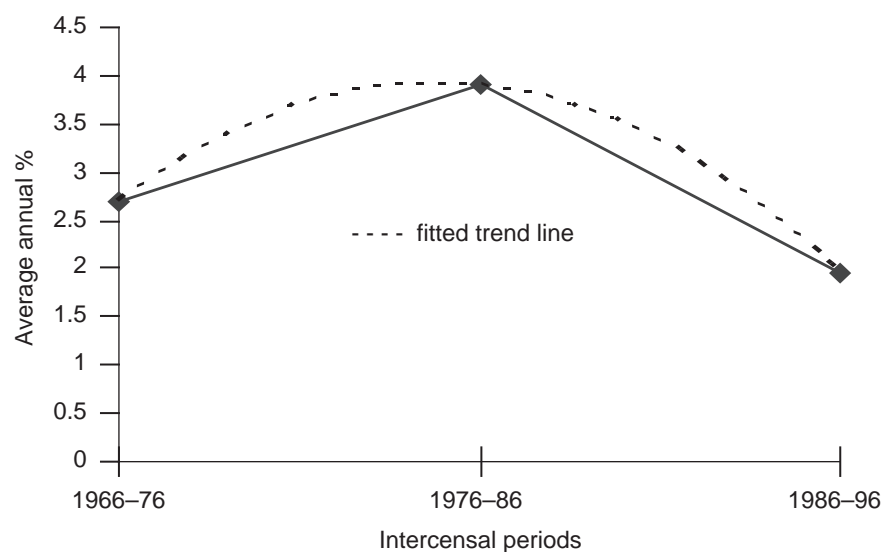
Particularly severe was the contraction of the oil sector, which had taken the brunt of the war with Iraq. The destruction of oil production facilities and lack of investment had severely affected Iran's oil production, which collapsed from 5.8 million barrels a day in the 1970s to about 1.4 million early on in the war (1981). The oil sector's share of GDP too had plummeted from a peak of about 25 percent in the mid-1970s to merely 5 percent in 1981 (World Bank, 2003, Chapter 1: 3).

Another development of lasting significance was a major surge in Iran's population growth during the first decade after the Revolution. Reaching an average annual growth rate of almost 4 percent in the mid-1980s, Iran's population was by now one of the fastest growing in the world (see figure 6).¹⁶ In the intercensal period 1976–86, Iran's population thus expanded by nearly 50 percent to just under 50 million people. This implied a (net) total addition of about 16 million on a population base of just below 34 million in 1976 (shortly before the Revolution). Measured by child–woman ratio (CWR), fertility rose 17 percent during this period (reaching almost 860 children per thousand women of reproductive age—up from 732 a decade earlier; Hakimian, 2006).

¹⁵ See Lautenschlager (1986); Behdad (1988); Pesaran (1992); and Karshenas and Pesaran (1995) for a discussion of the foreign exchange regime in Iran in these years.

¹⁶ For a more in-depth discussion of Iran's population issues after the revolution, see Aghajanian (1991) and Hakimian (2000 and 2006).

Figure 6: Population Growth Rate, 1966–96



Source: Based on census data by the Statistical Centre of Iran.

Soon after the Revolution, the government introduced strong pronatalist measures, leading to what was arguably a “reversal” of Iran’s earlier demographic transition. These included shutting down family planning clinics, promoting early marriage, lowering the legal age of marriage (to 9 for girls and 14 for men), and discouraging birth control. These were further reinforced by new “Islamizing” measures, which aimed to reshape the regulatory and socioeconomic environments affecting women’s position. In general, these aimed to redefine their role in the economy and to encourage their retreat into the family and the domestic domain. It was in this context that the baby boom of the 1980s was officially hailed as an important indicator of “success.” However, as we shall see below, by the late 1980s concerns over rapid population growth, and its growing burdens on the economy, led to one of the most notable population policy (and in due course demographic trends) reversals of modern times (Hakimian, 2006).

A dramatic collapse in international oil prices in 1986 compounded these pressures, raising the government’s war burden to unsustainable levels by the latter part of the 1980s. The economy shrank by over 5 percent in real terms in the three-year period 1986–88 and the government budget was approximately 50 percent in deficit by the last year of war (1988). By then, Iran’s real per capita GDP had shrunk back to levels attained in the mid-1960s (figure 1).

It was against such an austere and harsh economic background that the eight-year war with Iraq had to come to an end.

4.2. The Pragmatic Years (1989–93)

The end of the war with Iraq in the late 1980s opened up a new window of opportunity for economic reform and reconstruction in Iran. The impetus for this

new drive came partly from the long process of economic exhaustion Iran had suffered during the previous decade, and partly by the accumulation of long and deep-rooted economic problems since the early days of the Revolution. It was against a background of mounting economic difficulties, shrinking living standards, and a contracting public sector resource base that the government embarked on an ambitious reconstruction and economic reform program within the framework of its First Five-Year Development Plan covering the period 1989–93 (Hakimian and Karshenas, 2000; Nili, 1997).

The Plan aimed at market liberalization by dismantling the intricate network of price and quantity controls that had evolved over the war years, a gradual liberalization of foreign trade including the removal of quantitative restrictions on imports and exports, and the unification of the exchange rate system.

This was the first significant step, in principle at least, toward promoting the private sector and a general reduction in the state's hitherto dominant position in the economy. The implementation of the Plan, however, ran into practical problems as reforms were accompanied by an overly ambitious fiscal and monetary expansion leading to serious macroeconomic imbalances. Despite much emphasis on the private sector and the need to reduce the extent and scope of the state's economic intervention, the record in practice was very different. In the end, the implementation and commitment to reforms were scaled back and modified to make space for the public sector-led reconstruction efforts. The outcome of the First Plan reflected some of these tensions and inconsistencies in kick-starting the economy.

There was some early success, no doubt. For instance, GDP growth rate shot up to 12–14 percent per year in 1990 and 1991, which was particularly impressive coming after difficult years marked by contraction and decline (see figure 5 above). However, success was short-lived and proved unsustainable. Economic activity slowed down noticeably in the last two years of the Plan with GDP growth easing back to single figures (4 percent in 1992 and a mere 1.5 percent in 1993). The slow-down in growth was also accompanied by an inflationary buildup, with the consumer price index jumping almost 23 percent in 1993 and liquidity expansion (growth of M2) exceeding 34 percent in the same year (Central Bank data).

The Plan's implementation was, however, ultimately marred by an external debt crisis, which broke out in the latter part of the period causing severe imbalances in the external accounts. By 1994, austerity measures were adopted to deal with the crisis, which signaled the end of the rapid growth phase. By then, the economy was virtually at a standstill and the reforms were gradually scaled back and reversed. A notable example was the case of the newly unified exchange rate system, which was thwarted in late 1993, less than a year after its

introduction (Farzin, 1995). Declining oil revenues after 1992 made matters worse (falling from \$18 billion in 1990 to about \$14 billion in 1993 and 1994).¹⁷

Despite the First Plan's mixed fortunes and the government's subsequent wavering commitment to reforms, the Plan was a watershed in the development of Iran's postwar economy. First, it played a major part in dismantling the country's hitherto centrally administered economy in the late 1980s. Second, it initiated—albeit slowly—the beginnings of the economic adjustment and reform agenda with its ramifications continuing to the present.

The First Plan's successes emanated partially from the energizing effect of the reform measures themselves, which proved to be particularly important after years of central control and state administration of the economy. Although few far-reaching measures were adopted to address the problem of weak productive efficiency in the economy (such as in the ailing industrial sector), the reforms did, by virtue of their focus on allocative efficiency, take important if somewhat modest steps to address some of the gross distortions that had crept into the Iranian economy during the earlier populist years.

Another impetus came from the “peace dividend.” For the first time in about a decade, resources did not have to be diverted for war purposes and could be used to foster construction instead.

The economic boom also was fueled, at least partially, by improving oil revenues in these years. This was particularly true of the early years of the Plan, when government spending was boosted by a doubling of oil revenues. For instance, foreign exchange revenues from oil sales almost doubled between 1988 and 1990: rising from \$9.7 billion to about \$18 billion and accounting for some 60 percent of total government revenues (up from 39 percent in 1988).¹⁸ Oil export revenues averaged about \$15.4 billion for the entire Plan period of 1989–93 (table 2 below). There were other contributory factors too.

First, the baby boom of the early 1980s had moderated substantially, although the lasting effects of the population momentum from the earlier period continued to pose a burden on the economy. Reflecting mounting concerns over population growth, the earlier pronatalist policies were swiftly and decisively reversed by the late 1980s and early 1990s. A hallmark of this period was the introduction of an active population control program, which marked a significant U-turn in official thinking and policy after 1988. At the heart of this policy was a supply side approach in which the Ministry of Health and Medical Education (MOHME) set up an extensive Primary Health Network (PHN) made up of the so-called Health Houses in rural areas to distribute and promote contraceptives. Later on, demand side factors too were introduced that offered

¹⁷ All dollar amounts in this paper are U.S. dollars unless otherwise indicated.

¹⁸ The rise in oil revenues was partly due to price increases in the wake of Iraq's invasion of Kuwait and partly due to the expansion of output. Crude oil exports increased by 43 percent between 1988 and 1990, and by another 28 percent between 1990 and 1993, as production and export facilities damaged during the war were gradually restored (Central Bank data).

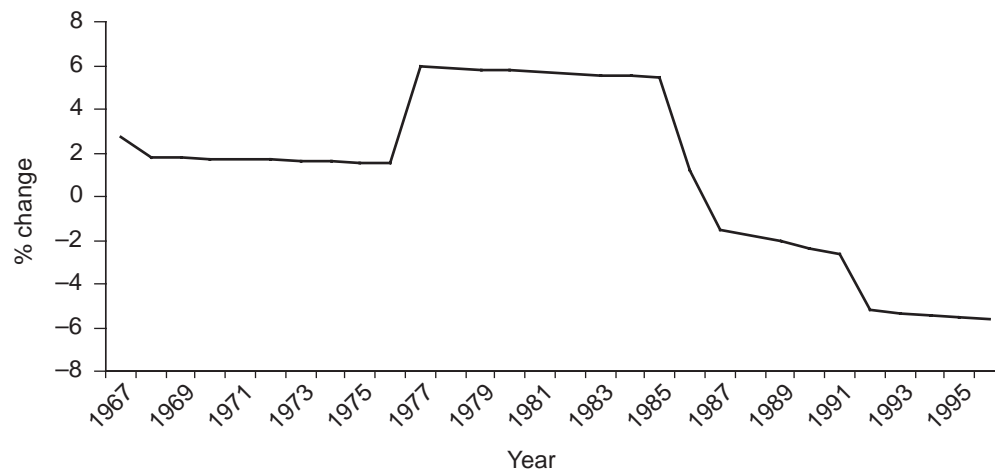
incentives to encourage smaller family size. For instance, starting in the early 1990s, official child benefits were limited to three children per household only.

Such was the extent of the population policy reversal—and arguably its success—that by the early 1990s, Iran had succeeded in resuming her stalled demographic transition with a vengeance and was now established at the forefront of demographic transition in the MENA region (Hakimian, 2006).

Figure 6 above shows that the population growth rate followed a “hump” shape during the three decades of 1966–96: rising sharply first before falling back again. As mentioned before, average annual population growth rate climbed to nearly 4 percent in the intercensal period 1976–86, followed by a steep fall in the 1990s. The fall was especially pronounced in the second half of the 1986–96 period, with annualized growth rate for the five-year period 1991–96 dropping to just 1.47 percent.

Figure 7 sheds more light on Iran’s experience of “fertility boom and bust” in the span of these three decades. It shows annual percentage changes in young Iranian children below the age of five between 1967 and 1996. This too confirms a contrasting pattern of a rapid surge in fertility in the 1980s followed by a steep decline in the 1990s. It can be seen that a moderately declining trend of the early 1970s was suddenly reversed in 1978, when the annual growth rate of the number of young Iranians jumped to 6 percent (from less than 2 percent in much of the decade prior to the Revolution). Thereafter, the population growth tempo stayed high until 1986 when a sudden and sharp fall put an end to the booming number of the young. Evidence of baby bust is particularly manifest in the sharp falls in the growth rates recorded in 1986 and 1987 but is also sustained thereafter. As we have seen, dramatically reversing the baby boom of less than a decade earlier, the growth rate of this cohort of population has continued to fall around 6 percent per year since 1992.

Figure 7: Annual % Change in Iran's Population of Children Age 0–4 (1967–96)



Source: Hakimian (2006) based on census data by the Statistical Centre of Iran.

Another important factor in these years was Iran's changing interaction with the rest of the world. It was in the First Plan years that external savings began to supplement domestic resources. After years of pursuing seclusionist policies and relative insulation from the international economy, foreign capital (mostly bank loans) began to flow into the country soon after the reconstruction program got under way. Although foreign competition to lend to Iran was keen, Iranian appetite for foreign loans to finance its postwar reconstruction drive was also significant. By 1992, however, it was already clear that short-term debt (mostly trade-related) had been accumulated in an unsustainable manner and the country was in the throes of a big debt crisis. Although neither the volume (\$23 billion in 1993) nor the relative size of external debt (reaching at its peak one-third of GDP) should have been of direct concern, its composition was, and led to a full-blown external crisis. It was principally made up of short-term trade finance (debts of less than one-year maturity averaged 80 percent of the total during the entire First Plan period). Most important, the onset of the debt crisis revealed serious gaps in Iran's macroeconomic policy management and exposed lack of cohesion, communication, monitoring, and coordination of policy making during this period of increasing exposure to the international economy (Farzin, 1995; Hakimian and Karshenas, 2000: 51–57).

Significantly, the debt crisis also exposed the high economic cost of Iran's isolationist stance. The inability of the country to raise long-term credit in international markets meant that much of the debt consisted of suppliers' credit, suggesting short-term finance had been used on a large scale for medium- and long-term investment projects with longer gestation periods.

The government's abortive attempt at the unification of the exchange rate system in March 1993 was another example of failing reforms in these years. The timing and the manner of the unification attempt were indicative of implementation weaknesses rooted in administrative inconsistencies and lack of cohesion and coordination that marred the results of these reforms (Farzin, 1995).

4.3. From Crisis to Reform (1994–2004)

The decade after the mid-1990s was characterized by a gradual—and nonlinear—move towards restoration of macroeconomic stability and reintroduction of limited reforms. First, the economy contracted sharply during the implementation of the Second Five-Year Plan (1994–99). In this phase, as mentioned above, much of the First Plan reforms were either aborted or reversed in response to the external debt crisis of 1993/94. Second, and after the introduction of the Third Plan (2000–04), Iran's economy witnessed the return of relative stability and the resumption of gradual reforms. These two phases were separated by a period of policy ambiguity and wavering, punctuated by the international oil price collapse of the late 1990s.

The austerity measures introduced in 1994 to deal with the debt and balance of payments crises were swift, decisive, and ultimately highly successful in

restoring external equilibrium.¹⁹ However, they retarded growth and their short-term impact was particularly harsh.²⁰ Consequently, real GDP growth plummeted to 0.5 percent per year in 1994, falling below the population growth rate (of 1.5 percent) for the first time after the end of war. Overall, growth averaged just under 3 percent in the five years to 1999, against the Plan's projected target of 5.1 percent, and well below half that achieved during the First Plan (7.5 percent; see table 2).

These years also witnessed persistent inflationary pressures signaling the return of stagflation, which had adversely affected Iran for much of the 1980s. Inflation reached a peak of nearly 50 percent in 1995, and its period average was about 30 percent, well above the period average for the First Plan (itself a double digit at about 19 percent).

The final years of the Second Plan saw renewed hopes for breaking out of the economic doldrums of the 1990s as a new reformist administration (led by Mr. Khatami) took office. Despite its strong political mandate, however, three factors militated against the adoption of a decisive approach to economic reforms in these early years: (i) the coincidental but severe collapse of the international oil prices during 1997–99 (after the Asian financial crisis); (ii) the difficult combination of internal and external macroeconomic conditions the new administration had inherited; and (iii) the high popular expectations that were infused with its very wide electoral support base from the outset. The latter, in particular, led to an initial fuzzy period during which strong but vague populist overtures were punctuated by occasional bouts of pragmatist policies and overtones.²¹

It was not until the introduction of the Third Plan (2000–04) that the direction of the government policy became somewhat clearer. Although the Plan recognized the need for certain structural reforms (in areas such as trade, public finances, exchange rate and divestiture of public enterprises), its main focus was, however, to resume growth and achieve macroeconomic stability. By this time, external conditions had also improved and the Plan's implementation was aided by the recovery of the international oil prices after 1999/2000.

¹⁹ This was done primarily through a strict import compression regime. Imports were slashed by one-third in 1994 alone, and overall the Second Plan's average annual imports bill was about a third lower than that for the First Plan (\$13.7 billion against \$19.9 billion; table 2). Total foreign debt was hence successfully renegotiated and by the end of 1997 it was almost halved when compared to its peak in 1993.

²⁰ Import compression, in particular, exacerbated macro inefficiency as it worsened the problem of low capacity utilization in industrial units by restricting their access to imported intermediate products and capital goods, in turn accentuating the low growth cycle.

²¹ This was, for instance, evident in the period 1997–99, when ideals of social justice and "sustainable development" were stressed alongside those of economic and managerial efficiency.

Table 2: Selective Economic Indicators—First, Second and Third Plan Years (Average Annual Figures)

| | First Plan (1989–93) | Second Plan (1994–99) | Third Plan (2000–04) |
|---|---------------------------------|----------------------------------|---------------------------------|
| Real GDP growth (%) | 7.5 | 2.8 | 5.8 |
| Non-oil GDP (%) | 7.2 | 3.7 | 5.8 |
| Fixed investment (% of GDP, 1997/98 prices) | 29.4 | 26.7 | 33.5 |
| Real private consumption (% change) | 4.4 | 2.8 | 7.4 |
| Inflation (% , urban CPI) | 18.9 | 27.2 | 14.1 |
| Liquidity growth (% change in M2) | 25.2 | 26.3 | 28.9 |
| Budget deficit (% GDP) | –2.0 | –1.0 | –2.3 |
| Oil exports revenues (million US\$) | 15,451 | 15,245 | 26,051 |
| Annual growth rate (%) | 10.6 | 8.2 | 18.5 |
| Non-Oil export revenues (million US\$) | 2,348 | 3,541 | 5,638 |
| Annual growth rate (%) | 33.3 | 3.1 | 14.0 |
| Imports (fob, million US\$) | 19,906 | 13,704 | 24,602 |
| Current balance (million US\$) | –4,006 | 3,368 | 4,866 |

Source: See details in Annex.

Note: All figures refer to realized or actual outcomes during the three Plans.

Table 2 shows comparative indicators of this Plan against the previous two. It can be seen that a realized annual growth rate of 5.8 percent was almost double that achieved by the Second Plan (2.8 percent only). Besides, the Third Plan managed to dent the stagflationary trap of the previous Plan by resuscitating aggregate demand while moderating persistent inflationary pressures. Both total investment and private consumption expenditure rose again, and the inflation rate was almost halved (coming down to a period average of 14.1 percent against 27.2 percent).

Significantly, however, and after a long decade grappling with austerity and policy ambiguity, the Third Plan saw the early stages of a number of important structural reforms in the Iranian economy. One of the earliest reforms involved the setting up of an Oil Stabilization Fund (OSF), which aimed to cushion the impact of fluctuations in oil prices on government expenditure. This reform had been necessitated by endemic fluctuations in government oil income in the past, and especially the oil price collapse of the late 1990s, which had reinforced the need to reduce the dependency of public finances on oil revenues.

The setting up of the OSF was accompanied by further budgetary reforms in 2002 to make transparent the exchange rate subsidies and from 2003 also the energy subsidy, which amounted to 10 percent of GDP. Until 2002, most government subsidies were provided implicitly through the subsidized exchange rate. These covered a wide range of essential household commodities (such as wheat, rice, oil, sugar, milk, and cheese) as well as imports of medical equipment and pharmaceuticals, fertilizers, and debt service payments on publicly-guaranteed debt. Although the government had gradually tried to reduce

explicit subsidies on food, they were still substantial and constituted about 4 percent of GDP in 2003/04.

In March 2002, following far more favorable external circumstance than the last unification in the early 1990s, the exchange rate was unified, leading to the elimination of most foreign exchange restrictions for current account purposes. This unification enabled the government to make food and energy subsidies explicit in its budget.

A number of other reforms too followed in these years. Regarding the external accounts, for instance, steps were taken to liberalize trade: the tariff structure was rationalized and nontariff barriers were replaced with tariffs during 2000–04. Most export restrictions were eliminated too and a new legal framework for the promotion of FDI was approved in 2002 after a long and drawn-out judicial process.

A number of financial reforms were introduced to encourage savings. For instance, more flexibility was allowed in setting the rates of return for both deposits and lending and several private banks were licensed to operate. “Participation papers” (saving bonds) were introduced to finance government projects in a noninflationary way and to mop up excess liquidity from the market. Iran also adopted a number of important fiscal reforms in these years, including the tax reforms of 2002/03, which reduced both personal and corporate tax rates (the latter were reduced from a high of 68 percent to a single rate of 25 percent).

Although taking a few modest steps in the direction of reform, the Third Plan’s main success was in restoring macroeconomic balance and regenerating growth. It was far less successful in achieving its more strategic goals in the areas of reducing unemployment, encouraging foreign investment, achieving large scale privatization, and reducing reliance on oil exports.

Overall, therefore, the success of this Plan came against a background of increased openness to international trade and widening economic reforms, but it also benefited from improved oil prices and sustained fiscal stimulus. Despite these, by the end of the Plan in 2004, official unemployment was still as high as 11.2 percent (against 13.4 percent at the start), foreign investment was largely absent from the Iranian economy, and the reform of ailing state-owned enterprises had hardly begun.

5. Structural Constraints and Institutional Impediments to Growth

The above discussion of policy challenges and responses in Iran since 1979 has highlighted a number of structural and institutional features that have affected the performance of the Iranian economy since the Revolution. First and foremost, although Iran has a longer history of industrial development and capital

accumulation compared to most other MENA countries, its economic structure still continues to be dominated by oil. As we shall see below, reliance on oil has, in fact, increased during the period under consideration and continues to influence resource allocation at a macroeconomic level.

Second, prospects for growth are also constrained in Iran by the institutional setting in which government policies have been formulated and implemented in these decades. We shall discuss both these sets of issues in turn below.

5.1. Oil Dependency

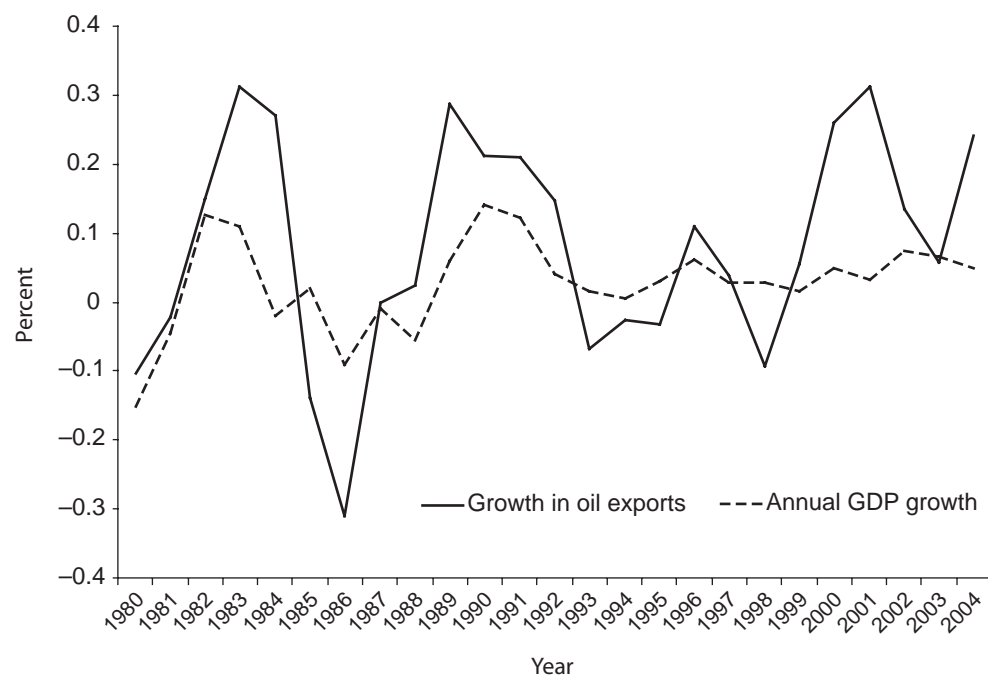
The importance of oil in Iran's economy is clearly reflected in the dominance of oil exports in both the balance of payments and the government's fiscal revenues. Despite the varied internal and external conditions in the three Plan periods discussed above (1989–2004), the share of oil exports in total exports remained consistently high (about 81–87 percent on averages for the Plan periods). Only during oil price crashes (such as in 1998) did this share drop (still to no less than about 75 percent). Similarly, oil revenues have consistently amounted to more than half all government revenues (57 percent–60 percent on average during these three Plans).

Although non-oil exports have risen in recent years (by two and a half times between the First and Third Plans), there are as yet few signs of real economic diversification away from the oil sector. This is in sharp contrast with the experience of other countries in the MENA region. For instance, Turkey and Tunisia have managed to raise their share of manufactured exports in total exports to as high as three-quarters. Egypt and Morocco too have a much higher comparable share (over one-third) in contrast to Iran with only 9 percent in the late 1990s.

Lack of sufficient diversification and continued high oil dependency are indeed at the heart of Iran's long-term economic challenges. Figure 8 underscores the interlinked cycles of oil exports income and real GDP in Iran suggesting a close fit between the two.

This is further supported by a more detailed examination of the nature of economic cycles in Iran and their correlation with the oil boom and bust periods. Table 3 shows a strong relationship between changes in Iran's oil exports earnings and the real GDP growth rate during both boom and bust phases since the late 1970s. It can be seen that there is a very strong association between these two variables both on the up and down phases of the growth cycle. For instance, the strongest relative recovery in economic activity after the Revolution (during the two-year period 1982–83) was helped by a strong recovery in oil revenues (exceeding 51 percent on an average annual basis). Similar growth revivals occurred during 1989–91 (the initial stages of the First Plan), 1996, and more recently in 2000–04 (during the Third plan). In these instances, it is clear that buoyant oil revenues have aided recovery.

Figure 8: Cycles of Economic Growth and Oil Exports Income in Iran (1980–2004)
(annual % growth rates)



Source: Based on data from the Central Bank of Iran.

Note: Oil exports are measured in current US\$, three-year moving averages.

Table 3: Boom and Bust Cycles (% change in real GDP & oil revenues)

| | % Change GDP | % Change non-oil GDP | % Change oil revenues |
|--------------------|--------------|----------------------|-----------------------|
| Boom phases | | | |
| 1982–83 | 11.8 | 8.2 | 51.2 |
| 1989–91 | 10.7 | 10.2 | 21.0 |
| 1996 | 6.1 | 7.1 | 27.6 |
| 2000–04 | 5.8 | 5.8 | 18.5 |
| Bust phases | | | |
| 1978–81 | -7.8 | -0.9 | -9.9 |
| 1984–86 | -3.1 | -1.7 | -31.1 |
| 1988 | -5.5 | -7.8 | -10.1 |
| 1993/94 | 1.0 | 1.3 | -6.6 |
| 1997–98 | 2.8 | 3.6 | -27.8 |

Source: Based on data from the Central Bank of Iran. GDP figures are in constant 1997/98 prices.

Strong negative associations too can be observed on the down swing, when contracting oil incomes have been closely associated with declining economic activity. Prominent examples of these include the following:

- early days of the Revolution and outbreak of war (1978–81)
- the OPEC crisis of the mid-1980s (1984–86)
- the last year of war with Iraq (1988)
- the austerity package associated with the debt crisis (1993/94)
- the oil price slump of 1997/98 and the subsequent recession in 1998

There is thus little doubt that there has been a strong long-term relationship between oil export revenues and economic growth in both pre- and post-revolutionary periods. However, and perhaps contrary to most expectations, evidence suggests that oil dependency has increased (not decreased) during the years of the Islamic Republic. Table 4 puts oil dependency in a broader perspective, showing simple and partial correlation coefficients calculated for annual percentage changes in oil exports income and real GDP over subperiods since the early 1960s. It can be seen that oil dependency has in fact risen during the post-revolutionary period: the correlation coefficient for the period after 1979 is twice that for the period before (+0.62 against +0.31). Although the peak—meaning the strongest positive correlation—was achieved in the heyday of the 1970s’ oil boom (with a coefficient of +0.77), most subperiods after 1979 exhibit a higher coefficient than the long-term trend coefficient of +0.53 for the entire period (1961–2004).

The one notable and encouraging exception in recent years is the Third Plan period (2000–04) with a strong negative correlation coefficient (–0.88). As discussed in the last section, this is the period during which an Oil Stabilization Fund was set up to soften the impact of oil price fluctuations on government revenues.

**Table 4: Real Annual GDP and Oil Income Growth Rates—
Correlation Coefficients by Subperiods, 1961–2004**

| | Correlation coefficient | |
|------------------------------|------------------------------------|---------------------------|
| Before the Revolution | | |
| 1973–77 | +0.77 | The 1970s’ oil-boom years |
| 1961–78 | +0.31 | The Shah’s years |
| After the Revolution | | |
| 1980–88 | +0.64 | War years |
| 1989–93 | +0.61 | First Plan |
| 1994–99 | +0.50 | Second Plan |
| 2000–04 | –0.88 | Third Plan |
| 1979–2004 | +0.62 | All IR Years |
| 1961–2004 | +0.53 | Entire period |

Source: Calculated from data from the Central Bank of Iran.

Note: Oil exports are measured in current US\$, three year moving averages.

Although it is still too early to generalize (oil prices, for instance, have moved only upwards in this short period), early indications are that setting up the OSF has may have indeed contributed to the de-linking of Iran's growth and oil exports earnings.

That oil dependency has increased for most of the post-1979 period is indeed noteworthy. We should remember that since 1979, Iran has pursued a relatively insular course driven by strong ideals of achieving self-sufficiency and economic independence (Section 2 above). The root cause of this phenomenon is the continued lack of economic diversification and competitiveness of the non-oil sector in Iran, which cannot be remedied without deep-rooted policy reforms.

5.2. Policy Ambiguity and its Impact on Growth

The foregoing discussion focused on structural weaknesses in Iran's economy as manifested in a persistent state of oil dependency. This feature has been exacerbated by inadequate, ambivalent, or contradictory policy responses during the different subperiods after 1979 (examined in Section 4 above). Despite its renowned mineral riches, therefore, Iran has continued to exhibit deep economic fragility characterized by an uncertain investment climate, fragile public finances, and an inward-orientated economy for much of the last two and a half decades discussed here.

The root cause of these weaknesses can be perceived at two interrelated levels, both of which impinge on the institutional setting in which economic development has taken place in the period under study. These are (i) the post-revolutionary legal framework and (ii) policy formulation and implementation. These are discussed below.

The legal framework

There is little doubt that both public discourse and the conduct of economic policy in Iran have been heavily shaped and influenced by the legal framework that emerged after the Revolution. Iran's constitution is indeed different from Western constitutions for its direct and detailed interest in economic issues, and the attention it pays to defining economic aspects of the post-revolutionary society (Abrahamian, 1993: 33–36).²² Although respecting private property, for instance, the notion of ownership embedded in the constitution has set the boundaries between the private and public sectors constraining somewhat the former's role in the economy.

Most prominently, perhaps, Article 44 assigns ownership of all large-scale and "mother industries" to the state sector. By contrast, the private sector' a role that "supplements" the economic activities of "the state and cooperative sectors." This vision was formulated in the 1970s when state ownership of industries was

²² The constitution, for instance, "promises to make Iran fully independent, pay off external loans, cancel foreign concessions, nationalize foreign companies ... balance the government budget and encourage 'home ownership' " (Abrahamian, 1993: 36).

widely acceptable and prevalent. Despite much public debate in 1980s and 1990s, only in 2004 was this clause revisited to take account of Iran's present fiscal realities as well as the economic performance of loss-making state-owned enterprises (SOEs). Meanwhile, the continued ambivalence towards the private sector has until recently tainted discussions of reforms in general and privatization in particular.

Such ambivalence is also reflected toward foreign ownership and involvement in the Iranian economy. Deep-rooted in Iran's economic history and going back to the popular backlashes against the exploitative concessions granted the late nineteenth century monarchs, the Iranian legislature has ever since the Constitutional Revolution in the early twentieth century felt obliged to keep a watchful eye on the extent of foreign involvement in Iran. This is evident from the current constitution, which goes into some detail to spell out the limits to foreign involvement. Several of its provisions either severely curtail or directly ban foreign ownership or interference in several spheres of the economy.

Article 81 prohibits the establishment of foreign companies or organizations in most key sectors of commerce, industry, agriculture, mining, and services. Article 82 forbids the employment of "foreign experts except in cases of necessity" and only then subject to parliamentary approval. Likewise, Article 83 prohibits the transfer of property to foreigners without such approval. Article 153 prohibits the conclusion of agreements that would result in foreign control of natural resources, economic resources, military affairs, culture, and others.²³

Other than complexities rooted in the Constitution, in practice, too, law-making has been complicated by a legislative process that requires all approved parliamentary bills to be vetted by another clerical body—the Guardian Council—for their compliance with Islamic principles. Because this body has the power to reject legislation approved by parliament, yet a third high-level body—the Expediency Council—was created to adjudicate between them. The result, as we shall see below (in the context of legislation for the protection and promotion of foreign investment), is a complex labyrinth of decision making amenable to intense internal strife and factional politics with predictably adverse consequences for growth and development.

Policy formulation and implementation

As we have seen, official policy in Iran has evolved in an ambiguous and contradictory manner, punctuated by recurrent cycles of populism and reform. For most of the time after 1979, Iran was ideologically set on an isolationist path that stressed self-sufficiency and shunned foreign investment. Partial attempts under the First Plan to encourage greater international integration ran into deep structural problems. For instance, the unification of the exchange rate system in 1993 failed due to bad timing, poor design, and weak implementation. Moreover,

²³ See details of "Constitution of the Islamic Republic of Iran, 24 October 1979"; and its amendment on July 28, 1989, at <http://www.oefre.unibe.ch/law/icl/ir00000.html>.

the external debt crisis, unleashed by the imports spree after the war, led to greater austerity for much of the 1990s. Both these events helped set the clock back in terms of redefining Iran's role and place in the international market place. Following several years of hesitancy and wavering, the Third Plan finally seemed to begin to address some of the pressing reforms. By 2000, attention was being given—albeit in a modest way—to increasing the role of the private sector, reducing obstacles to foreign and domestic investment, initiating privatization, supporting export-led growth, and developing the non-oil sectors.

The outcome, as we have seen, was encouraging, at least judged by short-term macroeconomic indicators. Realized growth rate was almost double that for the previous Plan period (table 2). External accounts improved significantly, aided partly by favorable oil prices after 2000. The current account, trade balance, and external debt obligations all stabilized and foreign exchange reserves strengthened substantially (IMF, 2003 and 2004). Of more long-term significance, perhaps, non-oil exports, which had dipped after 1997, climbed back to achieve on average 14 percent year-on-year growth in the period 2000–04. Inflation moderated to about 14 percent (almost half the previous Plan's average rate of 27.2 percent). However unemployment, proved to be stubbornly high at a double digit figure of over 11 percent.

However, such short-term improvements should not mask the environment of institutional ambiguity that has continued to adversely affect economic performance, inhibiting Iran from achieving its greater economic potential (see comparative growth data presented in Section 2 above). Indeed, some of the toughest structural changes that could transform the competitiveness of the economy are yet to be tackled both in terms of domestic and external economic policies.

Some observers have characterized Iran's failure to achieve structural transformation since 1980 as a state of "structural trap." This is defined as the situation "in which political and economic obstacles avert the reallocation of capital from low productivity firms and sectors to high productivity ones" (Alizadeh, 2003). Accordingly, Iran's economy remains dominated by inefficient, subsidized, and loss-making SOEs, as well as the unregulated and opaque parastatal organizations (*bonyads* or religious foundations) that operate as conglomerates and receive substantial implicit and explicit government subsidies. Ironically, perhaps, these foundations also highlight one of the most notable contradictions of Iran's post-revolutionary populism: despite the veneer of religious probity, they have enabled a new elite to emerge that accumulates wealth through opaque and unaccountable means.

But policy outcomes depend only partially on the type of policies that are adopted: good or bad, and right or wrong. The quality of implementation too has an important bearing on economic performance, and in both these respects (policy choice and implementation) Iran's experience has been marred by the institutional setting after the Revolution. Key in this context has been the

emergent legal framework discussed above, and intensified political strife in recent years.

During the Third Plan, for instance, fractured internal politics and factionalism spilled over into several key areas of public policy, leading at times to a gridlock in high-level decision making processes. A notable example is the struggles over the Foreign Investment Law, which became the space for intense wrangling between the (reformist) legislature backing the amendment to the anachronistic 1955 Law and the conservative Guardian Council that opposed it in many ways. The law was finally approved in 2002, following intense debates impinging on fundamental aspects of Iran's place in the global economic system.²⁴

It is not surprising that despite this important step for stimulating foreign investment, persistent uncertainty continues to mar real flows of investment, and Iran's ability to attract FDI has been notably weak: average annual FDI inflows amounted to \$326 million only in the period 2000–04, or less than 3 percent of all FDI inflows into the MENA region at large (UNCTAD data). This is in sharp contrast with Turkey, for instance, which has a similar population size but succeeded in attracting six-fold the volume of FDI for Iran (\$2 billion). Most of MENA region's FDI is in fact concentrated in North Africa (40 percent) and the Gulf Cooperation Council (GCC) countries (21 percent), which have economies that are much more open than that of Iran (even a much smaller country like Morocco attracted four-times as much FDI as Iran). Considering that the MENA region as a whole is still severely underrepresented in the global FDI flows (accounting for 1.3 percent only of the world's total inflows and 5.5 percent of the inflows into LDCs), Iran clearly has a long way to go to create an attractive environment for foreign investment.

In other key areas, too, the adoption and implementation of reforms has been marred by the prevalent institutional setting in these years. For instance, the divestiture of SOEs was a major objective of the Third Plan. Although the required legislative and regulatory environments were put in place during the Plan years, the actual pace of privatization in Iran has nevertheless been very slow and the process is still in its infancy. Given that SOEs are politicized institutions in which both workers and managers strive to prolong subsidies and perpetuate their redistributive function (Alizadeh, 2003), privatization has so far been limited to sales of government equity shares to private investors and *bonyads*, with the majority control retained by the government.

Another area of reform with modest outcomes is the setting up of the OSF in 2000 (Section 4.3 above). This was ostensibly to allow the government to manage its finances more independently of fluctuations in oil prices. This is clearly a step in the right direction as in practice favorable oil prices since then have allowed

²⁴ At the heart of these debates were the definition of "foreign investor" (and whether it included Iranian expatriates), ownership of immovable property by foreigners, the ratio of foreign ownership, and areas permissible for foreign investment (Hakimian, 2003).

the government to divert its excess revenues from the oil windfalls for purposes other than short-term budgetary needs (such as drawing down foreign debt).

Although the OSF funds are also used to encourage and promote private sector development projects, the fund itself is nevertheless primarily set up and acts as a facility for managing fluctuations in the oil income. It is, therefore, different from long-term development funds (such as Kuwait's), which are set up more explicitly as a source of savings "for the future generations."

Withdrawals from the OSF are unsurprisingly controversial, if not politically charged, in Iran. This can come about in two ways: indirectly, by the projected oil prices built into the budget (oil allocations to the OSF are a residual saving after budgetary allocations have been made); and more directly through withdrawals for "special purposes." Given that this requires parliamentary approval, such negotiations can become effectively a source of strife and faction fighting between the executive and the legislature branches of government.²⁵

6. Summary and Conclusions

The purpose of this paper has been to highlight Iran's macroeconomic challenges, the broad policies adopted by the government in response to different external and internal conditions, and the economic track record since the fall of the Shah.

We have seen that despite raised expectations after the tumultuous events of 1979, debates over the nature and direction of economic policy in Iran have intensified—not subsided—in post-revolutionary Iran. After almost three decades, the structural features of the Iranian economy are remarkably unchanged: oil-dependency continues, the general investment climate is weak and beset by uncertainty, public finances are fragile, and the economy continues to be inward-looking and unsure of its position in the wider international economy.

During this period, the economy has leapfrogged through recurrent cycles of populism and pragmatism with macroeconomic performance reflecting some of the internal tensions as well as external dislocations experienced partly by isolationism and partly by the vicissitudes of the international oil markets.

Iran's experience seems to provide interesting material for ascertaining the proposition that "sound macroeconomic management and appropriate legal and regulatory institutions are *necessary* for growth..." (El-Erian and Spence, 2008; emphasis added). We have seen above how a combination of uneven macroeconomic performance and an ambivalent legal framework and institutional setting has constrained Iran's real growth potential in these decades. This is all the more pertinent as Iran could have (arguably should have)

²⁵ According to the IMF data, about 70 percent of the average annual oil revenue accrued to the OSF account was withdrawn for further government financing during the period 2002–06.

exploited the double advantages bestowed to it from its substantial mineral and human resource riches, as well as the strong “initial conditions” when it embarked on its far-reaching process of change and transformation in the late 1970s. Yet the outcome is anything but impressive, whether judged by Iran’s past growth track record or against the experience of recent success stories (notably China and India), which have progressed along almost diametrically opposite lines to that of Iran (starting in 1978, China’s liberalization experiment somehow spans remarkably the same period). On the contrary, Iranians have witnessed stagnation, if not retrogression, in their living standards measured in GDP per capita terms and compared to countries with similar or even lower initial conditions at the end of the 1970s (even if we exclude the effect of war and Revolution during the 1980s, Iran’s growth has still underperformed in this period).

We have also seen how through three ostensibly different phases, Iranian policy makers have confronted specific challenges: from external war to reconstruction and reform; from foreign debt and currency crises to austerity and consolidation of the economy during peace time; followed by the modest structural reforms introduced under the Third Plan (2000–04). A fourth and more recent phase—after the demise of reformists in 2005—points to a resurgence of populism with the daunting prospects of unraveling even the modest gains that were made under the Third Plan period.

Although differences have been substantial and this paper has highlighted many, they should not mask the constancy of the challenge faced by the Islamic Republic of Iran since its inception. At the heart of this is the very nature of the economic system that has been shaping up in Iran since 1979 and the need to achieve clarity and consistency in the direction and type of economic policies pursued. It is clear that persistent cycles of slow growth and high inflation in the Iranian economy cannot be resolved without contemplating more fundamental institutional changes and a reform of the system of governance.

But whether and when these challenges can be successfully addressed will depend only partially on the design and adoption of appropriate economic policies, important though these are. The experience of economic reforms in Iran both under the First and the Third Plans (when there were bouts of growth) points strongly to the need for an equally far-reaching, comprehensive, and sustainable package of political and institutional reforms.

Delaying these reforms can only add to the eventual costs and pains of future adjustments.

Annex: Selective Macroeconomic Indicators of Iran, 1989–2004

| | 2000 | 2001 | 2002 | 2003 | 2004 | Average 1989–93 | Average 1994–99 | Average 2000–04 |
|---|-------|-------|-------|-------|-------|--------------------|--------------------|--------------------|
| Real sector | | | | | | | | |
| Real GDP growth (% p.a.; constant 1997/98 prices; CBI) | 5.0 | 3.3 | 7.5 | 8.3 | 5.1 | 7.5 | 2.8 | 5.8 |
| Non-oil GDP Growth (% p.a.) | 4.5 | 5.5 | 8.1 | 6.0 | 5.1 | 7.2 | 3.7 | 5.8 |
| Private consumption (real growth % p.a.) | 7.2 | 4.4 | 11.7 | 5.3 | 8.6 | 4.4 | 2.8 | 7.4 |
| Fixed investment (real % growth p.a.) | 4.1 | 14.2 | 12.0 | 10.8 | 7.0 | 10.8 | 4.6 | 9.6 |
| Public | -1.9 | 6.6 | 13.9 | 8.3 | -5.2 | 24.5 | -0.6 | 4.4 |
| Private | 7.7 | 18.3 | 11.1 | 12.0 | 12.9 | 6.3 | 9.6 | 12.4 |
| Fixed investment (% GDP 1997 prices) | 29.8 | 32.9 | 34.3 | 35.1 | 35.7 | 29.4 | 26.7 | 33.5 |
| Gross domestic savings (% GDP 1997 prices) | 38.8 | 34.4 | 37.2 | 38.6 | 39.6 | 32.4 | 37.8 | 37.7 |
| Savings/investment balance (% GDP 1997 prices) | 9.1 | 1.5 | 2.9 | 3.5 | 3.9 | 3.0 | 11.1 | 4.2 |
| Public sector | | | | | | | | |
| Government revenue (% GDP) | 18.0 | 18.7 | 17.8 | 18.7 | 18.1 | 15.5 | 21.1 | 18.3 |
| % Oil revenue | 56.8 | 57.3 | 62.1 | 61.7 | 59.0 | 56.7 | 59.9 | 59.4 |
| % Tax revenue | 35.0 | 33.3 | 30.6 | 31.3 | 33.1 | 33.1 | 29.4 | 32.7 |
| Government expenditure (% GDP) | 18.1 | 18.7 | 21.8 | 22.7 | 21.6 | 17.4 | 22.1 | 20.6 |
| Budget deficit (% GDP) | -0.1 | 0.0 | -4.0 | -4.0 | -3.5 | -2.0 | -1.0 | -2.3 |
| Non-oil budget deficit (% GDP) | -10.3 | -10.7 | -15.1 | -15.5 | -14.2 | -11.0 | -13.8 | -13.2 |

| | 2000 | 2001 | 2002 | 2003 | 2004 | Average 1989-93 | Average 1994-99 | Average 2000-04 |
|--|---------|---------|---------|---------|---------|--------------------|--------------------|--------------------|
| Monetary sector | | | | | | | | |
| M2 Growth (% year-end) | 29.3 | 28.8 | 30.1 | 26.1 | 30.2 | 25.2 | 26.3 | 28.9 |
| Inflation (urban CPI) | 12.6 | 11.4 | 15.8 | 15.6 | 15.2 | 18.9 | 27.2 | 14.1 |
| Wholesale price index (% growth) | 14.8 | 5.1 | 9.6 | 10.1 | 14.7 | 25.5 | 29.7 | 10.9 |
| Interest rates [1] | 14.0 | 13.0 | 13.0 | 13.0 | 13.0 | 9.6 | 13.6 | 13.2 |
| External sector | | | | | | | | |
| Oil export revenues (m US\$) | 24,280 | 19,339 | 22,966 | 27,355 | 36,315 | 15,451 | 15,245 | 26,051 |
| Non-oil exports (m US\$) | 4,181 | 4,565 | 5,271 | 6,636 | 7,537 | 2,348 | 3,541 | 5,638 |
| Oil export as % of total exports | 85.3 | 80.9 | 81.3 | 80.5 | 82.8 | 87.1 | 80.8 | 82.2 |
| Growth of oil exports (% annual) | 42.1 | -20.4 | 18.8 | 19.1 | 32.8 | 10.6 | 8.2 | 18.5 |
| Growth of non-oil exports (% annual) | 6.1 | 9.2 | 15.5 | 25.9 | 13.6 | 33.3 | 3.1 | 14.0 |
| Imports (fob, m US\$) | 15,086 | 18,129 | 22,036 | 29,561 | 38,199 | 19,906 | 13,704 | 24,602 |
| Trade balance (m US\$) | 13,375 | 5,775 | 6,201 | 4,430 | 5,653 | -2,107 | 5,082 | 7,087 |
| Current balance (m US\$) | 12,501 | 5,985 | 3,585 | 816 | 1,442 | -4,006 | 3,368 | 4,866 |
| External debt (m US\$) | 9,044 | 9,012 | 12,530 | 17,024 | 23,074 | 13,212 | 16,950 | 14,137 |
| % <i>Short-term</i> | 40.7 | 29.4 | 16.6 | 28.1 | 44.4 | 79.7 | 27.4 | 31.9 |
| Debt service (% of Exports) | 11.3 | 5.4 | 5.2 | 4.9 | 4.4 | 5.3 | 26.7 | 6.2 |
| Overall balance (change in international reserves) | 6,529.3 | 4,760.2 | 4,667.3 | 3,709.7 | 8,731.0 | -0.4 | 450.5 | 5,679.5 |

Source: The Central Bank of Iran; World Bank.

Notes: [1]: Banking system's one-year deposit rate.

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Debates over the nature and direction of economic policy in the Islamic Republic of Iran have intensified rather than abated after the tumultuous changes brought about by the Revolution in 1979. In the span of these three decades, Iran has witnessed sweeping institutional changes and has been affected by significant economic and political upheavals. Recurrent cycles of populism and pragmatism also characterize this period. At the macroeconomic level, too, there have been a number of shocks ranging from oil booms and busts, to war (with Iraq), trade sanctions, and internal political strife.

This paper uses Iran's experience to reflect on growth and development in the context of political upheaval and an uncertain institutional environment. Iran's recent past presents a rare, "laboratory" like, case for the study of growth and development in a broad context. Two sets of factors have conditioned Iran's performance and will continue to taint her prospects for sustainable growth into the future. These are (i) Iran's limited economic diversification and continued dependence on the oil sector, and (ii) the institutional setting in which post-revolutionary economic policies have been formulated and implemented for much of the last three decades.

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