The Rt Hon Sir Edward George GBE: Overview of recent financial and economic developments in Iran

Speech by The Rt Hon Sir Edward George GBE, Governor of the Bank of England, at the Iran Invest 2000 Conference, held in London, on 28 September 2000.

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I am delighted to be able to take part in this conference, and particularly pleased to be sharing the platform this morning with Governor Mohsen Nourbakhsh of the Central Bank of Iran, Bank Markazi.

I first met Governor Nourbakhsh soon after he became Governor in 1994 - which was not an easy time for Iran. I was immediately impressed not only by his command of the issues confronting him - which was perhaps not surprising: it was his second period in office as Governor, having in the meantime taken a vacation as Minister of Economic Affairs and Finance, and as Deputy to the President, with responsibility for Economic Affairs. But I was immediately impressed too by his calm and always reasoned approach and by his reliability. He has played an important role in steering his country through a difficult period to the more promising prospect that Iran faces today. Since our first meeting, I have very much enjoyed the opportunity of seeing the Governor periodically at a whole series of international meetings, and it is a very great pleasure, Mohsen, to be able to join in welcoming you here to London this morning. I have been immensely interested in - and greatly encouraged by - what you have had to tell us.

Perhaps I might add a few observations of my own - from my inevitably more distant perspective.

For much of the past two or three years the external environment facing Iran was a difficult one. The slowdown in world economic growth in the wake of the global financial crisis and the associated fall in oil prices - to an unsustainably low level - significantly weakened the financial positions of all major oil-exporting countries. Iran was no exception. The current account swung from a surplus of 2.2% of GDP in 1997/98 to a deficit of over 2%. And the fiscal position deteriorated to a deficit of 6.7% of GDP.

But Iran’s response to worsening economic conditions was a positive one. The authorities began to formulate a medium-term reform strategy, which has now been articulated as the Third Five Year Development Plan. Since then, the combination of sound economic management at home, coupled with continued economic expansion in the industrial countries and rising oil prices, have improved Iran’s prospects considerably.

The IMF forecast GDP growth of 3.4% in Iran in 2000/01. The external account has strengthened, with a surplus of 4.7% of GDP recorded in 1999/2000. And the budgetary position swung from deficit to a surplus of 1% of GDP in 1999/00. Foreign exchange reserves have risen by $2 billion to $6 billion since 1998/99. Although inflation remains still quite high at around 20%, broad money growth has shown signs of moderating. Debt levels are also now below the average for emerging market economies. Perhaps above all else, it is encouraging that the authorities have not rested on their laurels, but have instead sought to take advantage of this recent more favourable economic environment to increase the momentum of reform. The overall macroeconomic prospect, therefore, is a positive one.

The Third Five-Year Development Plan represents an ambitious step forward. It maps out a realistic sequence for a balanced liberalisation of Iran’s economy. The aim of increasing growth to 6% per annum, from an average of 2.5% between 1997 and 2000, should generate employment opportunities for the growing labour force and help to raise living standards. The plan aims to promote growth through privatisation and liberalisation, and to enhance stability by further encouraging diversification of the economy. Macroeconomic policies under the plan are aimed at fiscal consolidation to help reduce inflation, broadening the tax base (including the introduction of VAT), and unifying exchange rates at a market-determined level. Exchange controls will be further loosened. And it is planned that price distortions due to state subsidies will also decline. These are ambitious and wide-ranging plans and the key is now implementation.

The climate for business investment in Iran has steadily improved over the past decade, in particular following the election of President Khatami in 1997, as the process of liberalisation has accelerated. There has already been progress with privatisation, especially in the hydrocarbon industry. There are plans to restructure and privatise over 500 state enterprises during the next five years, and to commercialise - or "autonomise" - Iran's state-owned banking system. Trade and foreign investment are being encouraged by the extension of Iran's free-trade zones. And new legislation is expected soon to simplify and clarify the Law for the Encouragement and Protection of Foreign Investment. These are all clearly positive steps.

Iran is, of course, OPEC's second largest producer and has the second largest reserves of gas in the world. It has benefited from the recent rise in oil prices and is playing a positive role in promoting the stability of the oil market. President Khatami recently noted that OPEC may need to raise output in proportion to the increase in global oil demand to stabilise prices.

The government has taken positive steps to encourage foreign investment in the petroleum sector. For example, they have facilitated foreign participation in contracts to redevelop oil fields, and they have also signed an agreement with a consortium of nine leading international oil and gas companies to study Iran's potential as an exporter of gas.

The government is, moreover, actively seeking to cushion the economy from future fluctuations in the oil price. Establishing an Oil Stabilisation Fund, which ensures that the government balance sheet is strengthened when oil price movements are favourable, should help insure against the type of debt servicing problems faced by many emerging market economies during the difficult international environment of 1997-98. Iran was able to maintain an excellent debt service record through this period, and prudent debt management policies should help preserve this record going forward. Total external debt is expected to decline to around 10% of GDP this year, and short-term debt to only about 40% of reserves, having fallen from around 65% in 1999/2000. The strong external position has encouraged the World Bank to approve loans of some $230 million this year. Importantly, it should hold Iran in good stead in attracting inflows of private capital, which are so crucial to a country's long-term growth prospects.

The international financial crises of 1997-98 stemmed largely from vulnerabilities within countries' financial systems. In the aftermath of the crises, the official community has been assisting the financial sectors in emerging market economies through technical assistance and improved surveillance. This has been an area of notable success in the redesign of the international financial architecture.

A key step in this regard has been the joint IMF-World Bank initiative of Financial Sector Assessment Programs, or FSAPs. The FSAP process is designed to identify and assess strengths and weaknesses in financial systems from a best practice standpoint including: assessing financial institutions' structure and soundness; reviewing systemic risks in payment systems; examining the legal framework and the system of official oversight and prudential regulation and supervision; and assessing institutional arrangements for crisis management, including financial safety nets. Iran is addressing these aspects of the financial infrastructure and, in formulating and implementing their reform programme, Iran has maintained a constructive engagement with the IFIs. I am particularly pleased that the Bank of England will be involved with an IMF-World Bank led technical assistance team on financial sector restructuring and supervisory and regulatory frameworks for banks in Iran during the coming year.

Another key element of efforts to strengthen the international financial architecture has been the development and implementation of a range of international standards or codes of good practice. These codes are not meant to lay down strict or inflexible rules. They are designed, however, to promote best practices, while recognising that financial systems are likely to differ across countries and across time. The IMF and the World Bank, working together with the relevant standard-setting bodies, have been helping economies undertake assessments of their observance of some of these standards.

Iran is currently working towards the adoption of internationally accepted best practice standards in a number of areas. The central bank is developing a new bank accounting framework, which represents a move towards international accounting standards, while taking account of the special features of Islamic finance. The authorities are also developing an action plan for implementing supervision reforms. These developments ought to be good news for prospective investors in Iran. They also help illustrate that international best practice standards can be flexible enough to accommodate individual country circumstances.

The move to a more market-oriented environment brings with it new challenges. For example, liberalising exchange controls and freeing the exchange rate to market forces brings risks as well as opportunities. A sequenced approach to capital account liberalisation helps mitigate these risks and that is the route Iran has pursued. But that is not to say reform has stalled.

Since mid-1999, the central bank has taken important steps to improve and simplify the foreign exchange market, including allowing the exchange rate to depreciate to market clearing levels. In March 2000, requirements to surrender non-oil export receipts to the central bank were abolished. The intention now is to introduce a direct, interbank foreign exchange market, and to eliminate an advance import deposit requirement by March 2001. These will be important further steps in increasing Iran's exposure to international competition which in turn can contribute to its productive efficiency.

Exchange rate unification and the partial liberalisation of trade and exchange controls will make greater demands on the effectiveness of monetary policy. For example, monetary expansion may arise from the phased reduction in banks' reserve requirements. It will be important for the central bank to develop effective monetary instruments to sterilise the monetary impact of these reforms, and support the central bank's target for inflation. The issuance of CDs, together with the partial liberalisation of credit allocation, are all sensible and commendable steps. And I know that the central bank is actively considering additional possibilities. These measures will make for a financial system in Iran that is more efficient, liquid and transparent - and thereby more attractive to potential market entrants.

Mr Chairman, economic progress in any one country is not just a question of that country's national interest, it is - in today's increasingly economically and financially integrated world - a matter of collective, international interest. That is true both at the macro- and at the microeconomic level - the level of individual businesses and firms. That's why I think it is important that we encourage the forces working for reform and liberalisation by engaging constructively with them. Iran has embarked upon an ambitious, but realistically measured, programme of reform and liberalisation through the Third Five-Year Development Plan, and it is taking advantage of the present more favourable conditions in the world economy to advance that programme. I wish you, Governor Nourbakhsh, and the authorities in Iran all possible success in achieving your objectives in the interests of the Iranian people and in the interest of us all.