CHAPTER 10

FOREIGN EXCHANGE AND TRADE POLICY

Balance of Payments

Continued increase in world crude oil price accompanied by facilitation in foreign trade and liberalization of foreign exchange transactions as the targets set in the 4th FYDP affected balance of payments in 1385. Increase in value and volume of oil and gas export raised export proceeds (comprising exports of crude oil, oil products, condensates, and natural gas) by 15.2 percent to $62,011 million.

Extension of facilities (in rial and foreign exchange) to exporters of goods and services, exemption of exports from taxes and levies, and grant of export rewards and subsidies in tandem with relative stability in the foreign exchange market, raised non-oil exports to $14,044 million in 1385, against $10,546 million in the preceding year, showing 33.2 percent growth. The remarkable increase in the exports of chemicals and petrochemicals, construction materials, and metals, as well as rise in the exports of transportation vehicles and their spare parts and mineral metallic ores were responsible for this growth.

The gap between domestic inflation and that in major trade partners in the absence of appropriate exchange rate adjustments resulted in a surge in imports from $43,085 million in 1384 to $50,020 million in the review year. This shows 16.1 percent rise. Imports of foodstuffs and live animals, with a growth rate of 81 percent and a mere share of 7.8 percent in total imports, and the continued increase in imports of machinery and transportation vehicles, with a major share of 36 percent in total imports, were the main driving forces behind the changes in the trend of imports in 1385. Thus, the trade balance posted a surplus of $26,035 million.

BALANCE OF PAYMENTS

(million dollars)

	1383	1384	1385
Current account balance	1,442	16,637	20,402
Capital account (net)	7,388	-184	-4,383
Errors and omissions	-1,312	-1,879	-4,634
Overall balance (change in international reserves) (1)	**7,518**	**14,574**	**11,384**

(1) Components may not sum to total because of rounding.

Services account faced deficit as in the preceding years. On the receipts side, freight, insurance, and tourism (passenger and travel services), with $2,475 and 1,760 million, respectively, accounted for 49.5 percent of foreign exchange receipts of services account. On the payments side, freight, insurance, and tourism (passenger and travel services) and foreign investment expenses, with respectively $7,581.4 and 1,443 million constituted 61.4 percent of foreign exchange payments of this sector. Therefore, $6,146 million deficit of the services account, up by 14.3 percent compared with the year before, reveals the growing trend of imports of services (net).

Transfers account (net) ran a surplus of $513 million, mostly due to the remittances of Iranians residing abroad. Current account balance posted a surplus of $20,402 million, up by 22.6 percent compared with the $16,637 million recorded in the previous year.

Developments in foreign trade transactions of goods and services brought about the remarkable current account balance surplus. This was largely due to the favorable international crude oil market conditions. Furthermore, deficit in non-oil current account balance rose in 1385.

Capital account ran a deficit of $4,383 million, which is attributable to the large short-term account deficit of $4,418 million. In the review year, $2,333 million was paid due to buy-back contracts, creating new obligations valued at $2,186 million. The "other" in the long-term account recorded a surplus of $216 million, owing to the growth of foreign direct investment.

Deficit in the short-term capital account was largely attributable to the $31 million deficit of the short-term public account as well as that of banks and other by $4,387 million. Banks' clearing account (net) was debited in 1385, leading to a rise in banks' foreign assets, which appeared under the capital account as deficit in the short-term public account. Increase in banks' foreign assets (total foreign exchange transactions), extension of facilities to exporters, and reduction in the outstanding balance of the L/Cs opened for imports (by the repayment of more debts and the creation of less obligations) were also responsible for the deficit in the account of banks and other. Overall balance of payments went up by $11,384 million.

Current Account

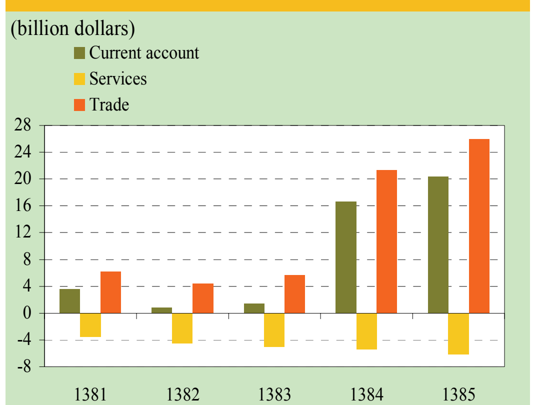
Current account balance witnessed an unprecedented surplus of $20,402 million in 1385. This was largely due to high growth in the price of world crude oil and oil products and exponential rise in non-oil exports. The relatively high growth of imports and deficit in services account resulted in the fact that the unprecedented foreign exchange revenues did not improve current account balance and foreign reserves as expected.

CURRENT ACCOUNT BALANCE

(million dollars)

					Percentage change	
	1382	1383	1384	1385	1384	1385
Current account balance	816	1,442	16,637	20,402	▣	22.6
Current account balance (non-oil)	-26,539	-34,873	-37,183	-41,609	6.6	11.9

Figure 10.1. Current account balance components



Foreign Trade Performance

Against the backdrop of benign conditions in international market for exportable goods, foreign exchange and trade policies of the previous years continued and boosted foreign trade in 1385. In this line, the value of exports reached a record high of almost $13 billion and imports amounted to $42 billion;

therefore, non-oil sector proved successful in financing 31.2 percent of import requirements.

Non-oil exports amounted to $12,997 million in the review year, up by 24.1 percent. The weight of exported goods amounted to 27,766 thousand tons, showing 11.1 percent growth compared with the figure for the previous year. The unit value of exported goods grew by 11.7 percent to reach $468.

The value of imports (cif) picked up by 6.3 percent to $41,723 million, against $39,248 million in 1384. The weight of imported goods amounted to 43,492 thousand tons, showing a rise of 22.6 percent compared with the same figure for the previous year. The unit value of imported goods reached $959 in 1385, against $1,107 in 1384, down by 13.3 percent.

FOREIGN TRADE
(excluding oil, gas and electricity)

					Percentage change		Share (percent)	
	1382	1383	1384	1385	1384	1385	1384	1385
Value (million dollars)								
1. Imports	26,598	35,389	39,248	41,723	10.9	6.3	78.9	76.2
2. Exports	5,972	6,847	10,474	12,997	53.0	24.1	21.1	23.8
Deficit (2-1)	-20,626	-28,542	-28,774	-28,726	0.8	-0.2		
Total (1+2)	**32,570**	**42,236**	**49,722**	**54,720**	**17.7**	**10.1**	**100.0**	**100.0**
Weight (thousand tons)								
1. Imports	30,106	34,448	35,466	43,492	3.0	22.6	58.7	61.0
2. Exports	15,467	18,077	24,983	27,766	38.2	11.1	41.3	39.0
Total (1+2)	**45,573**	**52,525**	**60,449**	**71,258**	**15.1**	**17.9**	**100.0**	**100.0**

Source: Foreign Trade Statistics

Imports

Composition of imports [1] in 1385 indicates that the highest growth was related to consumer goods by 33.9 percent. Share of this group in total imports grew from 11.7 percent in 1384 to 14.8 percent in the review year. This trend reveals that the exchange rate fluctuations effectively influence composition of imports. Thus, the rise in imports of consumer goods could be largely attributed to the appreciation of national currency.

Import of capital goods, unlike consumer goods, experienced a downward trend [2] in 1385 and reached 19.7 percent from 23.5 percent in the year before. Imports of raw materials and intermediate goods, with 65.5 percent share, still had the highest share in imports. This group showed a growth of 7.5 percent which is 0.4 percentage point more than the same figure for the previous year.

COMPOSITION OF IMPORTS BY USE (million dollars)

				Percentage change		Share (percent)	
	1383	1384	1385	1384	1385	1384	1385
Raw materials and intermediate goods	23,733	25,423	27,334	7.1	7.5	64.8	65.5
Capital goods	8,120	9,221	8,226	13.6	-10.8	23.5	19.7
Consumer goods	3,536	4,603	6,163	30.2	33.9	11.7	14.8
Total	**35,389**	**39,248**	**41,723**	**10.9**	**6.3**	**100.0**	**100.0**

(1) As of 1384, the "Broad Economic Classification" prepared by the United Nations is used.

(2) As of 1385, Iran's Customs Administration changed the method used for valuation of imported goods used or produced in the preceding years; therefore, the depreciation cost of such goods is deducted from the base price.

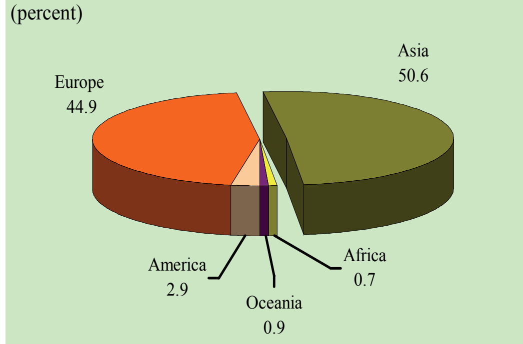
Composition of imports by the international classification of goods reveals that imports of machinery and transportation vehicles, with 36 percent share in total imports, enjoyed the highest share.

United Arab Emirates, Germany, China, Switzerland, and France, the top five exporting countries, accounted for 52 percent of Iran imports in 1385.

Distribution of imports by continents points to the higher share of Asia and Europe, so that the total value of imports from these two continents amounted to $21,098 million for Asia and $18,738 million for Europe, indicating 50.6 and 44.9 percent share for Asia and Europe, respectively.

Review of imports by group of countries indicates that, despite 7.7 percent fall in imports from the European Union, this group still took the highest share in total imports of goods. Imports from the European Union totaled $14,534 million, accounting for 34.8 percent of total imports.

Figure 10.2. Distribution of imports by continents in 1385



IMPORTS ACCORDING TO INTERNATIONAL CLASSIFICATION OF GOODS

(million dollars)

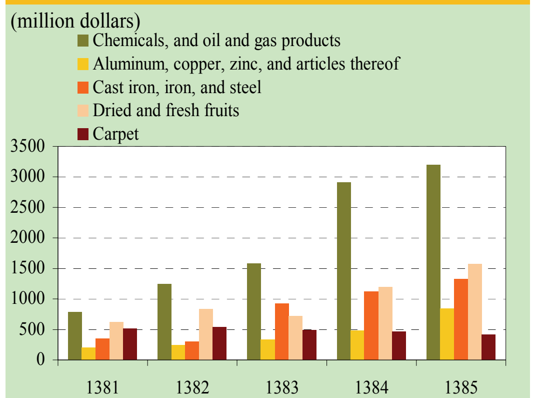
	1383	1384	1385	Percentage change 1384	Percentage change 1385	Share (percent) 1384	Share (percent) 1385
Machinery and transportation vehicles	15,825	17,217	15,017	8.8	-12.8	43.9	36.0
Goods classified according to their composition	7,182	8,266	8,876	15.1	7.4	21.1	21.3
Mineral products, fuels, industrial oils, and grease	3,044	4,198	5,356	37.9	27.6	10.7	12.8
Chemicals	4,208	4,191	4,850	-0.4	15.7	10.7	11.6
Others	5,130	5,376	7,624	4.8	41.8	13.6	18.3
Total	**35,389**	**39,248**	**41,723**	**10.9**	**6.3**	**100.0**	**100.0**

Non-oil Exports

In the review year, 27,766 thousand tons of non-oil products worth $12,997 million were exported, showing 11.1 and 24.1 percent growth in weight and value, respectively, compared with the previous year. Thus, the unit value of exported goods rose 11.7 percent to $468 in 1385.

The share of industrial goods in total exports remained virtually unchanged at 74.4 percent, against 74.1 percent in the previous year, still the highest share in total exports as before. Exports of industrial goods totaled $9,664 million in 1385. The lion's share in export of goods belonged to oil and gas products by 17.2 percent, mainly owing to

Figure 10.3. Major non-oil exports

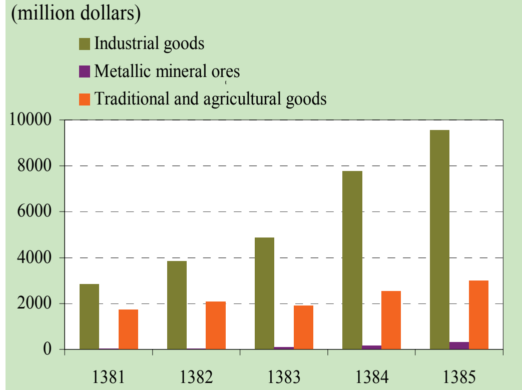


improved global prices and increase in export volume (due to the operation of new chemical and petrochemical units).

Share of traditional and agricultural goods in total exports slightly declined from 24.3 percent in 1384 to 23.2 percent in 1385. Total value of exports of these goods amounted to $3,012 million. Dried and fresh fruits, by 15 percent, had the lion's share in the export of this group. Among the main subgroups of traditional and agricultural goods, vegetables and plants enjoyed the highest growth in exports by 85.1 percent. Conversely, export of fresh and dried fruits, up by 31.1 percent, was the main driving force behind the $467 million increase in exports of this group. Export of metallic mineral ores, worth $321 million, had the lowest share of 2.5 percent in total.

The geographical distribution of non-oil exports in 1385 indicates that the first five trade partners of Iran (Iraq, United Arab Emirates, China, India, and Japan) together imported a total of $6,074 million, 46.7 percent of total non-oil exports. Furthermore, the lion's share of non-oil exports went to ESCAP member countries by 40.6 percent. Despite the 32.9 percent growth in non-oil exports to EU member countries, the share of exports to this Union was limited to 13.1 percent. The value of exports to the Asian Clearing Union (ACU) member countries grew moderately by 8.9 percent to $1,179 million, indicating a dramatic fall compared to the 70.7 percent of the previous year.

Figure 10.4. Exports (excluding oil and gas)



Utilization of External Sources and Foreign Exchange Obligations

Total foreign exchange obligations (including actual and contingent obligations) rose from $41,853 million at end-1384 to $45,338 million in 1385 year-end, representing 8.3 percent growth. Due to changes in the composition of contingent obligations and external debts (actual obligations), share of contingent obligations increased to 48.1 percent in 1385 year-end against 42 percent at end-1384.

External debts declined by 3.1 percent from $24,264 million to $23,514 million. The $750 million reduction resulted from $1,586 million reduction in short-term debts. Rise in

EXTERNAL OBLIGATIONS

(million dollars)

Year-end	1386	1387	1388	1389	From 1390 onwards
Amount	12,389	2,831	2,078	1,748	4,470

EXTERNAL OBLIGATIONS (million dollars)

	Year-end		
	1384	1385	Percentage change
Contingent obligations	**17,589**	**21,825**	**24.1**
External debt	**24,264**	**23,514**	**-3.1**
Short-term debts	10,686	9,100	-14.8
Long-term debts	13,578	14,414	6.2
Project finance	4,501	4,810	6.9
Finance	4,258	4,748	11.5
Loans extended from abroad without banking system guarantee	2,243	2,035	-9.3
Total	**41,853**	**45,338**	**8.3**

international interest rates, CBI's policy to limit short-term debts, surge in domestic foreign exchange resources due to the hike in oil revenues, and importers' tendency to use domestic financing (instead of foreign financing) were the main driving forces behind the fall in external debts in the review year.

Change in International Reserves

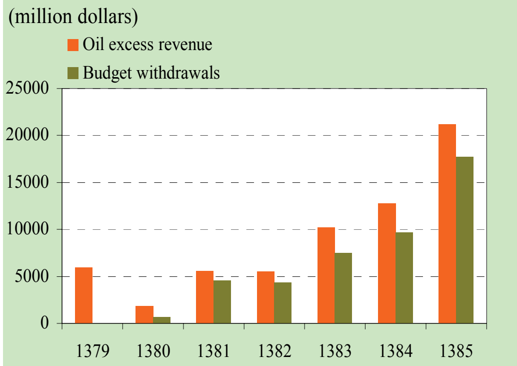
Despite the remarkable increase in the revenues derived from crude oil export, the cash balance of the OSF declined by 10.6 percent to $9,555 million. This was mostly due to frequent government withdrawals and allocation of resources to finance private sector projects.

Oil Stabilization Fund (OSF)

Continued run-up in oil prices raised the OSF sources in the review year. The total amount deposited into the OSF was $21,831 million in 1385, indicating a growth of 65.5 percent compared with the previous year. Roughly 97 percent ($21,174 million) was related to oil revenues. The remainder was related to the profit accrued to the balance of the account and repayment of loans extended during the previous years.

OSF uses in 1385 amounted to $23,273 million, showing a growth of almost 94 percent compared with the previous year. It has been the first time since the establishment of this account that its uses outpaced its sources. It should be noted that $17,761 million (76.3 percent) and $5,512 million (23.7 percent) of the OSF uses were allocated to budgetary withdrawals and extended facilities.

Figure 10.5. Oil excess revenue and budget withdrawals from the OSF since its establishment



The cash balance of the OSF at end-1385 reached $9,555 million, representing 10.6 percent reduction compared with $10,686 million of the previous year-end.

External Sector Analysis

External sector performed relatively well in the second year of the 4th Plan. Of particular note is that $11,384 million was added to foreign exchange reserves, albeit various limitations and adoption of prudential foreign exchange and trade policies. However, performance of this sector can be assessed on the basis of other criteria as well.

Ratio of short-term debts to total, an indicator of economy's flexibility in repayment of debts, fell from 44 percent in 1384 to 38.7 percent in 1385 year-end. Rise in government budgetary withdrawals from the OSF account in 1385 (roughly 83.6 percent) surpassed increase in OSF sources (65.5 percent). Despite the run-up in export price of

OIL STABILIZATION FUND (million dollars)

	1383	1384▲	1385	Percentage change
Sources	**10,484**	**13,194**	**21,831**	**65.5**
Oil excess revenue	10,207	12,806	21,174	65.3
Uses	**9,450**	**11,985**	**23,273**	**94.2**
Budget withdrawals	7,513	9,672	17,761	83.6
Extended facilities	1,937	2,313	5,512	138.3
Adjustments for US dollar and other currencies' parity against rial	**..**	**..**	**311**	**θ**
Cash balance (year-end)	**9,477**	**10,686**	**9,555**	**-10.6**

crude oil in the review year, balance of the OSF was reduced by $1,131 million compared with the previous year.

Foreign Exchange and Trade Policies

Trade policies in 1385 were directed toward further export promotion as well as support and expansion of trade and economic ties in the international front. To this end, various regional agreements were concluded. In imports area, major policies adopted aimed at further transparency and reduction of tariff rates of certain imported goods to regulate the domestic market. Reducing the impacts of limitations imposed on transactions in US dollar was the main objective of the foreign exchange policies adopted in the review year.

Foreign Exchange and Gold Markets

The significant growth of foreign exchange revenues, owing to continued oil price rise in the international markets during the past years, could help policy makers to better manage foreign exchange fluctuations than before. Rial parity rate against the US dollar and euro remained virtually unchanged in 1385. The misalignment of nominal exchange rate with the gap of internal and external inflation led to the appreciation of rial against hard currencies which could in turn affect export profit margin, real sector competitiveness, and current account deficit (non-oil). As a result of the surge in imports and banks' further use of domestic resources due to the rise in international interest rates, interbank market transactions faced an upward trend in the review year. The benign position of the OSF against the backdrop of international oil price hikes raised banks' capability to finance domestically, thus reducing the cost of foreign exchange transactions.

Parity Rate of the National Currency against Hard Currencies

Foreign exchange market enjoyed a relatively stable condition in 1385. The annual average rate of US dollar in the interbank market (reference rate) was Rls. 9,197, up by 1.9 percent from the previous year figure of Rls. 9,026: 1 US dollar. The annual average rate of rial against euro, pound, and Swiss franc appreciated to respectively Rls. 11,777, 17,373, and 7,427, by 7.0, 7.7, and 4.6 percent. Conversely, the Japanese yen depreciated against rial by 1.3 percent. Therefore, changes in the parity rates of such currencies against US dollar in the global markets mainly influenced the parity rate of rial against other currencies except US dollar.

Coefficient of variation of the reference rate of currencies stated above indicates that the highest fluctuations belonged to the rial parity rate with the pound, with a 3.41 percent coefficient of variation, followed by euro with a coefficient of variation of 2.42 percent and Japanese yen with 2.03 percent.

RATE OF MAJOR CURRENCIES IN THE MAIN INTERBANK MARKET (rials)

	1383		1384		1385		Percentage change
	Annual average	Coefficient of variation (percent)	Annual average	Coefficient of variation (percent)	Annual average	Coefficient of variation (percent)	Annual average
Dollar	8,719	1.2	9,026	0.8	9,197	0.33	1.9
Euro	10,959	5.2	11,004	2.2	11,777	2.42	7.0
Pound	16,077	3.5	16,136	2.2	17,373	3.41	7.7
Yen	81	3.8	80	3.2	79	2.03	-1.3
Swiss Franc	7,129	5.3	7,099	2.4	7,427	1.93	4.6

Developments in Official Exchange Market

The total value of official market transactions (in US dollar, euro, pound, and other currencies) amounted to $34,520 million in 1385, representing a rise of 16.9 percent compared with the $29,530 million of the previous year. The main (1) and the secondary (2) interbank markets held 46.9 and 53.1 percent of total transactions in the official exchange market, respectively. Composition of foreign exchange transactions remained the same as before, indicating relatively stable conditions prevailing in the main and secondary markets within the past two years.

The total value of main market transactions (including other currencies exchanged for dollar) grew by 16.8 percent to $16,199 million in 1385, against $13,871 million in the previous year. The Central Bank accounted for 91.7 percent of total foreign exchange sales in this market at $14,848 million, which is a remarkably high figure compared with the $1,351 million foreign exchange sales by banks. Meanwhile, banks purchased $15,523 million, i.e., 95.8 percent foreign exchange from the main market.

In 1385, the total value of secondary market transactions amounted to $18,321 million, indicating 17 percent growth compared with $15,659 million of the previous year. Sales of foreign exchange by the Central Bank reached $17,654 million, accounting for 96.4 percent of total foreign exchange sales in the secondary market. On the other hand, banks sold $667 million foreign exchange, down by 84.1 percent compared with the year before. Decline in the sales of foreign exchange by Bank Melli Iran, Bank Saderat Iran, and Bank Sepah, mainly attributable to a rise in their foreign exchange requirements and problems regarding the settlement of their accounts, was the driving force behind the decrease in total foreign exchange sales by banks. In the review year, the Central Bank purchased a mere $18 million foreign exchange from the secondary market, much less than $18,302 million foreign exchange purchased by banks.

FOREIGN EXCHANGE TRANSACTIONS IN THE MAIN AND SECONDARY INTERBANK MARKETS (million dollars)

					Percentage change		
	1382	1383	1384▲	1385	1383	1384	1385
Main market	12,929	11,363	13,871	16,199	33.1	-12.1	16.8
Share (percent)	52.6	50.1	46.9	46.9			
Secondary market	11,630	11,329	15,659	18,321	679.0	-2.6	17.0
Share (percent)	47.4	49.9	53.1	53.1			
Total	**24,558**	**22,692**	**29,530**	**34,520**	**119.2**	**-7.6**	**16.9**

(1) The main interbank market consists of banks operating in the mainland and licensed by the Central Bank to purchase and sell foreign exchange within the framework of regulations.

(2) The secondary interbank market consists of banks operating in Kish, Qeshm, and Chabahar Free Trade Zones as well as Iranian banks' branches abroad, which are engaged in purchase, sale, and transfer of foreign exchange at any amount, and everywhere within the framework of regulations.