CHAPTER 10

FOREIGN EXCHANGE AND TRADE POLICY

Balance of Payments

Certain developments affected the balance of payments performance in Iran in 1386. Rise in international oil prices, facilitation and liberalization of foreign trade and exchange market in line with 4th Plan target, and higher restrictions on Iran's external transactions and payments were major factors in shaping balance of payments of Iran in 1386. Remarkable increase in price of crude oil and condensates brought about a record rise of $81,567 million in oil and gas export proceeds (including crude oil, oil products, condensates and natural gas) by 31.5 percent.

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 together with relative stability in the foreign exchange market raised non-oil exports (1) to $16,101 million in 1386, against $14,044 million in the year before. Increase in the exports of industrial goods such as oil, gas, and chemical products as well as rise in the export of agricultural and traditional goods such as dried and fresh fruits were responsible for this growth.

The gap between domestic inflation and that in major trade partners of Iran, as well as lack of appropriate exchange rate adjustments led to sharp increase in imports in 1386. This resulted in a 16.4 percent rise in imports (2) from $50,020 million in 1385 to $58,240 million in the review year. Imports of iron and steel, electrical and non-electrical machinery and appliances, transportation vehicles, and gasoline, with a share of 59.2 percent, were the main imported goods in 1386. Therefore, trade balance faced a surplus of $39,428 million.

Services account faced deficit as in previous years. On the receipts side, "freight and insurance" and "tourism" (passenger and travel services) with respectively $2,740 and 1,950 million, accounted for 46.6 percent of foreign exchange receipts of services account. On the payments side, "tourism", "freight and insurance" and "investment expenditure" with $7,335, 1,931 and 1,924 million, respectively, constituted 63.7 percent of foreign exchange payments of this sector. Therefore, $7,499

Balance of Payments (million dollars)

	1384	1385	1386
Current account balance	16,637	20,402	32,571
Capital account	-184	-4,383	-14,165
Errors and omissions	-1,879	-4,634	-3,160
Overall balance (change in international reserves)	**14,574**	**11,384**	**15,246**

(1) Includes goods exported through Customs; export of electricity, ships, scrap oil tankers, goods delivered at frontier and an estimation of exports through unofficial channels.

(2) Includes imports through Customs and free zones; import of electricity, gas, ships, oil tankers and airplanes as well as imports of oil products not mentioned in Customs and an estimation of other imported goods not mentioned in Customs data.

million deficit of the services account, up by 22 percent compared with 1385, indicates the rising trend of imports of services (net).

Transfers account (net) ran a surplus of $642 million, mostly due to the remittances of Iranians residing abroad. Current account balance rose 59.6 percent to enjoy a surplus of $32,571 million against $20,402 million registered in the preceding year.

Hence, developments in foreign trade transactions of goods and services resulted in the significant surplus of current account balance. This was mostly due to the favorable conditions prevailing in the international crude oil market; therefore, non-oil current account balance deficit surged in 1386.

The capital account of balance of payments indicated a deficit of $14,165 million, comprising a deficit of $11,791 million in short-term and $2,375 million in long-term capital account transactions. The short-term account deficit was largely due to rise in banks' foreign assets and the country's foreign claims. On the other hand, long-term capital account deficit was mostly owing to international limitations on utilization of external financial resources, rise in repayment of foreign exchange liabilities, and obligations arising from buy-back contracts. In the review year, the amounts paid for repayment of buy-back contracts, and investment in oil and gas projects totaled $3,439 and 2,329 million, respectively. Thus, $694 million was absorbed as foreign investment within the framework of Foreign Investment Promotion and Protection Act. In this year, CBI foreign assets (overall balance) increased by roughly $15,246 million due to current account and financial transactions.

Current Account

High rise in global crude oil prices, condensates, and oil products as well as the remarkable increase in non-oil exports led to the record surplus of current account by $32,571 million.

Current Account Balance

(million dollars)

	1382	1383	1384	1385	1386	Percentage change 1385	Percentage change 1386
Current account balance	816	1,442	16,637	20,402	32,571	22.6	59.6
Current account balance (non-oil)	-26,539	-34,873	-37,183	-41,609	-48,996	11.9	17.8

Figure 10.1. Current account balance components

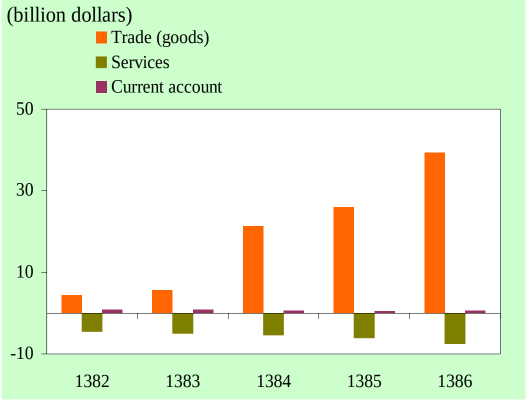
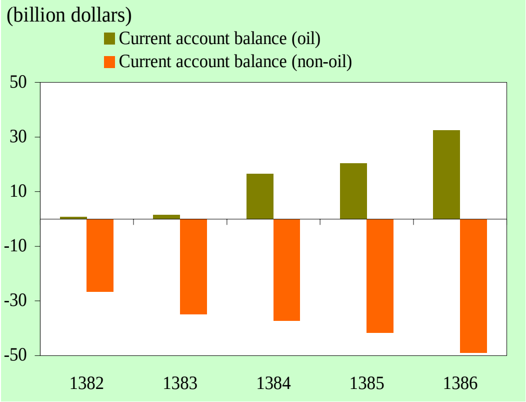


Figure 10.2. Current account balance



Foreign Trade Performance

Deregulation of foreign trade and the liberalization policies of exchange market of the years prior to 1386 were pursued and continued vigorously in the review year. Favorable GDP growth, appropriate international market for Iranian crude oil and non-oil exports combined with sound external trade policies boosted foreign trade in 1386. Therefore, the value of exports amounted to $15.3 billion, and imports totaled $48.4 billion. Thus, the non-oil sector could finance 31.6 percent of import requirements [1].

Non-oil exports rose 17.8 percent to $15,312 million in the review year. The weight of exported goods grew by 15.7 percent to 32,118 thousand tons compared with the previous year. In 1386, despite sharp fall in the unit price of metallic mineral ores, as well as exported agricultural and traditional goods, the unit value of exported goods reached $477 in the review year, up by 1.8 percent, against $468 in 1385. This was due to the rise in the international price of chemical and petrochemical products.

Imports

Composition of imports [2] in 1386 reveals that reduction in the share of capital goods in total imports continued in this year, from 19.7 percent in the previous year to 18.2 percent in 1386. On the other hand, share of raw materials and intermediate goods rose to 68.1 percent against 65.5 percent in the year before. Moreover, the upward trend of imports of consumer goods was moderate, and the share of these goods in total imports declined from 14.8 percent in 1385 to 13.7 percent in 1386.

Composition of imports in 1386 indicates that the highest share was related to iron and steel by 18.2 percent followed by non-electrical machinery by 17 percent, transportation vehicles by 9.2 percent, electrical machinery, tools, and appliances by 7.8 percent, and gasoline by 7 percent. Share of these goods reached 59.2 percent in total imports, down by 1.2 percent compared with 1385. Meanwhile, imports of sugar and its derivatives, gas oil, and gasoline were reduced by 56.3, 30.5 and 21.3 percent respectively, in comparison with the preceding year. The decline in gasoline and gas oil imports was largely due to reclassification of imports of a proportion of those two products in import adjustment category.

Composition of imports by the international classification of goods indicates that "machinery and transportation vehicles", despite the continued fall in their imports, still took the lion's share in total imports by 34 percent in 1386.

Foreign Trade
(excluding electricity and exports by NIOC and NIGC)

					Percentage change		Share (percent)	
	1383	1384	1385	1386	1385	1386	1385	1386
Value (million dollars)								
1. Imports	35,389	39,248	41,723	48,439	6.3	16.1	76.2	76.0
2. Exports	6,847	10,474	12,997	15,312	24.1	17.8	23.8	24.0
Deficit (2-1)	-28,542	-28,774	-28,726	-33,127	-0.2	15.3		
Total (1+2)	**42,236**	**49,722**	**54,720**	**63,751**	**10.1**	**16.5**	**100.0**	**100.0**
Weight (thousand tons)								
1. Imports	34,448	35,466	43,492	41,696	22.6	-4.1	61.0	56.5
2. Exports	18,077	24,983	27,766	32,118	11.1	15.7	39.0	43.5
Total (1+2)	**52,525**	**60,449**	**71,258**	**73,814**	**17.9**	**3.6**	**100.0**	**100.0**

Source: Foreign Trade Statistics

(1) Includes only trade of goods and trade through Customs.
(2) As of 1384, the "Broad Economic Classification" prepared by the United Nations is used.

Composition of Imports by Use (million dollars)

	1383	1384	1385	1386	Percentage change 1385	Percentage change 1386	Share (percent) 1385	Share (percent) 1386
Raw materials and intermediate goods	23,733	25,423	27,334	32,979	7.5	20.7	65.5	68.1
Capital goods	8,120	9,221	8,226	8,807	-10.8	7.1	19.7	18.2
Consumer goods	3,536	4,603	6,163	6,652	33.9	7.9	14.8	13.7
Total	**35,389**	**39,248**	**41,723**	**48,439**	**6.3**	**16.1**	**100.0**	**100.0**

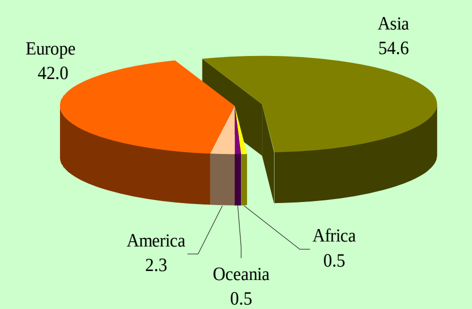
Geographical distribution of imports changed slightly in 1386 as compared with the previous year. The concentration indices (1) of the first 3, 5 and 10 exporting countries rose to respectively 43.6, 54.4 and 72.1 percent in this year, against 41.2, 51.3 and 69.8 percent in 1385. These changes reveal a rise in the geographical concentration of imports during 1386. United Arab Emirates, Germany, China, Switzerland, South Korea, England, Italy, France, India, and Japan were the main exporters to Iran in 1386.

The upward trend of distribution of imports by continents reveals that the increasing share of Asia in imports since 1381 continued to reach 54.6 percent in this year against 50.6 percent in 1385. Moreover, Europe remained the second large exporting continent, accounting for 42 percent of imports. Based on Customs data, Europe's share of imports to Iran declined by 2.9 percentage points in favor of Asian imports, indicating sharp rise of international trade share by East Asia and restrictions by Europeans on LC openings by Iranian entities.

Review of imports by group of countries during 1386 points to the highest share of ESCAP member countries in total imports of goods by $19,757 million (40.8 percent), followed by the European Union by $14,990 million (30.9 percent).

Figure 10.3. Distribution of imports by continents in 1386

(percent)



Non-oil Exports

In the review year, 32,118 thousand tons of non-oil products valued at $15,312 million were exported, indicating 15.7 and 17.8 percent growth in terms of weight and value, respectively. Therefore, the unit value of exported goods grew by 1.8 percent to $477, compared with 1385.

Imports according to International Classification of Goods (million dollars)

	1384	1385	1386	Percentage change 1385	Percentage change 1386	Share (percent) 1385	Share (percent) 1386
Machinery and transportation vehicles	17,217	15,017	16,493	-12.8	9.8	36.0	34.0
Goods classified according to their composition	8,266	8,876	12,672	7.4	42.8	21.3	26.2
Mineral products, fuels, industrial oils, and grease	4,198	5,356	4,406	27.6	-17.7	12.8	9.1
Chemicals	4,191	4,850	6,256	15.7	29.0	11.6	12.9
Others	5,376	7,624	8,612	41.8	13.0	18.3	17.8
Total	**39,248**	**41,723**	**48,439**	**6.3**	**16.1**	**100.0**	**100.0**

(1) Concentration indices are calculated from total share of the first 3, 5 and 10 exporting countries in total imports.

Industrial goods still took the lion's share in total exports. Share of these goods in total exports reached 75.8 percent, against 74.4 percent in the previous year. Exports of industrial goods totaled $11,603 million in 1386, up by 20.1 percent. Sharp rise in the exports of these goods mostly resulted from growth in the exports of "oil and gas products", "organic and inorganic chemical products" as well as "transportation vehicles and their spare parts". The highest growth in exports belonged to organic chemicals by 162.5 percentage change, raising the share of industrial goods from 5.3 percent in 1385 to 11.9 percent in the review year. Noticeable increase in global price of major exported industrial goods, together with a rise in the volume of exports due to development of chemical and petrochemical units, was the main driving force behind the rise in the export of these products.

Share of agricultural and traditional goods in total exports declined slightly to 22.7 percent, against 23.2 percent in 1385. Total value of exports of this group reached $3,482 million in 1386. The highest share in the exports of this group belonged to dried and fresh fruits by 11.9 percent. Exports of metallic mineral ores reached $227 million, holding the lowest share of 1.5 percent in total. As a result of the sharp fall in the international price of agricultural and traditional goods, their total export value decreased by 29 percent compared with the preceding year.

Geographical distribution of exports through Customs by group of countries in 1386 reveals that ESCAP countries absorbed the lion's share of exports through Customs by 50 percent, indicating 23.8 percent growth. The value of exports to the Asian Clearing Union (ACU) member countries fell sharply by 3.7 percent as compared with the corresponding figure of the previous year (8.9 percent).

Terms of Trade

Change in the degree of the external sector competitiveness may be manifested in terms of trade effect of a country with other countries. The ratio of the unit price of exported goods to that of imported goods is a well-known and reliable measure for the assessment of the terms of trade.

Based on the international data, terms of trade of most industrial countries show a relatively constant and stable trend, even during the uptrend in oil price, which varies for developing economies in proportion to their degree of dependence on imports of energy and changes in its global price.

Figure 10.4. Major non-oil exports

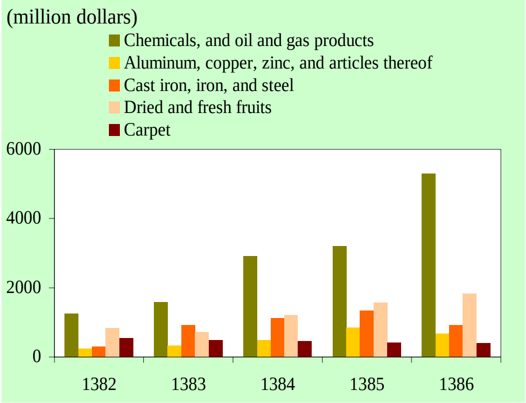
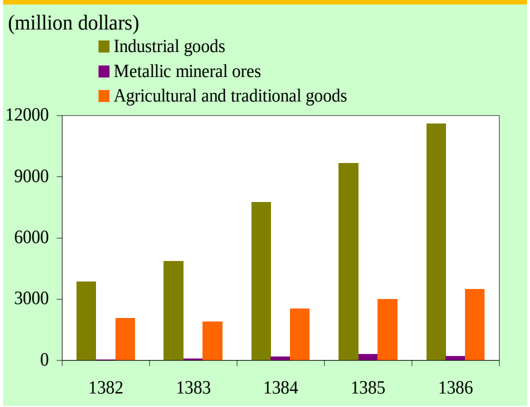


Figure 10.5. Exports



In 1386, terms of trade through Customs fell by 15.9 percent to 0.410, against 0.488 in the previous year. This was due to a higher rise in the unit price of imported goods by 21.1 percent than that of exported goods by 1.8 percent. This is indicative of a much lower rise in the price of exported goods despite the significant share of chemical and petrochemical products in exports through Customs and increase in their global price.

Terms of Trade (through Customs) (US$/ton)

	1384	1385	1386	Percentage change 1385	Percentage change 1386
Unit price of exports	419.2	468.1	476.7	11.7	1.8
Unit price of imports	1,106.6	959.3	1,161.7	-13.3	21.1
Terms of trade	0.379	0.488	0.410	28.8	-15.9

Source: Foreign Trade Statistics

Utilization of External Sources and Foreign Exchange Obligations

Total foreign exchange obligations (actual and contingent obligations) increased by 23.9 percent to $56,184 million at end-1386 from $45,338 million in 1385 year-end. Changes in the composition of contingent obligations and external debts (actual debts) brought about an increase in the share of contingent obligations to 49 percent in 1386 year-end, against 48.1 percent at end-1385.

External debts reached $28,647 million, up by 21.8 percent, from $23,514 million in 1385. This significant rise was largely fueled by identification of new loans extended from abroad without banking system guarantee and depreciation of US dollar against other currencies. Moreover, the first phase of the Eurobonds issued in 1381 was repurchased in this year.

External Obligations (million dollars)

Year-end	1387	1388	1389	1390	From 1391 onwards
Amount	13,873	3,050	2,670	2,210	6,844

Change in International Reserves

Increase in current account surplus raised international reserves by almost $15,246 million. A large portion of this increase was due to the rise in the balance of the OSF.

External Obligations (million dollars)

	Year-end 1385	Year-end 1386	Percentage change
Contingent obligations	**21,824**	**27,537**	**26.2**
External debt	**23,514**	**28,647**	**21.8**
Short-term debts	9,100	9,891	8.7
Long-term debts	14,414	18,756	30.1
Project finance	4,810	4,882	1.5
Finance	4,748	5,086	7.1
Loans extended from abroad without banking system guarantee	2,034	6,566	222.8
Eurobonds	1,413	632	-55.2
Others	1,409	1,590	12.8
Total	**45,338**	**56,184**	**23.9**

External Sector Analysis

The balance of payments of Iran had a positive performance in 1386, positively affecting the overall performance of the Iranian economy. It is noteworthy that despite various limitations and adoption of prudential foreign exchange and trade policies, foreign exchange reserves went up by $15,246 million. However, performance of this sector may be assessed on the basis of other criteria such as scheduling of external obligations and government withdrawals from the OSF.

Ratio of short-term debts to total, an indicator of economy's flexibility in repayment of debts, declined to 34.5 percent at end-1386 against 38.7 percent in 1385. Increase in OSF sources (50.4 percent) exceeded the rise in government budgetary withdrawals from the OSF account (almost 4.4 percent).

Foreign Exchange and Trade Policies

In 1386, trade policies were oriented towards further export promotion, support and expansion of trade, closer economic ties with the rest of the world, and better regulation of imports. Foreign exchange policies adopted in this year were mainly aimed at facilitating and reforming foreign exchange regulations and reduction of constraints imposed on foreign trade transactions of Iran.

Trade Policies and Regulations

The High Council of Non-oil Export Promotion approved the support policies of non-oil exports in Mordad 1386.

The mentioned non-oil export support policies comprised the following:

- Direct and indirect support to export companies by designing export incentive and bonus structure [(1)];
- Emphasis on the exports of technical and engineering services;
- Support of exports of goods with high value-added;
- Support of infrastructures related to export sector;
- Restructuring of export information system with due emphasis on export opportunities abroad;
- Establishment of representative offices and trade centers abroad with emphasis on export target markets;
- Support of non-public funds and entities in non-oil export activities;
- Support of non-public trade and marketing missions abroad;
- Support of Iranian export companies in international fairs;
- Support for protection and preservation of Iranian products in export target markets;
- Support of specialized export management companies, formation of export clustering and export consortiums;
- Market research and training programs in the export sector;
- Interest subsidies for bank loans to exporters and banks' issuance of guarantees and insurance for export sector;
- Promotion of technical standards in line with international standards for export sector;

(1) In pursuance of Paragraph (b), Article 33 of the 4th FYDP

- Support of projects on quality control of goods and services destined abroad;

- Support of packing and packaging for non-oil exports in line with standards of target markets; and

- Freight cost subsidies for non-oil exports.

Foreign Exchange Market Developments

The remarkable increase in foreign exchange revenues, due to continued oil price rise in the international markets in recent years, could help policy makers to better manage foreign exchange fluctuations. Rial parity rate against US dollar and euro remained the same in the review year. The misalignment of nominal exchange rate with the gap of internal and external inflation resulted in the appreciation of rial against hard currencies which could subsequently affect export profit margin, real sector competitiveness, and current account deficit (non-oil).

The rising trend of imports, banks' higher reliance on residents' foreign exchange deposits (due to rise in international interest rate and restrictions on banks' access to foreign financing) and the weakening of dollar led to sharp rise in dollar value of main interbank foreign exchange market transactions. The favorable position of international reserves and better performance of oil export increased banks' capability to substitute residents' foreign exchange deposits with reduced international financing.

Drastic fall in the value of US dollar versus other hard currencies as well as increased international restrictions on dollar settlements of international transactions of Iran led to sharp decline in the share of US dollar in foreign exchange transactions. In order to mitigate the risks of foreign exchange market participants, in mid-1386, the CBI officially substituted euro for dollar as market intervention currency [1].

The nominal value of rial against hard currencies declined in 1386. Since US dollar acted as the currency for exchange intervention during eight months of this year and depreciated against hard currencies in the international markets, the nominal value of rial against dollar depreciated less than its parity against other currencies. In 1386, the annual average rate of euro and US dollar by 11.2 and 0.96 percentage change posted the highest and lowest increase in the interbank market rates.

Rate of Major Currencies in the Main Interbank Market

(rials)

	1384		1385		1386		Percentage change
	Annual average	Coefficient of variation	Annual average	Coefficient of variation	Annual average	Coefficient of variation	Annual average
US dollar	9,026	0.81	9,197	0.33	9,285	0.75	0.96
Euro	11,004	2.25	11,777	2.42	13,096	4.13	11.2
Pound	16,136	2.25	17,373	3.41	18,636	1.98	7.3
Japanese yen	8,001	3.20	7,875	2.03	8,103	5.16	2.9
Swiss franc	7,099	2.38	7,427	1.93	7,986	4.97	7.5

(1) Reserve portfolio management of CBI encompasses several currencies, with appropriate weights attached to each to preserve the value of foreign reserve holdings. However, the CBI intervention in main and offshore foreign exchange interbank markets takes place with the use of one specific foreign currency called market intervention currency.

Coefficient of variation [1] of the reference rate of hard currencies reveals higher fluctuations of the rial parity rate against the said currencies (except the pound) in 1386 compared with the preceding year. Moreover, the highest fluctuations belonged to the rial parity rate with Japanese yen, Swiss franc, and euro.

Figure 10.6. Developments of US dollar rate in the official market

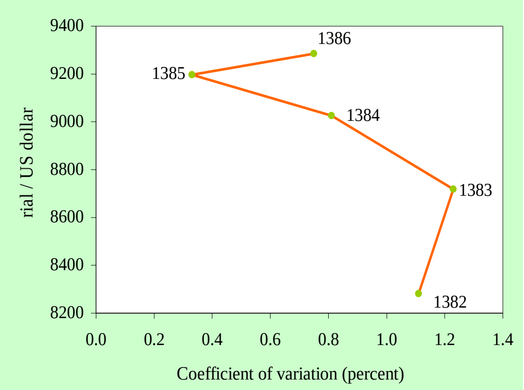
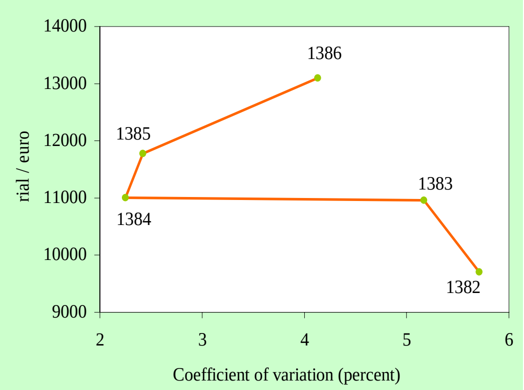


Figure 10.7. Developments of euro rate in the official market



Developments in the Official Exchange Market

The total value of official market transactions (in US dollar, euro, Japanese yen, pound, and other currencies) reached $42,535 million in 1386, indicating 23.2 percent growth against $34,520 million of the year before. The main [2] and the secondary [3] interbank markets accounted for respectively 39.5 and 60.5 percent of total transactions in the official exchange market. Composition of foreign exchange transactions altered in favor of the secondary market in 1386. Increase in the share of this market in total transactions is attributable to the rise in the cash payments in foreign exchange transactions, which is in turn due to the expansion of international limitations and ease of transactions in the secondary market.

The total value of main market transactions (including other currencies exchanged for dollar) rose 3.7 percent to $16,793 million in the review year from $16,199 million in 1385. The CBI held 89.6 percent of total foreign exchange sales in this market worth $15,046 million, much higher than the $1,747 million foreign exchange sales by banks. Meanwhile, banks purchased $15,246 million, i.e., 90.8 percent, foreign exchange from the main market.

In the review year, the total value of secondary market transactions increased by 40.5 percent to $25,742 million when compared with the $18,321 million of the preceding year. Sales of foreign exchange by the CBI amounted to $24,595 million, constituting 95.5 percent of total foreign exchange sales in the secondary market. On the other hand, banks sold $1,148 million foreign exchange, up by 72.2 percent compared with 1385. In the review year, the CBI

(1) Standard deviation divided by mean

(2) 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.

(3) 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 buying, selling, and transferring of foreign exchange at any amount, and everywhere within the framework of regulations.

purchased $270 million foreign exchange from the secondary market, much less than $25,473 million foreign exchange purchased by banks.

In 1386, the CBI remained the main seller of foreign exchange in the interbank market with a share of 93.2 percent in total sales. Meanwhile, banks stood as the main buyer of foreign exchange in this market, accounting for more than 95.7 percent of total purchases.

Foreign Exchange Transactions in the Main and Secondary Interbank Markets

(million dollars)

	1383	1384	1385	1386	Percentage change 1385	Percentage change 1386
Main market	11,363	13,871	16,199	16,793	16.8	3.7
Share (percent)	50.1	46.9	46.9	39.5		
Secondary market	11,329	15,659	18,321	25,742	17.0	40.5
Share (percent)	49.9	53.1	53.1	60.5		
Total	**22,692**	**29,530**	**34,520**	**42,535**	**16.9**	**23.2**