Research Department
Federal Reserve
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Iranian Connection

Iran's government last week moved to withdraw its deposits from U.S. banks, and thereby added an economic dimension to an already tense political situation. President Carter immediately ordered a freeze on official Iranian deposits in U.S. banks, and bankers everywhere began to pay close attention to the new moves on the Iranian chessboard. Economic analysts meanwhile reassessed the growth prospects of a nation which, until recently, had been a major U.S. trade and financial partner.

Within the past year, Iran's hopes for a modernized economy have been shattered. The burst of energy which followed the 1973-74 oil-price upsurge—what one American observer called Iran's "uncoordinated leap forward"—has been followed by an equally uncoordinated leap backward into severe recession. Gone are the dreams of becoming the Asian version of West Germany before the turn of the century. And gone are the dreams of the many Western corporations which had hoped to benefit from this era of modernization.

Problems of growth

In the petroleum boom of the mid-1970's, Iran recorded high growth rates for several years in a row, highlighted by 1973's 12-percent growth in real output. Within a half-decade, the oil sector's share of total GNP rose from one-fifth to almost one-third, while the farm sector's share dropped from roughly one-fifth to one-tenth. The rural unemployed and underemployed poured into the oil centers to work on large-scale petroleum and petrochemical complexes, and more of them poured into Tehran to work on massive commercial and luxury-housing developments, along with a new international airport and a $2 billion-dollar subway system.

Yet the pressures of the oil boom, along with Iran's highly skewed population distribution —only one half of the population is over 15 years of age—forced the government to call on foreign workers to meet its labor requirements. Korean truck drivers, Indian doctors, Afghan laborers, Filipino service workers, and Japanese and European professional and technical workers—plus more than 45,000 Americans—became critical components in Iran's development drive.

But the oil boom, together with low agricultural productivity, created severe strains on an unprepared economy. Imports soared, fueled by Iranians' growing appetite for foreign producer and consumer goods, as well as the country's growing dependence on foreign-produced staples such as meat, dairy products, eggs, rice and wheat. Farm imports alone went from practically zero in 1973 to about $1.5 billion in 1978. Consumer prices rose 10 to 15 percent a year throughout the 1973-76 period, and then jumped by 27 percent in 1977.

Problems of no growth

In a mid-1979 report from Tehran, the U.S. embassy staff reported that Iran's economy was still mainly paralyzed as a result of the past year's revolutionary turmoil. The new government inherited an industrial economy which was already badly disrupted by pre-revolution strikes, sagging productivity and large wage increases. Only agriculture remained relatively stable amid the turmoil, while construction and most manufacturing activities appeared paralyzed.

The Embassy report said, "the infrastructural fabric of water, electricity, telecommunications, post, petroleum supplies (and record traffic) is essentially sound, and supports one's expectations that all else should likewise be normal." But most major industries appeared to be operating at less than half normal levels. This suggests a sharp decline this year in real GNP, which apparently dropped about 20 percent in the period

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March 1978-March 1979 (year 1357 in the Islamic calendar). Still, Iran has been able to remain afloat on its ocean of oil, even though production at midyear was running 40 percent below year-earlier levels at an average of four million barrels/day. Indeed, with oil prices soaring, revenue could match or even exceed year-ago levels.

Unemployment has remained a major problem, although its magnitude has been disguised by the government's policy of maintaining employment at previous levels regardless of production requirements. Many factories have kept virtually the same complement of employees as a year ago, and now pay those workers higher wages while producing perhaps two-thirds less than a year ago. In this environment, inflation continues very high. Shortages of materials, continued wage increases, declining labor productivity, and the likelihood of increased government spending for job-creating projects all suggest that the inflation rate will return to 1977's high rate.

During the new government's first half-year in power, it cancelled or suspended many contracts with foreign firms. Civilian contracts worth perhaps $38 billion were cancelled, including such projects as nuclear plants, petroleum facilities, rail-highway-airport projects, and a lavish 50,000-person complex of office and residential buildings on the outskirts of Tehran. The new government meanwhile expanded its powers by nationalizing the banks and insurance companies in June, and followed that in July by taking over the metal-producing and transportation-machinery industries, as well as other industries and mines that have made "illegal benefits" in the past.

Impact on the West

All of these developments have had serious implications for the major industrial powers, the United States in particular. The sharpest impact, of course, has been felt in the petroleum market. Before the shut-off of Iranian oil imports, Iran satisfied roughly 5 percent of U.S. oil-import demand—about 300,000 barrels/day—but Administration officials claim that loss could be offset if American drivers reduced their travel by 3 miles a day. In any event, world oil prices will increase an estimated 82 percent between late 1978 and late 1979, which by itself would account for two percentage points of the 10-percent rise in the U.S. GNP price index over the past year. Moreover, many U.S. export industries—from arms producers to agriculturists, and from building contractors to nuclear-reactor manufacturers—have seen their contracts swept away with the disappearance of the old regime.

Iran has cancelled roughly $15 billion of military-related contracts with the U.S., plus many related services. The largest contract involved a $3.6-billion order for 160 F-16 fighter planes, and other major cancellations affected a $1.2-billion order for AWACS planes (airborne warning and control systems) and a $1.4-billion order for

Spruance class destroyers. The U.K. also suffered about $5 billion in cancellations, primarily for the production of 1,300 new Chieftain tanks. Many of the cancellations affected other NATO countries as well, because of losses on subcontracts or because of higher prices for military items which they as well as the Iranians had ordered.

U.S. nonmilitary exports to Iran, which reached $3.7 billion in 1978, have fallen to only about one-third of last year's pace. Still, farm exports rose 8 percent in the crop year ending September 30, to $490 million, as Iran continued as a major customer of the U.S. for food and feed supplies. Indeed, the U.S. contributed about three-fourths of the wheat, rice and vegetable oils which Iran imported to feed its population this past year. These sales amounted to only about 1½ percent of U.S. agricultural exports, but they represented significant business to some U.S. grain and feed producers. Iran has already announced that it will shift some wheat purchases to other suppliers, so a reduction in U.S. exports could occur in the new crop year, even if the political situation improves.

On the banking scene, the situation today is far different from the heady days of the oil boom, when Iran was one of the most favored customers of the major international banks. As late as May 1978, an international consortium lent $300 million to the National Iranian Gas Company at a rock-bottom interest rate—for the first five years, only ⅝ percent above Libor (London interbank offer rate, the base international lending rate). But now, bank portfolio examiners are closely watching this and all other Iranian loans. The Embassy's mid-1979 survey said "U.S. banks, with direct outstandings in Iran of about $3 billion in early 1979, are slowly reducing their exposure. As in the case of other foreign banks, they are booking little new debt." In any event, the amounts at stake are considerably less than the $8 billion in Iranian frozen assets, which as the President's freeze order noted, "will be available to satisfy lawful claims of citizens and entities of the United States against the Government of Iran."

Return to growth?
Iran's political and economic future remains uncertain, but once past the present crisis, it could still achieve substantial growth. With oil reserves of 63 billion barrels (second only to Saudi Arabia), with the world's second-largest known gas reserves, and with substantial mineral wealth, its foreign-exchange earning potential could support a major long-term development program.

Again, the recent oil boom, with all its distortions, created a major expansion of the nation's capital plant, higher levels of literacy and labor skills, and income levels capable of supporting expanded domestic industries. Iran's dreams of becoming the Germany of the Middle East may lie shattered, but the nation could still gain a respectable place in the middle rank of industrial powers if it surmounts its present problems.

William Burke

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 11/7/79	Change from 10/31/79	Change from year ago @ Dollar	Percent
Loans (gross, adjusted) and investments*	134,936	− 173	+ 16,895	+ 14.3
Loans (gross, adjusted) — total#	111,920	− 143	+ 16,320	+ 17.1
Commercial and industrial	31,279	− 111	+ 3,372	+ 12.1
Real estate	41,979	+ 260	+ 8,782	+ 26.5
Loans to individuals	23,822	− 24	NA	NA
Securities loans	1,534	− 171	NA	NA
U.S. Treasury securities*	7,384	− 12	− 766	− 9.4
Other securities*	15,632	− 18	+ 1,341	+ 9.4
Demand deposits — total#	44,289	− 890	+ 2,495	+ 6.0
Demand deposits — adjusted	31,861	+ 640	+ 858	+ 2.8
Savings deposits — total	29,116	− 148	− 1,390	− 4.6
Time deposits — total#	56,688	+ 50	+ 8,316	+ 17.2
Individuals, part. & corp.	48,342	+ 9	+ 9,412	+ 24.2
(Large negotiable CD's)	20,855	+ 118	+ 1,863	+ 9.8

Weekly Averages of Daily Figures	Week ended 1/7/79	Week ended 10/31/79	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	+ 151	+ 11	+ 21
Borrowings	202	+ 125	+ 50
Net free reserves (+)/Net borrowed(−)	− 51	− 114	− 29
Federal Funds — Seven Large Banks			
Net interbank transactions [Purchases (+)/Sales (−)]	+ 584	− 138	+ 707
Net, U.S. Securities dealer transactions [Loans (+)/Borrowings (−)]	+ 222	+ 185	+ 117

* Excludes trading account securities.
# Includes items not shown separately.
@ Historical data are not strictly comparable due to changes in the reporting panel; however, adjustments have been applied to 1978 data to remove as much as possible the effects of the changes in coverage. In addition, for some items, historical data are not available due to definitional changes.

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