

Financial Instability in a Developing Economic
Setting: The Case of Iran*
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The examination of the theory and history of financial crisis in Europe and the United States is the subject matter of two important works by Kindleberger (Kindleberger, 1978, and Kindleberger & Laffargue, 1982). In his first work, Kindleberger (1978), has provided us with a remarkable account of European and American financial history from 1720 to 1975. The second book (Kindleberger & Laffargue 1982) presents a collection of essays that include a more in-depth history of selected financial crises in England, Germany, Italy and the United States. In both of these books the authors argue that the observed financial swings have followed a similar pattern. This pattern is best explained by "financial instability hypothesis" that was first presented by Fisher (1932) in his debt-deflation framework of analysis, and later was elaborated by Professor Hyman Minsky (Minsky, 1972, 1982, Kindleberger 1978).

This paper is an attempt to show that the Iranian financial crisis of 1977 followed the same pattern that characterized these earlier European and American financial fluctuations. To this end, I shall develop a Fisher-Minsky-Kindleberger theory of financial instability, I shall then give an account of the oil boom and bust of 1973-1978 in Iran that culminated in the financial collapse of 1978.

The Fisher- Minsky- Kindleberger Financial Instability Hypothesis

The basic financial proposition advanced by the Fisher- Minsky-

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Kindleberger theory is that capitalism is an inherently unstable system of production and distribution of income and wealth. Furthermore, this approach attributes the economic instability of capitalism to "the normal functioning" of the economy.

This perception of capitalist economies emerges from the Keynesian view that finance plays a central role in investment behavior-of firms and individuals. As will be shown later, it is the nature of capitalist financial institutions that induce adventurous financing practices that lead to financial crisis.⁽¹⁾

The core of financial instability hypothesis may be summarized in a few pages. According to Minsky, the financial structure of the economy becomes too fragile during business upswings. Events trigger sell-off of assets in tight markets at distressed prices. Distressed selling often leads to financial crisis. Accordingly, the robustness of financial structure is determined by three factors. Firstly, the nature of financing, that is, whether financing is "hedge", "speculative" or "ponzi". Secondly, the liquidity of portfolio. Thirdly, the proportion by which the current investment is debt financed.

Minsky (1982 pp. 66-67) defines hedge, speculative, and ponzi finance as follows: "Hedge finance takes place when the cash flows from operations are expected to be large enough to meet the payment commitments on debt. Speculative financing takes place when the cash flows from operations are not expected to be large enough to meet payment commitments, even though the present value of expected cash receipts is greater than the present value of payment commitments." Furthermore, Ponzi finance is "a situation in which cash payments commitments on debt are met by increasing the amount of debt outstanding."

1- There is no unanimity among economists on the definition of financial crisis. However, according to Bordo (1985) the key elements of a financial crisis are considered to be expectation of change in economic environment; fear of insolvency of financial institutions; attempts to convert real and financial assets into money; bank runs precipitated by expectancy of failure of commercial banks; reduced money supply induced by bank failures; falling real output and the price level; a decline in profits and net worth; increased bankruptcy, and debit crisis induced by decline in asset prices and the general price level.

During the expansionary phases of a business cycle, Minsky argues, the demand for financing increases. The increased demand for financing is due to improved business opportunities, and the related increased investment demand. Increased demand for investment- financing exerts upward pressures on interest rates. In the short run, excess demand for financing is met with innovative financing. Financial innovation will supply additional liquidity for increased investment demand. Rising interest rates create four conditions that are characteristics of a fragile financial environment. They generate an increase in debt financing, a substitution of short- term for long- term debt by businesses, a shift by investors toward riskier financing, that is, use of hedge to speculative and from speculative to Ponzi finance, and a reduction of the safety margin of financial institutions. If, after inducing an environment of financial fragility, interest rates continue to rise, then firms are forced to move from hedge to speculative to Ponzi financing, thus precipitating a refinancing crisis. At this stage "distress selling" may take place if the central bank fails to act as the lender- of- last- resort.

The emergence and development of a financial crisis, according to the Fisher- Minsky- Kindleberger approach, passes through several phases and often begin with a "displacement."

Displacements are exogeneous factors such as the start or end of a war, a bumper harvest or a crop failure, technological inventions or any other outside factor shocking a macroeconomic system. Displacements bring opportunities for high profitability in some industries while reducing or altogether eliminating profit-making opportunities in others. Nonetheless, business booms are caused by a substantial domination of profitable opportunities over losses. As investors attempt to take advantage of profitable opportunities by investing in potentially profitable industries, total output in the economy increases. The bank credit supplies support the boom, thus increasing the total supply of money.

What causes the instability in bank credit? The instability of bank credit is due to its highly elastic supply. This view of credit supply can be traced directly to purely monetary business cycle theorists such as R. G. Hawtry (1932). Also, one major factor that causes the high elasticity of credit supply, and therefore financial instability is the divergence between what Knut Wicksell called the "market rate of interest" and the "natural rate of interest."

According to Wicksell, the "market or money rate of interest" is the actual rate of interest which is subject to influence by the policy of the banking system. He defined the "natural rate of interest" as an

equilibrium rate, i.e., that rate of interest which brings an equality between the demand for loan capital and the supply of savings. If the banks set the money interest rate below the equilibrium or "natural" interest rate, the demand for credit will rise and the increased demand for credit will exceed the supply of savings. To meet the increased credit demand, banks have to increase the supply of credit. This increased supply of credit will generate inflation. If, on the other hand the money rate is above the equilibrium rate, the demand for credit declines, and the total savings will not be used, necessitating liquidation of credit by the commercial banks.

Commercial bankers in pursuit of profits will adopt those policies which may lead to a lowering of the market rate below the equilibrium, thus causing an expansion of credit supply. This is the main source of high interest elasticity of credit supply.

Suppose there exists some degree of speculative tendency in the economy. The tendency is subsequently transformed into an effective demand for goods and financial assets. Then, the initial rise in the aggregate demand requires additional output of commodities and higher supply of financial assets, causing prices to rise. Higher prices provide new profit opportunities, and attract yet more investors; new investments increase income, and higher income induces additional investment. This stage in the development of a financial crisis is called "euphoria." "Euphoria" emerges after extensive speculative investment demand. Extensive "euphoria" leads to what Adam Smith called "overtrading."⁽¹⁾ There are three forms of "overtrading." It may involve: (1) pure speculation in anticipation of a price rise, or (2) overestimation of prospective profits, and / or (3) excessive "gearing." While the first two forms of "overtrading" are self-explanatory, the third one, excessive gearing, requires a few words of explanation. Excessive gearing means buying on margin, or by installments, an action arising from the shortage of required cash to purchase the financial assets or the commodities of choice. At euphoric investment stage, a bandwagon effect sets in. Individuals and firms observe others making profits by speculative deeds, so they engage also in speculation. When the speculative behavior reaches an epidemic scale, defying the bounds of rational profit-seeking

1- Most of these terminologies originated with the classical economists. For example, John S. Mill used these terms in dealing with the counteracting forces against the tendency of the rate of profits to fall (Mill 1965 p. 734).

behavior, especially by people who are not normally involved in profit-making endeavors, a situation arises which is described as "manias" or "bubbles." The term "manias" refers to irrationality while "bubbles" suggests the bursting. Of course the object of speculation varies from one mania to another. The history of financial crises has shown some or all of the following as objects of speculation: primarily products, goods manufactured for export, financial securities, land and other real estate properties, foreign exchange, and of course, gold and other precious metals. As investors attempt to amass wealth rapidly, and without an adequate understanding of the process by which they expect to become wealthy, assorted forms of schemes and swindles become prevalent.

Along with the speculative boom, interest rates, the velocity of circulation of money, and prices continue to rise. In time, some insiders decide to sell out and take the profits they have made. At the peak of the mania, the number of newcomers to the market roughly cancel out the number of individuals or firms leaving the market. This results in a leveling off of prices. This is usually followed by a period of "financial distress," meaning an awareness on the part of the speculative community that a rush to liquidity by a majority of the speculators may depress the prices of commodities and securities, thus forcing some speculative borrowers into financial default. The continuation of financial distress forces the speculators to withdraw, since they realize that the prices of the objects of the speculation in the market cannot increase further.

The attempt to liquidate sometimes is orderly and at other times is chaotic, resulting in a panic. The condition for a panic arises when the speculators realize that there are not sufficient sums of money in the economy to liquidate their assets and goods holdings at their inflated prices. This is called the "revulsion" stage. Banks' "revulsion" or "discredit" against securities or commodities means the bankers do not accept securities and commodities as collateral for loans. Revulsion may lead to panic; the panic aggravates the situation, thus forcing the emergence of a stronger panic psychology. Eventually this leads to one or all of the following outcomes:

1. Prices of assets and commodities fall drastically to a point where the holders of wealth decide to hold on to their assets.
2. Trade is suspended or constrained by closing down of exchanges, or setting a price floor for the commodities or the assets.
3. "A lender- of- last- resort" convinces people that there will be sufficient sums of money available to finance the increased volume of trade.

With regard to the last alternative, there need not be an actual increase in the supply of money. A mere knowledge that there is sufficient credit around will dampen the panic psychology.

There are some questions as to the validity of this hypothesis. However, as pointed out earlier, Charles P. Kindleberger has tested this hypothesis by showing how it explained the behavior of major financial crises of the past two hundred years.⁽¹⁾

At this point, let us look at economic events in Iran in light of the hypothesis discussed above.

The Economic Boom and Bust of 1973- 1978 in Iran

The origin of the 1973-78 boom and bust in Iran can be traced to the rapid increase in oil prices in 1971, and in 1973-74. The 1971 Tehran Agreement between the Organization of Petroleum Exporting Countries (OPEC) and the major petroleum companies, produced a sharp rise in petroleum prices. In 1973, the price of crude petroleum increased at an even faster rate than it had in the previous two years. The total effect of the increase in the price of oil for Iran was a phenomenal increase in government oil revenues.

Table 1 shows the Iranian government oil revenues, government expenditure, and private domestic investment for 1972-1977.

Relying on its increased foreign exchange earnings, the government increased its expenditure by 162 percent between 1973 and 1974. In the same time period, the commercial banks credits to private sector borrowers increased by 43 percent (Tables 2 & 3). The rapid increase in private and public spending induced 61 percent increase in the money supply in 1973-74 (Table 3).

Table 1 implies that the huge rise in oil revenues during 1973-74 created tremendous profit opportunities for businesses in Iran. To use the terminology developed in the previous section, added government oil revenues created a "displacement" in the Iranian economy. The absorption of such a vast sum into the economy and recycling it back to the Western economies created major difficulties for the authorities in Iran. They tried to solve both of these problems by upward revisions of government investment and expenditures during the Fifth Development Plan, and by making easy and ample credit available to the private sector.

1- On the question of ability of this hypothesis to explain a contemporary financial crisis, see

Kindleberger, 1978, specially pp. 20- 25

In January 1974 the Plan and Budget Organization (PBO), the government institution in charge of economic development, had to examine the effect of the newly received income on the economy and devised plans to absorb the funds, revising the Fifth Development Plan, which covered the five years after March 1978.

By July 1974, the PBO had developed three alternative investment strategies that called for increases of 31, 98, and 141 percent in the existing investment plan. After closed session meetings in August of 1974 between the Shah and his top advisors, the PBO adopted an investment scenario which called for more than doubling of the initial investment outlays for the 1973- 78 period (Graham, pp. 77- 78).

The result of this unprecedented rise in government expenditures was a boom in the economy. Not only did domestic investors raise their capital outlays, but foreign businessmen, observing the emergence of another "Gold Rush," rushed to Tehran to help recycle the enormous influx of petrodollars. This is how some journalists described the situation in 1974:

"Bent on a latter day mission of tribute to Persia, a swarm of foreign businessmen descended on the baggage room of Tehran's Mehrabad Airport last week. There were Americans and West Germans, Frenchmen, Britishers, Japanese and even a few Italians among them. In their briefcases they carried dream contracts and miraculous investment projects to offer His Imperial Majesty Muhammed Reza Pahlavi ..." (Benjamin et. al. 1975 pp. 38- 43).

Tehran in those days was compared to San Francisco in the days of the great "Gold Rush." These same journalists account of Tehran in those "Golden Days" is descriptive:

"Hordes of bankers, brokers, supersalesmen and carpet baggers of every description fill the three major hotels to overflowing ... By day a haze of smog drifts skyward against the magnificent backdrop of the Elburz Mountains. By night the city's restaurant and nightclubs are jammed with expense account tycoons wolfing down cavier and struffing wads of money into the bosoms of belly dancers." (Benjamin 1975 p. 43)

The combined effect of the investors' pursuit of handsome profits was a massive increase in investment. Gross domestic fixed capital formation rose at an average annual rate of 30 percent between 1974 and 1977. The rate of increase of the GNP for the same period was over

13 percent per annum at constant prices (Table 1). The banking system was playing a major role in the development of this business boom. Table 2 below shows the liability of the private sector to the financial institutions, and the liquidity of the private sector during 1972-1977.

It is apparent from Table 2 that the financial sector, which in Iran is dominated by the commercial and specialized banks, was providing large volumes of credit to the private sector. The private sector liquidity and its liability to the financial institutions rose at an average annual rate of 40 percent between 1972 and 1978. During this period of rapid economic growth, not only did the volume of credit to the private sector increase, but also the number of commercial and specialized banks and their branches rose as well. There were some 25 banks in all of Iran in 1972. During the next five years, the number of banks increased 44 percent to 36 banks. The rate of increase in the branches of banks was also phenomenal. In 1973 there were 1,238 bank branches in Iran. This number rose more than five-fold to 7,919 in 1977 (*Bank Markazi Iran*, 1977, p. 106). The rapid rate of increase in the number and activities of Iranian banks in this particular period of Iranian history is not accidental. There is evidence to show that the expansion in banking activities was in accordance with the policy of absorption and recycling on petrodollars.

It is instructive to point out that the new commercial banks were being established by the close associates of the Pahlavi family. A portion of existing commercial banks' assets also belonged to the Shah, through the Pahlavi Foundation, or to his close relatives or associates. It has been estimated that "... directly or indirectly, the Foundation controls over 15 percent of the commercial banking system" (Graham, p. 160). In addition to such direct control of the banking system, the Shah and his family had extensive contact with and influence over the banking system in Iran through a system of interlocking directorates among industrial and commercial concerns.⁽¹⁾ Additionally, former monetary authorities were selected as the chief executive officers of commercial banks. For example, in 1973, at least three former commercial banks' chief executive officers were employed by the Central Bank of Iran; two of them had served as Governors of the Central Bank and the third as Director of the Central Bank Exchange Control Department. Furthermore, the structure of the banking system was highly concentrated. The five largest banks controlled 70 percent of all loans,

1- for extensive holdings of the Pahlavi Foundation, see Graham, 1978, Chapter 9 and Appendix.

and 75 percent of the total deposits of the banking system (Rooney, 1982, p. 192). Furthermore, the control of the banking system by the Shah and his close associates enabled them to acquire loans far in excess of the equity capitals of their various enterprises. Having liquidated their equity capital at values above the actual market prices, the owners of these enterprises commenced an enormous transfer of capital abroad.

Table 3 shows the actual and the rate of change in the supply of money and credit for 1973- 1977 and 1979.

Unfortunately, macroeconomic time series for 1978, the year of revolutionary turmoil, are not available. However, the trends for the money and credit supplies indicate that the rate of growth for these variables continuously rose over the 1977- 1979 period. In spite of the monetary expansion, the relatively restrictive fiscal policy that was initiated by the government in late 1977, and a drop in the private investment demand, started the onset of a major recession that had dire political consequences for the nation.

At this point we trace, within the framework of Fisher- Minisky-Kindleberger hypothesis, the Iranian financial history during 1973- 1978. During the economic upswing of 1973-77, there was feverish speculation in Iran. The *object of speculation* was primarily real estate, although speculation in corporate stocks and carpets was also widespread.

The most immediate cause of the speculative activities in real estate was a change in the government housing policy in April 1973 which prohibited for at least five years all housing construction in Tehran and its suburbs by the Ministry of Housing and Urban Development and the private sector. The ostensible reason for the government decision was to dampen the rising prices of construction materials caused by the inadequate supply of those commodities. At this time, the Iranian government was engaged in construction of numerous military installations throughout the country so that "the implementation of certain government construction projects of high priority necessitated the transfer of a greater part of construction activities to the government". (*Bank Markazi Iran*, 1974, p. 91).

Due to a lagging housing supply, and rapidly, rising demand for housing in Tehran and other major cities, the prices of real estate skyrocketed. For example, the price of land in certain localities in Tehran increased 150 times in a period of 12 years. *Tehran Economist*, as noted before, a magazine with a close relationship with big businessmen and bankers, wrote the following in a 1974 editorial: "Unfortunately, land speculation in the cities is a factor in inducing the banks to open up more branches than is necessary, because if the

property (of the bank's branch) belongs to the bank the price of land goes up and if it is rented, the good will money increases". (*Tehran Economists*, 1974 c, p. 3).⁽¹⁾

A cursory review of Iranian business periodicals in this period reveals that by mid- 1974 a full- fledged *mania* or *bubble* had developed in Iran. In addition to the major corporations, the commercial banks, and wealthy individuals, the people of moderate means had now joined in the speculative activities. Again the (*Tehran Economists* 1974b, p. 13) wrote: "*one reason that ordinary people with normal means* (emphasis supplied) have tended to buy land is the present rate of inflation in this country. Another reason is the rising price of land and many people with moderate incomes have tried to take advantage of this situation."

Although the government passed a law discouraging speculation in real estate, there is ample evidence showing that the law was ineffective in achieving its objective. A passage in the *Tehran Economists* (1976 b, p. 3) very well sums up the situation:⁽²⁾

"A significant portion of capital and savings was being allocated to land speculation until the land law was passed two years ago. At that time the land transactions were the most substantial part of economic transaction of the country. We were making comments on this for 21 years. Once in a while these were effective but the numerous individuals and groups who had gained profits of millions and perhaps tens of millions of toman from these transactions were

1- A toman is equal to 10 rials, and equivalent of 12 cents at the going exchange rate at the time.

2- Due to the unavailability of certain publications in the U.S., it is not possible to establish the extent of personnel interrelationships between the commercial banks and the Central Bank for the period of 1974- 1978. However, it is reasonable to assume that commercial banks greatly benefited from the "expertise" of the Central Bankers as verified by this statement by the *Tehran Economist*, (with English edition) a business publication with close ties to the government and business community under the Shah: "... the Central Bank of Iran has loaned the Bankers' Association some of its top bankers." (*Tehran Economist*, 1973, p. 3)

trying to prevent any important steps being taken against land speculation. Finally, such a law was passed two years ago and this prevented the expansion of land speculation."

However, because of the increased demand for housing, the author argued, the price of real estate increased again:

"This increase may be estimated at 100 percent to 150 percent in different areas of a city like Tehran. In other words, even after the Land Law was passed, other factors caused the price of land to increase."

Apparently the 1973-78 boom peaked in 1976, although the trend of economic activities continued to be strong in 1977. Inflation was on a rampage by the end of 1977. In the urban centers, the cost of living was increasing by over 25 percent per year (*Iran Economic News*, 1978 b, p. 3). The rapidly increasing aggregate demand coupled with production bottlenecks, particularly shortage of skilled manpower, were primarily responsible for inflationary pressures in the economy.

In 1974 the government had adopted a price control program which was introduced to curb inflationary pressure. This program was primarily directed toward small businessmen, corner grocers, butchers, and the like. It was aimed at small businesses that supplied food to the population. The price control program was retained until 1978 without, of course, any success in containing the inflationary pressure, but with serious political consequences for the Shah's regime.

Added to the problems of inflation and strategic economic bottlenecks was a sudden decline in the growth rate of oil revenues. In 1977, the government's oil income declined sharply amidst the ever-rising credit and money supply expansion by the banking system (*Iran Economic News*, 1977 a, p. 1). However, the total government revenues from oil and natural gas rose modestly by 5 percent, a rise which proved to be inadequate in the face of ever-rising demand for money and credit.

Due to the rapid increase in demand for liquidity on the part of both private and public sectors, a reduction in the rate of growth of oil revenue, and a relatively tight monetary policy in late 1977 and early 1978, the banking system experienced a credit crunch. The decline in the private sector's liquidity was echoed by the *Tehran Economists* (1976 a, p. 26) which reported that the bankers were complaining "... about the shortage of liquidity in banks, especially the small banks ...". The shrinkage of liquidity in late 1977 and early 1978 was partially caused by a modest rise in the discount rate, a credit rationing, and a

nominal increase in the interest rate ceilings by the central Bank.

One factor that may have been responsible for the shortage of liquidity in the banking system was capital flight. Table 4 shows the net short and long term capital flow for the economy during 1973 and 1979. According to the data, rapid outflow of capital during 1974 and 1976 reduced monetary base of the banking system, thus slowing the rate of growth of money supply below what it might have been in the absence of capital flight from the economy.

According to the financial instability hypothesis, this is the period of *financial distress*. And it was during this period of financial distress that many well-to-do Iranians liquidated their properties and left the country for Europe and the United States.

A large number of these people sold their price-inflated houses, lands, or businesses and transferred their funds abroad, thus forcing real estate prices to decline (*Iran Economic News*, 1978a, p. 6).

A decline in the value of real estate combined with the liquidity squeeze created an atmosphere of panic in mid 1978. To ward off the growing panic psychology and in pursuit of attainment of yet higher profits, the Iranian banking system appealed to "the lenders-of-last-resort" by entering in international capital market.

The commercial and specialized banks continued to expand the supply of credit by borrowing from the Central Bank of Iran and foreign commercial banks. According to the Central Bank of Iran: "The net increase in the foreign exchange liabilities of specialized banks rose from 40.9 billion rials to 53.3 billion rials during 1976-77. The net increase in these banks' liabilities to the Central Bank of Iran amounted to 10.4 billion rials for the same period." And so far as commercial banks' borrowing was concerned, "during 1976, the commercial banks' foreign exchange liabilities rose by 25.8 billion rials, while their borrowings from the Central Bank increased by 20.5 billion rials. Additionally net savings and government deposits at the commercial banks amounted to 30.9 billion rials which assists these banks to meet their liquidity shortage" (*Bank Markazi Iran*, 1977, pp. 102-103). In retrospect, this "lender-of-last-resort" policy failed to achieve financial stability.

Apparently a number of factors including run-away inflation, speculation, an acute shortage of housing and of other commodities, and repeated blackouts in Tehran were in the mind of the Shah when on August 6, 1977, he replaced his Prime Minister of twelve years, A. A. Hovayda, with J. Amuzegar, an old-hand technocrat with supposedly top problem-solving capabilities.

Prime Minister Amuzegar's top priority was to solve the economic problems enumerated above. Thus in his government's budget presentation to the Parliament he set for his Cabinet the task of "The campaign against inflation, extravagance, and inefficiency and to overcome infrastructural shortages." (*Iran Economic News*, 1978, p.1). He specifically proposed the following policies to achieve the above objectives (*Iran Economic News*, 1978a, and Amuzegar, 1977):

1. Shelving of "low priority" development projects
2. A freeze on hiring by government agencies and ministries
3. A 22% cut in government subsidies on basic foodstuffs
4. Linkage between wages and worker's productivity
5. Maintenance of profits at a "reasonable" level
6. Enactment of legislation to discourage and forbid real estate speculation.

The tough anti-inflationary policy of the government did not stabilize prices (the consumer price index in urban centers rose by 14.5 percent between the third quarter of 1977 when Amuzegar became Prime Minister and the third quarter of 1978). However, it had major financial repercussions with a devastating political spillover. The anti-inflationary and contractive monetary-fiscal policy dampened the prospect for profit-making, weakened businesses' ability to fulfill their contractual commitments, increased unemployment rate, and generally created an atmosphere of pessimism among the business community, particularly small and traditional businessmen of the Bazaar. By the beginning of 1978 the financial crisis had induced a massive political crisis as well⁽¹⁾. In the midst of political violence and economic paralysis in the second half of 1977, the hoarding of the money increased in the country. A banking run occurred, and in August 1978 a total of 34 billion rials was withdrawn from saving accounts. The Central Bank responded to the desperate situation by expansionary monetary policy, but of no avail. The discount rate, the required reserve ratio, and compulsory purchases of government bonds by the banks were all reduced (Rooney 1982 p. 193). However, the expansionary monetary policy failed to dampen the panic psychology.

Under the revolutionary chaos, the political and economic crises were reinforcing each other. Feeling intense political pressure, the Shah

1- A discussion of socio-political events during 1978 in Iran is beyond the scope of this paper.

For a complete discussion of these issues see (Soofi, 1981).

left Iran in January 16, 1979, and shortly thereafter, the revolutionaries took power and established the Islamic Republic in mid- February 1979.

After the triumph of the revolution, the provisional government of Mr. Bazargan inherited a large number of bankrupt private commercial banks. The debtors, who had by now fled the country, were in default, and factories, held as collateral for bank loans, were idle. The bankruptcy of many commercial banks seriously threatened to cause the complete collapse of the monetary system. Therefore, to avoid such an outcome, after three months in power, Mr. Bazargan's government nationalized Iranian private commercial banks. Since then the government in Iran has eliminated interest payments and receipts from the process of banking.

Conclusion:

It is shown by other writers that the financial instability hypothesis gives a reasonably good explanation of the major financial crises in Europe and the United States. This paper traces the history of oil boom and bust in Iran during 1973- 1978. It shows how a displacement (massive increase in oil revenue) in the Iranian economy in 1971- 1973 gave a strong impetus to investment and government spending, created speculative manias in real estate and carpet markets, and finally resulted in overheating of the economy and high inflationary pressure. The conventional anti- inflationary policies, structural bottlenecks and shortages, and a slow growth in oil revenues helped to set the stage for popular political dissents and strikes. The ensuing political instability undermined the political authority of the government, increased uncertainty among investors, and encouraged massive capital flight. A combination of political- economic factors further destabilized the situation. The leading public and private sector personalities left the country. Under the pressure of the chaotic political situation, conventional policy measures of responding to panic selling were adopted, but they failed to restore confidence in the political- economic structure of the country within the business community, and the general public. Failure of the expansionary monetary policy led to further panic psychology, bank runs, and capital flight. The political and economic factors were dynamically interactive, that is, one set of factors was feeding into another and vice versa, ultimately leading to complete political and economic collapse.

In spite of the highly unusual circumstances in which the 1977- 1978 financial crisis ran its course, the foregoing analysis suggests that the Minsky- Kindleberger hypothesis is useful in identifying the main

reasons for occurrence of financial instability in an economy that is characterized by unsophisticated financial intermediation. Thus, it complements earlier studies that deal with the financial fragility of advanced capitalist economies.

TABLE 1
IRANIAN GOVERNMENT OIL AND NATURAL GAS REVENUES, GOVERNMENT
EXPENDITURES, AND PRIVATE DOMESTIC GROSS INVESTMENT, 1972- 1977
(In billion current rials)

Year	Oil and Natural Gas Revenues (in billion current rials)		Government Expenditures (in billion current rials)		Private Domestic Investment (in billion constant rials)	
		Percent Rate of Change		Percent Rate of change		Percent rate of Change
1972	178.2	—	359.1	—	198.9	—
1973	311.3	+75.0	478.0	+33.0	200.2	+0.5
1974	1,205.2	+287.0	1,254.4	+162.0	225.2	+12.0
1975	1,246.8	+3.5	1,569.4	+25.0	451.4	+100.0
1976	1,421.5	+14.0	1,874.0	+19.0	509.8	+13.0
1977	1,497.8	+5.0	2,422.8	+29.0	505.4	-1.0

Source: Bank Markazi Iran, *Annual Report and Balance Sheet, 1977* (Farsi dition).

TABLE 2
TOTAL LIABILITY OF THE PRIVATE SECTOR TO THE FINANCIAL INSTITUTIONS, AND
LIQUIDITY OF THE PRIVATE SECTORS, 1972- 1977 (in billion current rials)

Year	Amount of liability	Rate of	Liquidity of	rate of
	at the end of the year	change %	private sector	change %
1972	365.9	—	400.0	—
1973	396.8	36.0	518.0	29.0
1974	710.2	43.0	815.7	57.0
1975	1,103.2	55.0	1,156.5	42.0
1976	1,549.8	40.0	1,626.3	41.0
1977	1,921.5	24.0	2,139.5	32.0

* Liquidity is defined as currency, coin, demand deposits, and time deposits.

Source: Bank Markazi Iran, *Annual Report and Balance Sheet, 1977*, pp. 278- 280

Table 3
Supply of Money and Credit by the banking System
(1973- 1979) (Billion current rials)

Year	Money Supply*	Rate of change %	Credit Supply to the private sector	Rate of change %
1973	202.70	28	496.8	36
1974	327.20	61	710.2	43
1975	446.50	36	1,103.2	55
1976	611.20	37	1,549.8	40
1977	790.50	29	1,921.5	24
1978	NA	--	NA	--
1979	1,665.8	--	2,577.4	--

* Defined as Coin, Currency, and Demand Deposits.

Source: Bank Markazi Iran, *Annual Report and Balance Sheet*, Various issues.

Table 4
Short- and Long- term Capital Flow, 1973- 1979
(Million dollars)

Year	total Capital flow
1973	459
1974	(5,066)
1975	(3,949)
1976	(5,007)
1977	(2,590)
1978	(1,683.5)
1979	(110.2)

Source: Data for 1973 to 1977 are from International Monetary Fund, *International Financial Statistics*, October 1978. Data for 1978- 1979 are from Bank Markazi Iran, *Annual Report and Balance Sheet*, 1978.

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