

RESEARCH ON THE EFFECTS OF WTO ACCESSION ON PROFITABILITY OF SELECTED INDUSTRIES IN TEHRAN'S STOCK EXCHANGE

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ABSTRACT

In line with growing membership of countries in World Trade Organization (WTO) and their subsequent utilization of the benefits of customs tariff and taxation during time, activity of non-member countries' exporters will be much more limited as a result of high costs and customs tariff obstacles. Thus membership in this organization as an evidence of globalization provides an easier way to access welfare and development. So the current study attempts to evaluate the influences of Iran's accession to WTO on profitability of five active industries in Tehran Stock Exchange by using an econometric method and panel data technique based on the data obtained during the period of 1993-2012. The estimated model is based on SUR method and also by using Generalized Least Squares (GLS) Technique. The results of five studied industries show the negative and meaningful impact of import tariff on industry profitability so that by a decrease in import tariff, industries profitability will be increased, but two other variables namely inflation rate and exchange rate have positive and meaningful relationships with industries profitability, and positive impact of inflation rate is much higher than exchange rate. Also the results from the estimated profit function showed that Iran's membership in WTO and omission of import tariff have maximum and minimum negative impact on the profitability of automobile and part industry and also machinery and equipment industry, respectively.

Keywords: *World Trade Organization, Tariff, Inflation, Exchange, Profitability, Panel Data, Stock Exchange*

INTRODUCTION

WTO as an international organization was established in Geneva in Switzerland in 1995 to monitor and liberate goods trade and ownership service and rights throughout the world and to settle disputes between the members. Inspired by the free market ideas, this organization does not believe in state regulation of market and restrictions imposed by political units on political activities and calls for reducing the state's role in trade and limiting its role to create the right climate for investment (Navazony, 2011). WTO has now 120 members that control more than 97 percent of world trade. Therefore, almost entire world trade is controlled and regulated by the members of this organization. The rules and regulations of WTO have turned into international norms and Iran, whether as a member or not, should follow such rules (Fathollah, 2013). In the era of economy globalization and increasing development of nations' mutual dependence and also joining all the world economic powers to WTO, the nations of weak economy which are going to join the organization have been challenged by numerous problems including import and export restrictions, inability to utilize the relative advantages of national economy, inability to attract foreign investment, lack of easy access to the markets of other countries, etc. On the other hand, joining to this organization is accompanied by different problems including threat of nations' sovereignty, free entrance of powerful foreign companies to the domestic market, financial problems or even bankruptcy of industries with lower competitive prices, and reduced autonomy in economic decision making (Hosseini, 2007). The study of the consequences of business liberalization in developed and developing countries has always attracted attention of researchers. In Iran, several studies have attempted to examine potential impacts of reducing import tariffs as a part of a policy package needed to join the World Trade Organization. Given the significance of benefit factor to attract higher investment and further development of Iran's industry, and as profit is an instrument to accumulate higher amount of capital, the

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present paper attempts to analyze and estimate the potential impacts of Iran's incorporation into WTO with an emphasis on omitting import tariffs on profitability of the industries selected in the form of the econometric models using panel data.

Research Literature & Background

Tariff is a tax on the transportation of goods and services from the borders of a country. Customs tariff is the most important trade policy instrument basically to protect domestic producers. Along with such income impact, tariff's redistributive effect and its role in promoting infant industries should not be ignored. Pursuant to Article 2 of the Law on Amendment of some acts in Third Economic, Social and Cultural Plan of Islamic Republic of Iran, tariff rate includes customs duties, taxes, order registration fee, various fines and other amounts received from the imported goods and also commercial profit determined by the Council of Ministers and it can be obtained from the following equation:

$$TRR = \left[\frac{\text{customs duties} + \text{commercial profit}}{\text{value of imports}} \right] \times \left(\frac{P_m}{P_d} \right)_t$$

TRR= the average rate of imported commodities tariff

$\left(\frac{P_m}{P_d} \right)_t$ = index ratio of imported commodities to the price of produced and consumed commodities in the time t to base year constant price (Dehqani et al., 2007).

Inflation: inflation is disproportionate or indiscriminate increase in the general price level in a continuous and meaningful way. Whenever, in economy, efficiency and utility of production factors increase higher than the last period and such increase appear in quantitatively or qualitatively in national production, however, the general level of prices increases in proportional to the excess of productivity at a time, the increase in the general level of prices could not be taken into account as inflation (Roozbahan, 2005)

Regarding the relationship between inflation and the degree of economic openness, it can be said that increase in the degree of economic openness reduces the effectiveness of unforeseen monetary policies and has caused these policies to raise prices and have lesser impacts on actual production. In addition, in a more open economy, the reduction in actual price of currency due to monetary policies has not been predicted. As a result, negative impact of exchange relation will have more negative effects on the welfare of people. Therefore, motivation of monetary authorities in generating inflation will be reduced. This mechanism has been studied in the form of Romer's model. David Romer, in an article entitled "the openness of the economy and inflation" explains the impact of the openness of economy on its domestic inflation with an example. Romer believes that the benefits of an unexpected monetary expansion will be lower in more open economies. Therefore, assuming that monetary policies acts are applied in accordance with the discretion of monetary authorities rather than a fixed rule, monetary authorities' incentive to create inflation will be lower in more open economies. Roemer offers a model to explain its view that, in fact, a macroeconomic model is the assumption of imperfect competition and prices are inflexible in terms of the (Tayebnia and Zandiye, 2008).

Exchange Rate: The real exchange rate as a measure of a nation's currency value versus the currencies of other countries reflect the economic situation of a country compared with that of other countries (Guerin et al., 2006).The real exchange rate is obtained by multiplying the informal market rate of exchange by the ratio of America's producer price index to Iran's consumer price index. Therefore, to calculate the real exchange rate the following model can be used (Kazerooni et al., 2010).

$$RER = ER \times \left(\frac{P}{C} \right)$$

RER: real exchange rate

ER:the unofficial market rate of exchange

PPIus: the producer price index

CPI_{IR}: consumer price index in Iran

Some economists believe that increase in exchange rate has an expanding impact on economy. By an increase in exchange rate, the amount of exports in economic firms increases, and due to the high price of imports, imports will be reduced. So firms can achieve a higher amount of profits. In contrast, some

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believe that increase exchange rate has a contracting impact on economy because such increase leads to the increase in production savings and import capital commodities, increase in investment costs, and consequently reduced profitability and production. Variations in exchange rate can change the price of commodities and service, savings and receivables, in turn, it may influence present and future cash currents, profit and also the efficiency of economic firms (JalaliNaeini and QalibafAsl, 2002). Operating profit (loss): such profit (loss) emanates from companies operation. If operating costs are deducted from margin profits, operating profit is obtained. This type of profit is the best indicator for operational performance of management in a business unit (Tehrani, 2011). Among the internal studies conducted on Iran's accession to the WTO, the closest study to the present study is the one conducted by Ashrafzadeh and Nasirzadeh (2008). They studied the impact of globalization by using the variables namely ratio of exports and imports to GDP, tariffs, total productivity of production factors and the ratio of capital to labor on the profitability of the industries. In this study the price-wage gap was used as a measure of industries profitability. The model was estimated by a heterogeneous dynamic data panel and the fusion groups mean method. The results obtained in this study showed that the sign of each our variables are positive, and tariff has the maximum and ratio of export-import to GDP (Gross Domestic Product) has minimal impact on the profit. Therefore, the impacts of tariff reduction in the form of accession to the WTO will reduce the profitability of industries, and increasing trade volume has minimal effect on profitability. In another study, using econometric methods, Dehghani *et al.*, (2008) examined the impacts of Iran's membership in WTO on industry. The results from the study based on the analyses performed since 1971-2006 indicated that in case Iran join the WTO, and if average rate of exported commodities tariff increase by 40%, industrial imports will be increased by 200.2%. Also, if average rate of imported commodities tariff decrease by 14%, industrial import and net industrial export will be increased by 194.6%.

Aziznejad *et al.*, (2011) studied the impact of variables such as tariff rates, per capita real income, relative prices, the level of international trade and integration into the international trade on import of intermediary-capital commodities. In the present study, to estimate the studied commodities demand function, Johansson model and the vector error modification pattern were used. The study results indicated that long term function of import of such goods has a higher sensitivity to international trade and integration into international economy and lesser sensitivity to tariff rate and relative prices during the studied period of 1986-1999. Shock effects and variance analysis also shows that the effects of shocks to the demand for imports during the 3-year study tend to zero and changes in import demand for capital-intermediate goods experiences the greatest effect of integration into international trade. Tabibnia and Zandieh (2008) in a study entitled "the effects of globalization on inflation in Iran" examined the impact of variables such as internal growth, changes in the relative price of imported goods, globalization, economic prosperity and recession on inflation using a VAR (Vector Auto Regressive) model. The study results indicated that:

- 1-As the economy is more open and more broadly to the process of globalization the influences of domestic business cycles on inflation will be reduced and also it undergoes less volatility
- 2- Increase in the relative price of imported goods has acted as a supply shock in economy and increases inflation.
- 3-Booms and busts of Iranian trading companies have been transferred to Iran through trade and domestic inflation triggered.

Nahid and Nikbakht (2009) in their study examined the relationship between real exchange rate volatility and dividend index and stock prices on the stock exchange. So they used GARCH models to estimate volatility of a variable and destabilizing effects of the volatility on that variable. In this study, the monthly data of real exchange rate, dividends and stock prices during the period 2005 to 2007 were used. The estimation results of the research model in an OLS way indicate a positive relationship between the volatility of the real exchange rate dividends and stock prices.

Using econometric methods and through data experimental analysis during 20 past years. Zhiming *et al.*, (2013) in their study entitled " the influence of China membership in WTO on its economic growth",

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examined some variables such as foreign trade, foreign direct investment, technological progress, and China's physical capital accumulation on China economic growth.

The results suggest that joining the WTO by variables such as foreign direct investment and foreign trade indirectly cause physical and human capital accumulation and thus impact on China's economy. However, there is no significant relationship between joining WTO and some variables such as technological progress.

(Gash and Rao, 2010) in their study found that following China's membership in WTO, China's relationship with other countries increased, for example, China's real GDP increased by more than 2%. All industries, except automobile and agricultural industries, while especially raw material and clothes industries took privilege of this membership. In addition, China's integration into global economy through membership in WTP enables China to maximize its relative profit in production goods and goods relevant to user industries.

Lee and Wong (2012) performed a study on the impact of financial liberalization on liquidity of Shanghai stock market in China following China's membership in WTO. The study was done on 50 stock companies listed in Shanghai Stock Exchange. The results show the positive and significant impact of financial liberalization on the economy and liquidity of the stock exchange.

In this study, the indicators of financial liberalization such as capital account, banking system and stock markets are examined. The results not only indicate increase in liquidity and improved efficiency of capital assignment in China market, but also show susceptibility of China from a financial stability view. In addition, increased liquidity in market has led to the increased economic efficiency.

Ansari (2009) in a study entitled "the impact of globalization on the integration of the stock market" investigated monthly data from 10 great markets from 1990 to 2005, including Australia, Canada, France, Germany, Hong Kong, Japan, Singapore, Ukraine and the United States. This study which uses Johansson Integration Method to test long term equilibrium relationships between different markets showed that in the markets with lower efficiency, volatility of prices takes place randomly and unpredictably. The test results led to the formation of a large number of equalized vectors which show a long-term equilibrium relationship between markets. Thus, it appears that globalization have significant impacts on international financial integration.

(Siplack and Usiel, 2004) in their study entitled "estimating exports and imports for Turkey after the membership", using the vector self-explanation method, examined the relationship between economic variables such as real exchange rate, decrease in the value Turkish Lira rates, tariff rate with decrease in commercial account.

3-Data and Methodology: To obtain data on the tariff, the weighted average import tariff indices were used. For this purpose, a goods category was defined for each industry, then on the basis of the harmonized system (HS) of goods specification and coding for any item available in each industry, input income (tariff rates) was extracted and then multiplied by import value (in Rials) of the same goods in the same year.

Therefore, the weighted average tariff rate for each of the target industries over the years was obtained. The data on inflation rate and exchange rate were extracted from central Bank of Iran, the data on the profit were extracted from Rahavard Novin Software, and statistics related to goods import value were extracted from the website of Iran Customs, and Tehran Industries, Mines & Trading Organization.

The statistical sample in the study was obtained from seven industries listed in Tehran Exchange Market in the period 1993-2014, which they are significantly impacted by import tariff rate and include petroleum products industry, pharmaceutical industry, chemical industry, automotive and parts industry, Chemicals free from cosmetics industry and machinery and equipment industry and cosmetics industry.

The Hypotheses of the Present Study are as Follows

Primary Hypotheses

-Iran's membership in WTO significantly impacts the profitability of the selected industries listed in Tehran Stock Exchange

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Secondary Hypotheses

- 1- The omission of import tariff significantly impacts the profitability of the selected industries listed in Tehran Stock Exchange.
- 2- Changes in inflation rate significantly impacts the profitability of the selected industries listed in Tehran Stock Exchange.
- 3- Change in exchange rate significantly impacts the profitability of the selected industries listed in Tehran Stock Exchange.

In the present study, the model estimation method is based on a combination of data; this method is a compilation of time series information (1993-2012) and cross-section data of seven selected industries in Tehran Exchange Market. The software program used in the present study is Eviewse8. The estimated model for the hypotheses test is based on SUR method and GLS.

4-Model (I): Dynamic Model

$$\text{Model: } \text{prof}_{it} = \beta_0 + \beta_1 \text{Tarif}_{it} + \beta_2 \text{inf}_{it} + \beta_3 \text{exch}_{it} + \beta_4 \text{prof}_{it-1} + \varepsilon_{it}$$

prof_{it}: Profitability, industry i in the year t (unit: million Rials)

Tarif_{it}: Import tariffs, industry i in the year t (unit: percent)

inf_{it}: Inflation rate, industry i in the year t (unit: percent)

exch_{it}: Exchange rate, industry i in the year t (unit: Rials)

prof_{it-1}: Profitability, industry i in the year t-1

ε_{it} : a component of error

Table 1: The Results from the Dynamic Model

Constant Effects Model	Coefficient	Standard Deviation	Statistics t	P-Value
C	-5/32×10 ⁹	1/19×10 ⁹	-4/4534	0/0000
	-2/56×10 ¹⁰	2/90×10 ⁹	-8/8368	0/0000
	9/54×10 ⁹	4/06×10 ⁹	2/3477	0/0205
	702612/5	116837/5	6/0135	0/0000
	0.122163	0/108859	1/1222	0/2640
Specific Intercept of Each Industry				
Intercept of Industry 1	15027997			
Intercept of Industry 2	1/77×10 ⁹			
Intercept of Industry 3	1/48×10 ⁹			
Intercept of Industry 4	1/04×10 ⁹			
Intercept of Industry 5	-1/87×10 ¹⁰			
Intercept of Industry 6	7/34×10 ⁹			
Intercept of Industry 7	7/05×10 ⁹			
R²	0/73			
	0/70			
D.W	2/1			
F-Fisher	33/20 (prob. =0/0000)			

Based on the results in the Table 1, firstly the dynamism of the model was examined. As it is observed, given that the calculation statistics of the significance coefficient AR(1) is 1.1222, and also for 0.05, the amount of probability related to the t test is 0.26, it is specified that this coefficient is significant at 74%. So, given the lower amount of significance, it could be said that the dynamic hypothesis and dynamism of the model is rejected. The independent variables significantly influence the dependent variable (profit). The variable namely imports tariff rate has a negative significant impact, and for every one percent increase in tariff rate, the profitability of industries will be reduced to 25600 million Rials. However, the variables exchange rate and inflation rate have a significant positive impact on the profit of industries, and

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for every one percent increase in inflation rate and one unit increase in exchange rate, the profitability of industries will be increased to 9540 million and 702613 Rials. The coefficient of determination obtained indicates that the explanative variables of the model can explain 73% of the changes in the dependent variable. Given the modified coefficient of determination (70%), it is specified that this coefficient is high and is capable of defining an appropriate model. Durbin-Watson statistics computed (D.W =2.18) indicates the absence of autocorrelation in the model and based on the F Fisher test statistics (33.205), the fit of the total regression is valid. Due to the fact that, in the fusion method, for each of the sections (industries) an intercept is presented separately, therefore it is possible to write for each industry a model and it could be concluded that an industry with the largest intercept has a higher profitability than other industries.

The Overall Model in a Dynamic State

To compose the model for every industry, it is necessary to add intercept at each industry by the intercept of the overall model and to replace it with by the overall model.

Industry 1) Petroleum products

$$\hat{\text{prof}}_{1t}$$

$$\hat{\text{prof}}_{1t} = (-5.$$

Industry 2) Pharmaceutical

$$\hat{\text{prof}}_{2t} = (-5.$$

Industry 3) Chemicals

$$\hat{\text{prof}}_{3t} = (-5.$$

Industry 4) Chemicals free from cosmetics

$$\hat{\text{prof}}_{4t} = (-5.$$

Industry 5) Machinery & equipment

$$\hat{\text{prof}}_{5t} = (-5.3$$

Industry 6) Automobile and Parts

$$\hat{\text{prof}}_{6t} = (-5.$$

Industry 7) Cosmetics

$$\hat{\text{prof}}_{7t} = (-5.3$$

In the above model by considering a different intercept for each industry, the petroleum industry has the highest intercept (profit), and machinery and equipment industry has the lowest intercept.

5-Model (2): Static Model

$$\hat{\text{prof}}_{it} = \beta_0 + \beta_1$$

Given the non-significance of the coefficient AR(1) in investigating the dynamic process of the model, the static model is estimated to evaluate the effect of independent variables on the dependent variables

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without the presence of a lag independent variable. First, to investigate the model, fixed effects or random effects of Housman Test are taken into account. Based on the results of the Housman test, the fixed effects method is inconsistent and random effects method should be used.

Table 2: Housman Test Results

The Type of Test	Housman Test
Value of Statistics	0/0000
P-Value	1/0000
Type of Model	Random Effects

Source: the research calculations

Table 3: The Results from the Static Model

Random Effects Model	Coefficient	Standard Deviation	Statistics t	P-Value
C	-4/72×10 ⁹	1/17×10 ⁹	-4/0392	0/0001
	-2/32×10 ¹⁰	2/72×10 ⁹	-8/5565	0/0000
	8/89×10 ⁹	4/07×10 ⁹	2/1847	0/0307
	602317/7	108875/7	5/5321	0/0000
Specific Intercept of each Industry:				
Intercept of Industry 1	2/29×10 ⁸			
Intercept of Industry 2	1/80×10 ⁹			
Intercept of Industry 3	1/54×10 ⁹			
Intercept of Industry 4	1/15×10 ⁹			
Intercept of Industry 5	-1/777×10 ¹⁰			
Intercept of Industry 6	6/52×10 ⁹			
Intercept of Industry 7	6/49×10 ⁹			
R ²	0/67			
	0/65			
D.W	1/85			
F-Fisher	29/903 (prob =0/0000)			

As is evident in the results, the variable namely import tariff rate has negative effect on the earnings variable and it can be said for every one percent increase in the tariff rate, interest will be reduced by 23200 Rials. Therefore, the first hypothesis of the research regarding the impact of omitting imports tariffs on the impact of omitting import tariffs on the profitability of the industries selected will be confirmed. Given the results presented in Table 3, it can be said that the variables namely inflation rate and exchange rate have a significant positive impact on profitability; in other words, for every one percent increase in inflation rate and one percent increase in exchange rate, the profitability of industry will be increased up to 8890 million and 602318 Rials, respectively.

Therefore, the second and third hypotheses of the research regarding the impact of inflation and exchange rate on the profitability of the industries studied, is confirmed. Also like the previous model, the inflation rate due to greater value of its estimated coefficient in comparison to the exchange rate has more impact on the profitability of industries.

By converting the dynamic model into a static model and elimination of AR (1), in addition to changes in the estimated coefficients, the coefficient of determination (R²) has changed by 67%, and the coefficient of determination adjusted has changed by 65%, and the Durbin-Watson statistic is equal to 1.85 and Fisher F-statistic is 29.903, indicating the suitability of overall regression fit. In this case, we can write a model for every industry, and we can conclude that industry with the highest intercept has the highest profitability compared to other industries.

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The Overall Model as a Static State

Industry 1) Petroleum Products

$$\hat{\text{prof}}_{1t} = (-4.72)$$

Industry 2) Pharmaceuticals

$$\hat{\text{prof}}_{2t} = (-4.72)$$

Industry 3) Chemicals

$$\hat{\text{prof}}_{3t} = (-4.72)$$

Industry 4) Chemicals free from cosmetics

$$\hat{\text{prof}}_{4t} = (-4.72)$$

Industry 5) Machinery & Equipment

$$\hat{\text{prof}}_{5t} = (-4.72)$$

Industry 6) Automobile and Parts

$$\hat{\text{prof}}_{6t} = (-4.72)$$

Industry 7) Cosmetics

$$\hat{\text{prof}}_{7t} = (-4.72)$$

Table 4: A Summary of the Effect of the Independent Variables on the Dependent Variables

Profitability of Industries	Dependent Variable Variables	Independent Variables
Negative & Significant Effect	Imports Tariff	
Positive & Significant Effect	Inflation Rate	
Positive & Significant Effect	Exchange Rate	

In the static model by considering a different intercept for each of the industries, automobile and components industry is the most profitable and least profitable is the machinery and equipment industry.

Conclusion

The results of the model show that the effect of tariff's commercial policy on industries profitability is negative and significant. In this regard, it can be said that the trade liberalization (reduction or elimination of tariffs) decreases the prices of raw materials and intermediary commodities, reduces production costs and finished price of goods sold and thus increases profits. On the other hand, reduction of tariffs leads to a reduction in the domestic prices of imported goods and also increases demand for it. As a result of increase in demand, the rate of production and sales and ultimately profitability will be increased. The mechanism of the effect of inflation is in a way that manufacturing companies can observe their mutual impacts on their own activities. In fact, inflation gives rise to the increase in income and expenses of the company, and if the outcome is positive (i.e. the acceleration of growth income is than expenses), the company's profitability affected by waves of inflation will be increased. In this case, a company faces "inflated value added". Increased inflation rate that may result from fluctuations in the exchange rate and its deviation from the equilibrium path could pave the conditions for the rise in price of products manufactured by economic firms. In this case, if the economy is more dynamic and prosperous, sales market of economic firms in at home and abroad achieve growth in terms of share and size, which in this

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case growth and sales would result in an increase in profits of companies. In analyzing the positive and significant impact of exchange rate on profitability it could be said that by an increase in exchange rate, the cost of foreign savings to domestic currency will be increased. Therefore, assuming that there is substitution between domestic and external savings the share of external savings in production decreases, and share of domestic savings can increase, which is can lead to the increase in the profitability of firms. Another explanation is that by an increase in currency rate, more constraints will be imposed on imports and this can lead to the reduction in supply of domestic products, increase in market potential of firms, increase in product prices and so higher profitability of firms. On the other hand, by an increase in exchange rate, the companies involved in the stock exchange market become more competitive and, thereby by increasing revenues from exports of goods and services, they achieve a higher profitability. So it can be said that export companies benefit from greater exchange rate than non-export firms.

Discussion and Suggestions

Naturally, the effect of tariff reduction on the profitability is varied at different industries, i.e. industries with high tariff rates imposed on imports of their raw material stake privilege of a higher profitability when their import tariffs are omitted due to membership in WTO. Of course, automobile industry is an exception in this regard. Due to the support policies taken by the government to protect domestic producers, always tariffs levied on imported vehicles have a high rate. So by removing import tariffs due to membership in the WTO, given the low competitive potential of this industry globally, it will face vulnerability and damage; this is because, the automobile industry, due to inefficient management and monopoly cannot survive by a lower tariff. Automobile industry in Iran has never been economic. The continued trend of this industry has been always overshadowed by monopoly. If the situation of this industry goes the same way and governmental tariff supports are removed, the automobile industry loses a considerable part of its market and undergoes significant losses due to some causes including low quality products, a long way to manufacture cars in accordance with global standards and lack of a competitive potential to compete with world products. Global experiences and the experiences occurring in our country shows that tariff protection is not sufficient for the development of an industry and the main necessary support of an industry is to improve the business climate in the industry and generally economy. In addition to tariff protections should be temporary and scheduled. It is recommended in the current situation, government support industries which are able to compete in global markets and find some customers for sale such as petroleum products industry and chemical industry. High rate of tariffs, nontariff barriers extension, the number of tariff rows in Iran are all the problems of tariff system. However, perhaps the most challenging issue of tariffs is their high rate and existence resistance to reduce them, so reformation of the tariff structure should be seriously considered in the government agenda. It is recommended to investors invest in financial assets when the exchange rate face higher volatility. This is because by an increase in the risk caused by exchange rate volatility, the efficiency of assets increase and also likelihood of achieving considerable profits by manufacturing firms will be increased.

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