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Islamic Republic of Iran: 2002 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Islamic Republic of Iran

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the Article IV consultation with the Islamic Republic of Iran, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **July 11, 2002,** with the officials of the Islamic Republic of Iran on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on August 27, 2002.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of **September 18, 2002** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its September 18, 2002 discussion** of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director of the Islamic Republic of Iran.

The document(s) listed below have been or will be separately released.

Selected Issues and Statistical Appendix

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to Publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

ISLAMIC REPUBLIC OF IRAN

Staff Report for the 2002 Article IV Consultation

Prepared by Staff Representatives for the 2002 Consultation with the Islamic Republic of Iran

(In consultation with other departments)

Approved by George T. Abed and L. P. Ebrill

August 27, 2002

- Discussions for the 2002 Article IV consultation were held in Tehran from June 26 to July 11, 2002. The staff team consisted of Messrs. Jbili (head), Kramarenko, Goswami, Megarbane, and Ms. Celasun (all MED), Mr. Moissinac (FAD), and Ms. Calika (PDR). Mr. Dhonte (MED) participated in the concluding meetings. Mr. Mirakhor, Executive Director, and Mr. Nadali, Assistant to the Executive Director, participated in the discussions.

- The mission met with Governor Nourbakhsh; Deputy Governors Mojarrad and Komijani; Mr. Vahaji, Deputy Minister of Commerce; senior officials of the Ministry of Finance and Economic Affairs; and National Iranian Oil Company (NIOC) officials. The staff also met with representatives of commercial banks and the business community.

- The Article IV consultation mission overlapped with the technical assistance missions from LEG/MAE on the preparations for the acceptance of Article VIII, from STA on the implementation of Special Data Dissemination Standard (SDDS) requirements; and from FAD on a fiscal Report on the Observance of Standards and Codes (ROSC).

- In concluding the 2001 Article IV consultation discussions with Iran on September 6, 2001, Directors commended the authorities' efforts at maintaining prudent fiscal and monetary policies, reducing the external debt, and building fiscal surpluses in the Oil Stabilization Fund (OSF). They called on the authorities to reform the subsidy system, bring domestic energy prices in line with market prices, and establish a well-designed social safety system. Directors also supported the authorities' plans to unify the exchange rate and move to a managed float exchange rate system, and welcomed their intention to contain money growth to prevent an acceleration of inflation.

- Iran continues to avail itself of the transitional arrangements under Article XIV. It also maintains exchange restrictions and multiple currency practices that are subject to approval under Article VIII, Sections 2(a) and 3.

- Appendices I–III provide information on relations with the Fund and the World Bank, as well as Statistical Issues, respectively. Appendix IV presents medium-term scenarios. The forthcoming Selected Issues Paper elaborates on exchange regime considerations, competitiveness, determinants of inflation, labor market issues, and fiscal sustainability over the medium term.

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Executive Summary

Since the last Article IV consultation, the Iranian economy has performed well. In 2001/02, real GDP grew by 4.8 percent, driven by a 6 percent expansion in the non-oil sector; inflation was on a declining trend; and the fiscal and the external current account balances remained in surplus, albeit lower than in the previous year. Growth of monetary aggregates, however, remained high, the real exchange rate continued to appreciate, and unemployment was 16 percent at end-2001/02. Recent structural reforms, including the exchange rate unification, the passage of the foreign investment law, on-going trade reform, changes in tax legislation, and licensing of private banks have boosted business confidence and laid the ground for a further opening-up of the economy and better growth prospects.

In the short term, the growth outlook for 2002/03 is relatively favorable, with real GDP projected to grow by 5.8 percent and the non-oil sector by 6.3 percent. However, the expansionary fiscal stance embedded in the budget for 2002/03 could lead to higher inflation, put further pressure on the real exchange rate to appreciate, and increase the economy's vulnerability to a downturn in oil prices. The staff discussed with the authorities a policy mix of fiscal adjustment and monetary action to contain liquidity growth. The fiscal deficit would need to be limited to about 2 percent of GDP, which together with a more active use of monetary instruments could limit broad money growth to 20–25 percent. This would help reduce inflationary pressures and contain a further real appreciation of the Iranian rial. The authorities were in agreement with the above assessment and indicated that they were examining appropriate measures to contain the fiscal deterioration and its impact on monetary and exchange rate developments.

The authorities expressed their commitment to a managed float exchange rate system. They recognized that the stability in the nominal rate since the unification of the exchange rates has helped ensure a smooth transition to the new unified exchange rate system. However, they were mindful of the need to avoid a further real appreciation or a build-up of expectations of a de facto pegged exchange rate; they also agreed that the central bank should ensure that the interbank exchange rate fluctuate as warranted by economic fundamentals.

Iran's medium-term outlook is relatively favorable, provided fiscal policy is adjusted in a timely manner and structural reforms are accelerated. Increasing employment opportunities remains a key objective of the authorities' medium-term reform strategy, which explains in part the mounting political pressure to increase government spending and the authorities' cautious attitude to some structural reforms. The staff encouraged the authorities to continue efforts in: strengthening fiscal management; reducing implicit and explicit subsidies; reforming the financial sector; further liberalizing trade; enhancing competition; restructuring and privatizing public enterprises; and eliminating labor market rigidities. The staff emphasized that with a proper sequencing of reforms and supporting social safety net measures, temporary adverse effects on employment can be mitigated allowing employment creation to rise over the medium term, as the business climate becomes more conducive to investment and growth.

I. Background and Recent Developments

A. Background

1. **Iran is a major world oil and gas producer and the second most populous country in the Middle Eastern region, after Egypt, with per capita GDP of about US$1,300 in 2001/02.**[1] While oil and gas dominate several aspects of the economy, the production base is relatively diversified with agriculture and manufacturing accounting for about 30 percent of GDP, and services, including government services, representing close to one-half of GDP.[2] Oil and gas represented about 15 percent of GDP, but accounted for 82 percent of export earnings in 2001/02. The role of the public sector in the economy is significant, both in terms of ownership and share in GDP (60–70 percent), but the private sector is dominant in agriculture, construction, and certain services.

2. **The authorities' reform strategy under the current Third Five-Year Development Plan (TFYDP) for 2000/01–2004/05, together with strong oil market conditions, has helped improve Iran's recent economic performance**. Over the past two years, growth picked up, inflation was on a declining trend, the external debt was reduced to a very low level, international reserves were increased, and fiscal savings were accumulated in an Oil Stabilization Fund (OSF). More recent reforms, including the exchange rate unification, the passage of the foreign investment law, and licensing of private banks have boosted business confidence and laid the ground for a further opening-up of the economy and better growth prospects. Against this background, the authorities successfully floated a Eurobond issue of €625 million in July 2002,[3] marking Iran's return to the international financial markets since the revolution in 1979.

3. **Important structural impediments to growth remain, however, and financial stability is by no means assured**. Structural rigidities in the price system, the financial sector, and the labor market, as well as the dominant role of the state in the economy and the lack of competition in many sectors continue to weigh heavily on productivity and competitiveness. Moreover, high unemployment (16 percent) continues to exacerbate political pressure to increase government expenditure in the face of strong oil revenues. If unchecked, growth in government spending could lead to higher inflation and real exchange rate appreciation with further harmful effects on competitiveness.

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[1] The Iranian year begins March 21.

[2] These figures are average ratios over the past five years.

[3] The Eurobond spread over the benchmark euro swap was 425 basis points, in line with the comparable Romanian debt. Fitch Ratings assigned to Iran a long-term foreign currency sovereign rating of B+.

4. **The political climate for economic reform has improved.** The successful unification of the exchange rate and the floating of the Eurobond have provided policymakers with added confidence and reinforced their determination to pursue other ambitious objectives of the TFYDP. To this end, policy coordination has been strengthened and major strides are being made in enhancing transparency and dissemination of information to the public and to market participants.

5. **The Iranian authorities continue to value the policy dialogue with the Fund and its technical assistance, while maintaining a high degree of ownership of their economic reforms.** In recent years, they have shown responsiveness to past policy advice in many areas, including the exchange rate reform, the establishment of the OSF, the reform of the tax system, the opening-up of the economy through trade reform and the approval of the foreign investment law, and the licensing of private banks. Equally important are the bold steps taken recently, with Fund technical assistance, to enhance transparency and improve the quality and dissemination of data. In other areas, however, the policy response has been too cautious either because of lack of political consensus (government spending, energy prices and subsidies, and privatization) or because of lengthy approval process (financial sector reform).

B. Developments During 2001/02 and the First Quarter of 2002/03

6. **Overall macroeconomic developments in 2001/02 and the first quarter of 2002/03 were marked by sustained economic activity in the non-oil sector, improved fiscal and external positions, and declining inflation trends** (Table I). Real GDP growth in 2001/02 decelerated to 4.8 percent, reflecting a decline in oil output owing to a downward revision in OPEC production quotas (Table 1 and Figure 1). Non-oil activities, however, grew by 6 percent in real terms, slightly higher than during the previous year. Improved confidence, following progress in trade reform and the stability of the parallel exchange rate, contributed to strong domestic demand, which, in turn, was key to good broad-based growth performance of the non-oil sectors (Table II). Registered unemployment, however, remained high at 16 percent at end-2001/02, as employment creation of 450,000 jobs lagged behind the increase in the labor force by 600,000 newcomers.

7. **The external current account surplus decreased to 4.8 percent of GDP in 2001/02** (Tables 2–3 and Figure 2). Exports declined, as lower oil export receipts were only partially offset by 5 percent growth in non-oil exports, mainly representing chemicals and petrochemicals. At the same time, imports expanded by 20 percent owing to buoyant domestic demand and progress in trade liberalization. The decline in the current account surplus was partly offset by a significantly smaller deficit in the capital and financial account. This was attributable to a sizable reduction in debt repayments and a sharp rise in capital inflows in the form of buybacks and oil pre-financing. The surplus in the overall balance was US$4.9 billion, which financed the increase in gross official reserves to the equivalent of almost 10 months of imports of goods and services.

Table I. Islamic Republic of Iran: Selected Indicators, 1999/2000–2001/02

	1999/2000	2000/01	2001/02
	(Annual percentage change)		
GDP at constant prices	3.6	5.7	4.8
Non-oil GDP at constant prices	4.5	5.5	6.0
Oil exports (volume)	-5.7	9.5	-10.0
Non-oil exports (volume)	23.7	6.1	4.7
CPI, yearly average	20.1	12.6	11.4
Broad money	20.2	30.5	25.8
Private sector credit	40.4	31.1	34.1
	(In percent of GDP)		
Current account balance	6.4	13.4	4.8
Central government balance	-0.6	8.8	0.9
Of which: non-oil balance	-10.9	-13.8	-14.4
External debt, public and publicly guaranteed	10.5	8.4	6.3

Sources: Iranian authorities; and Fund staff estimates.

Table II. Islamic Republic of Iran: Sectoral Growth Rates, 1999/2000--2001/02

(Annual percentage change)

	1999/2000	2000/01	2001/02
GDP at factor cost	3.6	5.7	4.8
Oil	-6.0	8.4	-8.4
Non-oil	4.5	5.5	6.0
Agriculture	0.5	2.8	4.7
Industry	10.6	7.4	10.4
Mining	21.5	4.8	9.6
Manufacturing	8.9	8.0	10.0
Construction	13.9	7.0	12.3
Water and power	7.8	5.5	6.6
Services	3.8	5.6	4.8

Source: Bank Markazi Jomhouri Islami Iran.

8. **Fiscal policy was prudent in 2001/02.** Reflecting mainly lower oil prices and revenue, the central government's overall surplus shrank to 0.9 percent of GDP, down from 8.8 percent of GDP in the previous year (Table 4 and Figure 3). Non-oil revenue rose by ½ percent of GDP on account of higher social security contributions, while expenditure increased by 1¼ percent of GDP, with the rise in current expenditure more than offsetting the decline in capital outlays. The government continued to take advantage of the sustained high oil revenue to increase its deposits with the OSF to US$7.4 billion, and reduced the external public and publicly guaranteed debt to 6.3 percent of GDP.

9. **Growth of monetary aggregates remained relatively high in 2001/02.** It reflected the build-up of foreign exchange reserves, excluding the OSF, and a rapid credit expansion to public enterprises and the private sector (Table 5). Base money grew by 9 percent, as the Bank Markazi Jomhouri Islami Iran (BMJII) only partially sterilized the impact of large direct purchases of foreign exchange from the government through the issuance of Central Bank Participation Papers (CPPs).[4] This, together with an increase in the money multiplier,[5] led to 26 percent growth of broad money (Figure 4). Regulated rates of return on loans declined slightly in 2001/02, contributing to high credit demand of the private sector (Figure 4).

10. **CPI inflation continued its downward trend, despite the rapid monetary growth.** The stability of exchange rates at the parallel market and Tehran Stock Exchange (TSE) and, to some extent, an improved agricultural output contributed to a further decline in average CPI inflation to 11.4 percent in 2001/02, with the decline affecting tradable goods, while nontradable inflation remained high. In contrast, an acceleration in broad money growth in the first quarter of 2002/03 appears to have initiated a modest pick-up in inflation (Figure 1 and Box 1). Although controls on the prices of public enterprises and essential imports contributed to the deceleration of inflation to some extent, they do not appear to have resulted in a substantial build-up of repressed inflationary pressures so far.

11. **Asset prices rose significantly in the TSE, as measured by the TEPIX,[6] and in the real estate market (Figure 4).** This reflected improved fundamentals of the Iranian economy and higher real incomes, as well as the large differential in yields that helped attract capital inflows to the TSE[7] and savings of Iranians living abroad through informal channels. The continuation of high growth rates of monetary aggregates may have also contributed to asset price inflation, in particular in the real estate market.

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[4] Central Bank Participation Papers are offered at a fixed coupon rate, are nontradable in the secondary market, and can be redeemed at par before maturity. They are largely held by retail investors.

[5] Higher multiplier resulted mainly from a decrease in the weighted average required reserves ratio by 5 percentage points to about 17 percent.

[6] All-Share Price Index.

[7] Inflows and outflows of portfolio investment are generally restricted. Nonresident can, however, invest in the TSE up to a certain limit.

Box 1. Has There Been a Change in the Relation Between Inflation and Money Growth Since 2000/01?

Iranian CPI inflation gradually declined from a year-on-year rate of 18 percent at end-1999/2000 to 11.7 percent at end-2001/02. Somewhat surprisingly, the disinflation took place against a background of strong growth in monetary aggregates, with the increase in M1 and M2 at 34 and 30.5 percent at end-2000/01 and, 19 and 26 percent at end-2001/02, respectively. This apparent inconsistency in the relation between money growth and inflation was due to a combination of factors, including positive supply shocks and the stability of the TSE and parallel market exchange rates, which exerted downward pressures on CPI inflation, and seem to have more than offset the effects of the increase in the money supply:[1/]

- Agricultural output increased strongly from 2000/01–2001/02 relative to the earlier years, due to favorable weather conditions. The lessening of supply constraints has reduced the inflation of food prices, which amounted to a total weight of 31 percent in the CPI.
- The gradual easing of trade barriers and increased import penetration have also relaxed supply constraints in the tradable goods sector. Moreover, the stability of the Iranian rial against the U.S. dollar in the TSE market, and the strength of the U.S. dollar against other currencies have curbed the relative price of imports. With increased competition from imports, domestic producers of tradables appear to have had little scope to raise prices, bringing the inflation of tradables to single digit levels in 2001/02.
- The stability of the exchange rate at the parallel market, declining inflation, and strong output growth from 2000/01–2001/02 have increased real money demand, rendering the growth in nominal monetary balances less inflationary.
- The significant contemporaneous correlation between the parallel market exchange rate and CPI inflation over the past decade suggests that in Iran, the exchange rate plays an important role in the formation of inflationary expectations, as has been the case in other economies that have experienced high inflation. From 2000/01–2001/02, the strong supply of foreign exchange by the government and the attractiveness of the real rates on return on domestic monetary instruments, such as the CPPs and deposits have buoyed demand for domestic currency and stabilized the parallel market exchange rate, which seems to have curbed inflationary expectations.
- Under the TFYDP, which has been in effect since March 2000, the price increases of goods and services produced by public sector enterprises have been limited to 10 percent, as compared to a 25 percent limit in SFYDP. These price controls alone do not seem to have been binding to significantly alter the inflation rate, but they are likely to have had a restraining impact.

While these factors have so far generated a decline in overall CPI inflation, strong money growth fueled by high government spending has sustained the inflation of nontradables at high levels. Inflation of dwellings, for instance, stood at 18 percent at end-2001/02. Looking ahead, further excessive money growth would likely create considerable uncertainty regarding inflation and cause an upward revision in inflationary expectations. Early signs to this effect became apparent in the second month of 2002/03, when seasonal fruits and vegetables entered the CPI basket with significantly higher prices than in the previous year, pushing year-on-year inflation to above 14 percent, despite strong agricultural output.

[1/] Econometric analysis conducted by Fund staff for the period 1990/91–2001/02 has established a strong effect of excess M1 balances on inflation with no statistically significant break in the inflation equation around 2000/01 (Oya Celasun and Mangal Goswami, (forthcoming), "An Analysis of the Inflationary Process in the Islamic Republic of Iran," IMF Working Paper, Washington: International Monetary Fund). Excess M2 balances, however, were not found to significantly impact inflation. The study also reveals a strong link between inflation and the parallel market exchange rate depreciation, the stability of which seems to have been an important element in the disinflation process.

12. **The trend of real exchange rate appreciation continued.** The TSE rate and, subsequently, the exchange rate prevailing at the unified interbank market remained very stable while the CPI inflation rate averaged at about 12 percent in 2001/02 (Figure 1). The stability of the nominal exchange rate was made possible by the abundance of foreign exchange supplies due to strong oil export receipts and private capital inflows attracted by differentials in rates of return. Although the real effective exchange rate appreciated by about 17 percent in 2001/02, following an 18 percent appreciation in 2000/01, the appreciation vis-à-vis the five-year average real effective exchange rate index was only 20 percent (Box 2).

C. Progress in Structural Reform

13. **Structural reform has continued in many areas, though at an uneven pace of implementation.** The exchange rate unification was a landmark reform. After several months of extensive preparation, the exchange rate was unified on March 21, 2002, with foreign exchange transactions now taking place in the interbank market. The authorities also adopted a managed floating exchange rate system. The transition has been smooth with the BMJII seeking to maintain some stability in the nominal rate during the period immediately following the exchange rate unification. The law on foreign investment has been ratified, providing added protection and some incentives to foreign investors; the recently approved amendments to the legislation on direct taxes lowered and simplified the corporate and personal income tax rates; and a draft law on the value added tax (VAT) has been submitted to the cabinet for approval. Parliament also approved the establishment of the National Tax Organization and a large taxpayer unit in 2001/02. Trade reform focused on further reducing nontariff barriers and streamlining licensing procedures, with the bulk of import items now requiring only licensing at the Ministry of Commerce for recording purposes; the authorities also adopted a negative list of prohibited imports.[8] In the financial sector, progress in implementing reforms has been relatively slow, although a key reform has been the licensing of three private banks, one of which was already operating as a nonbank credit institution. The private banks are allowed to conduct business in all banking areas and operate under the same regulatory framework. Furthermore, draft legislation on anti-money laundering has been submitted to the cabinet. Despite the recent recapitalization of state-owned banks, their capital adequacy ratio remained below the Basel-recommended 8 percent (Table 6) and there is a risk of a further deterioration of their loan portfolios in connection with the rapid credit expansion in the recent years.[9] Progress in privatization has been limited to streamlining and clarifying the legislative and regulatory environment governing privatization, while actual privatization operations have mostly consisted of divestiture of government equity shares.

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[8] Authorization from other ministries may be required for specific purposes, such as health control. The negative list covers about 3 percent of tariff lines.

[9] Also, marginal improvements in the financial vulnerability indicators (Table 6) might not convey an accurate picture of the banks' weaknesses, given the inherent shortcomings of the accounting standards and practices.

Box 2. Measures of the Real Effective Exchange Rate

Figure 1. Evolution of the REER and the NEER

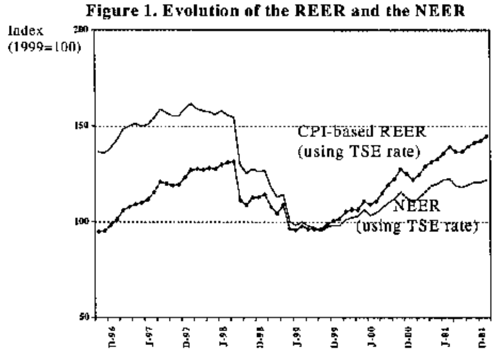


Figure 2. REER using TSE and Weighted Rate

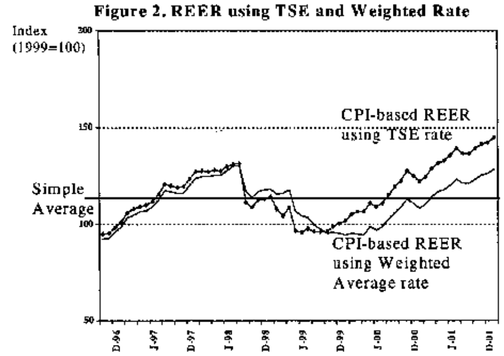


Figure 3. Evolution of Non-Tradable to Tradable Prices

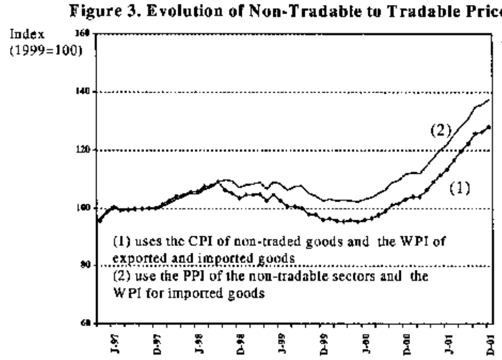
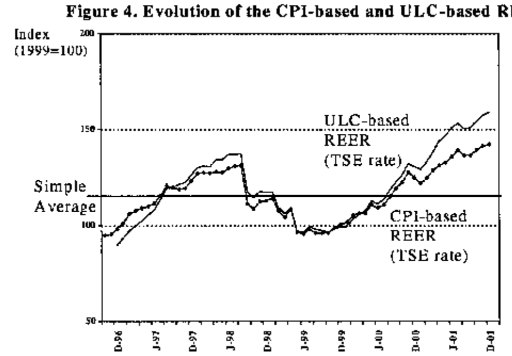


Figure 4. Evolution of the CPI-based and ULC-based REER



II. Policy Discussions

14. **The discussions, which took place against the background of renewed optimism and improved confidence, also mirrored the policy dilemma facing the authorities as they make advances in implementing their economic reform strategy**. Iran has now reached the point where a clear choice must be made between a strategy that continues to rely primarily on subsidies and government intervention to achieve gains in employment, but with long-term negative effects on macroeconomic stability and growth, and one aimed at sustaining long-term growth and employment creation through greater efficiency and private sector-led economic development. This policy choice has implications for the short-term outlook and the medium-term economic reforms.

A. Short-Term Policy Issues

15. **The mission commended the authorities for the high degree of ownership of their economic reform strategy as outlined in the TFYDP** and noted that the reform effort had started to pay off as evidenced by the high growth rates of non-oil activities, the pickup in domestic private sector investment, and the growing interest in investment in Iran on the part

of foreign investors. In the short term, the growth outlook for 2002/03 is relatively favorable, with real GDP projected to grow at 5.8 percent and the non-oil sector by 6.3 percent, buoyed by relatively favorable oil market conditions, rising domestic demand, and increased business confidence (Table 1 and Table III). However, the expansionary policy stance embedded in the current budget for 2002/03 could lead to higher inflation, put further pressure on the real exchange rate to appreciate, and increase the economy's vulnerability to a downturn in oil prices. If the authorities were to implement the budget as initially approved, the fiscal deficit would increase to 5.2 percent of GDP and monetary growth would reach about 40 percent. This, coming on the heels of two years of rapid liquidity growth, would heighten uncertainty about inflation, with the balance of risk shifting to the upside. Another by-product of this expansionary policy stance would be a further real appreciation of the rial that would erode competitiveness and increase vulnerability to external shocks, as OSF resources would be drawn down to finance the fiscal deficit.

Table III. Islamic Republic of Iran: Selected Indicators, 2001/02–2002/03

	2001/02	Current 2002/03	Adjustment 2002/03
		(In percent of GDP)	
Central government balance	0.9	-5.2	-2.0
Of which: non-oil balance	-14.4	-20.9	-17.7
Current account balance	4.8	2.1	3.2
		(Annual percentage change)	
Broad money growth	25.8	41.0	22.9
		(In millions of U.S. dollars)	
Gross official reserves	17,468	20,968	22,934

Sources: Fund staff estimates and projections.

16. **The mission stated that the policy focus for the remainder of 2002/03 must shift toward ensuring macroeconomic stability**. In this context, the staff discussed with the authorities a policy mix of fiscal adjustment and monetary action to contain liquidity growth. The fiscal deficit would need to be limited to about 2 percent of GDP, which together with a more active use of monetary instruments could limit broad money growth to 20–25 percent. Even though this growth rate is still high, it is a realistic target, which would help contain inflation and a further real appreciation of the rial. Moreover, tighter fiscal policy would lead to a smaller deterioration in the current account balance and allow the BMJII to accumulate

higher gross official reserves (a US$5.5 billion increase). The government would also be able to refrain from drawing on the deposits of the OSF from its end-2001/02 level. Such a policy outcome would reduce the external and fiscal vulnerabilities to exogenous shocks. The authorities were in agreement with the above assessment and indicated that they were examining appropriate measures to contain the fiscal deterioration and its impact on monetary and exchange rate developments.

Fiscal Policy

17. **The authorities indicated that the increase in government expenditure during the current fiscal year was due to the high cost of exchange rate unification and the need to deal with the high unemployment problem**. The staff pointed out that the fiscal deterioration which is taking place amidst high oil revenue, is driven by a sharp increase in current and capital outlays as well as by the cost of the exchange rate unification. Preliminary estimates based on the initially approved budget suggest that the fiscal position would swing from a surplus of 0.9 percent of GDP in 2001/02 to an overall deficit of 5.2 percent of GDP in 2002/03 (Table III). The deterioration mainly reflects the impact of the exchange rate unification net of the revaluation of oil revenue (2.8 percent of GDP) as well as the increase in other expenditure and net lending (Table IV). The non-oil deficit is estimated to increase by 6.5 percent of GDP to the equivalent of 21 percent of GDP in 2002/03.

18. **With regard to the effect of the exchange rate unification, the mission welcomed the authorities' decision to make all the implicit exchange rate subsidies explicit in the budget** and noted that the high cost to the budget stems from the authorities' decision not to allow any pass-through this year of the exchange rate depreciation and bear the full cost to public enterprises of the exchange rate losses on letters of credits and other foreign liabilities (contingent liabilities). The mission noted that the budgetary impact of the exchange rate unification would be manageable if the authorities kept the lid on the growth of other current and capital outlays.

Table IV. Islamic Republic of Iran: Factors Affecting the Fiscal Deficit Under Current Policies

(Increase in 2002/03 from 2001/02)

	In billions of Iranian rials	In percent of GDP	Percentage increase in real terms 1/
Change in the fiscal deficit	50,243	6.1	...
Impact of the exchange rate unification, net	23,775	2.8	...
Subsidies	27,608	3.2	...
Current subsidies	21,488	2.5	...
Capital transfers	6,121	0.7	...
Contingent liabilities	23,775	2.8	...
Revaluation of oil revenue	-27,608	-3.2	...
Autonomous changes	31,666	0.5	...
Expenditure and net lending	51,497	0.2	13.2
Current expenditure 2/	24,187	-1.0	5.6
Of which: wage bill	13,132	0.1	12.9
Capital expenditure 3/	19,800	1.4	49.9
Other expenditure and net lending	7,510	-0.2	8.1
Non-oil revenue	-19,831	0.2	9.8
Oil revenue 4/	-5,198	2.8	...

Sources: Iranian authorities; and Fund staff estimates.

1/ Deflated by the CPI inflation rate.
2/ Including subsidies not related to exchange rate unification.
3/ Excluding capital transfers related to the unification cost.
4/ Excluding revaluation at the unified exchange rate.

19. **The authorities agreed with the mission's assessment regarding the likely impact of the current fiscal stance on the macroeconomic situation**. They indicated, however, that expenditure commitments, mainly capital expenditure, would not take place if there were a revenue shortfall, and that they planned to step up collection of tax arrears and mobilize additional external financing. Recognizing the importance of prompt measures to contain the fiscal deficit, the authorities indicated that discussions were underway within the high level coordination committee,[10] chaired by President Khatami, to formulate appropriate corrective measures, which might be introduced sometime in the second half of 2002/03. However, the scope and the impact of the likely fiscal measures are yet to be determined. The staff suggested that the adjustment effort should be orderly and consistent with other macroeconomic objectives. In particular, fiscal measures should aim at reducing current expenditures, which have been budgeted to rise significantly; ensure an orderly scaling-down of capital expenditure, and preserve the integrity of the OSF by not withdrawing from past accumulated deposits. The staff also emphasized the need for revenue-raising measures which could include a reduction of tax exemptions and possible increases in excise taxes, in

[10] The recently established high level committee to coordinate macroeconomic policy aims to enhance coordination both at the policymaking and operational levels.

particular, the specific rates that have not been adjusted for inflation for some years. Moreover, an acceleration of privatization and divestiture of government equity shares would help mobilize significant additional resources.

Monetary Policy

20. **The mission pointed out that monetary policy alone would not be able to contain the liquidity and inflationary effects of the envisaged deterioration in the fiscal stance in 2002/03**. Indeed, the effectiveness of monetary policy action was made difficult by the excess liquidity in the banking system, a relaxation of fiscal discipline, pressures on the exchange rate to appreciate, inadequate instruments of liquidity management, and, until recently, limited policy coordination. While the authorities continue to target a broad liquidity growth (M2) of around 18 percent, this initial objective appears now difficult to achieve in the current policy environment, and the final outcome might be close to 40 percent, as indicated above, in the absence of corrective fiscal and monetary policy measures. As such, a policy mix of fiscal adjustment and monetary policy actions to mop up excess liquidity would be essential to bring domestic liquidity growth under control.

21. **The staff mission discussed with the authorities an illustrative adjustment scenario[11] based on the assumption of fiscal tightening, aimed at containing M2 growth to 20–25 percent**. Under such a scenario, a reduction in the fiscal deficit to 2 percent of GDP would reduce the budgetary recourse to domestic bank financing to about Rls 6.3 trillion (Tables 4–5 and Table IV). Depending on the balance-of-payments outlook and the need for BMJII to accumulate foreign exchange reserves to avoid an undue appreciation of the nominal exchange rate,[12] the central bank would need to increase the issue of CPPs to mop up liquidity by about Rls 24 trillion from the end-2001/02 stock. This would contain M2 growth to 20–25 percent and would help maintain inflation at about 15 percent. The authorities agreed to examine the possibility of increased recourse to CPPs and to other instruments such as a standing deposit facility (open deposit accounts) to mop up excess liquidity and sterilize the liquidity impact of the increased government spending. However, even if the legal ceiling on the net issuance of CPPs can be raised from its current level of Rls 10.4 trillion, the authorities concurred with the staff that this instrument should not be considered as a substitute for fiscal adjustment, but rather as a temporary instrument providing some time for fiscal policy to adjust.

[11] The scenario discussed with the authorities was adjusted in this report to reflect new higher WEO assumptions on oil prices for 2002/03. This adjustment does not change the thrust of policy advice.

[12] The proposed fiscal adjustment would reduce foreign exchange supply by the government thereby partly easing the appreciation pressures on the exchange rate.

Exchange Rate Policy

22. **The authorities reiterated their commitment to a managed float exchange rate system.** They recognized that the stability in the nominal rate has helped ensure a smooth operation of the new unified interbank foreign exchange market. They were confident that the market's response was very much in favor of some stability in the rate in the short run and that no evidence of misalignment of the nominal exchange rate had emerged. At the same time, they noted that under current policies, the large supply of foreign exchange to the domestic market on account of high government financing requirements and a high share of spending out of oil revenue would likely result in a real appreciation during 2002/03. However, they were mindful of the need to avoid a sustained real appreciation that could worsen the competitiveness outlook.

23. **The staff cautioned against the risk of building expectations of a de facto pegged exchange rate.** While agreeing that keeping the nominal exchange rate stable in the short run was sensible in the interest of ensuring stability during the initial phase of the exchange rate unification, the staff was concerned that this could make subsequent exchange rate movements politically difficult. Moreover, the perceived fixity of the nominal exchange rate may contribute to attracting potentially volatile capital inflows. The authorities shared the staff's view that the central bank would need to move sooner rather than later to ensure that the interbank exchange rate fluctuate as warranted by market conditions and economic fundamentals.

24. **While sustained appreciation of the real exchange rate would further exacerbate the "Dutch Disease" effects, the main impediments to competitiveness are structural in nature.** The mission pointed out that competitiveness problems of the non-oil sectors lay mainly in the dominance of inefficient state enterprises in economic activity, the lack of competition in the domestic market, the relatively high tariff protection, the distortive effects of subsidies and price controls, and the rigidities of labor regulations.[13] Removing these obstacles would require sustained implementation of reforms, together with efforts on the part of the private sector to enhance efficiency and raise productivity through restructuring and adopting modern management techniques. In this environment, exchange rate policy should neither be allowed to worsen the competitiveness outlook through continued real appreciation, nor should it be considered as a cure-all recipe for the ills of the non-oil economy.

[13] See the forthcoming Selected Issues Paper.

Exchange Restrictions

25. **The authorities have adopted a number of measures aimed at eliminating exchange restrictions and improving access to foreign exchange.** In particular, the need for and the amount of advance deposits for opening letters of credit have been left to the discretion of commercial banks; the procedure of foreign exchange allocation for authorized imports has been eliminated; and the process of obtaining most import licenses has been streamlined by reducing centers issuing permits to a single entity, the Ministry of Commerce. Moreover, the surrender requirement for foreign exchange receipts by non-oil exporters has been eliminated, and the bonus payment for early repatriation has also been abolished. Notwithstanding the considerable simplification and liberalization of the exchange system, a recent MAE/LEG mission has identified a number of multiple currency practices and exchange restrictions.[14] In particular, the exchange rate applying to the import of certain commodities and to debt service payments on the letters of credit contracted prior to March 21, 2002 by public enterprises is explicitly subsidized in the budget, giving rise to a multiple currency practice. The authorities plan to eliminate the remaining exchange restrictions to pave the way for Iran's acceptance of Article VIII, Sections 2(a) and 3 of the Fund's Articles of Agreement.

B. Medium-Term Outlook and Structural Reforms

26. **Iran's medium-term outlook is relatively favorable.** Under the current WEO projections for oil prices and the assumption that the fiscal expansion would be corrected in a timely manner and that structural reforms would be accelerated, real GDP growth would average almost 6 percent, the overall external position would remain in surplus, albeit on a declining trend, the external debt would remain low, and international reserves would be increased substantially (Appendix IV). In the absence of fiscal adjustment and structural reforms, real GDP growth could decelerate to 4 percent, while inflation would pick up. In the latter case, the emergence of current account deficits early in the projection period, a slow pace of accumulation of gross official reserves, and a depletion of the OSF deposits would intensify the vulnerability of Iran to potential external shocks (Appendix IV). Both medium-term scenarios are subject to uncertainties on several fronts, including oil prices, weather conditions, and the prospects for regional stability. Regarding the impact of oil prices, a US$1 decrease in the assumed oil prices would result in a ¾ of 1 percent of GDP deterioration in the fiscal balance and a 1 percent of GDP worsening of the current account balance on average over the medium term.

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[14] The preliminary findings of the MAE/LEG technical assistance mission are still under discussion with the authorities. The mission's final conclusions will be reflected in a supplement to the staff report to be circulated to the Executive Board.

27. **Increasing employment opportunities remains a key objective of the authorities' medium-term reform strategy**. The authorities indicated that political pressure to increase government spending was likely to intensify given the need to provide employment opportunities to more than a half million Iranians who enter the labor force each year. They pointed to various initiatives they have taken recently to promote employment, including the provision of subsidized credits to small- and medium-sized enterprises, tax exemptions on the salaries of new employees, and lending to private companies in foreign exchange from the OSF. The authorities also expressed concern about the potential negative fallout on employment of certain economic reforms, such as accelerated trade liberalization and privatization of public enterprises.

28. **The staff acknowledged the difficulty in reducing the current rate of unemployment** given Iran's demographic dynamics and the relatively weak employment content of growth compared to other countries.[15] The latter stems from several factors, including the excess labor in many public enterprises, the low energy cost and subsidies, which introduce a bias in favor of capital intensive industries, the highly restrictive labor market regulations, and the lack of private sector penetration in sectors such as services, which can contribute significantly to employment creation. The staff expressed the view that while financial incentives to create new jobs may help alleviate unemployment problems in the short run, their effectiveness and possible distortive effects would need to be assessed after a short period of implementation. A more enduring alternative would be to accelerate the pace of implementation of structural reforms aimed at opening up the economy, attracting foreign direct investment, encouraging private sector development, enhancing competition, and eliminating labor market rigidities. The staff agreed that trade liberalization and privatization can worsen employment in the short run, given the existing distortions in the Iranian economy, but with a proper sequencing of reforms, this temporary effect can be mitigated allowing employment creation to rise over the medium term, as the business climate becomes more conducive to investment and growth. The staff underscored the need to put the economy on a sustained path of growth and employment creation that is driven by private sector initiative through competition and improved economic efficiency rather than by subsidies and government intervention.

29. **Fiscal structural reforms should continue to ensure medium-term fiscal sustainability**. The OSF has provided a useful tool of fiscal management, but would need to be used more effectively to smooth out the impact of oil price fluctuations and help enhance fiscal discipline. The staff encouraged the authorities to reflect on the merits of setting fiscal policy in a longer term framework that would seek to limit current consumption out of oil resources to ensure balanced inter-generational sharing of resources. In this respect, fiscal sustainability would be cast within a framework that takes account of the nonrenewable nature of oil resources and the need to build assets for future generations. As such, fiscal

[15] See the forthcoming Selected Issues Paper.

policy would focus on reducing the non-oil deficit to a level that would be compatible with the desired accumulation of long-term savings and precautionary assets. As the next step in that direction, consideration could be given to building long-term savings in the OSF with stringent and transparent rules of accumulation and withdrawals, and in the context of a consolidated framework of fiscal management. The authorities indicated that they were reviewing the experience of other countries with such funds, including their usefulness in helping sterilize large inflows of oil-related foreign exchange.

30. **The staff advised against excessive recourse to tax incentives and privileges as instruments of industrial and social policy**. Most prominently, such exemptions might undermine the authorities' efforts to broaden and diversify the revenue base away from oil revenue. Similarly, exemptions from the proposed VAT would need to be kept to a minimum to facilitate the implementation of the new tax and avoid distortions. The authorities took note of the staff's recommendations and expressed interest in receiving Fund technical assistance in strengthening the administrative capabilities of the National Tax Organization, including for implementing the VAT.

31. **On the expenditure side**, the staff called for determined efforts to contain the growth of wages and salaries, including through a civil service reform, and encouraged the authorities to enhance public expenditure management, including with technical assistance from the Fund and the World Bank. The authorities would need to firm up their plans to phase out subsidies and replace them with a targeted subsidy system and introduce a social safety net that would provide adequate protection of the vulnerable groups of the population. The authorities indicated that technical work on the elimination of subsidies was underway with assistance from the World Bank, including plans to reduce some subsidies in the budget for 2003/04 and to bring domestic oil prices close the border price level over the medium term.[16]

32. **The staff underscored the need for rapid progress on financial sector reform along the lines of the FSAP recommendations (Box 3)**. It reiterated the need to develop monetary policy instruments that would provide the central bank with sufficient flexibility and agility in its conduct of monetary policy. The CPPs have provided a useful tool to mop up excess liquidity in the past year, but need some adaptation to be effectively used for open money market-type operations. Previous Fund technical assistance missions had advised the authorities to auction the CPPs to derive a benchmark rate of return, and remove restrictions on their secondary market trading. The authorities have not decided yet whether they would proceed with the recommended modifications to CPPs. They noted that work was continuing in other areas of financial sector reform in conformity with Islamic banking practices. These

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[16] Implicit energy subsidies are estimated at about 10 percent of GDP in 2001/02.

Box 3. FSAP (2000) Recommendations on Financial Sector Reform

Monetary instruments and markets

- Issue CPPs
- Allow the CPPs to be auctioned and used in open market operations
- Redesign the standing facilities
- Reform reserve requirement
- Introduce and develop intrerbank funds market

Bank competition and autonomy

- Liberalize deposit and lending rates
- Accelerate removal of directed credit and sectoral allocation of credit
- Recapitalize the banking system
- Tighten bank accounting rules that both take adequate account of Islamic instruments and are consistent with the International Accounting Standard (IAS)
- Reorient the state-owned banks towards clear commercial objectives and financial autonomy
- Move towards a more active and equitable competition between banks, and between banks and nonbank financial institutions and markets, including through financial sector liberalization and privatization

Prudential supervision and regulation

- Move towards an overall evaluation of banking risks and of the banks' capacity to manage them
- Prepare and implement a new regulatory framework consistent with international standards
- Intensify training of supervision staff

Capital Market

- Enact a securities market legislation to replace the Stock Exchange Act of 1966, to regulate the issue of securities (listed and unlisted)
- Create an independent securities commission
- Upgrade accounting, auditing, and disclosure standards

include allowing banks more freedom in setting the lending rates of return and establishing an interbank money market. In the meantime, the recently licensed private banks have been allowed more flexibility in credit allocation, and in the setting of deposit and lending rates of return, which would enhance competition and open the door for granting the same flexibility to state banks. The staff encouraged the authorities to follow through with their action plan for a fundamental banking supervision reform to improve compliance with the Basel Core Principles.

33. **The reform of the capital markets should be stepped up**. In the absence of a general securities law which would govern the issuance of securities both inside and outside of the stock exchange, it remains difficult to address weaknesses in the stock exchange in areas such as insider trading, lack of protection of minority shareholders' rights, unregulated activities of the investment companies, and the low level of disclosure of listed companies. The authorities agreed that these institutional weaknesses raised serious concerns in light of the recent stock market boom. In this regard, the staff emphasized that while regulations were being discussed by the TSE Board to address some of these concerns, a comprehensive approach to reforming the capital market would need to be developed along the lines of the recommendations of the FSAP follow-up technical assistance mission of March 2001.

34. **Trade reform has advanced, but restrictive elements remain.**[17] The staff commended the authorities on the progress achieved in replacing nontariff barriers with tariffs, adopting a negative list of imports, and streamlining licensing procedures. It also noted Iran's intention to become a member of the World Trade Organization (WTO) and welcomed the preparatory work toward achieving this objective. The staff noted, however, that further efforts were needed to reduce and rationalize tariff rates. In particular, the combined simple average tariff rate, including customs duties, commercial benefit tax, and other duties and charges, was relatively high (about 30 percent). The commercial benefit tax, with a simple average rate of 26 percent, has some 61 tariff rates, mostly ranging from 0 percent to 116 percent, with few even higher rates. The authorities indicated that they planned to consolidate all duties and charges on imports into one duty rate on imports. They also envisaged further rationalizing the tariff structure (including consolidating all duties and charges on imports into the tariff structure), reducing the dispersion of tariff bands, and lowering the simple average tariff rate. They intended, however, to move with caution in this area in line with the need to carefully assess the impact on domestic activities of the reforms already introduced and provide adequate time for some sectors to adjust to increased competition from abroad. The authorities also noted that some nontariff export barriers on subsidized goods would be phased out once the subsidies and price controls on these items were eliminated. The staff underscored the need to streamline customs and administrative procedures as part of the trade reform package.

[17] According to the Fund's overall trade restrictiveness index, Iran has a rating of 8 out of 10.

III. Statistical Issues, Transparency, and Other

35. **The authorities are committed to improving Iran's statistical base as evidenced by their intention to subscribe to the Special Data Dissemination Standard (SDDS).** To this effect, a multi-sector mission from the Fund's Statistics Department (STA) visited Iran during June 18–July 1, 2002 to assess the current data dissemination practices and provide assistance on ways to improve the compilation and dissemination of macroeconomic statistics. The STA mission has identified a number of shortcomings including, in particular, the coverage of the government's fiscal accounts, the classification of monetary data by sector and residency, and the reporting to the public of international reserves. The authorities intend to follow up, within the suggested timeframe, on the action plan recommended by the STA mission.

36. **A recent Fund technical assistance mission has reviewed the practices of transparency and observance of standards and codes (ROSC) in the fiscal area in Iran.** The preliminary conclusions of the fiscal ROSC mission highlight a number of positive elements. In particular, quasi-fiscal operations are increasingly being recognized; the audit framework for the public sector is based on a solid legal background; and fiscal reports are disseminated in the media. Improvements, however, are needed in the following three main areas (a) the government's involvement in the economy would need to be more fully disclosed, including by clarifying financial relationships within the enlarged public sector; (b) the quality of fiscal information should be upgraded by widening its coverage and enhancing the timeliness of budget reporting (Annex III); and (c) the budget process would need to be strengthened, including by rationalizing banking operations of the government and integrating extra budgetary funds in the budget process. The authorities indicated that they would continue to work on improving fiscal transparency in line with ROSC recommendations.

37. **The mission brought to the authorities' attention the issue of Iran's claims on two heavily indebted poor countries** (HIPC) and encouraged the authorities to provide relief under the HIPC Initiative. The authorities indicated that this matter was under consideration, including the need to seek parliamentary approval.

IV. Staff Appraisal

38. **The Iranian economy has performed well since the last Article IV consultation.** Economic activity was strong during 2001/02, especially in the non-oil sectors; the fiscal and external positions remained in surplus, allowing the authorities to reduce the external debt, build large foreign exchange reserves, and accumulate fiscal savings in the OSF; and the inflation rate continued its downward trend. This performance has enhanced business confidence and put Iran in a much more favorable position to pursue its economic reform program under the TFYDP.

39. **The Iranian authorities are to be commended for the timely implementation of the exchange rate unification and the smooth transition to a new exchange rate regime.** Coming on the heels of progress in trade liberalization and the elimination of most exchange restrictions on current account transactions, the exchange rate unification is, indeed, a major step forward that enhances the credibility of the authorities' reform strategy. The staff welcomes the successful floating of the Eurobond, which attests to the confidence of the international financial markets in Iran's economic prospects and the authorities' commitment to economic reform.

40. **The outlook for 2002/03 is favorable, especially with regard to oil market conditions and the growth prospects of non-oil activities.** Oil prices are expected to be slightly higher compared to the previous year, and real GDP is estimated to grow by close to 6 percent, with most sectors recording strong performance. Nonetheless, serious risks to the outlook are arising from the expansionary fiscal stance under the current budget, which if not corrected, could lead to higher liquidity growth, a pick-up in inflation, and further appreciation of the real exchange rate.

41. **The expansionary fiscal policy in 2002/03 reflects increased spending beyond the cost of the exchange rate unification.** The staff supports the authorities' decision to make all implicit exchange rate subsidies an explicit entry in the budget following the exchange rate unification and make adequate allowance for the cost of contingent liabilities to public enterprises. This represents an important step in fiscal transparency and paves the way for the subsequent phasing out of subsidies. Nonetheless, the sharp increase in other budgeted current and capital outlays is a clear departure from past fiscal prudence and its timing could complicate macroeconomic management with heightened risks of igniting inflation and endangering the success of the unification of the exchange rates.

42. **The staff urges the authorities to adopt appropriate corrective fiscal measures.** The staff underscores the need for well thought out measures aimed at curbing the growth of current spending, which have been budgeted to rise considerably, and for an orderly scaling-down of capital expenditures that would not harm future growth. Also revenue measures that would help bring down the fiscal deficit while contributing to a diversification of the revenue base, such as a reduction in tax exemptions, improvement in collection of tax arrears, and increases in certain excise taxes, should not be discounted altogether. The staff strongly advises against drawing from the OSF's past accumulated resources to finance the fiscal deficit, which otherwise, would carry a heavy cost in terms of loss of credibility of the OSF itself, given the prevailing high oil prices and the authorities' policy of cushioning the effects of fluctuations in oil prices.

43. **Monetary policy will need to focus on containing liquidity growth and inflation.** The staff welcomes the authorities' intention to use all instruments at the disposal of BMJII to contain the growth of liquidity, including issuing additional CPPs and using the standing

deposit facility with the central bank. To be successful, however, these actions must be part of a comprehensive fiscal and monetary package aimed at containing liquidity expansion and inflation.

44. **The staff welcomes the authorities' commitment to a managed float exchange rate regime** and notes the authorities' intention to ensure that the exchange rate in the interbank market reflects market conditions and economic fundamentals. This would enhance the credibility of the authorities' exchange rate policy and prevent a build-up of expectations of a pegged exchange rate regime. The staff reiterates its concern regarding the harmful effects of a sustained real exchange rate appreciation, but is aware that in the short run, it would be difficult to generate a depreciation of the nominal rate in the face of continued strong supply of foreign exchange by the government. As such, containing the inflation rate would offer a second line of defense in the effort to avoid an undue appreciation of the real exchange rate. The staff believes that while an active exchange rate policy aimed at depreciating the rate can help enhance the competitiveness of non-oil activities over the medium term, this cannot be a substitute for economic reforms that would remove the structural impediments to competitiveness.

45. **The current high rate of unemployment presents the authorities with difficult and complex issues over the medium term** against the background of high rates of growth of the labor force and relatively weak employment content of growth. Increasing employment creation in this environment would be a daunting task in Iran's circumstances, given the existing distortions, the labor market rigidities, and the prevalence of inefficient and overstaffed public enterprises. Political pressure to address employment issues through higher government spending, subsidies, and other financial incentives would be difficult to resist, and implementation of needed economic reforms might be delayed out of fear of worsening the employment situation in the short run. Such a policy course would need to be assessed carefully against the concomitant risk of leading to financial instability or exacerbating the existing impediments to long-term growth and employment. A more enduring strategy would be to step up the economic reforms aimed at improving the overall business environment to foster investment and growth, make room for the private sector to grow and create jobs, and eliminate labor market rigidities.

46. **Important steps have been taken in removing impediments to growth, but the pace of structural reforms needs to be accelerated**. The staff welcomes the progress achieved in opening the economy through trade liberalization, the adoption of the foreign investment law, the licensing of three private banks, and the return to the international financial market, which would provide a strong incentive for further reform and sound economic management.

47. **The staff underscores the need to step up financial sector reform aimed at deepening the financial market and enhancing the efficiency of bank intermediation**. It also urges the authorities to strengthen the financial system supervisory and prudential framework in line with the FSAP recommendations. Determined efforts in this area will help

address the potential risks that may emerge from the rapid credit growth in recent years, the growing inflow of foreign capital, and the recent asset price increases. To this end, the staff reiterates that restoring capital adequacy of banks should be accompanied by measures to enhance the profitability of banks and improve risk management.

48. **Other important reforms that are already on the government's medium-term reform agenda would need to be phased in rapidly to induce sustained improvement in productivity and growth**. These include: enhancing competition and promoting the role of the private sector; strengthening fiscal management and reducing the budget's vulnerability to fluctuations in oil prices; reforming the labor market to encourage employment creation; and overhauling price controls and the subsidy system together with the establishment of an appropriate social safety nets.

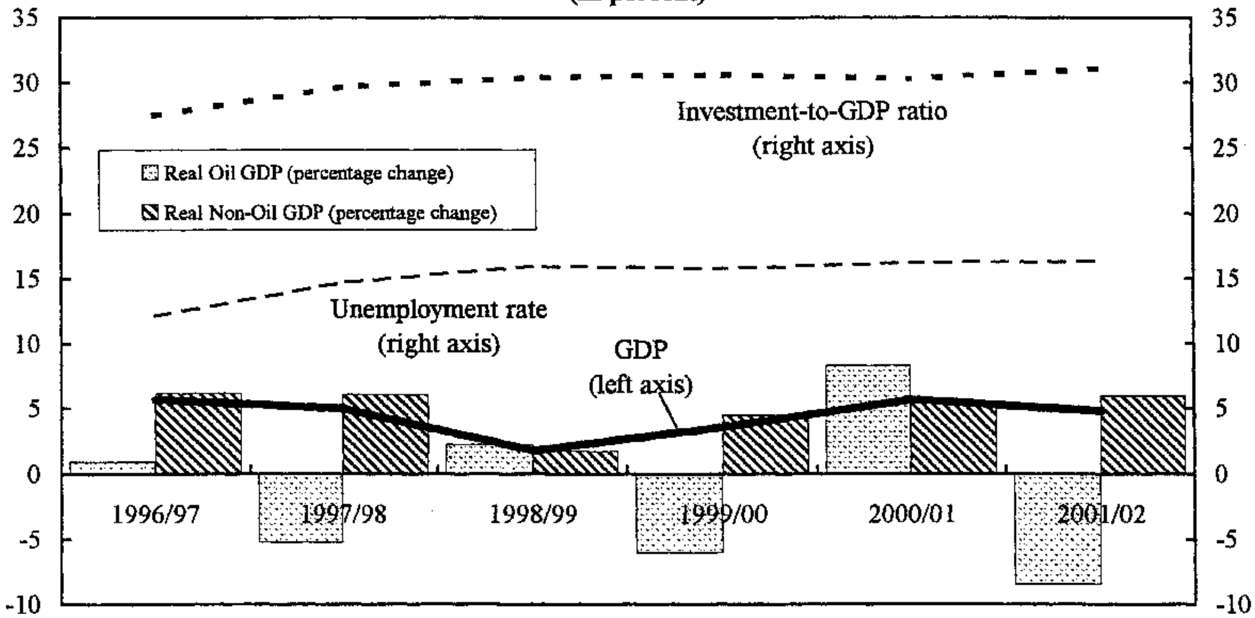
49. **The production and dissemination of economic statistics has improved markedly**, including the transition to the System of National Accounts 1993 Methodology; the preparation of quarterly national accounts data; and the adoption of Government Finance Statistics (GFS) fiscal classification. The staff commends the authorities for their intention to subscribe to the SDDS and welcomes the preparatory work underway to achieve this objective in conjunction with the technical assistance provided by STA. As a first step in this process, the staff encourages the authorities to disseminate data on international reserves.

50. **The staff welcomes the progress achieved in enhancing fiscal transparency**, including adopting GFS budget classification, making implicit subsidies an explicit entry in the budget, and disseminating fiscal information through the internet. Further commendable efforts in this area, include the authorities' work with a Fund technical assistance mission to enhance fiscal management and transparency through a fiscal ROSC. The staff encourages the authorities to follow through with the ROSC mission's recommendations.

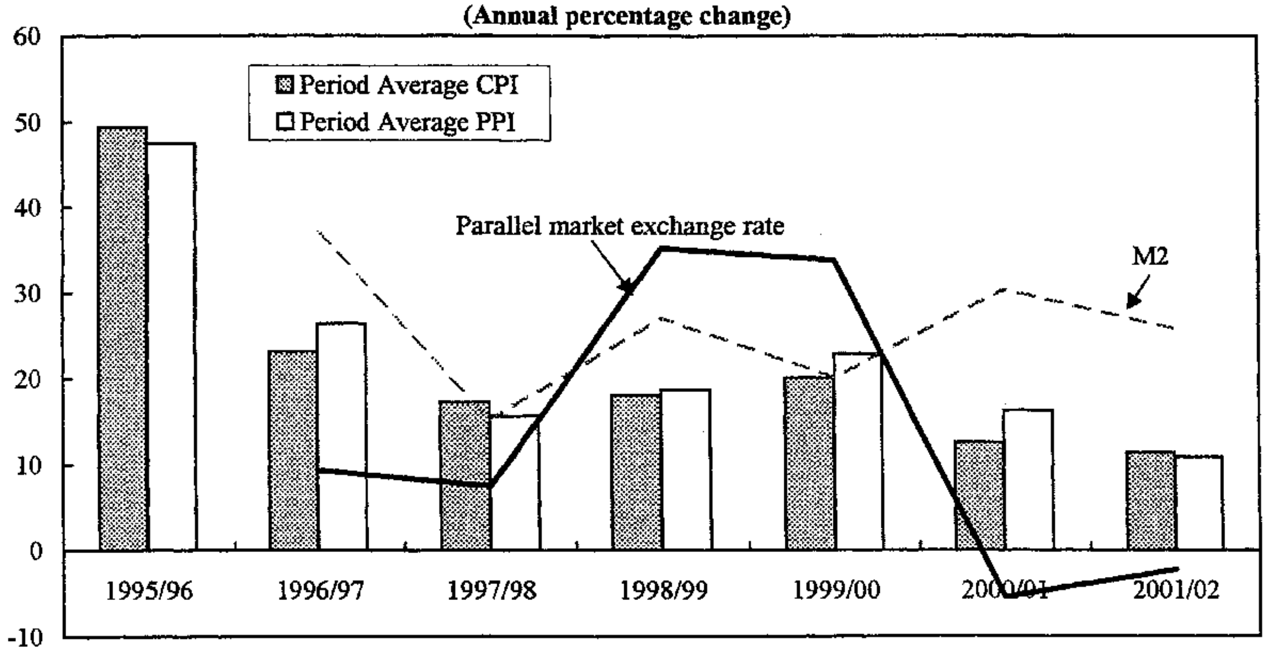
51. It is recommended that the next Article IV consultation mission with Iran be held on the standard 12-month cycle.

Figure 1. Islamic Republic of Iran: Macroeconomic Indicators, 1995/96–2001/02

Real GDP, Oil, and Non-oil Growth Rates, Unemployment and Investment-to-GDP Ratio
(In percent)



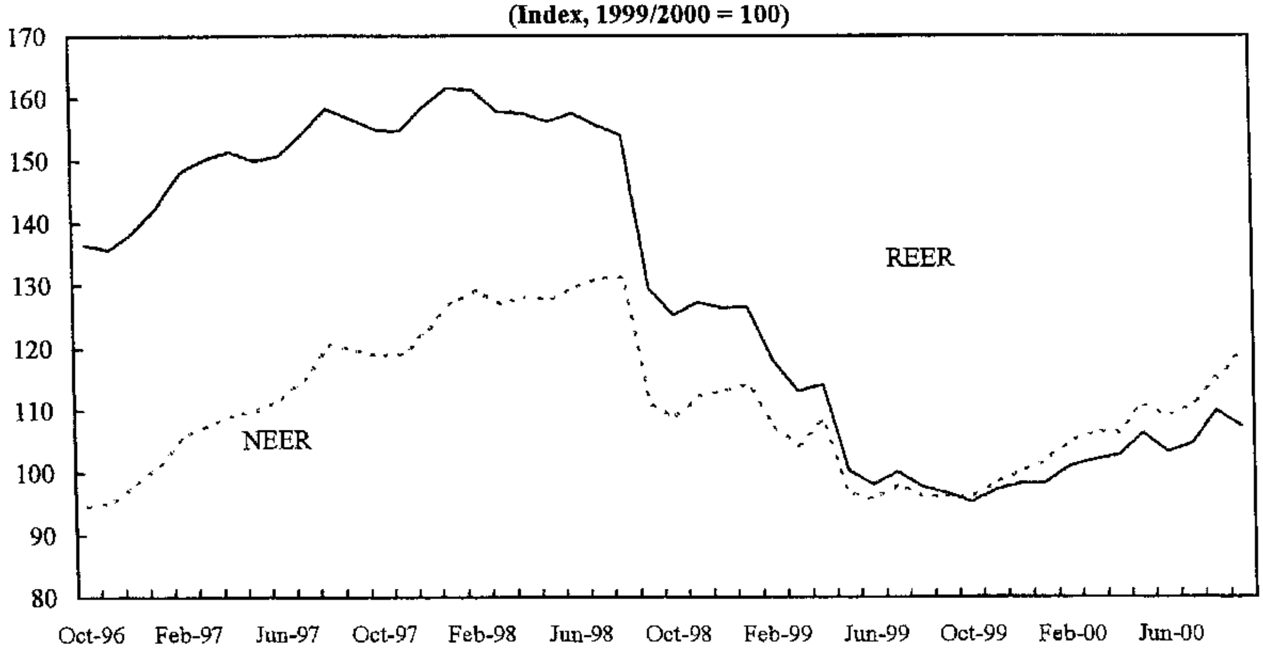
CPI, PPI, M2, and Parallel Market Exchange Rate Developments
(Annual percentage change)



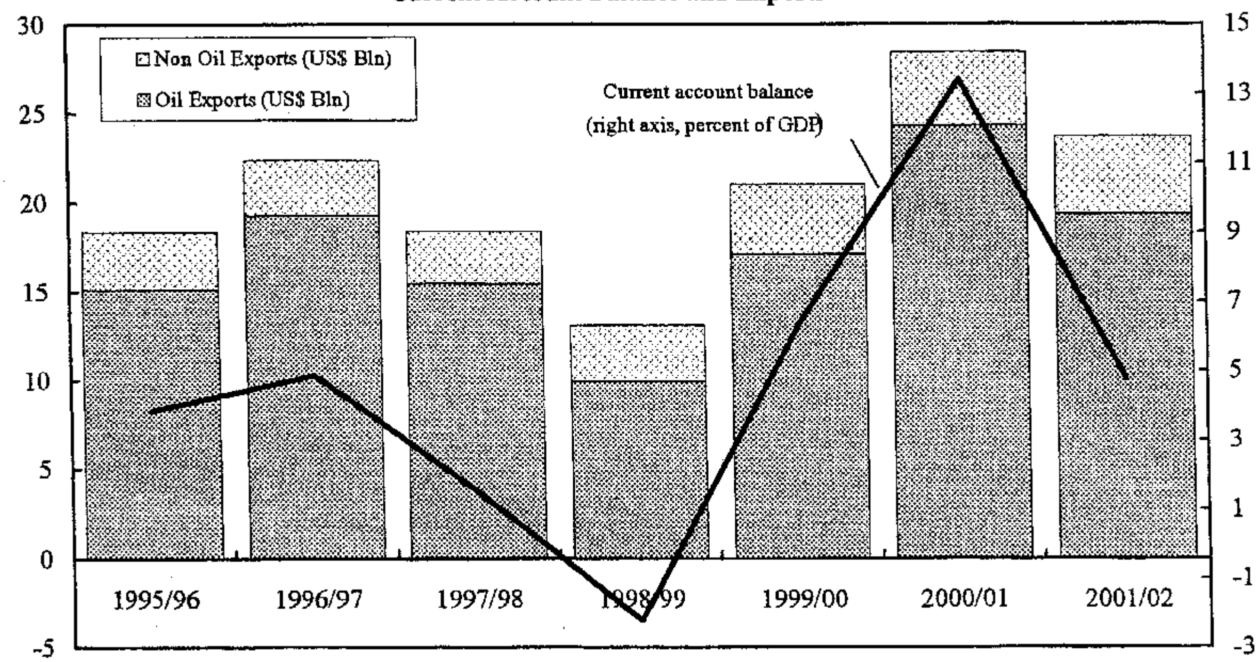
Sources: Iranian authorities; and Fund staff estimates.

Figure 2. Islamic Republic of Iran: Balance of Payments and Exchange Rate Developments, 1995/96–2001/02

Real and Nominal Effective Exchange Rate 1/
(Trade weighted, based on Tehran Stock Exchange (TSE) Iranian rial rate)
(Index, 1999/2000 = 100)



Current Account Balance and Exports

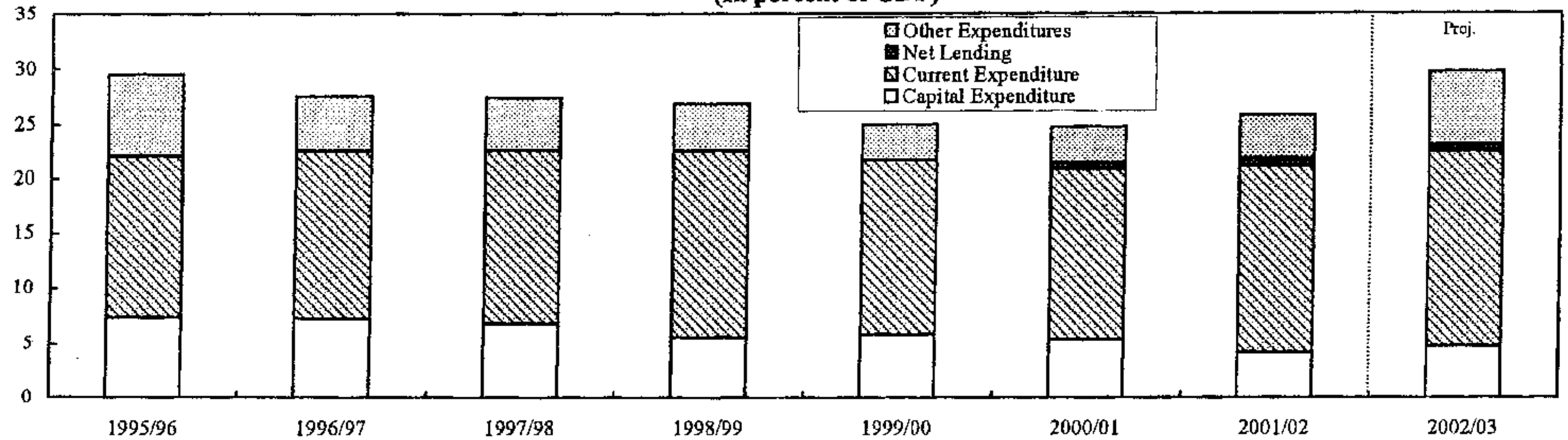


Sources: Iranian authorities; and Fund staff estimates.

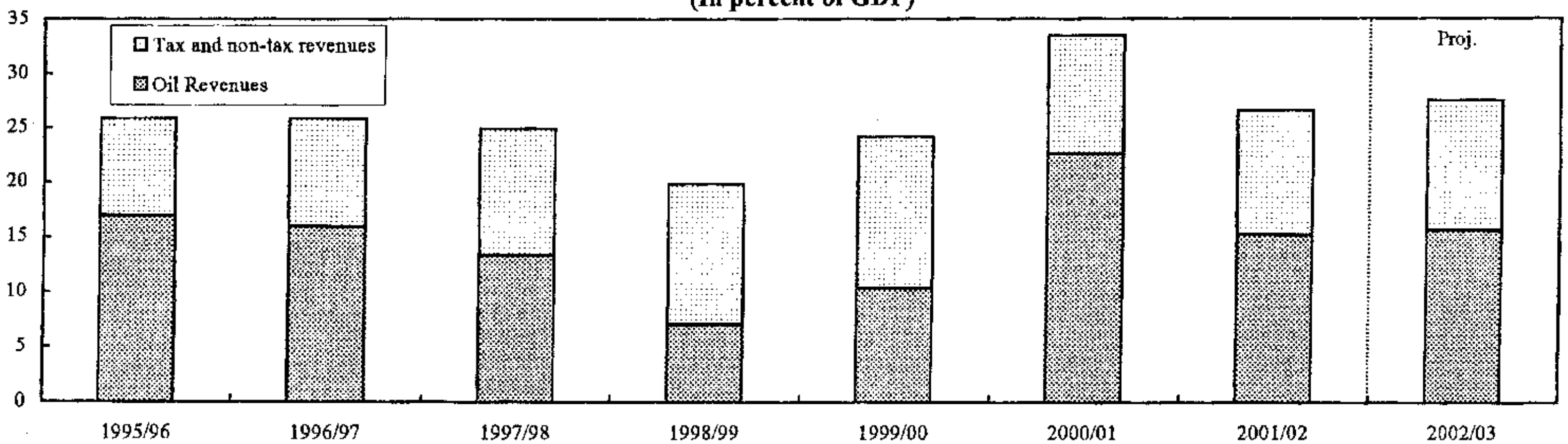
1/ Last observation: March 2002.

Figure 3. Iran: Revenue and Expenditure Developments, 1995/96–2002/03

Current, Capital, Net Lending, and Other Expenditures
(In percent of GDP)



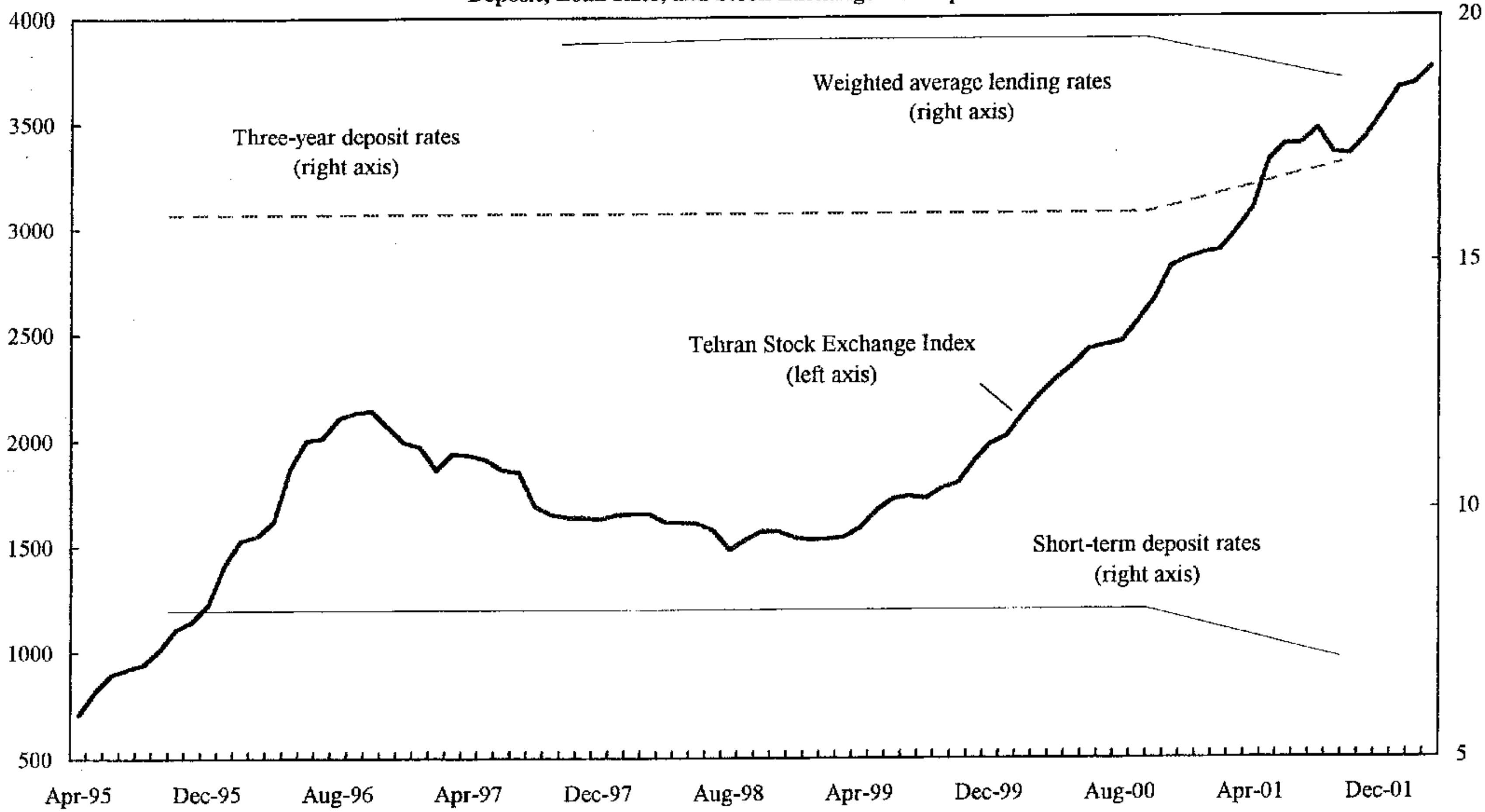
Oil, Tax, and Nontax Revenues
(In percent of GDP)



Sources: Iranian authorities; and Fund staff estimates.

Figure 4. Iran: Financial Market Indicators, 1995/96–2001/02

Deposit, Loan Rate, and Stock Exchange Developments



Sources: Iranian authorities; and Fund staff estimates.

Table 1. Islamic Republic of Iran: Key Indicators, 1998/99–2002/03 1/

	1998/99	1999/2000	2000/01	Prel. Est. 2001/02	Proj. 2002/03
		(In percentage change)			
Output and prices					
Nominal GDP at factor cost	13.8	32.0	32.5	16.7	29.0
Domestic demand (nominal)	20.0	22.7	29.6	23.0	28.3
Domestic demand (constant prices)	3.0	-2.3	4.7	8.1	8.8
Real GDP at factor cost	1.8	3.6	5.7	4.8	5.8
Real oil GDP	2.2	-6.0	8.4	-8.4	-1.0
Real non-oil GDP	1.7	4.5	5.5	6.0	6.3
Inflation rate					
CPI (yearly average)	18.1	20.1	12.6	11.4	15.0
GDP deflator at factor cost	11.8	27.4	25.4	11.3	21.9
Non-oil GDP deflator at factor cost	19.2	18.0	21.0	13.7	18.0
Unemployment rate 2/	14.7	16.0	15.8	16.2	16.3
Crude oil production (millions of barrels per day)	3.7	3.4	3.7	3.4	3.4
Average oil export price (in U.S. dollar per barrel)	10.5	18.6	25.3	21.5	23.0
		(In percent of GDP)			
Investment and savings					
Total fixed investment	30.4	30.7	30.3	31.1	30.9
Public	9.5	9.9	8.2	6.7	7.5
Private	20.9	20.7	22.1	24.4	23.3
Gross national savings	28.1	37.1	43.7	35.9	34.1
Public	2.0	9.4	17.0	7.6	5.5
Private	26.1	27.7	26.6	28.3	28.6
Savings/investment balance	-2.3	6.4	13.4	4.8	3.2
Budgetary operations					
Budgetary revenue	19.9	24.3	33.5	26.7	27.6
Budgetary expenditure and net lending	27.4	24.8	24.6	25.8	29.7
Budgetary balance (including OSF)	-7.5	-0.6	8.8	0.9	-2.0
Budgetary balance (excluding OSF)	-7.5	-0.6	0.6	-0.9	-5.0
		(Annual percentage change)			
Monetary sector 3/					
Net foreign assets	-90.2	619.4	182.9	38.4	42.7
Net domestic assets	27.8	16.8	25.9	28.7	21.4
Of which: credit to private sector	31.1	31.0	27.3	30.6	16.5
Broad money	19.6	20.2	30.5	25.8	22.9
Velocity of broad money	2.2	2.2	2.0	2.0	2.1
		(In billions of U.S. dollar)			
External sector					
Exports of goods and services	15.1	22.4	29.9	26.0	28.4
Imports of goods and services	-17.8	-16.4	-17.9	-21.6	-26.0
Current account balance	-2.1	6.6	12.6	5.4	3.5
External public- and publicly-guaranteed debt	14.1	10.8	8.0	7.2	7.3
Of which: short-term debt	4.5	4.0	3.7	2.7	1.7
Memorandum items:					
Nominal GDP (in billions of Iranian rials)	324,357	428,298	567,591	662,514	854,568
Nominal effective exchange rate 3/	163.2	118.9	130.1	143.4	...
Real effective exchange rate 3/	118.3	100.0	118.5	139.1	...
Average exchange rate (Iranian rials per U.S. dollar)	5,404.0	7,908.0	8,078.0	7,921.0	...

Sources: Data provided by the Iranian authorities; and Fund staff estimates.

1/ Iranian fiscal years ending March 20.
2/ Based on central bank data.
3/ Using TSE rate and 1999/2000=100.

Table 2. Islamic Republic of Iran: Balance of Payments, 1999/2000–2003/04 (continued) 1/

(In millions of U.S. dollars; unless otherwise indicated)

			Prel.	Proj.	
	1999/2000	2000/01	2001/02	2002/03	2003/04
Current account	6,589	12,634	5,432	3,486	2,932
(In percent of GDP)	6.4	13.4	4.8	3.2	2.5
Trade balance	7,597	13,375	5,578	3,937	3,270
Exports	21,030	28,461	23,716	25,761	27,739
Oil and gas	17,089	24,280	19,339	20,755	22,101
Crude oil export	14,718	21,490	17,029	17,146	17,605
Exports of petroleum products and gas	2,371	2,790	2,310	3,609	4,497
Refined product	2,151	2,497	2,133	2,584	2,907
Gas exports and others	220	293	177	1,025	1,590
Non-oil	3,941	4,181	4,377	5,006	5,638
Imports	-13,433	-15,086	-18,138	-21,824	-24,469
Services account	-1,533	-1,351	-1,144	-1,451	-1,389
Credits	1,396	1,416	2,304	2,678	3,483
Freight and insurance	310	450	657	773	832
Interest income	181	215	456	515	1,093
Other	905	751	1,191	1,391	1,558
Debits	-2,929	-2,767	-3,448	-4,130	-4,872
Freight and insurance	-1,240	-1,347	-1,569	-1,964	-2,202
Interest payments	-473	-370	-231	-221	-374
Other	-1,216	-1,050	-1,648	-1,944	-2,296
Transfers	525	610	998	1,000	1,050
Capital and financial account	-4,811	-4,897	-552	1,981	3,725
Medium-term and long-term capital	-2,944	-2,555	288	1,131	1,510
Bilateral project financing	-1,159	-473	168	96	592
Disbursements	829	653	959	700	1,100
Repayments	-1,988	-1,126	-791	-604	-508
Repayments of rescheduled debt	-1,581	-884	-327	-60	0
Other official financing and portfolio investment 2/	81	10	-35	664	1,117
Borrowing by MoF (collateral by securities)	-448	0	0	0	0
Oil prefinancing	163	-1,208	482	431	-199
Short-term capital	-330	-326	-1,026	-1,000	265
LC-related borrowing 3/	-330	-326	-1,026	-1,000	265
Other capital 4/	-1,937	-2,416	-1,899	-150	-250
Commercial banks	-1,637	-2,416	-1,899	-150	-250
Deferred payments to creditors by commercial banks	-300	0	0	0	0
Foreign direct investment and portfolio equity	400	400	2,085	2,000	2,200
Of which: buy-backs	365	360	2,000	1,900	2,000
Errors and omission	308	-857	61	0	0
Overall balance	2,086	6,880	4,941	5,466	6,657
Financing	-2,086	-6,880	-4,941	-5,466	-6,657
Change in NFA (increase -)	-1,917	-6,880	-4,941	-5,466	-6,657

Table 2. Islamic Republic of Iran: Balance of Payments, 1999/2000–2003/04 (concluded) 1/

(In millions of U.S. dollars; unless otherwise indicated)

	1999/2000	2000/01	Prel. 2001/02	Proj. 2002/03	2003/04
Memorandum items:					
Gross official reserves	5,647	12,527	17,468	22,934	29,591
Of which: Oil Stabilization Fund 5/	...	5,900	7,440	...	...
(In months of imports of G&S)	4.1	8.4	9.7	10.6	12.1
External debt service (as percent of exports of G&S) 6/	23.8	12.5	7.8	3.7	5.5
Oil exports (million barrel per day)	2.1	2.3	2.1	2.0	2.2
Oil exports average price (U.S. dollar per barrel) 7/	18.6	25.3	21.5	23.0	21.6
Exports volume growth	0.4	8.6	-6.3	3.5	11.1
Oil	-5.7	9.5	-10.0	-0.6	10.4
Non-oil	23.7	6.1	4.7	14.4	12.6
Imports volume growth	-4.3	13.1	24.5	18.9	10.0

Sources: Data provided by the Iranian authorities; and Fund staff estimates.

1/ Iranian fiscal years ending March 20.
2/ Includes World Bank lending as well as Eurobond borrowing in 2002/03.
3/ Some letters of credit (LC) have maturities in excess of one year.
4/ Reflecting borrowing of the Bank Markazi from the commercial banks and some deferred trade payments of banks.
5/ Represents the part of OSF that will be kept in foreign exchange.
6/ Excluding short-term debt.
7/ Projection is based on WEO prices.

Table 3. Islamic Republic of Iran: Summary External Debt and Debt Service, 1999/2000–2003/04 1/

(In millions of U.S. dollars)

	1999/2000	2000/01	Prel. 2001/02	Proj. 2002/03	Proj. 2003/04
Total external debt	10,815	7,952	7,214	7,345	9,120
Medium- and long-term debt 2/	6,811	4,274	4,562	5,693	7,203
Bilateral debt	3,058	2,585	2,753	2,849	3,441
Official financing 3/	774	784	749	1,413	2,530
Rescheduled debt	1,253	387	60	0	0
Of which: 1998 rephased debt	1,032	355	44	0	0
Borrowing by MoF (collateral by securities)	0	0	0	0	0
Oil prefinancing	1,726	518	1,000	1,431	1,232
Short-term debt 2/	4,004	3,678	2,652	1,652	1,917
LC-related borrowing 4/	4,004	3,678	2,652	1,652	1,917
Arrears	0	0	0	0	0
Oil prefinancing	0	0	0	0	0
Total external debt services	-10,248	-7,752	-5,665	-3,755	-4,012
Medium- and long term debt	-5,299	-3,706	-1,983	-1,037	-1,664
Short-term debt	-4,949	-4,046	-3,682	-2,718	-2,348
Total amortization	-9,865	-7,386	-5,426	-3,534	-3,638
Medium- and long-term debt	-4,916	-3,340	-1,744	-816	-1,290
Short-term debt	-4,949	-4,046	-3,682	-2,718	-2,348
Interest					
Total interest payments 5/	-383	-366	-239	-221	-374
Medium- and long-term debt	-383	-366	-239	-221	-374
Short-term	...	...	...	...	...
Memorandum items:					
Debt service ratio (excluding short-term debt)	23.8	12.5	7.8	3.7	5.5
Debt outstanding/GDP (including arrears)	10.5	8.4	6.3	6.8	7.8

Source: Data provided by the Iranian authorities; and Fund staff estimates.

1/ Iranian fiscal years ending March 20.
2/ Reflect authorities data (actuals) and projections of disbursements and amortization.
3/ Includes World Bank loans and Eurobonds.
4/ Some letters of credit (LC) may have maturities in excess of one year.
5/ Includes interest on projected new borrowing for 2000/01–2001/02.

Table 4. Islamic Republic of Iran: Central Government Fiscal Operations, 1999/2000–2002/03 (continued) 1/

	1999/2000	2000/01 2/	Est. 2001/02	Proj. 2002/03 Current Policies	Proj. 2002/03 Adjustment
	(In billions of Iranian rials)				
Revenue	103,891	189,989	176,860	229,498	236,220
Revenue from oil and gas exports	44,487	128,205	101,522	134,329	134,329
Of which: earmarked revenue for Oil Stabilization Fund (OSF)	...	n.a.	14,636	28,926	28,926
Tax and nontax revenue	59,404	61,784	75,337	95,169	101,891
Tax revenue	38,757	33,298	38,797	49,536	49,536
Nontax revenue	9,072	12,004	13,824	16,496	16,496
Of which: revenue income on OSF 2/	...	n.a.	1,240	1,570	1,570
Earmarked revenue 3/	11,575	16,481	22,717	29,136	29,136
Revenue measures	0	0	0	0	6,723
Expenditure and net lending	106,301	139,893	170,861	273,741	253,573
Current expenditure	67,987	88,068	112,551	158,225	151,503
Of which: wages and salaries	n.a.	n.a.	44,000	57,132	57,132
Of which: subsidies	7,651	8,118	11,784	39,475	39,475
Capital expenditure	24,942	30,115	27,359	53,280	39,834
Coverage of contingent liabilities (LCs)	...	...	...	19,813	19,813
Earmarked expenditure 4/	11,575	16,481	22,717	29,136	29,136
Foreign exchange losses 5/	1,993	2,028	0	3,963	3,963
Net lending	-196	3,201	4,370	5,362	5,362
Of which: net lending from the OSF	...	399	3,961	5,548	5,548
Extrabudgetary expenditure	...	...	3,863	3,963	3,963
Overall balance (deficit (-))	-2,410	50,096	5,999	-44,244	-17,352
Excluding OSF	...	3,472	-5,917	-69,193	-42,301
Overall non-oil balance (deficit (-))	-46,897	-78,110	-95,523	-178,572	-151,681
Financing	2,410	-50,096	-5,999	44,244	17,352
Net domestic	2,290	-43,221	-1,370	37,030	10,139
Banking system (net)	-390	-45,265	-3,205	23,833	6,264
Financing by BMJII 5/	1,813	...	-2,348	3,713	3,713
OSF (net)	...	-46,625	-11,853	11,506	-6,063
Other bank financing	...	...	10,995	8,614	8,614
Nonbank	2,680	2,044	1,835	13,197	3,875
Net external	120	-6,875	-4,629	7,213	7,213

Table 4. Islamic Republic of Iran: Central Government Fiscal Operations, 1999/2000–2002/03 (concluded) 1/

	1999/2000	2000/01 2/	Est. 2001/02	Proj. 2002/03	
				Current Policies	Adjustment
			(In percent of GDP)		
Revenue	24.3	33.5	26.7	26.9	27.6
Revenue from oil and gas exports	10.4	22.6	15.3	15.7	15.7
Of which: earmarked revenue for OSF	...	n.a.	2.2	3.4	3.4
Tax and nontax revenue	13.9	10.9	11.4	11.1	11.9
Tax revenue	9.0	5.9	5.9	5.8	5.8
Nontax revenue	2.1	2.1	2.1	1.9	1.9
Earmarked revenue 3/	2.7	2.9	3.4	3.4	3.4
Revenue measures	0.0	0.0	0.0	0.0	0.8
Expenditure and net lending	24.8	24.6	25.8	32.0	29.7
Current expenditure	15.9	15.5	17.0	18.5	17.7
Of which: wages and salaries	n.a.	n.a.	6.6	6.7	6.7
Of which: subsidies	1.8	1.4	1.8	4.6	4.6
Capital expenditure	5.8	5.3	4.1	6.2	4.7
Coverage of contingent liabilities (LCs)	...	...	...	2.3	2.3
Earmarked expenditure 4/	2.7	2.9	3.4	3.4	3.4
Foreign exchange losses 5/	0.5	0.4	0.0	0.5	0.5
Net lending	0.0	0.6	0.7	0.6	0.6
Extrabudgetary expenditure	...	...	0.6	0.5	0.5
Overall balance (deficit (-))	-0.6	8.8	0.9	-5.2	-2.0
Excluding OSF	...	0.6	-0.9	-8.1	-5.0
Overall non-oil balance (deficit (-))	-10.9	-13.8	-14.4	-20.9	-17.7
Financing	0.6	-8.8	-0.9	5.2	2.0
Net domestic	0.5	-7.6	-0.2	4.3	1.2
Banking system (net)	-0.1	-8.0	-0.5	2.8	0.7
Nonbank	0.6	0.4	0.3	1.5	0.5
Net external	0.0	-1.2	-0.7	0.8	0.8
Memorandum item:					
Nominal GDP	428,298	567,591	662,514	854,568	854,568

Sources: Bank Markazi Jomhouri Islami Iran; Plan and Budget Organization; and Fund staff estimates and projections.

1/ Iranian fiscal years ending March 20.
2/ Includes OSF domestic lending facility.
3/ Mostly revenue of the Social Security Organization and medical services provided by universities.
4/ Counterpart of earmarked revenue.
5/ Budget outlays to cover the foreign exchange losses of the central bank, inclusive of contingent liabilities due to exchange rate unification. For 2002/03, includes US$500 million on contingent liabilities to be financed by BMJII.

Table 5. Islamic Republic of Iran: Monetary Survey, 1999/2000–2002/03 1/

(In billions of Iranian rials; unless otherwise indicated)

	1999/2000	2000/01	2001/02	2001/02 2/	Proj. 2002/03
Net foreign assets	6,747	19,090	26,429	119,684	170,761
Foreign assets of BMJII	12,095	22,631	30,837	139,648	182,800
Foreign assets of banks	5,290	9,266	12,588	57,007	64,932
Foreign liabilities of BMJII	4,227	2,946	4,310	19,517	19,517
Foreign liabilities of banks	6,410	9,862	12,687	57,454	57,454
Net domestic assets	191,193	240,655	309,759	222,036	269,650
Net domestic credit	227,559	261,239	329,765	286,495	337,709
Net credit to govenrment	41,739	24,637	20,659	-22,611	-16,347
Claims on the government	65,519	63,364	68,582	74,774	82,449
Deposits	23,781	38,727	47,922	97,385	98,796
Claims on NFPEs	47,907	55,731	66,564	66,564	71,418
Claims on the private sector	137,913	180,871	242,542	242,542	282,638
Other items, net, excluding CPPs	-36,366	-20,584	-20,006	-64,459	-68,059
Broad money (M3)	197,940	259,745	336,190	341,719	440,410
M2	197,940	258,274	325,023	325,023	399,314
Cash	22,119	25,158	29,189	29,189	35,861
Deposits	175,821	233,116	295,834	295,834	363,453
Demand deposits	69,882	98,425	117,833	117,833	144,766
Time deposits	105,938	134,690	178,001	178,001	218,687
CPPs held by nonbanks	0	0	9,600	9,600	34,000
Foreign exchange deposits 3/	0	1,471	1,567	7,096	7,096
In millions of U.S. dollars	0	841	895	895	895
Accounting exchange rate,					
Iranian Rls per U.S. dollar	1,750	1,750	1,750	7,925	7,925
Memorandum items:					
M1	92,002	123,584	147,022	147,022	180,627
M2, excluding foreign currency deposits and CPP	197,940	258,274	325,023	325,023	399,314
Multiplier (base money/M2)	2.55	2.73	3.14	3.05	3.15
Income velocity of M2	2.16	2.20	2.04	2.04	2.14
GDP	428,298	567,591	662,514	662,514	854,568
Annual percentage changes:					
NFA	619.4	182.9	38.4	...	42.7
NDA	16.8	25.9	28.7	...	21.4
Base money	16.5	22.3	9.3	...	18.9
M2, excluding foreign currency deposits and CPP	20.2	30.5	25.8	...	22.9
M3	20.2	31.2	29.4	...	28.9
Credit to the private sector and NFPEs	31.0	27.3	30.6	...	14.5
Credit to the private sector	40.4	31.1	34.1	...	16.5

Sources: Bank Markazai Jomhouri Islami Iran; and Fund staff estimates and projections.

1/ Iranian fiscal years ending March 20.
2/ End-2001/02 were revalued at the unified exchange rate of March 23, 2002.
3/ Data on foreign currency deposits before 2000/01 are reported under foreign liabilities.

Table 6. Islamic Republic of Iran: Vulnerability Indicators, 1998/99–2001/02 1/

(In percent; unless otherwise indicated)

	1998/99	1999/2000	2000/01	Prel. Est. 2001/02
External solvency indicators				
REER (TSE, average period, percent change)	...	...	18.5	17.6
Total external debt (in billions of U.S. dollars)	14.1	10.8	8.0	7.2
(In percent of GDP)	14.6	10.5	8.4	6.3
Short-term external debt (in billions of U.S. dollars)	4.5	4.0	3.7	2.7
(In percent of GDP)	4.7	3.9	3.9	2.3
(In percent of exports of goods and services)	34.4	22.2	13.6	14.4
External debt service (excluding short-term debt)	33.5	23.8	12.5	7.8
External liquidity indicators				
Total official reserves (in billions of U.S. dollars)	3.7	5.6	12.5	17.5
In months of imports of goods and services	2.5	4.1	8.4	9.7
In percent of short-term external debt	83	141	341	659
Commercial banks net foreign assets (in billions of U.S. dollars) 2/ 3/	-1.8	-0.6	-0.3	-0.1
Foreign assets	1.4	3.0	5.3	7.2
Foreign liabilities	3.2	3.7	5.6	7.3
Oil and oil-related exports/total exports	65.6	76.2	81.3	74.3
Public sector solvency indicators				
Government debt/GDP	31.9	25.1	19.5	16.7
Oil revenue/total revenue	35.8	42.8	67.5	57.4
Financial sector indicators				
Risk-weighted capital adequecy of banks (in percent) 4/	...	...	6.6	6.9
Ratio of non-performing loans of banks (in percent) 4/	5.1	4.3	4.4	5.4
Return on average assets of banks (in percent) 4/	0.3	0.3	0.9	...
Net domestic credit (percent change)	31.5	22.5	14.8	26.0
Private sector credit (percent change)	29.7	40.4	31.1	34.1
Net domestic credit/GDP	44.9	50.2	52.3	56.8
Market assessment/financial market indicators				
Stock market price index (percent change; end-of-period)	-7.0	43.4	35.0	42.3
Stock market capitalization (in percent of GDP)	8.2	10.2	11.0	12.3
Stock market turnover ratio (in percent)	9.1	10.4	14.7	...
Fitch ratings	...	...	...	B+

Sources: Iranian authorities; and Fund staff estimates and projections.

1/ Iranian fiscal years ending on March 20.

2/ Data valued at weighted average exchange rate.

3/ New regulation has been issued with allowable limit on net open position for individual currencies at 10 percent of capital and an overall net open position limit of 30 percent of capital.

4/ Estimates are preliminary and provided by Iranian authorities. Estimates from FSAP report (July 2000) indicate less favorable ratios.

Islamic Republic of Iran: Fund Relations

As of June 30, 2002

I. Membership Status: Joined: 12/29/1945; Article XIV

II. General Resources Account

	SDR Million	Percent of Quota
Quota	1,497.20	100.00
Fund holdings of currency	1,497.20	100.00

III. SDR Department

	SDR Million	Percent of Allocation
Net cumulative allocation	44.06	100.00
Holdings	267.69	109.68

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements: None

VI. Projected Obligations to Fund: None

Under the Repurchase Expectations Assumptions:

Repurchase expectations apply to purchases after November 28, 2000 in the credit tranches, including the Compensatory Financing Facility, and under the Extended Fund Facility. Repurchases in the credit tranches and the Extended Fund Facility are expected to be completed in 2¼–4 years and 4½–7 years, respectively. The Fund has the option of extending the repurchase expectations upon request by members.

Nonfinancial Relations

VII. Exchange System

On March 21, 2002, a unified exchange rate regime, based on managed floating exchange rate system, was adopted and the former official exchange rate of Iranian Rls 1,750 per U.S. dollar was abolished. The new exchange rate is determined in the interbank foreign exchange market. As a result, effective March 30, 2002, the exchange rate arrangement of the Islamic Republic of Iran has been reclassified to the category of managed floating with no preannounced path for the exchange rate from the conventional pegged arrangement. Under new foreign exchange regulations (a) there is no surrender requirements of the foreign exchange earned by non-oil exporters; (b) the need for and the amount of advance deposits for opening LCs are now left to the discretion of the authorized financial institutions; (c) the procedure of foreign exchange allocation for authorized imports has been eliminated; (d) the distinction between internally and externally sourced foreign exchange deposit accounts has been largely eliminated; and (e) the base rate for converting the dollar value of imports for the collection of customs duties and commercial benefits taxes were revised from Iranian Rls 1,750 per U.S. dollar to the market rate.

Prior to March 21, 2002, the foreign exchange market operated mostly under a multiple exchange system, consisting of two officially approved rates: (a) an official exchange rate pegged at Iranian Rls 1,750 per U.S. dollar that applied mainly to imports of essential goods and services as well as servicing public and publicly guaranteed debt; and (b) an effective Tehran Stock Exchange (TSE) rate, applicable for imports from a positive list issued by the Ministry of Commerce (MOC). There was also an unofficial exchange market and the Bank Markazi Jomhouri Islami Iran (BMJII) allowed commercial banks limited access to this market to cover certain current transactions.

VIII. Last Article IV Consultation

The last Article IV consultation was concluded by the Executive Board on September 6, 2001.

IX. Technical Assistance

Since FY 1999, Iran received the following technical assistance:

FAD

FY 1999 - Tax system and VAT
FY 2000 - Tax administration and VAT
FY 2001 - Tax administration and VAT

MAE

FSAP

FY 2000 - FSAP mission
FY 2001 - Follow-up multi-topic mission

Banking Supervision

FY 1999 - Short visit in context of policy discussions on banking sector restructuring
FY 2000 - Short visits by MAE expert on banking supervision

FY 2001 - Short visits by MAE expert on banking supervision
FY 2002 - Resident expert on banking supervision
FY 2003 - Short visits by MAE expert on banking supervision

Monetary Instruments

FY 1999 - Follow-up in two technical assistance missions dealing mainly with exchange system reforms
- Staff visit on details of central bank securities

FY 2000 - Follow-up in one short visit and in one technical assistance mission dealing mainly with exchange system reforms
FY2002 - Technical assistance mission on the issuance of central bank participation papers

Exchange System

FY 1997 - Multi-topic mission covered foreign exchange reserves management
FY 1999 - Two technical assistance missions dealing mainly with exchange system reforms, each followed by policy discussions on implementation of reforms
FY 2000 - Follow-up in one short visit, in context of further policy discussions
- One technical assistance mission on details of implementation of exchange system reforms

FY 2002 - One technical assistance mission on foreign exchange system reforms
- Follow-up technical assistance on exchange rate unification and interbank foreign exchange market

FY 2003 - Technical assistance mission to review foreign exchange system after the unification of exchange rate

STA

FY 2000 - Balance of payment statistics
- Government finance statistics
- National accounts statistics

FY 2002 - Monetary and financial statistics
FY 2003 - Multi-sector mission to assess current data dissemination practices against the requirements of the Special Data Dissemination Standard (SDDS) and provided technical assistance on ways to improve the compilation of the macroeconomic statistics that would facilitate SDDS subscription.

Islamic Republic of Iran: Relations with the World Bank Group[1]

1. World Bank lending to Iran resumed in May 2000 with the approval by the Board of Executive Directors of two projects: the Second Primary Health Project (US$87 million) and the Tehran Sewerage Project (US$145 million). These loans were approved after a hiatus of seven years during which World Bank activities were limited and focused mainly on supervision of ongoing projects and limited economic work. While approving the two loans, the Executive Directors requested that Staff prepare an interim assistance strategy note reviewing the progress in economic reform and developments and outlining the World Bank Group's approach in Iran.

2. This interim assistance strategy note was discussed by the Board of Directors in May 10, 2001. It outlines the interim assistance strategy that the World Bank Group will follow while preparing a full Country Assistance Strategy (CAS) for consideration by the Executive Directors towards the end of the two years currently covered by the Interim Strategy. The CAS will reflect the further deepening of the World Bank's knowledge of Iran's development process and priorities.

3. The World Bank Group Interim Assistance Strategy will follow a two-pronged approach (a) policy dialogue on the reform program through nonlending services; and (b) targeted lending in the key social and environment areas consistent with the TFYDP and focusing on projects that have the most tangible benefits and quickest impact on the population, that are least affected by policy distortions that could constrain their effectiveness, and that are resilient to Iran's risk factors.

4. In support of the government's reform efforts, the World Bank will intensify economic and sector work covering the main reform areas and provide support for capacity building in the formulation of economic and sector policies, their sequencing, and implementation. This nonlending support will also be useful in the preparation of the full CAS. A series of economic studies is either under way or planned over the next two years to provide the basis for policy dialogue and policy analysis and to prepare the CAS. These include a study on the reform of the energy pricing system; a Trade and Foreign Exchange System reform study; a Public Expenditure Review; a Country Economic Memorandum providing analysis of the medium-term framework for the economic transition and the sequencing of reforms; an evaluation of the costs of reforms and how to address them; as well as other sectoral studies, including a Water Management Policy Review note, and sectoral strategy notes on housing, agriculture, and air pollution control.

5. Lending during this transitory period is envisaged in the strategy to be up to US$755 million and will focus mainly on priority areas such as low income housing, sewerage, urban upgrading, environmental management, and community-based infrastructure and employment creation schemes for the poor. Small technical assistance lending will also

[1] Prepared by the World Bank staff.

be considered in support of the structural reform program, especially in the area of the financial sector reforms. The World Bank will continually assess the lending program on the basis of progress in macroeconomic performance and policy outcomes and project implementation in the areas identified as a priority for World Bank involvement. The IFC and the World Bank Institute will combine efforts in support of this reform program.

Islamic Republic of Iran: Statistical Issues

The data transmitted to the Fund, through direct contacts with the authorities and/or through the Executive Director's office, provided a basis for sound assessment of economic developments and to form a realistic perspective on Iran's medium-term prospects. The new Bank Markazi's Economic Accounts Department has implemented significant improvements in the statistical database, including the dissemination of data to the public. The quarterly publication on economic and financial data, *Economic Trends,* is disseminated on the Internet at <http://www.cbi.ir/e/>, ahead of the release of the hard copy publication. However, the timeliness of key monthly data could be improved by the implementation of data dissemination practices that incorporate revision policies and by the utilization of electronic modes of data releases that would also enhance data accessibility.

A multisector mission of the Statistics Department (STA) of the IMF visited Iran during June 18–July 1, 2002 to assess current data dissemination practices against the requirements of the Special Data Dissemination Standard (SDDS). The mission also provided assistance on ways to further improve the compilation of the macroeconomic statistics.

Real sector statistics

- National accounts statistics are reasonably sound and the compilation is currently in transition to the System of National Accounts (SNA) 1993 methodologies. Bank Markazi has also updated the quarterly GDP statistics for the period 1988–2001. Price statistics have generally been reported to the Fund in a timely manner. Labor market statistics, however, still need improvement, particularly with regard to employment data.

- Even though some of the recommendations made by the 1999 STA mission have not yet been fully implemented, considerable progress was made, most notably concerning the change of the base year for the constant price calculations, implementation of the *1993 SNA*, and work on the development of quarterly national accounts. Improvements have also been made in the coverage of the informal economy. However, additional work remains, especially in the coverage of small-scale industries and services.

Government finance statistics

- One significant improvement in the central government statistics has been the adoption of the Government Finance Statistics classification which will enhance transparency and help improve fiscal management.

- Data on the central government operations cover the general budget, the special purpose funds, and transactions with the Social Security Organization. There is a need to expand the coverage of central government to include the complete transactions of the Social Security Organization, four pension funds, five procurement and distribution centers, and the Oil Stabilization Fund (OSF).

- No data for the consolidated general government, comprising the central government and the municipalities, are compiled.

- The existing cash-based government accounting system should be upgraded to enable recording of expenditures at the pre-payment stage.

- Based on its understanding of its structure of control and management, the Bonyad-e-Mostazafan va Janbazan (BMJ, Foundation of the Oppressed and Injured) could be considered a holding company and can be classified in the nonfinancial public corporations sector.

- Financing data in the GFS are not broken down by residency of debt holders or by type of debt instruments. Data used by the Economic Research and Policy Department (ERPD) for preparing financing data could be further analyzed to distinguish debt by type of holder and by instrument.

- Information on domestic government debt with the BMJII and commercial banks are disseminated in the Table, "Monetary and Credit Aggregates Outstanding at the end of the Period" in *Economic Trends*. However, domestic debt with the public at large, or economic sectors excluding the banking sector, mainly in the form of Government Participation Papers (GPP) are not monitored. There is a need to develop a comprehensive database on domestic debt, including debt held by the nonbank sector.

Monetary statistics

- Monetary data are in general made available on a timely basis, and their compilation broadly follows Fund methodology but a number of improvements are needed.

- Monetary statistics do not include banks' positions with a number of central government extra-budgetary funds (these positions are included in the banks' positions with other domestic sectors). On the other hand, the measure of broad money employed by the BMJII does not include deposits of public corporations. On balance, the broad money stock tends to be underestimated. The coverage of broad money needs to include deposits of public non-financial corporations, local government, and all foreign currency deposits of residents (other than central government). It is recommended that ERPD, in coordination with Accounting and Bank Information Departments of the BMJII, request more detailed information on extra-budgetary funds in reporting of the BMJII and banks' balance sheet data and reclassifying these units under central government.

- Foreign currency deposits of domestic subsectors at banks, mainly including those of nonfinancial corporations and households, are currently classified as foreign liabilities along with foreign currency deposits of nonresidents. Recently, efforts have been made to collect information needed for separately identifying foreign currency deposits of resident sectors and nonresidents and to reclassify foreign currency deposits of residents under relevant domestic liabilities categories. The Fund staff has received data on foreign currency deposits of residents for 2000/01 and 2001/02.

- Foreign currency deposits of banks with the BMJII are currently misclassified as foreign liabilities of the BMJII in BMJII's analytical accounts, which results in an overstatement of the BMJII foreign liabilities position. These deposits should be reclassified as BMJII's domestic liabilities to banks.

- In the BMJII's analytical accounts, central bank participation papers (CPPs) are included in other unclassified liabilities. Separate data on holdings of CPPs broken down by bank holders and non-bank holders should be collected in the BMJII monthly report. These separate data would allow the BMJII and other data users to construct broader liquidity measures, which would include CPPs held by nonbank sectors.

External sector data

- Work on the transition to Balance of Payments Manual Edition 5 (*BPM5)* is underway for the annual BOP series; recoding of transactions—initiated during the 1999 mission—is completed, and efforts are now directed at improving the estimates for transactions not recorded in the *BPM4* format, and for which historical data are unavailable.

- With regards to the treatment of "buy-back" agreements in Iran's balance of payments according to the methodology of *BPM5*, the previous IMF balance of payments statistics mission (1999) recommended that they be included under *direct investment*. The authorities have gradually included some elements of the buy-back schemes in the balance of payments presentational format and have classified them as *direct investment*.

- Iran's international reserves data are not published and it is recommended that the authorities make this information available to the public.

- Annual and quarterly external debt statistics (in millions of U.S. dollars) are published with a maturity breakdown and an annual maturity profile for a five-year horizon. It is recommended that the BMJII disseminate additional tables with detailed breakdowns and methodological notes in its publications, and on its Internet website.

Islamic Republic of Iran: Survey of Reporting of Main Statistical Indicators

(As of June 30, 2002)

	Exchange Rates	International Reserves	Reserve/ Base Money	Central Bank Balance Sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/GNP
Date of latest observation	May-02	Apr-02	Apr-02	Apr-02	Apr-02	Apr-02	Apr-02	Apr-02	Apr-02	Apr-02	2001/02
Date received	Jun-02	Jun-02	Jun-02	Jun-02	Jun-02	Jun-02	Jun-02	Jun-02	Jun-02	Jun-02	Jun-02
Frequency of data	W	M	M	M	M	F	M	Q	Q	H	F
Frequency of reporting	W	1/	1/	1/	1/	1/	1/	1/	1/	1/	1/
Source of data	Bank Markazi	Bank Markazi	Bank Markazi	Bank Markazi	Bank Markazi	Bank Markazi	Bank Markazi	Bank Markazi	Bank Markazi	Bank Markazi and MPO	Bank Markazi
Mode of reporting	Transmitted	Mission	Mission	Mission	Mission	Mission	Visit by official to HQ	Visit by official to HQ	Visit by official to HQ	Visit by Official to HQ	Visit by Official to HQ
Confidentiality	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted
Frequency of publication	Quarterly	Quarterly	Quarterly	Quarterly	Quarterly	Quarterly	Quarterly	Quarterly	Quarterly	Quarterly	Quarterly

1/ Tables received from the authorities prior/during missions, Fund staff visits, and visits by officials to headquarters, supplemented by data sent to STA, and the central bank's Economic Trends.

Islamic Republic of Iran: Stylized Medium-Term Scenario

A. Adjustment Scenario

1. Real GDP growth can reach an annual average of almost 6 percent during 2003/04–2007/08 provided the authorities pursue prudent macroeconomic policies and continue structural reforms as outlined in paragraphs 27–34. Oil production is expected to increase by 4.2 percent per year on average, reflecting in part the projected expansion in capacity. Non-oil real GDP is projected to grow by an annual average of 6 percent, rising to about 6.6 percent by the end of the projection period. Inflation would remain about 15 percent at the beginning of the projection period, mainly reflecting administered price adjustments, but thereafter it would decline to about 10 percent, underpinned by further fiscal adjustment and monetary restraint.

2. High private sector investment and productivity gains are expected to contribute significantly to medium-term growth. Private fixed investment is projected to rise from 23.3 percent of GDP in 2002/03 to 25.7 percent by 2007/08. Private consumption would also remain strong. In contrast, public investment is projected to stabilize at about 9 percent of GDP, and public consumption would decline to 10 percent of GDP from 12 percent, consistent with the path of fiscal adjustment. Unemployment is projected to increase in the first years of the medium-term forecast but would then decline progressively to 15.2 percent in 2007/08, as growth accelerates and structural reforms, in particular in the labor market, advance.

3. Iran's medium-term balance of payments projections reflect the July 2002 WEO assumptions for oil prices and other indicators, a depreciation of the nominal exchange rate by inflation differentials, external financing arrangements for oil and gas sectors investments that are ongoing and in the pipeline, as well as economic and financial reforms, including ongoing trade reform and the newly ratified Foreign Investment Law. In particular, crude oil prices are projected to decline from about US$23 per barrel in 2002/03 to about US$19 per barrel by 2007/08 and crude oil export volumes would grow by 3¾ percent per year on average. However, exports of refined products and natural gas are anticipated to pick up strongly, owing in part to realization of buyback investments. Non-oil exports are projected to continue their robust growth, including industrial goods, chemicals and petrochemicals. Imports are projected to reflect the opening-up of the economy as well as its strong growth, coming to constitute about 20–21 percent of GDP. The decline in oil prices would not be fully offset by the expansion of export volumes. This together with high import growth would result in the current account surplus of 3 percent of GDP in 2002/03 turning into a deficit of less than 1 percent of GDP by 2007/08. Improved access to international financial markets and structural reforms would facilitate a steady inflow of capital. With the anticipated portfolio equity capital inflows and FDI, and higher net external borrowing, the overall balance of payments is projected to remain in surplus through 2007/08. Official international reserves are projected to rise steadily to about 14 months of imports of goods and services, in part reflecting a significant increase in the OSF deposit.

4. Fiscal policy is key to maintaining macroeconomic stability in the medium term. The overall fiscal balance would fluctuate over the medium term, reflecting the WEO projected decline in oil prices and the fiscal adjustment along the lines recommended by the Fund staff. The latter is measured by the non-oil deficit, which is projected to decline from 17.7 percent in 2002/03 to 10 percent in 2007/08, assuming that the authorities proceed with their plans to broaden the revenue base and rationalize public expenditure. As regards the OSF, net savings from the oil revenue are projected to decline from close to 2 percent of GDP in 2003/04 to about 1 percent of GDP in 2007/08, as oil prices would drop significantly during that period. The OSF deposits are nevertheless projected to increase by end-2007/08.

5. The fiscal adjustment is based on assumptions of revenue and expenditure measures. On revenue, the planned introduction of a 10 percent VAT in 2005/06 would replace the current narrow-based sales taxes. It is also assumed that the tax base would be broadened as a result of reductions in tax exemptions and gradual increases in excise taxes. Finally, the scenario assumes that the domestic prices of petroleum products would be increased at higher rates than in recent years, which would bring higher transfers to the budget from companies supplying these products. These price increases together with the assumed reduction of explicit subsidies would be cushioned by the development of a targeted social safety net starting from 2003/04. Efforts to streamline public expenditure should also involve a gradual phasing-out of domestic on-lending from the OSF and reductions in transfers to the non-financial public sector. This strategy would preserve an adequate level of capital expenditure throughout the period (5.5 percent of GDP) and keep the wage bill constant as a share of non-oil GDP (8.1 percent).

B. Slow Reforms Scenario

6. In the absence of fiscal adjustment and lack of further progress in structural reforms, the macroeconomic outlook would be less favorable and the vulnerability of the economy to shocks would increase. It is likely that the combination of relatively high fiscal deficits, rampant inflation, stagnant FDI, and an uneven pace of structural reforms would reduce the medium term annual average growth rate to as low as 4 percent. This would exacerbate unemployment and competitiveness problems. The emergence of current account deficits early in the projection period, a slow pace of accumulation of gross official reserves, and a depletion of the OSF deposits would intensify the vulnerability of Iran to potential external shocks, increasing the probability of forced adjustment in macroeconomic policies from a position of weakness.

C. Sensitivity Analysis

7. Both medium-term scenarios are subject to uncertainties on several fronts, including oil prices. In particular, a US$1 decrease in the assumed oil prices would result in a ¾ of 1 percent of GDP deterioration in the fiscal balance and a 1 percent of GDP worsening of the current account balance on average over the medium term.

8. A sensitivity analysis, assuming a mechanical impact of a drop in oil prices to US$16 per barrel from 2003/04 onward, is presented to highlight that fiscal adjustment would help reduce the vulnerability of public finances and the external sector to an oil price shock. Under such circumstances, most macroeconomic indicators would deteriorate but the situation would remain manageable. The current account deficit would reach 3.5 percent of GDP while the overall fiscal deficit would reach a peak of 4.4 percent of GDP in 2003/04 and then decline to about 2 percent of GDP by 2007/08. The combination of the higher current account and fiscal deficits would result in a decline of import coverage by gross official reserves to seven months by the end of the projection period. This exercise highlights the importance of building sufficient reserves in the OSF and the need for fiscal policy to play a counter cyclical function to smooth out the impact of oil prices on economic activity.

Islamic Republic of Iran: Medium-Term
Sensititvity Analayis, 2002/03–2007/08

(In percent of GDP)

	Current Account Balance		Fiscal Balance	
	Adjustment	Low oil price	Adjustment	Low oil price
2002/03	3.2	3.2	-2.0	-2.0
2003/04	2.5	-2.3	-0.5	-4.4
2004/05	1.4	-2.5	-0.8	-3.8
2005/06	0.4	-3.2	0.6	-2.0
2006/07	-0.3	-3.4	0.5	-1.7
2007/08	-0.4	-3.5	-0.1	-2.1

Source: Fund staff estimates and projections.

Islamic Republic of Iran: Illustrative Medium-Term Scenario, 1998/99–2007/08 1/

				Prel. Est	Baseline Scenario Projections					
	1998/99	1999/2000	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Oil Sector										
Total oil exports (in billions of U.S. dollars)	9.9	17.1	24.3	19.3	20.8	22.1	22.7	23.4	24.2	25.7
Average oil export price (in U.S. dollar/barrel)	10.5	18.6	25.3	21.5	23.0	21.6	20.3	19.8	19.1	19.1
Crude oil production (in millions of barrels/day)	3.7	3.4	3.7	3.4	3.4	3.6	3.8	3.9	4.0	4.1
						(In percentage change)				
National accounts										
Nominal GDP (in billions of Iranian rials)	324,357	428,298	567,591	662,514	854,568	1,027,364	1,201,092	1,387,073	1,607,140	1,874,532
Real GDP at factor cost	1.8	3.6	5.7	4.8	5.8	5.5	5.5	5.6	6.0	6.4
Real oil GDP	2.2	-6.0	8.4	-8.4	-1.0	7.3	4.0	3.2	3.2	3.3
Real non-oil GDP	1.7	4.5	5.5	6.0	6.3	5.4	5.6	5.8	6.2	6.6
Inflation rate										
CPI inflation (average)	18.1	20.1	12.6	11.7	15.0	15.0	12.0	10.0	10.0	10.0
GDP deflator at factor cost	19.2	18.0	25.4	11.3	21.9	13.9	10.8	9.3	9.3	9.7
Unemployment rate	14.7	16.0	15.8	16.2	16.3	16.8	16.9	16.7	16.1	15.2
						(In percent of GDP)				
Investment and savings										
Total fixed investment	30.4	30.7	30.3	31.1	30.9	32.8	33.8	34.1	34.4	34.6
Public	9.5	9.9	8.2	6.7	7.5	8.4	8.9	8.9	8.9	8.9
Private	20.9	20.7	22.1	24.4	23.3	24.4	24.9	25.2	25.5	25.7
Gross national savings	28.1	37.1	43.7	35.9	34.1	35.3	35.2	34.4	34.1	34.3
Public	2.0	9.4	17.0	7.6	5.5	7.9	8.1	9.5	9.4	8.8
Private	26.1	27.7	26.6	28.3	28.6	27.3	27.1	25.0	24.8	25.4
Savings/investment balance	-2.3	6.4	13.4	4.8	3.2	2.5	1.4	0.4	-0.3	-0.4
Public	-7.5	-0.6	8.8	0.9	-2.0	-0.5	-0.8	0.6	0.5	-0.1
Private	5.2	7.0	4.6	3.9	5.2	2.9	2.2	-0.2	-0.8	-0.3
Budgetary operations										
Budgetary revenue	19.9	24.3	33.5	26.7	27.6	27.0	25.6	26.5	25.9	25.1
Oil	7.1	10.4	22.6	15.3	15.7	14.7	13.2	11.9	10.6	9.7
Non-oil	12.7	13.9	10.9	11.4	11.1	11.5	11.7	13.9	14.5	14.7
Budgetary expenditure	27.4	24.8	24.6	25.8	29.7	27.5	26.4	25.9	25.4	25.1
Current	0.0	15.9	15.5	17.0	17.7	17.4	17.0	16.6	16.2	15.9
Capital	6.8	5.8	5.3	4.1	4.7	5.2	5.5	5.5	5.5	5.5
Budgetary balance (including OSF)	-7.5	-0.6	8.8	0.9	-2.0	-0.5	-0.8	0.6	0.5	-0.1
Budgetary balance (excluding OSF)	-7.5	-0.6	0.6	-0.9	-5.0	-2.6	-2.5	-1.0	-0.9	-1.2
						(Annual percentage change)				
Monetary sector										
Net foreign assets	-90.2	619.4	182.9	38.4	42.7	...	...	...	...	...
Net domestic assets	27.8	16.8	25.9	28.7	21.4	...	...	...	...	...
Of which: credit to private sector	31.1	31.0	27.3	30.6	16.5	...	...	...	...	...
Broad money	19.6	20.2	30.5	25.8	22.9	...	...	...	...	...
Velocity of broad money	2.2	2.2	2.0	2.0	2.1	...	...	...	...	...
						(In billions of U.S. dollars)				
External sector										
Exports of goods and services	15.1	22.4	29.9	26.0	28.4	31.2	33.4	35.4	37.3	40.1
Oil	9.9	17.1	24.3	19.3	20.8	22.1	22.7	23.4	24.2	25.7
Non-oil	3.2	3.9	4.2	4.4	5.0	5.6	6.3	7.0	7.7	8.4
Imports of goods and services	-17.8	-16.4	-17.9	-21.6	-26.0	-29.3	-32.7	-36.0	-39.0	-42.0
Current account balance	-2.1	6.6	12.6	5.4	3.5	2.9	1.8	0.5	-0.4	-0.6
External public- and publicly-guaranteed debt	14.1	10.8	8.0	7.2	7.3	9.1	10.9	13.4	16.1	19.2
Of which: short-term debt	4.5	4.0	3.7	2.7	1.7	1.9	2.2	2.5	2.8	3.1
Memorandum items:										
Nominal effective exchange rate 2/	163.2	118.9	130.1	143.4	...	...	...	...	...	...
Real effective exchange rate 2/	118.3	100.0	118.5	139.1	...	...	...	...	...	...
Average exchange rate (Iranian rials per U.S. dollar)	5,404.0	7,908.0	8,078.0	7,921.0	...	...	...	...	...	...

Sources: Data provided by the Iranian authorities; and Fund staff estimates.

1/ Iranian fiscal year ending March 20.
2/ Using 1999/2000=100.

Islamic Republic of Iran: Illustrative Medium-Term Scenario With No Reforms, 1998/99–2007/08 1/

	1998/99	1999/2000	2000/01	Prel. Est. 2001/02	Baseline Scenario Projections 2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Oil Sector										
Total oil exports (in billions of U.S. dollars)	9.9	17.1	24.3	19.3	20.8	22.1	22.7	23.4	24.2	25.7
Average oil export price (in U.S. dollar/barrel)	10.5	18.6	25.3	21.5	23.0	21.6	20.3	19.8	19.1	19.1
Crude oil production (in millions of barrels/day)	3.7	3.4	3.7	3.4	3.4	3.6	3.8	3.9	4.0	4.1
					(In percentage change)					
National accounts										
Nominal GDP (in billions of Iranian Rials)	324,357	428,298	567,591	662,514	854,568	1,091,775	1,351,968	1,675,274	2,076,198	2,573,885
Real GDP at factor cost	1.8	3.6	5.7	4.8	5.8	4.2	4.0	4.0	4.0	4.0
Real oil GDP	2.2	-6.0	8.4	-8.4	-1.0	7.3	4.0	3.2	3.2	3.3
Real non-oil GDP	1.7	4.5	5.5	6.0	6.3	4.0	4.0	4.0	4.1	4.1
Inflation rate										
CPI inflation (average)	18.1	20.1	12.6	11.7	15.0	20.0	20.0	20.0	20.0	20.0
GDP deflator at factor cost	19.2	18.0	25.4	11.3	21.9	22.6	19.1	19.2	19.2	19.2
Unemployment rate	14.7	16.0	15.8	16.2	16.3	17.3	18.2	18.8	19.3	19.8
					(In percent of GDP)					
Investment and savings										
Total fixed investment	30.4	30.7	30.3	31.1	32.5	31.9	31.9	31.9	32.0	32.2
Public	9.5	9.9	8.2	6.7	9.8	9.0	9.0	9.0	9.0	9.0
Private	20.9	20.7	22.1	24.4	22.7	22.9	22.9	22.9	23.0	23.2
Gross national savings	28.1	37.1	43.7	35.9	34.6	33.1	31.8	30.6	29.8	29.7
Public	2.0	9.4	17.0	7.6	4.6	6.4	5.7	6.5	5.9	5.1
Private	26.1	27.7	26.6	28.3	30.0	26.7	26.2	24.0	23.9	24.5
Savings/investment balance	-2.3	6.4	13.4	4.8	2.1	1.3	0.0	-1.3	-2.2	-2.6
Public	-7.5	-0.6	8.8	0.9	-5.2	-2.6	-3.4	-2.5	-3.1	-3.9
Private	5.2	7.0	4.6	3.9	7.3	3.9	3.3	1.2	0.9	1.3
Budgetary operations										
Budgetary revenue	19.9	24.3	33.5	26.7	26.9	25.5	24.5	25.6	25.2	24.6
Oil	7.1	10.4	22.6	15.3	15.7	14.5	13.1	12.0	10.9	10.3
Non-oil	12.7	13.9	10.9	11.4	11.1	11.1	11.4	13.6	14.2	14.4
Budgetary expenditure	27.4	24.8	24.6	25.8	32.0	28.1	27.8	28.1	28.3	28.5
Current	15.8	15.9	15.5	17.0	18.5	17.5	17.9	18.2	18.5	18.7
Capital	6.8	5.8	5.3	4.1	6.2	5.6	5.6	5.6	5.6	5.6
Budgetary balance (including OSF)	-7.5	-0.6	8.8	0.9	-5.2	-2.6	-3.4	-2.5	-3.1	-3.9
Budgetary balance (excluding OSF)	-7.5	-0.6	0.6	-0.9	-8.1	-4.4	-4.7	-3.6	-3.9	-4.5
					(Annual percentage change)					
Monetary sector										
Net foreign assets	-90.2	619.4	182.9	38.4	29.8	...	...	...	...	...
Net domestic assets	27.8	16.8	25.9	28.7	48.8	...	...	...	...	...
Of which: credit to private sector	31.1	31.0	27.3	30.6	34.3	...	...	...	...	...
Broad money	19.6	20.2	30.5	25.8	41.1	...	...	...	...	...
Velocity of broad money	2.2	2.2	2.0	2.0	1.9	...	...	...	...	...
					(In billions of U.S. dollars)					
External sector										
Exports of goods and services	15.1	22.4	29.9	26.0	28.3	30.9	32.8	34.3	35.8	38.1
Oil	9.9	17.1	24.3	19.3	20.8	22.1	22.7	23.4	24.2	25.7
Non-oil	3.2	3.9	4.2	4.4	4.9	5.4	5.9	6.4	6.9	7.3
Imports of goods and services	-17.8	-16.4	-17.9	-21.6	-26.9	-30.4	-33.9	-37.3	-40.3	-43.4
Current account balance	-2.1	6.6	12.6	5.4	2.4	1.5	-0.1	-1.8	-3.3	-4.1
External public and publicly guaranteed debt	14.1	10.8	8.0	7.2	7.3	8.7	10.0	11.9	14.1	16.4
Of which: short-term debt	4.5	4.0	3.7	2.7	1.7	1.9	2.2	2.5	2.8	3.1
Memorandum items:										
Nominal effective exchange rate 1/	163.2	118.9	130.1	144.4	...	...	...	...	...	...
Real effective exchange rate 2/	118.3	100.0	118.5	139.3	...	...	...	...	...	...
Average exchange rate (Iranian rials per U.S. dollar)	5,404.0	7,908.0	8,078.0	7,921.0	...	...	...	...	...	...

Sources: Data provided by the Iranian authorities; and Fund staff estimates.

1/ Fiscal year ending March 20.
2/ Using 1998/99=100.

Statement by the IMF Staff Representative
September 18, 2002

Since issuance of the staff report (SM/02/279), additional information on recent developments and policy measures has become available. This statement reports on these developments as well as on the findings of the MAE/LEG mission, which, at the request of the authorities, has reviewed the remaining exchange restrictions and multiple currency practices in Iran. This information does not alter the thrust of the staff appraisal.

1. **Recent developments**

- **Growth**. Preliminary data for the first quarter of 2002/03 are in line with the projected real growth rate of close to 6 percent. Agricultural output is expected to be higher than projected and construction, manufacturing, and housing continue to grow at double digit rates.

- **Inflation**. Inflation edged up to 14 percent on average during the first quarter of 2002/03 compared to the same period last year.

- **Money**. The year-on-year growth of M2 accelerated to 28.5 percent by end-July 2002. The authorities have issued CPPs and activated the standing deposit facility in an effort to absorb excess liquidity.

- **Fiscal data**. During the first quarter, non-oil revenue performance has been disappointing compared to the budget, but the shortfall is likely to be offset by higher oil revenue.

2. **New measures**

- The executive and legislative branches are examining revenue raising measures and expenditure cuts to reduce the fiscal deficit. These measures might include excises on various consumer goods and services, cuts on current expenditure, further prioritization of capital outlays, and steps to expedite divestiture of state-owned enterprises. The authorities are also considering measures to strengthen customs administration to reduce smuggling and enhance revenue collection.

- The authorities have approved the establishment of four private insurance companies.

- The draft law on anti-money laundering and combating of terrorism financing (AML/CFT) has been approved by the cabinet and submitted to parliament. An AML/CFT unit has been established in the supervision department of the central bank.

3. **Exchange restrictions**. At the request of the authorities, LEG and MAE undertook a review of the exchange system of Iran in June/July 2002 in connection with the intention of

the authorities to accept the obligations of Article VIII, Sections 2, 3, and 4. The staff has concluded that :

- Effective March 21, 2002, Iran has simplified its exchange system and eliminated several of the exchange restrictions and multiple currency practices that were identified at the time of the 2001 Article IV consultation. In particular (a) the multiple exchange rate system has been replaced by a unified exchange rate determined in the interbank market; (b) bonus payments for early repatriation of non-oil export proceeds have been eliminated for export contracts entered into after March 20, 2002; and (c) the mandatory advance import deposit requirement has been eliminated.

Based on the information available to date, the staff concludes that Iran maintains a number of exchange restrictions and multiple currency practices subject to Fund jurisdiction under Article VIII, Sections 2(a) and 3. The restrictions identified are as follows:

- Multiple currency practices resulting from (a) the new system of subsidies associated with both essential imports and contingent liabilities involving letters of credit opened at subsidized rates prior to March 21, 2002, and maturing thereafter; (b) the absence of a mechanism to ensure that the reference rate used by the central bank for the purchase of oil proceeds from the government does not diverge at any time by more than two percent from the prevailing market exchange rate; and (c) the repatriation bonus for export receipts associated with contracts entered into before March 21, 2002.

- Exchange restrictions resulting from (a) limitations imposed on the availability of foreign exchange for the making of payments for current international transactions associated with certain invisibles (including, for example, travel, education and medical treatment); and (b) restrictions on the convertibility and transferability of rial balances held by non-residents that represent the proceeds of current international transactions. The authorities plan to eliminate all remaining restrictions prior to the acceptance of the obligations of Article VIII, Sections 2, 3, and 4.

The staff is still reviewing the jurisdictional implications of several features of the Iranian exchange system and is in contact with the authorities in order to complete this analysis. The staff does not recommend approval of the retention of the exchange restrictions and multiple currency practices at this stage since the authorities are still in the process of establishing a timetable for their removal. The staff recommends that the authorities eliminate all the exchange restrictions and multiple currency practices subject to the Fund's jurisdiction.

Statement by Abbas Mirakhor, Executive Director of the Islamic Republic of Iran
September 18, 2002

Key Points

- Iran's macroeconomic performance in 2001/02 was satisfactory and progress was made in advancing the structural reform agenda of the TFYDP;
- While economic growth is expected to accelerate in 2002/03, the initially approved budget threatens the declining inflationary trend achieved by implementation of prudent fiscal policies of the last few years. Corrective measures are to be introduced to contain fiscal expansion in the remaining half of this year;
- In coordination with tighter fiscal policy stance, monetary policy will aim at containing liquidity growth and inflation;
- To promote higher sustainable growth, the authorities intend to intensify progress in implementation of structural reforms;
- Increasing employment opportunities remains a key objective of the authorities' medium-term reform strategy.

My authorities thank the staff for their hard work in preparing an excellent set of papers on Iran's recent economic developments, achievements to date, as well as policy options to meet future challenges. They appreciate the high-quality Fund technical assistance and advice which have been a great help to their own efforts in unifying the exchange rates, strengthening bank supervision, reforming the tax system and enhancing tax administration, accessing the international capital markets, liberalizing current account transactions, improving statistical database, and increasing fiscal transparency. My authorities concur with the thrust of the staff report's balanced appraisal and its main policy recommendations.

The concluding statement of the Article IV consultation mission was placed on the external web site of the central bank; the same will be done with the staff documents, PIN, and the summing up after the conclusion of the Executive Board discussions. My authorities have benefited greatly from previous Board discussions and look forward to the Directors' views on this year's staff report, as well as to continued close policy dialogue with the Fund.

Developments in 2001/02

The Iranian economy performed well in the second year of the Third Five-Year Development Plan (TFYDP 2000/02 – 2004/5), reflecting in large measure a steadfast pursuit of prudent macroeconomic policies and structural reforms envisioned in the TFYDP. Despite lower oil production resulting from three consecutive downward revisions in OPEC quotas, the real economy expanded by 4.8 percent, thanks to a stronger broad-based growth in the non-oil sector. Inflation declined further to an average of 11.4 percent, mainly due to deceleration in prices of tradable goods and food. Fiscal and external positions remained in surplus and gross official reserves strengthened, reaching a comfortable level of nearly 10 months of imports of goods and services. The rise in international reserves, combined with a continued fall in the external debt, enhanced Iran's position as a net external creditor, with reserves approaching 250 percent of the total external debt stock. This performance accompanied by progress in structural reforms boosted business confidence and paved the way for Iran's return to international capital markets, after a 23-year absence, with successful floating of a euro 625 million Eurobond issue in July 2002. These advancements notwithstanding, however, unemployment increased as job creation lagged behind the growth in the labor force.

Fiscal policy was prudent in 2001/02. Despite a sharp drop in oil and gas revenue, the fiscal position remained in surplus. Non-oil revenue rose on account of higher social security contributions, while total expenditure increased. The higher oil revenue, compared with conservative budget assumptions, allowed a further accumulation of savings in the Oil Stabilization Fund to US$7.4 billion. For the first time in Iran's recent economic history, these policies signaled a break with the boom-bust cycles of the past.

Broad money grew by 26 percent last year despite central bank's efforts to mop up excess liquidity by reducing lending to commercial banks and issuing Central Bank Participation Papers (CPPs). This reflected an accumulation of foreign exchange inflows, excluding the OSF, as well as increasing bank credit to the private sector and public enterprises. Growth in broad money was also due to a reduction in reserve and advance import deposit requirements. Prudent fiscal policies, moderation in inflation expectations, due to stability of the market exchange rate, and relaxation of supply constraints in the tradable goods sector, enhanced by increased imports, helped further reduction in the inflation rate.

The external current account remained in surplus, notwithstanding a 20 percent decline in oil and gas exports, and a surge in imports, stemming from a buoyant domestic demand and further trade liberalization. Non-oil exports grew by 5 percent, mainly due to rapid growth in exports of chemicals and petrochemicals. Despite the sizable reduction in debt repayments and the sharp rise in oil prefinancing, the outstanding stock of external debt fell to around 6 percent of GDP, a level not witnessed in Iran's recent history, while the debt maturity profile continued to improve, with short-term debt now representing one-third of the total external debt stock. The surplus in the overall balance led to an increase in gross official reserves and to a further improvement in vulnerability indicators.

Structural reforms, as articulated in the TFYDP, continued in many areas. After substantial technical and operational preparation, with Fund technical assistance, the exchange rate was unified on March 21, 2002 with foreign exchange transactions now being effected in the interbank market. The strength of fiscal accounts and the external position as well as the stability in the market exchange rate facilitated a smooth process of exchange rate unification and adoption of a managed floating exchange rate system.

There was further progress in opening the economy through trade liberalization. Trade restrictions were eased by reducing non-tariff barriers (NTBs) and their replacement with tariffs, streamlining licensing procedures, adopting a negative list of prohibited imports, and reducing tariffs. Moreover, the need for and the amount of advance import deposit requirement were left to the discretion of commercial banks, and foreign exchange allocation procedures for authorized imports as well as the surrender requirement for foreign exchange receipts by non-oil exporters were eliminated.

On structural fiscal reforms, with Fund technical assistance, a national tax organization (NTO) and a large taxpayer unit (LTU) were established following which amendments to the direct taxes law reduced and simplified the corporate and income tax rates. Elimination of tax exemptions for public enterprises and foundations has further enhanced efficiency and transparency of the tax system. A draft law on the VAT was also submitted to the Cabinet for approval.

The new Foreign Direct Investment (FDI) Law was passed in June 2002, providing added protection and incentives to foreign investors and allowing foreign investment in all economic sectors that are open to domestic private companies.

In the financial sector, the parliament approved the law for the establishment of private insurance companies, three private banks were licensed, and the state-owned banks were recapitalized in line with the FSAP recommendations.

Progress in privatization continued as the regulatory environment governing privatization was streamlined and divestiture of government's equity shares proceeded.

Policies in 2002/03

The authorities intend to maintain prudent demand management policies and to consolidate recent macroeconomic gains. They will focus on implementing structural reforms aimed at attaining higher growth rates and creating job opportunities to absorb the rapidly growing labor force. Economic growth is expected to be broad based and is projected at close to 6 percent, buoyed by higher oil prices, rising domestic demand, and increased business confidence. Based on the present budgetary and monetary policy stance, inflation is expected to accelerate. The authorities agree that there is an urgent need to shift the policy focus for the remainder of this budget year toward ensuring macroeconomic stability, and, as indicated in the staff statement, are contemplating a policy mix of fiscal adjustment and monetary action to contain liquidity growth. Fiscal position, based on the present approved budget, is estimated to swing from a surplus of 1 percent to a deficit of 5 percent of GDP. This expectation reflects primarily the budgetary cost of exchange rate unification. It is worth noting that this year's budget was prepared according to GFS and explicitly reflects all the exchange rate subsidies in the budget. In line with the commitment to a balanced budget envisioned in the TFYDP Law, a high level coordination committee, chaired by the President of the Republic, is in the process of formulating revenue-raising and expenditure-restraining measures to be introduced in the second half of the current fiscal year. In this context and notwithstanding a one-time withdrawal from the OSF, envisaged in the 2002/03 budget to compensate for the exchange rate unification cost, every effort will be made to contain the non-oil fiscal deficit and to preserve the integrity of the OSF by not withdrawing from its accumulated deposits.

Monetary policy will focus on containing liquidity growth and inflation. In coordination with fiscal tightening, the authorities intend to limit broad money growth to around 20 percent, using all available instruments, including issuing additional CPPs, activating the central bank's special open deposit account, an instrument which has been successfully used in the past to help mop up excess liquidity, and restricting commercial banks' access to central bank's overdraft facility.

The authorities are committed to a managed float regime, limiting interventions to correct large exchange rate movements not warranted by market conditions and economic fundamentals. The authorities are mindful of the need to avoid further real appreciation that could harm export competitiveness. As indicated in the Selected Issues paper, inflation expectations in Iran are highly sensitive to large movements in nominal exchange rates, stability of which has exerted substantial influence in dampening these expectations. On a related issue, the analysis in the Selected Issues paper points to the extremely low total factor productivity growth in Iran, which in turn explains the low employment content of growth. In this context, the authorities are fully cognizant of the fact that an accelerated pace of implementation of structural reforms is needed to improve total factor productivity growth and improve competitiveness.

In the external sector, increased exports will help keep the current account in surplus at above 3 percent of GDP, despite a 20-percent projected rise in imports reflecting continued trade liberalization and buoyant economic activity. External debt stock is expected to rise to about 7 percent of GDP, while gross official reserves, including the OSF, are projected to increase further, approaching the level of 11 months of imports.

The authorities are persevering with the implementation of their structural reform agenda and the remaining reform objectives of the TFYDP. In the trade area, after carefully assessing the impact of the reforms already introduced in domestic activities, the authorities will proceed with further rationalizing the tariff structure, reducing the dispersion of tariff bands, and lowering the simple average tariff rate. They intend to eliminate the remaining exchange restrictions, in line with the recommendations of the recent MAE/LEG mission, to facilitate Iran's acceptance of the Article VIII obligations.

On structural fiscal reforms, the authorities have requested Fund technical assistance in strengthening the administrative capabilities of the NTO, including for the planned introduction of a 10 percent VAT in 2005/06. Work is also underway, with assistance from the World Bank, to reduce subsidies and introduce a targeted social safety net in the next year's budget, and to bring domestic oil prices close to the border price level over the medium term. In this context, in line with the budget law mandate for next year, all oil-related entries will be made at border prices, and oil subsidies will be made transparent by their explicit incorporation in the next year's budget. Moreover, building on recent progress in enhancing transparency, the authorities intend to implement the recommendations of the recent fiscal ROSC mission.

Following the ratification of the new FDI Law, its executive bylaws and implementing regulations entered into force on September 15, 2002. To increase the effectiveness of the OSF, the authorities are reviewing the relevant staff recommendations, contained in their report and the Selected Issues paper, as well as other countries' experience with such funds, including their usefulness in helping sterilize large oil revenue inflows. The authorities intend to establish, with Fund technical assistance, an investor relations center which will focus on providing assistance and information to prospective investors.

In the financial sector, banks will be allowed more freedom in allocating credit and setting the lending rates of return paving the way for the establishment of an interbank money market. With three private banks already licensed, further applications are being considered. In line with the recommendation of the FSAP, the authorities will implement their comprehensive action plan aimed at a fundamental risk-based banking supervision reform and will further strengthen compliance with the Basle Core Principles. A proposed bill on capital market is under consideration by the Ministry of Finance to regulate the issue of listed and unlisted securities.

Iran has strongly supported international efforts in anti-money laundering and combating the financing of terrorism within the framework of the United Nations, the European Union, the Bonn Meeting, and the Islamic Conference. A bill on anti-money laundering was submitted last week to the parliament and is presently under discussion in its Judiciary and the Economic Affairs Commissions. Following the cabinet's approval of the draft AML/CFT bill, establishment of the financial police is now under active consideration. The Supervision Department of the Central Bank has prepared executive by-laws for customer recognition and prohibition of the use of the financial system in money laundering and financing of terrorism. The central bank has also issued directives to all bank and non-bank financial institutions to report suspicious transactions with detailed information on customers and transactions. Moreover, an AML/CFT Unit has been established in the Supervision Department of the Central Bank.

The authorities are studying ways and means of removing obstacles to acceleration of the implementation of the privatization agenda of the TFYDP. An independent law is being drafted to ensure continuity in the privatization of public enterprises beyond the TFYDP. According to a draft bill, aimed at seeking improvement in the privatization process, holding companies will be obliged to cede shares of the affiliated firms directly to private entities.

On statistical issues, the authorities are committed to improving data production and dissemination and intend to subscribe to the SDDS as soon as possible. Preparatory work is underway to achieve this objective in line with the action plan recommended by the recent STA mission.

Medium-Term Objectives

Iran faces the challenge of deepening structural reforms to promote higher sustainable growth, and to reduce unemployment. Therefore, increasing job opportunities remains a key objective of the authorities' medium-term reform strategy. As indicated in the Selected Issues paper, demography, rapid urbanization, and a shift in the country's economic structure are cited as the main causes of rising unemployment in Iran. The relatively low employment intensity of growth stems from excess labor in many public enterprises, bias in favor of energy-intensive industries, labor market rigidities, and low private sector penetration in services sector. The authorities have taken initiatives to promote employment, including the provision of vocational training, development of an information databank on job seekers, tax exemptions for new employees, subsidized credits to small enterprises, and lending to private firms at international market rates in foreign exchange from the OSF. Recent amendments to the legislation on direct taxes and the ratification of the new FDI Law promise to encourage productive domestic and foreign investment to create additional jobs. To address labor market rigidities, a tripartite committee comprising representatives of the government, labor organizations, and employers is examining possible improvements in the present Labor Law. Recognizing that there are no quick-fix solutions to the unemployment problem, the authorities remain committed to steadfast implementation of the ambitious reform agenda contained in the TFYDP . They share the staff view that by establishing appropriate social safety nets, the temporary adverse effects of reforms on employment could be mitigated allowing employment generation to rise over the medium term.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2002 Article IV Consultation with the Islamic Republic of Iran

On September 18, 2002 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Islamic Republic of Iran.[1]

Background

Overall macroeconomic developments in 2001/02 were marked by sustained economic activity in the non-oil sector, improved fiscal and external positions, and declining inflation trends. Against a background of improved business confidence, the authorities continued to implement economic reforms in line with their Third Five-Year Development Plan. They also successfully issued a €625 million Eurobond, marking Iran's return to international financial markets.

Real GDP growth in 2001/02 was strong and broad-based, with non-oil activities growing by 6 percent in real terms. However, reflecting a decline in oil output owing to a downward revision in OPEC production quotas, total real GDP growth decelerated to 4.8 percent. CPI inflation declined to 11.4 percent. Registered unemployment remained high at 16 percent at end-2001/02, as employment creation lagged behind the increase in the labor force.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the September 18, 2002 Executive Board discussion based on the staff report.

The external current account position remained in surplus (4.8 percent of GDP) in 2001/02, albeit lower than during the previous year. Exports declined, as lower oil export receipts were only partially offset by 5 percent growth in non-oil exports, mainly representing chemicals and petrochemicals. At the same time, imports expanded by 20 percent owing to buoyant domestic demand and progress in trade liberalization. The decline in the current account surplus was partly offset by a significantly smaller deficit in the capital and financial account. This was attributable to a sizable decline in debt repayments and a sharp rise in capital inflows in the form of buybacks and oil pre-financing. The surplus in the overall balance was US$4.9 billion, which financed the increase in gross official reserves to the equivalent of almost 10 months of imports of goods and services.

Fiscal policy was prudent in 2001/02. Reflecting mainly lower oil prices and revenue, the central government's overall surplus shrank to 0.9 percent of GDP, down from 8.8 percent of GDP in the previous year. The government continued to take advantage of the sustained high oil revenue to increase its deposits with the Oil Stabilization Fund (OSF) to US$7.4 billion, and reduced the external public and publicly guaranteed debt to 6.3 percent of GDP.

Growth of monetary aggregates remained relatively high in 2001/02, despite the central bank's action to mop up excess liquidity by reducing its lending to commercial banks and issuing Central Bank Participation Papers. The money growth reflected the build-up of foreign exchange reserves, excluding the OSF, and a rapid credit expansion to public enterprises and the private sector. The real effective exchange rate appreciated by about 17 percent in 2001/02, following an 18 percent appreciation in 2000/01.

During 2001/02 and the first quarter of 2002/03, the authorities pressed ahead with their economic reforms. These included the exchange rate unification, the passage of the foreign investment law, on-going trade reform, changes in tax legislation, licensing of private banks and approval of private insurance companies. These steps have boosted business confidence and laid the ground for improved growth prospects.

The exchange rate unification was a landmark reform. The exchange rate was unified on March 21, 2002, with foreign exchange transactions now taking place in the interbank market. The authorities adopted a managed float exchange rate system. The transition has been smooth with the central bank seeking to maintain stability in the nominal rate during the period immediately following the exchange rate unification.

The growth outlook for 2002/03 is relatively favorable, with oil prices expected to remain relatively high, real GDP projected to grow by 5.8 percent, and the non-oil activities expected to expand by 6.3 percent. However, the large projected fiscal deficit under the current budget for 2002/03 could lead to higher inflation, put further pressure on the real exchange rate to appreciate, and increase the economy's vulnerability to a downturn in oil prices. The authorities are examining appropriate measures to contain the fiscal deterioration and its impact on monetary and exchange rate developments.

Executive Board Assessment

Directors noted that the Iranian economy performed well in 2001/02, as real GDP growth was strong, inflation declined, and, despite lower oil prices, the fiscal and external current account balances remained in surplus, allowing the authorities to reduce significantly the external debt, build large foreign exchange reserves, and accumulate fiscal savings in the OSF. Iran's strong economic performance over the past two years has now laid the basis for the authorities to meet the challenges of their medium-term economic reform strategy, which aims at achieving sustained economic growth and creating jobs in an environment of macroeconomic stability while correcting a legacy of distortions and imbalances. Directors commended the authorities for the strong ownership of their reform program under the Third Five-Year Development Plan, and expressed their appreciation for the close cooperation between the Fund and Iran that has contributed positively to economic reform in an environment of broad-based domestic consensus.

Directors commended the authorities for the sound execution of their plan for exchange rate unification which, combined with the new exchange rate regime and a more liberal payments and trade system, will help enhance efficiency and underpin growth. They viewed the favorable response of foreign investors to the issue of a Eurobond in July 2002 as acknowledgement that Iran is on a path of economic reform and reintegration into the global economy and financial markets.

Directors observed that maintenance of macroeconomic stability will be crucial for the success of Iran's economic reforms. They considered that the expansionary fiscal stance under the current year's budget, as adopted, and continued expansion of domestic liquidity, risk adding to inflationary pressures and further real exchange rate appreciation, and will require the implementation of timely corrective measures. Directors, accordingly, welcomed the authorities' intention to ensure macroeconomic stability by introducing measures in the remainder of 2002/03 to reduce the fiscal deficit and contain the growth of domestic liquidity. In this context, the authorities should consider a comprehensive set of measures, ranging from steps to curb the growth of current spending and prioritize and scale down non-growth-reinforcing capital expenditure, to reducing tax exemptions, improving tax arrears collection, and increasing excise taxes. By helping to reduce the financing needs of the central government, these measures should also eliminate the need to draw from the OSF, thereby maintaining its integrity. Directors also welcomed the authorities' intention to use all available monetary policy instruments, in conjunction with fiscal tightening, to reduce the recent strong growth of broad money during the remainder of 2002/03 in line with the objective of containing inflation. They also recommended that the OSF's operations be based on stringent and transparent rules.

Directors commended the authorities for making all implicit exchange rate subsidies explicit in the budget, thereby increasing fiscal transparency and taking a first step toward reforming the subsidy system. They encouraged the authorities to continue working with the World

Bank to adopt a comprehensive medium-term plan to overhaul subsidies, including on energy prices, and to consider how to replace them with a targeted subsidy scheme in ways that better protects the poor, enhances economic efficiency, and redirects budgetary resources toward more productive uses. They urged the authorities to follow through on the recommendations of the fiscal Reports on the Observance of Standards and Codes mission.

Directors supported the authorities' decision to move to a managed float exchange rate regime and to introduce an interbank foreign exchange market. They noted that market stability so far has been underpinned by strong oil revenues and lower inflation, and considered that, over time, it will be important for exchange rate developments to be in line with economic fundamentals. In this context, market participants should be exposed to exchange rate fluctuations and discouraged from building expectations of a de facto pegged nominal exchange rate. Directors drew attention to the need to avoid, mainly through appropriate fiscal policy, a sustained appreciation of the real effective exchange rate, which in the absence of strong and lasting gains in productivity, would harm competitiveness and economic diversification. They welcomed the authorities' intention to eliminate the remaining multiple currency practices and exchange restrictions as steps to facilitate Iran's acceptance of the obligations of Article VIII of the Fund's Articles of Agreement.

Over the medium term, Directors saw the reduction of the high unemployment rate as a crucial challenge facing the Iranian economy, given the high growth rate of the labor force, rising participation rate, and the low employment content of growth. Policies that promote openness, greater economic efficiency, and an improved business climate will foster private sector growth and investment as well as contribute significantly to job creation. In this context, Directors welcomed the progress achieved recently with respect to foreign investment legislation and the licensing of private banks. They also welcomed the initiatives to improve vocational training and to develop a data bank on job seekers. Directors agreed with the view that tax and financial incentives established to increase employment are likely to be of limited value. Rather, they encouraged the authorities to take steps to address impediments to the business environment, including administrative impediments. In addition, elimination of labor market rigidities, restructuring and privatization of public enterprises, and the pursuit of further trade liberalization will serve to promote investment, employment, and growth. Directors also considered that, as a more supportive regulatory and financial infrastructure is set in place, the Iranian economy should offer considerable potential, over time, for non-oil sector investment and associated growth in private sector activity and employment.

Directors encouraged the authorities to press ahead with financial sector reforms aimed at enhancing the efficiency of bank intermediation through the introduction of more market-determined rates of return and greater competition. They welcomed the authorities' intention to implement a comprehensive action plan aimed at fundamental risk-based banking supervision in line with the recommendations of the Financial Sector Assessment Program, and their work on a comprehensive securities market reform. Directors also welcomed the progress made with legislation on anti-money laundering and combating the financing of terrorism, and looked forward to its early approval by the National Assembly and its full implementation.

Directors welcomed the progress in the production and dissemination of economic statistics, including the preparation of quarterly national accounts data and the adoption of Government Finance Statistics classification in the presentation of fiscal data. They commended the authorities for the steps taken to subscribe to the Special Data Dissemination Standard in conjunction with the technical assistance provided by the IMF Statistics Department. Directors encouraged the authorities to follow up on the action plan recommended by the technical assistance mission.

Iran is a significant bilateral creditor for some heavily indebted poor countries, and the hope was expressed that Iran will provide its share of relief under the Heavily Indebted Poor Countries Initiative.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Islamic Republic of Iran: Selected Economic Indicators

	1998/99	1999/2000	2000/01	2001/02
Real GDP growth (factor cost, percentage change)	1.8	3.6	5.7	4.8
CPI inflation (period average, percentage change)	18.1	20.1	12.6	11.4
Central government balance (percent of GDP)	-7.5	-0.6	8.8	0.9
Broad money growth (percentage change)	19.6	20.2	30.5	25.8
Current account balance (percent of GDP)	-2.3	6.4	13.4	4.8
Overall external balance (percent of GDP)	-1.6	2.0	7.3	4.3
Gross international reserves (billions of U. S. dollars)	3.7	5.6	12.5	17.5
Public and publicly guaranteed external debt (billions of U.S. dollars)	14.1	10.8	8.0	7.2
Exchange rate (end-of-period, in Rials per U.S. dollar) 1/	5,404	7,908	8,078	7,921

Sources: Iranian authorities, and IMF staff estimations.

1/ Tehran Stock Exchange exchange rate