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April 2014

2014 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE; 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 2014 Article IV consultation with Iran, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on March 28, 2014, following discussions that ended on February 8, 2014, with the officials of Iran on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on March 13, 2014.
- An **Informational Annex** prepared by the IMF.
- A **Press Release** summarizing the views of the Executive Board as expressed during its March 28, 2014 consideration of the staff report that concluded the Article IV consultation with Iran.
- A **Statement by the Executive Director** for Iran.

The following document has been or will be separately released.

Selected Issues Paper

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

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INTERNATIONAL MONETARY FUND

ISLAMIC REPUBLIC OF IRAN

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION

March 13, 2014

KEY ISSUES

Context. Iran had achieved considerable progress in raising per capita income and living standards in previous decades. But in recent years, such progress stalled as both domestic policies and the external environment deteriorated. Inflation has increased sharply and non-oil growth is well below potential. Corporate and financial-sector vulnerabilities have emerged, and unemployment rates are high. A difficult external environment and domestic vulnerabilities raise the risk of entrenching the economy in a low-growth high-inflation scenario. The authorities are well aware of the challenges and the reforms needed, but face a highly-complex institutional set-up and socio-political context. Advancing reforms will require broad political commitment and needs to be supported by strong coordination and cooperation among key policymakers.

A highly uncertain outlook. Facing continued constraints on oil revenues and to carry out international transactions, the economy is expected to continue to contract in 2013/14. With some positive tailwinds from the external side and modest incipient signs that the pace of contraction in domestic demand is slowing, economic activity would begin to stabilize in 2014/15. While the current outlook is subject to downside risks, the interim agreement with the P5+1 also brings upside risks. Were this progress to derail, the economy could be subject to new adverse shocks.

Dealing with stagflation. The policy mix should support the economy while also gradually reducing inflation. Fiscal deficits should be contained at around 2–3 percent of GDP, by broadening the revenue base away from oil and by keeping a tight lid on spending. This should be complemented by reforms that boost the supply side (product, labor, and credit markets) as well as the demand side (to restore monetary policy credibility, reduce uncertainty, and better coordinate fiscal management).

Subsidy Reform. Iran's design of the subsidy reform has been exemplary and the reform remains a priority. Plans to increase domestic energy prices gradually are prudent but should be underpinned by an automatic price adjustment mechanism to ensure full implementation, by consistent macroeconomic policies, and by reforms to foster the adoption of new technologies and tighter budget constraints, particularly in energy-intensive sectors.

Strengthening the Policy Framework. Fiscal reforms should empower the scope for countercyclical fiscal policy, better support macroeconomic stability, and be framed within a medium-term expenditure planning to limit fiscal risks. Priority needs to be given to price stability, by improving the mandate and operational autonomy of the Central Bank of Iran and by reviewing government-mandated credit policies. Work to unify the exchange rate should be initiated, while preserving flexibility ahead to ensure competitiveness.

Reforms to Promote Growth and Jobs. There is a need to improve business regulations, advance effective privatizations, and reduce nonwage labor costs. Addressing weaknesses in the banking system is important, including by improving the supervisory and crisis preparedness frameworks.

Approved By
Alfred Kammer and Taline Koranchelian

Discussions took place in Tehran during January 25–February 8, 2014. Staff representatives comprised R. Blotevogel, M. Cerisola (head), O. Demirkol, R. Zytek (all MCD), and G. Esposito (LEG) and were assisted by Mr. Monajemi (OED). Messrs. Kammer (MCD) and Mojarrad (OED) participated in the concluding discussions. The team met with Central Bank of Iran (CBI) Governor Seif, Minister of Economy and Finance Taiebnia, Vice President of Management and Planning Office Noubakht, the President's Chief of Staff Nahavandian, and other senior public officials, as well as representatives from the private sector and academia.

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CONTEXT

1. **Over the past two decades, Iran had achieved considerable progress in raising per capita income and living standards**. This progress was largely underpinned by investment, rising employment-to-population and productivity since the early 1990s, and by high terms of trade since the early 2000s (Figure 1). To a large extent, Iran has continued to benefit from its vast hydrocarbon wealth, as well as from being a relatively diversified resource-intensive economy. Social indicators show declining poverty and income inequality, supporting a relatively high level of human development. Notwithstanding this progress, per capita income and living standards were still below other resource-intensive economies.

2. **Such progress stalled during the past several years**. Large shocks and weak macroeconomic management have had a significant impact on macroeconomic stability and growth. With a long history of high inflation and facing large relative price changes, macroeconomic policies leading to and following the subsidy reform in 2010, remained accommodative to ease corporate adjustment and support household transfers, while also exhibiting high volatility and some procyclical trends. At the same time, the implementation of certain ambitious social programs, such as for housing, significantly compounded these problems. The intensification of international trade and financial sanctions since 2012 brought renewed shockwaves to the economy, further undermining macroeconomic conditions significantly.

3. **The policy response to these shocks prioritized output over inflation stabilization, and exposed the limitations of and the need to rethink the policy framework**. The large relative price change associated with the subsidy reform led to a significant increase in inflation and a deceleration in non-oil growth in 2011, which were exacerbated by the deterioration in the external environment in 2012. The policy response aimed to prioritize output over inflation stabilization by continuing to accommodate the financing demands of the corporate and government sectors. Following the intensification of economic sanctions, greater exchange rate flexibility helped to buffer output to some extent but, as monetary policy remained accommodative, such flexibility resulted in a sharp rise in inflation. All in all, macroeconomic policies contributed to a significant rise in the level and volatility of inflation and output since the mid-2000s, and corporate and financial sector vulnerabilities have now emerged, with unemployment at high levels. And while it would have been difficult for the authorities to have fully buffered the economy from the recent shocks, the policy framework did not provide sufficient resilience and the policy response did not appear sufficiently timely, well-implemented, and coordinated.

4. **Iran now stands at a crossroad**. The external environment remains uncertain and delaying domestic reforms raise the risk of entrenching the economy in a low-growth and high-inflation scenario, underscoring the need to address long-standing weaknesses in the policy framework and the economy. The new administration that took office in August 2013 earned a strong mandate and has already made significant progress in improving the external environment and confidence in the outlook. The administration's 100-day report confirmed how well aware the authorities are of the

economic challenges ahead and many of the reforms needed. But the task of advancing reforms ahead will be difficult, not least due to a highly complex institutional set-up and a difficult socio-political context. This will require broad political commitment, supported by strong coordination and cooperation among key policymakers. The 2014 Article IV Consultation provided a timely opportunity to discuss and assess these issues.

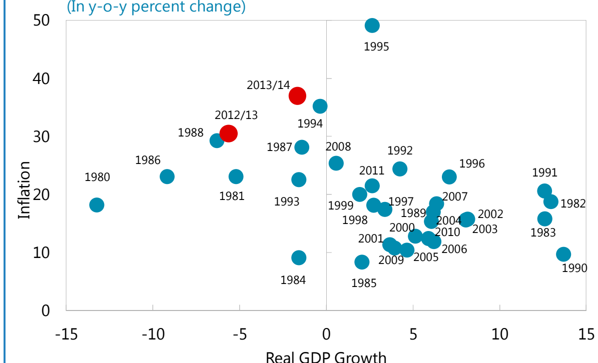
A BRIEF LOOK AT ECONOMIC DEVELOPMENTS OVER THE PAST THREE YEARS

5. **Macroeconomic performance worsened markedly following the subsidy reform in late 2010 and the intensification of sanctions in 2012**.

- ***The economy slowed down markedly following the subsidy reform launch in December 2010***. A large relative price change brought a significant deceleration in economic activity, particularly in the industrial sector. Real non-oil GDP growth decelerated from about 7½ percent in the quarter prior to the reform to about 2 percent a year later. From the demand side, the sources of growth also narrowed, with growth exclusively led by private consumption, as investment declined sharply (Table 1 and Figure 2).

Growth and Inflation, 1980–2013

(In y-o-y percent change)

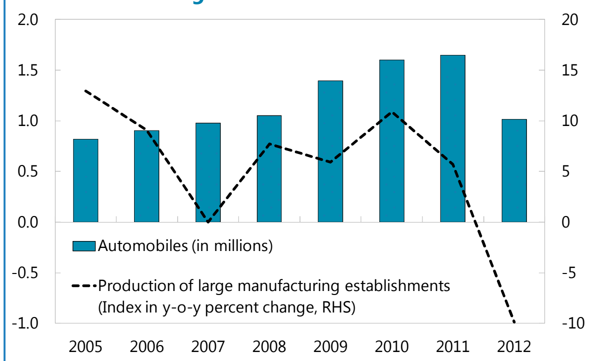


Source: Iranian authorities.

- ***Twelve-month inflation doubled in 2011***. It accelerated from about 13 percent on the eve of the subsidy reform to about 22 percent by December 2011. This owed much to the pass-through from the adjustment in subsidized prices for food and energy, as producer price inflation rose from 12 percent to 39 percent (y/y) during the same period. This relative price change also took place against a backdrop of administrative measures, such as price monitoring and the use of strategic inventories of key staples, as well as some tightening of macroeconomic policies, which helped limit the pass-through.

- ***Since early 2012, international trade and financial sanctions brought renewed shockwaves and pushed the economy into a deep contraction***. A series of sanctions restricting oil exports, the supply chain of some key sectors (like automobiles), and transactions of international and domestic banks, impaired Iran's ability to conduct international current and capital transactions and brought a sharp decline in income (Box 1). Oil production fell to a 20-year low, oil-export proceeds declined by more than half (by about 15 percent of GDP), and the rial lost about 80 percent of its value in the bureau/parallel market. Key sectors, such as automobiles, experienced severe disruptions in production, including from administered-price policies. These shocks imparted significant contractionary effects on the economy, with real GDP declining by almost 6 percent in 2012/13. During the first half of 2013/14, real GDP is estimated to have declined by about 2½ percent, compared with the same period in the previous year.

Manufacturing and Automobile Production



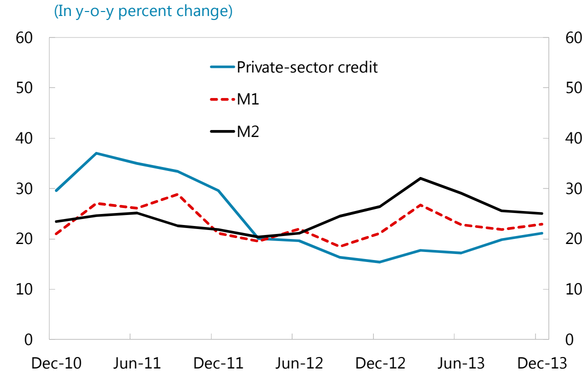
Sources: International Organization of Motor Vehicle Manufacturers (OICA); and Central Bank of Iran.

- ***The authorities abandoned their managed exchange rate regime***. Following a sharp depreciation in the bureau/parallel market in September 2012, the Central Bank of Iran (CBI) introduced a new Foreign Exchange center (FX center), mostly supplied with hydrocarbon export receipts. The CBI initially offered foreign exchange for most current transactions at an official rate of 2 percent below the rate offered in the bureau/parallel market, while maintaining the previous official exchange rate for basic necessities. With the bureau/parallel market rate continuing to depreciate, the 2 percent target was eventually abandoned, with three exchange rates (an official for basic necessities, one for other current transactions (FX center), and a bureau/parallel market rates) available for transactions. With the premium in the foreign exchange market (between the bureau/parallel and the FX center rates) still high, at around 50 percent, loose monetary conditions, and new sanctions being introduced in early 2013, the authorities eventually unified official exchange rates in June 2013. Market conditions have stabilized since the Presidential elections in mid-June, with the rial appreciating by about 20 percent in the bureau/parallel market and the premium declining to about 20 percent in recent months (Figure 3).

- ***Throughout these shocks, monetary conditions were relatively accommodative and inflation continued to accelerate***. In the wake of the subsidy reform, the CBI tightened base money but did not succeed in reducing money growth significantly, as specialized and other banks continued to expand credit to the private sector at rates exceeding 30 percent in 2011. Domestic interest rates became increasingly negative, the exchange rate premium began to widen, and domestic asset prices continued to rise rapidly (Figure 4). In January 2012, the CBI decided to increase its rate for participation papers and for other short-term rates. But lending and deposit rates were subsequently kept fixed as part of the government and Money and Credit Council's (MCC) credit policies.[1] M2 growth accelerated toward 30 percent, with M1 declining markedly in real terms by end-2012/13. Twelve-month inflation rose to 45 percent due to loose monetary conditions and the unification of the official exchange rates, reflecting a trend visible during the last decade, when macroeconomic policies contributed to keep tradable and nontradable inflation at high levels. More recently, the CBI has kept a lid on base money growth thanks to tighter credit to the banking system and some fiscal consolidation, the exchange rate in the bureau/parallel market has appreciated, and 12-month inflation has declined to about 29 percent in January 2014 (Figure 3).[2]

Money and Credit Growth

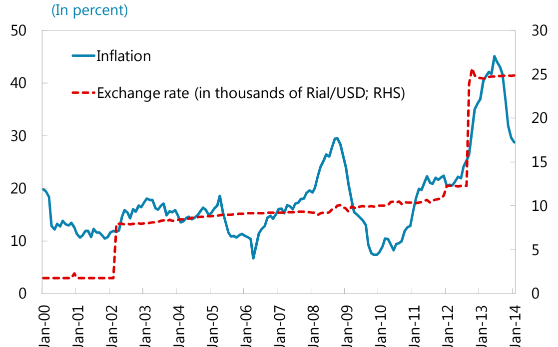
(In y-o-y percent change)



Source: Iranian authorities.

Inflation and the Exchange Rate

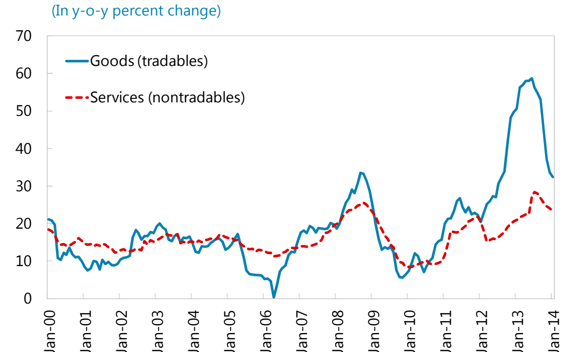
(In percent)



Source: Iranian authorities.

CPI Inflation

(In y-o-y percent change)



Source: Iranian authorities.

[1] In early 2012, the MCC allowed banks to determine deposit rates. But this failed to translate into greater flexibility and link with inflation, as lending rates for transactional contracts remained subject to officially-mandated caps.

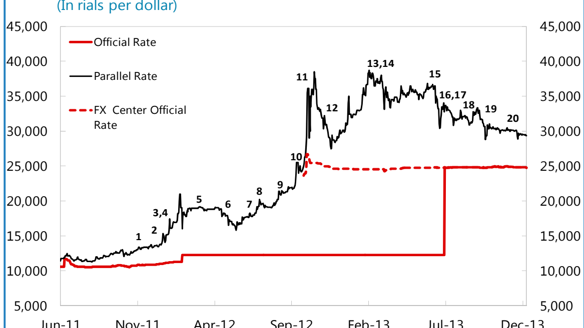
[2] In March 2013, the CPI basket was updated to reflect 2011 household spending patterns and entailed a 4½ percentage point higher weight for services (housing, health, and communications) relative to goods (food, clothing, and furniture).

Box 1. A Chronology of Significant Economic and Political Events, 2011–13

A series of significant external and domestic events took place since the last Article IV Consultation in 2011. These events have shaped the course of economic policy making.

1	November 2011	U.S. identifies Iran as a jurisdiction of primary money laundering concern and determines that Iran's financial system, including the central bank, constitutes a threat to governments or financial institutions that do business with these banks. Britain and Canada stopped doing business with Iranian financial institutions as well as the central bank.
2	December 2011	The U.S. adopts legislation to sanction foreign banks that deal with Iran's central bank unless the parent country of the bank significantly reduces its oil purchases from Iran, which is to be reviewed every six months. The new sanctions start to apply to non-oil transactions with the central bank by end February 2012 and to oil related transactions by end June 2012.
3	January 2012	The EU decides to freeze new contracts to purchase Iranian oil and to wind down existing contracts by July 1, 2012. Also, the EU decision bans insurance for shipping oil or petrochemical products, stops all trade with Iran in petrochemicals and precious metals and stones and freezes the assets of the central bank.
4	January 2012	The parallel market exchange rate depreciates by 25 percent. In response, the central bank depreciates the official exchange rate by 8.5 percent and increases profit rates for deposits by 5 percentage points.
5	March 2012	Society of Worldwide Interbank Financial Telecommunications (SWIFT) cuts off sanctioned Iranian banks from its network.
6	May 2012	A new U.S. Executive Order gives the U.S. Treasury Department the ability to identify and sanction foreign persons who help Iran evade U.S. and other multilateral sanctions.
7	June 2012	U.S. regulators fine a large financial institution in violations of the sanctions regime.
8	July 2012	The EU oil embargo and accompanying insurance ban on shipping of oil or petrochemical products, and the U.S. legislation requiring reductions in oil imports from Iran and banning purchase of Iranian petrochemical products take effect.
9	August 2012	U.S. regulators fine another large financial institution in violations of the sanctions regime.
10	September 2012	Parallel market exchange rate depreciates by about 30 percent and the central bank introduces a Foreign Exchange Center for foreign exchange transactions.
11	October 2012	The rial depreciates sharply in the parallel market. The EU bans transactions between European and all Iranian banks unless specifically authorized, prohibits provision of short term export credits, guarantees, and insurance to Iran and forbids provision of flagging and classification services for Iranian tankers and cargo vessels.
12	November 2012	The U.S. Treasury Department announces that financial transactions with National Iranian Oil Company would be sanctioned.
13	February 2013	New U.S. measures take effect preventing Iran from bringing its hard currency back to Iran and barring transfer of those proceeds to a third country for payments, thereby compelling Iran to buy the products of the oil importing country. U.S. legislation also bans supplying or transferring precious metals, in particular gold, to Iran.
14	February 2013	The EU General Court rules that the EU should lift the sanctions imposed on one of Iran's largest banks.
15	June 2013	Presidential elections take place in Iran. The parallel exchange rate appreciates by about 10 percent.
16	July 2013	The U.S. adopts new measures sanctioning companies that supply goods or services to Iran's automotive sector or finance transactions with this sector. Also, the U.S. measures banning provision of underwriting, insurance and reinsurance services for broad range of activities in Iran including shipping of oil and shipbuilding take effect.
17	July 2013	Central Bank of Iran unifies its two official exchange rates at the more depreciated official rate.
18	August 2013	President Rouhani's government takes office. The parallel market exchange rate appreciates by an additional 10 percent after the Presidential elections.
19	September 2013	The EU General Court rules that measures against Iran's largest shipping company should be lifted.
20	November 2013	Iran reaches an interim agreement with P5+1 over its nuclear program.

Iran: FX Rates, June 2011–December 2013
(In rials per dollar)



Source: Central Bank of Iran.

- ***The fiscal position deteriorated significantly***. Facing about 10 percentage point of GDP decline in total revenues since 2010/11, the authorities cut spending by close to 6 percentage points of GDP (with capital spending comprising about two-thirds of the cut). As a result, the overall fiscal balance shifted from a surplus of 3 percent of GDP in 2010/11 to an estimated deficit of 1 percent of GDP in 2013/14 (Tables 3 and 4). The cash deficit of the Targeted Subsidies Organization (TSO) remained high, at an estimated 1–2 percent of GDP in the same period, bringing the expanded overall deficit to about 2¼ percent of GDP in 2013/14 (Figure 2).

- ***The financial system was also adversely affected***. Banks' asset quality and profitability have been significantly affected by the combination of sanctions and rigid government credit policies (Tables 5, 6, and 7). Reported nonperforming loans (NPLs) peaked at 17 percent of total loans in 2012/13 (almost 10 percent of non-oil GDP), largely mirroring external trade and cash flow problems in the corporate sector, particularly state-owned enterprises (SOEs).[3] Credit to the private sector grew by 21 percent (year-on-year) in December 2013, implying a decline of about 6 percent in real terms. Lending activity of state-owned banks was the most sluggish, as these banks were heavily exposed to weak corporate borrowers. Despite these challenges, private-sector deposit growth (year-on-year) outpaced credit growth by 6 percentage points as of December 2013.

- ***The balance of payments remained in surplus, but external arrears emerged as international sanctions impaired access to foreign exchange***. Iran's current account surplus declined to 6½ percent of GDP in 2012/13, almost halving from the year before (Table 2). The sharp fall in oil exports was the main factor, partly offset by import compression. The deficit of the capital account remained contained, leaving the overall balance of payments in a surplus of 3½ percent of GDP in 2012/13. Gross foreign assets of the CBI rose to about $104 billion by end-2012/13. The liquidity of official reserve assets remained tight, and some external creditors have reported rising public and private external arrears, mostly related to lack of access to hard currencies for repayment.

- ***There was a limited and temporary easing of economic sanctions in November 2013***. Under the interim agreement with the P5+1 in November 2013, Iran's crude oil sales would be allowed to stabilize at the level of around 1 million bpd and Iran could access US$4.2 billion of its own funds held abroad in the six months, following the agreement taking effect on January 20, 2014. Sanctions on Iran's petrochemical exports, the automobile industry, and on the trading of gold and precious metals, were also waived temporarily, potentially providing US$1.5 billion in revenue. The United States and the European Union have also committed to establish a financial channel to facilitate humanitarian trade with Iran, including for civil aviation needs and to enable payment of tuition fees for Iranian students abroad. All in all, Iran would be able to dispense about US$6–7 billion (2 percent of GDP) during the six months following its implementation on January 20, 2014. The interim agreement maintained the sanctions against the Central Bank of Iran and other domestic financial institutions.

[3] NPLs could be underreported given past supervisory forbearance and weak loan classification standards.

NEAR-TERM RISKS AND THE MEDIUM-TERM OUTLOOK

6. **The near-term outlook remains highly uncertain, with the distribution of risks becoming more balanced but still tilted to the downside**. Facing continued constrained prospects for oil revenues and to conduct international trade and financial transactions, staff expects the economy to continue to contract in 2013/14, with real GDP estimated to decline by 1¾ percent. With some positive tailwinds from the external side and some incipient signs that the pace of contraction in domestic demand is slowing, it is projected that economic activity would begin to stabilize in 2014/15, with real GDP projected to increase by 1–2 percent. The real exchange rate depreciation has continued to provide impetus to sectors such as agriculture, parts of manufacturing, and non-oil exports, and prospects for hydrocarbons and manufacturing have also improved. But the current outlook remains highly uncertain and subject to several downside risks, most notably from a difficult external environment and from failure to address high unemployment (Appendix I). In the meantime, the authorities are taking steps to make the regulatory framework for foreign investment in the oil sector more attractive, while the interim agreement with the P5+1 brings upside risks. Nonetheless, were this progress to derail, the economy could be subject to new adverse shocks. In any event, staff's baseline scenario—which is based on sustained constraints for oil revenues and to conduct international transactions—shows that growth would remain below potential and inflation would remain high (Table 8).

7. **Even with a sustained improvement in the external environment, medium-term prospects hinge on strengthening the overall policy framework and on boosting overall investment and productivity** (Alternative scenario in Appendix II). Comprehensive structural reforms would be required to improve the business environment, enforce budget constraints and restructure the corporate sector (to reduce its dependence on subsidies and energy intensity in production), promote private sector investment, allow the financial sector to better allocate savings and handle risks, and address high unemployment. At the same time, the hydrocarbon sector faces large investment needs at a time when the call on OPEC is on a downward path. Being an already well-diversified economy with a large domestic market provides a good starting point to advance reforms. Nonetheless, the overall institutional policy and regulatory frameworks for product and labor markets lag in global competitiveness. Reforms are needed to improve the business environment to attract investment to boost productivity, and help restore sustainable growth and employment.

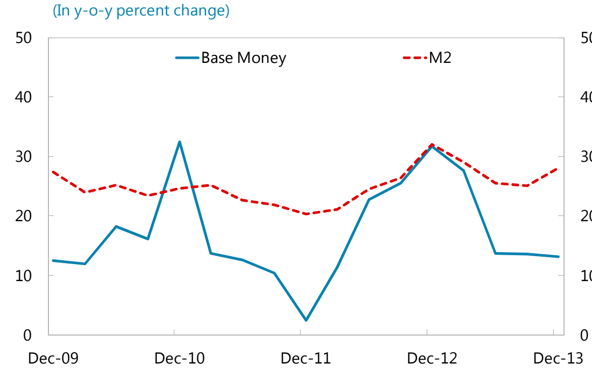
POLICY DISCUSSIONS

8. **The policy discussions focused on how to restore macroeconomic stability and address long-standing challenges in the policy framework and the structure of the economy to achieve sustainable growth**. The Fund's past policy advice and technical assistance has had some important impact on fiscal policy and statistics. The authorities made progress in implementing a VAT, enhancing tax administration, adopting the Government Financial Statistics Manual (GFSM, 2001), and becoming a Global Data Dissemination Standard (GDDS) member. Nonetheless, many of the past recommendations—on monetary, interest and exchange rates policies and on the policies to support the subsidy reform have been difficult to implement and remain relevant, especially in light of the constraints posed by the external environment. Against this backdrop, the discussions focused on:

Dealing with Stagflation: A Three-Pronged Strategy Centered on Tighter Monetary Policy, Some Fiscal Consolidation, and Supply-Side Reforms

9. **The authorities emphasized that focusing on disinflation was the best means to address stagflation**. CBI senior officials stressed that they have taken important steps to reduce inflation. A tight control of base money over the past seven months has been underpinned by a government-supported agreement to remove the financing of the *Mehr* Housing Program from the CBI's balance sheet. The authorities saw this agreement as a significant achievement and signal to the economy of the commitment to reduce inflation (Box 2). The tight control of base money, along with the appreciation of the currency and a decline in global prices for some key staples helped to bring down inflation quickly. Looking ahead, CBI authorities remained confident that inflation prospects would continue to improve, as they saw the amendments to the 2013/14 budget and the new 2014/15 budget as critical in helping to strengthen the overall consistency of macroeconomic policies. CBI senior officials also stressed their commitment to contain money growth by placing participation papers at higher profit (interest) rates.[4] It was agreed that a gradual tightening of monetary policy would have limited output costs, help anchor expectations and entrench disinflation, and also help contain the second-round impact from the planned increase in domestic energy prices.

Money and Credit Growth
(In y-o-y percent change)



Source: Fund staff estimates based on data from Iranian authorities.

[4] There are two types of lending contracts: transactional and participatory. Transactional contracts involve the financing of working capital, and the CBI fixes their interest rates by industry. Participatory ones involve the financing of some longer-term investment activity. The bank, and the depositor financing the loan, is entitled to a share of the profit from these investments. As the amount of profits is not known at the time when banks collect the deposit and make the loan, they indicate provisional profit rates. Economically, these profit rates are similar to interest rates.

Box 2. The Mehr Housing Project and Its Macroeconomic Implications

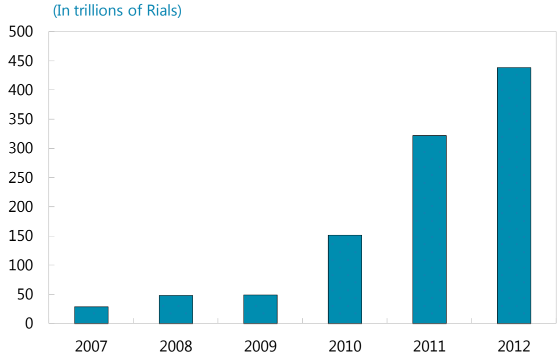
Iran started an ambitious affordable housing project in 2007 to bring some two million homes to the housing market over a five year period. The *Mehr* Housing Project targeted low-income families and was triggered by growing demand for new housing by Iran's young population, with 0.8 million additional housing units needed every year on top of a deficit of 1.5 million housing unit estimated in 2006. Under the scheme, the authorities provide land to private developers free of charge and new homeowners get a 99-year lease on the publicly owned land. The housing bank (Bank *Maskan*) extends, among other facilities, subsidized mortgage loans to new homeowners to finance their home purchases.

The financing of this project was placed upon the Central Bank of Iran (CBI), significantly complicating the conduct of monetary policy. Bank *Maskan* relied on credit lines and other financing facilities from the CBI. In fact, CBI financing to Bank *Maskan* tripled in 2010, in the run up to the subsidy reform, and doubled during the implementation of the first phase of the reform. By end-2011, CBI financing to Bank *Maskan* represented about 40 percent of base money. This trend undermined the CBI's efforts to ensure that second round effects from the change in domestic energy prices were minimized, while also forcing the CBI to tighten credit to the rest of the economy, with adverse implications for economic activity.

The government has stopped the CBI financing of the *Mehr* Housing Project but its future financing remains uncertain. Outstanding commitments under the project and the rise in the demand for affordable housing would require a permanent solution. To avoid any future pressure on the CBI for further financing and increase transparency of the fiscal accounts, the authorities should consider including the project in the annual budget and finance it through budgetary resources.

CBI Facilities to Maskan Bank

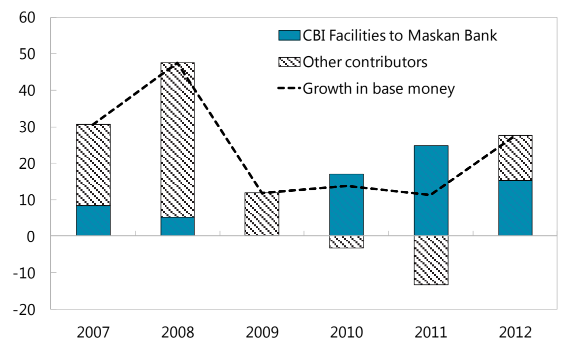
(In trillions of Rials)



Source: Central Bank of Iran.

Contributors to Base Money Growth

(In percent of base money growth)



Sources: Central Bank of Iran; and IMF staff calculations.

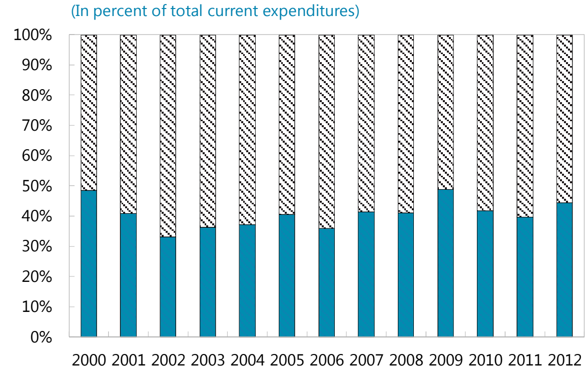
10. **The authorities and staff agreed that the 2014/15 budget provided a good balance between disinflation and supporting the economy**. The authorities emphasized that the approved budget continued with their task of advancing fiscal consolidation initiated with the amendment to the 2013/14 budget in late 2013. The new budget advances important tax and expenditure reforms while also maintaining a tight lid on current spending. Several ministries will participate in a pilot performance budgeting next year that will be extended to all in 2015/16 and better entrench savings on current spending. While capital spending has been prioritized and is envisaged to rebound, it would still remain well below pre-2012/13 levels. While the specifics on how to proceed with increasing domestic energy prices were still being discussed, the authorities indicated that such plans would help bring the deficit of the TSO from 1⅓ percent of GDP in 2013/14 to balance in 2014/15. These measures, along with several others on the revenue side, would help keep the overall deficit at around 2½ percent of GDP in 2014/15.

11. **The authorities have also begun to broaden the revenue base away from oil**. They explained their intention to broaden the base for non-oil tax revenues from 6 percent of GDP to 10 percent of GDP over the next several years. This would increasingly allow the financing of current spending through the tax system rather than oil revenues, which would be mostly allocated to capital spending.

- ***Several reforms were being implemented to strengthen tax administration***: (i) the implementation of an integrated tax system; (ii) a new framework to limit and reform tax incentives for certain activities (exports, properties, and employment taxes) and for large nontaxpayers (such as in manufacturing and large statutory bodies), and through a new structure (accelerated depreciations); and (iii) the completion of the implementation of the VAT—to reduce exemptions and strengthen the link of its collection information with direct taxation.

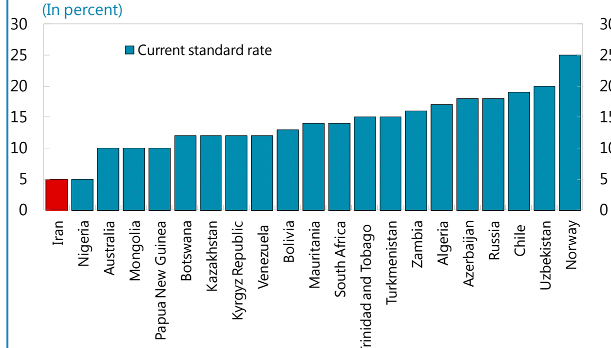
- ***The authorities also explained that the scheduled increase in the VAT rate was brought forward by one year***. They noted that the VAT rate could be gradually raised to around 10 percent once the trial implementation period of the VAT law expired in the next two years. They agreed that this would help bring the VAT rate more in line with other resource-intensive country levels.[5]

Share of Tax Revenues in Current Expenditures
(In percent of total current expenditures)



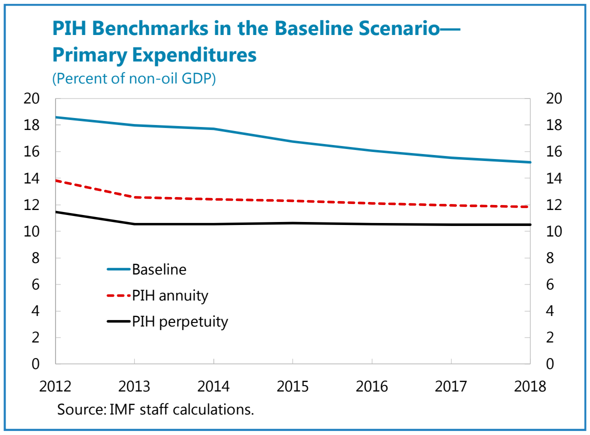
Source: Iranian authorities.

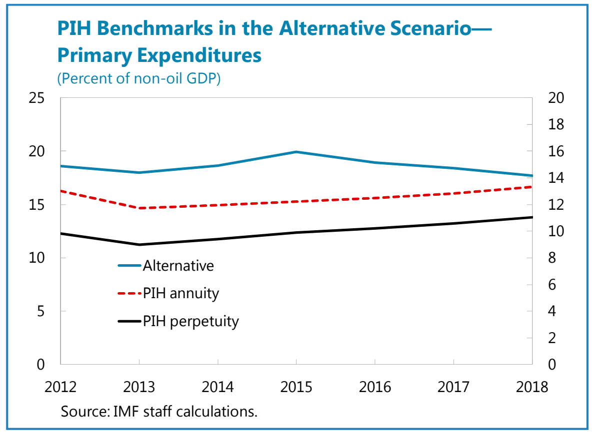
VAT Rates across Resource-Intensive Countries, 2013
(In percent)



Source: International Bureau of Fiscal Documentation, IBFD, www.ibfd.org (2013). Introduction data from earlier TP publications.

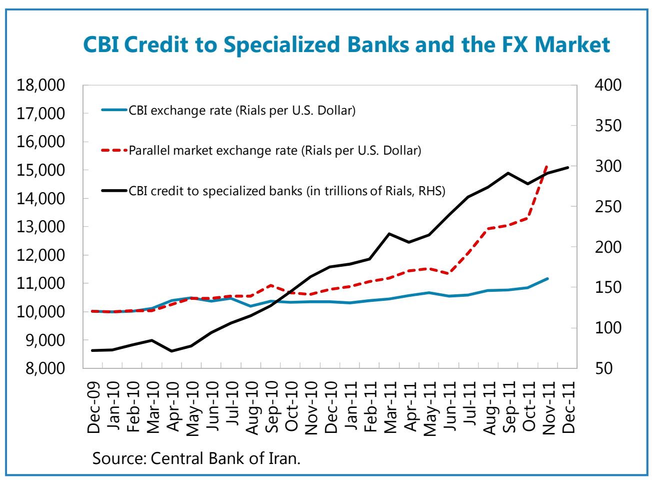
[5] The VAT was introduced in 2008 and its current rate of 6 percent will be increased to 8 percent in 2014/15 instead of 2015/16. A recent FAD TA mission has continued to support reforms related to compliance and risk-management. The authorities have requested TA on the possible design and implementation of a capital gains tax.





- ***The authorities underscored ongoing efforts to strengthen tax compliance***. These included large taxpayers and other indirect taxes (such as on professions), and they agreed on the potential to tax activities that have experienced large gains in recent years, such as on capital gains on equity investment and real estate. It was agreed that these efforts should help limit deficits and risks, improve the quality of the envisaged fiscal adjustment, and help lay the ground for a more sustainable fiscal policy ahead. Staff noted that these efforts were critical to entrench fiscal consolidation, as the results from the PIH on the illustrative medium-term scenarios confirmed the need for further fiscal adjustment of about 1–4 percent of non-oil GDP.[6]

12. **With the economy vulnerable at this juncture, staff stressed that the timing for advancing the subsidy reform had to be carefully considered**. The subsidy reform aimed to be budget-neutral and to align domestic energy prices gradually to international ones, by shifting large implicit subsidies to explicit cash transfers to households. While its design was particularly innovative—especially for a hydrocarbon-intensive economy, its implementation was not as effective and transparent as originally planned (Box 3).[7]



[6] The PIH calculates the net-present value of fiscal oil revenue from 2012/13 to 2050 for baseline and alternative scenarios. For the period post 2019, both scenarios assume that oil revenues stabilize at the 2019 level, and gas revenue grows by 3 percent per year. Given forecasts of non-oil revenue, the PIH calculates a level of public spending that is consistent with the net-present value of oil wealth. The PIH annuity assumes that oil wealth is spent up to 2050, while the PIH perpetuity assumes that expenditures are at a level that leaves the real value of wealth unchanged.

[7] The subsidy reform law stipulated the preparation by the TSO and the Supreme Audit Court of semi-annual reports to Parliament on the status and assessment of its implementation. These reports have not been made public. A Selected Issues paper reviews the macroeconomic impact of the first phase of the reform and draws lessons for its future implementation.

The authorities and staff agreed that increasing domestic energy prices was an important step to reduce energy consumption, pollution, improve the efficiency of the economy, and bring domestic prices toward international levels. The authorities acknowledged staff concerns on placing the economy through another large adverse supply shock at the current juncture and explained that the contemplated price increases were needed to address serious imbalances. Therefore, the price increases would be significantly lower than during the first phase of the reform and done gradually to minimize the impact on the economy and inflation. They agreed that such a gradual increase should be underpinned by a medium-term plan (about five years) to anchor the price increases and by an automatic price adjustment mechanism. Staff emphasized that the experience of the first phase of the subsidy reform showed that shocks could significantly undermine the stability of the exchange rate and the envisaged relative price adjustment. Consistent macroeconomic policies and reforms to tighten budget constraints in the corporate sector are crucial to make this reform sustainable.

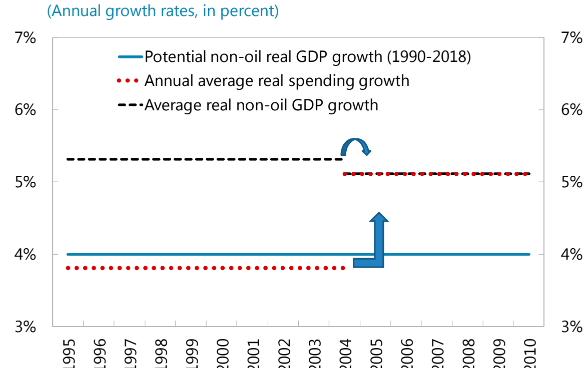
13. **The authorities agreed that reforms to boost the supply-side and productivity would also help in dealing with stagflation**. While the difficult external environment limited the scope for reforms and potential benefits, they stressed that restoring policy credibility and advancing reforms to entrench disinflation were essential. First and foremost, the authorities emphasized promoting macroeconomic stability, deepening domestic capital markets to further promote long-term financing, and easing the administrative burden on the private sector. Addressing cash-flow constraints and arrears in the corporate and banking sectors were also seen as important. Senior CBI officials noted that the cash-flow constraints and interlinkages in the corporate, government, and banking sectors were complex and difficult to solve immediately. They viewed sustained disinflation and higher profit rates as means for banks to better support credit needs of the economy.

Strengthening the Policy Framework for Macroeconomic Stability

Fiscal Policy: Improving Macroeconomic Coordination and Enhancing Resilience and Efficiency

14. **Staff suggested that reforms to the fiscal policy framework would strengthen the scope for countercyclical fiscal policy, limit fiscal risks, and better support macro-stability**. While Iran's fiscal framework has helped save part of the oil-price boom, the conduct of fiscal policy has exhibited some pro-cyclicality and excessive volatility. In particular, growth in public spending in real terms has tended to exceed potential non-oil GDP growth and the structural fiscal balance has been relatively volatile, especially when compared to other resource-intensive economies with fiscal rules (text table). The authorities could consider advancing several reforms that would facilitate the formulation and anchoring of fiscal policy on a rule, such as on the structural balance:

Fiscal Policy Indicators, 1995–2010
(Annual growth rates, in percent)



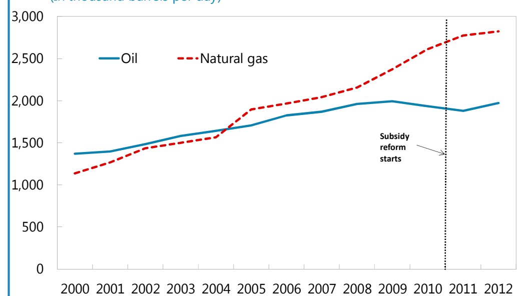
Sources: Iranian authorities; and IMF staff estimates.

Box 3. A Brief Look at the Implementation of the Subsidy Reform and the Next Steps

The Targeted Subsidies Reform (TSR) is one of the most courageous moves to reform subsidies in an energy exporting country, but has yet to fulfill its potential. Despite initial successful roll out of the TSR, its implementation did not go as planned. Both domestic policies and external factors played a role in undermining the reform. Relatively accommodative macroeconomic policies, deficits in the household cash transfer program, failure to impose tight budget constraints on enterprises, and a lack of open communications and coordination problems within the government during the implementation adversely affected the implementation of the TSR. Subsequently, the intensification of sanctions and the large depreciation led to a reversal of the gains achieved and eventual postponement of the reform.

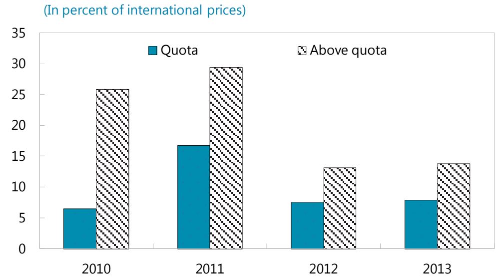
The initial success of the reform in driving down the consumption of subsidized products and improving income distribution waned with the sharp increase in inflation. After a steep reduction following the launch of the TSR, domestic energy consumption picked up later with the real decline in energy prices as inflation and nominal incomes rose. Improvements in income distribution, with the poverty rate declining by about 5 percentage points in the first three months of the TSR and Gini coefficient by 0.04 points for the whole year, were partially reversed by the rapid increase in inflation and decline in real value of wages and cash transfers.

Developments in Oil and Natural Gas Consumption, 2000–12
(In thousand barrels per day)



Source: BP Statistical Review of World Energy 2013.

Gasoline Prices 1/
(In percent of international prices)



Sources: Iranian authorities; and IMF staff calculations.

1/ Prices converted to cents per liter using the parallel market exchange rate, then taken as a share of Singapore retail gasoline prices.

The TSR implementation faced several macro and microeconomic problems. First, the authorities did not put in place a supportive and coherent macroeconomic policy package after the reform was launched to support macroeconomic stability. The central bank continued to finance the government's large housing program when there were already signs that the monetary financing was putting pressure in the foreign exchange and asset markets, and endangering macroeconomic stability. Also, administrative price controls put further strain on monetary policy as enterprises, facing administered-price measures and rising input costs, continued to rely on subsidized credit. Furthermore, the TSR budget became a source of fiscal deficit in the order of an estimated 1½ percent of GDP, adding to macroeconomic pressures. Second, despite being one key premise of the TSR, there was no progress in reforming the production structure of enterprises and their energy efficiency. In the event, the reform was also challenged by the lack of hard budget constraints at the corporate level, which thwarted price-stabilization attempts.

- ***Rethink the framework that allocates oil-wealth/savings among the goals of macroeconomic stability, intergenerational equity, and development***. In recent years, the Oil Stabilization Fund (OSF) has been "de facto" not operational, while the National Development Fund (NDFI) is not allowed to finance the budget.[8] With NDFI receiving a fixed and increasing share of oil and gas export proceeds and no ability to finance government deficits, recent large adverse shocks have forced large public spending cuts and resort to inflationary budgetary financing. The mechanism for allocating oil revenues seems too rigid and detached from changing macroeconomic conditions. OSF resources need to be replenished to support countercyclical fiscal policy. Also, the decisions on how to distribute hydrocarbon revenues among budget financing, lending to the non-oil economy through NDFI, needs to be better coordinated to assess the fiscal impulse, limit procyclicality and enhance macroeconomic stability.

A Comparison of Fiscal Policy

(In percent of GDP, unless otherwise noted)

	2006	2007	2008	2009	2010	2011	2012	Std. Dev.
Structural Balance								
Iran (non-oil)	-23.2	-18.1	-21.2	-16.1	-19.1	-17.6	-10.4	4.1
Chile	1.4	1.1	-1.0	-3.1	-2.1	-1.0	-0.4	1.6
Norway (mainland GDP)	-3.0	-2.9	-3.4	-5.4	-5.5	-5.3	-5.6	1.3
Saudi Arabia	0.6	1.6	4.2	4.9	1.0	-4.0	-3.3	3.4

Source: Fund staff estimates; structural balance defined as per national authorities.

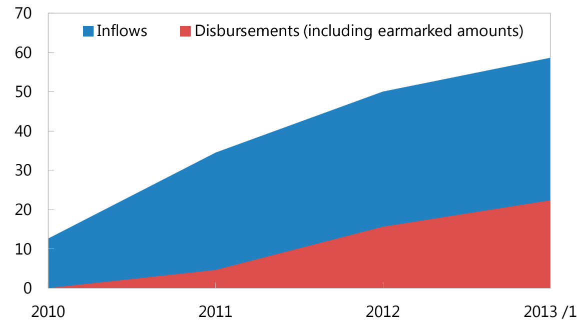
- ***Take steps toward annual multi-year expenditure and budget planning***. Iran has in place a one-year budgeting framework, with limited requirements for formulating a fiscal policy consistent with a longer horizon. Within the annual budget bill, the authorities are not required under the law to submit a medium-term projection. A medium-term approach should help insulate the economy from oil-revenue shocks, strengthen expenditure planning, and thus reduce the volatility of expenditure.

[8] The OSF was established in 2000 to insulate the budget from fluctuations in oil prices (revenues) and to generate savings to be used when prices fell, as well as to support development of the private sector. However, in 2010, the NDFI was established as a nongovernment public entity to promote development and savings, while forbidden from lending to the government.

- ***Broaden the coverage of fiscal accounts, their transparency and accountability***. In recent years, the authorities have shifted part of their public sector accounts presentation to the Government Financial Statistics Manual 2001. However, the coverage remains limited to mostly the central government and excludes other parts of the general government such as provinces and SOEs. Also, their supervisory framework remains unclear, especially for ex-post performance and pre-emptive corrective actions.

- ***Review quasi-fiscal activities (QFAs)***. NDFI senior officials emphasized that with the establishment of the NDFI, important steps have been taken in only three years to strengthen the management of oil wealth. A framework for saving a significant part of oil-revenues is now well established, which ensures its independence from the government and also strengthened its transparency.[9] They noted that the financing of private non-oil projects is now done through the agency of domestic banks, which limits credit risks and reassures the quality of these domestic investments. In response to staff concerns, they explained that their financial statements and balance sheets were in the process of being finalized with the assistance of a local private firm, while the criteria for selecting commercial banks were now placing more emphasis on economic and risk management factors. In addition, based on the past experience with the OSF, they had recently finished reviewing contracts and projected cash flows and returns on loans with commercial banks. They agreed with staff that there was significant scope to enhance NDFI's investment targets, risk-management policy, transparency, and accountability along the lines of the Santiago principles and the vast international experience.[10] Staff noted that other QFAs (such as the *Mehr* Housing Program) and their respective interest rate subsidies should be made more transparent and gradually incorporated into the central government budget.

National Development Fund
(In billions of U.S. Dollars)



Source: National Development Fund.
1/ As of December 2013.

[9] As of the third-quarter of 2013, the Sovereign Wealth Fund Institute's Linaburg-Maduell transparency rating for the NDFI was 5 (out of 10), similar to those of China, Russia, and Qatar, and below the minimum rating of 8 recommended to claim adequate transparency.

[10] A Selected Issues paper discusses the framework supporting the NDFI and potential reforms to improve its effectiveness in light of international best practice.

The Next Steps of the Subsidy Reform: A Robust Supporting Framework

15. **The authorities agreed that it was essential to ensure an adequate framework for advancing the subsidy reform**. It was agreed that the current deficit associated with the subsidy reform stemmed from shortcomings in its implementation, mostly related to the failure to impose budget discipline on high-energy users, as well as a higher number of households receiving cash transfers than originally planned. Specifically:

- ***The authorities noted that future energy price increases would have to better balance competing social needs rather than increasing cash transfers to all households***. The authorities explained that while they intended to maintain the framework associated with the first phase of the reform, the political support to maintain the same design going forward had waned. As a result, efforts had been mostly focused on identifying and means testing recipients with a view to only including in future phases those households deemed most vulnerable to higher domestic energy prices. But the identification of high- and middle-income groups has proved difficult and the authorities continued to work on establishing a comprehensive and reliable database of potential recipients. In the meantime, they were considering a proposal that would be implemented based on criteria using a broad range of indicators (such as the number of trips abroad per year, of luxury cars owned, professional occupation, or even re-registering beneficiaries) to exclude less vulnerable groups. The proceeds from higher energy prices would be used to support household spending on health insurance (as two-thirds of health care costs are out-of-pocket), several high-energy intensive sectors, and also increase cash transfers only to some of the most vulnerable households.

- ***The authorities saw the reforms to tighten budget constraints at the corporate level as one of the most difficult challenges***. They agreed that the experience with the first phase of the subsidy reform underscored the need to ensure that energy-intensive corporations were able to optimize their energy use and adopt new technologies, as domestic prices were gradually aligned with international ones. In this regard, they explained that diesel prices would be adjusted more gradually than other fuels to facilitate such a process, while several options were being considered to support such an adjustment and proper incentives, including the options to link financial support to concrete energy savings. The authorities also indicated their desire to announce future price increases within a medium-term horizon to increase the transparency for investors.

16. **While supporting the need to advance with the reform, staff highlighted several risks**. The criteria for identifying and excluding less vulnerable groups had to be simple, transparent, and perceived as fair. In addition, the distribution of resources for supporting energy-intensive sectors should effectively foster the adoption of new technologies and tighter budget constraints. The extent of the difficulties facing energy-intensive sectors likely exceeds the contemplated resources, making the criteria for accessing such support critical. In subsequent stages of the reform, staff noted the scope to make direct cash transfers more conditional on social goals and also tilted toward savings for the broader population. Consideration could also be given to phasing out the cash transfers to the population and potentially replacing them with a consolidated public

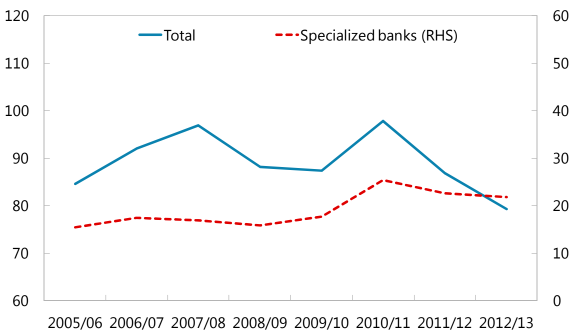
framework that distributes oil wealth or with a scheme to promote private savings. The authorities could also make the lessons from the first phase of the reform well known to the public, to muster support to future phases of the reform and to assist other countries in their reform efforts.

Monetary Policy and the Exchange Rate: Reforms to Strengthen Price Stability

17. **The authorities and staff agreed that the monetary policy framework needs to be strengthened**. Staff noted that the shocks and policy response in recent years showed that the CBI had to deal with competing demands without a mandate focused on price stability. In addition, staff stressed that the CBI's operational effectiveness had been undermined by the institutional decision-making process. The Money and Credit Council (MCC) remains responsible for most decisions and is dominated by government and private-sector representatives, with competing and oftentimes contradictory goals. As a result of these constraints, the exchange rate—the traditional nominal anchor—has been a key instrument of adjustment to shocks, and with fixed profit (interest) rates, real profit (interest) rates have declined sharply. This response has compounded difficulties in stabilizing inflation expectations and constrained the use of some of the traditional sterilization instruments.

Private Sector Credit

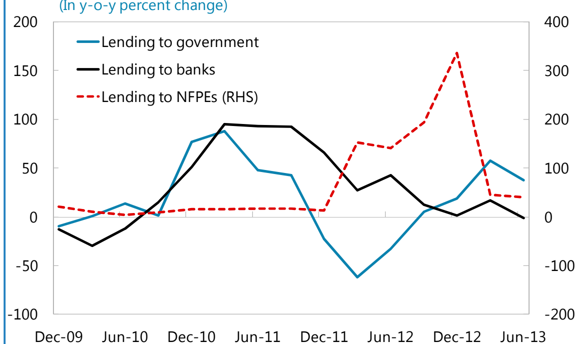
(In percent of non-oil GDP)



Sources: Iranian authorities; and IMF staff estimates.

CBI Asset Growth

(In y-o-y percent change)



Source: Iranian authorities.

18. **The authorities and staff agreed that several measures would help to reduce and stabilize inflation at low levels**:

- ***Interest rates will need to be more reflective of inflation, with more scope for being market-determined***. CBI senior officials explained that bringing profit (interest) rates for government-mandated credit and participation papers more in line with inflation would help address some difficulties in credit markets and enable the CBI to better manage liquidity. At the same time, the CBI would also signal its commitment to lower inflation, bolster the demand for the rial, and thus help better anchor the needed exchange rate flexibility and money. While they acknowledged difficulties in gradually increasing interest rates at this juncture, given the state of the economy and concerns on renewed shocks, CBI senior officials saw limited output costs from higher profit (interest) rates and a need to contain money growth to support disinflation. To do so, they were determined to issue participation papers with higher profit (interest) rates than before.[11]

- ***Strengthen the mandate and operational effectiveness of the CBI***. With less scope to use foreign exchange reserves for sterilization purposes and risks from large and persistent fiscal deficits, staff emphasized that reforms were needed to ensure that monetary policy can stabilize inflation successfully. The authorities noted that there was growing consensus at the MCC to strengthen the CBI's mandate on price stability and its operational effectiveness. These reforms would help entrench the benefits for disinflation stemming from the landmark decision on the *Mehr* Housing Program. It was agreed that simplifying the CBI's mandate and strengthening its operational autonomy would significantly enhance the effectiveness of monetary policy, in line with the experience of other chronic inflation countries that have successfully achieved price stability.

19. **The authorities stressed their commitment to return to a unified exchange rate regime**. They recognized that the current external environment imposed several constraints on their ability to unify the official and bureau/parallel exchange rates, and also underscored the significant preparatory work that a unification would entail. Nonetheless, they were committed to unify both markets by mid-2015. They also recognized that arrears on external payments by public- and private-sector entities had emerged, but attributed these to technical difficulties in accessing foreign exchange. CBI senior officials explained that they were prepared to clear public-sector arrears with foreign assets held abroad and to eliminate foreign exchange restrictions and any arrears arising from these restrictions. They also agreed with staff on the need to preserve some exchange rate flexibility, given the relatively rapid exchange rate appreciation in real terms in recent months and the lingering risks to the outlook. They also noted that the 2014/15 budget contemplated steps to depreciate the official rate and bring it closer to the bureau/parallel rate.

20. **The official exchange rate appears somewhat overvalued, but uncertainties over Iran's external environment cloud its assessment**. The authorities noted that the bureau/parallel exchange rate—which is 15–20 percent more depreciated than the official rate—seemed to be more in line with fundamentals. They stressed that the exchange rate has regained stability and that Iran's external buffers were comfortable, although they recognized some difficulties with accessibility. Based on conventional CGER-methodologies, the official exchange rate seems moderately overvalued (see Appendix III). However, these approaches are based on staff's baseline macroeconomic scenario, which shows Iran's oil exports well below historical averages. Were Iran's external environment to improve, oil exports could revert back to about 2½ million barrels per day (roughly the average of the years 2007–11), and the exchange rate would appear to be more in line with fundamentals.

[11] A Selected Issues Paper explores the tradeoff between inflation and output stabilization in Iran and the scope for reforms to the monetary policy framework, in line with international experiences.

21. **The current exchange rate regime gives rise to exchange restrictions and multiple currency practices**. The authorities explained that a significant part of current account transactions were conducted at the official exchange rate. However, they recognized that several import categories were being prioritized (basic necessities over other categories of authorized imports) and that, given some delays in the process of granting of foreign exchange some importers were effectively conducting their transactions through the bureau market. They emphasized that the effective premium was in fact small due to the high transaction costs in the official market. They emphasized the many difficulties in accessing foreign exchange, in transferring assets from countries where they had trade surpluses to those with deficits, and in finding correspondent banks. In addition, they explained that limits of US$300 and US$15,000 were effectively in place for travel and for studies abroad, respectively, and that amounts in excess of these limits were accessed through the bureau/parallel market at a more depreciated rate. These foreign exchange limitations, including as a result of import priority categories, give rise to exchange restrictions subject to Fund approval under Article VIII, Section 2(a). Furthermore, the establishment of an official exchange rate for use in all exchange transactions which in practice differs by more than 2 percent from the rate used by licensed foreign exchange bureaus gives rise to a multiple currency practice and an exchange restriction subject to Fund approval under Article VIII, Sections 2(a) and (3). The authorities also confirmed that no changes had been made regarding the transferability of profits under the Foreign Investment Promotion and Protection Act and to the making of other investment-related current payments under this act, but noted that they intend to examine possible modifications to the regulations to remove the restriction. In addition, the authorities confirmed that the letters of credit opened before March 21, 2002 that benefited from subsidies were still outstanding.[12]

The Business Environment and Financial Stability: Reforms to Promote Jobs and Growth

22. **The authorities viewed as critical the need to advance reforms to improve the business environment and address high unemployment**. Staff noted that comprehensive steps would be needed to enhance the efficiency of product, financial, and labor markets, as well as to strengthen the institutional framework and effectiveness of the government (Figure 5). Discussions with a broad group of representatives from different economic sectors highlighted the need to enhance the enforcement of the rule of law and property rights, maintain policy and macroeconomic stability, and enhance the transparency of policy making. In particular:

- ***The authorities recognized that the corporate sector was facing difficult conditions***. The authorities explained that several reforms to simplify administrative procedures under the *Law for Continued Improvement of the Business Environment* were now being implemented. They also explained that past privatizations failed to effectively transfer ownership to the private sector and tighten budget constraints, and therefore, have taken steps to improve the privatization process. In addition, senior government officials stressed the administration's commitment to

[12] The multiple currency practice arising from foreign exchange subsidies in connection with the payment of certain letters of credit, opened before 2002, is temporary as it relates to a limited number of letters of credit expected to expire by 2016. Please refer to the Informational Annex for further details.

promote foreign and private sector investment, which they saw as beneficial not only for Iran but also the region. The authorities recognized that efforts to improve the business environment would require significant coordination with other state-agencies and the private sector. These efforts would help improve the standards of corporate governance and support the deepening of domestic capital markets, which they viewed as critical to entrench macroeconomic stability and higher productivity. The authorities noted that the tight liquidity conditions reigning in some sectors of the economy and their linkages, was a complex and difficult issue to solve in the near term.

- ***There was broad recognition that dealing with high unemployment will require reforms to the labor market***. The administration has placed unemployment (at 24 percent for youth and 20 percent for women by December 2013, respectively) as the most pressing problem. In addition, the extent of underemployment is high.[13] Labor force participation remains high (mainly for men) but has been declining and prospective new entrants bring considerable risks to social conditions over the medium term. As highlighted in several development plans, staff noted that labor regulations should be reviewed to ease the rigidity of contracts (in terms of hiring, firing, and special employment conditions such as study leave and force majeure) and lower costs of labor (severance payments, social security contributions, and labor insurance) which have led to high redundancy costs and low flexibility in employment and wage determination (Box 5).

Labor Market Indicators, 2000/01–2013/14 1/

(In percent of labor force)

	2001/02	2005/06	2009/10	2010/11	2011/12	2012/13	2013/14 2/
Unemployment	14.2	11.5	11.9	13.5	12.3	12.2	10.3
Youth unemployment	33.6	22.4	24.1	26.7	26.3	25.8	24.3
Urban	14.8	13.8	13.5	15.3	13.7	13.8	11.7
Rural	13.5	7.1	8.3	9.1	8.9	8.2	6.9
Male	13.2	10	10.8	11.9	10.5	10.5	8.5
Female	19.9	17.1	16.8	20.5	20.9	19.9	20.3
Labor force participation	37.2	41.0	38.9	38.3	36.9	37.7	36.7
Urban	35.8	39.4	37.7	37.3	35.8	36.7	36
Rural	39.1	44.7	41.9	40.8	39.8	40.3	38.6
Male	62.1	64.7	62.8	62.1	60.7	61.1	62.1
Female	11.8	17.0	14.5	14.1	12.6	13.8	11.3

Source: Statistical Center of Iran.

1/ The Iranian fiscal year ends March 20.

2/ Corresponds to September 23–December 21, 2013.

[13] Official employment statistics consider all persons aged 10 or over working one hour per week as effectively employed, consistent with ILO standards. The rate of underemployment is about 9 percent of the employed population (roughly equivalent to 80 percent of those unemployed).

Box 4. Labor Market Issues and Unemployment in Iran

Iran's labor market has faced difficult conditions over the past two decades. Participation rates have been declining, employment between genders and age groups differ markedly, and unemployment rates have been persistently high, averaging more than 12 percent since 2000. Moreover, unemployment rates for urban workers and the youth have been even higher, at 13.8 percent and 24.5 percent, respectively, in 2012.

The new administration recognizes high unemployment as a major challenge. An unprecedented number of students—4.5 million—that are currently inactive are expected to enter the labor market in the years ahead. In the current environment of slow economic growth, such a development could have significant implications for socio-economic conditions. To better understand the relationship between growth and employment in Iran, staff used a template created by MCD staff to calculate the elasticity of employment to GDP, based on the following equation: [1]

$$\log(E_t) = \alpha + \rho \log(E_{t-1}) + \beta \log(\text{non-oil GDP}_t)$$

where E is the number of people employed at time t, and β is the long-term elasticity, estimated at 0.35 for Iran. This elasticity is relatively low compared with the MENA region, and may reflect the impact of the regulatory framework on employment conditions.

Several scenarios help to assess the implications of macroeconomic policies and structural reforms on the labor market and project different paths for the unemployment rate over the medium term. In particular:

Islamic Republic Of Iran: Medium Term Outlook for Unemployment 2012–2018

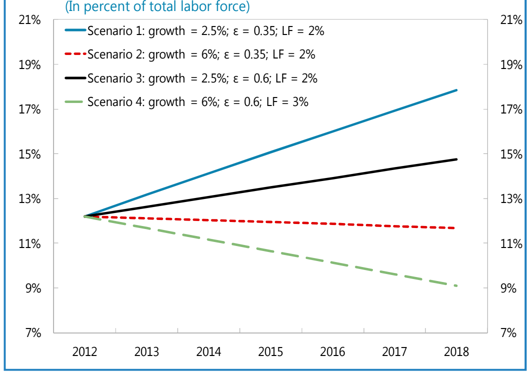
2012	
Labor Force (millions)	24.0
Unemployment Rate (percent)	12.2%
Unemployed (millions)	2.9
Employed (millions)	21.1
2018	
Labor Force (millions)	27.1
2013 - 2018	
New Entrants to the labor force (millions)	3.0
Total number of currently unemployed and new entrants	6.0
Employment elasticity	0.35
Scenario 1: Change in employment required to achieve 12.2% unemployment target (percent)	12.6%
Scenario 1: Annual employment growth required to achieve 12.2 % unemployment target (percent	2.0%
Scenario 1: Required annual real GDP growth rate for 2013 - 2018 (percent)	**5.7%**

- ***Under current conditions, unemployment is envisaged to continue rising***. Were the non-oil economy to grow at an average annual rate of 2½ percent and the labor force by 2 percent per year, and with the current estimated elasticity, the unemployment rate would likely rise toward 20 percent by 2018.

- ***Non-oil GDP growth rates close to 6 percent per year would help reduce unemployment somewhat***. This would entail a significant change in current economic conditions facing Iran, either a comprehensive change in the external environment and/or structural reforms to increase investment and productivity. These reforms could, for example, increase the elasticity of employment to growth and allow for lower growth rates to reduce unemployment under adverse external conditions. Reforms are essential but need the support from higher non-oil growth.

- ***A combination of reforms and higher non-oil growth seems essential to minimize risks from new entrants and also reduce current high unemployment rates***. For example, were all 4½ million students to enter the market—the combination of high growth and more elastic demand for labor could reduce unemployment to around 9 percent.

Unemployment Rate Projections 1/
(In percent of total labor force)



1/ Chami et.al., 2012, "A Template for Analyzing Projecting Labor Market Indicators," IMF Technical Notes and Manual 12/01.

2/ Crivelli, E., D. Furceri and J. Toujas-Bernate, 2012, "Can Policies Affect Employment Intensity of Growth? A Cross-country Analysis," IMF Working Paper No. 12/218

23. **The authorities underscored the need to improve the consistency of financial sector policies**. They explained that the banking system had faced a difficult environment over the past several years. A combination of government directives, including through government-mandated credit policies, had weakened risk management, particularly in state-owned banks, and incentives for supervision. As a result, regulatory forbearance on prudential limits had become more widespread and difficult to solve, due to the severity of past shocks and to the lack of proper enforcement capacity and supervisory powers by the CBI, including bank supervisors not enjoying full legal immunity. Banks' loan classification procedures have been reportedly weak, resulting in under provisioning and overstated capital adequacy ratios, particularly for state-owned banks. While market participants expressed overall satisfaction with the direction the CBI was imparting to financial sector policies, the authorities stressed that advancing many of the needed reforms would require continued efforts to muster political support. In particular:

- ***The authorities were considering different options to resolve NPLs and recapitalize banks***. They stressed and staff agreed that their main goal was to strengthen risk management and compliance with prudential limits. Senior management at state-owned banks had already been replaced and consideration was being given to make those banks subject to better accounting and provisioning standards, so as to make them more robust financially, including through recapitalization and consolidation. The authorities were broadly satisfied with private banks, which had already begun to recapitalize themselves.

- ***The authorities saw a good opportunity to gradually dismantle government-mandated credit policies, to promote competition and better risk management***. They noted that there were major differences between private and state-owned bank practices, with many banks having increasingly moved away from government-mandated credit policies. Staff encouraged the authorities to begin reviewing and dismantling directed-lending policies promptly. This step could also involve closing the gap between domestic and international best practices in risk management, internal controls, and governance. In addition, staff saw merit in the view of some market participants that privatizing state-owned banks and managing them on a more commercial basis would help level the field of competition in the system.

- ***The authorities saw a need to enhance supervision***. While there has been increased coordination between off-site risk assessments and on-site supervision, the authorities acknowledged that enforcing supervision was still difficult. They explained that off-site supervision remained constrained in swiftly penalizing banks that fail to abide by regulatory standards, including the dissemination of prudential information to the CBI. Steps were being taken for on-site inspections to be more risk-based, prioritizing weakest banks. Despite enforcement challenges, the authorities were drawing up remedial action plans for banks that fail to meet regulatory standards. Staff noted the urgent need to strengthen the CBI's supervisory powers and enforcement capacity.

- ***There is a need to strengthen the crisis preparedness framework***. Staff noted that risk-based supervision should be supported by frequent stress testing of the banking sector, which would also provide a useful warning signal and cross-check to on-site reviews. The authorities also explained that the bank resolution framework needed improvement, particularly regarding the recently implemented deposit guarantee fund, which remained too comprehensive and onerous to banks.

- ***Some steps should be taken toward expanding the supervision of bank-affiliates, business conglomerates, and nonbank credit institutions***. With many of the private banks part of large business conglomerates, staff noted that it would be important to improve the information coverage to better map individual bank exposures into a system-wide network to assess linkages and risks. Nonbank credit institutions, primarily credit unions and microfinance charities, can collect deposits that are exempt from some elements of the regulatory framework.[14] The banking supervision department has encouraged consolidation among nonbank institutions and asked the larger merged entities to apply for a banking license.

24. **Staff noted that the recent progress on the external environment provided a good chance to advance on the AML/CFT legislation**. Some progress has been made in strengthening the AML regulatory framework, most notably the adoption by the AML High Council of fourteen new AML instructions, the establishment of an economic crime prosecutor office, and a defined roadmap for improving the AML system.[15] The authorities noted that all financial institutions have been subjected to an AML supervisory inspection over the past two years. However, while a bill on countering the financing of terrorism (CFT) had been prepared and approved by Parliament in 2012, the authorities reported that it is currently pending before the judiciary for an opinion. Staff noted that there was scope to move towards risk-based AML/CFT supervision and encouraged the authorities to adopt a CFT law that is improved regarding the criminalization of terrorism financing and related activities, the freezing and confiscation of assets, the reporting and analysis of suspicious transactions, and international cooperation.

OTHER ISSUES

25. **The authorities underscored that official statistics, particularly for prices and unemployment, were underpinned by sound methodologies**. Traditionally, Iran has had adequate statistics for surveillance, notwithstanding some methodological shortcomings in some areas, but delays in publication became more pronounced amid the intensification of international sanctions in 2012. Staff noted that official statistics, particularly for consumer prices and unemployment, had come under increased scrutiny. The authorities emphasized that the methodologies for consumer prices and unemployment followed best international practice and that they have taken steps since taking office to publish information on a more timely basis. Staff agreed and offered the authorities technical assistance to help reaffirm the underlying methodologies.

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[14] An important share of these institutions deposits are being included in the monetary survey.

[15] The instructions include among others the identification of Iranian and foreign customers, the identification of suspicious transactions and the method of reporting, and the monitoring and control of Politically Exposed Persons.

STAFF APPRAISAL

26. **Iran had achieved considerable progress in raising per capita income in previous decades, but large shocks and weak macroeconomic management in recent years have had a significant impact on macroeconomic stability and growth**. A combination of shocks, associated with the implementation of the first phase of the subsidy reform, social-programs inadequately funded, and a marked deterioration in the external environment have weakened the economy. Inflation and unemployment are high, while the corporate and banking sectors are weak. The experience over the past several years has exposed structural weaknesses in the economy and in the policy framework.

27. **The economic outlook remains highly uncertain**. Facing continued constrained prospects for oil revenues and international transactions, the economy is expected to have continued to contract in 2013/14. With some positive tailwinds from the external side and incipient signs that the pace of contraction in domestic demand is slowing, economic activity would begin to stabilize in 2014/15. But the current outlook remains highly uncertain and subject to downside risks. The authorities are taking steps to make the regulatory framework for foreign investment in the oil sector more attractive, while the interim agreement with the P5+1 brings upside risks.

28. **The opportunity to advance comprehensive reforms should not be missed**. There is a need to advance reforms to the product, labor, and credit markets to promote stability, investment, and productivity. The authorities should avoid postponing reforms and "muddling-through" in the hope of an improved external environment. Advancing reforms would lay the basis for sustained high growth and employment, especially should the external environment continue to improve.

29. **Dealing with stagflation requires several measures, careful sequencing and coordination**. A three-pronged strategy should be centered on tightening monetary policy, some balanced fiscal consolidation, and structural reforms to boost the supply side. Staff welcomes the steps taken to remove the financing of the *Mehr* program from the Central Bank of Iran's balance sheet, which bode well for stabilizing inflation in the future. The authorities are encouraged to find an alternative noninflationary source of financing for this program to minimize macro-stability risks ahead. Increasing profit rates gradually would help to firmly anchor expectations and contain second-round effects from the planned increases in domestic energy prices. The 2014/15 budget continues with the government's decision to consolidate fiscal policy and would help balance the support for disinflation and needs of the economy. Staff welcomes the proposed measures to begin broadening the revenue base away from oil, most notably, the decision to bring forward and increase the scheduled VAT rate, as well as the reforms to strengthen tax administration and reduce exemptions. Staff sees scope to further increase the VAT rate in the years ahead—as it remains well below those of other resource-intensive countries—as well as to expand the taxation to specific activities that have experienced large gains. These measures would help to improve the quality of the fiscal adjustment and help lay the ground for a sustainable fiscal policy ahead.

30. **Reforms to the monetary and fiscal policy frameworks are also essential to entrench macroeconomic stability**. The Central Bank of Iran's mandate needs to be simplified and refocused toward price stability. To build a solid foundation for the future, it is essential to bring the institutional decision-making setup at the Money and Credit Council in line with those of countries that have successfully resolved high chronic inflation. Reforms to the fiscal policy framework should strengthen its countercyclical role, limit fiscal risks, and enhance macroeconomic coordination. The current framework supported by the Oil Stabilization Fund (OSF) and the National Development Fund of Iran (NDFI) could better balance the goals of macroeconomic stability, intergenerational equity, and development. For this, OSF resources need to be replenished soon to support noninflationary budget financing and build buffers for future shocks. Decisions on how to save and invest NDFI resources should be better coordinated explicitly with macro policies and underpinned by more explicit safeguards and transparency. Adopting a multi-year budget planning and expanding the coverage of the general government should enhance the operational conduct, monitoring, and accountability of fiscal policy, and thus limit fiscal risks. Staff encourages the authorities to review how best to bring quasi-fiscal activities into the budget to make them explicit so as to reform or discontinue them.

31. **The authorities' intention to unify the foreign exchange market by mid-2015 is welcome**. In the transition, the authorities should manage the exchange rate flexibly in light of external risks and still high inflation. The assessment of the official exchange rate is subject to an unusual degree of uncertainty. In the current circumstances, the official exchange rate would be moderately overvalued, with the bureau/parallel market rate closer to equilibrium. Staff recommends Executive Board approval of the retention of the exchange restrictions and multiple currency practices referred to in paragraph 20 since these are maintained for balance of payments reasons, are nondiscriminatory, and are temporary in light of the authorities' commitment to unify the exchange rate regime and to remove the restrictions by mid-2015.

32. **The subsidy reform needs to proceed with the right supporting framework and macroeconomic policies**. Iran's design of the subsidy reform has been exemplary and the reform remains a priority. The implementation of the first phase has faced significant and varied difficulties and there is a need to make the lessons known to the public. Plans to increase domestic prices gradually are prudent but should be underpinned by an adjustment mechanism with strong political backing to support full implementation. The proposed distribution of resources among households and specific sectors presents a departure from the original design. The process for identifying and excluding less vulnerable groups requires criteria that are simple, transparent, and perceived as fair. In addition, the distribution of resources for supporting energy-intensive sectors needs to ensure a framework that fosters the adoption of new technologies and tighter budget constraints. In subsequent stages of the reform, transfers could be made more conditional on social goals and tilted toward private savings for the broader population.

33. **There is an urgent need to strengthen the Central Bank of Iran's supervisory powers and enforcement capacity**. The CBI should be able to swiftly take action in case banks fail to abide by regulatory standards. Staff welcomes the CBI's initial steps toward a risk-based approach to supervision. Staff shares the view of some market participants about the scope for leveling the field of competition in the system through further privatization and reforms to government-mandated credit policies. Current proposals to deal with nonperforming loans and recapitalize public banks need to be supported by restructuring plans and reforms to enhance their risk management and accountability. In terms of crisis preparedness, it would be important to strengthen the bank resolution framework and putting the deposit guarantee fund on a sustainable financial footing.

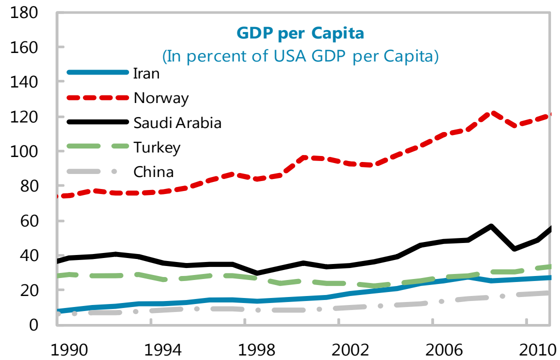
34. **Reforms to improve the business environment and the labor market are complementary and essential to restore stability and boost employment and growth**. The scope to improve the business environment is large and can provide a significant boost to productivity and growth in the years ahead. Enhancing the enforcement of the rule of law and property rights, maintaining policy and macroeconomic stability, and enhancing the transparency of policy making are fundamental pillars that would also pave the way for taking advantage of the growing foreign investor interest. Advancing reforms on AML/CFT would also help reinsert the domestic financial system into the global economy, lower transaction costs, and provide an important impetus to productivity. With large potential entrants to the labor force in the years ahead, reforms are needed to facilitate the reallocation of labor across sectors and lower nonwage labor costs. Staff encourages the authorities to review labor regulations to ease the rigidity of contracts and nonwage costs.

35. **There is a good opportunity to improve the timeliness of official statistics publication and to reaffirm the underlying methodology behind consumer price and unemployment data**. In recent years, the quality and timeliness of price and unemployment statistics have come under increased scrutiny. The authorities have taken some steps under difficult circumstances, but there is scope for further improvement in the reporting and timeliness of official statistics. Technical assistance in these areas would help address these issues.

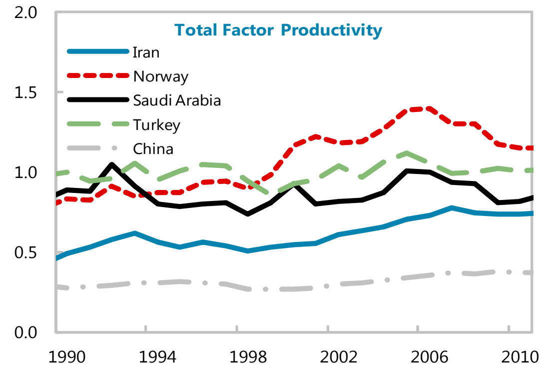
36. **It is recommended that the next Article IV consultation takes place on the standard 12-month cycle**.

Figure 1. Islamic Republic of Iran: A Look Back at Economic Performance

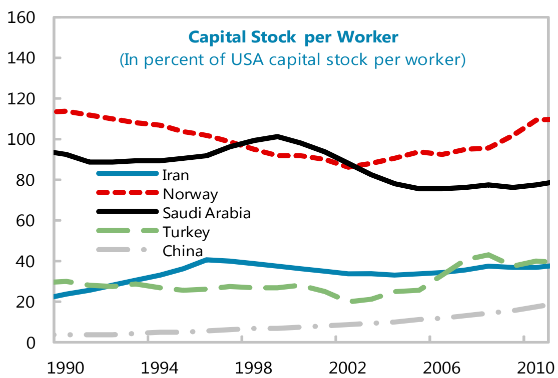
There has been significant convergence over the past couple of decades...



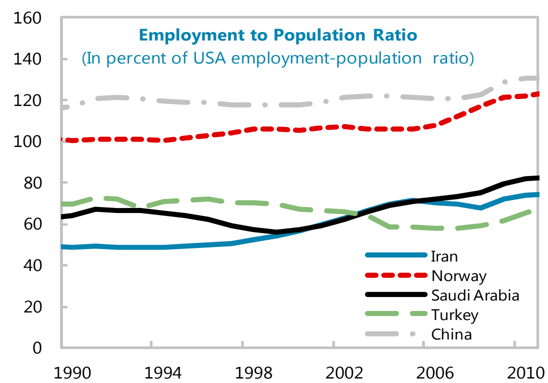
...led by strong productivity growth through the mid-2000s...



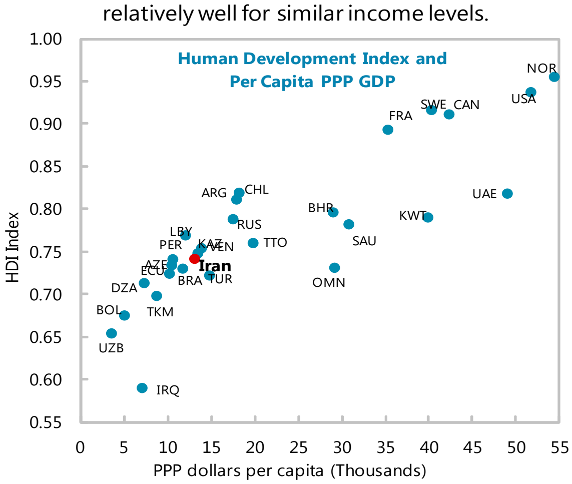
...early gains in capital per worker...



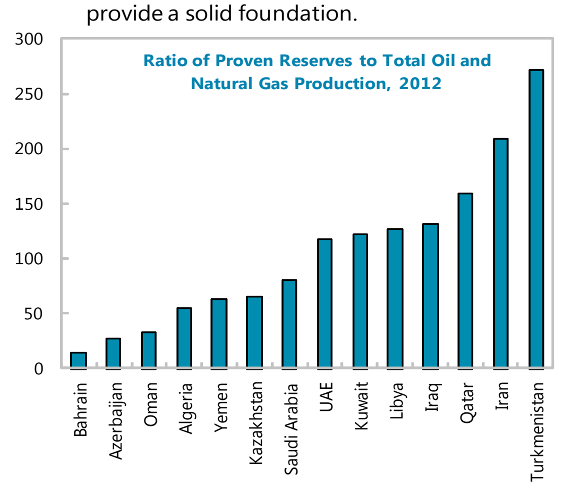
...and improved employment through the mid-2000s.



Iran's human development compares relatively well for similar income levels.

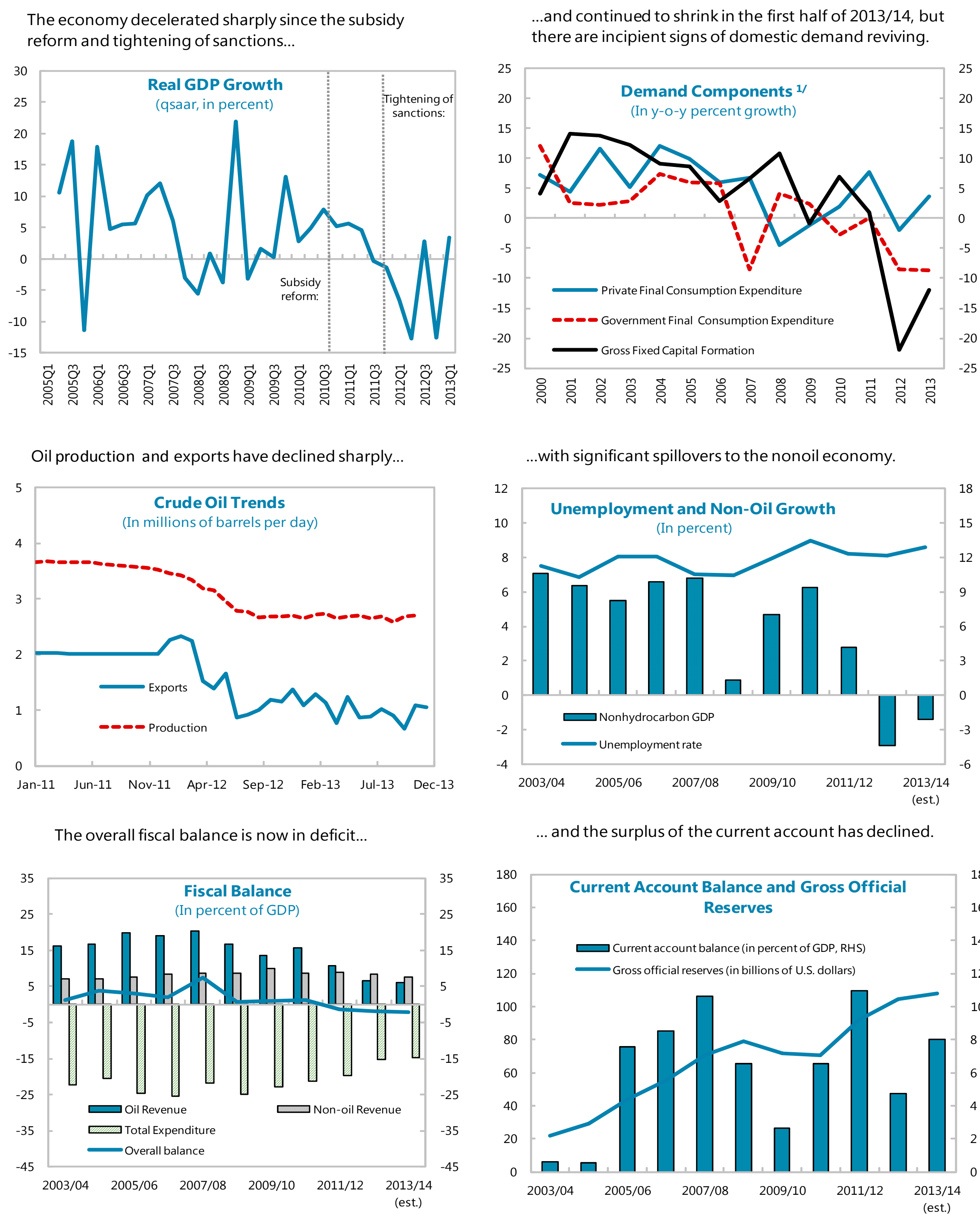


And its vast hydrocarbon resources continues to provide a solid foundation.



Sources: Feenstra, Robert C., Robert Inklaar and Marcel P. Timmer (2013), "The Next Generation of the Penn World Table" available for download at www.ggdc.net/pwt; UNDP Human Development Report; and IMF WEO.

Figure 2. Islamic Republic of Iran: Macroeconomic Indicators, 2000/01–2013/14

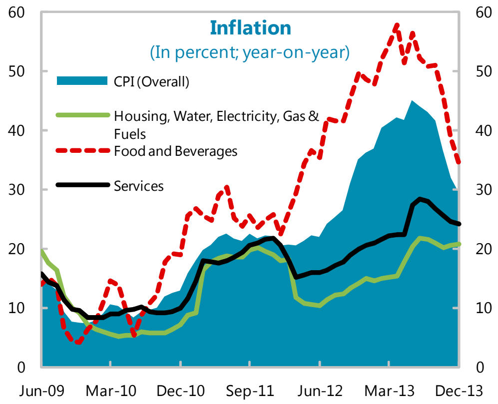


Sources: Iranian authorities; OPEC, secondary sources; and IMF staff estimates.

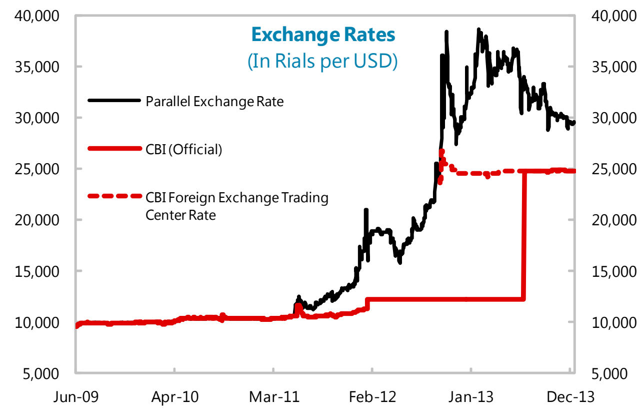
1/ The 2013 values are semi-annual; the first six months of the year are compared to the first six months of 2012.

Figure 3. Islamic Republic of Iran: Macroeconomic and Price Developments, 2007/08–2012/13

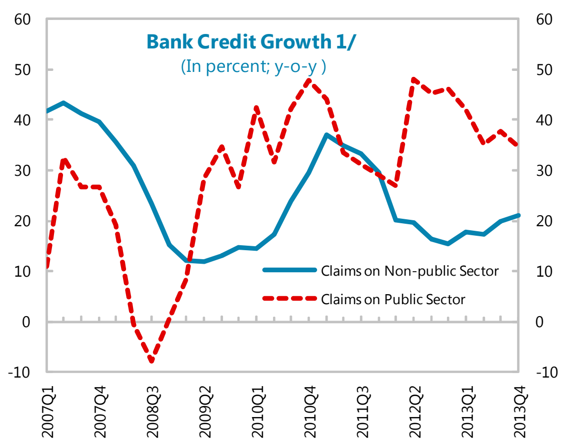
High inflationary pressures have begun to ease more recently...



...following the unification of the official exchange rate and appreciation of the parallel rate.

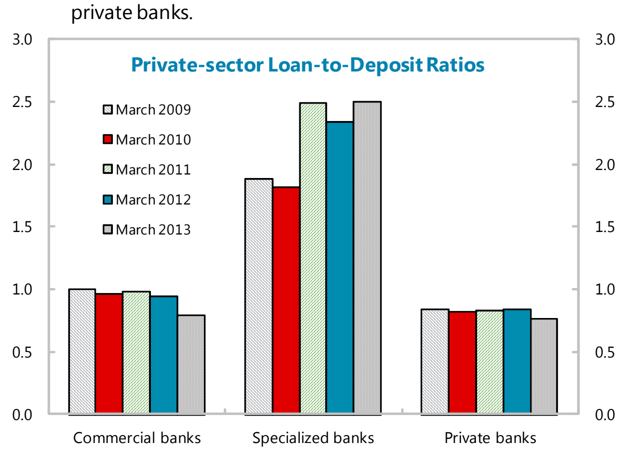


Banks have been rebalancing their credit portfolios towards the government...

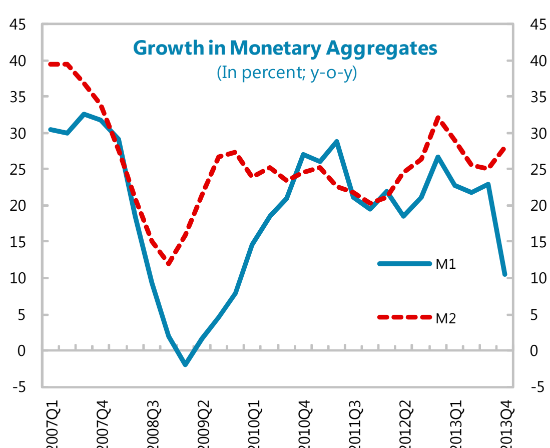


1/ Excludes Central Bank of Iran.

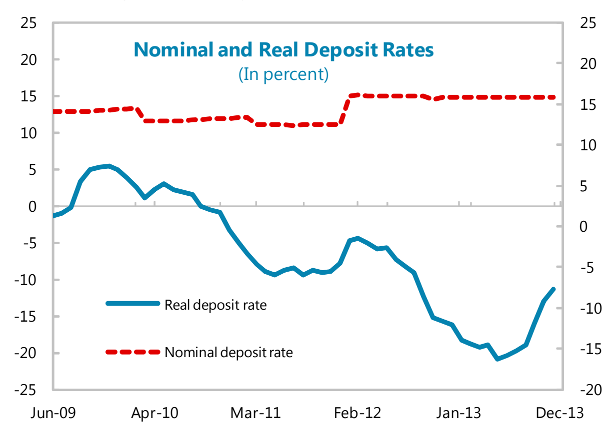
...helping to bring down LTD ratios of commercial and private banks.



Money growth is beginning to slow...



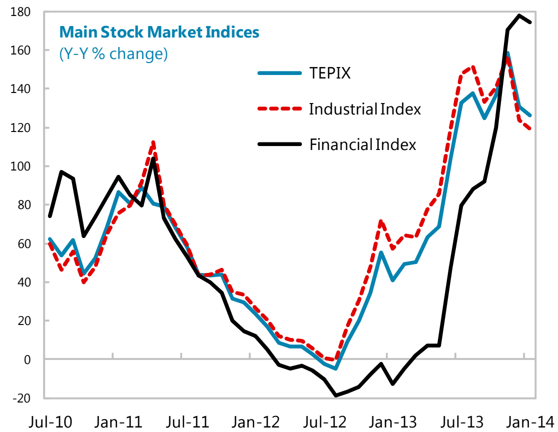
...while real interest rates are bouncing back gradually from negative territory.



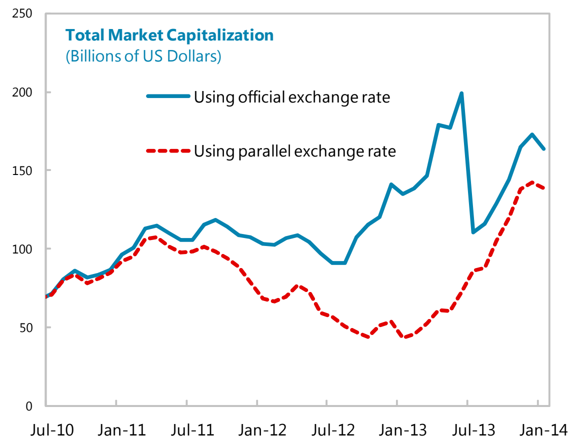
Sources: Iranian authorities; and Fund staff estimates.

Figure 4. Islamic Republic of Iran: Stock Market Indicators, 2010–13

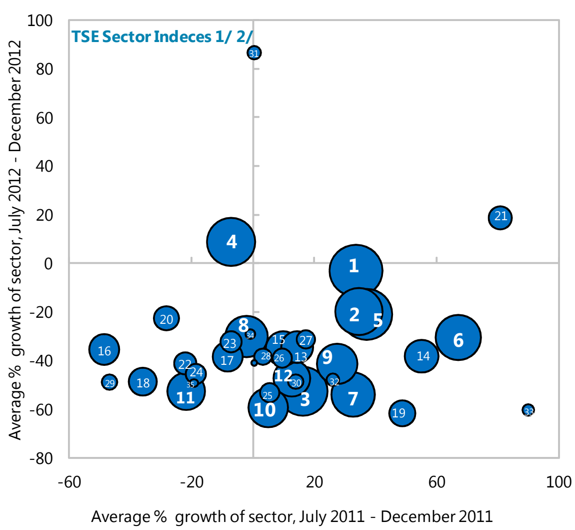
After a sharp decline during 2012, equity prices have recovered markedly since early 2013....



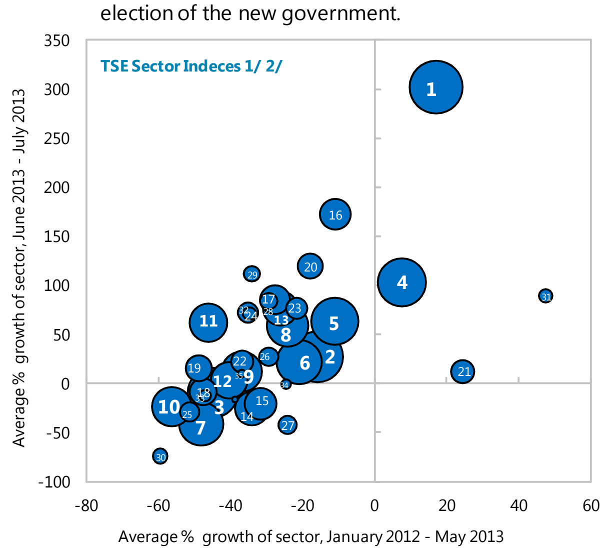
...with capitalization now above pre-sanctions levels.



Most sectors that had been negatively affected by the intensification of sanctions...



... have been recovering strongly, especially since the election of the new government.



Sources: Tehran Stock Exchange; and IMF staff calculations.

1/ In counterclockwise order, the four quadrants represent the following scenarios: (i)positive growth for both periods.; (ii)positive growth for recent period, negative growth for past period.;(iii) negative growth for both periods.; and (iv) negative growth for recent period, positive growth for past period.

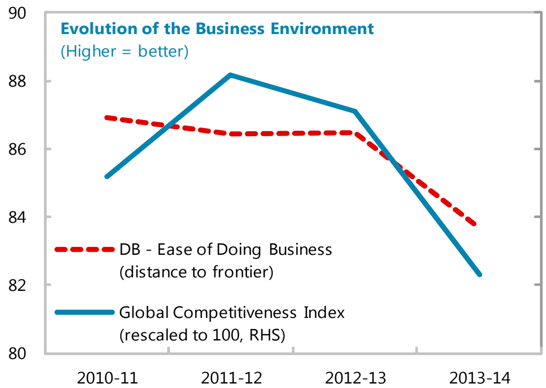
2/ Growth rates are computed using the parallel market exchange rate. We then take the geometric average of the y-o-y growth rates for the given period .

The data labels in the bubble charts represent the rank of each sector in terms of market capitalization. Below see the corresponding sectors and percent market share (July 2013). The dimensions of the bubbles are relative (approximately) to their market share.

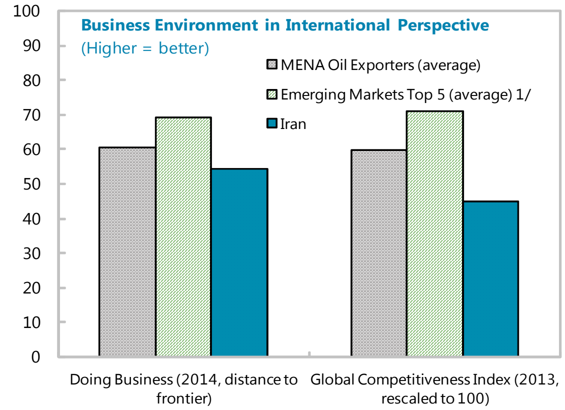
1 - Chemicals & By-products (22.9%)
2 - Basic Metals (14.7%)
3 - Monetary Intermediation (11.3%)
4 - Refined Petrol. Products (10.8%)
5 - Metal Ores Mining (9.0%)
6 - Diversified Industrials (7.8%)
7 - Post and Telecomm. (4.2%)
8 - Cement, Lime & Plaster (3.1%)
9 - Investment Companies (2.4%)
10 - Motor Vehicles (2.3%)
11 - Technical & Engineering Services (2.0%)
12 - Pharmaceuticals (1.9%)
13 - Food Products (1.6%)
14 - Computer and Related Activities (1.0%)
15 - Real Estate and Construction (0.8%)
16 - Transportation and Storage (0.6%)
17 - Oil and Gas Extraction (0.5%)
18 - Insurance and Pension (0.5%)
19 - Electric Machinery (0.4%)
20 - Rubber and Plastic Products (0.4%)
21 - Sugar and Byproducts (0.4%)
22 - Machinery and Equipment (0.4%)
23 - Other Non-metal Mineral Products (0.3%)
24 - Fabricated Metal Products (0.3%)
25 - Financial Leasing (0.2%)
26 - Ceramic and Tiles (0.2%)
27 - Medical and Precision Instruments (0.1%)
28 - Paper and Byproducts (<0.1%)
29 - Radio, TV and Comm. Equipment (<0.1%)
30 - Tanning and Dressing of Leather (<0.1%)
31 - Agriculture (<0.1%)
32 - Textiles (<0.1%)
33 - Coal and Lignite Mining (<0.1%)
34 - Publishing and Printing of Media (<0.1%)
35 - Wood and Byproducts (<0.1%)
36 - Other Mining (<0.1%)

Figure 5. Islamic Republic of Iran: Business Environment Indicators, 2005–13

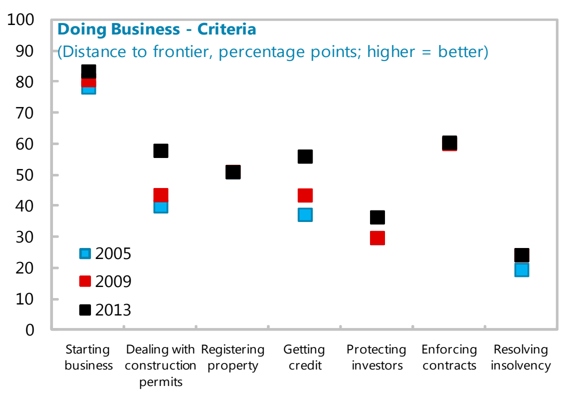
The business environment has deteriorated in recent years...



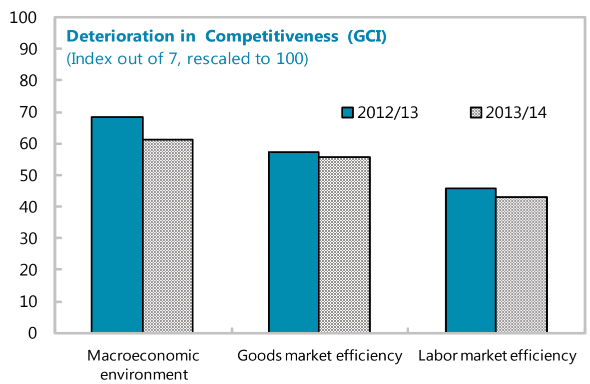
...and compares unfavorably regionally and with other emerging markets.



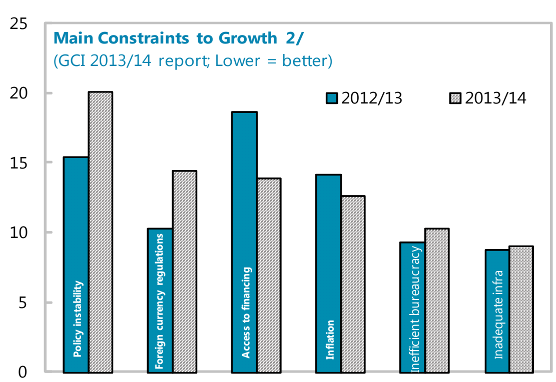
Doing business remains difficult in many key areas...



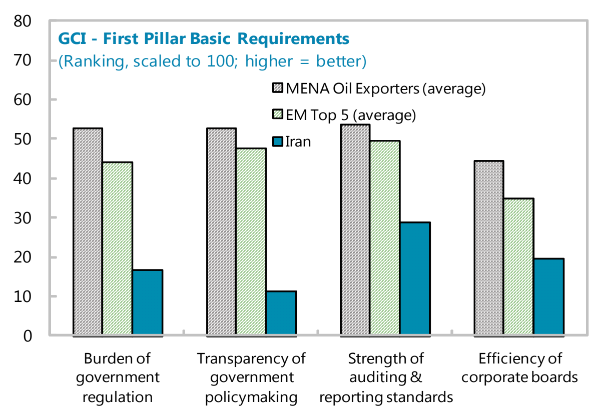
...as key "efficiency enhancers" continue to deteriorate.



There are key priorities on the policy side....



...that need to be supported by reforms to enhance the government's and corporate effectiveness.



Sources: World Bank's Doing Business 2014; and the World Economic Forum's Global Competitiveness Report 2013–14.

1/ Includes South Korea, Mexico, Turkey, Russia, and China.
2/ Each bar shows the percent of survey respondents who feel the particular issue in question is the most problematic for doing business in Iran.

Table 1. Islamic Republic of Iran: Selected Macroeconomic Indicators, 2011/12–2015/16 1/

	2011/12	2012/13	Est. 2013/14	Staff Proj. 2014/15	2015/16
	(Annual change, in percent, unless otherwise indicated)				
National accounts					
Nominal GDP at market prices (in billions of Iranian rials)	6,121,004	6,793,170	9,068,975	11,057,015	13,612,678
Real GDP at factor cost	3.0	-5.8	-1.7	1.5	2.3
Real oil and gas GDP	1.3	-34.1	-5.7	-0.5	-0.3
Real nonoil GDP	3.2	-3.1	-1.4	1.6	2.5
CPI inflation (average)	21.5	30.5	35.2	23.0	22.0
CPI inflation (end of period)	20.5	41.2	22.0	24.0	20.0
GDP deflator at factor cost	37.6	17.6	35.8	20.1	20.3
Unemployment rate (in percent of labor force)	12.3	12.2	12.9	14.0	14.6
	(In percent of GDP)				
Investment and savings					
Investment	41.3	41.9	37.9	37.2	36.5
Total fixed capital investment	24.9	23.7	25.7	25.3	24.8
Public	6.7	3.7	2.7	3.6	3.4
Private	18.2	20.0	23.0	21.7	21.4
Gross national savings	52.3	48.5	45.9	42.3	39.1
Public	5.3	1.8	0.5	1.1	0.8
Private	47.0	46.8	45.4	41.2	38.3
Savings/investment balance	11.0	6.6	8.0	5.0	2.7
Public	-1.4	-2.0	-2.2	-2.5	-2.5
Private	12.4	8.6	10.2	7.5	5.2
Budgetary operations					
Revenue	19.7	15.0	13.9	12.4	11.8
Taxes	5.9	5.8	5.2	5.7	6.0
Other revenue	13.8	9.1	8.7	6.7	5.8
Of which: oil revenue	10.8	6.6	6.2	4.5	3.7
Expenditure	19.5	15.3	14.8	14.9	14.3
Expense	14.8	13.1	13.6	12.9	12.5
Net acquisition of nonfinancial assets	4.7	2.2	1.2	2.0	1.8
Net lending/borrowing (overall balance)	-1.4	-2.0	-2.2	-2.5	-2.5
Net lending/borrowing (budget)	0.2	-0.3	-0.9	-2.5	-2.5
Balance of Targeted Subsidy Organization	-1.6	-1.6	-1.3	0.0	0.0
Financial assets	-2.6	-0.4	-1.2	-0.2	0.1
Liabilities	-1.2	1.6	1.1	2.2	2.7
	(Annual change in percent, unless otherwise indicated)				
Monetary sector					
Net foreign assets	36.8	5.6	106.5	25.0	20.5
Net domestic assets	4.1	52.6	-16.1	21.4	27.0
Credit to the private sector in rials	20.1	17.7	24.6	19.6	22.9
Narrow money (M1)	15.8	29.1	20.5	19.4	21.9
Broad money (M2)	19.6	30.6	24.9	24.1	24.5
	(In billions of U.S. dollars, unless otherwise indicated)				
External sector					
Current account balance	59.4	26.3	29.2	20.4	11.3
In percent of GDP at market prices	11.0	6.6	8.0	5.0	2.7
Exports of goods and services	153.9	105.0	100.2	98.9	95.1
Imports of goods and services	-95.5	-80.4	-72.9	-79.2	-84.5
External and publicly guaranteed debt	17.3	7.7	7.6	7.3	7.0
Of which: short-term debt	8.3	0.9	1.6	2.2	2.9
Gross official reserves	92.2	104.4	107.7	110.1	110.0
	(In U.S. dollars, unless otherwise indicated)				
Oil and gas sector					
Total oil and gas exports (billions)	118.2	62.9	56.3	52.8	46.5
Liquid fuels production (in millions of barrels/day)	4.0	3.2	2.8	2.7	2.6
Memorandum items:					
Average exchange rate (Iranian rials per U.S. dollar)	11,312	12,260	24,770	…	…
End-of-period exchange rate (Iranian rials per U.S. dollar)	12,260	12,260	24,770	…	…

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

1/ The Iranian fiscal year ends March 20.

Table 2. Islamic Republic of Iran: Balance of Payments, 2011/12–2015/16 1/
(In millions of U.S. dollars, unless otherwise indicated)

			Est.	Staff proj.	
	2011/12	2012/13	2013/14	2014/15	2015/16
Current account balance	59,382	26,272	29,247	20,442	11,298
(in percent of GDP at market prices)	11.0	6.6	8.0	5.0	2.7
Trade balance	67,068	30,975	32,761	26,192	18,000
Exports	144,873	98,033	93,560	92,226	88,524
Oil and gas	118,231	62,916	56,328	52,754	46,472
Crude oil	93,725	44,345	37,837	34,555	29,482
Petroleum products and natural gas	24,506	18,571	18,491	18,199	16,990
Non-oil and gas	26,642	35,117	37,231	39,472	42,052
Imports	-77,805	-67,058	-60,799	-66,034	-70,524
Services (net)	-8,110	-5,255	-4,122	-6,418	-7,444
Credits	10,792	9,155	8,457	7,140	6,991
Debits	-18,902	-14,410	-12,578	-13,558	-14,435
Transfers (net)	424	552	608	668	742
Capital and financial account balance	-17,465	-12,155	-25,969	-17,999	-11,466
Foreign direct investment and portfolio equity	-515	180	0	0	0
Medium- and long-term debt	-2,382	-3,018	-667	-1,029	-988
Trade credit	-3,202	-3,362	-8,851	1,481	1,974
Other capital 2/	-11,366	-5,955	-16,451	-18,451	-12,451
Errors and omissions	-20,481	-1,904	0	0	0
Overall balance	21,436	12,213	3,277	2,443	-168
Change in gross official reserves (increase -)	-21,436	-12,213	-3,277	-2,443	168
Memorandum items:					
Gross official reserves (in millions of U.S. dollars)	92,215	104,428	107,705	110,148	109,980
(in months of the following year's imports)	13.8	17.2	16.3	15.6	15.0
External debt (in percent of GDP)	3.2	1.9	2.1	1.8	1.7

Sources: Iranian authorities; and Fund staff estimates and projections.
1/ The Iranian fiscal year ends March 20.
2/ Includes Asian Clearence Union (ACU) and commercial banks

Table 3. Islamic Republic of Iran: Statement of Government Operations, 2011/12–2015/16 1/
(In billions of rials)

			Est.	Staff proj.	
	2011/12	2012/13	2013/14	2014/15	2015/16
Revenues (a)	1,203,714	1,015,803	1,257,962	1,374,488	1,603,441
Taxes	359,451	395,169	469,745	633,384	819,579
Taxes on income, profits and capital gains	207,505	232,385	271,296	339,113	424,094
Taxes on property	12,913	15,894	21,156	26,444	33,071
Taxes on goods and services	60,104	70,487	123,829	203,965	281,438
Of which: value added tax	32,702	54,129	101,175	175,647	246,024
Taxes on international trade and transactions	78,930	76,403	53,463	63,863	80,976
Other revenue	844,263	620,634	788,217	741,104	783,861
Property income	731,636	545,284	674,651	614,945	626,086
Of which: Rents (oil revenue)	659,244	447,597	558,763	499,059	510,145
Expenditure (b)	1,191,784	1,039,256	1,339,780	1,647,922	1,950,473
Expense (b.1)	904,225	889,974	1,232,400	1,424,542	1,702,248
Net acquisition of nonfinancial assets (b.2)	287,560	149,282	107,380	223,380	248,225
Gross operating balance (a-b.1)	299,490	125,829	25,562	-50,054	-98,808
Net lending/borrowing (overall balance)	-85,820	-133,830	-203,736	-273,434	-347,033
Net lending/borrowing (a-b) (budget)	11,930	-23,453	-81,818	-273,434	-347,033
Balance of Targeted Subsidy Organization	-97,750	-110,377	-121,918	0	0
Financial assets	-158,806	-25,893	-107,195	-26,964	19,426
Liabilities	-72,986	107,937	96,541	246,470	366,459
Memorandum items:					
Nonoil net lending/borrowing	-745,064	-581,427	-762,499	-772,493	-857,178
Nonoil net lending/borrowing incl. NDFI loans	-797,099	-716,287	-923,504	…	…

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

1/ The statement of government operations covers budgetary central government and balance of the Targeted Subsidies Organization but excludes the NDFI.

Table 4. Islamic Republic of Iran: Statement of Government Operations, 2011/12–2015/16 1/
(In percent of GDP)

			Est.	Staff proj.	
	2011/12	2012/13	2013/14	2014/15	2015/16
Revenues (a)	19.7	15.0	13.9	12.4	11.8
Taxes	5.9	5.8	5.2	5.7	6.0
Taxes on income, profits and capital gains	3.4	3.4	3.0	3.1	3.1
Taxes on property	0.2	0.2	0.2	0.2	0.2
Taxes on goods and services, of which	1.0	1.0	1.4	1.8	2.1
Value added tax	0.5	0.8	1.1	1.6	1.8
Taxes on international trade and transactions	1.3	1.1	0.6	0.6	0.6
Other revenue, of which	13.8	9.1	8.7	6.7	5.8
Property Income, of which	12.0	8.0	7.4	5.6	4.6
Rents (Oil Revenue)	10.8	6.6	6.2	4.5	3.7
Expenditure (b)	19.5	15.3	14.8	14.9	14.3
Expense (b.1)	14.8	13.1	13.6	12.9	12.5
Net acquisition of nonfinancial assets (b.2)	4.7	2.2	1.2	2.0	1.8
Gross operating balance (a-b.1)	4.9	1.9	0.3	-0.5	-0.7
Net lending/borrowing (overall balance)	-1.4	-2.0	-2.2	-2.5	-2.5
Net lending/borrowing (a-b) (budget)	0.2	-0.3	-0.9	-2.5	-2.5
Balance of Targeted Subsidy Organization	-1.6	-1.6	-1.3	0.0	0.0
Financial assets	-2.6	-0.4	-1.2	-0.2	0.1
Liabilities	-1.2	1.6	1.1	2.2	2.7
Memorandum items:					
Non-oil net lending/borrowing 2/	-16.8	-10.5	-10.3	-8.3	-7.4
Non-oil net lending/borrowing including NDFI loans 2/	-17.9	-12.9	-12.5	…	…

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

1/ The statement of government operations covers budgetary central government and balance of the Targeted Subsidies Organization but excludes the NDFI.

2/ Non-oil overall balance, as a percentage of non-oil GDP.

Table 5. Islamic Republic of Iran: Central Bank Balance Sheet, 2011/12–2015/16
(In billions of rials, unless otherwise indicated)

			Est.	Staff proj.	
	2011/12	2012/13	2013/14	2014/15	2015/16
Net foreign assets (NFA)	1,126,501	1,203,020	2,511,753	3,085,784	3,625,809
In millions of U.S. dollars	*91,884*	*98,126*	*101,403*	*103,846*	*103,678*
Foreign assets	1,170,557	1,280,287	2,667,864	3,273,061	3,846,216
In millions of U.S. dollars	*95,478*	*104,428*	*107,705*	*110,148*	*109,980*
Foreign liabilities 1/	44,056	77,268	156,111	187,277	220,407
In millions of U.S. dollars	*3,593*	*6,302*	*6,302*	*6,302*	*6,302*
Net domestic assets (NDA)	-333,584	-143,741	-1,251,044	-1,533,855	-1,755,577
Net domestic credit	-12,061	127,444	-164,469	39,811	308,346
Central government, net	-555,528	-543,527	-1,046,253	-1,048,612	-1,093,406
Claims	65,455	103,202	103,202	103,202	103,202
Deposits	620,983	646,729	1,149,455	1,151,814	1,196,608
Claims on banks	418,303	488,314	699,126	905,765	1,246,493
Claims on nonfinancial public enterprises (NFPEs)	125,163	182,657	182,657	182,657	155,259
Other items net, excluding central bank participation papers (CPPs)	-321,522	-271,185	-1,086,574	-1,573,666	-2,063,922
Base money	784,819	993,939	1,178,524	1,462,719	1,820,555
Currency	310,956	371,610	388,913	438,816	546,166
Currency in circulation	263,826	330,164	350,022	394,934	491,550
Cash in vaults	47,130	41,446	38,891	43,882	54,617
Reserves	453,613	604,185	765,081	993,731	1,237,577
Required reserves	357,327	491,535	591,226	738,101	918,668
Excess reserves	96,285	112,651	173,855	255,630	318,909
Deposits of NFPE and municipalities	20,251	18,144	24,530	30,172	36,811
Other liabilities	8,097	64,415	82,186	89,210	49,677
CPPs	0	47,000	47,000	47,000	0
Foreign currency deposits of NFPEs and municipalities	8,097	17,415	35,186	42,210	49,677
Memorandum items:					
End-period change (in percent of base money)					
Base money	12.5	26.6	18.6	24.1	24.5
NFA	52.0	9.7	131.7	48.7	36.9
NDA (net of other liabilities)	-43.6	17.0	-113.2	-24.6	-12.5

Sources: Central Bank of Iran; and Fund staff estimates and projections.

1/ Includes liabilities in foreign currency to residents.

Table 6. Islamic Republic of Iran: Monetary Survey, 2011/12–2015/16 1/
(In billions of rials, unless otherwise indicated)

			Est.	Staff proj.	
	2011/12	2012/13	2013/14	2014/15	2015/16
Net foreign assets (NFA)	1,733,047	1,830,458	3,779,424	4,725,393	5,695,361
In millions of U.S. dollars	*141,358*	*149,303*	*152,581*	*159,023*	*162,856*
Foreign assets	1,981,667	2,106,715	4,337,571	5,394,968	6,483,388
In millions of U.S. dollars	*161,637*	*171,836*	*175,114*	*181,557*	*185,389*
Foreign liabilities 2/	248,620	276,257	558,147	669,575	788,027
In millions of U.S. dollars	*20,279*	*22,533*	*22,533*	*22,533*	*22,533*
Net domestic assets (NDA)	2,052,057	3,131,430	2,627,871	3,191,352	4,052,044
Net domestic credit	3,746,543	4,528,648	5,425,174	6,785,226	8,551,675
Net credit to government	-268,439	-115,657	-584,207	-385,510	-115,794
Claims on nonfinancial public enterprises (NFPEs)	150,132	211,365	256,635	286,226	241,127
Claims on the private sector	3,864,849	4,432,940	5,752,746	6,884,510	8,426,342
Of which: domestic currency claims	3,516,846	4,138,975	5,158,821	6,172,014	7,587,801
Other items, net, excluding CPPs	-1,694,486	-1,397,217	-2,797,302	-3,593,874	-4,499,631
Broad money (M3)	3,830,578	4,961,890	6,407,295	7,916,745	9,747,405
M2	3,542,455	4,625,080	5,774,767	7,167,322	8,920,719
Cash	263,826	330,164	350,022	394,934	491,550
Deposits	3,278,629	4,294,916	5,424,745	6,772,388	8,429,169
Demand deposits	630,584	824,698	1,041,645	1,266,553	1,534,254
Time deposits	2,648,045	3,470,218	4,383,101	5,505,835	6,894,915
CPPs held by nonbanks	0	47,000	47,000	47,000	0
Foreign currency deposits	288,123	289,809	585,529	702,423	826,686
Memorandum items:					
Net credit to government (without valuation effect)	-268,439	-115,657	-57,330	227,142	579,280
Base money	784,819	993,939	1,178,524	1,462,719	1,820,555
M1	894,410	1,154,862	1,391,666	1,661,487	2,025,804
Multiplier (M2/base money)	4.5	4.7	4.9	4.9	4.9
Velocity of M2	1.7	1.6	1.4	1.5	1.5
GDP	6,121,004	6,793,170	9,068,975	11,057,015	13,612,678
	(Annual change, in percent)				
NFA	36.8	5.6	106.5	25.0	20.5
NDA	4.1	52.6	-16.1	21.4	27.0
Base money	12.5	26.6	18.6	24.1	24.5
M1	15.8	29.1	20.5	19.4	21.9
M2	19.6	30.6	24.9	24.1	24.5
Credit to private sector in rials	20.1	17.7	24.6	19.6	22.9

Sources: Central Bank of Iran; and Fund staff estimates and projections.

1/ The Iranian fiscal year ends March 20.
2/ Includes liabilities in foreign currency to residents.

Table 7. Islamic Republic of Iran: Vulnerability Indicators, 2010/11–2013/14 1/

	2010/11	2011/12	2012/13	Est. 2013/14
External solvency indicators				
Real effective exchange rate (REER) (end of period; percent change)	8.3	2.9	-30.1	…
Total public and publicly guaranteed external debt (in billions of U.S. dollars)	22.6	17.3	7.7	7.6
(In percent of GDP)	5.4	3.2	1.9	2.1
Short-term external debt (in billions of U.S. dollars)	11.5	8.3	0.9	1.6
(In percent of GDP)	2.7	1.5	0.2	0.4
(In percent of exports of goods and services) 2/	9.5	5.4	0.9	1.6
External debt service (in percent of exports of goods and services) 2/ 3/	1.4	2.0	3.6	1.7
External liquidity indicators				
Total official reserves (in billions of U.S. dollars)	70.8	92.2	104.4	107.7
(In months of the following year's imports of goods and services) 2/	8.9	13.8	17.2	16.3
(In percent of short-term external debt)	617	1,116	11,074	6,944
Commercial banks net foreign assets (in billions of U.S. dollars)	48.5	49.5	51.2	51.2
Foreign assets	65.8	66.2	67.4	67.4
Foreign liabilities 4/	17.2	16.7	16.2	16.2
Oil and oil-related exports (in percent of exports of goods)	80.0	81.6	64.2	60.2
Financial sector indicators				
Risk-weighted capital adequacy of banks (in percent) 5/ 6/	8.4	7.9	8.6	6.8
Ratio of nonperforming loans of banks (in percent of total loans) 5/ 6/	13.7	15.1	13.7	14.4
Loan provisions as a percentage of nonperforming loans	35.1	37.5	39.4	36.1
Return on assets (in percent)	1.0	0.9	1.0	…
Net domestic credit (percent change)	31.6	12.1	20.9	19.8
Net domestic credit (in percent of GDP)	77.1	61.2	66.7	59.8
Private sector credit in local currency (percent change)	37.1	20.1	17.7	24.6
Market assessment/financial market indicators				
Stock market price index (percent change; end-of-period) 7/	89.2	8.5	50.5	126.5
Stock market capitalization (in percent of GDP) 7/	26.9	19.8	36.8	44.6

Sources: Iranian authorities; and Fund staff estimates.

1/ The Iranian fiscal year ends March 20.
2/ Excluding interest receipts and payments.
3/ Excluding service of short-term external debt.
4/ Including contingent liabilities under letters of credit.
5/ Islamic banks exhibit important differences in their risk profile and asset classification, which limit international comparability.
6/ As of September 2014.
7/ As of January 2014.

Table 8. Islamic Republic of Iran: Medium-term Scenario, 2011/12–2019/20 1/

			Est.	Staff proj.					
	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
	(Annual change, in percent, unless otherwise indicated)								
National accounts									
Nominal GDP at market prices (in billions of Iranian rials)	6,121,004	6,793,170	9,068,975	11,057,015	13,612,678	16,523,461	20,098,692	24,463,745	29,841,784
Real GDP at factor cost	3.0	-5.8	-1.7	1.5	2.3	2.3	2.3	2.3	2.3
Real oil and gas GDP	1.3	-34.1	-5.7	-0.5	-0.3	-0.1	0.0	0.0	0.0
Real nonoil GDP	3.2	-3.1	-1.4	1.6	2.5	2.4	2.5	2.5	2.5
CPI inflation (average)	21.5	30.5	35.2	23.0	22.0	20.0	20.0	20.0	20.0
CPI inflation (end of period)	20.5	41.2	22.0	24.0	20.0	20.0	20.0	20.0	20.0
Unemployment rate (in percent of labor force)	12.3	12.2	12.9	14.0	14.6	15.3	15.6	15.9	16.2
	(In percent of GDP)								
Investment and savings									
Savings/investment balance	11.0	6.6	8.0	5.0	2.7	1.8	1.1	0.6	0.4
Public	-1.4	-2.0	-2.2	-2.5	-2.5	-2.9	-3.2	-3.5	-3.7
Private	12.4	8.6	10.2	7.5	5.2	4.7	4.3	4.2	4.1
Budgetary operations									
Revenue	19.7	15.0	13.9	12.4	11.8	11.1	10.4	9.9	9.4
Of which: oil revenue	10.8	6.6	6.2	4.5	3.7	3.1	2.5	2.1	1.6
Expenditure	19.5	15.3	14.8	14.9	14.3	13.9	13.6	13.4	13.2
Expense	14.8	13.1	13.6	12.9	12.5	12.3	12.1	12.1	12.0
Net acquisition of nonfinancial assets	4.7	2.2	1.2	2.0	1.8	1.6	1.5	1.3	1.2
Net lending/borrowing (overall balance)	-1.4	-2.0	-2.2	-2.5	-2.5	-2.9	-3.2	-3.5	-3.7
Net lending/borrowing (budget)	0.2	-0.3	-0.9	-2.5	-2.5	-2.9	-3.2	-3.5	-3.7
Balance of Targeted Subsidy Organization	-1.6	-1.6	-1.3	0.0	0.0	0.0	0.0	0.0	0.0
	(Annual change in percent, unless otherwise indicated)								
Monetary sector									
Credit to the private sector in rials	20.1	17.7	24.6	19.6	22.9	18.6	16.8	15.9	15.6
Broad money (M2)	19.6	30.6	24.9	24.1	24.5	20.1	19.3	18.9	18.9
	(In billions of U.S. dollars, unless otherwise indicated)								
External sector									
Current account balance	59.4	26.3	29.2	20.4	11.3	7.7	5.2	3.0	1.9
In percent of GDP at market prices	11.0	6.6	8.0	5.0	2.7	1.8	1.1	0.6	0.4
Gross official reserves	92.2	104.4	107.7	110.1	110.0	106.9	104.3	99.6	93.7
	(In U.S. dollars, unless otherwise indicated)								
Oil and gas sector									
Total oil and gas exports (billions)	118.2	62.9	56.3	52.8	46.5	41.1	36.5	32.4	28.7
Crude oil production (in millions of barrels/day)	4.0	3.2	2.8	2.7	2.6	2.6	2.5	2.4	2.3
Memorandum items:									
Average exchange rate (Iranian rials per U.S. dollar)	11,312	12,260	24,770	…	…	…	…	…	…

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

1/ The Iranian fiscal year ends March 20.

Appendix I. Risk Assessment Matrix[1]

Nature/source of main threats	Likelihood of realization in the next three years	Expected impact on the economy if risk is realized
Failure to address high unemployment. Youth unemployment is high and could rise significantly ahead, when school graduates enter the labor force. Social conditions could deteriorate markedly.	**High**	**Medium-High** The new administration has identified unemployment as Iran's biggest challenge. If the economy does not generate a sufficient number of jobs, social conditions would worsen and risk political support for reforms. In turn, preserving the economic status quo would exacerbate weaknesses in the corporate and financial sectors, undermining future growth prospects. Hysteresis effects could become significant.
CBI financing for the *Mehr* housing program. The decision to discontinue CBI financing could be reversed if no alternative source of funding is found.	**Medium**	**Medium-High** If the CBI were to be called upon to resume supporting the program, it would undermine its efforts to stabilize money growth and the exchange rate, contain aggregate demand, and reduce inflation to low levels.
A further deterioration of Iran's external environment. There is a risk of further intensifications of trade and financial sanctions, including FATF countermeasures.	**Medium**	**Medium–High** An intensification of sanctions on trade and financial transactions would negatively affect oil production, reduce external surpluses, and put downward pressure on the exchange rate. Fiscal revenue would decline, triggering cuts in capital spending with adverse consequences for growth. Confidence in the private and financial sector may also fall, and reliance on the informal sector might increase.
A large and prolonged decline in global oil prices. New energy sources may come online sooner than expected, or the global economy may enter a new synchronized downturn, depressing demand.	**Low**	**Medium–High** Oil export revenue has already about halved from its 2011 peak following the tightening of economic sanctions. It is likely to continue declining due to the current sanctions. Lower oil prices would depress oil revenues further, which may require a new round of import and expenditure cuts. To minimize the social impact of the adjustment, fiscal and monetary policy may not tighten sufficiently, fuelling inflation.
Sharp slowdown in growth in China. The buildup of excess capacity may eventually lead in large financial and fiscal losses.	**Medium**	**Low–Medium** China accounts for about 40 percent of all Iranian oil exports since mid-2012. Given the constraints on exports, it would be difficult to replace weaker demand from China with exports to other destinations.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline. The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Nonmutually exclusive risks may interact and materialize jointly.

Appendix II. Illustrative Medium-Term Scenarios

These scenarios show that, in the absence of a sharp increase in oil prices or production and structural reforms that fundamentally boost potential non-oil growth, Iran will continue to face significant constraints in achieving sustainable growth and lower inflation.

1. **Baseline scenario**: With sustained restrictions on oil exports and international financial transactions, the external and fiscal accounts will continue to deteriorate over the medium term. In response, the authorities will reduce expenditure to levels that yield manageable deficits and stabilize inflation at relatively high levels. The exchange rate will depreciate in line with inflation, with risks of periodic volatility and sharp real depreciation, while credit to the private sector will be crowded out by credit to government linked to fiscal deficits. Non-oil growth stabilizes well below potential. Relatively soft budget constraints in the corporate sector help to hoard labor, but unemployment still rises, as low growth impedes job creation needed to absorb new entrants.

Medium-Term Baseline Scenario, 2011/12–2019/20 1/

			Projection						
	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
	(Annual percentage change)								
Real GDP at market prices	2.7	-5.6	-1.7	1.5	2.3	2.3	2.3	2.3	2.4
CPI inflation (average)	21.5	30.5	35.2	23.0	22.0	20.0	20.0	20.0	20.0
	(In percent of GDP; unless otherwise indicated)								
Overall general government balance	-1.4	-2.0	-2.2	-2.5	-2.5	-2.9	-3.2	-3.5	-3.7
Non-oil balance in percent of non-oil GDP	-16.8	-10.5	-10.3	-8.3	-7.4	-6.9	-6.6	-6.3	-6.0
External current account balance	11.0	6.6	8.0	5.0	2.7	1.8	1.1	0.6	0.4
Gross official reserves (in billions of U.S. dollars)	92.2	104.4	107.7	110.1	110.0	106.9	104.3	99.6	93.7
M2 growth (in percent)	19.6	30.6	24.9	24.1	24.5	20.1	19.3	18.9	18.9
Private sector credit growth (in percent)	20.1	17.7	24.6	19.6	22.9	18.6	16.8	15.9	15.6
Memorandum items:									
Oil and gas sector									
Total oil and gas exports (in billions of U.S. dollars)	118.2	62.9	56.3	52.8	46.5	41.1	36.5	32.4	28.7
Crude oil production (in millions of barrels/day)	4.0	3.2	2.8	2.7	2.6	2.6	2.5	2.4	2.3

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

1/ The Iranian fiscal year ends March 20.

2. **Alternative scenario**: Sanctions continue to ease in 2014/15. Oil production and exports recover by about 1 million barrels per day by 2015/16, with oil output back to 2007 levels by 2017/18. Policies are adjusted to lessen the inflationary impact of the fiscal deficit. The exchange rate is unified in 2015/16, around the current bureau/parallel market rate, supported by profit (interest) rates that are aligned more closely with inflation. Non-oil tax revenues grow somewhat faster than GDP, mostly benefiting from improved tax administration. However, there are no new tax policy measures, which along with the continued net savings in the NDFI, constrain public expenditures. These expenditures remain broadly in line with the path derived from a PIH rule. Structural reforms, along with the use of NDFI resources, support private investment, a recovery in non-oil growth and lower unemployment.

Islamic Republic of Iran: Medium-Term Alternative Scenario, 2011/12–2019/20 1/

			Projection						
	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
			(Annual percentage change)						
Real GDP at market prices	2.7	-5.6	-1.7	2.2	4.2	4.3	5.4	5.7	5.7
CPI inflation (average)	21.5	30.5	35.2	21.5	18.0	12.5	8.7	6.3	5.0
			(In percent of GDP; unless otherwise indicated)						
Overall general government balance	-1.4	-2.0	-2.2	-0.5	0.5	0.8	1.0	1.3	1.3
Non-oil balance in percent of non-oil GDP	-16.8	-10.5	-10.3	-8.8	-9.3	-7.9	-6.8	-5.5	-4.7
External current account balance	11.0	6.6	8.0	4.2	5.2	3.2	2.4	1.3	1.0
Gross official reserves (in billions of U.S. dollars)	92.2	104.4	107.7	111.1	121.7	139.5	158.5	174.0	195.8
In months of imports of goods and services	13.8	17.2	12.8	11.5	11.3	12.1	12.8	13.4	12.1
M2 growth (in percent)	19.6	30.6	24.9	24.2	21.1	19.1	19.4	19.9	19.6
Private sector credit growth (in percent)	20.1	17.7	24.6	24.0	24.3	20.0	20.1	20.7	19.8
Memorandum items:									
Oil and gas sector									
Total oil and gas exports (in billions of U.S. dollars)	118.2	62.9	56.3	69.8	86.5	87.4	88.8	85.0	82.3
Crude oil production (in millions of barrels/day)	4.0	3.2	2.8	3.2	3.8	4.0	4.2	4.3	4.3

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

1/ The Iranian fiscal year ends March 20.

Appendix III. External Sustainability and Exchange Rate Assessment

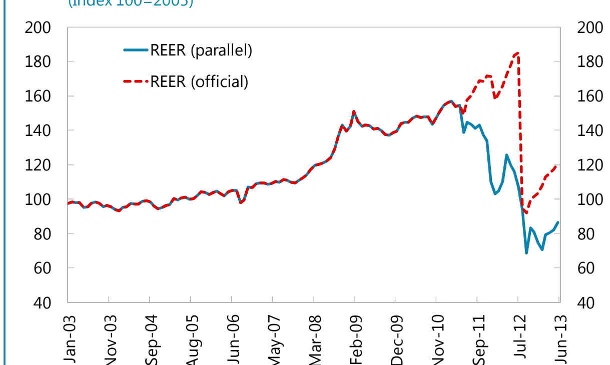
Models based on high-frequency data suggest that the rial remains above its estimated equilibrium on a real effective basis, despite the significant depreciation in 2012. Likewise, the macroeconomic balance approach for estimating current account norms of oil exporters also suggest that Iran's medium-term current account is slightly below its equilibrium level. In contrast, the external sustainability approach indicates the opposite conclusion, finding that the medium-term current account is above the norm. Staff believes that the worsened external environment in recent years and the uncertainty about Iran's external conditions in the future complicate estimates of current account norms, clouding the assessment of the exchange rate.

1. **Iran's current account surplus has declined markedly in recent years amid a deteriorating external environment**. Oil export receipts have declined by over 50 percent since mid-2012, mostly reflecting a decline in oil export volume. Non-oil exports have remained broadly unchanged. Imports have also decline markedly as a result of the real exchange rate depreciation and higher costs of conducting international business. As a result, the current account surplus declined from 11 percent of GDP in 2011/12 to 6.6 percent of GDP in 2012/13.

2. **External buffers still appear comfortable**. Gross foreign exchange reserves stood at about $110 billion, equivalent to 17 months of imports and 49 percent of broad money, at end-December 2013. However, difficulties in accessing the international payment system and making payments in convertible currencies following the intensification of international sanctions in 2012 have affected the liquidity and currency composition of foreign assets. External debt has declined to $7 billion (6 percent of gross reserves), given difficulties in securing foreign credit for imports.

3. **Iran's real effective exchange rate depreciated significantly in 2012, but accelerating domestic inflation has since reversed some of the decline**. The Iranian authorities introduced a three-tiered exchange rate system in September 2012. Imports of a few basic necessities such as medicine remained at the unchanged official exchange rate, while importers of most other priority imports received their foreign exchange at the newly established Foreign Exchange Center at a rate that more depreciated than the official rate but preferential compared to the bureau/parallel rate. As a result, the real effective exchange rate based on the bureau/parallel exchange rate started to depreciate earlier in 2012 and depreciated significantly more than the real effective exchange on the official rate, but the trajectories have been similar. Both rates fell steeply in the second half of 2012 amid the coming into effect of new economic sanctions against Iran. The

Official and Parallel Real Effective Exchange Rates
(Index 100=2005)

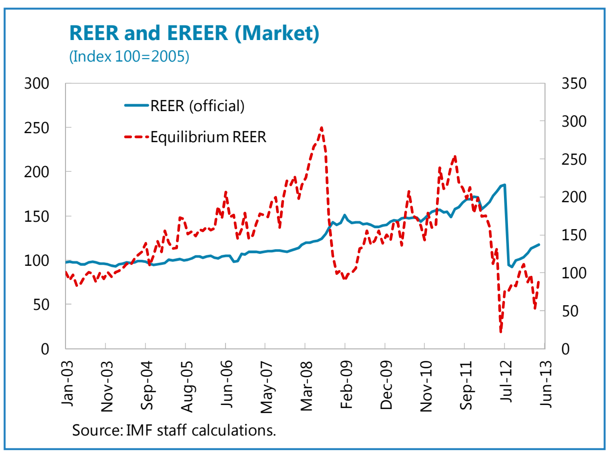


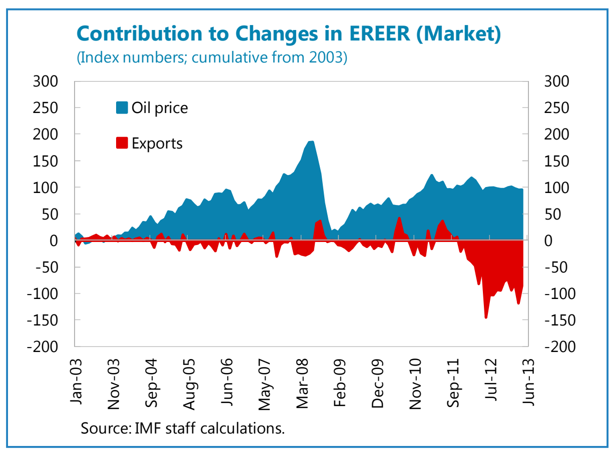
Source: IMF staff calculations.

authorities ceased transacting at the most appreciated official rate in July 2013, making the FX Center rate the official rate. Since the end of last year, accelerating inflation has pushed up the REERs by more than 30 percent.

4. **The equilibrium real effective exchange rate approach analyzes the relationship between Iran's official exchange rate and economic fundamentals**. Using monthly data, a vector error-correction model estimates the long-run relationship between Iran's real effective exchange rate (REER) and oil prices and oil exports. Given observed values of the fundamentals, the model predicts an equilibrium level of the REER in every period. In addition, the model can break down movements in the equilibrium into changes in the fundamentals.

5. **The equilibrium approach suggests that the official real effective exchange rate was overvalued despite the significant depreciation in 2012**. The rial depreciated by about 50 percent on a real effective basis in September 2012, when the authorities introduced a new depreciated official rate applicable to most current account transactions. Meanwhile, however, the equilibrium REER dropped even more sharply due to the steep fall in reported export volumes. The model therefore suggests that the depreciation in 2012 reflected the marked deterioration in Iran's external environment. The value of the rial in the bureau/parallel market has remained about 20 percent more depreciated than the official rate, providing another angle to examine the degree of exchange rate misalignment.



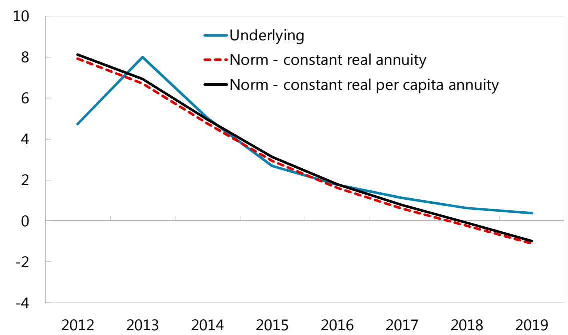


6. **The external sustainability approach suggests the projected current account deficit in the medium term (the underlying current account) is close to its sustainable level**. Bems and de Carvalho Filho's (2009) present a methodology for estimating external sustainability for resource-intensive countries. In their framework, external positions are sustainable if import expenditure equals the income stream derived from resource wealth. Applying this approach to Iran requires two steps. First, to estimate Iran's hydrocarbon wealth, staff assumes that export volumes of crude oil remain constant from 2019 at a level that is three quarters below the average export volume in 2007–12. Gas export volumes grow by 2.4 percent per year from 2018, consistent with the U.S. EIA 2013 annual report. Assumptions about export prices are consistent with the Fall 2013 WEO database. The discounted sum of all future hydrocarbon exports is then equal to $712 billion, an

estimate of Iran's external hydrocarbon wealth. Second, to estimate the flow of income available for import expenditures, the stock of resource wealth has to be converted into annuities. Two common conversion methodologies exist—constant real per capita annuity and constant real annuity, although the differences are very small in the case of Iran, given low population growth. The results suggest that Iran's projected (or underlying) current account balance is narrowly above the sustainable levels of around –1 percent of GDP.

7. **The current account norms derived from the external sustainability approach are sensitive to parameter choice**. For example, if the nominal rate of return that discounts future hydrocarbon export revenue increases from 6 to 8 percent, but real rates of return are unaffected, the current account norm under the constant real per capita rule increases to a surplus of 0.7 percent of GDP in 2019, compared to a deficit of 1.1 percent of GDP. The effect of trimming the assumption of gas export volume growth from 2.4 to 0 percent (because of higher domestic consumption, for example) on the current account norm has a similar magnitude.

Current Account—Underlying and Norms
(In percent of GDP)



Source: Fund staff calculations.

Current Account-GMM Estimation and Implied Norm for Net-Oil Exporters 1/
(Dependent variable: current account balance, as a share of GDP)

	Specification I		Specification II		Specification III		Specification IV	
	GMM Coefficients	Contribution to CA Norm1	GMM Coefficients	Contribution to CA norm1	GMM Coefficients	Contribution to CA Norm1	GMM Coefficients	Contribution to CA Norm1
Core CGER regressors								
Constant	0.039	3.9%	0.350	3.5%	0.043	4.3%	0.044	4.4%
Lagged dependent	0.330	2.5%					0.383	2.9%
Fiscal balance/Non-oil fiscal balance GDP	0.851	-3.2%	0.385	-2.1%	0.363	-2.0%	0.391	-2.1%
Oil trade balance/GDP			0.454	2.7%	0.469	2.7%	0.459	2.7%
Old age dependency	-0.053	-0.4%	-0.059	-0.4%	-0.034	-0.2%	-0.034	-0.2%
Population growth	-0.693	-0.9%	-0.930	-1.2%	-0.632	-0.8%	-0.589	-0.8%
NFA/GDP	0.023	0.7%	0.022	0.7%				
Relative income	-0.017	-0.4%	0.044	1.0%	0.071	1.7%	0.073	1.7%
Economic growth	-0.053	-0.1%	-0.069	-0.2%	-0.064	-0.2%	-0.056	-0.1%
Net oil-exporter specific regressors								
Oil wealth			0.000	0.7%	0.001	2.1%	0.000	-1.4%
Degree of maturity in oil production					0.160	2.8%	0.170	-3.0%
Additional regressors								
REER growth	0.073	0.1%						
Terms of trade growth	4.269	-1.6%						
Estimated current account norm (2019)		**0.5%**		**4.7%**		**10.5%**		**4.0%**
Underlying current account					**0.4%**			

1/ Methodology based on Beidas-Strom and Cashin, 2011, "Are Middle Eastern Current Account Imbalances Excessive?" IMF Working Paper 11/195.

8. **The macroeconomic balance approach also finds that Iran's underlying current account is close to its norm**. However, unlike the external sustainability approach, the macroeconomic balance approach suggests that Iran's underlying current account is below the norm. Following Beidas-Strom and Cashin (2011), the macroeconomic balance approach estimates four main specifications of Iran's equilibrium current account. The specifications differ as to whether they include a lagged dependent variable and how they proxy resource wealth (see text table). Specifications II and IV are the most appropriate for Iran as they capture the economic impact of Iran's significant oil and gas reserves. In contrast, specification I does not take into account that Iran's resource wealth surpasses current net foreign assets, and specification III carries a counterintuitive sign on the contribution of oil and gas wealth to the current account norm. The macroeconomic balance approach therefore puts the current account norm at about 4 percent of GDP, which is above staff's projected current account surplus of 0.6 percent of GDP in 2019.

9. **The overall assessment of the rial is different in the alternative scenario, which assumes a different external environment and reforms**. In staff's alternative scenario, oil exports reach their pre-crisis levels by the end of next year, and keep growing to 2.5 million barrels per day in 2019. At these levels of oil exports, the equilibrium REER would be significantly more appreciated, suggesting that the rial is currently undervalued. The external sustainability approach would not detect a misalignment, with the sustainable current account norms practically identical with the underlying current account. Only the result of the macroeconomic balance approach would be unchanged, with the current account norms significantly above staff's projected current account in the medium term of 1 percent of GDP. In sum, using inputs from the alternative scenario illustrates that the exchange rate assessment hinges crucially on assumptions about the prospects of Iran's external environment.

Appendix IV. Debt Sustainability Analysis

Islamic Republic of Iran: Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

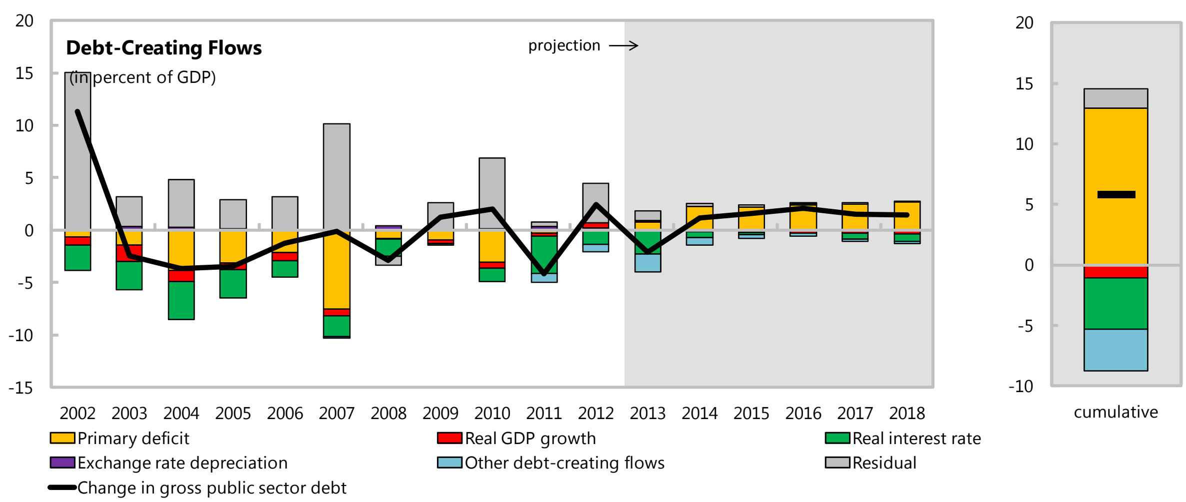
(in percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators [1/]

	Actual			Projections						As of December 31, 2013		
	2002-2010 [2/]	2011	2012	2013	2014	2015	2016	2017	2018	Sovereign Spreads		
Nominal gross public debt	15.5	9.3	11.8	9.7	10.9	12.5	14.6	16.1	17.6	EMBIG (bp) 3/		"n.a."
Public gross financing needs	n.a.	3.7	4.1	4.9	7.8	7.5	9.1	6.0	7.9	5Y CDS (bp)		"n.a."
Real GDP growth (in percent)	5.5	2.7	-5.6	-1.7	1.5	2.3	2.4	2.3	2.3	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	16.8	37.6	17.6	35.8	20.1	20.3	18.6	18.9	18.9	Moody's	n.a.	n.a.
Nominal GDP growth (in percent)	23.3	41.3	11.0	33.5	21.9	23.1	21.5	21.6	21.7	S&Ps	n.a.	n.a.
Effective interest rate (in percent) [4/]	1.9	1.0	1.1	9.3	13.2	18.3	20.5	14.8	13.6	Fitch	n.a.	n.a.

Contribution to Changes in Public Debt

	Actual			Projections							
	2002-2010	2011	2012	2013	2014	2015	2016	2017	2018	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	0.1	-4.1	2.4	-2.1	1.2	1.6	2.1	1.5	1.5	5.8	
Identified debt-creating flows	-5.2	-4.6	-1.3	-3.0	0.9	1.4	2.0	1.5	1.4	4.2	-1.3
Primary deficit	-2.6	-0.3	0.3	0.8	2.3	2.2	2.4	2.5	2.7	12.9	
Primary (noninterest) revenue and grant	25.1	19.7	15.0	13.9	12.4	11.8	11.1	10.4	9.9	69.5	
Primary (noninterest) expenditure	22.5	19.4	15.2	14.7	14.7	14.0	13.4	13.0	12.6	82.4	
Automatic debt dynamics [5/]	-2.6	-3.5	-0.8	-2.1	-0.7	-0.4	-0.1	-0.8	-1.1	-5.3	
Interest rate/growth differential [6/]	-2.7	-3.8	-0.8	-2.1	-0.7	-0.4	-0.1	-0.8	-1.1	-5.3	
Of which: real interest rate	-2.0	-3.6	-1.3	-2.3	-0.6	-0.2	0.1	-0.5	-0.8	-4.2	
Of which: real GDP growth	-0.7	-0.3	0.5	0.1	-0.1	-0.2	-0.2	-0.3	-0.3	-1.0	
Exchange rate depreciation [7/]	0.2	0.3	0.0	...	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	-0.8	-0.8	-1.7	-0.7	-0.4	-0.3	-0.2	-0.2	-3.5	
Privatization (negative)	0.0	-0.8	-0.8	-1.7	-0.7	-0.4	-0.3	-0.2	-0.2	-3.5	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other Debt Creating Flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	5.2	0.4	3.8	0.9	0.2	0.2	0.1	0.1	0.0	1.6	



Source: IMF staff.

1/ Public sector is defined as central government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

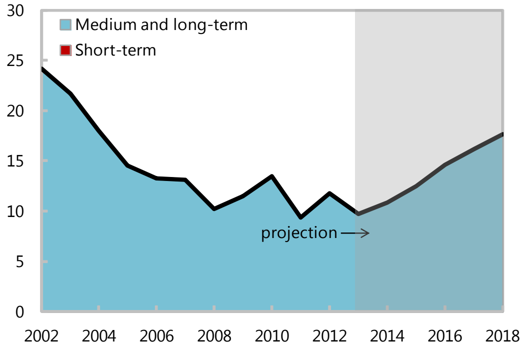
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

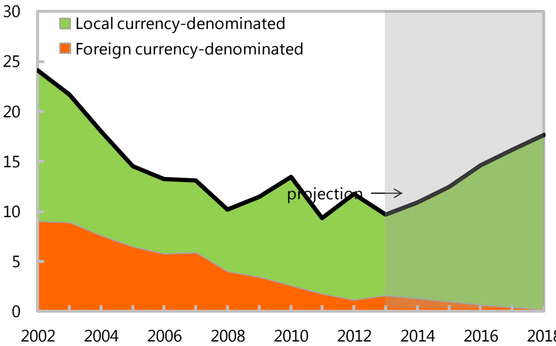
Islamic Republic of Iran: Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



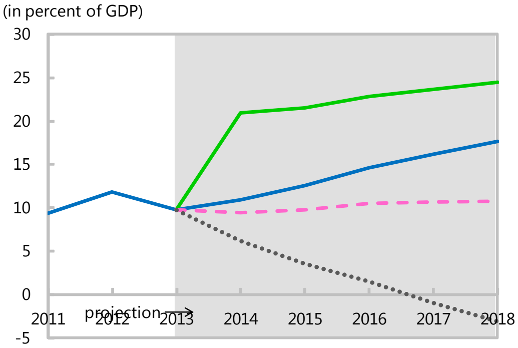
By Currency
(in percent of GDP)



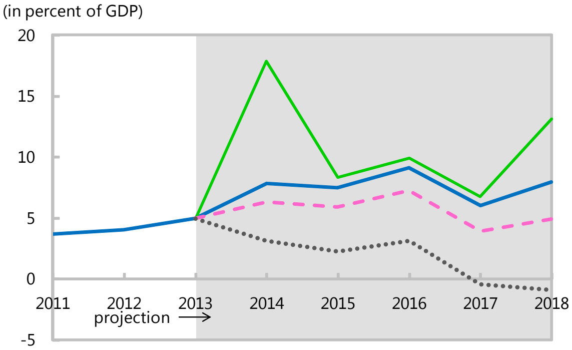
Alternative Scenarios

Baseline
Historical
Constant Primary Balance
Recognition of Arrears in 2014, 10 % of GD

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

Baseline Scenario	2013	2014	2015	2016	2017	2018
Real GDP growth	-1.7	1.5	2.3	2.4	2.3	2.3
Inflation	35.8	20.1	20.3	18.6	18.9	18.9
Primary Balance	-0.8	-2.3	-2.2	-2.4	-2.5	-2.7
Effective interest rate	9.3	13.2	18.3	20.5	14.8	13.6
Constant Primary Balance Scenario						
Real GDP growth	-1.7	1.5	2.3	2.4	2.3	2.3
Inflation	35.8	20.1	20.3	18.6	18.9	18.9
Primary Balance	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8
Effective interest rate	9.3	13.2	19.6	23.5	16.6	15.5
Recognition of Arrears in 2014, 10 % of GDP						
Real GDP growth	-1.7	1.5	2.3	2.4	2.3	2.3
Inflation	35.8	20.1	20.3	18.6	18.9	18.9
Primary Balance	-0.8	-12.3	-2.2	-2.4	-2.5	-2.7
Effective interest rate	9.3	13.2	14.5	16.4	13.4	12.8

Historical Scenario	2013	2014	2015	2016	2017	2018
Real GDP growth	-1.7	3.9	3.9	3.9	3.9	3.9
Inflation	35.8	20.1	20.3	18.6	18.9	18.9
Primary Balance	-0.8	2.3	2.3	2.3	2.3	2.3
Effective interest rate	9.3	13.2	21.2	37.5	22.8	-11.5

Source: IMF staff.

INTERNATIONAL MONETARY FUND

ISLAMIC REPUBLIC OF IRAN

March 13, 2014

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Approved By: Middle East and Central Asia Department (In Consultation with Other Departments)

CONTENTS

FUND RELATIONS

(As of January 31, 2014)

Membership Status: Joined: 12/29/1945; Article VIII

General Resources Account

	SDR Million	Percent Quota
Quota	1,497.20	100.00
Fund holdings of currency	1,497.20	100.00
Reserve position	0.01	0.00

SDR Department

	SDR Million	Percent of Allocation
Net cumulative allocation	1,426.06	100.00
Holdings	1,551.87	108.82

Outstanding Purchases and Loans: None

Financial Arrangements: None

Projected Payments to Fund
(SDR Million; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2014	2015	2016	2017	2018
Principal					
Charges/Interest	0.01	0.01	0.01	0.01	0.01
Total	**0.01**	**0.01**	**0.01**	**0.01**	**0.01**

Nonfinancial Relations

Exchange System

The exchange rate is determined in the central bank's foreign exchange trading center. The de jure exchange rate arrangement has been a managed floating arrangement against a basket of currencies since 2002. Since the rial continued to depreciate against the basket with some step adjustments, the de facto exchange rate arrangement has been reclassified to other managed arrangement from a stabilized arrangement, effective May 1, 2011. With effect from September 6, 2004, the Islamic Republic of Iran accepted the obligations under Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement. Iran maintains exchange restrictions and multiple currency practices subject to Fund jurisdiction under Article VIII, Sections 2(a) and 3:

Exchange restrictions arise from (i) limitations on the availability of foreign exchange for travel and studies abroad as well as for the payment for imports based on priority lists. Amounts in excess of these limitations may only be purchased in the foreign exchange bureau market but at a more depreciated exchange rate, and (ii) limitations on the transferability of rial profits from certain investments under the Foreign Investment Promotion and Protection Act and from limitations on other investment-related current international payments under this act.

A Multiple currency practice, which also gives rise to an exchange restriction, arises from the establishment of an official exchange rate for use in all exchange transactions, which in practice differs by more than 2 percent from the rate used by foreign exchange bureaus.

A Multiple currency practice arises from the budget subsidies for foreign exchange purchases in connection with payments of certain letters of credit opened prior to March 21, 2002 under the previous multiple exchange rate system.

Last Article IV Consultation

The last Article IV consultation was concluded by the Executive Board on July 20, 2011.

Technical Assistance

Since FY 2009, Iran received the following technical assistance:

FAD

FY 2009	Tax administration and VAT
FY 2010	Tax policy
FY 2010	Tax Administration—Risk Management and Audit
FY 2011	Tax Administration
FY 2013	Tax Administration
FY 2014	Tax Administration

LEG

FY 2009	Anti-Money Laundering/Combating Financing of Terrorism regulations

MCM

FY 2010	Macrofinancial Policies and Financial Stability (with MCD and LEG)

STA

FY 2011	GDDS: Metadata Development

RELATIONS WITH THE WORLD BANK

JMAP Implementation

Area	Product	Delivery Date
World Bank		
Poverty Reduction	Employers Survey Analysis	FY09
Energy and Mining	Electricity Pricing and Power Sector Reform TA	FY09
Energy and Mining	Promotion of Renewable Energy TA	FY09
Transport	Transport TA	FY10
Country Monitoring	Economic Monitoring	FY12–FY14
IMF		
Financial Sector	2009 Article IV Consultation Report	
	Technical Assistance	
	Currency Reform	FY2008–10
	Monetary Policy Modeling	FY2009–10
	AML/CFT	FY2009–10
	Bank Restructuring and Supervision	FY2010
Fiscal Sector	2009 Article IV Consultation Report	
	Selected Issues Paper	
	Energy Sector Reform	FY2009–10
	Technical Assistance	
	Major Tax Reforms	FY2009–10
Trade and Exchange Restrictions	2009 Article IV Consultation Report	
	Exchange Rate Assessment CGER Methodologies	
	Technical Assistance	
	Implementing Changes to the Foreign Investment Regulatory Framework	FY2009–10

STATISTICAL ISSUES

Data provision to the Fund is generally adequate for effective surveillance; however, the data have been reported with significant delays, notwithstanding the recent improvement in timeliness. The Central Bank of Iran (CBI) disseminates key statistical aggregates in its quarterly *Economic Trends*, also available at <http://www.cbi.ir/e/>. Iran has participated in the International Monetary Fund's General Data Dissemination System (GDDS) since August 2012 by publishing comprehensive information on the statistical production and dissemination practices on the IMF's Dissemination Standards Bulletin Board. Iran, however, still needs to improve timeliness of data dissemination to fully meet the GDDS standards.

Real sector statistics

- National accounts statistics are reasonably sound but should be released in a timely manner. There is scope for further progress, especially in the coverage of small-scale industries and services, informal sector and calculation of sector based economic activity deflators. Also, the CBI and the Statistical Center of Iran (SCI) could make further progress to review and unify their respective GDP estimates.

- Price statistics are methodologically sound and released in a timely manner. The official labor market statistics are released by the SCI, and are based on the definitions by the International Labor Organization (ILO). The data is based on an urban and rural population sample of about 60,000 households, and the threshold for considering a person employed is to have worked at least one hour during the reference week. Labor market statistics, however, could benefit from further improvement, particularly with regard to hours worked and wage data.

Government finance statistics

- Fiscal statistics on budgetary central government operations are reasonably sound but should be released in a timely manner.

- The data are compiled in accordance with the *Government Finance Statistics Manual 2001 (GFSM2001)* for the budgetary central government operations. The data consist of a statement of operations for budgetary central government operations and do not cover nonfinancial public corporations. There is scope to improve coverage of fiscal reporting on general government by including the nonfinancial public corporations sector data. In addition, regular reporting on the financial activities of the National Development Fund and the Targeted Subsidy Organization and their consolidation into the public sector accounts could help improve fiscal data coverage. Under current presentation, the Targeted Subsidy Organization is considered as a public corporation and is classified in the nonfinancial public corporations sector.

- Data on central government operations cover the general budget, the special purpose funds, and certain transactions with the Social Security Organization. These data are not consolidated. There is a need to expand the coverage of central government to include the complete transactions of the Social Security Organization, four pension funds, and five procurement and distribution centers.

- The existing cash-based government accounting system should be upgraded toward an accrual accounting system or a modified cash accounting where noncash operations (such as advances and arrears) are identified.

- Financing data in the GFS are broken down by residency of debt holders and by type of debt instruments according to *GFSM 2001*. However, there is a need to develop a comprehensive database on domestic and external public debt and to align the coverage of the monetary data with the coverage of the fiscal data.

Monetary statistics

- Monthly monetary data are reported to STA for publication in *IFS*, but timeliness needs to be improved.

- Compilation of monetary statistics diverges from international standards in the application of the residency criterion and in the sectorization and classification of accounts. The authorities are undertaking improvements in each of these areas, in line with the recommendations of past STA missions.

- The measure of broad money employed by the CBI does not include deposits of public nonfinancial corporations, local governments, or foreign-currency deposits of residents.

External sector data

- The accounting system for foreign exchange receipts and payments of the CBI and banks is being implemented in line with the methodological guidelines of the Fund's *Balance of Payments Manual*, fifth edition (BPM5).

- Data on the international investment position are compiled, but not disseminated. Only data on public and publicly guaranteed debt are disseminated, but classifications do not fully accord with the guidelines of the *External Debt Guide*. The data template on international reserves and foreign currency liquidity is not compiled.

Islamic Republic of Iran: Common Indicator Required for Surveillance

(As of February 25, 2014)

	Date of latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	March 12, 2014	March 12, 2014	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	December 2013	February 2014	M	I	Q
Reserve/Base Money	December 2013	February 2014	M	Q	Q
Broad Money	December 2013	February 2014	M	Q	Q
Central Bank Balance Sheet	December 2013	February 2014	M	Q	NA
Consolidated Balance Sheet of the Banking System	December 2013	February 2014	M	Q	Q
Interest Rates[2]	March 2013	November 2013	M	Q	Q
Consumer Price Index	January 2014	February 2014	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]–General Government[4]			NA	NA	NA
Revenue, Expenditure, Balance and Composition of Financing[3]–Central Government	December 2013	January 2014	M	Q	Q
Stocks of Central Government and Central Government-Guaranteed Debt[5]	March 2013	November 2013	Q	Q	Q
External Current Account Balance	September 2013	February 2014	M	Q	Q
Exports and Imports of Goods and Services	September 2013	February 2014	M	Q	Q
GDP/GNP	September 2013	January 2014	Q	Q	Q
Gross External Debt	December 2013	February 2014	M	Q	Q
International Investment Position 7/	Sept. 2010	May 2011	A	I	NA

1/ Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
2/ Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, and notes and bonds.
3/ Foreign, domestic bank, and domestic nonbank financing.
4/ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
5/ Including currency and maturity composition.

6/ Daily (D), weekly (W), monthly (M), quarterly (Q), annually (A), irregular (I), and not available (NA).

7/ Includes the external financial assets and liabilities vis-à-vis nonresidents of the financial sector.

INTERNATIONAL MONETARY FUND

COM COMMUNICATIONS DEPARTMENT

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

IMF Executive Board Concludes Article IV Consultation with the Islamic Republic of Iran

On March 28, 2014 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Islamic Republic of Iran.

Iran had achieved considerable progress in raising per capita income and living standards in previous decades. But in recent years, such progress stalled as both domestic policies and the external environment deteriorated.

Macroeconomic performance worsened markedly following the subsidy reform in late 2010 and the intensification of sanctions in 2012. The economy contracted by almost 6 percent in 2012/13 and 12-month inflation rose from about 12 percent in late 2010 to around 45 percent in July 2013. With the deterioration in the external environment in 2012, the authorities abandoned their unified and managed exchange rate regime until they eventually unified the official exchange rates again in June 2013. The balance of payments remained in surplus, but the current account surplus declined to 6½ percent of GDP in 2012/13, almost halving from the year before. The sharp fall in oil exports was the main factor, partly offset by import compression. The deficit of the capital account remained contained, leaving the overall balance of payments in a surplus of 3½ percent of GDP in 2012/13. Gross foreign assets of the Central Bank of Iran (CBI) rose to about $105 billion by end-2012/13. The fiscal position also deteriorated significantly. With about 10 percentage points of GDP decline in total revenues since 2010/11, the authorities cut spending and the overall budget balance shifted from a surplus of 3 percent of GDP in 2010/11 to an estimated deficit of 1 percent of GDP in 2013/14. The deficit of the Targeted Subsidy Organization remained high, bringing the expanded overall deficit to about 2¼ percent of GDP

[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.

in 2013/14. Throughout these shocks, monetary conditions were relatively accommodative, as domestic interest rates became increasingly negative in real terms. The financial system was also adversely affected, particularly banks' asset quality and profitability.

Since the Presidential election in mid-2013, there have been some signs of stability. The exchange rate has appreciated markedly in the bureau/parallel market. The CBI has kept a lid on base money growth thanks to tighter credit to the banking system and some fiscal consolidation, and 12-month inflation has declined to about 29 percent in January 2014.

Looking ahead, the near-term outlook remains highly uncertain. Facing continued constrained prospects for oil revenues and international financial transactions, the economy is envisaged to remain stagnant in 2013/14, with real GDP estimated to decline by 1¾ percent. With some positive tailwinds from the external side and some incipient signs that the pace of contraction in domestic demand is slowing, it is projected that economic activity would begin to stabilize in 2014/15, with real GDP projected to increase by 1–2 percent. But the current outlook remains highly uncertain and subject to downside risks. In the meantime, the authorities are taking steps to make the regulatory framework for foreign investment in the oil sector more attractive, while upside risks emanate from the interim agreement with the P5+1.

Executive Board Assessment[2]

Executive Directors acknowledged the difficult economic environment facing the Iranian economy in recent years. While Directors were heartened by incipient signs of stabilization in economic activity and the decline in inflation, they noted that the economic outlook remains uncertain and subject to downside risks. They encouraged the authorities to continue implementing prudent macroeconomic policies and advancing structural reforms to lay the basis for sustained high growth and employment.

Directors emphasized that tight monetary policy, balanced fiscal consolidation, and supply-side reforms are essential to deal with stagflation. They welcomed the removal of the financing of the Mehr housing program from the Central Bank of Iran's balance sheet, and encouraged the authorities to seek long-term noninflationary financing for this program. Directors also

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[2] 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. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

recommended increasing interest rates gradually to bring inflation down and anchor expectations. They welcomed the measures to broaden the revenue base away from oil, as well as the steps to strengthen tax administration and reduce exemptions.

Directors noted that institutional reforms to refocus the Central Bank of Iran's mandate on price stability are essential to entrench macroeconomic stability. Reforms to the fiscal policy framework should strengthen its countercyclical role, limit risks, and enhance macroeconomic policy coordination.

Directors took note of the staff assessment that the official exchange rate in real effective terms appears to be somewhat overvalued relative to the level implied by medium-term fundamentals, while recognizing the uncertainty surrounding that assessment. They welcomed the authorities' intention to unify the foreign exchange market and remove restrictions, and encouraged the authorities to manage the exchange rate flexibly in light of external risks and still high inflation.

Directors agreed that subsidy reform should proceed with the right supporting framework and macroeconomic policies. They supported the authorities' plans to increase domestic energy prices gradually, while improving targeted cash transfers. Directors also noted that the reform should foster the adoption of new technologies and tighter budget constraints in energy-intensive sectors.

Directors urged the authorities to strengthen the central bank's supervisory powers and enforcement capacity. They encouraged the authorities to level the field of competition through further privatization and reforms to government-mandated credit policies. Directors also agreed that plans to deal with nonperforming loans and recapitalize public banks should be supported by restructuring, enhanced risk management and accountability, a strengthened bank resolution framework, and a financially-sound deposit guarantee fund.

Directors viewed improvements to the business environment as potentially providing a boost to productivity and growth. They encouraged the authorities to review labor regulations to ease the rigidity of contracts and nonwage costs. Strengthening the regime against money laundering and the financing of terrorism would also help reinsert the domestic financial system into the global economy, lower transaction costs, and increase productivity.

Directors welcomed the authorities' recent steps to improve the timeliness of official statistics and noted that there is scope for further improvements.

Islamic Republic of Iran: Selected Macroeconomic Indicators, 2011/12–2013/14 1/

	2011/12	2012/13	Est. 2013/14
	(Annual change, in percent, unless otherwise indicated)		
National accounts			
Nominal GDP at market prices (in billions of Iranian rials)	6,121,004	6,793,170	9,068,975
Real GDP at factor cost	3.0	-5.8	-1.7
Real oil and gas GDP	1.3	-34.1	-5.7
Real non-oil GDP	3.2	-3.1	-1.4
CPI inflation (average)	21.5	30.5	35.2
CPI inflation (end of period)	20.5	41.2	22.0
Unemployment rate (in percent of labor force)	12.3	12.2	12.9
	(In percent of GDP)		
Budgetary operations			
Revenue	19.7	15.0	13.9
Of which: oil revenue	10.8	6.6	6.2
Expenditure	19.5	15.3	14.8
Expense	14.8	13.1	13.6
Net acquisition of nonfinancial assets	4.7	2.2	1.2
Net lending/borrowing (overall balance)	-1.4	-2.0	-2.2
Net lending/borrowing (budget)	0.2	-0.3	-0.9
Balance of Targeted Subsidy Organization	-1.6	-1.6	-1.3
	(Annual change in percent, unless otherwise indicated)		
Monetary sector			
Narrow money (M1)	15.8	29.1	20.5
Broad money (M2)	19.6	30.6	24.9
	(In billions of U.S. dollars, unless otherwise indicated)		
External sector			
Current account balance	59.4	26.3	29.2
In percent of GDP at market prices	11.0	6.6	8.0
Gross official reserves	92.2	104.4	107.7
	(In U.S. dollars, unless otherwise indicated)		
Oil and gas sector			
Total oil and gas exports (billions)	118.2	62.9	56.3
Liquid fuels production (in millions of barrels/day)	4.0	3.2	2.8
Memorandum items:			
Average exchange rate (Iranian rials per U.S. dollar)	11,312	12,260	24,770

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

1/ The Iranian fiscal year ends March 20.

Statement by Jafar Mojarrad, Executive Director for Iran
March 28, 2014

My authorities thank staff for their hard work and the frank and candid discussions. They are in broad agreement with staff on a wide range of issues, and intend to draw on the Fund's policy advice and technical assistance in moving forward with their reform strategy.

The government of President Rohani, which took office in June 2013, has strong political and social support and a clear mandate to address the economic challenges ahead, including containing inflation, promoting high and inclusive growth, increasing employment opportunities, and reducing the economy's dependence on oil. My authorities are committed to steadfast implementation of ambitious reforms in several key areas, despite the enormous obstacles posed by the international trade and financial sanctions. They have already taken steps to reduce inflation, stabilize the exchange market, and prepare the groundwork for critical structural reforms to strengthen the economy's resilience to external shocks.

Overview

Since 2011, the Iranian economy has been exposed to two major domestic and external shocks, namely the subsidy reform and international trade and financial sanctions, which were compounded by weak macroeconomic management and inadequate policy response. These developments, which are well rendered in the report, have led to a significant growth contraction in 2012/13 and 2013/14, in connection with the intensification of the sanctions, and a sharp rise in inflation, also reflecting accommodative fiscal and monetary policies and the large pass-through of the sizable exchange rate depreciation. Nonetheless, the economy has exhibited a measure of resilience, given the magnitude of the shocks, and is expected to emerge from recession in 2014/15 and grow by 1.5 percent in real terms. Year-on-year CPI inflation, which doubled in 2012/13 to 41 percent, has been declining since then, and is estimated at about 23 percent in February 2014 in line with the Central Bank of Iran's (CBI) effort to contain the growth of base money. Moreover, the external current account balance has remained in surplus, gross international reserves have increased, and external debt has remained negligible.

The new government has firmly moved in the direction of easing external constraints and addressing the many economic, financial, and social challenges ahead. High priority is given to reducing inflation, unifying the exchange rates, completing the subsidy reform, improving fiscal management, strengthening the banking system, and embarking on critical structural reforms to invigorate growth and increase employment. Despite the new government's initial efforts, including fiscal and monetary discipline, and constructive engagement with the outside world, it may take some time to achieve macroeconomic stability and set the economy on a path of high growth and employment creation.

Addressing stagflation

The authorities agree on the strategy to address stagflation through tight monetary policy, fiscal consolidation, and structural reforms to improve supply response. They plan to lower the average CPI inflation from 35 percent to 23 percent in a year's time, notwithstanding the potential impact from the second phase of the subsidy reform, and have already taken steps to this effect through a tight control of base money and terminating the financing of the large housing program (Mehr) by CBI. The authorities agree that bringing profit rates more in line with inflation would help address some difficulties in credit markets and enable the CBI to better manage liquidity. They intend to issue CBI participation papers to contain money growth. While there are concerns about output costs and second-round effects from the planned increase in domestic energy prices, staff and authorities concur that a gradual monetary policy tightening will limit these effects, in line with the SIP findings about the inflation-output trade-off in Iran.

Ensuring a successful disinflation strategy also requires a comprehensive reform of the monetary policy framework, including strengthening the price stability mandate of the CBI and enhancing its operational independence, on which consensus within the government is growing. My authorities are open to examining all options in this area in conformity with Iran's institutional setting.

Since the successful exchange rate unification in 2002, Iran has adopted a managed float exchange rate regime, eliminated most exchange rate restrictions for current transactions, and liberalized some capital movements. Progress in this area, however, has been set back in recent years, and a large premium has emerged in the bureau/parallel market compared to the official exchange rate. The authorities are committed to unifying the official and bureau/parallel exchange rates by mid-2015, notwithstanding the complexity of the task given external environment constraints. Difficulties in accessing foreign exchange have also resulted in the emergence of arrears on external payments by public and private sector entities. The authorities are prepared to clear these arrears with foreign assets held abroad, and to eliminate foreign exchange restrictions and related arrears.

On the supply side, trade and financial sanctions involve drastic physical limitations to output and exports, as well as high production costs stemming from shortages of inputs and foreign exchange. These severe constraints, which cannot be easily overcome by increased productivity or competitiveness, have not allowed the economy to fully benefit from the change in relative prices induced by exchange rate deprecation, as would be the case under normal circumstances. Nonetheless, the authorities' reform agenda includes wide-ranging structural reforms to improve the business environment, enhance economic efficiency, and raise growth to absorb new entrants to the labor market.

Fiscal policy

With a significant loss of budget oil revenue due to international sanctions since 2010/11, the fiscal situation deteriorated in 2012/13 and 2013/14, despite sizable cuts in both capital and current spending. The overall fiscal balance shifted from a surplus of 3 percent of GDP in 2010/11 to a deficit estimated at 1 percent of GDP in 2013/14. Adding the cash deficit of the Targeted Subsidies Organization (TSO) raises the expanded deficit to 2¼ percent of GDP.

The 2014/15 budget bill approved on February 6, 2014, seeks to maintain the expanded deficit at around 2½ percent of GDP (the second phase of subsidy reform should eliminate the TSO deficit) to continue to support the economy while taking steps to broaden the revenue base away from oil, prioritizing capital spending, and containing the growth of current spending. Total spending growth is significantly reduced compared with the previous budget. The VAT rate was increased from 6 to 8 percent and the authorities intend to raise it further to 10 percent one year ahead of schedule. The tax law will be reviewed and tax incentives for certain activities and for large statutory bodies will be reduced. Moreover, capital gains tax on equity investments and real estate are to be introduced, the tax administration is proceeding with the implementation of an integrated tax system, and efforts are underway to strengthen compliance. These efforts would increasingly allow current spending to be covered by tax revenue rather than oil revenues, which would be mostly allocated to capital spending.

Subsidy reform

The landmark targeted subsidy reform (TSR), which was launched in December 2010, initiated a major shift in a decades-old subsidy system that was very costly and inefficient. The TSR aimed at replacing subsidies with targeted cash transfers to households, and providing assistance to enterprises and the government to adjust to the cost of high energy bills. After initial success in the first phase of the reform, shortcomings in implementation and mounting economic difficulties, including large depreciation of the nominal exchange rate, led to the postponement of the second phase in mid-2012. Staff assessment of this important reform in terms of its economic impact and its implementation, as well as the lessons to be drawn from such experience, is well articulated in the useful SIP, and my authorities will give them adequate attention in formulating next steps.

The authorities are committed to pursuing the reform, but with adjustments aimed at improving the targeting of the most vulnerable households through better identification and means testing of beneficiaries. The corporate sector will be encouraged to save energy, including the increased use of less energy-intensive technology, and will be subjected to tighter budget constraints. With strong political backing for gradually increasing domestic prices, in early February 2014, Parliament approved plans to cut subsidies on fuel and food, but delayed implementation to allow the authorities to mitigate the impact on consumers. In an effort to reduce the subsidies' burden on the budget and improve the cash flow of the reform, the 2014/15 budget calls for savings of about 2 percent of GDP in subsidy payments.

Financial Sector

Iran's financial system has been adversely affected by the sanctions and by distortive government-mandated credit policies, together with weakened risk management and incentives for adequate supervision, which resulted in high non-performing loans (NPL), low profitability, and weak credit growth. Efforts to address these problems include strengthening the CBI's supervisory powers and extending them to all banks and financial institutions. Non-bank credit institutions have been encouraged to consolidate and apply for a banking license. In order to strengthen risk management and compliance with prudential limits, senior management at state-owned banks have been replaced, and consideration is being given to subjecting these banks to better accounting and provisioning standards. In addition, steps are underway to restructure and recapitalize public banks to make them more robust financially. Private banks which have continued to exhibit a relatively better situation, are also strengthening their capital base. With regard to the rise in NPL, the authorities intend to continue to monitor the situation closely and will take additional measures, as needed, to strengthen banks' balance sheets.

Medium-term outlook and structural reforms

The authorities agree that the lifting of the restrictions on oil exports and international financial transactions, as well as stepped-up implementation of critical reforms will shape Iran's medium-term outlook. Quantification of the outlook, however, is subject to a high degree of uncertainty, and assumptions underlying the scenarios are not necessarily binary, i.e. reforms and lifting of sanctions take place together (alternative scenario), or do not (baseline scenario). The authorities are determined to move forward with their reform agenda to the full extent possible regardless of whether current international restrictions are partially or fully eliminated. Under the circumstances, authorities believe that with the right policies and reform, Iran has the potential to achieve growth rates exceeding those stated in the staff alternative scenario.

Deepening structural reforms will be critical to promote higher sustainable growth and increase employment opportunities, and remains a key objective of the authorities' medium-term strategy. Various initiatives have been taken to promote private sector activity and employment, including simplifying administrative procedures under the 'Law for Continued Improvement of the Business Environment" and taking steps to improve the privatization process. The authorities are aware of the need to raise the employment content of growth by making the labor market more responsive to changing conditions in the economy, including improving labor skills and addressing other labor market rigidities. They remain committed to promoting private sector investment and attracting FDI to facilitate technology transfer and enhance efficiency. Further efforts would also be made toward improving corporate governance and deepening domestic capital markets, which the authorities view as critical to promote efficient long-term financing of the economy.

Other issues

Progress on strengthening the AML regulatory framework has been made, most notably the adoption by the AML High Council of 14 new AML instructions, the establishment of an economic crime prosecutor office, and a defined roadmap for improving the AML system. The CFT bill has been approved by Parliament, and since it includes criminalization and punishment issues, it has been forwarded to the judiciary for an opinion. Recommendations have been made to make the bill more compliant with best international practice, and it is expected to have the judiciary's opinion before end-2014.

On statistical issues, the authorities remain confident that their system is consistent with best international practice and are considering Fund TA to help reaffirm the underlying methodologies.

Conclusion

Overall, my authorities face daunting challenges of addressing the multi-layered reforms that are needed to set the economy anew on a path of macroeconomic stability and high growth in a highly unfavorable external environment. While the task will be arduous, and will require buy-in and strong social support, the authorities are firmly determined to see through this difficult period and look forward to continued close cooperation with the Fund in support of their reform strategy.