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Islamic Republic of Iran: 2006 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Islamic Republic of Iran

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2006 Article IV consultation with the Islamic Republic of Iran, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on November 14, 2006, with the officials of the Islamic Republic of Iran on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on February 1, 2007. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF;
- a staff statement of February 21, 2007 updating information on recent developments;
- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its February 23, 2007 discussion of the staff report that concluded the Article IV consultation; and
- a statement by the Executive Director for the Islamic Republic of Iran.

The document listed below has been or will be separately released.

Statistical Appendix

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

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

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INTERNATIONAL MONETARY FUND

ISLAMIC REPUBLIC OF IRAN

Staff Report for the 2006 Article IV Consultation

Prepared by the Staff Representatives for the 2006 Consultation with the Islamic Republic of Iran

Approved by Lorenzo L. Pérez and Scott Brown

February 1, 2007

- Discussions for the 2006 Article IV consultation were held in Tehran from November 4–14, 2006. The staff team comprised Messrs. Di Tata (head), Bonato, and Zytek, Mrs. Moalla-Fetini, Ms. Farhan, and Mrs. Djahanyekta (assistant) (all MCD). Mr. Mirakhor, Executive Director for Iran, and Mr. Monajemi, Senior Advisor to Mr. Mirakhor, participated in the discussions.
- The mission met with Central Bank Governor Sheibani; Minister of Economic Affairs and Finance Danesh Jafari; and representatives of other ministries and government agencies, the banking sector, the Tehran Stock Exchange, and the business community.
- The Islamic Republic of Iran maintains one exchange restriction and two multiple currency practices that are subject to approval under Article VIII, Sections 2(a) and 3. The Fund has approved the retention of the restriction through March 10, 2007, and of the two multiple currency practices through March 10, 2009. The exchange rate regime has been reclassified, effective January 1, 2005, from the category of a managed float with no predetermined path for the exchange rate to a de facto crawling peg system.
- Despite progress in recent years, the authorities have not yet fulfilled the requirements for subscription to the Special Data Dissemination Standard (SDDS).

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LIST OF ACRONYMS

AML	Anti-Money Laundering
CBI	Central Bank of Iran
CBPPs	Central Bank Participation Papers
CFT	Combating the Financing of Terrorism
CGER	Consultative Group on Exchange Rate Issues
CPPO	Consumer and Producer Protection Organization
FATF	Financial Action Task Force
FDI	Foreign Direct Investment
FFYDP	Fourth Five-Year Development Plan
FIPPA	Foreign Investment Promotion and Protection Act
FSAP	Financial Sector Assessment Program
MBD	Millions of Barrels Per Day
OSF	Oil Stabilization Fund
SDDS	Special Data Dissemination Standard
TSE	Tehran Stock Exchange
VAT	Value-Added Tax
WEO	World Economic Outlook
WTO	World Trade Organization

Executive Summary

Focus of the report

The discussions for the 2006 Article IV consultation focused on the macroeconomic and structural policy adjustments that would be necessary to achieve and sustain higher growth rates while reducing inflation, which remains entrenched in the double digits.

Background

With high oil prices and a significant policy stimulus, real GDP growth is estimated at 5½ percent in 2005/06 (the fiscal year starts on March 21), and is projected at near 6 percent in 2006/07. End-of-period inflation declined to below 7 percent in April 2006, but increased in recent months, reaching 14.7 percent in November. The rial appreciated by over 11 percent in real effective terms from March 2005 to September 2006. The fiscal stance has been highly expansionary. Although the overall fiscal position (commitment basis) is projected to be roughly in balance, the non-oil fiscal deficit is expected to increase to 21 percent of GDP in 2006/07, from 15 percent in 2004/05. Broad money and private sector credit have continued to grow at a strong pace. In March 2006, the authorities lowered the rate of return (interest rate) on state banks' lending and set the rate on private banks' lending, which was previously freely determined. The external current account and the international reserves position have strengthened owing to the sharp increase in oil exports.

Views of the authorities

The authorities indicated that their main objective was to use the additional oil revenue to sustain growth and job creation, with emphasis on addressing social needs. They said that they would slow the pace of government spending if inflationary pressures were to persist. The government intends to seek parliament's approval for a value-added tax (VAT) by mid-2007/08. The transportation system will be upgraded as a precondition for reforming energy subsidies. The central bank intends to tighten monetary policy by intensifying open market operations, and the rial will continue to depreciate at a slower pace to contain inflation. On the structural front, the authorities have decided to reinvigorate the privatization program.

Staff recommendations

The staff encouraged the authorities to implement a strong fiscal adjustment supported by a tighter monetary policy and greater exchange rate flexibility to ease demand pressures and put inflation on a downward path. It also stressed the importance of addressing the numerous distortions stemming from the extensive controls on prices and rates of return, and of phasing out energy subsidies, which are very large. The staff emphasized that, to be successful, the privatization program needed to be accompanied by reforms aimed at ensuring a level-playing field for the private sector and improving investor confidence.

I. INTRODUCTION

1. **The main challenge faced by Iran is the need to attain and sustain higher rates of growth to provide employment for its fast growing labor force while lowering inflation.** Every year approximately 750,000 Iranians enter the labor market for the first time, putting enormous pressure on the ability of the economy to create jobs. Attempts to support economic activity and job creation through fiscal and monetary stimuli have resulted in persistent double-digit inflation, which undermines the objective of achieving high sustainable growth rates over the medium term. Against this background, the consultation discussions focused on:

- The adjustments in fiscal, monetary, and exchange rate policies that are necessary to achieve a significant reduction in inflation.

- The need to address the distortions caused by extensive administrative controls on prices and rates of return (interest rates), as well as large subsidies, particularly those on energy products.

- The authorities' structural reform plans, including their decision to reinvigorate the privatization program.

Fund surveillance in recent years has focused on the macroeconomic imbalances associated with an expansionary policy stance and structural obstacles to growth and job creation (Box 1).

Box 1. Effectiveness of IMF Surveillance

Fund advice has concentrated on the need to reduce the non-oil fiscal deficit and enhance fiscal transparency, improve the effectiveness of monetary policy, and accelerate structural reforms.

On the fiscal side, the authorities have made progress in strengthening the tax administration and improving transparency, and have established the Oil Stabilization Fund (OSF) to address oil price volatility. However, containing current expenditures and phasing out subsidies has proven difficult, as the authorities continue to face strong political pressure to increase spending in order to promote growth and reduce unemployment.

In the monetary and exchange rate areas, the Fund has called for increasing central bank independence, eliminating administrative controls, and allowing for greater exchange rate flexibility. Although discussions to strengthen the role of the central bank are under way, the effectiveness of monetary instruments remains weak and progress in increasing exchange rate flexibility has been limited.

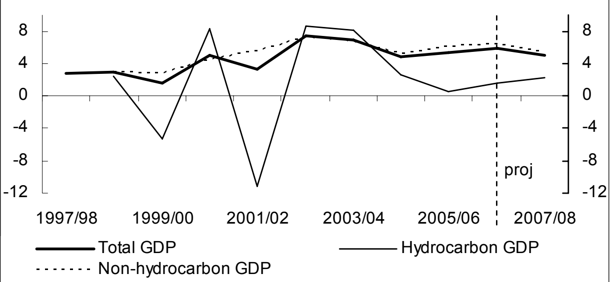
On the structural front, several important reforms were implemented during 2000/01–2002/03, including exchange rate unification, trade liberalization, tax reform, and the adoption of a new foreign direct investment (FDI) law. Significant changes have also been introduced in the financial sector through the adoption of a number of the 2000 Financial Sector Assessment Program (FSAP) recommendations. Progress has been slow, however, in the areas of privatization and subsidy reform.

II. Recent Developments

2. **The government's economic priorities have been reassessed after the change of administration.** Structural reforms introduced during 2000/01–2002/03 fostered the integration of Iran in the global economy. Since the administration of President Ahmadi Nejad took office in 2005, the focus of economic policies has shifted toward reducing social and regional disparities. This new approach has entailed using much of the additional revenue from high oil prices to finance higher government spending.

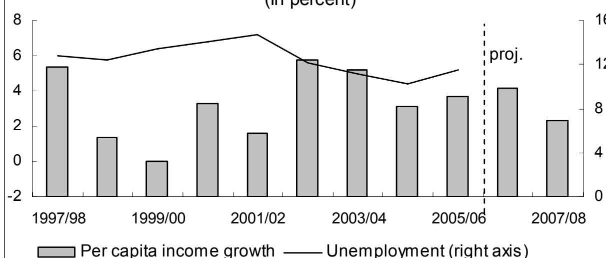
3. **The economy experienced robust growth in 2005/06, but unemployment remained high.** Real GDP growth is estimated at 5.4 percent in 2005/06, boosted by high oil prices, a weather-related recovery in agriculture, and strong fiscal and monetary stimuli (Figure 1a and Table 1). Oil GDP growth was modest owing to capacity constraints, while non-oil GDP growth was broad-based, reaching 6 percent. The tensions associated with the nuclear issue, however, had some adverse effects on private investment, particularly FDI. The unemployment rate increased to 11.5 percent in 2005/06 (Figure 1b), before declining to 10.2 percent in the first half of 2006/07.

Figure 1a. Islamic Republic of Iran: Real GDP Growth
(In percent)



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

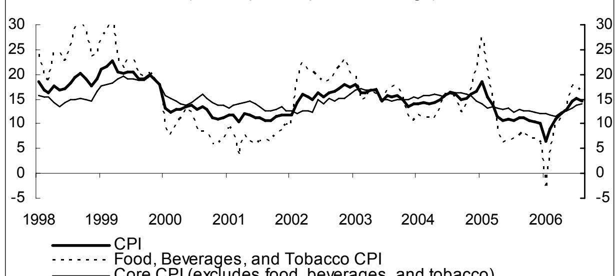
Figure 1b. Islamic Republic of Iran: Real Per Capita Income Growth and Unemployment Rate
(In percent)



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

4. **Inflation decelerated through April 2006, but increased markedly in recent months.** End-of-period inflation declined from 16.7 percent in 2004/05 to 10.2 percent in 2005/06, owing mainly to a fall in food prices associated with a bumper harvest and a slower rate of depreciation of the currency (Figure 2). After declining further to below 7 percent in April 2006, the 12-month rate of inflation increased in recent months, reaching 14.7 percent in November.

Figure 2. Islamic Republic of Iran: Inflation Rate
(End of period; percent change)

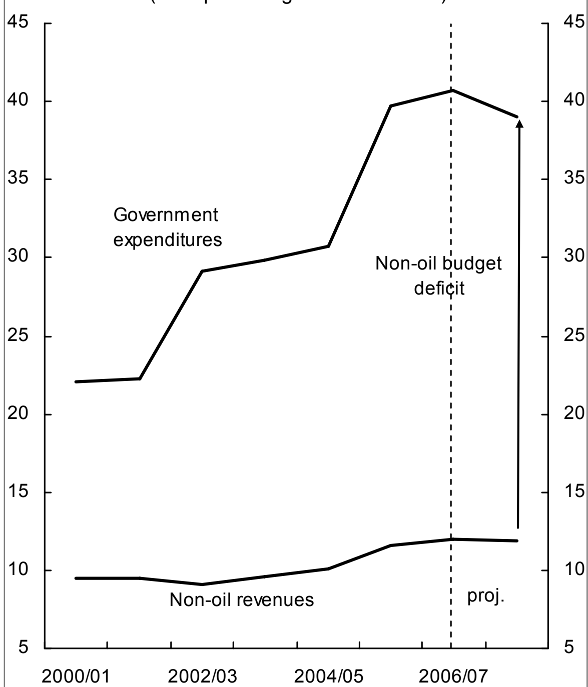


Source: Iranian authorities.

5. **The fiscal stance in 2005/06 was highly expansionary.** The original 2005/06 budget sought to reduce the non-oil fiscal deficit by raising revenue and keeping government

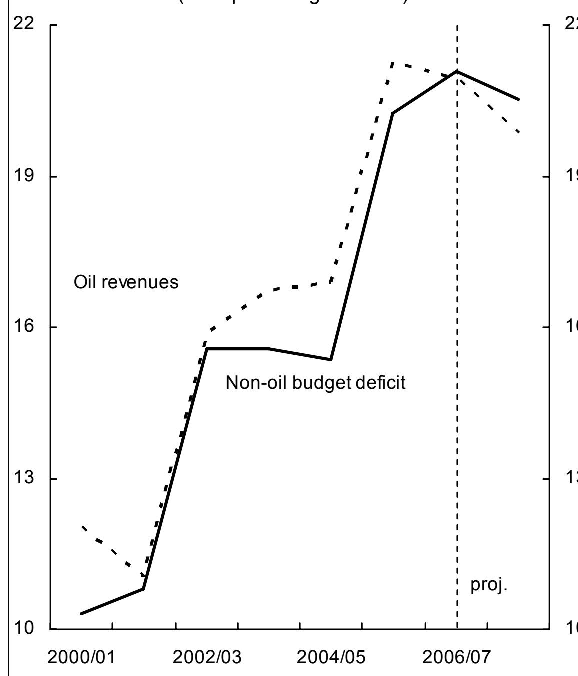
expenditures constant relative to GDP. However, two supplementary budgets passed by parliament contained additional appropriations to cover higher gasoline imports and food subsidies, bring teachers' salaries in line with those of other civil servants, and improve rural infrastructure. As a result, despite the large increase in oil revenue, the consolidated surplus of the central government and the OSF (commitment basis) declined from 1.7 percent of GDP in 2004/05 to 1.1 percent in 2005/06, with the non-oil deficit widening from 15.2 percent of GDP to more than 20 percent over the same period (Figures 3a and 3b).

Figure 3a. Islamic Republic of Iran: Budgetary Aggregates
(As a percentage of non-oil GDP)



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

Figure 3b. Islamic Republic of Iran: Budgetary Aggregates
(As a percentage of GDP)



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

6. **The fiscal expansion is projected to continue in 2006/07.** Notwithstanding a projected increase in non-oil revenues associated with a strong performance of direct taxes, a further increase in both current and capital outlays would result in a roughly balanced overall fiscal position (commitment basis) in 2006/07, with the non-oil deficit rising further to 21 percent of GDP (Text Table 1 and Tables 2 and 3).[1] Substantial resources were withdrawn from the OSF during 2005/06–2006/07 to finance government spending as well as net lending to the private sector (Table 4).[2] As a result, reserves in the OSF rose by only

[1] The original budget for 2006/07 was modified in October 2006 to cover the rising cost of gasoline imports, and a bill before parliament envisages a further increase in the budget appropriations for wages and salaries and the execution of investment projects.

[2] The OSF can lend up to 50 percent of its balance in foreign currency to the private sector via the domestic banking system.

Text Table 1. Islamic Republic of Iran: Consolidated Accounts of the Central Government and the Oil Stabilization Fund, 2004/05–2006/07 (In percent of GDP)			
			Proj.
	2004/05	2005/06	2006/07
Total revenues	24.4	29.6	30.0
Oil revenues	16.9	21.3	21.2
Non-oil revenues	7.4	8.2	8.7
OSF non-oil revenues	0.1	0.1	0.1
Total expenditures (commitment basis)	22.7	28.5	30.0
Total expenditures (cash basis)	22.7	24.1	31.5
Overall balance (commitment basis)	1.7	1.1	0.0
Overall balance (cash basis)	1.7	5.5	-1.5
Non-oil budget balance (commitment basis)	-15.2	-20.1	-21.2
Non-oil budget balance (cash basis)	-15.2	-15.8	-22.6
Financing	-1.7	-5.5	1.5
Foreign financing	0.0	0.0	0.2
Domestic nonbank financing	0.4	0.7	1.2
Bank financing	-2.1	-6.2	0.0

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

US$1.2 billion in 2005/06, reaching US$10.7 billion at the end of that fiscal year. OSF reserves are expected to increase further to US$12.4 billion by end-2006/07.

7. **A large portion of the additional expenditures committed in the last budget amendment for 2005/06 was shifted to 2006/07, which is expected to increase the pressures on monetary policy.** Due to this deferred spending, the fiscal outturn on a cash basis for 2005/06 was considerably better than that on a commitment basis. As these resources are spent, a considerable injection of liquidity is expected to take place this fiscal year.

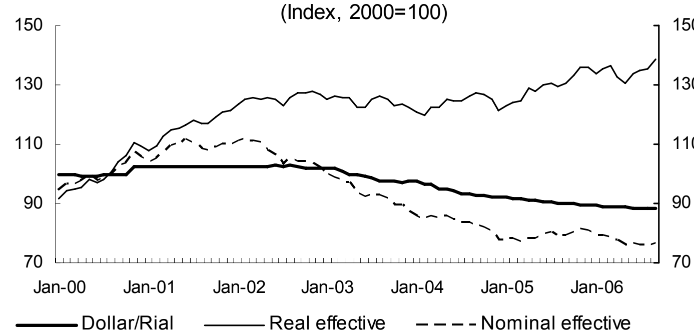
8. **Monetary policy remains constrained by fiscal dominance and limitations on the effective use of the available monetary instruments.** The large spending out of oil revenues has continued to challenge the ability of the Central Bank of Iran (CBI) to meet its monetary targets. Broad money increased at an annual rate of about 35 percent in 2005/06 and the first half of 2006/07, with base money growing even more rapidly (Tables 5 and 6). Credit to the private sector has continued to grow at a strong pace. The CBI's efforts to mop up liquidity by placing central bank participation papers (CBPPs) have been hampered by the need to obtain parliamentary approval for new issues. Moreover, monetary conditions were eased in March 2006 by lowering the rate of return for state-owned banks' lending from 16 to 14 percent and setting the rate of return for private banks' lending, which was previously freely determined, at 17 percent.[3] In addition, in April 2006 parliament approved legislation

[3] The rates of return on deposits were kept broadly unchanged, ranging from 7 percent (short term) to 16 percent (five year). The rate of return on CBPPs had been reduced from 17 to 15½ percent in May 2005; it has been kept unchanged since then.

that commits the government and the CBI to reduce the rate of return on bank facilities to single digits by the end of the Fourth Five-Year Development Plan (FFYDP), in 2009/10.

9. **The nominal effective exchange rate appreciated in 2005/06.** From March 2002 (when the exchange rate was unified) through end-2004, exchange rate policy was mainly driven by concerns about external competitiveness, and succeeded in keeping the rial broadly stable in real effective terms. In 2005/06, to help contain the rapid monetary expansion associated with the buildup of international reserves, the rial was allowed to appreciate in nominal effective terms by 2.1 percent. This trend was partially offset during April–September 2006, as the U.S. dollar weakened against the euro. Owing to the inflation differential with its trading partners, Iran's real effective exchange rate appreciated by over 11 percent from March 2005 to September 2006 (Figure 4).

Figure 4. Islamic Republic of Iran: Exchange Rate Developments
(Index, 2000=100)



Sources: Datastream; and Fund staff estimates and projections.

10. **Reflecting the sharp increase in oil prices, external indicators continued to improve in 2005/06.** The external current account surplus rose to 7.4 percent of GDP, from 1.2 percent in 2004/05. Oil production was slightly over 4 million barrels per day (mbd) in 2005/06, with a substantial part being absorbed domestically. Oil export volumes remained flat at about 2.4 mbd, but higher crude prices led to a sharp increase in export receipts (Table 7). Despite the real exchange rate appreciation, non-oil exports grew rapidly, while import growth slowed following a substantial increase in the two previous years (Text Table 2).[4] The strong export performance continued in the first half of 2006/07, with import growth accelerating to over 20 percent.

Text Table 2. Islamic Republic of Iran: Sectoral Contributions
to the Annual Growth in Exports and Imports, 2003/04–2005/06
(In percent; unless otherwise indicated)

	2003/04	2004/05	2005/06
Exports (non-hydrocarbon)	29.6	14.7	53.0
Agriculture and traditional exports	8.2	-2.5	10.7
Fresh and dry fruit	4.6	-1.6	6.5
Industrial goods	21.1	16.4	41.2
Chemicals and petrochemicals	5.9	5.7	20.5
Other	13.6	0.5	14.5
Imports	19.4	33.1	10.9
Raw materials and intermediate goods	12.4	19.6	4.8
Capital goods	5.3	9.6	3.1
Consumer goods	1.7	3.8	3.0

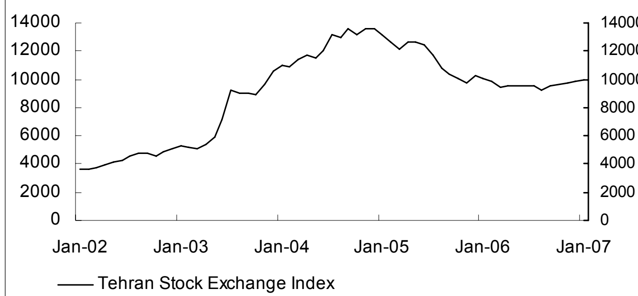
Sources: Iranian authorities; and Fund staff estimates.

[4] Although petrochemicals, in particular, have benefited from highly subsidized inputs, most other non-oil exports have also performed strongly in recent years.

Gross international reserves, including those in the OSF, rose to US$55.6 billion at end-September 2006 (nine months of imports of goods and nonfactor services), and the external debt declined to about 11 percent of GDP (Table 8).

11. **After increasing sharply in the two previous years, the stock market declined markedly in 2005/06.** Prices in the Tehran Stock Exchange (TSE) dropped by 22 percent owing to the political uncertainty associated with the presidential elections and the escalation of tensions on the nuclear issue (Figure 5). The correction had little repercussion on the financial sector due to the banks' limited exposure to the market (1 percent of assets). Stock prices recovered by about 5 percent from April 2006 to mid-January 2007.

Figure 5. Islamic Republic of Iran: Tehran Stock Exchange Index



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

12. **Structural reforms slowed during the initial months of the current administration, but the government recently decided to provide new impetus to the privatization program.** Following the amendment of Article 44 of the constitution, in July 2006 Iran's supreme leader Ayatollah Khamenei issued an executive order to privatize 80 percent of the state-owned companies over the next 10 years (excluding the upstream oil sector, crucial infrastructure, and some banks). The program has a strong social orientation, as part of the shares of a significant number of enterprises will be allocated to the poorer segments of the population (Box 2).

13. **Under a new Capital Markets Law,** the authorities have established a Security and Exchange Commission, and regulations are being developed on investment banking, mutual funds, and supervision of investment companies.

III. Policy Discussions

14. **During the discussions, the authorities indicated that their policies and reform strategy continue to be guided by the main directives contained in the FFYDP, adjusted in light of the higher oil revenues.** Specifically, the authorities stated that their main policy priority was to use the additional oil revenue to sustain growth and job creation, with particular emphasis on the expansion of the activities of small- and medium-size enterprises, the reduction of economic disparities among regions, and the social needs of the population. The authorities also noted that special attention will be given to the completion of a large number of investment projects.

Box 2. Public Enterprises and Privatization

Iran's economy is state dominated. A large number of state enterprises and quasi-state institutions (*bonyads*) are engaged in economic activities in virtually all sectors. Purely private firms are currently found mostly in agriculture, domestic and foreign trade, small-scale manufacturing, and mining. The private sector's role in large-scale economic activity remains negligible.

An initial effort toward privatization began in the late 1980s—largely through stock market offerings. A second wave of reform in the late 1990s sought to create a more attractive investment environment and included a new privatization program. However, complicated regulatory and legal structures and weak political support prevented an effective implementation of this program. The executive order issued in July 2006 has given new impetus to privatization. Excluded from privatization are the upstream oil sector, crucial infrastructure, some banks, and a few entities in the insurance, utilities, and transport sectors.

The current privatization program has a strong regional and social orientation. Priority access to subsidized financial support will be accorded to less developed and deprived regions, which will receive some 30 percent of total privatization proceeds. In the case of a significant number of small profitable enterprises, some 40 to 100 percent of the shares will be allocated to the poorest segments of the population (justice shares). The shares will be sold to holding companies or mutual funds, on behalf of the poor, at a 50 percent discounted price and with a 10-year repayment period. The government will retain 20 percent of the shares in the enterprises, and the remainder will be offered on the TSE. Foreign investors will be permitted to participate within a 10 percent limit, with approval of the Ministry of Economic Affairs and Finance. A number of other companies will be offered fully at the TSE.

About 19 enterprises have already been identified for privatization. Of these, 15 small-sized firms have been fully given away as justice shares, and four large firms have had 40 percent of their shares distributed as justice shares; another 40 percent will be offered to the private sector at the TSE.

The program envisages an annual privatization rate of 20 percent of state-owned companies, beginning with small-sized firms. State-owned banks will be privatized in the next 2 to 3 years, and the program as a whole should be completed by the end of the Fifth Five-Year Development Plan, in 2014/15.

15. **With energy prices projected to remain high and external demand continuing to support non-oil exports, Iran's near-term growth prospects look favorable.** Real GDP growth is projected at 5.8 percent in 2006/07 on account of continued strong activity in the non-oil sector. Though the external current account surplus would decline owing to the fiscal expansion, the international reserves position is expected to strengthen further. The continuation of the current macroeconomic policies, however, poses a serious risk of a further intensification of inflationary pressures, with detrimental effects on Iran's medium-term growth and employment prospects.[5]

16. **The staff encouraged the authorities to address these risks through a significant fiscal adjustment supported by a tighter monetary policy and greater exchange rate flexibility, along with structural reforms.** Discussions also focused on the importance of addressing the numerous distortions stemming from the extensive regulations and controls on

[5] Other risks include a sharp decline in oil prices in the event of a slowdown in global growth, and a further escalation of the political tensions associated with Iran's nuclear program, which would affect adversely investment and growth.

prices and rates of return, as well as the credit targets for specific sectors, and of phasing out subsidies, in particular those on domestic fuels, to increase economic efficiency and contain environmental degradation.

17. **The authorities noted that while they attached the highest priority to promoting growth and job creation, they were also concerned about inflation** and intended to lower it gradually to single-digit levels. They underscored that they would take steps to slow the pace of government spending if inflationary pressures were to persist.

A. Fiscal Policy

18. **The authorities indicated that, as a medium-term objective, the government intended to fully cover recurrent expenditures with non-oil revenues.** To move in that direction, the government would seek parliament's approval for the introduction of a VAT by mid-2007/08. Steps would also be taken to strengthen tax administration, particularly controls over large taxpayers, and to gradually reduce subsidies on several consumer items (e.g., sugar and fertilizers) (Box 3). Owing to the increase in the cost of external borrowing faced by Iran, the authorities intend to resort to further use of OSF resources, along with foreign financing.[6]

19. **The staff encouraged the authorities to take additional fiscal measures equivalent to 2 percentage points of GDP on an annual basis, starting in the last quarter of 2006/07, to reduce demand pressures and prevent a large further real appreciation.** This would require adopting a policy of expenditure restraint during the remainder of 2006/07 and intensifying the fiscal effort in 2007/08 by advancing the overdue reform of energy subsidies. The staff argued that the early adoption of a plan to phase out these subsidies would not only contribute to improving the overall fiscal position, but would also provide room for social spending and poverty reduction, including additional resources to compensate the poor for the impact of energy price hikes.

20. **The authorities indicated that efforts will be intensified to upgrade the transportation system as a precondition for phasing out energy subsidies.** The metro and bus networks would be expanded, and the use of natural gas encouraged in order to reduce gasoline consumption. The restructuring and upgrading of the system is expected to take three years. Once this process is under way, the government will consider a gradual adjustment of domestic fuel prices. The government also intends to expand domestic refining capacity, which would require substantial new investments.

21. **The staff prepared a baseline medium-term fiscal scenario based on current policies and WEO oil prices of early December 2006, including the introduction of the**

[6] In April 2006, Iran's sovereign debt was downgraded by Fitch from BB- to B+ due to the perceived increase in country risk.

Box 3. Iran's Subsidy System

Iran's social safety net reaches a significant portion of the poor, including through direct cash transfers, housing, and health and social security coverage. The country also maintains extensive subsidies, including on energy, food, and bank credit. Implicit and explicit energy subsidies alone reached 17½ percent of GDP in 2005/06, while total subsidies are estimated at over 25 percent of GDP.

Energy Subsidies

Because of energy subsidies, Iran's fuel product prices are among the lowest in the world, with gasoline priced at about 9 U.S. cents per liter. The low prices have led to a rapid growth in domestic consumption, which has averaged 10 percent a year over the past five years, with adverse environmental implications. As energy prices are well below those of most neighboring countries, the subsidy system has encouraged smuggling of fuel products. Although Iran is the fourth largest oil producer in the world, the strong growth in domestic consumption and a slow expansion of refining capacity have led to a surge in gasoline imports.

Nonenergy Subsidies

Price controls on over 20 goods are currently in place. Administered prices are set by the Consumer and Producer Protection Organization (CPPO) in collaboration with parliament and the country's economic council. The most important subsidized goods include cereals (50 percent of all subsidies); basic commodities such as sugar, edible oils and baby milk (25 percent); and other goods such as paper, agricultural machinery, fertilizers and pharmaceuticals (25 percent). The CPPO sets consumer prices below both border prices and producer prices, and the difference is borne by the budget. Explicit nonenergy subsidies amounted to US$5.5 billion (about 3 percent of GDP) in 2005/06, and are expected to reach US$6.1 billion in 2006/07.

Subsidy Reform

Phasing out energy subsidies has been on the government's reform agenda since the inception of the Third Five-Year Development Plan (1999/00–2003/04). However, little progress has been made to date. Since 2005, the government has been working on a four-pronged strategy to phase out these subsidies involving the introduction of a nationwide rationing scheme, a major upgrading of public transportation, the conversion of vehicle engines from gasoline to natural gas, and a phased increase in domestic fuel prices. The first phase of this strategy was expected to start at the beginning of 2006/07, but there have been delays in deploying the rationing scheme.

The government intends to reduce other subsidies (including those on wheat, sugar, agricultural machinery, and fertilizers) gradually, by replacing them with cash transfers.

VAT starting in 2008/09, as envisaged by the authorities. The scenario suggests that the projected non-oil primary fiscal deficit, including the implicit subsidies on fuels, would remain broadly in line with the sustainable path over the medium term if the long-term real oil price for the WEO reference basket were to be US$65 per barrel (similar to the WEO price for 2006/07). If the long-term real WEO oil price were US$55 per barrel, however, the projected non-oil primary deficits would be above the sustainable path (Text Table 3).

B. Monetary and Exchange Rate Policies

22. **To help reduce inflation, the fiscal effort needs to be accompanied by a tighter monetary stance.** The authorities concurred on the need to intensify open market operations to absorb part of the excess liquidity associated with the use of oil revenue. To that end, during the remainder of 2006/07 the CBI intends to place CBPPs in an amount of Rls 30 trillion (1½ percent of GDP), of which Rls 20 trillion has already been approved by

Text Table 3. Islamic Republic of Iran: Medium-Term Fiscal Sustainability, 2006/07–2011/12
(In percent of GDP)

	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
Medium-term outlook under current policies						
Non-oil primary fiscal deficit (incl. implicit energy subsidies)	35.8	34.1	32.3	32.2	31.8	31.9
Non-oil primary fiscal deficit	19.1	18.6	16.6	16.4	16.0	16.0
Sustainable consumption out of energy wealth 1/						
Long-term real oil price of US$65/barrel 2/	36.7	33.9	32.4	32.0	31.6	31.2
Long-term real oil price of US$55/barrel 3/	31.8	29.4	28.1	27.8	27.4	27.1
Memorandum item:						
Price of WEO oil reference basket	64.7	65.8	67.2	65.9	64.8	63.8
Price of Iranian basket	55.0	55.9	57.1	56.0	55.0	54.2

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

1/ Consistent with constant real per capita consumption out of energy wealth (IMF Country Report No. 04/308).
2/ Consistent with WEO projections for international oil prices until 2011/12, as of early December 2006. For 2012/13 onwards, energy prices are consistent with a constant price of US$65 per barrel (at 2006/07 constant dollars) for the WEO oil reference basket, adjusted for the composition of the Iranian basket.
3/ Consistent with WEO projections for international oil prices until 2011/12, as of early December 2006. For 2012/13 onwards, energy prices are consistent with a constant price of US$55 per barrel (at 2006/07 constant dollars) for the WEO oil reference basket, adjusted for the composition of the Iranian basket.

parliament. The authorities were of the view that the current rate of return on CBPPs (15½ percent) should be sufficiently attractive to domestic investors. They also noted that progress had been made in drafting a new Money and Banking Law providing more independence to the Money and Credit Council, and that a separate draft law would be presented to parliament empowering the CBI to place CBPPs as needed for purposes of managing liquidity.

23. **Preliminary monetary projections** prepared by the staff show that it would be difficult to reduce broad money growth below 30 percent by the end of 2006/07, even if the authorities are successful in placing the envisaged amount of CBPPs. As a result, inflation is unlikely to decline. The authorities were more optimistic than the staff regarding the ongoing process of remonetization and the future path of inflation.[7]

24. **The authorities viewed the current level of the real exchange rate as favorable to the tradable goods sector.** They noted that growth of non-oil exports remained very strong, notwithstanding the recent real appreciation of the currency. They also indicated that exchange rate policy would continue to be geared at containing inflation through a slower nominal depreciation of the rial against a basket of currencies composed mainly of the euro,

[7] The authorities were of the view that the behavior of inflation, which has not been in line with the strong growth of M2, pointed to a structural change in the relationship between these two variables. However, a forthcoming working paper prepared by the staff that was discussed with the authorities shows that money (M1) continues to play a dominant role in inflation in Iran, both in the long and short run.

the yen, and the U.S. dollar. The authorities did not favor greater exchange rate flexibility because of its potential adverse implications on the stability of the foreign exchange market.[8]

25. **Iran maintains an exchange restriction arising from limitations on the transferability of rial profits from certain foreign investments set out in the by-laws of the Foreign Investment Promotion and Protection Act (FIPPA)**. The Fund has approved the retention of this restriction through March 10, 2007. Recently, Iran's Ministry of Economic Affairs and Finance, which is responsible for implementing the FIPPA, has raised some questions about the effects of the relevant regulations. Staff are currently seeking to clarify this issue with the authorities.

C. The Financial Sector

26. **Iran's financial system remains dominated by large state-owned banks and extensive regulations, including controls on rates of return, subsidized credit for specific regions, and a credit target for the agricultural and water sectors.**[9] The scope for competition is limited and most banks lack commercial autonomy.[10] The staff called for a gradual elimination of distortionary regulations and controls, which in addition to being cumbersome, do not favor an efficient intermediation of financial savings and encourage the development of circumventing mechanisms.

27. **Financial soundness indicators weakened somewhat in 2005/06.** Bank profitability declined, reflecting the narrower rate of return margins, and the ratio of nonperforming loans to total loans increased to 9.9 percent, from 7.7 percent in 2004/05 (the authorities attributed this increase to continued improvements in accounting and data compilation). The average risk weighted capital/assets ratio remained almost unchanged at 9.8 percent, above the

[8] The three methodologies developed by the Consultative Group on Exchange Rate Issues (CGER) show no evidence of a serious misalignment of the rial. The macroeconomic balance approach shows that in recent years Iran's current account balance has oscillated around its long-term norm. Similarly, a regression-based estimate of the equilibrium exchange rate shows no evidence of misalignment, though it suggests that the rial may be somewhat undervalued. The external sustainability approach shows that a lower-than-projected current account surplus would be needed in 2006/07 to keep net foreign assets constant, also indicating that there may be some scope for a real appreciation of the rial.

[9] The state-owned banks (which hold 90 percent of deposits) comprise six commercial banks, four specialized banks, and one postal bank. Since 2001, six private banks have been licensed. All banks operate under Islamic law principles. Following the adoption of the FFYDP, all sectoral credit targets were eliminated, except for a target of 25 percent of total credit for the agricultural and water sectors. Bank data show that credit to agriculture was 18 percent of total credit in 2005/06. A credit target of 35 percent has also been introduced for small- and medium-sized enterprises at subsidized rates, with the subsidy being covered by the budget.

[10] The narrower margin on rates of return has encouraged banks to increase to 35 percent of total lending the share of profit-sharing agreements (i.e., contracts where the rates of return are determined ex-post and are not subject to controls). In these arrangements, market risks are borne proportionally to each party's participation in the project.

regulatory minimum. Two new private banks were licensed in 2005/06, raising the participation of private banks to 10½ percent of total deposits by year's end.[11]

28. **Reforms to strengthen bank supervision have continued, but substantial additional work is needed in this area.** Steps have been taken to move from compliance-based to risk-based prudential supervision, strengthen the banks' internal control mechanisms, and update information technology. In addition, the authorities are working on bringing more financial institutions under the supervision of the CBI. Looking forward, there is a need to revise the legal framework in order to provide for CBI autonomy, accountability, and effectiveness in supervisory matters; refine several prudential regulations; fully integrate on-site inspection with off-site work; and strengthen regulation enforcement.[12]

29. **The staff discussed with the authorities the impact of the recent decision by the U.S. Treasury to cut off Bank Saderat Iran (the second largest state-owned commercial bank) from direct and indirect access to the U.S. financial system.** The U.S. claims that its decision was adopted on the grounds that Bank Saderat had been involved in the financing of terrorist groups. The authorities stressed that two external audits of the activities of Bank Saderat conducted in Lebanon and London had found no evidence of any transaction involving terrorist groups. They also indicated that as a result of the U.S. decision, Bank Saderat was currently unable to issue letters of credit denominated in U.S. dollars and was experiencing slower deposit growth. In addition, several correspondent banks in Europe and Asia with activities in the U.S. were cutting off the bank from operating in other currencies. The authorities have sent a note requesting Fund management to ascertain whether the measure adopted by the U.S. Treasury constitutes an exchange restriction subject to Fund approval. More recently, the U.S. authorities also cut off Bank Sepah (Iran's fifth largest state-owned bank) from conducting any business linked to the U.S. financial system. The U.S. authorities claim that through its role as a financial conduit, Bank Sepah has facilitated purchases of sensitive material for Iran's missile program.

D. Structural Reforms

30. **Discussions on structural issues focused on the authorities' ambitious privatization program and on trade issues.** To a large extent, the success of the privatization effort depends on an effective transfer of majority control to the private sector, which could bring better technologies and management practices to the privatized companies. Moreover, the privatization program needs to be accompanied by an appropriate regulatory

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[11] However, new applications by private banks are expected to decline in the future in response to a substantial recent increase in the minimum capital requirement.

[12] An MCM mission visited Tehran in December 2006 to provide technical assistance on bank supervision, and the World Bank is expected to support the process of bank restructuring and privatization. In addition, an FSAP update is tentatively planned for 2007.

framework and by reforms aimed at streamlining the administrative burden, ensuring a level-playing field for private sector activities, and improving the business environment.[13] The authorities indicated that they were preparing competition and anti-monopoly legislation to support the privatization effort.

31. **No significant reforms in the trade system are expected in the near future.** Despite substantial progress on trade liberalization in recent years, Iran's simple average tariff is still around 25 percent and tariff dispersion remains high. The authorities indicated that no further trade liberalization measures were envisaged before the negotiations for accession to the World Trade Organization (WTO), which have been halted for political reasons, could be resumed. They identified the more favorable treatment given by WTO members to other WTO countries and competition from Asian countries in textiles and manufactures as the main obstacles faced by Iranian exports.

E. Medium-Term Scenarios

32. **The staff has prepared two illustrative medium-term scenarios: a "baseline" scenario that assumes the continuation of the authorities' current policies, and an "active" scenario that incorporates the staff's recommendations (Table 9).**[14] Under the baseline scenario, real GDP growth is projected to decelerate gradually to 4 percent a year, with inflation remaining in the double digits. The non-oil fiscal deficit is projected to decline from 20.4 percent of GDP in 2007/08 to 17.4 percent of GDP over the medium term, on account of the introduction of the VAT and a reduction in net lending by the OSF. The external current account would remain in surplus for most of the period, as high oil prices would encourage a gradual increase in capacity and provide substantial export revenues, but the surpluses would decline over time. The international reserves cover would decline below 9 months of imports by 2011/12. A US$10 decline in oil prices relative to the baseline would reduce the current account surplus by about 4 percentage points of GDP. In this case, the international reserves position would decline gradually to 3 months of imports by the end of the period.

33. **The active scenario assumes a stronger fiscal effort** through the adoption of additional fiscal measures equivalent, on a net basis, to 2–3½ percent of GDP over the medium term. Under this scenario, the non-oil fiscal deficit would decline from 18.5 percent of GDP in 2007/08 to 13.7 percent in 2011/12. Real GDP growth is projected to slow to 4 percent in 2007/08 and 2008/09 in response to the initial impact of the adjustment effort,

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[13] The World Bank's 2006 "Doing Business" report ranked Iran number 119 among 175 countries, compared with 113 in the previous year.

[14] Based on the World Economic Outlook (WEO) projections of early December 2006 (for a world oil price of US$64.5 per barrel in 2007) adjusted for the composition of the Iranian basket; oil prices for Iran in both scenarios are assumed to decline slightly from US$55 per barrel in 2006/07 to US$54.2 per barrel in 2011/12.

before rebounding gradually to 6½–7 percent a year over the medium term. Inflation would decline gradually, owing to the impact of phased increases in domestic fuel prices.[15] The external current account would remain in surplus throughout the period, with the gross international reserves cover increasing to about 12 months of imports.

F. Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT)

34. **AML reforms are ongoing in light of vulnerabilities identified by the authorities.** Iran has taken a number of steps in recent years to develop an AML framework. The authorities recognize that the current framework needs strengthening and have sought the Fund's assistance in this regard. An IMF staff team recently visited Tehran to identify key strengths and weaknesses in this area and help the authorities develop an action plan. Although money laundering is not criminalized as a specific offence and there is as yet no framework AML law in place, the CBI issued in 2002 an anti-money laundering regulation setting out preventive measures for banks and certain other financial institutions. A number of provisions and the scope of entities covered by the regulation, however, fall short of the Financial Action Task Force (FATF) standard.

35. **A draft framework AML law is nearing the final stages of the legislative process.** The new law should provide a firmer basis for an AML legal and institutional framework, inter alia, by criminalizing money laundering, expanding the list of entities covered by the AML framework, and authorizing the establishment of a Financial Intelligence Unit. Although a significant step, the draft law, as it stands, does not adequately cover the requirements of the FATF standard, and leaves a number of important aspects of the AML/CFT legal framework to by-laws that have yet to be prepared.

36. **With respect to combating the financing of terrorism, while there are measures in place to address some of the relevant requirements under the FATF Special Recommendations, there are important shortcomings.** Iran's criminal code includes terrorism offences, and the CBI has issued circulars requiring banks and nonbank financial institutions regulated by the CBI to report the accounts of designated terrorist groups. Lists of suspected terrorists under UN Resolutions 1267 and 1373 are circulated to the banks, but the mission raised questions about CBI's legal authority to freeze or block accounts. Although not specifically designed for CFT, there is also a declaration system in place for cross-border cash movements, a regulatory system for remittances, and a legal framework for nonprofit organizations. However, terrorism financing is not an offence under the law, there is no clear requirement for financial institutions to report suspicious transactions, and FATF requirements on wire transfers are not in place. The CBI is currently in the early stages of developing a draft CFT law to strengthen the legal framework in this area.

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[15] The active scenario assumes that energy prices will be adjusted gradually over the next five years to above 60 percent of border prices.

37. **The authorities indicated that both the AML law and the CFT law are being revised in line with the staff's recommendations,** and that they are in the process of requesting further assistance from the Fund as they pursue their efforts to strengthen Iran's AML/CFT framework.

G. Statistical Issues

38. **While the data provided to consultation missions are generally adequate for surveillance purposes, the timeliness and availability of key data in between missions remains inadequate, especially regarding the fiscal and financial sectors.** During the consultation discussions, progress was made in improving the consistency of fiscal data, but it was not possible to extend the coverage of the fiscal accounts owing to insufficient information and data deficiencies. Subscription to the SDDS has been delayed because current dissemination practices are not yet in compliance with SDDS requirements.

IV. Staff Appraisal

39. **The Iranian economy continued to register robust growth in 2005/06, with strong performance of the non-oil sector.** Economic activity was boosted by a weather-related recovery of agriculture and a strong policy stimulus. The external current account surplus rose sharply owing to the large increase in oil revenues, and international reserves increased further. The near-term growth prospects look favorable, and the external position is expected to strengthen further in 2006/07. Inflationary pressures, however, have intensified in recent months. Major downside risks include a sharp drop in oil prices and a further escalation of the tensions associated with the nuclear issue, which would affect adversely investment and growth.

40. **The main challenge faced by the authorities is to attain and sustain higher rates of growth to reduce unemployment, which is still high, while consolidating macroeconomic stability.** This requires the adoption of a consistent set of macroeconomic policies to lower inflation. It also calls for deepening and accelerating structural reforms, improving resource allocation, and fostering investor confidence.

41. **A substantial fiscal effort is needed to ease demand pressures and prevent a large erosion of external competitiveness.** The sharp rise in oil revenues in recent years has been accompanied by a marked widening of the non-oil fiscal deficit, largely on account of higher government spending. There is a need to reverse this trend by adopting strong corrective measures. In this regard, the authorities' intention to seek parliamentary approval for a VAT by mid-2007/08, and to gradually reduce nonenergy subsidies is welcome. However, the fiscal effort should also include the early adoption of a plan to phase out energy subsidies, which have reached staggering levels. This reform will also provide much needed additional resources for social spending, poverty reduction, and physical infrastructure.

42. **The role of the budget as the main instrument of fiscal policy should be strengthened.** Frequent recourse to the OSF to finance additional spending and lend resources to the private sector should be avoided, and consideration should be given to transferring net lending operations to the budget to improve transparency and strengthen fiscal management.

43. **Monetary policy should be tightened to help reduce inflation.** This requires greater flexibility in the use of monetary instruments accompanied by a gradual lifting of controls over rates of return. In this connection, the authorities are encouraged to reconsider the decision taken earlier this year to lower the rate of return on state-owned banks' lending and set the rate on private banks' lending, which was previously freely determined. In addition, efforts should continue in the context of the discussions on the new Money and Banking Law to provide the central bank with greater independence to adjust rates of return and place participation paper as needed to manage liquidity.

44. **Greater exchange rate flexibility is also desirable.** Notwithstanding the recent appreciation experienced by the rial in real effective terms, the present level of the real exchange rate appears favorable to the tradable goods sector. Efforts aimed at moderating further real appreciation by preventing a nominal appreciation of the rial are unlikely to be successful, as the real appreciation would eventually materialize through higher inflation. The authorities should therefore consider allowing for further exchange rate flexibility to reduce inflationary pressures. Looking ahead, the main tools to preserve external competitiveness are increased fiscal discipline and deeper structural reforms.

45. **In the financial sector, priority should be given to phasing out distortionary regulations and controls in order to promote a more efficient intermediation of financial savings.** There is also a need to increase competition and reduce the role of state-owned banks, including through a vigorous implementation of the government's privatization plans. In addition, efforts should continue to strengthen bank regulation and supervision, particularly in light of growing financial intermediation and the prospects of bank privatization. Close attention should be given to the quality of bank portfolios in view of the strong growth in credit to the private sector in recent years. It is also necessary to strengthen the draft AML and CFT laws, and to move ahead promptly with their implementation.

46. **On the structural front, the authorities' decision to launch an ambitious privatization program constitutes a welcome, major shift in the orientation of policies.** Ultimately, the success of the program will depend on an effective transfer of majority control to the private sector and on the implementation of reforms aimed at creating a level-playing field for private investment and improving the business climate. Regarding trade issues, further trade liberalization by lowering high tariff rates and reducing tariff dispersion, regardless of WTO accession negotiations, would be important to strengthen external competitiveness.

47. **Although progress has been made in improving Iran's macroeconomic statistics with Fund assistance, further work is needed to subscribe to the SDDS.** In particular, the dissemination practices for some key macroeconomic indicators fall short of SDDS requirements.

48. It is recommended that the next Article IV consultation with the Islamic Republic of Iran be held on the standard 12-month cycle.

Table 1. Islamic Republic of Iran: Selected Macroeconomic Indicators, 2004/05–2007/08 1/

(Quota: SDR 1,497.20 million)
(Population: 68.6 million)
(Per capita GDP: US$2,802)
(Poverty rate: 20.9 percent)
(Main exports: oil, gas, chemical and petrochemical products, and pistachios.)

	2004/05	Prel. 2005/06	Proj. 2006/07	Proj. 2007/08
Oil and gas sector				
Total oil and gas exports (in billions of U.S. dollars)	36.8	48.8	55.6	58.0
Average oil export price (in U.S. dollars/barrel)	34.1	49.1	55.0	55.9
Crude oil production (in millions of barrels/day)	3.9	4.0	4.1	4.2
	(Annual change; in percent; unless otherwise indicated)			
National accounts				
Nominal GDP at market prices (in billions of Iranian rials)	1,406,031	1,701,215	2,065,865	2,525,512
Nominal GDP (in billions of U.S. dollars)	161.3	188.5	...	...
Real GDP at factor cost	4.8	5.4	5.8	5.0
Real oil and gas GDP	2.6	0.6	1.5	2.3
Real non-oil GDP	5.1	6.0	6.4	5.3
CPI inflation (average)	15.2	12.1	14.6	17.8
CPI inflation (end of period)	16.7	10.2	18.0	17.0
GDP deflator at factor cost	20.6	15.9	15.3	16.4
Unemployment rate (in percent of labor force)	10.3	11.5	…	…
	(In percent of GDP at market prices)			
Investment and savings				
Investment	32.7	33.3	33.4	32.2
Change in stocks	7.4	6.8	5.6	4.6
Total fixed capital investment	25.2	26.5	27.8	27.6
Public	6.2	8.0	9.5	9.3
Private	19.0	18.5	18.4	18.3
Gross national savings	33.9	40.7	38.6	35.8
Public	7.9	13.5	8.0	8.6
Private	26.0	27.3	30.6	27.1
Savings/investment balance	1.2	7.4	5.2	3.6
Public	1.7	5.5	-1.5	-0.7
Private	-0.5	2.0	6.7	4.3
Budgetary operations				
Revenue	24.4	29.6	29.7	28.7
Oil	16.9	21.3	20.9	19.7
Non-oil	7.4	8.2	8.6	8.9
Expenditure and net lending, *of which:*	22.7	28.5	29.7	29.4
Current	16.5	19.4	20.2	20.1
Capital	5.1	6.9	8.2	8.5
Balance (commitment basis)	1.7	1.1	0.0	-0.7
Balance (cash basis)	1.7	5.5	-1.5	-0.7
Financing	-1.7	-5.5	1.5	0.7
Domestic financing (banking sector)	-2.1	-6.2	0.0	-0.9
Domestic financing (nonbank, including privatization)	0.4	0.7	1.3	1.7
External financing	0.0	0.0	0.2	-0.1
Non-oil balance (commitment basis)	-15.2	-20.1	-21.0	-20.4
Non-oil balance (cash basis)	-15.2	-15.8	-22.4	-20.4
Non-oil balance in percent of non-oil GDP	-20.6	-28.1	-28.8	-27.1
	(Annual percentage change)			
Monetary sector				
Net foreign assets	132.2	53.5	32.0	27.5
Net domestic assets	3.8	29.0	37.1	29.6
Credit to the private sector	24.2	27.8	23.5	20.8
Broad money	29.8	34.6	31.3	28.2
Velocity of broad money (index)	2.0	1.8	1.7	1.6
	(In billions of U.S. dollars; unless otherwise indicated)			
External sector				
Exports of goods and services	51.3	67.6	80.1	87.4
Imports of goods and services	-50.1	-54.5	-69.6	-79.4
Current account balance	2.0	14.0	11.4	9.0
In percent of GDP at market prices	1.2	7.4	5.2	3.6
External public and publicly guaranteed debt	23.1	24.3	24.8	24.9
Of which: short-term debt	10.3	10.5	10.5	10.5
Gross official reserves	33.3	46.3	59.1	69.2
In months of the following year's imports of goods and services	7.5	8.2	9.2	10.0
Memorandum items:				
Nominal effective exchange rate, 2000/01=100	81.6	79.5	…	…
Real effective exchange rate, 2000/01=100	124.6	132.4	…	…
Average exchange rate (Iranian rials per U.S. dollar)	8,719	9,026	…	…

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

1/ The Iranian fiscal year ends March 20.

Table 2. Islamic Republic of Iran: Consolidated Accounts of the Central Government and the Oil Stabilization Fund, 2004/05–2007/08
(In billions of rials)

	2004/05	Prel. 2005/06	Budget 2006/07	Proj. 2006/07	Proj. 2007/08
Revenues	342,828	503,765	531,622	612,630	724,617
Oil revenues	237,663	361,866	334,515	432,302	498,065
Oil revenues to the budget	214,165	316,277	329,322	393,246	477,619
Profit tax on the National Iranian Oil Company (NIOC)	0	31,869	26,134	26,134	43,602
Dividend transfers from NIOC	0	28,682	23,520	23,520	39,242
Budget allocation	150,413	186,342	151,801	175,256	153,836
Transfers from the Oil Stabilization Fund (OSF)	63,752	69,383	127,867	168,335	240,938
Oil revenues transferred to the OSF (after transfers to the budget)	23,498	45,589	5,193	39,056	20,446
Non-oil revenues to the budget	103,587	139,823	194,802	177,912	223,547
Tax	84,422	102,705	151,484	132,116	165,660
Direct tax	41,897	52,161	78,663	71,408	90,262
Indirect tax	9,437	14,590	15,652	16,336	20,650
Customs duties	33,088	35,954	57,169	44,371	54,749
Nontax	19,166	37,118	43,318	45,796	57,887
Non-oil revenues to the OSF	1,578	2,076	2,305	2,416	3,006
Expenditure	319,290	484,332	536,859	613,198	741,487
Central government expenditures	303,230	447,570	536,859	587,371	721,283
Current expenditures	231,923	330,884	377,935	417,773	506,398
Compensation of employees	112,206	153,220	...	175,437	214,471
Wages and salaries	93,656	137,180	...	157,071	192,019
Social contributions	18,550	16,040	...	18,366	22,452
Interest payments	2,752	4,264	...	4,264	4,264
Subsidies	42,463	53,192	...	65,628	80,230
Goods and services	30,837	41,637	...	51,371	62,801
Grants	4,855	2,168	...	2,483	3,035
Social benefits	3,613	7,142	...	8,178	9,997
Gasoline imports	0	35,748	...	45,830	52,649
Other	35,198	33,513	...	64,582	78,951
Capital expenditures	71,307	116,687	158,924	169,598	214,885
OSF expenditures	16,060	36,762	...	25,827	20,204
Domestic on-lending	16,060	19,370	...	25,827	20,204
Other	0	17,392	...	0	0
Overall balance (commitment basis)	23,538	19,433	-5,237	-568	-16,870
Overall balance (cash basis)	23,538	93,103	-5,237	-30,568	-16,870
Non-oil balance (commitment basis)	-214,125	-342,433	-339,752	-432,870	-514,934
Non-oil balance (cash basis)	...	-268,763	...	-462,870	...
Financing	-23,538	-93,103	...	30,568	16,870
Foreign financing	288	626	...	4,983	-2,874
Domestic financing	-23,826	-93,729	...	25,585	19,744
Banking system	-29,157	-104,862	...	-353	-22,607
Central bank	-36,175	-80,907	...	1,504	-18,501
Commercial banks	7,018	-23,955	...	-1,857	-4,106
Other domestic, including privatization	5,330	11,133	...	25,938	42,351

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

Table 3. Islamic Republic of Iran: Consolidated Accounts of the Central Government and the Oil Stabilization Fund, 2004/05–2007/08

(In percent of GDP; unless otherwise indicated)

	2004/05	Prel. 2005/06	Budget 2006/07	Proj. 2006/07	Proj. 2007/08
Revenues	24.4	29.6	25.7	29.7	28.7
Oil revenues	16.9	21.3	16.2	20.9	19.7
Oil revenues to the budget	15.2	18.6	15.9	19.0	18.9
Profit tax on NIOC	0.0	1.9	1.3	1.3	1.7
Dividend transfers from NIOC	0.0	1.7	1.1	1.1	1.6
Budget allocation	10.7	11.0	7.3	8.5	6.1
Transfers from OSF	4.5	4.1	6.2	8.1	9.5
Oil revenues transferred to the OSF (after transfers to the budget)	1.7	2.7	0.3	1.9	0.8
Non-oil revenues to the budget	7.4	8.2	9.4	8.6	8.9
Tax	6.0	6.0	7.3	6.4	6.6
Direct tax	3.0	3.1	3.8	3.5	3.6
Indirect tax	0.7	0.9	0.8	0.8	0.8
Customs duties	2.4	2.1	2.8	2.1	2.2
Nontax	1.4	2.2	2.1	2.2	2.3
Non-oil revenues to the OSF	0.1	0.1	0.1	0.1	0.1
Expenditure	22.7	28.5	26.0	29.7	29.4
Central government expenditures	21.6	26.3	26.0	28.4	28.6
Current expenditures	16.5	19.4	18.3	20.2	20.1
Compensation of employees	8.0	9.0	...	8.5	8.5
Interest payments	0.2	0.3	...	0.2	0.2
Subsidies	3.0	3.1	...	3.2	3.2
Goods and services	2.2	2.4	...	2.5	2.5
Grants	0.3	0.1	...	0.1	0.1
Social benefits	0.3	0.4	...	0.4	0.4
Gasoline imports	0.0	2.1	...	2.2	2.1
Other	2.5	2.0	...	3.1	3.1
Capital expenditures	5.1	6.9	7.7	8.2	8.5
OSF expenditures	1.1	2.2	0.0	1.3	0.8
Domestic on-lending	1.1	1.1	0.0	1.3	0.8
Other	0.0	1.0	0.0	0.0	0.0
Overall balance (commitment basis)	1.7	1.1	-0.3	0.0	-0.7
Overall balance (cash basis)	1.7	5.5	-0.3	-1.5	-0.7
Non-oil balance (commitment basis)	-15.2	-20.1	-16.4	-21.0	-20.4
Non-oil balance (cash basis)	-15.2	-15.8	-15.4	-22.4	-20.4
		(In percent of non-oil GDP)			
Non-oil revenues	10.1	11.6	13.1	12.0	11.9
Expenditure	30.8	39.7	35.7	40.7	39.0
Non-oil budget balance	-20.6	-28.1	-22.6	-28.8	-27.1
			(In percent of GDP)		
Memorandum items:					
Net public debt	13.1	6.1	...	6.1	5.1
Gross public debt	26.3	22.4	...	19.1	16.6
Government assets	13.2	16.3	...	13.1	11.5
Of which: OSF reserves (in millions of U.S. dollars)	9,477	10,685	...	12,359	12,706
Implicit energy subsidies	10.5	15.7	...	16.4	...

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

Table 4. Islamic Republic of Iran: Operations of the Oil Stabilization Fund, 2004/05–2007/08
(In millions of U.S. dollars)

	2004/05	Prel. 2005/06	Proj. 2006/07	Proj. 2007/08
Total Inflows	10,388	13,036	22,362	25,998
Oil revenues inflows	10,207	12,806	22,105	25,702
Income revenues	181	230	258	296
On foreign assets	175	216	244	282
On domestic lending	6	14	14	14
Total Outflows	9,354	11,828	20,695	25,679
Transfers to the budget	7,512	7,755	17,942	23,692
Extra budgetary transfers	0	1,927	0	0
Net domestic on-lending	1,842	2,146	2,753	1,987
Issued letters of credit (LCs)	2,220	2,109	2,438	...
Maturing LCs	1,938	2,303	2,938	...
Repayment	96	157	185	...
Overall Balance	1,034	1,208	1,668	319
Financing	-1,034	-1,208	-1,668	-319
Change in foreign exchange deposits at the central bank (increase -)	-1,034	-1,208	-1,668	-319
Memorandum items:				
Oil Stabilization Fund (OSF) stock of foreign exchange deposits at the central bank	9,477	10,685	12,352	12,672
OSF stocks of domestic loans	2,615	4,761	7,514	9,501

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

Table 5. Islamic Republic of Iran: Central Bank Balance Sheet, 2004/05–2007/08
(In billions of rials; unless otherwise indicated)

		Prel.	Prel.	Proj.	
	2004/05	2005/06	2006/07Q2	2006/07	2007/08
Net foreign assets (NFA)	257,945	383,978	448,219	499,550	644,854
in millions of U.S. dollars	29,100	42,011	49,018	52,581	62,619
Foreign assets	294,783	423,071	508,159	561,827	712,359
Foreign liabilities	36,838	39,092	59,939	62,277	67,505
Net domestic assets (NDA)	-72,840	-127,108	-127,425	-121,060	-157,898
Net domestic credit	-17,006	-81,964	-86,234	-65,992	-78,215
Central government	-58,931	-139,838	-149,130	-138,334	-156,835
Claims	95,285	84,610	88,021	76,739	73,428
Deposits	154,216	224,448	237,151	215,073	230,263
Claims on banks	21,493	35,916	38,562	44,895	48,202
Claims on nonfinancial public enterprises (NFPEs)	20,432	21,957	24,334	27,447	30,418
Other items net, excluding central bank participation papers (CPPs)	-55,834	-45,143	-41,191	-55,068	-79,683
Base money	161,532	238,966	278,078	329,976	420,940
Currency	48,477	55,681	55,730	64,033	73,638
Currency in circulation	44,772	50,676	47,259	58,277	67,018
Cash in vaults	3,705	5,005	8,471	5,756	6,620
Reserves	102,723	164,860	178,179	195,210	245,170
Required reserves	94,573	128,002	150,510	170,181	219,360
Excess reserves	8,149	36,858	27,670	25,029	25,810
Deposits of NFPE and municipalities	10,332	18,424	44,169	70,733	102,132
Other liabilities	23,573	17,905	42,716	48,514	66,016
CPPs	20,250	10,769	13,171	30,000	40,000
Deposits of NFPE and municipalities in foreign exchange	3,323	7,136	29,545	18,514	26,016
Memorandum items:					
End-period change (in percent of base money)					
Base money	19.1	47.9	50.1	38.1	27.6
NFA	60.9	78.0	74.7	48.4	44.0
NDA (net of other liabilities)	-41.8	-30.1	-24.6	-10.3	-16.5

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

Table 6. Islamic Republic of Iran: Monetary Survey, 2004/05–2007/08 1/
(In billions of rials; unless otherwise indicated)

		Prel.		Proj.	
	2004/05	2005/06	2006/07Q2	2006/07	2007/08
Net foreign assets (NFA)	266,888	409,582	487,612	540,479	689,219
Foreign assets	548,992	709,573	796,044	860,941	1,036,579
Foreign assets of the Central Bank of Iran (CBI)	294,783	423,071	508,159	561,827	712,359
Foreign assets of banks	254,209	286,502	287,885	299,114	324,221
Foreign liabilities	282,104	299,991	308,432	320,462	347,361
Foreign liabilities of CBI	36,838	39,092	59,939	62,277	67,505
Foreign liabilities of banks	245,266	260,899	248,493	258,185	279,856
Net domestic assets (NDA)	450,005	580,563	670,984	796,101	1,031,865
Net domestic credit	873,806	1,015,350	1,132,117	1,264,661	1,520,815
Net credit to government	-53,544	-158,406	-166,527	-158,759	-181,366
Claims on nonfinancial public enterprises (NFPEs)	87,217	99,813	94,443	97,556	100,527
Claims on the private sector in rials	625,715	865,315	991,104	1,054,649	1,249,074
Claims on the private sector in foreign currency 2/	214,417	208,627	213,097	271,215	352,580
Other items, net, excluding CPPs	-423,801	-434,787	-461,133	-468,560	-488,951
Broad money (M3)	740,535	990,145	1,158,596	1,336,580	1,721,083
M2	692,707	932,308	1,074,590	1,224,211	1,569,886
Cash	44,772	50,676	47,259	58,277	67,018
Deposits	647,935	881,632	1,027,332	1,165,934	1,502,867
Demand deposits	214,883	278,532	307,552	369,842	481,421
Time deposits	433,052	603,100	719,780	796,092	1,021,446
CPPs held by nonbanks	20,250	10,769	13,171	30,000	40,000
Foreign exchange deposits	27,578	47,068	70,835	82,369	111,198
Memorandum items:					
Base money	161,532	238,966	278,078	329,976	420,940
M1	259,655	329,208	354,811	428,119	548,439
M2	692,707	932,308	1,074,590	1,224,211	1,569,886
Multiplier (M2/base money)	4.29	3.90	3.86	3.71	3.73
Income velocity of M2	2.03	1.82	1.92	1.69	1.61
End-period percentage changes					
NFA	132.2	53.5	49.5	32.0	27.5
NDA	3.8	29.0	40.6	37.1	29.6
Base money	19.1	47.9	50.1	38.1	27.6
M1	15.8	26.8	30.0	30.0	28.1
M2, excluding foreign currency deposits and CPPs	29.8	34.6	35.1	31.3	28.2
M3	31.0	33.7	37.7	35.0	28.8
Credit to the private sector and NFPEs in rials	33.6	35.4	34.2	19.4	17.1
Credit to private sector in rials	37.6	38.3	39.0	21.9	18.4
Total claims on private sector	24.2	27.8	29.2	23.5	20.8

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

1/ The Iranian fiscal year ends March 20.
2/ Includes on-lending of the Oil Stabilization Fund resources and claims under letters of credit for trade financing.

Table 7. Islamic Republic of Iran: Balance of Payments, 2004/05–2011/12 1/

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

		Prel.	Projection					
	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
Current account	1,952	14,038	11,431	8,957	8,124	4,266	114	-3,023
(In percent of GDP at market prices)	1.2	7.4	5.2	3.6	3.0	1.5	0.0	-1.0
Trade balance	6,165	19,044	16,530	15,162	15,066	12,124	9,296	7,937
Exports	44,364	60,013	70,514	76,498	80,344	82,479	84,992	88,125
Oil and gas	36,827	48,824	55,579	57,956	59,488	59,000	58,544	58,375
Crude oil	31,731	43,896	50,345	51,071	51,266	50,270	49,369	48,655
Petroleum products and natural gas	5,096	4,928	5,234	6,885	8,222	8,730	9,176	9,720
Refined products	2,650	3,704	4,765	6,159	7,443	7,786	8,058	8,422
Natural gas and others	2,446	734	469	725	779	944	1,118	1,298
Non-Oil and gas	7,537	11,189	14,935	18,542	20,856	23,478	26,447	29,750
Imports	-38,199	-40,969	-53,984	-61,336	-65,278	-70,354	-75,696	-80,188
Of which: gasoline	-2,639	-4,190	-5,745	-6,135	-6,581	-6,750	-6,927	-7,094
Services (net)	-5,012	-5,894	-6,057	-7,241	-8,060	-9,066	-10,487	-12,370
Credits	6,905	7,612	9,598	10,855	12,009	13,182	14,207	15,063
Of which: interest income	918	1,018	2,476	3,163	3,703	4,211	4,518	4,599
Debits	-11,917	-13,506	-15,655	-18,095	-20,069	-22,248	-24,693	-27,433
Of which: interest payments	-1,129	-1,307	-1,626	-1,962	-2,000	-2,011	-2,027	-2,047
Transfers (net)	799	888	959	1,036	1,119	1,208	1,305	1,409
Capital and financial accounts	7,416	27	1,416	1,081	1,376	1,465	1,405	1,405
Medium- and long-term capital	586	258	520	177	604	605	605	605
Bilateral project financing	49	185	336	-68	266	175	183	255
Other official financing and portfolio investment 2/	1,628	274	184	245	338	429	421	350
Oil prefinancing	-1,091	-201	0	0	0	0	0	0
Short-term capital 3/	5,462	247	-4	4	0	0	0	0
Other capital 4/	295	-1,254	-300	-300	-428	-340	-400	-400
Foreign direct investment and portfolio equity	1,073	776	1,200	1,200	1,200	1,200	1,200	1,200
Of which: buybacks	677	493	500	500	500	500	500	500
Errors and omissions 5/	-819	-1,033	0	0	0	0	0	0
Overall balance	8,548	13,032	12,847	10,038	9,501	5,731	1,519	-1,619
Change in gross official reserves (increase -)	-8,548	-13,032	-12,847	-10,038	-9,501	-5,731	-1,519	1,619
Change in central bank reserve liabilities (increase -)	113	121	2,278	0	0	0	0	0
Change in net official reserves (increase -)	-8,435	-12,911	-10,569	-10,038	-9,501	-5,731	-1,519	1,619
Memorandum items:								
Net official reserves (in millions of U.S. dollars)	29,100	42,011	52,581	62,619	72,119	77,850	79,369	77,750
Gross official reserves (in millions of U.S. dollars)	33,256	46,288	59,136	69,174	78,674	84,405	85,924	84,305
Of which: Oil Stabilization Fund 6/	9,477	10,685	12,352	12,672	16,109	17,788	18,076	15,986
(in months of the following year's imports)	7.5	8.2	9.2	10.0	10.4	10.3	9.8	8.9
Gross foreign liabilities of the Central Bank of Iran (in millions of dollars)	4,156	4,277	6,555	6,555	6,555	6,555	6,555	6,555
External debt service (as percent of exports) 7/	6.4	4.0	3.2	4.6	4.6	4.4	4.7	4.7
External debt (in percent of GDP)	14.3	12.9	11.3	10.0	9.3	8.9	8.5	8.2
Oil exports (in millions barrels/day)	2.6	2.4	2.5	2.5	2.5	2.5	2.5	2.5
Oil exports average price (in U.S. dollars/barrel)	34.1	49.1	55.0	55.9	57.1	56.0	55.0	54.2
Real merchandise exports (percentage change)	10.2	-3.0	6.8	7.6	4.2	4.7	5.2	5.5
Hydrocarbon	11.2	-8.0	1.7	2.5	0.4	1.1	1.0	1.3
Non-hydrocarbon	5.2	32.5	29.9	21.5	11.1	11.2	11.1	10.9
Real merchandise imports (percentage change)	21.8	4.8	31.6	13.7	6.4	7.7	7.2	5.6
GDP (in billions of dollars)	161	188	220	248	269	283	297	312

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

1/ The Iranian fiscal year ends March 20.
2/ Includes World Bank lending as well as Eurobond borrowing in 2002/03.
3/ Letters of credit related borrowing, a minor part of which may have maturities in excess of one year.
4/ Including commercial banks.
5/ Including valuation adjustments.
6/ Represents the part of the Oil Stabilization Fund that is invested together with the gross international reserves.
7/ Excluding short-term debt.

Table 8. Islamic Republic of Iran: Vulnerability Indicators, 2001/02–2006/07 1/

	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07Q2
External solvency indicators						
Real effective exchange rate (REER) (end of period; percent change)	11.7	-0.2	-2.6	1.9	9.4	6.2
Total public and publicly guaranteed external debt (in billions of U.S. dollars)	7.2	12.5	17.0	23.1	24.3	24.1
(In percent of GDP)	1.9	10.8	12.7	14.3	12.9	10.3
Short-term external debt (in billions of U.S. dollars)	2.7	2.1	4.8	10.3	10.5	9.6
(In percent of GDP)	0.7	1.8	3.6	6.4	5.6	4.1
(In percent of exports of goods and services) 2/	9.9	6.4	12.1	20.4	15.8	12.4
External debt service (in percent of exports of goods and services) 2/ 3/	7.4	3.7	4.5	6.4	4.0	3.4
External liquidity indicators						
Total official reserves (in billions of U.S. dollars)	16.6	21.4	24.7	33.3	46.3	55.6
(In months of the following year's imports of goods and services) 2/	6.8	6.5	6.1	7.5	8.2	8.8
(In percent of short-term external debt)	625	1031	516	324	441	577
Commercial banks net foreign assets (in billions of U.S. dollars)	-0.4	-2.3	-7.1	1.0	2.8	4.3
Foreign assets	1.2	6.4	7.3	28.7	31.3	31.3
Foreign liabilities 4/	1.6	8.6	14.4	27.7	28.5	27.0
Oil and oil-related exports (in percent of exports of goods)	80.9	81.3	80.5	83.0	81.4	79.8
Public sector solvency indicators						
Public and publicly guaranteed debt (in percent of GDP)	13.7	25.4	26.4	26.3	22.4	…
Oil revenue (in percent of total revenue)	58.2	69.6	69.7	69.3	71.8	…
Financial sector indicators						
Risk-weighted capital adequacy of banks (in percent) 5/	6.9	4.5	5.7	9.5	9.8	…
Ratio of nonperforming loans of banks (in percent of total loans) 5/	5.4	5.7	7.4	7.7	9.9	…
Loan provisions as a percentage of nonperforming loans	31.0	36.7	44.6	57.9	47.1	…
Net profit margin of banks to total assets (in percent)	2.2	2.5	1.0	1.3	0.8	…
Net domestic credit (percent change)	-0.9	33.7	35.1	3.8	29.0	40.6
Private sector credit in local currency (percent change)	34.1	34.9	39.1	37.6	38.3	39.0
Net domestic credit (in percent of GDP)	35.7	34.6	39.1	32.0	34.1	29.2
Market assessment/financial market indicators						
Stock market price index (percent change; end-of-period)	26.2	34.7	124.8	6.4	-21.9	5.3 6/
Stock market capitalization (in percent of GDP)	8.8	10.6	22.0	22.8	15.8	16.8 6/
Fitch sovereign rating	B+	B+	B+	BB-	BB-	B+

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. The substantial increase in 2003/04 arises from a reclassification in line with STA recommendations.
5/ Islamic banks exhibit important differences in their risk profile and asset classification, which limit international comparability.
6/ As of January 15, 2007.

Table 9. Islamic Republic of Iran: Medium-Term Scenarios, 2005/06–2011/12 1/

	Prel.	Proj.					
	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
	I. Baseline (Current Policies) Scenario						
	(Annual percentage change)						
Real GDP at market prices	4.4	5.3	5.0	5.0	4.5	4.5	4.0
CPI inflation (end of period)	10.2	18.0	17.0	16.0	16.0	16.0	16.0
	(In percent of GDP; unless otherwise indicated)						
Overall general government balance (cash basis)	5.5	-1.5	-0.7	0.2	-0.7	-1.3	-2.2
Non-oil balance (commitment basis)	-20.1	-21.0	-20.4	-18.3	-18.1	-17.5	-17.4
Non-oil balance (cash basis)	-15.8	-22.4	-20.4	-18.3	-18.1	-17.5	-17.4
Gross debt	22.4	19.1	16.6	15.0	14.2	13.5	12.9
Gross assets	16.3	13.1	11.5	11.6	11.3	10.6	9.2
Of which: Oil Stabilization Fund (OSF)	0.6	0.6	0.5	0.5	0.5	0.4	0.3
OSF balance (in billions of U.S. dollars)	10.7	12.4	12.7	16.1	17.8	18.1	16.0
External current account balance	7.4	5.2	3.6	3.0	1.5	0.0	-1.0
Investment	33.3	33.4	32.2	31.3	31.5	31.0	30.9
Change in stocks	6.8	5.6	4.6	3.8	3.6	3.5	3.4
Total fixed capital investment	26.5	27.8	27.6	27.6	27.8	27.5	27.5
Public	8.0	9.5	9.3	9.1	9.2	9.0	9.1
Private	18.5	18.4	18.3	18.4	18.6	18.5	18.4
Gross national savings	40.7	38.6	35.8	34.3	33.0	31.0	29.9
Public	13.5	8.0	8.6	9.4	8.5	7.7	6.9
Private	27.3	30.6	27.1	25.0	24.5	23.4	23.0
Gross official reserves (in billions of U.S. dollars)	46.3	59.1	69.2	78.7	84.4	85.9	84.3
In months of imports of goods and services	8.2	9.2	10.0	10.4	10.3	9.8	8.9
	II. Active Scenario						
	(Annual percentage change)						
Real GDP at market prices	4.4	5.0	4.2	4.5	5.5	6.5	7.0
CPI inflation (end of period)	10.2	16.5	13.5	11.0	9.5	8.5	7.5
	(In percent of GDP; unless otherwise indicated)						
Overall general government balance (cash basis)	5.5	-1.0	1.3	2.7	2.0	1.7	1.2
Non-oil balance (commitment basis)	-20.1	-20.6	-18.5	-16.2	-15.6	-14.5	-13.7
Non-oil balance (cash basis)	-15.8	-21.9	-18.5	-16.2	-15.6	-14.5	-13.7
Gross debt	22.4	19.1	16.8	15.4	14.8	14.2	13.7
Gross assets	16.3	14.8	14.9	17.1	19.1	21.0	22.3
Of which: OSF	0.6	0.6	0.8	1.0	1.2	1.3	1.3
OSF balance (in billions of U.S. dollars)	10.7	13.2	18.4	28.3	37.5	46.7	55.2
External current account balance	7.4	5.5	4.1	3.9	2.8	2.0	1.0
Investment	33.3	33.9	33.0	32.8	33.3	33.5	34.5
Change in stocks	6.8	5.6	4.6	3.8	3.6	3.5	3.4
Total fixed capital investment	26.5	28.4	28.4	29.1	29.7	30.0	31.2
Public	8.0	9.5	9.6	10.1	10.5	11.0	12.2
Private	18.5	18.9	18.8	18.9	19.1	19.0	18.9
Gross national savings	40.7	39.4	37.0	36.7	36.1	35.5	35.5
Public	13.5	8.5	10.9	12.8	12.5	12.7	13.4
Private	27.2	30.9	26.2	23.9	23.6	22.8	22.1
Gross official reserves (in billions of U.S. dollars)	46.3	59.8	71.4	83.0	92.3	100.5	109.4
In months of imports of goods and services	8.3	9.4	10.6	11.4	11.9	11.7	11.8
Memorandum items:							
Oil and gas sector							
Total oil and gas exports (in billions of U.S. dollars)	48.8	55.6	58.0	59.5	59.0	58.5	58.4
Average oil export price (in U.S. dollars/barrel)	49.1	55.0	55.9	57.1	56.0	55.0	54.2
Crude oil production (in millions of barrels/day)	4.0	4.1	4.2	4.3	4.4	4.5	4.6

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

1/ The Iranian fiscal year ends March 20.

INTERNATIONAL MONETARY FUND

ISLAMIC REPUBLIC OF IRAN

2006 Article IV Consultation
Informational Annex

February 1, 2007

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Annexes

ANNEX I. Islamic Republic of Iran: Relations with the Fund

As of December 31, 2006

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

II. General Resources Account

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

III. SDR Department

	SDR Million	Percent of Allocation
Net cumulative allocation	244.06	100.00
Holdings	275.76	112.99

IV. Outstanding Purchases and Loans None

V. Financial Arrangements None

VI. Projected Payments to Fund

(SDR Million; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2007	2008	2009	2010	2011
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

VII. Exchange System

The exchange rate is determined in the interbank foreign exchange market. The exchange rate regime was reclassified, effective January 1, 2005, from the category of managed float with no predetermined path for the exchange rate to a de facto crawling peg system. 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 one exchange restriction and two multiple currency practices subject to Fund jurisdiction under Article VIII, Sections 2(a) and 3.

a. **The exchange restriction** arises from limitations set out in the by-laws adopted to implement the Foreign Investment Promotion and Protection Act on the transferability of (periodic) rial profits from certain foreign direct investments.

b. **The multiple currency practices** arise from:

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; and

Obligations of entities that had received allocations of foreign exchange at subsidized "allocated rates" under the previous multiple exchange rate system to surrender unused allocations to the Central Bank of Iran at the allocation rate.

VIII. **Last Article IV Consultation**

The last Article IV consultation was concluded by the Executive Board on March 10, 2006.

IX. **Technical Assistance**

Since FY 2003, Iran received the following technical assistance:

FAD

FY 2004 - Tax administration and VAT

LEG

FY 2007 - Anti-Money Laundering/Combating Financing of Terrorism regulations

MCM/MFD

FY 2003 - Banking Supervision, short visits by MFD expert
FY 2003 - Exchange System, reviewed the foreign exchange system after the exchange rate unification; explored issues of capital account liberalization
FY 2004 - Article VIII acceptance mission
FY 2007 - Banking regulation and supervision, and monetary modeling.

STA

FY 2003 - Multisector mission, assessed current data dissemination practices against the requirements of the SDDS and provided technical assistance on ways to improve the compilation of the macroeconomic statistics that would facilitate SDDS subscription
FY 2004 - Follow-up mission on progress in meeting SDDS requirements
FY 2005 - Follow-up mission on progress in meeting SDDS requirements in balance of payments and international investment position

ANNEX II. Islamic Republic of Iran: Relations with the World Bank Group
(As of November 30, 2006)

1. As of November 30, 2006, Iran had received 54 World Bank loans totaling $3,163 million net of cancellations and terminations, of which $2,145 million had been disbursed. The ongoing portfolio consists of nine loans for a total amount of $1,355 million, of which $1,001 million remain undisbursed.

2. World Bank lending to Iran resumed in 2000 after a hiatus of seven years. This coincided with the revival of the government's large reconstruction effort. Between 2000 and April 2005, the Board approved several projects: Tehran Sewerage Project, Second Primary Health Care and Nutrition Project, two Emergency Earthquake Reconstruction projects (following the Qazwin and Bam earthquakes), Environmental Management, Ahwaz and Shiraz Water and Sanitation, Urban Upgrading and Housing Reform, Northern Cities Water and Sanitation, and Alborz Integrated Land and Water Management.

3. On May 2001, a two-year Interim Assistance Strategy (IAS) was approved by the Board of Executive Directors. This strategy followed a two-pronged approach: (a) policy dialogue on the reform program through nonlending services; and (b) targeted lending in key social and environment areas consistent with the Third FYDP objectives. During the IAS period, the World Bank undertook a series of economic studies in support of the government's reform efforts, which formed the basis for policy dialogue and analysis. These included a study on the reform of the Energy Pricing System, a Trade and Foreign Exchange System Reform Study, a Public Expenditure Review, and a Country Economic Memorandum (CEM), as well as other sectoral studies. In addition, Policy Review Notes were prepared for urban water, housing, agriculture, and air pollution control. Work is under way on the pension system and safety nets.

4. A new four-year Country Assistance Strategy (CAS) is under preparation. The overarching aim of the new CAS is to assist the government in implementing the structural reform agenda, supporting the transformation of the economy, promoting high and sustainable growth, and creating employment opportunities. The CAS puts emphasis on poverty alleviation and capacity building for a knowledge-based economy. It envisages a lending program in water and sanitation, urban transport, agriculture, community-based development, and education and vocational training. The analytical and advisory program proposes to include public finance, financial and public sector reform, and labor markets and human capital development, in addition to recently completed or ongoing work on growth diagnostics as well as public expenditure and pension strategies. The CAS seeks to align its policy recommendations with the government's priorities and the objectives of the Fourth FYDP. To support Iran's reform efforts, the World Bank is also intensifying its assistance for capacity building in the formulation, sequencing, and implementation of economic and sectoral policies.

5. The International Finance Corporation's (IFC) support of the World Bank's program for Iran will focus on selected investments as well as technical assistance and advisory services. IFC's activities will focus on the private sector, supporting higher and sustained growth and accelerating job creation. IFC will support the establishment of a modern, open, and competitive financial sector, a cornerstone for private sector development. As of November 30, 2006, IFC's committed portfolio in Iran was $29 million, primarily in the financial sector.

6. Iran became a full member of the Multilateral Investment Guarantee Agency (MIGA) in December 2003. In May 2005, MIGA issued $122 million in guarantee coverage for a joint venture petrochemical project, its first coverage ever for a project in Iran. MIGA also provided coverage for a small manufacturing plant in Tabriz, in the northwest of Iran, for an amount of $5 million in December 2005. There appears to be potential demand for MIGA guarantees among Iranian investors venturing abroad. As Iranian companies become more aware of MIGA's potential value added in South-South transactions, MIGA may see more requests for coverage, particularly in neighboring countries.

ANNEX III. Islamic Republic of Iran: Statistical Issues

Data provision to the Fund is generally adequate for effective surveillance; however, the data are reported with significant delays. The Central Bank of Iran (CBI) disseminates key statistical aggregates in its quarterly *Economic Trends,* also available at <http://www.cbi.ir/e/>. Since 2002, the Fund's Statistics Department has assisted the authorities in their efforts to subscribe to the Special Data Dissemination Standard (SDDS). The progress, however, has been slow and gaps in meeting SDDS requirements for data coverage, periodicity, and timeliness remain.

Real sector statistics

- National accounts statistics are reasonably sound. Improvements have been made in the coverage of the informal economy. However, there is scope for further progress, especially in the coverage of small-scale industries and services. Also, the CBI and the Statistical Council of Iran (SCI) have undertaken to review and unify their respective GDP estimates.

- Price statistics are sound and released in a timely manner. The official labor market statistics are released by the SCI, and are based on the definitions recommended by the International Labor Organization (ILO). The data are based on an urban and rural population sample of about 100,000 households, and the threshold for considering a person employed is two days a week. Labor market statistics, however, could benefit from further improvement, particularly with regard to employment and wage data.

Government finance statistics

- The data are compiled in accordance with the *Government Finance Statistics Manual, 2001 (GFSM 2001)* for the core central government operations. Starting 2003/04, the fiscal data include implicit energy subsidies.

- 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, five procurement and distribution centers, and the OSF.

- The submission for the 2006 *Government Finance Statistics Yearbook* included for the first time data for general and local governments.

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

- Financing data in the GFS are not broken down by residency of debt holders or by type of debt instruments. The discrepancy between fiscal and monetary data on deficit financing has often been relatively large, partly due to foreign currency valuation problems. There is a need to develop a comprehensive database on domestic public debt, with a breakdown by domestic creditor.

- The Bonyad-e-Mostazafan va Janbazan (BMJ, Foundation of the Oppressed and Injured) could be considered a holding company and classified in the nonfinancial public corporations sector.

Monetary statistics

- Monthly monetary data are reported to STA on a regular basis for publication in *IFS,* but periodicity has been lagging.

- Compilation of monetary statistics diverges from international standards in the application of the residency criterion and in sectorization and classification. The authorities are undertaking improvements in each of these areas, in line with the recommendations of two recent 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)*. This will allow compilation of balance of payments statistics on a quarterly basis. Annual balance of payments data up to 2000 have been reported to STA for publication in *BOPSY* and *IFS*.

- 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: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
(AS OF DECEMBER 19, 2006)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	Dec. 2006	Dec. 2006	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]					
Reserve/Base Money	Sep. 2006	Nov. 2006	M	M	Q
Broad Money	Sep. 2006	Nov. 2006	M	M	Q
Central Bank Balance Sheet	Sep. 2006	Nov. 2006	M	M	Q
Consolidated Balance Sheet of the Banking System	Sep. 2006	Nov. 2006	M	M	Q
Interest Rates[2]	Sep. 2006	Nov. 2006	M	M	Q
Consumer Price Index	Nov. 2006	Jan. 2007	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]—General Government[4]	2005/06 (Mar. 20, 2006)	Nov. 2006	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[3]—Central Government	2005/06 (Mar. 20, 2006)	Nov. 2006	A	A	A
Stocks of Central Government and Central Government—Guaranteed Debt[5]	Aug. 2006	Nov. 2006	A	A	A
External Current Account Balance	Aug. 2006	Nov. 2006	M	M	Q
Exports and Imports of Goods and Services	Aug. 2006	Nov. 2006	M	A	A
GDP/GNP	2005/06	Nov. 2006	Q	Q	Q
Gross External Debt	Aug. 2006	Nov. 2006	M	A	A

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, 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).

Statement by the IMF Staff Representative
February 23, 2007

This statement updates the information provided in the staff report for the 2006 Article IV consultation with the Islamic Republic of Iran that was issued on February 1, 2007. The new information does not alter the thrust of the staff appraisal.

- Following the downward revision of the WEO oil price baseline on January 22, 2007, the staff has updated the medium-term macroeconomic projections presented in the staff report. The lower oil prices would increase the fiscal deficit and reduce the current account surplus relative to the staff report's "current policies" scenario by about 2¾ percentage points of GDP, on average, over the medium term. Gross international reserves would be $41 billion (4½ months of imports) by the end of 2011/12. These projections are subject to a high degree of uncertainty, as oil prices remain volatile. Moreover, the authorities are considering significant measures to strengthen the fiscal position (see below).

- End-of-period inflation increased to 15.9 percent in December 2006, from 14.7 percent in November. The rial has remained stable vis-à-vis the U.S. dollar in the past two months. Parliament recently approved the issuance of Rls 10 trillion (close to 4 percent of base money) in central bank participation papers (CBPPs) to help absorb liquidity. This is in addition to the issuance of Rls 20 trillion in CBPPs, which had already been approved by parliament.

- The fiscal outturn for 2006/07 is now likely to be significantly better than projected. The staff report's fiscal projections for 2006/07 included an additional budgetary appropriation of Rls 45 trillion (2¼ percent of GDP), to be financed mainly by resources from the Oil Stabilization Fund, which was expected to be approved before the end of the fiscal year. Following parliamentary opposition, the government scaled down the requested appropriation to Rls 30 trillion (1½ percent of GDP). However, the proposed amendment bill has been rejected by the Plan and Budget Commission and has not been approved by parliament.

- The 2007/08 budget was submitted to parliament in late January 2007. Based on preliminary information, the proposed budget is based on a conservative oil price of US$33.7 per barrel, compared with US$46.9 per barrel implied in the new WEO oil price baseline. The budget proposal envisages a non-oil fiscal deficit of about 14½ percent of GDP, compared with 20½ percent of GDP in the staff report, owing to substantial cuts in current outlays. In particular, the proposal envisages cuts in the subsidies on selected nonenergy items and a reduction in gasoline imports, which are financed through the budget. The reduction in gasoline imports will be supported by the introduction of a rationing scheme. While the proposed fiscal retrenchment is very ambitious, the parliamentary discussion of the budget and its implementation are likely to involve changes.

- The authorities informed the staff that the share of deposits held by private banks rose from 10½ percent of total deposits in March 2006 to 15 percent in November.

- The authorities have taken steps to improve the timeliness of data dissemination. In January 2007, the Central Bank of Iran started disseminating on its website the monthly electronic publication *Selective Economic Indicators*. In addition, the Tehran Stock Exchange plans to disseminate market data and related information, including English translations of rules and regulations.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 07/29
FOR IMMEDIATE RELEASE
March 5, 2007

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

IMF Executive Board Concludes 2006 Article IV Consultation with the Islamic Republic of Iran

On February 23, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Islamic Republic of Iran.[1]

Background

With high oil prices and a significant policy stimulus, the Iranian economy continued to grow strongly in 2005/06 (fiscal year starts March 21). Real GDP growth is estimated at 5½ percent. Oil GDP growth was modest owing to capacity constraints, while non-oil GDP growth was broad-based, reaching 6 percent. The tensions associated with the nuclear issue, however, had some adverse effects on private investment. Unemployment remains relatively high (10.2 percent in the first half of 2006/07).

End-of-period inflation decelerated to 10.2 percent in 2005/06, owing to a fall in food prices and a slower rate of depreciation of the rial. After declining further to below 7 percent in April 2006, the 12-month rate of inflation increased in recent months, reaching 15.9 percent in December 2006. The rial remained broadly stable in nominal effective terms during the 18 months ended in September 2006. Owing to the inflation differential with its trading partners, Iran's real effective exchange rate appreciated by 11 percent over the same period.

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

Financial policies have been expansionary during the last two fiscal years. Although the overall fiscal position is projected to be in surplus, the central government non-oil deficit (commitment basis) is expected to increase to 17¾ percent of GDP in 2006/07, from 14¼ percent in 2004/05. Large spending out of oil revenues has continued to challenge the ability of the Central Bank of Iran to meet its monetary targets. Broad money increased at an annual rate of about 35 percent in 2005/06 and the first half of 2006/07, and credit to the private sector has continued to grow at a strong pace. In March 2006, the authorities lowered the rate of return (interest rate) on state banks' lending and set the rate on private banks' lending, which was previously freely determined. After a sharp correction experienced in 2005/06, prices in the Tehran Stock Exchange recovered somewhat in April–December 2006.

External indicators continued to improve in 2005/06. The current account surplus rose to 7½ percent of GDP, from 1¼ percent in 2004/05, reflecting higher crude prices and a strong performance of non-oil exports. Gross international reserves, including those in the Oil Stabilization Fund (OSF), rose to the equivalent of nine months of imports of goods and nonfactor services at end-September 2006, and the external debt declined.

Although the pace of structural reforms slowed during the initial period of the current administration, the government has recently provided new impetus to the privatization program. Following the amendment to Article 44 of the constitution and an executive order by Iran's supreme leader, the authorities intend to privatize some 80 percent of the state-owned companies over the next 10 years (excluding the upstream oil sector, crucial infrastructure, and some banks).

With energy prices projected to remain high and external demand continuing to support non-oil exports, Iran's near-term growth prospects look favorable. Real GDP growth is projected at 5.8 percent in 2006/07 on account of continued strong activity in the non-oil sector. Inflation is likely to remain entrenched in the double digits. The external current account surplus is projected to decline owing to the fiscal expansion, but the international reserves position is expected to strengthen further during the remainder of 2006/07. An escalation of the tensions associated with the nuclear program could, however, affect adversely the growth outlook.

The 2007/08 draft budget was submitted to parliament in late January 2007. The proposed budget is based on a conservative oil price and envisages a reduction in the central government non-oil deficit to about 14½ percent of GDP in 2007/08, owing to substantial cuts in current outlays, including subsidies.

Executive Board Assessment

Executive Directors commended Iran's continued robust economic growth and improved external position, which reflected both a strong performance of the non-oil sector and favorable oil market conditions. Directors expressed concern, however, that macroeconomic policies continue to be expansionary and this is fueling inflationary pressures. They noted also that the possibility of a sustained drop in oil prices poses an additional risk to Iran's fiscal sustainability and macroeconomic outlook.

Directors considered Iran's main challenges to be the continued transition toward a viable and efficient market economy, and the attainment of the sustained growth rates necessary to provide employment for the country's fast-growing labor force. Directors reiterated that, to meet these challenges, the authorities will need to tighten financial policies and accelerate structural reforms in order to ensure macroeconomic stability and external competitiveness, build investor confidence, and accelerate further the development of the non-oil private sector.

Against this background, Directors called for a more restrictive fiscal stance to ease demand pressures and prevent an erosion of external competitiveness. They welcomed the authorities' plans to restrain expenditures in 2007/08, introduce a value added tax in the near future, and improve tax administration. In this context, Directors underscored the importance of phasing out energy subsidies while adequately protecting the poor, prioritizing expenditure, strengthening the role of the budget as the main instrument of fiscal policy, and avoiding frequent recourse to the OSF to finance spending. Efforts to increase public awareness of the importance of these reforms will be essential to garner the necessary public support.

Directors also called for a tightening of monetary policy and more effective use of monetary instruments. In this regard, they stressed that the central bank needs greater independence to issue short-term paper as needed to absorb liquidity. More generally, Directors encouraged the authorities to gradually lift controls on banks' rates of return and phase out remaining credit allocations.

Many Directors supported greater exchange rate flexibility, noting that it would buffer the economy against external shocks and increase the effectiveness of monetary policy in controlling inflation. They emphasized that competitiveness is better enhanced through fiscal discipline and appropriate structural reforms. Some Directors instead favored nominal exchange rate stability.

Directors commended the progress made in developing a risk-based prudential framework and broadening the supervisory powers of the central bank. They encouraged the authorities to continue strengthening prudential supervision and regulation. Directors also urged that the impact of ongoing rapid credit expansion on the quality of banks' portfolios should be monitored closely. They welcomed the fact that the authorities have recognized that the current Anti-Money Laundry framework needs strengthening, and encouraged them to reinforce and quickly adopt the draft laws against money laundering and terrorism financing.

Directors welcomed the renewed momentum to privatize state-owned enterprises, including some of the largest banks. They urged vigorous design and implementation of an appropriate regulatory framework within the privatization program to ensure a level playing field and to enhance competition and efficiency in the economy. They noted that the success of the program in stimulating private investment will depend, in large part, on the effective transfer of majority control to the private sector and on the implementation of reforms to improve the business climate.

Directors welcomed recent improvements in the timeliness of macroeconomic data dissemination. They encouraged further progress on enhancing the availability of data, extending the coverage of the fiscal accounts, and bringing the dissemination practices for some key macroeconomic indicators in line with the IMF’s Special Data Dissemination Standards.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Islamic Republic of Iran: Selected Economic Indicators, 2001/02–2005/06

	2001/02		2002/03	2003/04	2004/05	2005/06
Real GDP growth (factor cost; percentage change)	3.3		7.4	6.7	4.8	5.4
CPI inflation (period average; percentage change)	11.4		15.8	15.6	15.2	12.1
CPI inflation (end of period; percentage change)	11.7		17.5	16.0	16.7	10.2
Unemployment rate (in percent)	14.7		12.2	11.2	10.3	11.5
Central government balance (in percent of GDP)	1.8		-2.4	-0.1	1.7	1.1
Broad money growth (percentage change)	25.8		30.1	26.2	29.8	34.6
Current account balance (in percent of GDP)	5.3		3.1	0.6	1.2	7.4
Overall external balance (in percent of GDP)	3.9		4.1	2.1	5.2	6.9
Gross international reserves (in billions of U.S. dollars)	16.6		21.0	24.7	33.3	46.3
Public and publicly guaranteed external debt (in billions of U.S. dollars)	7.2		9.3	17.0	23.1	24.3
Exchange rate (period average; rials per U.S. dollar)	7,921	1/	7,967	8,282	8,719	9,026

Sources: Iranian authorities; and IMF staff estimates.
1/ Average market exchange rate before the March 2002 exchange rate unification.

Statement by Abbas Mirakhor, Executive Director
for the Islamic Republic of Iran
February 23, 2007

1. The authorities gratefully acknowledge the work of the IMF mission and appreciate the policy dialogue with staff. As stated during the Board discussions of last year's Article IV consultations, the platform of the then newly elected government focused on: (i) acceleration of growth aimed at increasing the pace of job creation with particular emphasis on expansion of activities by small- and medium-size enterprises and enhancing the absorptive capacity of the economy through public investment to remove infrastructural bottlenecks; and (ii) more equitable geographic distribution of resources to reduce large and widening regional disparities. These objectives have been pursued with a strong commitment to the strategic objective of the Fourth Five-Year Development Plan (FFYDP, covering the period 2004-09) of developing the non-oil sector of the economy with increasing reliance on the private sector as the engine of growth and using additional oil revenues for this purpose.

2. The fiscal stimulus led to faster and broad-based GDP growth of 5.4 percent in 2005/06, compared to 4.8 percent in the previous year. For the sixth year in a row, growth rate of the non-oil sector, at 6 percent, outpaced the overall growth of the economy; non-oil exports grew at a significantly faster rate than expected; the current account registered a five-year high surplus; the outstanding stock of debt declined and its profile, which had been a staff concern, shifted to longer maturities; and gross official and Oil Stabilization Fund (OSF) reserves increased. In addition to open market operations, the central bank tightened access to its overdraft facility and the rate of depreciation of domestic currency decelerated resulting in a smaller nominal effective depreciation leading to a decline in the CPI inflation rate to 12.1 percent from 15.2 percent a year earlier. The benchmark ex ante rate of return on the central bank's participation paper remained positive in real terms. Credit to the private sector increased substantially while directed credit remained limited to the agriculture and water sectors at 25 percent (down from 55 percent in 2003/04), and credit subsidies to medium- and small-size firms were fully and transparently reflected in the budget.

3. While the oil-GDP growth has been modest in 2006/07, continued strong growth of the non-oil GDP has strengthened further the momentum of the broad-based growth of overall GDP to a projected 5.8 percent. Unemployment declined to 10.2 percent in the first half of 2006/07, compared to 10.9 percent in the same period of 2005/06; the external sector has been enhanced; non-oil exports have continued their robust growth, notwithstanding the real effective appreciation; imports have declined after a sharp increase in the last two years; and reserves have increased. Fiscal stimulus intensified inflationary pressures in the second half of 2006/07 as additional liquidity challenged the management of monetary policy by the central bank which moved to limit the inflationary impact by further constraining access to its overdraft facility and carried out open-market operations. Moreover, exchange rate policy continued to support monetary policy through slower depreciation. Additional IRls 10,000 billion of the central bank participation paper have been authorized for sale during the remaining period of this Iranian calendar year (ending March 20, 2007) to reinforce the monetary policy stance.

4. For 2007/08, efforts are being made to offset, as much and as soon as possible, the inflationary impact of fiscal expansion of the last two years by rebalancing macro policies. Accordingly, the 2007/08 Budget—submitted recently by the Government to the Parliament—envisages a significant fiscal contraction of 3.4 percent of GDP in real terms. Monetary policy is set to support fiscal tightening by absorbing substantial liquidity through open market operations to the tune of IRls 30,000 billion. Exchange rate policy, within the context of the managed floating regime, will continue to support disinflation efforts through a slower pace of nominal depreciation. Early indication is that the Government intends to maintain a tight fiscal stance through 2008/09 with continued support from strong performance of the non-oil revenues, as was the case in 2006/07, which is to be further enhanced after the upcoming implementation of the VAT.

5. Progress in implementation of the structural reform agenda, envisioned in the FFYDP, has gained significant momentum with the decision in 2006/07 to amend Article 44 of the Constitution to allow privatization of some 80 percent of state-owned enterprises. The list includes large-scale industries and banks; eight large companies with a book value of US$4.6 billion (market value estimated at US$16 billion) are going through the final stage of privatization as their shares are placed on the Tehran Stock Exchange (TSE). In addition, the most recent large company being sold (February 3) on the TSE is National Copper Manufacturing with a book value of US$620 million (market value estimated at US$2.5 billion). The recently approved by-laws authorizing foreign portfolio investment should strengthen the operations of the TSE. In conjunction with the decision on massive privatization, the Government has actively solicited the views of the private sector through Chambers of Commerce on how best to facilitate the process of empowerment of the private sector to assume management of the portion of the economy being devolved to this sector through privatization. A program to improve the business and investment environment and to reduce the cost of doing business is being designed and articulated. Much has been said about the urgency to reform the subsidy system and need not be repeated here. Suffice it to say that the authorities are fully cognizant that the subsidies are inefficient, embody harmful economic and environmental externalities, and are the Achilles' heel of the medium-term fiscal sustainability, undermining the efforts to achieve the full potential growth of the economy. However, given the more than half a century history of subsidies and their deeply entrenched nature, the authorities believe that a strong social consensus and significant public support are needed before undertaking meaningful reforms. They further believe that such support could be garnered once an effective and efficient public transportation system is in place that would obviate the need to rely on private means of transportation and cash transfers to those adversely affected by reforms become a viable option. Meanwhile, they intend to press ahead with the implementation of the smart card system to limit subsidized consumption of refined petroleum. As a result, the 2007/08 proposed Budget envisages substantial reduction in subsidies for higher-income groups. Further efforts will be made to expand reliance on natural gas as a substitute for petroleum.

6. In the financial sector, private sector banks continued their robust growth as their market share has increased to 15 percent (as of November 2006), compared to 10.5 a year earlier, and licensing applications to establish new banks continued to be submitted to the central bank despite a sharp and sizable increase in the required level of start-up capital. This

trend is expected to accelerate with the privatization of four large state-owned banks. A recent MCM Department mission, which the authorities welcomed, concluded that considerable progress has been made by the central bank in strengthening financial sector supervision and regulation; further improvements are underway through ongoing revisions of the banking and central bank laws. In addition to enhancing the central bank's independence in monetary management, these revisions will broaden the range of financial institutions subject to its supervision and will increase its autonomy and accountability in regulatory and supervisory matters. While the non-performing loans have increased by 2 percentage points, the supervisory authorities believe that much of this increase is due to a recent shift to a more stringent classification as well as improved accounting, reporting, and transparency standards. At the authorities' request, a recent and much appreciated TA mission from the Legal Department has reviewed progress to date in the AML/CFT reform initiatives and has made valuable recommendations which the authorities are studying as they revise AML draft law and prepare CFT legislation.

7. Regarding recent decisions of the US authorities relating to two Iranian banks, it is important that the suggestion that these decisions "cut off" these banks "from direct and indirect access to the US financial system" (paragraph 29 of the staff report) be placed in the proper context. The comprehensive US sanctions regime in place for more than a decade had already covered nearly all bilateral financial transactions. The exception, before recent decisions, had been the so called concept of the "U-Turn," according to which Iranian banks could turn around US dollar oil earnings through the US financial system to pay for international dollar transactions (e.g., payment for medicine purchases from the US permitted under the sanctions regime). The recent decisions have prohibited U-Turn transactions by the two Iranian banks, in effect, widening the coverage of the sanctions regime from ostensibly bilateral to international restrictions on not only these banks' access to international trade and financial system, but also on other countries or financial institutions to transact with these banks in US dollar. The authorities believe these decisions constitute violations of members' obligations under the IMF Articles of Agreement. They further believe that using international financial restrictions to settle bilateral political disputes undermines the integrity and credibility of the international financial system to the detriment of the global economy. They contend that the IMF, as the sentinel of the international financial system, has statutory responsibility to protect not only the right of its individual members to unrestricted access to the international financial system, but also the global integrity of that system.