September 2004
IMF Country Report No. 04/306

# Islamic Republic of Iran: 2004 Article IV Consultation—Staff Report; Staff Supplement; Staff Statement, and Public Information Notice on the Executive Board Discussion

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 2004 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 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **June 19, 2004,** with the officials of the Islamic Republic of Iran on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on August 20, 2004**. 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 supplement of **September 8, 2004** on the Islamic Republic of Iran's acceptance of the obligations of Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement.

- a staff statement of **September 10, 2004** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its September 10, 2004 discussion** of the staff report that concluded the Article IV consultation.

The documents listed below have been or will be separately released.

Selected Issues Paper
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 2004 Article IV Consultation

Prepared by the Staff Representatives for the 2004 Consultation with
The Islamic Republic of Iran

Approved by Saleh M. Nsouli and Donal Donovan

August 20, 2004

- The 2004 Article IV consultation discussions were held in Tehran from June 5 to 19. The team comprised Messrs. Jbili (Head), Kramarenko, Bailen, and Ms. Farahbaksh (all MCD); Mr. Nielsen (PDR); and Ms. Djahanyekta, assistant (MCD).
- The mission met with Minister of Economy and Finance Husseini, Head of Management and Planning Organization Shoraka, Central Bank Governor Sheibani, Vice Minister of Commerce Vahaji and senior officials of the Social Security Organization, the Statistical Center of Iran, the Tehran Stock Exchange (TSE), and representatives of commercial banks, charitable foundations, and the private sector.
- In concluding the last Article IV consultation on August 26, 2003, Executive Directors noted that the economy had performed well owing in large part to structural reforms implemented over the last three years. Nevertheless, Directors expressed concern about the procyclical stance of monetary and fiscal policies and the slow pace of implementation of some structural reforms. In this regard, Directors welcomed the authorities' intention to introduce corrective fiscal and monetary policy measures in FY 2003/04 and called for accelerating structural reforms.
- Iran maintains exchange restrictions and multiple currency practices (MCPs) that are subject to approval under Article VIII, Sections 2(a) and 3, but plans to eliminate or request Fund approval for the remaining restrictions in the near future in the context of accepting the obligations under Article VIII.
- The authorities consented to the publication of the 2003 Article IV consultation papers, and it is expected that they will do so for the 2004 Article IV Staff Report, Selected Issues, and Statistical Appendix. The authorities are following up on STA Technical Assistance (TA) recommendations to prepare for subscription to the Special Data Dissemination Standard (SDDS).
- The principal authors of this report are Abdelali Jbili and Vitali Kramarenko.

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## List of Acronyms

| | |
|---|---|
| AML/CFT | Anti-money laundering and combating the financing of terrorism |
| CBI | Central Bank of Iran |
| CBPP | Central Bank Participation Papers |
| ERPD | Economic Research and Policy Department |
| FDI | Foreign direct investment |
| FFYDP | Fourth Five-Year Development Plan |
| GFS | Government Finance Statistics |
| HIPC | Heavily Indebted Poor Countries |
| INS | Information Notice System |
| NEER | Nominal effective exchange rate |
| MCPS | Multiple Currency Practices |
| OSF | Oil Stabilization Fund |
| REER | Real effective exchange rate |
| SCI | Statistical Center of Iran |
| SDDS | Special Data Dissemination Standards |
| TFP | Total Factor Productivity |
| TFYDP | Third Five-Year Development Plan |
| TSE | Tehran Stock Exchange |
| VAT | Value-added tax |
| WEO | World Economic Outlook |

## Executive Summary

### Background

Real GDP grew by 6.7 percent in 2003/04[1] on account of an increase in hydrocarbon output and continued strong growth momentum in the non-hydrocarbon sector. The improved growth performance of the last three years reflects in part important reforms implemented during 2000–02, but also an expansionary policy mix and high oil prices. While unemployment declined to 11.2 percent in 2003/04 from 14.1 percent in 2000/01, inflation remained in double digits at about 15 percent for the second year in a row. Some progress was achieved in establishing risk-based banking supervision, streamlining tariff and nontariff barriers to trade, and preparing medium-term reforms in the context of the forthcoming five-year development plan. Progress in other areas of reform, however, was slow.

### Policy issues

Real GDP growth is projected to remain at 6½ percent on account of strong private sector investment and consumption, as well as continued expansionary fiscal and monetary policy mix. The authorities intend to scale back government spending from a high level budgeted for 2004/05 and introduce a series of policy measures to rein in liquidity growth and contain inflation. It is likely, however, that M2 growth will remain high with no deceleration in inflation.

The staff expressed the view that expansionary fiscal and monetary policies at this stage of the oil price cycle were neither needed, given the private sector's strong response to economic reforms, nor desirable in the face of persistent double-digit inflation. The authorities shared the mission's assessment, but pointed out that demographic dynamics and pressing social needs called for a pro-active growth and employment policy stance. They highlighted that unemployment was their major concern, while reducing inflation would be achieved gradually over the medium term.

The medium-term outlook is sensitive to oil price assumptions and the authorities' resolve to implement fiscal adjustment and structural reforms expeditiously. The staff underscored that high growth and steady gains in employment creation crucially depended on steadfast implementation of key structural reforms as foreseen under the forthcoming five-year development plan. These include financial sector reform, the phasing-out of explicit and implicit subsidies, the strengthening of the non-oil revenue base, labor market reform, and privatization, as well as streamlining of administrative procedures.

[1] Fiscal year begins on March 21.

# I. INTRODUCTION

1. **During the period 2000/01–2003/04, growth accelerated, external debt ratios improved, gross official reserves increased substantially, and unemployment declined (Text Table I and Figure 1)**. The proportion of the population living below the poverty line declined to 21 percent in 2002 from 26 percent in 1990. These positive achievements are in part attributable to important structural reforms implemented at the beginning of the Third Five-Year Development Plan (2000/01–2004/05, TFYDP), including exchange rate unification, progress in trade and exchange liberalization, passage of a new foreign direct investment (FDI) law, tax reform, and the granting of licenses to private banks and insurance companies. High oil prices and expansionary fiscal and monetary policies also helped sustain domestic demand (Figure 2) and growth, but contributed to high liquidity growth and inflation.

Table I. Islamic Republic of Iran: Selected Indicators, 1989/90–2004/05 1/

(Period average percentage change, unless otherwise indicated)

| | 1989/90–1993/94 | 1995/96–1999/2000 | 2000/01–2004/05 2/ |
|---|---|---|---|
| | First Plan | Second Plan | Third Plan |
| GDP 3/ | 7.4 | 3.3 | 5.6 |
| M2 | 24.1 | 26.0 | 29.1 |
| CPI 4/ | 18.7 | 25.6 | 13.9 |
| Oil prices (U.S. dollars/barrel) | 17.2 | 16.5 | 25.5 |
| External debt (in percent of GDP) | 11.4 | 15.7 | 9.1 |
| Reserves (in months of imports) | 2.5 | 4.4 | 6.7 |

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

1/ There was a lapse of one year between the first and the second plans.
2/ Four-year average, 2000/01–2003/04.
3/ At factor cost at constant 1997/98 prices.
4/ End-period.

2. **Major challenges remain in the period ahead**. In the short run, the authorities' policy of stimulating growth and employment creation through expansionary fiscal and monetary policies is contributing to persistently high inflation and increased vulnerability to a possible downturn in oil prices. Withdrawal of the policy stimulus to reduce inflation is necessary, but the magnitude and timing of the needed adjustment are key to containing the related output cost. In the long term, structural reforms are needed to consolidate the gains achieved so far and complete the transition to a market economy in which the private sector is the primary engine of growth.

Figure 1. Islamic Republic of Iran: Selected Macroeconomic Indicators, 1996/97–2004/05

(Annual percentage change, unless otherwise indicated) 1/

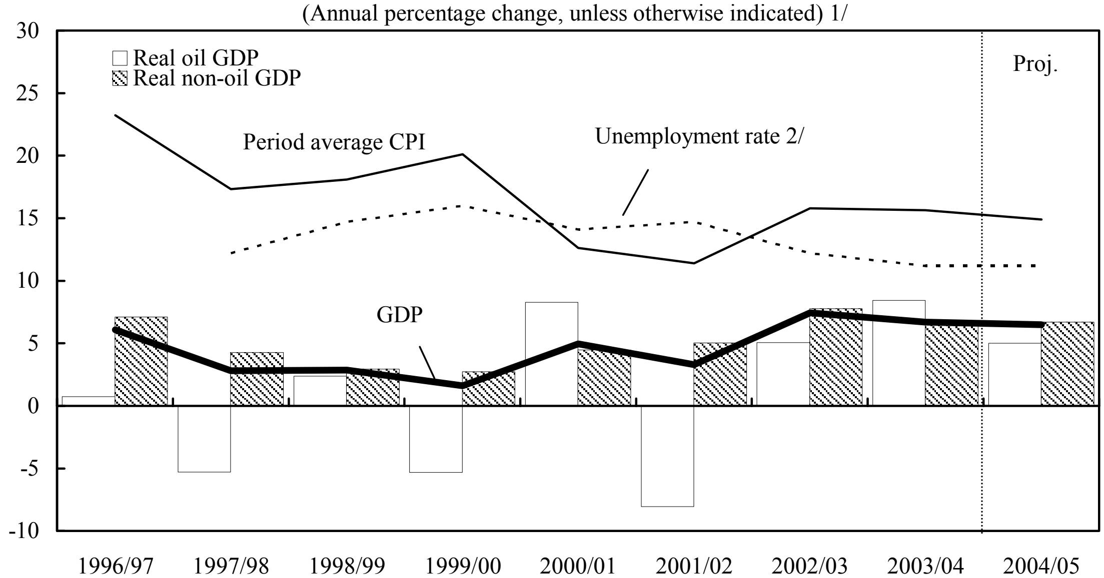
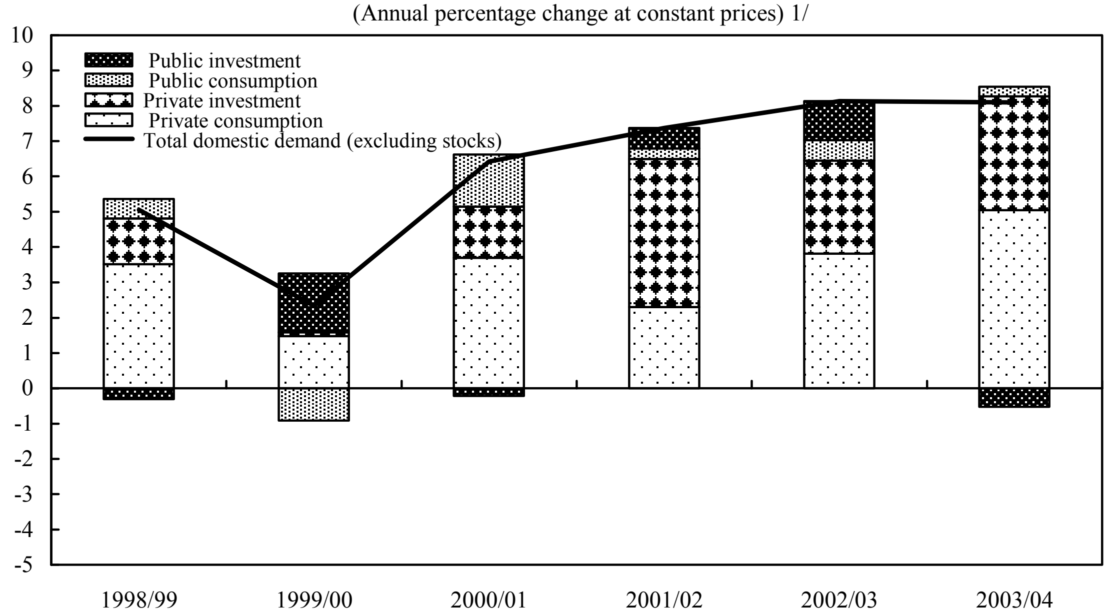



Figure 2. Islamic Republic of Iran: Breakdown of Domestic Demand Growth, 1998/99–2003/04

(Annual percentage change at constant prices) 1/




Sources: Iranian authorities; Fund staff estimates and projections.

1/ Last observation: projection for 2004/05.
2/ First observation: 1997/98; last observation: 2003/04.

3. **In light of these policy challenges, Fund staff advice has focused on the need for restrained fiscal and monetary policies to help reduce inflation and critical structural reforms to sustain private sector investment and growth**. The authorities broadly share the staff's views, but have been reluctant to tighten monetary policy and adjust fiscal policy sufficiently out of concern for employment (Text Table II). While implementation of critical structural reforms in 2003/04 was slow after a promising start at the beginning of the TFYDP, major strides in this area are foreseen under the Fourth Five-Year Development Plan (FFYDP, 2005/06–2009/10).

4. **The 2004 Article IV consultation mission took place against the background of significant political changes**. Following the February 2004 elections, in which the conservatives won a majority of seats in the parliament, President Khatami reshuffled his cabinet.[2] Many important policy decisions, including the draft FFYDP, are awaiting approval by the newly elected legislature. The political calendar in the period ahead is also marked by the approaching presidential elections, scheduled for May 2005, in which Mr. Khatami will not run, given the constitutional term limit. External political developments were dominated by regional instability (mainly in Iraq and Afghanistan), as well as by the on-going discussions with European countries concerning Iran's cooperation with the International Atomic Energy Agency regarding its nuclear energy program.

## II. Recent Developments

5. **Growth remained strong in 2003/04, albeit lower than in the previous year, and unemployment declined**. Growth was driven by higher oil production following increases in Iran's OPEC oil production quota, as well as by rising private sector investment, including foreign direct investment. The non-hydrocarbon GDP growth remained strong, even though it decelerated to 6.5 percent from 7.8 percent in 2002/03. Agricultural output growth reverted to its trend after an exceptionally good rainfall during the previous years and there was some slowdown in construction and services. Other sectors, however, such as manufacturing and mining grew at double-digit rates (Text Table III). Employment increased by 3.7 percent, with most of the increase taking place in the private sector. This led to a decline in the unemployment rate to 11.2 percent in 2003/04 from 12.2 percent in 2002/03.[3] Domestic demand continued to grow rapidly under the impetus of an expansionary policy mix, as evidenced by the strong growth in credit and liquidity (Figures 2 and 3). As a result, average CPI inflation remained at 15½ percent in 2003/04.

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[2] The main changes were in the Ministry of Economy and Finance, the Ministry of Labor, and the Management and Planning Organization.

[3] Official unemployment data are those reported by the Statistical Center of Iran (SCI), which are based on the definition recommended by the International Labor Organization (ILO) (Appendix III).

Table II. Islamic Republic of Iran: Selected Indicators, 2001/02–2003/04

| | 2001/02 | 2002/03 | Est. 2003/04 |
|---|---|---|---|
| | (In percent of GDP, unless otherwise indicated) | | |
| Central government balance | 1.8 | -2.4 | -0.2 |
| *Of which:* non-oil balance | -13.7 | -18.7 | -16.5 |
| Current account balance | 5.3 | 3.1 | 1.5 |
| Excluding hydrocarbon exports | -11.7 | -16.7 | -18.3 |
| Oil price, U.S. dollars per barrel | 21.5 | 27.2 | 28.0 |
| | (Annual percentage change) | | |
| Broad money growth 1/ | 25.8 | 30.1 | 30.0 |
| | (In billons of U.S. dollars) | | |
| Gross official reserves | 16.6 | 21.4 | 24.4 |

Sources: Central Bank of Iran; and Fund staff estimates.
1/ Including a deposit of the Telecommunication Company with the Postal Bank, which is not reflected in Tables 1 and 5.

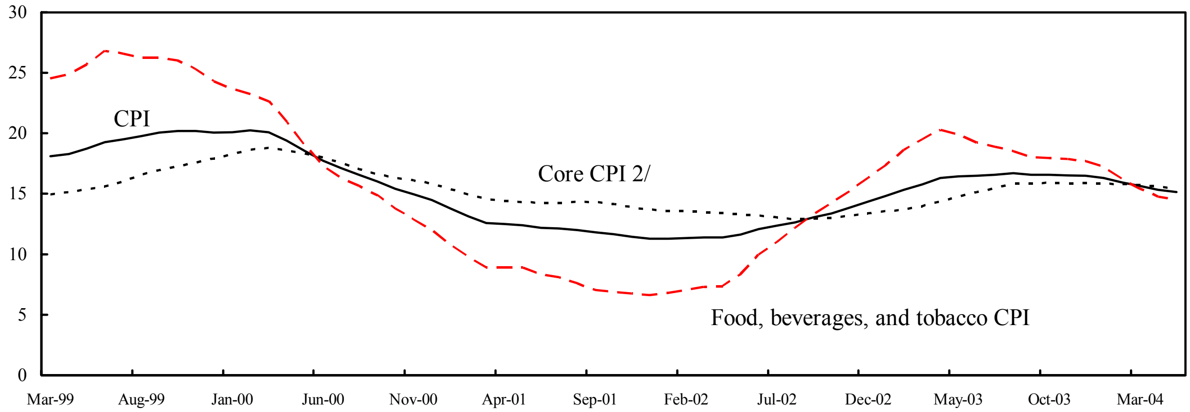
Table III. Islamic Republic of Iran: Selected Growth Rates, 2000/01–2003/04

(Annual percentage change at constant prices)

| | 2000/01 | 2001/02 | 2002/03 | 2003/04 |
|---|---|---|---|---|
| GDP at factor cost | 5.0 | 3.3 | 7.4 | 6.7 |
| Hydrocarbon | 8.3 | -8.1 | 5.1 | 8.4 |
| Non-hydrocarbon | 4.5 | 5.1 | 7.8 | 6.5 |
| Agriculture | 3.5 | -0.7 | 11.4 | 5.3 |
| Industry | 9.5 | 9.1 | 11.8 | 11.0 |
| *of which:* | | | | |
| Mining | -2.7 | 18.4 | 12.0 | 15.4 |
| Manufacturing | 10.9 | 9.9 | 11.0 | 10.8 |
| Construction | 7.6 | 6.1 | 14.9 | 11.8 |
| Services | 2.9 | 4.8 | 5.1 | 4.8 |

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

Figure 3. Islamic Republic of Iran: Inflation Developments, 1999–2004 1/
(Year-on-year percentage change of 12-month average index)




Source: Iranian authorities.

1/ Last observation: May 2004.
2/ Excluding food, beverages, and tobacco.

6. **Buoyant domestic demand also led to a decline in the external current account surplus to about 1½ percent of GDP in 2003/04 from 3.1 percent in 2002/03**. Despite a significant increase in both oil and non-oil exports, imports continued to rise significantly. The capital and financial account recorded a large surplus, reflecting increasing FDI inflows—mainly in the energy sector—and short-term financing through letters of credit. Gross official reserves increased by \$3.0 billion to \$24.4 billion, equivalent to 6½ months of next year's imports of goods and services. External debt remained low at \$11.9 billion,[4] equivalent to 8.7 percent of GDP. External vulnerability indicators have remained at satisfactory levels (Tables 2 and 3).

7. **The managed float exchange regime has continued to operate smoothly**. The central bank has not committed to, or publicly announced a specific exchange rate target, but has aimed to smooth out fluctuations in the exchange rate vis-à-vis a basket of currencies. In 2003/04, the average nominal and real effective exchange rate (NEER and REER) indexes depreciated by 16.4 percent and 8.8 percent, respectively, in part due to expansionary monetary policy and the appreciation of the euro vis-à-vis the dollar (Figure 4). If oil trade is excluded in compiling weights, the average REER remained broadly unchanged in 2003/04 compared to 2002/03.[5]

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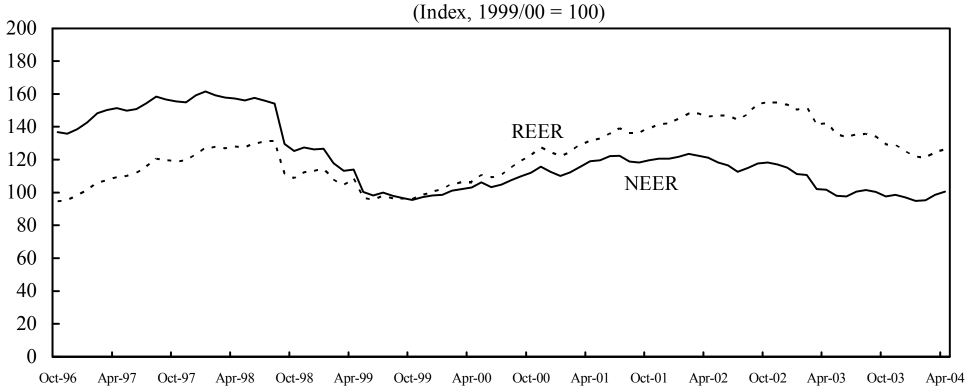
[4] This does not include short-term contingent liabilities under letters of credit opened by domestic banks for trade financing, which increased to \$9.2 billion (7 percent of GDP) by end-March 2004 from \$4.3 billion (3.2 percent of GDP) at end-March 2003.

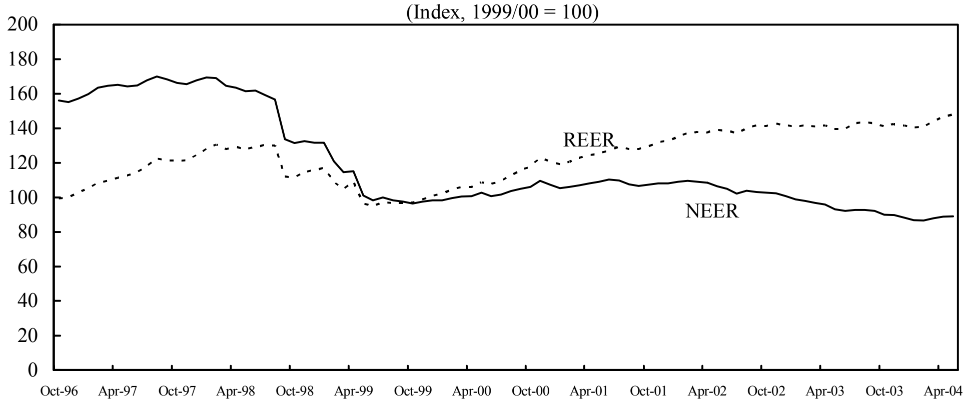
[5] Excluding oil trade from REER calculations reduces the relative weight of the euro and yen in the basket and provides a better indicator of competitiveness.

Figure 4. Islamic Republic of Iran: Competitiveness Indicators, 1993–2004

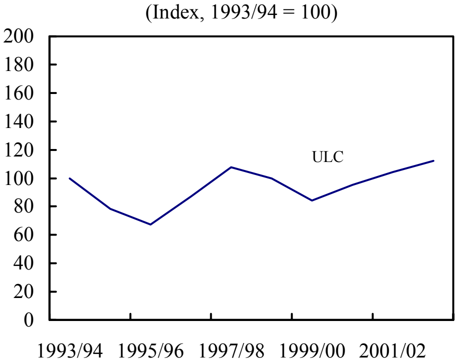
Real and Nominal Effective Exchange Rate 1/, 1996–2004
(Index, 1999/00 = 100)



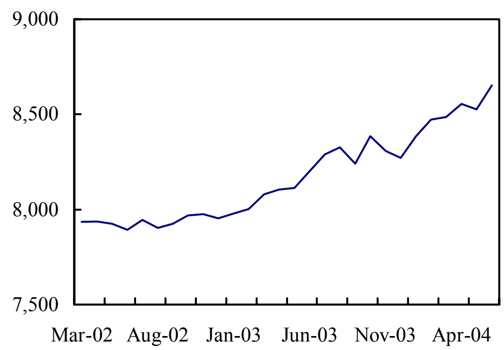

Real and Nominal Effective Exchange Rate with New Weights 2/, 1996–2004
(Index, 1999/00 = 100)




Unit Labor Cost-Based REER Index,
1993/94–2003/04
(Index, 1993/94 = 100)




Rials per U.S. Dollar, March 2002-June 2004




Sources: Iranian authorities; and Fund staff stimates.
1/ Using INS weights.
2/ Using weights derived from non-oil trade composition.

8. **While fiscal policy was tightened in 2003/04, the fiscal stimulus introduced during 2000/01–2002/03 was not fully withdrawn**.[6] The non-oil fiscal deficit was brought down to 16½ percent, or close to 2 percent of GDP lower than in the previous year, mainly through expenditure restraint, while non-oil revenue remained unchanged relative to GDP. The overall fiscal deficit also declined from 2.4 percent of GDP to 0.2 percent and was mainly financed by privatization proceeds and Government Participation Papers[7] (Table 4). Notwithstanding these efforts, however, government spending remained high (27 percent of GDP) at a time when private sector demand was expanding rapidly.

9. **Despite the persistence of double-digit inflation, monetary policy remained expansionary**. Average bank lending rates have remained broadly unchanged in both nominal and real terms (Figure 5). Unsterilized purchases of foreign exchange from the government by the central bank and increased central bank lending to commercial banks led to a rapid growth of base money.[8] This, together with a higher money multiplier, fueled private sector credit and M2 growth to the tune of 39 percent and 30 percent,[9] respectively (Table 5).

10. **The stock market price index rose by 125 percent**, contributing to a significant increase in the TSE capitalization to about 27 percent of GDP by end-2003/04 (Figure 5). This performance reflected improved fundamentals, such as higher earnings and strong business confidence, but other factors were at play, including the low starting base of equity valuation and the effect of high money and credit growth.

11. **The authorities are undertaking the necessary steps toward accepting the obligations under Article VIII, sections 2, 3 and 4 of the Fund's Articles of Agreement**. The regulatory changes recommended by a LEG/MFD technical assistance (TA) mission to eliminate all exchange restrictions have been largely made and are being reviewed by Fund staff (Appendix I). Moreover, steps are being taken to liberalize capital account transactions, including foreign direct investment and access to foreign exchange through off-shore zones.

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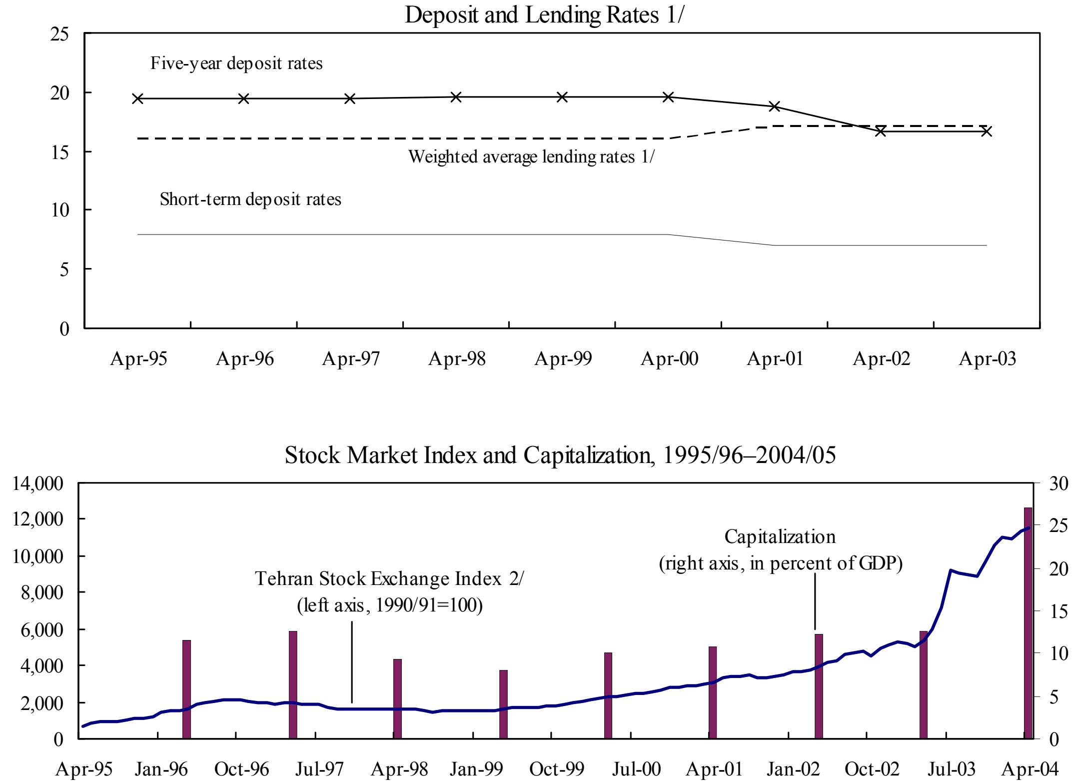
[6] The underlying fiscal stance is measured in terms of the non-oil deficit ratio to GDP. It increased to 18.7 percent of GDP in 2002/03 from 10.8 percent of GDP in 1999/2000.

[7] Government bonds complying with Islamic finance principles.

[8] A Selected Issues Paper—"Moving Toward Market-based Monetary Policy"—provides an overview of the current monetary policy framework and instruments, and outlines the reform agenda in these areas.

[9] Including a large deposit of the Telecommunication Company with the Postal Bank, which is not reflected in the monetary survey in Tables 1 and 5.

Figure 5. Islamic Republic of Iran: Financial Market Indicators, 1995/96–2004/05




Sources: Iranian authorities; and Fund staff estimates.

1/ Rates are fixed at the beginning of every fiscal year; last observation: 2003/04.
2/ Last observation: July 15, 2004.

12. **The authorities' structural reform agenda is ambitious, but implementation has slowed somewhat since the beginning of 2003/04**. Efforts have mainly focused on completing the preparation of major reforms, such as the energy price reform, the capital market law, and the preparation of the value-added tax (VAT). Also, the unweighted average import tax was reduced to 23 percent in 2004/05 from 27 percent in 2003/04 and the import ban on automobiles was replaced with high tariffs.[10] In the financial sector, banking supervision reform continued (Box 1), and new private insurance and leasing companies were licensed.

[10] Currently there are 13 import tariff bands with tariff rates ranging from 4 to 174 percent. There is a small negative list of prohibited import goods for non-economic reasons.

**Box 1. Banking Supervision Reforms**

**Major measures which have been undertaken**:

- Regulations on licensing, net open positions, and AML procedures for banks were approved in 2002/03.
- Regulations on capital adequacy, large exposures, and connected lending were approved in 2003/04.
- On- and off-site inspections have begun, using risk-based criteria; and reporting forms and supervision manuals are being developed.

**The remaining reform agenda includes the following**:

- Approving the essential regulations pertaining to liquidity risk, asset classification, provisioning, and investments.
- Amending the banking legislation (Banking Act) to incorporate the concept of bank soundness in the objectives of bank supervision; enlarge the range of sanctions of banks, which do not comply with the regulations; define services that banks and other financial entities are allowed to provide; and define the role of external auditors in banks.
- Bringing all deposit-taking institutions under central bank supervision.
- Incorporating staff training and the development of information technology into the central bank's priorities are essential elements for successful implementation of this reform.

13. **Progress in other areas, however, remains slow**. The restructuring of public banks has not moved beyond a modest increase in their capital base through re-investment of post-unification foreign exchange gains, which has left the average capital adequacy ratio below the 8 percent recommended by the Basel I Accord; little progress was made in improving the supervision of the insurance sector and issuance and trading of securities,[11] the pace of divestiture of public companies has been slow and none of these operations has resulted in a transfer of majority stake to the private sector; and there have been no significant efforts to reform the labor market or streamline administrative procedures. While anti-money laundering/combating the financing of terrorism (AML/CFT) regulations for banks have been approved, comprehensive legislation covering the entire financial system is still awaiting parliamentary approval.

[11] A Selected Issues Paper—"Iranian Financial Landscape"—provides an overview of the current state of the financial system and its supervision.

14. **Some progress has been achieved in enhancing fiscal transparency**. Large charitable foundations (Bonyads)[12] have been subjected to greater oversight and reporting requirements, including the publication of their audited annual reports. Moreover, the companies under their ownership will start paying profit taxes in 2004/05. In the fiscal area, progress is being made toward compiling experimental consolidated accounts in general government operations.

## III. Policy Discussions

15. Against the background of a favorable outlook for 2004/05, the discussions focused on the short-term policies to reduce inflation, as well as on structural reforms to sustain high rates of growth and employment creation over the medium term.

### A. Short-Term Outlook and Policies

#### Outlook for 2004/05

16. **The outlook for 2004/05 is favorable**. Against the background of high oil prices, a comfortable level of international reserves, and low external debt, business confidence is expected to remain strong and FDI inflows are likely to remain high. This, together with a continuation of the expansionary fiscal and monetary policy mix of the past year, will help keep real GDP growth at about 6½ percent, with healthy contribution from most sectors (Table 1). The authorities intend to scale back government spending from a high level budgeted for 2004/05 and introduce a series of policy measures to rein in liquidity growth and bring inflation under control. Staff estimates, however, indicate that M2 would grow at about 30 percent with average CPI inflation remaining at 15–17 percent.

17. **Under the current policy stance, despite higher oil prices,[13] the external current account position is projected to deteriorate on account of strong domestic demand**. Exports are projected to increase by 10 percent in U.S. dollar terms, but continued strong growth in imports of goods and services is likely to fully eliminate the current account surplus. The capital account is expected to remain in surplus, mainly on account of FDI inflows in the hydrocarbon sector, and gross official reserves would increase by $3 billion to $27.5 billion at end-2004/05, or the equivalent of about 6½ months of next year's imports (Table 2).

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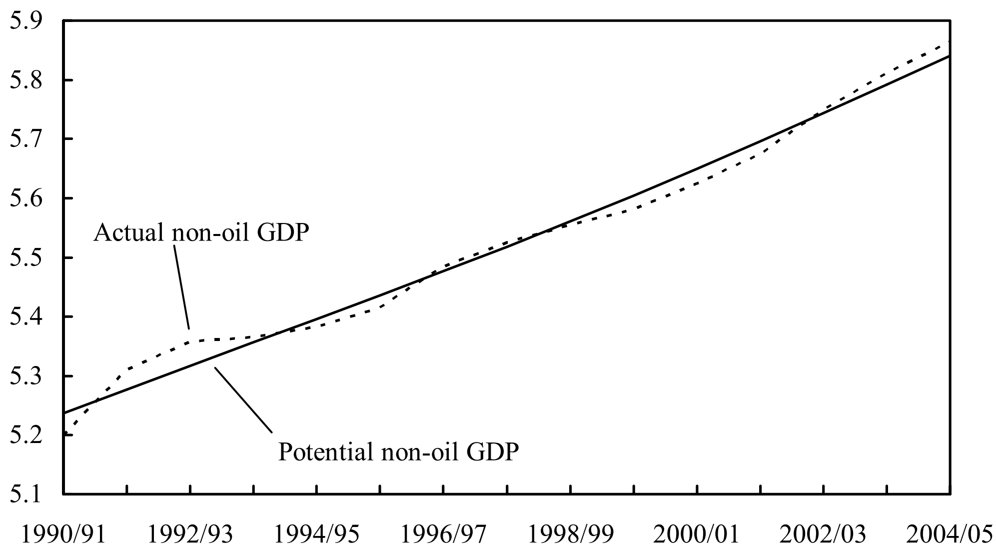
[12] Bonyads are charitable foundations that also control large segments of economic activity and their relations with the public sector are not fully transparent. They are funded by the net incomes of their asset holdings, government transfers, and charitable contributions.

[13] During the 2004 Article IV consultation mission, the average price for Iranian crude oil was conservatively projected to increase to $30 per barrel in 2004/05 from $28 per barrel in 2003/04. The impact of the latest August 2004 WEO assumption on oil prices is discussed in the sensitivity analysis.

**Macroeconomic policies**

18. **Fiscal and monetary tightening is needed in 2004/05**. The staff expressed the view that expansionary fiscal and monetary policies at this stage of the oil price cycle were not needed, given the private sector's strong response to economic reforms, nor were they desirable in the face of mounting pressure on the price level. In particular, the staff argued that higher government spending was making it difficult for the central bank to sterilize large oil inflows, while contributing to fuel domestic demand and private sector credit growth. Moreover, it highlighted that the current expansionary policy mix may provide only a temporary cyclical respite for the unemployment problem, as non-hydrocarbon GDP is above estimated potential (Figure 6).

Figure 6. Islamic Republic of Iran: Non-oil Output Gap, 1990/91–2004/05




Sources: Fund staff estimates and projections based on Hodrick-Prescott filter.

19. **The authorities shared the mission's assessment, but pointed out that demographic dynamics and pressing social needs called for a pro-active growth and employment policy stance**. In particular, they underscored the need to complete major infrastructure projects that had been delayed, provide housing and basic social services to the population in remote rural areas, and improve education and training to help foster employment and productivity. While recognizing that fiscal and monetary policy adjustment in 2004/05 was needed, the authorities intended to follow a cautious approach that would not jeopardize their growth and employment objectives. The staff argued that withdrawal of fiscal stimulus should be made from a position of strength in the economic cycle, rather than under

duress when oil prices decline and private sentiment turns bearish. The latter would entail higher output costs over the medium term and undermine external viability in the face of a possible medium-term decline in oil prices.

**Fiscal policy**

20. **The mission pointed out that the approved budget for 2004/05 continues past years' expansionary policy stance.** All of the projected increase in oil revenue due to higher oil prices (see footnote 13) will be used for the budget, contrary to the authorities' objective of accumulating savings in the Oil Stabilization Fund (OSF) when oil prices are high. While non-oil revenues are budgeted to rise significantly compared to the previous year's outcome, shortfalls are likely given the absence of new major revenue measures.[14] As budgeted, total expenditure and net lending are expected to increase from 27 percent of GDP in 2003/04 to 30 percent in 2004/05 (Table 4). This reflects a sharp increase in capital expenditure, including delayed projects from the previous years. The growth rate of current expenditure, however, is relatively modest, since some food subsidies are being phased out and the budgeted increase in the wage bill is limited.

21. **The authorities were in broad agreement with the staff's projection of possible revenue and privatization shortfalls of about 2 percent of GDP under the approved 2004/05 budget**. They intend to offset these shortfalls by reducing capital spending and improving tax administration, which the staff estimates could help bring the overall fiscal deficit to about 1½ percent of GDP. Such a deficit would be financed mainly by a net withdrawal from the OSF of about 0.7 percent of GDP, issuance of government participation papers, and privatization proceeds. The non-oil fiscal deficit is projected to increase by ½ percent of GDP to about 17 percent of GDP (Table 4).

22. **The staff proposed further fiscal adjustment to bring the overall deficit closer to balance, which would facilitate the achievement of the authorities' monetary target and reduce vulnerability to a decline in oil prices over the medium-term**. While welcoming the efforts to contain the growth of current expenditure, including the wage bill, the staff called for further savings on explicit subsidies and steadfast progress in phasing out implicit energy subsidies.[15] It noted that the recent adjustment in gasoline prices by 23 percent on average, which brought the domestic price to about one-third of the border price level, was a step in the right direction,[16] and underscored the need to make headways in overhauling the

[14] Shortfalls will likely occur, notwithstanding the lifting of the ban on automobile imports, which may bring an additional 0.4 percent of GDP in revenue.

[15] Explicit subsidies (about 5 percent of GDP) are mainly for basic necessities, fertilizers, and foreign exchange losses stemming from the 1993 and 2002 exchange rate unifications. Implicit energy subsidies (10½ percent of GDP) arise from the differential between domestic and border prices.

[16] There are indications of across the border smuggling of petroleum products to neighboring countries, but they represent a small share of the overall domestic consumption.

subsidy system. Additional fiscal measures for 2004/05 suggested by the staff also include a reduction in net lending from the OSF and larger cuts in capital spending, together with further improvements in tax administration. The staff argued that a tighter fiscal position in 2004/05 would help contain the growth of domestic demand and the liquidity impact of central bank's purchases of foreign exchange from the government, thereby reducing the need for large sterilization operations. An upfront fiscal adjustment would also help build precautionary fiscal savings in the OSF and smooth the adjustment to a possible decline in oil prices.

**Monetary policy and financial sector issues**

23. **The authorities agree that reducing money supply (M2) growth is key to disinflation**. The authorities' monetary program aims at containing M2 growth within a range of 20–24 percent in 2004/05, from 30 percent in 2003/04, through a series of policy measures, including the issuance of additional Central Bank Participation Papers (CBPP) of up to Rls 5,000 billion and an increase in the share of credit facilities not subject to sectoral allocation limits. The authorities also plan to make use of the standing deposit facility at the central bank to mop up excess liquidity.

24. **The staff argued that based on its estimated fiscal and balance-of-payments outcomes for 2004/05, M2 would grow by about 30 percent in 2004/05**. As such, additional monetary policy measures, supported by fiscal adjustment, would be needed to bring down the growth of liquidity within the targeted range. To curb the expected rapid pace of growth in private sector credit, the staff recommended increasing the administered rates of return, which would also be interpreted as minimum expected rates, and allowing the state-owned banks to charge higher rates as warranted by credit conditions.[17] In this context, the staff pointed out that the authorities' decision in early 2004/05 to lower the rates of return on loans extended to manufacturing companies was inconsistent with the need to curb credit growth and reduce inflation. The staff also suggested that access to the central bank's overdraft facilities would need to be tightened and greater efforts should be made to secure commercial banks' cooperation in restraining credit growth. At the same time, however, it advised against raising the ratio of obligatory reserves, which would shift the cost of monetary policy implementation to the banks and further weaken their financial position. The authorities indicated that increasing bank lending rates was not feasible in the current political circumstances, but agreed to keep the staff's suggestions under review.

25. **The staff stressed the importance of a strong track record of credibility in meeting monetary policy targets**. It underscored the need to put forward more realistic monetary targets, consistent with the desired medium-term disinflation path, which would anchor inflation expectations. The authorities explained that with greater central bank

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[17] Under Islamic banking principles, ex-ante interest rates are not allowed, but financial rates of return are used based on expected profitability.

independence envisaged under the forthcoming FFYDP and better coordination between fiscal and monetary policies, monetary policy implementation would gain in credibility. The authorities also plan to open an interbank market for rial funds and develop indirect instruments of monetary policy.

26. **Despite recent reforms, the financial system is still weak and supervision is inadequate**. The staff called for steadfast progress in banking supervision reform (Box 1), which is needed for a proper monitoring of risks and urged the authorities to finalize a timeline for its completion. In particular, the main risk to the stability of the banking system emanates from a possible deterioration in loan portfolios following the rapid credit growth. Moreover, the rapid build-up of banks' exposure to short-term foreign currency-denominated debt under letters of credit for trade financing could be a potential source of risk. The authorities indicated that although the current system of loan classification and provisioning was not consistent with international standards, the evolution of their indicators of non-performing loans do not suggest any problems for now. They assured fund staff that they would monitor closely the financial position of banks and their credit risks. The Iranian authorities are also determined to enforce compliance with newly approved regulations on capital adequacy within two years and continue their reform of banking supervision. With regard to the mounting exposure of banks under letters of credit, the authorities were monitoring developments in this area, which in their view, reflected normal trade finance flows.

27. **The staff welcomed the steps toward developing the infrastructure of the TSE and deepening the capital market, but expressed concern over the rapid increase in equity valuation**. The authorities maintained that the current level of the average price/earning ratio, estimated at nine, did not indicate the presence of a price bubble, even though they conceded that the supply of equities was still limited. They also noted that the direct exposure of banks and other financial institutions to the stock market was small. The staff called for early adoption of the capital market law, which would help foster the development of the TSE and strengthen the supervision of issuance and trading of securities, particularly through the establishment of an independent Securities and Exchange Commission, as well as better monitoring of margin lending.

### Exchange rate policy

28. **The staff underscored the need for exchange rate policy to give a considerably greater weight to monetary policy objectives.** Tensions have emerged between monetary and exchange rate objectives. Under the current fiscal policy stance, achieving the authorities' M2 target might not be consistent with the desire to continue with a gradual nominal exchange rate depreciation aiming at preserving competitiveness. Given the size of projected purchases of foreign exchange from the government, sterilization might be too costly and would only provide a temporary remedy against inflation-induced real appreciation. In the short run, real appreciation could be contained through fiscal adjustment. If the latter is not possible, the authority should give priority to achieving the M2 target. While this might result in some nominal appreciation, it would also contribute to faster disinflation.

29. **The current level of the exchange rate does not raise concerns with regard to competitiveness as evidenced by the rapid growth of the tradable sector, including non-oil exports**. Further gains in competitiveness could be achieved in the medium term primarily through structural reforms. While some real appreciation in the short run may be inevitable, as highlighted above, this should not be sustained over the medium term since it would undermine the objective of economic diversification away from oil. The authorities indicated that the central bank is determined to smooth out short-term fluctuations in the exchange rate vis-à-vis a basket of currencies, while avoiding a nominal effective appreciation that might hinder competitiveness.

30. **The staff supported the authorities' gradual approach to capital account liberalization**. The authorities have put increased emphasis on attracting FDI under the recently adopted FDI law. They are also considering authorizing limited portfolio investment of non-residents with time limitations on the repatriation of principal capital. The staff underscored that further financial sector reforms and steady progress in disinflation are key preconditions for further capital account liberalization.

## B. Medium-Term Issues

31. **The current draft of the FFYDP puts forward ambitious macroeconomic objectives and a comprehensive structural reform agenda**. The plan targets a real GDP growth of 8 percent compared to 5.7 percent on average during the TFYDP. This is expected to be achieved through higher private sector investment and improved efficiency (higher total factor productivity, TFP) that would result from stepped up implementation of structural reforms. Inflation is projected to decelerate to 9.9 percent on average during the plan period, from an estimated 15–17 percent in 2004/05.

32. **The staff encouraged the authorities to finalize their reform programs and assess the macroeconomic implications of the plans' targets and structural reform agenda**. The staff welcomed the planned ambitious privatization program, which will open most sectors to private sector participation, including banks and insurance companies, and called for early implementation of labor market reform, further trade liberalization, and various measures to improve the business climate.

33. **The staff endorsed the authorities' plans to set the budget within a medium-term framework, given the central role of fiscal policy in Iran**. The fiscal policy objectives set forth in the draft FFYDP aim at reducing the dependency on oil revenue and limiting growth in current expenditure. The reform agenda also includes the introduction of the Value Added Tax (VAT) in 2006, a reduction in tax exemptions, a gradual phasing out of implicit energy subsidies (10½ percent of GDP in 2004/05), a reduction in explicit subsidies, and an overhaul of benefits and contributions under the current social security system. There are also plans to improve expenditure management and streamline Treasury operations with TA from the World Bank.

34. **The staff called for early implementation of financial sector reform under the FFYDP**. These include restructuring of public banks and improving their management in connection with recapitalization; the privatization of most public banks and insurance companies; a significant reduction in controls on credit allocation and rates of return; and a complete transition toward a risk-based supervision system.

35. **These reforms will support an increase in TFP and GDP growth**. While past experience shows that the Iranian economy can sustain relatively high growth rates over an extended period of time, the plan's objectives are particularly challenging given the lags in reform-driven increases in TFPs (Box 2), the likelihood of forced fiscal adjustment in response to a possible decline in oil prices over the medium term, and the need to overcome entrenched rigidities and improve the business climate.

36. **The staff developed an illustrative baseline medium-term scenario, assuming a gradual implementation of the reforms under the FFYDP and a back-loaded adjustment in fiscal and monetary policies**. This scenario is also based on a conservative assumption of a steady decline in oil prices to about $24 per barrel at the end of the plan period, as well as a gradual implementation of the energy price reform. Under this scenario, real GDP growth is projected to decline to below 5 percent in 2009/10 and the unemployment rate is likely to increase (Figure 7, Table 6, and Box 3). The fiscal adjustment will be gradual and will be achieved mainly through additional revenue measures, including energy subsidy reform,[18] of the VAT implementation in 2006/07, as well as lower growth in capital spending and net lending. Such a fiscal stance, together with modest monetary policy tightening at the beginning of the period, as well as the planned phasing out of subsidies, may well result in inflation being entrenched at about its current level. Under this scenario, a deficit in the external current account would emerge in 2005/06 and widen thereafter, as sluggish oil export earnings are likely to be more than offset by continued import growth (Figure 7 and Table 7). While external and public debt ratios would remain at an appropriate level, the OSF resources would be depleted by the end of the plan period and external liquidity indicators would deteriorate significantly. However, a sensitivity analysis shows that if average oil prices were to be about $5 per barrel higher relative to the baseline projection,[19] Iran's external position would be stronger than currently projected (Figure 8). Conversely, a decline in oil prices by

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[18] Based on broad indications regarding the planned energy price reform, it is assumed that energy prices will be increased by 25 percent per year with two-thirds of the additional revenue spent on social protection and public investment.

[19] In this scenario, oil prices are consistent with the August WEO benchmark price and a discount of about $3 per barrel for Iranian crude.

## Box 2. Sources of Growth in Iran

In the period 1960–2002, the Iranian economy grew at an average rate of 4½ percent, which compares favorably with the rest of the countries in the MENA region (with average growth rates of 4.2 percent). This growth performance, however, shows a high degree of variability: rapid growth in the 1960s and early 1970s was followed by a period of negative growth during the 1979 revolution and the war with Iraq which lasted well into the 1980s. Growth rebounded following the post-war reconstruction and subsequent economic reforms.

Text Table IV shows the decomposition of the sources of growth in Iran during the period, drawing on a Selected Issues Paper "Economic Growth in the Islamic Republic of Iran." The negative contribution of TFP to economic growth and the relatively high rates of investment in physical capital (30 percent of GDP on average during 1960–2002) suggest that growth in Iran resulted from high savings and investment rather than from an efficient use of resources. Text Table V shows that while the investment to GDP ratio has been relatively high compared with high-growth countries, average GDP growth has been 50 percent lower.

Text Table IV. Iran: Sources of Economic Growth, 1960–2002
(In percentage points)

| Period | Average Growth Rate | Contribution of Capital | Contribution of Human Capital | Contribution of TFP |
|---|---|---|---|---|
| 1960–1976 | 9.8 | 3.9 | 2.7 | 3.2 |
| 1977–1988 | -2.4 | 1.7 | 5.5 | -9.6 |
| 1989–2002 | 4.7 | 2.3 | 4.3 | -1.8 |
| 1960–2002 | 4.6 | 2.1 | 3.7 | -1.2 |

Sources: Central Bank of Iran, and IMF staff estimations.

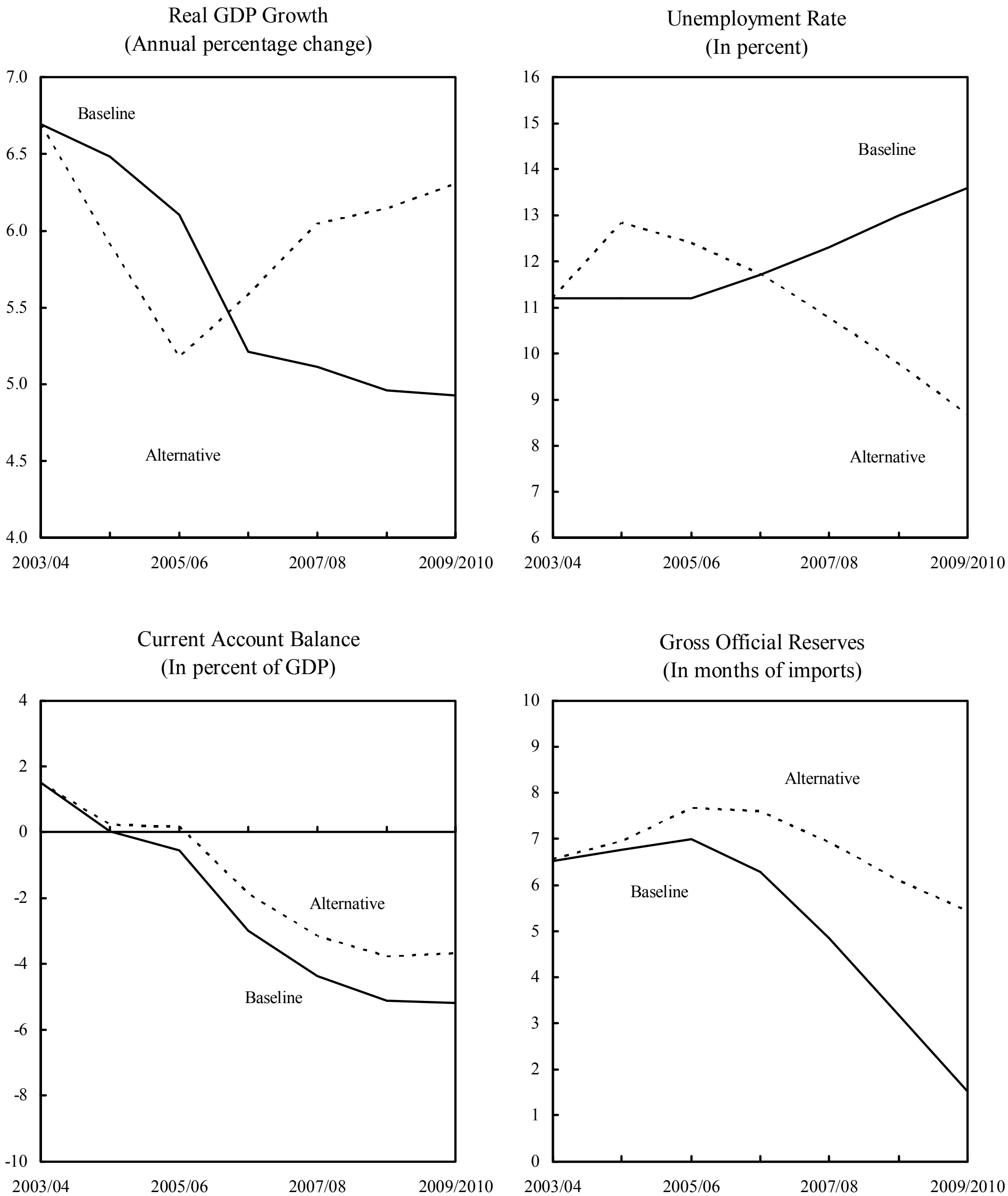
Table V. Comparison of the Investment and Growth Performance of Iran
with Six High-Growth Asian Economies
(In percent)

| | Average GDP growth 1962–2002 | Average investment/GDP 1962–2002 | Investment/GDP growth 1962–2002 |
|---|---|---|---|
| China,P.R.:Hong Kong SAR | 7.0 | 26.1 | 3.7 |
| Indonesia | 5.4 | 21.7 | 4.0 |
| Korea | 7.8 | 27.9 | 3.6 |
| Malaysia | 6.7 | 28.6 | 4.3 |
| Singapore | 7.9 | 36.0 | 4.5 |
| Thailand | 6.7 | 26.5 | 4.0 |
| Average | 6.9 | 27.8 | 4.0 |
| Iran | 4.6 | 30.5 | 6.6 |

Sources: International Financial Statistics, and IMF staff estimates.

These results suggest that if the government targets an increase in real GDP growth to 8 percent on average—as proposed under the draft FFYDP—TFP would need to contribute about 2.2 percent to the average growth rate in the future (versus -1.8 percent during 1989–2002), if investment ratios were to remain at about 30 percent of GDP. The authorities' growth target for the next five years seems overly ambitious. However, cross-country evidence suggests that while structural reforms are necessary to increase TFP, these effects tend to be delayed by about two to four years.

Figure 7. Islamic Republic of Iran: Medium-Term Projections, 2003/04–2009/2010




Sources: Iranian authorities; and Fund staff estimates.

## Box 3. Employment under Alternative Medium-Term Scenarios

This Box describes the projected evolution of total employment and unemployment under two alternative medium-term scenarios presented in the text. Both exercises assume the same rate of growth of labor supply of 3.3 percent per year over the medium term and no change in labor participation rates, consistent with the experience in the past decade (in which the labor participation rate for females increased but decreased for males).

Under the baseline medium term-framework, the absence of labor market reform would imply that the elasticity of employment to non-oil GDP growth is likely to remain at its historical level of 0.5. The reform and adjustment (alternative) medium-term scenario assumes upfront labor market reform that would introduce greater flexibility in the labor market and progressively cause the elasticity of employment to grow from 0.5 to 0.7 over the medium term. The needed labor market reform includes reducing dismissal costs, eliminating regulations of wages in many industries dominated by state-owned companies, and improving the information system for job seekers.

Table VI. Employment and Unemployment Under the Baseline Medium-Term Scenario.
(In thousands, unless otherwise indicated)

| | Prel. | Proj. | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2002/03 | 2003/04 | 2004/05 | 2005/06 | 2006/07 | 2007/08 | 2008/09 | 2009/10 |
| Active population (average increase of 3.3 percent) | 20,429 | 21,014 | 21,707 | 22,424 | 23,164 | 23,928 | 24,718 | 25,534 |
| Employment (elasticity to growth = 0.5) | 17,937 | 18,660 | 19,284 | 19,911 | 20,451 | 20,988 | 21,517 | 22,051 |
| Unemployment | 2,492 | 2,354 | 2,424 | 2,513 | 2,713 | 2,941 | 3,201 | 3,482 |
| Unemployment rate, in percent | 12.2 | 11.2 | 11.2 | 11.2 | 11.7 | 12.3 | 13.0 | 13.6 |

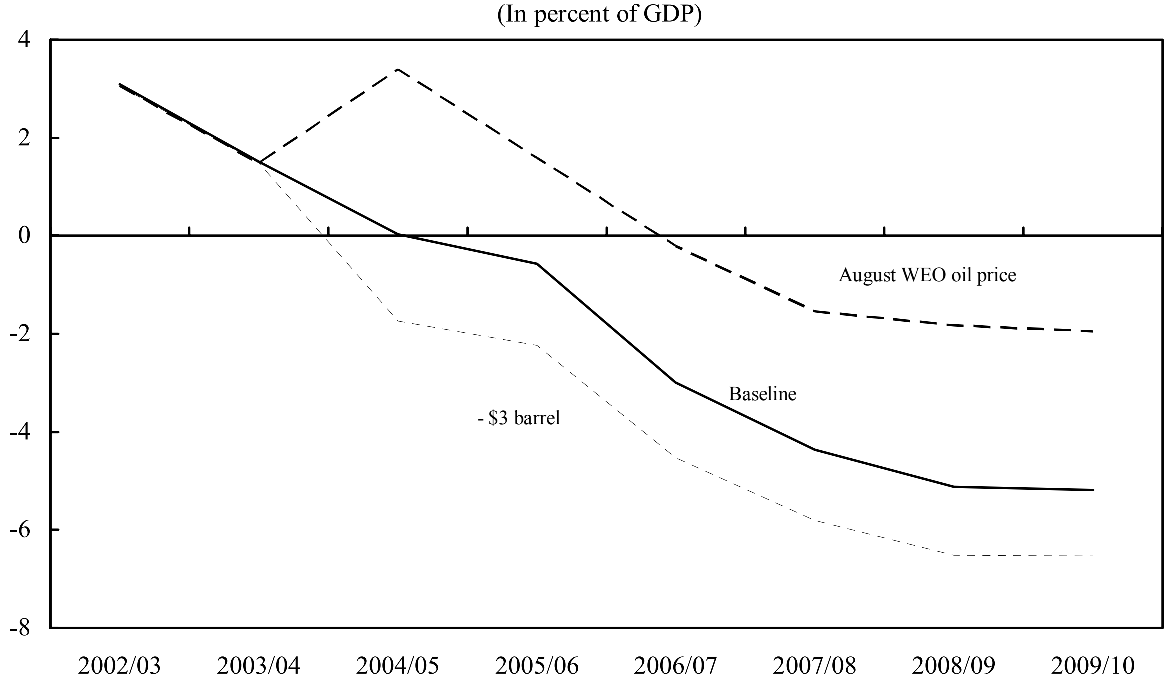
Sources: Data provided by the Iranian authorities; and Fund staff estimates and projections.

Table VII. Employment and Unemployment Under the Alternative Medium-Term Scenario.
(In thousands, unless otherwise indicated)

| | Prel. | Proj. | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2002/03 | 2003/04 | 2004/05 | 2005/06 | 2006/07 | 2007/08 | 2008/09 | 2009/10 |
| Active population (average increase of 3.3 percent) | 20,429 | 21,014 | 21,707 | 22,424 | 23,164 | 23,928 | 24,718 | 25,534 |
| Employment (elasticity to growth = 0.5 to 0.7) | 17,937 | 18,153 | 18,920 | 19,643 | 20,447 | 21,348 | 22,300 | 23,318 |
| Unemployment | 2,492 | 2,354 | 2,787 | 2,781 | 2,717 | 2,580 | 2,417 | 2,215 |
| Unemployment rate, in percent. | 12.2 | 11.2 | 12.8 | 12.4 | 11.7 | 10.8 | 9.8 | 8.7 |

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

Figure 8: Islamic Republic of Iran: Sensitivity of the Current Account Balance to Oil Prices, 2002/03 - 2009/10
(In percent of GDP)




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

about $3 per barrel relative to the baseline scenario would result in a significant deterioration of the current account balance and in reserve coverage of imports by the end of the projection period (Figure 8).

37. **An alternative scenario developed by the staff assumes an upfront fiscal adjustment supported by monetary policy restraint** (Table 8 and Figure 7).This, together with expeditious implementation of structural reforms, would result in a much better outcome for inflation, a stronger liquidity position of the government, as reflected in a steady build-up of savings in the OSF, a better resilience to external shocks due to a much higher coverage of imports by gross official reserves, and possibly faster growth and employment creation (Figure 7 and Box 3). The recommended policy scenario would also help achieve fiscal sustainability in the long run by moving consumption of hydrocarbon wealth closer to the optimal path.[20]

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[20] A Selected Issues Paper—"Issues in Medium-term Management of Oil Wealth"—provides estimates of optimal consumption out of oil wealth based on various assumptions for oil prices and inter-generation equity considerations.

### C. Other Issues

38. **The authorities attach great importance to transparency and improvements to data dissemination**. They are committed to moving toward compliance with the requirements of the IMF's Special Data Dissemination Standard (SDDS). In this regard, the staff stressed the need for rapid implementation of the recommendations of recent STA TA missions (Appendix III).

39. **The track record of implementing Fund TA recommendations has been mixed**. During 2003/04, the authorities made substantial progress in implementing the recommendations of a LEG/MFD mission on eliminating exchange restrictions for current account transactions. However, progress in implementing Fund TA in tax administration and VAT has been slow so far. The authorities continue to value Fund's assistance and expressed interest in receiving TA in the areas of banking system restructuring and capital account liberalization.

40. The authorities reiterated their commitment to provide debt relief to Nicaragua and Tanzania under the Heavily Indebted Poor Countries (HIPC) Initiative.

## IV. Staff Appraisal

41. **Iran has enjoyed two consecutive years of real GDP growth at above 6 percent, supported by economic reforms and a favorable external environment, but key challenges remain**. This growth performance has been accompanied by lower unemployment, rising international reserves, low external debt, and enhanced business confidence. While initial structural reforms implemented at the beginning of the TFYDP have played a key role in improving economic efficiency, attracting foreign direct investment, and improving the business environment, less enduring factors such as high oil prices and expansionary policies, have also been at play. The authorities are now facing challenges on both fronts: the temporary factors may soon run their course and require policy adjustment, while the initial structural reforms need to be consolidated and deepened to sustain high growth and employment creation.

42. **Fiscal and monetary policy stimulus at the height of the oil price cycle has increased inflationary pressure and intensified the economy's vulnerability to a retrenchment in oil prices**. Channeling larger oil revenue to finance higher government spending, together with accommodating monetary policy, has led to the persistence of rapid credit and liquidity growth and double-digit inflation. This, together with inadequate instruments of monetary policy and a relatively weak banking system, poses a serious challenge for macroeconomic management. While the authorities take comfort in the positive employment outcome of their policy and seem willing to tolerate inflation at its current level, a continuation of the current expansionary policy mix could make inflation entrenched and increase the output cost of lowering it in the medium term.

43. **The projected outcome for 2004/05 calls for a shift in the policy mix**. Despite the expenditure cuts that are envisaged to deal with shortfalls in revenue and privatization receipts, the level of government spending remains high and the non-oil fiscal deficit is estimated by the staff to increase. This, together with the authorities' reluctance to raise bank lending rates, may lead to another year of high money and credit growth, double-digit inflation, and the elimination of the current account surplus at a time of high oil prices.

44. **A withdrawal of the policy stimulus is needed** through tightening in fiscal policy that would be sufficient to support the central bank disinflation objective and contain upward pressure on the exchange rate. The output cost of an upfront adjustment is likely to be offset by the benefits of more sustainable growth and employment creation in the medium term. The authorities in all likelihood will need to consider further fiscal adjustment in 2004/05 beyond offsetting possible revenue shortfalls. While there is limited room for revenue measures, efforts could focus on reducing subsidies and containing the steep increase in capital spending and net lending. These efforts would help move the overall fiscal position close to balance. Assuming that average oil prices will be higher than assumed in the baseline scenario, the authorities should strongly resist pressures to increase expenditure and, instead, use the windfall gains to build savings in the OSF. This would help achieve the authorities' disinflation objectives, contain the pressure on the exchange rate to appreciate, and build a financial cushion to ride out a possible downturn in oil prices.

45. **Monetary policy should give priority to reducing the rate of inflation**. The authorities' package of monetary policy measures, including issuing additional CBPP and providing commercial banks with greater freedom in credit allocation, are steps in the right direction. The staff welcomes the authorities' commitment to take additional measures to contain credit growth and mop up excess liquidity, along with their determination to strengthen fiscal and monetary policy coordination to achieve their inflation objective. In this respect, sufficient flexibility to use a variety of policy instruments would go a long way to help the central bank achieve its objectives. The staff welcomes the authorities' plans to grant the central bank greater instrument independence, enhance the monetary policy formulation framework, and develop adequate instruments of liquidity management. The authorities should also consider announcing a feasible medium-term disinflation path consistent with their other priorities, including employment.

46. **The exchange rate level is not misaligned, but greater flexibility in exchange rate management is needed**. Given the likelihood of continued large inflows of oil revenue and FDI, and in the absence of sufficient fiscal tightening, tensions will continue to arise between the central bank's attempt to avoid a real appreciation of the exchange rate through nominal depreciation and its disinflation objective. In this regard, priority should be given to achieving the intermediate monetary policy targets, which calls for greater exchange rate flexibility, including allowing for some nominal appreciation in the short run, if warranted. While fostering competitiveness is key to facilitating the diversification of the Iranian economy, major obstacles in this area are of a structural nature and would need to be removed through stepped up reforms to improve the business environment. The staff commends the authorities for the decisive progress in eliminating exchange restrictions on current account transactions

and supports their strategy of a gradual capital account liberalization to be underpinned by further progress in financial sector reform and disinflation.

47. **Structural reforms must be carried further to sustain high rates of growth and employment creation**. The current period of high oil prices and strong business confidence provides an opportunity to implement major reforms that would put the economy on a long-term path of high growth and employment creation. With abundant natural resources, an educated work force, and long traditions of entrepreneurship, Iran is in a position to realize its economic potential if wide-ranging reforms are implemented. The staff welcomes the ambitious reform agenda under the forthcoming five-year development plan and encourages the authorities to ensure steadfast implementation. In addition to medium-term fiscal and financial sector reforms, the authorities would need to follow through with their plans of privatization, further trade liberalization, labor market reform, and improvements to the business climate.

48. **The staff supports the authorities' intention to set fiscal policy in a medium-term framework and to accelerate fiscal reforms**. The authorities' objective of reducing dependence on oil revenue is commendable, and would need to be pursued through determined implementation of the VAT, a phasing-out of implicit and explicit subsidies, and the development of targeted social assistance. Early action on other fiscal reforms is also needed, including public expenditure and cash management, with assistance from the World Bank and the IMF. The staff encourages the authorities to continue with their practice of audit and oversight of charitable foundations (bonyads).

49. **The staff and the authorities agree on the importance of early financial sector reform**. Progress in establishing sound foundations for a market-based financial system must be commensurate with the liberalization of the Iranian economy and the attraction of large capital inflows. As such, the staff stresses the need to move forcefully to restructure state-owned banks, reform banking supervision by establishing a full-fledged risk-based supervisory framework, and adopt the capital market law while strengthening the supervision of the stock exchange. Moreover, the authorities are encouraged to adopt the AML/CFT legislation and introduce relevant implementing regulations. Looking ahead, the staff welcomes the banking system reform agenda outlined in the draft FFYDP, which aims at establishing a dynamic and competitive banking system with majority private ownership.

50. **While there was some progress in timeliness and quality of statistical information provided to the Fund, further efforts are needed in a number of areas**. The authorities are encouraged to compile and publish the international reserves template, along with Iran's international investment position, and improve monetary and fiscal data in line with STA TA missions recommendations.

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

Table 1. Islamic Republic of Iran: Selected Macroeconomic Indicators, 2000/01–2004/05 1/

| | 2000/01 | 2001/02 | 2002/03 | Prel. 2003/04 | Proj. 2004/05 |
|---|---|---|---|---|---|
| Hydrocarbon Sector | | | | | |
| Total hydrocarbon exports (in billions of U.S. dollars) | 24.3 | 19.3 | 23.0 | 27.0 | 29.2 |
| Average oil export price (in U.S. dollar/barrel) | 25.3 | 21.5 | 27.2 | 28.0 | 30.0 |
| Crude oil production (in millions of barrels/day) | 3.7 | 3.6 | 3.2 | 3.8 | 3.9 |
| | (Annual percentage change, unless otherwise indicated) | | | | |
| National accounts | | | | | |
| Nominal GDP at factor cost (in billions of Iranian rials) | 576,493 | 663,126 | 922,433 | 1,132,634 | 1,373,625 |
| Nominal GDP at factor cost (in billions of dollars) | 71.4 | 83.7 | 115.8 | 136.8 | ... |
| Per capita GDP (in U.S. dollars) | 1,124 | 1,296 | 1,762 | 2,050 | ... |
| Real GDP at market prices | 5.1 | 3.7 | 7.5 | 6.6 | 6.6 |
| Real GDP at factor cost | 5.0 | 3.3 | 7.4 | 6.7 | 6.5 |
| Real hydrocarbon GDP | 8.3 | -8.1 | 5.1 | 8.4 | 5.0 |
| Real non-hydrocarbon GDP | 4.5 | 5.1 | 7.8 | 6.5 | 6.7 |
| Inflation rate | | | | | |
| CPI inflation (average) | 12.6 | 11.4 | 15.8 | 15.6 | 15.6 |
| Unemployment rate | 14.1 | 14.7 | 12.2 | 11.2 | 11.2 |
| Population (in millions) | 63.5 | 64.6 | 65.7 | 66.7 | ... |
| | (In percent of GDP at market prices) | | | | |
| Investment and savings | | | | | |
| Investment | 33.0 | 35.3 | 39.8 | 41.0 | 36.3 |
| Change in stocks | 6.5 | 6.3 | 12.0 | 12.2 | 5.3 |
| Total fixed capital investment | 26.4 | 29.0 | 27.8 | 28.9 | 31.0 |
| Public | 8.9 | 8.8 | 8.9 | 8.0 | 8.8 |
| Private | 17.6 | 20.2 | 18.8 | 20.9 | 22.1 |
| Gross national savings | 46.0 | 40.5 | 42.9 | 42.5 | 36.3 |
| Public | 23.3 | 14.6 | 13.1 | 13.7 | 14.1 |
| Private | 22.8 | 25.9 | 29.8 | 28.8 | 22.2 |
| Savings/investment balance 2/ | 13.1 | 5.3 | 3.1 | 1.5 | 0.0 |
| | (In percent of GDP at factor cost) | | | | |
| Budgetary operations | | | | | |
| Revenue | 33.0 | 27.3 | 26.9 | 27.0 | 27.0 |
| Oil | 22.2 | 15.6 | 16.2 | 16.3 | 15.5 |
| Non-oil | 10.7 | 11.7 | 10.7 | 10.7 | 11.5 |
| Expenditure and net lending | 24.3 | 25.5 | 29.3 | 27.2 | 28.5 |
| *Of which:* current | 15.3 | 17.0 | 16.1 | 16.0 | 16.1 |
| capital | 5.2 | 3.8 | 6.1 | 5.1 | 6.1 |
| Balance | 8.7 | 1.8 | -2.4 | -0.2 | -1.4 |
| Domestic financing | -7.5 | -1.1 | 0.9 | 0.6 | 2.1 |
| External financing | -1.2 | -0.7 | 1.5 | -0.5 | -0.7 |
| Non-oil balance | -13.5 | -13.7 | -18.7 | -16.5 | -16.9 |
| | (Annual percentage change) | | | | |
| Monetary sector | | | | | |
| Net foreign assets | 136.8 | 14.3 | 37.6 | -3.6 | -0.1 |
| Net domestic assets | 26.2 | 30.2 | 29.4 | 35.7 | 37.9 |
| Credit to private sector in rials | 27.3 | 30.5 | 34.9 | 39.1 | 32.0 |
| Broad money (M2) | 30.5 | 25.8 | 30.1 | 26.2 | 29.3 |
| Velocity of broad money | 2.2 | 2.0 | 2.2 | 2.1 | 2.0 |
| | (In billions of U.S. dollars, unless otherwise indicated) | | | | |
| External sector | | | | | |
| Exports of goods and services | 30.5 | 27.4 | 33.3 | 40.2 | 44.2 |
| Oil and gas | 24.3 | 19.3 | 23.0 | 27.0 | 29.2 |
| Non-oil goods | 4.2 | 4.6 | 5.3 | 6.8 | 7.5 |
| Imports of goods and services | -18.6 | -22.1 | -30.6 | -39.4 | -45.6 |
| Current account balance | 12.5 | 6.0 | 3.6 | 2.1 | 0.0 |
| External public and publicly guaranteed debt | 8.0 | 7.2 | 9.3 | 11.9 | 13.2 |
| *Of which:* short-term debt | 3.7 | 2.7 | 2.1 | 4.6 | 6.0 |
| Gross official reserves | 12.2 | 16.6 | 21.4 | 24.4 | 27.4 |
| In months of next year imports of goods and services | 6.7 | 6.8 | 6.6 | 6.5 | 6.7 |
| Memorandum items: | | | | | |
| Nominal effective exchange rate , 1999/00=100 3/ | 109.4 | 120.6 | 114.0 | 95.2 | ... |
| Real effective exchange rate, 1999/00=100 3/ | 118.4 | 139.0 | 147.2 | 134.2 | ... |
| Average exchange rate (Iranian rials per dollar) | 8,078.0 | 7,921.0 | 7,967.1 | 8,282.0 | ... |

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

1/ Iranian fiscal year ending March 20.
2/ Using the current account balance from the balance of payments and the market-determined exchange rate.
3/ Using INS weights.

Table 2. Islamic Republic of Iran: Baseline Balance of Payments, 2000/01–2004/05 1/

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

| | 2000/01 | 2001/02 | 2002/03 | Prel. 2003/04 | Proj. 2004/05 |
|---|---|---|---|---|---|
| Current account | 12,500 | 5,985 | 3,585 | 2,059 | 40 |
| | | | | | |
| Trade balance | 13,375 | 5,775 | 6,201 | 4,993 | 2,816 |
| Exports | 28,461 | 23,904 | 28,237 | 33,788 | 36,704 |
| Oil and gas | 24,280 | 19,339 | 22,966 | 27,033 | 29,238 |
| Crude oil | 21,011 | 16,806 | 19,380 | 23,113 | 25,185 |
| Petroleum products and natural gas | 3,269 | 2,533 | 3,586 | 3,920 | 4,053 |
| Refined products | 2,391 | 2,141 | 2,587 | 2,517 | 2,740 |
| Natural gas and others | 878 | 392 | 999 | 1,403 | 1,313 |
| Non-Oil and gas | 4,181 | 4,565 | 5,271 | 6,755 | 7,466 |
| Imports | -15,086 | -18,129 | -22,036 | -28,795 | -33,888 |
| | | | | | |
| Services (net) | -1,485 | -495 | -3,503 | -4,160 | -4,266 |
| Credits | 2,012 | 3,488 | 5,025 | 6,415 | 7,476 |
| *Of which:* interest income | 215 | 655 | 653 | 633 | 645 |
| Debits | -3,497 | -3,983 | -8,528 | -10,575 | -11,742 |
| *Of which:* interest payments | -370 | -397 | -1,082 | -604 | -616 |
| | | | | | |
| Transfers (net) | 610 | 705 | 887 | 1,226 | 1,490 |
| | | | | | |
| Capital and financial accounts | -4,567 | -470 | 2,455 | 4,016 | 2,960 |
| Medium-term and long-term capital | -2,555 | 288 | 2,354 | -360 | -46 |
| Bilateral project financing | -473 | 168 | 521 | 175 | 940 |
| Repayments of rescheduled debt | -884 | -327 | -60 | 0 | 0 |
| Other official financing and portfolio investment 2/ | 10 | -35 | 1,015 | 51 | 85 |
| Oil prefinancing | -1,208 | 482 | 878 | -586 | -1,071 |
| Short-term capital 3/ | -326 | -1,026 | -575 | 2,538 | 1,370 |
| Other capital 4/ | -2,416 | -1,995 | -541 | 127 | 0 |
| Foreign direct investment and portfolio equity | 730 | 2,263 | 1,217 | 1,711 | 1,636 |
| *Of which:* buybacks | 649 | 2,169 | 967 | 1,068 | 986 |
| | | | | | |
| Errors and omissions | -1,296 | -1,075 | -1,247 | -3,057 | 0 |
| | | | | | |
| Overall balance | 6,637 | 4,440 | 4,793 | 3,018 | 3,000 |
| | | | | | |
| Change in gross official reserves (increase -) | -6,637 | -4,440 | -4,793 | -3,018 | -3,000 |
| | | | | | |
| Memorandum items: | | | | | |
| | | | | | |
| Gross official reserves (in millions of U.S. dollars) | 12,176 | 16,616 | 21,409 | 24,427 | 27,427 |
| *Of which:* Oil Stabilization Fund 5/ | 5,944 | 7,440 | 8,033 | 8,606 | 7,940 |
| (in months of next year's imports) | 6.7 | 6.8 | 6.6 | 6.5 | 6.7 |
| External debt service (as percent of exports) 6/ | 12.2 | 7.4 | 3.7 | 4.5 | 5.6 |
| Oil exports (in million barrels/day) | 2.3 | 2.2 | 2.0 | 2.3 | 2.3 |
| Oil exports average price (in U.S. dollars/barrel) 7/ | 24.5 | 20.9 | 27.2 | 28.0 | 30.0 |
| Real merchandise exports (percentage change) | 11.8 | -3.5 | -6.1 | 14.1 | 1.7 |
| Oil and gas | 7.4 | -6.3 | -8.9 | 14.2 | 1.1 |
| Non-Oil and gas | 10.9 | 10.8 | 9.5 | 13.6 | 4.1 |
| Real merchandise imports (percentage change) | 11.7 | 23.3 | 15.8 | 16.4 | 11.9 |

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

1/ Fiscal year ending 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/ Represents the part of the Oil Stabilization Fund that is invested together with the gross international reserves.
6/ Excluding short-term debt.
7/ Projection for 2004/05 is based on the average export price for the first two months of the year.

Table 3. Islamic Republic of Iran: Vulnerability Indicators, 1998/99–2003/04 1/

| | 1998/99 | 1999/00 | 2000/01 | 2001/02 | 2002/03 | Prel. 2003/04 |
|---|---|---|---|---|---|---|
| External solvency indicators | | | | | | |
| REER ( percent change) | -0.8 | -11.4 | 18.4 | 17.4 | 5.9 | -8.8 |
| Total public and publicly guaranteed external debt (in billions of U.S. dollars) | 14.1 | 10.8 | 8.0 | 7.2 | 9.3 | 11.9 |
| (In percent of GDP) | 23.2 | 19.7 | 11.1 | 8.6 | 8.0 | 8.7 |
| Short-term external debt (in billions of U.S. dollars) | 4.5 | 4.0 | 3.7 | 2.7 | 2.1 | 4.6 |
| (In percent of GDP) | 7.4 | 7.3 | 5.2 | 3.2 | 1.8 | 3.4 |
| (In percent of exports of goods and services) 2/ | 30.2 | 18.0 | 12.2 | 9.9 | 6.4 | 11.7 |
| External debt service (in percent of exports of goods and services) 2/ 3/ | 33.5 | 23.8 | 12.2 | 7.4 | 3.7 | 4.5 |
| External liquidity indicators | | | | | | |
| Total official reserves (in billions of U.S. dollars) | 3.7 | 5.6 | 12.2 | 16.6 | 21.4 | 24.4 |
| In months of next year imports of goods and services 2/ | 2.8 | 3.7 | 6.7 | 6.8 | 6.6 | 6.5 |
| In percent of short-term external debt | 82.8 | 141.0 | 331.0 | 626.5 | 1,030.8 | 529.3 |
| Commercial banks net foreign assets (in billions of U.S. dollars) | -1.1 | 0.0 | -0.6 | -1.8 | -2.3 | -7.2 |
| Foreign assets | 1.3 | 2.9 | 5.1 | 5.6 | 6.4 | 7.4 |
| Foreign liabilities 4/ | 2.4 | 2.9 | 5.7 | 7.4 | 8.6 | 14.5 |
| Oil and oil-related exports (in percent of exports of goods) | 75.7 | 81.3 | 85.3 | 80.9 | 81.3 | 80.0 |
| Public sector solvency indicators | | | | | | |
| Public and publicly guaranteed debt (in percent of GDP) | 41.3 | 34.8 | 22.7 | 20.7 | 20.8 | 18.9 |
| Oil revenue (in percent of total revenue) | 35.8 | 42.8 | 67.5 | 57.0 | 60.3 | 60.4 |
| Financial sector indicators | | | | | | |
| Risk-weighted capital adequacy of banks (in percent) 5/ | ... | ... | 6.6 | 6.9 | 4.5 | 7.2 |
| Ratio of nonperforming loans of banks (in percent) 5/ | 5.1 | 4.3 | 4.4 | 5.4 | 5.7 | 5.2 |
| Loan provisions as a percentage of nonperforming loans | 38.6 | 40.2 | 37.3 | 31.0 | ... | ... |
| Net profit margin of banks to total assets (in percent) | ... | ... | ... | 0.94 | 0.58 | ... |
| Net domestic credit (percent change) | 33.2 | 22.1 | 14.8 | 26.0 | 62.5 | 35.1 |
| Private sector credit in local currency (percent change) | 29.7 | 40.4 | 31.1 | 34.1 | 34.9 | 39.1 |
| Net domestic credit (in percent of GDP) | 57.3 | 52.9 | 46.2 | 42.7 | 49.9 | 55.0 |
| Market assessment/financial market indicators | | | | | | |
| Stock market price index (percent change; end-of-period) | -7.0 | 43.4 | 35.0 | 26.2 | 34.7 | 124.8 |
| Stock market capitalization (in percent of GDP) | 8.1 | 10.1 | 10.8 | 12.3 | 12.8 | 27.3 |
| Stock market turnover ratio (in percent) | 9.1 | 10.4 | 14.7 | … | ... | ... |
| Fitch sovereign rating | … | … | … | B+ | B+ | B+ |

Sources: Iranian authorities; and Fund staff estimates.

1/ Iranian fiscal years ending March 20.
2/ Excluding interest receipts and payments.
3/ Excluding short-term external debt.
4/ Including contingent liabilities under letters of credit.
5/ The classification is not consistent with international practices.

Table 4. Islamic Republic of Iran: Central Government Operations, 2000/01–2004/05 1/

(In billions of rials)

| | 2000/01 | 2001/02 | 2002/03 | Prel. 2003/04 | Budget 2004/05 | Proj. 2/ 2004/05 |
|---|---|---|---|---|---|---|
| Revenue | 189,989 | 180,979 | 248,261 | 305,735 | 385,758 | 371,290 |
| Revenue from oil and gas exports | 128,205 | 103,138 | 149,685 | 184,535 | 205,988 | 213,060 |
| Tax and nontax revenue | 61,784 | 77,841 | 98,576 | 121,201 | 179,770 | 158,230 |
| Tax revenue | 33,298 | 41,682 | 50,553 | 65,099 | 88,998 | 80,117 |
| Nontax revenue | 12,004 | 13,443 | 15,035 | 15,633 | 33,775 | 21,116 |
| Of which: revenue from OSF (income earned) | 0 | 1,241 | 1,592 | 1,895 | 4,107 | 4,249 |
| Earmarked revenue 3/ | 16,481 | 22,717 | 32,988 | 40,469 | 56,997 | 56,997 |
| Expenditure and net lending | 139,893 | 168,987 | 270,621 | 307,521 | 414,197 | 390,819 |
| Current expenditure | 88,068 | 112,551 | 148,748 | 181,600 | 216,851 | 221,041 |
| Wages and salaries | 60,036 | 44,000 | 57,132 | 65,725 | 74,300 | 74,300 |
| Interest payments | ... | 1,926 | 3,075 | 3,344 | 3,543 | 3,724 |
| Subsidies | 8,118 | 11,784 | 36,648 | 45,123 | 39,700 | 43,709 |
| Goods and services | ... | ... | 19,110 | 24,761 | 26,400 | 26,400 |
| Grants | ... | ... | 5,917 | 7,048 | 8,400 | 8,400 |
| Social benefits | ... | ... | 21,941 | 31,770 | 38,800 | 38,800 |
| Other | ... | ... | 4,925 | 3,829 | 25,708 | 25,708 |
| Capital expenditure | 30,115 | 25,488 | 56,305 | 57,772 | 112,386 | 83,639 |
| Coverage of contingent liabilities under letters of credit | 0 | 0 | 19,895 | 14,942 | 13,360 | 13,920 |
| Earmarked expenditure | 16,481 | 22,717 | 32,988 | 40,469 | 56,997 | 56,997 |
| Foreign exchange losses | 2,028 | 0 | 3,979 | 3,653 | 5,402 | 5,629 |
| Net lending | 3,201 | 1,776 | 4,726 | 9,084 | 9,200 | 9,594 |
| Of which: lending domestically from OSF | 399 | 1,366 | 4,912 | 9,336 | 9,394 | 9,788 |
| Extrabudgetary outlays requiring special permission | 0 | 6,456 | 3,979 | 0 | 0 | 0 |
| Overall balance (deficit (-)) | 50,096 | 11,992 | -22,360 | -1,785 | -28,438 | -19,530 |
| Overall non-oil balance (deficit (-)) | -78,110 | -91,146 | -172,045 | -186,320 | -234,427 | -232,589 |
| Financing | -50,096 | -11,992 | 22,360 | 1,785 | 28,438 | 19,530 |
| Net domestic | -43,221 | -7,395 | 8,398 | 7,070 | 37,217 | 28,676 |
| Banking system (net) | -45,265 | -3,215 | 2,608 | -1,850 | 9,768 | 10,228 |
| Of which: OSF | -46,625 | -11,862 | -4,713 | -4,757 | 5,566 | 5,799 |
| Nonbanks, including privatization proceeds | 2,044 | -4,180 | 5,790 | 8,920 | 27,449 | 18,449 |
| Of which: privatization proceeds 4/ | 0 | -331 | 1,064 | 2,331 | 12,000 | 3,000 |
| Net external | -6,875 | -4,598 | 13,962 | -5,285 | -8,779 | -9,147 |
| Memorandum item: | | | | | | |
| Energy subsidies | ... | ... | ... | 117,429 | 104,000 | 144,770 |

Table 4. Islamic Republic of Iran: Central Government Operations, 2000/01–2004/05 1/ (concluded)

(In percent of GDP, unless otherwise indicated)

| | 2000/01 | 2001/02 | 2002/03 | Prel. 2003/04 | Budget 2004/05 | Proj. 2/ 2004/05 |
|---|---|---|---|---|---|---|
| Revenue | 33.0 | 27.3 | 26.9 | 27.0 | 28.1 | 27.0 |
| Revenue from oil and gas exports | 22.2 | 15.6 | 16.2 | 16.3 | 15.0 | 15.5 |
| Tax and nontax revenue | 10.7 | 11.7 | 10.7 | 10.7 | 13.1 | 11.5 |
| Tax revenue | 5.8 | 6.3 | 5.5 | 5.7 | 6.5 | 5.8 |
| Nontax revenue | 2.1 | 2.0 | 1.6 | 1.4 | 2.5 | 1.5 |
| Of which: revenue from OSF (income earned) | ... | 0.2 | 0.2 | 0.2 | 0.3 | 0.3 |
| Earmarked revenue 3/ | 2.9 | 3.4 | 3.6 | 3.6 | 4.1 | 4.1 |
| Expenditure and net lending | 24.3 | 25.5 | 29.3 | 27.2 | 30.2 | 28.5 |
| Current expenditure | 15.3 | 17.0 | 16.1 | 16.0 | 15.8 | 16.1 |
| Wages and salaries | 10.4 | 6.6 | 6.2 | 5.8 | 5.4 | 5.4 |
| Interest payments | … | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 |
| Subsidies | 1.4 | 1.8 | 4.0 | 4.0 | 2.9 | 3.2 |
| Goods and services | ... | ... | 2.1 | 2.2 | 1.9 | 1.9 |
| Grants | ... | ... | 0.6 | 0.6 | 0.6 | 0.6 |
| Social services | ... | ... | 2.4 | 2.8 | 2.8 | 2.8 |
| Other | ... | ... | 0.5 | 0.3 | 1.9 | 1.9 |
| Capital expenditure | 5.2 | 3.8 | 6.1 | 5.1 | 8.2 | 6.1 |
| Coverage of contingent liabilities under letters of credit | 0.0 | 0.0 | 2.2 | 1.3 | 1.0 | 1.0 |
| Earmarked expenditure | 2.9 | 3.4 | 3.6 | 3.6 | 4.1 | 4.1 |
| Foreign exchange losses | 0.4 | 0.0 | 0.4 | 0.3 | 0.4 | 0.4 |
| Net lending | 0.6 | 0.3 | 0.5 | 0.8 | 0.7 | 0.7 |
| Of which: lending domestically from OSF | ... | 0.2 | 0.5 | 0.8 | 0.7 | 0.7 |
| Extrabudgetary outlays requiring special permission | ... | 1.0 | 0.4 | 0.0 | 0.0 | 0.0 |
| Overall balance (deficit (-)) | 8.7 | 1.8 | -2.4 | -0.2 | -2.1 | -1.4 |
| Overall non-oil balance (deficit (-)) | -13.5 | -13.7 | -18.7 | -16.5 | -17.1 | -16.9 |
| Financing | -8.7 | -1.8 | 2.4 | 0.2 | 2.1 | 1.4 |
| Net domestic | -7.5 | -1.1 | 0.9 | 0.6 | 2.7 | 2.1 |
| Banking system (net) | -7.9 | -0.5 | 0.3 | -0.2 | 0.7 | 0.7 |
| Of which: OSF | -8.1 | -1.8 | -0.5 | -0.4 | 0.4 | 0.4 |
| Nonbanks, including privatization proceeds | 0.4 | -0.6 | 0.6 | 0.8 | 2.0 | 1.3 |
| Of which: privatization proceeds 4/ | 0.0 | 0.0 | 0.1 | 0.2 | 0.9 | 0.2 |
| Net external | -1.2 | -0.7 | 1.5 | -0.5 | -0.6 | -0.7 |
| Memorandum item: | | | | | | |
| Energy subsidies | ... | ... | ... | 10.4 | 7.6 | 10.5 |

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

1/ Fiscal year ends March 20.
2/ Staff projections reflecting current policies.
3/ Reflects mainly transactions with the social security organization.
4/ In 2001/02, privatization proceeds include restructuring costs of the privatized enterprises.

Table 5. Islamic Republic of Iran: Monetary Survey, 2000/01–2004/05 1/

(In billions of rials; unless otherwise indicated)

| | 2000/01 | 2001/02 | Est. 2/ 2001/02 | Prel. 2002/03 | Prel. 2003/04 | Proj. 3/ 2004/05 |
|---|---|---|---|---|---|---|
| Net foreign assets | 18,671 | 21,339 | 96,635 | 133,010 | 128,259 | 128,094 |
| Net domestic assets | 242,140 | 315,375 | 248,015 | 321,011 | 435,665 | 600,841 |
| Net domestic credit | 266,055 | 340,097 | 283,455 | 460,680 | 622,518 | 819,538 |
| Net credit to goverrnment | 24,637 | 22,717 | -25,355 | -5,898 | -25,217 | -26,456 |
| Claims on the government | 63,364 | 70,639 | 76,851 | 122,231 | 125,809 | 123,702 |
| Deposits | 38,727 | 47,922 | 102,206 | 128,129 | 151,026 | 150,158 |
| Claims on NFPEs | 55,731 | 66,267 | 66,267 | 77,210 | 77,312 | 77,912 |
| Claims on the private sector in rials | 180,871 | 242,543 | 242,543 | 327,073 | 454,800 | 600,170 |
| Claims on private sector in foreign currency 4/ | 4,816 | 8,570 | 38,810 | 62,295 | 115,623 | 167,913 |
| Other items, net, excluding CBPP | -23,915 | -24,721 | -35,440 | -139,669 | -186,853 | -218,697 |
| Broad money (M3) | 260,811 | 336,715 | 344,649 | 454,021 | 563,923 | 728,935 |
| M2 | 258,274 | 325,022 | 325,023 | 422,887 | 533,560 | 689,926 |
| Cash | 25,158 | 29,189 | 29,189 | 34,780 | 38,733 | 46,578 |
| Deposits | 233,116 | 295,834 | 295,834 | 388,107 | 494,827 | 643,348 |
| Demand deposits | 98,425 | 117,833 | 117,833 | 153,235 | 185,588 | 243,482 |
| Time deposits | 134,690 | 178,001 | 178,001 | 234,871 | 309,240 | 399,866 |
| CBPP held by nonbanks | 0 | 9,444 | 9,444 | 17,052 | 16,648 | 21,648 |
| Foreign exchange deposits | 2,537 | 2,249 | 10,183 | 14,082 | 13,716 | 17,361 |
| Memorandum items: | | | | | | |
| M1 | 123,584 | 147,022 | 147,022 | 188,015 | 224,320 | 290,060 |
| M2 | 258,274 | 325,022 | 325,023 | 422,887 | 533,560 | 689,926 |
| Multiplier (base money, excl. sterilization/M2) | 2.73 | 3.18 | 3.09 | 3.32 | 3.79 | 4.07 |
| Income velocity of M2 | 2.23 | 2.04 | 2.04 | 2.18 | 2.12 | 1.99 |
| End-period percentage changes: | | | | | | |
| NFA | 136.8 | 14.3 | ... | 37.6 | -3.6 | -0.1 |
| NDA | 26.2 | 30.2 | ... | 29.4 | 35.7 | 37.9 |
| Base money | 22.3 | 7.8 | ... | 21.0 | 10.6 | 20.5 |
| M1 | 34.3 | 19.0 | ... | 27.9 | 19.3 | 29.3 |
| M2, excluding foreign currency deposits and CPP | 30.5 | 25.8 | ... | 30.1 | 26.2 | 29.3 |
| M3 | 30.6 | 29.1 | ... | 31.7 | 24.2 | 29.3 |
| Credit to the private sector and NFPEs in rials | 27.3 | 30.5 | ... | 30.9 | 31.6 | 27.4 |
| Credit to private sector in rials | 31.1 | 34.1 | ... | 34.9 | 39.1 | 32.0 |
| Total claims on private sector | ... | ... | ... | ... | 46.5 | 34.7 |

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

1/ Iranian fiscal years ending March 20.
2/ End-2001/02 were revalued at the unified exchange rate of March 23, 2002.
3/ Current policies.
4/ Includes on-lending of OSF resources and claims under letters of credit for trade financing.

Table 6. Islamic Republic of Iran: Baseline Medium-Term Scenario Under Current Policies, 2000/01–2009/10 1/

| | | | Est. | Proj. | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2000/01 | 2001/02 | 2002/03 | 2003/04 | 2004/05 | 2005/06 | 2006/07 | 2007/08 | 2008/09 | 2009/10 |
| Hydrocarbon Sector | | | | | | | | | | |
| Total hydrocarbon exports (in billions of U.S. dollars) | 24.3 | 19.3 | 23.0 | 27.0 | 29.2 | 30.5 | 28.5 | 27.5 | 27.2 | 28.0 |
| Average oil export price (in U.S. dollar/barrel) | 25.3 | 21.5 | 27.2 | 28.0 | 30.0 | 30.0 | 27.0 | 25.0 | 24.0 | 24.0 |
| | (Annual percentage change unless otherwise indicated) | | | | | | | | | |
| National accounts | | | | | | | | | | |
| Real GDP at market prices | 5.1 | 3.7 | 7.5 | 6.6 | 6.6 | 5.2 | 5.3 | 5.1 | 5.0 | 4.9 |
| Real GDP at factor cost | 5.0 | 3.3 | 7.4 | 6.7 | 6.5 | 6.1 | 5.2 | 5.1 | 5.0 | 4.9 |
| Real hydrocarbon GDP | 8.3 | -8.1 | 5.1 | 8.4 | 5.0 | 3.1 | 3.6 | 4.1 | 4.3 | 4.6 |
| Real non-hydrocarbon GDP | 4.5 | 5.1 | 7.8 | 6.5 | 6.7 | 6.5 | 5.4 | 5.2 | 5.0 | 5.0 |
| Inflation rate | | | | | | | | | | |
| CPI inflation (average) | 12.6 | 11.4 | 15.8 | 15.6 | 15.6 | 15.0 | 15.0 | 15.0 | 15.0 | 15.0 |
| Unemployment rate | 14.1 | 14.7 | 12.2 | 11.2 | 11.2 | 11.2 | 11.7 | 12.3 | 13.0 | 13.6 |
| | (In percent of GDP at market prices) | | | | | | | | | |
| Investment and savings | | | | | | | | | | |
| Investment | 33.0 | 35.3 | 39.8 | 41.0 | 36.3 | 35.2 | 33.8 | 33.0 | 32.4 | 31.9 |
| Change in stocks | 6.5 | 6.3 | 12.0 | 12.2 | 5.3 | 4.3 | 3.6 | 3.0 | 2.5 | 2.1 |
| Total fixed capital investment | 26.4 | 29.0 | 27.8 | 28.9 | 31.0 | 30.9 | 30.2 | 30.0 | 30.0 | 29.9 |
| Public | 8.9 | 8.8 | 8.9 | 8.0 | 8.8 | 8.3 | 7.9 | 7.6 | 7.2 | 6.9 |
| Private | 17.6 | 20.2 | 18.8 | 20.9 | 22.1 | 22.6 | 22.2 | 22.5 | 22.7 | 23.0 |
| Gross national savings | 46.0 | 40.5 | 42.9 | 42.5 | 36.3 | 34.7 | 30.9 | 28.9 | 27.7 | 27.1 |
| Public | 23.3 | 14.6 | 13.1 | 13.7 | 14.1 | 14.0 | 12.9 | 11.0 | 9.6 | 8.5 |
| Private | 22.8 | 25.9 | 29.8 | 28.8 | 22.2 | 20.7 | 18.0 | 18.0 | 18.1 | 18.7 |
| Savings/investment balance 2/ | 13.1 | 5.3 | 3.1 | 1.5 | 0.0 | -0.5 | -2.8 | -4.1 | -4.8 | -4.8 |
| | (In percent of GDP at factor cost) | | | | | | | | | |
| Budgetary operations | | | | | | | | | | |
| Revenue | 33.0 | 27.3 | 26.9 | 27.0 | 27.0 | 26.1 | 25.9 | 24.8 | 24.1 | 24.0 |
| Oil | 22.2 | 15.6 | 16.2 | 16.3 | 15.5 | 14.6 | 12.8 | 11.6 | 11.1 | 11.2 |
| Non-oil | 10.7 | 11.7 | 10.7 | 10.7 | 11.5 | 11.5 | 13.1 | 13.1 | 13.0 | 12.9 |
| Expenditure and net lending | 24.3 | 25.5 | 29.3 | 27.2 | 28.5 | 27.1 | 27.3 | 27.0 | 26.5 | 26.4 |
| *Of which:* current | 15.3 | 17.0 | 16.1 | 16.0 | 16.1 | 16.1 | 16.5 | 17.0 | 17.4 | 18.2 |
| capital | 5.2 | 3.8 | 6.1 | 5.1 | 6.1 | 6.0 | 5.8 | 5.4 | 4.5 | 3.7 |
| Balance | 8.7 | 1.8 | -2.4 | -0.2 | -1.4 | -1.0 | -1.4 | -2.2 | -2.4 | -2.4 |
| Domestic financing | -7.5 | -1.1 | 0.9 | 0.6 | 2.1 | 0.3 | 0.7 | 2.0 | 2.2 | 2.1 |
| External financing | -1.2 | -0.7 | 1.5 | -0.5 | -0.7 | 0.7 | 0.7 | 0.2 | 0.2 | 0.3 |
| Non-oil balance | -13.5 | -13.7 | -18.7 | -16.5 | -16.9 | -15.6 | -14.2 | -13.9 | -13.5 | -13.6 |
| Non-oil balance to non-oil GDP | -16.5 | -16.3 | -23.9 | -21.1 | -21.6 | -19.8 | -17.6 | -17.0 | -16.5 | -16.5 |
| Public debt | 23.3 | 19.5 | 19.0 | 18.1 | 17.0 | 17.6 | 19.0 | 20.0 | 21.2 | 22.3 |
| | (In billions of U.S. dollars, unless otherwise indicated) | | | | | | | | | |
| External sector | | | | | | | | | | |
| Exports of goods and services | 30.5 | 27.4 | 33.3 | 40.2 | 44.2 | 46.9 | 46.4 | 47.0 | 48.3 | 51.0 |
| Imports of goods and services | -18.6 | -22.1 | -30.6 | -39.4 | -45.6 | -49.5 | -53.7 | -57.5 | -61.3 | -65.1 |
| Current account balance | 12.5 | 6.0 | 3.6 | 2.1 | 0.0 | -1.0 | -5.5 | -8.6 | -10.8 | -11.7 |
| External public and publicly guaranteed debt | 8.0 | 7.2 | 9.3 | 11.9 | 13.2 | 15.7 | 18.4 | 20.3 | 22.1 | 24.1 |
| *Of which:* short-term debt | 3.7 | 2.7 | 2.1 | 4.6 | 6.0 | 6.5 | 7.0 | 7.5 | 8.0 | 8.5 |
| Gross official reserves | 12.2 | 16.6 | 21.4 | 24.4 | 27.4 | 30.6 | 29.2 | 24.0 | 16.6 | 8.6 |
| In months of next year imports of goods and services | 6.7 | 6.8 | 6.6 | 6.5 | 6.7 | 7.0 | 6.3 | 4.9 | 3.2 | 1.5 |
| OSF foreign exchange deposits | 5.9 | 7.4 | 8.0 | 8.6 | 7.9 | 9.0 | 9.2 | 6.7 | 3.6 | 0.2 |

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

1/ Iranian fiscal year ending March 20.

2/ Using the current account balance from the balance of payments and the market-determined exchange rate.

Table 7. Islamic Republic of Iran: Baseline Balance of Payments, 2000/01–2009/10 1/

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

| | | | | Prel. | Proj. | Projections | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2000/01 | 2001/02 | 2002/03 | 2003/04 | 2004/05 | 2005/06 | 2006/07 | 2007/08 | 2008/09 | 2009/10 |
| Current account | 12,500 | 5,985 | 3,585 | 2,059 | 40 | -965 | -5,486 | -8,577 | -10,795 | -11,688 |
| Trade balance | 13,375 | 5,775 | 6,201 | 4,993 | 2,816 | 2,022 | -1,963 | -4,820 | -6,935 | -7,806 |
| Exports | 28,461 | 23,904 | 28,237 | 33,788 | 36,704 | 38,776 | 37,719 | 37,768 | 38,636 | 40,674 |
| Oil and gas | 24,280 | 19,339 | 22,966 | 27,033 | 29,238 | 30,454 | 28,473 | 27,496 | 27,223 | 27,995 |
| Crude oil | 21,011 | 16,806 | 19,380 | 23,113 | 25,185 | 25,727 | 23,652 | 22,370 | 21,936 | 22,405 |
| Petroleum products and natural gas | 3,269 | 2,533 | 3,586 | 3,920 | 4,053 | 4,727 | 4,821 | 5,125 | 5,288 | 5,590 |
| Refined products | 2,391 | 2,141 | 2,587 | 2,517 | 2,740 | 2,822 | 2,616 | 2,495 | 2,467 | 2,541 |
| Natural gas and others | 878 | 392 | 999 | 1,403 | 1,313 | 1,905 | 2,205 | 2,630 | 2,820 | 3,049 |
| Non-Oil and gas | 4,181 | 4,565 | 5,271 | 6,755 | 7,466 | 8,322 | 9,246 | 10,272 | 11,412 | 12,679 |
| Imports | -15,086 | -18,129 | -22,036 | -28,795 | -33,888 | -36,755 | -39,681 | -42,588 | -45,571 | -48,480 |
| Services (net) | -1,485 | -495 | -3,503 | -4,160 | -4,266 | -4,626 | -5,327 | -5,740 | -6,041 | -6,283 |
| Credits | 2,012 | 3,488 | 5,025 | 6,415 | 7,476 | 8,141 | 8,664 | 9,187 | 9,714 | 10,315 |
| *Of which:* interest income | 215 | 655 | 653 | 633 | 645 | 724 | 807 | 772 | 635 | 439 |
| Debits | -3,497 | -3,983 | -8,528 | -10,575 | -11,742 | -12,767 | -13,991 | -14,927 | -15,755 | -16,597 |
| *Of which:* interest payments | -370 | -397 | -1,082 | -604 | -616 | -745 | -1,220 | -1,596 | -1,843 | -2,088 |
| Transfers (net) | 610 | 705 | 887 | 1,226 | 1,490 | 1,639 | 1,803 | 1,983 | 2,182 | 2,400 |
| Capital and financial accounts | -4,567 | -470 | 2,455 | 4,016 | 2,960 | 4,097 | 4,165 | 3,384 | 3,391 | 3,610 |
| Medium-term and long-term capital | -2,555 | 288 | 2,354 | -360 | -46 | 1,967 | 2,128 | 1,419 | 1,339 | 1,463 |
| Bilateral project financing | -473 | 168 | 521 | 175 | 940 | 2,091 | 2,009 | 2,067 | 1,683 | 1,340 |
| Repayments of rescheduled debt | -884 | -327 | -60 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Other official financing and portfolio investment 2/ | 10 | -35 | 1,015 | 51 | 85 | 97 | 119 | -648 | -344 | 123 |
| Oil prefinancing | -1,208 | 482 | 878 | -586 | -1,071 | -221 | 0 | 0 | 0 | 0 |
| Short-term capital 3/ | -326 | -1,026 | -575 | 2,538 | 1,370 | 515 | 500 | 500 | 500 | 500 |
| Other capital 4/ | -2,416 | -1,995 | -541 | 127 | 0 | 0 | 0 | 0 | 0 | 0 |
| Foreign direct investment and portfolio equity | 730 | 2,263 | 1,217 | 1,711 | 1,636 | 1,615 | 1,537 | 1,465 | 1,552 | 1,647 |
| *Of which:* buybacks | 649 | 2,169 | 967 | 1,068 | 986 | 900 | 750 | 600 | 600 | 600 |
| Errors and omissions | -1,296 | -1,075 | -1,247 | -3,057 | 0 | 0 | 0 | 0 | 0 | 0 |
| Overall balance | 6,637 | 4,440 | 4,793 | 3,018 | 3,000 | 3,132 | -1,322 | -5,193 | -7,404 | -8,078 |
| Change in gross official reserves (increase -) | -6,637 | -4,440 | -4,793 | -3,018 | -3,000 | -3,132 | 1,322 | 5,193 | 7,404 | 8,078 |
| Memorandum items: | | | | | | | | | | |
| Gross official reserves (in millions of U.S. dollars) | 12,176 | 16,616 | 21,409 | 24,427 | 27,427 | 30,559 | 29,237 | 24,044 | 16,640 | 8,562 |
| *Of which:* Oil Stabilization Fund 5/ | 5,944 | 7,440 | 8,033 | 8,606 | 7,940 | 9,008 | 9,221 | 6,674 | 3,554 | 216 |
| (in months of next year's imports) | 6.7 | 6.8 | 6.6 | 6.5 | 6.7 | 7.0 | 6.3 | 4.9 | 3.2 | 1.5 |
| External debt service (as percent of exports) 6/ | 12.2 | 7.4 | 3.7 | 4.5 | 5.6 | 3.2 | 2.8 | 6.0 | 7.2 | 7.6 |
| Oil exports (in million barrels/day) | 2.3 | 2.2 | 2.0 | 2.3 | 2.3 | 2.3 | 2.4 | 2.5 | 2.5 | 2.6 |
| Oil exports average price (in U.S. dollars/barrel) 7/ | 24.5 | 20.9 | 27.2 | 28.0 | 30.0 | 30.0 | 27.0 | 25.0 | 24.0 | 24.0 |
| Real merchandise exports (percentage change) | 11.8 | -3.5 | -6.1 | 14.1 | 1.7 | 5.3 | 5.2 | 5.0 | 4.1 | 4.2 |
| Oil and gas | 7.4 | -6.3 | -8.9 | 14.2 | 1.1 | 4.2 | 3.9 | 4.3 | 3.1 | 2.8 |
| Non-Oil and gas | 10.9 | 10.8 | 9.5 | 13.6 | 4.1 | 10.0 | 10.0 | 10.0 | 10.0 | 10.0 |
| Real merchandise imports (percentage change) | 11.7 | 23.3 | 15.8 | 16.4 | 11.9 | 8.0 | 7.0 | 6.0 | 5.5 | 5.2 |

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

1/ Fiscal year ending 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/ Represents the part of the Oil Stabilization Fund that is invested together with the gross international reserves.
6/ Excluding short-term debt.
7/ Projection for 2004/05 is based on the average export price for the first two months of the year.

Table 8. Islamic Republic of Iran: Alternative Medium-Term Scenario Under Improved Policies, 2000/01–2009/10 1/

| | | | Est. | Proj. | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2000/01 | 2001/02 | 2002/03 | 2003/04 | 2004/05 | 2005/06 | 2006/07 | 2007/08 | 2008/09 | 2009/10 |
| Hydrocarbon Sector | | | | | | | | | | |
| Total hydrocarbon exports (in billions of U.S. dollars) | 24.3 | 19.3 | 23.0 | 27.0 | 29.2 | 30.5 | 28.5 | 27.5 | 27.2 | 28.0 |
| Average oil export price (in U.S. dollar/barrel) | 25.3 | 21.5 | 27.2 | 28.0 | 30.0 | 30.0 | 27.0 | 25.0 | 24.0 | 24.0 |
| | (Annual percentage change unless otherwise indicated) | | | | | | | | | |
| National accounts | | | | | | | | | | |
| Real GDP at market prices | 5.1 | 3.7 | 7.5 | 6.6 | 6.0 | 5.1 | 5.9 | 6.0 | 6.2 | 6.3 |
| Real GDP at factor cost | 5.0 | 3.3 | 7.4 | 6.7 | 5.9 | 5.2 | 5.6 | 6.0 | 6.1 | 6.3 |
| Real hydrocarbon GDP | 8.3 | -8.1 | 5.1 | 8.4 | 5.0 | 3.1 | 3.6 | 4.1 | 4.3 | 4.6 |
| Real non-hydrocarbon GDP | 4.5 | 5.1 | 7.8 | 6.5 | 6.0 | 5.5 | 5.8 | 6.3 | 6.4 | 6.5 |
| Inflation rate | | | | | | | | | | |
| CPI inflation (average) | 12.6 | 11.4 | 15.8 | 15.6 | 14.9 | 13.0 | 12.0 | 11.0 | 10.0 | 10.0 |
| Unemployment rate | 14.1 | 14.7 | 12.2 | 11.2 | 12.8 | 12.4 | 11.7 | 10.8 | 9.8 | 8.7 |
| | (In percent of GDP at market prices) | | | | | | | | | |
| Investment and savings | | | | | | | | | | |
| Investment | 33.0 | 35.3 | 39.8 | 41.0 | 34.1 | 33.2 | 31.8 | 31.8 | 31.9 | 32.2 |
| Change in stocks | 6.5 | 6.3 | 12.0 | 12.2 | 5.4 | 4.5 | 3.8 | 3.2 | 2.8 | 2.4 |
| Total fixed capital investment | 26.4 | 29.0 | 27.8 | 28.9 | 28.7 | 28.8 | 28.0 | 28.6 | 29.1 | 29.8 |
| Public | 8.9 | 8.8 | 8.9 | 8.0 | 7.7 | 7.2 | 7.1 | 7.1 | 7.0 | 7.1 |
| Private | 17.6 | 20.2 | 18.8 | 20.9 | 21.1 | 21.6 | 20.9 | 21.4 | 22.0 | 22.7 |
| Gross national savings | 46.0 | 40.5 | 42.9 | 42.5 | 34.3 | 33.4 | 30.0 | 28.7 | 28.1 | 28.5 |
| Public | 23.3 | 14.6 | 13.1 | 13.7 | 13.0 | 14.1 | 13.7 | 12.6 | 12.1 | 12.2 |
| Private | 22.8 | 25.9 | 29.8 | 28.8 | 21.3 | 19.3 | 16.2 | 16.0 | 16.0 | 16.3 |
| Savings/investment balance 2/ | 13.1 | 5.3 | 3.1 | 1.5 | 0.2 | 0.2 | -1.9 | -3.1 | -3.8 | -3.7 |
| | (In percent of GDP at factor cost) | | | | | | | | | |
| Budgetary operations | | | | | | | | | | |
| Revenue | 33.0 | 27.3 | 26.9 | 27.0 | 27.1 | 26.5 | 26.5 | 25.5 | 25.0 | 25.0 |
| Oil | 22.2 | 15.6 | 16.2 | 16.3 | 15.6 | 15.0 | 13.2 | 12.0 | 11.5 | 11.5 |
| Non-oil | 10.7 | 11.7 | 10.7 | 10.7 | 11.5 | 11.5 | 13.3 | 13.5 | 13.5 | 13.5 |
| Expenditure and net lending | 24.3 | 25.5 | 29.3 | 27.2 | 27.6 | 25.2 | 25.4 | 25.3 | 25.2 | 25.1 |
| *Of which:* current | 15.3 | 17.0 | 16.1 | 16.0 | 16.0 | 15.2 | 15.3 | 15.4 | 15.4 | 15.3 |
| capital | 5.2 | 3.8 | 6.1 | 5.1 | 5.3 | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 |
| Balance | 8.7 | 1.8 | -2.4 | -0.2 | -0.5 | 1.3 | 1.1 | 0.2 | -0.1 | -0.1 |
| Domestic financing | -7.5 | -1.1 | 0.9 | 0.6 | 1.2 | -2.1 | -1.9 | -0.5 | -0.1 | -0.2 |
| External financing | -1.2 | -0.7 | 1.5 | -0.5 | -0.7 | 0.8 | 0.7 | 0.2 | 0.2 | 0.3 |
| Non-oil balance | -13.5 | -13.7 | -18.7 | -16.5 | -16.1 | -13.7 | -12.0 | -11.8 | -11.6 | -11.6 |
| Non-oil balance to non-oil GDP | -16.5 | -16.3 | -23.9 | -21.1 | -20.6 | -17.4 | -15.1 | -14.6 | -14.3 | -14.3 |
| Public debt | 22.7 | 20.7 | 20.8 | 18.7 | 17.7 | 16.8 | 17.2 | 17.5 | 18.5 | 19.6 |
| | (In billions of U.S. dollars, unless otherwise indicated) | | | | | | | | | |
| External sector | | | | | | | | | | |
| Exports of goods and services | 30.5 | 27.4 | 33.3 | 40.2 | 44.2 | 47.3 | 47.4 | 48.7 | 51.1 | 55.2 |
| Imports of goods and services | -18.6 | -22.1 | -30.6 | -39.4 | -45.3 | -48.7 | -52.7 | -57.1 | -61.6 | -66.4 |
| Current account balance | 12.5 | 6.0 | 3.6 | 2.1 | 0.4 | 0.3 | -3.5 | -6.4 | -8.4 | -8.8 |
| External public and publicly guaranteed debt | 8.0 | 7.2 | 9.3 | 11.9 | 13.2 | 15.7 | 18.4 | 20.3 | 22.1 | 24.1 |
| *Of which:* short-term debt | 3.7 | 2.7 | 2.1 | 4.6 | 6.0 | 6.5 | 7.0 | 7.5 | 8.0 | 8.5 |
| Gross official reserves | 12.2 | 16.6 | 21.4 | 24.4 | 27.7 | 32.9 | 35.1 | 34.5 | 32.7 | 31.5 |
| In months of next year imports of goods and services | 6.7 | 6.8 | 6.6 | 6.6 | 6.9 | 7.7 | 7.6 | 6.9 | 6.1 | 5.4 |
| OSF foreign exchange deposits | 5.9 | 7.4 | 8.0 | 8.6 | 9.3 | 11.8 | 14.3 | 14.3 | 13.7 | 13.4 |

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

1/ Iranian fiscal year ending March 20.
2/ Using the current account balance from the balance of payments and the market-determined exchange rate.

Table 9. Islamic Republic of Iran: Millennium Development Goals, 1990–2015

| | 1990 | 1995 | 2001 | 2002 | Target 2015 |
|---|---|---|---|---|---|
| General Social Indicators | | | | | |
| Population (millions) | 54.4 | 59.0 | 64.5 | 65.5 | ... |
| Adult literacy rate (percent of people of ages 15 and over) | 63.2 | 70.0 | 77.1 | ... | ... |
| Total fertility rate (births for women) | 4.7 | 3.3 | 2.3 | 2.0 | ... |
| Life expectancy at birth | 64.7 | 67.1 | 68.8 | 69.3 | ... |
| Goal 1. Eradicate extreme poverty and hunger | | | | | |
| Target: Halve the 1990 proportion of people who suffer from hunger by 2015 | ... | ... | ... | ... | ... |
| 1. Population below $1 a day (in percent) | ... | ... | ... | ... | ... |
| 2. Poverty gap at $1 a day (in percent) | ... | ... | ... | ... | ... |
| 3. Percentage share of income or consumption held by poorest 20 percent | ... | ... | ... | ... | ... |
| 4. Prevalence of child malnutrition (percent of children under 5) | ... | 15.7 | ... | ... | ... |
| 5. Population below minimum level of dietary energy consumption (in percent) | 5.0 | 5.0 | 5.0 | ... | 2.5 |
| Goal 2. Achieve universal primary education | | | | | |
| Target: Ensure that children everywhere will be able to complete a full course of primary schooling by 2015 | | | | | |
| 6. Net primary enrollment ratio (percent of relevant age group) | 97.2 | 89.8 | 86.5 | ... | 100.0 |
| 7. Percentage of cohort reaching grade 5 (in percent) | 89.9 | 90.4 | 93.7 | ... | 100.0 |
| 8. Youth literacy rate (in percent of ages 15-24) | 86.3 | 90.9 | 94.2 | ... | 100.0 |
| Goal 3. Promote gender equality | | | | | |
| Target: Eliminate gender disparity in primary and secondary education by 2005 and to all levels of education no later than 2015. | | | | | |
| 9. Ratio of girls to boys in primary and secondary education (in percent) | 83.4 | 89.2 | 95.6 | ... | 100.0 |
| 10. Ratio of young literate females to males (percent of ages 15-24) | 88.1 | 92.4 | 95.3 | 95.6 | 100.0 |
| 11. Ratio of women employed in the nonagricultural sector (in percent) | 18.0 | ... | ... | ... | ... |
| 12. Proportion of seats held by women in national parliament (in percent) 1/ | ... | 3.0 | ... | 3.1 | ... |
| Goal 4. Reduce child mortality | | | | | |
| Target: Reduce 1990 under 5 mortality by two-thirds | | | | | |
| 13. Under five mortality rate (per 1,000) | 72.0 | 55.0 | 44.0 | 41.0 | ... |
| 14. Infant mortality rate (per 1,000 live births) | 54.0 | 43.0 | 36.0 | 34.0 | ... |
| 15. Immunization, measles (percent of children under 12 months) | 85.0 | 95.0 | 96.0 | 99.0 | ... |
| Goal 5. Improve maternal health | | | | | |
| Target: Reduce 1990 maternal mortality by three-fourths | | | | | |
| 16. Maternal mortality ratio (modeled estimate per 100,000 live births) | ... | ... | 76.0 | ... | ... |
| 17. Births attended by skilled health staff (percent of total) | ... | 86.1 | 89.6 | ... | ... |
| Goal 6. Combat HIV/AIDS, malaria, and other diseases | | | | | |
| Target: Have halted by 2015, and begin to reverse, the spread of HIV/AIDS and other diseases | | | | | |
| 18. Prevalence of HIV, female (in percent for ages 15-24) | ... | ... | 0.0 | ... | ... |
| 19. Contraceptive prevalence rate (in percent of women ages 15-49) | 49.0 | 73.0 | ... | ... | ... |
| 20. Number of children orphaned by HIV/AIDS | ... | ... | ... | ... | ... |
| 21. Incidence of tuberculosis (per 1000,000 people) | ... | ... | 52.0 | 29.0 | ... |
| 22. Tuberculosis cases detected under DOTS (in percent) | ... | 29.0 | 33.0 | 60.1 | ... |
| Goal 7. Ensure environmental sustainability | | | | | |
| Target: Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources. Halve by 2015 the proportion of people without sustainable access to safe drinking water. | | | | | |
| 23. Forest area (in percent of total land area) | 4.5 | ... | 4.5 | ... | ... |
| 24. Nationally protected areas (in percent of total land area) | ... | 5.1 | 5.1 | 5.1 | ... |
| 25. GDP per unit of energy use (PPP $ per kg oil equivalent) | 3.0 | 3.0 | 3.4 | ... | ... |
| 26. CO2 emissions (metric tons per capita) | 3.9 | 4.6 | 4.9 | ... | ... |
| 27. Access to an improved water source (in percent of population) | ... | ... | 92.0 | ... | ... |
| 28. Access to improved sanitation (in percent of population) | ... | ... | 83.0 | ... | ... |
| 29. Access to secure tenure (in percent of population) | ... | ... | ... | ... | ... |
| Goal 8. Develop a Global Partnership for Development | | | | | |
| Target: various | | | | | |
| 30. Youth unemployment rate (in percent of total labor force ages 15-24) | ... | ... | ... | ... | ... |
| 31. Fixed line and mobile telephones (per 1,000 people) | 40.4 | 86.3 | 201.0 | 220.1 | ... |
| 32. Personal computers (per 1,000 people) | ... | 25.3 | 69.7 | 75.0 | ... |

Source: World Development Indicators database

1/ Information in the 2002 column refers to latest information available (as of June 30, 2004).

## Islamic Republic of Iran: Fund Relations

As of June 30, 2004

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

**II. General Resources Account**

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

**III. SDR Department**

| | SDR Million | Percent of Allocation |
|---|---|---|
| Net cumulative allocation | 244.06 | 100.00 |
| Holdings | 273.63 | 112.12 |

**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 | | |
|---|---|---|---|---|---|
| | 2004 | 2005 | 2006 | 2007 | 2008 |
| Principal | | | | | |
| Charges/Interest | 0.02 | 0.02 | 0.02 | 0.02 | 0.02 |
| **Total** | 0.02 | 0.02 | 0.02 | 0.02 | 0.02 |

### Nonfinancial Relations

**VII. Exchange System**

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

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

Iran continues to avail itself of the transitional arrangements under Article XIV but maintains no exchange restrictions under these arrangements. Based on the information available to date, the staff concludes that Iran maintains a number of exchange restrictions and multiple currency practices subject to Fund jurisdiction under Article VIII, Sections 2(a) and 3. The restrictions identified are as follows:

**Exchange restrictions** arise from:

1. Quantitative limits on the availability of foreign exchange for certain current payments and transfers (for example, travel, education, medical expenses, or family remittances);

2. Limitations on the availability of foreign exchange for current payments and transfers not expressly authorized in the Foreign Exchange Regulations;

3. Limitations on the transferability from nonresident rial accounts of proceeds from current transactions;

4. Limitations on the availability of foreign exchange for advance payments; and

5. Limitations on the availability of foreign exchange for the transfer of certain rial profits from investment under Foreign Investment Promotion and Protection Act.

**Multiple currency practices** arise from:

1. Payments in respect of contingent liabilities pertaining to certain letters of credit opened prior to the exchange rate unification in March 2002; and

2. CBI purchases of unused allocations of foreign exchange at pre-unification "allocated rates."

The authorities are making changes to foreign exchange regulations to eliminate most restrictions in the near future and are elaborating plans for removing MCPs.

**VIII. Last Article IV Consultation**

The last Article IV consultation was concluded by the Executive Board on August 25, 2003.

**IX. Technical Assistance**

Since FY 1999, Iran received the following technical assistance:

**FAD**

FY 1999 - Tax system and VAT
FY 2000 - Tax administration and VAT
FY 2001 - Tax administration and VAT
FY 2004 - Tax administration and VAT

**MFD**

***FSAP***

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

*Banking Supervision*

FY 1999 - Short visit in context of policy discussions on banking sector restructuring
FY 2000 - Short visits by MFD expert on banking supervision
FY 2001 - Short visits by MFD expert on banking supervision
FY 2002 - Resident expert on banking supervision
FY 2003 - Short visits by MFD expert on banking supervision

*Monetary Instruments*

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

FY 2000 - Follow-up in one short visit and in one technical assistance mission dealing mainly with exchange system reforms
FY 2002 - Technical assistance mission on the issuance of central bank participation papers

*Exchange System*

| | | |
|---|---|---|
| FY 1997 | - | Multi-topic mission covered foreign exchange reserves management |
| FY 1999 | - | Two technical assistance missions dealing mainly with exchange system reforms, each followed by policy discussions on implementation of reforms |
| FY 2000 | - | Follow-up in one short visit, in the context of further policy discussions |
| | - | One technical assistance mission on details of implementation of exchange system reforms |
| FY 2002 | - | One technical assistance mission on foreign exchange system reforms |
| | - | Follow-up technical assistance on exchange rate unification and interbank foreign exchange market |
| FY 2003 | - | Technical assistance mission to review the foreign exchange system after the exchange rate unification and explore issues of capital account liberalization |
| FY 2004 | - | Article VIII acceptance mission |

**STA**

| | | |
|---|---|---|
| FY 2000 | - | Balance of payment statistics |
| | - | Government finance statistics |
| | - | National accounts statistics |
| FY 2002 | - | Monetary and financial statistics |
| FY 2003 | - | Multi-sector mission to assess current data dissemination practices against the requirements of the 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 |

## Islamic Republic of Iran: Relations with the World Bank Group

1. As of June 30, 2004, Iran received 51 World Bank loans totaling $2,599 million net of cancellations and terminations, of which $1,867 million has been disbursed. Forty-five of these loans have been fully disbursed. The ongoing portfolio consists of six loans for a total of $791 million, of which $59 million has been disbursed.

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. Four projects: Tehran Sewerage Project, Second Primary Health Care and Nutrition Project, Environmental Management and the Earthquake Emergency Project, were approved during the years 2000-02. An Environmental Management and an Earthquake Emergency Projects were approved by the Board, in April and June of 2003, respectively. In May 2004, two new projects were approved, Ahwaz and Shiraz Water and Sanitation, and the Urban Upgrading and Housing Reform. Health, urban development, environment and sewerage sectors are currently the major recipients of the Bank's loans. In addition, a loan for reconstruction of the quake-hit city of Bam is under preparation for Board approval in late-summer 2004.

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 TFYDP 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 have been prepared for urban water, housing, agriculture, and air pollution control. Work is under way on the pension system.

4. A new Country Assistance Strategy (CAS) for FY 2005–08 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 emphasis is on poverty alleviation and capacity building for a knowledge-based economy. The CAS envisages a lending program in water and sanitation, urban transport, agriculture, education, and community-based development. The analytical and advisory program proposes to include public finance, economic management, improvement in the investment climate, and human capital development, in addition to ongoing work on public expenditures and pension strategies. The CAS also seeks to align with the government's priorities and objectives of the FFYDP. To support Iran's reform efforts, the Bank is also intensifying its assistance for capacity building in the formulation of economic and sectoral policies, their sequencing, and implementation.

5. The International Finance Corporation (IFC) support of the Bank's program for Iran will focus on technical assistance and advisory services. IFC's activities support private sector firms while focusing on how to boost a private-sector supply response that Iran needs to achieve higher and sustained growth, while accelerating job-creation opportunities. IFC supports the establishment of a modern, open, and competitive financial sector, a cornerstone for private sector development.

6. Iran became a full member of the Multilateral Investment Guarantee Agency (MIGA) on December 2003. MIGA's entry into Iran will play an important role in attracting foreign direct investment to the country and promote outbound investment from Iran.

World Bank contact person: Sophie Warlop; Tel: (202) 473 -7255.

## Islamic Republic of Iran: Statistical Issues

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

A multisector mission of the Statistics Department (STA) of the Fund visited Iran during from June 18 to July 1, 2002 to assess current data dissemination practices against the requirements of the SDDS. The mission also provided assistance on ways to further improve the compilation of the macroeconomic statistics. In December 2003 and June 2004, STA reviewed data dissemination practices and advised the authorities on the steps needed to subscribe to the Special Data Dissemination Standards (SDDS).

### Real sector statistics

- National accounts statistics are reasonably sound. The CBI has updated the quarterly GDP statistics for the period 1988–2003. Most of the recommendations made by the 1999 STA mission have been fully implemented, most notably concerning the change of the base year to 1997/98 for the constant price calculations, implementation of the *1993 SNA*, and the development of quarterly national accounts. Improvements have also been made in the coverage of the informal economy. However, additional work remains, especially in the coverage of small-scale industries and services. Also, the recommended joint project between the CBI and the Statistical Center of Iran (SCI) to compare and analyze the two sets of estimates of GDP they compile has not been implemented. The base year for national accounts has been recently updated to 1997/98.

- Price statistics have generally been reported to the Fund in a timely manner. The official labor market statistics are released by the Statistical Center of Iran (SCI), and are based on the definition 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, still need improvement, particularly with regard to employment and wage data.

**Government finance statistics**

- One significant improvement has been the adoption of the Government Finance Statistics (GFS) classification for the core central government operations which will enhance transparency and help improve fiscal management.

- Coverage of the 2003/04 budget was broadened and implicit energy subsidies were included in the budget for the first time.

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

- Only experimental data for the consolidated central and general government, comprising the central government and the municipalities, are compiled. The preliminary data are compiled with a sample of municipalities (all large and a selection of the small municipalities). Some time later (one or two years), more complete municipalities data will be used to compile the final estimates. These data are not disseminated, although they are used for compiling the SNA.

- 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. Data used by the Economic Research and Policy Department (ERPD) for preparing financing data could be further analyzed to distinguish debt by type of holder and by instrument. The discrepancy between fiscal and monetary data on deficit financing remains relatively large. From an SDDS perspective, this discrepancy raised questions about the accuracy of the fiscal data and the 2003 SDDS missions held a number of discussions with the objective of improving the collection and classification of government debt. No information is available on the status of implementation of the recommendations that were made.

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

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

**Monetary statistics**

- Monthly monetary data are reported to STA on a regular basis for publication in the Fund's *International Financial Statistics or IFS*, with a lag of about two months. 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 government, and foreign-currency deposits of residents. As a result, the broad money stock tends to be underestimated.

- In the CBI's analytical accounts, CBPP are included in other unclassified liabilities. Separate data on holdings of CBPP broken down by bank holders and nonbank holders should be collected in the CBI monthly report. These separate data will allow the CBI and other data users to construct broader liquidity measures, which will include CBPP held by nonbank sectors.

**External sector data**

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

- In line with the effort of improving the balance of payments estimates for transactions not recorded in the *BPM4* format and for which historical data are unavailable, the coverage of services and other balance of payments entries have been significantly improved. In particular, the services debit and credit entries for 2000/01–2002/03 have been revised. Work is proceeding to carry these revisions to past seven years. Moreover, the balance of payments has been revised to better reflect buy-back transactions under direct investment and other balance of payments entries.

- Data on the international investment position are compiled but not disseminated. Only data on public and publicly guaranteed debt are compiled and 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; the June 2004 STA mission provided technical advice on the methodological and compilation aspects of this data set.

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

(As of July 26, 2004)

| Exchange Rates | International Reserves | Reserve/ Base Money | Central Bank Balance Sheet | Broad Money | Interest Rates | Consumer Price Index | Exports/ Imports | Current Account Balance | Overall Government Balance | GDP/GNP |
|---|---|---|---|---|---|---|---|---|---|---|
| 26-Jul-04 | Mar-04 | Mar-04 | Mar-04 | Mar-04 | Mar-04 | May-04 | Mar-04 | Mar-04 | Mar-04 | Mar-04 |
| 26-Jul-04 | Jun-04 | Jun-04 | Jun-04 | Jun-04 | Jun-04 | Jul-04 | Jun-04 | Jun-04 | Jun-04 | Jun-04 |
| D | M | M | M | M | M | M | M | M | A | Q |
| D | M | M | M | M | M | M | M | M | A | Q |
| CBI | CBI | CBI | CBI | CBI | CBI | CBI | CBI | CBI | CBI | CBI |
| CBI Website | CBI | CBI | CBI | CBI | CBI | CBI Website | CBI | CBI | CBI | CBI |
| Unrestricted | Unrestricted | Unrestricted | Unrestricted | Unrestricted | Unrestricted | Unrestricted | Unrestricted | Unrestricted | Unrestricted | Unrestricted |
| D | Q | Q | Q | Q | Q | M | Q | Q | A | Q |

INTERNATIONAL MONETARY FUND

ISLAMIC REPUBLIC OF IRAN

# Staff Report for the 2004 Article IV Consultation
# Supplementary Information

Prepared by the Staff Representatives for the 2004 Consultation
with the Islamic Republic of Iran

Approved by Donal Donovan, François Gianviti, Stefan Ingves and Saleh M. Nsouli

September 8, 2004

1. In the attached communication, the Governor of the Central Bank of the Islamic Republic of Iran has formally notified the Fund that the Islamic Republic of Iran has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement with effect from September 6, 2004.

2. The exchange system of the Islamic Republic of Iran was reviewed by staff during a mission to Tehran in February 2004. In response to staff's findings of a number of exchange restrictions and multiple currency practices, the authorities made changes to the foreign exchange regulations and eliminated most of the restrictions and multiple currency practices identified. However, one exchange restriction and two multiple currency practices subject to Fund approval under Article VIII, Sections 2(a) and (3) remain:

- An **exchange restriction** arises from limitations set out in the by-laws adopted to implement the Foreign Investment Promotion and Protection Act (FIPPA) on the transferability of (periodic) rial profits from certain foreign direct investments. The authorities have committed to making the necessary changes to the by-laws within the next 12 months and thus have requested approval of the restriction.

- A **multiple currency practice** arises 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. As of February 2004, the outstanding letters of credit have a volume of about US$5,870 million and remaining maturities of up to 14 years. These letters of credit had been opened by ministries, other government entities, and government-owned and private companies for medium- and long-term financing purposes.

- A **multiple currency practice** also arises from the obligation of entities that had received allocations of foreign exchange for payments based on subsidized "allocated rates" under the previous multiple rate system to surrender unused allocations to the CBI at the allocation rate. While the great majority of these allocations have been resolved, there are still some outstanding amounts of unused allocations that have not been returned.

3. The staff welcomes Iran's decision to accept the obligations of Article VIII, Sections 2, 3, and 4 and supports the request for approval of the restriction limiting the transfer of rial profits in view of the non-discriminatory nature of the measure and the authorities' commitment to its elimination within the next 12 months. The two remaining multiple currency practices are not being maintained for balance of payments reasons; they do not materially impede Iran's balance of payments adjustment, and they do not discriminate among members or harm the interests of other members. Therefore, staff supports the authorities' request for approval for their retention for an initial period of two years, after which time the issue would be revisited.

ATTACHMENT

BANK MARKAZI JOMHOURI ISLAMI IRAN

(The Central Bank of the Islamic Republic of Iran)

Governor

No . EB-2652

Date : 7 SEP 2004

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. de Rato,

It is my pleasure to notify the International Monetary Fund that the Islamic Republic of Iran hereby accepts the obligations of Article VIII, Sections 2, 3 and 4 of the Fund's Articles of Agreement as of September 6, 2004.

We request that the Fund approve the retention of two multiple currency practices arising from measures taken in the context of the unification of the exchange rate in 2002. These measures are not maintained for balance of payment reasons and will disappear by 2018, once the relevant contracts have been fulfilled. Furthermore, within the next twelve months, we will review the By-Laws issued under the Foreign Investment Promotion and Protection Act (FIPPA) and eliminate the restrictions on some type of profit remittances to make their provisions consistent with the obligations of Article VIII, Section 2(a). We request that the Fund approve their retention in the meantime.

Sincerely yours,

Ebrahim Sheibany

E. Sheibany

Governor of Bank Markazi Jomhouri Islami Iran and
Governor of the Fund for the Islamic Republic of Iran

cc: Mr. Abbas Mirakhor, Executive Director

Form N604-50 c. 1001-1381

**Statement by the IMF Staff Representative**
**September 10, 2004**

This statement contains updated information on recent economic developments in Iran that have become available since the Staff Report was circulated to the Executive Board on August 23, 2004. This information does not change the thrust of the staff appraisal.

1. Since the Staff Report was issued, oil prices have continued to rise. Iran's average oil export price for fiscal year 2004/05 is now estimated at $36 per barrel, in line with the August 2004 World Economic Outlook. The impact of the stronger oil market conditions is reflected in the sensitivity analysis shown in Figure 8 of the Staff Report. The authorities have informed staff that the windfall gains from higher-than-budgeted oil revenue (estimated at $5 billion, or 2.5 percent of GDP) will be deposited in the Oil Stabilization Fund.

2. CPI inflation was 14.4 percent in the 12-month period ending July 2004. Preliminary estimates for the 12-month period ending June 2004 point to an increase in broad money (M2) of 29 percent and in credit to the private sector of 42 percent. The monetary authorities have already issued Central Bank Participation Papers to mop up excess liquidity in an amount of Rls 5 trillion (3 percent of base money) on a net basis.

3. The draft law of the Fourth Five-Year Development Plan (2005–09), which has been approved by the outgoing parliament, was re-submitted to the newly elected parliament after the Guardian Council had raised a number of issues, one of them relating to the conformity of the proposed privatization of public banks with the provisions of the Iranian Constitution. This and other issues are being considered in various committees, but the authorities do not expect major changes in the plan's reform agenda.

INTERNATIONAL MONETARY FUND
*Public Information Notice*
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 04/109
FOR IMMEDIATE RELEASE
September 27, 2004

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

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

On September 10, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Islamic Republic of Iran.[1]

**Background**

During the first four years of the Third Five-Year Development Plan (TFYDP) (2000/01- 2003/04), real GDP grew by 5.6 percent on average, the external current account was in surplus, external debt was reduced to a very low level, international reserves increased, and the unemployment rate declined. This performance has taken place against the background of increased openness of the economy to international trade and investment and economic reforms, but also sustained high oil prices and expansionary fiscal and monetary policies.

Notwithstanding these achievements, the Iranian economy faces the challenge of maintaining high growth and employment creation in a stable macroeconomic environment.
The expansionary fiscal and monetary policies of recent years have maintained inflation at double-digit rates and led to a substantial reduction in the external current account surplus at a time when oil prices were high. Moreover, there is a pressing need to step up implementation of structural reforms to enhance economic efficiency and foster private sector development and growth. These include financial sector reform, privatization, further trade liberalization, and improvement of the business climate.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies.
On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the September 10, 2004 Executive Board discussion based on the staff report.

Real GDP grew by 6.7 percent in 2003/04 (fiscal year ending on March 20), with strong contribution from both the oil and non-oil sectors. The unemployment rate declined to 11.2 percent from 14.1 percent in 2000/01. Domestic demand continued to grow rapidly under the impetus of an expansionary policy mix, as reflected in high rates of growth of credit and money supply (M2). As a result, average CPI inflation remained at 15 ½ percent in 2003/04.

The external current account surplus declined to about 1½ percent of GDP in 2003/04 from 3.1 percent in 2002/03. Despite a significant increase in both oil and non-oil exports, imports continued to rise significantly, on the strength of domestic demand. The capital and financial account recorded a large surplus, largely on account of increasing FDI inflows—mainly in the energy sector—and short-term financing through letters of credit. Gross official reserves increased by $3.0 billion to $24.5 billion, equivalent to 6½ months of next year's imports of goods and services. External debt remained low at $11.9 billion, equivalent to 8.7 percent of GDP.

While fiscal policy was tightened in 2003/04, the fiscal stimulus was not fully withdrawn. The non-oil fiscal deficit was brought down to 16½ percent, or close to 2 percent of GDP lower than in the previous year, mainly through expenditure restraint, while non-oil revenue remained unchanged relative to GDP. The overall fiscal deficit also declined from 2.4 percent of GDP to 0.2 percent.

Monetary policy was expansionary in 2003/04. The average bank lending rates have remained broadly unchanged in both nominal and real terms. Unsterilized purchases of foreign exchange from the government by the central bank and increased central bank lending to commercial banks led to rapid growth of base money. This, together with a higher money multiplier, fueled private sector credit and M2 growth to the tune of 39 percent and 30 percent, [2] respectively. The managed float exchange regime has continued to operate smoothly.

Progress in structural reforms slowed down in 2003/04. While the preparation of medium-term reforms advanced and some progress was made in trade liberalization and banking supervision reforms, little progress was made in reforming the labor market, implementing privatization, or streamlining administrative procedures.

Real GDP is projected to grow at 6.5 percent in 2003/04 on account of high oil prices and the continuation of the current expansionary policy stance. The authorities aim at achieving a money growth target of 20–24 percent to reduce inflation.

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[2] Including a deposit of the Telecommunication Company with the Postal Bank, which is not reflected in the monetary survey.

**Executive Board Assessment**

Directors welcomed Iran's strong growth performance over the last four years, which has been supported by important structural reforms implemented at the beginning of the Third Five-Year Development Plan (2000–04), as well as by favorable oil market conditions. Directors noted with satisfaction that unemployment has declined, gross official reserves have continued to increase, and the external debt has remained low. These positive developments have been associated with strengthened confidence in the economy, and a rise in private sector activity and foreign direct investment, including in the non-hydrocarbon sector. Directors considered that key challenges going forward will be to further strengthen the foundations for strong and sustained economic growth and diversification to provide the basis for continued job creation in an environment of macroeconomic stability. Iran's pursuit of stronger macroeconomic policies and far reaching structural reforms will be crucial for underpinning its transition to a market economy and away from oil dependence.

The outlook for the Iranian economy remains favorable. Directors urged the authorities to use the opportunity of high oil prices and improved business confidence to better balance the policy mix by undertaking an upfront tightening of the fiscal and monetary policy stance to bring about a sustained reduction in inflation, which has persisted at double-digit levels. They considered that fiscal policy has a crucial role to play in assisting monetary policy to reduce inflation by containing the growth of domestic demand. In this regard, they welcomed the authorities' intention to scale down expenditure from the high level budgeted for 2004/05, and to improve revenue collections. They noted, however, that additional fiscal adjustment measures may be needed to ease demand pressures and reduce the liquidity effects of spending. To continue strengthening the fiscal position, especially for the medium term, they called for further containment of capital spending and net lending, the phasing out of explicit subsidies, early implementation of the Value Added Tax, and further strengthening of tax administration. Directors also underscored the need to increase savings in the Oil Stabilization Fund while oil prices are high, and encouraged the authorities to resist pressure to relax fiscal policy in the likely event of higher than expected oil revenue.

Directors stressed the importance of setting a medium-term framework for fiscal policy that aims to preserve an adequate level of wealth from non-renewable hydrocarbon resources, while ensuring that fiscal policy supports macroeconomic stability. Directors also encouraged the completion of the preparatory work on energy price reform, which aims at phasing out implicit energy subsidies while putting in place a well-targeted and integrated social safety net.

Directors endorsed the authorities' intention to tighten monetary policy, and welcomed the range of measures that have been approved to contain domestic liquidity growth, including stepped up sterilization operations. They urged the authorities to work toward establishing a clear monetary policy framework that serves to promote disinflation. This should be accompanied by further steps to strengthen indirect instruments of monetary policy, curtail the use of direct credit controls, introduce more market-based flexibility in setting rates of return, and limit the recourse

by banks to the central bank's overdraft facilities. They looked forward to the establishment of central bank independence and to the further development of money markets.
Directors endorsed the efforts underway to strengthen Iran's financial system and improve its resilience to exogenous shocks. Directors welcomed the licensing of private banks and leasing companies and supported actions to restructure public banks and strengthen their capital base. They urged the authorities to move quickly to complete the establishment of a risk-based supervision framework to effectively monitor potential risks that may emerge from rapid credit growth, and to monitor developments in asset prices. Directors encouraged the authorities to seek early approval of the capital markets law, which aims at improving the regulatory framework for the issuance and trading of securities and strengthens the supervision of the Tehran Stock Exchange. They welcomed steps to improve transparency and oversight of charitable institutions, and called for early passage of a comprehensive anti-money laundering law covering the entire financial system.

Directors agreed that the managed floating exchange rate regime, which has been in place since the March 2002 exchange rate unification, has served Iran well, and that the current level of the exchange rate is broadly appropriate. They welcomed the assurance that, going forward, exchange rate policy will give considerably greater weight to monetary policy objectives.
They commended the authorities for eliminating most exchange restrictions for current international transactions and their intention to phase out the remaining ones, and for accepting the obligations under Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement.

Directors welcomed the authorities' aim to develop the private sector as the major engine of growth and to further open the economy to international trade and foreign investment. Several Directors noted that the Fourth Five-Year Development Plan legislation containing key reforms is undergoing further deliberation, and welcomed the assurance that its approval is expected soon. They stressed the importance of further improving the business climate by streamlining administrative procedures, disengaging the government from commercial activities that can be carried out more efficiently by the private sector, and increasing labor market flexibility to raise the employment content of growth.

Directors noted the steps taken to improve data quality and transparency, including in the presentation of fiscal accounts and the oil sector, and encouraged the authorities to accelerate preparatory work on moving toward compliance with the Special Data Dissemination Standard.

Iran is a bilateral creditor for two heavily indebted countries. Directors commended the Iranian authorities' commitment to provide Iran's share of debt relief to these countries under the Heavily Indebted Poor Countries Initiative.

***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. The Staff Report for the 2004 Article IV Consultation with the Islamic Republic of Iran is also available

**Islamic Republic of Iran: Selected Economic Indicators**

| | 2000/2001 | 2001/2002 | 2002/2003 | 2003/2004 |
|---|---|---|---|---|
| Real GDP growth (factor cost, percentage change) | 5.0 | 3.3 | 7.4 | 6.7 |
| CPI inflation (period average, percentage change) | 12.6 | 11.4 | 15.8 | 15.6 |
| Unemployment rate (percent) | 14.1 | 14.7 | 12.2 | 11.2 |
| Central government balance (percent of GDP) | 8.7 | 1.8 | -2.4 | -0.2 |
| Broad money growth (percentage change) | 30.5 | 25.8 | 30.1 | 30.0 |
| Current account balance (percent of GDP) | 13.1 | 5.3 | 3.1 | 1.5 |
| Overall external balance (percent of GDP) | 6.9 | 3.9 | 4.1 | 2.2 |
| Gross international reserves (billions of U. S. dollars) | 12,176 | 16,616 | 21,409 | 24,427 |
| Public and publicly guaranteed external debt (billions of U.S. dollars) | 7,953 | 7,215 | 9,250 | 11,924 |
| Exchange rate (period average, rials per U.S. dollar) | 8,078 1/ | 7,921 1/ | 7,967 | 8,282 |

Sources: Iranian authorities, and IMF staff estimates.

1/ Average market exchange rates before the March 2002 exchange rate unification.