

**Islamic Republic of Iran: 2003 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Islamic Republic of Iran**

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2003 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 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **June 26, 2003**, 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 1, 2003.** 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 Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its August 25, 2003 discussion** of the staff report that concluded the Article IV consultation.
- a statement by the Executive Director for the Islamic Republic of Iran.

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

Statistical Appendix

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

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INTERNATIONAL MONETARY FUND

ISLAMIC REPUBLIC OF IRAN

**Staff Report for the 2003 Article IV Consultation**

Prepared by the Staff Representatives for the 2003 Consultation with  
the Islamic Republic of Iran

(In consultation with other departments)

Approved by Lorenzo Perez and Matthew Fisher

August 1, 2003

- The 2003 Article IV consultation discussions were held in Tehran during June 14–26. The team comprised Messrs. Jbili (Head), Kramarenko, and Bailen (all MED); Mr. Mani (FAD); Ms. Calika (PDR); Mr. Roger (MFD); and Ms. Alavi, assistant (MED). Mr. Mirakhor, Executive Director, and Mr. Monajemi, Advisor to the Executive Director, participated in discussions.
- The mission met with the new Central Bank Governor Ebrahim Sheibani, Vice Governors Mojarrad and Komijani, Minister of Economy and Finance Mazaheri, Vice Minister of Commerce Vahaji, and senior officials of the Management and Planning Organization, Ministry of Labor, and representatives of commercial banks and the private sector.
- In concluding the last Article IV consultation on September 18, 2002, Executive Directors commended the authorities for the sound execution of their plan for exchange rate unification which, combined with a more liberal payments and trade system, will help enhance efficiency and underpin growth. While noting that maintenance of macroeconomic stability will be crucial for the success of Iran's economic reforms, Directors observed that policies to promote openness, greater economic efficiency, and improved business climate will foster private sector growth and investment and contribute significantly to job creation.
- Iran maintains exchange restrictions and multiple currency practices that are subject to approval under Article VIII, Sections 2(a) and 3.
- The authorities have continued to increase the transparency of their policies and published the concluding statement of the 2003 Article IV consultation mission. The authorities are following up on STA Technical Assistance (TA) recommendations to prepare for subscription to the Special Data Dissemination Standards (SDDS).
- The principal authors of this report are Abdelali Jbili and Vitali Kramarenko.

	Page
Contents	
List of Acronyms.....	4
Executive Summary.....	5
I. Introduction.....	6
II. Recent Developments .....	8
III. Report on the Discussions.....	16
A. Short-Term Policy Issues.....	16
B. Structural Reforms and Medium-Term Policy Issues.....	20
IV. Other Issues.....	22
V. Staff Appraisal .....	25
Text Boxes	
1. Major Structural Reforms in 2000–03 .....	7
2. Financial Sector Reform.....	15
3. Medium-Term Scenarios Under Current Policies.....	24
Text Tables	
I. Selected Indicators, 1990/91–2004/05.....	6
II. Selected Indicators, 2001/02–2002/03.....	8
III. Sectoral Growth Rates, 2000/01–2002/03 .....	8
IV. Employment in the Public and Private Sectors, 1997–2000.....	17
V. Selected Countries: Price/Earning Ratios in Selected Stock Markets, mid-2003.....	19
VI. Operations of the Oil Stabilization Fund, 2000/01–2003/04.....	21
Figures	
1. Unemployment Rate and Real GDP, CPI, Oil, and Non-oil GDP, 1996/97–2003/04.....	9
2. Breakdown of Domestic Demand Growth, 1998/99–2003/04.....	9
3. Inflation Developments, 1999–2003 .....	10
4. Financial Market Indicators, 1995/96–2002/03.....	10
5. REER and NEER Developments, 1997/98–2002/03.....	13
6. Output Gap, 1990–2003 .....	17
7. Baseline Medium-Term Scenario—Oil Prices, and Current Account and Fiscal Balances, 2002/03–2008/09 .....	23
8. Alternative Medium-Term Scenario—Oil Prices, and Current Account and Fiscal Balances, 2002/03–2008/09 .....	23

Tables

1.	Selected Macroeconomic Indicators, 1998/99–2003/04 .....	28
2.	Balance of Payments, 2000/01–2003/04 .....	29
3.	Vulnerability Indicators, 1998/99–2002/03 .....	30
4.	Central Government Operations 2001/02–2003/04 .....	31
5.	Monetary Survey, 2000/01–2003/04 .....	33
6.	Baseline Medium-Term Scenario Under Current Policies, 2000/01–2008/09 .....	34

Appendices

I.	Fund Relations .....	35
II.	Relations with the World Bank Group .....	39
III.	Statistical Issues .....	41

### List of Acronyms

AML/CFT	Anti-money laundering and combating the financing of terrorism
CBI	Central Bank of Iran
CBT	Commercial benefit tax
CPI	Consumer Price Index
CPPs	Central Bank Participation Papers
ERPD	Economic Research and Policy Department
FDI	Foreign direct investment
GFS	Government Finance Statistics
GPP	Government Participation Papers
MCC	Monetary and Credit Council
NEER	Nominal effective exchange rate
NTBs	Nontariff barriers
OSF	Oil Stabilization Fund
PPI	Producer price index
REER	Real effective exchange rate
ROSC	Report on the Observance of Standards and Codes
SCI	Statistical Center of Iran
SDDS	Special Data Dissemination Standards
TSE	Tehran Stock Exchange
TFYDP	Third Five-Year Development Plan
ULC	Unit labor costs
VAT	Value-added tax
WPI	Wholesale price index

## Executive Summary

### Recent developments

**Growth was high and broad-based in 2002/03 (fiscal year ending March 20).** Real GDP is estimated to have grown at 6.8 percent, with non-oil GDP expanding by 7.9 percent, reflecting a positive impact of economic reforms and favorable exogenous shocks, including good weather conditions and a higher oil price. Unemployment declined somewhat, but remained high at 15.7 percent.

**Domestic demand continued to grow at rapid rates, despite corrective fiscal and monetary policy measures.** As a result, Consumer Price Index (CPI) inflation accelerated to 15.8 percent from 11.4 percent in 2001/02, and the current account surplus narrowed to 3 percent of GDP despite higher oil prices. Moreover, equity and real estate prices continued to increase rapidly not only in response to economic liberalization measures, but also because of the high growth of money and credit, and a relatively stable exchange rate. During that period, most prudential indicators in the banking system deteriorated somewhat. Nonetheless, gross official reserves increased to the equivalent of seven months of next year's imports, and fiscal savings in the Oil Stabilization Fund (OSF) increased by about \$500 million. The twelve-month real effective exchange rate (REER) index depreciated by about 4 percent by end-April 2003.

**Progress in structural reforms was uneven across the reform areas.** While trade and financial sector reforms advanced and foreign direct investment (FDI) regulations were liberalized, there was less progress in improving the business environment, reducing labor market rigidities, and restructuring and privatizing public enterprises.

### Policy discussions

**Against the background of a favorable growth outlook in 2003/04, there was agreement that fiscal and monetary policy tightening would help contain inflationary pressures.** Real GDP is projected to grow at 6.5 percent. However, the fiscal policy stance based on the current budget could exacerbate demand pressures, leading to high liquidity growth and inflation. To address these risks, the staff recommended to reduce the fiscal deficit from an estimated 2.2 percent of GDP under current policies to 1.4 percent and contain M2 growth within a 20–25 percent range. The current exchange rate regime and exchange rate level are appropriate, but improving competitiveness over the medium-term will require intensified efforts in structural reforms and prudent demand management policies.

**Progress in structural reforms is key to enhancing growth and employment creation over the medium term.** The staff stressed the need for further advances in trade liberalization, improved fiscal management, financial system restructuring, labor market reform, privatization, and elimination of subsidies. Staff projections for the period 2004–08 based on current policies, suggest that real GDP growth would average 5.2 percent; unemployment would remain high; and external vulnerability might increase, but would remain manageable. An alternative scenario, assuming a fall in oil prices to \$18 per barrel beginning in 2004/05 and lower FDI in the oil sector, highlights the vulnerability of the budget and external accounts to these two assumptions.

## I. INTRODUCTION

1. **During the first three years of the Third Five-Year Development Plan (TFYDP) (2000/01–2002/03), real GDP grew by 5.8 percent on average**, despite declines in oil output during the past two years. At the same time, real per capita GDP and per capita private consumption increased on average by 4.1 percent and 4.7 percent, respectively. In addition, the overall macroeconomic situation improved significantly compared to the previous five-year development plan (Text Table I): the external current account was in surplus, the external debt was reduced to a very low level, international reserves increased significantly, and fiscal savings were accumulated in the OSF. This performance has taken place against the background of increased openness of the economy to international trade and investment, and increased economic reforms (Box 1), but also benefited from sustained high oil prices and fiscal stimulus.

Table I. Islamic Republic of Iran: Selected Indicators, 1990/91–2004/05

(Period average percentage change, unless otherwise indicated)

	1990/91–1994/95 Outcome Plan I	1995/96–1999/2000 Outcome Plan II	2000/01–2004/05 Outcome Plan III	1/
GDP 2/	6.7	3.8	5.8	
M2	27.0	26.0	29.0	
CPI	25.0	25.0	13.0	
Oil prices (U.S. dollars/barrel)	16.3	16.5	24.6	
External debt (in percent of GDP)	18.2	15.8	7.7	
Reserves (in months of imports)	1.9	4.4	6.7	

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

1/ Three-year average, 2000/01–2002/03.

2/ At factor cost at constant 1990 prices.

2. **Notwithstanding these achievements, the Iranian economy continues to face important challenges:** employment creation has not been sufficient to meet the rapid increase in the labor force; inflation is high and rising again; price subsidies and controls continue to hinder economic efficiency; and structural impediments for private sector development remain.

3. **The authorities' reform strategy under their development plan has effectively addressed many of these issues and helped improve economic performance in line with Fund's policy advice and technical assistance recommendations.** The successful unification of the exchange rate and the positive response of the private sector to trade liberalization and other reforms have created a favorable policy climate and stimulated the preparations of additional reforms. However, the need for political and social consensus continues to slow down the pace of implementation of reforms that have short-term adverse social effects. Following up on the Fund's assessment and recommendations regarding macroeconomic policies in the context of the 2002 Article IV consultation, the authorities cut

### **Box 1. Major Structural Reforms in 2000–03**

Iran has undertaken several major structural reforms in the past three years. Among them, the most important are:

#### *Exchange and trade regimes:*

- Exchange rate unification and elimination of most foreign exchange restrictions for current account transactions (March 2002).
- Trade liberalization: elimination of most export restrictions, replacement of nontariff barriers (NTBs) with tariffs, streamlining of import licensing procedures, and rationalization of the tariff structure (2000/01–2003/04).
- Approval of a new FDI law (2002) that establishes a clear legal framework for foreign investment in Iran.

#### *Financial sector reforms:*

- Introduction of Central Bank Participation Papers (CPPs); more flexibility in setting rates of return<sup>1/</sup> (on both deposits and lending rates); licensing of four private banks; authorization of private insurance companies; and implementation of risk-based banking supervision.
- Preparation of a draft law on capital markets.

#### *Fiscal reforms:*

- Establishment of the OSF in December 2000 with the objective of insulating the budget from fluctuations in oil prices.
- Tax administration: Setup of the National Tax Organization (which includes a Large Taxpayer Unit) in June 2001.
- Tax reform: In 2002/03, personal income tax rates were reduced significantly and minimum nontaxable income raised along with a reduction of corporate tax rates (from a high of 64 percent to 25 percent); and tax assessment and collection methods were made less discretionary. As a part of rationalization of indirect taxes, in 2003/04, several taxes and fees were combined in a single sales tax of 3 percent on all goods and services; and all import duties, taxes, and charges (except commercial benefit taxes) were unified into a single customs duty rate of 4 percent.
- Submission to Parliament of a draft law on the value-added tax (VAT).
- Reflection of the cost of most subsidies in the budget: The 2002/03 budget included exchange rate subsidies and this year's budget explicitly identifies the cost of energy subsidies (about 10 percent of GDP).
- Reduction in government employment by about 5 percent during 2000–03.

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<sup>1/</sup> Under Islamic banking principles, ex-ante rates are not allowed, but financial rates of return are used, based on expected profitability.



expenditure and enhanced revenue collection, thereby reducing the non-oil fiscal deficit by 1.6 percent of GDP compared to the initial budget estimates. Action was also taken by the central bank to absorb excess liquidity. However, the package of measures fell short of the recommended adjustment to contain liquidity growth and inflation, mainly out of concern for the negative impact of fiscal tightening on employment (Text Table II).

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

	2001/02	Initial policies 2002/03	Staff recommendation 2002/03	Est. 2002/03
(In percent of GDP, unless otherwise indicated)				
Central government balance	1.8	-5.2	-2.0	-2.3
<i>Of which: non-oil balance</i>	-13.9	-20.9	-17.7	-19.3
Current account balance	5.3	2.1	3.2	3.0
Oil price, U.S. dollars per barrel	21.5	23.0	23.0	27.1
(Annual percentage change)				
Broad money growth	25.8	41.0	22.9	30.1
(In millions of U.S. dollars)				
Gross official reserves	16,936	20,968	22,934	21,794

Source: Fund staff estimates.

## II. RECENT DEVELOPMENTS

4. **Growth was high and broad-based in 2002/03.** Real GDP is estimated to have grown at 6.8 percent, with non-oil GDP expanding by 7.9 percent (Text Table III, Figure 1, and Table 1). Positive supply shocks, including the effects of ongoing reforms, good weather conditions, and higher oil prices contributed to growth acceleration. At the same time, enhanced business confidence and monetary and fiscal stimuli spurred domestic demand, with private and public investment registering particularly high growth rates. Following strong wage growth, private consumption also increased rapidly (Figure 2). Preliminary indications point to a pick-up in the rate of employment creation in 2002/03, leading to a decline in the unemployment rate. This may be attributable to the acceleration of growth, and, to some extent, to the impact of recent employment incentive schemes such as subsidized credits and tax incentives for employment creation.

Table III. Islamic Republic of Iran: Sectoral Growth Rates, 2000/01–2002/03

	(Annual percentage change at constant prices)		
	2000/01	2001/02	2002/03
GDP at factor cost	5.1	5.4	6.8
Oil	8.6	-8.4	-7.1
Non-oil	4.8	6.5	7.9
Agriculture	2.9	4.2	10.1
Industry	8.8	13.1	13.0
Services	4.0	4.8	5.1

Source: Central Bank of Iran.

Figure 1. Islamic Republic of Iran: Unemployment Rate and Real GDP, CPI, Oil, and Non-oil GDP, 1996/97–2003/04  
(Annual percentage change, unless otherwise indicated) 1/

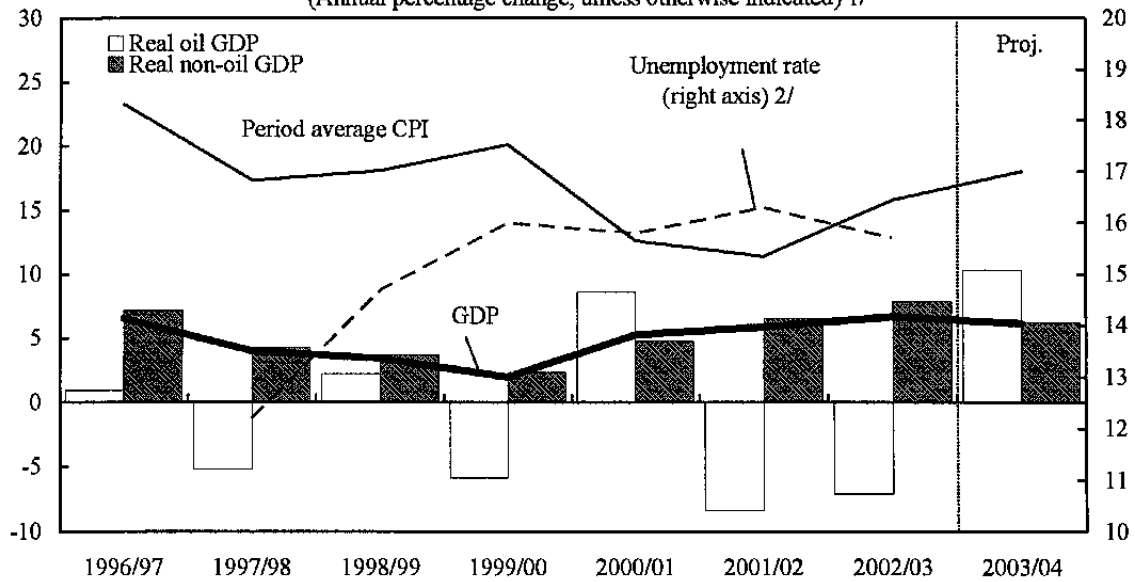
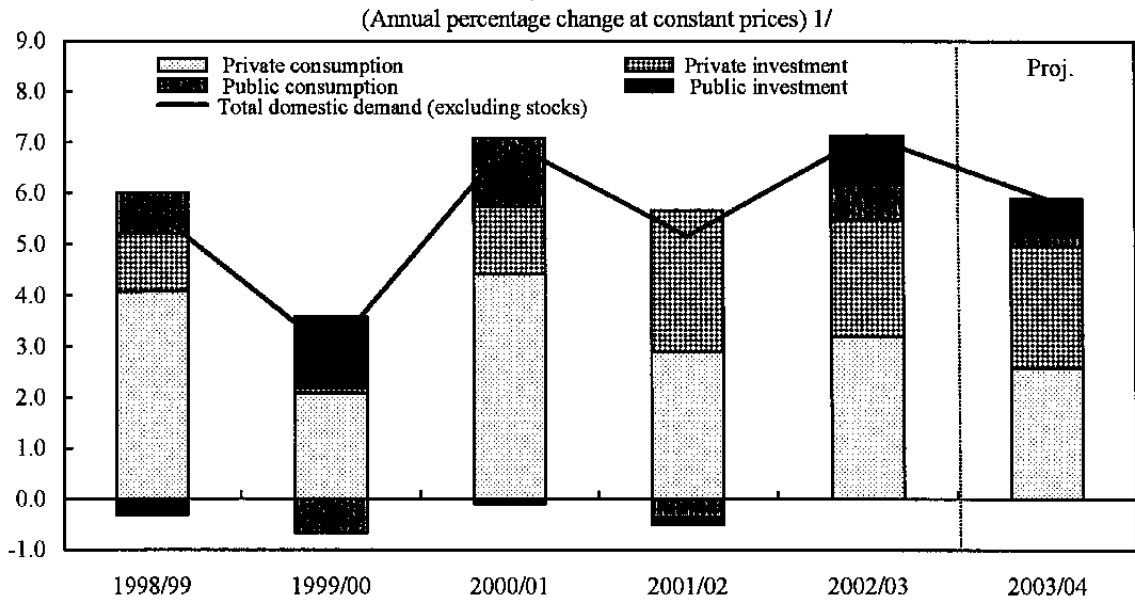


Figure 2. Islamic Republic of Iran: Breakdown of Domestic Demand Growth, 1998/99–2003/04  
(Annual percentage change at constant prices) 1/



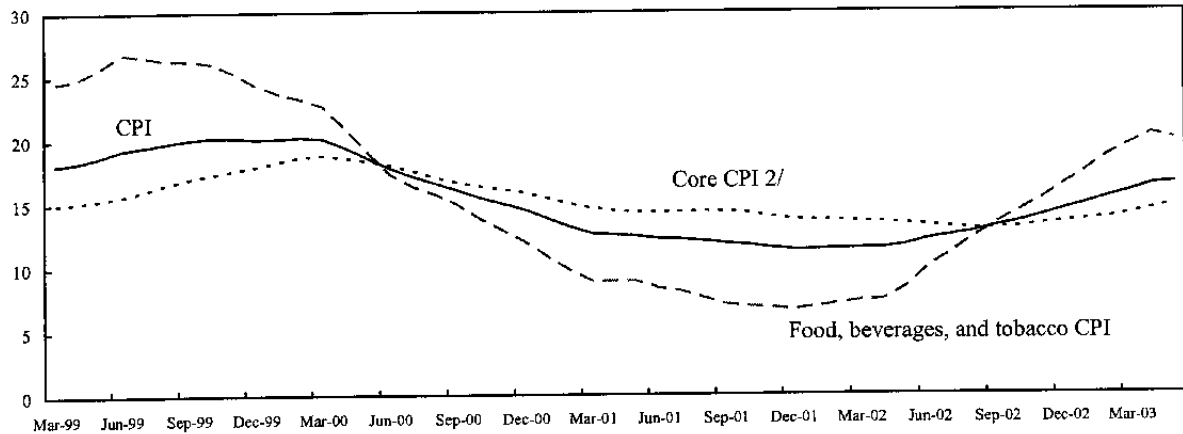
Sources: Iranian authorities; Fund staff estimates and projections.

1/ Last observation: projection for 2003/04.

2/ Last observation: 2002/03.

5. **CPI inflation accelerated to 15.8 percent in 2002/03 from 11.4 percent in 2001/02**, owing to a relatively expansionary fiscal stance and accommodating monetary policy (Figure 3). Moreover, equity and real estate prices continued to increase rapidly not only in response to economic liberalization measures, but also owing to the high growth of money and credit, as well as a relatively stable exchange rate (Figure 4).<sup>1</sup>

Figure 3. Islamic Republic of Iran: Inflation Developments, 1999–2003 1/  
(12-month percentage change)

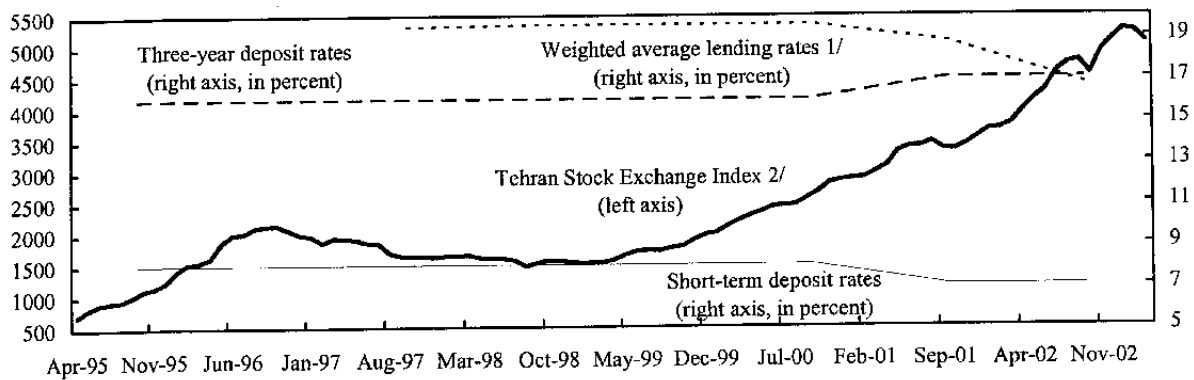


Source: Iranian authorities.

1/ Last observation: May 2003.

2/ Excluding food, beverages, and tobacco.

Figure 4. Islamic Republic of Iran: Financial Market Indicators, 1995/96–2002/03



Sources: Iranian authorities; and Fund staff estimates.

1/ Last observation: 2002/03.

2/ Last observation: March 2003. TSE index stood at 9,596.1 on July 30, 2003.

<sup>1</sup> Price/earning ratios at about 10 do not suggest a market overvaluation, but uncertainties over accounting practices do not allow for a determined judgment on the current level of stock market valuations.

6. **Rapidly growing domestic demand weighed on the external current account balance.** The current account surplus is estimated to have narrowed to 3 percent of GDP in 2002/03 from 5.3 percent in 2001/02 (Table 2). Exports continued to grow on account of higher oil prices and strong performance of non-oil exports, but imports rose sharply due to buoyant domestic demand, recent trade liberalization measures, and a build-up of inventories in the period leading up to the Iraq war. The current account surplus, together with large capital inflows,<sup>2</sup> led to the increase in gross official reserves by \$4.8 billion (to the equivalent of about seven months of next year's estimated imports). A large outflow under errors and omissions may reflect unrecorded imports and some capital outflows through the offshore interbank market for foreign exchange (see below). External vulnerability indicators point to a strong international liquidity position (Table 3), and Iran's external debt remains low (8.4 percent of GDP).

7. **Despite efforts to cut expenditure, fiscal policy was expansionary in 2002/03.** The overall fiscal balance is estimated to have shifted to a deficit of about 2.3 percent of GDP, compared to a surplus of 1.8 percent of GDP in 2001/02 (Table 4). This deterioration mainly reflects the budgetary cost of the exchange rate unification and rapid growth of capital expenditures. In the meantime, the non-oil deficit is estimated to have widened sharply by 5.4 percentage points to 19.3 percent of GDP, notwithstanding expenditure cuts introduced in the fall of 2002 (amounting to 1.6 percent of GDP).

8. **Monetary policy was accommodating.** Although the central bank issued additional CPPs to reduce excess liquidity, it could not independently adjust the rates of return, which in fact were reduced for retail lending.<sup>3</sup> The central bank accommodated the higher credit demand by increasing significantly its claims on banks and nonfinancial public enterprises. This, together with unsterilized purchases of foreign exchange from the government<sup>4</sup> and higher money multiplier (Figure 4),<sup>5</sup> led to the acceleration of M2 growth to 30 percent while credit to the private sector grew by 35 percent.

9. **State-owned banks remain unprofitable and undercapitalized.** Low profitability is attributable to controls on rates of return and high operating costs. The authorities intend to

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<sup>2</sup> FDI inflows were mainly in the form of buybacks. Under these agreements, foreign companies finance investments in oil exploration and extraction in Iran, and recover the initial investment and profits in kind when exports of crude oil commence. Official borrowing included two Eurobond issues (€1 billion) at 401 basis points above similarly dated European swaps.

<sup>3</sup> Rates of return on state-owned banks' loans are controlled in Iran.

<sup>4</sup> The sterilization operations (an increase of Rls 7 trillion in the stock of CPPs) only partially offset net purchases of foreign exchange and fell short of the authorities' target of Rls 10 trillion, in part owing to low rates of return.

<sup>5</sup> The multiplier increased owing to the decline in the share of cash relative to deposits and a lower weighted average reserve requirement ratio.

reinvest nearly \$2 billion of post-unification revaluation gains in banks' capital, raising capital adequacy ratios to around 8 percent from the current 4½ percent (Table 3). Banks' direct exposure to the equity market is limited, as margin lending for purchases of stocks is prohibited and investment in stocks by banks is limited to 2 percent of deposits.

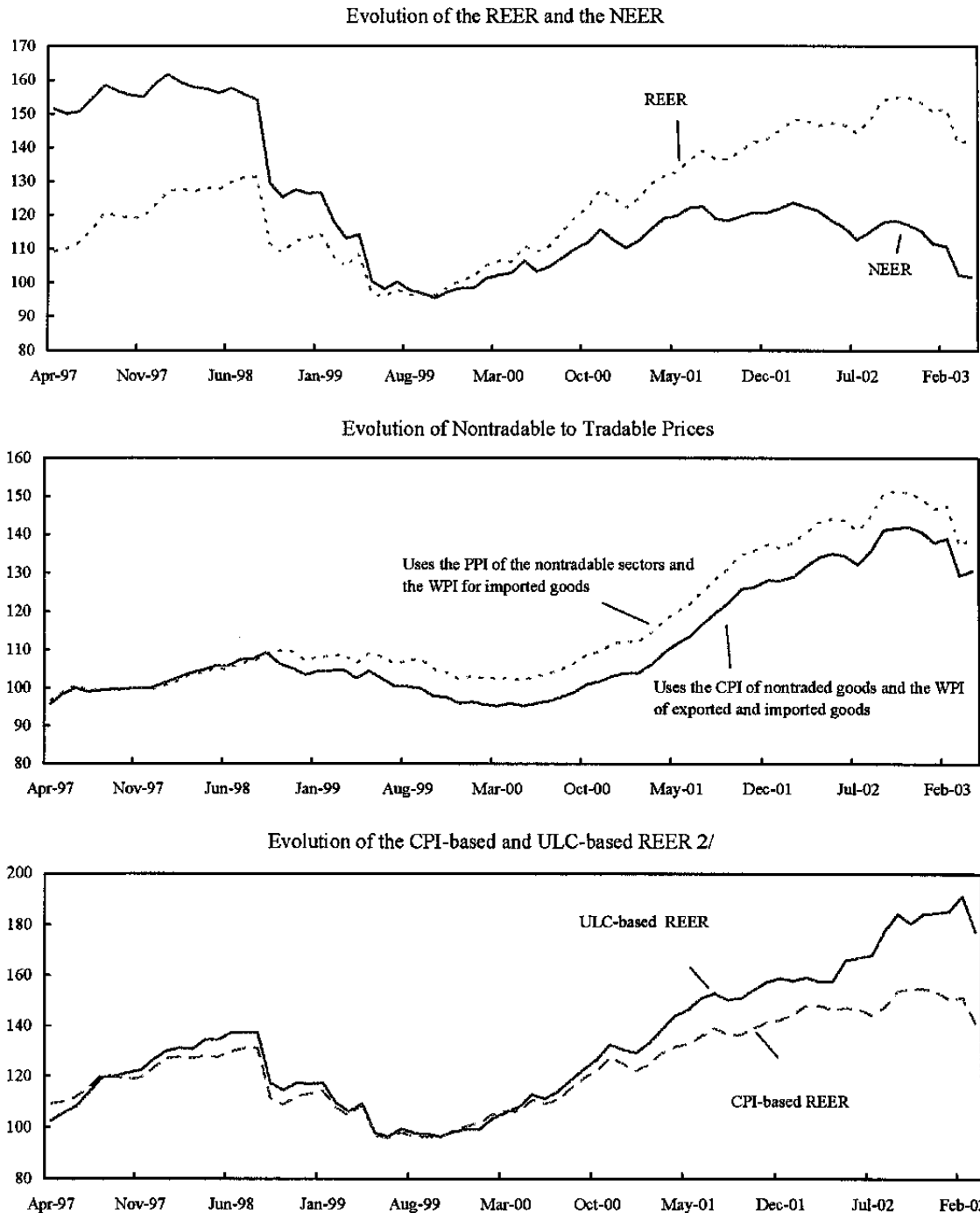
10. **After a period of stability following the March 2002 exchange rate unification, the unified exchange rate has depreciated in nominal and real terms since September 2002.** Under the managed floating exchange rate regime, the central bank has not committed to or publicly announced a specific exchange rate target, but has aimed to smooth out fluctuations in the exchange rate using an undisclosed basket of currencies. It has also permitted a nominal depreciation of the Iranian rial vis-à-vis the basket, to offset the deterioration in competitiveness resulting from the high inflation differentials between Iran and its trading partners. As a result, the nominal effective exchange rate and the REER depreciated by 17 percent and 4 percent, respectively, from March 2002 to April 2003 (Figure 5). Since the exchange rate unification, the parallel market premium has remained below 0.5 percent, except during the war in Iraq, in part due to central bank intervention in the offshore market throughout the year.<sup>6</sup>

11. **Despite the REER depreciation in 2002/03, the trend since 1999 has been for real appreciation.** The CPI-based and ULC-based REER show an average appreciation of 18 percent and 30 percent, respectively, during the 2000–02 period with respect to the previous four-year period. Despite this real appreciation, non-oil exports grew by about 11 percent on average during this period, reflecting improved access to imported intermediate and capital goods used as inputs in the export sector, as well as the implicit energy subsidies that reduce export costs relative to competitors. These factors are temporary however, and their effect may taper off, leading to a significant loss of competitiveness in the future if the REER appreciation trend continues.

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<sup>6</sup> Following the March 2002 unification, foreign branches of Iranian banks or banks located in offshore zones have been permitted to operate in the offshore foreign exchange market for current and some capital account transactions.

Figure 5. Islamic Republic of Iran: REER and NEER Developments, 1997/98–2002/03 1/  
(1999/00 = 100)



Source: Fund staff estimates.

1/ Initial observation: April 1997. Last observation: April 2003. NEER denotes nominal effective exchange rate, PPI–producer price index, WPI–wholesale price index, and ULC–unit labor costs.

2/ Initial observation: April 1997. Last observation: March 2003.

12. **Since the last Article IV consultation, structural reforms have advanced unevenly across reform areas.** While trade and financial sector reforms advanced, there was less progress in improving the business environment, reducing labor market rigidities, and restructuring and privatizing public enterprises.

13. **Steadfast progress has been made in liberalizing Iran's trade regime.** Recent decisions include: (a) consolidating customs duty rates and other import charges and fees into a single customs duty rate at 4 percent; (b) eliminating exemptions from the customs duty; (c) reducing sharply the number of commercial benefit tax (CBT) rates to 24 from 60; (d) continuing replacement of NTBs with tariffs; and (e) reducing significantly the number of NTBs. Despite these efforts, the combined simple average import tariff rate<sup>7</sup> is still relatively high at 27.6 percent.<sup>8</sup>

14. **Financial sector reform has gained momentum (Box 2).** Four private banks have been licensed, two mid-size public banks are expected to be privatized, and legislation authorizing private insurance companies has been passed. Moreover, some progress is being made in establishing indirect instruments of monetary policy and de-regulating rates of return in the banking system. In the area of banking supervision, the authorities have made significant progress, with Fund TA, in establishing a risk-based banking supervision. In addition, regulations for banking and credit institutions on anti-money laundering and combating the financing of terrorism (AML/CFT) were approved by the MCC in February 2003, and legislation on AML/CFT has been submitted to parliament. However, progress in modernizing the payment system and developing a sound framework for regulation and supervision of capital markets has been slow.

15. **In other areas, positive steps have been taken, but the pace of reform has remained slow.** Following the passage of the FDI law in 2002, the government approved relevant by-laws, determining a clear framework for FDI in Iran. Steps to reduce consumer and energy subsidies have been taken in the form of increases in retail prices of gasoline, flour, rice, and sugar. Moreover, preparatory work to phase out implicit energy subsidies is being carried out with assistance from the World Bank. Divestiture of government's shares to the private sector and the Social Security Organization have continued without transfer of majority control. Finally, an amendment of the labor code has liberalized hiring and firing regulations for small companies.

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<sup>7</sup> Customs duty combined with CBT.

<sup>8</sup> The Fund's overall trade restrictiveness index remains at 8.

## **Box 2. Financial Sector Reform**

**Central to efforts to increase the efficiency and flexibility of the financial system are measures to increase competition and private sector participation in the banking sector.** In the past year, four privately-owned banks were established, and although their share of banking system assets is very small, they are expanding rapidly and putting pressure on state-owned banks to improve the range of services available to customers.

**The Central Bank of Iran (CBI) is also moving toward a more market-based, indirect approach to monetary policy implementation.**

- The CPPs were introduced in 2001. Although their returns are set by the Monetary and Credit Council (MCC) and cannot fluctuate in the secondary market, CPPs have played an important role in sterilization operations;
- More recently, the central bank has eased direct controls over retail lending rates and the sectoral allocation of credit; and
- It also plans to introduce auctions for commercial bank fixed-term deposits with central bank. This is likely to introduce benchmark market rates of return, particularly if an active secondary interbank market in such deposits develops.

**Measures are also being taken to facilitate international trade and investment.** Since March 2003, banks have been permitted to deal in foreign exchange in the offshore market, mainly in Dubai and the Kish Free Trade-Industrial Zone. Most of these transactions are trade-related, and now account for around one-third of total foreign exchange market turnover. Banks' exposures in the offshore market are constrained by foreign exchange regulations applying to banks on a consolidated basis, and transactions are subject to new AML/CFT regulations.

**Measures are being taken to enhance the strength of the financial system.**

- A comprehensive program to develop and implement a risk-based regulatory and supervisory framework for the banking sector is underway. Key regulatory reforms are in place, including licensing and net open positions, or in the process of being prepared; supervisory functions have been unified under one single department at the central bank, on- and off-site inspections have begun, using risk-based criteria; and reporting forms and supervision manuals are being developed.
- The authorities are planning to raise state-owned banks' capitalization to conform to Basel standards.

**Draft legislation to enhance the supervisory and regulatory framework governing the Tehran Stock Exchange (TSE) is being considered by the government,** and the TSE has very recently established a separate regulatory unit.



### III. REPORT ON THE DISCUSSIONS

16. **The discussions focused on the appropriate policy mix for 2003/04 and medium-term challenges.** There was agreement that conditions were favorable for high growth to continue in 2003/04, but the staff suggested that fiscal and monetary policy be tightened to contain inflationary pressures. It also discussed the authorities' structural reform program aimed at sustaining high growth, increasing employment creation, and fostering an optimal use of oil wealth.

#### A. Short-Term Policy Issues

##### Outlook for 2003/04

17. **The investment and growth momentum of the past few years is expected to continue in 2003/04.** Real GDP growth is projected at 6.5 percent, reflecting higher oil output,<sup>9</sup> continued strong performance of non-oil activities (6.2 percent), though at a more moderate pace than during last year, as agriculture output returns to its trend growth. Downside risks to this outlook include regional instability and uncertainties about oil prices, which could affect investment and business confidence.

18. **The staff expressed concern about the pro-cyclical nature of the authorities' policy stance.** It underscored that in Iran's current cyclical position—in which oil prices are high, capital inflows are increasing, and inflation is rising—the government should be running fiscal surpluses and accumulating savings in the OSF. Also of some concern is the projected shift into a small deficit of the current account balance (0.6 percent of GDP) at a time when oil prices are relatively high, even though the overall balance of payments is expected to be in surplus (about \$2 billion) owing to sustained FDI in the oil sector.

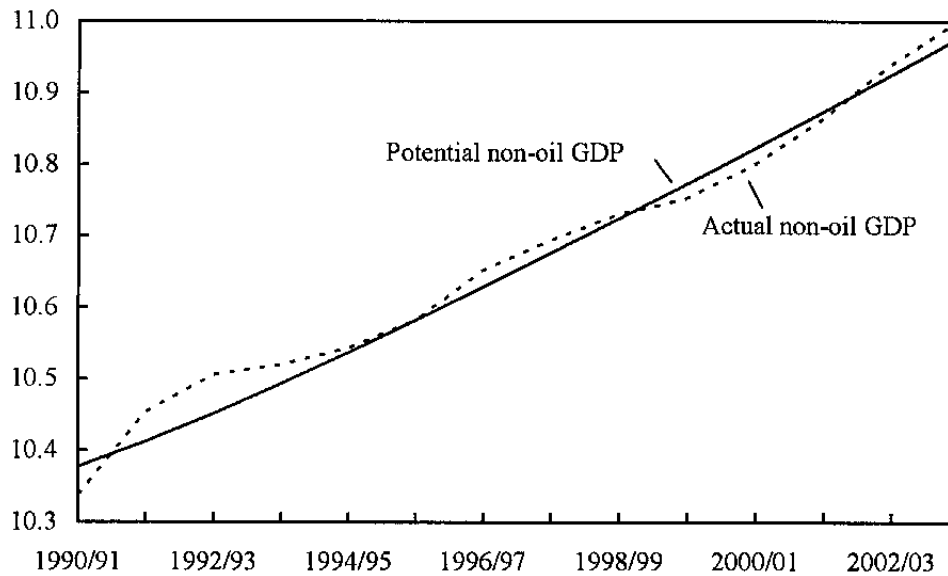
19. **The authorities and the staff shared the view that the fiscal policy stance based on the budget approved in February 2003 would exacerbate demand pressures, leading to high liquidity growth and inflation.** The sizable liquidity impact of the fiscal deficit financing, continued private capital inflows, and sustained growth in private demand could cause domestic liquidity to grow by about 35 percent. Recognizing these risks, the authorities indicated that they had approved a package of monetary policy measures and were considering fiscal measures aimed at containing domestic demand and limiting inflation to 18 percent. Despite the projected tightening of monetary policy, inflation is still expected to be higher in 2003/04 than in 2002/03, owing to lagged effects of M2 growth in 2002/03 and readjustments of administered prices.

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<sup>9</sup> This is due to the increase in OPEC quota for Iran to 3.7 millions of barrels per day.

20. **The authorities remain concerned about the impact of fiscal tightening on employment.** The staff argued that stimulating employment through expansionary fiscal policy at a time when output seems to be above its potential can be costly in terms of inflation (Figure 6), particularly if unemployment is of a structural nature as is the case in Iran. Moreover, given the strong private sector response to economic reforms in recent years, and the fact that a large share of employment creation originated in the private sector, a fiscal stimulus was not necessary (Text Table IV).

Figure 6. Islamic Republic of Iran: Output Gap, 1990–2003  
(at 1990 constant prices, in logarithms)



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

Table IV: Islamic Republic of Iran: Employment  
in the Public and Private Sectors, 1997–2000

(In percent; unless otherwise indicated)

	Share in total employment 1997–2000	Annual growth in employment 1997–2000	Annual job creation (in thousands) 1997–2000
Total	100.0	1.7	254.7
Private	73.2	3.8	343.0
Public	26.4	-4.0	-87.0
Cooperative sector	0.4	-3.9	-1.3

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

## **Fiscal policy**

21. **The staff noted that budget revenue was overestimated and capital expenditure and lending from the OSF were budgeted to increase significantly.** The budget calls for an increase in non-oil revenue by 2.3 percent of GDP (Table 4), which appears highly optimistic even if additional revenue measures are accounted for (Box 1). The overall shortfall of non-oil revenue and financing, mainly on account of taxes on international trade, privatization proceeds, and telecommunication license fees, could reach Rls 35 to Rls 38 trillion (3.5 percent to 3.8 percent of GDP). Total expenditure is budgeted to remain largely unchanged in 2003/04 relative to GDP, compared with the outcome for 2002/03, but capital expenditure and net lending from the OSF are budgeted to increase sharply (by 1.3 percent of GDP).

22. **The authorities plan to introduce fiscal measures in the second half of the current fiscal year.** An interagency budget committee was considering revenue measures, including raising taxes on international trade<sup>10</sup> and expenditure cuts to offset the expected revenue shortfall. The authorities indicated that across-the-board cuts of 3 percent were already being applied to nonwage current outlays and the investment budget was expected to be curtailed significantly, which would bring the fiscal deficit down to 2.2 percent of GDP. The staff advised against raising import taxes, which would undermine ongoing trade liberalization efforts. It also called for additional cuts mostly in capital expenditures and improved revenue collection that would bring down the fiscal deficit to the equivalent of 1.4 percent of GDP corresponding to a non-oil deficit of 15.4 percent of GDP (Table 4). The authorities concurred that such a deficit would be consistent with their monetary objective and with the need to achieve a gradual adjustment to a possible downturn in oil prices.

## **Monetary policy and financial system stability**

23. **The authorities agreed on the need for monetary policy to focus on disinflation, which would enhance the credibility of the monetary anchor (M2) under the managed float exchange regime.** In this regard, the staff indicated that achieving the authorities' inflation objective would require a deceleration in M2 growth to 20–25 percent and reiterated the importance of the recommended fiscal adjustment and monetary restraint (Table 5). The authorities agreed with this target and indicated that the MCC had already approved a range of monetary policy measures to contain domestic liquidity growth. These include:  
(a) sterilization operations of up to Rls 10 trillion (6 percent of end-period base money) through issuance of CPPs and auctioning of bank deposits with the central bank; and  
(b) raising the rates of return on government participation papers to 17 percent.

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<sup>10</sup> Mainly the commercial benefit tax.

24. **The staff welcomed these steps, but noted potential upside risks to liquidity growth.** In particular, negative real rates of return and further increases in central bank's claims on banks could lead to higher credit growth and jeopardize the achievement of the M2 target. In this context, the staff recommended that the central bank should have sufficient flexibility in determining the rates of return on its facilities, including overdrafts, and the minimum rates of return in the banking system. Moreover, the staff urged the authorities to strengthen banking supervision and discourage banks from their large use of overdraft facilities. The authorities indicated that the central bank had full control on the rates of return of the auctioned deposit facility, and that the MCC could increase the rate of return on CPPs to make them more attractive. They were confident that the increase in claims on banks would be limited, owing to stronger supervisory efforts and moral suasion. The authorities also indicated that consideration was being given to enhancing the independence of the central bank in light of the experience of other countries.

25. **The mission discussed the potential risks to the stability of the financial system associated with rapid credit growth and a possible downward adjustment in stock prices.** The staff drew the authorities' attention to the relative deterioration in most prudential indicators (Table 3) and urged the authorities to enforce new prudential regulations after the expiration of the transition periods for full compliance. The authorities expressed concern about rising nonperforming loans, but did not see major immediate risks associated with rapid credit growth given the adequacy of banking supervision. They also maintained that the risks associated with banks' exposure to the real estate market were manageable because of high collateral and an effective enforcement of foreclosures by the courts. Regarding the stock market, the authorities expressed the view that recent price increases reflected the low starting point of the equity market, which had been dormant for several years, and were confident that a sharp downward adjustment was unlikely to take place since the major investors—the Social Security Organization, government pension funds, and other large institutional investors—would not exit the market in a disorderly manner, given the long-term nature of their commitment and the limited alternatives for investment (Text Table V). The staff stressed the need for early adoption of a draft capital market law, which will help strengthen the supervision of the stock market.

Table V. Selected Countries: Price/Earning Ratios in Selected Stock Markets, mid-2003

Egypt	14.9
Iran 1/	10.0
Jordan	13.9
Pakistan	7.8
S&P 500	34.9

Sources: *Datastream*; Morgan Stanley Capital International; and Iranian authorities.

1/ Provided by the Iranian authorities.

### Exchange rate policy

26. **The staff concurred that the foreign exchange market had operated smoothly since the exchange rate unification, but highlighted the risks associated with higher inflation.** The staff argued in favor of increased exchange rate flexibility that would also be

consistent with the need to achieve the monetary policy objective. This should be supported by tighter fiscal policy and further trade liberalization to take some pressure off the exchange market. The staff also noted that the risk of acceleration of inflation associated with the continuation of expansionary policies poses a serious challenge to exchange rate management. Further significant real appreciation could erode competitiveness over the medium term, as the temporary factors that have recently boosted competitiveness taper off. The authorities acknowledged this risk and shared the staff views that under Iran's current circumstances, larger and lasting gains in competitiveness should be obtained through structural reforms.

27. **The staff discussed the potential vulnerabilities that could arise from the involvement of Iranian banks in the offshore foreign exchange market.** These include potential difficulties to intermediate large and volatile capital inflows and the exposure of parent banks to offshore branches. The authorities indicated that the operations in the offshore markets were mainly related to current account transactions. Should there be evidence of large capital outflows through this channel, the authorities would be able to re-impose restrictions on offshore market transactions. The authorities also stated that banks' exposure to offshore branches is constrained by foreign exchange regulations applying to banks on a consolidated basis, and requested Fund's TA on the adequacy of the relevant prudential regulations.

28. **The staff welcomed the authorities' continued interest in accepting the obligations of Article VIII, Sections 2(a) and 3 of the Fund's Articles of Agreement.** In this respect, it had further discussions with the authorities regarding foreign exchange regulations or practices that are inconsistent with Article VIII obligations (Appendix I). Since the 2002 Article IV consultation, the authorities have eliminated the multiple currency practice resulting from exchange rate subsidies on certain imports. The staff is reviewing documentation relating to recent changes in relevant Iranian regulations, as well as other issues regarding Iran's foreign exchange regime.<sup>11</sup>

#### **B. Structural Reforms and Medium-Term Policy Issues**

29. **The staff welcomed the authorities' intention to further liberalize trade through the remaining years of the TFYDP.** It emphasized that efforts in this area should aim at eliminating any remaining NTBs, rationalizing the tariff structure by having a uniform schedule, and reducing the number of tariff bands and the average and maximum rates. Simultaneously, efforts will need to continue in streamlining customs and administrative procedures.

30. **The staff encouraged the authorities to develop a medium-term fiscal framework that would help smooth out the impact of fluctuations in oil prices, build savings for**

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<sup>11</sup> If new information on the review is available by the time of the Executive Board meeting, such information will be provided to the Board.

**future generations, and reduce the scope of implicit and explicit subsidies.** As a first step in this direction, the authorities would need to strictly adhere to the OSF objectives of helping absorb the shocks coming from oil price volatility. In this regard, the staff reiterated its concern that OSF resources were being run down at a time when oil prices were high, thereby leaving little financial room to cushion the impact of a decline in oil prices (Text Table VI). The next step would be to give consideration to accumulating long-term savings to maintain per capita oil wealth constant across generations. The authorities indicated that the preparation of the next five-year development plan offered an opportunity to consider these and other medium-term reforms, which are at various stages of preparation. In this regard, while implementation of the VAT is scheduled for 2005/06, the reform of energy subsidies is still at an early stage of preparation in collaboration with the World Bank. The authorities favor a gradual approach to the energy price reform, but specific plans have not yet been developed. The staff encouraged the authorities to accelerate the preparation of these reforms, including putting in place an adequate social safety net with appropriately targeted assistance for households in need and phasing out subsidies.

Table VI. Islamic Republic of Iran: Operations of the Oil Stabilization Fund,  
2000/01–2003/04  
(In millions of U.S. dollars)

	2000/01	2001/02	Prel. 2002/03	Budget 2003/04	Proj. 1/ 2003/04
Inflows:	5,944	1,997	5,605	2,615	2,615
<i>Of which:</i> investment income	0	149	200	230	230
Outflows:	0	500	5,088	5,294	4,174
Withdrawals for budget financing	0	0	4,500	4,500	3,380
Lending to companies (net of repayments)	0	500	588	794	794
Net change in stocks	5,944	1,497	517	-2,679	-1,559
End-of-period stock of foreign exchange deposits	5,944	7,441	7,958	5,279	6,399

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

1/ Assuming fiscal adjustment.

**31. Wide-ranging reforms to increase the efficiency and stability of the financial system are essential for the development of the Iranian economy.** The staff welcomed the authorities' commitment to complete implementation of the risk-based regulation and supervision in the banking system, including adoption of remaining prudential regulations, and to overhaul the payment system. In addition, it endorsed the authorities' intention to encourage increased private sector participation in the financial sector and welcomed their plans to privatize two state-owned banks in the coming years. These, together with further easing of directed credit and controls on the rates of return, will help enhance efficiency and improve banks' profitability. The staff also urged the authorities to press ahead with measures to implement a more indirect, market-based approach to monetary policy implementation. The authorities indicated that the envisaged draft legislation to improve capital markets regulation

would establish a Security and Exchange Commission and strengthen the supervision of the stock exchange. The staff recommended that efforts in this direction be accelerated.

32. **The staff pointed out that labor market reform and increased private sector participation would accelerate employment creation.** Labor market reform should aim at reducing labor market rigidities, including high dismissal costs, excessive regulation, an inefficient information system to match job seekers and potential employers, and government determination of salaries in most industries.<sup>12</sup> This, together with privatization, increased competition, and a reform of the education system, would enhance productivity and growth. The authorities confirmed their intentions to move gradually with such reforms. They intend to draw lessons learnt from the experiment with liberalizing labor regulations in small companies before expanding the reform to other companies. The staff cautioned against excessive reliance on tax and credit incentives as a means to reduce unemployment. In the area of privatization, the authorities indicated that a more ambitious privatization plan that would help bring about managerial expertise and know-how was under active consideration. Large-scale privatization, however, would be preceded by reforms in subsidies and competition policy.

33. **The mission discussed with the authorities the medium-term outlook (2004/05–2008/09) for the Iranian economy,** based on a scenario of a gradual decline in oil prices, an easing of regional tensions, and a gradual implementation of the above structural reforms (Box 3). Under such a scenario, real GDP growth would average about 5 percent; unemployment would remain high; and external vulnerability might increase (Table 6 and Figure 7). An alternative scenario, assuming a fall in oil prices to \$18 per barrel beginning in 2004/05 and lower FDI in the oil sector highlights the vulnerability of the budget and external accounts to these two assumptions (Figure 8). These scenarios, however, are indicative and are subject to considerable uncertainties. The authorities indicated that the next five-year development plan (2005/06–2009/10) would aim at achieving much higher growth rates than projected by the staff, but the related medium-term macroeconomic framework and policies were at an early stage of preparation.

#### IV. OTHER ISSUES

34. **The staff commended the authorities for improving the statistical database and further enhancing transparency.** Following the 2002 statistical mission on subscription to the SDDS, progress has been made in moving toward a presentation conforming to the fifth

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<sup>12</sup> See SM/02/286, Chapter VI.

Figure 7. Islamic Republic of Iran: Baseline Medium-Term Scenario—Oil Prices, and Current Account and Fiscal Balances, 2002/03–2008/09

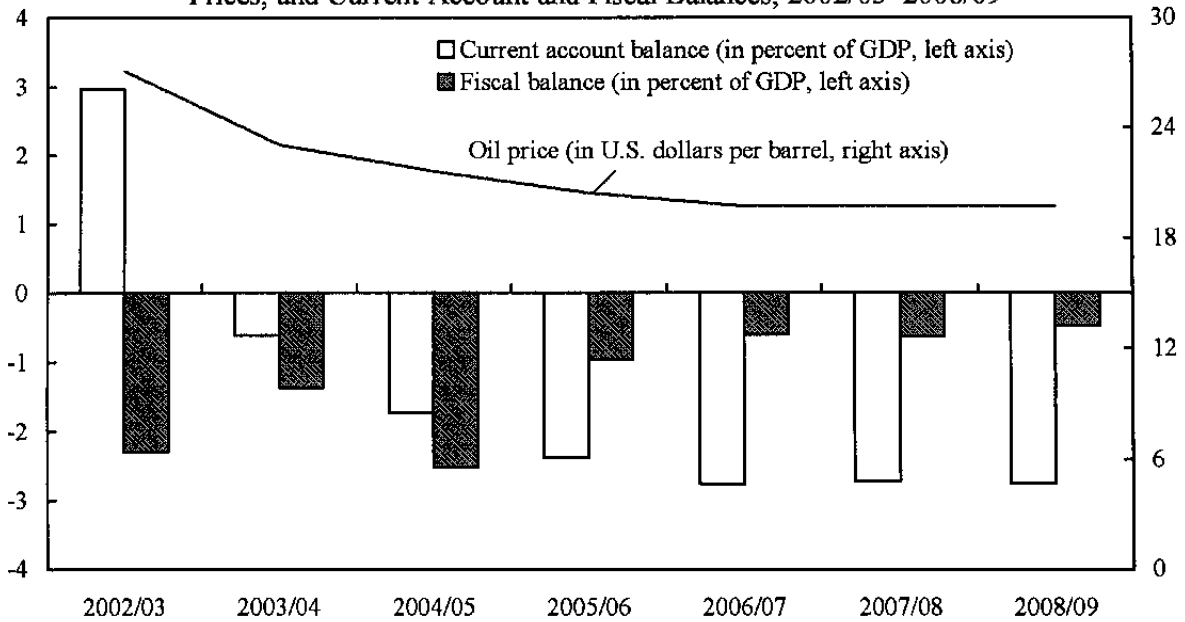
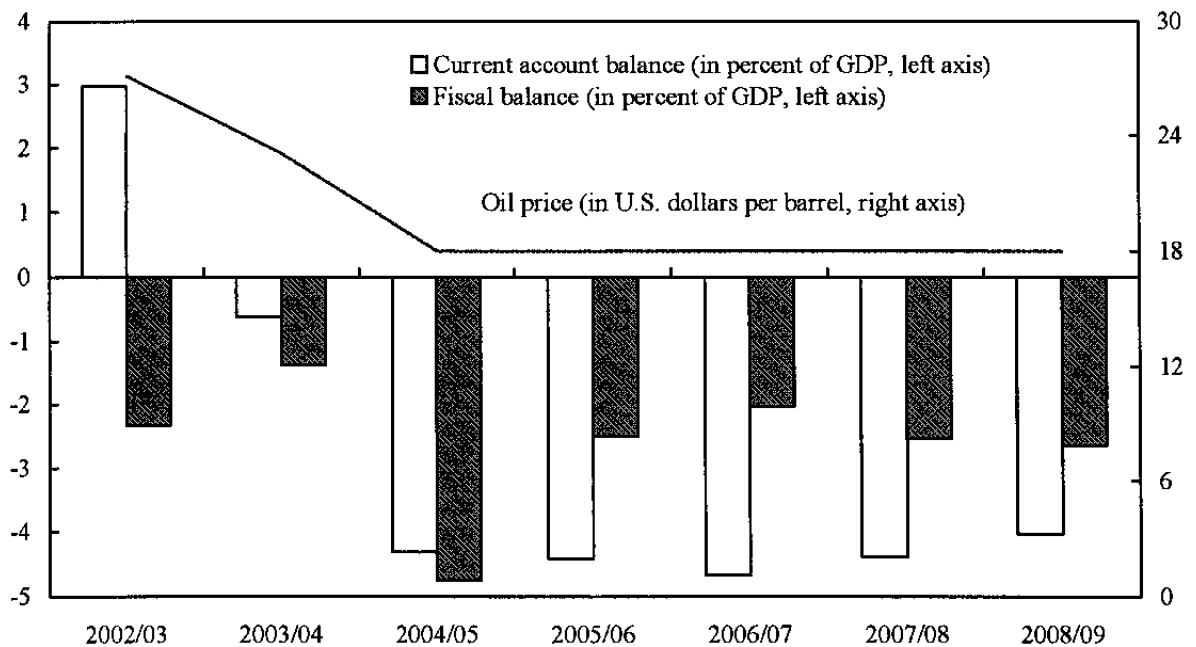


Figure 8. Islamic Republic of Iran: Alternative Medium-Term Scenario—Oil Prices, and Current Account and Fiscal Balances, 2002/03–2008/09



Sources: Iranian authorities; Fund staff estimates and projections.



### **Box 3: Medium-Term Scenarios Under Current Policies**

#### **1. Key assumptions**

- A decline in oil prices from \$27.1 per barrel in 2002/03 to \$19.7 in 2008/09; a gradual increase in interest rates over the projection period; and stable spreads on emerging markets debt.
- A gradual pace of reforms, including slow privatization, a continuation of energy price adjustments in the 10–15 percent range per year, further steps in trade reforms, implementation of VAT in 2005/06, and a gradual strengthening of the banking system and capital markets.

#### **2. Outcome**

- Real GDP is projected to grow by 5.2 percent on average during 2004/05–2008/09, compared to 4.7 percent on average during the previous five years. Oil production capacity is projected to increase from 4.1 million barrels per day to about 5 million on account of sustained oil-related FDI.<sup>1/</sup>
- The external current account balance would deteriorate to a deficit of 2.6 percent in 2008/09 from a surplus of 3 percent of GDP in 2002/03, mainly on account of lower oil prices and decelerating growth of non-oil exports. FDI in the oil sector would continue to grow, but would remain modest in other sectors. External debt is projected to increase to 14.5 percent of GDP in 2008/09 from 8.4 percent in 2002/03 and the reserve coverage of imports of goods and services would decline to 5.6 months during the same period.
- The fiscal deficit is expected to fluctuate in the range of 0.5–2.5 percent of GDP. On the revenue side, implementation of a VAT in 2005/06 would raise revenue by 2.2 percent of GDP on average thereby softening the impact of lower oil prices. On the expenditure side, net lending would be cut and a gradual reduction in subsidies would be implemented in response to the decline in oil revenue, while the OSF resources would be gradually depleted. Gross public and publicly guaranteed debt is expected to remain at 18–20 percent of GDP in 2003/04–2008/09, while net debt would increase to about 19 percent of GDP in 2008/09 from 12.7 percent in 2002/03.
- Medium-term projections are sensitive to assumptions on oil prices, FDI inflows, and spreads on foreign currency and local currency-denominated debt. If oil prices were to fall to \$18 per barrel in 2004/05 and stay at that level through 2008/09, and FDI were one-half of the level under the baseline scenario, growth would be 1 to 2 percentage points below the baseline scenario. Also, spreads on Iran's external borrowing would likely increase, and the external debt ratios would increase slightly compared to the baseline scenario, while the reserve coverage of imports would decline to two months.

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<sup>1/</sup>Recent discoveries of large oil reserves may affect production capacity beyond the projection period.

edition of the balance of payments manual (Annex III). Further improvements are needed, including for monetary and banking statistics, the coordination of balance of payments and government finance statistics, labor market data, and the cooperation between the CBI and the Statistical Center of Iran (SCI). With regards to transparency, following the recommendations of the fiscal Report on the Observance of Standards and Codes (ROSC), the authorities expanded the coverage of the budget and identified implicit energy subsidies in the budget document for the first time. The staff encouraged the authorities to continue to enhance transparency, in particular, by consolidating all extra-budgetary operations into the budget, including the accounts of the OSF, the social security, and government pension funds. It also recommended that a template on International Reserves and Foreign Currency Liquidity be prepared and published on a regular basis.

35. **The staff expressed the Fund's willingness to continue to provide TA to Iran in various areas in light of the authorities' generally adequate implementation of past TA recommendations.** A TA team will visit Tehran shortly to follow up on VAT implementation and other tax administration matters. The authorities have expressed interest in having Fund TA in treasury and cash management, banking supervision, and foreign exchange regulations.

36. The staff encouraged the authorities to consider debt relief in favor of Nicaragua and Tanzania under the HIPC initiative.

## V. STAFF APPRAISAL

37. **The Iranian economy continues to grow at high rates.** Since 2000/01, real GDP growth has been strong and broad-based, leading to significant gains in real per capita income and private consumption. Growth has been mainly driven by the non-oil sector, which grew by about 8 percent in 2002/03, while the rate of unemployment edged downward. These developments clearly attest to the favorable impact of economic reforms that have been put in place in recent years, including the opening up of the economy to international trade and investment, the improved macroeconomic conditions that enhanced confidence by foreign and domestic investors, and the authorities' commitment to economic reforms. Less enduring factors were also at play, such as sustained high oil prices and expansionary fiscal and monetary policies.

38. **At the same time, the expansionary fiscal and monetary policy stance of the last two years has shown up in higher inflation and a deterioration in the current account balance.** The policy mix of the past two years has clearly provided a fertile ground for a reversal of disinflation trends. Fiscal policy was expansionary at a time when private sector demand was also very strong, bank credit and domestic liquidity continued to grow at a rapid pace, and the central bank lacked instrument independence to conduct monetary policy, including the flexibility to make timely adjustments to rates of return. The authorities moved during 2002/03 to reduce the fiscal deficit and contain liquidity growth, but the corrective measures fell short of what was needed to achieve the authorities' target of liquidity growth.

39. **The outlook for 2003/04 is favorable, but there are downside risks.** Real GDP growth is projected at 6.5 percent, reflecting higher oil output and sustained domestic demand, which will continue to boost growth in non-oil activities. Downside risks to this outlook include a decline in oil prices that could undermine confidence and worsen the current account position. Also, inflation could be higher than projected if fiscal and monetary policies are not tightened. Even if these risks materialize, however, the growth momentum in 2003/04 is likely to continue.

40. **The staff welcomes the authorities' intention to introduce corrective fiscal and monetary policy measures to contain inflation.** The staff believes that government spending plans must be brought in line with the need to ease domestic demand pressures and help contain liquidity growth. The authorities' intention to curtail capital outlays, which are budgeted to rise sharply, is appropriate, but efforts should also focus on containing the growth of current expenditure and mobilizing non-oil revenue. The staff recommends reducing the overall fiscal deficit to 1.4 percent of GDP, down from the current estimate of 2.2 percent. This would also diminish the need to draw on the resources of the OSF, help achieve the monetary growth target, and facilitate adjustment to a possible decline in oil prices.

41. **The managed float exchange regime remains appropriate for Iran,** given the economy's vulnerability to terms of trade shocks, labor market rigidities, and ongoing trade reforms. Now that a smooth transition to the new unified exchange rate system has taken place and the supervision of banks' foreign exchange positions has improved, the authorities can move to a more flexible exchange rate management under which the rate would be more fully determined by market forces. The current level of the exchange rate appears broadly appropriate, but there is little scope over the medium term for sustained real appreciation, which would erode competitiveness. Improvements in competitiveness should be primarily achieved through structural reforms and demand management policies aimed at reducing inflation.

42. **The overall economic strategy must place greater emphasis on economic efficiency and private sector development.** At the present stage of Iran's transition to a market economy, the private sector has shown a welcome response to economic reforms in the form of higher investment and employment creation. The authorities would need to capitalize on this dynamism and generate sustained improvement in investor confidence. This could be achieved through fiscal discipline and prudent monetary policy, which would reduce inflation and enhance the credibility of the authorities' commitment to financial stability. The promising contribution to employment creation by the private sector should also obviate the need for the government to boost public spending in the current position in the economic cycle, which could endanger macroeconomic stability. Instead, the government could more confidently restrain its spending out of oil resources, build precautionary balances in the OSF, and accumulate savings for future generations. In parallel, it should also disengage from key economic activities and push through the necessary reforms to improve the business and investment climate.

43. **The authorities are to be commended for accelerating the pace of financial sector reform.** The staff welcomes the establishment of four private banks and the authorization of private insurance companies, which are important steps toward enhancing competition and efficiency in the financial system. It also welcomes the reforms under way to implement a risk-based regulatory and supervisory system and calls for further advances in providing banks with more leeway in determining the rates of return and reducing the scope for directed credit. The planned re-capitalization of public banks is a step in the right direction and should be accompanied by measures to enhance their efficiency and profitability. The staff encourages the authorities to move forward in this direction and to accelerate other financial sector reforms, including approval of the capital market law and upgrading of the payment system.

44. **Further progress in structural reform is key to sustaining high growth and employment creation.** Building on the advances made in recent years, the authorities would need to secure further progress in trade liberalization, streamline administrative controls, reform the labor market, and foster competition. This, together with concomitant advances in financial sector liberalization, would pave the way for decisive steps toward privatization and deregulation. The staff encourages the authorities to overhaul the subsidy system, including those on energy prices, and to put in place a targeted scheme to protect the poor.

45. **The staff welcomes the authorities' intentions to accept the obligations of Article VIII, Sections 2(a) and 3 of the Fund's Articles of Agreement.** It welcomes the elimination of the multiple currency practice resulting from exchange rate subsidies for certain imports and encourages the authorities to eliminate the remaining restrictions and multiple currency practices. The staff does not recommend approval of the retention of the exchange restrictions and multiple currency practices at this stage since the authorities are in the process of establishing a timetable for their removal.

46. **The authorities are to be commended for further improving the statistical database and enhancing transparency.** The data provided to the Fund for surveillance are adequate and timely. The staff commends the authorities for expanding the coverage of the budget document, identifying the cost of implicit energy subsidies, and publishing the Fund consultation reports in 2002. It encourages the authorities to make further progress in implementing the recommendations of the Fund's fiscal ROSC mission, including consolidating some extra-budgetary operations in the central government accounts and publishing international reserve data on a regular basis.

47. **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, 1998/99–2003/04 1/

	1998/99	1999/2000	2000/01	2001/02	Est. 2002/03	Proj. 4/ 2003/04
<b>Oil Sector</b>						
Total oil exports (in billions of U.S. dollars)	9.9	17.1	24.3	19.3	22.9	22.4
Average oil export price (in U.S. dollars/barrel)	10.5	18.6	25.3	21.5	27.1	23.1
(Annual percentage change, unless otherwise indicated)						
<b>National accounts</b>						
Nominal GDP at factor cost (in billions of rials)	328,474	434,300	575,895	657,388	877,565	1,064,203
Real GDP at market prices	3.4	2.0	5.3	5.9	6.7	6.1
Real GDP at factor cost	3.6	1.7	5.1	5.4	6.8	6.5
Real oil GDP	2.3	-5.8	8.6	-8.4	-7.1	10.3
Real non-oil GDP	3.7	2.3	4.8	6.5	7.9	6.2
<b>Inflation rate</b>						
CPI inflation (average)	18.1	20.1	12.6	11.4	15.8	18.0
GDP deflator at factor cost	8.7	30.1	26.2	8.4	24.9	13.9
Unemployment rate	14.7	16.0	15.8	16.3	15.7	...
(In percent of GDP at market prices)						
<b>Investment and savings</b>						
Investment	37.1	32.9	33.8	33.6	34.9	30.6
Change in stocks	7.3	3.7	6.7	5.8	2.1	0.9
Total fixed capital investment	29.8	29.1	27.1	27.8	32.8	29.8
Public	10.2	10.6	9.1	8.3	12.9	9.5
Private	19.6	18.5	18.0	19.5	19.9	20.2
Gross national savings	35.0	39.2	46.9	38.9	37.9	30.0
Public	8.9	15.8	23.5	14.7	17.6	13.6
Private	26.1	23.4	23.4	24.2	20.3	16.4
Savings/investment balance 2/	-2.2	6.3	13.1	5.3	3.0	-0.6
(In percent of GDP at factor cost)						
<b>Budgetary operations</b>						
Revenue	19.1	23.9	33.0	27.5	28.5	25.8
Oil	6.9	10.2	22.3	15.7	17.0	14.0
Non-oil	12.3	13.7	10.7	11.8	11.5	11.7
Expenditure and net lending	25.8	24.5	24.3	25.7	30.8	27.1
Of which: current	16.3	15.7	15.3	17.1	17.0	16.5
capital	5.4	5.7	5.2	3.9	6.4	4.8
Balance	-6.7	-0.6	8.7	1.8	-2.3	-1.4
Non-oil balance	-13.5	-10.8	-13.6	-13.9	-19.3	-15.4
(Annual percentage change, unless otherwise indicated)						
<b>Monetary sector</b>						
Net foreign assets	-90.2	619.4	182.9	55.2	11.0	21.1
Net domestic assets	27.8	16.8	25.9	29.6	33.1	20.5
Of which: credit to private sector	31.1	31.0	27.3	30.5	34.9	18.0
Broad money	19.6	20.2	30.5	25.8	30.1	23.3
Velocity of broad money	2.2	2.2	2.0	2.0	2.1	2.0
(In billions of U.S. dollars, unless otherwise indicated)						
<b>External sector</b>						
Exports of goods and services	15.1	22.4	30.5	27.4	34.0	34.9
Imports of goods and services	-17.8	-16.4	-18.6	-22.1	-31.9	-37.2
Current account balance	-2.1	6.6	12.5	6.0	3.3	-0.8
External public and publicly guaranteed debt	14.1	10.8	8.0	7.2	9.2	10.5
Of which: short-term debt	4.5	4.0	3.7	2.7	2.1	2.4
Gross official reserves	3.7	5.6	12.2	16.9	21.8	23.7
In months of next year's imports of goods and services	2.8	3.7	6.7	6.4	7.1	7.1
<b>Memorandum items:</b>						
Nominal effective exchange rate 3/	137.3	100.0	109.4	120.8	113.7	...
Real effective exchange rate 3/	118.1	100.0	118.5	139.7	148.8	...
Average exchange rate (rials per U.S. dollar)	5,404.0	7,908.0	8,078.0	7,921.0	7,967.1	...

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

1/ Iranian fiscal year ends March 20.

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

3/ Using 1999/2000=100.

4/ Assuming fiscal and monetary policy adjustment.

Table 2. Islamic Republic of Iran: Balance of Payments, 2000/01–2003/04 1/

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

	2000/01	2001/02	Prel. 2002/03	Proj. 2/ 2003/04
Current account	12,500	5,985	3,282	-780
(In percent of GDP)	13.1	5.3	3.0	-0.6
Trade balance	13,375	5,775	4,538	-166
Exports	28,461	23,904	28,324	28,223
Oil and gas	24,280	19,339	22,945	22,423
Crude oil export	21,490	17,029	19,311	18,518
Exports of petroleum products and gas	2,790	2,310	3,634	3,905
Refined products	2,497	2,133	2,587	2,600
Gas exports and others	293	177	1,047	1,305
Non-Oil	4,181	4,565	5,379	5,800
Imports	-15,086	-18,129	-23,786	-28,389
Services account	-1,485	-495	-2,452	-2,105
Credits	2,012	3,488	5,698	6,690
<i>Of which: interest income</i>	215	655	543	389
Debits	-3,497	-3,983	-8,150	-8,795
<i>Of which: interest payments</i>	-370	-397	-260	-320
Transfers	610	705	1,196	1,490
Capital and financial accounts	-4,567	-470	3,584	2,663
Medium-term and long-term capital	-2,555	288	2,610	963
Bilateral project financing	-473	168	754	1,093
Repayments of rescheduled debt	-884	-327	-60	0
Other official financing and portfolio investment 3/	10	-35	1,038	266
Oil prefinancing	-1,208	482	878	-396
Short-term capital 4/	-326	-1,026	-575	300
Other capital 5/	-2,416	-1,995	-275	-500
Foreign direct investment and portfolio equity	730	2,263	1,824	1,900
<i>Of which: buybacks</i>	649	2,169	1,575	1,400
Errors and omission, including net short-term capital	-1,404	-755	-2,008	0
Overall balance	6,529	4,760	4,858	1,883
Financing	-6,529	-4,760	-4,858	-1,883
Change in NFA (increase -)	-6,529	-4,760	-4,858	-1,883
Memorandum items:				
Gross official reserves (in millions of U.S. dollars)	12,176	16,936	21,794	23,677
<i>Of which: Oil Stabilization Fund 6/</i>	5,944	7,440	7,958	...
<i>(in months of next year's imports)</i>	6.7	6.4	7.1	7.1
External debt service (as percent of exports) 7/	12.2	7.4	3.5	5.1
Oil exports (in million barrels/day)	2.345	2.206	1.952	2.200
Oil exports average price (in U.S. dollars/barrel)	25.3	21.5	27.1	23.1
Exports volume growth (annual percentage change)	9.7	-0.8	-1.4	11.8
Oil	11.0	-4.0	-8.5	13.6
Non-Oil	6.1	9.2	17.8	7.8
Imports volume growth (annual percentage change)	17.8	21.6	40.7	7.3

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

1/ Fiscal year ending March 20.

2/ Projection is based on WEO prices.

3/ Includes World Bank lending as well as Eurobond borrowing in 2002/03.

4/ Some letters of credit have maturities in excess of one year.

5/ Reflecting borrowing of the Central Bank of Iran from commercial banks and some deferred trade payments of banks.

6/ Represents the part of OSF that is kept in foreign exchange.

7/ Excluding short-term debt.

Table 3. Islamic Republic of Iran: Vulnerability Indicators, 1998/99–2002/03 1/

	1998/99	1999/2000	2000/01	2001/02	Est. 2002/03
<b>External solvency indicators</b>					
REER (period average, percent change)	-0.8	-15.5	18.4	16.9	6.9
Total external debt (in billions of U.S. dollars)	14.1	10.8	8.0	7.2	9.2
(In percent of GDP)	23.2	19.7	11.2	8.7	8.4
Short-term external debt (in billions of U.S. dollars)	4.5	4.0	3.7	2.7	2.1
(In percent of GDP)	7.4	7.3	5.2	3.2	1.9
(In percent of exports of goods and services) 2/	30.2	18.0	12.2	9.9	6.2
External debt service (in percent of exports of goods and services) 3/ 2/	33.5	23.8	12.2	7.4	3.5
<b>External liquidity indicators</b>					
Total official reserves (in billions of U.S. dollars)	3.7	5.6	12.2	16.9	21.8
In months of next year imports of goods and services 2/	2.8	3.7	6.7	6.4	7.1
In percent of short-term external debt	82.8	141.0	331.0	638.6	1,049.3
Commercial banks net foreign assets (in billions of U.S. dollars)	-1.8	-0.6	-0.3	3.0	-0.3
Foreign assets	1.4	3.0	5.3	7.2	7.5
Foreign liabilities	3.2	3.7	5.6	4.2	7.8
Oil and oil-related exports (in percent of exports of goods)	75.7	81.3	85.3	80.9	81.0
<b>Public sector solvency indicators</b>					
Public and publicly guaranteed debt (in percent of GDP)	41.3	34.8	22.7	19.6	20.0
Oil revenue (in percent of total revenue)	35.8	42.8	67.5	57.0	59.6
<b>Financial sector indicators</b>					
Risk-weighted capital adequacy of banks (in percent)	...	...	6.6	6.9	4.5
Ratio of nonperforming loans of banks (in percent) 4/	5.1	4.3	4.4	5.4	5.7
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)	31.5	22.5	14.8	26.0	38.2
Private sector credit (percent change)	29.7	40.4	31.1	34.1	34.9
Net domestic credit (in percent of GDP)	44.9	50.2	52.3	53.7	46.6
<b>Market assessment/financial market indicators</b>					
Stock market price index (percent change; end-of-period)	-7.0	43.4	35.0	26.2	35.6
Stock market capitalization (in percent of GDP)	8.1	10.1	10.9	12.4	13.2
Stock market turnover ratio (in percent)	9.1	10.4	14.7	...	...
Fitch sovereign rating	...	...	...	B+	B+

Sources: Iranian authorities; and Fund staff estimates.

1/ Iranian fiscal years ending on March 20.

2/ Excluding interest receipts and payments.

3/ Excluding short-term external debt.

4/ The classification is not consistent with international practices.

Table 4. Islamic Republic of Iran: Central Government Operations, 2001/02–2003/04 1/

(In billions of rials)

	2001/02	Est. 2002/03	Budget 2003/04	Proj. 4/ 2003/04
Revenue	180,975	249,995	288,733	274,142
Revenue from oil and gas exports	103,134	149,031	141,691	149,266
<i>Of which:</i> allocated to the budget	...	101,978	122,732	129,293
Tax and nontax revenue	77,841	100,965	147,041	124,876
Tax revenue	41,682	52,940	74,781	58,821
Nontax revenue	13,442	15,036	31,791	25,586
<i>Of which:</i> revenue from OSF (income earned)	1,240	1,593	1,831	1,929
Earmarked revenue 2/	22,717	32,988	40,469	40,469
Expenditure and net lending	168,992	270,426	329,118	288,734
Current expenditure	112,551	148,749	183,014	176,089
Wages and salaries	44,000	57,132	65,725	65,725
Interest payments	1,926	3,076	3,718	3,793
Subsidies	11,784	36,648	43,823	43,823
Goods and services	...	19,110	24,761	19,761
Grants	...	5,917	7,048	7,048
Social benefits	...	21,941	31,770	31,770
Other	...	4,925	6,169	4,169
Capital expenditure	25,488	56,305	85,206	50,644
Coverage of contingent liabilities under letters of credit	0	19,918	14,310	15,075
Earmarked expenditure	22,717	32,988	40,469	40,469
Foreign exchange losses	0	3,984	0	0
Net lending	4,370	4,499	6,119	6,457
<i>Of which:</i> lending domestically from OSF	3,961	4,685	6,312	6,650
Extrabudgetary outlays requiring special permission	3,865	3,984	0	0
Overall balance (deficit (-))	11,984	-20,431	-40,386	-14,592
Overall non-oil balance (deficit (-))	-91,150	-169,461	-182,077	-163,858
Financing	-11,984	20,431	40,386	14,592
Net domestic	-7,397	6,453	34,512	19,956
Banking system (net)	-3,207	663	21,966	12,410
<i>Of which:</i> OSF	-11,855	-4,127	21,465	13,060
Nonbanks, including privatization proceeds	-4,190	5,790	12,547	7,547
Net external	-4,587	13,978	-5,083	-5,364
Unidentified financing 3/	...	...	10,956	...
Memorandum item:				
Energy subsidies	...	...	103,886	103,886



Table 4. Islamic Republic of Iran: Central Government Operations, 2001/02–2003/04 1/ (concluded)

(In percent of GDP, unless otherwise indicated)

	2001/02	Est. 2002/03	Budget 2003/04	Proj. 4/ 2003/04
Revenue	27.5	28.5	27.1	25.8
Revenue from oil and gas exports	15.7	17.0	13.3	14.0
<i>Of which:</i> allocated to the budget	...	11.6	11.5	12.1
Tax and nontax revenue	11.8	11.5	13.8	11.7
Tax revenue	6.3	6.0	7.0	5.5
Nontax revenue	2.0	1.7	3.0	2.4
<i>Of which:</i> revenue from OSF (income earned)	0.2	0.2	0.2	0.2
Earmarked revenue 2/	3.5	3.8	3.8	3.8
Expenditure and net lending	25.7	30.8	30.9	27.1
Current expenditure	17.1	17.0	17.2	16.5
Wages and salaries	6.7	6.5	6.2	6.2
Interest payments	0.3	0.4	0.3	0.4
Subsidies	1.8	4.2	4.1	4.1
Goods and services	...	2.2	2.3	1.9
Grants	...	0.7	0.7	0.7
Social services	...	2.5	3.0	3.0
Other	...	0.6	0.6	0.4
Capital expenditure	3.9	6.4	8.0	4.8
Coverage of contingent liabilities under letters of credit	0.0	2.3	1.3	1.4
Earmarked expenditure	3.5	3.8	3.8	3.8
Foreign exchange losses	0.0	0.5	0.0	0.0
Net lending	0.7	0.5	0.6	0.6
<i>Of which:</i> lending domestically from OSF	0.6	0.5	0.6	0.6
Extrabudgetary outlays requiring special permission	0.6	0.5	0.0	0.0
Overall balance (deficit (-))	1.8	-2.3	-3.8	-1.4
Overall non-oil balance (deficit (-))	-13.9	-19.3	-17.1	-15.4
Financing	-1.8	2.3	3.8	1.4
Net domestic	-1.1	0.7	3.2	1.9
Banking system (net)	-0.5	0.1	2.1	1.2
<i>Of which:</i> OSF	-1.8	-0.5	2.0	1.2
Nonbanks, including privatization proceeds	-0.6	0.7	1.2	0.7
Net external	-0.7	1.6	-0.5	-0.5
Unidentified financing 3/	...	...	1.0	...
Memorandum items:				
Oil price, in U.S. dollars per barrel	21.5	27.1	23.1	23.1
GDP at factor cost (in billions of rials)	657,388	877,565	1,064,203	1,064,203

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

1/ Fiscal year ends March 20.

2/ Reflects mainly transactions with the social security organization.

3/ Parliament has instructed the government to cut expenditure to compensate for lack of financing.

4/ Based on fiscal and monetary policy adjustment measures.

Table 5. Islamic Republic of Iran: Monetary Survey, 2000/01–2003/04 1/

(In billions of rials; unless otherwise indicated)

	2000/01	2001/02	2001/02 2/	Prel. 2002/03	Proj. 3/ 2003/04
Net foreign assets	19,090	29,619	134,130	148,867	180,276
Net domestic assets	240,655	311,860	231,974	308,799	372,025
Net domestic credit	261,239	331,527	288,275	398,385	472,382
Net credit to government	24,637	22,717	-20,534	-5,898	3,512
Claims on the government	63,364	70,639	76,851	122,231	122,762
Deposits	38,727	47,922	97,386	128,129	119,250
Claims on NFPEs	55,731	66,267	66,267	77,210	82,943
Claims on the private sector	180,871	242,543	242,543	327,073	385,927
Other items, net, excluding CPPs	-20,584	-19,667	-56,301	-89,586	-100,357
Broad money (M3)	259,745	341,322	365,513	457,666	552,302
M2	258,274	325,022	325,023	422,887	521,242
Cash	25,158	29,189	29,189	34,780	39,397
Deposits	233,116	295,834	295,834	388,107	481,845
Demand deposits	98,425	117,833	117,833	153,236	192,348
Time deposits	134,690	178,001	178,001	234,871	289,497
CPPs held by nonbanks	0	9,444	9,444	17,052	12,052
Foreign exchange deposits 4/	1,471	6,856	31,047	17,728	19,008
Memorandum items:					
M1	123,584	147,022	147,022	188,016	231,745
M2, excluding foreign currency deposits and CPPs	258,274	325,022	325,023	422,887	521,242
Multiplier (base money, excl. sterilization/M2)	2.73	3.18	3.09	3.32	3.45
Income velocity of M2	2.2	2.0	2.0	2.1	2.0
GDP	575,895	657,388	657,388	877,565	1,064,203
End-period percentage changes:					
NFA	182.9	55.2	...	11.0	21.1
NDA	25.9	29.6	...	33.1	20.5
Base money	22.3	7.8	...	21.0	26.6
M1	34.3	19.0	...	27.9	23.3
M2, excluding foreign currency deposits and CPP	30.5	25.8	...	30.1	23.3
M3	31.2	31.4	...	25.2	20.7
Credit to the private sector and NFPEs	27.3	30.5	...	30.9	16.0
Credit to the private sector	31.1	34.1	...	34.9	18.0

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/ Fiscal and monetary policy adjustment scenario.

4/ Data on foreign currency deposits before 2000/01 are reported under foreign liabilities.

Table 6. Islamic Republic of Iran: Baseline Medium-Term Scenario Under Current Policies, 2000/01–2008/09 1/

			Est.		Proj.				
	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
<b>Oil Sector</b>									
Total oil exports (in billions of U.S. dollars)	24.3	19.3	22.9	22.4	22.9	23.2	24.3	26.0	27.9
Average oil export price (in U.S. dollars/barrel)	25.3	21.5	27.1	23.1	21.6	20.4	19.7	19.7	19.7
(Annual percentage change, unless otherwise indicated)									
<b>National accounts</b>									
Nominal GDP at factor cost (in billions of rials)	575,895	657,388	877,565	1,064,203	1,289,601	1,559,969	1,877,924	2,242,028	2,642,298
Real GDP at market prices	5.3	5.9	6.7	6.1	5.7	5.2	5.2	5.2	5.0
Real GDP at factor cost	5.1	5.4	6.8	6.5	5.5	5.5	5.5	5.0	4.7
Real oil GDP	8.6	-8.4	-7.1	10.3	2.4	3.1	3.1	3.3	0.8
Real non-oil GDP	4.8	6.5	7.9	6.2	5.7	5.6	5.6	5.1	4.9
<b>Inflation rate</b>									
CPI inflation (average)	12.6	11.4	15.8	18.0	17.0	16.0	15.0	14.0	13.0
GDP deflator at factor cost	26.2	8.4	24.9	13.9	14.8	16.2	17.6	15.4	13.9
Unemployment rate	15.8	16.3	15.7	...	...	...	...	...	...
(In percent of GDP at market prices)									
<b>Investment and savings</b>									
Investment	33.8	33.6	34.9	30.6	29.5	29.0	28.8	28.8	28.7
Change in stocks	6.7	5.8	2.1	0.9	0.0	0.0	0.0	0.0	0.0
Total fixed capital investment	27.1	27.8	32.8	29.8	29.5	29.0	28.8	28.8	28.7
Public	9.1	8.3	12.9	9.5	9.5	9.3	9.2	9.2	9.2
Private	18.0	19.5	19.9	20.2	20.0	19.7	19.6	19.6	19.5
Gross national savings	46.9	38.9	37.9	30.0	27.8	26.7	26.1	26.2	26.0
Public	23.5	14.7	17.6	13.6	12.3	13.6	13.8	13.7	13.8
Private	23.4	24.2	20.3	16.4	15.4	13.1	12.4	12.5	12.2
Savings/investment balance 2/	13.1	5.3	3.0	-0.6	-1.7	-2.3	-2.7	-2.6	-2.6
(In percent of GDP at factor cost)									
<b>Budgetary operations</b>									
Revenue	33.0	27.5	28.5	25.8	23.5	24.5	24.4	24.2	24.0
Oil	22.3	15.7	17.0	14.0	12.7	11.7	11.0	10.8	10.5
Non-oil	10.7	11.8	11.5	11.7	10.8	12.8	13.4	13.5	13.5
Expenditure and net lending	24.3	25.7	30.8	27.1	26.1	25.5	25.1	24.8	24.5
Of which: current	15.3	17.1	17.0	16.5	16.7	16.5	15.9	15.7	15.4
capital	5.2	3.9	6.4	4.8	4.8	4.8	4.8	4.8	4.8
Balance	8.7	1.8	-2.3	-1.4	-2.5	-1.0	-0.6	-0.6	-0.5
Non-oil balance	-13.6	-13.9	-19.3	-15.4	-15.3	-12.6	-11.6	-11.4	-11.0
(In billions of U.S. dollars, unless otherwise indicated)									
<b>External sector</b>									
Exports of goods and services	30.5	27.4	34.0	34.9	36.6	38.5	40.7	43.7	46.9
Imports of goods and services	-18.6	-22.1	-31.9	-37.2	-40.6	-43.8	-47.0	-50.4	-54.1
Current account balance	12.5	6.0	3.3	-0.8	-2.4	-3.6	-4.5	-4.7	-5.1
External public and publicly guaranteed debt	8.0	7.2	9.2	10.5	12.2	15.2	18.9	22.7	27.2
Of which: short-term debt	3.7	2.7	2.1	2.4	2.8	3.3	3.8	4.2	4.7
Gross official reserves	12.2	16.9	21.8	23.7	23.8	24.2	24.6	24.7	25.3
In months of next year's imports of goods and service	6.7	6.4	7.1	7.1	6.6	6.3	6.0	5.6	5.6

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

1/ Iranian fiscal year ending March 20.

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

### Islamic Republic of Iran: Fund Relations

As of April 30, 2003

<b>I. Membership Status:</b>	Joined: 12/29/1945; Article XIV	
<b>II. General Resources Account</b>		
	SDR Million	Percent of Quota
Quota	1,497.20	100.00
Fund holdings of currency	1,497.20	100.00
<b>III. SDR Department</b>		
	SDR Million	Percent of Allocation
Net cumulative allocation	244.06	100.00
Holdings	268.08	109.84
<b>IV. Outstanding Purchases and Loans:</b>	None	
<b>V. Financial Arrangements:</b>	None	
<b>VI. Projected Obligations to Fund:</b>	None	

### 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 preannounced path for the exchange rate from the conventional pegged arrangement. Under new foreign exchange regulations (a) there is no surrender requirements of the foreign exchange earned by non-oil exporters; (b) the need for and the amount of advance deposits for opening 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 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:

- Multiple currency practices resulting from (a) the new system of subsidies associated with contingent liabilities involving letters of credit opened at subsidized rates prior to March 21, 2002, and maturing thereafter; (b) the absence of a mechanism to ensure that the reference rate used by the central bank for the purchase of oil proceeds from the government does not diverge at any time by more than 2 percent from the prevailing market exchange rate; and (c) the repatriation bonus for export receipts associated with contracts entered into before March 21, 2002.
- Exchange restrictions resulting from (a) limitations imposed on the availability of foreign exchange for the making of payments for current international transactions associate with certain invisibles (including, for example, travel, education, and medical treatment); and (b) restrictions on the convertibility and transferability of Iranian rials balances held by nonresidents that represent the proceeds of current international transactions.

### **VIII. Last Article IV Consultation**

The last Article IV consultation was concluded by the Executive Board on September 18, 2002.

### **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

**MFD**

*FSAP*

- FY 2000 - FSAP mission
- FY 2001 - Follow-up multitopic 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
- FY2002 - Technical assistance mission on the issuance of central bank participation papers

*Exchange System*

- FY 1997 - Multitopic 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

**STA**

- FY 2000 - Balance of payment statistics
  - Government finance statistics
  - National accounts statistics
- FY 2002 - Monetary and financial statistics

FY 2003 - Multisector 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.

### **Islamic Republic of Iran: Relations with the World Bank Group<sup>1</sup>**

1. As of June 30, 2003, Iran received 49 World Bank loans totaling \$2,242.8 million net of cancellations and terminations, of which \$1,845 million was disbursed. Forty five of these loans were fully disbursed. The ongoing portfolio consists of four loans for a total of \$432 million, of which \$37 million were disbursed.
2. World Bank lending to Iran resumed in May 2000 with the approval by the Board of Executive Directors of two projects: the Second Primary Health Project (\$87 million) and the Tehran Sewerage Project (\$145 million). These loans were approved after a hiatus of seven years during which World Bank activities focused mainly on supervision of ongoing projects and limited economic work. While approving the two loans, the Executive Directors requested that staff prepare an interim assistance strategy note reviewing the progress in economic reform and developments, and outlining the World Bank Group's approach in Iran.
3. The World Bank Group Interim Assistance Strategy has followed a two-pronged approach: (a) policy dialogue on the reform program through nonlending services; and (b) targeted lending in the key social and environment areas consistent with the TFYDP and focusing on projects that have the quickest and most tangible impact on the population, that are least affected by policy distortions and that are resilient to Iran's risk factors.
4. The two-year interim assistance strategy note was discussed by the Board of Executive Directors in May 10, 2001, and outlines the strategy that the World Bank Group will follow while preparing a full Country Assistance Strategy (CAS) to be presented to the Board in FY 2004. The CAS will reflect a further deepening of the World Bank's knowledge of Iran's development process and priorities.
5. In support of the government's reform efforts, the World Bank has undertaken economic and sector work covering the main reform areas and provided support for capacity building in the formulation of economic and sector policies, their sequencing, and implementation. A series of economic studies have been undertaken, which have formed the basis for policy dialogue and analysis, and which will be inputs into the CAS. These include a study on the reform of the Energy Pricing System, a Trade and Foreign Exchange System Reform Study, a Public Expenditure Review, and a Country Economic Memorandum (CEM), as well as other sectoral studies. This CEM, completed in January and finalized in April 2003, analyzes the medium-term framework for the economic transition and the sequencing of reforms; and evaluates the costs of reforms and how to address them. In addition, Policy Review Notes have been prepared for urban water, housing, agriculture, and air pollution control. Work is underway on the pension system.

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<sup>1</sup> Prepared by the World Bank staff.



6. During this interim period, the Environmental Management Project (\$20 million) was approved by the Board in April 2003, and the Earthquake Emergency Response (\$180 million) was approved in June 2003. Of the total ongoing portfolio, about \$37 million has been disbursed to date. The government of Iran and the World Bank are devoting more resources to ensure that there are no bottlenecks in the implementation of the loans.

7. The IFC contributed to this reform program by approving its first leasing project in December 2002.

### **Islamic Republic of Iran: Statistical Issues**

The data transmitted to the Fund, through direct contacts with the authorities and/or through the Executive Director's office, provided a basis for sound assessment of economic developments and to form a realistic perspective on Iran's medium-term prospects. The 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 on the Internet at <http://www.cbi.ir/e/>, ahead of the release of the hard copy publication. However, the timeliness of key monthly data could be improved by the implementation of data dissemination practices that incorporate revision policies and by the utilization of electronic modes of data releases that would also enhance data accessibility.

A multisector mission of the Statistics Department (STA) of the Fund visited Iran during June 18–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.

#### **Real sector statistics**

- National accounts statistics are reasonably sound. The CBI has updated the quarterly GDP statistics for the period 1988–2001. Most of the recommendations made by the 1999 STA mission have been fully implemented, most notably concerning the change of the base year 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 SCI to compare and analyze the two sets of estimates of GDP they compile has not been implemented.
- Price statistics have generally been reported to the Fund in a timely manner. Labor market statistics, however, still need improvement, particularly with regard to employment data.

#### **Government finance statistics**

- One significant improvement in the central government statistics has been the adoption of the Government Finance Statistics (GFS) classification 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.

- No data for the consolidated general government, comprising the central government and the municipalities, are compiled.
- The existing cash-based government accounting system should be upgraded to enable recording of expenditures at the pre-payment stage.
- 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.
- It is essential that timely monthly fiscal reports are published and that they are consistent with the monetary accounts.
- 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 disseminated as a quarterly set of data with a lag of about two months although some data are made available with a shorter lag for CBI internal uses. 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 recommendation of two recent STA missions.
- On balance, the broad money stock tends to be underestimated. The coverage of broad money needs to include deposits of public nonfinancial corporations, local governments, and all foreign currency deposits of residents (other than central government).
- Foreign currency deposits of domestic subsectors at banks, mainly including those of nonfinancial corporations and households, are currently classified as foreign liabilities.

Recently, efforts have been made to collect information needed for separately identifying foreign currency deposits of resident sectors and nonresidents and to reclassify foreign currency deposits of residents under relevant domestic liabilities categories. The Fund staff has received data on foreign currency deposits of residents for 2000/01–2002/03.

- Foreign currency deposits of banks with the CBI are currently misclassified as foreign liabilities of the CBI in CBI's analytical accounts, which results in an overstatement of the CBI foreign liabilities position. These deposits should be reclassified as CBI's domestic liabilities to banks.
- The statistics on the consolidated balance sheet of commercial banks suggests that commercial banks have a short position in foreign exchange, while data submitted by the banking supervision department imply that the consolidated open position is long. Supplementary information on banks' assets and liabilities by the currency of denomination should be developed in order to reconcile the statistical data with the supervisory data.
- In the CBI's analytical accounts, CPPs are included in other unclassified liabilities. Separate data on holdings of CPPs broken down by bank holders and nonbank holders should be collected in the CBI monthly report. These separate data would allow the CBI and other data users to construct broader liquidity measures, which would include CPPs held by nonbank sectors.

#### **External sector data**

- The accounting system for foreign exchange receipts and payments of the CBI and banks is being designed according to the *Balance of Payments Manual*, fifth edition (*BPM5*) and is being put in operation. Balance of payments presentation based on *BPM5* is anticipated to be ready within the next three to four months.
- In line with the effort to 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.

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

(As of July 24, 2003)

	Exchange Rates	International Reserves	Reserve/ Base Money	Central Bank Balance Sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/GNP
Date of latest observation	23-Jul-03	Mar-03	Mar-03	Mar-03	Mar-03	May-03	May-03	Mar-03	Mar-03	Mar-03	Mar-03
Date received	23-Jul-03	Jun-03	Jun-03	Jun-03	Jun-03	Jun-03	Jul-03	Jun-03	Jun-03	Jun-03	Jun-03
Frequency of data	D	M	M	M	M	M	M	M	M	A	M
Frequency of reporting	D	M	M	M	M	M	M	M	M	A	M
Source of data	CBI	CBI	CBI	CBI	CBI	CBI	CBI	CBI	CBI	CBI	CBI
Mode of reporting	CBI Website	Article IV Mission	Article IV Mission	Article IV Mission	Article IV Mission	Article IV Mission	CBI Website	Article IV Mission	Article IV Mission	Article IV Mission	Article IV Mission
Confidentiality	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted
Frequency of publication	D	Q	Q	Q	Q	Q	M	Q	Q	A	Q



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700 19<sup>th</sup> Street, NW  
Washington, D. C. 20431 USA

## **IMF Concludes 2003 Article IV Consultation with the Islamic Republic of Iran**

On August 25, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Islamic Republic of Iran.<sup>1</sup>

### **Background**

During the first three years of the Third Five-Year Development Plan (TFYDP—2000/01–2002/03), real GDP grew by 5.8 percent on average, despite declines in oil output during the past two years. The overall macroeconomic situation improved significantly compared to the previous five-year development plan: the external current account was in surplus, the external debt was reduced to a very low level, international reserves increased significantly, and fiscal savings were accumulated in the Oil Stabilization Fund (OSF). This performance has taken place against the background of increased openness of the economy to international trade and investment, and increased economic reforms, but also benefited from sustained high oil prices and fiscal stimulus.

Notwithstanding these achievements, the Iranian economy continues to face important challenges: employment creation has not been sufficient to meet the rapid increase in the labor force; inflation is high and rising again; price subsidies and controls continue to hinder economic efficiency; and structural impediments for private sector development remain.

Growth was high and broad-based in 2002/03 (fiscal year ending March 20). Real GDP is estimated to have grown at 6.8 percent, with non-oil GDP expanding by 7.9 percent, reflecting

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<sup>1</sup> 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.

a positive impact of economic reforms and favorable exogenous shocks, including good weather conditions and a higher oil price. Unemployment declined somewhat, but remained high at 15.7 percent.

Domestic demand continued to grow at rapid rates in 2002/03, despite corrective fiscal and monetary policy measures. As a result, Consumer Price Index (CPI) inflation accelerated to 15.8 percent from 11.4 percent in 2001/02, and the current account surplus narrowed to 3 percent of GDP despite higher oil prices. Moreover, equity and real estate prices continued to increase rapidly not only in response to economic liberalization measures, but also because of the high growth of money and credit, and a relatively stable exchange rate. Nonetheless, gross official reserves increased to the equivalent of seven months of next year's projected imports, and fiscal savings in the OSF increased by about \$500 million.

The overall fiscal balance is estimated to have shifted to a deficit of about 2.3 percent of GDP in 2002/03, compared to a surplus of 1.8 percent of GDP in 2001/02. This deterioration mainly reflects the budgetary cost of the exchange rate unification and rapid growth of capital expenditures. In the meantime, the non-oil deficit is estimated to have widened sharply by 5.4 percentage points to 19.3 percent of GDP, notwithstanding expenditure cuts (amounting to 1.6 percent of GDP).

Monetary policy was accommodating in 2002/03. Although the central bank issued additional central bank participation papers to reduce excess liquidity, it could not independently adjust the rates of return, which in fact were reduced for retail lending. The central bank accommodated the higher credit demand by increasing significantly its claims on banks and nonfinancial public enterprises. This, together with unsterilized purchases of foreign exchange from the government and higher money multiplier, led to the acceleration of M2 growth to 30 percent while credit to the private sector grew by 35 percent. Banking system prudential indicators deteriorated somewhat and state-owned banks remained under capitalized and nonprofitable in part due to controls on rates of return and high operating costs.

The 12-month real effective exchange rate index depreciated by about 4 percent by end-April 2003. Under the managed floating exchange rate regime, 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 against an undisclosed basket of currencies.

Progress in structural reforms was uneven across the reform areas. While trade and financial sector reforms advanced and foreign direct investment regulations were liberalized, there was less progress in improving the business environment, reducing labor market rigidities, reforming subsidies, and restructuring and privatizing public enterprises.

Real GDP is projected to grow at 6.5 percent in 2003/04, but the risk of inflation acceleration remains. The fiscal policy stance based on the current budget could exacerbate demand pressures, and lead to high liquidity growth and inflation acceleration. To address these risks, the authorities have approved a range of monetary policy measures and are considering revenue and expenditure measures to reduce the fiscal deficit with the ultimate objective of limiting inflation to 18 percent at most.

## **Executive Board Assessment**

Directors noted that the Iranian economy has performed well over the last three years, as evidenced by the rapid growth of the non-oil sector, a decline in unemployment, a reduction in external debt, the accumulation of gross official reserves and an improvement in key social indicators. These achievements are in large part attributable to structural reforms implemented over the last three years, including the opening up of the economy to international trade and foreign direct investment, exchange rate unification, and further progress in enhancing fiscal management and reforming the financial system.

Nevertheless, Directors expressed concern about the procyclical stance of monetary and fiscal policies and the slow pace of implementation of some structural reforms. Expansionary policies in the current environment of strong private demand—in particular, the use of the Oil Stabilization Fund (OSF) in a period of high oil prices—have contributed to a build-up of inflationary pressures and a narrowing of the external current account surplus. Directors emphasized that the key medium-term challenge will be to achieve sustained high economic growth and a reduction in the still-high level of unemployment while maintaining low inflation and macroeconomic stability. Timely implementation of structural reforms and prudent macroeconomic policies will be crucial to achieve these objectives. In this context, Directors commended Iran's firm commitment to promoting economic reforms under its current Five-Year Development Plan, and urged the authorities to speed up the pace of implementation.

Directors welcomed the authorities' intention to introduce corrective fiscal and monetary policy measures during the current fiscal year. They stressed the need to reduce the fiscal deficit and contain liquidity growth in order to ease demand pressures. They supported consolidating all spending into the budget and a gradual reduction in overall expenditure, particularly subsidies. There was also a need for a strong effort at revenue mobilization over the medium term to ensure that fiscal sustainability is maintained in the face of a possible decline in oil prices. While acknowledging that critical capital and social spending should be protected, Directors emphasized the need to improve prioritization of public investment on the basis of efficiency and productivity considerations. They called for more stringent rules on the use of the Oil Stabilization Fund within the context of a medium-term fiscal framework to ensure its proper use as a counter-cyclical tool.

Directors noted the authorities' concerns over the impact of expenditure cuts on employment. They suggested that the authorities take advantage of the current environment of strong economic growth to accelerate structural reforms with a view to stimulating private investment. They believed that continued positive response of the private sector to economic reforms would lessen the need to stimulate growth and employment generation through government spending policies, which in any case could not be sustained. They encouraged development of an adequate social safety net, with better targeted assistance to poor households, to help cushion the adverse short-term impact of reforms and preserve social stability and political consensus for reform.

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 implement these measures forcefully, and to take further steps to increase the effectiveness of monetary policy and the independence of the central bank. Thus, they stressed the need to further develop indirect instruments of monetary policy, curtail the use of direct controls, introduce more flexibility in using rates of return, and limit the recourse by banks to the central bank's overdraft facilities. Directors noted that rapid credit growth has led to a rise in credit risk and deterioration in prudential indicators in the banking system. They took note of the authorities' view that potential financial sector vulnerabilities are low. Nevertheless, they stressed the need to closely monitor vulnerabilities associated with rapid credit growth, a possible downward adjustment in asset prices, and increased activity in the off-shore foreign exchange market. Directors welcomed the authorities' request for technical assistance in the area of prudential regulations.

Directors urged the authorities to continue to deepen and accelerate financial sector reform. They welcomed the recent steps taken, including the licensing of four private banks and the authorization of private insurance companies and the progress in implementing a risk-based regulatory and supervisory framework for the banking system. Directors called on the authorities to press ahead with the reform of banking supervision and capital market oversight and the modernization of the payments system. Directors stressed the need for restructuring and other supporting measures to enhance the efficiency and profitability of the public banks, together with plans for recapitalizing these banks. In this respect, the recent easing of controls on rates of return and on sectoral credit allocation is a step in the right direction, and further liberalization in this area is needed. Directors were encouraged by the authorities' adoption of regulations on anti-money laundering and combating terrorism financing, and urged the authorities to complete the legislative process in this area.

Directors noted that following the smooth transition to a unified exchange rate system, the authorities can move to a more flexible exchange rate management to enhance credibility and facilitate the achievement of monetary policy objectives. Directors were of the view that sustained real appreciation of the exchange rate over the medium term would need to be countered with productivity-enhancing structural reforms and prudent demand management policies to maintain competitiveness. Directors also welcomed the authorities' interest in accepting the obligations under Article VIII, Sections 2(a) and 3 of the Fund's Articles of Agreement, and their intention to establish a timetable for removing remaining exchange restrictions.

Directors were encouraged by the private sector's positive response to economic reforms, and stressed that further progress in structural reforms is key to a sustainable growth and employment creation in the medium term. In this regard, while commending the recent progress in liberalizing trade and encouraging foreign direct investment, they urged the authorities to place greater emphasis on reducing state intervention in economic activity and on improving economic efficiency. They stressed the importance of further efforts to liberalize trade, reduce administrative controls, reform labor markets, foster competition, and restructure and privatize public enterprises. They also encouraged acceleration of key medium-term fiscal reforms, including the introduction of a value-added tax—with Fund technical assistance—and the phasing out of subsidies.

Directors welcomed Iran's continued progress in enhancing transparency and improving the statistical data base. They commended the authorities for identifying the cost of energy subsidies in the budget, and expanding the coverage of fiscal accounts. Directors also encouraged the authorities to implement other recommendations of the Fund's Fiscal Report on the Observance of Standards and Codes, including consolidating extra-budgetary operations in the central government accounts and publishing international reserve data on a regular basis. These and other improvements would go a long way toward facilitating Iran's subscription to the Special Data Dissemination Standard.

Iran is a bilateral creditor for two heavily indebted poor countries. Directors expressed a hope that Iran will provide its share of debt relief to these countries under the Heavily Indebted Poor Countries Initiative.

**Public Information Notices (PINs)** are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2003 Article IV Consultation with the Islamic Republic of Iran is also available.

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

	<b>1999/2000</b>	<b>2000/2001</b>	<b>2001/2002</b>	<b>2002/2003</b>
Real GDP growth (factor cost, percentage change)	1.7	5.1	5.4	6.8
CPI inflation (period average, percentage change)	20.1	12.6	11.4	15.8
Unemployment rate (percent)	16.0	15.8	16.3	15.7
Central government balance (percent of GDP)	-0.6	8.7	1.8	-2.3
Broad money growth (percentage change)	20.2	30.5	25.8	30.1
Current account balance (percent of GDP)	6.3	13.1	5.3	3.0
Overall external balance (percent of GDP)	2.0	6.8	4.2	4.4
Gross international reserves (billions of U. S. dollars)	5.6	12.2	16.9	21.8
Public and publicly guaranteed external debt (billions of U.S. dollars)	10.8	8.0	7.2	9.2
Exchange rate (period average, rials per U.S. dollar)	7,908	8,078	7,921	7,967

Sources: Iranian authorities, and IMF staff estimates.

**Statement by Abbas Mirakhor, Executive Director for Islamic Republic of Iran  
August 25, 2003**

1. My authorities thank staff for their efforts in preparing this year's Article IV consultation report and concur with the thrust of their appraisal. They greatly appreciate the constructive dialogue with staff and value highly the technical assistance received from the Fund and the World Bank, which has helped in implementation of their fully-owned adjustment and reform program. They also thank management and the Executive Board for their support and advice.

**Developments in 2002/03**

2. With strong performance in agricultural and industrial sectors resulting from on-going economic reforms, growth picked up momentum in 2002/03 to reach 6.8 percent despite contraction of production in the oil sector. On the demand side, the increase in aggregate and per capita consumption as well as public and private investment provided impetus to growth. Indications are that, unlike in the past, the employment content of growth has been high as preliminary data suggest that more than 700,000 new jobs were created, despite the fact that government employment was reduced by 5 percent. With job creation exceeding the average annual flow of new entrants into the market, unemployment declined. While recent employment incentives have been helpful, the high non-oil GDP growth has played the key role in this process.

3. Increased fiscal transparency, which allowed implicit subsidies to be incorporated in the budget, the impact of exchange rate unification, and an increase in capital expenditures, led to a fiscal deficit of about 2 percent of GDP despite the authorities' efforts in the fall of 2002 to curtail spending. As the staff report rightly points out, the non-oil deficit widened by a substantial margin.

4. Monetary policy remained accommodative notwithstanding the central bank's efforts to control liquidity. The pressure came about from both net domestic and net foreign assets when lending to banks, especially through overdrafts, and purchases of foreign exchange from the government were only partially sterilized. Full operation of the two main instruments of liquidity control—namely the Central Bank's Participation Papers (CPPs) and Open Deposit Account (ODA)—was impaired as the ceiling on issuance of CPPs was too low and the rate of return on ODA was not attractive enough. The relatively low rate of return on ODA created an incentive for banks to withdraw their own deposits with the central bank prematurely and/or to take advantage of the overdraft facility. These problems are being addressed as the ceiling on CPPs issuance has been increased and the central bank is modifying its policy on ODA. The fixed rate on the ODA is to be replaced with a bid/offer auction system, according to which banks will decide at what rates they would place deposits with the central bank. This is an important step not only in strengthening liquidity management, but also in introducing further flexibility into the rate of return structure as the banks will use the auction rate as a benchmark.

5. Bringing the economy back on the disinflation path is the highest priority of the monetary authorities. The large expansion in money supply in 2002/03 beyond the central bank's target imparted further impulse to inflation already picking up steam as a result of the pass-through of exchange rate unification as well as adjustments in some administered prices. The central bank believes that some of the uptick in inflation is temporary, and that the strengthening of instruments of liquidity control will allow it to mop up excess liquidity so that inflation could regain its downward trend assisted by the positive supply response of the economy and prudent demand management policies.

6. The exchange rate has been relatively stable vis-à-vis the US dollar since the unification (March 21, 2002), and the parallel market premium has remained very low. The managed floating regime has served the economy well, as reflected in the strengthening of market confidence. The central bank remains committed to the managed floating regime and has limited its intervention to smoothing rate fluctuations. The staff report correctly points out that competitiveness remains satisfactory, as evidenced by the healthy growth of non-oil exports, despite the appreciation trend since 2000 in the real effective exchange rate. The appreciation trend is partly justified, given that the reforms have led to a pick-up in productivity growth. The authorities, however, are aware that the inflation differential with trading partners needs to narrow substantially to allow further growth of non-oil exports. They are committed to continued structural reforms as a key to improving competitiveness.

7. The external sector continued its strong performance in 2002/03. While both oil (in value terms) and non-oil exports increased significantly, the current account registered a smaller surplus due to a substantial surge in imports, reflecting trade liberalization and strong domestic demand—with capital and intermediate goods imports constituting more than 80 percent of the total. The capital account registered a sizable surplus as large foreign direct investment—mainly in the oil sector—continued, and capital flows into the Tehran Stock Exchange (TSE) increased. Net external borrowing turned positive as the country returned to the international capital markets with the issue of two five-year Euro bonds, both of which were well received by the markets. The first issue—launched in July 2002 for €500 million and, subsequently, increased to €625 million—carried a coupon of 8.75 percent. The second issue—launched in December 2002 for €375 million—carried a coupon of 7.75 percent with yields at 401 basis points above similarly dated European swaps. The primary objective of these issues was to set a benchmark for the Iranian corporates rather than for balance of payments or budget support. Last year also marked the end of repayment of rescheduled debt, which left Iran with a low external debt relative to GDP (8 percent).

8. The Tehran Stock Exchange (TSE) continued its strong performance in 2002/03 as the All-shares Price Index increased sharply as did market capitalization. Steps are being taken to strengthen the supervisory and regulatory framework, and a separate regulatory unit has been established in the TSE. These steps, along with the passage of a comprehensive security law, now under consideration by the parliament, and legislation that is to govern foreign direct investment in the TSE should strengthen the operation of the market.

9. Implementation of structural reforms continued in 2002/03 with strong momentum in the financial sector (Box 2 of the staff report) and trade liberalization (listed in the staff

report, paragraph 13). In the financial sector, four private banks were established, thereby strengthening financial market operations and increasing competition, and formation of private insurance companies was authorized. Also, state-owned banks were recapitalized in line with the FSAP recommendations in 2001/02 and there are plans for reinvesting post-unification gains into these banks' capital in 2003/04; supervisory functions were unified under a single department at the central bank with Fund technical assistance; and the central bank increased its capacity to handle and process financial reporting and set up unified accounting procedures for banks. Moreover, foreign branches of Iranian banks were allowed to operate in the offshore foreign exchange market for current and some capital account transactions. The Foreign Direct Investment Law was passed in 2002, and the government approved the relevant Bylaws. The Law, inter alia, allows FDI in all sectors open to domestic investors; confirms the right of foreign investors to hold more than 49 percent of a local enterprise; prohibits exposure of foreign investment to nationalization and expropriation; permits repatriation of profits in foreign currency at the market exchange rate; and establishes a maximum of 45 days for processing investment applications. Besides the unification of exchange rates—which had direct impact on the reform of subsidies—retail prices of gasoline, flour, sugar, and rice were increased. Steady progress was made in the preparation of a plan to phase-out energy subsidies, with technical assistance from the World Bank, that also includes a better-targeted safety net for the most vulnerable groups to be implemented concurrently. Progress was also made in liberalizing the labor code for small enterprises, and it is hoped that this improvement would serve as a model for future reform of the Labor Law governing larger enterprises. The authorities believe that structural reforms are proceeding as articulated in the Third Five-Year Development Plan, although they agree that the pace of implementation should be accelerated.

#### **Policies in 2003/04**

10. The strong growth is expected to be sustained in 2003/04 as the increase in investment and imports of capital and intermediate goods assists the continuation of the positive supply response. While the authorities believe that sustaining high growth is necessary to employment generation, they share staff's concern regarding the resurgence of inflationary pressures. Accordingly, they intend to improve the fiscal-monetary policy mix by reigning in expenditures and tightening monetary policy. A high-level committee—headed by the President—is preparing a list of measures to reduce expenditures. This committee, formed under the provision of the zero-fiscal deficit law, has been effective in responding promptly to the need for expenditure cuts to bring government outlays in line with realized revenues. On the monetary policy side, an easing of controls on the of rate of return structure, the offer/bid liquidity auction mechanism for the ODA, and raising the ceiling on the amounts of CPPs issuance should allow the central bank to absorb excess liquidity and reduce inflationary pressures.

11. As the vulnerability assessment of the staff report makes clear, the external position is strong and there are no immediate risks to its viability. The authorities also believe that the internal financial stability is not at risk. While credit has grown rapidly, it does not pose undue threat to the stability of the banking system. Part of the credit expansion accommodated the surge in economic growth. More importantly, banks are not overly

exposed to either the real estate sector—particularly in view of high collaterals legally enforced—or the stock market. Moreover, the shift to risk-based supervision, in line with the recommendations of the FSAP mission, strengthened regulation of banking and credit institutions, and the passage of anti-money laundering and combating of financing of terrorism (AML/CFT) regulations have given the central bank considerable power for effective supervision.

12. Iran has strongly supported international efforts in anti-money laundering and combating the financing of terrorism (AML/CFT) and has made considerable efforts within the framework of UN resolutions to fully implement the adopted measures. An executive bylaw has been approved by the Monetary and Credit Committee (MCC), requiring financial institutions to set up administrative measures regarding AML/CFT, which are now effective in the banking system. In addition, regulations for banking and credit institutions on AML/CFT were passed in February 2003.

13. Following the 2002 multi-sector mission of the Statistics Department (STA), significant progress has been made in improving the statistical database, including dissemination of data to the public. The authorities are working toward further improving data production and subscribing to the SDDS as soon as possible.

### **Medium-Term Policy Challenges**

14. Based on recent developments and the prospects in 2003/04, the medium-term economic outlook is favorable. The pick-up in growth has demonstrated a considerable pay-off to economic reform. The single most important challenge facing Iran is the need for rapid and substantial reduction in unemployment. While other economies in the region face a similar challenge, the unique feature of this problem in the Iranian context is the annual flow of over half a million highly-educated young people into the labor force. Despite the improvement in 2002/03, to begin to reduce the stock of unemployment meaningfully the economy has to grow at a faster pace. Improving the efficiency of investment and accelerating productivity gains are essential to higher growth. The authorities are aware that effective implementation of economic adjustment and reforms—to right-size the government; allow full operation of an undistorted price mechanism; improve the environment for private sector development and create a level playing for all economic agents; fully liberalize the financial system; and create a flexible labor market—is necessary. They are committed to this objective. It is generally assumed that the vociferous domestic debates regarding political and social reforms reflect doubts on the commitment to economic reforms. However, it is worth reiterating that there is a remarkable degree of consensus at all levels of the society and within the body politic on the economic reform agenda. The debate has always been about the pace and sequencing, and not about the economic reform agenda itself as evidenced by successive five-year development plans. Past setbacks to the pace of reform have almost always been dictated by policy responses to external shocks, including, inter alia, a long and devastating war, comprehensive trade and financial sanctions, and an externally-generated serious debt crisis. The authorities' policy responses were squarely aimed at preserving social stability and safeguarding the achievements made on the social agenda, which has been the government's primary objective since the 1980s. In this regard, a

recent excellent World Bank study (Iran: Medium-Term Framework for Transition; Report No. 25848) suggests that, despite the shocks that had created severe external and internal financial difficulties, the country has achieved significant progress in poverty reduction—from 47 percent in 1978 to 19 percent in 2000 (the World Bank study, page 8)—as well as in health and education. Additionally, the study provides the following data on selected social indicators:

<b>Indicator</b>	<b>1980</b>	<b>2000</b>
Female illiteracy rate (% of age 15-24)	60.7	30.1
Male illiteracy rate (% of age 15-24)	38.3	16.5
Infant mortality (per 1,000)	86.8	25.5
Rural population with access to improved water source (%)	33.0	89.0
Urban population with access to improved water source (%)	70.0	99.0

The authorities' task has been to pace and sequence the reform process to preserve and advance these and other gains, thereby striking the right balance between the need for high growth and stability on the one hand, and their oft-stated goal of achieving social justice on the other. While they do not see a conflict between economic reform and their social objective, it is now amply clear that unless the urgent needs to address the unemployment problem and reduce inflation are met, both social stability and the gains made on the social agenda could be at risk. They are also aware of the need to ensure greater coordination between monetary and fiscal policies to bring inflation down to single digits. Furthermore, they acknowledge the necessity of retrenching government expenditures to levels more in line with non-oil revenues to reduce the economy's vulnerability to oil price shocks. Accordingly, they continue to reaffirm their commitment to implementation of their economic reform agenda. My authorities have always appreciated the views of Executive Directors and look forward to this year's Board discussion of the Article IV consultation report.