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Islamic Republic of Iran: 2005 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 2005 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 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on December 10, 2005, with the officials of the Islamic Republic of Iran on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on February 15, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of March 10, 2006 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its March 10, 2006 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 listed below has been or will be separately released.

Statistical Appendix

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

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

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INTERNATIONAL MONETARY FUND

ISLAMIC REPUBLIC OF IRAN

Staff Report for the 2005 Article IV Consultation

Prepared by the Staff Representatives for the 2005 Article IV Consultation with the Islamic Republic of Iran

Approved by Juan Carlos Di Tata and Scott Brown

February 15, 2006

- The 2005 Article IV consultation discussions were held in Tehran during May 21–June 6 and December 3–10, 2005. The staff team comprised Messrs. Jbili (head) and Bailén (both MCD), and Hobdari (PDR). Ms. Elborgh-Woytek and Mr. Schimmelpfennig (MCD) participated in the first mission; Mr. Bonato joined the second mission (MCD).

- The missions met with Central Bank Governor Sheibani; Minister of Economic Affairs and Finance Danesh Jafari; and representatives of the Management and Planning Organization, the National Iranian Oil Company, the Chamber of Commerce, the Tehran Stock Exchange, commercial banks, think tanks, and the private sector.

- The Islamic Republic of Iran maintains one exchange restriction and two multiple currency practices that are subject to approval under Article VIII, Sections 2(a) and 3, but plans to eliminate them or request Fund approval for their continuation during a transitory period.

- The authorities operate a managed float exchange regime. While not committing to, or publicly announcing, any specific exchange rate level or path, the central bank intervenes in the foreign exchange market to smooth out fluctuations in the exchange rate vis-à-vis a basket of currencies. The composition of the basket is not released publicly.

- The authorities are following up on STA technical assistance recommendations to prepare for subscription to the Special Data Dissemination Standards.

- The main authors of this report are Leo Bonato and Abdelali Jbili.

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List of Acronyms

AML/CFT	Anti-money laundering and combating the financing of terrorism
CBPP	Central Bank Participation Papers
FFYDP	Fourth Five-Year Development Plan
FDI	Foreign Direct Investment
MCC	Money and Credit Council
NIOC	National Iranian Oil Company
OSF	Oil Stabilization Fund
ROSC	Report on the Observance of Standards and Codes
SDDS	Special Data Dissemination Standards
TFYDP	Third Five-Year Development Plan

Executive Summary

Background and Outlook: The new government formed after the June 2005 presidential elections has committed to the reform agenda outlined in the Fourth Five-Year Development Plan (FFYDP) and the Twenty-Year Vision. After a temporary slowdown in 2004/05, **growth** has resumed on the back of high oil prices and an expansionary policy stance, and is expected to accelerate to about 6 percent in 2005/06 (the fiscal year starts on March 21). With the government spending a large part of the oil price windfall and an accommodative monetary policy, **inflation** remains relatively high at 13 percent. The **external position** has strengthened significantly, with the current account surplus expected to reach 6½ percent of GDP in 2005/06. While short-term prospects remain favorable, the economic outlook is dominated by uncertainties related to the volatility of oil prices, international tensions over the nuclear issue, and developments in Iran's relations with its major trading partners.

Policy Discussions: The key issues addressed were:

a. **The appropriate fiscal policy stance**. Based on current projections of oil revenues, medium-term sustainability is not a concern. Fiscal restraint is required to help monetary policy reduce high persistent inflation, and to build fiscal savings to cushion against an unexpected downturn in oil prices. However, the authorities maintain their view that job creation in the non-oil sector is the top policy priority and that this requires a supportive policy stance. In the staff's view, fiscal tightening could be achieved through cuts of the extensive energy subsidies, which are inefficient and environmentally unsound.

b. **Monetary and exchange rate policies should aim at reducing inflation**. The FFYDP identifies single-digit inflation as a medium-term objective, which the authorities seek to achieve. Staff argued, however, that monetary policy had largely accommodated the increase in government spending out of oil revenue. It also indicated that effective monetary instruments and a clear mandate to control inflation were needed, and that exchange rate policy had to be subordinated to this primary objective. The authorities noted that they had already allowed greater exchange rate flexibility, having experienced some nominal appreciation in the course of 2005/06, but were concerned about the rapid growth of imports and the need to build a reserve buffer against oil price fluctuations.

c. **The structural reform agenda**. As the effects of the reforms undertaken at the beginning of the Third Five-Year Development Plan (TFYDP) may start to taper off, new impetus is needed to consolidate and strengthen the foundations for further growth. The authorities reiterated their commitment to pursue a wide range of reforms under the FFYDP, but plans are still being elaborated by the new government.

I. INTRODUCTION

1. **The Iranian economy has continued to benefit from high oil prices and the reforms introduced in the last few years.** In the period 2000/01–2002/03, several important reforms were implemented, including exchange rate unification, reduction of exchange restrictions and import tariffs, new legislation on foreign direct investment (FDI), tax reform, and licensing of private banks and insurance companies. By increasing the openness of the economy and removing major obstacles to trade and investment, these reforms improved long-term growth prospects, with some of the benefits already showing. During the Third Five-Year Development Plan (TFYDP, 2000/01–2004/05), real GDP growth reached 5½ percent on average, contributing to a significant reduction of unemployment. The growth momentum was also supported by high oil prices and increased government spending out of abundant oil revenue, together with an accommodating monetary policy.

2. **Notwithstanding these positive developments**, **difficult challenges lie ahead**. Unemployment remains high and, due to the age structure of the population, the labor market is likely to be under increasing pressure in the coming years from large inflows of new entrants. Expansionary fiscal and monetary policies, partially aimed at alleviating unemployment, have maintained inflation relatively high at around 13 percent. With non-oil exports accounting only for 15 percent of the total, the economy remains dependent on oil. In this context, economic policies continue to face the dilemma of reconciling the need of high growth and employment creation with macroeconomic stability, while enhancing the competitiveness of the non-oil sector. Distortions induced by extensive administrative controls on prices and rates of returns (interest rates), consumer and energy subsidies, and rigid employment regulations remain widespread, with large efficiency costs.

3. **Iran's political landscape has undergone important changes over the last two years.** In February 2004, conservatives won a majority of seats in the parliament, and the presidential elections held in June 2005 led to a large victory of Mr. Ahmadinejad over former president Hashemi Rafsanjani. The parliament has strengthened its oversight role as demonstrated during the confirmation process of new cabinet members, as well as in taking a more assertive role in economic and financial matters. On the international front, there has been an escalation of tensions over Iran's nuclear program.

4. **The new government has committed to the reform agenda outlined in the current Fourth Five-Year Development Plan (2005/06–2009/10) and the Twenty-Year Vision**. The authorities indicated that their economic policy and reform strategy would aim at achieving the objectives of the FFYDP, including through privatization, financial sector reform, an overhaul of the subsidy system, and development of technology and knowledge-based activities. Within this framework, the new government also vowed to concentrate its efforts on improving social justice, eliminating corruption, and reducing regional economic disparities.

Box 1. Effectiveness of IMF Surveillance

The main themes of recent IMF surveillance have focused on the macroeconomic imbalances induced by an expansionary policy stance and the structural impediments to growth and employment creation.

Staff advice has focused on the need to contain the growth of current expenditure while expanding the non-oil revenue base; enhancing fiscal transparency; reducing the pro-cyclicality of fiscal policy; and improving its coordination with monetary policy. In principle, the authorities agree with these recommendations, and have made significant progress in reforming tax administration, improving transparency, and creating the Oil Stabilization Fund as a buffer against oil price volatility. However, reducing subsidies and other current expenditure has proved more difficult. Given the sharp rise in oil revenue and the high unemployment rate, the authorities continue to face intense political pressure to increase spending.

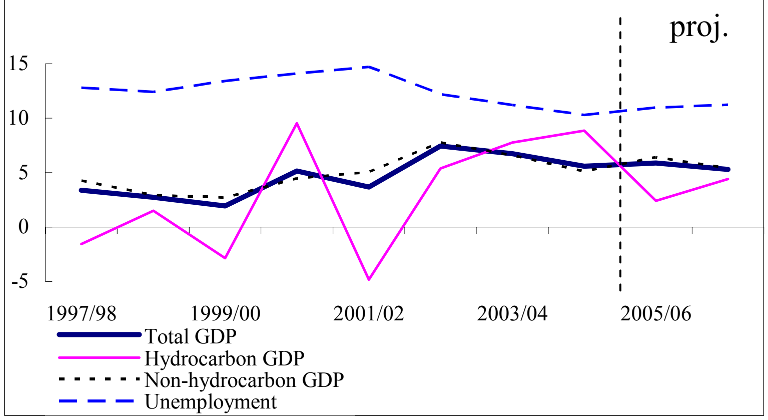
Staff has stressed the need to reduce inflation via more effective policy instruments, greater central bank independence, and increased exchange rate flexibility. The role of administrative controls in monetary policy has been reduced somewhat and central bank independence has been recognized as an objective in the FFYDP. The unification of the exchange rate in 2002 has been successful, paving the way for Iran's acceptance of the obligations under Article VIII. However, little progress has been made in reducing inflation and the effectiveness of monetary policy instruments remains weak. The authorities are reluctant to allow for greater exchange rate flexibility because of its possible implications for market stability and the competitiveness of the non-oil sector.

Staff recommended a number of measures aimed at fostering the role of the private sector and improving the functioning of markets. The authorities have made progress in streamlining regulations on foreign trade and investment, with the elimination of all non-tariff barriers, continued tariff reduction, and a new FDI law approved in 2002. Important changes have also been introduced in financial markets, with the implementation of a large number of the 2000 FSAP recommendations. Following staff advice, the quality of statistics has improved in important areas. Progress has been slow, however, on privatization, subsidy reform, and labor market reform.

II. Recent Economic Developments

5. **After a temporary slowdown in 2004/05, growth resumed on the back of favorable external conditions and an expansionary policy stance**. With agriculture output affected by adverse weather conditions and weaker construction activity, real GDP growth decelerated to 4.8 percent in 2004/05 (Figure 1). Preliminary information for the first half of 2005/06 point to robust economic activity in the non-hydrocarbon sector, while growth in the oil and gas industries was constrained by capacity. Supported by external demand and continued strength in consumption and investment, real GDP growth is expected to accelerate to about 6 percent for 2005/06 as a whole.

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

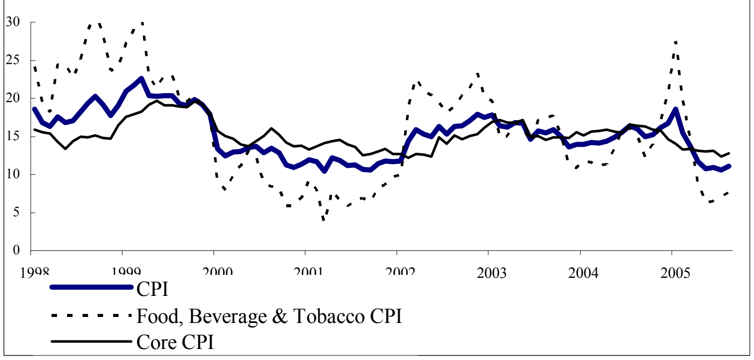


6. **The unemployment rate has continued to hover above 10 percent**. Reflecting improvements in economic activity, employment grew strongly in 2004/05 and unemployment fell to an eight-year low of 10¼ percent. In 2005/06, despite the acceleration of growth, job creation has not been sufficient to match the new entrants in the labor force—averaging about 700 thousands or 3.3 percent of the labor force, every year—and unemployment is projected to edge up to 11 percent.

7. **Inflation remains high, despite its recent decline**. Owing to high government spending and rapid money growth, average CPI inflation failed to decline significantly in 2004/05, hovering above 15 percent (Figure 2). Reflecting the impact of improved weather conditions on food prices, the price freeze on certain goods and services—including on highly-subsidized petroleum products—and some exchange rate appreciation, average inflation is expected to decline to 13 percent in 2005/06. Under the current policy stance, however, this slowdown is likely to be temporary, and inflation may pick up again once the adjustment of food prices is completed and the price freeze lifted.[1]

[1] The impact of these transitory factors, although difficult to estimate precisely, is likely to be substantial. While the weight of explicitly regulated prices in the CPI is relatively small, pricing by the extensive network of state-owned enterprises typically reflects social policy considerations.

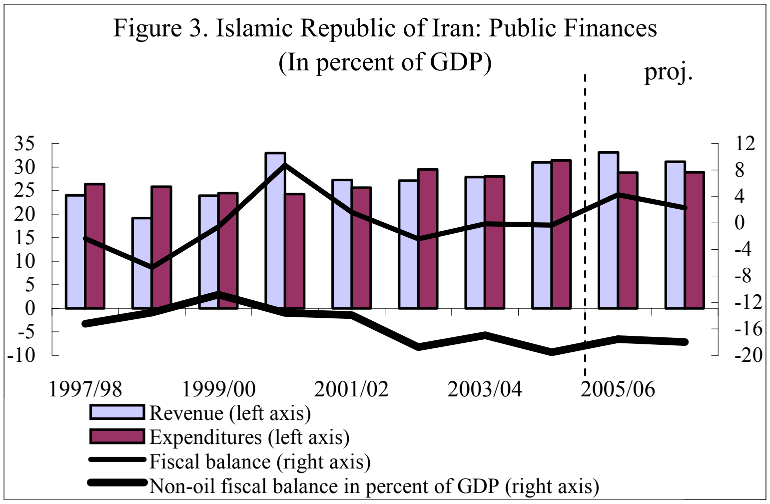
Figure 2. Islamic Republic of Iran: Inflation Rate
(E.o.p.; percent change)



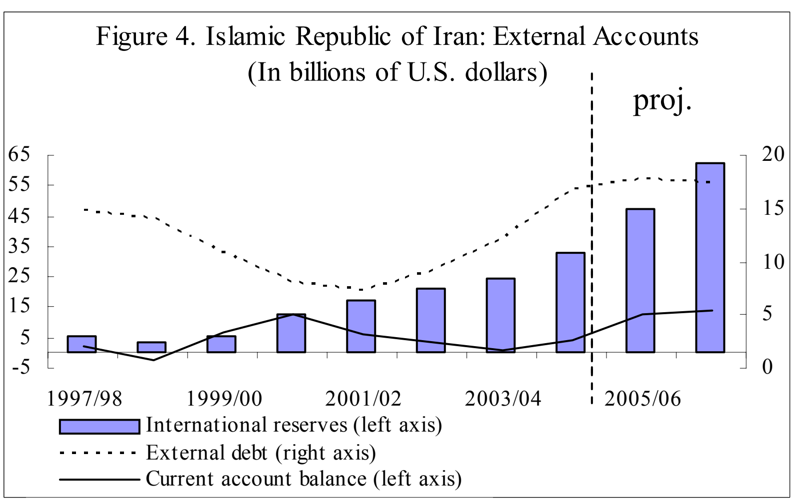
8. **A large part of the oil price windfall has been spent by the government**. Higher oil prices raised government revenues by 2¼ percentage points of GDP in 2004/05, and a further increase of about 2¾ percent of GDP is estimated by staff in 2005/06. Additional spending on current outlays and subsidies, however, more than offset the oil revenue increase in 2004/05. With the overall fiscal position deteriorating slightly, the non-oil fiscal deficit of the central government reached a nine-year high of 19½ percent of GDP (Figure 3 and Table 2). Large increases in current spending, particularly in subsidies, continued in 2005/06, although delays in forming the new cabinet and putting in place administrative changes held back budget execution.[2] Due to high oil revenues, the overall fiscal balance is expected to move into a surplus of 4¼ percent of GDP in 2005/06, while the estimated improvement in the non-oil deficit to 17½ percent of GDP largely reflects accounting changes.[3]

[2] New measures taken in 2005/06 include the setting up by the new government of a US$1.3 billion fund (0.8 percent of GDP) to help young couples pay for the cost of marriage and other household expenditure.

[3] More specifically, a US$5 billion transfer of tax revenue in domestic currency from the National Iranian Oil Company (NIOC) to the budget is classified as non-oil revenue, whereas US$2.3 billion subsidies of imported petroleum products—previously born by NIOC—are now explicitly charged to the government budget. Net of these changes, the non-oil deficit would have increased slightly as a percentage of GDP.

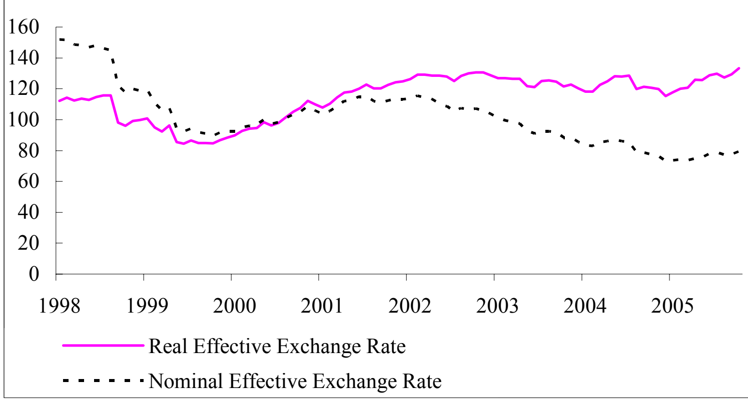


9. **The external position strengthened significantly over the last two fiscal years**. With hydrocarbon exports increasing by 35 percent in US dollar terms, the current account surplus reached 2.5 percent of GDP in 2004/05 (Figure 4). Non-hydrocarbon exports also grew, but not as rapidly, and their contribution to total exports remained relatively small. In 2005/06, notwithstanding some real exchange rate appreciation (see para. 10), export growth continued apace and import growth decelerated, but remained high. As a result, the current account surplus is projected to have improved markedly to 6½ percent of GDP, and international reserves are expected to reach US$47.4 billion by year's end, equivalent to 9.4 months of next year's imports of goods and nonfactor services. Although still low at 10¼ percent of GDP, external debt increased significantly in 2004/05, reflecting a larger use of letters of credit for trade finance and, possibly, to exploit arbitrage opportunities. The tightening of prudential controls and changing market conditions helped curb this practice in 2005/06.



10. **In the context of the managed float exchange rate regime, the authorities have allowed the currency to appreciate**. To compensate for the inflation differential vis-à-vis Iran's trading partners and preserve the competitiveness of the non-oil sector, the central bank has in the past targeted a gradual nominal depreciation. In 2004/05, despite rising oil prices, the nominal effective exchange rate depreciated by 11¼ percent, thus helping maintain the real effective parity unchanged. As external developments became increasingly favorable and fiscal policy remained expansionary, the central bank allowed the rial to appreciate in nominal effective terms in the new fiscal year, while the depreciation vis-à-vis the U.S. dollar continued, albeit at a slower pace. The nominal effective exchange rate had appreciated by 9½ percent from March to November 2005. Combined with a positive inflation differential, this led to a significant real effective appreciation (12½ percent), marking a departure from previous trends (Figure 5).

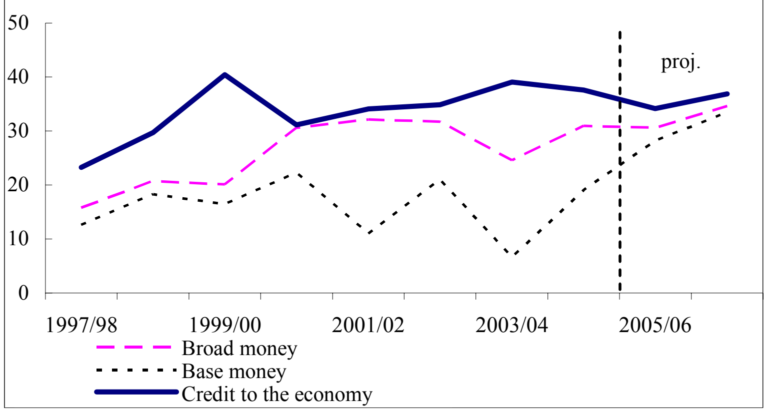
Figure 5. Islamic Republic of Iran: Effective Exchange Rates
(2000=100)



11. **Monetary policy has remained accommodative**. As oil-related inflows grew larger, the central bank increased its unsterilized purchases of foreign currency. With administratively-set lending rates relatively low in real terms, credit growth remained close to 38 percent in 2004/05 and domestic liquidity, as measured by broad money, grew by some 30 percent (Figure 6). As fiscal policy remained expansionary in 2005/06, the central bank moved to tighten access to its overdraft facilities by commercial banks, and allowed the exchange rate to appreciate. The task of the central bank was complicated by new challenges to its operational autonomy, as the authority to approve the issue of central bank participation papers (CBPPs) was transferred from the Money and Credit Council to parliament, thereby reducing flexibility in the use of this instrument. Moreover, the rate of return on CBPPs was

lowered from 17 percent to 15.5 percent.[4] As a result, new issues of CBPPs were not sufficient to cover the amortized amounts, which translated into a net injection, rather than a net withdrawal, of liquidity. Overall, despite the tightening of the central bank credit facilities, the desired slowdown in money growth could not be achieved, with M2 expected to increase by 31½ percent in 2005/06 (Figure 6).

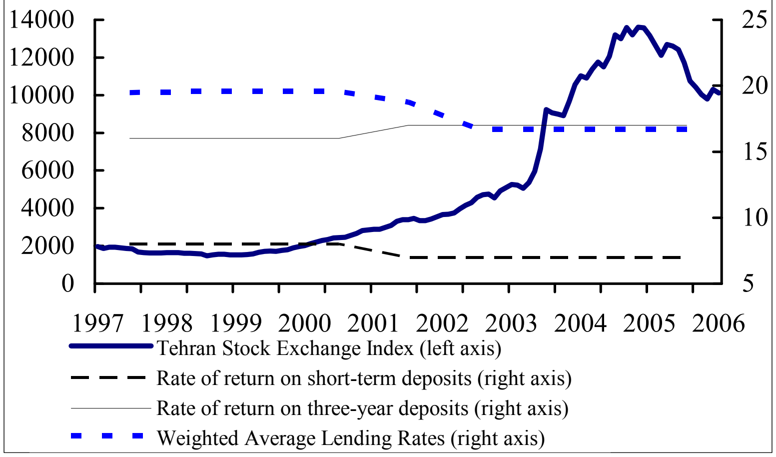
Figure 6. Islamic Republic of Iran: Money and Credit Aggregates
(Percentage change)



12. **Financial markets suffered from political uncertainty**. After having experienced rapid growth in previous years, the stock market lost 20 percent of its value in 2005/06, reflecting uncertainty in connection with the presidential election and the negotiations on the nuclear program (Figure 7). Despite the continued rise of nonperforming loans, profitability in the banking sector strengthened, reflecting increased provisioning in earlier years (Table 8). For the first time, bank capitalization reached above the 8 percent level recommended by the Basel I Capital Adequacy Accord.

[4] CBPPs are central bank bonds complying with Islamic finance principles. Issued to the public at a provisional rate of return (equivalent to an interest rate), they are the key liquidity management tool. The Money and Credit Council includes, among others, the Minister of Economic Affairs and Finance and the head of the Management and Planning Organization, and is chaired by the Governor of the central bank. The Council sets the rates of return on the participation papers as well as minimum lending rates for state-owned banks.

Figure 7. Islamic Republic of Iran: Financial Market Indicators



Box 2. Subsidies in Iran

Explicit subsidies, which amount to 6 percent of GDP, include budgetary subsidies to households for a number of essential commodities such as wheat, rice, oil, sugar, milk, and cheese; imports of medical equipment and pharmaceuticals; fertilizers; gasoline imports; as well as for some debt service payments on publicly-guaranteed debt. Initially, most of these subsidies had been provided implicitly through the official exchange rate. Following the 2002 exchange rate unification, they became explicit in the budget. Subsidies are also provided to farmers by a specialized government-owned agency to guarantee minimum purchase prices of agricultural products. Food subsidies are rationed through coupons, which are given to all households irrespective of their income levels. They had a cost of about 4 percent of GDP in 2004/05. Gasoline import subsidies had an estimated cost to the budget of US$2.1 billion (1.3 percent of GDP) in 2004/05, and are estimated at US$4.4 billion in 2005/06 (2.3 percent of GDP).

Implicit subsidies to energy prices are estimated at 15½ percent of GDP, based on border prices of hydrocarbon fuels. The price of gasoline in Iran is about US$0.09 per liter, one of the lowest in the world. Due to car emissions, air pollution is emerging as a major environmental and health problem, especially in Tehran, which is among the most polluted cities in the world according to indicators elaborated by the World Resource Institute.

Domestic Gasoline Prices in Selected Countries

(In U.S. dollars per liter, end of period)

	Regular Gasoline (unleaded)			
	2002	2003	2004	2005
Algeria	0.24	0.28	0.28	0.29
Azerbaijan	0.31	0.30	0.35	0.36
Egypt	0.20	0.15	0.15	0.16
Iran	0.07	0.09	0.10	0.09
Iraq	0.01	0.01	0.01	0.07
Morocco	0.85	0.99	1.09	1.04
Pakistan	0.56	0.59	0.68	0.82
Saudi Arabia 1/	0.24	0.24	0.24	0.24
United States	0.38	0.39	0.47	0.61

Source: Energy Information Administration of the U.S.; MCD and FAD databases.

1/ High octane gasoline.

13. **Progress on structural reforms was uneven.** Financial system reform has continued. Minimum lending rates and reserve requirements were unified and the clearing house was moved from Bank Melli to the central bank. The share of credit subject to mandatory allocation was further reduced, and banking supervision strengthened. Two private banks and three non-bank financial institutions were licensed. Parliament approved a new capital market law and a bill to improve corporate governance in state-owned banks is under discussion. Other reforms to strengthen central bank operational independence are being implemented (para. 22). Article 44 of the constitution, which delineates the domains of activity of the public sector, the cooperative sector, and the private sector, was amended in a way that opens the door to the privatization of both financial and non-financial enterprises. Although this change is an important legal step, the scope and modalities of actual privatization plans are yet to be determined. No progress was achieved on the key reform of energy subsidies, despite the increasing economic and environmental costs of the current system.

III. The Policy Discussions

14. Key issues addressed during the policy discussions were:

a. **The economic outlook.** While high oil prices and expansionary policies will continue to boost growth in the short term, medium-term prospects depend largely on the authorities' ability to consolidate macroeconomic stability and accelerate structural reforms.

b. **The appropriate fiscal policy stance**. Based on current projections of oil revenues, medium-term sustainability is not an immediate concern. However, fiscal restraint is required to help monetary policy reduce high persistent inflation, and to build fiscal savings to cushion against an unexpected downturn in oil prices.

c. **Monetary and exchange rate policies aimed at reducing inflation.** The FFYDP identifies single-digit inflation as a medium-term objective. Monetary and exchange rate policies would need to be consistent with this objective.

d. **The structural reform agenda.** As the effects of the reforms undertaken at the beginning of the Third Five-Year Development Plan (TFYDP) may start to taper off, new impetus is needed to consolidate and strengthen the foundations for further growth.

A. Economic Outlook

15. **Iran's short-term outlook is benign.** Economic activity will continue to be boosted by high oil prices, which, under current WEO projections, are expected to persist in the near future. Based on current policies, the overall fiscal position would remain in surplus, but inflation could return to its previous levels unless the policy stimulus is reigned in. Reflecting large current account surpluses, the external debt would continue to decline.

16. **Medium-term prospects, however, look challenging.** After strengthening in 2005/06, growth is likely to decelerate gradually in the absence of significant policy changes,

reaching well below the authorities' average target of 8 percent under the FFYDP. Capacity constraints in the hydrocarbon sector, high inflation, and the possibility of a prolonged "wait and see" attitude on the part of the private sector could restrain growth, aggravating the unemployment problem. This outlook is subject to a high degree of uncertainty related to the volatility of oil prices, the international tensions over the nuclear issue, and developments in Iran's relations with its major trading partners. While the long-term sustainability of current policies crucially depends on oil prices, a baseline scenario prepared by the staff on the basis of WEO oil prices suggests that Oil Stabilization Fund (OSF) reserves would decline significantly by 2010/11 in the absence of policy adjustments (Text Table 1 and Table 7).

Text Table 1. Islamic Republic of Iran: Sustainable Non-Oil Fiscal Deficit, 2005/06–2010/11 1/
(In percent of GDP)

	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
Sustainable path based on:						
A long-term real oil price of $45/barrel 2/	-27.0	-20.6	-17.6	-16.7	-17.6	-15.1
A long-term real oil price of $30/barrel 3/	-15.6	-11.2	-9.1	-8.5	-9.1	-7.4
Staff projections for actual deficit (baseline scenario)	-17.6	-18.0	-17.3	-16.5	-15.6	-14.4
Memo: Average oil export price (in U.S.$/barrel)	50.6	55.2	55.4	53.8	53.0	50.5

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

1/ Consistent with constant real per capita consumption out of oil revenue (Country Report No. 04/307, August 30, 2004).
2/ Based on WEO oil prices deflated by world inflation until 2010/11, then real oil prices of $45 per barrel are maintained constant.
3/ Based on WEO oil prices deflated by world inflation until 2010/11, then real oil prices of $30 per barrel are maintained constant.

B. Fiscal Policy

17. **Staff argued that, while the oil price windfall gave policy more leeway, fiscal restraint was required for macroeconomic stability.** The authorities broadly concurred, stressing that a downsizing of the government was one of the medium-term objectives of the FFYDP. In their view, however, job creation in the non-oil sector remained a top policy priority, for which supporting policies, including the use of increased oil revenue, were needed. Nonetheless, the authorities stated their commitment to reducing current spending across government departments, and suggested that the Majlis (parliament) was likely to discontinue the current practice of authorizing withdrawals from the OSF to finance expenditure not foreseen in the budget.

18. **The 2006/07 budget currently being discussed by parliament foresees additional fiscal expansion.** Based on current information, the non-oil fiscal deficit is expected to increase to 18 percent of GDP in 2006/07, raising further concerns about the inflationary impact of fiscal policy. Staff suggested that the budget be formulated within a framework aimed at achieving the FFYDP inflation target of 11½ percent. In this regard, it recommended a fiscal adjustment of about 2 percent of GDP relative to the budget proposal in order to bring broad money growth down to about 22 percent, compared with a projected increase to about 35 percent in the absence of additional measures. The required fiscal effort could be smaller if monetary policy were to be tightened further. Fiscal adjustment could be achieved mainly by cutting and targeting subsidies, reducing other current outlays, and

containing the growth of capital expenditure, which is expected to rise by some 50 percent. While the authorities recognized the need to reduce subsidies, they argued that more time was needed to complete the preparatory work and build consensus on such a difficult reform. The staff called for steadfast progress in this area and stressed the need for interim measures to adjust the prices of energy and other subsidized goods and services.

19. **Continued tax reform and increased fiscal transparency remain crucial**. The authorities referred to some reforms introduced in 2004/05, including the removal of tax exemption for bonyads (charitable organizations), and confirmed that plans to introduce the VAT in 2007/08 were on course. They also highlighted recent improvements in fiscal transparency, with the total cost of implicit and explicit subsidies—including on imported petroleum products—now being fully reflected in the budget. Staff commended the authorities' efforts, but stressed the need for further improvements in several areas. In particular, staff underscored the importance of clarifying the complex financial relationships within the public sector, consolidating the accounts of the OSF with the central government, strengthening the budget process and cash management, and improving the quality of fiscal information (Appendix III).

20. **The authorities concurred with staff that a medium-term fiscal framework could help anchor fiscal policy and reduce its pro-cyclicality**. Staff suggested that a macroeconomic framework, which should be periodically updated to reflect new circumstances, would contribute to clarifying the policy trade-offs, improving policy coordination, and encouraging a more prudent use of oil resources. It would also facilitate setting fiscal targets consistent with a gradual reduction of inflation to single digits by 2010, as envisaged by the FFYDP. The authorities underscored that the FFYDP provided such a medium-term framework, but agreed that it needed to be updated more frequently.

C. Monetary and Exchange Rate Policies

21. **A more effective and less accommodative monetary policy is needed**. Staff pointed out that money growth had systematically exceeded the central bank target, and that the volume of CBPPs issued was not sufficient to curb the rapid growth of credit and M2. Based on the current draft budget, the continuation of an accommodative monetary policy stance could cause inflation to increase above 15 percent in 2006/07. The authorities noted that some tightening of monetary conditions had already occurred through higher sales of foreign exchange to banks and more restricted access to the central bank's overdraft facility. Staff called for further monetary policy tightening, including through issuance of CBPPs, limiting even more the access to the central bank overdraft facility, and a more active use of the open deposit account (a standing deposit facility at the central bank). Moreover, lending rates should be increased if warranted by developments in credit and liquidity.

22. **Views differed on the need to strengthen the framework for monetary policy formulation and implementation.** Staff pointed out that a clear mandate and greater central bank independence in the use of monetary policy instruments were needed to achieve well-defined time-bound objectives. The recent shift of the authority to approve the issue of CBPPs from the Money and Credit Council (MCC) to parliament and the reduction in the rates of return on those instruments were clearly inconsistent with these objectives. Moreover, the use of these policy instruments requires a high degree of flexibility and does not lend itself to a lengthy parliamentary approval process. The authorities, however, did not consider the required parliamentary approval for the issue of CBPPs as significantly affecting central bank autonomy or policy effectiveness. They also pointed to a number of reforms aimed at strengthening central bank operational independence, which were being introduced under the FFYDP, such as i) the explicit prohibition of government financing from the central bank; ii) the transfer of the chair of the MCC from the minister of finance to the governor of the central bank; and iii) the direct appointment of the governor by the president.

23. **There is a need to allow for greater exchange rate flexibility to help reduce inflation.** Staff noted that, with continued high inflows of oil revenue and an expansionary fiscal policy, the real effective exchange rate was bound to appreciate. Attempts to resist nominal appreciation would eventually be followed by higher inflation, thereby undermining the stated objective of preserving the competitiveness of the non-oil sector. Noting that the authorities had recently allowed some nominal effective appreciation to take place, staff advocated further exchange rate flexibility in line with the authorities' objective of lowering inflation. The authorities indicated that their exchange rate policy had been successful in providing stability to the market and enhancing confidence, and that it had contributed to containing the rapid growth of imports and to building up reserves as a buffer against risks related to oil price volatility. Staff argued that the vulnerability to oil prices could be better addressed through a larger accumulation of savings in the OSF, and that fiscal and structural policies were more appropriate tools to foster competition in the non-oil sector.

24. **Traditional indicators of competitiveness seem adequate, but there is a need for improvements in the business climate.** Staff assessments do not find any significant misalignment in the exchange rate (Box 3). The recent appreciation in real effective terms is moderate and can be fully explained by higher long-term oil prices. Moreover, the non-oil export dynamics do not seem to have been affected adversely. Other impediments to competitiveness, which are mainly related to the business climate and are likely to overshadow the importance of the exchange rate, need to be addressed through structural reforms.

Box 3. Competitiveness and Business Climate in Iran

A recent study by staff concludes that **there is no evidence of a significant misalignment of the exchange rate in Iran.**[1/] Several indicators suggest that the level of the exchange rate is not an obstacle to the performance of the tradable sector. One such indicator is the current account "norm," which defines the long-term level of the current account for Iran as a function of a number of macroeconomic variables (fiscal balance, net foreign assets, dependency ratio, terms of trade volatility, financial deepening, relative PPP-adjusted income). The norm for Iran has been estimated on the basis of coefficients from a cross-country study.[2] Depending on the specification, the estimates vary from a small deficit to a surplus of 1½ percent of GDP for 2003/04, which is reasonably close to the actual outcome (Table 4). This conclusion is reinforced by the good performance shown by the tradable sector in recent years, with the volume of non-oil exports increasing by almost 10 percent a year on average since 2000/01. However, the Iranian economy is affected by various distortions, including interest rate and price controls, as well as significant direct and indirect subsidies. These distortions may have helped improve the performance of the tradable sector in the short run, but at the expense of a less efficient allocation of resources in the long run.

The regulatory environment is a key determinant of competitiveness. Excessive regulation and controls can impose considerable costs on businesses, preventing competition and stifling innovation. The table below compares some indicators of business climate in several countries drawn from the World Bank's Doing Business database.

Government Regulation of Business, 2005

	Time to Start a Business (days)	Procedures to Obtain a License (number)	Cost of Hiring (as a perc. of salary)	Rigidity of Employment Index	Time to Register Property (days)	Investor Protection Index	Time to Import (days)	Time to Enforce a Contract (days)	Time to Go through Insolvency (years)
Iran	47	21	23.0	49	36	2.7	51	545	4.5
Jordan	36	17	11.0	34	22	3.7	28	342	4.3
Tunisia	14	21	18.5	54	57	3.3	33	27	1.3
United Arab Emirates	54	21	12.5	33	9	4.7	18	614	5.1
Middle East and North Africa Region	46	19.9	15.9	40	52	4.6	42	432	3.8
Malaysia	30	25	13.3	10	143	8.7	22	300	2.2
Turkey	9	32	22.1	55	9	5.0	25	330	5.9
OECD	20	14.1	20.7	36	32	5.9	14	40	1.5

Source: World Bank, Doing Business

These indicators point to **several areas where the business climate in Iran could be improved**. Obtaining a license to build a warehouse or completing import procedures takes a large number of procedures and much longer than in any of the listed countries. Labor market regulations are more restrictive. The cost of hiring a new workers—expressed as the sum of social security payments and payroll taxes as a percentage of the worker's salary—is high by international standards. Employment rigidity—measured by an index encompassing regulations concerning contract flexibility, minimum wage, working time, and dismissals—is also very high. Contract enforcement is slow and bankruptcy procedures are protracted. In addition, investor protection—measured by an index reflecting different aspects of corporate governance—is weak.

1/ Vitali Kramarenko, to be published, "Approaches to Assessing the Exchange Rate Level," in Jbili, A., V. Kramarenko, and J. Bailén, "Islamic Republic of Iran: Managing the Transition to a Market Economy," IMF Papers on Policy Analysis and Assessment.

2/ Chinn, M., and E. Prasad, 2003, "Medium-Term Determinants of Current Accounts in Industrial and Developing Countries: An Empirical Exploration," Journal of International Economics, vol. 59, pp. 47–76.

D. The Financial Sector

25. **Stepped-up efforts are needed to strengthen the financial sector.** The staff stressed the importance of strengthening the financial system and further enhancing its supervision. It welcomed the licensing of private banks, insurance, and leasing companies, as well as the progress being made in upgrading banking supervision. Under the approved amendment to article 44 of the constitution, bank privatization is possible after restructuring, and the authorities expressed interest in receiving Fund technical assistance in this area. While the authorities plan to license additional private banks, they would seek to avoid creating too many small banks. A major review of the central bank law is expected to start in 2006, and a new portfolio investment law to regulate foreign investment in the stock market has been prepared. In addition, new legislation on AML/CFT and bank corporate governance has been tabled for discussion by parliament. The authorities also stated their interest in an FSAP update during the next fiscal year.

26. **The authorities concurred on the need for close scrutiny of the risks to financial stability**. The authorities agreed that the continued increase in nonperforming loans was a reason for concern, but noted that it reflected past difficulties in some sectors—like consumer durables, construction, and textiles—as well as more stringent classification rules. The recent increase in capital adequacy was largely a result of asset revaluations, but the authorities were committed to recapitalize public banks. Risks stemming from the excessive use of letters of credit in the recent past had been averted through effective supervision. The authorities saw limited risks from the stock market price correction, which followed two years of very strong performance. The losses incurred were spread among a large number of investors, with limited repercussions on the balance sheet of financial intermediaries, and equity prices had stabilized in recent months. The mission underscored the need to further strengthen the regulatory framework and supervision of the Tehran Stock Exchange and develop its infrastructure.

E. Structural Policies

27. **The authorities reiterated their commitment to pursuing a wide range of reforms under the FFYDP.** Particular emphasis was given to development of infrastructure and improvement of the provision of basic services in the most disadvantaged regions outside Tehran in an effort to reduce economic disparities among the provinces. This is to be achieved through budgetary allocations and tax incentives to attract private sector investment in remote areas. Staff pointed out that this program should preferably be carried out through a reallocation of existing resources, rather than an overall increase in spending.

28. **The authorities expressed their intention to initiate a gradual disengagement of the government from various economic activities, which is seen as critical to the development of the private sector**. As policies are being reconsidered, the initial momentum for privatization under the TFYDP has slowed down over the past two years, but the privatization process is expected to receive new impetus following the amendment of

Article 44 of the constitution.[5] However, details concerning major privatization operations have yet to be worked out and announced. Moreover, under a new privatization scheme called “justice shares”, which is currently being elaborated, a number of restructured firms would be grouped in holding companies, and a large proportion of their shares would be transferred to low-income families and paid for from future dividends. Staff cautioned about the difficulties encountered in Eastern Europe and other countries with similar privatization schemes, and encouraged the authorities to seek World Bank assistance in this area.

29. **Further steps have been taken to liberalize trade**. Following the end of the ban on car imports in 2003/04, all import quotas have now been eliminated, with the exception of those motivated by security and public morality. In addition, the gradual reduction of tariffs continued during 2004/05, bringing the simple average tariff rate below 23 percent, from about 25 percent in 2003/04 and 27 percent in 2002/03 (about 60 percent of imports have tariff rates below 20 percent). Furthermore, the standard tariff rate was consolidated with commercial taxes on imports.[6] On May 26, 2005, a Working Party was established to consider Iran’s application for accession to the WTO. Accession negotiations could commence after Iran submits the required Memorandum on Foreign Trade Policies.

30. On September 6, 2004 , the Islamic Republic of Iran accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund’s Articles of Agreement. In this regard, the IMF approved the retention of the exchange restriction and multiple currency practices described in paragraph 2 of Country Report No. 04/306, Supplementary Information. The exchange restriction arises from limitations on the transferability of (periodic) rial profits from certain foreign direct investment under the by-laws of the Foreign Investment Promotion Act. Notwithstanding the authorities’ commitment to remove this exchange restriction, action was delayed by the June 2005 presidential elections and the inauguration of the new government. The authorities have confirmed their intention to review and eliminate this restriction within one year. The multiple currency practices arise from measures taken in the context of the unification of the exchange rates in 2002 (Appendix I). One multiple currency practice arises from budget subsidies for foreign exchange purchases in connection with payments of certain letters of credit opened prior to March 21, 2002. The outstanding amount of such debt has continued to decline and now stands at US$2.7 billion. The other multiple currency practice arises from the obligation of entities that had received allocations of foreign exchange for payments based on subsidized “allocated rates.” The outstanding amounts are very small.

[5] In the period 2001–05, 272 state-owned companies were sold for a total exceeding US$2 billion.

[6] The tariff rate is composed of the standard tariff rate and commercial benefit taxes. The former is set by parliament and has remained unchanged at 4 percent in recent years. In contrast, commercial benefit taxes, which are set by the government and vary by import category, have changed at least once a year over the recent past.

F. Other Issues

31. **Further progress has been made in improving statistical information and its dissemination**. Staff noted the authorities' efforts to enhance the transparency of fiscal operations, including by making subsidies for imported petroleum products and lending rates to specific sectors explicit in the budget. However, adequate and timely consolidated data on fiscal developments for both the central government and the OSF are still lacking. Staff also pointed out that full compliance with the Special Data Dissemination Standards (SDDS) required the publication of data on international reserves and the international investment position. While not ready yet to commit to a timetable, the authorities confirmed their intention to conform to SDDS requirements. They are also considering a proposal by the IMF's Statistics Department for a data ROSC.

32. The authorities confirmed that discussions were ongoing regarding their contribution to the new shock facility and the debt relief to Nicaragua and Tanzania under the Heavily Indebted Poor Countries (HIPC) initiative.

IV. Staff Appraisal

33. **The growth momentum in Iran has continued, but the outlook is fraught with uncertainties**. Iran has enjoyed several years of sustained high growth and employment creation, following initial advances in opening up the economy and introducing economic reforms. The growth performance has been supported by high oil revenues and expansionary policies. While most macroeconomic indicators have continued to improve, inflation remains relatively high and large subsidies and administrative impediments to economic activity continue to hamper efficiency. Moreover, the recent escalation of tensions over Iran's nuclear program has increased economic uncertainty.

34. **Against this background, a challenging task for the authorities is to consolidate macroeconomic stability while strengthening the momentum of structural reforms.** In particular, there is a need to focus on lowering inflation and a consistent set of policies to achieve this objective. In parallel, a deepening and acceleration of structural reforms would help complete the transition to a market economy, tap Iran's considerable economic potential, and provide much needed confidence on the direction of future policies.

35. **Reducing inflation from current levels requires the adoption of a tighter financial policies stance, which remains expansionary and pro-cyclical**. While fiscal and monetary policies have brought about some short-term gains in terms of output and employment, this has been achieved at the cost of high and persistent inflation, which can undermine long-term growth and adversely affect the poor. In addition, attempts to minimize the side effects of these policies on the competitiveness of the non-oil sector through nominal exchange rate depreciation can only compound the problem.

36. **A more ambitious fiscal effort involving greater moderation in the pace of government spending is necessary to reduce demand pressures**. While the central government non-oil deficit is estimated to have declined in 2005/06, additional efforts will be

required in 2006/07 and thereafter to put overall liquidity growth on a declining trend. In particular, the authorities need to effectively tackle the large subsidies, including on energy prices, which are a major source of waste and inefficiency and have negative environmental implications. This would create fiscal space that could be used in part for high-quality projects in infrastructure and social services, as well as for protecting vulnerable groups. There is no doubt that competing demands for public resources in an environment of abundant oil revenue will severely test the authorities' resolve to rein in public spending. This strengthens the case for anchoring fiscal policy within a medium-term framework, as called for by the FFYDP, in order to help reduce its pro-cyclicality and improve policy coordination.

37. **Monetary policy should be tightened and effective policy instruments provided to the monetary authorities.** A credible disinflation program—based on the targets set by the FFYDP, with periodic revisions to reflect changing circumstances—requires a clear definition of the central bank mandate and effective policy instruments. The upcoming review of the central bank law presents a good opportunity to give adequate emphasis to the objective of price stability. The central bank should have full authority to issue its participation papers and greater leeway in ensuring that the MCC decisions about rates of return are consistent with monetary policy objectives. In addition, a more active use of the open deposit facility to mop up liquidity would be desirable.

38. **Although the managed float regime has worked well in providing stability to the foreign exchange market, additional exchange rate flexibility would help attain the inflation objective.** While the recent moderate appreciation in the nominal effective exchange rate is a welcome step, further flexibility would contribute to lowering inflation, particularly if high oil prices persist and an expansionary fiscal policy is maintained. In turn, a vigorous implementation of structural reforms would help foster competitiveness in the non-oil sector.

39. **Further efforts are needed to address banking sector weaknesses, although there are no immediate threats to financial stability**. The continued increase in nonperforming loans is a source of concern, both for its fiscal implications and its repercussions on the health of financial institutions. The authorities should closely monitor bank credit quality to avert problems that could arise from rapid credit growth. Moreover, it would be important to move ahead decisively with the government's plans to improve the management of the large public banks, recapitalize them, and license additional private banks. A series of reforms should also be introduced to allow market forces to play a more important role in financial intermediation, particularly in the determination of rates of return, while ensuring a level playing field for public and private banks. Further strengthening of supervision for the banking, insurance, and securities sectors is necessary.

40. **The structural reform agenda should be revived as an effective way to improve the business climate and accelerate employment creation**. Key reforms would need to focus on reducing the heavy administrative and regulatory burden, removing the distortions created by subsidies and state ownership of companies, and streamlining labor market

rigidities. Plans for restructuring and privatizing state-owned banks should be accelerated to complement the ongoing financial sector reform.

41. **The statistical information is adequate for Fund surveillance purposes, but further improvements in quality are needed**. The authorities are encouraged to complete the necessary steps for full compliance with the SDDS, with a special focus on improving the quality, timeliness, and availability of information on the operations of the public sector.

42. **The remaining exchange restriction should be removed**. The staff welcomes the authorities' intention to review the restriction and eliminate it within one year. Therefore, the staff recommends approval of the retention of the exchange restriction through March 10, 2007. Regarding the two multiple currency practices, the retention of which had been approved by the Executive Board though September 10, 2006 (see Country Report No. 04/306, Supplementary Information), the staff recommends approval of their retention through March 10, 2009 as these practices are not maintained for balance of payments purposes, do not materially impede Iran's balance of payments adjustment, and do not discriminate among, or harm the interest of, other members.

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

Table 1. Islamic Republic of Iran: Selected Macroeconomic Indicators, 2002/2003–2006/07 1/

(Quota: SDR 1,497.20 million)
(Population: 68.0 million)
(Per capita GDP: $2,814) 2/
(Poverty rate: 7.3 percent)
(Main exports: oil, gas, chemical and petrochemical products, and pistachios.)

	2002/03	2003/04	2004/05	Proj. 2005/06	2006/07
Oil and gas sector					
Total oil and gas exports (in billions of U.S. dollars)	23.0	27.4	36.8	49.4	55.5
Average oil export price (in U.S. dollar/barrel)	27.2	28.0	35.9	50.6	55.2
Crude oil production (in millions of barrels/day)	3.2	3.8	4.0	4.0	4.2
	(Annual percentage change, unless otherwise indicated)				
National accounts					
Nominal GDP at factor cost (in billions of Iranian rials)	916,465	1,095,717	1,382,608	1,723,454	2,124,369
Nominal GDP in billions of U.S.dollars	115.0	132.3	158.6	...	...
Real GDP at market prices	7.5	6.7	5.6	5.9	5.3
Real GDP at factor cost	7.4	6.7	4.8	6.0	5.4
Real oil and gas GDP	5.1	7.6	2.6	2.6	5.0
Real non-oil GDP	7.8	6.6	5.1	6.4	5.4
CPI inflation (average)	15.8	15.6	15.2	13.0	17.0
GDP deflator at factor cost	28.3	12.1	20.4	17.6	17.0
	(In percent of GDP at market prices)				
Investment and savings					
Investment	36.5	39.3	37.6	37.3	36.1
Change in stocks 2/	8.3	10.5	8.2	6.5	5.3
Total fixed capital investment	28.2	28.8	29.3	30.8	30.8
Public	10.6	9.8	10.2	10.5	12.7
Private	17.5	19.0	19.1	20.3	18.0
Gross national savings	39.5	39.9	40.0	43.8	42.0
Public	14.8	15.6	16.4	21.3	22.8
Private	24.7	24.2	23.6	22.4	19.2
Savings/investment balance	3.1	0.6	2.5	6.4	5.9
	(In percent of GDP at factor cost)				
Budgetary operations					
Revenue	27.1	27.9	31.0	33.1	31.1
Oil	16.3	16.8	19.1	21.8	20.2
Non-oil	10.8	11.1	11.9	11.2	10.9
Expenditure and net lending	29.5	28.0	31.4	28.8	28.8
Of which: current	16.2	16.6	19.0	19.6	18.7
capital	6.1	5.3	5.5	5.7	7.0
Balance	-2.4	-0.1	-0.4	4.3	2.3
Domestic financing	0.9	0.6	1.2	-4.2	-2.2
External financing	1.5	-0.5	-0.8	-0.1	0.0
Non-oil balance	-18.7	-16.9	-19.5	-17.6	-18.0
	(Annual percentage change)				
Monetary sector					
Net foreign assets	37.7	-0.8	118.8	43.4	32.6
Net domestic assets	29.4	35.1	4.2	22.4	36.1
Credit to the private sector	34.9	39.1	37.6	34.2	36.8
Broad money	30.1	26.2	29.8	31.5	35.0
Velocity of broad money (index)	2.2	2.1	2.0	1.9	1.7
	(In billions of U.S. dollars, unless otherwise indicated)				
External sector					
Exports of goods and services	33.3	40.2	51.4	65.9	74.4
Imports of goods and services	-30.6	-40.3	-48.4	-54.7	-61.9
Current account balance	3.6	0.8	4.0	12.7	14.2
In percent of GDP at market prices	3.1	0.6	2.5	6.4	5.9
External public and publicly guaranteed debt	9.3	12.1	16.8	17.8	17.4
Of which: short-term debt	2.1	4.8	10.3	10.6	9.5
Gross official reserves	21.0	24.7	33.0	47.4	62.3
In months of the following year's imports of goods and services	6.4	6.3	7.4	9.4	11.2
Memorandum items:					
Nominal effective exchange rate, 2000/01=100	109.4	93.3	80.2	…	…
Real effective exchange rate, 2000/01=100	128.6	124.1	122.6	…	…
Average exchange rate (Iranian rials per U.S.dollar)	7,967.1	8,282.0	8,719.0	…	…

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

1/ The Iranian fiscal year ends March 20.
2/ At market prices, estimated for 2005/06. Per capita GDP in PPP terms is $8,100.

Table 2. Islamic Republic of Iran: Central Government Operations, 2003/04–2006/07

(In billions of rials)

	2003/04	2004/05	Budget 2005/06	Proj. 2/ 2005/06	Proj. 3/ 2006/07
Revenue	305,540	428,872	323,168	570,087	661,003
Revenue from oil and gas exports	184,387	264,632	152,423	376,277	429,762
Of which: allocated to the budget	138,660	175,639	152,423	150,915	206,176
Tax and nontax revenue	121,154	164,240	170,745	193,810	231,241
Tax revenue	65,099	84,421	111,970	98,180	119,504
Nontax revenue 3/	15,586	20,730	33,374	70,228	80,427
Of which: revenue from OSF (income earned)	1,895	1,574	3,790	3,753	7,761
Earmarked revenue	40,469	59,090	25,401	25,401	31,310
Expenditure and net lending	306,772	433,670	419,851	496,367	612,879
Current expenditure	181,600	262,443	272,921	337,868	396,674
Wages and salaries	65,725	76,300	74,200	87,745	100,907
Interest payments	3,344	3,727	5,408	5,397	6,287
Subsidies	45,123	73,403	56,943	101,370	125,351
Basic goods subsidies	45,123	55,743	43,300	61,748	71,628
Gasoline import and gas subsidies	...	17,660	13,643	39,622	53,723
Social benefits	31,770	38,800	36,600	62,055	71,984
Goods and services	24,761	43,140	25,300	25,300	29,348
Grants	7,048	8,400	11,100	11,100	12,876
Other	3,829	18,674	37,700	44,901	49,922
Capital expenditure	57,772	76,680	121,529	98,519	147,694
Earmarked expenditure	40,469	59,090	25,401	25,401	31,310
Foreign exchange losses	18,595	19,591	...	14,408	12,740
Net lending	8,335	15,866	...	20,171	24,461
Overall balance (deficit (-))	-1,231	-4,799	-96,682	73,719	48,124
Overall non-oil balance (deficit (-))	-185,618	-269,430	-249,105	-302,558	-381,638
Financing	1,231	4,799	...	-73,719	-48,124
Net domestic	6,516	16,131	...	-71,685	-47,267
Banking system (net)	-2,404	-4,582	...	-86,206	-66,384
Of which: OSF	-3,000	-9,011	...	-86,206	-59,784
Nonbanks, including privatization proceeds	8,920	20,714	...	14,521	19,117
Net external	-5,285	-11,333	...	-2,035	-857
Memorandum item:					
Implicit energy subsidies	117,429	170,608	127,143	270,898	325,077

Table 2. Islamic Republic of Iran: Central Government Operations, 2003/04–2006/07 1/ (concluded)

(In percent of GDP)

	2003/04	2004/05	Budget 2005/06	Proj. 2/ 2005/06	Proj. 3/ 2006/07
Revenue	27.9	31.0	18.8	33.1	31.1
Revenue from oil and gas exports	16.8	19.1	8.8	21.8	20.2
Tax and nontax revenue	11.1	11.9	9.9	11.2	10.9
Tax revenue	5.9	6.1	6.5	5.7	5.6
Nontax revenue 3/	1.4	1.5	1.9	4.1	3.8
Of which: revenue from OSF (income earned)	0.2	0.1	0.2	0.2	0.4
Earmarked revenue	3.7	4.3	1.5	1.5	1.5
Expenditure and net lending	28.0	31.4	24.4	28.8	28.8
Current expenditure	16.6	19.0	15.8	19.6	18.7
Wages and salaries	6.0	5.5	4.3	5.1	4.7
Interest payments	0.3	0.3	0.3	0.3	0.3
Subsidies	4.1	5.3	3.3	5.9	5.9
Basic goods subsidies	4.1	4.0	2.5	3.6	3.4
Gasoline import and gas subsidies	...	1.3	0.8	2.3	2.5
Social benefits	2.9	2.8	2.1	3.6	3.4
Goods and services	2.3	3.1	1.5	1.5	1.4
Grants	0.6	0.6	0.6	0.6	0.6
Other	0.3	1.4	2.2	2.6	2.3
Capital expenditure	5.3	5.5	7.1	5.7	7.0
Earmarked expenditure	3.7	4.3	1.5	1.5	1.5
Foreign exchange losses	1.7	1.4	...	0.8	0.6
Net lending	0.8	1.1	...	1.2	1.2
Overall balance (deficit (-))	-0.1	-0.3	-5.6	4.3	2.3
Overall non-oil balance (deficit (-))	-16.9	-19.5	-14.5	-17.6	-18.0
Financing	0.1	0.3	...	-4.3	-2.3
Net domestic	0.6	1.2	...	-4.2	-2.2
Banking system (net)	-0.2	-0.3	...	-5.0	-3.1
Of which: OSF	-0.3	-0.7	...	-5.0	-2.8
Nonbanks, including privatization proceeds	0.8	1.5	...	0.8	0.9
Net external	-0.5	-0.8	...	-0.1	0.0
Memorandum item:					
Implicit energy subsidies	10.7	12.3	7.4	15.7	15.3

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

1/ The Iranian fiscal year ends March 20.
2/ Staff projections reflecting current policies.
3/ In 2005/06 and 2006/07, includes a transfer of profits and revenue of about $5 billion from the oil company (NIOC).

Table 3. Islamic Republic of Iran: Use of Oil Resources, 2002/03-2006/07
(In millions of U.S. dollars)

	2002/03	2003/04	2004/05	2005/06	2006/2007
1. Crude oil export revenue 1/	19,380	23,113	31,220	43,894	49,713
2. Freight and Insurance	0	0	0	0	0
3. Buy Backs	571	695	868	2,109	2,486
4. Net government oil revenue (=1-2-3)	18,809	22,418	30,352	41,785	47,227
5. Budget Allocation 2/	12,713	16,910	20,145	16,759	22,657
6. Other government payments	500	0	0	0	0
7. Oil revenue to the OSF (=4-5-6)	5,596	5,508	10,207	25,026	24,570

OSF Operations
(In millions of U.S. dollars)

	2002/03	2003/04	2004/05	2005/06	2006/2007
1. Net transfer of oil revenue	1,065	1,148	2,695	11,396	8,405
Transfer during the year	5,596	5,508	10,207	25,026	24,570
Withdrawals during the year for government financing 3/	4,531	4,361	7,512	13,630	16,165
2. Income on foreign deposits	282	246	175	405	785
3. Income on domestic deposits	0	3	6	12	67
4. Domestic lending to the private sector (net of repayments)	563	1,034	1,842	2,240	2,688
5. Net change in OSF reserves (=1+2+3-4)	784	361	1,034	9,573	6,570
End of period reserves	8,082	8,443	9,477	19,050	25,620

1/ Including freight and insurance.
2/ For 2005/06, includes $14,128 million budgetary allocation of oil revenue plus a foreign exchange transfer from the NIOC to the budget of $1,993 of profit taxes and $638 of dividends.
3/ In 2005/06: $7.7 billion budget, plus $940 payment of last-year capital expenditures, plus $2.9 billion additional gasoline import subsidies, plus $600 million wheat subsidies, plus $1 billion for the electricity company, plus $440 for other expenditures.

Table 4. Islamic Republic of Iran: Balance of Payments, 2002/03–2006/07 1/
(In millions of U.S. dollars, unless otherwise indicated)

	2002/03	2003/04	2004/05 Prel	2005/06	2006/07
				Proj	
Current account	3,585	816	3,989	12,657	14,174
(In percent of GDP at market prices)	3.1	0.6	2.5	6.4	5.9
Trade balance	6,201	4,430	7,764	17,262	19,266
Exports	28,237	33,991	44,403	58,122	65,252
Oil and gas	22,966	27,355	36,827	49,395	55,517
Crude oil	19,380	23,113	31,731	43,894	49,713
Petroleum products and natural gas	3,586	4,242	5,096	5,500	5,804
Refined products	2,587	2,517	2,650	3,786	4,134
Natural gas and others	999	1,725	2,446	1,714	1,670
Non-Oil and gas	5,271	6,636	7,576	8,727	9,735
Imports	-22,036	-29,561	-36,639	-40,860	-45,986
Services (net)	-3,503	-4,535	-4,812	-6,119	-6,727
Credits	5,025	6,249	6,991	7,771	9,166
Of which: interest income	653	781	808	1,093	1,953
Debits	-8,528	-10,784	-11,803	-13,890	-15,894
Of which: interest payments	-1,082	-1,046	-1,166	-1,266	-1,376
Transfers (net)	887	921	1,037	1,514	1,635
Capital and financial accounts	2,455	4,476	6,308	3,135	785
Medium-term and long-term capital	2,354	-360	-946	635	645
Bilateral project financing	521	175	-91	351	483
Repayments of rescheduled debt	-60	0	0	0	0
Other official financing and portfolio investment 2/	1,015	51	236	448	199
Oil prefinancing	878	-586	-1,091	-164	-37
Short-term capital 3/	-575	2,714	5,462	350	-1,060
Other capital 4/	-541	-285	113	200	-300
Foreign direct investment and portfolio equity	1,217	2,407	1,679	1,950	1,500
Of which: buybacks	967	1,907	1,179	1,250	1,250
Errors and omissions 5/	-2,515	-1,582	-1,979	-1,408	0
Overall balance	3,525	3,710	8,318	14,384	14,958
Change in gross official reserves (increase -)	-3,525	-3,710	-8,318	-14,384	-14,958
Memorandum items:					
Gross official reserves (in millions of U.S. dollars)	20,965	24,675	32,993	47,377	62,336
Of which: Oil Stabilization Fund 6/	8,082	8,443	9,435	...	...
(in months of the following year's imports)	6.4	6.3	7.4	9.4	11.2
External debt service (as percent of exports) 7/	3.7	4.5	6.4	3.6	3.4
External debt (in percent of GDP)	8.0	9.1	10.6	9.3	7.5
Oil exports (in million barrels/day)	2.0	2.3	2.4	2.4	2.5
Oil exports average price (in U.S. dollars/barrel)	27.2	28.0	35.9	50.6	55.2
Real merchandise exports (percentage change)	-6.1	14.9	5.2	-3.6	2.8
Hydrocarbon	-8.9	15.5	5.1	-4.7	2.9
Non-hydrocarbon	9.8	12.1	5.5	9.7	10.1
Real merchandise imports (percentage change)	8.0	20.5	16.1	11.5	12.2

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

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

Table 5. Islamic Republic of Iran: Central Bank Balance Sheet, 2002/03–2006/07
(In billions of rials, unless otherwise indicated)

	2002/03	2003/04	2004/05	Proj. 2005/06	Proj. 2006/07
Net foreign assets	151,492	192,358	279,863	418,528	554,646
Foreign assets	173,046	209,646	294,783	433,861	569,979
in millions of U.S.dollars	*21,745*	*24,834*	*33,294*	*47,678*	*62,636*
Foreign liabilities	21,553	17,288	14,920	15,333	15,333
in millions of U.S.dollars	*2,708*	*2,055*	*1,685*	*1,685*	*1,685*
Net domestic assets	-7,196	-40,036	-98,080	-196,473	-256,337
Net domestic credit	40,144	19,685	-15,281	-97,724	-157,508
Central government	-5,391	-22,756	-57,206	-143,411	-203,195
Claims	104,913	102,222	97,010	97,010	97,010
Deposits	110,304	124,978	154,216	240,422	300,205
Claims on banks	25,654	23,542	21,493	23,213	23,213
Claims on NFPEs	19,880	18,898	20,432	22,475	22,475
Other items net, excluding CPPs	-47,340	-59,720	-82,799	-98,748	-98,829
Base money	127,245	135,675	161,532	207,055	276,308
Currency	37,176	42,106	48,477	55,749	64,111
Currency in circulation	34,780	38,733	44,772	51,488	59,211
Cash in vaults	2,396	3,373	3,705	4,261	4,900
Reserves	81,356	86,605	102,723	132,959	177,950
Required reserves	62,569	76,513	94,573	125,462	170,827
Excess reserves	18,787	10,093	8,149	7,497	7,123
Deposits of NFPE and municipalities	8,713	9,229	10,332	18,347	34,247
Other liabilities					
Participation Papers (CPPs)	17,052	16,648	20,250	15,000	22,000
Memorandum items:					
End-period change (in percent of base money)					
Base money	21.0	6.6	19.1	28.2	33.4
NFA	38.9	32.1	64.5	85.8	65.7
NDA (net of CPPs)	-17.9	-25.5	-45.4	-57.7	-32.3

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

Table 6. Islamic Republic of Iran: Monetary Survey, 2002/03–2006/07 1/
(In billions of rials; unless otherwise indicated)

		Act.	Adj. 3/		Proj.	
	2002/03	2003/04		2004/05	2005/06	2006/07
Net foreign assets	133,010	131,966	131,966	288,805	414,045	549,146
Foreign assets	224,403	271,530	271,530	548,992	721,750	857,072
Foreign assets of BMJII	173,046	209,646	209,646	294,783	433,861	569,979
Foreign assets of banks	51,357	61,885	61,885	254,209	287,889	287,093
Foreign liabilities	91,393	139,564	139,564	260,187	307,705	307,926
Foreign liabilities of BMJII	21,553	17,288	17,288	14,920	15,333	15,333
Foreign liabilities of banks	69,840	122,277	122,277	245,266	292,372	292,593
Net domestic assets	321,011	433,535	433,535	451,730	552,989	752,822
Net domestic credit	460,680	624,906	730,664	875,530	1,038,760	1,293,593
Net credit to government	-5,898	-24,387	-24,387	-51,819	-136,863	-204,767
Claims on NFPEs	77,210	78,869	78,869	87,217	95,939	103,285
BMJII	19,880	18,898	18,898	20,432	22,475	22,475
Banks	57,330	59,971	59,971	66,786	73,464	80,811
Claims on the private sector in rials	327,073	454,800	454,800	625,715	839,502	1,148,752
Claims on private sector in foreign currency 2/	62,295	115,623	221,382	214,417	240,182	246,323
Other items, net, excluding CPPs	-139,669	-191,371	-297,129	-423,801	-485,771	-540,771
Broad money (M3)	454,021	565,501	565,501	740,535	967,034	1,301,968
M2	422,887	533,560	533,560	692,707	911,042	1,229,572
Cash	34,780	38,733	38,733	44,772	51,488	59,211
Deposits	388,107	494,828	494,828	647,935	859,554	1,170,361
Demand deposits	153,235	185,588	185,588	214,883	266,273	375,364
Time deposits	234,871	309,240	309,240	433,052	593,281	794,997
CPPs held by nonbanks	17,052	16,648	16,648	20,250	15,000	22,000
Foreign exchange deposits	14,082	15,292	15,292	27,578	40,992	50,396
Memorandum items:						
M1	188,015	224,321	224,321	259,655	317,761	434,575
M2	422,887	533,560	533,560	692,707	911,042	1,229,572
Multiplier (M2/base money, excl. sterilization)	3.32	3.93	3.93	4.29	4.40	4.45
Income velocity of M2	2.17	2.05	2.05	2.00	1.89	1.73
GDP	916,465	1,095,717	1,095,717	1,382,608	1,723,454	2,124,369
End-period percentage changes:						
NFA	37.7	-0.8	...	118.8	43.4	32.6
NDA	29.4	35.1	...	4.2	22.4	36.1
Base money	21.0	6.6	...	19.1	28.2	33.4
M1	27.9	19.3	...	15.8	22.4	36.8
M2, excl. foreign currency deposits and CPPs	30.1	26.2	...	29.8	31.5	35.0
M3	31.7	24.6	...	31.0	30.6	34.6
Credit to the private sector and NFPEs in rials	30.9	32.0	...	33.6	31.2	33.8
Credit to private sector in rials	34.9	39.1	...	37.6	34.2	36.8
Total claims on private sector	38.4	46.5	...	24.2	28.5	29.2

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

1/ The Iranian fiscal year ends March 20.
2/ Includes on-lending of OSF resources and claims under letters of credit for trade financing.
3/ Letters of credit opened by residents were reclassified from other items net to claims on the private sector in foreign currency in October 2004. The retroactive adjustment for end-2003/04 is Rls. 106 trillion. Growth rates are calculated based on the adjusted data for 2003/04.

Table 7. Islamic Republic of Iran: Baseline Medium-Term Scenario Under Current Policies, 2002/03–2010/11 1/

			Est.	Proj.					
	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
Oil and Gas Sector									
Total oil and gas exports (in billions of U.S. dollars)	23.0	27.4	36.8	49.4	55.5	57.6	57.3	57.4	55.6
Average oil export price (in U.S. dollar/barrel)	27.2	28.0	35.9	50.6	55.2	55.4	53.8	53.0	50.5
Crude oil production (in millions of barrels/day)	3.2	3.8	4.0	4.0	4.2	4.4	4.5	4.6	4.7
	(Annual percentage change unless otherwise indicated)								
National accounts									
Nominal GDP at factor cost (in triillions of Iranian rials)	916.5	1,095.7	1,382.6	1,723.5	2,124.4	2,531.9	3,013.0	3,610.6	4,323.2
Real GDP at market prices	7.5	6.7	5.6	5.9	5.3	5.0	5.0	5.0	4.8
Real GDP at factor cost	7.4	6.7	4.8	6.0	5.4	5.0	5.0	5.0	4.8
Real oil and gas GDP	5.1	7.6	2.6	2.6	5.0	5.1	4.9	4.7	4.5
Real non-oil GDP	7.8	6.6	5.1	6.4	5.4	5.0	5.0	5.0	4.9
Inflation rate									
CPI inflation (average)	15.8	15.6	15.2	13.0	17.0	17.0	17.0	17.0	17.0
GDP deflator at factor cost	28.3	12.1	20.4	17.6	17.0	13.5	13.3	14.1	14.2
Unemployment rate	12.2	11.2	10.3	11.0	11.2	11.7	12.2	12.7	13.2
	(In percent of GDP at market prices)								
Investment and savings									
Investment	36.5	39.3	37.6	37.3	36.1	34.1	32.2	30.1	28.0
Change in stocks	8.3	10.5	8.2	6.5	5.3	4.4	3.7	3.1	2.6
Total fixed capital investment	28.2	28.8	29.3	30.8	30.8	29.7	28.5	27.0	25.4
Public	10.6	9.8	10.2	10.5	12.7	12.4	11.9	11.1	9.8
Private	17.5	19.0	19.1	20.3	18.0	17.2	16.6	15.8	15.7
Gross national savings	39.5	39.9	40.0	43.8	42.0	38.5	34.7	31.1	27.5
Public	14.8	15.6	16.4	21.3	22.8	20.9	18.0	15.3	11.9
Private	24.7	24.2	23.6	22.4	19.2	17.6	16.7	15.8	15.6
Savings/investment balance 2/	3.1	0.6	2.5	6.4	5.9	4.4	2.5	1.0	-0.5
	(In percent of GDP at factor cost, unless otherwise indicated)								
Budgetary operations									
Revenue	27.1	27.9	31.0	33.1	31.1	29.5	27.1	25.1	22.7
Oil	16.3	16.8	19.1	21.8	20.2	18.0	15.1	12.6	10.1
Non-oil	10.8	11.1	11.9	11.2	10.9	11.4	12.0	12.5	12.6
Expenditure and net lending	29.5	28.0	31.4	28.8	28.8	28.7	28.5	28.1	27.0
Of which: current	16.2	16.6	19.0	19.6	18.7	18.8	18.9	18.6	18.4
capital	6.1	5.3	5.5	5.7	7.0	6.8	6.5	6.1	5.4
Balance	-2.4	-0.1	-0.4	4.3	2.3	0.8	-1.5	-3.0	-4.3
Domestic financing	0.9	0.6	1.2	-4.2	-2.2	-0.5	1.6	2.1	3.6
External financing	1.5	-0.5	-0.8	-0.1	0.0	-0.3	-0.1	1.0	0.7
Non-oil balance	-18.7	-16.9	-19.5	-17.6	-18.0	-17.3	-16.5	-15.6	-14.4
Non-oil balance to non-oil GDP	-24.3	-22.0	-26.1	-24.4	-24.9	-23.2	-21.5	-19.9	-17.9
Public debt	19.0	18.9	16.1	17.4	14.2	11.4	9.2	8.9	8.5
OSF balance (in milions of dollars)	8,082	8,443	9,435	19,050	25,620	29,496	27,101	22,614	10,152
	(In billions of U.S. dollars, unless otherwise indicated)								
External sector									
Exports of goods and services	33.3	40.2	51.4	65.9	74.4	78.9	80.8	83.1	83.6
Imports of goods and services	-30.6	-40.3	-48.4	-54.7	-61.9	-68.0	-74.1	-81.0	-88.3
Current account balance	3.6	0.8	4.0	12.7	14.2	12.6	8.5	4.2	-2.4
In percent of GDP	3.1	0.6	2.5	6.4	5.9	4.4	2.5	1.0	-0.5
External public and publicly guaranteed debt	9.3	12.1	16.8	17.8	17.4	14.9	12.5	15.4	18.3
Of which: short-term debt	2.1	4.8	10.3	10.6	9.5	8.0	6.5	5.0	3.5
Gross official reserves	21.0	24.7	33.0	47.4	62.3	74.0	81.7	90.4	92.5
In months of the following year's imports of goods and services	6.4	6.3	7.4	9.4	11.2	12.2	12.3	12.6	11.9

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

1/ The Iranian fiscal year ends March 20.

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

Table 8. Islamic Republic of Iran: Vulnerability Indicators, 2000/01–2005/06 1/

	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06 2/
External solvency indicators						
REER (end of period, percent change)	23.0	12.6	-2.0	-3.3	-1.4	13.4
Total public and publicly guaranteed external debt (in billions of U.S. dollars)	8.0	7.2	9.3	12.1	16.8	16.5
(In percent of GDP)	8.3	6.3	8.0	9.1	10.6	7.8 3/
Short-term external debt (in billions of U.S. dollars)	3.7	2.7	2.1	4.8	10.3	10.5
(In percent of GDP)	3.8	2.3	1.8	3.6	6.5	4.9 3/
(In percent of exports of goods and services) 4/	12.2	9.9	6.5	12.4	20.6	16.4
External debt service (in percent of exports of goods and services) 4/ 5/	12.2	7.4	3.7	4.5	6.4	...
External liquidity indicators						
Total official reserves (in billions of U.S. dollars)	12.7	17.4	21.0	24.7	33.0	38.3
In months of the following year's imports of goods and services 4/	7.0	7.1	6.4	6.3	7.4	7.6
In percent of short-term external debt	345	658	1009	515	322	365
Commercial banks net foreign assets (in billions of U.S. dollars)	-0.6	-1.8	-2.3	-7.3	1.0	16.4
Foreign assets	5.1	5.6	6.4	7.5	28.6	30.0
Foreign liabilities 6/	5.7	7.4	8.8	14.7	27.6	13.6
Oil and oil-related exports (in percent of exports of goods)	85.3	80.9	81.3	80.5	82.9	84.9
Public sector solvency indicators						
Public and publicly guaranteed debt (in percent of GDP)	22.7	20.6	19.0	18.9	16.1	...
Oil revenue (in percent of total revenue)	67.5	57.0	60.3	60.3	61.7	...
Financial sector indicators						
Risk-weighted capital adequacy of banks (in percent) 7/	6.6	6.9	4.5	7.2	8.8	...
Ratio of nonperforming loans of banks (in percent) 7/	4.4	5.4	5.7	5.2	7.0	...
Loan provisions as a percentage of nonperforming loans	37.3	31.0	36.7	50.0	42.1	...
Net profit margin of banks to total assets (in percent)	...	2.2	2.5	2.1	2.7	...
Net domestic credit (percent change)	14.8	26.0	62.5	35.6	40.1	13.4
Private sector credit in local currency (percent change)	31.1	34.1	34.9	39.1	37.6	34.4
Net domestic credit (in percent of GDP)	46.2	42.7	50.3	57.0	63.3	48.7 3/
Market assessment/financial market indicators						
Stock market price index (percent change; end-of-period)	35.0	26.2	34.7	124.8	19.3	-14.6 8/
Stock market capitalization (in percent of GDP)	10.8	12.3	12.9	28.3	29.9	20.0 3/ 8/
Fitch sovereign rating	…	B+	B+	B+	BB-	...

Sources: Iranian authorities; and Fund staff estimates.

1/ The Iranian fiscal year ends March 20.
2/ Second quarter, unless otherwise indicated.
3/ Staff forecasts for GDP.
4/ Excluding interest receipts and payments.
5/ Excluding service of short-term external debt.
6/ Including contingent liabilities under letters of credit. The substantial increase in 2003/04 arises from a reclassification in line with STA recommendations.
7/ Islamic banks exhibit important differences in their risk profile and asset classification, which limit international comparability.
8/ January 2006.

Islamic Republic of Iran: Fund Relations

As of December 31, 2005

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

II. General Resources Account

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

III. SDR Department

	SDR Million	Percent of Allocation
Net cumulative allocation	244.06	100.00
Holdings	274.66	112.54

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements: None

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

	Forthcoming				
	2006	2007	2008	2009	2010
Principal					
Charges/Interest	0.02	0.02	0.02	0.02	0.02
Total	0.02	0.02	0.02	0.02	0.02

Nonfinancial Relations

VII. Exchange System

On March 21, 2002, a unified exchange rate regime, based on a managed floating exchange rate system, was adopted and the former official exchange rate of Rls 1,750 per U.S. dollar was abolished. The new exchange rate is determined in the interbank foreign exchange market. As a result, effective March 30, 2002, the exchange rate arrangement of the Islamic Republic of Iran has been reclassified to the category of managed floating with no preannounced path for the exchange rate from the conventional pegged arrangement. Under the 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.

With effect from September 6, 2004, the Islamic Republic of Iran accepted the obligations under Article VIII, Sections 2,3, and 4 of the Fund's Articles of Agreement. Prior to March 21, 2002, the foreign exchange market operated mostly under a multiple exchange system, consisting of two officially approved rates: (a) an official exchange rate pegged at Rls 1,750 per U.S. dollar that applied mainly to imports of essential goods and services as well as servicing public and publicly guaranteed debt; and (b) an effective Tehran Stock Exchange (TSE) rate, applicable for imports from a positive list issued by the Ministry of Commerce. There was also an unofficial exchange market and the CBI allowed commercial banks limited access to this market to cover certain current transactions.

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

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

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

- Budget subsidies for foreign exchange purchases in connection with payments of certain letters of credit opened prior to March 21, 2002 under the previous multiple exchange rate system; and

- Obligation of entities that had received allocation of foreign exchange for payments based on subsidized "allocated rates" under the previous multiple exchange rate system to surrender unused allocations to the CBI at the allocation rate.

VIII. Last Article IV Consultation

The last Article IV consultation was concluded by the Executive Board on September 10, 2004.

IX. Technical Assistance

Since FY 1999, Iran received the following technical assistance:

FAD

FY 1999 - Tax system and VAT

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

MFD

FSAP

FY 2000 - FSAP mission
FY 2001 - Follow-up 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
FY 2004	-	Article VIII acceptance mission

STA

FY 2000	-	Balance of payment statistics
	-	Government finance statistics
	-	National accounts statistics
FY 2002	-	Monetary and financial statistics
FY 2003	-	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
FY 2004	-	Follow-up mission on progress in meeting SDDS requirements
FY 2005		Follow-up mission on progress in meeting SDDS requirements in balance of payments and international investment position

ISLAMIC REPUBLIC OF IRAN: RELATIONS WITH THE WORLD BANK GROUP

(As of January 31, 2006)

1. As of January 31, 2006, Iran received 54 World Bank loans totaling $3,163 million net of cancellations and terminations, of which $1,989 million have been disbursed. The ongoing portfolio consists of nine loans in the total amount of $1,355 million, of which $1,167 million remain undisbursed.

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

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

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

5. The International Finance Corporation's (IFC) support of the World Bank's program for Iran will focus on selected investments as well as technical assistance and advisory services. IFC's activities will support the private sector supply response that Iran needs to achieve higher and sustained growth and accelerate job creation. IFC will support the establishment of a modern, open, and competitive financial sector, a cornerstone for private sector development. As of January 31, 2006, IFC's committed portfolio in Iran was $29 million, primarily in the financial sector.

6. Iran became a full member of the Multilateral Investment Guarantee Agency (MIGA) in December 2003. In May 2005, MIGA has issued $122 million in guarantee coverage for a joint venture petrochemical project, its first coverage ever for a project in Iran. At present, MIGA is considering several arrangements to provide coverage for both inward and outward investment. There appears to be significant potential demand for MIGA guarantees among Iranian investors venturing abroad. As the Iranian government and Iranian companies become more aware of MIGA's potential value added in South-South transactions, MIGA may see more requests for coverage, especially for transactions with neighboring countries like Afghanistan and Iraq.

Islamic Republic of Iran: Statistical Issues

Iran's data provision to the Fund is adequate for effective surveillance,; however, adequate and timely consolidated fiscal data for both the central government and Oil Stabilization Fund (OSF) are still lacking. The data transmitted to the Fund, through direct contacts with the authorities and/or through the Executive Director's office, provide a basis for adequate assessment of economic developments and a realistic perspective on Iran's medium-term prospects. The Central Bank of Iran's new Economic Accounts Department has implemented significant improvements in the statistical database, including the regarding 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 release 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. In December 2003 and June 2004, STA reviewed data dissemination practices and further advised the authorities on the steps needed to subscribe to the Special Data Dissemination Standard (SDDS).

Real sector statistics

- National accounts statistics are reasonably sound. The CBI has updated the quarterly GDP statistics for the period 1988–2003. Most of the recommendations made by the 1999 STA mission have been fully implemented, most notably concerning the change of the base year to 1997/98 for the constant price calculations; implementation of the *1993 SNA*; and the development of quarterly national accounts. Improvements have also been made in the coverage of the informal economy. However, there is scope for further work, especially in the coverage of small-scale industries and services. Also, the recommended joint project between the CBI and the Statistical Center of Iran (SCI) to compare and analyze the two sets of estimates of GDP they compile is pending.

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

Government finance statistics

- One significant improvement has been the adoption of the classification recommended by the *Government Finance Statistics Manual, 2001 (GFSM 2001)* Government Finance Statistics (GFS) classification for the core central government operations which will enhance transparency and help improve fiscal management.

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

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

- Only experimental data for the consolidated central and general government, comprising the central government and the municipalities, are compiled. The preliminary data are compiled with a sample of municipalities (including all the large municipalities and a reduced number of smaller local governments). About one or two years later more complete municipalities data are used to compile the final estimates. Based on the available information, these data are not disseminated, although they are used for compiling the SNA.

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

- Financing data in the GFS are not broken down by residency of debt holders or by type of debt instruments. Data used by the Economic Research and Policy Department (ERPD) for preparing financing data could be further analyzed to distinguish debt by type of holder and by instrument. The discrepancy between fiscal and monetary data on deficit financing remains has often been relatively large. From an SDDS perspective, this discrepancy raised questions about the accuracy of the fiscal data. The SDDS missions held a number of meetings with the authorities with the objective of explaining ways to improving improve the collection and classification of government debt. No information is available on the status of the implementation of these recommendations.

- 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 debt held by nonbanks, with the public at large, or economic sectors excluding the banking sector, mainly in the form of Government Participation Papers (GPP), is not monitored. There is a need to develop a comprehensive database on domestic public debt, with a breakdown by domestic creditor.

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

Monetary statistics

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

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

- The measure of broad money employed by the CBI does not include deposits of public nonfinancial corporations, local government, and or foreign-currency deposits of residents. As a result, the broad money stock tends to be underestimated.

- In the CBI's analytical accounts, central bank participation papers (CPPs) are included in other unclassified liabilities. Separate data on holdings of CPPs broken down by bank holders and nonbank holders should be collected in the CBI monthly report. These Disaggregated separate data will allow the CBI and other data users to construct broader liquidity measures, which will 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 implemented in line with the methodological guidelines of the Fund's *Balance of Payments Manual*, fifth edition *(BPM5)* and is being put in operation. Periodic dissemination of balance of payments presentation based on *BPM5* is expected later this year.

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

Moreover, the balance of payments has been revised to better reflect buy-back transactions under direct investment and other balance of payments entries.

- Data on the international investment position are compiled, but not disseminated. Only data on public and publicly guaranteed debt are compiled and disseminated, but classifications do not fully accord with the guidelines of the *External Debt Guide*. The data template on international reserves and foreign currency liquidity is not compiled; the June 2004 STA mission provided technical advice on the methodology and compilation aspects of this dataset.

ISLAMIC REPUBLIC OF IRAN: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

(As of January 24, 2005)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	Dec 2005	Jun 2006	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]					
Reserve/Base Money	June 2005	Sept 2005	M	M	Q
Broad Money	June 2005	Sept 2005	M	M	Q
Central Bank Balance Sheet	June 2005	Sept 2005	M	M	Q
Consolidated Balance Sheet of the Banking System					
Interest Rates[2]	June 2005	Sept 2005	M	M	Q
Consumer Price Index	Oct 2005	Jan 2006	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]					
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government					
Stocks of Central Government and Central Government-Guaranteed Debt[5]					
External Current Account Balance	Mar 2004	Jun 2004	M	M	Q
Exports and Imports of Goods and Services					
GDP/GNP	Dec 2004	Oct 2005	Q	Q	Q
Gross External Debt					

1/ Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
2/ Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
3/ Foreign, domestic bank, and domestic nonbank financing.
4/ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
5/ Including currency and maturity composition.
6/ Daily (D), weekly (W), monthly (M), quarterly (Q), annually (A), irregular (I), and not available (NA).

Statement by the IMF Staff Representative
March 10, 2006

Since the issuance of the Staff Report, the following information has become available to staff. This information does not alter the thrust of the staff appraisal.

1. CPI inflation declined from an annual rate of 11.3 percent in December 2005 to 10.7 percent in January 2006. In the twelve months ending in January 2006, the average inflation rate was in line with the staff projection for the Iranian year 2005/06 as a whole. Preliminary information for the quarter ending in December 2005 indicates that monetary aggregates continued to grow rapidly, with broad money increasing at an annual rate of 33 percent. At Rls 9,131 per U.S. dollar at the end of February 2006, the bilateral exchange rate has been stable, having depreciated by only 0.4 percent in the last two months.

2. Based on preliminary information, the balance of payments' current account surplus is likely to exceed the staff projections for 2005/06. This reflects strong performance of non-oil exports, while the growth of imports seems to have been relatively contained.

3. Developments in the stock market have been mixed. After staging a moderate recovery from the low level reached in November 2005, trade on the Tehran Stock Exchange weakened, and the main price index dropped by 4 percent during the two months January-February 2006.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 06/34
FOR IMMEDIATE RELEASE
March 27, 2006

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

IMF Executive Board Concludes 2005 Article IV Consultation with the Islamic Republic of Iran

On March 10, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Islamic Republic of Iran.[1]

Background

During the Third Five-Year Development Plan (TFYDP, 2000/01–2004/05), real GDP growth reached 5½ percent a year on average, unemployment declined, and macroeconomic indicators improved significantly, supported by favorable oil market conditions. By increasing the openness of the economy and removing major obstacles to trade and investment, the reforms introduced in the period 2000/01–2002/03 contributed significantly to this strong performance. Many challenges, however, lie ahead. The economy remains heavily dependent on oil and demographic dynamics will put increasing pressure on the labor market in the coming years. Expansionary fiscal and monetary policies have kept inflation relatively high at about 15 percent. Extensive administrative controls, widespread subsidies, and labor market regulations impose substantial efficiency costs.

On the back of favorable external conditions and an expansionary policy stance, growth resumed in 2005/06 after a temporary slowdown in the previous year. Activity has been strong, mostly in the non-hydrocarbon sector, and real GDP growth is expected to accelerate to about 6 percent in 2005/06. Unemployment, however, has continued to hover around 11 percent. Reflecting the impact of improved weather conditions on food

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

prices, the price freeze on certain goods and services, and some exchange rate appreciation, inflation is expected to decline to 13 percent in 2005/06.

Government spending, particularly on subsidies, has continued to increase on the back of higher oil revenue, and the non-oil deficit is expected to remain high. As external developments became increasingly favorable and fiscal policy remained expansionary, the central bank allowed the exchange rate to appreciate in nominal effective terms in 2005/06. However, export growth continued apace and the current account surplus is projected to rise to 6½ percent of GDP, with international reserves reaching about $47 billion by year's end, equivalent to 9½ months of next year's imports of goods and nonfactor services. External debt remains low.

As oil-related inflows grew larger, and fiscal policy remained expansionary, the central bank increased its unsterilized purchases of foreign currency to limit the exchange rate appreciation. The monetary impact of these purchases was only partially offset by a tightening of the banks' access to the central bank credit facility, while the use of its participation papers (central bank bonds complying with Islamic finance principles) was not sufficient to mop up excess liquidity. Overall, the desired slowdown in money growth was not achieved. After having experienced rapid growth in previous years, the stock market lost about 20 percent of its value in 2005/06, reflecting uncertainty in connection with the presidential election and the negotiations on Iran's nuclear program.

Progress on structural reforms has been uneven. While financial system reform has continued, no decision has been taken on the key reform of energy subsidies, despite the increasing economic and environmental costs of the current system. The amendment of article 44 of the constitution—which delineates the domains of activity of the public sector, the cooperative sector, and the private sector—opens the door to the privatization of both financial and nonfinancial enterprises. Although this change is an important legal step, the scope and modalities of actual privatization plans are yet to be determined.

The short-term outlook is relatively favorable. Economic activity will continue to be boosted by high oil prices, although inflation could start rising again, unless the policy stimulus is reigned in. Reflecting large current account surpluses, the external debt would decline. In the medium term, however, prospects look challenging. Oil price volatility and capacity constraints in the oil sector, international tensions over the nuclear issue, and the possibility of a prolonged period of "wait and see" on the part of the private sector could adversely affect the economic outlook.

Executive Board Assessment

Executive Directors observed that real GDP growth has been robust in 2005/06 and the external position has strengthened as a result of the structural reforms implemented at the beginning of the TFYDP, favorable oil market conditions, and an expansionary policy stance. However, Directors expressed concern over the persistent high inflation that hurts the poor and fixed-income earners, the slower pace of structural reforms, and the vulnerability of the economy to a potential decline in oil prices. Directors considered that the key medium-term challenge will be to sustain high growth rates in the non-oil sector to increase employment opportunities and improve the living standard of the population. To address this challenge in an effective and sustainable way, it will be crucial to reduce inflation significantly by tightening financial policies and to accelerate the momentum for structural reforms to stimulate private sector development, lessen the dependence on the oil sector, and enhance economic efficiency, consistent with the objectives of the Fourth Five-Year Development Plan (FFYDP).

Directors noted that the substantial pro-cyclical fiscal stimulus in recent years has contributed to maintaining double-digit inflation, and underscored the need to reduce the pace of fiscal expansion and to build up precautionary savings in the Oil Stabilization Fund (OSF), consistent with the original objectives in the OSF legislation. In this context, Directors cautioned against using OSF resources to further increase government spending, as envisaged in the proposed budget for 2006/07. They recommended instead a vigorous fiscal consolidation with a reduction in government outlays in relation to GDP and implementation of revenue-enhancing measures through a broadening of the tax base and an accelerated pace of introduction of the Value Added Tax, which has been in the preparation stage for a number of years. Moreover, Directors emphasized the need for fiscal policy to be anchored within a medium-term framework to help reduce its pro-cyclicality and improve policy coordination. Directors noted with concern the size of the growing and ill-targeted subsidies, particularly on energy, which have harmful economic and environmental consequences. They welcomed the indications that the authorities plan to gradually phase out implicit energy subsidies and reduce explicit subsidies, in order to enhance economic efficiency and channel resources toward more productive uses. Accordingly, Directors urged an expeditious design and implementation of a phased program of overhauling the system, with clear time-bound reduction targets, as well as an efficient social safety net to protect the vulnerable groups.

Directors called for a tightening and a more effective use of monetary policy instruments to lower inflation to single-digit levels, consistent with the FFYDP. They welcomed the reduction in access to the central bank's overdraft facility and increased use of central bank participation papers, and encouraged a more active use of the open deposit account. While welcoming the recent steps, as well as the measures to increase the operational independence of the central bank under the FFYDP, Directors expressed concern about the new requirement of parliamentary approval for the issuance of central bank participation papers, which limits the flexibility of central bank operations in managing domestic liquidity. They noted that administrative controls on the rates of return charged on bank loans and on central bank participation papers and the continuation of directed credit hinders financial intermediation. Directors urged the authorities to remove these administrative controls and allow the rates of return to be market-determined to strengthen financial intermediation. More generally, Directors noted that a credible and successful disinflation effort will require a clearer mandate for the central bank and more effective policy instruments at its disposal. They considered that the upcoming review of the central bank law offers a good opportunity to address these issues in a decisive manner. The authorities were commended for enacting Anti-Money Laundering/Combating Financing of Terrorism legislation, and were urged to implement it expeditiously.

Directors noted that the exchange rate had been allowed to appreciate somewhat, reflecting more favorable external conditions, but, given that the fiscal stance continues to impart an expansionary impulse to the economy, they stressed the need for greater exchange rate flexibility to help contain inflationary pressures. Looking forward, Directors emphasized that the concerns on the exchange rate policy for competitiveness should be addressed by reinvigorating implementation of structural reforms and major improvements in the business climate.

Directors welcomed the progress made in establishing a risk-based supervision framework and other reforms aimed at improving the functioning of financial markets. However, they expressed concern that the continued increase in nonperforming loans and the rapid credit growth could exacerbate potential weaknesses in the financial system. Directors encouraged the authorities to further strengthen the supervision of banks, insurance companies, and securities markets. They commended the authorities for licensing additional private banks and insurance companies and encouraged them to continue opening up the banking sector to private sector participation, including through privatization, which had been made possible by the amendment to Article 44 of the constitution.

Directors underscored the importance of fostering private sector development to sustain strong growth and employment creation. They encouraged the authorities to focus on reducing the administrative and regulatory burden on private sector activities, removing barriers to competition, streamlining labor market regulations, and removing other impediments to efficiency, and accelerating the implementation of the privatization program.

Directors urged prompt action to eliminate the residual exchange restriction on the making of payments and transfers for current transactions, and welcomed the authorities' commitment in this regard.

Directors recognized the progress made in improving data quality and transparency. In particular, they were encouraged by the identification of subsidies in the central government budget. Directors stressed, however, that more work is needed to ensure an adequate and timely monitoring of public sector operations. Accordingly, they encouraged the authorities to develop a consolidated public sector balance sheet with possible technical assistance from the World Bank and the IMF. They urged the authorities to complete the requirements for full compliance with the Special Data Dissemination Standard.

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

Islamic Republic of Iran: Selected Economic Indicators

	2000/2001	2001/2002	2002/2003	2003/04	2004/05
Real GDP growth (factor cost, percentage change)	5.0	3.3	7.4	6.7	4.8
CPI inflation (period average, percentage change)	12.6	11.4	15.8	15.6	15.2
Unemployment rate (percent)	14.1	14.7	12.2	11.2	10.3
Central government balance (percent of GDP)	8.7	1.8	-2.4	-0.1	-0.4
Broad money growth (percentage change)	30.5	25.8	30.1	26.2	29.8
Current account balance (percent of GDP)	13.1	5.3	3.1	0.6	2.5
Overall external balance (percent of GDP)	6.9	3.9	4.1	2.1	5.2
Gross international reserves (billions of U. S. dollars)	12,176	16,616	20,965	24,675	32,993
Public and publicly guaranteed external debt (billions of U.S. dollars)	7,953	7,215	9,250	12,100	16,831
Exchange rate (period average, rials per U.S. dollar)	8,078 1/	7,921 1/	7,967	8,282	8,719

Sources: Iranian authorities, and IMF staff estimates.

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

Statement by Abbas Mirakhor, Executive Director for Islamic Republic of Iran
March 10, 2006

My authorities thank staff for the frank, candid, and fruitful dialogue, appreciate their hard work in preparing this year's Article IV consultation report, and concur with the thrust of their appraisal. The new government, which assumed office in August 2005, is aware of the need to address the challenges ahead—including increasing employment opportunities for the growing labor force, containing inflation, and reducing the economy's dependence on oil—and is committed to continued implementation of the ambitious reform agenda envisaged in the Fourth Five-Year Development Plan (FFYDP) and the Twenty-Year Vision.

Developments in 2004/05-2005/06

As the staff report notes, growth decelerated in 2004/05 to 4.8 percent due to adverse weather conditions, slowdown in construction activities, and capacity constraint in the hydrocarbon sector. Activity is expected to strengthen in 2005/06 to 6 percent, supported by buoyant aggregate demand and recovery of the construction and agricultural sectors. Inflation has declined to an average of 13 percent in 2005/06 as a result of lower prices of tradable goods and house rents as well as the price freeze on food and petroleum products. Unemployment also receded to an eight-year low of 10.3 percent in 2004/05 as job creation exceeded the flow of new entrants to the labor market. External position improved on account of high oil prices and strong non-oil exports, and gross official reserves increased further. The structural reforms implemented during the TFYDP have resulted in rapid growth of the non-oil sector at a rate exceeding the pace of growth in the overall economy for the fifth consecutive year. In addition, reforms have resulted in the steady growth of TFP. Living standards have improved with per capita income increasing, on average, by 4 percent. According to a recent study by the central bank, income distribution has improved as the Gini index has declined by 2 percentage points to about 40 percent.

Fiscal transparency was improved in 2004/05 as implicit subsidies, including on imported oil products, were incorporated in the budget. This, combined with additional current spending, resulted in deterioration of the overall fiscal deficit even though government revenues increased substantially. For the first time in four years, the overall fiscal balance is expected to turn positive in 2005/06 reflecting higher oil revenues and expenditure restraint in the second half of the year. Capital expenditure remained broadly constant in GDP terms and the increase in subsidies was more than offset by higher oil revenues.

Monetary policy remained accommodative despite central bank's efforts to control liquidity. The growth in broad money was around 30 percent in 2004/05, of which 23 percent was due to an increase in net foreign assets. To mop up the additional liquidity, the central bank issued CBPPs for 5 trillion rials. In 2005/06, it reduced credit to banks and allowed the exchange rate to appreciate. The Money and Credit Council (MCC) unified the minimum lending rate at 16 percent, one percentage point higher than the previous average of a plethora of lending rates. There is no ceiling on the lending rate and, with an inflation rate of 13 percent, there is a positive real rate of return.

The central bank has been granted organizational independence. The Governor of the central bank now chairs the MCC—formerly chaired by the Minister of Finance—and is directly appointed by the President. With a share of about 9 percent of total assets and 12 percent of deposits, private banks have rapidly increased their market share since they began operating in 2001. There are currently five private banks on the mainland, and two foreign banks operating in the free-trade zones without any restriction. Two private banks and three non-bank credit institutions have been licensed recently. Banks' profitability has improved and, for the first time, their capitalization exceeded the 8 percent level recommended by the Basel I Capital Adequacy Accord. The share of credit subject to mandatory allocation has been further reduced to about 25 percent, banking supervision has strengthened, and offshore banks are being supervised in accordance with the regulations for mainland banks. The stock market has begun to stabilize, the new capital market law has been enacted, and further steps have been taken to strengthen infrastructure and regulation of the stock exchange. A new portfolio investment law has been approved by the Council of Stock Exchange to regulate foreign investment in the stock market.

Despite higher imports stemming from trade liberalization and strong domestic demand, the external position remained favorable, underpinned by high international oil prices and strong non-oil exports, with a declining trend of the external debt-to-GDP ratio, and a rapid accumulation of international reserves. In 2004/05, the current account surplus reached 2.5 percent of GDP. The rapid growth in exports continued in 2005/06 and is projected to increase the current account surplus to 6.5 percent of GDP. The external debt that had increased in 2004/05 due to a larger use of letters of credit for trade finance has been curbed by a tightening of prudential control.

Under a new privatization strategy, a number of restructured firms have been grouped in holding companies and 30 percent of their shares, called "justice shares," will be transferred to low-income families at market prices to be paid from future dividends. This scheme has already been initiated in four provinces. The remaining 70 percent of the share will be privatized through the stock exchange. As a result of this privatization strategy, the market capitalization is expected to increase by 100 percent before the end of 2006. The new legislation on AML/CFT, recently approved by parliament, awaits the approval of the Guardian Council, the body responsible for ensuring consistency of all legislation with the constitution. In addition, a law on bank corporate governance is under discussion in the parliament. An important decision has been made to allow majority private-sector ownership of enterprises in key sectors of the economy; accordingly, the sale of up to 65 percent of shares in most state-owned companies is now permitted. This will further enhance the private sector share in non-oil economic activities which, in terms of value added, has grown to an estimated 71 percent of the total. In the trade area, following the earlier important liberalization efforts, the simple average tariff was reduced further to 22.6 percent from 25.7 percent. A working party for accession to WTO was established on May 26, 2005.

Near-term prospects and policies

The growth momentum is expected to continue as the GDP is projected to grow by 5.8 percent in 2006/07. Fiscal policy will be guided by the objectives of the FFYDP, and fiscal prudence strengthened through revenue enhancement and expenditure restraint. The 2006/07 budget is being discussed by the parliament, and a 20-25 percent cut in expenditures has been proposed by a special committee charged with the initial vetting of the budget. The parliament has reiterated that the rule on no-government borrowing from the central bank will be strictly enforced. Efforts are underway to strengthen tax administration and reduce exemptions, while preparations for the implementation of the VAT in 2006/07 are progressing.

Monetary policy will aim at containing broad money growth to about 24 percent to reduce inflationary pressures. To mop up excess liquidity, the central bank has been authorized to issue additional CBPPs, as needed. The managed floating exchange rate regime continues to serve the economy well and competitiveness remains satisfactory, as evidenced by the strong growth of non-oil exports. It has also provided stability to the market and has helped contain the rapid growth of imports and build up reserves. The exchange rate policy will continue to balance concerns for competitiveness and disinflation. In the external sector, increased non-oil exports and high oil prices are expected to keep the current account at a surplus of 6 percent of GDP. External debt is set to decline, while gross official reserves, including the OSF, are projected to increase further.

The authorities are fully aware that an accelerated pace of implementation of structural reforms is needed to improve total factor productivity growth and enhance competitiveness. They intend, therefore, to press ahead with their reform agenda. They will continue to improve financial operations and management of public enterprises and take steps to enhance private-sector participation in the economy. To strengthen the growth of the private sector, access to credit to small- and medium-size firms will be further improved. The monetary and banking law has been reviewed and a bill is under preparation with new amendments to enhance the effectiveness of monetary policy, including transfer of the authority of issuing participation papers back to the central bank, given to parliament in 2004/05. A rial interbank market, incorporating Real Time Gross Settlement System (RTGS), will become operational in 2006/07. Efforts at improving the legal and economic environment for foreign direct investment will continue.

Medium-term policies

The authorities recognize the need to improve substantially the productive utilization of the country's considerable resources. On the fiscal front, they intend to reduce dependency on oil revenues. In line with the objective of the FFYDP, this includes gradual phasing out of implicit energy subsidies, reduction in explicit subsidies, strengthening of the non-oil revenue base, reducing tax exemptions, and improving expenditure management. In the financial area, they plan to implement a broad reform and liberalization agenda, including establishment of a dynamic and competitive banking system. Privatization of four state-owned banks is on the agenda; they are being restructured to facilitate their sale under the amendment to Article 44 of the Constitution. The authorities have requested Fund technical assistance in this area.

The FFYDP aims at reducing economic disparities among the provinces through redistribution of budgetary resources and improved living conditions of the poor as well as providing impetus to growth and employment by increasing the role of the private sector in economic activities in line with the amendment of Article 44 of the Constitution. The authorities are fully committed to achieving the poverty and unemployment reduction objectives as well as substantial gains in efficiency and competitiveness as envisaged in the FFYDP, including through labor market reforms and further improved business conditions.

My authorities have high regards for Fund's views, appreciate the advice of the Executive Directors, and look forward to the Board discussion of this year's Article IV consultation report.