INTERNATIONAL MONETARY FUND

ISLAMIC REPUBLIC OF IRAN—2005 ARTICLE IV CONSULTATION

CONCLUDING STATEMENT

December 10, 2005

I. INTRODUCTION

The IMF mission that visited Iran during the period December 3-10 has completed the discussions with the Iranian authorities under Article IV of the IMF's Articles of Agreements. The mission wishes to thank the authorities for their generous hospitality and their valuable assistance, which made its stay in Tehran productive and enjoyable. The main findings and preliminary conclusions of the mission are briefly highlighted below, while a more detailed report will be presented to the IMF Executive Board in due course.

II. OVERALL DEVELOPMENTS IN 2005/06

The Iranian economy continued to benefit from high oil prices in fiscal year 2005/06 and agricultural production recovered following a drought in the previous year. The domestic political environment was marked by the June presidential elections and the subsequent change in government. The authorities have indicated that their economic policies and reform strategy would continue to be guided by the Fourth Five-Year Development Plan (FFYDP) and the Twenty-Year Vision document. Within this framework, the new government has stated its commitment to social justice, elimination of corruption, and reduction of economic disparities among regions.

Against this background, the growth performance of the Iranian economy has remained strong and broad based, with real GDP expected to grow by 6 percent in 2005/06. Unemployment, however, is projected to increase slightly to 11 percent. External indicators, namely the balance of payments' current account, the external debt to GDP ratio, and the level of international reserves have all strengthened. Inflation has declined recently from 15.2 percent, but remains high at 13 percent. This decline mainly reflects lower food prices after a weather-related hike last year; price freezes, including those of highly-subsidized petroleum products; and some effective nominal exchange rate appreciation. The Tehran Stock Exchange has experienced a price correction of about 25 percent since December 2004, reflecting the sharp increase in stock prices in the last two years and uncertainties in connection with the presidential elections and the nuclear program negotiations. After reaching a low in November 2005, equity prices have somewhat recovered.

A. Macroeconomic policies

As in previous years, macroeconomic policies have continued to face the dilemma of how to reconcile the use of abundant oil revenues to foster high growth and employment creation with the need to reduce inflation and preserve the competitiveness of the non-oil sector. The expansionary policy stance, however, has exacerbated tensions between these objectives and the underlying policies, rendering macroeconomic management more difficult.

Fiscal policy

Fiscal policy remained expansionary in 2005/06. As oil revenue accruing to the budget increased by 43 percent, total expenditure — excluding earmarked expenditure — rose by 25 percent over the previous year, or 27 percent in excess of the budgeted amount. The non-oil deficit declined only because of the transfer of profits and revenue from the National Iranian Oil Company to the budget. The increase in government expenditure was largely on current spending, including wages and salaries, and subsidies. The increase in total subsidies partly reflected improved transparency as the cost of subsidizing imported petroleum products and rates of return is now explicitly born out by the budget. However, the level reached by explicit subsidies is very high, both as a share of government expenditure (23 percent) and as a ratio of GDP (6¼ percent). If implicit energy subsidies were included, these shares would reach respectively 48 percent and 22 percent.

In the mission's view, the current fiscal policy poses serious concerns regarding:

i. the optimal use of high oil revenue, a significant portion of which is being allocated to current spending and inefficient and untargeted subsidies, rather than being channeled to quality investment that would strengthen the foundations of sustainable growth;

ii. the risk of loss of credibility of the budget as an instrument of fiscal discipline, as reflected in the frequent recourse to the OSF to finance additional spending during the year; and

iii. the inadequate attention paid to the liquidity and inflationary implications of increased government spending out of oil revenue, which cannot be fully offset through monetary policy instruments.

Monetary policy

Large inflows of foreign exchange connected with oil revenues boosted gross official reserves, which are expected to reach almost 10 months of next-year imports at the end of 2005/06. The central bank encountered many difficulties in sterilizing its foreign currency purchases, which were somewhat exacerbated this year when the authority to approve the issue of central bank participation papers was transferred from the Money and Credit Council (MCC) to the Majlis. Despite a tightening of its credit facilities, the central bank could not slow down significantly liquidity growth. Even after the unification of administratively-set minimum lending rates at 16 percent, these rates remain low in view of the continued rapid credit growth.

The managed float exchange rate regime continued to operate smoothly and allowed some appreciation pressures to be reflected in the nominal effective exchange rate. To compensate for the inflation differential vis-à-vis Iran's trading partners and protect the competitiveness of the non-oil sector, the central bank has in the past targeted a gradual nominal depreciation. As external developments became increasingly favorable and fiscal policy remained expansionary, the nominal effective exchange rate appreciated by almost 5 percent between March and August, contributing to the reduction in inflation. Due to the positive inflation differential, the real effective appreciation was about 7 percent. Non-oil exports were not negatively affected and continued to grow rapidly.

In the current policy setting, the objective of single-digit inflation set by the FFYDP will be difficult to achieve. The expansionary fiscal stance remains the main obstacle, but there are other issues that need to be tackled promptly:

i. the inflation objective should be given higher priority. In the current context marked by fiscal dominance, inflation is the weakest link.

ii. the independence of the central bank in using its instruments to control liquidity should be explicitly recognized. While some positive steps have been taken, including the appointment of the Governor of the central bank as chairman of the MCC, the mission believes that the authority to issue participation papers should be transferred to the central bank. The setting of rates of return should have the necessary flexibility to deal with changes in economic conditions and the rates should be consistent with monetary policy objectives. Any reduction of the rates of return from their current level should be made conditional on inflation developments; and

iii. the exchange rate policy should be more flexible and subordinated to the inflation objective, while stepped up implementation of structural policies would help achieve lasting improvements in competitiveness.

III. OUTLOOK AND POLICIES FOR 2006/07

The 2006/07 budget is still at an early stage of preparation and indications regarding key elements of fiscal and monetary policies are tentative at this stage. The mission notes the authorities' intention to restrain and rationalize government spending, including subsidies, reduce economic disparities among the provinces and help improve the living conditions of the poor. The mission supports these objectives and welcomes the authorities' determination to translate them into concrete and coherent policy actions.

While fiscal policy in 2006/07 will be guided by the objectives under the FFYDP, the mission recommends that the macroeconomic framework underlying the formulation of fiscal and monetary policies be updated to take into account recent and prospective short-term developments. Such a framework would facilitate arbitrage between conflicting objectives and ensure greater coherence of the policy mix. In this regard, the mission stresses the need for fiscal policy to take into account its impact on inflation, which disproportionately affects the poor and undermines long-term growth. This could be achieved by providing for a more measured pace of government spending, improving the allocation of budget resources to support future growth, and building precautionary savings to reduce the economy's vulnerability to exogenous shocks.

The authorities' stated policy of channeling more resources toward less-developed provinces is welcome as it would help reduce regional income disparities and reduce pressure on major urban areas. In working toward the attainment of these objectives, the authorities should rely on a reallocation of resources rather than on large increases in spending, in view of the current expansionary fiscal stance.

In order to achieve the FFYDP targets of broad money growth of 22 percent and inflation of 11½ percent, tentative staff projections point to the need of a fiscal adjustment of about 3 percent of GDP in 2006/07 relative to the projected outcome for 2005/06. This would need to be supported by a tightening of monetary policy including the issuance of participation papers and the use of the open deposit account. These preliminary estimates would need to be revisited in light of developments in the last quarter of the current year and changes to the short-term outlook.

Structural reforms

The mission notes the authorities' commitment to implement the structural reforms envisaged in the FFYDP and welcomes their determination to move forward with privatization of public enterprises. By clarifying the scope of private sector participation in economic activities in Iran, the amendment of Article 44 of the Iranian constitution opens the door to a more ambitious strategy of private sector development that would help provide impetus to growth and employment over the medium term. The mission encourages the authorities to accelerate the pace of preparation and implementation of privatization and ensure that majority control is effectively transferred to private shareholders who can bring know how and best management practices to the privatized companies. The mission notes the authorities' intention to make the poor benefit from equity shares in privatizations operations, and encourages the authorities to work closely with the World Bank to draw on international experience in this area and ensure the success of this privatization scheme.

The mission welcomes the authorities' intention to reduce subsidies and target them to the needy. It is clear that the growing resources absorbed by non-targeted explicit and implicit subsidies are a source of waste, inefficiency, and environmental degradation. Any delays in addressing this situation would only worsen the distortions in the economy. The mission calls on the authorities to accelerate the formulation and implementation of the energy price reform, and initiate a phasing out of across-the-board explicit subsidies, accompanied by the establishment of a social safety net for low-income households.

The mission stresses the importance of strengthening the financial system and further enhancing its supervision. It welcomes the licensing of private banks, insurance, and leasing companies, as well as the progress being made in upgrading banking supervision in line with international standards. It encourages the authorities to restructure public banks, complete their recapitalization, and consider opening their capital for private sector participation. The mission underscores the need to further strengthen the regulatory framework and supervision of the Tehran Stock Exchange and develop its infrastructure.

Data and transparency issues

The mission is encouraged by the progress in moving toward compliance with the requirements of the IMF's Special Data Dissemination Standards. It also welcomes 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. This, together with the current practice of highlighting the cost of implicit energy subsidies as a memorandum item in the budget document, is a step in the right direction.

The mission recommends to improve further the presentation of fiscal accounts by integrating the operations of OSF in the budget document, and publishing on a regular basis a detailed breakdown of current expenditure according to the economic classification. It also reiterates the need to publish data on international reserves and the international investment position.

The mission notes the authorities' interest in receiving technical assistance in the areas of bank restructuring and privatization, central bank accounting, and economic modeling at the central bank.