Statement at the Conclusion of the 2014 Article IV Consultation Mission to Islamic Republic of Iran

An International Monetary Fund (IMF) team, led by Martin Cerisola, Assistant Director for the Middle East and Central Asia Department, visited Tehran during January 25-February 8, 2014 to conduct the 2014 Article IV Consultation discussions. Alfred Kammer, Deputy Director of the Middle East and Central Asia Department, also participated in the concluding discussions of the mission. The team exchanged views with senior officials of the Central Bank of Iran and Ministry of Economy and Finance on recent developments in the Iranian economy, the near-term outlook, and the authorities' macroeconomic plans and structural reform agenda. The IMF team also met with a wide range of public and private sector representatives. Based on the visit, a staff report will be prepared and presented to the IMF's Executive Board in late March.

At the conclusion of the visit, Mr. Cerisola issued the following statement:

Large shocks and weak macroeconomic management over the past several years have had a significant impact on macroeconomic stability and growth. A combination of shocks, associated with the implementation of the first phase of the subsidy reform, ambitious social-programs inadequately funded, and a marked deterioration in the external environment stemming from the intensification of trade and financial sanctions, have weakened the economy. Inflation and unemployment are high, while the corporate and banking sectors show signs of weakness. These shocks have exposed structural weaknesses in the economy and in the policy framework.

Iran now stands at a crossroad. With risks that the economy could continue to face a low-growth and high-inflation environment ahead, there is a need to begin advancing reforms to promote stability, investment, and productivity. The new authorities should embark on a prompt and vigorous implementation of fundamental reforms to the frameworks supporting product, labor, and credit markets. These reforms would lay the basis for sustained high growth and lower unemployment, especially should the external environment continue to improve. The new authorities are well aware of these challenges and the need to advance reforms, and have begun the preparatory work in many of these areas.

The pace of contraction in economic activity is slowing. The economy has continued to shrink in the first half of 2013/14, and staff expects further but diminishing contraction in the second half, with real GDP declining by 1-2 percent in 2013/14. 12-month inflation has dropped rapidly, from about 45 percent in July 2013 to below 30 percent in December 2013. This drop reflects tighter CBI credit, the appreciation of the *Rial*, and global disinflation in some key staples. Inflation could end at 20-25 percent by March 2014 (end-2013/14).

Prospects for 2014/15 have improved with the interim P5+1 agreement but still remain highly uncertain. Under the current external environment, staff projects economic activity to

begin to stabilize in 2014/15, with real GDP growing by 1-2 percent in 2014/15. Inflation would potentially decline to 15-20 percent, excluding the impact of planned higher domestic energy prices.

Comprehensive reforms are needed to address many complex challenges:

The Policies for Dealing with Stagflation

A three-pronged strategy to arrest stagflation should be centered on: i) tightening monetary policy; ii) balanced fiscal consolidation; and iii) advancing supply-side reforms (see below).

- ***Tighter monetary policy will help entrench disinflation***. Staff analysis suggests that the output costs of disinflation in Iran could be low. While some of the recent deceleration in inflation may be temporary, the steps taken by the Central Bank of Iran (CBI) to remove the financing of the *Mehr* program from its balance sheet bode well for controlling liquidity and stabilizing inflation in the future. It would be important to begin increasing profit rates gradually to firmly anchor expectations and contain second-round effects from the planned increases in domestic energy prices.

- ***Containing the general government fiscal deficit at around 2-3 percent of GDP should help balance the support for disinflation and the economy***. The 2014/15 draft budget continues with the government's decision to consolidate fiscal policy in light of the sharp decline in oil revenues. Staff welcomes the proposed measures to begin broadening the revenue base away from oil, most notably, the decision to bring forward and increase the scheduled VAT rate, as well as the reforms to strengthen tax administration, including the reform of tax exemptions for large nontaxpayers. Staff sees scope to further increase the VAT rate in the years ahead, as well as to introduce a capital gains tax on specific activities that have experienced large gains. These measures would help to improve the quality of the fiscal adjustment and help lay the ground for a sustainable fiscal policy ahead.

- ***With the economy vulnerable at this juncture, the timing of advancing the subsidy reform should be carefully assessed***. Increasing domestic energy prices is an important step to continue with the much needed reform to reduce energy consumption, improve the efficiency of the economy, and help close an estimated cash deficit of the Targeted Subsidy Organization of about 1 percent of GDP. The authorities' intention to adjust prices gradually is prudent given stagflation risks but, as the experience of the first phase showed, external shocks could significantly undermine the hard-won stability of the currency and the envisaged relative price adjustment. In addition, the reforms needed to tighten budget constraints in the corporate sector are difficult and have yet to be well-established, notwithstanding the envisaged support to specific sectors. Without these conditions, there are risks to sustaining consistent macroeconomic policies through such relative price change.

Strengthening the Policy Framework for Macroeconomic Stability

- ***Monetary policy needs to place greater emphasis on price stability***. For this, the CBI's mandate needs to be simplified and refocused toward price stability. The CBI also needs to be granted with the operational ability to target base money consistently, by being able to set profit rates at levels that allow its limited instruments to be used effectively to respond to macroeconomic conditions. It is essential to bring the institutional decision-making setup at the Monetary and Credit Council in line with those of countries that have successfully resolved chronic inflation.

- ***Several reforms to the fiscal policy framework would strengthen its countercyclical role, limit fiscal risks, and enhance macroeconomic coordination***. Specifically:

  ✓ ***Managing hydrocarbon savings***. The current framework supported by the OSF and NDFI could better balance the goals of macroeconomic stability, intergenerational equity, and development. OSF resources need to be replenished soon to support non-inflationary budget financing and build buffers for future shocks. Decisions on how to save and invest NDFI resources should be better coordinated explicitly with macro policies and underpinned by more explicit safeguards and transparency.

  ✓ ***The steps toward adopting a fiscal rule***. The authorities should begin to formulate and anchor the conduct of fiscal policy on the structural nonhydrocarbon balance. Toward this end, they should adopt a multi-year budget and expenditure planning, and expand the coverage of the general government in GFSM 2001 toward the one presented in the annual budget, so as to enhance the operational conduct, monitoring, and accountability of fiscal policy, and thus limit fiscal risks.

  ✓ ***Quasi-fiscal activities (QFAs), such as government mandated credit policies.*** The authorities should begin to review how best to bring QFAs and their financing into the budget to make them explicit so as to reform or discontinue them. The *Mehr* housing program would be a good starting point. Given the size of the NDFI's domestic lending and risks, the authorities could initiate a review of its disbursed and earmarked resources, as well as of government-mandated credit policies.

  ✓ ***Proceeding with the subsidy reform.*** Iran's design of the subsidy reform has been exemplary and the reform remains a priority. The implementation of the first phase has faced significant and varied difficulties and there is a need to make the lessons known to the public. The authorities' planned increase in domestic energy prices is welcome, although the proposed distribution of resources among households and specific sectors presents a departure from the original design. This departure risks undermining the strong support that was achieved during the first phase. Some measures would be needed to address such risk. First, the contemplated gradual adjustments in domestic prices need to be supported by an automatic adjustment

mechanism that is underpinned by strong political support to ensure its full implementation. Second, the process for identifying and excluding less vulnerable groups requires criteria that are simple, transparent, and perceived as fair. In addition, the distribution of resources for supporting energy-intensive sectors needs to ensure a framework that fosters the adoption of new technologies and tighter budget constraints. In subsequent stages of the reform, transfers could be made more conditional on social goals and tilted toward private savings for the broader population.

- ***The intention to unify the foreign exchange market as external conditions normalize is welcome***. In the transition, the authorities should continue to manage the exchange rate flexibly in light of external risks and still high inflation, which is eroding competitiveness. The assessment of the official exchange rate is subject to an unusual degree of uncertainty due to the external environment and prospects. In current circumstances, the official exchange rate would be moderately overvalued, with the parallel market rate closer to equilibrium.

Reforms to Promote Financial Stability, Jobs, and Growth

- ***The state of the banking system and the regulatory-supervisory framework***. Staff noted an overall satisfaction among market participants with the direction the CBI is imparting to financial sector policies. Nonetheless, staff sees an urgent need to strengthen the CBI's supervisory powers and enforcement capacity, as well as the legal protection of its staff. Staff welcomes the CBI's initial steps toward a risk-based approach to supervision. Staff shares the view of some market participants about the scope for leveling the field of competition in the system through further privatization and reforms to government-mandated credit policies. Current proposals to deal with nonperforming loans and recapitalize public banks need to be better specified and should be supported by concrete restructuring plans and reforms to enhance their risk management and accountability. In terms of crisis preparedness, it would be important to strengthen the bank resolution framework and putting the deposit guarantee fund on a sustainable financial footing. Staff notes the discussions on the AML/CFT framework.

- ***Reforms to improve the business environment and foster employment are complementary***. Discussions with representatives from different economic sectors suggest the need to enhance the enforcement of the rule of law and property rights, maintain policy and macroeconomic stability, and enhance the transparency of policy making. Facing large potential entrants into the labor force in the years ahead, reforms are needed to facilitate the reallocation of labor across sectors and lower nonwage labor costs. A review of labor regulations that ease the rigidity of contracts and costs of labor could help to significantly absorb discouraged and informal workers and facilitate youth employment.