Recent Economic Developments in Iran

A Quarterly Report

بانک خاورمیانه
Middle East Bank

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Disclaimer

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Iran's Economy at a Glance

	2014/15	2015/16	2015 Q1	2015 Q2	2015 Q3	2015 Q4	2016 Q1
Participation and Unemployment Rates (percent)							
Participation	37.2	38.2	37.3	38.0	38.9	38.1	37.7
Unemployment (10 years and over)	10.6	11.0	11.5	10.8	10.9	10.7	11.8
Unemployment (Youth ages 15-24)	25.2	26.1	27.4	25.0	25.7	25.4	28.6
Real Growth Rates of Economic Sectors (percent)*							
Oil	4.8	3.6	-5.2	3.6	3.4	-9.0	16.5
Agriculture	3.8	5.4	3.1	8.4	5.6	3.3	5.5
Industries and Mines	5.0	-2.8	1.2	-3.8	-2.2	-4.0	-1.1
Services	2.4	0.2	2.3	0.0	-0.3	0.4	0.8
Gross Domestic Product (GDP)	3.0	1.0	0.6	0.5	1.1	0.3	2.0
GDP (Except Oil)	2.8	0.9	1.3	0.4	1.1	0.6	1.6
Gross Fixed Capital Formation	3.5	-15.6	-17.7	-10.1	-14.9	-19.5	-17.6
Oil (thousand barrels per day)							
Production	3,063	-	3,015	3,093	3,161	3,299	-
Export	1,435	-	1,428	1,422	1,534	1,561	-
Inflation Rates (percent)							
Growth Rate of Consumer Price Index	15.6	11.9	16.0	16.3	12.8	10.1	8.9
Growth Rate of Producer Price Index	14.8	4.9	11.8	7.4	5.3	4.0	3.2
Balance of Payments (USD million)							
Oil Exports	55,352	-	9,461	10,633	9,432	7,028	-
Non-Oil Exports	31,119	-	7,925	7,047	6,504	9,740	-
Imports of Goods	65,079	-	16,685	12,902	13,171	12,510	-
Goods Account (Net)	21,392	-	701	4,778	2,764	4,258	-
Non-Oil Goods Account (Net)	-30,012	-	-7,600	-5,218	-6,214	-2,149	-
Current Account	15,861	-	-1,008	3,947	2,190	3,816	-
Capital Account	-1,664	-	2,926	-4,218	4,166	2,122	-
Change in Foreign Reserves	8,561	-	239	-647	2,209	2,206	-
Exchange Rates (IRR)							
Exchange Rate in Free Market (USD/IRR)	32,801	31,482	32,931	34,556	33,279	33,484	35,470
Exchange Rate in Interbank Market (USD/IRR)	26,509	26,276	26,772	27,530	28,499	29,681	30,012
Monetary and Credit Aggregates (IRR trillion)							
Monetary Base	1,311.5	1,535.7	1,311.5	1,317.2	1,375.0	1,427.8	1,535.7
Central Bank Claims on Banks	858.0	836.1	858.0	813.7	806.0	829.9	836.1
Money (M1)	1,207.6	1,367.1	1,207.6	1,123.8	1,180.2	1,158.1	1,367.1
Notes and Coins with the Public	351.7	372.0	351.7	297.6	306.4	301.2	372.0
Sight Deposits	855.9	995.1	855.9	826.2	873.8	856.9	995.1
Non-sight Deposits (Quasi-money)	6,616.3	8,805.8	6,616.3	7,042.9	7,547.3	8,093.6	8,805.8
Liquidity (M2)	7,823.8	10,172.9	7,823.8	8,166.7	8,727.5	9,251.7	10,172.9
Government Budget (IRR billion)							
Total Revenues	1,609,501	1,797,306	459,368	293,217	452,696	416,386	635,007
Tax Revenues	709,652	791,891	230,927	142,181	191,921	173,859	283,927
Oil Revenues	628,837	670,335	118,502	100,120	179,327	173,373	217,516
Other Revenues	271,012	335,080	109,940	50,916	81,447	69,155	133,561
Total Expenditures	1,737,816	2,022,538	490,753	359,579	490,315	439,059	709,695
Current Expenditures	1,438,316	1,706,885	426,672	359,194	392,842	358,492	596,358
Development Expenditures	299,500	276,990	64,080	385	85,804	77,465	113,337
Budget Balance	-128,316	-196,303	-20,785	-90,252	-37,619	-22,673	-45,759
Tehran Stock Exchange (end of period)							
Overall Index (TEDPIX)	62,532	80,219	62,532	63,811	61,577	61,519	80,219
Financial Index	135,089	158,225	135,089	138,168	131,121	125,938	158,224
Industrial Index	51,296	66,994	51,296	52,313	50,661	51,010	66,994
Market Capitalization (IRR trillion)	2,813.2	3,448.4	2,813.2	2,793.7	2,640.3	2,661.5	3,448.4

Source: Central Bank of Iran (CBI), and Statistical Centre of Iran (SCI), various reports

* GDP statistics for 2014/15 are based on CBI reports in constant 2004/05 basic prices and the data for 2015/16 is based on SCI reports in constant 1997/98 market prices.

1. The Real Sector

Following eight consecutive quarters of contraction, Iran's GDP registered positive GDP growth rates beginning in spring of 2014 and achieved a 3.0 percent growth in 2014/15 (Iranian year 1393; March 21, 2014 to March 20, 2015). But sharp declines in international oil prices severely checked that growth in 2015/16. Direct and indirect dependency on oil revenues, structural problems in the money market and deficiencies in the capital market, exacerbated the existing credit crunch and weak demand and brought about difficult economic conditions.

According to preliminary estimates by the Statistical Center of Iran (SCI), in 2015/16 growth rates of the GDP and non-oil GDP stood at 1.0 percent and 0.9 percent, respectively. As exhibited in Table 1, all three sectors of the economy experienced positive growth rates in the first quarter of 2016 to bring about a GDP growth of 2.0 percent that contributed substantially to the overall GDP growth of 1.0 percent in 2015/16. The agriculture sector, while accounting for a small share of the GDP, had the highest growth rates in all four quarters of the year and was the main contributor to the positive GDP growth. The services sector, too, despite contracting in the third quarter of 2015, experienced positive growth in 2015/16 as a whole. But the mnufacturing sector contracted in three of the four quarters and registered negative growth for the year 2015/16 as a whole.

Table 1: Real Growth Rates of GDP and its Sectoral Components (percent)

	2015			2016	2015/16
	Q2	Q3	Q4	Q1	
Agriculture	8.4	5.6	3.3	5.5	5.4
Manufacturing	-3.1	-1.7	-4.4	0.6	-2.2
Services	0.0	-0.3	0.4	0.8	0.2
GDP	0.5	1.1	0.3	2.0	1.0
Non-oil GDP	0.4	1.1	0.6	1.6	0.9

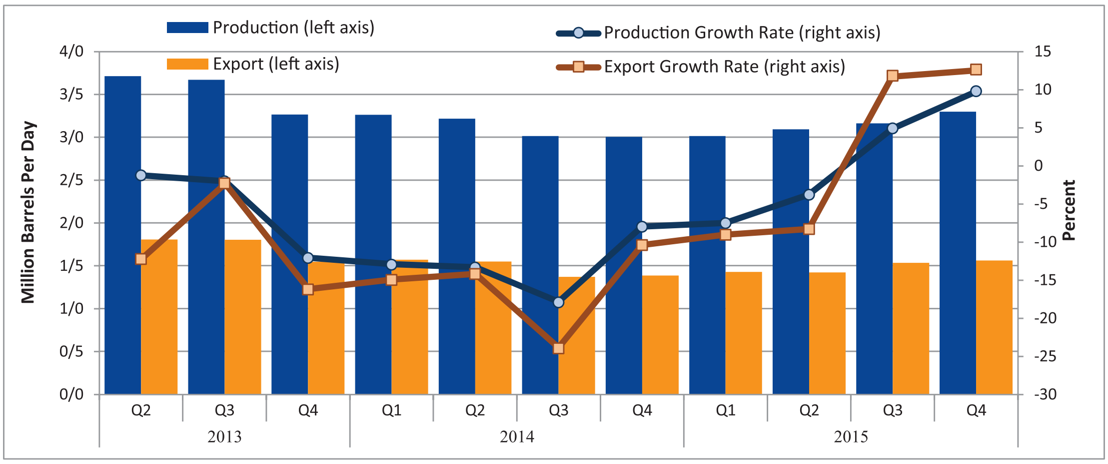
Source: Report of Economic Growth Rate in 1394, Statistical Center of Iran

On the expenditure side, in 2015/16 private consumption and government consumption expenditures grew by 2.5 percent and 7.3 percent, respectively, but gross domestic fixed capital formation contracted by as much as 15.6 percent.

1.1 Energy

Iran's average crude oil production, which had decreased significantly as a result of international sanctions, began to increase in early 2015 and gradually reached an average 3.30 million barrels per day (bpd) by the end of the year, and according to OPEC reports, 3.38 million bpd in the first quarter of 2016. As shown in Figure 1, in the third and fourth quarters of 2015 oil exports reached an average of 1.55 million bpd, but the fall in oil prices were such that despite the increase in the volume, oil export revenues during the last three quarters of 2015 dropped by 41 percent compared to the same period the year before, to reach only USD27.1 billion.

Figure 1: Iran's Average Daily Crude Oil Production and Export, and their Point-to-Point Growth Rates

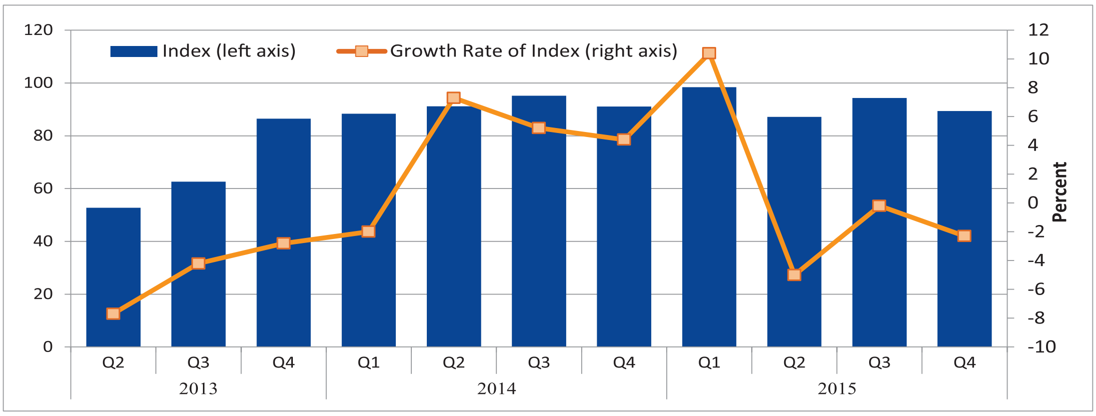


Source: Central Bank of Iran, Economic Trends

1.2 Industry

Production by large manufacturing units fell by 9.1 percent during the last three quarters of 2015. Indeed, as can be seen in Figure 2, the index of production by large manufacturing units experienced negative growth in each of these three quarters compared to similar quarters the year before. During these three quarters the number of licenses issued for the operation of industrial plants and the IRR value of new investments were influenced by the unfavorable conditions and fell by 7.1 percent and 5.8 percent, respectively, compared to the same period the year before.

Figure 2: Production Index of Large Manufacturing Units (2011=100) and its Point-to-Point Growth Rate

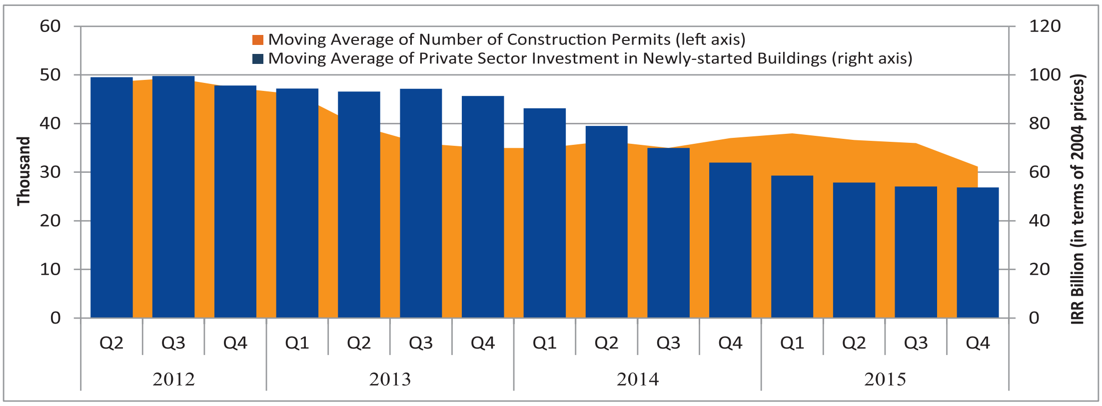


Source: Central Bank of Iran, Economic Trends

1.3 Housing

The housing market stagnation of 2014/15 took a turn for the worse in 2015/16 so much that housing values occasionally fell even in nominal terms, an unprecedented plight at least during the past three decades. Despite this, the number of transactions also fell from the year before. As an example, in 2015/16 only about 155 thousand residential units were traded in Tehran, registering a 10 percent drop from the year before. A review of the construction permits issued by municipalities and the real investment in newly-started projects in 2015/16 indicates the reluctance of investors to enter the housing market. As can be seen in Figure 3, the number of construction permits issued by municipalities has fallen continuously since the beginning of 2014 and fewer investors have applied for the permits. Despite the 32 percent drop in the number of issued construction permits in 2014/15, this number fell by another 12 percent during the last three quarters of 2015 compared to the same period the year before. During these three quarters, private investment in newly-started buildings in urban areas dropped by 20 percent in nominal terms compared to the same period the year before and reached IRR117.5 trillion.

Figure 3: Private Sector Investment in Newly-started Buildings and Number of Construction Permits in Urban Areas



Source: Central Bank of Iran, Economic Trends

1.4 Labor Force

In 2015/16 the economic participation rate of the population aged 10 and above jumped by one percentage point and reached 38.2 percent, consisting of 63.2 percent for men and 13.3 percent for women. The graduation of a large number of university students that previously had chosen to enter higher education—partly to avoid unemployment, and a general aura of optimism about economic improvements following the implementation of the contributed to this significant shift of the population from economically inactive to economically active categories. Out of the 24.7 million economically active individuals, 2.7 million, or approximately 11.0 percent, were unemployed. As in previous years, the unemployment among women was much higher than among men, and was much higher in urban areas than in rural areas. Furthermore, the 23.3 percent unemployment rate in the age group 15-29 underlines the fact that the youth are much more under pressure. Finally, 9.8 percent of the employed population was underemployed in 2015/16. Quarterly statistics on participation and unemployment rates in each quarter of 2015/16 as well as for the year as whole are presented in Table 2.

Table 2: Participation Rate and Unemployment Rate (percent)

	2015			2016	2015/16
	Q2	Q3	Q4	Q1	
Participation Rate	38.0	38.9	38.1	37.7	38.2
Unemployment Rate	10.8	10.9	10.7	11.8	11.0

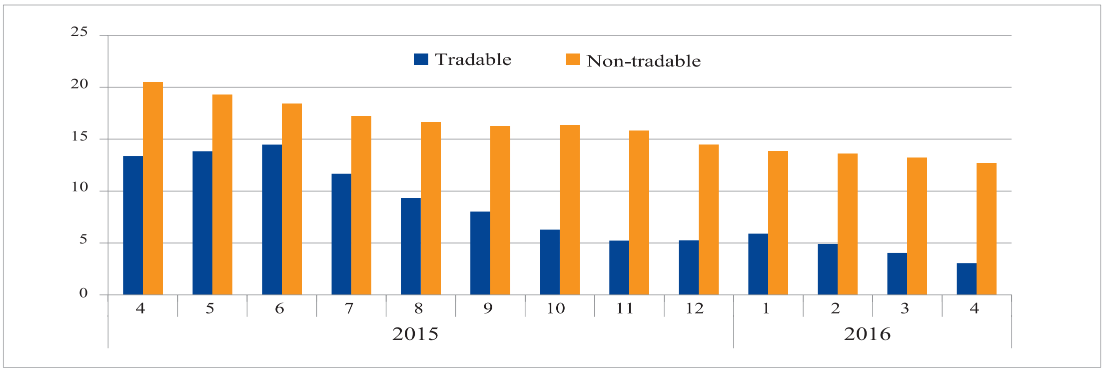
Source: Summary Results of the Workforce Survey Project 1394, Statistical Center of Iran

2. Prices

The monthly point-to-point inflation rate that had been on a downward trend since June 2013 fell to 6.8 percent in June 2016. Consequently, the average annual inflation rate has also been declining since October 2013, and in June 2016 finally registered the psychologically important level of a single digit – not seen since November 2010. For the year 2015/16 as a whole, an average annual inflation rate of only 9.7 percent in the face of a 30 percent liquidity growth was unexpected by many analysts.

An examination of the liquidity components reveals that term deposits contributed 28 percentage points and money (M1) growth contributed only the remaining 2 percentage points to this liquidity growth. The main factor responsible for the 33.1 percent growth of term deposits has been banks' real deposits rate of approximately 8 percent. This high real interest rate on term deposits, in conjunction with the existing credit crunch led to a modest 6.6 percent growth in M1, which managed to neutralize the inflationary pressures of the liquidity growth. As a result of reduction of the nominal interest rates on one-year bank deposits to 15 percent in July 2016, the real interest rate on one year deposits fell to 5 percent. With the continuation of this trend it is likely that M1 money growth rate would increase in 2016/17 and the subsequent inflationary pressure from the liquidity growth could appear in the medium run. Meanwhile, due to the relative stability of the USD/IRR exchange rate, the presence of the so-called Dutch Disease in Iran's economy and the low inflation in global market, domestic inflation rates in tradable goods is considerably lower than in non-tradable goods (see Figure 4).

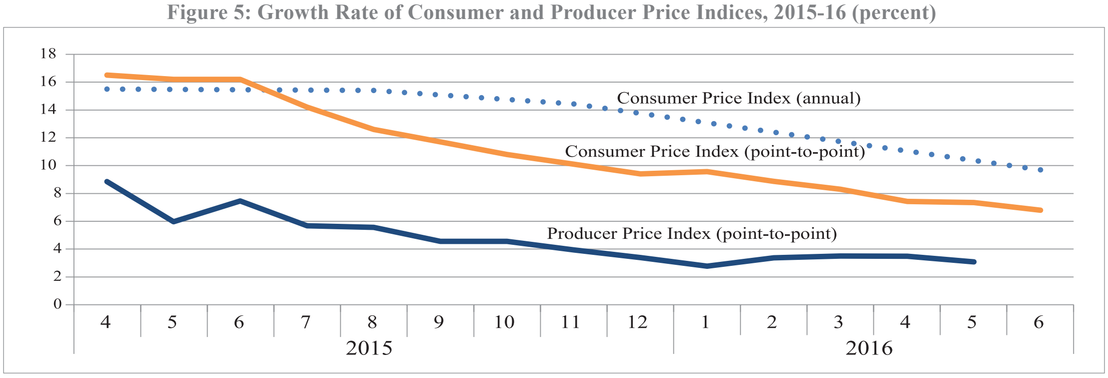
Figure 4: Monthly Point-to-point Inflation Rates for Tradable and Non-tradable Goods (percent)



Source: Central Bank of Iran, Consumer Price Index – Tradable and Non-tradable Goods reports

The fall in producer price (PPI) inflation rate has been an influential precursor to the fall in consumer price (CPI) inflation rate. In January 2016 the point-to-point PPI inflation rate fell to 2.8 percent, which is the lowest since the beginning of measuring and recording this indicator some 26 years ago. However, the monthly PPI inflation rate has been on a gradual rise since then, and reached 3.1 percent in May 2016. Figure 5 demonstrates annual and monthly point-to-point CPI and PPI inflation rates in the past 15 months.

Figure 5: Growth Rate of Consumer and Producer Price Indices, 2015-16 (percent)



Source: Central Bank of Iran, Consumer Price Index and Producer Price reports

Since the inflation rate of imported goods has been falling and the USD/IRR exchange rate has been fairly stable, and given the lag in the influence of the fall in PPI inflation on the fall in CPI inflation, the CPI inflation rate is expected to fall even further in the coming months. Economic slowdown and inventory increases have been important factors in bringing down the PPI inflation rate.

A closer examination of the consumption basket indicates that the reduction in the inflation rate of food and beverages has had a significant impact on the reduction in the overall CPI inflation rate. The point-to-point monthly inflation rate of food and beverages dropped from 20.8 percent in May 2015 to only 1.8 percent in May 2016. Food and beverages account for 27.4 percent of the consumption basket, second only to "housing, water, electricity, gas and other fuels" with a weight of 32.8 percent that experienced a point-to-point inflation rate of 10.3 percent in May 2016. Inflation rate in the tobacco group, which had experienced a negative rate of 2.8 percent in 2015/16, reached 10.7 percent in

May 2016 on a point-to-point basis, mainly due to the provisions in the Budget Law of 2016/17 that levied taxes of IRR500 on imported cigarettes, IRR350 on jointly produced cigarettes, and IRR100 on domestically produced cigarettes. Table 3 presents the average annual inflation rates in 2015/16 and the monthly point-to-point inflation rates in April and May of 2016 for major categories of the consumption basket.

Table 3: Inflation Rates in Various Consumption Categories, 2015-16 (percent)

	Annual 2015/16	Point-to-point April 2016	Point-to-point May 2016
Food and Beverages	10.6	2.0	1.8
Tobacco	-2.8	-0.5	10.7
Clothing and Footwear	10.5	7.2	6.9
Housing, Water, Electricity, Gas and other Fuels	12.3	10.7	10.3
Household Equipment and Routine Household Maintenance	5.6	4.4	4.3
Health	24.3	17.1	16.4
Transport	11.2	7.6	8.8
Communication	3.7	5.6	5.8
Recreation and Culture	15.4	7.7	7.7
Education	16.2	21.8	22.2
Restaurants and Hotels	16.3	10.5	10.1
Miscellaneous Goods and Services	11.2	9.3	9.3

Source: Central Bank of Iran, Consumer Price Index reports

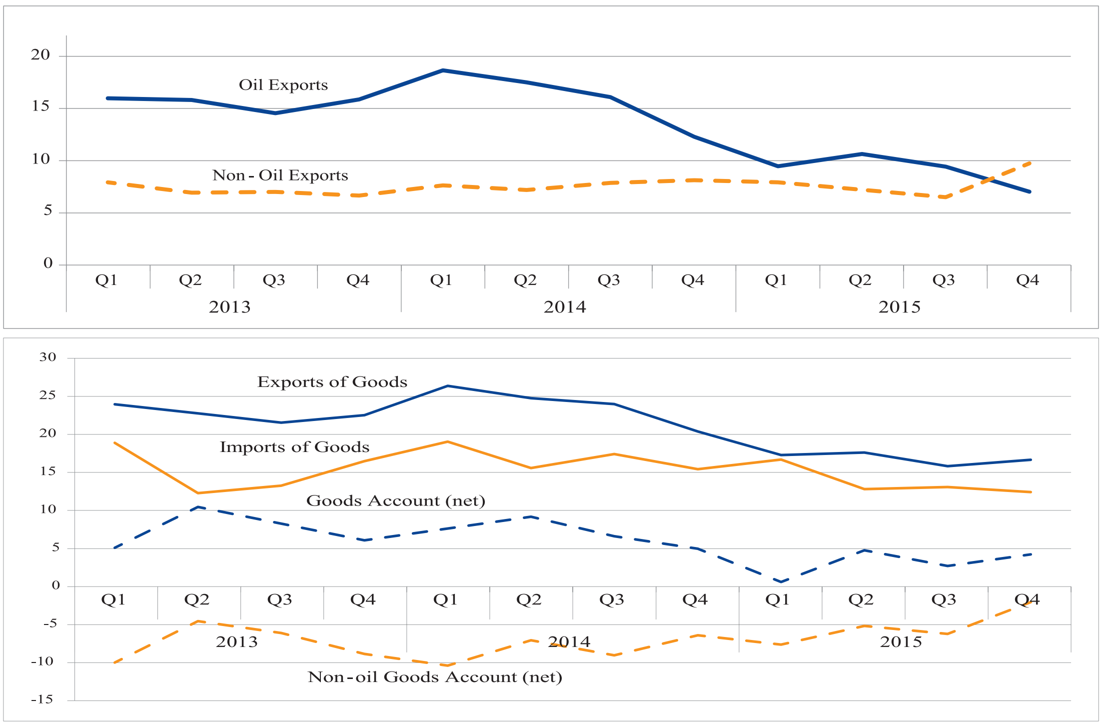
3. Balance of Payments

Despite the relative increase in the volume of Iran's oil exports, the sharp decline in global oil prices were such that the USD value of oil exports (including crude oil, petroleum products, natural gas, condensate and liquefied natural gas) fell by 25.5 percent in the 4th quarter of 2015 to register a 42.8 percent reduction compared to the 4th quarter of the preceding year.

Revenues from oil exports during the last three quarters of 2015 dropped by 41 percent compared to the same period in the year before. At the same time the USD value of oil imports (gas and petroleum products) in the last three quarters of 2015 fell by 38.6 percent compared to the same period of the year before. As a result, the oil trade balance in that period contracted by 41 percent.

The USD value of non-oil exports increased by 49.8 percent during the 4th quarter of 2015, registering a 19.8 percent increase from the 4th quarter of 2014. On the other hand, the USD value of non-oil imports fell by 6.5 percent in the 4th quarter of 2015, registering an 18.2 percent decline compared to the same period the year before. Consequently, the non-oil trade deficit during the last three quarters of 2015 fell by 39.4 percent compared to the same period the year before. Figure 6 illustrates the trends of various trade balance components during 2013-2015.

Figure 6: Goods Account Components (USD billion)



Source: The Central Bank of Iran, Economic Trends

Overall, Iran's trade balance in the 4th quarter of 2015 was 54 percent above its level in the 3rd quarter but 14.6 percent below its level in the 4th quarter of 2014. The current account balance dropped by 41 percent in the last three quarters of 2015 compared to the same period the year before. This was mainly due to the reduction in the trade balance because which was in turn the result of a more severe contraction of exports compared to imports. Table 4 presents quarterly data on the main components of the current account in 2014/15 and 2015/16.

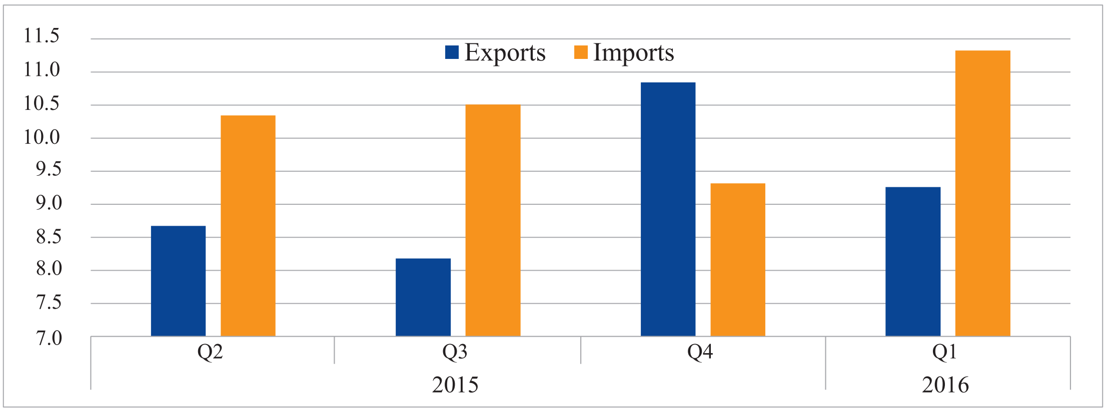
Table 4: Current Account Components (USD million)

	2014			2015			
	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Goods account (net)	9,113	6,593	4,985	701	4,778	2,765	4,258
Services account (net)	-2,270	-1,387	-1,342	-1,986	-1,206	-1,077	-759
Income account (net)	211	289	297	146	237	360	189
Current transfers account (net)	125	126	129	131	138	142	128
Current account balance	7,179	5,621	4,069	-1,008	3,947	2,190	3,816

Source: The Central Bank of Iran, Economic Trends

Customs data for the 1st quarter of 2016 indicate a 13.3 percent contraction in the USD value of exports and 21.5 percent increase in the USD value of imports, registering a 6.0 percent and 16.4 percent reduction compared to the same period the year before, respectively. As shown in Figure 7, in the last quarter of 2015 compared to its previous quarters the USD value of exports increased and the USD value of imports fell significantly -which is somewhat unusual. Exports and imports in April and May of 2016 fell by 14.7 percent and 13.5 percent from the same months the year before, reaching USD6.9 billion and USD5.5 billion, respectively.

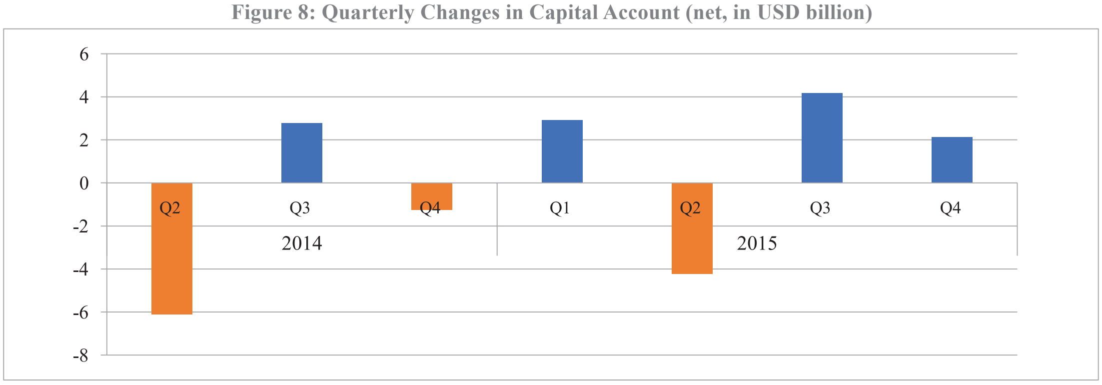
Figure 7: Non-oil exports* and Customs Imports (USD billion)



Source: Islamic Republic of Iran Customs Administration
* Excludes natural gas condensate exports

Significant improvement in net capital account in the last three quarters of 2015 compared to the same period the year before prevented a severe worsening of the balance of payments. Meanwhile, due to the nuclear deal and the relative improvement in the economic outlook for the next few years, the net capital inflows in the last three quarters of 2015 reached over USD2 billion. As it can be seen in Figure 8, the net capital inflow in the 3rd and 4th quarters of 2015 amounted to USD6.3 billion.

Figure 8: Quarterly Changes in Capital Account (net, in USD billion)



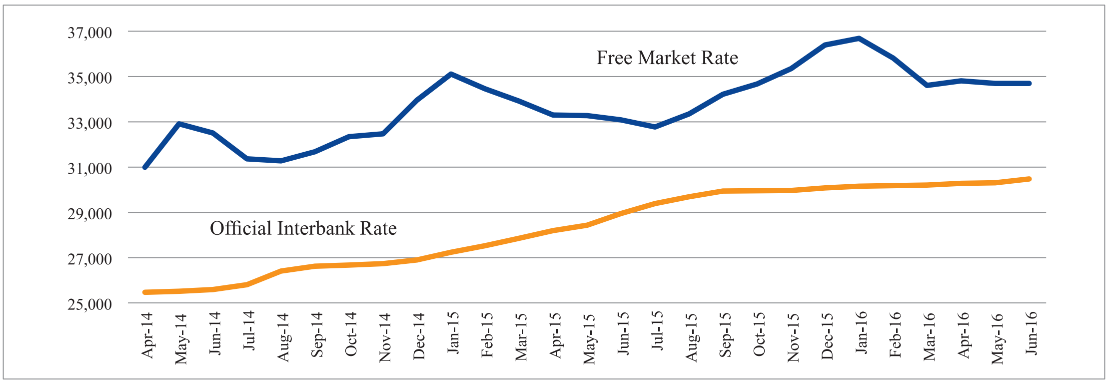
Source: The Central Bank of Iran, Economic Trends

Iran's international reserves increased by USD3.8 billion during the last three quarters of 2015 and its level is currently estimated to be in the range of USD100-130 billion. However, a large part of it is not accessible as it has been used as collateral for financing domestic projects by China's Export Credit Agency and investing in oil and gas projects through Naftiran Intertrade Company (NICO), which is the National Iranian Oil Company's international trading arm. According to the responsible authorities, following the lifting of sanctions at best about USD23 billion of international reserves that were previously frozen in Japan, South Korea, and the United Arab Emirates, and USD6 billion held in India would become accessible.

4. Foreign Exchange Market

With the gradual firming up of oil prices since January 2016 and the gradual lifting of international sanctions following the nuclear agreement, during the 2nd quarter 2016 the free market USD/IRR exchange rate fell a bit and stabilized around 35,000. Figure 9 exhibits the trends of the free market and official USD/IRR exchange rates during the past two years.

Figure 9: Average Monthly USD/IRR Exchange Rates

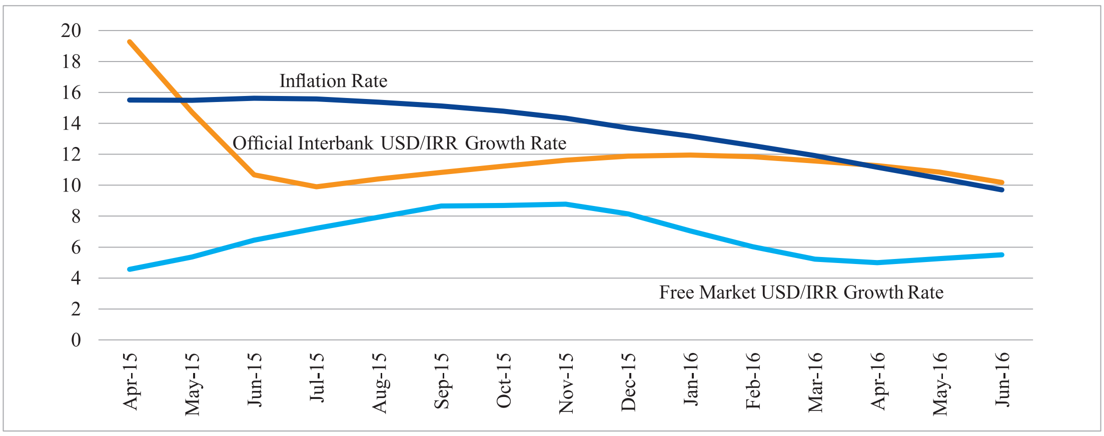


Source: The Central Bank of Iran, Exchange Rate archive

For years, the failure to adjust the nominal exchange rates in line with inflation rate differentials in Iran and abroad has weakened the real exchange rates and thus strengthened the IRR vis-à-vis foreign currencies. The direct consequences have included falls in the competitiveness of domestic producers relative to foreign producers, suppression of domestic production and exports and the eventual deepening of recession. It seems that in recent years, policy makers' priority has been controlling exchange rate fluctuations in order to stabilize the economic environment rather than maintaining the purchasing power of the IRR, i.e., adjusting the nominal exchange rates in line with the domestic and foreign inflation rate differentials.

Despite numerous promises, the Central Bank (CBI) seems to have postponed the unification of foreign exchange rates until it has a larger foreign exchange reserves at its disposal. Notwithstanding the current government's success in harnessing inflation, with the presidential election less than a year away, it seems that the short-term costs of doing away with two-tiered exchange rate system, eliminating economic rents, and bringing about the subsequent price adjustments are considered too high and thus the unification of foreign exchange rates may not be implemented for at least another year. Figure 10 presents inflation rates and average growth rates of the official and free market USD/IRR exchange rates during the twelve months periods culminating in the last day of each month in 2015 and the first six months of 2016.

Figure 10: Annual Inflation Rate and Growth Rates of USD/IRR in Interbank and Free Market (percent)



Source: The Central Bank of Iran, Exchange Rate archive

5. Monetary and Credit Aggregates

Although the monetary base grew by 8.9 percent during the last three quarters of 2015, it's growth rate jumped to 17.1 percent for the year 2015/16 as a whole, i.e., 6.4 percentage points above that in the year before. The main factor in this jump was the 21.3 percent growth of the "net foreign assets of CBI" that contributed 25.7 percentage points toward the monetary base growth. Within the net foreign assets of CBI, the major contributor to the growth was the change in the exchange rate used for the conversion of CBI's net foreign assets. Excluding that effect, the increase in net foreign assets of CBI would contribute 15.5 percentage points toward the 17.1 percent growth of the monetary base.

In 2015/16, "net other components", with a share of 13.9 percentage points, fell by 15.7 percent and was the most influential factor in reducing the monetary base growth during that period. The main factor responsible for the reduction of "net other components" was the increase of IRR133.5 trillion in net foreign assets of CBI, which was due to changes in the exchange rate used in CBI's net foreign assets assessment and contributed 10.2 percentage points toward the reduction of the monetary base growth. If the effect of this factor is taken out, net other components would contribute 3.7 percentage points toward the monetary base growth. Table 5 presents components of the monetary base at the end of the year 2014/15 and each quarter of the year 2015/16.

Table 5: Monetary Base Components (end of period balance, in IRR trillion)

	2015				2016	2016 Q1 to 2015 Q1	
	Q1	Q2	Q3	Q4	Q1	Growth Rate (percent)	Share of Growth (percentage point)
Monetary Base	1,311.5	1,317.2	1,375.0	1,427.8	1,535.7	17.1	17.1
CBI foreign assets (net)	1,584.7	1,653.4	1,769.8	1,806.6	1,921.9	21.3	25.7
CBI claims on public sector (net)	33.2	112.7	107.2	120.0	124.6	274.8	7.0
CBI claims on banks	858.1	813.7	806.0	829.9	836.1	-2.6	-1.7
Others (net)	-1,164.5	-1,262.6	-1,308.0	-1,328.7	-1,346.9	15.7	-13.9

Source: The Central Bank of Iran, Economic Trends; and Speech of Deputy Governor of CBI in 26th Conference on Monetary and Exchange Rate Policy, May 2016

In 2015/16 net public sector debt to the CBI, with a share of 7.0 percentage points in monetary base growth, increased by 274.8 percent. During the same period the government's indebtedness to the CBI fell by 0.7 percent and reached IRR182.4 trillion. Given the IRR264.9 trillion government indebtedness to the CBI at the end of 2015, it can be observed that IRR82.5 trillion has been repaid during the 1st quarter of 2016. CBI officials claim that the majority of the government's indebtedness to the CBI is related to revolving funds which are settled by the end of the 1st quarter of each year. Comparing the reduction of government's indebtedness to the CBI in 2015/16 with the 20.3 percent and 16.0 percent increases in government's indebtedness to the CBI in the two preceding years, it can be concluded that the government has observed fiscal discipline in 2015/16.

Since data on public corporations' and institutions' debt to the CBI and public sector deposits with the CBI for the year 2015/16 is not yet available, the reason for the increase in net public sector debt to the CBI cannot be determined with certainty. However, given the IRR24 trillion increase in public sector deposits with the CBI during the last three quarters of 2015, the increase in net public sector debt to the CBI in 2015/16 was probably due to the increase in public corporations' and institutions' debt to the CBI. Another reducing factor in the growth of monetary base in 2015/16 was the banks' indebtedness to the CBI that had a negative growth rate of 2.6 percent and a share of 1.7 percentage points in the growth of the monetary base. One of the reasons that prevented further reduction of banks' indebtedness to the CBI in 2015/16 was the CBI's support of domestic producers in the form of a stimulus package. This is despite the fact that in 2014/15 the main cause of the monetary base growth was the growth of banks' indebtedness to the CBI.

Following eight consecutive quarters of growth, the liquidity multiplier registered an 11.0 percent annual growth rate to reach 6.6 at the end of the year 2015/16, i.e., the 1st quarter of 2016. As a result, the liquidity in 2015/16 increased by 30.0 percent to IRR10,172.9 trillion. During the same period, quasi-money (non-sight deposits) experienced a 33.1 percent growth rate and accounted for 86.6 percent of the liquidity. Table 6 presents quarterly data on M2 money multiplier and liquidity components from winter 2015 to winter 2016.

Table 6: Money Multiplier and Liquidity Components (end of period balance, in IRR trillion)

	2015				2016	percentage change (2016 Q1 to 2015 Q1)
	Q1	Q2	Q3	Q4	Q1	
Liquidity (M2)	7,823.8	8,166.7	8,727.5	9,251.7	10,172.9	30.0
Money (M1)	1,207.6	1,123.8	1,180.2	1,158.1	1,367.1	13.2
Notes and coins with the public	351.7	297.6	306.4	301.2	372.0	5.8
Sight deposits	855.9	826.2	873.8	856.9	995.1	16.3
Quasi-money	6,616.3	7,042.9	7,547.3	8,093.6	8,805.8	33.1
M2 money multiplier	6.0	6.2	6.3	6.5	6.6	11.0

Source: The Central Bank of Iran, Economic Trends, March 2016

Due to the rapid decline in inflation rate in recent months and the failure of deposit rates to follow suit, the real interest rate on term deposits increased substantially to reach levels unprecedented in recent history. This phenomenon decreased the volume of bank notes and coins in circulation, and in turn increased term deposits and consequently reduced the share of M1 (money) in liquidity. High real interest rates in the economy led to lower levels of private consumption and investment in the country. On the other hand, the reduction in oil revenues led to a reduction in government spending and resulted in a substantially weaker aggregate demand. Consequently, weak demand has not allowed the inflationary pressures of the liquidity growth and expansionary monetary policy to surface for now. But this disconnection between the liquidity growth and inflation is temporary, and the decline in real interest rates and gradual economic expansion, especially after the Implementation Day, would lead to higher growth of liquidity and thus higher inflationary pressure in due course.

Another important point about the monetary aggregates is the reduction of M1 money multiplier to under 1 in years 2014/15 and 2015/16 which demonstrates how the increase in real interest rates has weakened the effectiveness of CBI's expansionary policies and banks' role as financial intermediaries in the economy.

Banks' credit facilities in 2015/16 reached IRR4,173.2 trillion, registering a 22.2 percent growth compared to its preceding year. It is worth mentioning that 16.6 percent of these loans were granted in the last month of the year, i.e., April 2016. Given the annual inflation rate of 11.9 percent in 2015/16, the real growth rate of granted loans was 9.2 percent while it was 25.0 percent the year before. The ratio of non-performing loans (NPLs) to total loans reached 12.2 percent at the end of February 2016, which is well above the desirable range.

6. Government Budget

The general government budget in 2016/17 was legislated at IRR9,786 trillion, which is 2.7 percent higher than the level proposed by the government and 21.8 percent higher than the first ceiling in last year's budget. The budget of state-owned companies has grown by 13.3 percent and reached IRR6,817 trillion, and the general budget reaches IRR3,354 trillion which is 30.0 percent higher than the first ceiling in last year's budget. Note that the budget of 2015/16 was legislated with two ceilings. The first ceiling assumed an oil price of USD45 per barrel, and in the case of higher oil prices (USD70 per barrel) and the realization of other resources, expenditures were allowed to overrun to the second ceiling. In the event, the government's performance in 2015/16 was in line with the first ceiling budget. A comparison of these nominal figures under the assumption of a single-digit inflation rate in 2016/17 implies a positive real growth rate of the budget and an expanded role of the government in the economy. Table 7 presents and compares the main components of the Budget Laws of 2015/16 and 2016/17.

Table 7: The Main Subdivisions of the Budget Laws of 2015/16 and 2016/17 (IRR trillion)

Description	First Ceiling of Budget Law of 2015/16		Second Ceiling of Budget Law of 2015/16		Budget Law of 2016/17		Percentage Change 2016/17 to First Ceiling of 2015/16		Percentage Change 2016/17 to Second Ceiling of 2015/16	
General Government Budget*	8,033.5		8,467.4		9,785.5		21.8		15.6	
General Budget	2,581.7		2,744.1		3,354.9		30.0		22.3	
General Resources	2,200.4		2,362.8		2,943.9		33.8		24.6	
	Sources	Uses	Sources	Uses	Sources	Uses	Sources	Uses	Sources	Uses
Operating Revenues and Expenses	1,288.5	1,630.2	1,288.5	1,747.2	1,573.8	2,137.6	22.1	31.1	22.1	22.3
Disposal and Acquisition of Non-financial Assets	564.8	473.9	727.3	508.9	790.5	574.8	40.0	21.3	8.7	13.0
Disposal and Acquisition of Financial Assets	347.0	96.3	347.0	106.7	579.6	231.5	67.0	140.4	67.0	116.9
Dedicated Revenues	381.3		381.3		411.0		7.8		7.8	
Government-owned Companies, Banks and For-profit Institutions Affiliated to Government Budget	6,019.4		6,019.4		6,816.9		13.3		13.3	

Source: General Government Budget Laws

* The general government budget in the first ceiling of 1394 has been estimated as the sum of the general budget and government-owned companies, banks and for-profit institutions affiliated to the government, adjusted for double countings.

In the budget of 2016/17, current revenues and current expenditures show an increase of 22.1 percent and 31.1 percent, respectively, over the first ceiling of the 2015/16 budget and the government has relied on oil revenues to compensate for a significant portion of the increase in current expenditures. Even though increased oil exports following the nuclear deal has contributed toward the realization of this expectation, uncertainty about future oil prices threaten its materialization.

In the government's Budget Bill, the general resources in 2016/17 stood at IRR2,674 trillion, but the parliament raised it to IRR2,944 trillion. It is worth noting that before the adoption of the 2016/17 Budget Law, the parliament's Research Center had expressed doubt about the wisdom of general resources exceeding IRR2,040 trillion, and thus general resources in the 2016/17 Budget Law may be overestimated by IRR634 trillion

The parliament substantially increased the figures on both disposal and acquisition of financial assets in the government's budget bill. Issuance of IRR125 trillion of treasury settlement securities in both disposal and acquisition of financial assets is one of the most important changes to the 2016/17 budget. Other important changes to the 2016/17 budget include requiring the government to cease distributing cash subsidies to families that meet certain criteria, and implementing a two-tiered fuel price system.

The government's actual performance has always deviated from the Budget Law. Table 8 exhibits details of government performance and fiscal positions in recent years.

Table 8: Main Public Finance Statistics (IRR trillion)

	A	B	C		
	2014/15 Performance	2015/16 Performance	2016/17 Budget Law of	Percentage Change (B to A)	Percentage Change (C to B)
Revenues	1,609.5	1,797.3	2,364.3	11.7	31.5
Current Revenues	978.0	1,123.7	1,573.8	14.9	40.0
Disposal of Non-financial Assets	631.5	673.6	790.5	6.7	17.4
Expenditures	1,737.8	2,022.5	2,712.4	16.4	34.1
Current Expenditures	1,438.3	1,706.9	2,137.6	18.7	25.2
Development Expenditures	299.5	277.0	574.8	-7.5	107.5
Budget Balance	**-128.3**	**-196.3**	**-348.1**	**53.0**	**77.3**

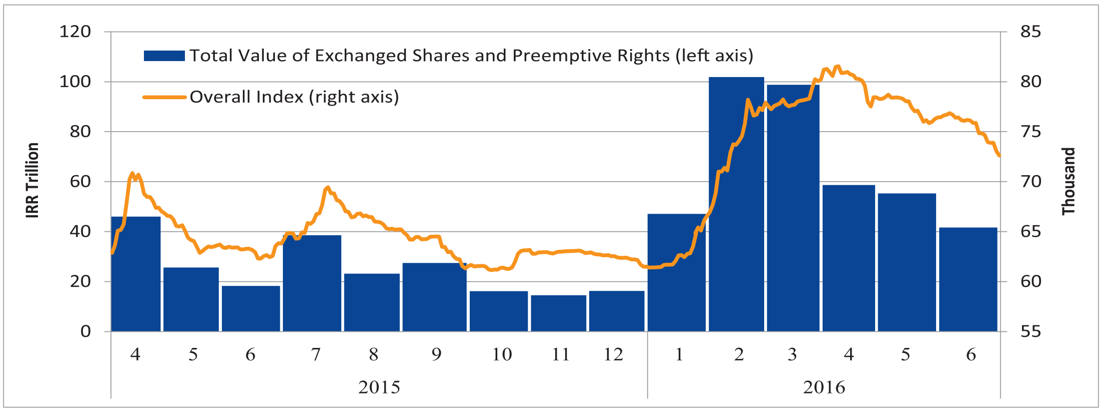
Source: Central Bank of Iran, Selected Economic Indicators reports, Government Budget and Fiscal Data; and The Budget Law of 2016/17

The Budget Law of 2016/17 includes current revenues that are 40 percent higher than actual revenues in 2015/16, and tax revenues are expected to be the main source of the overall current revenues. Given the current economic difficulties, there are doubts that increased tax revenues to such an extent could materialize. There are also doubts about the materialization of figures relating to the disposal of non-financial assets -- mostly the sale of oil and oil products. Although the lifting of sanctions has removed some limitations on such sales, lower oil prices makes the 17.4 percent growth in the disposal of non-financial assets highly improbable. The government's current expenditures are assumed to experience a 25.2 percent growth in 2016/17 and since these expenditures usually get realized at the approved amount or even above that, this significant growth indicates an expanded role of government in the economy. Finally, development expenditures --that usually materialize at levels much below the legislated figures—seem highly overestimated at 107.5 percent above the actual figure in the year 2015/16.

7. Capital Market

Tehran Stock Exchange (TSE) overall index that had experienced a 31 percent growth during the 1st quarter of 2016 fell by 10 percent during the 2nd quarter to reach 72,615. As shown in Figure 11, the total value of exchanged shares and preemptive rights that had increased substantially in the 1st quarter of 2016 and reached IRR102 trillion in February, fell significantly in the 2nd quarter of 2016 and reached only IRR42 trillion in June 2016. This happened at a time when banks' deposits, that constitute the main alternative to the stock market, had experienced several drops in their interest rates beginning in the 2nd quarter of 2016, while other substitute markets remained almost unchanged. It seems that the remarkable performance of the stock market in the 1st quarter of 2016 was primarily due to the unrealistic expectations about the developments in post Implementation Day that in the event did not materialize. However, after the dramatic fall of the TSE's overall index in the 2nd quarter of 2016, the market may have corrected sufficiently, and considering the relative firming up of oil prices and increases in oil revenues, and in light of the cooperation of the new parliament with the government's economic policies, the stock market is expected by some to begin its upward trend in the near future.

Figure 11: TSE's Overall Index and Total Value of Exchanged Shares and Preemptive Rights



Source: Report of the Performance of Securities Market, Tehran Stock Exchange, various issues; and Rahavarde Novin website

8. Other Economic Developments

An important development in the past three months was the fall of interest rates. In Iran, bank interest rates have always been set, and to varying degrees enforced, by CBI, although there have been a number of attempts at changing that practice. Between 2001 and 2005 when interest rates on one-year deposits and five-year deposits were respectively set at 13 percent and 17 percent, the banks were allowed for the first time to set their own interest rates on two-year, three-year and four-year deposits in the range of 13 to 17 percent. In February 2012 the task of setting deposit interest rates was delegated to the banks and credit institutions themselves, but in practice once the rates were agreed upon by state-owned banks' Coordinating Council and the Association of Private Banks and Credit Institutions, the Money and Credit Council announced the rates. In June 2016 the banks agreed to reduce the interest rate on one-year deposits to 15 percent, but this time before the announcement by the Money and Credit Council, a few private banks took the initiative of lowering their one-year deposit rates from the ongoing 18 percent to 16 percent. CBI announced that the Money and Credit Council had not changed the rates and unless banks that had reduced their deposit rates reduce their loan rates as well, CBI would intervene. This was interpreted as CBI's unwillingness to do away with its administrative setting of interest rates and an admission that its efforts to adjust interest rate through intervention sin the interbank market has not worked. It should be noted that CBI, by injecting funds in the interbank market and reducing interest rates on CBI claims on banks and converting those claims to credit lines, has been trying to reduce interest rates, and has indeed succeeded in reducing the interbank rate from 29 percent to 17 percent. However, it led to the growth of the monetary base that should in turn bring about inflationary pressures.

Another significant recent development relates to the gap between expectations and reality in the post-nuclear deal era. Following a 2008 verdict of the United States District Court for the Southern District of New York, the US Supreme Court recently ruled that USD1.75 billion in CBI frozen assets in the form of bonds with Citibank must be used to compensate the families of victims of the explosion in the 1983 bombing of US Marine barracks in Beirut. This verdict is part of Peterson's case which calls for the confiscation of USD2.6 billion of Iranian assets. This ruling was interpreted by some as contradicting the nuclear deal while in fact in the US the Judicial branch is totally independent of the executive branch and this issue has nothing to do with the implementation of the nuclear agreement. Apart from legal actions by the Iranian government to repatriate those assets, Iran has dispatched a team of experts to the US to negotiate the return of Iranian frozen assets.

On the other hand, some of the opportunities resulting from the implementation of the nuclear agreement have come to fruition; one relating to Iran's aircraft fleet that has an average age of about 23 years, almost twice the global average rate. The first step toward modernizing the fleet was taken by negotiating the purchase of 118 Airbus planes in a memorandum of understanding, but restrictions on financial transactions have thus far prevented its implementation. In fact, the lack of a license from the Office of Foreign Assets Control of the US Department of the Treasury is one of the most important obstacles in the way of this transaction. In the meantime, Iran Air entered into negotiations with the US Boeing company and has just signed an agreement to purchase and lease around 100 planes. Boeing announced that the deal has been made under authorization by the US government following a determination that Iran had met its obligations under the nuclear deal, and the US Treasury Department has stressed that it respects the Boeing's contract with Iran.

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