Recent Economic Developments in Iran

A Quarterly Report

بانک خاورمیانه
Middle East Bank

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Disclaimer

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A Note on the Persian Calendar

The Persian calendar is a solar calendar in which years start on the first day of spring and end on the last of winter. The four quarters of the year correspond exactly to the four seasons.

The current Persian year is 1395, which happens to be a leap year. It started on March 20, 2016 and will end on March 20, 2017. The first quarter of 1395 (1395Q1) overlaps with spring and roughly corresponds to the second quarter in the Gregorian calendar (2016Q2). Similarly, 1395Q4 roughly corresponds to 2017Q1, etc.

The following table provides an easy reference while reading this Report.

1394Q1 = 03/21/2015 – 06/19/2015, roughly **2015Q2**

1394Q2 = 06/20/2015 – 09/22/2015, roughly **2015Q3**

1394Q3 = 09/23/2015 – 12/21/2015, roughly **2015Q4**

1394Q4 = 12/22/2015 – 03/19/2016, roughly **2016Q1**

1395Q1 = 03/20/2016 – 06/20/2016, roughly **2016Q2**

1395Q2 = 06/21/2016 – 09/21/2016, roughly **2016Q3**

1395Q3 = 09/22/2016 – 12/20/2016, roughly **2016Q4**

1395Q4 = 12/21/2016 – 03/20/2017, roughly **2017Q1**

Iran's Economy at a Glance

	1393	1394Q1	1394Q2	1394Q3	1394Q4	1394	1395Q1	1395Q2
Participation and Unemployment Rates (percent)								
Participation	37.2	38.0	38.9	38.1	37.7	38.2	-	-
Unemployment (10 years and over)	10.6	10.8	10.9	10.7	11.8	11.0	-	-
Unemployment (Youth ages 15-24)	25.2	25.0	25.7	25.4	28.6	26.1	-	-
Real Growth Rates of Economic Sectors (percent) *								
Oil	4.8	3.6	3.4	-9.0	16.5	3.6	57.3	-
Agriculture	3.8	8.7	5.9	3.6	6.2	5.7	4.0	-
Industries and Mines	5.0	-3.8	-2.3	-3.9	-1.4	-2.9	2.9	-
Services	2.4	-0.6	-0.1	1.2	1.0	0.4	2.9	-
Gross Domestic Product (GDP)	3.0	0.3	1.4	1.3	2.3	1.3	4.4	-
GDP (Except Oil)	2.8	0.2	1.4	1.5	1.9	1.3	2.9	-
Gross Fixed Capital Formation	3.5	-10.1	-15.1	-19.3	-18.2	-15.7	-10.0	-
Oil (thousand barrels per day)								
Production	3,063	3,093	3,161	3,299	3,379	3,231	-	-
Export	1,435	1,422	1,534	1,561	1,787	1,574	-	-
Inflation Rates (percent)								
Consumer Prices	15.6	16.3	12.8	10.1	8.9	11.9	7.2	8.3
Producer Prices	14.8	7.4	5.3	4.0	3.2	4.9	2.7	2.9
Balance of Payments (USD millions)								
Oil Exports	55,352	10,633	9,432	7,028	6,476	33,569	-	-
Non-Oil Exports	31,119	7,047	6,504	9,740	7,737	31,028	-	-
Imports of Goods	65,079	12,902	13,171	12,510	13,836	52,419	-	-
Goods Account (Net)	21,392	4,778	2,764	4,258	377	12,177	-	-
Non-Oil Goods Account (Net)	-30,012	-5,218	-6,214	-2,149	-5,577	-19,158	-	-
Current Account	15,861	3,947	2,190	3,816	-937	9,016	-	-
Capital Account	-1,664	-4,218	4,166	2,122	-4,583	-2,513	-	-
Change in Foreign Reserves	8,561	-647	2,209	2,206	-1,535	2,233	-	-
Foreign Exchange Rates (USD/IRR)								
Exchange Rate in Free Market	32,801	33,279	33,484	35,465	35,731	34,481	34,691	35,326
Exchange Rate in Official Market	26,509	28,499	29,681	29,997	30,179	29,632	30,358	30,956
Monetary and Credit Aggregates (IRR trillions)								
Monetary Base	1,311.5	1,317.2	1,375.0	1,427.8	1,533.6	1,535.7	1,585.2	-
Central Bank Claims on Banks	858.0	813.7	806.0	829.9	836.1	836.1	895.1	-
Central Bank Claims on Public Sector (Net)	33.3	112.7	109.4	-	182.2	182.2	238.9	-
Money (M1)	1,207.6	1,123.8	1,180.2	1,158.1	1,367.1	1,367.1	1,364.4	-
Sight Deposits	855.9	826.2	873.8	856.9	995.1	995.1	1,052.8	-
Non-sight Deposits (Quasi-money)	6,616.3	7,042.9	7,547.3	8,093.6	8,805.8	8,805.8	9,230.6	-
Liquidity (M2)	7,823.8	8,166.7	8,727.5	9,251.7	10,172.9	10,172.9	10,595.0	-
Government Budget (IRR billions)								
Total Revenues	1,609,501	293,217	452,696	416,386	635,007	1,797,306	255,519	-
Tax Revenues	709,652	142,181	191,921	173,859	283,927	791,891	184,860	-
Oil Revenues	628,837	100,120	179,327	173,373	217,516	670,335	43,598	-
Other	271,012	50,916	81,447	69,155	133,561	335,080	27,061	-
Total Expenditures	1,737,816	359,579	490,315	439,059	709,695	2,022,538	415,269	-
Current Expenditures	1,438,316	359,194	392,842	358,492	596,358	1,706,885	368,796	-
Development Expenditures	299,500	385	85,804	77,465	113,337	276,990	1,400	-
Budget Balance	-128,316	-90,252	-37,619	-22,673	-45,759	-196,303	-159,750	-
Tehran Stock Exchange (end of period)								
Overall Index (TEDPIX)	62,532	63,811	61,577	61,519	80,219	80,219	72,615	76,451
Financial Index	135,089	138,168	131,121	125,938	158,224	158,225	145,481	155,263
Industrial Index	51,296	52,313	50,661	51,010	66,994	66,994	60,464	63,495
Market Capitalization (IRR trillions)	2,813.2	2,793.7	2,640.3	2,661.5	3,448.4	3,448.4	3,080.6	3,168.1

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

* GDP statistics for 1393 are based on CBI reports in constant 1383 basic prices and the datas for 1394 and 1395 are based on SCI reports in constant 1376 market prices.

1. Real Sector

According to the Statistical Center of Iran (SCI), Iran's GDP growth rate fell to 1.3 percent in 1394 mainly as a result of the fall in global oil prices, and then registered 4.4 percent growth in the first quarter of 1395 (1395Q1). As shown in Table 1, during 1394 the agriculture sector had a pivotal role in turning the GDP growth positive as the industry sector experienced a negative growth and services grew by only 0.4 percent. In 1395Q1, however, all of the three sectors registered positive growth rates. A closer examination of the 4.4 percent growth in 1395Q1 reveals the dominant role of the energy sector; the 57.3 percent growth in the value-added of oil and natural gas extraction accounted for 1.5 percentage points of the GDP growth rate. The significant growth of the energy sector has indirectly contributed to the growth in other sectors, and this cannot be expected to continue for long. The construction sector whose growth often stimulates growth in other industries but had actually contracted by 16.7 percent in 1394, contracted by a further 8.8 percent in 1395Q1, while agriculture and services registered 4.0 and 2.9 percent growth, respectively, during the same quarter.

Table 1 - Real GDP Growth Rate at Market Prices (percent)*

	1394					1395
	Q1	Q2	Q3	Q4	Year	Q1
Industries and Mining	-3.1	-1.8	-4.4	0.3	-2.2	8.8
Manufacturing	-2.4	-0.5	-0.1	1.6	-0.3	4.2
Mining	2.4	1.8	-7.3	9.9	1.7	41.4
Natural oil and gas extraction	3.6	3.4	-0.9	16.5	3.6	57.3
Other mines	-0.9	-2.3	-2.7	-7.5	-3.3	-5.6
Water, electricity and natural gas supply	0.4	5.7	-1.1	7.9	3.2	15.4
Construction	-13.5	-13.8	-21.3	-17.8	-16.7	-8.8
Agriculture	8.7	5.9	3.6	6.2	5.7	4.0
Services	-0.6	-0.1	1.2	1.0	0.4	2.9
Gross Domestic Product	0.3	1.4	1.3	2.3	1.3	4.4
Non-oil Gross Domestic Product	0.2	1.4	1.5	1.9	1.3	2.9

Source: Economic Growth Rate Report, 1395Q1, Statistical Center of Iran
*Growth rates are estimated on the basis of 1376 constant prices. Small differences between some figures in this Table and in Table 1 of previous issues of this Report are due to SCI's revision of its 1394 data.

On the expenditures side, in 1395Q1 private consumption and government expenditures grew by 0.7 and 5.2 percent, respectively, while as shown in Table 2, gross fixed capital formation contracted by a further 10.0 percent. Insufficient investment in non-oil sectors, especially in machinery, has been a major factor in the dependency of GDP growth on natural resources and constitutes a risk to sustainable growth.

Table 2 - Real Growth Rate of Gross Fixed Capital Formation Components (percent) *

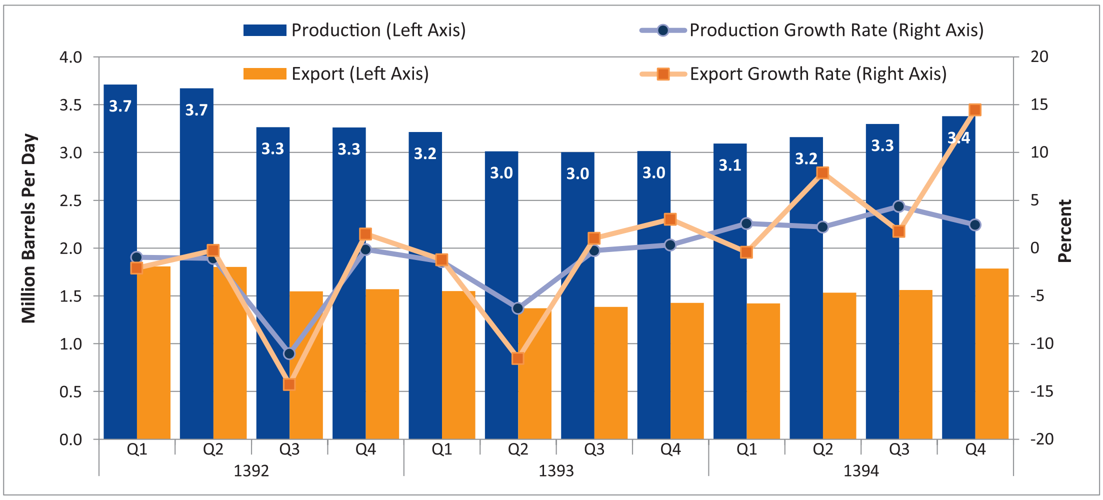
	1394					1395
	Q1	Q2	Q3	Q4	Year	Q1
Gross Fixed Capital Formation	-10.1	-15.1	-19.3	-18.2	-15.7	-10.0
-in Machinery	-7.6	-16.1	-17.7	-18.5	-15.0	-10.7
-in Construction	-13.5	-13.8	-21.3	-17.8	-16.7	-8.8

Source: Economic growth rate report, 1395Q1, Statistical Center of Iran
* Growth rates are based on 1376 constant prices.

1.1 Energy

Despite having the highest energy reserves in the world as measured by the energy content of proven oil and gas reserves, Iran has not enjoyed a high rank in global oil and gas production and exports in recent years, and the rank fell further during the period after the imposition of sanctions. But Iran's crude oil production has gradually increased in recent quarters although it still has not reached the average production level during the first half of 1392. According to OPEC reports, Iran's production reached 3.57 million barrels per day (bpd) in 1395Q1. As shown in Figure 1, Iran's oil production and export have started to grow since the winter and fall of 1393, respectively. Besides, after a declining trend in global oil prices up to the end of 1393 that pushed Iran's heavy crude oil price to as low as USD24 a barrel in 10/1394, it started to rise as of mid-winter 1394 and registered an average of USD41 a barrel in 1395Q1.

Figure 1 - Iran's Average Daily Oil Production and Export, and Their Quarterly Growth Rates

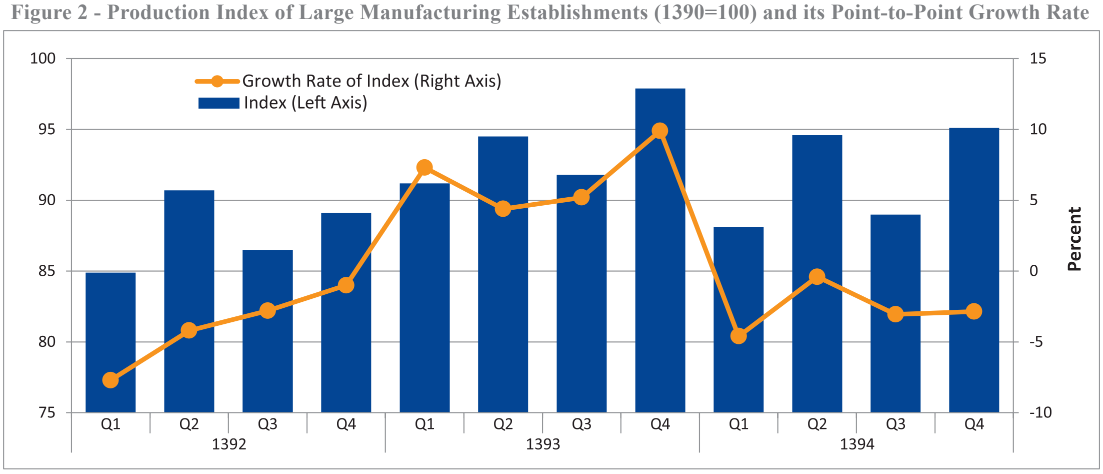


Source: Central Bank of Iran, Economic Trends

1.2 Industry

Mostly as a result of capacity underutilization in preceding years, industry sector experienced a positive growth rate in 1393 but turned to negative 0.3 percent in 1394. Data on the production of large manufacturing establishments[1] published by the Central Bank of Iran (CBI) are also consistent with this contraction. As shown in Figure 2, the quarterly point-to-point growth rate of this production index has been negative in all quarters of 1394 and shows a 2.3 percent drop from 1393. This has resulted in the contraction of investments for developing current production units and establishing new ones. According to data by the Ministry of Industry, Mine and Trade, in 1394 the number of permits for the establishment of manufacturing units and the number of permits for the operation of manufacturing units have dropped by 11.9 and 2.6 percent, respectively, compared to the year before.

Figure 2 - Production Index of Large Manufacturing Establishments (1390=100) and its Point-to-Point Growth Rate



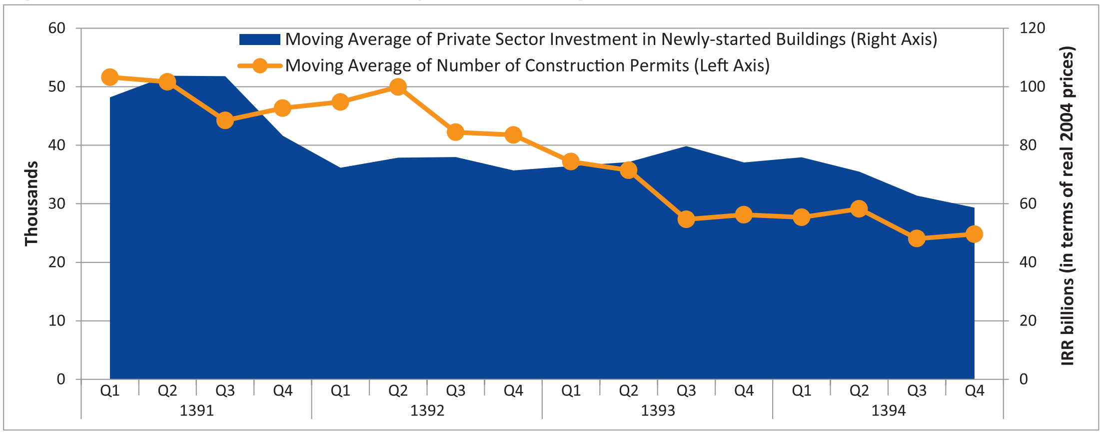
Source: Central Bank of Iran, Economic Trends

1.3 Housing

Housing market recession that had started in the second half of 1392 continued in 1394. According to the data on price of residential units in urban areas, nominal housing prices grew by 1.5 percent in 1394 compared to 1393 which, considering the much higher rate of inflation, implies a fall in real housing prices. As can be seen in Figure 3, the moving average of the real value of investments in newly-started buildings and moving average of the number of construction permits, both fell in 1394 as a result of investors' reluctance to enter the housing market. However, in the first five months of 1395, developments in Tehran and other metropolitan housing markets seemed to indicate the end of recession. According to data from Tenement Management Information System, in the first five months of 1395 the total number of transactions and the average price of a square meter of residential unit in Tehran have increased by 15 and 4 percent, respectively, compared to the same period in the preceding year. It indicates that the demand for housing is gradually going up. But there are little signs of a change on the supply side from the preceding year.

1 - Establishments with 100 employees or more.

Figure 3 - Real Value of Investments in Newly-started Buildings and Number of Construction Permits in Urban Areas



Source: Central Bank of Iran, Economic Trends

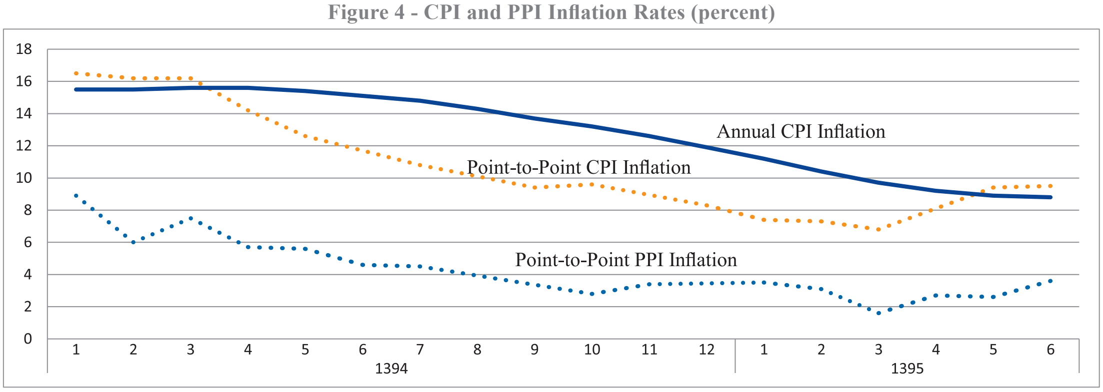
2. Prices and Inflation

Following a downward trend in the point-to-point consumer price inflation rate, it finally reached a single-digit level in 9/1394, and in 3/1395 registered its local minimum of 6.8 percent. From that point on, it increased and reached 9.5 percent in 6/1395.

Monetary aggregates reveal that the growth rate of M1 money in the year ending in 3/1395 has been 8 percentage points higher than in the year ending in 12/1394. Besides, the share of quasi-money in liquidity (M2) in the year ending in 3/1395 is lower than in the year ending in 12/1394, which may be due to the gradual reduction of deposit interest rates. These two developments could be considered as probable origins of the recent rise in point-to-point CPI inflation rate. Despite the increase in point-to-point inflation rate since 3/1395, the annual inflation rate continued its decreasing trend - alas at a slower pace - and reached 8.8 percent in 6/1395.

As a precursor to CPI inflation rate, the PPI point-to-point inflation increased from its lowest level of 1.6 percent in 3/1395 to 3.6 percent in 6/1395. This is a factor that may lead to further increases in CPI point-to-point inflation rate. Figure 4 presents the point-to-point CPI and PPI monthly inflation rates from 1/1394 to 6/1395.

Figure 4 - CPI and PPI Inflation Rates (percent)



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

The intensity of the influence of PPI inflation rate on CPI inflation rate depends on the composition of the consumption basket. The more domestically produced goods and services in the consumption basket, the more dominant will be the effect of PPI on CPI inflation rates. Developments in CPI inflation rates may also be examined from the point of view of tradable and non-tradable goods and services. According to the most recent data, the point-to-point inflation rate in tardables group is much lower than that in non-tradables group, which can be attributed to the stability in foreign exchange market and the low imports inflation rate.

The gap between CPI and PPI point-to-point inflation rates has widened from 4.2 percentage points in 2/1395 to 5.9 percentage points in 6/1395, implying that the cost of the factors of production has been growing faster than market retail prices. The increase in PPI inflation rate is expected to reach market prices with a short lag, and this may lead to a drop in demand and the GDP growth rate.

Recent data on consumption basket of goods and services reveals that among the twelve main groups, the group of “Housing, Water, Electricity, Gas and other Fuels” with the highest weight in the basket has experienced a moderate decline in point-to-point inflation rate. In contrast, this rate has increased in “Food and Beverage” group with the second highest weight in the basket, and has sharply affected the CPI point-to-point inflation rate. Table 3 shows CPI inflation rates in the 12 consumption basket groups.

Table 3 - Inflation Rate in Consumption Basket (percent)

	Annual	Point-to-Point					
	1394	1/1395	2/1395	3/1395	4/1395	5/1395	6/1395
Overall	**11.9**	**7.4**	**7.3**	**6.8**	**8.1**	**9.4**	**9.5**
Food and Beverages	10.3	2.0	1.8	2.7	5.3	9.5	9.5
Tobacco	-3.1	-0.5	10.6	11.2	11.6	12.0	11.9
Clothing and Footwear	10.4	7.2	6.9	6.8	7.0	7.0	6.9
Housing, Water, Electricity, Gas and Other Fuels.	12.2	10.7	10.2	10.0	9.9	9.5	9.1
Household Equipment and Routine Household Maintenance	5.7	4.4	4.3	4.3	4.0	4.5	4.5
Health	23.8	21.4	16.3	12.9	15.9	17.3	18.1
Transport	11.0	7.6	8.7	4.2	4.8	5.8	6.8
Communication	3.5	5.6	5.8	6.4	6.7	0.7	0.1
Recreation and Culture	14.9	7.7	7.7	7.2	7.7	8.1	10.7
Education	16.4	21.8	22.2	21.7	21.5	21.5	21.7
Restaurants and Hotels	16.1	10.5	10.0	9.4	10.0	9.1	8.6
Miscellaneous Goods and Services	11.1	9.3	9.3	9.2	10.2	10.9	10.2

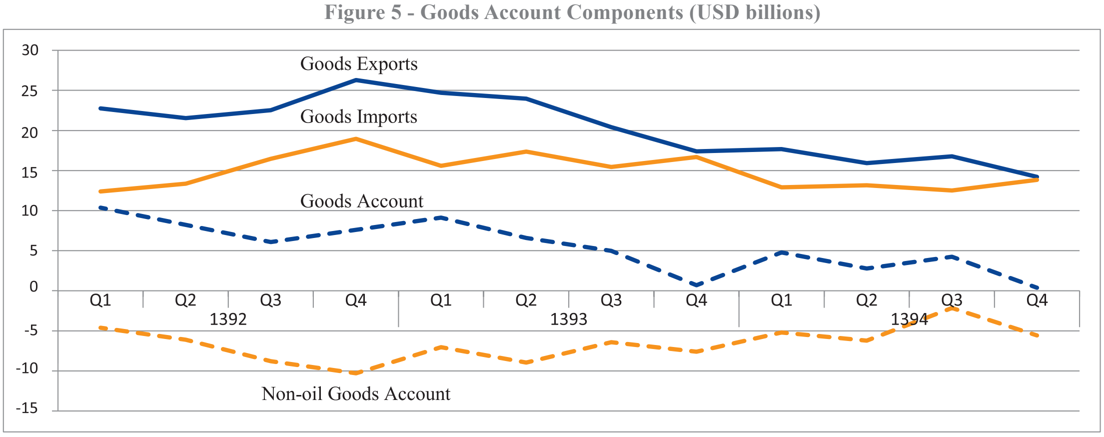
Source: Central Bank of Iran, Consumer Price Index Reports

3. Balance of Payments

Despite the gradual rise in global oil prices during 1394Q4, Iran's average oil price in this quarter experienced a drop relative to the price in the 3 preceding quarters while oil exports increased by 14.4 percent compared to 1394Q3. The USD value of oil exports (including crude oil, petroleum products, natural gas condensate and natural gas liquids) fell by 7.9 compared to 1394Q3 and by 31.6 percent compared to 1393Q4.

Oil imports value (including petroleum products, natural gas, natural gas condensate and natural gas liquids) decreased by 15.9 percent in 1394Q4 compared to the previous quarter and reached USD522 million. The significant drop in oil exports value in 1394 led to a 39 percent decline in oil trade balance compared to the year before. Besides, the value of non-oil exports in the 1394Q4 decreased by 20.6 compared to 1394Q3 and 2.4 percent from the same quarter of the preceding year. In the same quarter, non-oil imports fell by 12.0 percent from 1394Q3 and by 14.2 percent from 1393Q4. Hence, in 1394 non-oil trade balance deficit decreased by 36.2 percent to reach USD19.2 billion. Figure 5 depicts quarterly goods account components from 1392 to 1394.

Figure 5 - Goods Account Components (USD billions)



Source: Central Bank of Iran, Economic Trends

In 1394 merchandise trade balance (goods account) decreased by 43 percent to USD12.2 billion as a result of a 25.3 percent decline in exports value and a 19.5 percent decline in imports value. In the same period, a decrease in imported services led to a USD2.5 billion increase in net services account. In contrast, net income account and net current transfers account did not change much. Overall, net current account decreased by 43.2 percent in 1394 compared to the preceding year and registered approximately USD9 billion. This decrease has been mainly due to the decrease in goods account. Table 4 exhibits current account components from 1393Q1 to 1394Q4.

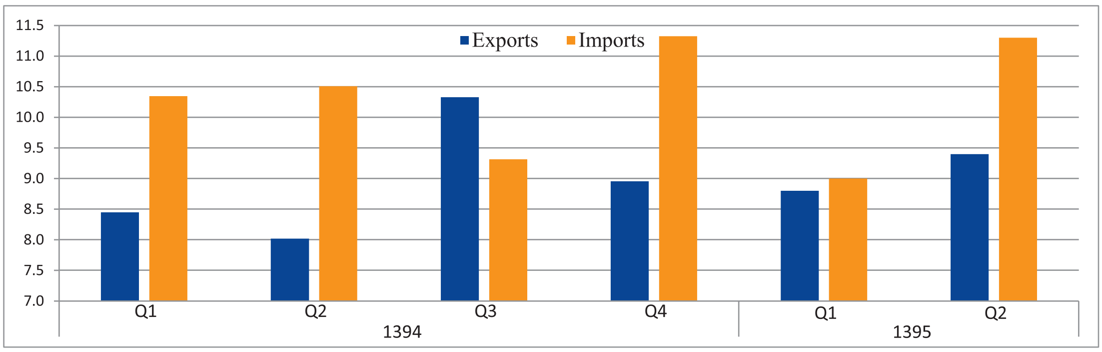
Table 4 - Current Account Components (USD millions)

	1393				1394			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Goods Account (net)	9,113	6,593	4,985	701	4,778	2,765	4,258	377
Services Account (net)	-2,270	-1,387	-1,342	-1,986	-1,206	-1,077	-759	-1,430
Income Account (net)	211	289	297	146	237	360	189	-23
Current Transfers Account (net)	125	126	129	131	138	142	128	139
Current Account Balance	7,179	5,621	4,069	-1,008	3,947	2,190	3,816	-937

Source: Central Bank of Iran, Economic Trends

In 1395Q1, the value of exports (excluding natural gas condensates) decreased by 1.7 percent compared to 1394Q4 but increased by 4.2 percent compared to 1394Q1. In the same quarter, the value of imports decreased by 20.5 percent compared to its preceding quarter and 13.0 percent compared to 1394Q1. Figure 6 depicts imports and exports values from 1394Q1 to 1395Q2. As can be seen in this Figure, the difference between value of imports and exports in 1395Q1 is much lower than in preceding quarters. According to the preliminary data published by the Islamic Republic of Iran Customs Administration (IRICA), during the first half of 1395 the value of non-oil exports, including natural gas condensates, reached USD21.7 billion and the value of imports reached USD20.3 billion. These figures show a 6.0 percent increase in exports value and a 2.6 percent fall in imports value compared to the same period in the preceding year.

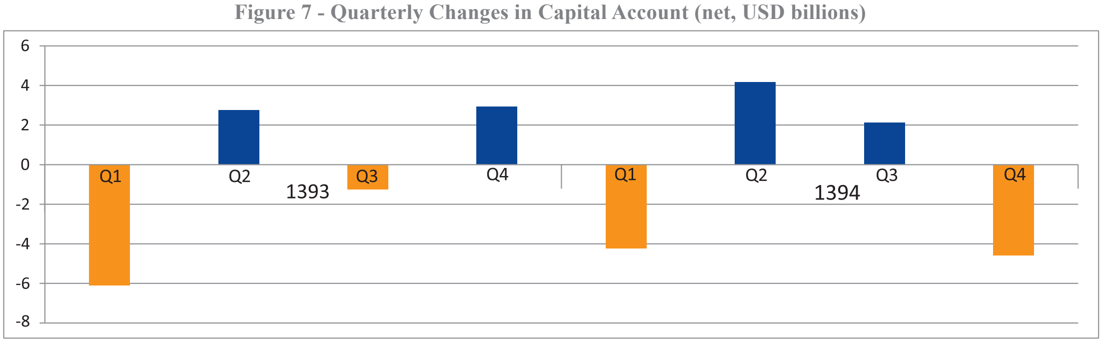
Figure 6 - Non-oil Exports* and Customs Imports Value (USD billions)



Source: Islamic Republic of Iran Customs Administration, Provisional Foreign Trade Statistic
*Excluding natural gas condensates

During the first half of 1395, exports of natural gas condensates decreased both in terms of weight and value compared to the same period in the preceding year. According to IRICA data, in this period the value share of natural gas condensate exports decreased to 16.1 compared t0 19.6 percent in the same period of the preceding year. In contrast, during this 6-month period export of petrochemicals increased to 40.0 percent of the exports value. During the period under review, China, UAE and Iraq were the main exports destinations and China, UAE and the Republic of Korea were the major sources of imports, respectively. It should be noted that the value of imports is actually much more than that published by IRICA as the contraband has not been taken into account. Moreover, since a large part of Iran's "non-oil" exports are in fact dependent on oil, gas and petrochemical products. As such, statements about Iran's surplus in non-oil trade should be treated with due care. An examination of changes in net capital account reveals the equivalent of USD2.5 billion net capital outflow in 1394. This happened as the USD6.3 billion capital net inflows during 1394Q2 and 1394Q3 was offset by USD4.2 billion net outflows in 1394Q1 and USD4.6 billion net outflows in 1394Q4. Figure 7 illustrates quarterly changes in net capital account during a 2-year period from 1393 to 1394. Taking into account USD4.3 billion in errors and omissions, along with current account balance and net capital account, Iran's international reserves has increased by USD2.2 billion in 1394.

Figure 7 - Quarterly Changes in Capital Account (net, USD billions)

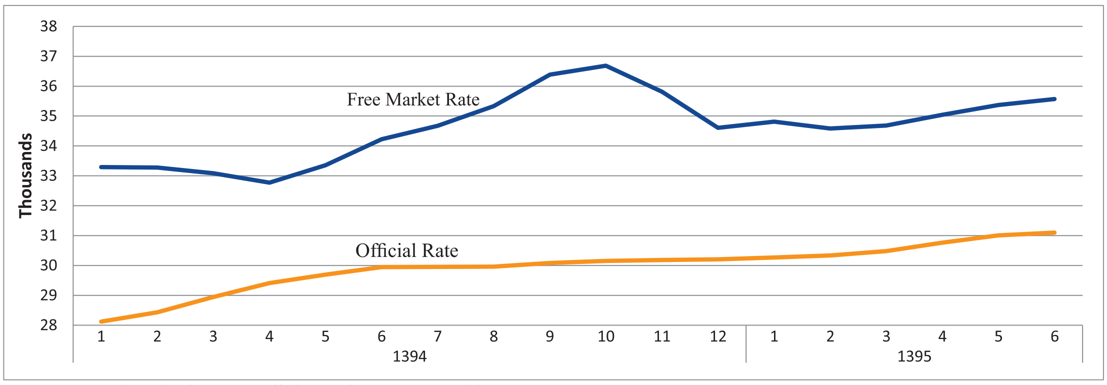


Source: Central Bank of Iran, Economic Trends

4. Foreign Exchange Market

In contrast to severe fluctuations of the USD/IRR exchange rate in the early 1390s, this rate has experienced relative stability since 1394 and has hovered around 35,000 in recent months. Among all economic and political developments that have affected this rate in recent years, the nuclear deal in July 2015 and two episodes of oil price changes are most remarkable. Oil price development included a severe fall in mid-summer 1394 which resulted in IRR depreciation relative to USD, and a gradual increase in since 11/1394 (February 2016) that caused IRR appreciation against the USD. Implementation of some JCPOA[2] articles such as resuming SWIFT operations in early winter of 1394 (February 2016) are among the other factors affecting USD/IRR exchange rate. Figure 8 shows the trends of official and free market USD/IRR exchange rates since 1/1394.

Figure 8 - Foreign Exchange Rates (USD/IRR)

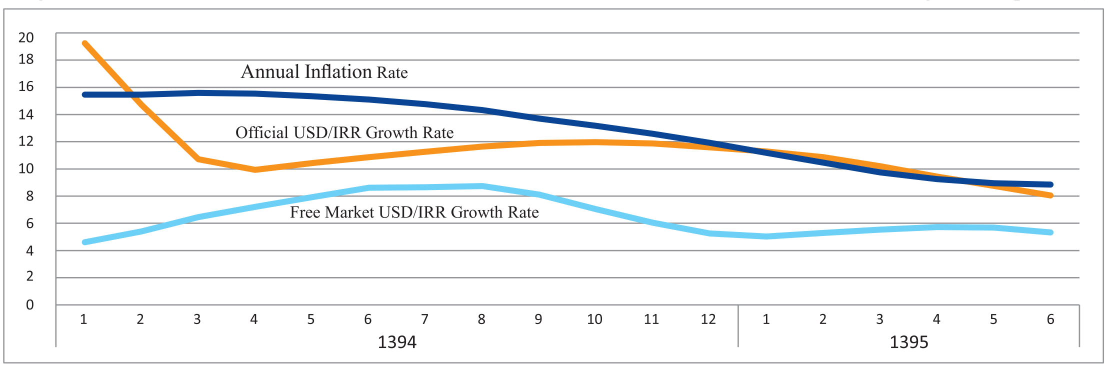


Source: Central Bank of Iran; Unofficial Exchange Rate Archives

As shown in Figure 8, since 1/1395 the USD/IRR free market exchange rate has fluctuated around IRR35,000 with very low variance. In addition, the gap between the official and free market exchange rates has been narrowing and has reached around 14.0 percent in 6/1395. A narrower gap between the two rates coupled with easier access to the country's USD resources puts CBI in a better position to implement its goal of exchange rate unification. On average, the USD/IRR official and free market exchange rates have respectively grown by 0.6 percent and 0.4 percent a month, since the beginning of 1394, thereby narrowing their gap.

The continuous decline of the inflation rate has been a major factor affecting the foreign exchange market. This has slowed the real depreciation of the IRR and also made it easier for the CBI to manage the exchange rate according to the inflation differentials between Iran and the global economy. Figure 9 depicts annual inflation rate and average growth rates of the official and free market USD/IRR exchange rates during the 12-month periods culminating in the last day of each month in 1394 and the first 6 months of 1395.

Figure 9 - Annual Inflation Rate and Growth Rates of Official and Free Market USD/IRR Exchange Rates (percent)



Source: Central Bank of Iran; Calculations of the research

Banks return to the foreign exchange market that was permitted by the CBI in 5/1395 can be a stabilizing factor in that market as it increases competitiveness. Additionally, the likely establishment of a foreign exchange futures market in the near future can play a significant role in covering exchange rate fluctuation risks, making Iran more attractive to foreign investors.

2. The Joint Comprehensive Plan of Action

5. Monetary and Credit Aggregates

In 1395Q1 the monetary base expanded by 20.3 percent compared to 1394Q1 and by 3.4 percent compared to the end of 1394. Main contributors to the big jump from 1394Q1 to 1395Q1 were increase in CBI net foreign assets, CBI net claims on public sector, and CBI claims on banks. Among these factors the 13.5 percent increase in CBI net foreign assets accounted for 16.9 percentage points of this 20.3 percent growth rate. This has been the result of a 3.5 percent increase in CBI foreign assets and a 6.7 percent decrease in CBI foreign debt. In contrast, compared to 1394, CBI net foreign assets fell by 3.1 percent in 1395Q1, as a result of 3.4 percent and 3.7 percent decreases in CBI foreign assets and foreign debt, respectively.

The 112 percent increase in CBI net claims on public sector during 1395Q1 was the second cause of the monetary base growth and accounted for 9.6 percentage points of that 20.3 percent. The 112 percent increase was due to an 18.6 percent increase in CBI claims on public sector and 8.7 percent decrease in public sector deposits in CBI. Despite the increase in CBI claims on public companies and institutions, the major source of increase in CBI claims on public sector has been government debt, especially in 1395Q1.

The 10.0 percent increase in CBI claims on banks, which accounted for 6.2 percentage points of the growth of monetary base, was the third cause of monetary base growth in that period. During 1395Q1 this component experienced 7.0 percent growth from its end of 1394 level, mostly due to public commercial banks debt. Unlike in the preceding year, in 1395Q1 CBI claims on banks contributed to the monetary base growth. Finally, the 12.9 percent increase in net value of other components of the monetary base contributed -12.4 percent to the monetary base growth. Table 5 exhibits quarterly data on monetary base components from 1394Q1 to 1395Q1.

Table 5 -Monetary Base Components (end of period balance, IRR trillions)

	1394				1395	1395 Q1 to 1394 Q1	
	Q1	Q2	Q3	Q4	Q1	Growth Rate (percent)	Share of Growth (percentage point)
Monetary Base	1,317.2	1,375.0	1,427.8	1,533.6	1,585.2	20.3	20.3
CBI Foreign Assets (net)	1,653.4	1,769.8	1,806.6	1,936.4	1,876.6	13.5	16.9
CBI Claims on Public Sector (net)	112.7	107.2	120.0	182.2	238.9	112.0	9.6
CBI Claims on Banks	813.7	806.0	829.9	836.3	895.1	10.0	6.2
Others (net)	-1,262.6	-1,308.0	-1,328.7	-1,421.3	-1,425.4	12.9	-12.4

Source: Central Bank of Iran, Economic Trends, 1395/3

In 1395Q1 the M2 money multiplier grew by a further 8.1 percent from its 1394Q1 level to reach 6.7 and resulted in an M2 liquidity level of IRR10,595 trillion. This 29.7 percent expansion of M2 money includes a 21.4 percent increase in M1 money and a 31.1 percent growth in quasi money that respectively contributed 2.9 and 26.8 percentage points to it. In that period, notes and coins with the public grew by 4.7 percent and sight deposits grew by 27.4 percent and respectively accounted for 1.2 and 20.2 percentage points of M1 growth. Therefore, following the high growth of sight deposits by 16.1 percent in 1394Q4, it increased by only 5.8 percent in 1395Q1. Besides, quasi-money grew by 4.8 percent in 1395Q1 compared to 1394, which was its lowest quarterly growth since the beginning of 1393. Ultimately, in 1395Q1 M1 money and quasi money shares of M2 reached 12.9 and 87.1 percent, respectively. Table 6 exhibits data on M2 money multiplier and M2 components from 1394Q1 to 1395Q1. The increase in sight deposit quarterly growth rates in 1394Q4 and 1395Q1 may be attributed to the reduction of the interest on time deposits from 20 to 18 percent by the Money and Credit Council on 27/10/1394 (February 16, 2016) which dampened economic agents' incentives for time deposits. After further reductions of the interest rate on one-year time deposits to 15 percent on 8/4/1395 (June 28, 2016) and the gradual improvements in the economy, it is expected that sight deposits will expand, which would result in increasing inflation pressures and deviations from the goal of further lowering the inflation rate. The reversal of the downward trend in the point-to-point CPI inflation rate in the 4th and 5th months of 1395 (July and August 2016) may be early signals of such an event. It seems that the lowering of the real interest rate is aimed at stimulating private consumption and investment and thus raising the GDP growth rate.

The balance of facilities extended by the banking system in 1395Q1 increased by 18.2 percent compared to 1394Q1. In the same period, balance of deposits before and after deduction of bank's legal reserves grew by 27.2 and 29.7 percent, respectively. The ratio of loans on deposits after bank's legal reserves deduction, following its gradual decreasing trend, reached 82.1 percent by the end of 1395Q1. According to CBI data, over the first 4 months of 1395, IRR1, 295.1 trillion loans have been made by the banking system to various sectors, which is 37.8 percent higher than in the same period of the preceding year. During the same period, 67.8 percent of the loans was allocated to provide working capital, which shows a 42.6 percent increase from the first 4 months of 1394. Consumer and capital loans respectively accounted for 10.8 and 7.7 percent of all extended facilities. Usually, a proportion of loans is not paid back at maturity and hence are classified as non-performing loans which is due to inefficient system of credit evaluation of borrowers. The ratio of non-performing loans to total loans (both in IRR and foreign exchange) has continued to decrease in the past three years and reached 10.2 percent in 1394, which is still much higher than the world average.

Table 6 - M2 Components and Money Multiplier (end of period balance, IRR trillions)

	1394				1395	1395Q1 to 1394Q1 Growth Rate (percent)
	Q1	Q2	Q3	Q4	Q1	
M2	8,166.7	8,727.5	9,251.7	10,172.8	10,595.0	29.7
Money (M1)	1,123.8	1,180.2	1,158.1	1,367.0	1,364.4	21.4
Notes and coins with the public	297.6	306.4	301.2	371.9	311.6	4.7
Sight deposits	826.2	873.8	856.9	995.1	1,052.8	27.4
Quasi-money	7,042.9	7,547.3	8,093.6	8,805.8	9,230.6	31.1
M2 Money Multiplier	6.2	6.3	6.5	6.6	6.7	8.1

Source: Central Bank of Iran, Economic Trends, 3/1395

6. Government Budget

An amendment to the budget law of 1395 was proposed to the 10th parliament soon after it assembled in summer of 1395. It was ultimately approved by the parliament with some modifications and also passed the vetting of the Guardian Council. Settlement of IRR450 trillion CBI claims on banks by a revaluation of CBI foreign assets is one of the major proposed modifications to the budget law. One or a combination of the following outcomes are likely to happen should the revaluation be enforced: settlement of state-owned banks claims on government, increase in capital stock of government in the state-owned banks, and exemption of late payment penalties on the loans up to IRR1 billion. The revaluation will be enforced conditionally, i.e., no growth in monetary base should be result from this revaluation of CBI foreign assets. It should be noted that the revaluation which converts CBI foreign assets at the most recent exchange rates[3], will result in generating a sum of IRR450 trillion, and is aimed to be allocated for settlement of CBI claims on state-owned banks. Since, according to the amendment, the increase in CBI foreign assets will offset the decrease of CBI claims on banks in the CBI balance sheet, there would be no change in the monetary base. The logic behind the conditional enforcement of the law is controlling inflation rate, while it seems that it will ultimately expand the liquidity (M2) and raise the inflation rate. In other words, the IRR450 trillion settlement of CBI claims on state-owned banks through revaluation will lead to at least IRR160 trillion increase in the capital of state-owned banks. This capital increase is equivalent to an increase in state-owned banks' ability to create money, which will result in liquidity (M2) growth. Besides, decrease in non-performing loans of state-owned banks and settlement of state-owned banks claims on government will lead to diminishing cost of these banks, hence their money creation ability increases. Accordingly, the claim that the revaluation plan will not have an inflationary effect does not seem to be correct.

The implementation of the revaluation plan could be considered a penalty on disciplined private banks on the one hand, and a source of rent for undisciplined state-owned banks on the other. Consequently, this plan will lead to transfer of public properties to state-owned banks, and ultimately exacerbates the management of these banks. It also acts as an incentive for the government since it can implement such plans to finance its debts in this way in the future.

Regarding CBI and banks claims on government and state-owned companies, it is specified that balances in the post-amendment by the end of 1395 ought not to be more than the balances in the pre-amendment period. Regardless of the enforcement of this clause, it should be noted that no specific measure is taken to prevent possible fiscal indiscipline in the coming years.

The aforementioned note to the budget is aimed at resolving credit crunch as well as eliminating some toxic assets. The CBI deputy governor has estimated that a toxic assets total around IRR2,655 trillion. Considering this figure, the IRR450 trillion designated to settle CBI claims on state-owned banks is unlikely to be effective in improving their financial status.

Another note in the law permits the government to finance its debts by issuing treasury bills or other Islamic securities with a maximum of 5-year maturity. The government debt should be settled with banks, contractors, and municipalities (cities with a population of less than 20,000 are given a priority). Guaranteed purchase of strategic agricultural products up to IRR400 trillion is also included. The government is also allowed to finance the interest payments which should be paid by the end of 1395 by issuing new treasury bills, but any obligation imposed on CBI to purchase such bills is prohibited. In order to clear "Iran Health Insurance Organization" debts, completely or partially, another note permits the government to issue up to IRR80 trillion of treasury bills or other Islamic securities. The notes are aimed to encourage the government to finance its debts by securitization. However, the government discipline both in preventing any new debt creation or debt repayments by their maturities, is a major prerequisite to the proper implementation of the new law. It should be noted that large scale securitization may result in financial crowding out and upward pressure on interest rates. Given the fact that structural weaknesses persist, the experience of the past few years indicates that the expected securitization may not be completely implemented.

According to another note, the government is allowed to take out a USD5 billion loan from Russia to finance development expenditures with the priorities given to renewable energy sources, nuclear energy, railroad, highways, dams, and irrigation and water supply networks. According to the government's spokesman, there are 2 thousand unfinished projects in Iran and IRR4000 trillion to complete them. According to recent data, foreign debt has increased from USD5.1 billion in 1394 to USD7.5 billion in 1395.

Also, clauses II and VIII in the note 14 of the budget law are eliminated in the amendment. According to clause II, it was a criminal action for members of parliament, judges, universities academic staff, doctors, individuals with an annual income exceeding IRR350 million, or those in the top three income deciles, and Iranians living abroad, to receive the government's cash subsidies. According to clause VIII, the government was required to provide fuel cards for vehicles and make it impossible for them to get fuel without it. In the post-amendment, this obligation is relaxed but it does not imply doing away with fuel cards.

The IRR17.5 trillion designated in the pre-amendment budget for repayment of principals of participation bonds and treasury bills is eliminated and is designated for participation bonds interest payments. It seems that the government intends to pay the former participation bond principals by issuing new bonds and

3. A significant portion of these foreign exchange assets had been converted to IRR at rates below the current ones.

only include interest payments in the budget. This is a common practice in many countries, but its proper implementation requires setting a ceiling on government debt.

The fiscal performance of government in 1395Q1 reveals that despite the 12.9 percent decrease in revenues from 1394Q1, government expenditures have grown by 8.3 percent, which has resulted in a 77 percent increase in budget deficit. Table 7 provides government fiscal status in 1395Q1 and compares it to other periods.

Table 7- Government Revenues and Expenditures (IRR trillions)

	1394Q1 Performance	1395Q1 Performance	Percentage Change	Approved Budget (1395Q1)	Performance (percent of approved)
Revenues	293.2	255.5	-12.9	602.4	42.4
Tax Revenues	142.2	184.9	30.0	264.5	69.9
Other Current Revenues	50.6	26.3	-47.9	136.4	19.3
Oil Revenues	100.1	43.6	-56.5	189.8	23.0
Other Non-financial Revenues	0.3	0.7	131.0	11.6	6.1
Expenditures	383.5	415.3	8.3	691.1	60.1
Current Expenditures	359.2	368.8	2.7	544.7	67.7
Development Expenditures	0.4	1.4	263.6	146.5	1.0
Revolving Fund	23.9	45.1	88.7	0.0	-
Budget Balance	**-90.3**	**-159.8**	**77.0**	**-88.7**	**180.1**

Source: Central Bank of Iran, Selected Economic Indicators Reports, Government Budget and Fiscal Data

In 1395Q1 tax revenues, despite a 30 percent increase in from its 1394Q1 level, covered only 70 percent of the legislated 3-month budget. Oil revenues decreased by 56.5 percent and covered approximately 23 percent of the legislated 3-month budget and goes totally against expectations in the post-sanctions era. The 47.9 percent decrease in other current revenues is due to a drop in revenues from government ownership and sale of public goods and services.

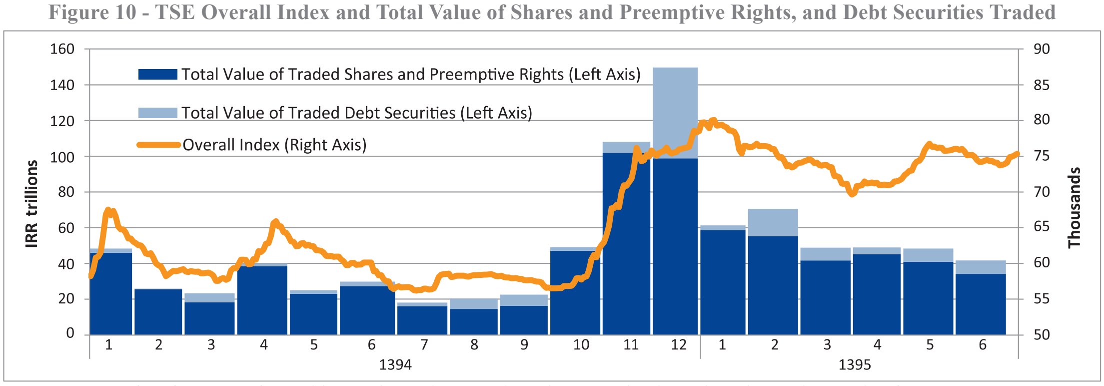
On the expenditures side, current expenditures have covered 67.7 percent of the legislated budget and development expenditures have been only one percent of the legislated amount. Shortage of development funds has been the main reason in the approval of a USD5 billion loan from Russia. Overall, in 1395Q1 the budget deficit has overshot the legislated figure by 80.1 percent. Considering the sluggish trend of privatization, issuing government bonds or foreign borrowing would be the only ways of financing the budget deficit, and these will result in added pressure on future annual budgets.

7. Capital Market

The overall index of the Tehran Stock Exchange (TSE) rose by 3,836 in 1395Q2 and closed at 76,451. Following a sharp rise during the last couple of months of 1394, the index had been falling during the previous quarter before starting to rise again from the beginning of the latest quarter and went up to as high as 78,705 by mid-5/1395. As can be seen in Figure 10, some of this gain was lost during the latter half of this quarter.

TSE transacts in (i) share and preemptive rights, (ii) debt securities, and (iii) stocks futures and options. Following a decreasing trend in the preceding quarter, the value of traded share and preemptive rights fell to IRR34.2 trillion in 6/1395, which shows a sharp decline from its level of IRR58.7 trillion in 1/1395. In contrast, the value of debt securities traded in 1395Q2 experienced an increasing trend and reached IRR7.5 trillion in 6/1395 – much above its level of IRR3.8 trillion in 4/1395. Compared to the spring of 1395 (1395Q1), the total value of both “shares and preemptive rights” and “debt securities” have decreased by 22.6 and 26.0 percent in 1395Q2, respectively. The value of stocks futures and options traded is usually negligible and highly volatile. According to the TSE, the value of stocks futures and options traded during 1395Q2 totaled IRR0.7 billion.

Figure 10 - TSE Overall Index and Total Value of Shares and Preemptive Rights, and Debt Securities Traded



Source: Report of Performance of Securities Market, Tehran Stock Exchange; and Rahavard Novin Database and Software

8. Other Economic Developments

In 2007 the Financial Action Task Force (FATF), the intergovernmental institution for combating money laundering and terrorism financing, blacklisted Iran and in 2009 asked its members to take action against Iranian financial institutions. Currently around 200 countries are committed to observing FATF standards, and up to a few months ago only Iran and North Korea were in FATF's blacklist. In the aftermath of JCPOA and following recent moves by various Iranian financial institutions to strengthen their measures for combating money laundering and terrorism financing, in June 2016 FATF suspended its blacklisting of Iran for a one-year period in order to assess its performance in those regards. Some domestic observers have voiced skepticism about Iran's renewed commitment to observe FATF standards, fearing that it could lead to the blacklisting of some domestic individuals and legal entities. They are particularly concerned about the implementation of FATF's recommendation number 7 that calls for combating the financing of weapons of mass destruction – something that Iran has been accused of in the past but has consistently denied. The Minister of Economic Affairs and Finance has tried to put those concerns to rest by noting that only a few countries have fully implemented all of FATF recommendations and Iran will also not be required to observe all of them, including recommendation number 7. In any case, it is has become clear that cooperation with the FATF is a pre-requisite for the smooth working of Iran with foreign and international financial Institutions in the post-sanctions era. Besides, implementation of the Basel Committee standards -- to which Iranian financial institutions are committed -- hinges to a large extent on observing standards that include those recommended by the FATF.

Another significant recent development is the drafting of two laws titled "Central Bank of Iran Law" and "Banking Law" that aim at reforming the banking system. According to the draft of the CBI Law, the "Money and Credit Council" will be replaced by the two the boards of "Monetary Policymaking" and "Supervision" with distinct terms of reference. An important aspect of the draft is the absence of any reference to a specific exchange rate regime, allowing CBI to determine the optimal regime in any given macroeconomic environment. According to the draft, CBI's main objectives are price ensuring stability and preserving IRR's value. This may be a weakness of the draft as CBI objectives need to be more flexible given the changing economic environment. As for open market operations, the draft limits CBI to trading only in securities issued or guaranteed by the government, and this may constrain CBI in combating financial crises. Another noteworthy point in the draft is the lowering of the minimum legal reserves ratio for the banks to 6 percent, even though setting legal reserves ratio has already been removed from the monetary policy toolbox of many central banks and the reserves ratio has been allowed to reach zero. It is likely that by reinforcing the deposit guarantee fund and appealing to monetary policy tools such as entering the interbank market and expanding open market operations, proper working of the banking system would require legal reserves ratios below 6 percent, but the current draft does not take account of such possibilities. Moreover, article 16 of the draft allows CBI to set various interest rates, and this is in contradiction with the longer term objective of liberalizing the money market and limits banks' ability to compete. The draft also calls for the appointment of CBI Governor and members of the Monetary Policymaking Board in ways that continue to undermine CBI's independence. Finally, section 8 of the draft sets guidelines for the formation of an advisory Islamic Jurisprudence Council at CBI.

The monetary and banking law of 1351 (1972/73) requires the CBI to keep gold, foreign exchange, and IRR-denominated public and non-public securities equivalent to the notes and coins in circulation, and the foreign exchange and gold reserves are required to account for at least 25 percent of the notes and coins In circulation. The current draft has eased these restrictions and permits CBI to include other asset types as reserves. It also bars CBI from granting loans to government ministries, state-owned companies and their subsidiaries, and from discharging new revolving funds to the government before previous year's revolving funds have been settled. The draft also bars CBI from purchasing or acquiring securities issued or guaranteed by the government in initial public offerings (IPOs). This will rein in the growth of monetary base by controlling CBI claims on government. This component has been a major factor in its growth of the monetary base in recent past during which monetary policy was frustrated by fiscal policy.

In the draft of Banking Law, only CBI can issue licenses for the establishment of banks and credit institutions. It is noteworthy that only recently CBI and the Ministry of Cooperation, Labor and Social Welfare, have jointly issued licenses for the establishment of cooperative financial and credit institutions. In recent years the mushrooming of unlicensed banks and other financial institution and cooperatives has been a major destabilizing factor in the money market. In an effort to enforce corporate governance, article 33 of the draft bars members of a bank's board of directors from assuming executive positions at that bank. However, it exempts state-owned banks from this requirement and allows the chairman of the board of directors to serve as the CEO. At the same time it allows CBI to not only set a cap on bank service fees, but also set caps on fees charged by credit rating agencies. As such, the proposed law not only fails to curtail CBI's interventionist role in banks operations, it extends it to credit rating agencies as well.

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