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Recent Economic Developments in Iran

A Quarterly Report



No. 12 | October 2018

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No. 12, October 2018

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Notes

Note 1: In this Report the growth rate of a variable means the percentage change of that variable during the period under review, or at the point under discussion, from the similar period or point in the preceding year. As such, “the growth rate of oil revenues in the first quarter of 1397” indicates the percentage change in oil revenues between the first quarter of 1396 and the first quarter of 1397.

Note 2: Iran follows the Persian Calendar, a solar calendar in which years start on the first day of spring and end on the last day of winter. The four quarters of the year correspond exactly to the four seasons. The current Persian year is 1397 that started on March 21, 2018, and ends on March 20, 2019. The second quarter of 1397 (referred to as 1397Q2), summer of 1397, roughly corresponds to the third quarter of 2018 in the Gregorian Calendar (2018Q3).

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

1396Q2 = 06/22/2017 – 09/22/2017, roughly **2017Q3**

1396Q3 = 09/23/2017 – 12/21/2017, roughly **2017Q4**

1396Q4 = 12/22/2017 – 03/20/2018, roughly **2018Q1**

1397Q1 = 03/21/2018 – 06/21/2018, roughly **2018Q2**

1397Q2 = 06/22/2018 – 09/22/2018, roughly **2018Q3**

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Iran's Economy at a Glance

| | 1396Q1 | 1396Q2 | 1396Q3 | 1396Q4 | 1396 | 1397Q1 | 1397Q2 |
|---|----------|----------|----------|----------|----------|----------|---------|
| Labor Force Participation & Unemployment Rates (percent) | | | | | | | |
| Participation (10 Years and Over) | 40.6 | 41.0 | 40.1 | 39.7 | 40.3 | 41.1 | - |
| Unemployment (10 Years and Over) | 12.6 | 11.7 | 11.9 | 12.1 | 12.1 | 12.1 | - |
| Unemployment (Youth Aged 15-24) | 28.8 | 27.3 | 28.4 | 29.2 | 28.4 | 28.3 | - |
| Real Growth Rates of GDP and Its Subsectors at Constant 1390 Prices (percent)* | | | | | | | |
| Gross Domestic Product (GDP) | 4.6 | 5.1 | 2.4 | 2.7 | 3.7 | 1.8 | - |
| Oil | 5.9 | 5.7 | -3.3 | -4.2 | 0.9 | 5.2 | - |
| Agriculture | 2.2 | 3.3 | 4.0 | 2.1 | 3.2 | 0.3 | - |
| Manufacturing and Mining | 4.6 | 5.5 | 4.5 | 5.5 | 5.1 | 0.1 | - |
| Services | 4.3 | 4.8 | 4.0 | 4.4 | 4.4 | 1.1 | - |
| Non-Oil GDP | 4.3 | 4.9 | 4.2 | 4.8 | 4.6 | 0.7 | - |
| Gross Fixed Capital Formation (at market prices) | -1.8 | 1.4 | 4.1 | 1.2 | 1.4 | -0.8 | - |
| Oil (daily average - thousand barrels) | | | | | | | |
| Production | 3,880 | 3,867 | 3,836 | 3,812 | 3,849 | 3,804** | - |
| Export | 2,344 | 2,367 | 2,291 | 2,295 | 2,324 | - | - |
| Inflation Rates (percent) | | | | | | | |
| Growth Rate of Consumer Price Index (1395=100) | 11.4 | 8.8 | 9.3 | 9.1 | 9.6 | 10.5 | 24.5 |
| Growth Rate of Producer Price Index (1395=100) | 8.9 | 9.0 | 10.4 | 11.7 | 10.0 | 14.6 | 35.4 |
| Balance of Payments (USD millions) | | | | | | | |
| Oil Exports | 14,166 | 15,736 | 16,468 | 19,448 | 65,818 | - | - |
| Non-Oil Exports | 7,176 | 7,200 | 8,332 | 9,616 | 32,324 | - | - |
| Import of Goods | 16,283 | 17,269 | 19,158 | 22,836 | 75,546 | - | - |
| Goods Account (Net) | 5,059 | 5,667 | 5,643 | 6,227 | 22,596 | - | - |
| Non-Oil Goods Account (Net) | -8,814 | -9,708 | -10,039 | -11,897 | -40,458 | - | - |
| Current Account | 3,723 | 3,718 | 3,473 | 4,902 | 15,816 | - | - |
| Capital Account | -1,338 | -4,956 | -5,499 | -7,528 | -19,321 | - | - |
| Change in Foreign Reserves | -1,585 | -3,968 | -3,078 | 491 | -8,140 | - | - |
| Foreign Exchange Rates (USD/IRR daily average) | | | | | | | |
| In Free Market*** | 37,494 | 38,236 | 40,719 | 45,548 | 40,552 | 60,365 | 103,721 |
| Official Rate | 32,445 | 32,900 | 34,800 | 36,842 | 34,276 | 41,392 | 42,646 |
| Monetary and Credit Aggregates (end of period - IRR trillions) | | | | | | | |
| Monetary Base (M0) | 1,851.9 | 1,964.9 | 1,995.0 | 2,139.8 | 2,139.8 | 2,186.6 | - |
| Central Bank Claims on Banks | 1,013.7 | 1,097.1 | 1,130.7 | 1,320.3 | 1,320.3 | 1,397.1 | - |
| Central Bank Claims on Public Sector (Net) | 282.0 | 292.2 | 279.9 | 55.1 | 55.1 | 82.8 | - |
| Liquidity (M2) | 13,149.1 | 13,899.5 | 14,453.1 | 15,299.8 | 15,299.8 | 15,827.5 | - |
| Money (M1) | 1,647.1 | 1,682.4 | 1,737.4 | 1,946.7 | 1,946.7 | 2,059.5 | - |
| Sight Deposits | 1,307.0 | 1,337.7 | 1,385.8 | 1,504.0 | 1,504.0 | 1,635.5 | - |
| Non-Sight Deposits (Quasi-Money) | 11,502.0 | 12,217.1 | 12,715.7 | 13,353.1 | 13,353.1 | 13,768.0 | - |
| Government Budget and Fiscal Position (IRR trillions) | | | | | | | |
| Total Revenues | 426.1 | 590.5 | 579.2 | 1,002.7 | 2,598.5 | 590.6 | - |
| Tax Revenues | 181.9 | 249.3 | 252.6 | 474.6 | 1,158.4 | 225.9 | - |
| Oil Revenues | 188.9 | 257.8 | 193.0 | 279.6 | 919.2 | 326.0 | - |
| Other Revenues | 55.3 | 83.5 | 133.6 | 248.5 | 520.9 | 38.7 | - |
| Total Expenditures**** | 600.8 | 596.9 | 783.4 | 887.4 | 2,868.6 | 880.7 | - |
| Current Expenditures | 548.8 | 526.1 | 560.3 | 794.2 | 2,429.4 | 588.1 | - |
| Development Expenditures | 8.2 | 70.0 | 224.0 | 137.0 | 439.2 | 226.7 | - |
| Budget Balance | -174.7 | -6.4 | -204.3 | 115.3 | -270.1 | -290.1 | - |
| Tehran Stock Exchange (end of period) | | | | | | | |
| Overall Index (TEDPIX) | 78,736 | 85,832 | 95,509 | 96,290 | 96,290 | 108,873 | 160,538 |
| Financial Index | 130,664 | 129,604 | 134,057 | 119,176 | 119,176 | 120,837 | 165,359 |
| Industrial Index | 67,681 | 74,823 | 74,078 | 86,082 | 86,082 | 98,476 | 146,264 |
| Market Capitalization (IRR trillions) | 3,201 | 3,396 | 3,946 | 3,847 | 3,847 | 4,213 | 6,124 |

Source: Central Bank of the Islamic Republic of Iran (CBI), and Statistical Center of Iran (SCI), various reports

* Based on CBI reports at basic prices

** According to OPEC reports from direct sources

*** Since 21/01/1397, the free market USD/IRR exchange rate has been calculated based on USD/EUR exchange rate in the international currency market and EUR/IRR exchange rate in Tehran's black market.

**** The difference between the data on sum of current and development expenditures and total expenditures in a given quarter is due to the fact that revolving funds are not settled in each quarter but only at the end of the year.

1. Real Sector

According to the statistics of the Central Bank of the Islamic Republic of Iran (CBI), Iran's economy grew by 1.8 percent at basic prices in 1397Q1, out of which 1.2 percentage points was attributed to the oil sector. In the first three months of 1397, this sector expanded by 5.2 percent and, unlike all quarters of 1396, was the main contributor to the economic growth. The services sector ranked second with 0.5 percentage points of share in growth (mainly owing to the growth in "transportation, storage, and communications" subsector). Agriculture and Manufacturing

& Mining sectors recorded negligible growth rates of 0.3 percent and 0.1 percent, respectively, and contributed the least to the economic growth. Table 1 presents real growth rates of GDP and its main components. Due to the inconsiderable role of the non-oil sector in the economic growth in 1397Q1 and the return of international sanctions, especially in oil exports, the economic growth rate is predicted to be roughly zero or even experience negative figures in the last nine months of 1397.

Table 1- Growth Rates of GDP and Its Subsectors at Constant 1390 Prices (percent) and Their Shares in Growth Based on Current Prices (percentage points)

| | 1396 | | | | | 1397Q1 | |
|---|------------|------------|-------------|-------------|------------|------------|-----------------|
| | Q1 | Q2 | Q3 | Q4 | Year | Growth | Share in Growth |
| Agriculture | 2.2 | 3.3 | 4.0 | 2.1 | 3.2 | 0.3 | 0.0 |
| Oil | 5.9 | 5.7 | -3.3 | -4.2 | 0.9 | 5.2 | 1.2 |
| Manufacturing & Mining | 4.6 | 5.5 | 4.5 | 5.5 | 5.1 | 0.1 | 0.0 |
| Mining | 3.7 | 1.5 | 0.8 | 5.5 | 2.9 | 4.0 | 0.0 |
| Manufacturing | 5.0 | 6.4 | 4.4 | 5.4 | 5.3 | -1.5 | -0.2 |
| Electricity, Gas, and Water | 8.3 | 6.3 | 7.1 | 8.4 | 7.5 | 2.1 | 0.1 |
| Construction | -3.5 | 3.1 | 1.4 | 2.0 | 1.2 | 0.1 | 0.0 |
| Services | 4.3 | 4.8 | 4.0 | 4.4 | 4.4 | 1.1 | 0.5 |
| Trade, Restaurant, and Hotel | 6.6 | 5.7 | 2.6 | 4.4 | 4.7 | -1.1 | -0.1 |
| Transportation, Storage, and Communications | 5.6 | 8.0 | 6.4 | 8.1 | 7.1 | 5.7 | 0.5 |
| Financial and Monetary Institutions Services | 2.6 | 3.5 | 3.5 | 3.4 | 3.3 | 1.3 | 0.0 |
| Real Estate, Specialized and Professional Services | 4.0 | 4.2 | 3.9 | 4.7 | 4.2 | 0.9 | 0.1 |
| Public Services | 3.2 | 4.7 | 8.2 | 2.6 | 4.4 | -0.5 | 0.0 |
| Social, Personal, and Household Services | -1.7 | -3.3 | -8.2 | -1.9 | -3.8 | -1.9 | 0.0 |
| Non-Oil Gross Domestic Product (at basic prices) | 4.3 | 4.9 | 4.2 | 4.8 | 4.6 | 0.7 | 0.6 |
| Gross Domestic Product (at basic prices) | 4.6 | 5.1 | 2.4 | 2.7 | 3.7 | 1.8 | 1.8 |

Source: Central Bank of Iran, Summary of Iran Economic Developments in Real Sector in 1396 and 1397

Out of IRR3,987.8 trillion value-added produced at current prices in 1397Q1, the share of the agriculture sector was 8.9 percent. Preliminary estimates of the Ministry of Agriculture-Jahad indicate 2.1 percent, 3.6 percent, and 5.0 percent growth rates for farm products, garden products, and animal husbandry products, respectively, compared to the same period in the preceding year. The share of the oil sector in the produced value-added at current prices was 19.6 percent, which rose by 5.2 percentage points and 5.7 percentage points from the preceding quarter and the same quarter in the year before, respectively, mainly due to the increase in crude oil exports, production of natural gas condensates and also production and export of natural gas, as reported by the CBI. Moreover, the role of oil price hike cannot be ignored. The manufacturing & mining sector, which contributed to 20.4 percent of the produced value-added at current prices, was not in decent condition in 1397Q1. In the period under review, among the most crucial variables of this sector, the production index of large manufacturing establishments¹ (in manufacturing subsector) declined by 0.5 percent and the value-added of private constructions (in construction subsector) shrank by 2.0 percent

at constant prices. Among the subsectors of the services sector, which is the largest economic sector with the GDP share of 53.5 percent at current prices, "social, personal, and household services", "trade, restaurant, and hotel services", and "public services" contracted in 1397Q1 at constant prices and other services did not contribute significantly to the economic growth, except "transportation, storage, and communications services".

Table 2 represents the demand side of the economy, according to which the gross domestic expenditures in 1397Q1 expanded roughly by 2.5 percent at market prices and at constant 1390 prices. Public consumption grew by 3.9 percent, whereas private consumption and gross fixed capital formation contracted in real terms. The decline in production and import of capital goods led to 5.2 percent of contraction in gross fixed capital formation in machinery subsector, while 1.9 percent of growth in capital formation in construction subsector was owing to the increase in public construction activities in spite of the decrease in private ones. Net exports in 1397Q1 rose by 12.7 percent at constant prices and amounted to IRR361.4 trillion at current prices.

1. These establishments contain almost 70 percent of the value-added in manufacturing sector.

Table 2- Growth Rates of GDP and Its Subsectors on the Expenditures Side at Constant 1390 Prices (percent)

| | 1396 | | | | Year | 1397 |
|--|------|------|-------|------|------|------|
| | Q1 | Q2 | Q3 | Q4 | | Q1 |
| Private Consumption | 5.7 | 4.8 | -1.5 | 1.0 | 2.5 | -0.3 |
| Public Consumption | 2.6 | 4.1 | 7.7 | 2.1 | 3.9 | 3.9 |
| Gross Fixed Capital Formation | -1.8 | 1.4 | 4.1 | 1.2 | 1.4 | -0.8 |
| Machinery | -0.7 | -0.6 | 4.6 | 5.5 | 2.5 | -5.2 |
| Construction | -2.5 | 2.1 | 3.8 | -0.6 | 0.9 | 1.9 |
| Net Export of Goods and Services | -3.7 | 4.3 | -16.0 | 3.8 | -3.0 | 12.7 |
| Export of Goods and Services | 1.3 | 6.0 | -9.0 | 9.5 | 1.8 | 10.0 |
| Import of Goods and Services | 16.4 | 10.2 | 6.2 | 21.1 | 13.4 | 3.2 |
| Change in Stock and Statistical Errors | 13.5 | 17.6 | 33.1 | 15.2 | 20.5 | -1.7 |
| Gross Domestic Product (at market prices) | 3.5 | 6.1 | 2.4 | 2.9 | 3.8 | 2.5 |

Source: Central Bank of Iran, Summary of Iran Economic Developments in Real Sector in 1396 and 1397

The real growth rate of gross domestic expenditures (2.5 percent), calculated at market prices, is considerably different from the economic growth rate computed on the value-added side at basic prices (1.8 percent). Unlike in market prices, subsidies and indirect taxes are not considered in basic prices and, therefore, the two economic growth rates on the basis of these two prices are not necessarily the same. The higher growth rate at market

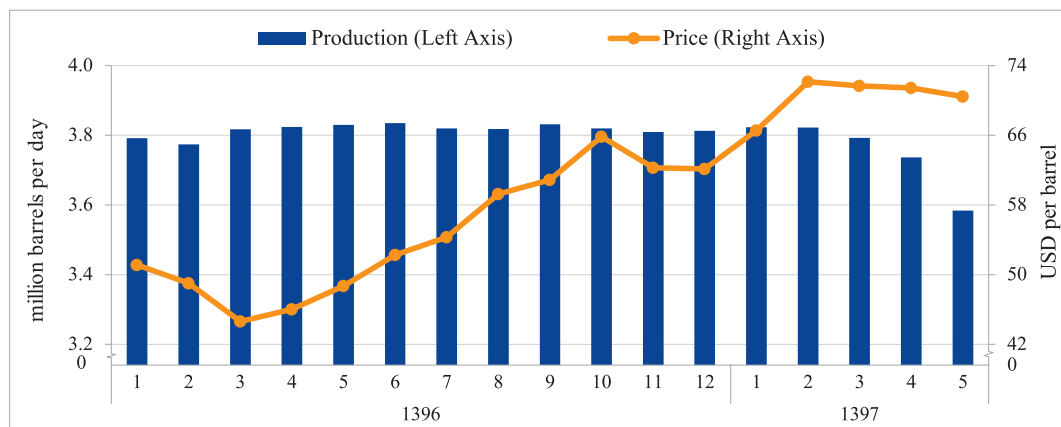
prices implies an increase in the net indirect taxes in 1397Q1 compared to the same period a year earlier and also indicates that its growth rate was greater than that of production at market prices. According to Selected Economic Indicators published by the CBI, tax on imports and on goods and services grew by 104.8 percent and 39.3 percent, respectively, which brought about 52.7 percent of growth in indirect taxes at current prices.

Energy

Production and export of oil are among the sectors in the Iranian economy which are largely affected by international sanctions. As is depicted in Figure 1, based on the most recent OPEC report on secondary sources², the average daily crude oil production in 05/1397 declined by 200 thousand barrels compared to its previous six-month average and recorded around 3.6 million barrels per day (bpd), which has been the lowest monthly production level of the Iranian crude oil since 02/1395. However, in the same report, oil production in 04/1397 and 05/1397 was reported as 3.8 million bpd on the basis of direct sources with no significant reduction, which seems unlikely considering the gradual effects of sanctions return. The price of Iran's heavy crude oil started a downward trend from 02/1397 and reached USD70.5 per barrel

in 05/1397. According to the latest CBI statistics, average oil exports recorded 2.3 million bpd in 1396Q4. Nonetheless, based on some unofficial reports, total crude oil exports in August 2018 were estimated at less than 70 million barrels, the lowest amount during the last 16 months. Most of oil customers reduced their purchases in this month and foreign banks and insurance companies stopped providing their services to Iranian oil sector. For instance, China's oil imports from Iran declined from 24 million barrels in July to 18.4 million barrels in August and that of India dropped from 20 million barrels to 8.2 million barrels in the same period. Iran, however, tries to maintain its customers by offering price discounts.³ Figure 1 demonstrates developments in production and exports of Iran's crude oil.

Figure 1- Iran's Average Daily Crude Oil Production and Average Price of Iran's Heavy Oil*



Source: OPEC monthly reports, statistics on production are based on secondary sources

*OPEC statistics are based on Gregorian calendar years and their conversion into Persian calendar years are only approximate.

2. OPEC consults two sources to publish the data on oil production for different countries. One of them is direct sources that are officially published by each country and the other one is secondary sources that consist of different unofficial international reports.

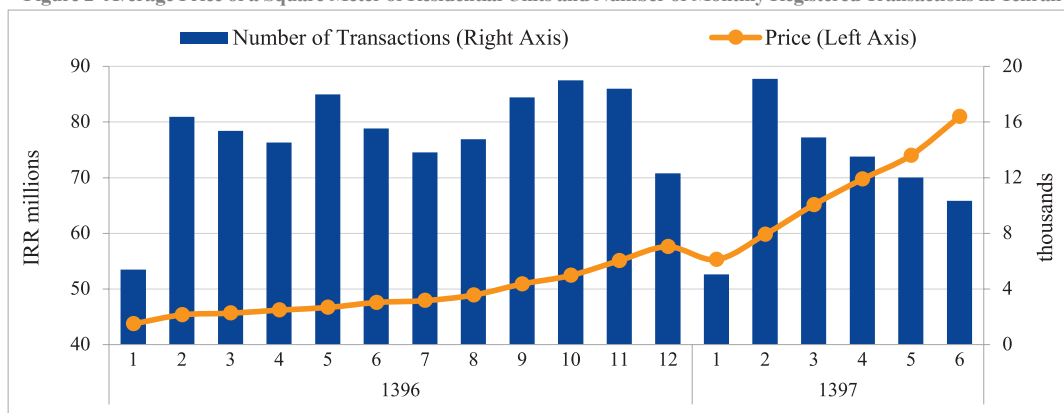
3. According to Reuters: <https://www.reuters.com/article/iran-crude/rpt-iran-oil-exports-set-to-drop-in-aug-ahead-of-u-s-sanctions-data-idUSL3N1VK03P>

Housing

Owing to the climbing trend of housing prices since the first few days of the second half of 1396 (1396H2), more speculators and investment-oriented demanders entered this market. In 06/1397, the average price of a square meter of residential units, therefore, soared to just over IRR81.0 million, showing a 74.1 percent increase. The enormous current amount of liquidity in the Iranian economy, whose considerable portion had been deposited as quasi-money in the banking system, kept the demand in this market high despite the jump in prices. The 9.4 percent escalation in the average housing prices in 06/1397 compared to its previous month was the highest monthly growth rate since 03/1392.

However, there was no increase in the mortgage loan or the other factors of household's purchasing power. Moreover, from almost the end of 1397Q1, the gold and foreign exchange markets became more attractive for investors in comparison to the housing market. Henceforward, the number of transactions in this market started to decline from 03/1397 and reached a mere 10 thousand in 06/1397, the lowest amount from 07/1395 (without considering the first month in each year when transactions typically drop because of the New Year's holidays). The recent developments in housing prices and transactions are depicted in Figure 2.

Figure 2- Average Price of a Square Meter of Residential Units and Number of Monthly Registered Transactions in Tehran



Source: Central Bank of Iran, Developments in the Housing Market in Tehran, various issues

Labor Force

According to the latest report of the Statistical Center of Iran, certain indicators of the labor market continued their slight improvements in 1397Q1. The participation rate, for example, rose by 0.5 percentage points to just over 41.1 percent and the unemployment rate fell by 0.5 percentage points to 12.1 percent, compared to the same quarter a year earlier. The above ups and downs translate into a rise of 756 thousand in the number of the employed and a fall of 45 thousand in the number of the unemployed which increased the number of active population by 711 thousand, overall. The Unemployment rate of the population aged 15-29 dropped by

0.9 percentage points and reached 25.5 percent, which is still pretty high. Highly-educated individuals were another group whose rate of unemployment followed a fairly similar pleasant pattern. However, they comprised roughly 36.4 percent of the whole unemployed. Besides, 10.2 percent of the employed population was underemployed, working less than 44 hours per week, despite being enthusiastic and able to work more. Even though the underemployment share in 1397Q1 was the same as in 1396Q1, it should be noted that almost 88 thousand individuals added to this category. Table 3 indicates the most important statistics of the Iranian labor market.

Table 3- Most Important Labor Market Indicators for the Population Aged 10 and Over

| | 1396 | | | | 1397 | |
|---|----------|----------|----------|----------|----------|----------|
| | Q1 | Q2 | Q3 | Q4 | Year | Q1 |
| Economic Participation Rate (percent) | 40.6 | 41.0 | 40.1 | 39.7 | 40.3 | 41.1 |
| Unemployment Rate (percent) | 12.6 | 11.7 | 11.9 | 12.1 | 12.1 | 12.1 |
| Unemployment Rate for the Population Aged 15-29 (percent) | 26.4 | 24.4 | 25.0 | 25.2 | 25.3 | 25.5 |
| Share of the Underemployed (percent) | 10.2 | 9.2 | 10.8 | 11.5 | 10.4 | 10.2 |
| Number of Active Population (1000 people) | 26,675.3 | 26,983.3 | 26,472.8 | 26,223.9 | 26,588.8 | 27,386.7 |
| Number of the Employed (1000 people) | 23,308.4 | 23,827.2 | 23,331.2 | 23,047.8 | 23,378.6 | 24,064.7 |
| Number of the Unemployed (1000 people) | 3,367.0 | 3,156.1 | 3,141.7 | 3,176.1 | 3,210.2 | 3,322.0 |

Source: Statistical Center of Iran, Summary of the Labor Force Survey in 1396 and 1397Q1

Concerning genders, economic participation rate among men was higher and their unemployment rate was lower compared to women in 1397Q1, as was the case in previous quarters. The participation rate was 16.8 percent among women and 65.3 percent among men, while the unemployment rate was 19.2 percent among women and 10.3 percent among men. In the period under review, 50.1 percent of the employed population was working in services, the largest sector of the Iranian economy which produces almost half of its value-

added. Manufacturing and agriculture contained 31.2 percent and 17.8 percent of the employed population, respectively.⁴ Regarding the provincial distribution of the labor market, the rural unemployment rate (7.9 percent) was less than urban unemployment rate (13.6 percent). In 1397Q1, Chaharmahal and Bakhtiari province experienced the highest unemployment rate at 22.8 percent, while Semnan province enjoyed the lowest rate at 7.1 percent.

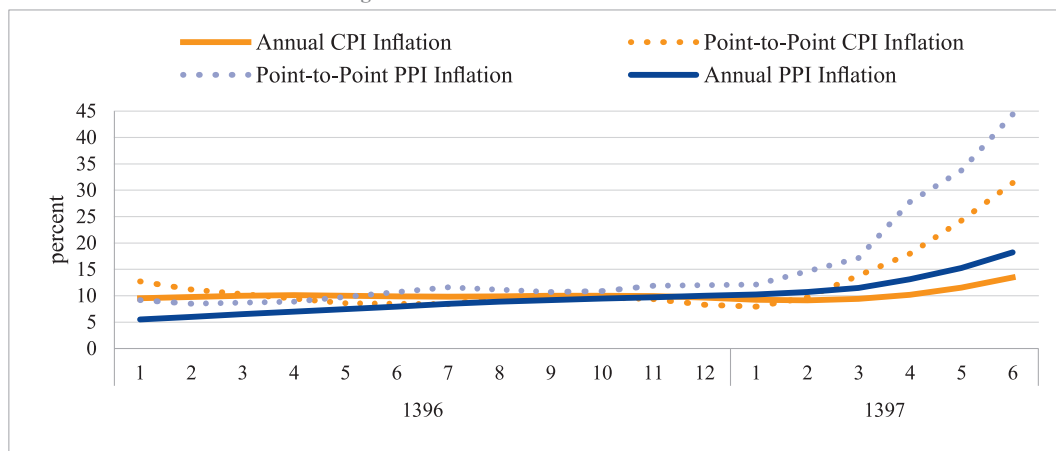
2. Prices and Inflation

The point-to-point consumer price index (CPI) inflation rate, that had reached its lowest level of 7.9 percent since 04/1395, started its upward trend in 02/1397 and amounted to 31.4 percent in 06/1397. However, due to the fast rise of the point-to-point producer price index (PPI) inflation rate in preceding months, the increase in the point-to-point CPI inflation rate had been predicted and it is expected to continue in the remainder of the year. The annual CPI inflation rate at the end of each month maintained its increasing path, which had started from 03/1397, touched a two-digit level after five months and registered 13.5 percent in 06/1397.

The point-to-point PPI inflation rate on the basis of the new base year (1395) that had recorded 12.1 percent in the first

month of 1397 experienced a sharp rising trend in 1397H1, almost tripled in the middle of 1397Q2 and reached 44.4 percent in 06/1397. This increase was mainly due to the depreciation of the Iranian rial against foreign exchanges, since around 60 percent of goods imported to the country are intermediate goods which have led to higher production costs.⁵ The point-to-point CPI inflation rate had not exceeded the point-to-point PPI inflation rate since 05/1396 and their gap widened in the first few months of 1397 to 13.0 percentage points in 06/1397. Given the lagged effect of PPI inflation rate on CPI inflation rate, the latter is expected to increase faster in coming months. Figure 3 depicts point-to-point and annual CPI and PPI inflation rates in 1396 and 1397H1.

Figure 3- CPI and PPI Inflation Rates in 1397H1



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

The point-to-point CPI inflation rate of tradable goods, which recorded 6.2 percent in 01/1397, more than quadrupled in 04/1397, mainly owing to the rial depreciation against foreign exchanges. This implies that tradable goods were more effective in raising the CPI inflation rate. In 04/1397, the point-to-point inflation rate of non-tradable goods increased to 12.3 percent according to the latest CBI statistics.

Out of 12 major groups in the consumption basket of goods and services in 1397Q2, the point-to-point inflation rate in all

groups increased, with “food and beverages” and “transport” recording significant increases. Given that these groups are the second and the third largest in the consumption basket, respectively, the increase in point-to-point CPI inflation rate was largely due to the sharp increase in their prices. Unlike these two groups, “housing, water, electricity, gas and other fuels” group with the largest weight in the consumption basket grew slightly. Table 4 exhibits point-to-point CPI inflation rates in major groups of the consumption basket during 1397H1.

4. Based on the Statistical Center of Iran, the Iranian economy is divided into three sectors: agriculture, services, and manufacturing (including manufacturing, mining, construction, oil, and water, electricity, and natural gas)

5. According to the Report of Islamic Parliament Research Center on the composition of imported goods in 06/1397

Table 4- Point-to-Point Inflation Rates of Major Groups in the Consumption Basket in 1397H1 (percent)

| | Weight in the Basket | 1397 | | | | | |
|---|----------------------|------------|------------|-------------|-------------|-------------|-------------|
| | | 01/1397 | 02/1397 | 03/1397 | 04/1397 | 05/1397 | 06/1397 |
| Overall | 100.00 | 7.9 | 9.7 | 13.7 | 18.0 | 24.2 | 31.4 |
| Housing, Water, Electricity, Gas and Other Fuels | 37.05 | 8.8 | 9.0 | 10.1 | 10.9 | 11.6 | 12.3 |
| Food and Beverages | 25.51 | 5.0 | 8.4 | 16.8 | 25.0 | 35.9 | 46.5 |
| Transport | 8.90 | 7.9 | 10.7 | 17.6 | 23.1 | 35.9 | 54.9 |
| Health | 7.83 | 8.6 | 8.9 | 10.9 | 13.3 | 15.2 | 17.1 |
| Clothing and Footwear | 4.62 | 5.9 | 7.6 | 9.8 | 13.9 | 19.5 | 28.1 |
| Household Equipment and Routine Household Maintenance | 4.33 | 10.5 | 14.3 | 16.4 | 23.1 | 37.5 | 52.6 |
| Miscellaneous Goods and Services | 3.17 | 14.8 | 17.4 | 20.5 | 25.0 | 32.7 | 43.4 |
| Communication | 2.30 | 2.4 | 5.5 | 10.1 | 17.5 | 23.5 | 43.2 |
| Recreation and Culture | 2.07 | 14.7 | 20.0 | 24.2 | 34.1 | 51.6 | 70.0 |
| Education | 2.03 | 14.1 | 14.1 | 13.7 | 14.1 | 14.2 | 14.5 |
| Restaurants and Hotels | 1.82 | 11.0 | 11.5 | 12.0 | 13.9 | 16.9 | 23.7 |
| Tobacco | 0.37 | 20.6 | 22.6 | 28.7 | 72.4 | 114.4 | 125.6 |

Source: Central Bank of Iran, Consumer Price Index Reports, various issues

3. Balance of Payments

Balance of payments continued its downward trend in 1396 and fell by USD474 million compared to a year earlier. The increase in net capital account deficit and the decrease in current account adversely affected the balance of payments in 1396. Nonetheless, in 1396Q4, the balance of payment grew by 134.9 percent compared to 1395Q4.

The current account, which includes all non-financial transactions of the country, rose by 9.6 percent in 1396Q4 and reached USD4,902 million. This account incorporates goods account, services account, income account, and current transfers account. In the period under review, goods account boosted by 29.5 percent, since the exports surpassed the imports. In this period, the services account remained negative and its deficit rose by 78.6 percent, compared to 1395Q4. The income account which includes, among other items, compensation of foreign employees

inside the country and Iranians working outside the country as well as earnings from foreign investments, fell by 140.3 percent in 1396Q4 compared to the same period a year earlier. The current transfers account declined by 11.3 percent as a result of 20.7 percent of growth in payments as opposed to 2.8 percent of rise in receipts.

The capital account deficit of USD19,321 million at the end of 1396 indicates that capital outflow exceeded capital inflow. In 1396Q4, the net capital account deficit grew by 81.2 percent compared to the same period a year earlier. In the period under review, the errors and omissions climbed sharply and increased from negative USD110 million to positive USD3,117 million. Table 5 presents the components of balance of payments in 1395, 1396 and the last quarter of these two years.

Table 5- Components of Balance of Payments (USD millions)

| | 1395Q4 | 1395 | 1396Q4 | 1396 | Percentage Change of 1396Q4 to 1395Q4 | Percentage Change of 1396 to 1395 |
|---------------------------|------------|---------------|------------|---------------|---------------------------------------|-----------------------------------|
| Current Account | 4,473 | 16,388 | 4,902 | 15,816 | 9.6 | -3.5 |
| Goods Account | 4,807 | 20,843 | 6,227 | 22,596 | 29.5 | 8.4 |
| Exports (f.o.b.) | 23,686 | 83,978 | 29,064 | 98,142 | 22.7 | 16.9 |
| Oil Exports | 15,875 | 55,752 | 19,448 | 65,818 | 22.5 | 18.1 |
| Non-Oil Exports | 7,811 | 28,226 | 9,616 | 32,324 | 23.1 | 14.5 |
| Imports (f.o.b.) | 18,879 | 63,135 | 22,836 | 75,546 | 21.0 | 19.7 |
| Gas and Oil Products | 216 | 1,388 | 1,323 | 2,764 | 512.5 | 99.1 |
| Other Goods | 18,662 | 61,747 | 21,513 | 72,782 | 15.3 | 17.9 |
| Non-Oil Goods Account | -10,851 | -33,521 | -11,897 | -40,458 | 9.6 | 20.7 |
| Services Account | -719 | -5,941 | -1,349 | -7,916 | 87.6 | 33.2 |
| Income Account | 253 | 928 | -102 | 669 | -140.3 | -27.9 |
| Current Transfers Account | 142 | 558 | 126 | 467 | -11.3 | -16.3 |
| Net Capital Account | -4,154 | -18,288 | -7,528 | -19,321 | 81.2 | 5.6 |
| Errors and Omissions | -110 | -5,766 | 3,117 | -4,635 | -2,933.6 | -19.6 |
| Overall Balance | 209 | -7,666 | 491 | -8,140 | 134.9 | 6.2 |

Source: Central Bank of Iran, Selected Economic Indicators, various issues

According to the latest report of Trade Promotion Organization of Iran, USD1.8 billion of capital goods with value share of 16.7 percent, USD1.8 billion of consumption goods with value share of 17.1 percent and USD7 billion of intermediate goods with

value share of 66.2 percent were imported in 1397Q1. Based on these statistics, the composition of imported goods moved from consumption goods to intermediate goods in 1397Q1, compared to 1396Q1. On the other hand, the volume and value of imported

consumption goods declined more than that of other goods in the period under review. Moreover, in 1397Q1, in spite of the increase in the value share of intermediate goods in imports, the import volume of these goods fell by 10.8 percent. The firms may experience serious disruptions in their daily activities if these conditions persist in the forthcoming quarters when international sanctions intensify.

On the basis of the same report and on the side of exports,

USD9.4 billion of intermediate goods with value share of 81.3 percent, USD0.2 billion of capital goods with value share of 2.1 percent and USD1.9 billion of intermediate goods with value share of 16.6 percent were exported in 1397Q1. Compared to 1396Q1, the share of intermediate goods in exports fell and that of consumption and capital goods rose. Table 6 depicts the details of trade in different categories of goods.

Table 6- Details of Trade in Different Categories of Goods in 1396Q1 and 1397Q1

| | 1396Q1 | | | 1397Q1 | | | Percentage Change | | |
|---------|---------------------------|-------------------------|-----------------------------|---------------------------|-------------------------|-----------------------------|-------------------|-------|-------|
| | Weight (thousand tons) | Value (USD millions) | Value Share (percent) | Weight (thousand tons) | Value (USD millions) | Value Share (percent) | Weight | Value | |
| Imports | Capital Goods | 193.0 | 1,771.1 | 15.5 | 166.5 | 1,768.1 | 16.7 | -13.7 | -0.2 |
| | Consumption Goods | 970.5 | 2,463.7 | 21.6 | 724.7 | 1,806.9 | 17.1 | -25.3 | -26.7 |
| | Intermediate Goods | 7,262.9 | 7,164.0 | 62.8 | 6,475.8 | 7,011.0 | 66.2 | -10.8 | -2.1 |
| | Total | 8,426.4 | 11,398.8 | 100.0 | 7,367.0 | 10,586.0 | 100.0 | -12.6 | -7.1 |
| Exports | Capital Goods | 21.3 | 79.3 | 0.8 | 25.4 | 242.7 | 2.1 | 19.2 | 206.1 |
| | Consumption Goods | 1,402.8 | 1,647.3 | 16.4 | 1,949.1 | 1,928.6 | 16.6 | 38.9 | 17.1 |
| | Intermediate Goods | 26,693.7 | 8,296.1 | 82.8 | 25,907.8 | 9,445.4 | 81.3 | -2.9 | 13.9 |
| | Total | 28,117.8 | 10,022.7 | 100.0 | 27,882.3 | 11,616.7 | 100.0 | -0.8 | 15.9 |

Source: Trade Promotion Organization of Iran

According to customs statistics in 1397H1, international trade reached USD45,305 million and balance of trade amounted to USD941 million. The non-oil exports, including natural gas condensates, registered 56,644 thousand tons, valued at USD23,123 million. The weight of the economy's exports in the period under review contracted by 3.3 percent and its dollar value boosted by 13.0 percent. In the same period, goods imports recorded 16,220 thousand tons, valued at USD22,182 million, which fell by 9.3 percent in weight and by 11.9 percent in dollar value. The value of international trade in 1396H1 reached USD45,650 million and its trade balance touched negative USD4,722 million.

The trade balance in 06/1397 grew by USD362 million compared to the preceding month and amounted to USD516 million. In 06/1397, imports and exports registered USD3,289 million and USD3,805 million, respectively, whereas in 06/1396, the registered figures were USD4,273 million and USD3,474 million, in that order. The export of petrochemicals, natural gas condensates, and other goods stood at USD1,175 million, USD248 million, and USD2,382 million, respectively, in 06/1397.

4. Foreign Exchange Market

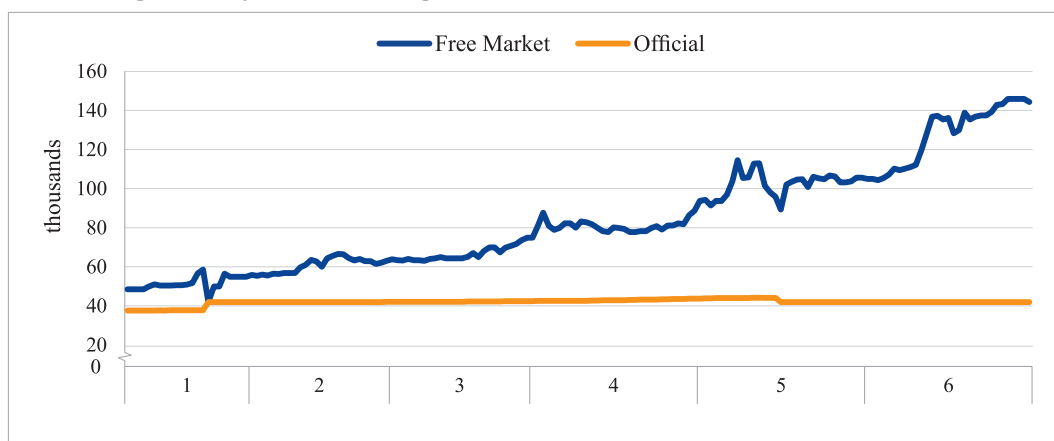
The foreign exchange market experienced one of its most unstable periods during 1397Q2. The USD/IRR free market exchange rate which had reached 50,000 at the beginning of 1397, passed 150,000 in the middle of 06/1397. In 1397Q2,

The main exported items in 1397H1 were natural gas condensates valued at USD2,418 million, liquefied propane at USD1,074 million, light crude oil except gasoline at USD861 million, and methanol at USD693 million. In the period under review, China, Iraq, the UAE, Afghanistan, and India were the main export destinations, comprising respective shares of 20.0 percent, 19.7 percent, 17.6 percent, 7.2 percent, and 5.4 percent in Iran's total exports value. The average price of exported goods grew by 16.8 percent in the period under review and amounted to USD408 per ton.

Auto parts valued at USD978 million, rice at USD964 million, cattle feed corn at USD961 million, soybean at USD705 million, and charcoal electrodes at USD287 million were the main imported items, in that order. The highest levels of imports were from China, the UAE, South Korea, India, and Germany with respective shares of 24.8 percent, 14.2 percent, 6.5 percent, 6.2 percent, and 5.3 percent of Iran's total imports. The average price of imported goods fell by 2.9 percent in the period under review and reached USD1,368 per ton.

the average rate grew by 66 percent compared to 1397Q1 and by 162 percent relative to 1396Q2, both of which are quite high growth rates. Figure 4 depicts the daily USD/IRR exchange rates during 1397H1 in various markets.

Figure 4- Daily USD/IRR Exchange Rates in the Free Market and Official Market in 1397H1



Source: Central Bank of Iran; Financial Informing Network; Research calculations

*Due to the halt in announcing USD/IRR free market exchange rates since 21/01/1397, the rate has been calculated based on USD/EUR rate in the international currency market and EUR/IRR rate in Tehran's black market.

As expected, the so-called exchange rate unification policy, which was announced in the late of 01/1397 and was being implemented afterwards, was not effective and exacerbated the complications in the foreign exchange market. This policy was made to control the jumps in foreign exchange rates, but it was unsuccessful and became the source of huge economic rents. The USD/IRR exchange rate in the unofficial market (black market), which had not touched 70,000 until the last days of 1397Q1, exceeded 80,000 in less than a week at the beginning of 04/1397. The secondary market for foreign exchanges began to operate on 19/04/1397, where 20 percent of the foreign exchange earnings from exports were traded in NIMA⁶ according to the priorities assigned by the Ministry of Industry, Mine, and Trade. The USD/IRR exchange rate declined below 80,000 afterwards, but soon reversed course and started to rise. In 05/1397, the new governor of the CBI took office. Moreover, a number of US sanctions returned on August 6th following the US unilateral withdrawal from the Joint Comprehensive Plan of Actions, among which the sanctions on the purchase or acquisition of US dollar banknotes by the Government of Iran was of the utmost importance. During the 10-day gap between the appointment of the new governor of the CBI and the return of a number of US sanctions, the USD/IRR unofficial market exchange rate exceeded 100,000 and stayed above that in the remainder of 05/1397, except a few days.

The CBI announced its new package for foreign exchange policy in the second half of 05/1397, according to which the official USD/IRR exchange rate that had already increased

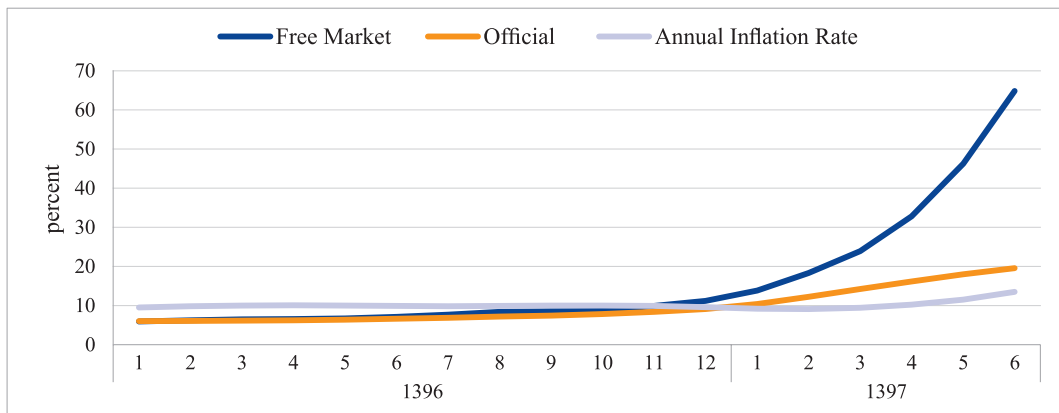
to 44,000 was set to 42,000. Moreover, the authorized currency exchange brokers were allowed to sell no more than 5 percent of their drafts in banknotes and for 1 percent above the registered price in SANA and NIMA for a number of services determined by the CBI, in addition to their foreign exchange drafts and foreign exchange trades for import and export purposes. Following the declaration of the new package, the USD/IRR exchange rate dropped below 90,000 only for a single day and exceeded 100,000 for the remainder of 1397Q2. Due to the large gap between the rates in the secondary and free markets, most currency exchange brokers did not sell any foreign exchange banknotes for 1 percent above the price at the secondary market, or sold them at the unofficial market rate.

The USD/IRR exchange rate approached 110,000 in the first few days of 06/1397 and surpassed 150,000 in the second week of this month. The CBI then nullified the limitation of foreign exchange sales by the authorized currency exchange brokers. In its aftermath, the USD/IRR free market exchange rate was fluctuating from 120,000 to 140,000 in the second half of 06/1397.

Comparison of the USD/IRR free market exchange rate and the inflation rate reveals that the former rose considerably much more than the latter in 1397H1. The decline in relative export prices due to the jump in the exchange rate is an opportunity to raise the share of these goods. Figure 5 depicts monthly inflation rates alongside the growth rates of the USD/IRR exchange rates in unofficial and official markets from the beginning of 1396 to the end of 1397Q2.

6. The integrated Iranian foreign exchange platform

Figure 5- Annual Inflation Rate and Growth Rates of USD/IRR Exchange Rates in Unofficial and Official Markets



Source: Central Bank of Iran; Research calculations

5. Monetary and Credit Aggregates

In 04/1397, CBI net foreign assets, its claims on banks, and net other items increased by 30.1 percent, 36.4 percent, and 28.0 percent, respectively, while its net claims on public sector fell

by 91.1 percent, compared to 04/1396. Statistics on monetary base components in these two months and in different quarters of 1396 and 1397 are presented in Table 7.

Table 7- Monetary Base Components (end of period – IRR trillions)

| | 1396 | | | | | 1397 | | 04/1397 to 04/1396 | |
|---------------------------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|-----------------------|-------------------------------------|
| | Q1 | 04/1396 | Q2 | Q3 | Q4 | Q1 | 04/1397 | Growth Rate (percent) | Share in Growth (percentage points) |
| Monetary Base | 1,851.9 | 1,863.7 | 1,964.9 | 1,995.0 | 2,139.8 | 2,186.6 | 2,202.2 | 18.2 | 18.2 |
| CBI Net Foreign Assets | 1,853.9 | 1,854.5 | 1,874.4 | 1,913.8 | 2,159.8 | 2,377.0 | 2,413.4 | 30.1 | 30.0 |
| CBI Net Claims on Public Sector | 282.0 | 263.8 | 292.2 | 279.9 | 55.1 | 82.8 | 23.5 | -91.1 | -12.9 |
| CBI Claims on Banks | 1,013.7 | 1,078.7 | 1,097.1 | 1,130.7 | 1,320.3 | 1,397.1 | 1,470.9 | 36.4 | 21.1 |
| Other Items (Net) | -1,297.7 | -1,333.3 | -1,298.8 | -1,329.4 | -1,395.4 | -1,670.3 | -1,705.6 | 28.0 | -20.0 |

Source: Central Bank of Iran, Selected Economic Indicators, various issues

For the year ended 04/1397, CBI net foreign assets and CBI claims on banks were the drivers of upswing in monetary base, whose shares in growth were 30.0 percentage points and 21.1 percentage points, respectively. CBI claims on banks are reflected either as credit lines or overdrafts, both of which result in increasing the monetary base. As was the case in the preceding two years, the increase in CBI claims on banks in 04/1397 was limited to non-public banks and non-bank credit institutions, since CBI claims on public commercial banks in 04/1397 fell by 41.8 percent. CBI claims on public specialized banks dropped by 9.9 percent as well, whereas CBI claims on non-public banks and non-bank credit institutions in 04/1397 climbed by 96.2 percent compared to the same period a year earlier.

In the first four months of 1397, liquidity grew by 4.7 percent, 1.7 percentage points below that in the same period a year before. On the other hand, the point-to-point growth rate of liquidity in 04/1397 reached 20.1 percent, 0.3 percentage points below that in the preceding month.

The point-to-point growth rate of money in 04/1397 amounted to 34.7 percent, the highest rate in the past five years. In the first four months of 1397, money rose by 10.4 percent. Unlike the upward trend in the growth rate of money, quasi-money has experienced

a decline in its growth and its point-to-point growth rate declined from 24.6 percent in 04/1396 to 18.1 percent in 04/1397. Based on this trend, the rise in money growth rate as well as the fall in quasi-money growth rate were due to a decline in the growth rate of short-term investment deposits. For the year ended 04/1397, the short-term investment deposits fell by 23.2 percent and the long-term investment deposits rose by 64.2 percent. A considerable portion of short-term deposits was converted to one-year deposits in the period under review, mainly as a result of the temporary rise in the interest rate of long-term deposits in the first 11 days of 06/1397 and in the last few days of the year.

In 04/1396, the share of money in total liquidity was 12.0 percent. Three months later, this share dropped to 11.7 percent, but reversed course since then. According to the latest CBI statistics in 04/1397, the share of money in liquidity was 13.4 percent, which was as expected owing to the decrease in the interest rate of long-term deposits in 06/1396, jump in the exchange rate and sharp increase in the price of other assets. Table 8 demonstrates statistics on M2 money multiplier and liquidity components in different quarters of 1396 and 1397, as well as in the first month of summer in these two years.

Table 8- M2 Money Multiplier and Liquidity Components (end of period – IRR trillions)

| | 1396 | | | | | 1397 | | 04/1397 to 04/1396 | |
|---------------------------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------------|-------------------------------------|
| | Q1 | 04/1396 | Q2 | Q3 | Q4 | Q1 | 04/1397 | Growth Rate (percent) | Share in Growth (percentage points) |
| Liquidity | 13,149.1 | 13,337.4 | 13,899.5 | 14,450.1 | 15,299.8 | 15,827.5 | 16,022.5 | 20.1 | 20.1 |
| Money | 1,647.1 | 1,595.1 | 1,682.4 | 1,737.4 | 1,946.7 | 2,059.5 | 2,149.1 | 34.7 | 4.1 |
| Notes and Coins with the Public | 340.1 | 341.5 | 344.7 | 348.6 | 442.7 | 406.0 | 415.6 | 21.7 | 0.5 |
| Sight Deposits | 1,307.0 | 1,253.6 | 1,337.7 | 1,385.8 | 1,504.0 | 1,653.5 | 1,733.5 | 38.3 | 3.6 |
| Quasi-Money | 11,502.0 | 11,742.3 | 12,217.1 | 12,715.7 | 13,353.1 | 13,768.0 | 13,873.4 | 18.1 | 16.0 |
| M2 Money multiplier | 7.1 | 7.2 | 7.1 | 7.2 | 7.2 | 7.2 | 7.3 | 1.4 | - |

Source: Central Bank of Iran, Selected Economic Indicators, various issues

The balance of deposits of banks and non-bank credit institutions stood at IRR17,195.0 trillion at the end of 03/1397, indicating 28.6 percent rise from 03/1396 and 4.4 percent of growth from 12/1396. Moreover, at the end of 03/1397, the balance of total extended facilities reached IRR12,974.8 trillion, 29.2 percent and 3.1 percent above that in 03/1396 and 12/1396, respectively. The ratio of extended facilities to deposits (less reserve requirement) recorded 84.1 percent in 03/1397. However, a large portion of extended facilities in recent years has not yet been settled which has led the ratio of non-performing loans to total extended facilities to reach 10.3 percent at the end of 1396, 0.3 percentage points up from that at the end of 1395.

The rial interbank market is a component of the money market and a way of financing the banks' operations that enables transactions among the member banks. The goal of forming this market was to facilitate the flow of short-term rial funds in order to manage the liquidity. The CBI intervenes in this market to play the role of the lender of last resort and also to stabilize the targeted interest rate. The CBI Report on the rial interbank market in 1396 indicates that the weighted average interest rate in the market in 1396 rose by 0.1 percent from 1395 to reach 18.7 percent. In the first four months of 1396, this rate increased in an upward trend from 19.9 percent in 01/1396 to 20.3 percent in 04/1396, but reversed course in 05/1396, recorded its lowest level during the whole year with 18.1 percent in 11/1396 and registered 18.9 at the end of the year. The interbank lending in 1396 increased sharply compared to the preceding year and amounted to IRR640,055.7 trillion. The number of transactions and their daily average value in 1396 rose by 21.3 percent and 106.2 percent, respectively.

Public banks made the largest contribution to interbank lending in 1396 with the share of 62.0 percent, followed by private banks,

privatized banks, and non-bank credit institutions. The highest lending rate was 19.3 percent, pertaining to private banks. The lending rates for credit institutions, privatized banks, and public banks were 19.1 percent, 18.8 percent, and 18.5 percent, in that order. On the other hand, the depositing shares in the interbank market in 1396 for private banks, privatized banks, public banks, and non-bank credit institutions were 51.5 percent, 26.6 percent, 13.7 percent, and 8.1 percent, respectively. However, the amount of interbank depositing in the last category grew by more than 10 times in 1396, compared to a year earlier. It may be the case that after the settlement of unauthorized credit institutions and the decreed reduction in the interest rate of long-term investment deposits, other credit institutions were guided to the interbank market to finance themselves. The amount of interbank depositing in private banks in 1396 rose by 142.5 percent.

According to the latest report of Shaparak⁷, the number and value of total transactions in 04/1397 expanded by 7.2 percent and 8.1 percent, respectively, compared to 03/1397 and by 28.9 percent and 46.4 percent, respectively, compared to 04/1396. The effectiveness of electronic payment industry on easing economic transactions, which is the share of liquidity paid electronically, is represented by the ratio of total value of transactions to liquidity. Considering the 20.1 percent increase in liquidity during the period under review, the ratio of total value of transactions to liquidity recorded 12.7 percent, 2.3 percentage points above that in 04/1396. Moreover, more than 1.7 billion transactions were processed in 04/1397, which indicates 28.9 percent rise in number and 24.1 percent real growth in value, compared to 04/1396. The rise in the tendency of using different payment methods instead of using banknotes was a main factor of the aforementioned growth.

6. Government Budget and Fiscal Position

Total revenues of the government, which experienced a growth of 17.9 percent in 1396, boosted by 32.1 percent in the first four months of 1397. The sizeable increase in oil revenues during the period under review was the main contributor to the considerable rise in total revenues. The increase in oil exports volume, international oil price, and the conversion exchange rate of foreign exchange earnings from oil sales resulted in a growth of 60.7 percent of oil revenues in this period. After the great decrease in oil prices in 1393H2, government oil revenues were less than its tax revenues, except for 1396Q1 and 1396Q2. In the first four months of 1397, nonetheless, oil revenues

were IRR70.8 trillion above tax revenues.

The CBI converts foreign exchange earnings from oil sales at the official USD/IRR exchange rate. The average official exchange rate rose from around 32,500 in the first four months of 1396 to 42,000 in the first four months of 1397. This 29 percent growth rate of the official rate explains almost half of the growth in government oil revenues. However, the government claims that it has benefited from this growth in official exchange rate to import essential goods.

Despite the fact that actual performance of government oil revenues

7. Electronic Card Payment Network System (SHAPARAK) is a platform which brings together payment service providers (PSP) and their POS terminals in a highly integrated system and by advocating central management and monitoring functionality will promote efficiency, effectiveness and security of card payment network.

was 22.3 percent above the legislated figure in the Budget Law due to 60.7 percent growth rate of oil revenues, government budget deficit increased sharply in the first four months of 1397, even though current expenditures are only slightly affected by the foreign exchange rate, as opposed to oil revenues. For instance, compensation of government employees, which constitutes a large portion of total current expenditures, does not change with exchange rate fluctuations. The modest 15.2 percent growth rate of current expenditures, compared to that of exchange rate, in the first four months of 1397 confirms this claim. The government current expenditures rose by 22.6 percent in the first four months of 1396 and by 17.2 percent in the whole year 1396. Moreover, the performances of these expenditures relative to the legislated figures were 86.0 percent in the first four months of 1396 and 85.5 percent in the same period in 1397. Thus, contrary to the usual state of different governments in Iran, the jump in oil revenues in the first four months of 1397 did not bring about irregular rise in current expenditures, but the government widely expanded its development expenditures to be able to optimally exploit the available resources in the long run, before the second round of US sanctions hit the Iranian economy in early November 2018. However, it should be noted that development expenditures are somehow influenced by the increase in foreign exchange rate.

Most of the time, actual performance of development expenditures has stood below its legislated figure. In the first four months of 1396, this performance was 94.7 percent below the legislated amount, whereas it rose to 11.2 percent above the legislated figure during the same period in 1397. Hence, the surplus of non-financial assets balance (net disposal of non-financial assets), that represents the amount by which oil revenues exceed development expenditures, suffered from a considerable decline of 25.4 percent in the period under review.

This drop, coupled with the large increase of 21.2 percent in the operating balance deficit (the difference between current revenues and current expenditures), made the budget deficit grow by 93.0 percent.

While the budget deficit amounted to IRR270.1 trillion in 1396, the acquisition of financial assets (repayment of previous government debts, including matured debt securities) stood at IRR331.7 trillion. To finance these figures, the government issued IRR445.0 trillion new debt securities, the amount of IRR41.8 trillion was allocated through the disposal of state-owned companies, IRR5.5 trillion was assigned through last years' payment returns, and IRR109.4 trillion was withdrawn mainly from the National Development Fund resources and the Treasury's revolving funds. Consequently, the main portion of financing the government budget deficit was achieved through issuing government debt securities. No detailed statistics on disposal of financial assets in the first four months of 1397 has been published yet, but it is expected that the main part of the total IRR314.5 trillion of the disposal of financial assets (the sum of budget deficit and acquisition of financial assets) has been attained by issuing new government debt securities. Considering the lengthy process of the disposal of debt securities to contractors and the issuance of these securities by contractors in the capital market, it is predicted that interest rates in the government debt market will rise due to extensive issuance of these securities. The intervention of the CBI to control the interest rates by purchasing government debt securities will raise the monetary base, while the banks' interest rates will rise to compete with the rates of government securities otherwise. Both cases will lead to an escalation in liquidity and its inflationary consequences. Table 9 exhibits the government fiscal performance in 1396 and 1397.

Table 9- The Government Fiscal Performance (Except Dedicated Revenues and Payments)

| | 1396 | | | | | | 1397 | | |
|--|------------------------|------------------|--|------------------------|------------------|--|------------------------|------------------|--|
| | First Four Months | | | Year | | | First Four Months | | |
| | Amount (IRR trillions) | Growth (percent) | Performance Compared to the Legislated Figures (percent) | Amount (IRR trillions) | Growth (percent) | Performance Compared to the Legislated Figures (percent) | Amount (IRR trillions) | Growth (percent) | Performance Compared to the Legislated Figures (percent) |
| Revenues | 636.9 | 26.3 | 64.0 | 2,598.5 | 17.9 | 88.7 | 841.2 | 32.1 | 76.5 |
| Tax Revenues | 296.9 | 0.0 | 75.1 | 1,158.4 | 14.2 | 99.5 | 348.8 | 17.5 | 72.3 |
| Other Current Revenues | 77.9 | -22.5 | 39.8 | 517.3 | 16.0 | 89.7 | 72.3 | -7.2 | 28.7 |
| Oil Revenues | 261.0 | 147.0 | 67.5 | 919.2 | 24.4 | 80.7 | 419.6 | 60.7 | 122.3 |
| Other Disposal of Non-Financial Assets | 1.0 | -17.4 | 6.0 | 3.6 | -8.3 | 7.1 | 0.5 | -53.2 | 2.2 |
| Expenditures | 798.8 | 26.4 | 72.3 | 2,868.6 | 16.7 | 88.2 | 1,153.7 | 44.4 | 95.4 |
| Current Expenditures | 741.3 | 22.6 | 86.0 | 2,429.4 | 17.2 | 95.7 | 854.1 | 15.2 | 85.5 |
| Development Expenditures | 12.8 | 23.5 | 5.3 | 439.2 | 13.6 | 61.5 | 234.1 | 1,729.3 | 111.2 |
| Budget Balance | -161.9 | 26.8 | 148.1 | -270.1 | 5.7 | 84.0 | -312.5 | 93.0 | 285.3 |
| Operating Balance | -411.2 | 83.9 | 151.8 | -753.7 | 23.2 | 94.5 | -498.5 | 21.2 | 188.6 |
| Net Disposal of Non-Financial Assets | 249.2 | 160.1 | 154.1 | 483.7 | 35.8 | 101.7 | 185.9 | -25.4 | 120.1 |
| <i>Disposal of Financial Assets</i> | <i>173.9</i> | <i>28.5</i> | <i>95.3</i> | <i>601.7</i> | <i>-4.2</i> | <i>112.0</i> | <i>314.5</i> | <i>80.8</i> | <i>146.8</i> |
| <i>Acquisition of Financial Assets</i> | <i>12.0</i> | <i>58.1</i> | <i>16.4</i> | <i>331.7</i> | <i>-11.0</i> | <i>153.8</i> | <i>1.9</i> | <i>-83.8</i> | <i>1.9</i> |

Source: Central Bank of Iran, Selected Economic Indicators, various issues

Note: The difference between the data on sum of current and development expenditures and total expenditures is due to the fact that revolving funds are not settled.

Indirect taxes accounted for a large part of tax revenues in the first four months of 1397. The 17.1 percent contraction of tax revenues from legal entities led to a fall in its share of total tax revenues and was the main factor in 4.6 percent fall in direct taxes. Revenues from income tax and wealth tax grew more than the inflation rate. On the other hand, among the subgroups of indirect taxes, revenues from tax on imports almost doubled and those from tax on goods and services rose by 30.8 percent. The jump in USD/IRR exchange rate during the period under review led to considerable growth in revenues collected from imposing tax on imports, in spite of the 4.2 percent decrease in dollar value of customs imports and roughly stable import tariffs.

Hence, unlike recent past periods in which value-added tax had served as the major component in the growth of revenues from indirect tax, share of tax on imports in the expansion of indirect tax revenues exceeded that of value-added tax in the first four months of 1397. However, the IRR24.8 trillion rise of revenues from tax on imports is negligible compared to total tax revenues, which amounted to IRR348.8 trillion and the budget deficit of IRR312.5 trillion, and therefore, may not be attributed to the government incentive for raising the exchange rate in order to cover its budget deficit. Table 10 exhibits the components of tax revenues in the first four months of 1396 and 1397.

Table 10- Components of Tax Revenues (IRR trillions - percent)

| | First Four Months of 1396 | | | First Four Months of 1397 | | |
|-----------------------|---------------------------|--------------|-------------|---------------------------|--------------|-------------|
| | Amount | Share | Growth | Amount | Share | Growth |
| Tax Revenues | 296.9 | 100.0 | 0.0 | 348.8 | 100.0 | 17.5 |
| Direct | 159.8 | 53.8 | -3.8 | 152.4 | 43.7 | -4.6 |
| Legal Entities | 98.0 | 33.0 | -9.1 | 81.2 | 23.3 | -17.1 |
| On Income | 53.5 | 18.0 | 6.8 | 59.9 | 17.2 | 11.9 |
| On Wealth | 8.4 | 2.8 | 0.4 | 11.3 | 3.3 | 35.5 |
| Indirect | 137.1 | 46.2 | 4.8 | 196.4 | 56.3 | 43.2 |
| On Imports | 25.2 | 8.5 | 18.4 | 50.0 | 14.3 | 98.3 |
| On Goods and Services | 111.9 | 37.7 | 2.2 | 146.4 | 42.0 | 30.8 |
| On Value-Added | 79.7 | 26.8 | 15.0 | 92.0 | 26.4 | 15.4 |

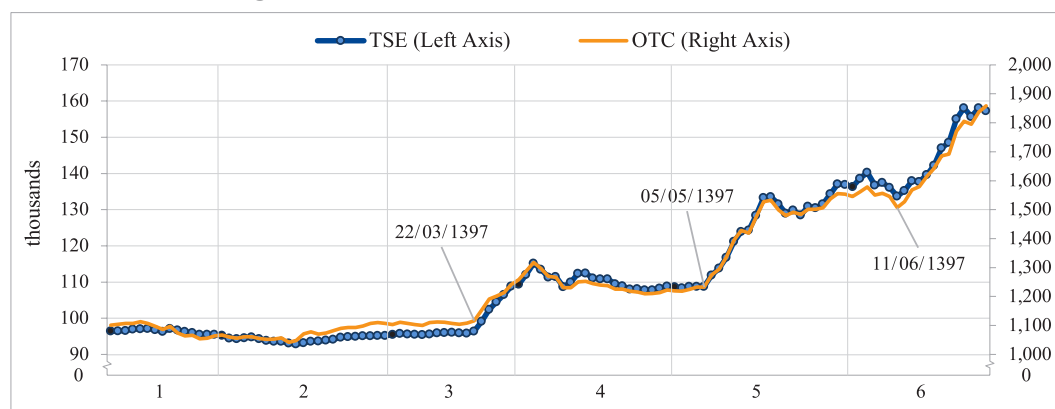
Source: Central Bank of Iran, Selected Economic Indicators, various issues

7. Capital Market

The overall index of Tehran Stock Exchange (TSE) fluctuated a lot during 1397H1 and eventually registered a growth rate of 66.5 percent in this period, rising from 96,462 on the first working day of the year to 160,538 on the last working day of 06/1397. The first significant jump occurred in the late spring, when the index rose by 12.9 percent in 10 days. In 04/1397, the index was fairly stable and even declined slightly. The second upsurge was registered in the first half of 05/1397 and the index rose by 22.9 percent in 15 days. In the last 20 days of 06/1397, the

index surged for the third time and recorded 20.1 percent growth. The largest daily increase in the index, which was a record in the history of the TSE, was registered in 21/06/1397, when it climbed by 4.5 percent. The other part of the capital market, Over the Counter (OTC), had almost the same experience as the TSE in the period under review and its index increased from 1,102 to 1,879, recording a considerable growth of 70.6 percent with three jumps similar to the index of the TSE. TSE and OTC overall indices are depicted in Figure 6.

Figure 6- TSE and OTC Overall Indices in the First Six Months of 1397



Sources: Official websites of the TSE (<http://new.tse.ir>) and the OTC (<http://ifb.ir>)

The main contributor to the aforementioned large increase in TSE index was the adjustment of the rial value of companies' stocks followed from the jump in the USD/IRR exchange rate, specifically for those companies with foreign exchange earnings. Moreover, following the sizeable climb in gold, housing, and automobile market prices, the huge amount of liquidity created

during past recent years flowed into the capital market and resulted in more transactions and, hence, higher prices. The value of transactions in the cash market of the TSE (shares and preemptive rights) grew by 270 percent compared to the same period a year earlier and registered IRR385 trillion in 1397Q2, while the transactions value in the debt securities market of the

TSE rose only by 9 percent and amounted to IRR22 trillion.

Table 11 represents the statistics on the transactions of shares and preemptive rights in each month during 1397H1 and indicates an upward trend in the daily average of transactions value. More than IRR8 trillion transactions were registered in 06/1397, far above roughly IRR4 trillion transactions recorded in 04/1397 and nearly IRR2 trillion transactions reported in 01/1397. This expansion is also noticed in the volume and the number of

transactions. The daily average of 75 thousand transactions and 945 million traded shares in 01/1397 grew by 146.0 percent and 233.4 percent, respectively, to register 184 thousand transactions and 3,151 million traded shares in 06/1397. This increase in demand together with the liquidity entered the capital market raised the market capitalization of the TSE which touched IRR6,124 trillion in the last working day of 1397Q2, implying 80.5 percent and 60.1 percent increases compared to the same time a year before and the beginning of 1397, respectively.

Table 11- Transactions of Shares and Preemptive Rights in the First Six Months of 1397

| Month | Number of Trading Days | Daily Average of Transactions Value (IRR billions) | Daily Average of the Volume of Transactions (million shares) | Daily Average of the Number of Transactions | Market Capitalization (IRR billions) |
|---------|------------------------|--|--|---|--------------------------------------|
| 01/1397 | 17 | 1,929 | 945 | 74,853 | 3,283,410 |
| 02/1397 | 22 | 2,170 | 1,064 | 47,197 | 3,727,865 |
| 03/1397 | 18 | 3,207 | 1,365 | 83,265 | 4,212,726 |
| 04/1397 | 21 | 3,994 | 1,578 | 101,174 | 4,250,801 |
| 05/1397 | 22 | 6,055 | 2,263 | 117,377 | 5,231,743 |
| 06/1397 | 20 | 8,377 | 3,151 | 184,155 | 6,124,139 |

Source: Report of Performance of the TSE, Tehran Stock Exchange, 06/1397

8. Other Economic Developments

The upsurge in USD/IRR exchange rate coupled with the constancy of gasoline price in the country led to a sharp decrease in its price denominated in US dollars. The Persian Gulf FOB prices for gasoline were around 6 times as much as the gasoline prices distributed in Iran, assuming 42 cents for each liter of gasoline delivered in the Persian Gulf and IRR140 thousands for US dollar in the unofficial market⁸, while the former was set even at higher values in neighboring countries. For instance, in 2018Q2, it was fixed at 54 cents in Saudi Arabia, 68 cents in the UAE, 76 cents in Pakistan, and USD1.36 in Turkey.⁹ Huge volumes of gasoline have been smuggled out of Iran due to this considerable discrepancy. However, some policy-makers have announced their disagreements about raising fuel prices. Hence, the officials may decide to implement a number of countermeasures like gasoline rationing. Estimates of the gasoline smuggled out of Iran range from 6 million to 30 million liters per day. Allowing for the daily gasoline supply of 130 million liters in the country and the consumption of 105 million liters, 25 million liters of gasoline smuggling per day would be a sensible estimate. Therefore, the hidden subsidies of gasoline go out of the country and the economic rent distributed among fuel smugglers amount to IRR1.2 trillion per day and IRR445 trillion per year. Moreover, around 15 million to 20 million liters of gas oil per day are smuggled out of the country. Taking the above assumptions into account, the gas oil supplied in Iran is priced at 2 cents per liter, whereas this price is 35 cents in Azerbaijan, 59 cents in Afghanistan, 72 cents in the UAE, 86 cents in Pakistan, and USD1.01 in Turkey.¹⁰ Hence, the hidden subsidies

of smuggled gas oil roughly stand at the same level as that of smuggled gasoline. Total cash subsidies paid to all Iranians, which is roughly IRR420 trillion in a year, may be tripled by using the economic rents distributed among fuel smugglers.

Another crucial recent economic issue has been the shortage of a number of goods in the market, which is more due to some inappropriate domestic policies rather than international sanctions. There was no doubt that the policy-maker would not be able to fulfill his promise of satisfying the economy's foreign exchange needs at his announced USD/IRR exchange rate of 42,000 and would be obliged to adopt discretionary allocations. The first step to eliminate excess demand for receiving foreign exchanges at the preferential rate was banning the import of unnecessary goods and also those foreign goods with domestic analogues, which brought about the goods shortage in the market. When the prices of domestic tradable goods and imported ones at the preferential exchange rate do not rise in line with the increase in unofficial exchange rate, their export demand will jump. In this situation, the policy-maker introduced exports embargo as the solution, which raised goods smuggling and led to rush on domestic goods by the residents of neighboring countries. To put it another way, the approach of the economic policy-maker was not based on economic principles, but he followed judicial procedures and implemented many sorts of embargoes. As a result of this approach, a significant number of economic agents halted their businesses, which in turn exacerbated the goods shortage. News of hoarding large volumes of goods in warehouses confirms this claim.

8. As reported on 30/06/1397

9. Bloomberg (July 25, 2018), Gasoline Prices Around the World: The Real Cost of Filling Up

10. Available at <http://globalpetrolprices.com>

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