9

Recent Economic Developments in Iran

A Quarterly Report

بانک خاورمیانه
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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 1396" indicates the percentage change in oil revenues between the first quarter of 1395 and the first quarter of 1396.

Note 2: The Persian Calendar is 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 1396 that started on March 21, 2017, and ends on March 20, 2018. The third quarter of 1396 (referred to as 1396Q3), fall of 1396, roughly corresponds to the fourth quarter of 2017 in the Gregorian calendar (2017Q4).

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

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

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

1396Q1 = 03/21/2017 – 06/21/2017, roughly **2017Q2**

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

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

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Iran's Economy at a Glance

	1395Q2	1395Q3	1395Q4	1395	1396Q1	1396Q2	1396Q3
Participation & Unemployment Rates (percent)							
Participation (10 years and over)	40.4	38.9	38.9	39.4	40.6	41.0	-
Unemployment (10 years and over)	12.7	12.3	12.5	12.4	12.6	11.7	-
Unemployment (Youth aged 15-24)	30.2	30.4	28.1	29.2	28.8	27.3	-
Real Growth Rates of GDP and its Subsectors at Constant 1390 Prices (percent) *							
Gross Domestic Product (GDP)	12.9	16.8	12.9	12.5	6.2	5.2	-
Oil	66.2	77.7	47.1	61.6	4.7**	3.9**	-
Agriculture	4.1	5.0	4.4	4.2	3.1	-0.5	-
Industries and Mining	3.0	4.1	6.4	2.2	4.8**	3.7**	-
Services	4.2	6.0	4.9	3.6	7.3	7.1	-
GDP (Excluding Oil)	3.9	5.4	5.6	3.3	6.6	5.5	-
Gross Fixed Capital Formation	*3.1*	*-9.5*	*3.1*	*-3.7*	*4.9*	*1.4*	-
Oil (thousand barrels per day)							
Production	3,639	3,963	3,909	3,761	3,878***	3.864***	-
Export	2,157	2,426	2,316	2,224	-	-	-
Inflation Rates (percent)							
Growth Rate of Consumer Price Index (1395=100)	9.2	8.9	10.5	9.1	11.4	8.8	9.3
Growth Rate of Producer Price Index (1390=100)	3.0	5.2	8.8	5.0	8.9	9.9	11.2
Balance of Payments (USD million)							
Oil Exports	13,167	15,070	15,875	55,752	14,166	-	-
Non-Oil Exports	6,073	7,078	7,811	28,226	7,176	-	-
Imports of Goods	15,114	16,761	18,879	63,135	16,283	-	-
Goods Account (Net)	4,126	5,387	4,807	20,843	5,059	-	-
Non-Oil Goods Account (Net)	-8,718	-9,135	-10,851	-33,521	-8,814	-	-
Current Account	3,459	3,225	4,473	16,388	3,723	-	-
Capital Account	-5,814	-3,298	-4,154	-18,288	-1,338	-	-
Change in Foreign Reserves	-1,473	-231	209	-7,666	-1,585	-	-
Foreign Exchange Rates (USD/IRR daily average)							
In Free Market	35,326	36,987	38,581	36,487	37,494	38,236	40,719
In Interbank Market	31,014	31,845	32,380	31,458	32,445	32,900	34,800
Monetary and Credit Aggregates (end of period, IRR trillion)							
Monetary Base (M0)	1,655.1	1,704.7	1,798.3	1,798.3	1,851.9	1,964.9	-
Central Bank Claims on Banks	942.2	1,047.9	996.9	996.9	1,013.7	1,097.1	-
Central Bank Claims on Public Sector (Net)	325.3	233.1	202.6	202.6	282.0	292.2	-
Liquidity (M2)	11,227.1	11,848.6	12,533.9	12,533.9	13,149.1	13,899.5	-
Money (M1)	1,480.3	1,540.7	1,630.3	1,630.3	1,647.1	1,682.4	-
Sight Deposits	1,151.1	1,213.0	1,237.0	1,237.0	1,307.0	1,337.7	-
Non-sight Deposits (Quasi-money)	9,746.8	10,307.9	10,903.6	10,903.6	11,502.0	12,217.1	-
Government Budget (IRR trillion)							
Total Revenues	580.9	473.5	892.7	2,202.7	426.1	590.5	-
Tax Revenues	248.2	221.9	359.7	1,014.7	181.9	249.3	-
Oil Revenues	201.5	176.8	316.9	738.8	188.9	257.8	-
Other	131.1	74.8	216.1	449.1	55.3	83.5	-
Total Expenditures****	674.7	488.2	912.4	2,491.2	600.8	596.9	-
Current Expenditures	582.2	449.2	670.0	2,070.2	548.8	526.1	-
Development Expenditures	120.9	36.0	262.7	421.0	8.2	70.0	-
Budget Balance	-93.8	-14.7	-19.7	-288.6	-174.7	-6.4	-
Tehran Stock Exchange (end of period)							
Overall Index (TEDPIX)	76,451	80,123	77,230	77,230	78,736	85,832	95,509
Financial Index	155,263	151,049	131,865	131,865	130,664	129,604	134,057
Industrial Index	63,495	67,466	66,100	66,100	67,681	74,823	74,078
Market Capitalization (IRR trillion)	3,168	3,374	3,220	3,220	3,201	3,396	3,946

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

* Statistics for 1395 are based on CBI reports at basic prices and statistics for spring and summer of 1396 are based on SCI reports at market prices.

** Due to differences in the definitions of "Oil" and "Industries and Mining" sectors by CBI and SCI, growth rates of these two sectors in spring and summer of 1396 are not fully comparable to their growth rates in preceding quarters.

*** According to OPEC reports from direct sources

**** 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

As we enter the last quarter of 1396, the Central Bank of Iran (CBI) is yet to publish any statistics on Iran's GDP in 1396. But the latest data released by the Statistical Center of Iran (SCI) indicate that at mid-year 1396 (1396H1), Iran's GDP stood at IRR7,807 trillion in current prices and registered 5.6 percent real growth for 1396H1, and 6.0 percent should the oil sector be taken out. According to SCI, all sectors of the economy along with their main subsectors showed positive growth in this period. Extraction of oil and natural gas grew by 2.7 percent in 1396H1, which is much below its performance in 1395, but that was to be expected. As a result of unusually low rainfalls, agriculture sector contracted in the second quarter (1396Q2) for the first time since 1392Q4, and is expected to contract further. Services sector that accounts for just over half of the GDP, rose by 7.1 percent in summer while construction sector continued to grow for the third consecutive quarter.

Table 1 - Growth Rates of GDP and its Subsectors at Constant 1390 Prices (percent)

	1395					1396		
	Q1	Q2	Q3	Q4	Year	Q1	Q2	H1
Industry	**13.3**	**18.8**	**20.1**	**18.1**	**17.6**	**5.1**	**3.8**	**4.4**
Manufacturing	2.7	5.0	6.5	11.7	6.5	4.6	3.8	4.2
Mining	26.0	38.9	40.5	27.1	32.9	4.7	3.9	4.3
Extraction of Oil and Natural Gas	27.9	41.6	43.4	28.5	35.0	3.7	1.6	2.7
Other Mines	-6.4	-3.6	-2.8	3.1	-2.5	5.8	2.2	4.0
Water, Gas, and Electricity Supply	20.3	14.2	28.9	16.7	20.1	5.1	11.3	8.0
Construction	-15.1	-3.8	-30.6	4.0	-11.3	4.1	0.8	2.3
Agriculture	**10.7**	**0.7**	**3.1**	**0.5**	**3.3**	**3.1**	**-0.5**	**0.9**
Services	**-0.9**	**3.3**	**5.7**	**15.7**	**5.8**	**7.3**	**7.1**	**7.2**
Gross Domestic Product	**5.8**	**9.8**	**11.9**	**16.3**	**11.0**	**6.2**	**5.2**	**5.6**
Non-oil Gross Domestic Product	**1.1**	**4.0**	**6.2**	**13.8**	**6.3**	**6.6**	**5.5**	**6.0**

Source: Statistical Center of Iran, Report of National Accounts

An examination of GDP from the expenditures side reveals positive growth in gross fixed capital formation in both machinery and construction in 1396H1. Gross fixed capital formation grew by 3.1 percent and reached IRR100.3 trillion in current prices, accounting for 12.8 percent of the GDP. Private consumption rose by 7.3 percent and government consumption expenditures by 7.2 percent in 1396H1. As shown in Table 2, net exports of goods and services contracted by 1.5 percent in 1396Q2, mainly due to the surge in the value of imports.

Table 2 - GDP Growth Rates from the Expenditures Side at Constant 1390 Prices (percent)

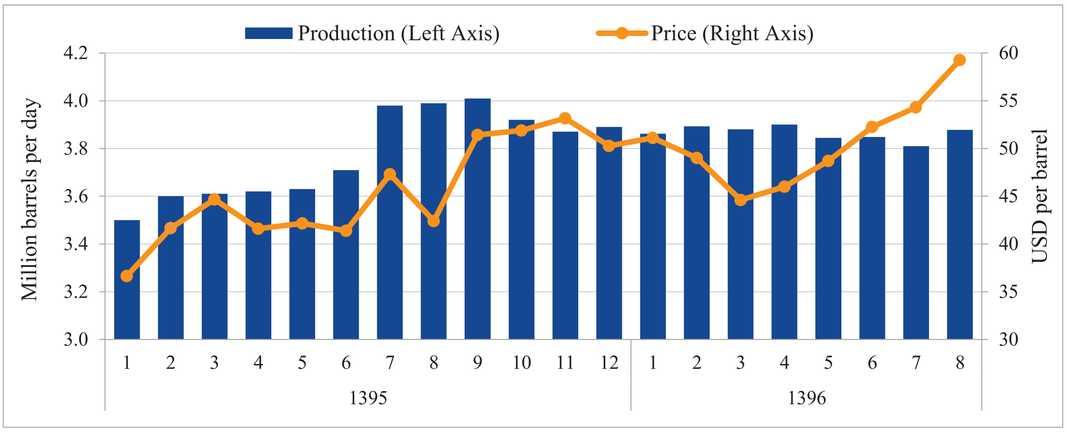
	1395					1396		
	Q1	Q2	Q3	Q4	Year	Q1	Q2	H1
Private Consumption	**1.4**	**2.8**	**1.6**	**7.5**	**3.4**	**6.9**	**7.6**	**7.3**
Government Consumption Expenditures	**3.5**	**3.5**	**3.5**	**3.5**	**3.5**	**7.2**	**7.2**	**7.2**
Gross Fixed Capital Formation	**-11.0**	**-2.6**	**-15.6**	**6.2**	**-5.8**	**4.9**	**1.4**	**3.1**
- in Machinery	-5.9	-1.0	4.0	8.5	1.3	5.6	2.3	4.0
- in Construction	-15.5	-3.8	-30.5	4.3	-11.3	4.2	0.8	2.3
Net Exports of Goods and Services	**81.6**	**84.5**	**132.4**	**68.7**	**89.0**	**-7.6**	**-1.5**	**-4.4**
Exports	57.6	64.2	83.0	42.3	60.7	-1.7	-0.4	-1.0
Imports	5.4	7.8	12.0	-9.9	3.4	20.1	4.9	13.1
Gross Domestic Product at Market Prices	**5.8**	**9.8**	**11.9**	**16.3**	**11.0**	**6.2**	**5.2**	**5.6**

Source: Statistical Center of Iran, Report of National Accounts

1.1 Energy

Iran's average crude oil production that had risen considerably in 1395Q3 and reached 4 million barrels per day (bpd), was hovering around 3.8 and 3.9 million bpd from the early winter of 1395 to the middle of fall of 1396. According to the latest OPEC report, Iran's crude oil production in the middle of 1396Q3 rose to 3.9 million bpd, almost the same level as in late spring. Iran's average heavy crude oil price rose steadily in recent months and reached USD59.3 per barrel in the middle of 1396Q3. As shown in Figure 1, Iran's heavy crude oil price had dropped earlier to as low as USD44.6 per barrel in late spring.

Figure 1 - Monthly Crude Oil Production and its Average Price*

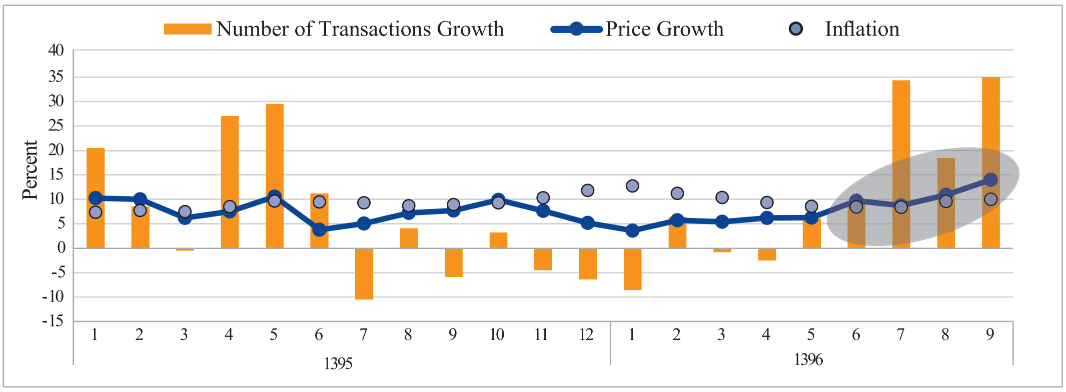


Source: OPEC monthly reports, available at: http://www.opec.org/opec_web/en/publications/338.htm
*OPEC statistics are based on Gregorian calendar years and their conversion into Iranian calendar years are only approximate.

1.2 Housing

Since the data on the country's housing market are released with several months lag, one can use the available information on Tehran's housing market as proxy. Tehran housing market experienced 50.2 percent rise in number of transactions and 14.9 percent rise in average price of a square meter of residential units in the last month of 1396Q3, which are the highest growth rates since the beginning of 1393. As can be seen in Figure 2, inflation rate as measured by the point-to-point consumer price index (CPI), registered 10.0 percent at the end of fall, indicating steady rise in real price of residential units for four consecutive months. The number of transactions in Tehran housing market reached 46 thousand, far above that in falls of the past four years. Also, statistics show that normally the number of transactions in the first two months of winter is much above that in the rest of the second half of each year. Given the 20.4 percent jump in the number of transactions observed in 9/1396 from its preceding month, it is not expected to increase further in the first two months of winter. Under such circumstances, the rise in housing prices and the number of transactions are expected to lead to boost private investment in housing.

Figure 2 - Point-to-point Growth Rates of Housing Price and Number of Transactions versus CPI Inflation Rate (percent)



Source: Central Bank of Iran, Developments in the Housing Market in Tehran; Reports of Consumer Price Index

Recent developments in the housing market signals the end of the deep recession of recent years. The CBI-imposed ceiling on deposit interest rates in late summer is thought of as a driver of the housing market boom. Should the banks adhere to the lower rates, further transfer of funds to the housing market and thereby rises in the price and number of transactions may be expected.

1.3 Labor Force

The unemployment rate among population aged 10 and above dropped by one percentage point in 1396Q2 from a year earlier to reach 11.7 percent. This was a very positive development as the point-to-point unemployment rate had been steadily rising for eleven quarters from 1393Q3 to 1396Q1. On the other hand, the economic participation rate followed its upward trend that had started in 1393Q3 and rose by another 0.6 percentage point to 41.0 percent in 1396Q2. During this season, active population rose by 614 thousand due to 181 thousand fall in the number of the unemployed and 795 thousand rise in the number of the employed population. The number of employed population registered 23.8 million, corresponding to 36.2 percent of the population aged 10 and above. Out of this 23.8 million, 49.5 percent were employed in services, 31.4 percent in manufacturing, and 19.1 percent in agriculture. 84.4 percent of the employed population were in the private sector and the remaining 15.6 percent in the public sector. The share of underemployment fell to 9.2 percent in that quarter. As shown in Table 3, most of the labor market indices improved in this summer compared to the last.

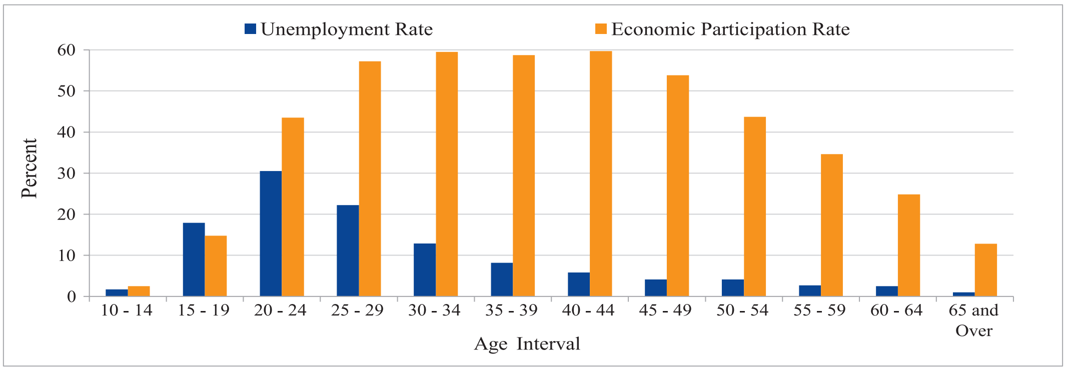
Table 3 - Labor Market Indices for the Population Aged 10 and Over

	1395					1396	
	Q1	Q2	Q3	Q4	Year	Q1	Q2
Unemployment Rate (percent)	12.2	12.7	12.3	12.5	12.4	12.6	11.7
Economic Participation Rate (percent)	39.5	40.4	38.9	38.9	39.4	40.6	41.0
Share of Underemployment (percent)	8.5	9.5	11.3	10.9	10.3	10.2	9.2
Number of Unemployed (1000 people)	3,149.7	3,337.4	3,127.7	398.8	3,203.4	3,367.0	3,156.1
Number of Employed (1000 people)	22,604.7	23,031.6	22,373.4	22,342.4	22,588.1	23,308.4	23,827.2

Source: Statistical Center of Iran, Summary results of the workforce survey

During the past two decades, the unemployment rate among the population aged 15-29 has been far above the average for other major age groups. Among the 5-year-interval age groups, population aged 20-24 accounted for the highest unemployment rate of 30.5 percent, consisting of 24.4 percent among males and 51.2 percent among females, pointing to undesirable labor market conditions for the latter group. The economic participation rate of population aged 20-24 was 66.6 percent for males and 20.0 percent for females, indicating that only one-fifth of the females in that age group had entered the labor market. Population aged 40-44 had the highest economic participation rate of 59.7 percent, consisting of 93.8 percent for males and 24.5 percent for females in this age category. Figure 3 depicts unemployment and economic participation rates in various age groups in 1396Q2

Figure 3 - Unemployment and Economic Participation Rate by Age Groups in 1396Q2



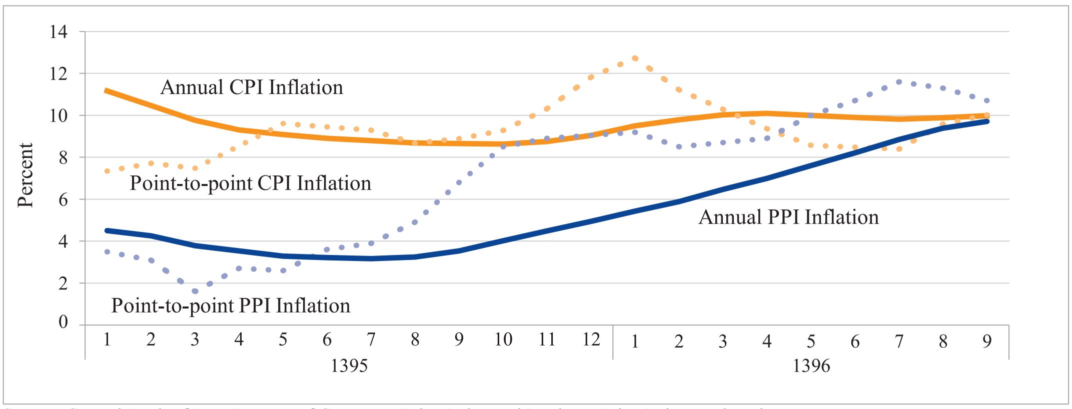
Source: Statistical Center of Iran, Summary results of the workforce survey, 1396Q2

2. Prices and Inflation

The point-to-point consumer price inflation rate reached 8.4 percent in 7/1396 following its downward trend from the beginning of summer, but reversed course and rose by 1.6 percentage points to 10.0 percent at the end of 1396Q3. The average annual Inflation rate at the end of each month that had turned single-digit again at the end of summer, was stable during fall and registered 10.0 percent at the end of that season.

The point-to-point producer price index (PPI) inflation rate reached 11.6 percent in 7/1396 following its upward trend from the middle of spring, but then reversed course and fell by 0.9 percentage points to 10.7 percent at the end of 1396Q3. Given the lagged effect of PPI inflation on CPI inflation, part of the increase in point-to-point CPI inflation rate at the end of fall could be attributed to the upward trend of PPI inflation rate in recent months. Accordingly, further rise in the point-to-point CPI inflation rate in the remainder of the year is expected. Figure 4 depicts the annual and point-to-point CPI and PPI inflation rates from the beginning of 1395 to the end of fall of 1396. As shown there, the point-to-point PPI inflation rate has exceeded that of the CPI from the middle of summer, indicating that cost of the factors of production has been increasing faster than retail prices.

Figure 4 - CPI and PPI Inflation Rates from 1395 to the End of Fall of 1396



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

Point-to-point inflation rate of tradable goods followed a downward trend through the end of summer and reached 8.5 percent, but then reversed course and rose by 1.7 percentage points to 10.2 percent in 8/1396, partly because of the IRR depreciation against foreign currencies since the beginning of the summer. Given further IRR depreciation in fall, the point-to-point inflation rate of tradable goods should have risen in the remaining months of that season. As for non-tradable goods, the point-to-point inflation rate registered 8.0 percent at the end of 7/1396 following its downward trend, but again rose and reached 8.9 percent in 8/1396.

Based on the latest CBI report on CPI inflation, during 1396Q3 out of the 12 main groups in the consumption basket, the point-to-point inflation rates in 9 groups rose but in the other three groups fell. The rises in point-to-point inflation rates of "Housing, water, electricity, gas and other fuels" and "Foods and beverages" that are the top 2 in the consumption basket in terms of weight, were the main contributors to the rise in the point-to-point CPI inflation rate from 8.4 percent at the beginning of fall to 10.0 percent at the end of that season. Table 4 exhibits the point-to-point CPI inflation rates in the major groups of basket of goods and services during summer and fall of 1396.

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

	Weight in the Basket	Q2			Q3		
		4/1396	5/1396	6/1396	7/1396	8/1396	9/1396
Overall	**100.0**	**9.4**	**8.6**	**8.4**	**8.4**	**9.6**	**10.0**
Housing, Water, Electricity, Gas and other Fuels	37.05	7.2	7.4	7.6	7.4	8.4	9.2
Food and Beverages	25.51	14.1	11.7	11.1	11.4	13.9	14.3
Transport	8.90	6.2	5.8	5.7	5.9	5.6	6.7
Health	7.83	9.8	8.4	8.2	7.9	8.4	8.5
Clothing and Footwear	4.62	5.6	5.6	5.6	5.5	5.0	4.9
Household Equipment and Routine Household Maintenance	4.33	8.0	8.2	8.6	8.3	8.4	8.5
Miscellaneous Goods and Services	3.17	8.7	9.1	9.4	9.6	9.8	11.4
Communication	2.30	7.9	7.9	6.8	7.2	7.1	6.8
Recreation and Culture	2.07	9.8	9.8	9.4	10.9	9.6	8.9
Education	2.03	10.6	10.5	10.5	8.2	8.3	13.9
Restaurants and Hotels	1.82	11.0	11.3	11.8	11.9	12.1	12.3
Tobacco	0.37	0.2	0.4	0.3	0.4	0.7	0.9

Source: Central Bank of Iran, Consumer Price Index Reports

The SCI also released CPI inflation rates at the end of 1396Q3, including, for the first time, by income deciles. According to its report, the average annual CPI inflation rate in the consumption basket of goods and services registered 8.8 percent for the lowest income decile, and 7.6 percent for the top income decile. The difference between the two rates is due to the difference in their consumption baskets, including the higher weight of food in the consumption basket of the poor and the higher inflation of food items. Note also that with the recent updating of the base year in CPI calculations, the weight of foods in the consumption basket has fallen while that of housing has risen.

As mentioned earlier, because of the upward trend of PPI inflation rate in recent months, the CPI inflation rate is expected to rise in soon and probably turn double-digit. The Majlis Research Center and the IMF have projected the end-of-year annual inflation rates of 10.5 percent and 9.9 percent, respectively.

3. Balance of Payments

According to the International Energy Agency statistics, in 1396Q1 Iran's average crude oil production rose by 5.0 percent to 3.8 million bpd. Iran's average oil price also rose by 17.7 percent to USD48.2 per barrel in that quarter. The volume of Iran's oil exports in 1396Q1 is expected to have been higher than that in 1395Q1, although CBI is yet to publish its official data in this regard. CBI's balance of payments statistics indicate that during spring, value of oil exports (including crude oil, oil products, natural gas, natural gas condensates and liquids) has increased by 21.7 percent to USD14.2 billion. Taking into account slight changes in oil imports (including oil products, natural gas, natural gas condensates and liquids), the oil trade balance in this period jumped by 22.3 percent and reached USD13.9 billion.

In 1396Q1, non-oil exports fell by 1.2 percent to USD7.1 billion, while its imports rose by 32.4 percent to USD16.0 billion; the latter resulted in 83.0 percent rise in non-oil trade deficit. Part of the rise in non-oil trade deficit could be attributed to the fall in IRR's real exchange rates that made domestically produced goods less competitive in global markets.

Taking into account changes in oil and non-oil exports and imports, the goods account surplus fell by 22.4 percent in spring to USD5.1 billion. Considering the negligible changes in "services", "income", and "current transfers" accounts, the current account surplus fell by 28.8 percent to USD3.7 billion. Table 5 shows the current account balance and its subgroups during 1394Q1 to 1396Q1.

Table 5 - Current Account Balance and Its Subgroups (USD million)

	1394				1395				1396
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Goods Account	4,778	2,765	4,258	377	6,522	4,127	5,387	4,807	5,059
Services Account	-1,206	-1,077	-759	-1,430	-1,610	-1,184	-2,428	-719	-1,713
Income Account	237	360	189	-23	198	360	127	243	263
Current Transfers Account	138	142	128	139	121	156	139	142	114
Current Account Balance	**3,947**	**2,190**	**3,816**	**-937**	**5,231**	**3,459**	**3,225**	**4,473**	**3,723**

Source: Central Bank of Iran, Economic Trends, various issues

Data on the capital account shows USD1.3 billion of net capital outflow during 1396Q1, 73.4 percent below that in 1395Q1. As no detail statistics on the capital account have been made available, shares of foreign direct investment (FDI), portfolio investment, and other types of investments in the capital outflow cannot be assessed. Considering changes in the current and capital accounts and about USD4.0 billion of errors and omissions, the balance of international reserves is estimated to have fallen by USD1.6 billion since 1395Q4 to reach USD119.1 billion at the end of 1396Q1.

On the basis of statistics published by Customs Administration, non-oil exports (excluding suitcase trade) in the first eight months of the year amounted to USD28.5 billion, indicating 1.2 percent fall. China, Iraq, UAE, South Korea, and Afghanistan were the main destinations of Iran's exports in the period under review. In this period, Iran's exports to China rose by 13.5 percent, to Iraq by 6.5 percent, to South Korea by 28.1 percent and to Afghanistan by 12.1 percent, while exports to UAE fell by 18.7 percent compared to the same period of the preceding year. Natural gas condensates valued at USD4.6 billion, liquefied propane at USD897 million, light crude oil except gasoline at USD764 million, methanol at USD752 million, and polyethylene film grade at USD750 million, were the major exported items in the period under review.

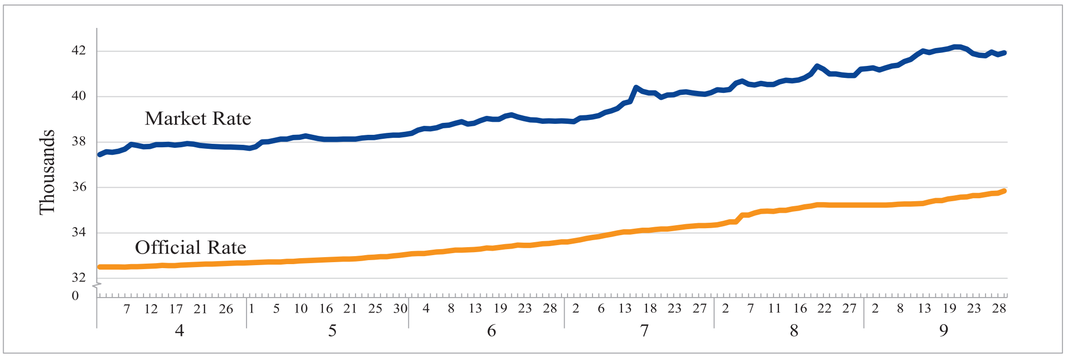
During the first eight months of the year, goods imports rose by 17.5 percent to USD32.4 billion, mainly due to the rise in imports of essential goods, auto parts, vehicles and capital goods. The highest levels of imports to Iran in terms of value were from China at USD8.0 billion, UAE at USD5.7 billion, Turkey at USD2.2 billion, South Korea at USD1.8 billion, and Germany at USD1.7 billion. Rice valued at USD1.0 billion, cattle feed corn at USD980 million, auto parts at USD972 million, soybean at USD669 million, and 1500-2000cc motor vehicles at USD643 million were the main imported items in the period under review.

4. Foreign Exchange Market

The foreign exchange market was more volatile in 1396Q3 than in its preceding quarters. The upward trend of free market USD/IRR exchange rate that had started in early summer, speeded up in the middle of that season and the rate exceeded 39,000 at the end of that season.

In advance of the US president's speech regarding his assessment of the degree to which Iran had adhered to the JCPOA, the USD/IRR exchange rate surpassed 40,000. But as his speech was less aggressive than the market anticipated and EU authorities also voiced their support for the JCPOA and Iran's adherence to it, the rate did fell a bit and hovered around 40,000 in the remainder of 7/1396. This exchange rate increased again in 8/1396 and exceeded 42,000 in the middle of the last month of fall because of the increased demand for foreign currencies by commercial companies for their international settlements but by the end of the season it stood just below 42,000. Overall, in 1396Q3 the free market USD/IRR exchange rate rose by 6.3 percent compared to 1396Q2 and by 9.9 percent compared to 1395Q3. Figure 5 depicts daily USD/IRR exchange rates from the beginning of summer to the end of fall of 1396.

Figure 5 - Daily USD/IRR Exchange Rate in Free Market and Official Market



Source: Central Bank of Iran; Financial Informing Network

As for the official USD/IRR exchange rate, the upward trend that had speeded up in summer, continued in fall too. However, the sharp rise in the market USD/IRR exchange rate in fall widened the gap between the official and free market rates from around 16.5 percent in four consecutive months to 17.5 percent at the end of fall. The gradual disqualification of import items from receiving foreign exchange at official rates that started in late summer is a noteworthy development and may signal a move towards the long promised exchange rate unification.

The annual CPI inflation rate that has been rising since the beginning of the year, turned single-digit again in the late summer and was stable at 9.9 though the end of 8/1396 before rising to 10.0 percent at the end of fall. In effect, it appears that in the year between 1395Q3 and 1396Q3, the free market USD/IRR exchange rate has moved at the same rate as the CPI. Given the low global inflation rate, this implies a little appreciation of the USD/IRR's real exchange rate – which is a welcome development for the economy.

5. Monetary and Credit Aggregates

At the end of 7/1396 the balance of monetary base rose by 18.3 percent from a year earlier and by 9.2 percent from the beginning of this year. The 12.3 percent fall in "net other" category, as a factor of decrease in monetary base, constitutes the main factor in the 18.3 percent rise in the monetary base. The 14.5 percent rise in CBI claims on banks due to the rise in CBI claims on non-public banks and non-bank credit institutions was the second factor in that 18.3 percent growth. During the period under review, CBI claims on non-public banks and non-bank credit institutions rose by 135.8 percent despite a 37.4 percent fall in CBI claims on commercial banks and 16.3 percent fall in that of the specialized banks. Accordingly, share of non-public banks and non-bank credit institutions in CBI claims on banks rose to 46.9 percent in 7/1396 from 22.8 percent in 7/1395. This 46.9 percent growth indicates that the banking system was short of funds to cover interest payments and loan extensions and thus CBI, as the lender of last resort, has had to fill the shortage. The 5.6 percent rise in CBI net claims on public sector, which was the result of the rise in CBI claims on government and the fall in government deposits with the CBI, constitutes the third factor in that monetary base expansion.

Meanwhile, CBI claims on state-owned companies and institutions have fallen while their deposits with the CBI have risen. Even though share of these companies and institutions in total CBI claims on public sector has fallen, it is still as high as 72.3 percent. The 1.8 percent fall in net foreign assets of CBI during the period under review was a contractionary factor in monetary base, indicating that foreign debts have grown faster than foreign reserves. Table 6 exhibits monetary base components from 1395Q1 to 1396Q2 and in 7/1396.

Table 6 - Monetary Base Components (end of period- IRR trillion)

	1395				1396			7/1396 to 7/1395	
	Q1	Q2	Q3	Q4	Q1	Q2	7/1396	Growth Rate (percent)	Share in Growth (percentage points)
Monetary Base	**1,585.2**	**1,655.1**	**1,704.7**	**1,798.3**	**1,851.9**	**1,964.9**	**1,963.5**	**18.3**	**18.3**
CBI Net Foreign Assets	1,876.6	1,859.4	1,898.2	1,924.6	1,853.9	1,874.4	1,863.8	-1.8	-2.0
CBI Net Claims on Public Sector	238.9	325.3	233.1	202.6	282.0	292.2	268.5	5.6	0.9
CBI Claims on Banks	895.1	942.2	1,047.9	996.9	1,013.7	1,097.1	1,123.8	14.5	8.5
Net Other	-1,425.4	-1,471.8	-1,474.5	-1,325.8	-1,297.7	-1,298.8	-1,292.6	-12.3	10.9

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

M2 money multiplier rose by 10 basis points from 7.0 to 7.1 at the end of 7/1396. The fall in the ratio of notes and coins with the public to total deposits, coupled with the fall in ratio of banks' excess reserves to total deposits were the factors of increase in M2 money multiplier, while the rise in ratio of banks' legal reserves to total deposits was a factor of decrease in it. As a result of simultaneous rise in monetary base and M2 money multiplier during the period under review, M2 liquidity rose by 23.3 percent to IRR14,030.5 trillion at the end of 7/1396. This jump was less than its 28.3 percent growth in 7/1395 due to slower rise in M2 money multiplier. M1 money rose by 13.0 percent and quasi-money by 24.8, accounting for 1.7 and 21.6 percentage points of M2 liquidity growth, respectively. Among M1 money components, notes and coins with the public rose by 5.2 percent and sight deposits by 15.2 percent, accounting for 0.2 and 1.5 percentage points of M2 liquidity growth, respectively. Accordingly, M1 money accounted for 11.7 percent and quasi-money for 88.3 percent of the M2 liquidity. Table 7 shows M2 money multiplier and M2 liquidity components from 1395Q1 to 1396Q2 and in 7/1396.

Table 7 - M2 Money Multiplier and M2 Liquidity Components (end of period- IRR trillion)

	1395				1396			71396 to 7/1395	
	Q1	Q2	Q3	Q4	Q1	Q2	7/1396	Growth Rate (percent)	Share in Growth (percentage Points)
M2	10,595.0	11,227.1	11,848.6	12,533.9	13,149.1	13,899.5	14,030.5	23.3	23.3
M1	1,364.4	1,480.3	1,540.7	1,630.3	1,647.1	1,682.4	1,638.0	13.0	1.7
Notes and Coins with the Public	311.6	329.2	327.7	393.3	340.1	344.7	343.6	5.2	0.2
Sight Deposits	1,052.8	1,151.1	1,213.0	1,237.0	1,307.0	1,337.7	1,294.4	15.2	1.5
Quasi-money	9,230.6	9,746.8	10,307.9	10,903.6	11,502.0	12,217.1	12,392.5	24.8	21.6
M2 Money Multiplier (ratio)	6.7	6.8	7.0	7.0	7.1	7.1	7.1	4.2	-

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

Balance of deposits, deposits after deduction of legal reserves, and extended facilities of the banking system at the end of 7/1396 show 21.6, 21.0, and 19.2 percent growths, respectively. Ratio of the balance of extended facilities to deposits (after deduction of legal reserves) fell by 1.3 percentage points to 84.0 percent. The upward trend of this ratio in 1395Q4 reversed course in 1396Q1 and remained at 84.0 percent. Point-to-point growth of balance of deposits and deposits after deduction of legal reserves, that had started to increase from the beginning of the year, reversed course and followed a downward trend in the aftermath of CBI's imposition of a cap on deposit interest rates. It should be noted that the ratio of legal reserves to total deposits of the banking system rose by 0.4 percentage points to 10.1 percent at the end of 7/1396. Latest CBI statistics indicate that during the first eight months of the year, approximately IRR3,574.3 trillion facilities have been extended, indicating a 9.6 percent rise. The share of various sectors in the extended facilities were, 7.3 percent in agriculture, 29.8 percent in industries and mining, 8.5 percent in housing and construction, 14.2 percent in commerce, and 40.1 percent in services. Out of total facilities extended, 62.5 percent was aimed at financing working capital, 2.8 percentage points below that in its preceding year. Financing working capital accounted for 84.4, 50.9, and 71.1 percent of the facilities extended to industries and mining, services, and commerce sectors, respectively.

6. Government Budget

6.1. Performance in the First Seven Months of 1396

Following a downward trend during 1396H1, tax revenues expanded in 7/1396 and caused total tax revenues in the first seven months of the year to show a 2.7 percent growth in nominal terms. Tax revenues during the period under review were 23.6 percent below the legislated figure in the Budget. During the first seven months of the year, "other current revenues" rose by 16.4 percent from a year earlier but still amounted to only 61.1 percent of the legislated amount in the Budget. Oil revenues that accounts for most of the "disposal of non-financial assets", rose by 56.8 percent but still covered only 69.6 percent of the legislated amount. Total government revenues in the period under review rose by 21.6 percent from a year earlier and equaled 69.6 percent of the legislated amount. Since a considerable portion of oil revenues in 1395Q1 was used to settle CBI claims on government and was not reported in oil revenues, the reported growth in oil revenues in these seven months is exaggerated.

Government expenditures in the first seven months of the year grew by 15.4 percent, slower than that of its revenues. Although actual expenditures during these seven months, amount to only 74.3 percent of the legislated amount, the actual performance of revenues is even lower. Current expenditures that accounted for the highest share of government expenditures, covered 82.8 percent of the legislated amount while development expenditures covered one-third of the legislated amount. Notwithstanding 56.8 percent rise in oil revenues, development expenditures rose by only 12.3 percent, indicating that a large portion of oil revenues has been spent on current expenditures. Operating balance deficit in the first seven months of the year amounted to IRR554.5 trillion, 31.3 percent up from a year earlier. IRR330.6 trillion of this deficit was financed by non-financial balance surplus, i.e., oil revenues minus development expenditures. Accordingly, the budget deficit reached IRR223.9 trillion, below that in a year earlier, but still 17.7 percent above the legislated amount.

During the first seven months of 1396, disposal of financial assets rose by 25.3 percent and exceeded the legislated amount by about 10 percent. The share of "sale of state-owned companies" in "disposal of financial assets" has been continually falling in recent years and authorities indicate that not many more companies are left to be disposed of.[1] The main cause of the rise in disposal of financial assets has been the issuance of government debt securities, whose repurchase will exert high pressure on government budget in coming years. During the first seven months of the year, acquisition of financial assets, i.e., settlement of government debts, rose by 301.9 percent to about IRR125 trillion as the previously issued debt securities matured. Note that acquisition of financial assets was very little in the corresponding period in 1394 and, both in that year and the years before, accounted for only a very small portion of government expenditures. Currently, financial expenditures constitute a large portion of the total government expenditures and if they continue to rise, it would lead to further cuts in future development expenditures since current expenditures are usually considered off-limit. In effect, not only the government has failed to invest oil revenues for future generations, but it is fore-selling future oil revenues in order to cover its current expenditures. It should be noted that ordinarily issuing government debt securities to settle old debts is acceptable as it results in more transparency in government debts. But issuing new debt securities irrespective of the macroeconomic conditions is unwise. Table 8 exhibits government fiscal performance during the first seven months of 1396.

Table 8 - Government Fiscal Performance in 1396

	1396						Performance of the first 7 months of 1396 compared to the legislated figure (percent)
	Q1		Q2		First 7 Months		
	Amount (IRR trillions)	Growth (percent)	Amount (IRR trillions)	Growth (percent)	Amount (IRR trillions)	Growth (percent)	
Revenues	**426.1**	**66.8**	**590.5**	**1.7**	**1,206.6**	**21.6**	**69.6**
Tax Revenues	181.9	-1.6	249.3	0.4	526.4	2.7	76.4
Other Current Revenues	54.5	107.0	82.1	-36.9	208.4	16.4	61.1
Oil Revenues	188.9	333.2	257.8	27.9	469.3	56.8	69.6
Other Disposal of Non-financial Assets	0.8	13.5	1.4	40.9	2.6	42.5	8.6
Expenditures	**600.8**	**44.4**	**596.9**	**-11.5**	**1,430.5**	**15.4**	**74.3**
Current Expenditures	548.8	48.8	526.1	-9.6	1,243.6	13.3	82.8
Development Expenditures	8.2	489.0	70.0	-42.2	141.2	12.3	33.4
Budget Balance	**-174.7**	**8.9**	**-6.4**	**-93.2**	**-223.9**	**-9.6**	**117.7**
Operating Balance	-356.2	75.8	-195.6	11.1	-554.5	31.3	117.5
Net Disposal of Non-financial Assets	181.4	329.8	189.2	130.1	330.6	88.6	117.4
Disposal of Financial Assets	*184.4*	*11.7*	*68.9*	*-37.0*	*349.2*	*25.3*	*109.9*
Acquisition of Financial Assets	*9.7*	*111.4*	*62.4*	*302.8*	*125.3*	*301.9*	*98.2*

Source: Central Bank of Iran, Selected Economic Indicators, various issues
Note: The difference between the sum of current and development expenditures and total expenditures is that the revolving funds were not yet settled.

In tax revenues, "tax on legal entities" is the main item in direct taxes, and "tax on goods and services" is the main item in indirect taxes. Tax on legal entities fell by 12.5 percent in the first seven months of the year due to the recession in economic firms. A considerable part of the shortage in tax revenues from legal entities is related to their weak performance due to 1394 economic recession. Overall, during the first seven months of 1396, revenues from direct taxes fell by 5.7 percent while those from indirect taxes rose by 12.6 percent. The rise in the latter is attributed to the 27.9 percent rise in revenues from value-added

1. Note that there remain many more state-owned companies whose budgets account for as much as two-thirds of the government's total budget, but general policies of Article 44 of the Constitution has not called for their disposition.

tax (VAT) which accounted for about 28 percent of total tax revenues. The rise in revenues from VAT was not due to rise in its rate but to the inclusion of more goods and services. Table 9 shows components of government tax revenues in the first seven months of 1395 and 1396.

Table 9 - Components of Tax Revenues

	First 7 Months of 1395			First 7 Months of 1396		
	Amount (IRR trillions)	Share (percent)	Growth (percent)	Amount (IRR trillions)	Share (percent)	Growth (percent)
Tax Revenues	**512.4**	**100.0**	**26.5**	**526.4**	**100.0**	**2.7**
Direct	**277.1**	**54.1**	**23.5**	**261.3**	**49.6**	**-5.7**
Legal Entities	178.8	34.9	22.7	156.5	29.7	-12.5
On Income	83.8	16.4	27.0	89.7	17.0	7.0
On Wealth	14.5	2.8	14.3	15.1	2.9	4.5
Indirect	**235.4**	**45.9**	**30.3**	**265.1**	**50.4**	**12.6**
On Imports	49.3	9.6	28.6	54.8	10.4	11.0
On Goods and Services	186.0	36.3	30.7	210.3	40.0	13.1
On Value Added	114.8	22.4	-3.9	146.8	27.9	27.9

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

6.2. Budget Bill of 1397

Budget Bill of 1397 was submitted to the parliament in late fall before its deadline. The figures in the Bill indicate smaller size of the government compared to those in 1396 Budget Law, but are considerably larger in comparison to performance thus far in 1396. Government budget, consisting of state-owned companies budget and the general budget, is 3.7 percent above that in 1396, far below the expected 10 percent inflation rate and thus pointing to a real contraction. Budget of state-owned companies has risen by 1.7 percent and government general budget by 6.5 percent. Government general budget itself consists of "general sources and uses" and "dedicated revenues and expenditures". Dedicated revenues are those which are created by government institutions and are also spent within them. In other words, dedicated revenues are not transferred to the treasury to be reallocated. Hence, general sources that consist of current revenues (mainly tax revenues), disposal of non-financial assets (mainly oil exports proceeds) and disposal of financial assets (mainly sale of debt securities) are directly in the hands of the government and the treasury. The treasury uses these revenues to cover current expenditures (mainly compensation of government employees and payments to pension funds), acquisition of non-financial assets (development expenditures), and acquisition of financial assets (settlement of debts). Table 10 exhibits an overview of 1397 Budget Bill.

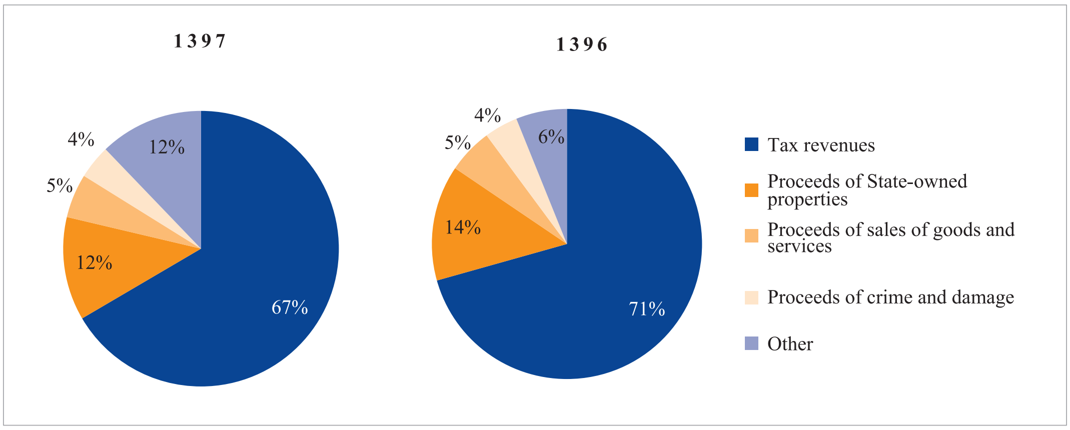
Table 10 - Overview of 1397 Budget Bill

	Sources				Uses		
	1397 Budget Bill (IRR trillions)	Growth Compared to 1396 Law (percent)	Growth Compared to Performance of 1396* (percent)		1397 Budget Bill (IRR trillions)	Growth Compared to 1396 Law (percent)	Growth Compared to Performance of 1396* (percent)
Revenues	1,934	11.1	20.2	Expenditures	2,764	8.9	15.7
Disposal of non-financial assets	1,066	-10.4	27.6	Acquisition of non-financial assets	604	-15.3	34.3
Disposal of financial Assets	681	26.8	28.5	Acquisition of financial Assets	312	44.6	48.5
Total General Sources	**3,680**	**6.1**	**23.8**	**Total General Uses**	**3,680**	**6.1**	**20.7**
Dedicated revenues	569	9.1	-	From dedicated revenues	569	9.1	-
Government General Budget Sources	**4,249**	**6.5**	**-**	**Government General Budget Uses**	**4,249**	**6.5**	**-**
State-owned Companies' Sources	8,140	1.7	-	State-owned Companies' Uses	8,140	1.7	-
Sources of Budget	**11,949**	**3.7**	**-**	**Uses of Budget**	**11,949**	**3.7**	**-**

Source: 1397 Budget Bill; 1396 Budget law; Central Bank of Iran, Selected Economic Indicators, various issues
* Estimation of performance of 1396 by Research Center of Majlis

Lower oil revenues and development expenditures are expected in 1397 due to the 10.4 percent fall in disposal of non-financial assets and 15.3 percent fall in acquisition of financial assets in 1397 Budget Bill compared to the 1396 Budget Law. On the other hand, disposal of financial assets is 26.8 percent higher, and their acquisition is 45.2 percent higher in 1397 Budget Bill compared to the 1396 Law. Therefore, the usual lowering of development expenditures at the expense of raising government financial expenditures is expected to continue and even intensify in 1397, which may result in lower GDP growth and higher inflation rates. As shown in Figure 6, the share of tax revenues is lower while that of other revenues is higher in 1397 Budget Bill compared to that of 1396. What actually happens is that CBI converts foreign exchange earnings from oil sale at the official exchange rate and puts it IRR equivalent at government's disposal. But it actually exchanges the foreign exchange earnings at the (higher) market exchange rate and keeps the difference in a special account that can later be used by the government to cover its current expenditures. This is a misguided practice that results in the domination of monetary and exchange policies by fiscal policy. The 1397 Budget Bill calls for IRR100 trillion of the budget sources to be financed in this way.

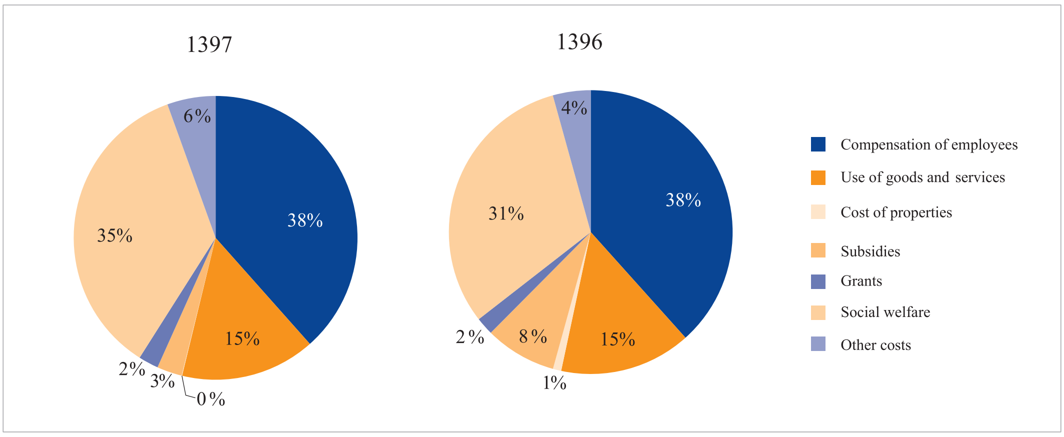
Figure 6 - Components of Government Current Revenues in 1396 and 1397 Budget Bills*



Source: Budget Bills of 1396 and 1397
*As details of 1396 Budget Law are not published, 1396 Budget Bill has been used instead to be compared with 1397 Budget Bill.

As can be seen in Figure 7, in 1397 Budget Bill the share of subsidies has fallen considerably while that of social welfare has risen in comparison to the 1396 Budget Law. However, cash and non-cash subsidies of items included in the Subsidies Reform Plan are not included in this section of the Budget Bill. The ones that are included are the likes of subsidies on public transportation, milk, medicine, etc. Part of the fall in share of subsidies in total government expenditures is due to the elimination of bread subsidy and inclusion of IRR33 trillion for bread and guaranteed purchase of wheat in the uses of the Subsidies Reform Plan. The rise in share of social welfare on the other hand was due to the pressure exerted on the government by insolvent pension funds. For instance, the funds aimed at helping government pension fund for financing retirement pensions has been increased by 43.2 percent from a year earlier to IRR265.4 trillion in 1397 Budget Bill.

Figure 7 - Components of Government Current Expenditures in 1396 Budget Law and 1397 Budget Bill



Source: 1396 Budget Law and 1397 Budget Bill

Use of oil revenues and National Development Fund (NDF) are notable in 1397 Budget Bill, where the share of NDF is set at 32 percent of oil revenues in line with the “Sixth Development Plan” and it is to be used for private investments in foreign exchange. On the other hand, according to the Bill, a portion of NDF funds ought to be converted to IRR and be used for public uses. Taking into account this portion of funds, in fact NDF’s share of oil revenues drops to about 20 percent. In 1394 and 1395 this share had dropped to 20 percent from 30 percent called for the “Fifth Development Plan”, attributed to the drop in oil revenues. Even though no drop of oil revenues is expected in 1397, use of NDF funds in 1397 Budget Bill has increased by 3,085 percent to IRR210.2 trillion compared to that of 1396, mainly due to the rise in government’s current expenditures and surge in its financial expenditures.

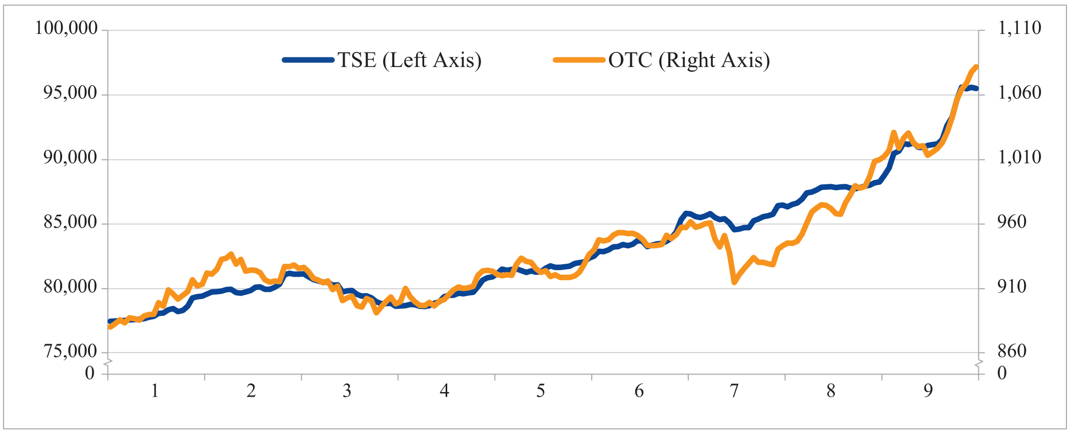
In 1397 Budget Bill, sources and uses of subsidies fell by 22.9 percent to IRR370 trillion from IRR480 trillion. The funds for cash subsidies are legislated at IRR230 trillion, translating to the elimination of 30 million individuals from cash subsidies recipients.

Government has been given the discretion to issue new series of debt securities in order to finance both principals and interests on its matured securities. This is misguided as the government should only be allowed to issue debt securities in order to pay the principals of its matured securities. Interest payments ought to be financed by its current revenues. Otherwise, government debts could easily surge exponentially and create a debt crisis.

7. Capital Market

Tehran Stock Exchange's (TSE's) overall index closed 1396Q3 at 95,510, indicating 11.3 percent rise from the beginning of that season and 23.3 percent from the beginning of the year. Total value of TSE transactions in 1396Q3 amounted to IRR134.5 trillion, including IRR19.9 trillion debt securities. Over the counter (OTC) market index closed 1396Q3 at 1,082, showing 13.0 percent rise from the beginning of that quarter and 22.9 percent rise from beginning of the year. Total value of OTC transactions amounted to IRR161.1 trillion, exceeding TSE's, out of which IRR105.3 trillion belonged to various types of debt securities including Islamic Treasury bills, participations bonds, Murabaha, and mortgages.

Figure 8 - TSE and OTC Overall Index during the First 9 Months of 1396



Source: http://new.tse.ir and http://fbi.ir

The 7th series of "banking" Islamic treasury bills valued at IRR35 trillion, that had been issued at the end of 1395 and were admitted in the late 1396Q2, became tradable at OTC market in early fall and will mature at the end of 1397. These bills that previously had to be traded directly between the buyer and the seller in selected branches of Melli Bank, became tradable at the OTC market and are not referred to as "banking" bills anymore.

After ceasing issuance of Islamic treasury bills in late 1395, another series of these bills amounting to IRR28 trillion were issued in 6/1396 and 8/1396 by the Ministry of Economic Affairs and Finance. These two series with one-year maturity were admitted at OTC market in the middle of fall and their tickers opened in the last days of that season. According to the 1396 Budget Law, government is allowed to issue IRR75 trillion of treasury bills. Additionally, four-year Murabaha bills with 6-month interest payments at 17 percent rate aimed at financing medical equipment purchases valued at IRR20 trillion and issued in fall by the same Ministry, were admitted to the OTC at the end of fall, basically.

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