بانک خاورمیانه
Middle East Bank

ANNUAL SURVEY OF THE IRANIAN ECONOMY

2013/2014

Disclaimer

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 1392” indicates the percentage change in oil revenues between the first quarter of 1391 and the first quarter of 1392.

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 1393 that started on March 21, 2014, and ends on March 20, 2015. The third quarter of 1392 (referred to as 1392Q3), fall of 1392, roughly corresponds to the fourth quarter of 2013 in the Gregorian Calendar (2013Q4).

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

1391Q4 = 12/21/2012 – 03/20/2013, roughly **2013Q1**

1392Q1 = 03/21/2013 – 06/21/2013, roughly **2013Q2**

1392Q2 = 06/22/2013 – 09/22/2013, roughly **2013Q3**

1392Q3 = 09/23/2013 – 12/21/2013, roughly **2013Q4**

1392Q4 = 12/22/2013 – 03/20/2014, roughly **2014Q1**

An electronic version of this Report is available at:
http://en.middleeastbank.ir/page/economic+developments+in+iran

Executive Summary

In an unprecedented event in at least the past thirty years, Iran's economy experienced stagflation in two consecutive years of 1391 and 1392 (years ending on March 20, 2013 and March 20, 2014). During these two years the GDP contracted by over 10 percent and prices sprang by over 75 percent. The severity of the recession in 1392 was less than in 1391, where the rate of GDP contraction fell from 6.8 percent in 1391 to 3.4 percent during the first nine months of 1392, but the inflation rate rose from 30.5 percent in 1391 to 34.7 percent in 1392. The month-to-month consumer price inflation rate that had been rising steadily since the early 2011, peaked to 45.1 percent in 3/1392 (June 2013), but then started a fast decline to reach 19.7 percent in the last month of 1392. The turning point was the outcome of the 11th presidential election that sparked optimism about the return of rationality to economic policymaking and dampened inflationary expectations.

The latest comprehensive economic data published by the Central Bank are for the first nine months of 1392. They indicate that during this period the positive growth of agriculture in 1391 gained momentum and the contraction in oil sector and in manufacturing and mining sector weakened, but the contraction in services sector worsened. On the demand side, private consumption grew but public expenditures fell and gross fixed capital formation also sharply declined, so that gross domestic expenditures experienced a 3.1 percent decline.

Notable economic developments in 1392 included the allocation of about 110 trillion rials for wheat production and the offering of liquefied gas at the energy exchange beginning in 9/1392 (early December 2013). In manufacturing and mining sector, industrial production fell by 7 percent during the first nine months of 1392 compared to the similar period in previous year, and the housing market faced its most severe contraction of the past decade. In the services sector, the value added of financial institutions experienced a sharp decline that could be attributed to the low rates of returns in money market compared to the foreign exchange and stock markets, financial institutions' difficulties in offering facilities, and the tightening of unilateral and multilateral sanctions.

The unemployment rate stood at 10.3 percent in 9/1392. This is not particularly high but the reason may lie in the fact that people working a minimum of one hour per week have been counted as employed and potential workers who have given up looking for employment are not taken into account. Under the previous definition of unemployment that defined employed workers as those working at least 16 hours per week, and also took into account those who had been discouraged from looking for a job, the unemployment rate would have been much higher. The high number of unemployed, especially among the youth, the large gap between unemployment rates for women and men, and the high fluctuation

of this gap across provinces are some of the main challenges facing Iran's labor market.
Pressures by the United States and the weakness of Iranian diplomacy in recent years led to the imposition of new economic sanctions in 11/1390 (February 2012) against all Iranian banks, including the Central Bank, that was later adopted by nearly all foreign banks. While previous sanctions primarily targeted individuals and sectors linked to the military and nuclear energy, the new sanctions targeted all aspects of Iran's international trade and exchange. Nonetheless they could not completely cut off Iran's international transactions, although they did raise the cost of doing business overseas for Iranians and led to the growth of inefficient and nontransparent communication channels that gradually created problems and caused the departure of many businesses from Iran.
In November 2013, under an interim agreement reached between Iran and the so-called group of 5+1 countries in Geneva, some of those sanctions were suspended for a period of six months and Iran was allowed to access part of its frozen assets overseas in exchange for its suspension of uranium enrichment to 20 percent level. This interim agreement somewhat ameliorated the air of distrust between Iran and the west and created the hope that sanctions may be eased soon and eventually removed.
An examination of the government's general budget during the first 11 months of 1392 indicates that 50 percent of the expenditures were financed by government revenues, 41 percent by the disposal of non-financial assets and the remaining 9 percent by the disposal of financial assets. During this period 466 trillion rials from the disposal of non-financial assets was transferred to the treasury. This amount equals 66.4 percent of the legislated amount and is 29.4 percent higher than that in the similar period of 1391. Of the 466 trillion rials, 99.5 percent was from the sale of oil and oil products and the remaining 0.5 percent from the proceeds of the sale of movable and immovable assets.
Government revenues totaled 406 trillion rials, which were 20.6 percent larger than in the preceding year and 72.5 percent larger than the legislated budget. Budget expenditures consisted of 89 percent in current expenditures, 10 percent in acquisition of non-financial assets, and the remaining 1 percent in acquisition of financial assets including bond repayment and other government debts. Based on the statistics for the first 11 months of 1392, operating fiscal balance registered a deficit of 448 trillion rials. Due to the rigidity of current expenditures, budget deficits led to the contraction of development expenditures that fueled economic recession.
In 1392 more than 418 trillion rials was distributed to households in direct cash subsidy in accordance with the Subsidies Reform Law (SRL), even though the net income from the implementation of the law, i.e., reduction of direct subsidies, was only about 302 trillion rials. Moreover, nothing of the 40 trillion rials that SRL had designated for to

cushion increased expenses of producers, improve public transport and encourage energy efficiency in manufacturing plants, etc.; and nothing of the 50 trillion rials that SRL had designated to help improve healthcare, were disbursed. The 116 trillion rials deficit was financed from general government budget resources. The improper implementation of SRL in recent years has caused many problems, including inefficiencies in the allocation of scarce financial resources.

In balance of payments, an important development during the first nine months of 1392 was a USD1.9 billion increase in trade balance -- mainly due to a severe decline in imports rather than an increase in export. During that period imports and exports declined by USD8.2 and USD6.2 billion, respectively, compared to the similar period in 1391. Oil exports which had in 1391 declined by approximately USD50 billion, or 42 percent, dropped by another USD5.5 billion during the first nine months of 1392. In a change from recent past, imports of gas and oil products also rose during that period by 24 percent to reach USD2 billion.

Following severe fluctuations of the rial exchange rates against major currencies in 1391 and the beginning of 1392, the foreign exchange market was calmer in the aftermath of the presidential election in late 3/1392 (June 2013) while the rial gradually appreciated and hard currency speculation tempered down. In 11/1392 (February 2013), the fall in hard currency supply along with increased speculative demand led to renewed volatility in the foreign exchange market and the depreciation of the rial. The decline in hard currency supply was partly due to the fall in petrochemical exports that resulted from the need to channel natural gas feedstock to household consumption for two months in winter. Overall, the USD/rial exchange rate dropped from around 36,000 in 3/1392 (June 2013) to less than 30,000 towards the end of the year (March 2013).

Prudent credit and monetary policies of the Central Bank and the new government's fiscal discipline helped to stabilize foreign exchange rates and calm the market, bring down inflation, and improve growth prospects. At the end of 11/1392 (February 2013), money supply and monetary base stood at 5,752 trillion rials and 1,026 trillion rials, respectively. During these 11 months money supply grew by 24.9 percent which was lower than its growth rate of 26.5 percent in1391. Regarding liquidity components, the share of money (including notes and coins in people's hands and sight deposits) declined while that of quasi-money (such as time deposits and savings accounts) increased.

Improved monetary policy during the second half of 1392 reduced the growth of the monetary base to 5.2 percent during the first eleven months of the year – much below its 17.2 percent growth during the same period in 1391. In addition, the monetary multiplier grew steadily from 4.8 in 12/1391 to 5.3 in 11/1392, highlighting the fact that money supply's growth during the first 11 months of 1392 was mainly due to the growth of the money multiplier rather than that of the monetary base -- which was the case in 1391. This positive development resulted from improved fiscal discipline and the Central Bank's prudent monetary policies -- such as changing the manner of financing the Mehr Housing Project from the old routine that had greatly increased banks' indebtedness to the Central Bank. The most important factor that contributed to the growth of the monetary base in 1392 was the expansion of Central Bank's foreign assets resulting from the switch of the exchange rate from the lower "base" exchange rate to the higher "transactional" exchange rate.

The banking system's loan facilities grew by 29 percent in 1392, 44 percent of which related to short-term finance credits and the remaining 56 percent to long-term investment loans. In addition, the ratio of non-performing loans to total loans reached 15.6, nearly 31 percent of which in manufacturing and mining sector. Disruption in the financial intermediation services of the banking system is among the negative consequences of defaulted loans. Reducing the share of non-performing loans requires a switch from bureaucratic setting of the interest rate to market-based interest rates as well as improving banks' credit rating systems.

The point-to-point rate of inflation that had stood at 41.2 percent at the end of 1391 reached its peak of 45.1 percent in 3/1392 and then, following the presidential election in that month, experienced a reversal and sharp decline to 19.7 percent by the end of 1392. Concurrently, the annual inflation rate, which is the average of point-to-point inflation rates in the preceding 12 months, increased from 30.5 percent at the end of 1391 to 40.4 percent in 7/1392 before declining to 34.7 percent at the end of 1392. Contributing to this decline were control of the growth of monetary base and money supply by the Central Bank, reduction in inflationary expectations by economic agents, stability of the foreign exchange rate, and the temporary easing of sanctions following the interim Geneva agreement in November 2013. Inflation rates measured by the producer price index exhibited a similar trend. In the first four months of the year, the point-to-point producer price inflation rate increased from 41.1 percent to 43.0 percent before reversing trend to reach 17.8 percent in the last month of the year.

The capital market enjoyed a strong growth in 1392. Despite a decline during the final three months of the year, the main index of the Tehran Stock Exchange grew by 108 percent during the year. Significant increases in the value of listed companies and the volume of transactions, a large increase in market liquidity and the initial public offering (IPO) of the Persian Gulf Holding Company were among the important capital market events in 1392. The introduction of the Exchange Traded Funds (ETFs) was another important development that offered the potential of attracting more domestic investors as well as foreign investor in the future. The fluctuations of the stock market in 1392 can be attributed to factors such as uncertainty over the outcome of the presidential election during the first three month of the year and a burst of optimism about economic prospects following the announcement of the outcome, and perceived progress or lack of progress in nuclear negotiations and the possibility of lifting the sanctions. The stock market reacted quickly and positively to the Geneva interim agreement and stocks of banks, petrochemical and refining companies and auto export companies rose sharply. Two negative factors, however, reversed this trend and lowered the overall index beginning in 10/1392 (mid-January 2014). The first one was the Majlis (Iranian parliament) discussions about raising the price of natural gas feedstock for petrochemical companies during its review of the 1393 fiscal budget, and the second one was the release of unfavorable nine-month income reports by many listed companies. Nevertheless, due to the relative stability of the exchange rate and the downturn in the gold and housing markets in the second half of the year, a large amount of speculative capital moved into the stock market to bring about significant increases in the price of most stocks in 1392

1. The Real Sector

The Central Bank of the Islamic Republic of Iran (CBI) is the country's official source of economic statistic. Up until the end of 1392 the Central Bank used the year 1376 as the base year for the presentation of its constant-price statistics. In 1393 it rebased its data to 1383 base year and reported its constant-price statistics for the first nine months of 1392 using that base year. Changing the base year impacts the GDP growth rate by altering the share of various economic sectors' added values. Given the current realities of the Iranian economy, changing the base year from 1376 to 1383 increased the shares of oil sector and industry and mining sector, but reduced the share of agriculture and services sectors. Given that both oil sector and mining and industry sector have had a significantly negative growth rates during the 1391 and the first nine months of 1392, this change of the base year led to lower estimates of GDP growth rates in recent years.

Table 1 presents the GDP and its components in current prices as well as shares of various sectors in GDP. As demonstrated in that table, in recent years services sector has been the largest economic sector, accounting for over 50 percent of the GDP. In the first nine months of 1392, service sector was followed in size by industry and mining sector with 21.4 percent, oil sector with 17 percent and agriculture with 11.6 percent of the GDP.

Table 1 - Gross Domestic Product by Economic Sectors (at current prices)

	(Trillion rials)					Share (percent)	
	1388	1389	1390	1391	1392*	1391	1392*
Agriculture	285.7	325.1	367.2	558.5	819.0	7.7	11.6
Oil	686.8	952.7	1,564.4	1,164.7	1,205.0	16.0	17.0
Manufacturing and Mining	892.2	1,011.7	1,338.2	1,768.3	1,514.4	24.3	21.4
Services	2,125.0	2,590.2	3,142.7	3,798.7	3,545.7	52.1	50.1
GDP in Basic Prices**	3,989.7	4,879.8	6,412.5	7,290.1	7,084.1	100.0	100.0
Non-Oil GDP in Basic Prices**	3,302.9	3,927.0	4,848.2	6,125.4	5,879.1	-	-

Source: Annual National Accounts of Iran, website of the Central Bank of IRI

* First 9 months only

** Prior to the deduction of imputed service charges

In 1391 several factors including uncertainties at different policy levels and improper implementation of the Subsidies Reform Law (SRL) negatively affected the economy so much that despite the improvements that were realized after the presidential elections in 3/1392 (June 2013), the adverse effects had the upper hand through the end of 1392. As demonstrated in Table 2, real GDP growth rate declined from 6.5 percent in 1389 to negative 6.8 percent in 1391. During the first nine month of 1392 GDP contracted by another 3.4 percent. In this nine-month period only the agriculture sector has experienced positive growth. The magnitude of contraction declined in oil sector and in manufacturing and mining sector but increased in services sector. A 15 percent decline in value added of the financial service institutions was the main cause of the increased contraction in services sector.

Table 2 - Real GDP Growth Rates Based (percent)

	1388	1389	1390	1391	1391*	1392*
Agriculture	9.6	4.9	-0.1	3.7	3.8	5.2
Oil	-5.4	4.2	-1.0	-37.4	-39.7	-12.6
Manufacturing and Mining	4.2	7.9	5.0	-6.4	-7.3	-6.3
Services	2.6	6.7	5.8	1.1	-0.2	-2.4
GDP in Basic Prices	1.3	6.5	4.3	-6.8	-8.3	-3.4
Non-oil GDP in Basic Prices	2.8	7.0	5.4	-0.9	-2.0	-2.3

Source: Annual National Accounts of Iran, website of the Central Bank of IRI

* First 9 months only

On the expenditure side of the GDP, the share of private consumption has increased in recent years while the shares of government consumption and gross fixed capital formation have decreased. As seen in Table 3, private consumptions accounted for half of the GDP in 1391 and 1392.

Table 3 - Gross Domestic Expenditures (at current prices)

	(Trillion rials)					Share (percent)	
	1388	1389	1390	1391	1392*	1391	1392*
Private Consumption Expenditures	1,827.6	2,161.5	2,778.6	3,546.4	3,448.3	49.6	49.3
Public Consumption Expenditures	470.3	560.2	631.2	708.1	655.8	9.9	9.4
Gross Fixed Capital Formation	1,216.1	1,333.4	1,648.7	1,973.1	1,674.7	27.6	23.9
Net Export of Goods and Services	63.5	242.9	573.2	116.5	653.0	1.6	9.3
Change in Stock	281.4	447.7	553.7	758.5	563.3	10.6	8.1
Gross Domestic Expenditure at Market Prices**	3,935.6	4,796.8	6,285.3	7,149.6	6,995.2	100	100

Source: Annual National Accounts of Iran, website of the Central Bank of IRI

* First 9 months only

** The difference between Gross Domestic Expenditure and it's components in some years is due to statistical errors.

Table 4 presents growth rates of the components on the gross domestic expenditure. It indicates that in the first nine months of 1392 despite a 1.1 percent growth in private consumption spending, the overall gross domestic expenditures shrank by 3.1 percent. This was mainly due to a 13.4 percent reduction in gross fixed investment and a 0.7 percent reduction in public sector consumption. The data indicate that during the first nine months of 1392 the growth rate of private consumption increased, the contraction of gross fixed capital formation decreased, and government consumption also underwent contraction.

Table 4 - Growth Rate of Gross Domestic Expenditures (percent)

	1388	1389	1390	1391	1392*	1391
Private Consumption Expenditures	2.3	4.2	4.2	-1.7	-4.5	1.1
Public Consumption Expenditures	0.1	-3.8	-3.4	-7.2	3.9	-0.7
Gross Fixed Capital Formation	2.9	3.8	3.5	-23.8	-24.7	-13.4
Gross Domestic Expenditure at market prices	2.3	6.6	3.7	-6.6	-8.3	-3.1

Source: Annual National Accounts of Iran, website of the Central Bank of IRI

* First 9 months only

Household expenditures and some components of public spending -- such as health and education expenditures -- have a direct influence on the welfare of households. Under the assumption that these expenditures have had the same growth rate as the total government expenditures, the simultaneous reduction in private and public consumption in1391 point to a significant deterioration in households' welfare in that year followed by a slight improvement during the first three quarters of 1392.

1.1. Agriculture Sector

Despite Iran being located in the dry belt and the country's average annual rainfall being about one-third of the world average of 860 millimeters, and the fact that in 1392 rainfall in Iran was even less than 220 millimeters, agriculture production was relatively good in 1392, thanks to the adoption of supportive policies by the 11th government. Rainfall in water year 1391-1392 (21 October 1391 to 21 October 1392) was 238.6 millimeters, which was 2 percent below the 44 year average rainfall but 17 percent higher than that in the preceding year.

Important developments in 1392 in agricultural sector included the assignment of agricultural policy making to the Jihad Ministry, drawing a five-year plan for agricultural self-sufficiency, increased government purchase of wheat and the allocation of 110 trillion rials for wheat production, timely supply of agriculture inputs, and the purchase of USD500 million worth of chemical fertilizers by the 11th government. In the livestock and poultry sector, important developments included the government's efforts to stabilize the feed market through interactions with other countries and the allocation of financial resources for customs clearance of ships that carry livestock and poultry.

In 1391 the production of horticultural crops was about 7 percent higher than in 1390 and exceeded 101 million tons. Estimates suggest that in 1392 the crops and horticultural production increased by 2.3 percent and 4.0 percent, respectively, while livestock production grew by 4.1 percent.

In 1392 the value and volume of agricultural products in Iran's Commodities Exchange was 2.7 trillion rials and 266 thousand tons, respectively. Compared to the preceding year, these figures were 108 percent and 44 percent larger, respectively. However, despite an increase in the turnover of agricultural products in the Commodities Exchange, the share of agricultural commodities in total transactions of this exchange declined from 0.80 percent in 1391to 0.64 percent in 1392 .

During the first nine months of 1392, agriculture sector's value added grew by 5.2 percent in comparison to the similar period in the preceding year. It had grown by 3.7 percent in 1391 and by 3.8 percent in the first nine months of 1391. The share of agriculture in GDP rose from 7.7 percent in 1391 to 11.6 percent in the first nine months of 1392.

The producer price index (PPI) for the "agriculture, hunting and forestry" sector rose in 1392 by 42.9 percent, which was 11.0 percent higher than that for the general PPI index of 31.9 percent. PPIs for "plants, vegetables and horticultural crops" and "animal husbandry" subgroups rose by 48.9 percent and 7.1 percent, respectively.

1.2. Oil Sector

The sharp decline in oil production in 1391, resulting from intensified sanctions and the fall in investments in that sector industry, created severe difficulties for oil and gas production in 1392. In the first half of 1391 while sanctions were not yet fully implemented, average oil production had already declined to about 3.2 million barrels per day (bpd) and exports had dropped to the record low level of 1.3 million bpd. According to OPEC statistics quoting other sources, in 1392 Iran’s oil production experienced an even further decline to an average 2.7 million bpd. During the first nine months of 1392, the value added of oil sector was 12.6 percent below that in the comparable period of the preceding year.

With the change of government in 1392, average oil production capacity increased from 3.1 million bpd in early summer to 3.8 million by the year’s end (March 2014). Another important development in oil sector was the sale of gas condensate in Iran’s energy exchange market that began in 9/1392 (December 2013). The government was also expected to offer crude oil in the energy exchange market as feedstock for small refineries but this did not materialize.

The interim Geneva agreement in November 2013 impacted Iran’s oil production and exports as well as global oil prices. Under this agreement, during the ensuing six months, which was referred to as “the verification period”, Iran’s oil export was allowed to continue at the level of the agreement date. In the last few months of 1392, China, India, Japan, the Republic of Korea and Turkey were major buyers of Iranian oil with preapproved import quotas. In 1392 average daily crude oil and condensate gas exports to these countries included 424 thousands to China, 199 thousands to India, 170 thousands to Japan, 145 thousands to the Republic of Korea, and 106 thousands to Turkey. All of these export levels were smaller than in the preceding year, and exports to other destinations were negligible.

1.3. Manufacturing and Mining Sector

Manufacturing and mining sector accounts for over one-fifth of the country’s GDP and is the second largest sector in Iran’s economy. As shown in Table 5, this sector contraction of 7.3 percent in 1391 was followed by a further 6.3 percent contraction during the first nine months of 1392. Manufacturing which is the largest subset of this sector, contracted by 7.5 percent in the first nine months of 1392.

Table 5 - Real Growth Rates in Manufacturing and Mining Group (percent)

	1388	1389	1390	1391	1391*	1392*
Manufacturing and Mining Group	4.2	7.9	5.0	-6.4	-7.3	-6.3
Mining	1.8	23.8	20.1	-2.5	-5.2	-3.0
Manufacturing	8.1	10.5	5.6	-8.5	-9.1	-7.5
Electricity, Gas and Water	4.7	5.6	0.3	1.1	0.4	5.1
Construction	-3.2	1.0	2.5	-3.6	-4.7	-6.5

Source: Annual National Accounts of Iran, website of the Central Bank of IRI

* First 9 months only

1.3.1. Mining

Iran, with its wide and diverse range of valuable mineral species, especially in the area of metal ores such as copper, lead, zinc, iron ore and many types of high quality decorative stones, ranks first among middle eastern countries in terms of mineral deposits and is an important country in this respect globally. Yet, the mining sector's GDP shares in 1391 and the first nine months of 1392 were less than 1 percent. The value added of this sector during the first nine months of 1392 was about 67 trillion rials, which in real terms was 3 percent smaller than that during the comparable period in 1391..

1.3.2. Manufacturing

The performance of the manufacturing sector has a major impact on other macroeconomic variables such as economic growth, employment, inflation and investment. The manufacturing sector contracted in the first nine months of 1392 although the degree of contraction was less than that in 1391. This sector's value added amounted to about 751 trillion rials and constituted about 50 percent of the value added in the manufacturing and mining sector and 13 percent of the non-oil GDP. The output of large industrial units suffered a 7 percent decline in the first nine months of 1392 following another 9 percent decline in 1391. The performance of the petrochemical, steel and automotive industries, which are the largest subsets of the Iranian manufacturing sector, will be further discussed below.

• Petrochemical Industries

As a result of investments in the framework of the Third Development Plan (1379-83), the petrochemical industry expanded fast until 1390 but then contracted in 1391. During 1384-90 petrochemical production and exports in terms of USD grew at average annual rate of 16 percent and 38 percent, respectively. In 1391, however, petrochemical production fell by 7 percent in weight and the USD value of petrochemical exports fell by 20 percent, mainly because of the extension of sanctions to these industries. On the other hand, export limitations and the high inflation rate caused the rial value of its domestic sale to increase by about 56 percent.

Table 6 presents petrochemical industry's performance from 1388 to 1391. Official statistics on the quantity and value of domestic sales in 1392 are not yet available but the preliminary estimate of the value of exports in this year is about USD10.7 billion, which is 1 percent higher than that in 1391.

Table 6 - Performance of Petrochemical Industries

					percentage change			
	1388	1389	1390	1391	1388	1389	1390	1391
Sum of Exports and Domestic Sales (thousand tons)	21,973	28,393	31,292	29,030	10.9	29.2	10.2	-7.2
Value of Exports (USD millions)	9,147	11,559	15,177	10,615	16.6	26.4	31.3	-30.1
Value of Domestic Sales (Rls. bn.)	46,766	67,692	112,264	174,777	16.8	44.7	65.8	55.7

Source: CBI, 1391 Annual Review, and Iran's Customs Office website

Large segments of Iran's petrochemical industry operate inefficiently and the industry as a whole has had an unbalanced growth in favor of upstream industries. A major cause of the faster development of the upstream industries that have low value added and lack of interest in investments in downstream industries that have high value added lies in the low price of gas feedstock charged by the government. In 1390 and 1391, fuel and basic products, which are among upstream products, accounted for over 65 percent of Iran's petrochemical products.

• Steel Industry

In recent years Iran has been the largest steel producer in the Middle East and the fifteenth in the world. As shown in Table 7, Iran's steel production has been rising during the past few years and grew by 8.8 percent in 1392 to reach 15.6 million tons. Iran has large iron ore and gas reserves, which are the main ingredients for steel production, and thus should enjoy comparative advantage in steel production. However, Iran remains a net importer of steel in the tune of five millions tons a year in recent years.

Table 7 - Steel Production (in thousand tons)

	1388	1389	1390	1391	1392
Raw Steel	**10,858**	**12,509**	**13,270**	**14,362**	**15,627**
Growth (percent)	4.0	15.2	6.1	8.2	8.8

Source: World Steel Association, variuos monthly reports

•Automotive Industry

Iran's automotive industry has faced a number of problems in recent years and its production has fallen in the past two years. Depreciation of the Iranian rial, liquidity shortage, and difficulties in procuring parts and raw materials due to the sanctions and other international restrictions were among the major factors that led to this contraction. Car production in 1391 fell by as much as 44 percent, from 1,651,000 units in 1390 to 921,000 in 1391. With the tightening of sanctions in 1392, automotive industry, that is heavily dependent on imports of intermediate materials, suffered another blow. As shown in Table 8, during the first ten months of 1392 automobile production declined by close to a quarter compared to the same period in the preceding year. In 1392 production of large and medium size trucks and movers contracted most by 61 percent while that of small trucks contracted least by 11 percent.

Under the terms of the interim Geneva agreement, Iranian automotive industry received a temporarily exemption from the US and EU sanctions and thus its performance is expected to improve in the near future.

Table 8 - Number of Vehicles Produced in Iran

	(thousand units)				percentage change	
	1390	1391	1391*	1392*	1391	1392*
All Vehicles	1,651	921	754	577	-44.2	-23.6
Passenger Cars	1,421	788	647	489	-44.5	-24.4

Source: Iran Vehicles Manufacturers Association

* First 10 months only

1.3.3. Construction and Housing

In recent years the housing sector has both contributed to the general economic recession and been affected by it. During the years1384-1392, while household incomes had an annual average growth of 16 percent in nominal terms and average annual inflation rate was 17.5 percent, the average price of residential units increased by 19 percent. As a result, the purchasing power of potential home buyers declined. A research project has concluded that prior to 1384, 60 percent of new households in the market were eventually becoming home owners, but during 1384-92, particularly after the implementation of the first phase of SRL, this share fell to 35 percent. With the onset of the housing market recession in the second quarter of 1387, the number of real estate transactions and new building permits issued by various municipalities started to decline. As shown in Table 9, the number of building permits issued in urban areas declined in 1388 by more than 21 percent, but then increased between 1389 and 1391 before falling again in 1392. Overall, in 1392 the housing market experienced stagflation and its worst contraction in the past decade.

Table 9 - Change in Construction Permits Issued by Municipalities in Urban Districts (percent)

	1388	1389	1390	1391	1391*	1392*
Number	-21.1	29.8	5.7	0.3	0.9	-2.4
Total Space	-15.8	36.6	5.7	8.9	2.8	16.6

Source: CBI, 1391 Annual Review, and Economic Trends, no74

* First 9 months only

1.4. Services sector

Table 10 exhibits the growth rate of services sector and its sub groups, the value added of this sector declined by 2.4 percent during the first nine months of 1392. The contraction of the value added in "trade, restaurants and hotels" and "financial services" subgroups played major roles in this decline. The poor performance of the financial institutions was mainly due to their reduced lending power, international sanction, and the lower attraction of the financial market in comparison to parallel markets such as gold and foreign exchange markets. The contraction of the trade, restaurants and hotels subgroup can be attributed to the decline in per capita income that led to a decline in demand in such services.

Table 10 - Real Growth Rates in Services Group (percent)

Year	1391	1391*	1392*
Services	1.1	-0.2	-2.4
Trade, Restaurant and Hotel	-8.9	-15.3	-7.4
Transportation, Storage and Communications	5	7.2	0
Financial and Monetary Institutions Services	-1.6	0.3	-15.2
Real Estate, Specialized and Professional Services	8.7	4.3	0.4
Public Services	0.4	12.1	0
Social, Personal and Household Services	0.7	-4.9	6.1

Source: Annual National Accounts of Iran, website of the Central Bank of IRI

* First 9 months only

In 1391 the share of services sector in GDP was 52.1 percent but it fell to 50.1 percent during the first nine months of 1392. The PPI of this group registered a 22.1 percent growth in the last month of 1392 compared to the last month of 1391. The PPI of the "transport, storage and communications" subgroup (that accounts for 21.04 percent of the services sector) registered an 18 percent increase between the same two months. The services sector accounted for 47.4 percent of total employment in 1392. The urban and rural areas accounted for 58.2 percent and 21.8 percent of employment in services sector, respectively.

1.5. Labor Market

The Statistical Center of Iran (SCI) is Iran's official source of labor force statistics. Based on SCI's definition, an unemployed person is anyone who is over 10 years of age who is willing to work and is seeking employment but is unable to find a job for even one hour a week. The unemployment rate is then defined as the proportion of the unemployed in the "active population", defined as those aged 10 and above who are either working or are unemployed by the above standards. As such, this methodology underestimates what is commonly regarded as the unemployment rate which, for instance, does not usually consider working an hour per week as employment.

The high number of the unemployed -- especially among the youth, the large gap between the unemployment rates of women and men and the high fluctuation of this gap across provinces are some of the main challenges facing Iran's labor market. Comparing employees in different economic sectors indicates that there has been an increase in the employment share of the services sector in comparison to the agriculture and manufacturing sectors in recent years.

Table 11 shows statistics on the rates of economic participation and unemployment in recent years and indicates that during the first nine months of 1392 the economic participation rate has fallen by 0.8 percentage points to reach 36.7 percent.

Table 11 - Economic Participation and Unemployment Rates (percent)

	1388	1389	1390	1391	1391*	1392*
Labor Force Participation Rate	38.9	38.3	36.9	37.7	37.5	36.7
Unemployment Rate	11.9	13.5	12.3	12.2	11.2	10.3

Source: The Statistical Center of Iran, "Labor Force Survey Results, 1391" and "A Selection of Labor Force Survey Results", Autumn 1392

* First 9 months only

Table 12 indicates that the labor participation rate in 1392 stood at 62.1 percent for men and 11.3 percent for women. In other words, the percentage of female population over 10 years old who are employed or are looking for job is much less than that for men. The unemployment rate in the first nine months of 1392 stood at 10.3 percent, which is lower than its rate of 11.2 percent a year earlier. There is, however, a significant gender gap in this unemployment rate, which was 8.5 percent for men but over 20 percent for women. In addition, while the unemployment rate in 1392 was about 6.9 percent in rural areas, it was about 11.7 percent in urban areas. The unemployment rate for youth aged 15 to 24 years of age during the first nine months of 1392 was 24.3 percent, indicating an unfavorable employment environment for the youth. The situation can get worse as a significant number of college graduates enter the labor market each year. It seems that higher education might be used by some as a means of postponing unemployment.

Table 12 - Labor Force Statistic for the First 9 Month of 1392

	Total	Male	Female	Urban	Rural
Labor Force Participation Rate	36.7	62.1	11.3	36.0	38.6
Unemployment Rate	10.3	8.5	20.3	11.7	6.9
Unemployment Rate of 15 to 24 Years	24.3	20.8	42.3	28.1	17.1
Share of Agriculture in Employment	17.5	16.7	23.1	4.8	47.9
Share of Industry in Employment	34.5	36.3	23.1	36.7	29.1
Share of Services in Employment	48.0	47.0	53.9	58.5	22.9

Source: SCI, A Selection of Labor Force Survey Results, Autumn 1392

2. Economic Sanctions against Iran

Since 2008 the United States has used the excuse of threats by Iran's nuclear activities to encourage other countries and the United Nation's Security Council to tighten existing sanctions and/or impose new ones against Iran. US pressures combined with Iran's weak diplomacy have led countries such as China and Russia to offer implicit or explicit support for such acts. Until late 1391 the sanctions generally targeted individuals and industries that were linked to nuclear energy or armed forces, but on February 5, 2012, all Iranian banks, including the Central Bank, were added to the list of sanctioned institutions. Consequently all international exchanges in the fields of banking and insurance services, energy services and equipment, industry, marine, aviation and petrochemicals came under sanction. Although these sanctions did not cut off Iran's international trade but caused the cost of foreign trade to go up and communication channels to become less efficient and transparent, and these, in turn, led to the departure of many entrepreneurs and companies from the country. Prolonged sanctions coupled with inappropriate domestic policies restricted foreign investment, weakened the rial, increased inflation, reduced production and export of oil and gas, and caused a severe recession in 1391 and 1392. Partly as a result of general international discontent, some of these sanctions were lifted in July 2013 and imports of food, medicines and medical equipment were exempted from the sanctions.

But the most important development occurred on November 24, 2013, when, under a six-month interim agreement between Iran and the so-called group of 5+1 countries reached in Geneva, Switzerland, some sanctions were suspended and Iran was also given access to part of its frozen assets abroad in return for its suspension of uranium enrichment to 20 percent grade. The concessions by the group of 5+1 included the lifting of sanctions on exports of certain petroleum products, import of automotive parts and aviation equipment, and trade in precious metals. The suspension of sanctions on some banks enabled them to repatriate about USD4.2 billion of Iran's oil revenue that had been frozen overseas. If further agreements are reached in the future, more sanctions should be lifted and more of Iran's overseas assets should be repatriated. However, for the lifting of sanctions to have significant economic impact, the engagement and cooperation of businesses from both sides is necessary.

In industries such as aviation and energy, prolonged sanctions have almost eroded the foundations of Iran's foreign trade and it will be very difficult to reconstruct them. Meanwhile, the optimism and eagerness of businesses on both sides for the resumption of trade is a cause for optimism in this regard.

3. Government Budget and Finance

The 1392 budget law was the third budget of the government in the framework of the Fifth Development Plan, drafted in line with the guidelines of the Twenty Year Vision, the provincial development plans and the general policy guidelines in article 44 of the Constitution. The 1392 budget was eventually approved by the parliament and communicated to the government for implementation in June 2013. According to this budget law, total revenues and proceeds from the sale of financial and non-financial assets on the one hand, and current expenditures including the acquisition of financial assets and non-financial assets on the other, each amounted to 2,104 trillion rials. The resort to a four-twelfth budget in 1392 budget represented the failure to realize the full budget revenues and the shortfall of revenues in comparison to expenses – an imbalance that created problems for the economy. Shortly after coming to office, the 11th government submitted an amendment to the 1392 budget law to the parliament which was approved in November 2013. The provisions in this amendment reduced the budget for the acquisition of non-financial assets by up to 10 percent, decreased the share of the National Development Fund from 26 percent to 20 percent and allocated the difference to the government's project finance fund, and reduced the projected revenue from the sale of non-financial assets to 10 trillion rials.

3.1. Comparison of the Budget Laws of 1391 and 1392

In comparison with the general government budget in 1391, on the sources side of the 1392 general government budget, the share of tax revenues was 8 percentage points lower and the share of revenues from the proceeds of state ownership was 8 percentage points higher. In the disposal of non-financial asset, the share of revenues from the sale of oil and oil products was lower and the share of revenues from the transfer of non-financial assets was higher by the same amount. Also, in the transfer of financial assets, the share of revenues from the divestiture of state-owned enterprises was 16 percent higher. The share of revenues from the sale of "participation bonds" and "back payments from previous years" each faced an 11 percent decline. At the same time, the share of revenues from withdrawal funds from the hard currency reserve account dropped from 11 percent to zero.

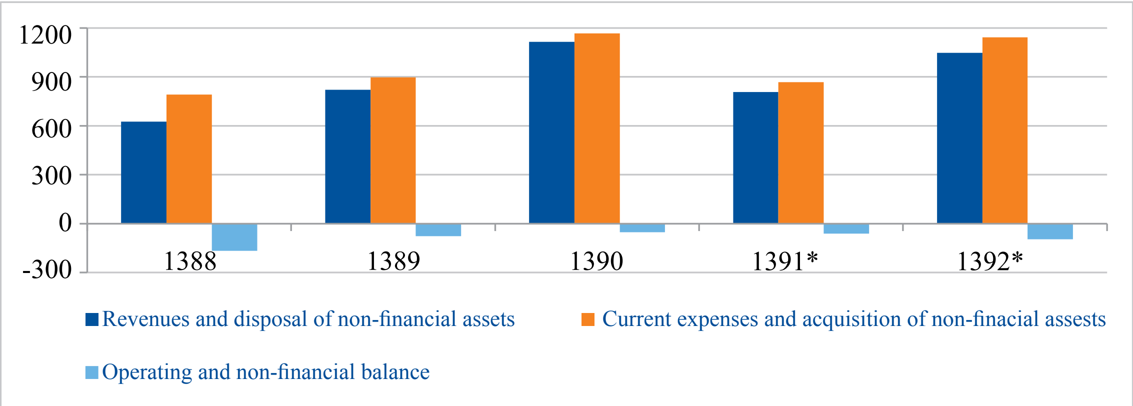
On the side of the uses of the general government budget, in the current expenditures category, in comparison to 1391, the share of employees' compensation costs grew by 11 percent and the share of welfare spending fell by the same percentage points. Moreover, the share of property and assets expenses and the share of grants and subsidies increased while the shares of public assistance budget and the cost of goods and services declined. In the category of the acquisition of non-financial assets, the share of spending on building structures dropped by 10 percent compared to the previous year while the expenditure shares of machinery and equipment and other fixed assets and other items increased. Also in the acquisition of financial assets, the share of credit facilities associated with the sale of public enterprises increased by 31 percent while the share of retirement of the principals of the participation bonds decreased. On the other hand, the budget share for the repayment of foreign loans, unpaid obligations in previous years, the repayment of public sector bank loans, foreign investments and foreign aid for cultural programs and economic assistance decreased, respectively, by 8 percent, 7 percent, 3 percent and 2 percent in comparison to the previous year.

3.2. Overview of the Budget Implementation

According to the 1392 budget law, the legislated levels for revenues (including tax revenues and other government revenues) and current expenses were 906 and 1,280 trillion rials, respectively. As a result, the operating balance had a deficit of 374 trillion rials. Furthermore, the legislated level of receivables and payments from the disposal and acquisition of non-financial assets were 702 and 564 trillion rials, respectively. As a result, the operating and non-financial balance showed a deficit of 236 trillion rials. The deficit was to be financed from the proceeds of the net disposal of financial assets - a large portion of which were proceeds from the divestiture of state-owned enterprises. The sources of legislated budget for 1392 is composed of 43 percent from tax and other government revenues, 34 percent from the disposal of non-financial assets, and 23 percent from the disposal of financial assets. The uses of the legislated budget is composed of 60 percent in current expenses, 27 percent in acquisition of non-financial assets, and 13 percent in acquisition of financial assets. During the first eleven months of 1392, 50 percent of the budget revenues have come from tax and other government revenues, 41 percent from the disposal of non-financial assets and 9 percent from the disposal of financial assets. On the expenditures side, 89 percent has been spent on current expenses, 10 percent on the acquisition of non-financial assets, and the remaining one percent on the acquisition of financial assets.

In the first eleven months of 1392, tax and other government revenues reached 580 trillion rials, which is 64 percent of the corresponding legislated budget figure and 30 percent higher than in 1391. Tax and other government revenues comprised of 70 percent and 30 percent of the mentioned revenues, respectively. In 1391 these proportions were 75.4 percent and 24.6 percent, respectively. Current government expenditures in the first eleven months of 1392 totaled 1,025 trillion rial, which is 31 percent higher than in 1391 and equals 81 percent of the corresponding legislated budget figure. As such, on the basis of government revenues and current expenditures during the first 11 months of 1392, the operating balance faced 448 trillion rials deficit. In the meantime, government receipts from the disposal of non-financial assets, including receipts from crude oil and oil products and movable and immovable assets reached 466 trillion rials. The acquisition of non-financial assets (development expenditures) amounted to about 115 trillion rials which is 37.8 percent higher than that in 1392 and accounts for 20.5 percent of the corresponding legislated budget figure. Therefore, the net disposal of non-financial assets realized a 351 trillion rials surplus. Based on the eleven-month performance of revenues and expenditures and disposal and acquisition of non-financial assets, the operating and non-financial balance registered a 98 trillion rials deficit in this period, which was 54.2 percent larger than that in 1391 and equals 41.6 percent of the legislated budget. During the same eleven months, proceeds from the disposal of financial assets amounted to 103 trillion rials and expenditures on the acquisition of financial assets was about 5 trillion rials, resulting in 98 trillion rials surplus in net disposal of financial assets which, as noted earlier, financed the operating and non-financial deficits. Figure 1 shows the main government fiscal statistics during 1388-1392.

Figure 1 - Government's Fiscal Statistics (in trillion rials)



Source: Based on data in "Selected Economic Indicators", CBI website

* First 11 months only

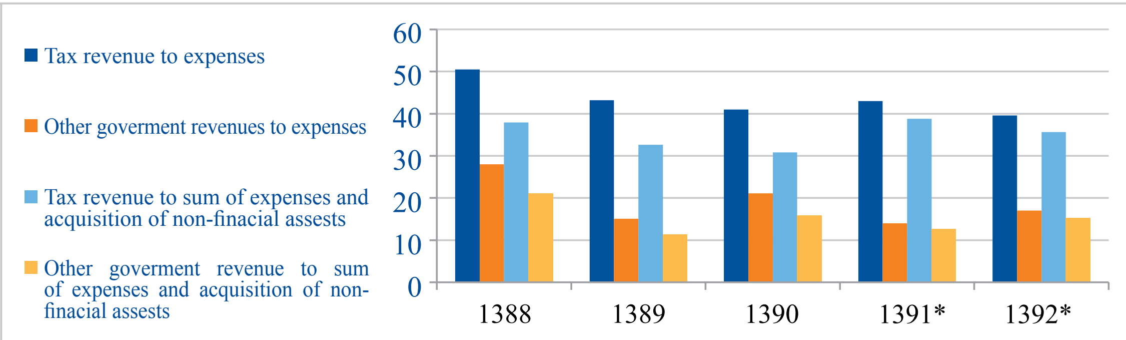
In the first eleven months of 1392 government tax revenues amounted to 406 trillion rials, which is 20.6 percent higher than in the same period in 1391. Tax revenues were 72.5 percent of the corresponding legislated budget figure and consisted of 234 trillion rials in direct taxes and 171 trillion rials in indirect taxes. In comparison to the corresponding figures in 1391, they were 10.1 percent and 38.8 percent higher, respectively, and as shares of the revenue targets in the legislated budget, they were 41.8 percent and 30.6 percent, respectively. Among the components of direct taxes, revenues from tax on legal entities amounted to 149 trillion rials, which is 4 percent higher than that in 1391 and accounts for 65 percent of the legislated amount.

Income tax receipts in this period amounted to about 66 trillion rials and included 43 trillion rials in salary tax, 19 trillion rials in professions tax, 3 trillion rials in real estate tax, and 55 trillion rials in other taxes. In comparison to the corresponding figures in 1391 tax revenues showed a 19.4 percent increase, and in comparison to the corresponding targets in the legislated budget, it registered an 81 percent performance. Also during this period, wealth tax -- including inheritance tax, transfer of goodwill tax, shares transfer tax, property transactions tax, stamp duty, checks, drafts, promissory notes tax and others -- amounted to 18 trillion rials, which was 36.1 percent higher than in 1391 and equaled 91.2 percent of the legislated amount.

In indirect taxes, import taxes amounted to 56 trillion rials and included 8 trillion rials in motor vehicle import duties, 48 trillion rials in import duties of other goods. In comparison to the previous year, this item showed 4.5 percent decline, and in comparison to the corresponding target in the legislated budget, it showed 53.5 percent performance.

Taxes on goods and services in this period amounted to 114 trillion rials, which was 78.7 percent higher than in 1391 and equaled 94 percent of the legislated amount. The main reason for this growth was a 138.6 percent increase in tax revenues from the sale of oil products and an 81 percent increase in revenues from value-added taxes in the first eleven months of 1392 compared to the same period in 1391.
Figure 2 shows the trend of ratios relating to tax and other revenues. As shown, the ratio of tax revenues to current expenses in 1392 decreased in comparison to 1391, but increased in comparison to other revenues.

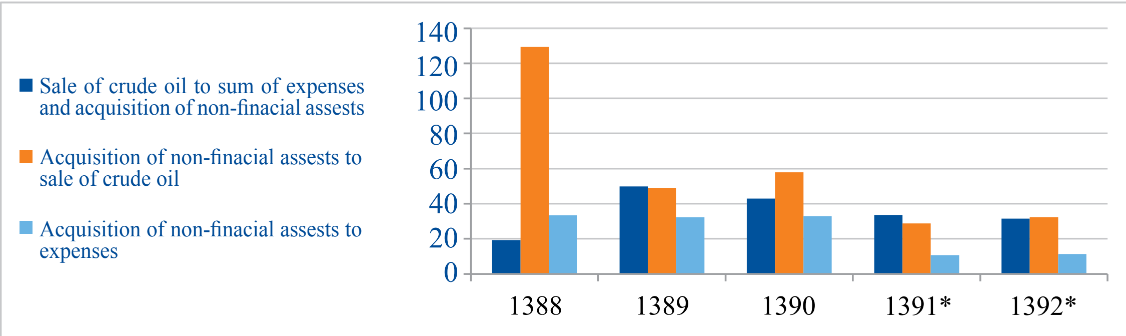
Figure 2 - Ratios of "Taxes" and "Other Revenues" to "Expenses" and "Acquisition of Non-financial Assets (in percentage points)



Source: Based on statistics in "Selected Economic Indicators", CBI website
* First 11 months only

In the first eleven months of 1392 proceeds from the disposal of non-financial assets amounted to 466 trillion rials, which showed a 29.4 percent increase in comparison to the previous year but equaled only 66.4 percent of its legislated budget. Of this amount, 99.5 percent came from the sale of crude oil and oil products and 0.5 percent from the sale of movable and immovable assets.
Figure 3 shows the trend of ratios relating to the sale of crude oil as well as the ratio of the acquisition of non-financial assets to current expenditures. As shown, the share of development expenditures in current expenses has risen moderately from the previous year to reach 11.3 percent. However, compared to its share of over 30 percent in 1388-90, it remains low. It also shows that the ratio of development expenditures to the sale of crude oil has increased, indicating that a larger share of development expenditures has been financed through other sources of revenue.

Figure 3 - Ratios Relating to the Sale of Crude Oil, and Ratio of Development Expenditures to Expenses (percent)



Source: Based on statistics from “Selected Economic Indicators” reports, CBI website

* First 11 months only

3.3. Privatization

The passing of “The Law on the Implementation of Article 44 of the Constitution” by the Majlis in 4/1387 (7/2008) offered a comprehensive framework for divestiture of much of government’s economic activities. It also focused the government’s attention to developing guidelines and regulations for the privatization process in a transparent and practical manner. The Ministry of Economic Affairs and Finance charged Iran’s Privatization Organization (IPO) with the task of coordinating and implementing this law, including equity sales and share offerings of state-owned companies, enforcing legal and accounting measures for offering the shares of privatized firms in the stock exchange, conducting other privatization sales such as block sales, negotiating private sales, managing the so-called “justice shares” and retiring government debts with equity shares.

From 1370 to 1379 the letting of governmental firms and public enterprises generated 8,329 billion rials, of which 78.3 percent was through the stock exchange, 8.7 percent through auctions, and the remaining 13 percent through negotiation. Table 13 present statistics on the value of the transferred state-owned shares and state-owned companies from 1380 to 1392.

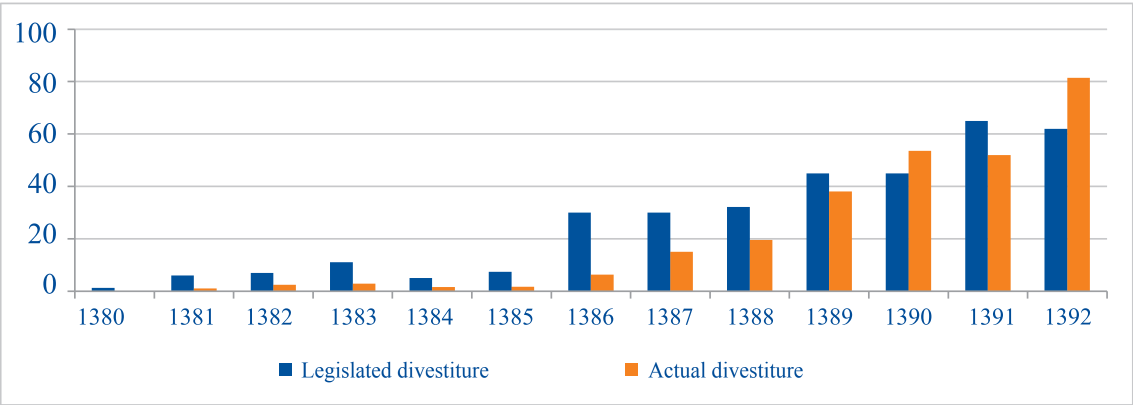
Table 13 - Annual Performance of Stocks and Assets Divestiture for Divestible Companies by Iran's Privatization Organization (billion rials)

Divestiture type		1380-1389	1390	1391	1392
Offering and sale of stock and assets to public	Assignment of sales proceeds to public revenues	295,921	44,205	25,067	233,831
	Assignment of sales proceeds for clearance of government debts	19,751	27,923	21,654	47,119
Sub-total		315,672	72,128	46,721	280,950
Divestment of stock and assets by direct transfer method to beneficiaries	Transmission of stocks or assets to government creditors	67,891	46,320	40,293	129,036
	Direct transfer of stocks and assets relating to "Justice stocks"	238,969	24,061	-	35,267
Sub-total		306,860	70,381	40,293	164,303
Total		622,532	142,509	87,014	445,253

Source: Privatization Performance and Records, website of Iran's Privatization Organization

Figure 4 shows the government's legislated and realized privatization revenues rising from the transfer of stocks and assets during 1380-92. As can be seen, in years 1390 and 1392 actual revenues were respectively 119 and 131 percent of the legislated amounts. According to the 1392 budget Law, the portion of these revenues that were designated for specific targeted expenditure was projected at 250 trillion rials, of which only 13 percent was realized. Furthermore, 12.2 trillion rials worth of privatization sales where used to retire government debt to private individuals.

Figure 4 - Divestiture Performance of Divestible Companies (trillion rials)



Source: Privatization performance and records, website of Iran's Privatization Organization

In 1392, 64 percent of privatization shares were offered in stock exchange, 11.3 percent in over-the-counter exchange, and the remaining 24.7 percent through auctions. In 1391, these percentages were 5.5, 39.3 and 55.2, respectively. Furthermore, 91.6 percent of these shares were offered as block shares, 8.1 percent were sold gradually as individual shares, and the remaining 0.3 percent was offered to employees and management of the companies as preferred shares. These percentages in 1391 were 95.6, 2.8 and 1.6, respectively.

3.4. Year 1393 Budget Law

The general government budget for fiscal year 1393 (that coincides with calendar year 1393) was legislated in the last month of 1392 (March 2013) and submitted to the government for implementation. Compared to the 1392 budget, in the 1393 budget law the share of tax revenues has risen and the share of revenues from the sale of government asset has declined. In revenues from disposal of non-financial assets, the share of revenues from sale of crude oil and oil products has increased and the share of receipts from disposal of projects related to the acquisition of non-financial assets has decreased. On the other hand, in the category of acquisition of non-financial assets, the share of machinery and equipment has increased and the share of buildings and other fixed assets has decreased. In the category of disposal of financial assets, the share of revenues from sale of participation papers has increased, while proceeds from the transfer of state-owned companies has decreased.

The main change in the category of acquisition of financial assets is the decline in share of repayments for participation papers and an increase in the share of repayments for the principal of foreign loans.

The government budget for 1393 seems to have been designed and legislated with an awareness of the poor performance of revenues, development expenditures and acquisition of financial assets in previous years. In spite of the ongoing dependency of budget revenues on oil revenues and uncertainty about the future of sanctions, the 11th government has adopted a more realistic approach to the reduction of budget deficit. This will further reduce the government’s dependency on Central Bank’s resources and ultimately improve the macroeconomic indicators such as economic growth and inflation. Table 14 illustrates the composition of fiscal budget in 1392 and 1393.

.

Table 14 - Comparison of the 1392 and 1393 Budget Laws (Trillion rials)

	Budget Law 1392	Budget Law 1393	Percentage change
Revenues	906	1,003	10.71
Expenses	1,280	1,493	16.64
Disposal of non-financial assets	702	798	13.68
Acquisition of non-financial assets	564	412	-26.95
Disposal of financial assets	494	309	-37.45
Acquisition of financial assets	259	205	-20.85
Total general government consumption	2,104	2,111	0.33
Special revenues	256	238	-7.03
General government consumption	2,360	2,350	-0.42
Budget consumption of public companies and private institutions affiliated to the government and banks	5,357	5,971	11.46
Total general government budget	7,277	8,033	10.39

Source: Budget Laws, 1392 and 1393

3.5. National Development Fund

The National Development Fund (NDF) was set up in 1389 in order to allocate a portion of proceeds from the sale of oil, gas and oil products to wealth-generating investments for the benefit of future generations. NDF mandates include supporting domestic and foreign investors (either independently or in partnership with Iranian partners) and participating in national or international projects. These are in line with the main objectives of national sovereign wealth funds whose administrative procedures and legal frameworks have been defined by Iran's legal code.

Through sovereign wealth funds, a portion of foreign exchange reserves is utilized with the aim of achieving long-term returns through productive investments. By doing so these funds contribute to the stability of the national economy, support the domestic economy, strengthen the inter-generational savings, and contribute to the integration of Iran in global economy. The share of NDF in oil revenues of 1389 and 1390 was 20 percent and this share is scheduled to increase by 3 percent in each of the next three years. Sector composition of hard currency projects that have been approved by NDF during the first half of 1392 appear in Table 15. It should be noted that hard currency constitutes 80 percent of all NDF resources.

Table 15 - Approved Foreign Currency Projects by Sector

Sector	Number of projects	Amount (USD million)	Job creation potential (Person)
Manufacturing and Mining	280	19,603	69,755
Construction and Housing	40	568	5,362
Water and Agriculture	22	243	2,152
Exportation	1	190	-
Transportation	4	685	1,409
Others	6	129	946
Total	**353**	**21,418**	**79,624**

Source: Iran National Development Fund, Performance Report Through 25/5/1392 (16 August 2013), NDF website

Table 6 presents the distribution of facilities granted to major subsections in the manufacturing and mining sector during the first five months of 1392. As shown, the share of oil and gas subsector is much larger than other subsectors. NDF funds amounted to USD2.1 billion for 119 projects in 1390 and USD17.6 billion for 192 projects in 1391. During the first five month of 1392, more than 1.7 billion dollars was allocated to 44 projects. Jobs created by these projects numbered 15,304 in 1390, 61,011 in 1391, and 3,309 in the first five months of 1392.

Table 16 - Approved Projects, by Manufacturing and Mining Sub-sector

Sector	Number of projects	Amount (million dollar)	Share (percent)
Oil and Gas	7	9,042	46
Upper-level petrochemical Industries	12	3,326	17
Powerhouse	22	2,380	12
Steel	31	1,674	9
Cement	20	439	2
Other	187	2,689	14
Total	**279**	**19,550**	**100**

Source: Iran National Development Fund, performance report, August 2013, NDF website

As of the end of 5/1392 (8/2013), NDF had approved 3,594 projects in water and agriculture sector worth 7.6 trillion rials, and 737 projects in mining sector worth 19.3 trillion rials.

4. Subsidies Reform Program

With the Majlis enactment of the Subsidies Reform Law (SRL) in 10/1388 (1/2010), reform of domestic energy, water and electricity prices were set through the end of the Fifth Five-Year Plan. Article 7 of SRL required the government to spend 50 percent of the net savings from the enforcement of this reform on assistance to needy households and finance of a comprehensive social safety net program, including social security, health care and social protection programs. Article 8 of SRL called on the government to allocate another 30 percent of the net savings from the implementation of SRL to support producers, inter-alia, through grants, special incentive loans for the optimization of energy use in manufacturing, services and residential units, expansion and improvement of public transport in the framework of the public transport development law, support for producers in agricultural and industrial sectors, and support for the development of non-oil exports. According to Article 11 of SRL, government enterprises would receive the remaining 20 percent of the net savings to compensate for the ensuing increases in development expenditures.

In the 1392 budget law of 3/1392, net income arising from reduced subsidies on prices of energy carriers in accordance with SRL was projected at 388 trillion rials. The government was allowed to use up to 112 trillion rials in savings from reduced subsidies on bread, electricity and other goods and services as resources for the Organization for Targeted Subsidies (OTS). Therefore, total resource of OTS in the 1392 budget law was estimated at 500 trillion rials. Table 17 shows projected net revenues of OTS according to the budget laws of 1391, 1392 and1393.

Table 17 - Resources of Iran's Organization for Targeted Subsidies in Annual Budget Laws (trillion rials)

Sector	1391	1392	1393
From increase in prices	560	388	480
From government budget	100	112	113
Total	**660**	**500**	**593**

Source: Budget Laws for the years 1391, 1392 and 1393

In the 1392 budget law, the expenditure side of OTS includes cash and non-cash assistance to households amounting to 410 trillion rials. Additionally, 40 trillion rials is designed to support producers, improve public transport, and optimize energy consumption. Another 50 trillion rials is allocated to the implementation of item B of article 34 of the Fifth Five-Year Development Plan relating to the health sector. Consequently, the share of article 7 of SRL, whose ceiling had been set at 50 percent, jumped to 82 percent. Furthermore, the share of article 8 of this law fell from 30 percent to 8 percent and the share of its article 11 fell from 20 percent to zero, thereby deviations from the original SRL continued. Table 18 presents OTS's projected expenditures in budget laws for the years 1391 to 1393 and shows that from the beginning of the implementation of SRL, general government revenues has never been credited its legislated 20 percent share of the savings.

Table 18 - Iran's Organization for Targeted Subsidies, Annual Expenditures in Budget Laws (trillion rials)

Sector	1391		1392		1393	
	Amount	**Percent**	**Amount**	**Percent**	**Amount**	**Percent**
Payment to families in cash and kind	480	73	410	82	425	72
Support for production, public transportation, and improvement and optimization of energy use	100	15	40	8	100	17
Payments to government	0	0	0	0	0	0
Healthcare system	60	9	50	10	48	8
Unemployment insurance	20	3	0	0	20	3
Total	**660**	**100**	**500**	**100**	**593**	**100**

Source: Budget Laws, 1391-1393

4.1. Performance of the Subsidies Reform Program in 1392 and Forecasts for 1393

In 1392 the government distributed a monthly cash subsidy of 455 thousand rials to 76.6 million individuals. In other words, in 1392 more than 418 trillion rials were disbursed to households in direct subsidies while OTS's revenues arising from increases in prices of energy carriers was only about 302 trillion rials. OTS's deficit of about 116 trillion rials was financed from the general government budget. This deficit materialized despite the fact that the 40 billion rials of price subsidy savings in 1392 that was to be spent on supporting the manufacturing sector and improving public transport and energy efficiency in production units and residential services, and another 50 trillion rials that was to support the health sector, were never disbursed. In other words, all of the net revenues resulting from increased energy prices, and more, were paid in cash and non-cash subsidies to households.

In 1393 the government announced that the number of people registered to receive subsidies had fallen to 73 million. Given that the amount of monthly subsidies has remained at 455 thousand rials per person, resources needed to finance these cash subsidies will be about 398 trillion rials. Also, given the increase in the price of energy carriers and assuming unchanged level of consumption from 1392, total revenue from the sale of energy products in 1393 will be about 636 trillion rials. After deducing corporate expenses and taxes, net revenue from the implementation of SRL is projected at 411 trillion rials. Given that new revenues from increases in energy prices in 1393 should be about 167 trillion rials, after the deduction of corporate taxes, duties and enterprise shares, net revenues from the implementation of SRL should increase by about 110 trillion rials. Therefore, in 1393 the deficit in cash subsidy payment program is expected to be eliminated and about 12 trillion rials from energy price increases and 113 trillion rials from the public budget should be available for the implementation of the other parts of SRL and repayment of its debt to the treasury.

Implementation of SRL in 1393 will include 593 trillion rials in payments, while, assuming the continuation of 1392 energy consumption pattern, its revenues would amount to only 411 trillion rials. Assuming an additional allocation of 113 trillion rials from the government's general budget to this figure, revenues would reach 524 trillion rials which will still fall short of its projected expenses in the 1393 Budget Law by 69 trillion rials. In other words, despite the increase in energy prices, the government is expected to face difficulties in meeting its budget objectives.

5. Current Account Balance

Fluctuations in oil revenues, low competitiveness of domestic firms in international markets and international sanctions have affected Iran's foreign trade and caused significant fluctuations in the components of Iran's balance of payments. At the time of preparing this report only the balance of payment data for the first nine months of 1392 are available. Table 19 presents balance of payments statistics for the years 1389-1391 and the first nine months of 1392, as well as for the first nine months of 1391 for comparison purposes.

Table 19 - Balance of Payments (USD million)

	1389	1390	1391	1391*	1392*	Change 1392 to 1391
Current Account Balance	27,554	59,383	26,271	20,180	22,066	1,886
Goods Account	37,330	67,069	30,975	23,445	25,368	1,923
Exports (f.o.b.)	112,788	144,874	98,033	73,366	67,126	-6,240
Oil Export	90,191	118,232	68,135	52,081	46,532	-5,549
Non-oil Exports	22,536	26,642	29,899	21,285	20,594	-691
Imports (f.o.b.)	75,458	77,805	67,058	49,921	41,758	-8,163
Gas and Oil Products	6,788	5,726	2,639	1,683	2,089	406
Other Goods	68,670	72,079	64,419	48,238	39,669	-8,569
Services Account	-10,040	-8,432	-6,293	-4,451	-4,376	75
Incomes Account	79	323	1,037	789	635	-154
Current Transfers	185	423	552	397	439	42
Capital and Financial Account Balance	-24,296	-37,974	-9,835	-10,798	-10,957	-159

Source: CBI, Economic Trends, no74

* First 9 months only

This table indicates there was a USD1.9 billion increase in trade surplus during the first nine months of 1392, which partially offsets the USD33 billion decline of this surplus in 1391. This improvement, however, was not caused by an increase in exports but by a severe decline in imports. During this period, volume of goods exports and imports declined by USD6.2 and USD8.2 billion, respectively. Oil exports, which declined by approximately USD50 billion, i.e., 42 percent, in 1391, dropped by an additional USD5.5 billion during the first nine months of 1392. On the other hand, during these nine month imports of oil and gas which had declined in 1391 grew by 24 percent to reach USD2 billion.

5.1. Merchandise Exports

Data based on Iran Customs Office statistics in Table 20 indicate that total merchandise exports in 1392 was larger than in 1391. Petrochemical exports -- that in 1391 had fallen by 29 percent in value to less than USD11 billion -- increased by 1 percent in 1392. Condensate gas exports enjoyed a 15.9 percent growth to exceed USD10 billion. However, exports of other commodities, including manufactured goods, agricultural, minerals, carpets and crafts, declined by 6 percent.

Table 20 - Non-oil Exports

	(USD millions)			percentage change	
	1390	1391	1392	1391	1392
Gas Condensate	10,156	8,881	10,295	-12.6	15.9
Petrochemical Products	15,042	10,615	10,723	-29.4	1.0
Other Goods	18,776	21,952	20,610	16.9	-6.1
Total	43,974	41,448	41,628	-5.7	0.4

Source: Iran Customs Office, preliminary foreign trade statistics for 1392

Main export items in 1392 included hematite iron ore (4.8 percent of total exports), liquid propane (3.9 percent) and oil bitumen (3.7 percent). The two largest export markets in 1392 were China (USD7.5 billion) and Iraq (USD5.9 billion).

5.2. Merchandise Exports

The value if merchandise imports in 1392 amounted to USD49.5 billion, which was 7.5 percent smaller than in 1391. The most important import items included rice (4.6 percent of total), soybean (3.7 percent) and maize (3.1 percent), followed by wheat and combustion engine vehicles. Table 21 presents statistics on weights and values of merchandise imports in recent years.

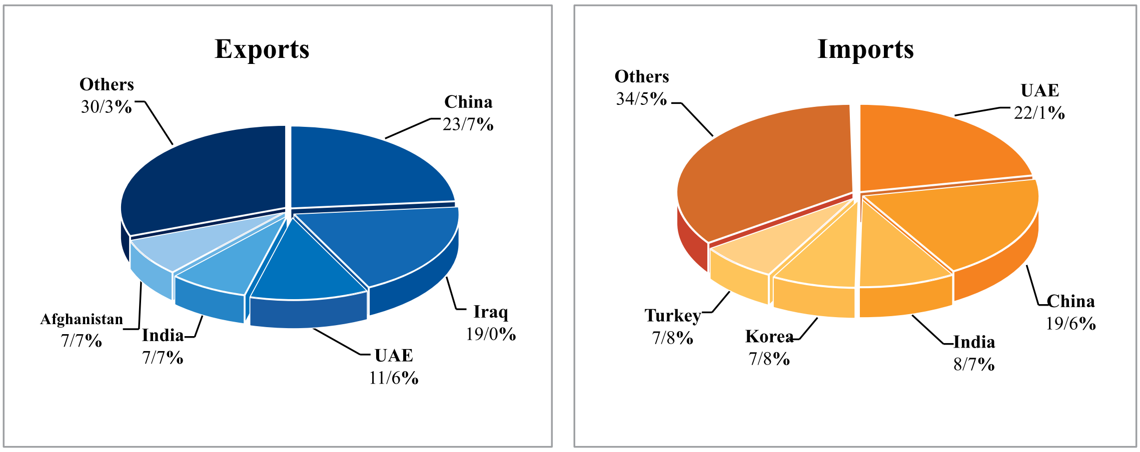
Table 21- Custom Imports of Iran

				percentage change	
	1390	1391	1392	1391	1392
Weight (thousand tons)	38,379	39,481	33,568	2.9	-15.0
Value (USD millions)	61,808	53,451	49,422	-13.5	-7.5

Source: Iran Customs Office, preliminary foreign trade statistics for 1392

In 1392, as in 1391, about 35 percent of imports entered the country through Shahid Rajaei port. Main countries of origin included UAE (USD10.9 billion), China (USD9.7 billion) and India (USD4.3 billion). The value of merchandise imports from European ports declined by 28.3 percent from USD15.3 billion in 1391 to USD11 billion in 1392 while those from Asian ports increased by 2.5 percent to USD37.4 billion. Switzerland, which was among Iran's top five major import origins in 1391, lost its place in 1392 while India, which was not on that list in 1391, ascended to the 3rd position. Figure 5 presents the top five import and export partners of Iran in 1392.

Figure 5 - Top Five Import and Export Partners of Iran and Their Shares in 1392

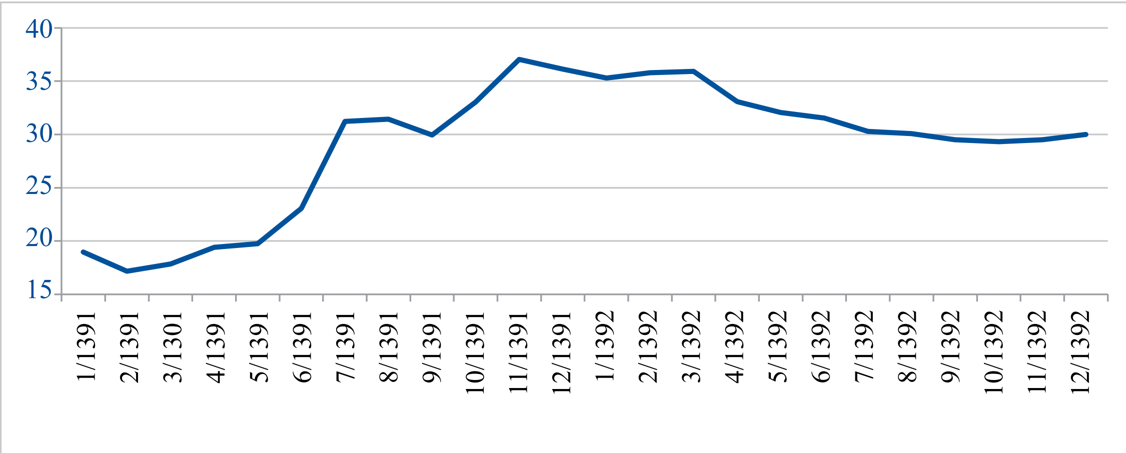


Source: Annual Budget Laws, 1391-1393

6. Foreign Exchange Market

In 1391 a significant growth in money supply coupled with accelerating inflation and erratic economic policies of the government led to a sharp increase in demand for foreign currencies. This occurred while sanctions on Iranian banks, oil exports and international trade were causing sharp declines in the supply of hard currencies. These developments led to a severe depreciation of the rial against major currencies. The US dollar exchange rate jumped from 18,000 rials in 2/1391 (May 2012) to over 38,000 rials in 11/1391 (February 2013). Despite the decline of this exchange rate to 35,000 during the last month of 1391 and the first month of 1392 (March and April 2013), it resumed its rise up to the time of the July 2013 presidential election. Following the outcome of the election and growing public expectations about improved economic prospect and better political and trade relations with the international community, foreign exchange rates began to stabilize and then the rial started to appreciate relative to hard currencies. The new government's attempts to reduce tensions with the international community further stabilized the foreign exchange market and reduced speculative demands for foreign currencies. As a result, the monthly average of the USD/IRR exchange rate declined from 36,000 in in 2/1392 (April 2013) to below 30,000 by the end of the year (March 2014). Figure 6 presents the trend of the monthly average USD/IRR exchange rate during 1391-1392.

Figure 6 - USD/Rial Market Exchange Rate (thousand rials)



Source: CBI, Economic Trends, nos. 68 to 75

In February 2013, after six months of relative stability in the informal foreign exchange market, the onset of factors that restricted supply and raised demand, as well as certain news and rumors led to increased market volatility that moderately raised foreign exchange rates against the rial. A notable event in this respect was the curtailment of gas supply to some petrochemical companies for over two months due to the shortage of gas for household use in winter, which reduced production and exports of petrochemical products.

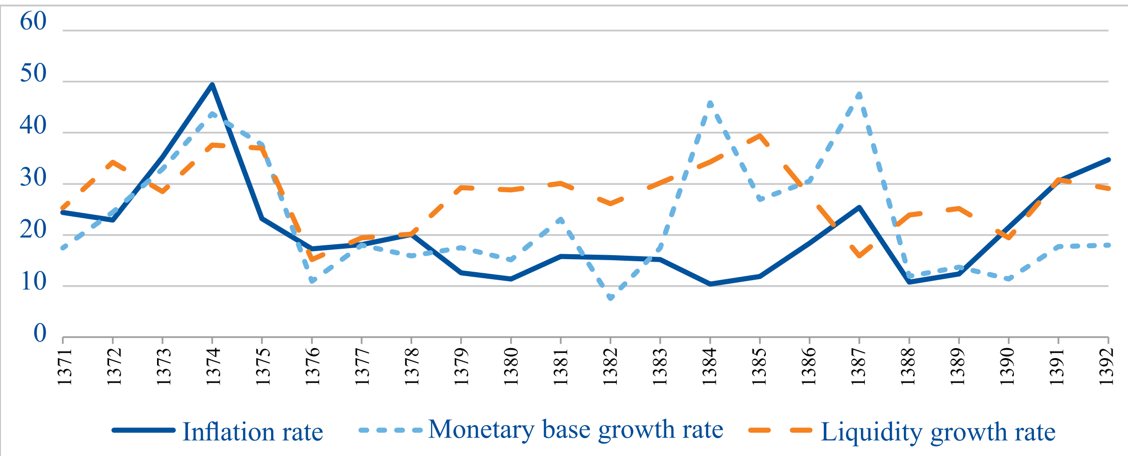
7. Monetary and Credit Policies

Economic growth, low unemployment and price stability are among the most important objectives of monetary and credit policies. In this context, Iran's monetary policymakers are expected to try to provide the liquidity required by producers and investment projects while at the same time avoid excessive liquidity and inflationary monetary expansions in line with development plans.

The most important monetary and credit variables are the monetary base and the money supply, which have the greatest impact on inflation rate and are thus of great concern to policymakers. On the sources side of the monetary base, net foreign assets of the Central Bank, net claims of the Central Bank on public sector, and claims of the Central Bank on commercial banks are the main items. On the uses side of the monetary base, commercial banks' required reserves with the Central Bank, their demand deposits with the Central Bank, and the notes and coins in circulation are the main components. Money (hard currency in the hands of the public, plus demand deposits) and quasi-money (savings and time deposits) are the two components of the money supply. Three factors that influence money supply are net foreign asset of the banking system, net debt of the public sector to the banking system, and net debt of the private sector to the banking system. Since money supply equals the product of monetary base and money multiplier, an increase in each of these two variables will increase liquidity.

In implementing monetary policy, the Central Bank can either directly use its authority to regulate the banking system or indirectly influence the liquidity market though the manipulation of high-powered money supply. Consequently, two distinct sets of monetary policy instruments can be distinguished, one set acts directly and the other acts indirectly. In Iran, direct methods include interest rate policy and credit ceiling policy. Indirect methods include commercial bank legal reserve requirement, issuance of Central Bank participation papers (open market operations) and provision of Central Bank accounts for commercial banks as a means of attracting their excess financial resources. Figure 7 compares growth rates of monetary base and money supply along with the inflation rate during 1371-92.

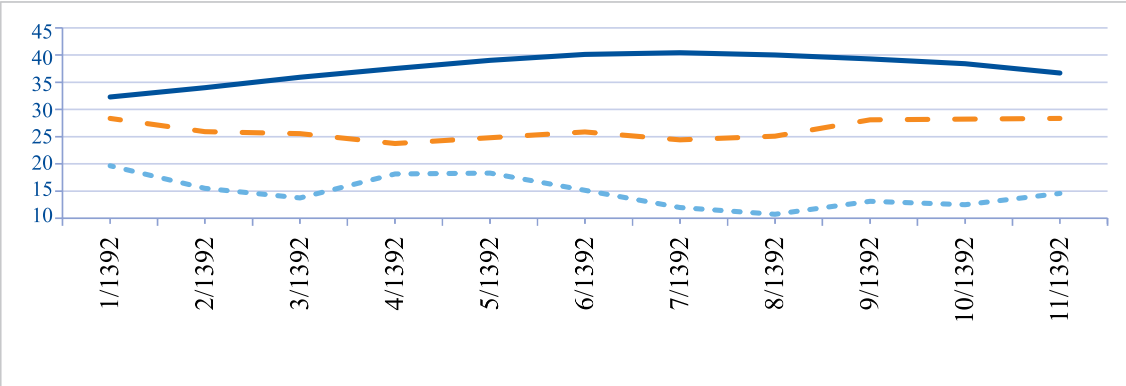
Figure 7 - Annual Growth Rates of Monetary Base and Liquidity, and Inflation Rate, 1371-92 (percent)



Source: CBI Selected Economic Indicators reports for 1371-1391 statistics and report by Deputy Governor of the CBI in 24th Annual Conference on Monetary and Exchange Rate Policy, June 15-16, 2014

Based on empirical evidence, changes in the monetary base affect the money supply within a three-month period and the impact of monetary base on inflation is about 90 percent. Figure 8 presents the month-to-month growth rate of the monetary base and the money supply during the first eleven months of 1392

Figure 8 - Monthly Growth Rates of Monetary Base and Liquidity, and Inflation rate in 1392 (percent)



Source: Based on statistics from Selected Economic Indicators, CBI website

Monetary policies in 1392 were aimed at preserving the value of national currency, controlling recession, reducing volatility of foreign exchange rates, reducing inflationary expectations and improving the economic outlook. Psitive achievements in these regards can be attributed to the Central Bank monetary and credit policies and the government's fiscal discipline. Lack of fiscal and monetary discipline, which results in excess growth of monetary base and money supply, is among the main causes of inflation which, in turn, is associated with low economic growth. During periods of high inflation, inflation and exchange rate volatility increase. Such volatilities raise economic uncertainty and financial costs and adversely affect investment and production.

On the other hand, the dependence of the government budget on oil revenues increases the vulnerability of monetary policy to oil price shocks that lead to large fluctuations in fiscal revenues. After the presidential election in June 2013, positive expectations about the new administration's economic and foreign policies were associated with higher stability in the foreign exchange market that contributed to lowering inflationary expectations and creating price stability.

An important step was taken to drastically reform the financing of the Mehr Housing Project (a poorly designed large scale residential real estate initiative for low-income households that was initiated by the previous government). The Central Bank instructed Maskan Bank to finance this project for a limited period with credits that it had received from the Central Bank so as to prevent an increase in the monetary base which would have led to higher inflation rates.

7.1. Money Supply and Factors that Influence it

At the end of 11/1392 (February 2013), the money supply and monetary based stood at stood at, respectively, 5,752 and 1,026 trillion rials. Up to then, i.e., during the first eleven months of 1392, money supply had grown by 24.9 percent, which was lower than 26.5

percent growth during the same period in 1391. By the end of 1392, the money supply growth rate had reached 28.3 percent which was again lower than its 32.2 percent rate in 1391. It should be noted that the base of estimating the money supply changed in 8/1392 (November 2013) when the Central Bank started to include the liabilities of five new financial institutions to the money supply. Therefore, growth rate of the money supply in 1392 on a comparable base was even smaller than 28.3 percent. Table 22 presents the composition of money supply in term of money and quasi-money and their components.

Table 22 - Liquidity and its Components (trillion rials)

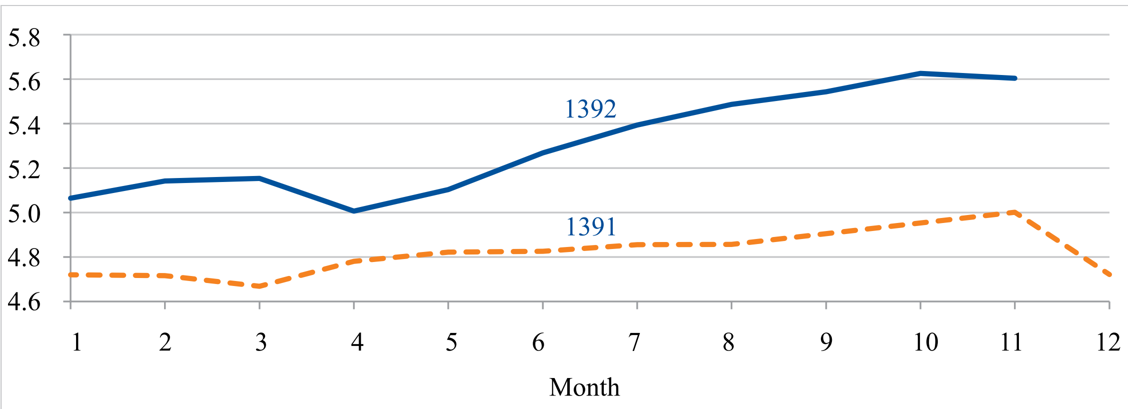
	Balance at the end of Bahman 1392	Percentage change compared with		Share (percentage points)		
		Bahman 1391	Esfand 1391	Bahman 1391	Esfand 1391	Bahman 1392
Money	1,121	1.2	-1.4	24.7	24.7	19.5
Notes and coins with the public	274	5.7	-17.0	5.8	7.2	4.8
Sight deposits	847	-0.1	5.1	18.9	17.5	14.7
Quasi-money	4,632	37.2	33.5	75.3	75.3	80.5
Gharz-al-hasaneh savings	310	15.4	0.0	6.0	6.7	5.4
Long-term Investment deposits	4,221	40.5	37.9	67.0	66.4	73.4
Miscellaneous deposits	101	-1.8	0.6	2.3	2.2	1.7
Liquidity	5,753	28.3	24.9	100.0	100.0	100.0

Source: Based on statistics in Selected Economic Indicators, CBI website

In 1392 the Central Bank was more concerned with reducing inflation than overcoming recession through monetary easing and stimulating demand. A significant portion of the economic downturn in 1392 was due to difficulties on the supply side, where factors such as adverse business environment, international sanctions, restrictions on currency transfers, difficulties in import of raw materials, intermediate goods and capital, lack of access to appropriate technology and low production efficiency limited the responsiveness of supply to demand stimuli. Under such conditions, clearly a monetary expansion would not help producers and firms and instead intensify inflationary pressures.

An important point to note in analyzing liquidity is that it is increasingly impacted by the money multiplier rather than the monetary base. Liquidity expansion through the money multiplier is an endogenous growth that is relatively harmless while a similar growth through the expansion of the monetary base is a harmful exogenous growth that should be avoided. In recent years, the rise in claims of the Central Bank on public sector and commercial banks expanded the monetary base. A large portion of those claims was brought about by commercial banks' mandatory credit facilities to various economic sectors. These policies forced the banks to offer credits over and above their own financial resources and hence had to borrow large sums from the Central Bank. In the second half of 1392, appropriate monetary policies slowed the growth of the monetary base. In the first eleven months of 1392, the monetary base rose by 5.2 percent, which was significantly less than its 17.2 percent growth rate in 1391. Furthermore, the growth rate of the money multiplier increased from 10.1 percent in the first eleven months of 1391 to 19.7 percent during the same period in 1392. As such, liquidity expansion during the first eleven months of 1391 was mostly driven by the expansion of the monetary base, whereas during the first eleven months of 1392 the monetary base was controlled and the liquidity expansion was driven instead by changes in the money multiplier. Figure 9 presents the trends of the monetary multiplier during 1391-92. In light of its trend during the first 11 months of 1392, growth rate of the monetary multiplier was expected to reach around 12 percent by the end of 1392. However, as a result of the end-of-the-year accounting operations, and settlement of the government's foreign exchange accounts with the Central Bank , the monetary base expanded by 18 percent by the end of 1392 to reach 1,150 trillion rials.

Figure 9 - Money Multiplier's Monthly Trend in 1391 and 1392



Source: Based on statistics in Selected Economic Indicators, CBI website

A closer look at components of the monetary base reveals that the monetary base growth in 1392 was mainly due to a 116 percent growth in the Central Bank's net foreign assets that was, in turn, mainly caused by the switch from the preferential "reference exchange rate" to the transaction exchange rate as of 4/1392 (July 2013). The Central Bank's claims on commercial banks registered a 22.1 percent growth and contributed more than 11 percent to the growth of the monetary base in 1392. This increase in commercial banks' debt to the Central Bank was entirely due to the reclassification and conversion of most of the overdraft credits for the Mehr housing project to direct credits; the Central Bank did not grant any new credits to commercial banks in this period.

The sale of participation papers by the Central Bank is regarded as a short run contractionary monetary policy that reduces the monetary base and liquidity. In late 11/1392 (2/2014), the Central Bank issued 30 trillion rials worth of 6-month participation papers, of which 22 trillion rials were sold and whose effect should appear in the monetary statistics for the last month of the year. 56 trillion rials worth of participation papers had been issued prior to 1392 which the Central Bank repurchased them at their maturity and thereby expanded the monetary base. Therefore, given the buyback of 56 trillion rials worth of participation papers in the first half of the year and the sale of 22 trillion rials in the second half of the year, the net effect of participation papers on the monetary base in 1392 was a 34 trillion rials increase. Accordingly, if in 1392 the monetary base had been estimated without taking the participation papers into account, almost 34 trillion rials would have been taken out of the 1,026 trillion rials estimate of this variable and thus the monetary base at the end of 11/1392 would have been less than 1,000 trillion rials.

7.2. Performance of Commercial Banks in 1392

• Sources and Uses of Funds

Latest available statistics indicate that at the end of 9/1392 total deposits in the banking system stood at 6,373 trillion rials -- which was 28 percent larger than that at the end of 1391, and total outstanding bank loans and credit facilities stood at 5,328 trillion rials -- which was 21.3 percent above that at the end of 1391. Moreover, nearly 11.1 percent of those deposits were kept at the Central Bank as required reserves. Table 23 shows the statistics on loans and deposit of commercial banks and non-bank financial institutions at the end of the years 1385 to 1391, as well as at the end of 9/1392.

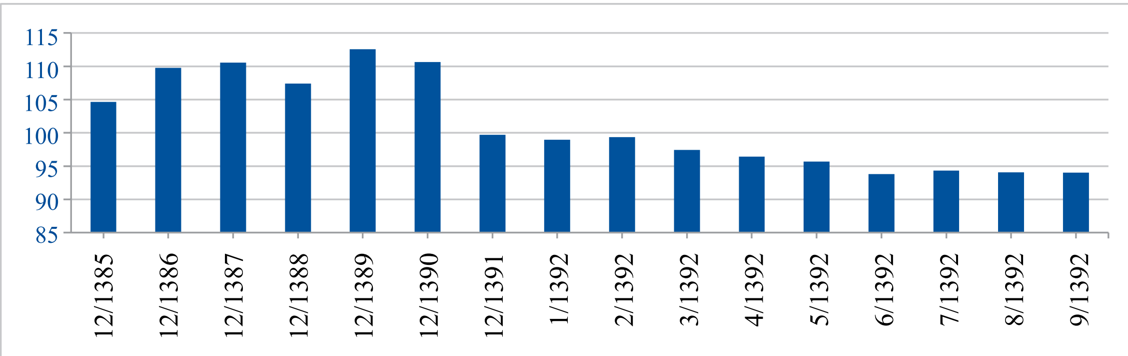
Table 23 - Deposits and Loans of Banks and Non-bank Financial Institutions (in both rial and foreign exchange)

Date	Deposits		Deposits after deducting Reserve requirement		Loans		Reserve requirement ratio (percent)
	Amount (billion rials)	Percentage change	Amount (billion rials)	Percentage change	Amount (billion rials)	Percentage change	
12/1385	1,340,613	-	1,149,142	-	1,202,831	-	14.3
12/1386	1,741,404	29.9	1,494,683	30.1	1,640,793	36.4	14.2
12/1387	1,943,281	11.6	1,675,776	12.1	1,852,355	12.9	13.8
12/1388	2,424,442	24.8	2,131,627	27.2	2,289,615	23.6	12.1
12/1389	3,187,671	31.5	2,823,184	32.4	3,177,895	38.8	11.4
12/1390	3,866,988	21.3	3,438,339	21.8	3,803,718	19.7	11.1
12/1391	4,977,262	28.7	4,403,691	28.1	4,390,642	15.4	11.5
9/1392	6,373,306	28.0	5,667,489	28.7	5,327,633	21.3	11.1

Source: Based on statistics in Selected Economic Indicators, CBI website

Banks and other financial institutions that play an intermediary role in the money market by receiving deposits and granting loans are required to deposit a certain percentage of their deposits with the Central Bank as required reserves. As a result, the amount of financial resources that such institutions can use in their lending activities equals their deposits minus required reserves. Based on the Central Bank's required reserve ratio contained in its policy package of 1390, the ratio of "credit facilities to deposits after the deduction of required reserves" is expected to be around 85 percent. Figure 10 shows the realized "credit facilities/deposits" ratio of commercial banks and credit institutions at the end of the years 1385-91 as well at the end of currently available months in 1392. It highlights the fact that in 9/1392 there was a 9 basic point gap between the actual lending/deposit ratio and its optimal level of 85 percent, which still showed an improvement compared to the preceding months and years.

Figure 10 - Loans to Deposits Ratio, Net of Reserve Requirements (percent)



Source: Based on statistics in Selected Economic Indicators, CBI website

Table 24 presents statistics on assets and liabilities of the banking system at the end of 11/1392 and indicates that they grew by 34.9 percent over the previous year to reach 10,998 trillion rials. The deposits of commercial banks with the Central Bank consist of required reserves and demand deposits. These two components registered 27.3 percent and negative 63.2 percent growth rates, respectively, compared to the end of 1391 and 28.4 percent and negative 42.3 percent growth, respectively, compared to 11/1391.

Table 24 - Summary of Assets and Liabilities of Banks and Non-bank Financial Institutions (billion rials)

	Balance at the end of 11/1392	Banks share (percentage points)			Percentage change	
		Commercial	Specialized	Private and Non-bank	11/1391 to 11/1392	12/1391 to 11/1392
Assets						
Foreign Assets	1,813,380.0	7.4	26.8	65.8	83.8	83.7
Notes and coins	85,215.9	42.9	7.0	50.1	9.8	105.6
Deposits with the Central Bank	667,340.1	20.8	8.8	70.4	19.3	10.5
Reseve requirement	625,836	19.9	8.1	72.0	28.4	27.3
Sight	41,504	33.2	19.8	46.9	-42.3	-63.2
Claims on public sector	745,637.0	29.3	26.2	44.5	31.6	25.1
Claims on non-public sector	4,890,960.2	17.2	28.3	54.4	21.0	18.2
Others	2,795,359.0	18.3	12.8	68.9	51.1	56.5
Assests=Liabilities	**10,997,892**	**17.1**	**22.6**	**60.3**	**36.1**	**34.9**
Liabilities						
Deposits of non-public sector	5,478,911.6	21.0	10.7	68.3	29.7	28.1
Claims of the Central Bank	620,838.1	14.4	80.6	5.0	18.8	27.1
Loans and deposits of public sector	279,507.2	20.2	51.7	28.1	100.4	100.4
Capital account	608,366.8	17.2	23.9	58.9	65.9	19.8
Foreign exchange loans and deposits	1,475,844.5	6.4	25.0	68.6	72.0	72.2
Others	2,534,424.0	15.3	29.3	55.4	28.4	34.5

Source: Based on CBI statistics in Selected Economic Indicators, CBI website

Table 25 shows the shares of deposits and liabilities of the public and private sectors in commercial banks, specialized banks and non-bank financial institutions in 11/1392, as well as their percentage changes since 12/1391. As can be seen, the largest part of the public sector deposits was in specialized banks and the largest part of its liabilities was to private banks and non-bank financial institutions. Furthermore, most of non-public deposits and debts were with private banks and non-bank financial institutions.

Table 25 - Balance of Deposits and Liabilities of Public and Non-public Sectors at the end 11/1392, and Their Changes from 1391 (percent)

	Public sector				Non-public sector			
	Deposits		Liability		Deposits		Liability	
	Share	Change	Share	Change	Share	Change	Share	Change
Commercial Banks	20.3	8.8	29.2	16.0	21.0	16.0	17.3	7.7
Specialized Banks	51.7	93.5	26.2	46.5	10.7	20.5	28.3	13.4
Private Banks and Non-bank Financial Institutions	28.0	509.0	44.6	20.9	68.3	33.7	54.4	24.7

Source: Based on statistics in Selected Economic Indicators reports, CBI website

Public sector debt consists of public enterprise debt and government debt. In 11/1392 these two components were, respectively, 25.6 percent and 15.5 percent larger compared to the end of 1391, and 32.1 percent and 21.4 percent larger compared to 11/1391. During this period, private deposits with the banking system included 15.5 percent demand deposit, 77 percent savings deposit and 5.7 percent "gharzol-hasaneh" (non-interest bearing) deposits. Long-term private savings deposits were 37.9 percent higher than that at the end of 1391.

• Bank Interest Rates

Setting interest rates below inflation rates, imposition of credit ceilings, credit rationing and setting high rates for required reserves create inefficiencies in banking activities and lead to financial repression. Financial repression has harmful consequences including reduced effectiveness of bank interest rates in absorbing and distributing liquidities, reduced transparency of the banking system, expansion of informal money market and the rise of rent-seeking activities in the allocation of bank facilities. Persistence of such policies leads to the assignment of scarce financial resources away from productive activities and ultimately depresses economic growth.

Monetary policies are implemented through the banking system. Financial repression in recent years has led to the expansion of informal money markets and the mushrooming of unauthorized financial institutions. These institutions not only ignore the regulations and instructions of the Central Bank but their existence effectively encourage commercial banks to also ignore regulations and engage in unhealthy activities. Successful implementation of monetary policy requires first and foremost an appropriate financial environment. Therefore, to improve the effectiveness of monetary policy, the activities of unauthorized financial institutions in the informal money market must be regulated as soon as possible.

At the onset of 1392, the Money and Credit Council announced that it will continue the "Monetary, Regulatory and Credit Policies of the Banking System" package that had been adopted in the winter of 1390 (2012). Up to 9/1392 (12/2013) a ceiling of 20 percent was generally observed for bank interest rates, but with the issuance of 6-month participation papers bearing 23 percent interest rate by the Central Bank in 11/1392 (2/2014), this ceiling was dropped and the six-month risk free interest rate (the floor rate at the money market) was set at this level. This Central Bank action, however, further loosened the discipline by unauthorized credit institutions and forced commercial banks into an inefficient and costly competition. They were forced to offer higher interest rates in order to prevent an outflow of deposits. The coincidence of these developments with the decline of the stock market index in 11/1392 (1/2014) led to talks of rising interest rates as a means of attracting small capital that were being withdrawn from the stock exchange. In the winter of 1392, commercial banks raised interest rates on loans and deposits and set the minimum interest rate on bank facilities at 26 percent even though the Money and Credit Council had set the ceiling for bank facilities with maturities shorter than two years at 14 percent, and for longer maturities at 15 percent. Interest rates for profit-sharing (mosharekati) contracts were also set between 18 percent and 21 percent.

In light of the above, it seems that a prerequisite for the correct determination of the interest rate in line with the ongoing inflation rate is regulating the unauthorized financial institutions on one hand and increasing transparency of the banking system on the other. Reform of the capital markets and raising awareness among its participants about the operation and functions of the capital marker can bring about a more realistic understanding of the relationship between banks as the main suppliers of working capital and short term resources to firms, and the capital market. A correct understanding of this relationship by all economic agents will improve the allocation of financial resources among different markets and thus raise economic efficiency and growth.

• Credit Facilities and Non-Performing Loans of the Banking System

Facilities granted by Iran's banking system grew by 29.9 percent in 1392. They consisted of 44 percent working capital and 56 percent long-term capital. Total value of these facilities amounted to 2,360 trillion rials, of which 700 trillion rials was granted to the manufacturing and mining sector. This may be compared to total facilities of 1,960 trillion rials in 1391 out of which 690 trillion rials had been granted to the manufacturing and mining sector.

Analysis of the balance of facilities granted by banks and non-bank financial institutions in the form of various Islamic contracts during the first eleven months of 1392 indicates that civil partnership and installment sale contracts accounted for 38.1 percent and 29.1 percent of the total facilities, respectively. Legal partnership contracts and Jo'aleh contracts had the highest growth rates 53.4 percent and 29.9 percent, respectively.

By the end of 11/1392 (2/2014) non-performing loans (NPL) had increased to 840 trillion rials or 15.6 percent of the total granted facilities, of which 31 percent was related to the manufacturing and mining sector which had experienced considerable difficulties due to sanctions and exchange rate issues. The sharp growth of NPL since 1384 compelled the 11th government to seriously look into this issue while the judiciary and the "Center for Combating Economic Corruption" also joined the effort to identify and act on defaulting borrowers. The Central Bank asked all banks do their utmost to collect their NPL and called for the establishment of a specialized court to deal with the defaulting borrowers and expedite the collection process.

Table 26 shows the ratio of NPL to total bank facilities during 1386-91 as well as at the end of 9/1393 (12/2014). It should be noted that in recent years some state-owned banks have been privatized and this has raised the ratio for private banks. The high ratio of NPL to total bank facilities is a warning to the banking system that lending policies are in a dire need of an overhaul. Such an overhaul can help reduce the lending risk of Iran's banking system and bring it closer to the international standard of below 1.5 percent.

Table 26 - Ratio of Non-Performing Loans to Total Loans (percent)

	1386	1387	1388	1389	1390	1391	1392*
Commercial Banks	11.4	16.9	21.5	18.2	20.5	18.4	18.2
Specialized Banks	11.4	13.2	13.2	8.6	8.6	8.2	8.9
Government-Owned Banks	11.4	16.1	17.7	12.9	14.0	12.5	12.6
Non-Government-Owned Banks	11.4	24.3	18.6	14.6	16.2	16.7	17.8
Banking system	11.4	17.5	18.2	13.8	15.1	14.7	15.6

Source: Based on statistics in CBI Selected Economic Indicators reports, CBI website

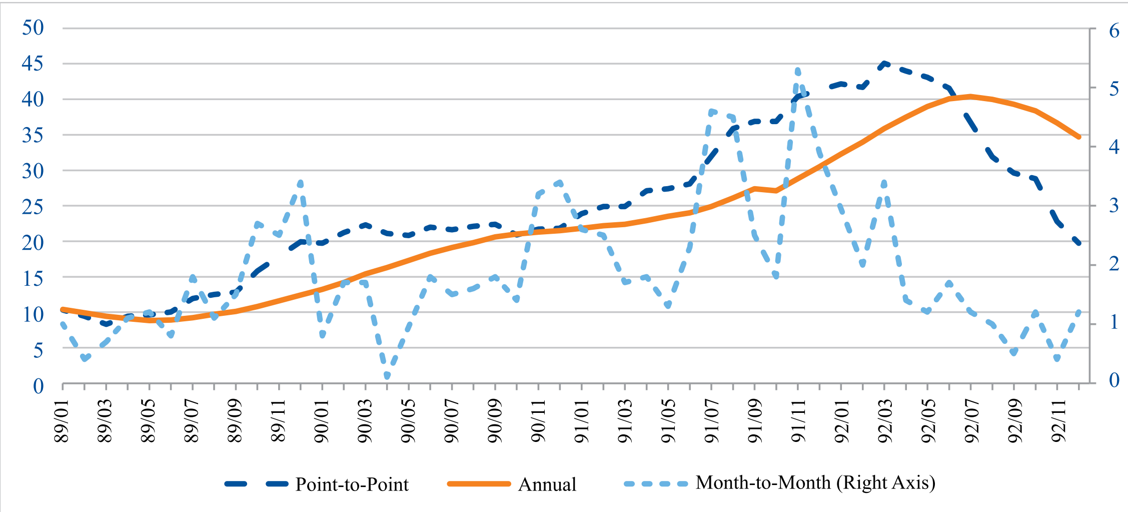
Regarding the reason for the rise of NPL, setting interest rates without regards to market forces is among the most important ones. When interest rates are set at a level far below the equilibrium rate, the balance between sources and uses of bank resources is disrupted and rent-seeking activities sprout that ultimately make it very difficult for banks to distribute their resources efficiently. A consequence of these conditions is an increase in the volume of NPL. The inefficiency of the banking system has its roots in external pressures that have led to administrative allocation of resources. Important examples of such external impositions include the granting of facilities to the "Mehr Housing Project" and to the so-called "Quick Return Projects" by the previous government. Weak credit rating systems in some banks is another reason for the increase in NPL. Given that state-owned banks have little freedom in setting the interest rate on their facilities, credit rating of their loan applicants can go a long way in reducing the incidence of NPL.

8. Prices and Inflation

The Central Bank's consumer price index (CPI) is an indicator of changes in the price of a basket of goods and services that are typically consumed by urban households of Iran. This index is set to 100 for the base year and the weights of goods and services in the basket are determined on the basis of household income and expenditure survey in the base year. Over time, consumption patterns change and thus the base year should also change so as to give a more accurate estimate of the inflation rate. Accordingly, in 10/1391 (January 2013) the base year for the Central Bank's CPI was switched from 1383 to 1390.

The point-to-point inflation rate at the beginning of 1392 stood at 42.2 percent and gradually increased to its peak of 45.1 in 3/1392. With the announcement of the outcome of the presidential election in that month and the ensuing burst of optimism for economic recovery, the point-to-point inflation rate rapidly and persistently declined to reach 19.7 percent at the end of the year. This decline appeared in the annual inflation rate with a lag so that the annual inflation rate, which had stood at 30.5 percent at the end of 1391, reached its peak of 40.4 percent in 6/1992 (October 1392) before declining to 34.7 percent in the last month of 1392. The trends of various inflation rates during 1389-1392 are exhibited in Figure 11.

Figure 11 - Trend of CPI Inflation Rates, 1389-1392 (percent)



Source: Based on Consumer Price Indices reports statistics, CBI website

Table 27 exhibits the point-to-point inflation rates for various sub-sectors in the last month of 1392 as well as their annual inflation rates in 1392. As can be seen, the health group had the highest point-to-point inflation rate of 34.3 percent, followed by 25.5 percent for the group of restaurants and hotels. In terms of annual inflation, the group of furnishings and household equipment experienced the highest rate of 52.9 percent while communications experienced the lowest inflation rate of 7.1 percent.

Table 27 - CPI Inflation Rate in Various Goods and Services Groups, 1392 (percent)

Group	Base Year Weight	12/1392 compared to 12/1391	1392 compared to 1391
General Index	100	19.7	34.7
Major Groups			
1- Food and Beverages	27.38	18.3	41.7
2- Tobacco	0.35	1.1	46.6
3- Clothing and Footwear	4.94	27	48.5
4- Housing, Water, Electricity, Gas and other Fuels	32.82	20.5	20.1
5- Furnishings, Household Equipment and Routine-Household Maintenance	5.13	18.5	52.9
6- Health	6.98	34.3	38.4
7- Transport	9.87	13.8	34.3
8- Communication	2.38	-1.9	7.1
9- Recreation and Culture	2.85	13.9	35.1
10- Education	2.24	13.5	12.6
11- Restaurants and Hotels	1.86	25.5	39.2
12- Miscellaneous Goods and Services	3.2	23.8	50.6
Special Groups			
1- Goods	52.68	18.3	41.9
2- Services	47.32	21.9	24.9
3- Housing, Water, Electricity, Gas and other Fuels	32.82	20.5	20.1

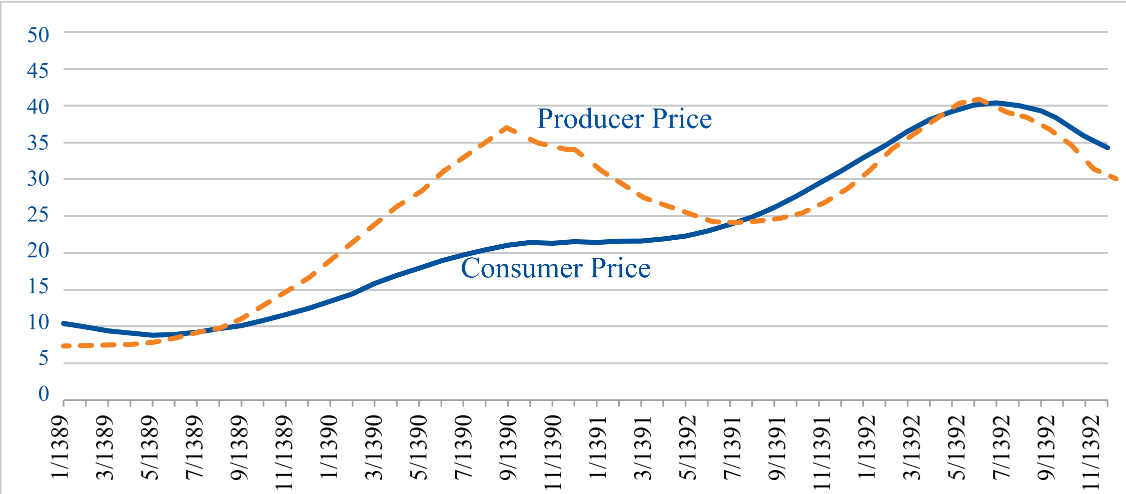
Source: Based on Consumer Price Indices reports statistics, CBI website

The export price index at the end of 1392 was 11.2 basis points below that at the end of 1391 while the average of this index for 1392 was 21.8 basis points higher than in 1391. This index for the group of plastic and natural rubber products jumped most by 39.9 percent while for the group of textiles and related products contracted by 1.1 percent.

The producer price index (PPI) is another measure of inflation and it rose by 34.5 percent in 1392 -- a little higher than its rates of 32.4 percent in 1391 and 34.2 percent in 1390. PPI inflation in 1392 included 34.9 percent inflation in manufactured products, 43.5 percent in agriculture, forestry and fishing, and 27.9 percent in services.

Figure 12 shows the annual inflation rates by PPI and CPI and highlights the fact that from mid-1389 to the end of 1392, inflation rate measured by PPI has been above that by CPI, with the gap ranging from 16.5 basis points to only 0.2 basis points at the close of 1392.

Figure 12 - Annual CPI and PPI Inflation Rates, 1389-1392 (percent)



Source: Based on Consumer and Producer Price Indices reports statistics, CBI website

The main factors that helped bring down inflation in 1392 were the fall in inflationary expectations following the presidential election and growing optimism about the resolution of the nuclear dispute and the lifting of economic sanctions. Effective control of the monetary base and money supply by the Central Bank, relative stabilization of foreign exchange rates against the rial, partial suspension of some sanctions after the interim Geneva agreement in and better fiscal discipline by the new government also contributed to the decline of inflation rate in 1392.

9. Capital Market

The Tehran Stock Exchange (TSE) enjoyed a significant growth in 1392 and, despite a drop in the final three months of the year, its main index marked a 107.7 percent return. The most important events in TSE during 1392 included the IPO of Persian Gulf Holding shares as the largest privatization initiative in Iran's investment history, and the introduction of Exchange Traded Funds (ETFs). The value of TSE listed companies increased by 126 percent to reach 3,866 trillion rials, highlighting the rapid development of equity markets and their growing role in the economy. Compared to 1391, the value of transactions grew by 275 percent to reach 964 trillion rials and the number of transactions jumped by 227 percent to reach 17 million. The nominal value of market capitalization rose by more than 33 percent, from 506 trillion rials to 673 trillion rials, due to the enlisting of new companies and new share offerings by the existing listed companies. Table 28 presents various stock market indices and their growth rates in 1392.

Table 28 - Various Capital Market Indices at the end of 1391 and 1392

	1391	1392	Percentage Change
Total Index	38,041	79,015	107.7
Primary Market Index	**30,031**	**58,607**	**95.2**
Secondary Market Index	62,840	152,441	142.6
Industrial Index	32,892	65,837	100.2
Financial & Monetary Intermediaries Index	60,812	157,627	159.2
Dividend and Price Index	154,771	321,478	107.7
Top 50 Performers Index	1,618	3,336	106.2
Thirty Largest Companies Index	2,005	3,760	87.5
Free Float Index	44,620	90,978	103.9

Source: Capital Market Indices statistics, Tehran Stock Exchange (TSE) Website

Figure 13 shows the daily movements of the TSE index in 1392. It can be seen that the general index enjoyed a steady upward trend during the first ten months of the year but it was partly offset by a downtrend in the last two months, recording 107.7 percent gain for the year. In terms of monthly returns, the highest one-month gain was 18.3 percent that was realized in 7/1392 (October 1392).

Figure 13 - Daily Trend of the Main Tehran Stock Exchange Index (TEPIX) in 1392

Source: Capital Market Index Statistics, Tehran Stock Exchange (TSE) Website

On average, shares of TSE listed companies were trading in 80 percent of the trading days, which was 23 percent larger than in 1391, and TSE index registered a positive gain in 149 of the 243 stock exchange trading days in 1392. As a result, the ratio of positive gain days to total trading days increased from 54 percent in 1391 to 61 percent in 1392. The number of active TSE traders also increased by 214 percent to reach 5.8 million individuals, and consequently the number of transaction codes also increased by 38 percent. In 1392, 112 TSE listed companies raised capital by various methods: 39 percent by issuing additional shares, 24 percent from retained earnings and cash reserves, and the remaining 37 percent from re-assessment of company assets.

Capital market developments in 1392 can be divided into four periods. In the first period, from the beginning of the year until the presidential election in late 3/1392, the market had a moderate growth. This period was concurrent with the lack of progress in nuclear negotiations and concerns about tougher sanctions and thus the deterioration of the economic environment.

The second period began after the presidential election and the formation of the new government until the Geneva interim agreement in 10/1393 (November 2013) during which TSE became even more optimistic about improving economic conditions. Despite the negative reaction of investors to the violence and political instability in the Middle East, positive earnings reports of listed companies and continued optimism about a nuclear agreement accelerated TSE's upward trend.

In the third period, the stock market reacted positively to nuclear negotiations and the interim Geneva agreement. After the announcement of the interim agreement, industries such as automotive industry that were considered unprofitable due to the sanction, attracted renewed attention from investors and demand for their shares increased. Equity investors were also attracted to the shares of banks, petrochemicals, refineries, and export oriented companies. Other factors that positively affected the stock market included the lifting of restrictions on SWIFT transactions and international trade finance, easier access to lines of credit and the government's announcement of plans to revive the industrial sector.

The fourth period began in 10/1392 (January 2014) when the general index rose to 89,500. Review of the 1393 government budget in the Majlis (parliament) led to revisions that were viewed as increasing the operation costs of some listed companies. This, along with disappointments with the 9-months financial reports of some companies, negatively affected TSE. Other issues that contributed to this downturn included increase in the price of government supplied gas feedstock to petrochemical companies from 2.8 cents per cubic meter to 13 cents, the Majlis passage of a 10 percent export duty on iron ore exports and its introduction of a 30 percent mining royalty, and increase of bank deposits rates to 23 percent following the Central Bank's issuance of six-month participation papers at that rate. As a result of these developments, TSE index fell by more than 15 percent during the last 75 days of the year. Although the decision to remove the DDD stock trading method (also known as group transactions) was a positive action that enhanced market transparency, it was overshadowed by the introduction of sale restriction policies that interrupted supply and demand and caused a downtrend in TSE until the end of the year when this policy was removed.

Despite these adverse developments toward the end of the year, share prices in most industry groups enjoyed good growth in the second half of the year, mainly thanks to the relative stability of the rial and price stagnation in parallel gold, foreign exchange and housing markets that helped direct liquidity into the equity market.

Table 29 exhibits TSE indices for various industries at the beginning and end of 1392 and shows that paper products industry group performed best with a 428.6 percent growth and wood products group performed worst with 19.5 percent growth. Banking and financial institutions group and financial intermediaries group ranked 15th and 16th, respectively, with 161.4 percent and 157.4 percent growth rates. According to this table, in 1392, groups ranked up to 24 performed better than the general stock market index.

Table 29 - Stock Price Indices and Their Growth Rates in 1392 for Various Capital Market Groups

Rank	Group	Index at the beginning of the year	Index at the end of the year	Percentage change
1	Paper products	2,084	11,015	428.6
2	Tiles and ceramics	740	3,067	314.5
3	Other non-metallic minerals	491	1,943	295.7
4	Engineering services	187	737	294.1
5	Pharmaceutical material and products	1,414	4,905	246.9
6	Textiles	341	1,153	238.1
7	Metallic products manufacturing	6,567	21,568	228.4
8	Electrical machinery and apparatus	81,062	264,135	225.8
9	Publishing, printing and reproduction	12,857	41,085	219.6
10	Transport, Storage and communication	3,001	9,427	214.1
11	Other mining and quarrying	1,379	4,331	214.1
12	Machinery and equipment	3,178	9,446	197.2
13	Cement, lime and plaster	312	913	192.6
14	Rubber and plastics	4,916	14,221	189.3
15	Banks and credit institutions	298	779	161.4
16	Financial intermediation	61,250	157,627	157.4
17	Oil and gas extraction and ancillary services, other than oil and gas exploration	369	926	150.9
18	Investments	693	1,726	149.1
19	Food and beverage products except sugar	1,139	2,714	138.3
20	Car and parts manufacturing	4,638	11,039	138.0
21	Mining of coal	456	1,072	135.1
22	Insurance and pension fund except social security	1,637	3,708	126.5
23	Chemical and petrochemical products	2,537	5,576	119.8
24	Computer and related activities	1,864	4,072	118.5
25	Industrial conglomerate companies	3,481	7,204	107.0
26	Petroleum products, coke and nuclear fuel	167,338	340,634	103.6
27	Telecommunication	277	554	100.0
28	Other financial intermediation	660	1,251	89.5
29	Medical instruments, optical and measuring instruments	1,441	2,497	73.3
30	Leather products and production of footwear	324	557	71.9
31	Agriculture and related services	3,576	5,987	67.4
32	Tract housing and real estate	536	897	67.4
33	Manufacturing of communications equipment	1,328	2,061	55.2
34	Sugar	3,737	5,762	54.2
35	Mining of metal ores	12,618	18,751	48.6
36	Basic metals	27,552	37,054	34.5
37	Wood products	24,020	28,697	19.5

Middle East Bank Headquarters

No. 2, 5th St., Ahmad Qasir (Bucharest) Ave., Tehran, Iran

Tel: (+98 21) 4217 8000 Fax: (+98 21) 8870 1095

www.middleeastbank.ir info@middleeastbank.ir