بانک خاورمیانه
Middle East Bank

ANNUAL SURVEY OF THE IRANIAN ECONOMY

2014/2015

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Notes

Note 1: In this Report the growth rate of a variable means the percentage change of that variable during the period under review, or at the point under discussion, from the similar period or point in the preceding year. As such, "the growth rate of oil revenues in the first quarter of 1393" indicates the percentage change in oil revenues between the first quarter of 1392 and the first quarter of 1393.

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 1394 that started on March 21, 2015, and ends on March 19, 2016. The third quarter of 1393 (referred to as 1393Q3), fall of 1393, roughly corresponds to the fourth quarter of 2014 in the Gregorian Calendar (2014Q4).

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

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

1393Q1 = 03/21/2014 – 06/21/2014, roughly **2014Q2**

1393Q2 = 06/22/2014 – 09/22/2014, roughly **2014Q3**

1393Q3 = 09/23/2014 – 12/21/2014, roughly **2014Q4**

1393Q4 = 12/22/2014 – 03/20/2015, roughly **2015Q1**

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Overview

The year 1393 may cautiously be termed as the year of recovery after a few years of stagflation, economic turmoil, uncertain policies and recklessness. Not only did the trends of main economic indices witness marked reversal, but there was a general mood of optimism, further strengthened by the progress in the negotiation between Iran and the so-called group of 5+1 of world powers over the lifting of certain economic sanctions in return for certain concessions by Iran over its nuclear program. During the period under review the economy grew by 3.0 percent, recovering from 8.7 percent of decline over the previous two years. Annual inflation rate seemed to have been harnessed at 15.6 percent, down from its peak of 45 percent two years earlier. The government kept its promise of not borrowing from the Central Bank (CBI). Liquidity continued to grow at a more moderate pace than the preceding year, mainly due to new CBI credits to the banks.

Real GDP was still 6.7 percentage points below its 1390 level. This positive performance of the real GDP represented an important shifting trend which is expected to continue, albeit at a slightly more moderate rate. All sectors participated in this drive with the exception of construction. On the other hand, unemployment at 10.6 percent of the active population does not indicate any real improvement over the similar period of the year before. The fact remains that in recent years unemployment data have not shown a corresponding trend with other economic indicators; hence, the procedure for its estimation must be further analyzed.

Government expenditures continued to grow, and so did the budget deficit. However, as stated before, the government did not borrow directly from the CBI to finance its deficit. On the positive side, even though the actual figure of 1393 was below the approved budget, the development expenditure regained its hitherto neglected importance and was the fastest growing expenditure item. On the negative side, because of the dramatic fall in the price of oil, government revenue fell short of projections. This unfortunate turn of events was intensified by an unavoidable monthly expenditure of cash subsidies, a legacy of the previous administration.

Meanwhile, the government had undertaken not to borrow from the CBI, and so instead the banking system was forced to carry the burden. This meant that the banks which were already heavily indebted to CBI had to borrow even more. Direct, or indirect, additional liquidity has been injected by the CBI; hence, we are where we have been for the last nine months, stuck at around 15 percent inflation rate starting from the last quarter of 1393 up to the middle of the present year.

It seems that the subject of how to finance government deficit while strictly observing Shari'a Rules, has not as yet been entirely sunk in with the authorities at the Plan and Budget Organization and the Ministry of Economic Affairs and Finance. While various Shari'a compliant debt instruments have been designed and utilized, authorities are stuck with taxes, oil revenue or bank borrowing as acceptable sources of revenue to fund or finance the budget. It is anticipated that in the current Iranian fiscal year, a formal and gradually enlarged debt market would be founded.

A vibrant debt market will not only help the government to finance its deficit like every other normal economy, it will allow CBI to be more proactive in reducing inflation; and yet, when the larger corporate borrowers are enticed to move to this market, the banking system's lending capacity will be utilized for Small and Medium Enterprises (SMEs) and smaller entities, again like many more advanced economies. The result of all these progressive measures will be for the economy to come out of its present stagflation period and move into a solid and steadfast moving phase and, with a bit of luck, with high rate of growth which it really deserves.

As for the inflation rate, its dramatic decline was surely a major achievement. This must have been due to two main factors: the decline in the rate of growth of M0 (Monetary Base) while M2 (liquidity) just kept up with the inflation rate, and the general mood of optimism stimulated by the overall adherence of the new government to its electoral promises concerning sanctions against Iran. The negotiation was between Security Council Members of the UN plus Germany on one side and Iran on the other; and, the subject was nuclear program of Iran vs. the sanctions. The eventual successful conclusion comprised certain concession by Iran concerning its nuclear program against the other side's undertaking to lift many of the sanctions enacted against Iran over the past many years. Lifting of sanctions begins when Iran has fulfilled its commitments.

CBI which had regained its important role when the new government came to office, continued its disciplinary monetary policy with the aim of containing inflation. A number of unauthorized non-bank financial institutions were brought under the control and supervision of the CBI. Stronger disciplinary actions were taken to make sure that prudential regulations were implemented across the board by all banks and non-bank credit institutions. Simultaneously, overdrawn accounts and inappropriate outstanding obligations of many banks were sorted out by new facilities with proper repayment schedules.

CBI seemed content with the moderate rise in the monetary base, but this was mainly due to the negative effect of decreases in net foreign assets. However, the substantial increase of over 42 percent in the CBI facilities extended to the banking system was the sole factor responsible for the 10.6 percent rise in the monetary base and increase in the total banks' facilities to the private sector of 16.7 percent and the public sector of some 37 percent, which proves the limitations of monetary policy in times of stagflation.

At the end of the year under review, there were 18 privately-owned banks, 12 state-owned banks (4 of which are newly privatized), 6 authorized non-bank credit institutions, and over 150 recently licensed financial cooperatives all are actively doing business mostly in larger cities across the country. In addition, there are many unauthorized financial intermediaries (estimated to account for over 15 percent of the market) which operate without supervision. Little is known of the business nature, ownership, and management of these entities.

The problematic assets of banks, i.e., non-performing loans (NPLs) continued to be a major weak point of the country's banking system. Latest official estimate of the NPLs is 12.6 percent (of all loans) in the first part of 1394 compared to 15 percent a year earlier. Equity investment by banks is another problem area of the system. While the CBI has asked all banks to conscientiously try to mend their loan portfolios on a priority basis, it has made it mandatory for all banks to observe a ceiling of 40 percent of their capital base as the ceiling for equity investments by banks by the end of 1394 (March 19, 2016).

Balance of payments (BOP) position of the country improved in the last fiscal year. Notwithstanding the steep fall in oil prices and the crippling effects of international sanctions, particularly for payments and receipts of funds, BOP showed a respectable positive balance of $8.6 billion in 1393. The most important factor contributing to this result was the improvement in net capital account which recovered from a negative $11.5b deficit to a negative $1.7b deficit, an almost $10b improvement. This also goes to show the change in the economic climate and attitudes towards our economy, both outside and inside the country. The increase in non-oil exports of $3.1b is the result of the efforts to move away from reliance on oil exports. This item rose from $23b in 1389 to $31.1b in 1393, a growth of about 35 percent. Without these efforts and results, BOP for the year would have been negative and the cost of financing a BOP deficit for a country under sanctions would have likely been dire.

The Tehran Stock Exchange (TSE) occupies a relatively small place in the market for financial transactions and in the overall Iranian Economy. Consequently, TSE Index's high volatility and its extreme-sensitiveness to news and even hearsay, while expected, is not a trendsetter. The Index began its downward trend in the last quarter of 1392, mainly because of uncertainty as to the result of the nuclear negotiations and the pricing of feedstock for TSE-listed petrochemical companies. While the price of feedstock was increased, prices of oil and petrochemical commodities were falling. This was more like a double whammy for the near-term of this sector. Considering that the aggregate market value of this sector makes up the largest segment of the TSE, falling Index was no surprise. Notwithstanding, and bearing in mind the lack of a substantive study on "lag effect" of economic activities with TSE-Index, the conflicting results must be attributed to the irrelevancy and super-sensitivity of TSE.

In summary, during the period under review the salient features of the Iranian economy consisted of general improvement in the main indices, bolstering hope and optimism which were caused by the stated intention of the new government to reach an acceptable conclusion in talks on nuclear issue and the removing of sanctions imposed on the country; and the new government's approach to economic activities which was manifested by rationalism, truthfulness, and faith in the future betterment of the nation.

1. REAL SECTOR

In 1393, after eight consecutive quarters of negative growth, GDP at current prices increased from IRR9,343 trillion to IRR10,807 trillion, registering a 3 percent growth rate at constant 1383 prices. This was a big improvement from negative real growth rates of 6.8 percent in 1392 and 1.9 percent in 1391. This trend reversal clearly seemed to herald the end of stagflation, especially in conjunction with an almost 30 percentage point fall in the annual inflation rate. Nonetheless, the GDP at the end of 1393 was still 5.9 percent below its level in 1390. GDP growth rate was 3.8 percent in the first three quarters of 1393. However, it slackened considerably in the fourth quarter and was only 0.6 percent higher than its level in the same period of the year before. This was mainly due to a sharp contraction in the construction industry. It is interesting to note that the sectors hit hardest during the period of stagflation -- that is, oil, manufacturing and mining -- experienced the highest rates of growth in 1393. Table 1 illustrates performance of various sectors during the years 1388-93.

Table 1: Real Growth Rates of GDP and its Components (at constant 1383 prices)

	1388	1389	1390	1391	1392*	1393**
Agriculture	9.6	4.9	-0.1	3.7	4.7	3.8
Oil	-5.4	4.2	-1.0	-6.4	-2.9	5.0
Manufacturing and mining	4.2	7.9	5.0	-6.4	-2.9	5.0
Services	2.6	6.7	5.8	1.1	-1.5	2.4
GDP	1.3	6.5	4.3	-6.8	-1.9	3.0
Non-oil GDP	2.8	7.0	5.4	-0.9	-1.1	2.8

Source: Report of the Economic Development in the Real Economic Sector, year 1393
* 1390–1392 statistics are preliminary.
** 1393 data are estimates and are subject to change.

As in the recent past, services had the highest, and agriculture the lowest, shares in the GDP. Services accounted for nearly half of the growth in GDP. The share of oil has been on the decline, while manufacturing and mining has maintained its contribution, and on occasions marginally increased it. More details are presented in Table 2.

Table 2: Share of Various Economic Sectors in GDP and their Growth Rates (percentage)

	Share in GDP				Real Growth Rate	
	1390	1391	1392	1393	1392	1393
Agriculture	5.7	7.7	8.9	9.3	0.3	0.3
Oil	24.4	16.0	16.7	15.3	-1.0	0.5
Manufacturing and Mining	20.9	24.3	22.7	23.0	-0.8	1.3
Services	49.0	52.1	51.7	53.8	-0.9	1.5
GDP in Basic Prices*	100.0	100.0	100.0	100.0	-1.9	3.0
Non-oil GDP in Basic Prices	75.6	84.0	83.3	84.7	-0.9	2.5

Source: Annual National Accounts of Iran, 1393 (at constant 1383 prices), Central Bank of Iran, Khordad 1393
* The aggregates shares of various sectors slightly differ from 100%. This is due to "imputed service charges".

During the period under review, based on preliminary data, Gross Domestic Expenditures (GDE) grew by 4.3 percent, compared to declines of 6.6 percent and 1.9 percent in 1391 and 1392, respectively. Private consumption, gross fixed capital formation and public consumption expenditures accounted for of 50.6 percent, 26.2 percent and 23.2 percent of the GDE, respectively. The increase in fixed capital formation by 3.5 percent was unexpected compared to the declines of 6.9 percent and 23.8 percent in the two previous years. The effects of isolation, interruption in foreign trade and inattention to budgetary allocation for development can be seen in Table 3.

Table 3: Real Growth Rates of Gross Domestic Expenditure and its Components

	1391	1392	1393				
	Year	Year	Year	Spring	Summer	Fall	Winter
Private consumption expenditures	-1.7	-1.0	3.1	3.9	3.5	5.3	-0.1
Public consumption expenditures	-7.2	1.6	2.7	8.7	-0.7	0.2	3.8
Gross fixed capital formation	-23.8	-6.9	3.5	2.5	22.0	15.4	-17.7
Machinery	-35.7	-16.1	8.7	13.5	15.7	5.5	2.5
Construction	-13.8	-1.1	0.7	-3.8	25.6	20.8	-27.3
Gross national expenditure (at market prices)	-6.6	-1.9	4.3	3.2	4.7	5.7	3.7

Source: Annual National Accounts of Iran, Year 1393 (based on constant prices of 1383), Central Bank of IRI

1.1. Agriculture

In 1393, agriculture accounted for 9.3 percent of the GDP, showing a slight improvement compared to the previous year. Agricultural value-added increased by 3.8 percent in 1393, compared to 4.7 percent in the year before. A review of the subgroups of agricultural products reveals that farming products rose by 8.1 percent, horticultural products by 1.5 percent, and livestock products by 4.9 percent. In the year under review, based on a sampling survey of this sector, the country's total agricultural land under cultivation -- including farm lands and horticulture but excluding forests and pastures -- was approximately 16.6 million hectares, which showed a decrease of 6.2 percent compared to the findings of the census of 1382. Inadequate water supply and change in land use were causes of this decline. Consequently, farming land decreased from 16 million hectares in 1382 to 14.7 million hectares in 1393 while horticultural land increased from 1.5 million hectares to 1.8 million hectares during the same period.

Agriculture, which was the center of attention immediately after the 1979 Revolution, seems to have fallen out of favor. There is less and less per capita arable land and there is an exodus of younger people from rural areas to urban areas. In many instances low productivity and higher relative prices of land make farming uneconomical.

In Iran, where only one fourth of the country is arable and water supply is quite scarce, farming is usually at the mercy of environmental conditions. On the other hand, the population has grown to a size that under no reasonable scenario domestic production of food items could feed the population. Under such a circumstance, it seems illogical to invest beyond what is necessary to maintain the present level of agricultural production. The country would of course be better off to focus on the production of items in which it has comparative advantage, and trade them with items in which it has comparative disadvantage.

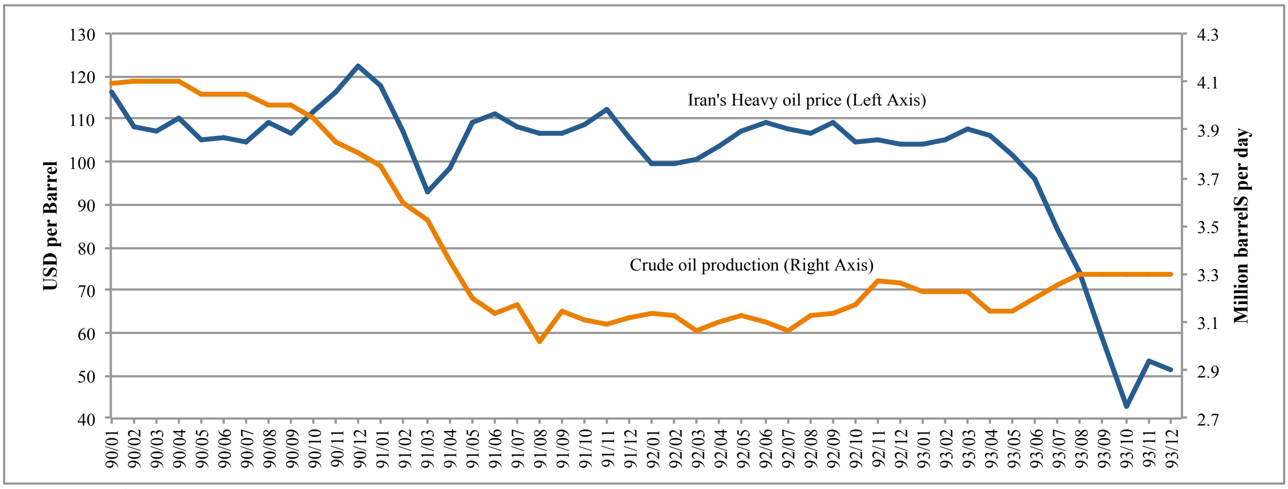
1.2. Oil and Gas

In 1393 Iran's average crude oil production decreased from an average of 3.5 to 3.1 million barrels per day (mb/d). During the same period exports decreased from 1.7 to 1.4 mb/d. The decline in production started some eight years before, in 1387, when production was about 4.0 mb/d of which 2.4 mb/d was exported. A number of factors caused this decline, including implementation of sanctions, curtailing investment in oil industry, and disallowing usage of new technology to maintain the production capacity of mature oil fields. The dramatic fall in price of oil in 1393 from over $108 to under $50 per barrel, was an added factor for severely reducing Iran' oil income. The forecasts now vary from around $50 to as low as $20 per barrel over the next five years. It seems it would be sensible for the present and future Iranian governments to lessen their dependence on oil revenue. Table (1) illustrates Iran's crude oil production and its heavy oil price for the period 1390-93 according to the International Energy Agency (IEA) and OPEC.

According to the IEA, in 2013 Iran's gross natural gas production amounted to almost 8.1 trillion cubic feet (Tcf), which was one percent lower than that in 2012. Natural gas production increased in 2014, although estimates are still preliminary. Of the 8.1 Tcf produced, 6.5 Tcf was marketed; about 1 Tcf was re-injected into oil wells to enhance oil recovery and the remaining 0.6 Tcf was flared. Reinjection of natural gas plays a critical role in oil recovery at Iran's fields. As a result, natural gas reinjection is expected to increase in the coming years. Some estimates indicate that the National Iranian Oil Company (NIOC) will require between 2.0 and 2.5 Tcf per year of natural gas for reinjection into its oil fields in the next decade.

Natural gas has also been battered by international sanctions. Lack of foreign investment and insufficient financing have resulted in slow growth in Iran's natural gas production. Iran was expected to become one of the world's leading natural gas producers and exporters given its vast proven reserves of natural gas, which is ranked either first or second largest in the world. However, development of its fields has been hampered by the shortage of financing, unavailability of technical know-how, and contractual issues. Nonetheless, Iran's natural gas production has grown, and output is likely to continue to increase in the coming years as new phases of the South Pars gas field come online.

Figure 1: Iran's Average Daily Crude Oil Production and Heavy Oil Price



Source: EIA and OPEC

1.3. Manufacturing and Mining

Manufacturing and mining accounted for nearly 23 percent of the GDP, and was responsible for about 1.3 percent of its 3.0 percent growth in 1393. After undergoing a substantial contraction in 1391 and 1392, it experienced a positive growth rate of 5 percent in 1393. Table 4 illustrates the growth rate of sub-sectors in manufacturing and mining at constant 1383 prices. The mining sector experienced the highest real growth rate of 9.8 percent, followed by "electricity, water, and gas", and manufacturing growth rate of 7.5 percent and 6.7 percent, respectively. Construction was the only sector that experienced negative growth in 1393. The 18.5 percent contraction of value-added in construction sector in the winter of 1393 caused 0.4 percent negative growth rate for the whole year.

Table 4: Real Growth Rate of Manufacturing and Mining and its Main Sub-sectors (percent)

	1388	1389	1390	1391	1392	1393
Manufacturing and Mining	4.2	7.9	5.0	-6.4	-2.9	5.0
Mining	1.8	23.8	20.1	-2.5	0.9	9.8
Manufacturing	8.1	10.5	5.6	-8.5	-3.9	6.7
Electricity, gas, and water	4.7	5.6	0.3	1.1	5.4	7.5
Construction	-3.2	1.0	2.5	-3.6	-3.1	-0.4

Source: Annual National Accounts of Iran, Year 1393 (based on constant 1383 prices), CBI, Khordad 1394

In 1393, the production index of large manufacturing units increased by 6.7 percent. In the same year, 14 out of the total 24 large manufacturing groups experienced an increase in their indices. Among these, manufactures of "motor vehicles, trailers, and semi-trailers" had the highest growth rate of 51.2 percent. About 83 percent of the value-added of the large manufacturing establishments belongs to six major groups, shown in the Table below.

Table 5: Production Index of 6 Major Large Manufacturing Sub-sectors in 1393 (1390=100)

Group	Share in Value-Added	Growth (percent)
Manufacturing	100.0	6.7
Chemical and cellulose	26.2	1.7
Basic metals	20.2	3.8
Motor vehicles, trailers, semi-trailers	16.3	51.3
Non-metallic mineral products	9.5	-2.8
Food and pharmaceutical	7.4	8.0
Electrical	4.0	11.1

Source: Central Bank of Iran; Report for 1394

Petrochemicals

Petrochemical products constitute the most important non-oil export of Iran. Indeed, most of the chemical exports are petrochemical-based. They carry the highest weight in TSE and are mostly responsible for its fluctuations in recent years. The reason for this volatility stems from the fact that the whole industry was built on the idea of making good use of unutilized natural gas, most of which had to be flared at the time and thus had no real market price. But with further development of this industry, production of shell gas on a commercial scale, as well as possible export of gas to the neighboring countries, a pricing scheme had to be devised to ensure that Iranian natural gas at-

tains its rightful place in the world market.
The industry was thriving on cheap gas prices and did well both at home and abroad up until the last quarter of 1392 when the Iranian parliament raised the price of natural gas from 3 cents to 13 cents per cubic meter. The immediate effect was of course dramatic for a number of downstream concerns. The government then took measures to alleviate the higher price of inputs and, overall, 1392 was a good year for petrochemicals with about 80 percent increase in domestic sales, from IRR174.8 trillion to IRR313.8 trillion.
Official data for 1393 are not available, but petrochemicals seem to have done well at least in foreign markets, with exports rising from $10.8b to $14.2b, or some 31.5 percent, notwithstanding the sanctions. In 1393 stock prices fluctuations seem to indicate more difficult times, mainly due to speculations regarding natural gas feedstock prices setting mechanisms rather than a real crisis in the industry.

Construction

Construction is often considered an important engine of industrial activities, playing a significant role in shaping of the business cycles and even being its precursor. But in the absence of a developed capital market, in Iran this sector also accounts for a major share of speculative investment and is used as a hedge against inflation. These characteristics make the construction sector to at times behave in a particular fashion.
However, in 1393, although its real value added decline was less than in the previous year, it constituted the main reason for the slowdown of the GDP growth during the last quarter of the year. This is clearly borne by the statistics regarding construction permits issued. For the third consecutive year, the number as well as the total floor space of the construction permits issued by municipalities slowed down and reached dramatic proportions, as shown in the Table below.

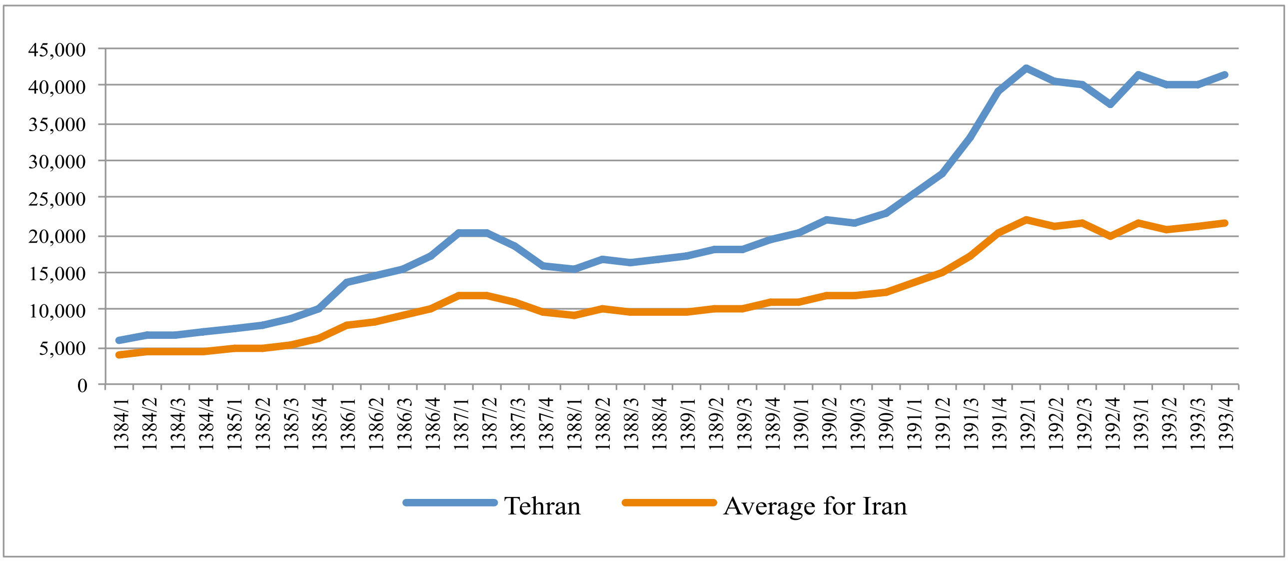
Table 6: Growth Rates of Construction Permits Issued by Municipalities in Urban Areas and their Floor Space (percent)

	1388	1389	1390	1391	1392	1393
Number of permits	-21.1	29.8	5.7	-2.4	-7.6	-32.1
Total floor space	-15.8	36.6	5.7	-3.4	3.5	-40.2

Source: CBI, 1391 Economic Trends, no 79, Khordad 1394

Meanwhile, prices have also softened in both Tehran and the provinces. It is believed that there are cycles of recession in construction, lasting two to three years. This may, to some extent, indicate the psychological factor behind the continuing recession in this sector while there seems to be a reigning mood of a general recovery. The recent contractions may have been brought about by the previous over-investments due to speculative motives.

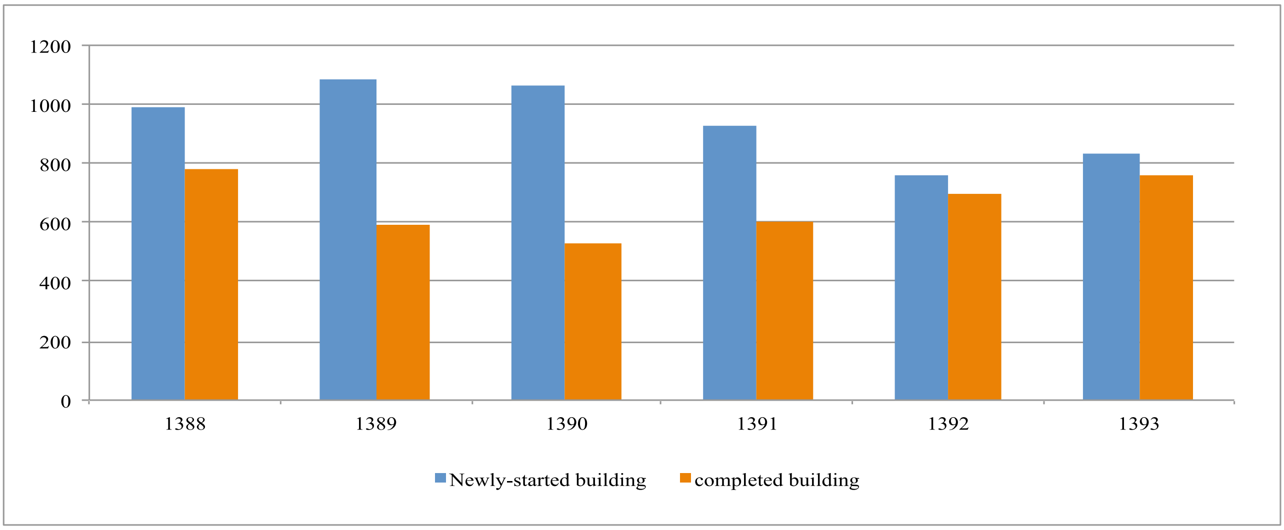
Figure 2: The Average Price of One Square Meter Housing in Tehran and Iran (IRR thousand)



Source: Based on data from the Statistical Center of Iran.

During the past few years most of the private sector's investment in constructions was in new projects. More recently there seems to have been a shift towards semi-finished projects. However, in 1393 there was almost the same decrease (4.9 percent and 4.4 percent, respectively) in the real value of investment in new constructions as well as semi-finished ones.

Figure 3: Private Sector Real Investment in Newly-started and Completed Buildings (IRR billion)



Source: Based on data from the Statistical Center of Iran.

1.4. Services

In 1393, services value-added amounted to IRR5,811 trillion and showed a real growth rate of 2.4 percent, compared to 1.5 percent in the previous year. Services have always occupied the lion's share in the GDP and during the year under review it accounted for 53.8 percent of the GDP and 1.5 percentage point of its 3.0 percent growth rate.

Services have been divided into six sub-sectors that include "Financial and Monetary Institutions" and "Trade, Restaurants, and Hotels", which had significant contributions to the value-added of this sector. In 1393, Financial and Monetary Institutions grew by 15.7 percent, which compared to its contractions during the previous two years, represents a great jump. This must have been mainly due to the change in trends and new wave of optimism.

Table 7: Real Growth Rates in Services Group (percent)

	1391	1392	1393
Services sector	1.1	-1.5	2.4
Trade, restaurants, and hotels	-8.9	-5.0	3.7
Transport, storage, and communication	5.0	1.9	2.9
Financial and monetary institutions' services	-1.6	-12.7	15.7
Real estate, specialized and professional services	8.7	-3.0	-0.4
Public services	0.4	0.0	0.0
Social, personal and household services	0.7	5.6	-1.5

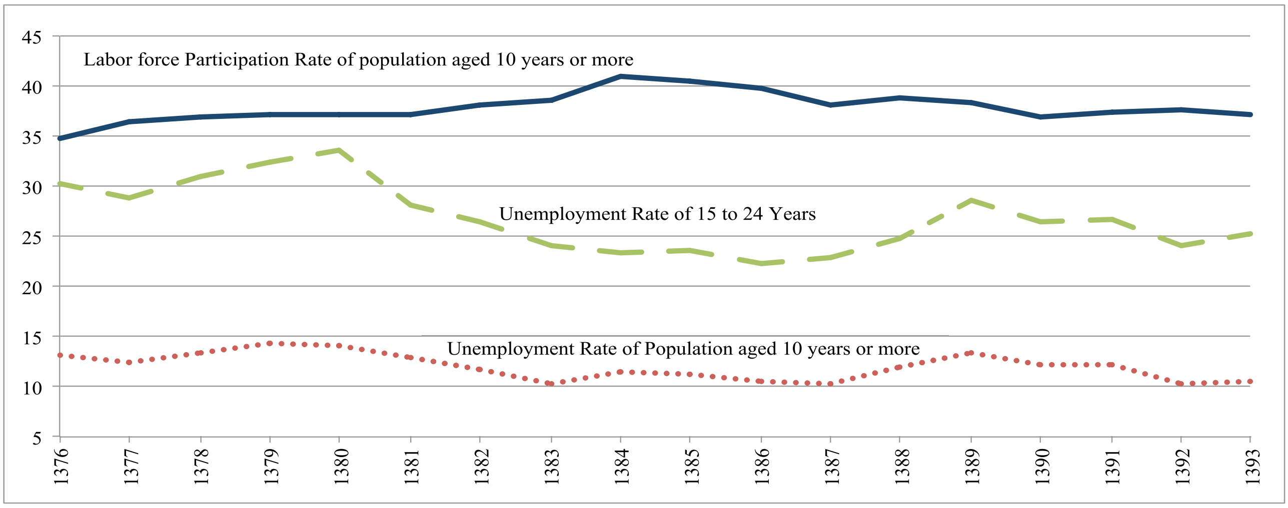
Source: Central Bank of Iran; Report for 1394

It is noteworthy that out of the total GDP growth rate of 3.0 percent, Financial and Monetary Institutions by itself contributed 0.6 percent percentage point, while Trade, Restaurants, and Hotels accounted for 0.5 percentage points. The combined contribution of these two subsectors to the GDP growth rate was more than twice the contribution of the Oil sector, and just below that of Industries and Mining.

1.5. Employment

During the period under review, the unemployment rate was 10.6 percent which is not too different from the 10.4 percent rate in the preceding year. In fact, during the past decade this rate has surprisingly remained stable, mostly vacillating around 11 percent, and has barely been affected by economic fluctuations. Many economists have raised doubts about the validity of these figures. The explanation, however, seems to be simple enough. It is based on two obviously unrealistic assumptions: definitions of employment as the minimum of 1 hour work per week, and the age of 10 and above for the work force. These minimalistic assumptions may be useful as part of an abstract investigation, showing employment variation under various hypothetical assumptions, but does not reflect the importance of labor as a factor of production and how it affects, and is affected by, economic and social variables.

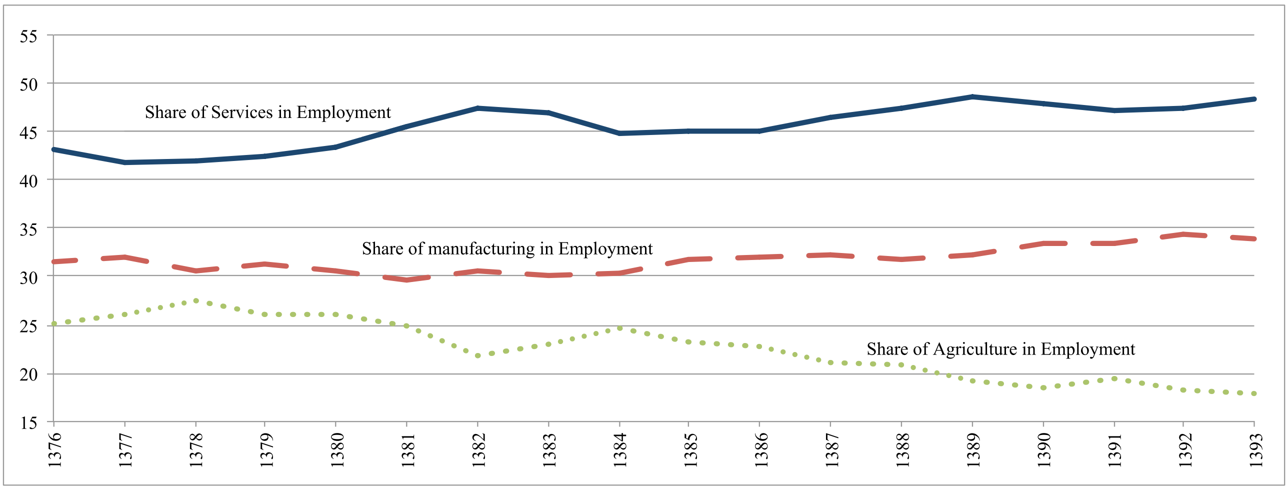
Figure 4: Participation and Unemployment Rates, 1376-1393 (Percent)



Source: Select Labor Force Survey Results, Statistical Centre of Iran, 1376-93

It is obvious how the first assumption underestimates unemployment. The second assumption has the same effect, as most of the adolescent persons are students and students are considered 'employed'. As a result, a fixed magnitude is added to the nominator and denominator of the fraction, increasing its numerical value, i.e., percentage of employment`.
The rate of unemployment is much higher and fluctuates more in the age-group 15-24. This underlines the economic and social fact that the youth have been much more under pressure, especially in the cities, probably as more young people move to urban areas. The data also show how agriculture gradually occupies a less important source of employment than services and industry, not only in the urban areas but also in the rural areas, as can be noted from the Figure below:

Figure 5: Share of Various Sectors in Labor Force Employment (Percent)



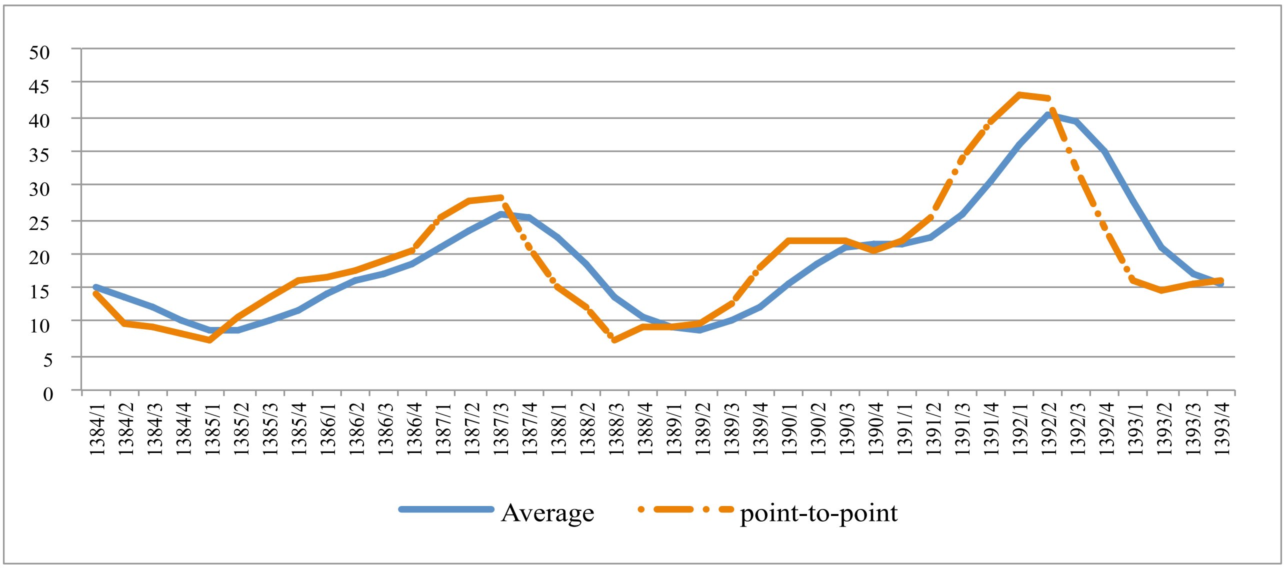
Source: Select Labor Force Survey Results, Statistical Centre of Iran, 1376-93

This trend of course corresponds with the general situation in agriculture where there is less and less per capita arable land and the productivity can hardly keep up with other sectors.

1.6. Inflation

In 1393 hyperinflation came to an end. The average annual rate of inflation dropped to 15.6 percent – a rate less than half of the 34.7 percent for the year before. The point-to-point inflation rate dropped from its peak of around 45 percent in the first quarter of 1392 by almost a third, namely 16.2 percent at the end of 1393. This was a triumph of mostly expectations from the new administration, rather than policies such as a veritable adoption of an actively tight monetary policy. As we have seen, other economic indicators also seem to confirm better times and the return to more subdued fluctuations.

Figure 6: Point-to-Point and Average Quarterly Inflation Rates (Percent)

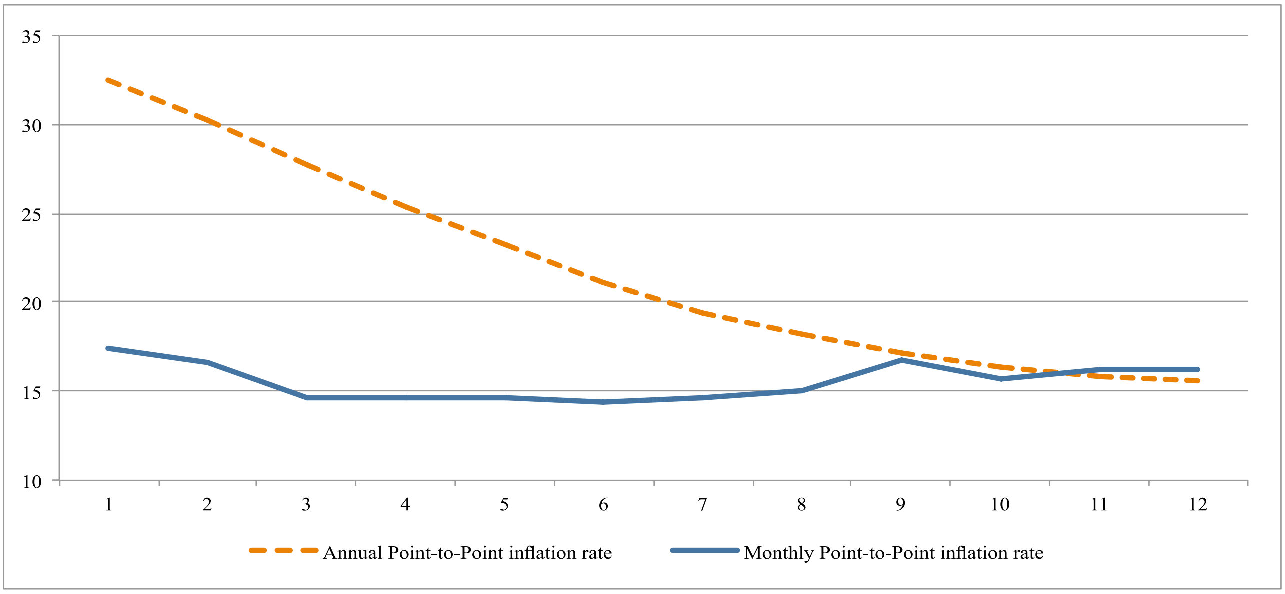


Source: Central Bank of Iran

However, it is believed that an end to all the basic economic constraints was not yet in sight and the cost of living index was expected to slowly rise again, but in more reasonable fractions, as in fact, it proved to be the case in the latter part of the year.

Slowly the point-to-point rate of inflation and the annual average approached each other at around 15-16 percent, as shown in the chart below.

Figure 7: Point-to-Point and Average Monthly Inflation Rates in 1393 (Percent)



Source: Central Bank of Iran*

It would be tempting to try to correlate these figures with the new economic policy. There certainly has been much coordination of economic measures taken, but given the misses and hits, the time lag, and limited data, seeking any conclusive results seems rather far-fetched. Noting that the fiscal policy's obvious domination of monetary policy in Iran's economy, cash subsidies, the balance of payments situation and the instability of the foreign exchange market were the main factors responsible for at times almost exponential rise in prices.

Amongst the most important categories of goods and services, foodstuff with 13.1 percent registered the lowest rate of inflation, while health at 33.2 percent was the worst hit. Despite its rather low weight in the consumer price index, the latter is of course of great social importance. Altogether, it seems that during the second half of the year, the lower income groups were slightly worse off. The following Table shows the salient feature of the Consumer Price Index.

Table 8: Consumer Price Index and its Components

	Base year Weights	12/1393 compared to 12/1392	1393 compared to 1392
General Index	100.0	16.2	15.6
Major Groups and selected sub groups			
Food and beverages	27.4	13.1	9.1
Tobacco	0.4	-3.8	-6.1
Clothing and Footwear	4.9	14.8	18.5
Housing, Water, Electricity, Gas and other Fuels	32.8	15.4	16.7
Furnishing, Household Equipment and Routine Household Maintenance	5.1	8.8	10.6
Health	7.0	33.2	31.7
Transport	9.9	20.9	24
Communication	2.4	11.4	10.7
Recreating and Culture	2.9	28.4	22
Education	2.2	10.9	12.8
Restaurants and Hotels	1.9	18.5	18.8
Miscellaneous Goods and Services	3.2	15.0	15.9
Special Groups:			
Goods	52.7	13.4	12.4
Services	47.3	20.4	20.5
Housing, Water, Electricity, Gas and other Fuels	32.8	15.4	16.7

Although hyperinflation may have been overcome, inflation has not really been harnessed and the ever-present price rise in recent years has left behind a radical change of behavior. The danger is that ordinary people, shopkeepers, firms and even probably economic policymakers seem to have accepted inflation as an everyday fact of life.

2. Fiscal Policy

During the year under review, Government revenue reached IRR1,609.5 trillion, which was 12 percent lower than the forecast and 21.1 percent higher than the previous year's revenue. Government expenditure amounted to IRR1,737.8 trillion, which was 19.3 percent higher than the forecast and 22.6 percent higher than the previous year's. As a result, the budget deficit reached IRR128.3 trillion, which was 7.9 percent lower than the forecast and 45.2 percent more than the year before. However, the operational deficit at IRR460.4 trillion was 4.1 percent lower than the year before. Development budget expenditure was 36 percent higher than the year before but still failed to reach the forecast.

The Government had promised not to borrow from the CBI as was the case with the previous administration. The consequences of deficit financing by the CBI were disastrous, and well-known, and the fact that despite all the pressure on its resources the Government abstained from it is certainly a positive point. In fact, the Government had little choice but to pass on the buck to the banking system, which in turn had to rely on the CBI to provide resources. However, the circumstances were such that in the absence of other expansionary forces (notably the oil revenue) the inflationary effect of this process was rather contained, as it is discussed further below under Monetary Policy.

Among the revenue items, for the first time in five years tax income at IRR709.7 trillion exceeded the oil revenue which amounted to IRR628.8 trillion. While faltering oil revenues suffered from severe price falls and sanctions, tax income increased substantially. It is interesting to note that probably more extensive and more efficient collection methods led to 43.6 percent increase in tax income (more than twice the rate of inflation), exceeding the budget forecast.

Indirect taxes amounted to IRR350.5 trillion, exceeding the forecast by 4.1 percent and the figure for the year before by 62 percent. The bulk of this item (61.9 percent) consists of taxes on goods and services, itself mainly composed of recently levied VAT (amounting to 77 percent of this sub-category), with much success. Tax on imports also surprisingly registered a 66 percent increase, and accounted for merely 5.6 percent rise in the value of imports according to the Customs. This must have been due to the importation luxury items with higher duties.

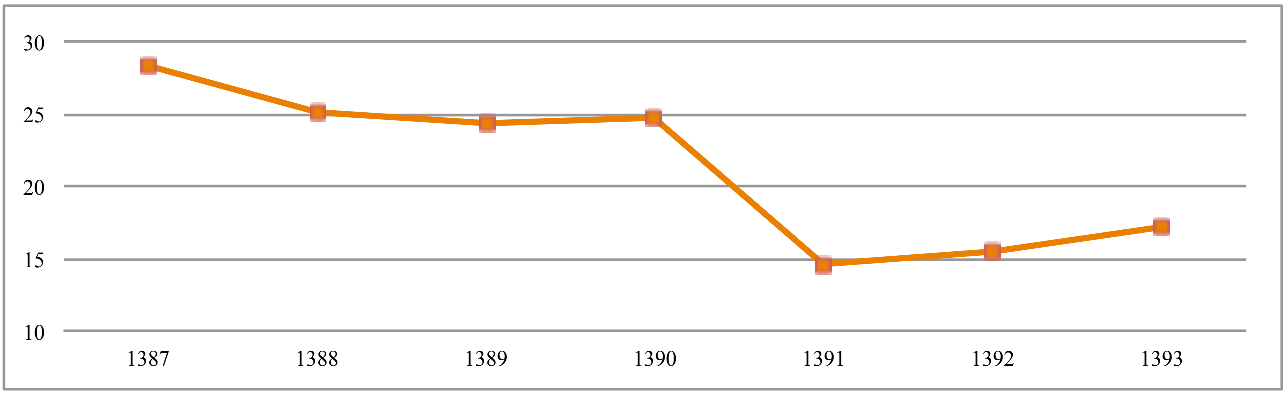
Table 9: Financial Position of the Government (IRR trillion)

					Growth (%)		Composition (%)		
	1391	1392	1393	Increase	1392/1391	1393/1392	1391	1392	1393
Revenues:									
Oil and gas	425.5	609.4	628.8	19.4	43.2	3.2	42.7	45.8	39.1
Taxes	395.2	494.2	709.7	215.5	25.1	43.6	39.7	37.2	44.1
Direct Tax	248.3	277.9	359.2	81.3	11.9	29.3	24.9	20.9	22.3
Indirect Tax	146.9	216.4	350.5	134.1	47.3	62.0	14.7	16.3	21.8
Others	176.0	225.8	271.0	45.2	28.3	20.0	17.7	17.0	16.8
Total	**996.7**	**1329.4**	**1609.5**	**280.1**	**33.4**	**21.1**	**100.0**	**100.0**	**100.0**
Expenditures:									
Current	890.0	1197.6	1438.3	240.7	34.6	20.1	85.4	84.5	82.8
Development	152.3	220.2	299.5	79.3	44.6	36.0	14.6	15.5	17.2
Total	**1042.3**	**1417.8**	**1737.8**	**320.0**	**36.0**	**22.6**	**100.0**	**100.0**	**100.0**
Surplus/Deficit	**-45.5**	**-88.4**	**-128.3**	**-39.9**	**94.0**	**45.2**			
Financed by:									
Acquisition of Assets	-22.2	-59.0	-40.4	18.6	166.2	-31.4	-48.8	-66.7	-31.5
Foreign borrow.	1.1	1.5	0.7	-0.8	36.1	-56.4	2.4	1.7	0.5
Privatization	51.6	114.4	149.4	35.0	121.6	30.6	113.4	129.4	116.4
Carried forward	14.4	30.7	7.8	-22.9	113.7	-74.5	31.6	34.7	6.1
Others	0.7	0.7	10.8	10.1	15.9	1563.2	1.5	0.8	8.4
Total	**83.3**	**161.1**	**156.6**	**-4.4**	**93.3**	**-2.8**	**100.0**	**100.0**	**100.0**
Operational balance	-321.8	-480.3	-460.4	19.9	49.2	-4.1			
Capital balance	276.2	391.9	332.0	-59.9	41.9	-15.3			

Source: Budget Legislation

On the expenditures side, out of the total of IRR1,737.8 trillion, IRR1,438.3 consisted of current expenditure while development expenditure accounted for only IRR299.5 trillion, or 17.2 percent, which nevertheless showed an increase of 36 percent over the previous year. In recent past this item was notoriously neglected by the previous administration. As a matter of fact, during the first half 1392, Government expenditure on development projects accounted for only 18.5 percent of the total, while the other 81.5 percent took place during the second half of the year by the newly elected administration.

Figure 7: Ratio Of Realized Development Expenditures to Total Realized, 1387-1393 (Percent)



Source:CBI Website

The per capita cash subsidies remained the most problematic item on the expenditures side. It amounted to IRR421.3 trillion which was almost 1/4th of the total expenditures. It exceeded the development expenditures by 40.7 percent and amounted to three times the entire budget deficit. The budgetary allocation under the Subsidies Reform Law included other subsidies relating to unemployment and promotion of industry, but they were totally disregarded by the authorities.

The question of what exactly budget deficit is has often been controversial and is somehow the function of how it is financed. For want of an efficient financial instrument, during the recent past the government has, for most intents and purposes, relied either directly upon the CBI and/or the then Oil Reserve Fund to borrow with the same undesirable effects. During the period under review the (operational plus capital) budget deficit amounted to IRR128.3 trillion, which exceeded the approved budget by 24 percent.

The deficit would have amounted to IRR757 trillion if the oil "revenue" of IRR628.8 trillion is added. But that item is more akin to the sale of national wealth than revenue. Besides this conceptual issue, the public sector's liabilities to the banking system increased by some IRR280 trillion, and the Government borrowings are generally for the purpose of covering its deficit. What is more controversial is that it looks like really the CBI financed this sum, as its lending to the banks increased by IRR245 trillion, almost 90 percent of the increase in public sector liabilities to the banking system, with all its ramifications in terms of the monetary base and the monetary policy having become a function of the fiscal policy.

There is also the less important issue that the budget deficit was partially financed by the sale of Government stocks, otherwise known as the Privatization Project. In effect, a large part of the sale of government stocks in state-owned enterprises (of some IRR149.4 trillion) under the Privatization Act, was in reality transfer to other State or semi-State organs rather than the public and in reality would not be counted as deficit financing.

2.1. The Subsidies

As yet there are no official data on the subsidies for the period under review, but a member of the Plan and Budget Commission of the Parliament has revealed the basic statistics on the sources and uses of funds for this budgetary allocation. The idea behind the legislation, the Subsidies Reform Law, was to make use of the proceeds of the increase in the price of fuel mainly to distribute cash subsidies to all Iranians, as well as, some subsidies in connection with promotion of production, public health and unemployment, as shown in the following Table.

Table 10: Subsidies, Sources and Uses of Funds, 1393 (IRR trillion)

	Forecast	Share of forecast	Realized	Share of Realized	% of realized to total
Increase in prices of energy carriers	480.0	80.9%	354.8	75.8%	73.9%
Government budget	113.0	19.1%	113.0	24.1%	100.0%
From previous year	-	-	0.4	0.1%	-
Total	**593.0**	**100.0%**	**468.2**	**100.0%**	**78.9%**
Uses					
Cash subsidies	425.0	71.7%	421.3	91.5%	99.1%
Support for production	100.0	16.9%	4.6	1.0%	4.6%
Healthcare	48.0	8.1%	28.4	6.2%	59.2%
Unemployment insurance	20.0	3.4%	6.4	1.4%	32.0%
Total	**593.0**	**100.0%**	**460.6**	**100.0%**	**78.0%**

Source: isna.ir/fa/print

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As may readily be observed, not only were the sources of funds' forecast, namely IRR480 trillion out of the price rise and IRR113 trillion out of the general budget, were proved to be unattainable, but the funds collected were not distributed according to the law. There was a shortage of IRR132.4 trillion (the difference between forecast and realized uses) and the percentage of per capita cash subsidies paid accounted for 91.5 percent of the total funds raised, instead of 71.7 percent. Production obtained 1.0 percent instead of 16.9 percent. In other words, the government had to almost completely disregard the part which had clear targets. Less than 10 percent of the population accepted not to register in response to a new voluntary registration for subsidies and the government demand for voluntary abstinence by the higher income groups.

Historically, there were no valid grounds for domestic underpricing of fuel, such a gasoline at less than a tenth of its Persian Gulf f.o.b. price. But having abolished this system, there were still less valid grounds for replacing the economy made, with something else, or worse with any kind of subsidy, rather than the development budget or some kind of investment fund, linked to it.

Another illogical aspect was general cash distributions regardless of any income or wealth. A fortiori, there is no economic justification for such an act either. The only end it must have served was electoral, and that is what makes it so difficult to stop it. And as of the first day, the amount of the economy made was insufficient even to cover the per capita cash subsidies, let alone achieve other objectives.

This is just to show that no matter how the budget deficit is calculated, the opportunity cost of these subsidies would have been a balanced budget with no inflationary effects, plus full disbursement of the development budget allocations. There would still remain enough for more effective subsidization of health, education and the environment. But, realistically, for political and social considerations, it seems impossible, at least in the short run, to do away with these subsidies. They have thus become another institutional constraint on the path of a sound economic policy.

3. Monetary Situation

The growth rate of most monetary aggregates seem to have begun falling during the year under review and the year before that, but there has been an important modification in the coverage of monetary statistics which makes comparisons unrealistic. This was an unwanted by-product of the CBI's success in extending its control over a significant number of new banks and non-bank financial intermediaries. As a result, any statistical comparison beyond two years has to be accompanied by further explanation and investigation. The first point to remember is that the high growth rates in 1392 (2013/14) due to this greater data coverage rather than any economic development. This point will be explained further below.

On the basis of the new statistical coverage, during the period under review liquidity at IRR7,823.8 trillion rose by 22.3 percent compared to 38.8 percent in the year preceding it, while on the basis of the old statistical coverage, the comparable figures are, respectively, IRR7,015.5 trillion, 20.9 percent and 25.9 percent, as shown in the Table below.

Table 11: Liquidity, Monetary Base and Money Multiplier Statistics Compared

Description		Balance at the end of year (tr IRR)			Growth (percent)	
Year		1391	1392	1393	1392	1393
Old Statistical Coverage	Liquidity	4,606.9	5,800.7	7,015.5	25.9	20.9
	Monetary Base	975.8	1,140.6	1,236.5	16.9	8.4
	Money Multiplier	4.7	5.1	5.7	7.7	11.6
New Statistical Coverage in 1393	Liquidity	4,606.9	6,395.5	7,823.8	38.8	22.3
	Monetary Base	975.8	1,184.9	1,310.5	21.4	10.6
	Money Multiplier	4.7	5.4	6.0	14.0	10.6

Source: CBI website

As may be observed, the rates of growth of money multiplier with the old statistical coverage increase from 7.7 percent to 11.6 percent, while in the case of full statistical coverage it falls from 14.0 percent to 10.6 percent, i.e., moving in opposite directions in the two cases. This is just to show that one has to be careful with such comparisons and avoid using superlatives. Alternatively, it may sometimes be useful to make comparison with two years (rather than one year) earlier.

The facts is, however, that in 1393 the base money increased much less than in 1392 and 1391, because during the period under review, among its constituent factors, both net foreign assets and net CBI lending to government, as well as "other items", had negative effects, while the only factor contributing to its increase was net CBI lending to the banks.

Table 12: Monetary Aggregates (IRR trillion and percentages)

	1390	1391	1392	1393
Money (tr IRR)	897.6	1,136.7	1,196.0	1,207.6
Growth of money	18.3%	26.6%	5.2%	1.0%
Liquidity (tr IRR)	3,542.6	4,606.9	6,395.5	7,823.8
Growth of liquidity	20.1%	30.0%	38.8%	22.3%
Base money (tr IRR)	764.6	975.8	1,149.4	1,311.5
Growth of base money	11.4%	28%	18%	14%
Money multiplier	4.6	4.7	5.6	6.0
Total loans	3,804	4,391	5,719	6,740
Term deposits (quasi_money)	2,645	3,470	5,199	6,616
Banks' claims on private sector	3,517	4,139	5,408	6,309
Commercial banks	2,511	2,917	3,998	4,696
Specialized banks	1,006	1,222	1,410	1,613
Banking system claims on public sector	638.5	910.4	1,109.5	1,466.0
Deposits of Private sector	3,279	4,277	6,061	7,472
Sight deposits	634.4	806.6	861.9	855.9

It is also interesting to note that with the old statistical coverage, too, the rate of growth of all aggregates declined with the exception of note and coins and the money multiplier, which shows that banks made greater use of their excess capacities. Liquidity growth, regardless of the statistical coverage, stayed more or less within the 23-25 percent declared objective of the CBI. As the most important factor responsible for the fluctuations of monetary aggregate, it is edifying to take an analytical look at the constituents of base money.

Table 13: Changes in the Constituents of Base Money

	Balance at the end of year (IRR trillion)			End of year 1393 to 1392					
				Growth (percent)			Share in the growth of the monetary base (percent)		
	1391	1392	1393	1391	1392	1393	1391	1392	1393
Monetary Base	975.8	1,184.9	1,310.5	27.6	21.4	10.6	27.6	21.4	10.6
Net foreign assets	769.2	1,678.3	1,574.8	2.8	118.2	-6.2	2.7	93.2	-8.7
Net Central Bank loans to Government	46.0	38.7	38.5	162.9	-15.8	-0.6	15.6	-0.7	0.0
Central Bank loan to banks	488.3	602.6	856.3	16.7	23.4	42.1	9.2	11.7	21.4
Net others	-327.7	-1,134.7	-1,159.1	0.5	-246.2	-2.1	0.1	-82.8	-2.1

Source: slides of the speech given by Vice-President of the CBI at the twenty-fifth conference on Monetary and Foreign Exchange Rate Policies, 10th and 11th of Khordad 1394

It seems that although the CBI made no new loans to the Government, it was nonetheless itself mainly responsible for the 22.3 percent rise in liquidity and, in effect, under the dictates of fiscal policy, indirectly financed the budget deficit by lending to the banks. This is only partially true, as for example some of the banks had been left with Participation Bonds the Government (and State entities) had handed over to the contractors, which the banks had accepted as collateral for the facilities they had extended. They became the banks' assets when the contractors failed to repay their loans, and at their maturity the CBI ostensibly had little choice but to redeem them. There were other cases of force majeure, too, notably commitments to disburse housing loans undertaken by the previous government. Furthermore, the main factor behind the budget deficit itself was a legacy of the past.

It is usual for banks and other financial institutions to hold sizable amounts of government treasury bills as part of their liquid assets, next only to cash, and there is no need for any coverage or redemption at maturity by the CBI. But in Iran, Government Participation Bonds are very different and considered to be illiquid. This is an idiosyncrasy of the local market that has to be explained elsewhere. Suffice it to say that the CBI in a sense had to bail the banks out, but in doing so it also acted as the so-called White Knight of fiscal policy.

On the uses side of base money, during the period under review, banks' total deposits with CBI of some IRR889.7 trillion increased by merely 12.2 percent, compared to 31.2 percent for the year before and 33.2 percent for 2 years earlier. Out of this amount, legal deposits with CBI increased by 25.4 percent (or IRR172.5 trillion), which was slightly more than the increase of 23.3 percent in the growth of their deposits. However, there was a sizable shift from the banks' other (sight) deposits with the CBI to their legal deposits, as the former was reduced by some 65.8 percent. The shift must have mostly been for the purpose of covering their needs in legal deposits arising out of new facilities granted. But greater increase in legal deposits compared to the rise in total deposits coupled with this shift must have been due to an increase of the legal deposit ratio, as the ratio of legal deposits held against sight deposits is also higher. This could mean tightening of bank credit by the CBI.

As for other monetary aggregates, total deposits continued to increase but at a slower pace than in the two preceding years (23.3 percent against 41.7 percent and 30.4 percent), and there was a shift from sight deposits to non-sight deposits. This shift has been a clear witness to greater consciousness and defensive reaction of depositors to inflation, the main losers in the inflationary and hyper-inflationary situations in recent years. In fact, except for the year under review, interest rates have generally been below inflation rates. This policy in the past has been based on an erroneous proposition that low interest rate is a good remedy against inflation as it helps promote investment and production, oblivious to the fact that it promotes demand much before it affects -- if at all -- supply.

During the period under review, lower inflation was apparently the justification for lowering interest rates. It seems that the proposition mentioned above has still got its adepts. Field studies seem to show that the main obstacles to investment and production are to be found not in interest rates but elsewhere.

The conclusion is that CBI's valiant efforts have yielded some important results, which should not be underestimated, but there still remain some structural obstacles to hurdle. Monetary policy by and large still remains a function of fiscal policy, and this is a dangerous legacy. Inflation remains a great threat and an obstacle to a meaningful economic policy, and so long as it lasts, the rate of interest has to find its own place in relation to it and there is no sense in trying to push it downwards.

3.1. Banking System

As discussed above, major changes took place in the structure of the banking system during the year under review. For a number of years there has been a growing number of non-bank or semi-bank credit institutions of different sizes and configurations springing up haphazardly across the country, without sometimes even the knowledge of the CBI, let alone its authorization or control. There were also, as might well have been expected, incidences of liquidity problems and even 'run on the bank'.

This was evidently a public matter which needed the intervention of public authorities. Furthermore, this obviously made the effectiveness of monetary policy, or any other economic policy for that matter, subject to uncertainty. It took a long time for the CBI to gather some data on these institutions and much longer to convince the authorities that this situation was a great obstacle to the implementation of many economic policies.

Even in the latter years of the previous administration, the CBI was more or less given the verbal approval to redress this situation. But in practice little progress was made, except probably in gathering more data and greater conviction on the part of some authorities. Any step in this direction was, therefore, of great importance, and during the past two years long strides have been taken. During this period six banks and four financial institutions were brought into the orbit of CBI control and statistical coverage. By the end of the year under review 20 privately owned banks, 8 State-owned banks (four of which are officially designagted "private") and 4 authorized credit institutions. Nevertheless, a great number of financial intermediaries, probably accounting for a good chunk of the market, operated without any real supervision and little is known of the nature and amount of their individual or aggregate operations.

Table 14: Assets and Liabilities of the Banking System

	Balance at the end of the year			Percentage change		
	1391	1392	1393	1391	1392	1393
Assets						
Foreign assets	591.3	1,335.1	1,243.2	-2.6	125.8	-6.9
Nots and coins	22.6	34.5	40.8	0.2	52.2	18.3
Deposits with the Central bank	374.7	557.0	652.9	33.8	48.6	17.2
Reserve requirement	335.5	495.3	631.5	40.5	47.6	27.5
sight	39.1	61.6	21.4	-5.1	57.4	-65.2
Claims on public sector	274.6	343.6	415.4	53.1	25.1	20.9
Government	264.7	329.6	405.1	54.5	24.5	22.9
Public corporations and institutions	9.9	14.0	10.2	22.3	40.7	-26.9
Claims on non-public sector	2,134.5	3,134.1	3,731.6	20.5	46.8	19.1
Others	1,074.6	1,961.0	2,685.9	53.2	82.5	37.0
Sub- total	4,472.7	7,365.5	8,770.1	25.6	64.7	19.1
Contingent assets	851.8	1,264.0	1,460.3	-5.8	48.4	15.5
Total assets = Total liabilities	5,324.5	8,629.5	10,230.4	19.2	62.1	18.6
Liabilities						
Deposits of non- public sector	2,800.00	4,346.00	5,325.30	33.60	55.20	22.50
sight	520.40	574.40	545.50	38.30	10.40	-5.00
Term	2,066.50	3,513.40	4,472.40	32.50	70.00	27.30
Gharz-al-hasaneh	158.90	192.30	230.40	30.30	21.00	19.80
Other	54.06	65.84	76.89	37.30	21.80	16.80
Claims on Central Bank	28.80	28.27	239.80	30.70	-2.20	-
Deposits and funds of public sector	12.85	80.10	106.90	2.10	-	33.40
Capital account	271.50	436.50	455.40	13.60	60.80	4.30
Foreign exchange loans and deposits	533.50	1,156.00	1,027.10	-11.70	116.70	-11.10
Others	825.80	1,318.50	1,615.20	40.60	59.60	22.50
Sub- total	4,472.70	7,365.50	8,770.00	25.60	64.70	19.10
Contingent liabilities	851.80	1,264.00	1,460.30	-5.80	48.40	15.50

Set against the background of a jump during 1391 and 1392 and a comparative decline during 1393, as the total assets of the banking system accelerated from 18.6 percent to 46.6 percent and in the year under review decelerated to 17.1 percent, most of the other components of the assets and liabilities of the banking system followed more or less the same pattern. Notwithstanding these fluctuations, one general remark that could be made is that the banking system has barely managed to keep up with the rate of inflation.

But the performance of various bank groups was not exactly in the same fashion. Overall, non-State-owned banks (including the big four considered to be "private") seemed to have performed better. But this was mainly because most of the institutions concerned by the new statistical coverage were "private". In fact the application of "private" is rather unrealistic in both cases and the two cases really designate two different concepts of ownership. Once again, one is faced with the problem of discrepancies between the real nature of the data and their appearance.

Be that as it may, the difference in performance by private banks and State-owned banks is borne by the statistical coverage of deposits and facilities. As for deposits, private banks showed a jump of about 6.2 percentage points in their share of total deposits during 1391-93, from 65.5 percent to 71.7 percent and 71.3 percent. State-owned banks' performance naturally showed a drop of 5.8 percentage points.

Table 15: Distribution of Bank Deposits (IRR trillion)

	Outstanding Deposits			Growth			Share in Total		
	1391	1392	1393	1391	1392	1393	1391	1392	1393
Banking System	4276.8	6061.4	7472.2	30.4%	41.7%	23.3%	100%	100%	100%
Private Banks	2800	4346	5325.3	33.6%	55.2%	22.5%	65.5%	71.7%	71.3%
State Banks	1476.7	1715.4	2146.8	24.8%	16.2%	25.1%	34.5%	28.3%	28.7%
Commercial Banks	989.2	1128.8	1386	26.6%	14.1%	22.8%	23.1%	18.6%	18.5%
Specialized Banks	487.5	586.6	760.8	21.4%	20.3%	29.7%	11.4%	9.7%	10.2%

A slightly different scenario applied to the facilities: private banks showed a jump of about 7.5 percentage points in their share of total facilities during 1391-93, from 51.6 percent to 58.0 percent and 59.1 percent. State-owned banks' performance was a drop of about 7.5 percentage points for the facilities.

Table 16: Distribution of Bank Deposits (IRR trillion)

	Outstanding Deposits			Growth			Share in Total		
	1391	1392	1393	1391	1392	1393	1391	1392	1393
Banking System	4138.9	5408.2	6309.1	17.7%	30.7%	16.7%	100%	100%	100%
Private Banks	2134.6	3134.2	3731.6	20.5%	46.8%	19.1%	51.6%	58.0%	59.1%
State Banks	2004.4	2273.9	2577.4	14.8%	13.4%	13.3%	48.4%	42.0%	40.9%
Commercial Banks	782.5	864	963.9	5.8%	10.4%	11.6%	18.9%	16.0%	15.3%
Specialized Banks	1221.9	1409.9	1613.5	21.5%	15.4%	14.4%	29.5%	26.1%	25.6%

For a more realistic and meaningful analysis of the more significant components of assets and liabilities of the banking system, one needs more detailed homogenous data for each category and a more realistic nomenclature approach. In fact, two sets of statistics are needed. At this stage the CBI has only been able to provide homogenous data for liquidity and base money.
Problematic assets of the banks, estimated at 15.0 percent in 1393, continued to be a major weak point of the system. This is an area where divergence from "admissible" ratios is so great that it matters little to investigate how far rollover loans replace the category of problematic loans. Most of this may be due to the previously administered interest rates that were set much below inflation rates and thus created an unrealistically high demand for bank credit.

3.2. Stock Market

In 1393 the Tehran Stock Exchange (TSE) experienced a rather difficult year. TSE's main index, TEPIX, lost 20.9 percent of its value, most of it in the last quarter of the year. This was mainly due to factors specific to TSE rather than a direct reflection of the overall economic situation. TSE's vulnerability arising out of its small size, its domination by a few large companies, the speculative tendencies of many participants in the market and TSE's hyper sensitivity to political developments have always overshadowed other considerations.

The negative trend began in 1392 and was triggered by the price increases of the natural gas feedstock to petrochemical companies which have the largest market capitalization. This price rise was due to the parliament's decision to take the matters in its own hand and quadruple the price of natural gas feedstock from about 3 cents to 13 cents. At the same time, as a result of the de-facto devaluation of the rial, companies claimed the rial price of their feedstock had been multiplied ten folds. This was true but overlooked the fact that as exporters, they also gained from the higher rial values of the foreign currency earnings. It has to be pointed out that for a number of years this sector benefited from unrealistically low price of gas and its increase should have been expected. This was followed by an exogenous factor, namely, the sharp fall of oil prices in the latter part of the year. There followed a general feeling of uncertainty in the petrochemical industry and the half measures adopted by the Government did not restore confidence.

The market has been very sensitive to the question of sanctions and the progress in the negotiations between Iran and the group of 5+1 to limit and eventually remove them. At times expectations and speculations in this regard dominated other factors in the market. In late 1393 (November 2014), the TSE experienced massive fluctuations as investors kept an eye on the final round of nuclear negotiations. With the announcement that the negotiations were extended for another 7 months, TEPIX fell dramatically.

Although some banks and financial intermediaries established a stabilization fund (Market Development Fund) to stabilize the TSE index, the recession continued. Overall, TEPIX fell by 44 percent since the last quarter of 1392. Average P/E of the market stood at 5.43 at the end of 1393 after the height of 7.1 in 1392. Trade values also decreased to IRR2.3 trillion. Market value of the capital market (TSE plus the unorganized market-OTC) declined by 24 percent and stood at IRR3,671 trillion by the end of 1393.

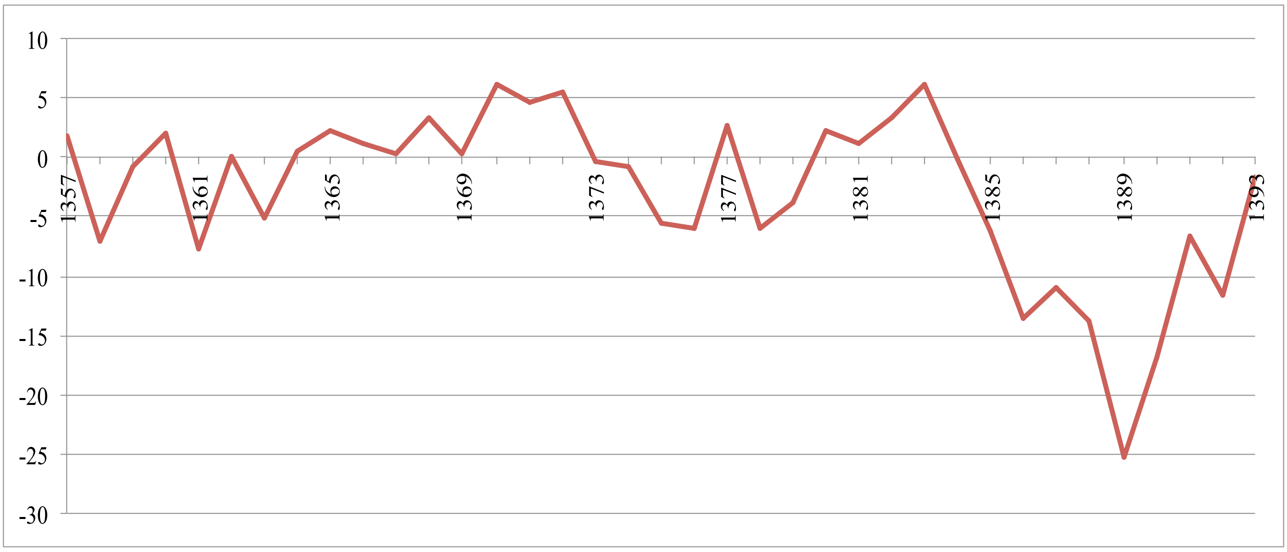
Meanwhile, the government increased its royalty on iron ore mining companies. As more than half of the weight of the Iranian market capitalization belongs to commodity based companies, the decline in global commodity prices was another blow to the market. At the end of 1393, financial statements of most of the listed companies showed considerable decrease in earnings compared to the projected ones. This led to further disincentive to invest in the market.

Among different sectors in the market in 1393, the leasing industry was the best performing sector in the market with 54 percent increase in its index. The transportation index was the second best performing industry and rose by 29 percent. The increase in the transportation index was because of the rise in Iranian shipping lines' (IRISL) stock price as its operations were almost stopped due to the sanctions and the lifting of the sanctions during the negotiations had a significant effect on its profitability. With the doubling of the production of auto makers, the auto sector index grew by 12 percent in 1393. The worst performing industries by importance (weight) were petrochemicals (-24 percent), oil products and refineries (-52 percent) and base metals (-28 percent).

4. Balance of Payments

In 1393 the balance of payments (BOP) surplus amounted to $8.6 billion. Nonetheless, it was 35 percent lower than in the previous year and the lowest in 4 years. Such a surplus was rather surprising because of two factors. The first was the crippling effects of the ever tightening international sanctions, particularly in the area of foreign transactions, which not only hindered the smooth working of foreign trade machinery and banking operations, but also put an embargo on most vital exports and most important import items. The second factor was the steep fall in oil prices. The principal idea behind the establishment of the Oil Stabilization Fund was setting up a mechanism to counter such an unexpected crisis, but in practice this objective was largely sacrificed by other consideration. This Fund was eventually replaced by the National Development Fund.
The current account surplus in 1393 was 40 percent less than in the year before, which was due to $6.6 billion fall in exports. The trade balance also fell because of the increase in imports. The services deficit at $7 billion was not exceptional. What was exceptional was the item "errors and omissions" of -$5.6 billion, up from -$1.7 billion the year before, but almost a quarter of its peak of $20.2 billion 3 years ago. This is usually attributed to the insufficiency of the statistics and so forth.
The most important unexpected factor responsible for the positive result of the BOP, both in quantitative as well as qualitative terms, was the improvement in the capital account from -$11.5 billion to -$1.7 billion, or an improvement of 86 percent, which indicates a positive net inflow of nearly $10 billion. This item has mostly been negative during the past decade and peaked at -$25.2 billion in 1389 which shows a total of some $60 billion. It is also an indication of the change in the economic climate and attitudes toward Iran's economy, both outside and inside the country.

Figure 8: Capital Account Balance, 1357-93 (USD billion)



Source: Based on statistics in "Selected Economic Indicators", CBI Website, 1389-93

Without this capital inflow, BOP balance would have been negative in 1993 and had to be financed at high costs. A BOP deficit, by definition, implies that it has been financed by some kind of external credit/borrowing. The implication therefore presents two unpleasant alternatives. One is to avoid deficit by cutting down on imports, which would reinforce inflationary forces. The other alternatives was, under the crippling banking sanctions, try borrowing at very unfavorable rates and conditions, which would further threaten the country's credibility and financial standing.
The next most important positive item was the increase in non-oil exports of $2.9 billion, which was due to efforts to substitute for oil exports. This item rose from $22.6 billion in 1389 to $31.1 billion in 1393, an average annual growth rate of 9 percent. According to the data released by the Customs, the value of non-oil exports, mainly petrochemicals and gas condensates, increased by 18.9 percent. The main destinations of these exports were China, Iraq, UAE and India. Meanwhile, imports rose by 5.6 percent, mainly consisting of wheat (4.4 percent), motor vehicles (3.8 percent), rice (2.7 percent), Corn (3.3 percent) and soya cake (2.4 percent). 77.3 percent of imports were sourced from Asia (mainly China) and 20.8 percent from Europe.

Table 17: Balance of Payments (USD million)

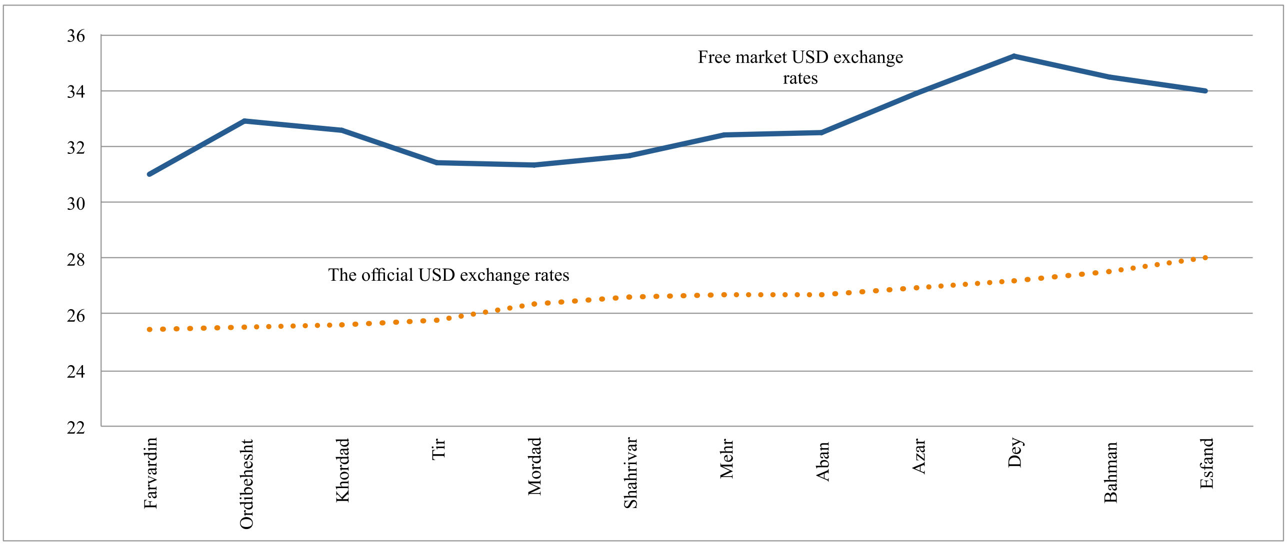
	1389	1390	1391	1392	1393	percentage change from 92 to 93
Current Account Balance	27,554	58,507	23,423	26,440	15,861	-40
Goods Account	37,330	67,779	28,559	31,970	21,392	-33
Exports (f.o.b.)	112,788	145,806	97,271	93,124	86,471	-7
Oil Export	90,191	119,148	68,058	64,882	55,352	-15
Non-oil exports	22,596	26,658	29,213	28,243	31,119	10
Imports (f.o.b.)	75,458	78,027	68,712	61,155	65,079	6
Gas and Oil Products	6,788	5,726	2,652	3,111	3,948	27
Other Goods	68,670	72,301	66,060	58,044	61,131	5
Services Account	-10,040	-9,771	-7,307	-7,137	-6,985	2
Income Account	79	93	1,661	1,066	943	-12
Current Transfers	185	406	510	541	511	-6
Capital and Financial Account Balance	-25,242	-16,875	-6,664	-11,547	-1,664	86
Errors and Omissions	-3,259	-20,195	-4,546	-1,703	-5,635	-231
Overall Balance	-947	21,436	12,213	13,189	8,561	-35

Source: Based on statistics in "Selected Economic Indicators", CBI Website, 1389-93

As the positive BOP trend bears witness, the domestic foreign exchange market was comparatively calm and its fluctuations within given limits mainly reflected expectations as to the result of the nuclear negotiations and oil prices. The CBI played an important role in adopting a generally calm attitude towards monetary policy. More specifically its declared policy of firm opposition to haphazard and speculative changes in foreign exchange (FX) rates, as was the case in recent past, turned up to have been quite effective.

While there was fear of semi-permanent pressure to increase FX rates in line with inflation and uncertain international relations, early progress in the negotiations led to the USD rate approaching and for a day or two falling below the psychologically important IRR30,000. CBI's declaration that it considered that USD rate as the lower limit had an almost immediate effect and seems still to be in force, notwithstanding the steep fall in oil prices. With the most recent expectations of a slow removal of the sanctions and better BOP situations, easier market conditions should prevail.

Figure 9: Fluctuations of the Rates



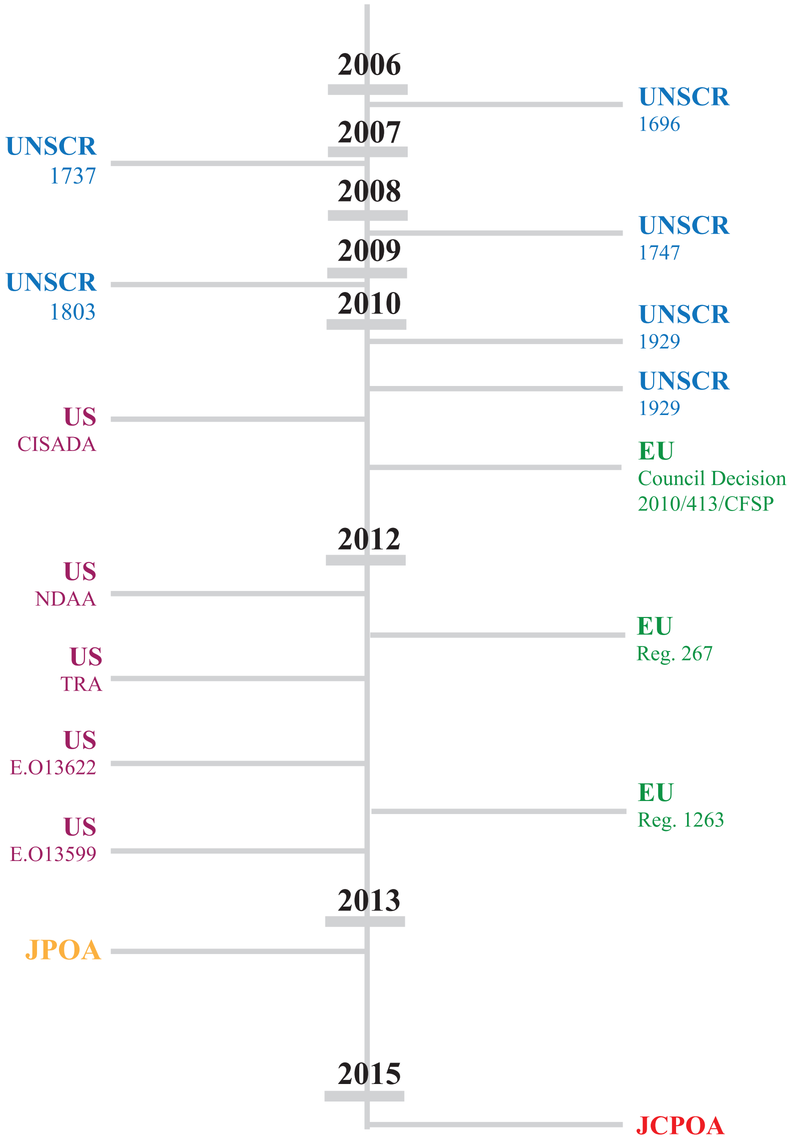
Source: Based on CBI data

5.1. International Sanctions against Iran

On November 24, 2013, a Joint Plan of Action (JPOA) was established between Iran and the five permanent members of the United Nations Security Council plus Germany (P5+1). Implementation of the JPOA started in January 2014, under which Iran agreed to scale back or freeze some of its nuclear activities during the negotiations in exchange for certain sanctions relief. Under JPOA, nearly $9 billion of Iran's frozen revenue abroad was released and processed by the CBI before the end of 1393 and, according to CBI officials, out of the total of $89.6 billion frozen revenue, $29 billion would be released immediately after the Implementation Day.

In 1393, many of the world's largest companies in oil and gas, petrochemical, mining and automotive industries declared interest in Iran in anticipation of a possible end to the sanctions and dispatched senior executives to meet Iranian officials in Tehran to discuss long-term investments in the country's major industries

Iran Nuclear Sanctions' Highlights



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