IRAN, ISLAMIC REPUBLIC

The Iranian economy strongly recovered in 2016, on the back of a significant rise in oil production and exports, following the removal of nuclear related international sanctions. However, unemployment remains high and non-oil sector activity remains subdued, as anticipated foreign investment flows have not materialized, in the absence of a full integration of the banking sector with the global banking system and continued uncertainties regarding full implementation of the JCPOA. Growth prospects in the medium term are modest.

Recent developments

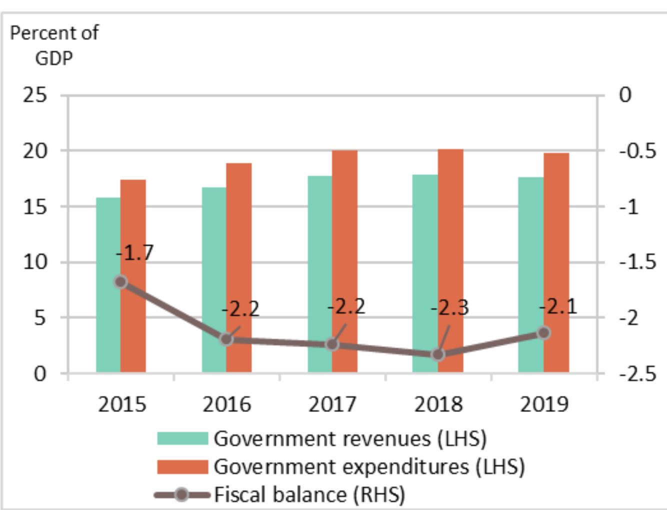
In 2016, the economy registered a strong oil-based bounce back, with an annual headline growth rate of 13.4 percent, compared to a contraction of 1.3 percent in 2015.[1] The largest contribution to growth was from the industry sector (at about 25 percent) as oil and gas production increased by a staggering 62 percent, mainly as a result of sanctions relief. Recovery in non-oil GDP however was limited at 3.3 percent, although this represents the highest growth rate in the last 5 years. Recent data suggests that growth in crude oil production in the first quarter of 2017 declined to 17 percent year over year. On the demand side, all components except investment registered improvements over the previous year. Investment continued to contract in 2016, albeit at a much lower rate of 3.7 percent (compared to 12 percent a year earlier). The reduction in investment was primarily driven by the continued contraction in the construction sector since 2012 following a boom in speculative demand for housing. Despite the growth in the non-oil sector, unemployment increased to 12.6 percent in Spring 2017 up from 12.4 percent six months earlier, which suggests a very limited employment generation capacity in the sectors spearheading growth. The CBI together with the Money and Credit Council have implemented measures to increase investment and non-oil growth. The average interbank interest rate was reduced by around 6 percent to 18.6 percent in 2016, although the declining trend in 2015 has ended. The fiscal deficit further widened to 2.2 percent of GDP in 2016, but the debt to GDP ratio fell to around 35 percent due to a higher GDP.[2] The current account surplus increased by more than 80 percent to reach around 4 percent of GDP, up from 2.3 percent in 2015, primarily as a result of increase in oil exports. However, non-oil merchandise exports declined by 9 percent in 2016 and recent data for the first four months of the new fiscal year indicates a negative growth in non-oil exports (-10 percent year over year).

The universal cash transfer program appears to have more than compensated for the likely increase in energy expenditures of less-well-off households, thus contributing to positive consumption growth of the bottom 40 percent of the population, with overall consumption growth between 2009 and 2013 being negative. Poverty increased in 2014 to 10.5 percent though and this may be associated with a declining social assistance in real terms.

Outlook

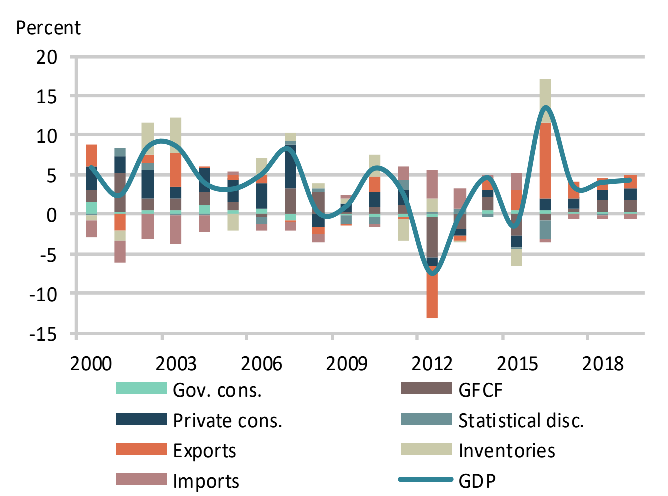
In the medium term, the economy is expected to undergo a significant moderation in growth as spare capacity in the oil sector is utilized. Growth in 2018-19 is expected to be slightly stronger than 2017 as investment growth turns positive and accelerates along with more political and economic stability, following the re-election of President Rouhani for a second

FIGURE 1 Islamic Republic of Iran / Fiscal outlook



Sources: Iranian authorities and World Bank staff calculations.

FIGURE 2 Islamic Republic of Iran / GDP growth decomposition



Sources: Iranian authorities and World Bank staff calculations.

4-year term in May 2017. With some indications of inflationary pressures due to the closing output gap as well as exogenous commodity price shocks, headline CPI inflation is expected to remain high but below 12 percent in the next three years especially considering the high unemployment rate and absence of demand pull factors. The Central Bank of Iran (CBI) is expected to use activist monetary policy, especially in reducing deposit rates to redirect credit towards the productive sectors and increase non-oil growth. The CBI remains committed to implementing the unification of the official and market exchange rates, although this may be further delayed from the revised target date of end 2017. The overvalued real exchange rate may put pressure on the monetary authorities to allow the rial to depreciate to promote export competitiveness and reduce pressure on foreign currency reserves. Falling real value of cash transfers may continue to have negative impact on poverty, while moderate economic growth and planned improved targeting of benefits may contribute to lower poverty after 2016.

Risks and challenges

The main risk to the economy is the political uncertainty around the continued implementation of the nuclear agreement, in the wake of new non-nuclear sanctions introduced by the US. This increases risk perceptions of the country and deters further improvement in foreign investment in the oil and non-oil sectors. At the same time, the delays in the banking sector reintegration with global banking combined with the challenge of fully implementing banking sector reforms create further risks for the medium term. Although the CBI has succeeded in reining in shadow banking operations considerably, the issue of high deposit rates, banks' frozen assets and non-preforming loans are yet to be adequately addressed and are major interrelated challenges facing the economy in the foreseeable future. On the fiscal side, the Ministry of Finance's attempts in determining the real levels of government debt and securitization of arrears highlights the need for a more comprehensive debt management framework complemented by prudent fiscal policy. The future prospects of the economy will also be conditional on the implementation of a wider range of structural reforms including improving the business environment, productivity, labor market flexibility, and further diversification of exports. Such reforms would also facilitate investment (both domestic and foreign) in order to achieve a more resilient medium-term growth performance.

1. The CBI has published a new base year (2011) national accounts series. This has resulted in some revisions to growth rates from the previous version of this report. The old series had reported growth rates of 5.4 and 9.2 percent for Q1 and Q2 2016 whereas the new series corresponds to 7.5 and 12.9 percent growth for those two periods.

2. IMF Article 4 (2017).

TABLE 2 Islamic Republic of Iran / Macro outlook indicators (annual percent change unless indicated otherwise)

	2014	2015	2016 e	2017 f	2018 f	2019 f
Real GDP growth, at constant market prices	4.6	-1.3	13.4	3.6	4.0	4.3
Private Consumption	2.0	-3.5	3.8	3.4	3.5	3.8
Government Consumption	4.2	4.8	3.7	3.8	3.0	2.9
Gross Fixed Capital Investment	7.8	-12.0	-3.7	1.7	8.4	9.2
Exports, Goods and Services	7.2	12.1	41.3	7.1	5.3	5.1
Imports, Goods and Services	-4.5	-20.2	6.1	6.0	7.0	6.6
Real GDP growth, at constant factor prices	3.2	-1.6	12.5	3.5	3.9	4.1
Agriculture	5.4	4.6	4.2	4.0	4.1	4.1
Industry	5.1	-1.4	24.7	4.6	4.7	4.8
Services	1.4	-2.5	3.7	2.3	3.0	3.4
Inflation (Consumer Price Index)	15.6	11.9	9.0	11.5	10.9	10.6
Current Account Balance (% of GDP)	3.1	2.3	3.9	4.1	4.0	3.8
Fiscal Balance (% of GDP)	-1.1	-1.7	-2.2	-2.2	-2.3	-2.1
Debt (% of GDP)	11.5	41.2	34.7	30.4	29.2	28.0
Primary Balance (% of GDP)	-1.1	-1.6	-2.1	-2.1	-0.9	-0.7

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: e = estimate, f = forecast.