IRAN, ISLAMIC REPUBLIC

The Iranian economy experienced a strong recovery in 2016 as a result of sanctions relief, following a 1.8 percent contraction in 2015. However, growth prospects in the medium term are expected to be modest due to near capacity oil production and weak non-oil sector activity. The latter will not pick up unless FDI recovers, the economy reconnects with the international banking system, and more progress is made in implementing domestic reforms. Unemployment has ratcheted up and inflationary pressures have started to increase.

Recent developments

GDP growth in the first half of the Iranian calendar year (ending on March 20), reached 7.4 percent yoy. The boost in growth was largely a result of the oil sector's bounce back, both in production and exports, following the removal of sanctions in January 2016 through the JCPOA. However, economic activity seems muted in non-oil sectors (0.9 percent yoy growth in the first half of 2016) as the delay in the Iranian banking sectors' integration with the global banking system continued to impede FDI and trade. Gross capital formation continued to contract in the first half of 2016, raising concerns for the medium-term outlook. Higher frequency economic activity data suggest some signs of growth in the non-oil sectors, albeit not widespread. Contraction in the construction sector slowed down as private investment in new construction projects grew rapidly after five consecutive quarters of decline.

Inflation appears to be stabilizing at around 10 percent after a declining trend over the past three years. This signals that the output gap is closing. The CBI has actively pursued tight controls on keeping the nominal exchange rate stable and resisted depreciation primarily relying on oil-based foreign exchange reserves. As a result, the real exchange rate has appreciated, which undermines the competitiveness of non-oil exports. By allowing a higher number of transactions to take place at the market rate, the government managed to reduce the gap between the official and market exchange rates from 112 percent in 2012 to 14 percent in September 2016 – which more recently increased to 20 percent in December. Yet, the planned unification of the two rates is delayed to next fiscal year.

The unemployment rate increased significantly to 12.7 percent in the second quarter of 2016 and remains particularly high among women and youth.

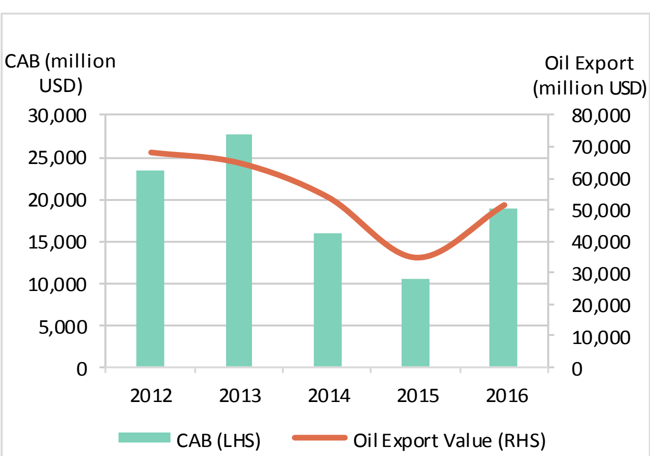
The current account surplus improved in 2016 to around 6.5 percent of GDP due to significantly higher exports to Iran's main trading partners such as the EU as a result of the removal of economic sanctions and a pick-up in oil shipments to Europe.

The fiscal deficit improved slightly to 1.5 percent of GDP in 2016, from 1.9 percent in 2015, even as oil revenues remained suppressed during the early part of the year. Government debt increased to 2 percent of GDP in 2016.

Outlook

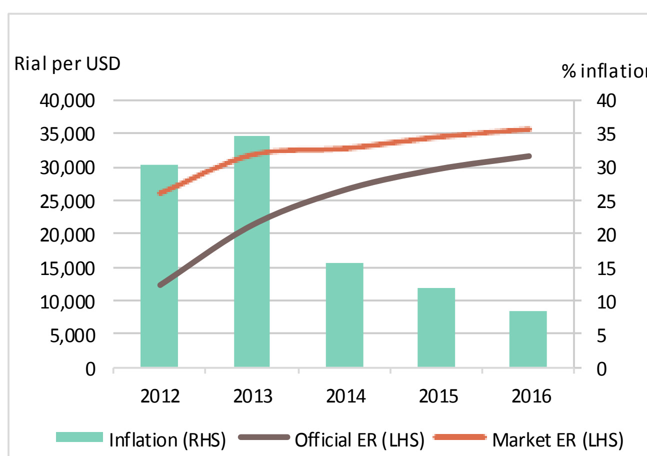
In the medium term, with some recovery in investment growth, Iran's economy is expected to experience moderate growth rates, at slightly over 4 percent. The contribution of exports will diminish, as spare capacity in the oil sector is utilized and the increase in oil production decelerates. On the production side, the revival of non-oil

FIGURE 1 Islamic Republic of Iran / Current account balance and oil exports



Sources: World Bank data and calculations, CBI and IMF.

FIGURE 2 Islamic Republic of Iran / Exchange rates (Rial per USD) and CPI inflation



Sources: World Bank calculations and CBI data.

industrial production is expected to be the main contributor to overall growth; agriculture and service sectors are projected to grow by around 4 and 3 percent, respectively. The gradual change in the composition of growth could also help increase employment due to higher job elasticity in these sectors.

While fiscal balances in the last few years suffered from low oil revenues, in the medium term spending pressures will dominate, given the expected rise in interest payments from securitization of government arears and the continued pressures from the pension system. Improved tax collection and prudent management of spending will help achieve a budget surplus in 2018-19.

Risks and challenges

The major risk in the near future is the political uncertainty around the full implementation of JCPOA. In addition, the Iranian presidential elections are scheduled for May 2017. These are likely to continue influencing consumer/investor confidence and may lead to a further weakening in private consumption and investment. Under this scenario, GDP growth will remain below 3 percent. Furthermore, lower than projected oil prices will put pressure on government revenues and undermine growth.

Going forward, the main challenge still facing the economy is channeling the 'oil boom' in a direction that will benefit the broader population. This would require not only tackling the structural reform agenda that will boost non-oil sector growth, connecting the Iranian banking sector with the rest of the world, and improved trade linkages, but also and most importantly, facilitating much needed job creation especially for the country's young and highly educated population.

TABLE 1 Islamic Republic of Iran / Macro outlook indicators (annual percent change unless indicated otherwise)

	2014	2015	2016 f	2017 f	2018 f	2019 f
Real GDP growth, at constant market prices	4.3	-1.8	6.4	4.0	4.1	4.2
Private Consumption	3.1	0.8	2.0	3.4	3.8	3.7
Government Consumption	2.7	-8.3	1.7	2.4	2.8	2.5
Gross Fixed Capital Investment	3.5	-9.8	-7.3	5.8	6.9	7.1
Exports, Goods and Services	12.0	7.1	35.0	7.0	5.0	4.8
Imports, Goods and Services	-5.7	-5.2	6.4	7.1	5.8	4.3
Real GDP growth, at constant factor prices	3.0	-1.8	6.4	4.0	4.1	4.2
Agriculture	3.8	3.9	4.6	4.2	4.1	4.1
Industry	4.9	4.2	8.1	6.8	5.9	5.8
Services	1.7	-6.3	5.4	1.9	2.7	3.0
Inflation (Consumer Price Index)	15.6	11.9	8.4	10.9	10.2	9.6
Current Account Balance (% of GDP)	3.8	2.7	6.5	6.5	5.5	4.6
Fiscal Balance (% of GDP)	-1.2	-1.9	-1.5	-0.6	0.2	1.1
Debt (% of GDP)	1.3	1.1	2.0	2.5	2.2	1.0
Primary Balance (% of GDP)	-1.1	-1.8	-1.4	-0.5	0.3	1.2

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice.
Note: f = forecast.