FOR AGENDA

SM/03/270
Supplement 1

August 21, 2003

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Islamic Republic of Iran—Staff Report for the 2003 Article IV Consultation—Draft Public Information Notice**

Attached for consideration by the Executive Directors is the draft public information notice for the staff report for the 2003 Article IV consultation with the Islamic Republic of Iran (SM/03/270, 8/4/03), which is tentatively scheduled for discussion on **Monday, August 25, 2003**. At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of the Islamic Republic of Iran indicating whether or not they consent to the Fund's publication of this paper; such communication may be received after the authorities have had an opportunity to read the paper.

Questions may be referred to Mr. Jbili (ext. 36973) and Mr. Kramarenko (ext. 34357) in MED.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the Islamic Development Bank, following its consideration by the Executive Board.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (1)

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Department Heads

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No.
FOR IMMEDIATE RELEASE

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2003 Article IV Consultation with the Islamic Republic of Iran

On August 25, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Islamic Republic of Iran.[1]

Background
During the first three years of the Third Five-Year Development Plan (TFYDP) (2000/01–2002/03), real GDP grew by 5.8 percent on average, despite declines in oil output during the past two years. The overall macroeconomic situation improved significantly compared to the previous five-year development plan: the external current account was in surplus, the external debt was reduced to a very low level, international reserves increased significantly, and fiscal savings were accumulated in the Oil Stabilization Fund (OSF). This performance has taken place against the background of increased openness of the economy to international trade and investment, and increased economic reforms, but also benefited from sustained high oil prices and fiscal stimulus.

Notwithstanding these achievements, the Iranian economy continues to face important challenges: employment creation has not been sufficient to meet the rapid increase in the labor force; inflation is high and rising again; price subsidies and controls continue to

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the August 25, 2003 Executive Board discussion based on the staff report.

hinder economic efficiency; and structural impediments for private sector development remain.

Growth was high and broad-based in 2002/03 (fiscal year ending March 20). Real GDP is estimated to have grown at 6.8 percent, with non-oil GDP expanding by 7.9 percent, reflecting a positive impact of economic reforms and favorable exogenous shocks, including good weather conditions and a higher oil price. Unemployment declined somewhat, but remained high at 15.7 percent.

Domestic demand continued to grow at rapid rates in 2002/03, despite corrective fiscal and monetary policy measures. As a result, Consumer Price Index (CPI) inflation accelerated to 15.8 percent from 11.4 percent in 2001/02, and the current account surplus narrowed to 3 percent of GDP despite higher oil prices. Moreover, equity and real estate prices continued to increase rapidly not only in response to economic liberalization measures, but also because of the high growth of money and credit, and a relatively stable exchange rate. Nonetheless, gross official reserves increased to the equivalent of seven months of next year's projected imports, and fiscal savings in the OSF increased by about $500 million.

The overall fiscal balance is estimated to have shifted to a deficit of about 2.3 percent of GDP in 2002/03, compared to a surplus of 1.8 percent of GDP in 2001/02. This deterioration mainly reflects the budgetary cost of the exchange rate unification and rapid growth of capital expenditures. In the meantime, the non-oil deficit is estimated to have widened sharply by 5.4 percentage points to 19.3 percent of GDP, notwithstanding expenditure cuts (amounting to 1.6 percent of GDP).

Monetary policy was accommodating in 2002/03. Although the central bank issued additional central bank participation papers to reduce excess liquidity, it could not independently adjust the rates of return, which in fact were reduced for retail lending. The central bank accommodated the higher credit demand by increasing significantly its claims on banks and nonfinancial public enterprises. This, together with unsterilized purchases of foreign exchange from the government and higher money multiplier, led to the acceleration of M2 growth to 30 percent while credit to the private sector grew by 35 percent. Banking system prudential indicators deteriorated somewhat and state-owned banks remained under capitalized and non-profitable in part due to controls on rates of return and high operating costs.

The twelve-month real effective exchange rate index depreciated by about 4 percent by end-April 2003. Under the managed floating exchange rate regime, the central bank has not committed to or publicly announced a specific exchange rate target, but has aimed to smooth out fluctuations in the exchange rate against an undisclosed basket of currencies.

Progress in structural reforms was uneven across the reform areas. While trade and financial sector reforms advanced and foreign direct investment regulations were liberalized, there was less progress in improving the business environment, reducing labor market rigidities, reforming subsidies, and restructuring and privatizing public enterprises.

Real GDP is projected to grow at 6.5 percent in 2003/04, but the risk of inflation acceleration remains. The fiscal policy stance based on the current budget could exacerbate demand pressures, and lead to high liquidity growth and inflation acceleration. To address these risks, the authorities have approved a range of monetary policy measures and are considering revenue and expenditure measures to reduce the fiscal deficit with the ultimate objective limiting inflation to 18 percent at most.

Executive Board Assessment

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Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Islamic Republic of Iran: Selected Economic Indicators

	1999/2000	2000/2001	2001/2002	2002/2003
Real GDP growth (factor cost, percentage change)	1.7	5.1	5.4	6.8
CPI inflation (period average, percentage change)	20.1	12.6	11.4	15.8
Central government balance (percent of GDP)	-0.6	8.7	1.8	-2.3
Broad money growth (percentage change)	20.2	30.5	25.8	30.1
Current account balance (percent of GDP)	6.3	13.1	5.3	3.0
Overall external balance (percent of GDP)	2.0	6.8	4.2	4.4
Gross international reserves (billions of U. S. dollars)	5.6	12.2	16.9	21.8
Public and publicly guaranteed external debt (billions of U. S. dollars)	10.8	8.0	7.2	9.2
Exchange rate (period average, Rials per U. S. dollar)	7,908	8,078	7,921	7,967

Sources: Iranian authorities, and IMF staff estimates.