IRAN, ISLAMIC REPUBLIC

Table 1	2018
Population, million	82.0
GDP, current US$ billion	495.1
GDP per capita, current US$	6037
Upper middle-income poverty rate ($5.5)[a]	11.6
Gini index[a]	40.0
School enrollment, primary (% gross)[b]	108.0
Life expectancy at birth, years[b]	76.2

Source: WDI, Macro Poverty Outlook, and official data.
Notes:
(a) Most recent value (2016), 2011 PPPs.
(b) Most recent WDI value (2017).

Iran's economy is expected to undergo a second consecutive year of recession, contracting by 8.7 percent in 2019/20. Inflation is estimated to reach 38 percent annually while fiscal pressures have mounted further. Economic activity is expected to remain subdued in the medium term.

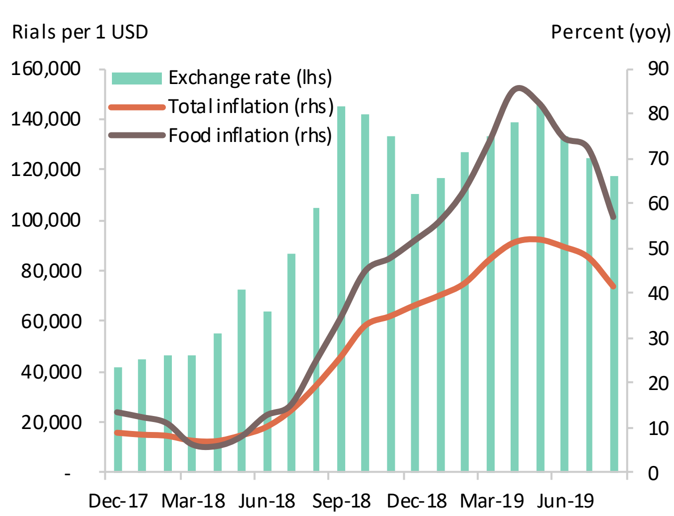
Recent developments

Iran's economy is expected to contract further by 8.7 percent in 2019/20 due to external shocks to oil and gas sector output. The plummeting exports comes after the expiration of US waivers to major importers of Iranian oil and tightening of banking sector restrictions in addition to new sanctions being imposed on the country's petrochemicals, metals, mining, and maritime sectors. The expected deterioration in economic growth would mean that by the end of 2019/20 the economy would be 90 percent of its previous size compared to just two years earlier.

The oil sector decline coupled with international trade and capital flow restrictions have negatively influenced economic activity in key non-oil sectors, including auto, machinery and construction sectors which have faced supply chain challenges and higher operational costs. In August 2019, the housing sector registered the lowest volume of sales in six years while prices rose by around 78 percent year over year (yoy). On the supply side, these developments among other shocks such as recent floods and earthquakes, are likely to result to further stagnation in the services sector, the largest production component of GDP (56 percent share in 2017/18). Similarly, the GDP expenditure components are to be strongly influenced by the shock to exports. However, the simultaneous reduction in imports is expected to moderate part of the downward pressure on the trade balance and the current account. Real government consumption is also expected to contract at a faster rate of 5.4 percent compared to the previous round of oil export embargos placed on Iran in 2012-13. The fiscal deficit is estimated to further widen to around 5.6 percent of GDP in 2019/20 as more than 30 percent (and as high as 63 percent in 2002/03) of the government budget is sourced directly from the sales of oil and gas. The reduction in the tax base due to lower economic activity would also have a negative effect on current revenues and is likely to come at the expense of lower capital expenditures which have been under-realized relative to the budget approved levels in the recent years.

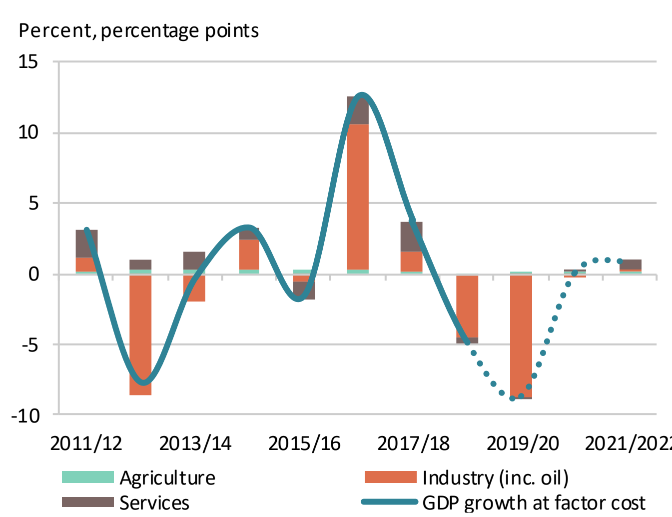
Consumer price inflation peaked at 52 percent, yoy, in May 2019 due to heightened economic uncertainty, inflationary expectations and strong depreciation of the rial in the preceding 12 months. Inflation has been especially high for food items (e.g., 116 percent, yoy, for meat products in April) and disproportionately affected the rural population (e.g., in August 2019, 46 percent, yoy, in rural areas vs. 41 percent, yoy, in urban areas). By August 2019, the rial recovered around 40 percent of its open market value against the dollar compared to its historical low in September 2018. The relative stabilization of the rial in tandem with the passing of the shock effects from a year earlier has contributed to a slight easing of the inflation rate (42 percent, yoy, in August 2019). Unemployment remains high at almost 11 percent while labor force participation rate slightly declined (yoy) to 40.6 percent in June quarter 2019 reflecting the labor

FIGURE 1 Islamic Republic of Iran / Exchange rate and inflation



Sources: SCI and local media.

FIGURE 2 Islamic Republic of Iran / GDP growth and supply side components



Sources: CBI, SCI and World Bank staff estimations.

market implication of the stagnant economy. The gender gap in the labor market, especially in participation rate and employment figures, remains high.

Poverty in Iran, measured at the World Bank's upper middle-income threshold of US$5.5 per day (2011 PPP), started to rise moderately between 2013 and 2016 from 8.1 to 11.6 percent. This negative trend in wellbeing was associated with the erosion of cash transfers in real terms. Universal cash transfers were the main driver of poverty reduction during 2009-2012, but due to inflation, the real value of benefits has diminished since.

Outlook

The medium-term economic outlook remains challenging. The baseline assumption for the medium-term rests on continued oil exports of around 500 thousand barrels per day on average in 2019/20 and the following years. In the course of the next two years (2020/21 to 2021/22) the economy is expected to grow at 0.5 percent annually, from a considerably smaller base. Inflationary pressures are expected to moderate but annual inflation is expected to remain above 20 percent which is considerably higher than the country's single digit inflation during 2016-17 and relative to other countries in the region.

In the coming years, the effect of the recent large exchange rate depreciation could allow the country's goods and services to become more competitive regionally and help close the expected current account deficit gradually.

The fiscal deficit is projected to further widen in the next two years due to the legacy of the 2018-19 oil shock pushing government expenditures such as social protection measures upwards at the same time as receiving lower oil income and tax revenues.

Political and economic uncertainty makes it difficult to project future poverty trends. However, a sharp decline in real GDP per capita and double-digit inflation are expected to have a strong negative impact on poverty rates through different channels, including the labor market, increasing costs of living and a further erosion of the real value of cash transfers. Future poverty rates will also depend on the government's public policy response. Any increases in the value of cash transfers, possibly along with introducing targeting mechanisms, could help the poor and vulnerable population cope with the social-economic shocks, but fiscal constraints may limit the scope for significant response.

Risks and challenges

The nature of uncertainties facing the economy means that downward risks to the projected growth path remain in place. If oil exports were to be curtailed further, the economy could enter into a deeper recession and experience higher inflation rates. The challenge of protecting the vulnerable households would put additional pressure on the government finances and potentially the value of rial. Further restrictions on existing trade volumes and financial transaction arrangements with Iran's neighbors could also pose as a major risk to the current projections. If remained unaddressed, the ongoing liquidity and recapitalization challenges of the banking sector could further undermine banks' ability to continue facilitating economic activity.

These important challenges highlight the crucial role of further economic diversification by focusing on non-oil sources of growth and government revenues. Building on the existing economic base in the non-oil traded sector would improve resilience to external shocks and achieve a long-envisioned development plan goal that has been elusive to Iran and other countries in the region.

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

	2016/17	2017/18	2018/19 e	2019/20 e	2020/21 f	2021/22 f
Real GDP growth, at constant market prices	13.4	3.8	-4.9	-8.7	0.1	1.0
Private Consumption	3.8	2.5	-2.2	-2.0	-0.3	0.5
Government Consumption	3.7	3.9	-1.3	-5.4	-2.1	1.7
Gross Fixed Capital Investment	-3.7	1.4	-5.9	-0.1	1.0	1.3
Exports, Goods and Services	41.3	1.8	-13.5	-28.7	1.6	2.0
Imports, Goods and Services	6.1	13.4	-38.3	-21.1	1.3	4.3
Real GDP growth, at constant factor prices	12.5	3.7	-4.9	-8.7	0.1	1.0
Agriculture	4.2	3.2	-1.5	1.0	1.0	1.5
Industry	24.7	3.0	-9.6	-19.8	-0.7	0.4
Services	3.7	4.5	-0.8	-0.2	0.5	1.2
Inflation (Consumer Price Index)	9.0	9.6	29.9	38.3	29.0	22.7
Current Account Balance (% of GDP)	3.9	3.5	0.1	-0.6	-0.5	-0.3
Fiscal Balance (% of GDP)	-1.9	-1.8	-5.4	-5.6	-5.9	-6.0
Gross Public Debt (% of GDP)	49.0	38.2	40.2	49.3	50.4	51.3
Primary Balance (% of GDP)	-1.8	-1.6	-5.1	-5.0	-4.1	-4.2

Source: World Bank, Poverty & Equity and Macroeconomics, Trade & Investment Global Practices.
Notes: e = estimate, f = forecast.