IRAN, ISLAMIC REPUBLIC

Table 1	2019
Population, million	82.8
GDP, current US$ billion	440.4
GDP per capita, current US$	5318.0
Upper middle-income poverty rate ($5.5)[a]	12.9
Gini index[a]	40.8
School enrollment, primary (% gross)[b]	110.7
Life expectancy at birth, years[b]	76.5

Source: WDI, Macro Poverty Outlook, and official data.
Notes:
(a) Most recent value (2017), 2011 PPPs.
(b) WDI for School enrollment (2017); Life expectancy (2018).

The COVID-19 pandemic has amplified the impact of economic sanctions and existing structural imbalances in Iran's economy. The decline in revenues led the government to issue new debt and sell assets on the stock market, increasing financial risk exposures. A sharp exchange rate depreciation has accelerated inflation, with negative consequences for the livelihoods of vulnerable households. The growth outlook remains subdued due to trade restrictions and the ongoing global pandemic.

Key conditions and challenges

Iran's economy has stagnated over the last decade, a legacy of sanctions and dependence on the volatile oil sector. Since 2010/11[1], GDP grew at an annualized rate of -0.1 percent and key opportunities such as peak oil prices were missed. Economic activity was highly volatile as the country underwent various economic sanctions and oil price cycles. High economic volatility led to a less favorable investment climate and heightened inflationary expectations. While the economic base is relatively diversified, non-oil sector growth has remained slow. COVID-19 amplified existing structural challenges but limited integration of Iran's economy with the rest of the world reduces exposure to external shocks. Abundant human capital and natural resources present opportunities for growth.

Fiscal policy has been procyclical and large public sector presence has overshadowed private sector's role in job creation. The oil export decline increased pressures on government revenues but progress in tax effort and debt issuance have helped contain the deficit and meet financing needs, respectively. Increasing reliance on bond issuance and asset sales in the equity market has increased financial risk exposures. High subsidy expenditures and large wage bill has inhibited counter-cyclical fiscal policy and the marginalization of the private sector has led to inadequate job creation. Poverty mitigation measures including cash transfers helped partly contain pressures on the poor.

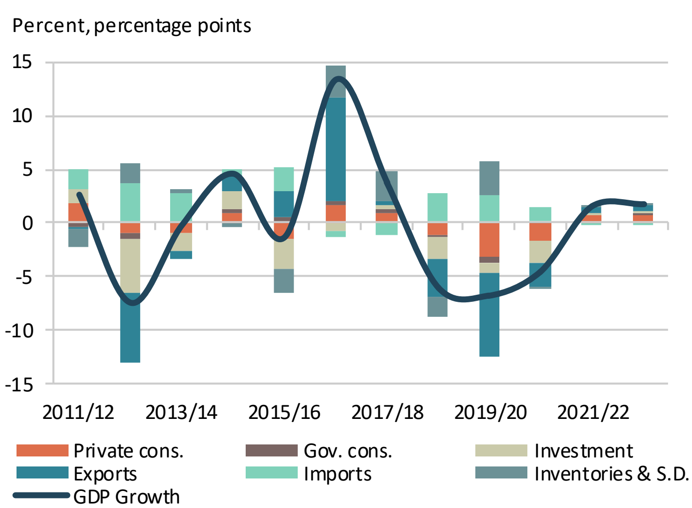
Recent developments

Iran's economy is undergoing a third consecutive year of recession due to US sanctions and the COVID-19 crisis. Iran's real GDP contracted by 6.8 percent in 2019/20 after sanctions led oil GDP to fall by 38.7 percent. Despite the expansion of sanctions to other key sectors, non-oil GDP grew by 1.1 percent as exchange rate (ER) depreciation made production more competitive. The GDP decline continued in Q1 2020/21 as COVID-19 containment measures contributed to GDP contracting by 3.5 percent (YoY); a modest contraction compared to most other countries. This smaller impact is partly due to the already lower economic base and limited integration with the rest of the world following decades of sanctions.

Inflationary pressures were high in 2019/20 and resurged in the first five months of 2020/21 as the rial depreciated. Inflation increased by 10 pp to 41.2 percent in 2019/20 due to inflationary expectations and higher cost push factors including higher trade costs and a sharp ER depreciation (45.7 percent). Inflation was led by food and housing rent, disproportionately impacting low-income deciles. In

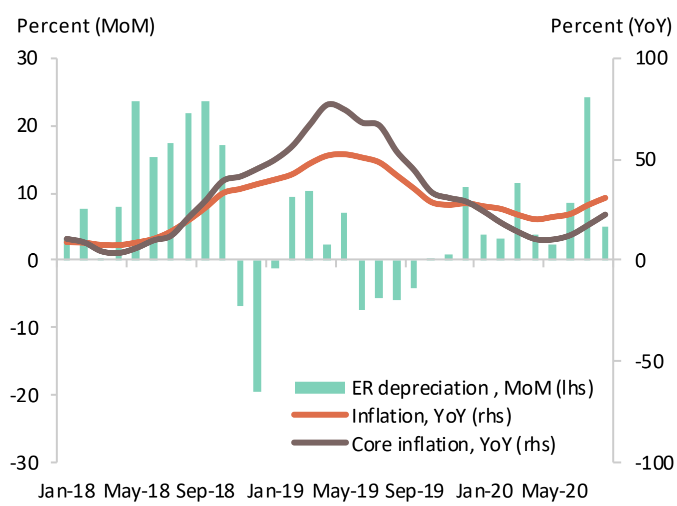
1/ The Iranian calendar year starts on March 21 of every year and ends on March 20 of the following year.

FIGURE 1 Islamic Republic of Iran / Real GDP growth and contributions to real GDP growth (demand side)



Sources: CBI, SCI and World Bank staff calculations.

FIGURE 2 Islamic Republic of Iran / Inflation and parallel market ER



Sources: CBI, SCI and World Bank staff calculations.

tandem with the ER trend, inflation jumped to 6.4 percent (MoM) in July 2020 (21 month high).

Rapid decline in exports led to a deterioration of external balances. The current account surplus declined to 0.9 percent of GDP in 2019/20 as real net exports contracted by 26.9 percent. Oil exports fell below 0.7 mbpd in 2019 after US sanction waivers for imports of Iran's oil ended in April 2019. Import contraction was large due to rationing of foreign exchange reserves and secondary US sanctions. Non-oil trade contracted by 31 percent (YoY, nominal) in Apr-Aug 2020 due to COVID-19 and the authorities' widening the import ban list.

The government resorted to bond issuance and sales of assets to compensate for oil revenue decline and lower tax base. The fiscal deficit to GDP ratio deteriorated in 2019/20 as oil revenues fell to 2.2 percent of GDP. Current expenditures grew faster due to wage bill and transfer growth. Bond issuance jumped to 6.9 percent of GDP following budget law amendments. In 2020/21, the government began selling shares in SOEs via the stock market and held additional bond auctions.

The worsening economic situation led to a deterioration of participation and employment rates. Employment had increased by 1.8 percent to reach 24.3 million people employed in 2019/20 but fell by 1.5 million (YoY) in Q1 2020/21 following COVID-19. Labor force participation declined by 0.4 pp in 2019/20 to 44.1 percent and in Q1 2020/21 the labor force shrank by 1.3 million (YoY). The unemployment rate in 2019/20 and Q1 2020/21 fell to 10.7 percent and 9.8 percent, respectively.

Poverty at the World Bank's upper middle-income threshold of US$5.5 per day (2011 PPP) was 12.9 percent in 2017/18, a moderate increase since 2013/14.

Outlook

Iran's economic outlook is impacted by the COVID-19 crisis and continuation of sanctions. Iran's GDP in 2020/21 is now estimated to contract at 4.5 percent due to a shorter lockdown period. Overall economic contraction is projected to increase in the second half of 2020/21 with a resurgence of cases in the colder season. In the absence of a widely adopted vaccine, recovery in 2021-2022 is projected to be weak and driven by the non-oil sector.

Fiscal pressures are projected to increase due to higher bond issuance and as COVID-19 costs increase in 2020/21. Government revenues are projected to reach a trough in 2020/21 before improving with moderate economic recovery. Inflationary pressures are expected to remain high due to economic uncertainties and ER pressures.

The COVID-19 outbreak will impact households through reduced incomes and high inflation. The fall in labor market incomes is estimated to increase poverty in the short-term by 7 pp, with worse outcomes for those working self-employed and in services. Government cash transfers help partly compensate for the shock, but their impact is hindered by high inflation eroding their value in real terms. Fiscal constraints may limit the scope for a wider response, but better targeting of cash transfers can help reduce mitigation costs.

Risks to Iran's economic outlook relate to the evolution of COVID-19 and geopolitical developments. The economic outlook is subject to significant risks if a large resurgence of COVID-19 cases forces stringent lockdown measures or a reliable vaccine is not distributed in 2021. Higher government debt issuance and stock market sales of assets increase financial risks and could place additional stress on the undercapitalized banking sector. External balances could worsen with further trade restrictions or if demand in other export partners remains weak. The lifting of US sanctions would have a large positive economic impact, similar to JCPOA implementation in 2016. With the economy operating below potential output, recovery in the outer years could be stronger.

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

	2017/18	2018/19	2019/20	2020/21 e	2021/22 f	2022/23 f
Real GDP growth, at constant market prices	3.8	-6.0	-6.8	-4.5	1.5	1.7
Private Consumption	2.5	-2.6	-7.7	-4.0	1.7	2.0
Government Consumption	3.9	-2.9	-6.0	1.2	0.5	0.7
Gross Fixed Capital Investment	1.4	-12.3	-5.9	-13.8	1.9	2.0
Exports, Goods and Services	1.8	-12.5	-29.9	-10.9	2.6	2.9
Imports, Goods and Services	13.4	-29.5	-38.1	-30.8	1.0	2.0
Real GDP growth, at constant factor prices	3.7	-5.4	-6.5	-4.5	1.5	1.7
Agriculture	3.2	-0.9	8.8	0.5	1.0	2.0
Industry	3.0	-11.0	-15.9	-5.5	2.2	2.2
Services	4.5	-0.7	-0.5	-4.6	1.1	1.3
Inflation (Consumer Price Index)	9.7	31.2	41.2	34.1	27.4	23.0
Current Account Balance (% of GDP)	3.5	5.9	0.9	-0.6	0.5	0.7
Fiscal Balance (% of GDP)	-1.8	-1.6	-3.7	-6.6	-6.7	-6.9
Gross Public Debt (% of GDP)	36.1	41.8	42.9	45.6	47.5	49.6
Primary Balance (% of GDP)	-1.6	-1.3	-3.0	-5.5	-5.3	-5.2

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