

IRAN, ISLAMIC REPUBLIC

Key conditions and challenges

| Table 1 | 2021 |
|---|--------|
| Population, million | 85.0 |
| GDP, current US\$ billion | 249.7 |
| GDP per capita, current US\$ | 2936.3 |
| School enrollment, primary (% gross) ^a | 110.7 |
| Life expectancy at birth, years ^a | 76.7 |
| Total GHG Emissions (mtCO ₂ e) | 819.9 |

Source: WDI, Macro Poverty Outlook, and official data.
a/ Most recent WDI value (2019).

Iran's economy continues its gradual recovery that started in mid-2020, driven by the oil sector and services. However, water and energy shortages led to contraction of the agriculture and industry sectors. Only a third of the pandemic period jobs losses have so far been recovered. Oil revenue shortfalls led to a growing budget deficit, adding to inflationary pressures through the government's deficit financing operations. Growth is forecast to remain modest with both upside and downside risks associated with oil market dynamics, geopolitical tensions, the pandemic, and climate change.

Iran's economy is slowly emerging from a decade-long stagnation bogged by two rounds of economic sanctions, marked oil price cyclicality, and the COVID-19 pandemic. Real GDP in 2020/21¹ was almost at the same level as 2010/11, and real GDP per capita in 2020/21 fell to the 2004/05 level. The large contractions in oil exports placed severe pressures on government finances at the same time, as oil prices started a downward trajectory in late-2018, which further worsened during the COVID-19 pandemic. While current account pressures were partly absorbed through the depreciation of the rial and import substitution, the depreciation together with the government's budget deficit financing operations fueled inflationary pressures. High inflation and lack of jobs negatively impacted household welfare and added to social grievances. The impact of the pandemic on Iran's labor market was significant following multiple and long-lasting waves of infections. Iran's economic challenges are also structural. Despite adjustments that partially mitigated the impact of external shocks, the economy remains constrained by widespread inefficiencies and price distortions that have contributed to the economy's

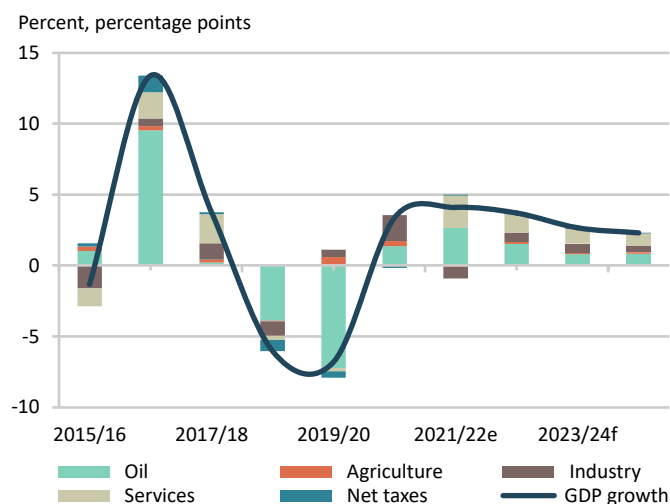
1/ The Iranian calendar year starts on March 21 of every year and ends on March 20 of the following year.

subpar performance. Iran is one of the largest subsidizers of fossil fuels globally, leading to allocative inefficiencies and significant budget and equity implications, as well as high carbon intensity of the economy. While social protection measures partly mitigated pressures, the lack of targeting and inflation indexation reduced their impact over time. Furthermore, climate change challenges in Iran have hurt growth, especially in labor-intensive agriculture and industry sectors following record high temperatures and low rainfalls. These factors constrain the pace of recovery and the dynamism of the economy in the outlook.

Recent developments

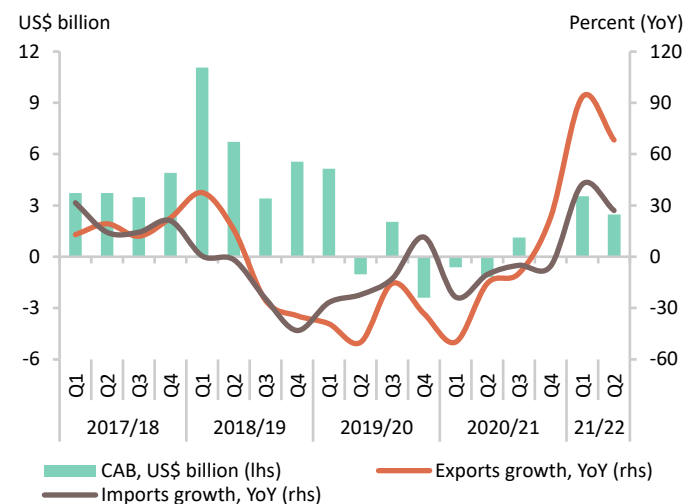
The economy continued to rebound in 9M-21/22 (Apr-Dec 2021), following a two-year recession. A recovery in the oil and service sectors (11.7 and 6.5 percent growth, respectively) – following a return of global and domestic activity after the start of the pandemic – led to a 5 percent YoY growth in 9M-21/22. However, the agriculture sector contracted by 2.1 percent due to drought and energy blackouts. On the demand side, a 3.4 percent expansion in consumption drove GDP growth as activity returned closer to pre-pandemic levels. Imports growth (25.5 percent) outweighed the pick-up in exports (5.4 percent), and investment also declined (5.2 percent). The economic rebound has yet to be reflected in the labor market as the recovery was largely

FIGURE 1 Islamic Republic of Iran / GDP growth and supply side decomposition



Sources: CBI and World Bank staff calculations.

FIGURE 2 Islamic Republic of Iran / Current account balance



Sources: CBI and World Bank staff calculations.

driven by the oil sector, and employment growth in services and industries could not compensate for job losses in the agriculture sector.

The government faced challenges in financing a growing fiscal deficit due to a shortfall in oil revenues and higher expenditures. In line with exports, oil revenues grew rapidly in H1-21/22 (over 300 percent YoY), however from a record low base. The oil proceeds only met 14 percent of the ambitious budget target for the year and accounted for 12 percent of government revenues (an improvement from the 4 percent share of H1-20/21 but far from pre-sanction share of 50 percent in H1-18/19). However, tax revenues grew by 60 percent, partly reflecting higher inflation, and expenditures also grew by 58 percent. This brought the budget deficit to 6.8 percent of GDP in H1-21/22, which was mainly financed through bond issuance (82 percent), as the government could not realize its planned sales of public assets.

Inflation continued its upward trend, driven by inflationary expectations, currency depreciation, and monetary expansion. Headline and core inflation in 2021/22 rose to an estimated 40.7 and 51 percent, respectively – recording the third consecutive year of inflation above 35 percent – but have since eased to 35.4 and 39.1 percent YoY in February 2022. In 10M-21/22, the currency depreciated by 14.7 percent

against the US dollar and M2 expanded by 39.8 percent.

A strong expansion in hydrocarbon exports drove the current account balance to a surplus of US\$5.9 billion in H1-21/22. Oil exports grew through both price and (likely) volume channels, reaching US\$18.6 billion (118 percent growth, YoY), partly a base effect from their 2020/21 collapse after the pandemic. While oil export volumes are not officially reported (because of the sanctions), the higher oil production growth in 2021 (21 percent) indicates an upward trend in exports including through indirect exports to China. Non-oil exports and imports surpassed their pre-pandemic levels during April 2021 - February 2022 by 12.7 percent and 16.6 percent, respectively.

Outlook

Average GDP growth is projected to remain modest in the medium term as the economy remains constrained by the continued impact of the pandemic through weaker domestic and global demand, while trade, especially oil exports, remains restricted by ongoing sanctions. Non-oil GDP growth is projected to remain below potential following previous years' decline

in real investment. Inflation is forecast to ease relative to 2021/22 but remain high, at over 30 percent annually, as fiscal and exchange rate pressures persist. Sustained inflation will continue to put pressure on the livelihood of poor and vulnerable households, already severely hit by the pandemic crisis.

Higher projected oil prices in the outlook period and growth in oil export volumes considering the tighter global oil market are forecast to curb fiscal pressures. However, high expenditure growth due to increasing wage bill and pension spending are projected to keep the fiscal balance in a deficit of 3.8 percent of GDP in 2022-24.

Iran's economic outlook is subject to significant risks. On the upside, further increase in oil prices following heightened global tensions can directly boost fiscal revenues and indirectly lead to a faster growth in oil export volumes if oil markets seek all available supply to ease price pressures. With both Iran and Russia under sanctions, higher trade and investment with Russia could reduce the impact of sanctions on Iran. Downside risks relate to the resurgence of new COVID-19 variants, a worsening climate change impact, and heightened geopolitical tensions including the recent conflict's impact on global food prices and Iran's imports.

TABLE 2 Islamic Republic of Iran / Macro poverty outlook indicators

(annual percent change unless indicated otherwise)

| | 2019/20 | 2020/21 | 2021/22 | 2022/23e | 2023/24f | 2024/25f |
|---|---------|---------|---------|----------|----------|----------|
| Real GDP growth, at constant market prices | -6.8 | 3.4 | 4.1 | 3.7 | 2.7 | 2.3 |
| Private Consumption | -7.7 | -0.4 | 3.4 | 2.9 | 2.3 | 1.9 |
| Government Consumption | -6.0 | -2.3 | 3.9 | 3.9 | 3.4 | 2.9 |
| Gross Fixed Capital Investment | -5.9 | 2.5 | -4.4 | 5.3 | 3.4 | 3.4 |
| Exports, Goods and Services | -29.9 | -5.4 | 8.9 | 8.7 | 5.6 | 4.5 |
| Imports, Goods and Services | -38.1 | -29.2 | 22.8 | 5.1 | 3.9 | 3.1 |
| Real GDP growth, at constant factor prices | -6.5 | 3.6 | 4.1 | 3.7 | 2.7 | 2.3 |
| Agriculture | 8.8 | 4.5 | -1.3 | 1.7 | 1.5 | 1.5 |
| Industry | -15.9 | 8.4 | 4.6 | 5.4 | 3.5 | 3.2 |
| Services | -0.5 | -0.1 | 4.6 | 2.6 | 2.1 | 1.7 |
| Inflation (Consumer Price Index) | 41.3 | 36.4 | 40.7 | 37.6 | 34.8 | 32.1 |
| Current Account Balance (% of GDP) | 1.5 | -0.3 | 1.8 | 4.7 | 3.1 | 2.8 |
| Fiscal Balance (% of GDP) | -5.0 | -6.3 | -5.5 | -3.7 | -3.8 | -3.9 |
| Gross Public Debt (% of GDP) | 48.0 | 52.0 | 49.8 | 46.4 | 44.5 | 43.2 |
| Primary Balance (% of GDP) | -4.5 | -5.3 | -4.5 | -2.8 | -3.0 | -3.1 |
| GHG emissions growth (mtCO2e) | -0.6 | -3.2 | 2.8 | 2.8 | 2.2 | 2.0 |
| Energy related GHG emissions (% of total) | 71.3 | 70.5 | 71.0 | 71.3 | 71.4 | 71.3 |

Source: World Bank, Poverty & Equity and Macroeconomics, Trade & Investment Global Practices. Emissions data sourced from CAIT and OECD.