

# **Inflation in IRAN**

## **Overview & Forecast**

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## Inflation Trend

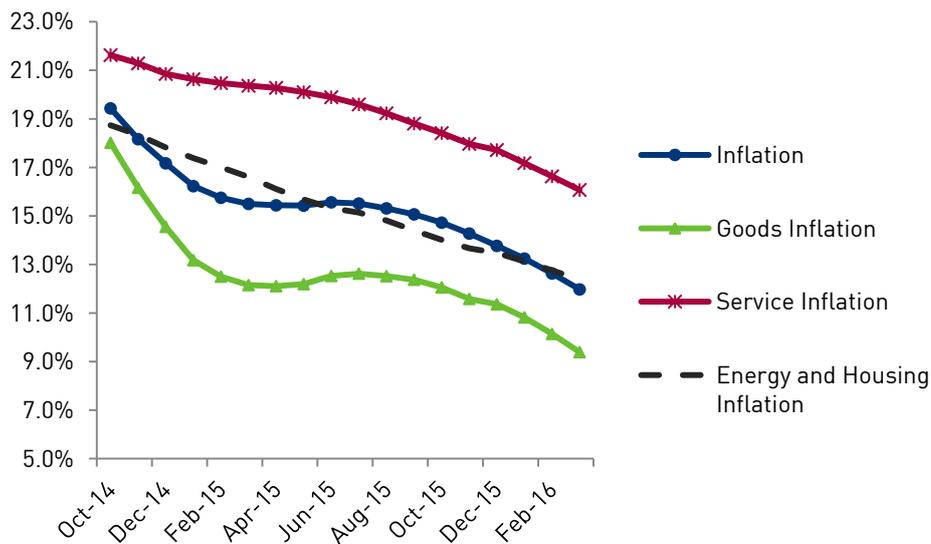
### Consumer inflation

According to the published report by CBI, Inflation was 11.9% in March 2016<sup>1</sup> which was considerably lower than the same period of last year (15.6%). Reasons of the inflation decline last year were as follow:

- Controlling monetary base
- Stability in the foreign exchange rate
- The sharp decline in producer prices
- Stagnation in the housing sector

Decomposition of inflation shows that this rate in services is higher than goods and commodities.

Figure1. Consumer Inflation Trend (%)



Source: CBI

The history of inflation in Iran shows that achieving this level of inflation is admirable successes, because of nature of the economy.

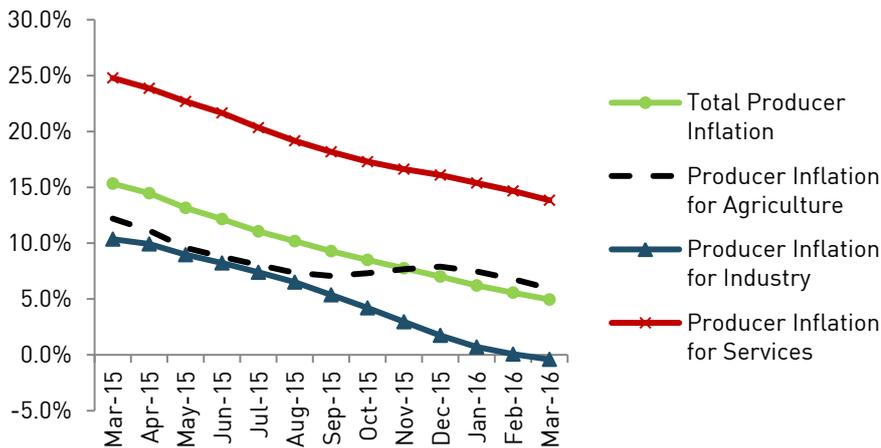
<sup>1</sup> . In Iran, the fiscal year starts on March 21 (1st of Farvardin) and concludes on next year's March 20.

## Producer inflation

Producer price index shows that the inflation in this sector has decreased from 14.5% in April 2015 to 4.9% in March 2016. Although inflation in service sector is higher than other sectors, it witnessed a considerable reduction from 24% in April 2015 to 13.8% in March 2016. Also manufacturing has the highest reduction from 9.9% in April 2015 to -.4% in March 2016. Reasons of such sharp downward trend are:

- Decline in global inflation
- Falling trade finance cost after lifting the sanctions
- Stagnation in the manufacturing sector due to lack of effective demand

Figure 2. Producer Price Index ( $\Delta\%$ )



Source: CBI

## Policy Approach

As mentioned in the previous number of this report, Iran's main economic policy was to control inflation which has led to a reduction of inflation at 2015. Inflation in March 2016, which was 9.4 compared to similar month in previous year, has been the first record of one-digit inflation after 5 years. Following nuclear agreement, positive view enhanced which led to exchange market stability. In addition, economic factors such as the decline in inflation expectations of consumers, signing JCOPA and ....help policy makers to successfully control inflation.

To reduce inflation, government tried to control monetary base. The last published data of Central Bank of Iran (CBI) shows that growth of liquidity was provided by money multiplier

not by increasing of monetary base. In addition, growth of monetary base was 8.9% in the November 2015 compared to 2014, while it has increased 10.8% in 2014 compared to 2013.

One of the most important components of the monetary base is the debt of banks to the central bank. So, CBI tried to prevent banks from borrowing money from CBI to control the monetary base growth. The data of 4<sup>rd</sup> quarter of 2015 shows that CBI claims on banks decreased 3.3% in November 2015 compared to March 2015.

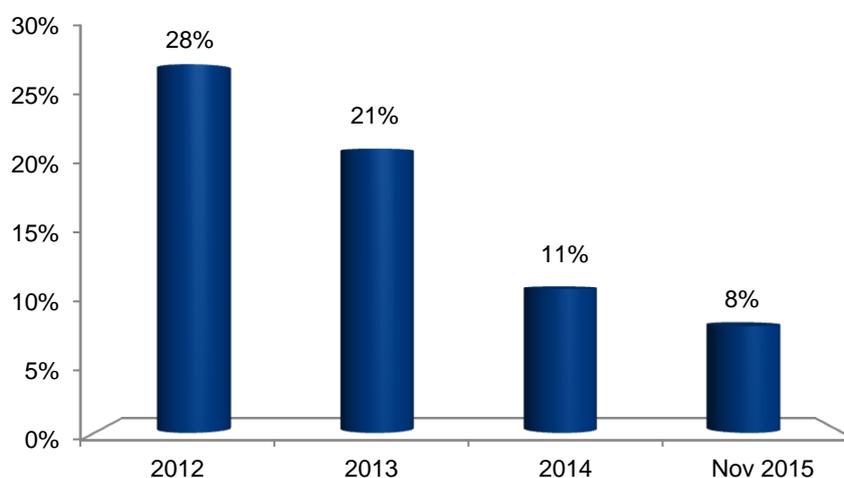
### Next year inflation

For the next year, major factors affecting inflation are monetary base, supply shock and inflation expectation which will be discussed below.

### Monetary base

As it is said before, monetary base is the main factor of increasing inflation. Trend of monetary base shows 8% increase in the November 2015 compared to March 2015.

Figure 3. Growth Rate of Monetary Base (%)



Source: CBI

To find a better way to analyze and forecast future trend of monetary base, it would be helpful to go through changes of its components, which are CBI's net foreign asset, net public sector indebtedness to CBI and CBI claims on banks.

- Statistics show that although net foreign assets of central bank decreased 5.6% in 2014 compared to 2013, it has increased 14% in November 2015 compared to March

2015 which has happened because of Iran`s foreign assets releasing. This variable seems to continue upward trend after lifting the sanctions against Iran.

- The other effective variable which has a great impact on monetary base is net public sector indebtedness to central bank which was always negative during 2008 to 2011. This means that a public sector deposit with CBI was always more than its indebtedness. But in 2012, net public sector indebtedness to CBI increased because of the budget deficit on which sanctions and reduction of oil income had a major impact. Also, this trend has continued until Nov 2015 and the main reason for this rise was a sharp drop in oil price. On the other hand, continuing of oil price reduction resulted in higher budget deficit.

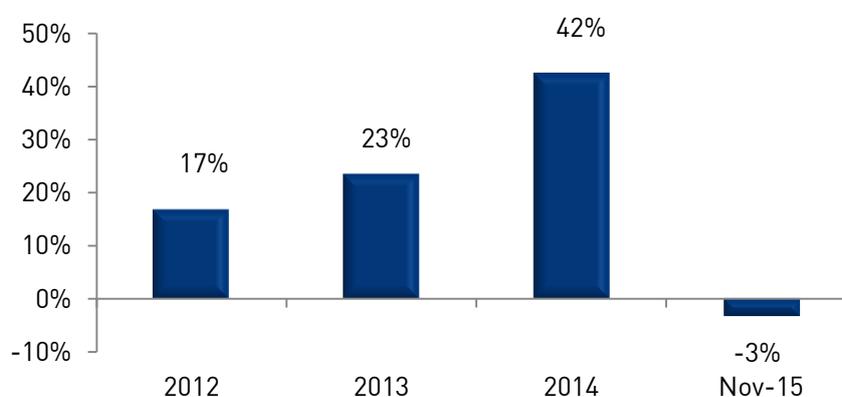
Table 1. Net Public Sector indebtedness to Central Bank (billion rials)

	2008	2009	2010	2011	2012	2013	2014	November 2015
Net Public Sector indebtedness to Central Bank	-109,951	-48,401	-13,874	-73,119	45,998	38,721	33,226	120,000

Source: CBI

- Central bank claims on banks, which increased 42.4% in 2014 compared to 2013, was the most important reason for monetary base increase in 2014. The main reason of banks indebtedness to CBI was financing the government development plans. But after 2014, central bank claims on banks decreased and growth rate of this was -3.3 percent in November 2015 compared to March 2015. Banking system claims on public sector has a rise of 9.6% in November 2015 compared to March 2015. It means that crowding out effects has happened in money market and the private money demand was replaced by government.

Figure 4. Central Bank claims on banks (%)



Source: CBI

## Supply shock

Supply shock has a great impact on inflation. Rising energy price, exchange rate and imported good inflations are the important variables of supply shock. We believe that there will not be a new shock on the supply side and since the exchange rate unification will be done gradually as result of strong price growth will not happen.

## Inflation expectation

Inflation expectation is a factor which has a rapid effect on inflation in short term. Inflation expectation has decreased recent years. Because simultaneously with the beginning of the new government, expectations for an end to the nuclear issue have been reinforced and after reaching the agreement, inflation expectations has decreased. It seems that inflation expectation will decreased in coming year by lifting the sanctions against Iran.

## Inflation Outlook

To forecast inflation rate for coming years, a macro econometric system was used. According to our forecast, the average inflation rate of 2016 could be near to 13.1% and this rate would be 10.3% in 2021.

Figure 3. Inflation Outlook

