BMI Research
A FitchGroup Company

Iran

Country Risk Report

Includes 10-year forecasts to 2026

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Iran's fiscal balance will gradually move towards a surplus over the coming years, as oil and tax revenue rise on the back of improving overall economic conditions. Risks to the country's fiscal stability from continued budget shortfalls out to FY2021/2022 are minimal, given its sizeable reserves, positive growth outlook and regained access to foreign assets.

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The Iranian rial will undergo renewed depreciation in the coming quarters after a period of relative stability following the unification of exchange rates. We forecast depreciation of between 5-10% against the US dollar over the coming years, which is broadly in line with the inflation differential. This contrasts starkly with the rapid depreciation seen over the past five years, with the nuclear deal, much lower inflation and an improving economy mitigating some of the forces to the downside.

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Iran's long-term economic outlook is one of the brightest in the MENA region, driven primarily by benefits from sanctions relief and a positive consumer story. However, the inability to fully exploit Iran's enormous oil and gas wealth and a challenging operational environment will keep a lid on economic growth over the next decade.

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Iran's hardliners will retain their hold on power over the coming decade, although moderates will continue to push for greater political and social liberalisation. Even if the relatively moderate President Hassan Rouhani wins re-election in 2017 as we expect, the main institutions of power – namely the Supreme Leader, Assembly of Experts and Revolutionary Guard – will remain under conservative control. Economic necessity led to a nuclear deal between Iran and the West in 2015, but risks to the deal collapsing will rise over the coming years, especially following the election of Donald Trump in the United States, or if a hardliner is selected as the next Supreme Leader after Ayatollah Ali Khamenei.
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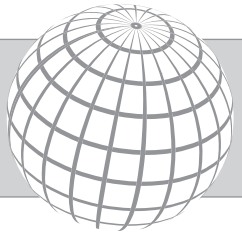
Executive Summary

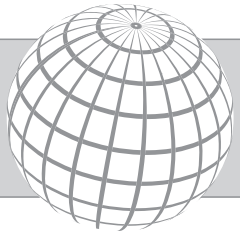


Core Views

- Iran will be one of the fastest growing economies in the region over the next five years as investment comes into the country following the removal of sanctions.
- Declining oil prices will force the government to cut current spending and investment in the country's infrastructure sector in 2017, which will result in slow expansion of private consumption and fixed investment.
- We expect the Iranian rial to keep depreciating against the US dollar over the coming quarters given relatively high inflation rates.
- President Rouhani will win re-election in the presidential elections due in May 2017.

Key Risks

- A breakdown in the agreement over the country's nuclear programme could prompt us to revise our real GDP growth forecasts sharply downward and our inflation forecasts upward.



SWOT Analysis

Strengths

- Iran has the world's second largest proven oil reserves after Saudi Arabia, and the world's second largest proven gas reserves after Russia.
- Oil and gas aside, Iran is rich in other resources and has a strong agricultural sector.

Weaknesses

- Local consumption of hydrocarbons is rising rapidly; this, coupled with ageing technology in the sector, will have a negative impact on its oil and gas exporting capacity.
- International sanctions discourage foreign oil companies from bringing much-needed technical knowledge and equipment to maintain oil output levels.

Opportunities

- The gas sector remains underdeveloped despite significant improvements in recent quarters, and there is considerable room to maximise this source of revenue.
- A shortage of housing, provides opportunities for investment in residential construction.

Threats

- Lower oil prices will have a marked impact on the economy. Although an Oil Stabilisation Fund exists to protect the economy at times of weaker oil prices, it has increasingly been used to fund government overspending and could be close to empty.
- A collapse of the nuclear deal is a distinct possibility, which would drastically worsen the economic outlook.

BMI Economic Risk Index

Iran's economy will grow substantially over the next five years following the removal of sanctions. The effects of elevated inflation and sanctions on the economy have been drastic over the past four years but will dissipate in the coming quarters. Improving relations with the West and better macroeconomic management, coupled with low base effects, have led to an improvement in the macroeconomic outlook in 2017, leading to a return to growth. That said, lower oil prices and the required huge sums of investment will weigh on growth over the next five years.

	S-T Economic	Trend	Regional Rank	Global Rank
United Arab Emirates	62.3	=	1	55
Qatar	61.3	=	2	58
Kuwait	60.4	-	3	60
Lebanon	54.2	=	4	75
Iran	**53.8**	**-**	**5**	**77**
Morocco	53.8	-	5	77
Saudi Arabia	53.5	=	7	79
Algeria	52.7	=	8	85
Iraq	48.8	=	9	102
Oman	47.1	=	10	114
Egypt	45.8	=	11	117
Bahrain	42.9	=	12	132
Jordan	39.8	=	13	146
Libya	39.2	=	14	148
Tunisia	36.9	=	15	155
West Bank and Gaza	36.7	=	16	158
Syria	24.2	=	17	185
Yemen	14.6	=	18	186

Regional ave 46.0 / Global ave 52.3 / Emerging Markets ave 48.0

	L-T Economic	Trend	Regional Rank	Global Rank
United Arab Emirates	65.8	=	1	41
Saudi Arabia	64.5	=	2	46
Kuwait	59.8	-	3	59
Qatar	57.7	=	4	67
Egypt	54.7	=	5	77
Morocco	54.2	-	6	79
Algeria	53.9	=	7	81
Lebanon	53.2	=	8	83
Bahrain	52.1	=	9	88
Oman	50.9	=	10	96
Jordan	48.6	=	11	107
Iran	**47.2**	**-**	**12**	**119**
Tunisia	45.5	=	13	127
Iraq	44.6	=	14	132
Libya	41.4	=	15	146
West Bank and Gaza	36.0	=	16	174
Syria	27.6	=	17	184
Yemen	23.0	=	18	186

Regional ave 48.9 / Global ave 53.3 / Emerging Markets ave 49.2

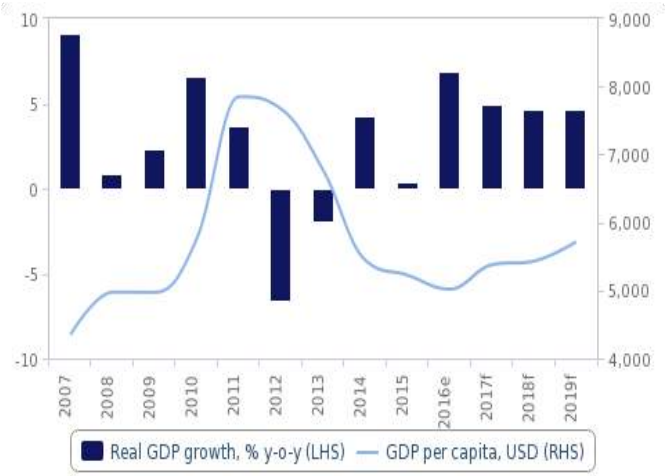
Economic Growth Outlook

Economic Growth To Outperform Region

BMI VIEW

Even with the removal of most sanctions, remaining impediments to doing business in Iran will continue to restrict foreign investment and prevent a boom in the economy. Economic growth will still be buoyant in 2017 given rising oil production, but this is already running out of steam. We do not expect an uptick in investment, as the legal framework becomes clearer and after Presidential elections have been held.

Sustained Growth Ahead
GDP

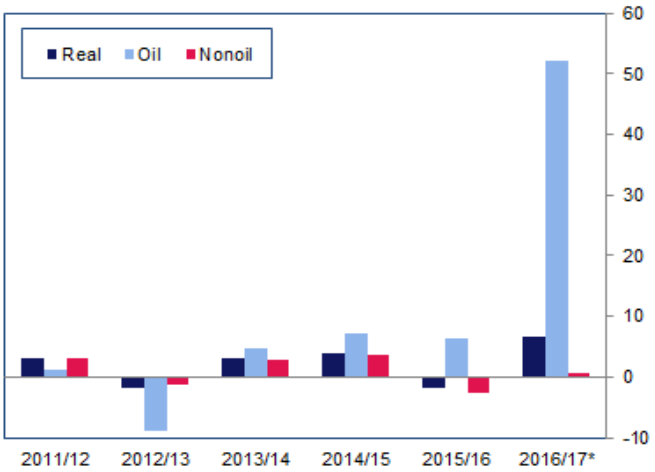


e/f = BMI forecast. Source: UN, BMI

Iran has seen few tangible benefits following the removal of most sanctions in January, and we expect this to remain the case until mid-2017 given uncertainty over the actions of US president Donald Trump; continuing restrictions on the banking sector; and sanctions on dealings with the Revolutionary Guards. Thus far, only the hydrocarbon sector has seen a jump in output, and this is already running out of steam with only marginal gains in output to come over the next five years. We forecast real GDP growth to come in at 5.0% in 2017 (the highest in MENA), and then average 4.5% per annum over 2018-2022, driven primarily by investment and exports.

We have previously highlighted Iran's huge potential across almost all sectors, especially in regards to industries related to the consumer – namely autos and food & drink. The removal of all UN- and almost all EU-sanctions, as well as all US secondary sanctions from January, allowed non-US companies to invest in the country for the first time in five years. In addition, Iranian banks are now re-connected to the international financial transaction system SWIFT, which will facilitate trade into the country. While there have been some big-ticket deals, most notably with Airbus and Boeing announcing multi-billion dollar transactions at the end of 2016, these will remain the exception rather than the rule.

Oil Sector Driving Growth
Real GDP Growth



Note: 2016/2017 is H1 only. Source: Central Bank of Iran, BMI

Banking Sector Restrictions Remaining In Place

There are still a plethora of regulations which will stop much investment coming into the country. US primary sanctions will remain in place for several years at least, ensuring the US dollar cannot be used in transactions. In addition, remaining secondary sanctions in the US stop any Western company doing business with the Iranian Revolutionary Guards, which have very opaque control over various sectors of the economy. Iran is also still not part of the World Trade Organization, and such an accession will likely be opposed by Saudi Arabia. Iran does not have any Anti-Money Laundering Legislation, which restricts European banks wanting to do business with the country, and Iran is blacklisted by the global agency responsible for combating money laundering, the Financial Action Task Force.

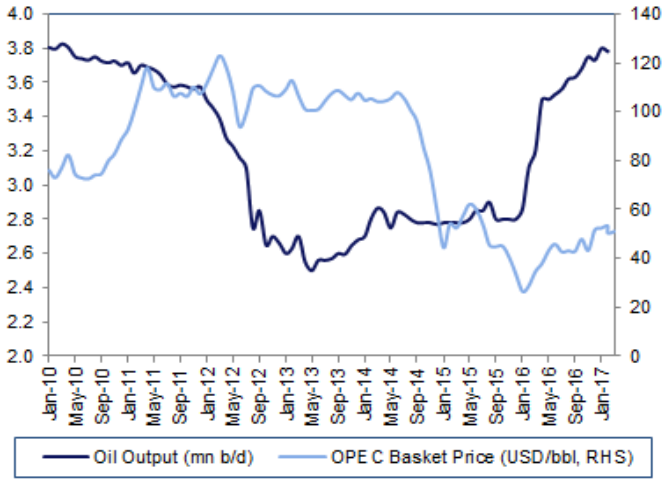
Indeed, the US State Department is clearly concerned about the lack of investment flowing into Iran and released a joint statement with European governments that promised that it 'will not stand in the way of permitted business activity with Iran, as long as they follow all applicable laws'. For European banks it is not a question of ambition. As well as the huge opportunities available as the 19th largest economy in purchasing power parity terms opens up, high-return opportunities in the West are few and far between given ultra-low interest rates.

Some of the reluctance on the part of European companies is due to the USD15bn that the Department of Justice has given

non-US banks for evading sanctions in Iran since 2012 – the most notable of which was the USD8.9bn fine levied in 2014 against BNP Paribas over deals with Iran, Cuba and Sudan.

Marginal Gains Much Harder To Come By

Oil Output, mn b/d



Source: Bloomberg, BMI

For both sides of the nuclear agreement there is a need for the economic benefits to flow. For Iran this is clear given the elevated levels of unemployment ahead of presidential elections this year. For the West, Iranians need to see the benefits of a nuclear deal to ensure their compliance and benefit the moderate elements of the government who are keen to increase engagement with the West. Indeed, since sanctions have been lifted, opinion polls indicate a slight improvement in the outlook for the economy among Iranians. For many companies, the picture has become more clouded since the election of Donald Trump in the United States in November 2016. While not our core scenario, the likelihood that unilateral sanctions are re-imposed on Iran, restricting opportunities in Iran for companies which have operations in the US, has increased.

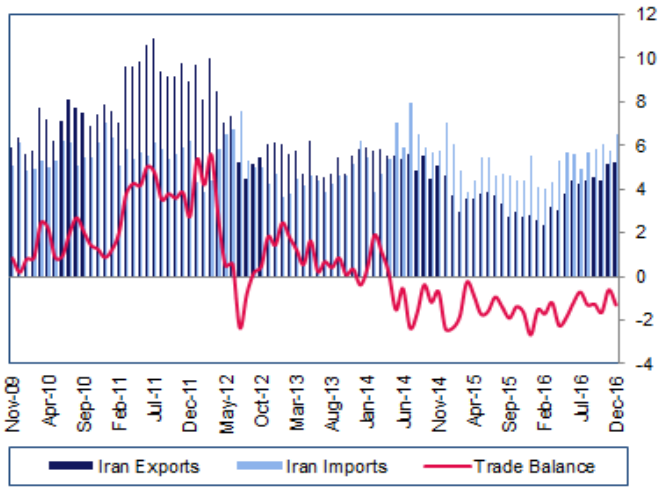
Corruption is another major concern which will continue to restrict investment. Iran provides a highly conducive environment for corruption to flourish, primarily due to the opaque and complex nature of government, and the convoluted process of completing bureaucratic procedures. Iran is ranked joint-fifth from bottom regionally in Transparency International's Corruption Perceptions Index 2016, along with Lebanon, and 144th out of 177 countries globally, alongside chronically corrupt states such as Nigeria and Russia. Given the control that the members of the political system – such as the Revolutionary Guards – have over key sectors of the economy, the opening of the country could cause corruption to become even more entrenched.

Oil Boom Almost Over

Turning to the key sectors in Iran, we believe the bulk of the increase in Iran's post-sanction oil production has already occurred. Since January, Iran has increased production by 760,000 barrels per day (b/d) to 3.6mn b/d. We expect another 100,000-200,000 b/d by the end of 2017, and then only another addition of 200,000 b/d by the end of 2019. While Iran's oil potential is enormous, investment will be held back by political wrangling over a new contract, the Iranian Petroleum Contract (IPC). The latest draft of the IPC, which Iran has promised to release for the past two years, remains unclear. A draft of the IPC, which in Farsi was reportedly named 'Improved Buy-Back', was approved by the Iranian Cabinet in early August. Hardliners retain significant influence in the country's oil sector and have most likely pushed for the removal of any kind of reserves ownership by a foreign company in the contract. The oil and gas sector remains one of the areas in which hardliners retain substantial influence, particularly through refining and fuels distribution. With a perceived reduction of influence in other areas, oil & gas may become a key bargaining chip for the more conservative politicians. Until the IPC is agreed upon – on favourable-enough terms – we do not expect to see foreign investment coming into Iran's oil sector.

Rising Exports Matched By Imports

Monthly Trade, USDbn

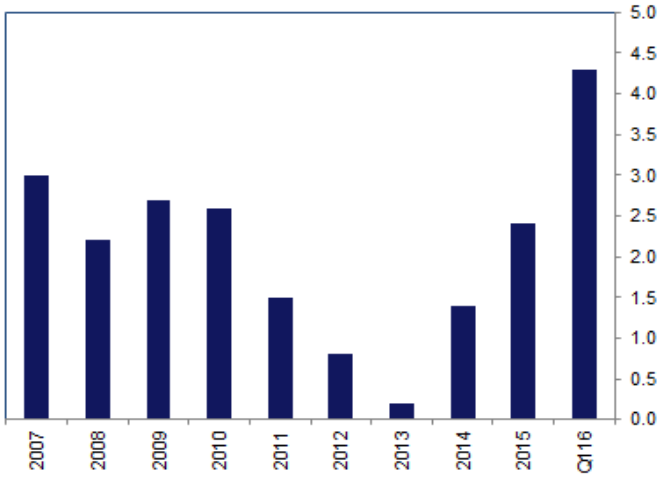


Source: IMF, BMI

After hydrocarbons, automotives is the second-largest industry in Iran, and is struggling even with the removal of sanctions. Indeed, 2016 autos sales were down 2.9% y-o-y. Looking ahead, we are very positive regarding the prospects of the automotive industry and expect it to be an outperformer globally. French automaker Renault has announced its aim to ramp up its production in Iran with the goal of 20% market share, up from the 10% it had in 2012. Renault Pars, a joint venture with Iran's two main auto manufacturers, Saipa and Iran Khodro,

has provided Renault with the capacity to produce as many as 500,000 vehicles a year. The resulting growth, as the economy emerges from years of sanctions and a positive consumer story, will continue to support passenger vehicle sales over the next five years, which we forecast to grow at an annual average of 12.6% to 2020

A Large Boost, But Overall Still Small
Foreign Direct Investment, USDbn



Source: FT, Bloomberg

Largest Announced Investments:

- Iran Air ordered 118 commercial planes from Airbus in a USD18bn deal.
- Italian metal industry firm Danieli has signed a contract to supply heavy machinery and equipment to Iran for USD4.3bn.
- Saipem, the Italian oil and gas contractor, has agreed a deal to revamp and upgrade the Pars Shiraz and Tabriz oil refineries in a USD3bn deal.
- Peugeot signed a USD350mn JV with the Iranian vehicle manufacturer Khodro to modernise a car factory near Tehran, where three new Peugeot models will be manufactured.
- In May 2016, Novo Nordisk announced plans to locally produce insulin in Iran, following a EUR70mn investment into an insulin production facility in the country slated for completion in 2020.
- The government of Iran plans to agree to an investment deal worth USD3bn with Turkish private firms for the construction of a 5,000MW power plant.
- Turkish firm UNIT International signed a USD4.2bn deal on June 1 with the Iranian energy ministry to build seven natural gas-fired power plants in Iran.
- Iran's Airports and Air Transport Company signed a memorandum of understanding with the Italian Milan Airport to build a terminal at Mehrabad International Airport in Tehran. The project is estimated to entail an investment of EUR250mn.

GDP By Expenditure Outlook

Iran's economy will see a substantial uptick in growth over the coming years as a result of the removal of sanctions in Q1 16.

Iran's economy is dominated by private consumption (53% of GDP in 2016), a share which has remained fairly constant over the past decade. We expect this percentage to stay stable over the coming years as the component benefits from an unwinding of sanctions. Given the aforementioned weaknesses in Iran's business environment, we expect fixed investment (23%) to decline over the coming decade. Government consumption (12%) will stay around the same levels as austerity measures take effect. Net exports (22%) will see a modest rise as oil exports are gradually allowed from Q116.

Private Consumption Outlook: A reduction in sanctions bodes well for private consumption over the longer term; however, this

TABLE: GDP GROWTH FORECASTS

	2015	2016e	2017f	2018f	2019f	2020f
Nominal GDP, IRRbn	11,562,895.1	12,721,911.1	14,883,589.5	16,998,563.5	19,509,823.0	22,174,099.3
Real GDP growth, % y-o-y	0.4	6.9	5.0	4.7	4.7	3.7
GDP per capita, IRR	145,488,578.4	158,114,365.8	182,794,119.9	206,393,544.6	234,297,989.4	263,511,186.5
	2021f	**2022f**	**2023f**	**2024f**	**2025f**	**2026f**
Nominal GDP, IRRbn	24,893,934.8	27,275,890.1	29,857,938.5	32,593,384.8	35,487,183.9	38,548,342.3
Real GDP growth, % y-o-y	3.5	3.7	3.7	3.3	3.0	2.6
GDP per capita, IRR	292,886,357.0	317,872,097.5	344,827,592.9	373,181,255.9	402,968,755.4	434,281,190.2

e/f = BMI estimate/forecast. Source: UN, BMI

positive impact is unlikely to be felt until 2017 at the earliest. Subsidy cuts, high inflation and a depreciating rial have dampened consumer demand substantially and will weigh on growth in the coming quarters. We forecast real growth of 4.5% and 5.0% in 2017 and 2018, respectively. The inflationary environment will improve, but persistently elevated price pressures will continue to hit purchasing power.

The purchasing power of Iranians has been eroding steadily over past quarters, with inflation making it increasingly difficult to purchase basic goods. According to reports from the government's statistics office, consumer price inflation decreased to 9.5% y-o-y in July 2016 – a significant drop on the previous two years. In addition, the availability of imported goods has decreased significantly as a result of the ongoing depreciation of the rial in the black market.

Government Spending Outlook: We forecast sustained fiscal

TABLE: PRIVATE CONSUMPTION FORECASTS

	2015	2016e	2017f	2018f	2019f	2020f
Private final consumption, IRRbn	5,989,486.1	6,756,140.3	7,600,657.8	8,588,743.3	9,705,279.9	10,821,387.1
Private final consumption, % of GDP	51.8	53.1	51.1	50.5	49.7	48.8
Private final consumption, real growth % y-o-y	-20.8	4.0	4.5	5.0	5.0	4.0
	2021f	**2022f**	**2023f**	**2024f**	**2025f**	**2026f**
Private final consumption, IRRbn	12,011,739.7	13,212,913.7	14,534,205.1	15,987,625.6	17,586,388.1	19,345,026.9
Private final consumption, % of GDP	48.3	48.4	48.7	49.1	49.6	50.2
Private final consumption, real growth % y-o-y	4.0	4.0	4.0	4.0	4.0	4.0

e/f = BMI estimate/forecast. Source: UN, BMI

TABLE: GOVERNMENT CONSUMPTION FORECASTS

	2015	2016e	2017f	2018f	2019f	2020f
Government final consumption, IRRbn	1,409,556.5	1,547,693.0	1,710,200.8	1,915,424.9	2,145,275.9	2,391,982.6
Government final consumption, % of GDP	12.2	12.2	11.5	11.3	11.0	10.8
Government final consumption, real growth % y-o-y	0.0	1.0	2.5	4.0	4.0	4.0
	2021f	**2022f**	**2023f**	**2024f**	**2025f**	**2026f**
Government final consumption, IRRbn	2,655,100.7	2,920,610.8	3,212,671.8	3,533,939.0	3,887,332.9	4,276,066.2
Government final consumption, % of GDP	10.7	10.7	10.8	10.8	11.0	11.1
Government final consumption, real growth % y-o-y	4.0	4.0	4.0	4.0	4.0	4.0

e/f = BMI estimate/forecast. Source: UN, BMI

TABLE: FIXED INVESTMENT FORECASTS

	2015	2016e	2017f	2018f	2019f	2020f
Fixed capital formation, IRRbn	2,902,274.2	2,955,383.5	3,239,553.7	3,578,512.0	3,946,482.8	4,304,730.1
Fixed capital formation, % of GDP	25.1	23.2	21.8	21.1	20.2	19.4
Fixed capital formation, real growth % y-o-y	-0.8	5.0	5.0	6.0	6.0	5.0
	2021f	**2022f**	**2023f**	**2024f**	**2025f**	**2026f**
Fixed capital formation, IRRbn	4,688,935.9	5,100,800.5	5,542,129.2	6,014,838.8	6,520,964.0	7,062,664.6
Fixed capital formation, % of GDP	18.8	18.7	18.6	18.5	18.4	18.3
Fixed capital formation, real growth % y-o-y	5.0	5.0	5.0	5.0	5.0	5.0

e/f = BMI estimate/forecast. Source: UN, BMI

TABLE : NET EXPORTS FORECASTS

	2015	2016e	2017f	2018f	2019f	2020f
Net exports of goods and services, IRRbn	415,070.6	-146,991.9	594,716.1	1,038,345.3	1,685,043.4	2,476,177.8
Net exports of goods and services, % of GDP	3.6	-1.2	4.0	6.1	8.6	11.2
Net exports of goods and services, real growth % y-o-y	91.3	14.4	8.3	5.0	5.0	3.4
	2021f	**2022f**	**2023f**	**2024f**	**2025f**	**2026f**
Net exports of goods and services, IRRbn	3,205,749.3	3,545,887.4	3,903,548.6	4,194,359.2	4,400,866.9	4,507,072.2
Net exports of goods and services, % of GDP	12.9	13.0	13.1	12.9	12.4	11.7
Net exports of goods and services, real growth % y-o-y	2.3	3.0	3.0	1.3	-0.4	-2.1

e/f = BMI estimate/forecast. Source: UN, BMI

deficits over the coming years primarily on the back of lower oil prices and a only-modest reduction in spending. We expect the government to quicken subsidy reforms and privatisation plans; however, this will be insufficient to prevent sustained deficits over the coming years.

Indeed, the administration will maintain its efforts to invest in areas such as social services and education, in a bid to maintain public support. For instance, in December, the parliament approved a plan for the country's most vulnerable groups to receive subsidised staple goods – including rice, vegetable oil and meat – every three months, in order to offset the erosion of their purchasing power

Fixed Investment Outlook: Even with an unwinding of sanctions against Iran, huge impediments remain to foreign companies looking to tap one of the Middle East's largest markets. Foreign companies in nearly every sector have recently expressed interest in returning to the Iranian market; however, the difficult operational environment – where corruption, bureaucracy and nepotism are rife – will ensure only a slow return of investment. Indeed, Iran scores poorly in **BMI**'s Operational Risk Index, with its score of 41.5 out of 100 placing the country 13th out of 18 states in the MENA region.

Net Exports Outlook: Iran will not be able to boost oil production and exports to pre-sanction levels within the coming one-to-two years. Years of underinvestment, maturing of oil fields and a lack of field and well maintenance could possibly have permanently destroyed some of the country's production capacity.

Overall, we estimate that Iran could bring back online some 500,000 barrels per day (b/d) of additional crude oil production in the one-to-two years following the lifting of oil sanctions in January 2016. This is in contrast to a more mainstream expectation of additional output capacity of 1mn b/d shortly after the lifting of sanctions. Import growth will be minimal due to a weak rial and only a small pick-up in economic activity.

Monetary Policy

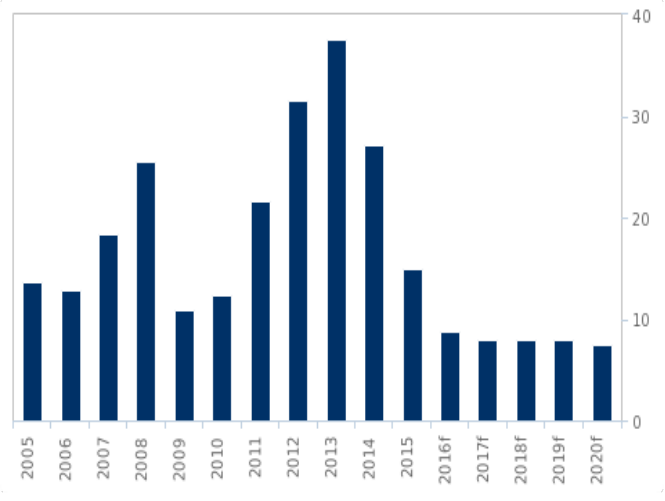
No Uptick In Inflation Coming

BMI VIEW

CPI inflation in Iran will remain just below double digits over the coming months as the rial sees only modest depreciation. This will aid President Rouhani's bid for re-election in May 2017, which we expect him to win.

Staying In Single Digits

Consumer Price Index Inflation, % chg y-o-y, ave

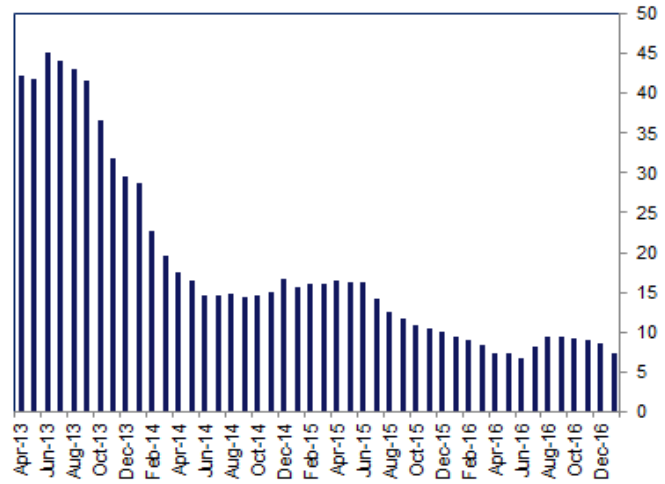


f = BMI forecast. Source: Central Bank of Iran, BMI

Inflationary pressures in Iran will remain subdued by historical standards as an improving economy, the lifting of import restrictions and stabilisation in the rial take hold over the coming quarters. Consumer price index (CPI) inflation came in at 7.3% y-o-y in January – a slight uptick on the past few months, but still one of the few single digit figures over the past 25 years.

Uptick Following Currency Devaluation, Before Subsiding

Monthly CPI Inflation, % y-o-y

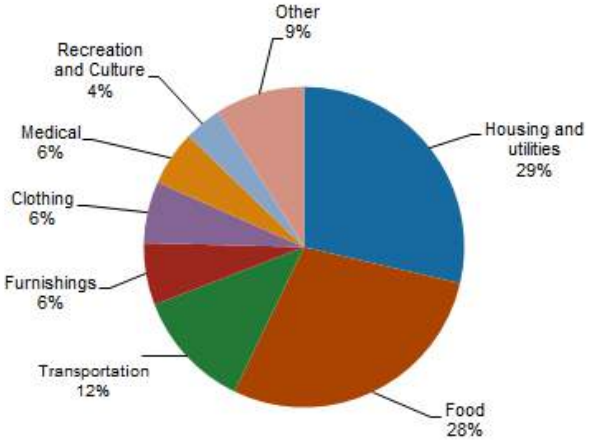


Source: Bloomberg, BMI

We project consumer price inflation to average 8.8% in FY2016/17 (fiscal year running from March 21 2016 to March 20 2017) and 8.0% in FY2017/18, a steep drop compared with 28.5% in FY2014/15.

Food inflation (27.4% of the consumer price basket) will marginally increase in 2017, as a result of a modest uptick in global wheat prices. Food prices have been the major driver of the decline in the headline print over the past two years, having expanded by only 3.2% y-o-y in December. The government will slightly reduce food subsidies in 2017 in our view, albeit gradually given the political sensitivity of higher food prices.

Food Price Pressures To Pick Up
Weightings Of CPI Index



Source: Central Bank of Iran, BMI

The Iranian rial will depreciate only modestly over the coming quarters following the devaluation in August. The black market rate for the Iranian rial has reappeared since the devaluation, but the divergence between the offical and parallel market is quite small, illustrating that the official rate is almost sufficient to meet domestic demand for foreign currency. The lower pace of depreciation will limit the potential for imported inflation.

Monetary Policy Framework

The sustained decline in inflation will ensure continued popular support for the President Hassan Rouhani, who won the presidency in June 2013 on the back of promises to restart growth, stem the decline in the value of the rial and moderate inflationary pressure. While this will not necessarily translate into increased moderate representation in parliamentary elections in February 2016 given the vetting of candidates, it does lend support to President Rouhani in his competition with more hardline elements in the regime (notably the Supreme Leader and Assembly of Experts) ahead of Presidential elections in May 2017, which we expect the incumbent to win. There has been notable progress in the political risk profile in Iran following the election of Rouhani and the concomitant improvement in the economy.

TABLE: MONETARY POLICY

	2013	2014e	2015e	2016e	2017f	2018f	2019f	2020f	2021f
Consumer price inflation, % y-o-y, ave	37.6	27.2	15.0	8.8	8.0	8.0	8.0	7.5	10.0
Producer price inflation, % y-o-y, eop	34.5	17.1	26.5	13.4	10.9	10.0	10.0	10.0	10.0
Producer price inflation, % y-o-y, ave	34.5	14.8	20.0	15.0	12.0	10.0	10.0	10.0	7.5
M1, IRRbn	1,136,717.7	1,071,249.0	1,285,498.8	1,542,598.6	1,866,544.3	2,277,184.0	2,800,936.3	3,473,161.0	4,341,451.3
M1, % y-o-y	22.0	22.8	-5.8	20.0	20.0	21.0	22.0	23.0	24.0
M2, IRRbn	4,606,935.9	4,729,530.5	5,675,436.6	6,810,523.9	8,240,733.9	10,053,695.4	12,366,045.4	15,333,896.2	19,167,370.3
M2, % y-o-y	29.0	2.7	20.0	20.0	21.0	22.0	23.0	24.0	25.0
Lending rate, %, eop	11.0	14.0	15.0	15.0	14.0	13.0	12.0	10.0	8.0
Lending rate, %, ave	11.0	14.0	15.0	15.0	14.0	13.0	12.0	10.0	8.0
Real lending rate, %, eop	-19.5	-29.0	-1.2	3.0	3.0	1.0	3.0	2.0	0.5
Real lending rate, %, ave	-20.6	-23.6	-12.2	0.0	5.2	5.0	4.0	2.0	0.5

e/f = BMI estimate/forecast. Source: National sources, BMI

Fiscal Policy And Public Debt Outlook

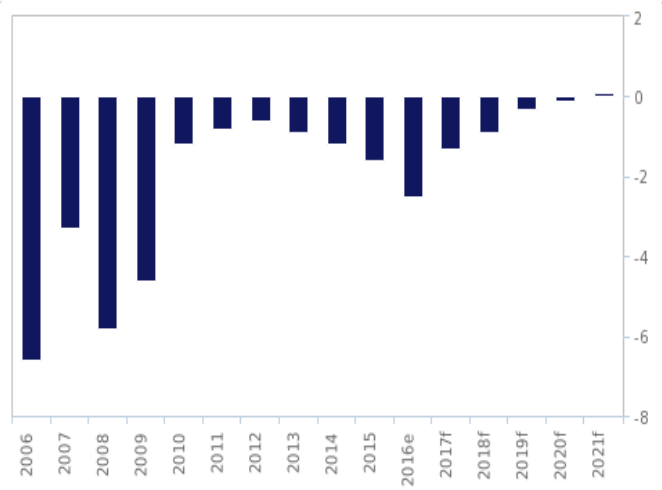
Deficit To Narrow On Improving Economy, Oil Earnings Uptick

BMI VIEW

Iran's fiscal balance will gradually move towards a surplus over the coming years, as oil and tax revenue rise on the back of improving overall economic conditions. Risks to the country's fiscal stability from continued budget shortfalls out to FY2021/2022 are minimal, given its sizeable reserves, positive growth outlook and regained access to foreign assets.

Rising Revenues To Improve Fiscal Position

Budget Balance, % Of GDP



e/f = BMI estimate/forecast. Source: CBI, BMI

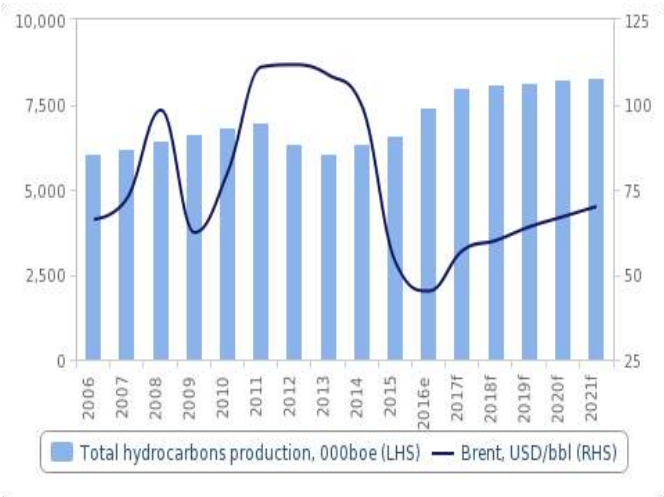
Iranian fiscal deficits will narrow gradually over the coming years, as revenues are boosted by rising oil and tax earnings on the back of steadily improving macroeconomic conditions. Indeed, we forecast the country's fiscal balance to swing into surplus at 0.1% of GDP in FY2021/22, from an estimated -2.5% in FY2016/17. Given Iran's still-sizable reserves, positive growth outlook and regained access to overseas assets, we see minimal risks to overall fiscal stability stemming from budget deficits over this time period. Tehran will continue to tap its reserves and issue domestic debt to cover budget shortfalls, albeit at a slowing pace.

Budget Moving Towards Surplus

We forecast robust growth in Iranian government revenue over the coming quarters. In particular, hydrocarbon earnings (which accounted for 40% of the total in the previous fiscal year) are set to rise as both prices and production levels tick up. Our Oil & Gas team forecast Brent to average USD57.0 per barrel (/bbl) in 2017 and USD60.0/bbl in 2018 (from USD45.1/bbl in 2016), and Iranian hydrocarbon production growth to increase by 8.1% and 1.3% in those two years, respectively. The government is also looking to increase tax income. We view its target of a 9% y-o-y tax revenue rise in FY2017/18 (starting March 21) as broadly achievable – based on its relative success in improving collection in recent years, and given our forecast for Iranian real GDP growth to average a robust 4.8% over 2017-2018.

Higher Oil Production, Prices To Boost State Earnings

Hydrocarbons Production & Global Price Of Brent



e/f = BMI estimate/forecast. Source: National sources, BMI

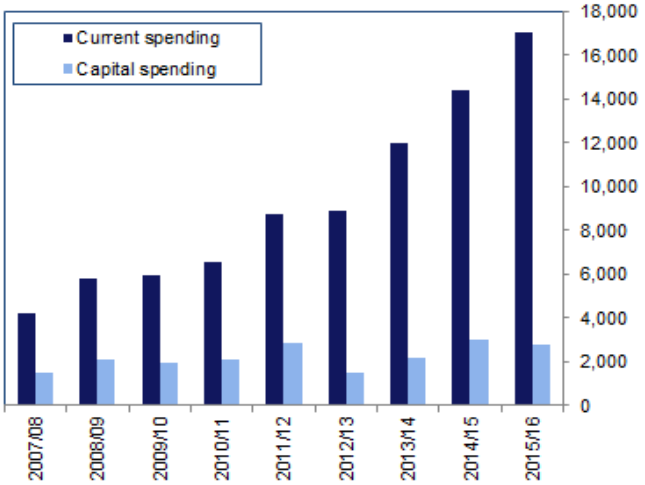
On the spending side, we expect real growth to remain largely flat. President Hassan Rouhani's general budget for FY2017/18 (which has been passed in parliament, but is awaiting final approval from the Guardian Council at the time of writing) envisions a nominal expenditure increase of about 9% against our forecast for inflation to average 8.0% over 2017-2018. The government is working to facilitate growth and raise living standards (as hardliner criticism over the lack of economic improvement resulting from the P5+1 nuclear deal intensifies), while at the same time ensuring continued fiscal stability and inflation containment.

The majority of the general budget (which excludes funding for state enterprises and banks) will continue to be allocated towards current spending – particularly public salaries, which according to Rouhani's budget plan will increase by 10% over FY2017/18. Indeed, civil servants and pensioners make up over 10.9% of the Iranian population. Meanwhile, military spending will grow significantly on the back of elevated tensions with the US; education spending will continue to increase amid a rapidly expanding youth population; and healthcare spending is set to rise given the ongoing implementation of national health coverage. We further note that interest payments (forecast by the IMF to rise from 0.9% of GDP in FY2016/17 to 3.0% over

the medium term) will gradually take up a large share of Iran's state budget over the coming years, as the government's recent recognition of payment arrears means it will need to securitise debt with interest-bearing instruments.

Current Spending Will Continue To Dwarf Investment

Government Expenditure, IRRtrn



Source: National sources, BMI

Given these current spending pressures, Tehran's budget for capital investment will remain limited over the coming quarters. This has long been the case in Iran, where the execution rate for government investment projects has stood at just 60% over the past decade, according to IMF estimates. Limited room for capital spending growth will constrain Rouhani's ability to accelerate economic development. Meanwhile, Tehran has announced some measures to limit overall expenditure levels in recent months – including the removal of a further 3mn Iranians from its cash subsidy scheme, and cuts to fuel subsidies.

Overall, we forecast Iran's budget balance to come in at -1.0% of GDP in FY2017/18 (from -2.5% in FY2016/17), before gradually moving towards a surplus of 0.1% of GDP by FY2021/22.

Fiscal Instability Risks To Remain Low

Iran's reserves are still substantial (estimated at USD120bn, equivalent to 22.1 months of imports, in 2015), and given our forecast for economic growth to average 4.3% y-o-y over the next five years, we do not see persistent budget deficits out to FY2021/22 as posing significant risks to the country's overall fiscal stability. Further strengthening this view is the fact that Iran has – as a result of the P5+1 nuclear deal (which we expect to remain in place, despite elevated tensions with the US) – regained access to overseas assets worth at least USD30-50bn, providing additional support.

To cover its gradually narrowing deficits, Tehran will, in addition to tapping reserves, continue to issue debt. Overall, the Iranian parliament appears to have approved the issuance of around USD9bn in government bonds through 2018, either in local or foreign currency. We do not expect Iran to return to international debt market over the near term, given still-elevated political risks; persistent US financial sanctions; and a lack of credit ratings.

Once these issues are addressed, however, strengths such as the country's still-sizable reserves, relatively low central government debt levels (estimated at 42% of GDP by the IMF in 2015/16) and favourable growth outlook are likely to attract foreign interest in Iranian bond sales.

Structural Fiscal Position

We expect further spending cuts to be enacted by the Iranian government following the reductions in fuel subsidies

TABLE: FISCAL POLICY

	2015	2016e	2017f	2018f	2019f	2020f	2021f
Revenue, % of GDP	15.5	15.5	16.1	16.2	16.0	15.6	15.3
Fiscal expenditure, IRRbn	198,387.6	229,530.7	254,214.0	286,680.6	319,445.4	348,647.2	377,532.6
Expenditure, % of GDP	17.2	18.0	17.1	16.9	16.4	15.7	15.2
Current expenditure, IRRbn	170,688.5	196,291.8	217,883.9	245,990.9	274,279.9	298,965.1	322,882.3
Current expenditure, % of total expenditure	86.0	85.5	85.7	85.8	85.9	85.8	85.5
Current expenditure, % of GDP	14.8	15.4	14.6	14.5	14.1	13.5	13.0
Capital expenditure, IRRbn	276,990	332,388	363,301	406,897	451,655	496,821	546,503
Capital expenditure, % of total expenditure	14.0	14.5	14.3	14.2	14.1	14.2	14.5
Capital expenditure, % of GDP	2.4	2.6	2.4	2.4	2.3	2.2	2.2
Budget balance, IRRbn	-186,551.3	-318824	-142270	-116395	-69371	-34286	27156
Budget balance, % of GDP	-1.6	-2.5	-1.0	-0.7	-0.4	-0.2	0.1

e/f = BMI estimate/forecast. Source: CBI, BMI

in May 2016. According to the government, gasoline prices rose to IRR10,000 per litre (USD0.35) from IRR7,000 per litre (USD0.24). In addition, motorists' allowance for heavily subsidised fuels was abolished, replaced by a single rate for refined fuel, according to Deputy Oil Minister Abbas Kazemi. Iran currently offers individuals a higher level of subsidisation on the first 60 litres of gasoline purchased each month, per car owned. The combination of cuts in subsidies, modest reductions in capital expenditure and some relief from sanctions, as well as the last resort of reserves, will ensure that Iran is not heading towards a fiscal crisis any time soon.

Currency Forecast

Modest Depreciation Ahead

BMI VIEW

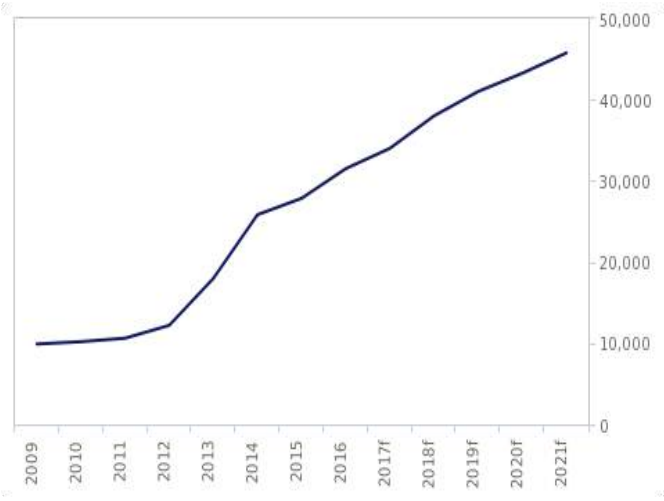
The Iranian rial will undergo renewed depreciation in the coming quarters after a period of relative stability following the unification of exchange rates. We forecast depreciation of between 5-10% against the US dollar over the coming years, which is broadly in line with the inflation differential. This contrasts starkly with the rapid depreciation seen over the past five years, with the nuclear deal, much lower inflation and an improving economy mitigating some of the forces to the downside.

Short-Term Outlook (three-to-six months)

The Iranian rial will undergo a further bout of depreciation in H217, having enjoyed a period of relative stabilisation on the official market since the end of 2016. At present we believe there is significant political influence to ensure the currency does not significantly weaken (which would result in inflationary pressures) before the presidential election in May 2017. From Q317 we expect a gradual depreciation in the currency against the dollar, in line with high inflation rates compared with the US. Indeed, depreciatory pressures are evidenced by the divergence between the official rate at IRR32,500/USD and the black market rate at IR39,100/USD (as of the start of April). We believe the black market rate has fallen partly due to concerns over the election of Donald Trump, and partly due to concerns over the sustainability of the nuclear deal. We expect the nuclear deal to remain intact, but for the key driver of depreciatory pressures to be relatively high inflation over the coming months.

Stready Depreciation Coming, But Devaluations Have Passed

IRR/USD, Exchange Rate



f = BMI forecast. Source: National sources, BMI

We expect the central bank to step into the foreign exchange market to help stabilise the value of the currency, especially given expected investment into the country. Although the economy's balance of payments position remains on a less-than-firm footing, the authorities should still possess a sufficient financial arsenal to use in their defence of the rial. According to the latest data from the IMF, foreign reserves currently sit at approximately USD111bn, which is equivalent to 12 months of imports.

Long-Term Outlook (six-to-24 months)

Improvement in the macroeconomic situation will lead to increasing confidence in the currency among traders. We forecast real GDP growth of 5.0% and 4.7% in 2017 and 2018, respectively, driven by improved investor and consumer confidence, more effective macroeconomic management and low base effects. Importantly, recent consumer price index readings point to a gradual decline in price pressures, which have been a major driver of currency depreciation in recent years. Inflation came in at 9.4% y-o-y in October (the latest figure available), one of the lowest levels for 25 years, and we expect headline inflation to moderate over the coming quarters.

TABLE: BMI CURRENCY FORECAST

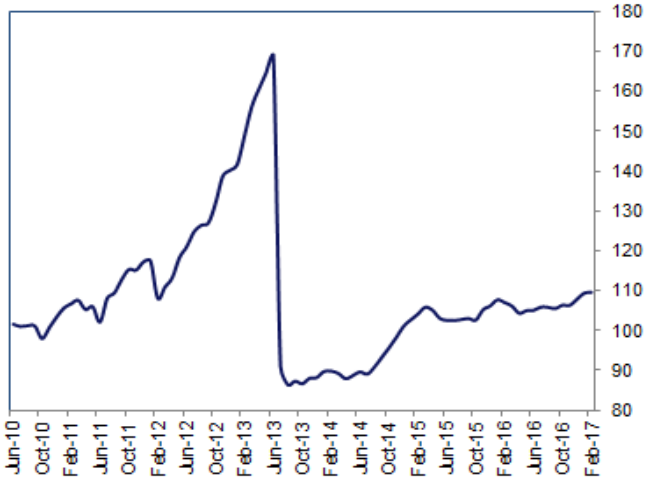
	Spot	2017	2018
IRR/USD, ave	32,425	34,000	38,000
IRR/EUR, ave	34,628	35,020	38,760

Source: Bloomberg, BMI Last updated: April 3 2017

Iran's real effective exchange rate index ticked up 109 in February, indicating a slight overvaluation against the currencies of its trading partners. The government is trying to bolster non-oil exports, but structural issues such as lack of access to financing remain an impediment, rather than the currency. A weaker currency would assist the fiscal position (by enlarging oil sales in local currency terms) and make Iran more attractive for investment.

Reduced Depreciatory Pressure

Real Effective Exchange Rate



Note: REER rebased to 100 from 1979. Source: IMF, Bloomberg, BMI

Risks To Outlook

Risks are weighted to the downside, with the possibility of depreciation, particularly if there was a breakdown in the nuclear deal (the risk of which has increased given President Donald Trump's rhetoric against Iran) or a sudden uptick in inflation due to subsidy cuts. Furthermore, the central bank and government may decide that foreign reserves are best suited to spending on dilapidated infrastructure or public services rather than supporting the currency at an overvalued level.

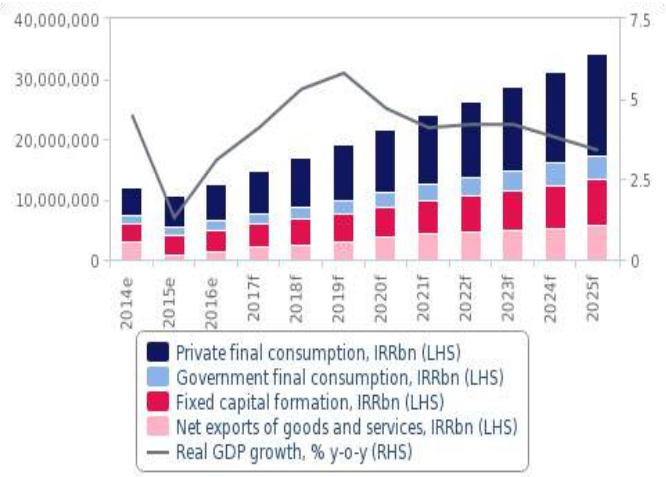
The Iranian Economy To 2026

MENA's Long-Term Outperformer

BMI VIEW

Iran's long-term economic outlook is one of the brightest in the MENA region, driven primarily by benefits from sanctions relief and a positive consumer story. However, the inability to fully exploit Iran's enormous oil and gas wealth and a challenging operational environment will keep a lid on economic growth over the next decade.

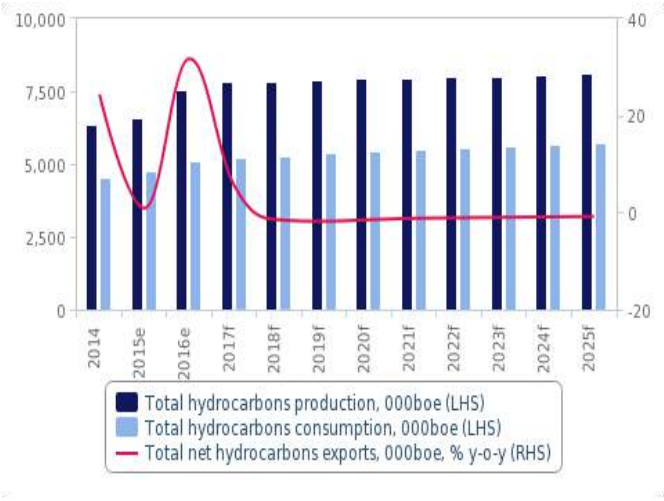
Consumer To Drive Positive Growth Outlook
Macroeconomic Forecasts



e/f = BMI estimate/forecast. Source: UN, BMI

The Iranian economy will benefit significantly from the removal of most sanctions, but growth will be below potential as huge impediments – not least years of under investment – weigh on growth. The failure to fully exploit its enormous oil and gas wealth and a challenging operational environment will result in slow expansion of Iran's economy over the coming decade. We project real GDP growth averaging 4.4% over the 2016-2026 period, compared to 2.7% over 2006-2015.

Elevated Consumption Leading To Declining Exports
Energy Industry



e/f = BMI estimate/forecast. Source: EIA, BMI

Energy Sector: Great Potential, Low Expectations

Iran's oil and gas sector has enormous growth potential. Both its proven oil and gas reserves are the second largest in the world – 137.0bn barrels and 29.7trn cubic metres, respectively, according to BP. However, oil production levels have plateaued since 2003.

TABLE: LONG-TERM MACROECONOMIC FORECASTS

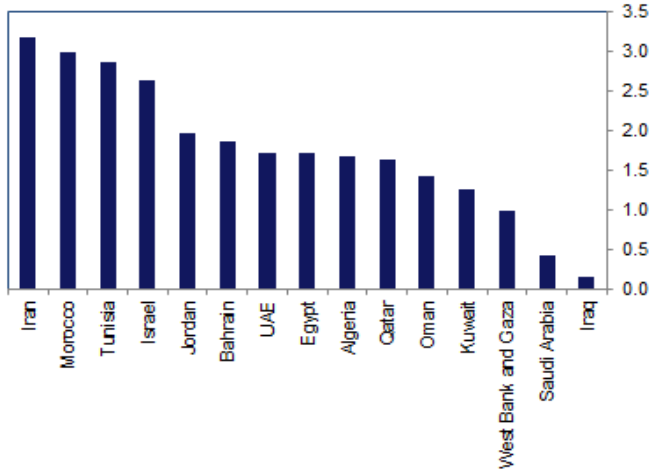
	2017f	2018f	2019f	2020f	2021f	2022f	2023f	2024f	2025f	2026f
Nominal GDP, USDbn	419.9	441.9	477.1	514.0	545.4	566.6	589.6	613.4	637.9	637.8
Real GDP growth, % y-o-y	5.0	4.7	4.7	3.7	3.5	3.7	3.7	3.3	3.0	2.6
Population, mn	80.9	81.8	82.6	83.4	84.1	84.8	85.4	86.0	86.5	87.0
GDP per capita, USD	5,156	5,365	5,729	6,107	6,416	6,603	6,809	7,023	7,243	7,185
Consumer price inflation, % y-o-y, ave	8.0	8.0	8.0	7.5	10.0	10.0	6.0	10.0	6.0	11.0
Current account balance, % of GDP	2.4	2.3	2.2	2.0	1.9	1.8	1.7	1.6	1.6	1.6
Exchange rate IRR/USD, ave	36,000.00	38,750.00	41,000.00	43,250.00	45,750.00	48,250.00	50,750.00	53,250.00	55,750.00	58,250.00
Parallel IRR/USD, eop	41,000.00	43,750.00	46,000.00	48,250.00	50,750.00	53,250.00	55,750.00	58,250.00	60,750.00	63,250.00

f = BMI forecast. Source: National sources, BMI

The upshot of these combined factors is that our Oil & Gas team forecasts average annual oil production growth to average 2.9% between 2017 and 2026, reaching 4.2mn barrels per day. We see natural gas production nearly doubling over the same period, although this is dependent on technology transfer, which is not assured given the sanctions. Combined oil and gas production growth will lead to total net hydrocarbon production growth averaging 2.9% per annum over the coming decade. That said, net hydrocarbon exports will contract by an average 1.3% per annum as a result of expanding energy consumption over the same period.

Iran The Outperformer

MENA – Average Annual % chg In Real GDP Per Capita (2017-2026)



Source: BMI

Based on long-term supply and demand dynamics, we view USD66.5 per barrel (/bbl) as the OPEC basket's average price over the forecast period compared to USD86.6/bbl over 2005-2014. Even as oil prices will be lower, the energy sector will remain at the core of the economy, as it will continue to account for the majority of Iran's exports and provide the bulk of the government's fiscal revenues – either directly through oil sales or indirectly through taxes on (state-owned) oil companies. Lower oil prices will lead to a significant worsening in the external position, and we expect the current account to come in at a surplus of 1.6% of GDP in 2026, from a 2.4% surplus in 2074. A dearth of financial account inflows, capital flight (as Iranians with the means to transfer their wealth abroad will continue to do so) and inflation rates that we see averaging 11.8% y-o-y over the forecast period all mean that depreciatory pressures on the rial will remain significant, and the unit will lose more than 60% of its value over the forecast period.

Western Companies Meeting Significant Challenges

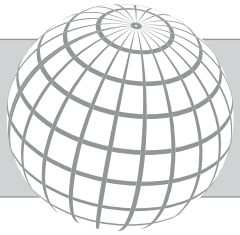
The Islamic Republic will see an uptick in foreign investment following a nuclear deal. We expect the current administration led by moderate cleric Hassan Rouhani to undertake significant efforts to reform the economy, and the operational environment to improve over the coming decade. That said, the political system will transform only partially over the forecast period, and internal resistance to open up the economy and high levels of bureaucracy will continue to hinder economic reform. We also do not expect core international sanctions to be lifted anytime soon, posing a substantial challenge to companies willing to enter the country. Iran scores poorly overall in the **BMI** Operational Risks Index, with 40.4 out of 100. This ranks the country 14th out of 18 states in the MENA region, and we expect the country to remain a regional underperformer over the forecast period.

Political Risks To Remain Elevated

There are domestic political risks to our outlook. The mass protests in the aftermath of June 2009's presidential election have shown that there is considerable dissatisfaction with the regime. That said, as long as the government continues to maintain the loyalty of the security services, it is unlikely to collapse. However, an extended period of low oil prices could weaken this loyalty if the government were forced to cut back on payments to the military.

In addition, Supreme Leader Ayatollah Ali Khamenei is rumoured to be in relatively poor health and there is certainly a chance that he could die during the coming decade. As the supreme leader is the true centre of power in Iran, Khamenei's successor will exert massive influence over Iran's future direction, adding to political uncertainty.

BMI's long-term macroeconomic forecasts are based on a variety of quantitative and qualitative factors. Our 10-year forecasts assume in most cases that growth eventually converges to a long-term trend, with economic potential being determined by factors such as capital investment, demographics and productivity growth. Because quantitative frameworks often fail to capture key dynamics behind long-term growth determinants, our forecasts also reflect analysts' in-depth knowledge of subjective factors such as institutional strength and political stability. We assess trends in the composition of the economy on a GDP by expenditure basis in order to determine the degree to which private and government consumption, fixed investment and the export sector will drive growth in the future. Taken together, these factors feed into our projections for exchange rates, external account balances and interest rates.



SWOT Analysis

Strengths

- Sanctions relief will substantially boost economic growth.
- Wealth distribution in Iran improved marginally over the past five years.
- The Revolutionary Guard and Basij militia are fiercely loyal to the supreme leader, helping to maintain social stability.

Weaknesses

- The country has one of the poorest human rights records in the region, and authorities do not hesitate to quell dissidents. A number of journalists and anti-government protesters are being held in custody.
- While decision-making ultimately rests with the supreme leader, the regime is heavily fragmented, and consensus is hard to reach.
- Widespread perceptions of electoral fraud during the course of June 2009's presidential elections have damaged the regime's legitimacy in the eyes of many Iranians.

Opportunities

- The Majlis (parliament) is more than just a rubber stamp; the move by 150 parliamentarians (out of 290) to hold former president Mahmoud Ahmadinejad accountable for his handling of the economy in March 2012 is a positive indication that checks exist.
- The victory of moderate cleric Hassan Rouhani in Presidential elections in June 2013 is leading to a significant improvement in relations with the West.
- The long-term potential in Iran across a range of sectors is enormous given a large population, well-educated workforce and pent-up demand.

Threats

- Despite progress in nuclear talks, the prospect of further US and EU sanctions and the possibility of a military strike by the US or Israel cannot be dismissed.
- Youth unemployment is high.
- The strong influence of the Revolutionary Guards within the political and economic arena will continue to present a challenge to reform.

BMI Political Risk Index

The removal of most sanctions on Iran's economy is a very positive step for the country and is a boost for the reformers within the country. There are significant risks to a deal holding, especially with presidential elections in Iran in May 2017 and the recent election of Donald Trump in the United State. We expect only marginal gains for the reformers in the coming years as the hardliners retain their dominance across key institutions. We expect Rouhani to be re-elected as President in May 2017.

	S-T Political	Trend	Regional Rank	Global Rank
Qatar	84.4	=	1	14
United Arab Emirates	83.1	=	2	17
Oman	79.8	=	3	27
Kuwait	77.1	-	4	37
Saudi Arabia	70.8	=	5	67
Bahrain	67.7	=	6	76
Morocco	67.1	-	7	81
Jordan	63.1	=	8	99
Tunisia	61.5	=	9	106
Algeria	60.8	=	10	109
Iran	**60.8**	**-**	**10**	**109**
Egypt	53.3	=	12	138
Lebanon	47.5	=	13	156
West Bank and Gaza	33.1	=	14	177
Iraq	31.7	=	15	180
Libya	26.0	=	16	183
Syria	22.9	=	17	186
Yemen	22.1	=	18	187

Regional ave 56.3 / Global ave 63.7 / Emerging Markets ave 59.7

	L-T Political	Trend	Regional Rank	Global Rank
Jordan	71.2	=	1	57
Qatar	71.0	=	2	59
Morocco	69.9	-	3	65
United Arab Emirates	69.6	=	4	69
Oman	68.9	=	5	72
Tunisia	68.6	=	6	74
Kuwait	67.4	-	7	75
Algeria	60.1	=	8	104
Saudi Arabia	58.7	=	9	111
Bahrain	57.5	=	10	117
Egypt	54.0	=	11	130
Iran	**54.0**	**-**	**11**	**130**
Lebanon	53.9	=	13	132
West Bank and Gaza	40.0	=	14	171
Iraq	36.7	=	15	174
Yemen	28.9	=	16	181
Syria	21.7	=	17	184
Libya	20.2	=	18	187

Regional ave 54.0 / Global ave 62.1 / Emerging Markets ave 57.2

Long-Term Political Outlook

Hardliners To Maintain Control, But Power Struggle Likely

BMI VIEW

Iran's hardliners will retain their hold on power over the coming decade, although moderates will continue to push for greater political and social liberalisation. Even if the relatively moderate President Hassan Rouhani wins re-election in 2017 as we expect, the main institutions of power – namely the Supreme Leader, Assembly of Experts and Revolutionary Guard – will remain under conservative control. Economic necessity led to a nuclear deal between Iran and the West in 2015, but risks to the deal collapsing will rise over the coming years, especially following the election of Donald Trump in the United States, or if a hardliner is selected as the next Supreme Leader after Ayatollah Ali Khamenei.

We expect Iran's hardliners to maintain their overall control of the country over the coming decade, although this does not preclude a partial liberalisation of the political scene by the early 2020s. The main power centres in Iran – the Supreme Leader, Assembly of Experts and Islamic Revolutionary Guard Corps (IRGC) – will remain dominated by conservatives and resist attempts at liberalisation, but there will still be considerable pressure for greater political and social freedoms. The struggle between hardliners and moderates will intensify in the run-up to the May 2017 presidential election, in which the relatively moderate Hassan Rouhani seeks a second term, following his election in 2013. Our expectation is for Rouhani to win re-election; however, risks to this view have risen following the victory by Donald Trump in the United States presidential election, and the recent passing of former President Akbar Hashemi Rafsanjani. Another key event in this struggle would be the death of Supreme Leader Ayatollah Ali Khamenei, who has held that post since 1989, which would be seen as a defining moment in Iran's post-revolutionary history. The successor is likely to be a hardliner, but he will need time to consolidate his authority, and this could provide an opportunity for moderates to challenge the conservatives. With regards to foreign policy, we maintain our view that the process of nuclear inspections will not be smooth. The agreement will hold over the coming years, primarily due to economic necessity, but risks of the deal falling apart will rise if Rouhani is not re-elected in June 2017. In the event that the deal eventually breaks down, we cannot rule out US or Israeli military action against Iran's nuclear facilities.

Although a period of lower oil prices will undoubtedly place

TABLE: POLITICAL OVERVIEW

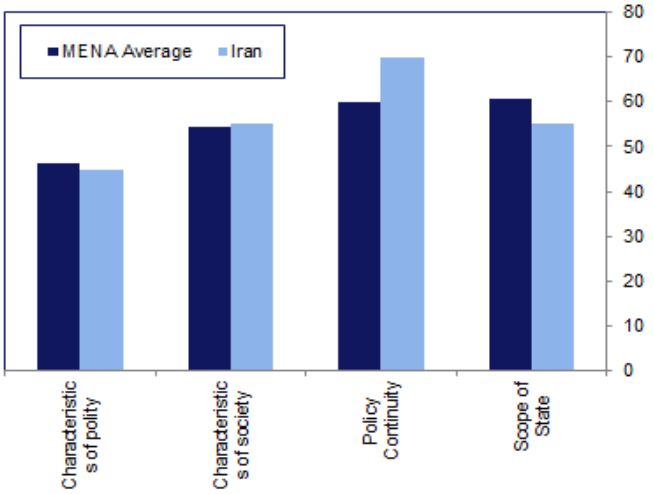
System of Government	Islamic Republic based on the 1979 Constitution. Supreme Leader – life-term, elected by Assembly of Experts). President – four-year terms, eligible for a second term and third non-consecutive term. Parliament (Majlis) – 290 members elected for four-year terms. Assembly of Experts – 86 clerics elected by direct public vote to eight-year terms.
Head of State	Supreme Leader Ayatollah Ali Khamenei
Head of Government	President Hassan Rouhani
Last Election	Parliamentary – March 2 2012
	Presidential – June 14 2013
Next Election	Presidential – May 2017
Key Figures	Mohammad Bagher Ghalibaf (Mayor of Tehran) Ali Larijani (speaker of parliament) Mahmoud Hashemi Shahroudi (acting chairman of the Assembly of Experts)
Main Political Coalitions	Ultra-conservatives : Generally Pro-Khamenei. This faction is led by Ayatollah Mesbah Yazdi, an ultra-conservative displaying a staunch anti-Western rhetoric.
	Moderate conservatives : Important members include Ali Larijani, Mohammad Bagher Ghalibaf and Mohsen Rezaii; support moderate economic and political reforms but still favour current policy formation.
	Moderates: Lead by Hassan Rouhani; support moderate economic and political reforms and favour a rapproachment with the West on the nuclear issue.
	Reformists : Made up of a number of factions with varying views, largely anti-government; favour political freedoms and more open policy formation.
Current Parliamentary Make-Up	Conservatives – 182 seats (62.7%); Reformists – 75 seats (25.9%); Independents – 19 seats (6.5%); Minority religions – 14 seats (4.8%)
Ongoing Disputes	US and EU (sanctions relating to terrorism and human rights abuses), Israel, UAE (Lesser and Greater Tunb), Azerbaijan and Turkmenistan (Caspian sea borders)
Key Relations/Treaties	WTO, Organisation of the Islamic Conference, increasing economic and political relations with Iraq, limited relations with GCC and member countries, strong alliances with Syria. Increasing relations with Russia and China.
BMI Short-Term Political Risk Rating	49.6
BMI Long-Term Political Risk Rating	52.9

Source: BMI

new strains on the government, the regime's resilience should not be underestimated. Iran's political system is virtually unique in the world, combining an Islamist theocracy with revolutionary republicanism and a very heavily managed democracy. Ever since the establishment of the Islamic Republic following the Iranian Revolution of 1979, outside observers have been predicting the collapse of the clerical regime, but it has proved highly resilient, surviving a brutal eight-year war with Iraq (1980-1988), subsequent international isolation and rising domestic opposition – most evident in the aftermath of the disputed 2009 presidential election.

Broadly In Line With Region

MENA And Iran – Components Of Long-Term Political Risk Index



Note: Scores are out of 100, with 100 representing the lowest risk. Source: BMI

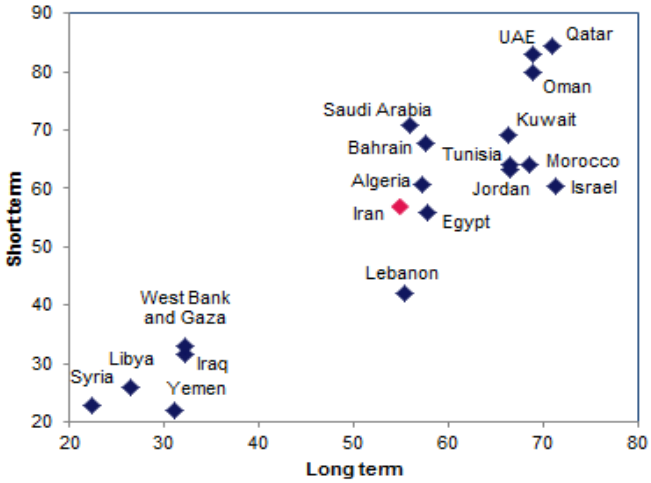
Challenges And Threats To Stability

Democratic Shortcomings: Although the Islamic regime swept to power in a mass uprising in 1979, the clerics who subsequently established control have failed to build liberal democratic institutions. Elections are held for parliament and the presidency, but candidates are thoroughly vetted and the process is heavily managed. Moreover, parliament and the president are subordinate to the clerics and the Supreme Leader. The legitimacy of the previous administration was tested severely in the aftermath of the disputed re-election of President Mahmoud Ahmadinejad in June 2009, when thousands of opposition supporters took to the streets to protest the result. Although the security services quickly quelled the demonstrations, they represented the biggest outburst of popular discontent since the 1979 revolution. Since then, Iranians have learned from the Arab Spring that popular uprisings are capable of toppling long-established leaders, but that they do not automatically result in democracy, and in some cases can make matters worse.

Replacing The Supreme Leader: The revolution established the position of Supreme Leader, which stands above day-to-day politics, while retaining command of the armed forces and judiciary, with more power than the office of president. Since 1979, Iran has had two such figures: Ayatollah Ruhollah Khomeini (1979-1989) and Ayatollah Ali Khamenei (1989-present). Khamenei, now 76, is rumoured to be in poor health and underwent prostate surgery in September 2014. Although procedures are well established for the selection of his successor, the transition period could be destabilising. Given that the Supreme Leader is the true centre of power in Iran, whoever assumes the role will have a major bearing on Iran's future. While the identity of the next Supreme Leader is difficult to call, we believe that hardliner Ayatollah Mahmoud Hashemi Shahroudi is the frontrunner at present (*see 'The Next Supreme Leader: Assessing Potential Successors', May 7 2016*).

Elevated Risks To Remain

MENA – Political Risk Index Scores



Note: Scores are out of 100, with 100 representing the lowest risk. Source: BMI

Competing Power Centres: Iran has many powerful institutions, including the Supreme Leader, president, Majlis (parliament), Expediency Council, Assembly of Experts, armed forces, Islamic Revolutionary Guard Corps (IRGC, Pasdaran), Basij militia and VEVAK intelligence service. While it could be argued that different bodies provide useful checks and balances on one another, competition between them can destabilise the political scene from time to time.

Growing Power Of The IRGC: The IRGC is an elite military force whose purpose is to defend the Islamic revolution (whereas the regular armed forces are responsible for national defence). The IRGC's power has grown in recent years, and it has substantial business interests which are estimated to comprise around 30% of the overall economy. Under Ahmadinejad's presidency (2005-2013), many IRGC officers were appointed to the cabinet, provincial governorships and other key political posts. Given its influence, the IRGC could eventually come to

challenge the authority of the clerical establishment and possibly the Supreme Leader himself.

Demographic Shifts: Iran's youthful population is a potential risk to political stability. According to UN figures, around 40% of the population was under 25 in 2016. Although this has decreased from an estimated 59% in 2000, it is still high when compared globally. Historically, such youth bulges have created instability, not least because of the challenges of creating sufficient employment opportunities for all new entrants to the workforce. Iran is no different; the official unemployment rate was above 12% in 2016, but unofficial estimates put it closer to 20%, with youth unemployment likely even higher. That said, Iran's total fertility rate (the average number of children a woman will have in her lifetime) has been falling sharply, from above 6.0 in the early 1980s to below 2.1 (the replacement level) by the early 2000s (it stood at 1.93 in 2015). This is likely to gradually reduce population pressure in Iran.

Diverse Population: According to the CIA World Factbook, Persians make up 61% of Iran's population, with Azeris accounting for 16%. Other minorities also are present, such as Kurds (10%), Arabs and Baluchis. Given that Iran's minorities are geographically concentrated, the country could become vulnerable to separatist pressure, especially if ethnic minorities are provided with external support as part of covert activities aimed at destabilising Iran. That said, Iran's Azeris are hardly a repressed minority; they are fully integrated with the Iranian religious, military and commercial elites.

External Pressure: Iran is subject to considerable external pressure. Until Rouhani's election, it had minimal political interaction with Western countries because of its perceived radical foreign policy, and because the Iranian government has been accused of being a sponsor of terrorism. In addition, Iran is viewed warily by most Arab states, who fear that the country is seeking to export radicalism and become the dominant power in the Middle East. In recent years, Iran's nuclear programme led to speculation that the US and/or Israel would attack the country to destroy its atomic facilities. Furthermore, geopolitical competition between Iran and Saudi Arabia has intensified, most notably in Bahrain, Lebanon, Syria and Yemen. Although Rouhani's election has led to more cordial relations with the West, including the signing of a nuclear programme in January 2016, we highlight the risk that a nuclear deal could break down, increasing the possibility of an armed conflict between Iran and its adversaries over the coming years. Although Iran maintains amicable relations with Russia, China, India and Brazil, none of these countries has the ability or willingness to come to Tehran's defence in the event of a conflict.

Long-Term Political Risk Index

BMI's long-term political risk index for Iran is 54.9 out of 100. This low score implies that we have considerable doubts over the sustainability of the current political system. Of the index's four sub-components, the lowest is the 'characteristics of polity' score, at 44.7/100. This reflects Iran's authoritarian political system. The 'characteristics of society' score is somewhat low at 55.0/100, owing to a diverse population and high levels of poverty, while the 'scope of state' score is 55.0/100, reflecting severe external pressure on the government as a result of international sanctions. The 'policy continuity' score is high at 70.0/100, because Iranian governments generally pursue similar policies especially domestically.

Scenarios For Political Change

While we maintain our core view that hardline control will continue over the next decade, we see four possible alternative scenarios for Iran's evolution over the coming decade:

Elite-Led Transformation: While not our core view, there is potential for the current religious and secular elite to gradually transform the political system. The trigger for this could be the death of the Supreme Leader, who could be succeeded by a more flexible figure. A more moderate Supreme Leader could gradually ease political, economic and social restrictions with the aim of preempting the kind of mass unrest seen during the Arab Spring.

'Regime transformation' could include some of the following changes: some devolution of power away from supreme rule by clerics in favour of secular politicians; the conduct of elections with reduced vetting of candidates for the presidency and parliament or a manipulation of the results; a relaxation of media censorship; and an easing of excessive state interference in social and cultural norms. These changes will likely lead to some forms of economic liberalisation, although conservative forces will still hold considerable sway. They would also most likely lead to Iran toning down its hostility (at least in public) towards the US, Israel and various Western countries.

Partial reform would increase the likelihood of a nuclear deal holding firm as a more moderate Supreme Leader would see the benefits of an easing of sanctions and the economic bounce that follows.

We expect the political scene to become more unstable over the coming years, as competing forces vie for power. As the regime's ideological appeal weakens, Iranian leaders will seek new causes to boost their support. The obvious replacement to radical Islam is Persian nationalism, but given that ethnic Persians constitute only 61% of the population, this could prove divisive. Furthermore, even if the clerics' political power somewhat weakens, they are bound to seek continued influence in society through religious means. It is quite possible that Iran's political scene could become divided along similar lines to present-day Turkey, where secular institutions struggle against Islamist ones.

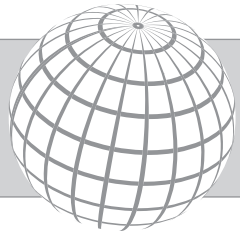
In terms of external relations, we expect Iran to pursue a multi-vector foreign policy, boosting ties with China, Russia, India and other emerging nations. Despite some improvements, a partially reformed Iran is unlikely to experience a permanent rapprochement with the West, even with the nuclear accord.

Popular Uprising: Alternatively, Iran could experience a new popular uprising over the coming years as public frustration with poor economic conditions, insufficient democratic representation, the absence of social freedoms and political infighting prompt hundreds of thousands of people to converge in the streets of Tehran and other cities to demand the resignation of key leaders and radical political change. The trigger for this could be a sharp deterioration of living standards, a blatantly rigged election in 2017, a sharp worsening of the economic situation following a possible breakdown of the nuclear agreement and re-imposition of sanctions, or any other 'shock' event. The regime cracked down heavily on post-election unrest in 2009, but there could come a time when intra-regime divisions become so pronounced that the leadership will be paralysed in the face of protests. The Iranian opposition currently lacks charismatic leaders capable of galvanising the public, but we highlight that the Arab Spring took place despite the absence of such figures. In any crisis triggered by an uprising, the stance of the military will be crucial to the outcome. For example, the Tunisian and Egyptian uprisings of 2011 succeeded because the armed forces largely refused to crack down on demonstrators. Iran's regime has the IRGC and Basij militia in addition to the regular military, but even these forces could eventually abandon the regime.

Even if the regime is nominally toppled by an uprising, we would expect any transition to democracy to be a long process, probably lasting at least five years. As events in Egypt since the Arab Spring have demonstrated, removing the president is not the same as removing the regime.

Military Takeover: Iran could conceivably experience a military coup or a creeping militarisation of political institutions over the coming decade. A sudden coup is unlikely unless Iran's political or economic environment deteriorates very sharply. This could occur as a result of an economic crisis followed by mass uprisings, which the regime would be unwilling to put down. If that were to happen, the regular armed forces or IRGC could conclude that they are the only ones capable of restoring order. Alternatively, Iran could experience a gradual but pronounced increase in military influence over the polity and economy as clerical rule falters. Although the IRGC is an ideological force, the weakening of the state's ideology could allow it to serve as bridge between religious and secular rule.

Descent Into War: Over the coming decade, Iran could find itself caught up in either foreign or civil wars. There is a minor possibility that Israel and/or the US could attack Iran if the country is discovered to be producing highly enriched uranium in secret facilities, in breach of the nuclear deal. Although such action would not necessarily be directed towards regime change, the resulting regional war would be the Islamic Republic's biggest challenge since the Iran-Iraq war. Although a foreign attack would initially cause the Iranian people to rally around the regime, the damage done to the country's infrastructure, the spectre of endless confrontation with the West, and the possibility of defeat could eventually discredit the regime irreversibly, prompting an uprising or a reformist coup. This would be a similar situation to the way in which military defeats in Argentina after the Falklands War (1982) and in Serbia after the Balkan wars (1991-1999) eventually helped topple their respective regimes.

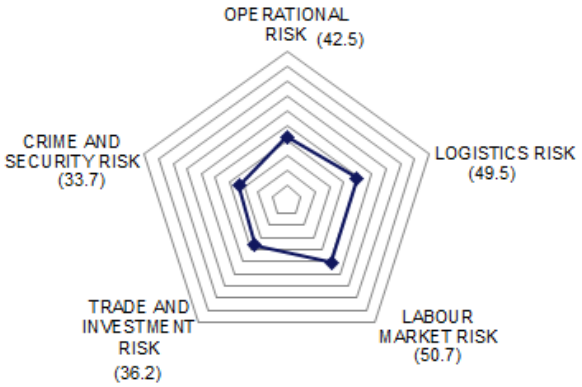


Operational Risk

BMI's Operational Risk report series provides a comprehensive overview of potential risks facing investors operating in a country, as well as a cross-country regional evaluation of threats and advantages. The Operational Risk service evaluates Logistics Risk, Trade and Investment Risk, Labour Market Risk and Crime and Security Risk. Below are sections from these reports.

Sanctions Weigh On Trade, Investment & Security Environment

Iran – Operational Risk Scores



Note: 100 = lowest risk; 0 = highest risk. Source: BMI Operational Risk Index

Iran is embarking on a historic rapprochement with the West which will improve international relations, alleviate the pressure of sanctions on the economy and create opportunities for foreign involvement in the country's vast hydrocarbons sector and consumer market. However, while the lifting of the sanctions regime will lead to a gradual improvement in the operating environment, the long-term survival of the nuclear agreement reached in July 2015 is not guaranteed, and many barriers will continue to stand in the way of greater foreign direct investment. These include obstacles to trade and regulatory restrictions, onerous taxes, stringent labour laws, the potential for terrorist activity and widespread corruption. Until structural reforms to the business environment take place, Iran will continue to offer a high-risk location for investment. The country scores below the regional average in **BMI**'s Operational Risk Index, with an overall score of 42.5 out of 100 placing it in 12th position out of 18 states in the Middle East and North Africa (MENA).

Crime And Security (33.7/100): Iran's isolated international position is the main driver behind the major security risks to business operations. The most pertinent concerns for investors are the potential for exposure to financial crime and cybercrime, both of which occur on a large scale in the country. In addition, the risk of interstate conflict remains high, as the country has poor relations with most global powers, and as its rivalries with Israel and Saudi Arabia have frequently appeared to bring it to the brink of conflict. Businesses also face risks from non-state actors such as Islamic State (IS), which Iran is aiding neighbouring Iraq in combating, and Sunni insurgent groups in the border region with Pakistan. Having said that, reasonably competent (if oppressive) security forces mean that the terrorist threat is lower than in other MENA states, while property crime is not a major problem for foreign workers and businesses.

Trade And Investment (36.2/100): The international sanctions imposed on Iran crippled the country's economy by preventing trade with major economies, restricting access to international financial markets and prohibiting foreign involvement in most industries. This has resulted in falling trade flows and tipped the

TABLE : OPERATIONAL RISK

	Operational Risk	Labour Market Risk	Trade And Investment Risk	Logistics Risk	Crime & Security Risk
Iran Score	42.5	50.7	36.2	49.5	33.7
MENA Average	47.2	50.6	47.4	46.6	44.1
MENA Position (out of 18)	12	8	12	9	12
Global Average	49.8	50.5	50.0	48.7	49.9
Global Position (out of 201)	129	96	151	94	154

Note: 100 = lowest risk; 0 = highest risk. Source: BMI Operational Risk Index

country into recession in 2012, while the economic recovery has been hindered by the sharp drop in oil prices over 2014. With an agreement over Iran's nuclear programme reached in July 2015, the sanctions regime is being gradually lifted, resulting in an improvement in trade flows and economic growth. However, Iran's appeal to investors will remain limited, despite considerable opportunities for FDI, due to a wide range of structural risks including the pervasive presence of the state in the economy, caps on foreign ownership in key sectors, a high tax burden, inefficient bureaucracy and rampant corruption.

Labour Market (50.7/100): The labour market in Iran boasts strong fundamentals due to the large size of the working age population, a robust healthcare system and an education system that produces large numbers of highly skilled workers. However, Iran suffers from a brain drain of its most well-educated citizens, who leave in order to seek more lucrative employment and better prospects abroad. This contributes to a lack of highly educated personnel in the Iranian labour force, representing significant risk for employers in terms of the cost of importing skilled labour. In addition, while there is a large pool of dormant labour to be tapped due to the high unemployment rate, formal work experience and vocational skills are lacking, particularly among young workers, increasing the costs of training for new employees. The costs of employment are further raised due to excessive government regulation of the labour market, which significantly restricts the flexibility of hiring and firing practices, and generous mandatory benefits for workers.

Logistics (49.5/100): Iran's logistics offerings are set to improve over the medium term as the lifting of sanctions alleviates pressure on the utilities supply and results in increasing investment in infrastructure. This will yield significant improvements in utilities reliability and place Iran in a strong position to take a growing role in regional and global trade flows. Nevertheless, the detrimental impact of sanctions on the utilities and transport networks has left existing infrastructure in a poor condition, resulting in continuing risks of disruption to utility supply and supply chains. In addition, bureaucratic and customs barriers to trade remain prominent and issues with internet connectivity and water scarcity will be key concerns for businesses irrespective of the lifting of sanctions.

Economic Openness

Iran offers one of the most unwelcoming environments for trade and investment globally, making it difficult for international firms to access its considerable economic potential. The country has been among the most isolated in the world, ostracised by the international community both politically and economically. International sanctions have depressed trade volumes and resulted in weak economic growth, while government-imposed restrictions on foreign investment and high levels of red tape will deter investors despite the lifting of most sanctions in January 2016 paving the way for greater foreign participation. Consequently, Iran is ranked 15th out of 18 states in the MENA region, for the Economic Openness pillar of **BMI**'s Trade and Investment Risk Index, with a poor score of 30.7 out of 100. Nevertheless, Iran holds huge potential for investors, particularly in terms of its hydrocarbons reserves and consumer market. Companies with a large risk appetite are therefore seeking opportunities in the country, which will boost trade and FDI flows over the medium term.

Latest Economic Openness Analysis:

- The election of Donald Trump to the US Presidency in November 2016 has cast doubt on the future of the nuclear deal. Trump and his team have not specified their policy towards Iran since the election, but the president had previously claimed he would scrap the agreement. This raises concerns for a recent deal struck by US plane manufacturer

TABLE: TARIFF AND NON-TARIFF TRADE BARRIERS

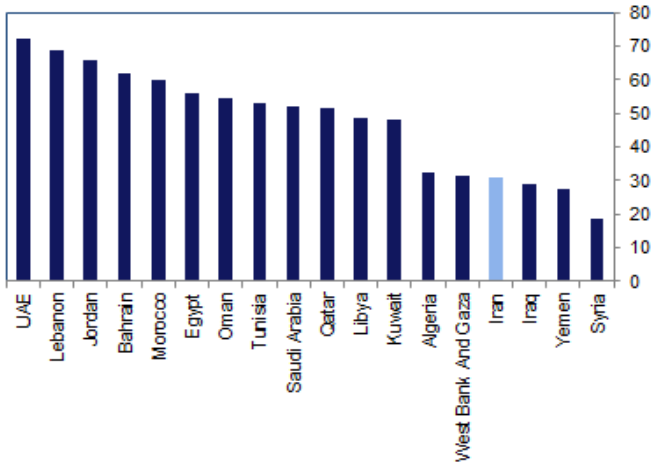
Measure Type	Trade Partners Affected	Business Impact
Import Tariffs	All	**High** – Iran's average import tariff rate of 15.2% is the highest in the MENA region. The Iranian government has traditionally applied high tariffs on imports to encourage domestic industry, but this significantly increases the costs of imported inputs for businesses and reduces Iran's competitiveness.
Customs and non-tariff barriers	All	**High** – Trade bureaucracy and customs delays are a major hindrance to business activity in Iran. Convoluted procedures significantly increase the times and costs required for international trade, and particularly complicate the import process. The potential for rent-seeking behaviour within the customs procedure adds further difficulties for businesses.
Sanctions	Mainly Western countries, particularly the US	**High** – Iran remains under US primary sanctions which prevent the use of dollar-denominated transactions for international trade. The inability to use dollars for trade transactions significantly increases the difficulty of selling into and operating in the Iranian market, as payments have to be made in EUR or CNY instead.

Source: Global Trade Alert, BMI

Boeing to provide new planes for the national airline, Iran Air, as a re-imposition of secondary sanctions would risk scuppering the agreement. While the Trump administration would not be able to restore all sanctions, as the UN and the EU are unlikely to agree to this, any reversal of the nuclear deal would be harmful for trade and investment in Iran and increase difficulties for foreign firms looking to do business in the country.

Numerous Impediments To Accessing Iranian Market

MENA – Economic Openness

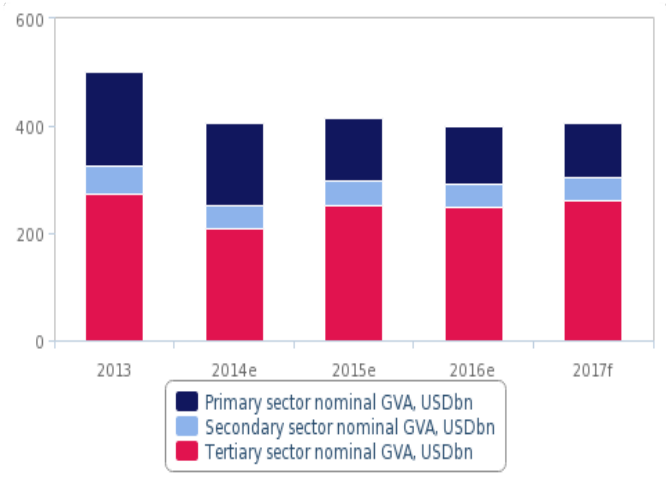


Note: 100 = lowest risk; 0 = highest risk. Source: BMI Trade and Investment Risk Index

- Iran is not experiencing an immediate boom in growth following the lifting of all UN sanctions, most EU sanctions and US secondary sanctions in January 2016, though real GDP growth will accelerate to 4.4% y-o-y on average over the medium term (2017-2021). The main benefits have been seen in the oil sector, as production has ramped up significantly, but most of these gains have now been realised. Investment in other sectors will be slow to return due to numerous impediments to business operations and the remaining US primary sanctions, which make it difficult for US companies to operate and prevent the use of dollars for transactions. Nevertheless, some large-scale deals have been struck including agreements with Airbus and Boeing to provide new planes for Iran Air's ageing fleet, while Daimler AG is restarting local production of trucks.
- Several Iranian banks were reconnected to the SWIFT international payment system in February 2016, allowing them to make transactions with foreign banks for the first time in four years. This is a significant development for the country's trade and investment openness. The reconnection will allow banks to make payments including letters of credit and facilitate exports of oil to European markets, as well as ensuring that foreign firms can repatriate profits and access financing from abroad.

Mining Sector Value Shrinking Under Lower Oil Prices

Iran – GVA By Sector (2013-2017)



e/f = BMI estimate/forecast. Source: UN, BMI

- Despite some high profile deals, Western banks and companies have remained reluctant to do business with Iran due to the complicated nature of sanctions and fears that they may be unwittingly implicated in financial crimes. The Iranian government is pushing for more trade and investment with the West in order to cement the nuclear deal, and opportunities are generating significant interest among Western companies. Nonetheless, the return of investment from the West will remain tentative over the short term at least, and FDI inflows will pick up more quickly from countries such as India, South Korea and China, which have already struck significant deals (*see 'Growing Investment Commitments To Support Construction Sector', June 9 2016*).

TABLE: FREE TRADE AGREEMENTS

Country/Bloc	Status	Positive Effect On Businesses
Pakistan	Active	**Moderate** – Trade with Pakistan is not significant, but assists with regional trade flows.
Syria	Active	**Low** – Trade with Syria is low and the country is mired in chaotic civil war.
Gulf Cooperation Council	Under negotiation	**High** – Iran is reliant on GCC states for imports, and trade will pick up once sanctions are lifted.
Indonesia	Under negotiation	**Moderate** – Indonesia is a large economy which could provide a market for Iranian oil exports.
Turkey	Under negotiation	**High** – Turkey is conveniently located next to Iran and offers a huge market for Iranian hydrocarbons.

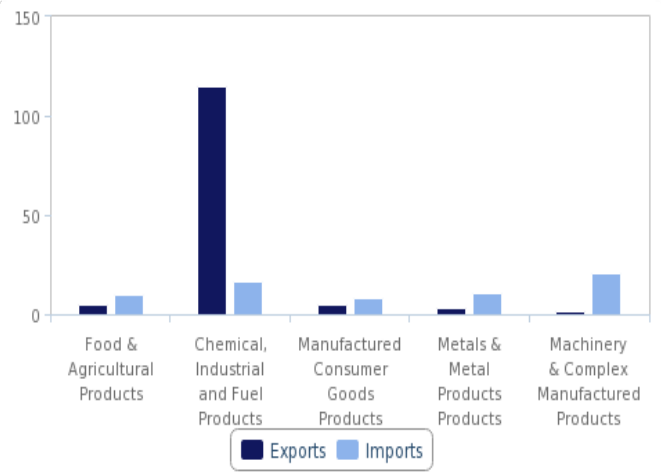
Source: BMI

Trade Openness

International trade in Iran has been shaped by the sanctions regime from which the country began to emerge in January 2016. The imposition of sanctions, led by the EU and the US, severely depressed trade volumes for Iran's key commodity export, oil, and prevented investment in the hydrocarbons industry, hindering economic growth. Sanctions have also stopped the use of dollars for international trade, and driven the focus of trade flows towards Asian countries. These dynamics are beginning to change as the majority of sanctions on the country have been lifted as of January 2016, but investors, banks and insurers remain cautious of dealing with the Iranian market, particularly as US primary sanctions are still in place, hindering the expansion of trade flows with Western states. Consequently, we expect to see only gradual improvement in Iran's score of 29.7 out of 100 for Trade Openness, which ranks it 17th out of 18 states in the MENA region.

International Trade Dominated By Hydrocarbons Exports

Iran – Goods Exports & Imports, USDbn (2011)

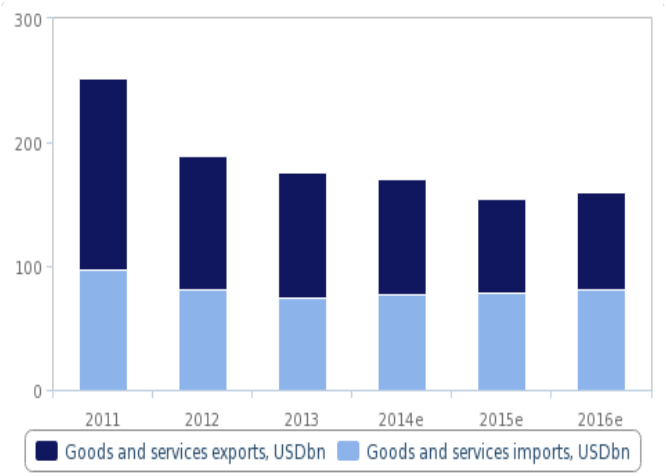


Source: Trade Map

The Iranian economy is dominated by its hydrocarbons sector, with the country boasting the world's fourth largest proven oil reserves (around 10% of the global total) and second largest natural gas deposits, at 17% of total proved reserves, according to the US Energy Information Administration. Mining sector value in gross value added (GVA) terms stood at an estimated USD75.97bn in 2016, with total primary sector value at an estimated USD102.2bn, though this has fallen from USD175.2bn in 2013 due to the significant fall in oil prices since H214. The tertiary sector remains the largest in terms of output, with GVA estimated at USD261.1bn in 2017, reflecting Iran's vast consumer market which has created huge demand for services. Though activities such as manufacturing represent a smaller share of output, with secondary sector GVA at USD43.7bn, there is considerable investor interest in areas such as autos production. The hydrocarbons sector remains the most important area of the Iranian economy, however, due to the government's extensive involvement in the industry and its consequent contribution to state revenues.

Sanctions Result In Significant Drop In Trade Value

Iran – Total Imports & Exports, USDbn (2012-2016)



e/f = BMI estimate/forecast. Source: CBI, BMI

Trade volumes in Iran are dominated by high-value hydrocarbons exports, which are the main driver of economic growth and the major source of government income. Iran's export values are expected to reach the fourth highest in the MENA region in 2016, at an estimated USD80.4bn, with mineral products accounting for 77% of goods exports in 2011 (latest available data). Other exports such as manufactured consumer goods, agricultural products and metals are of secondary importance. However, with exports expected to account for just 18.5% of GDP, the third lowest figure regionally, we highlight that there

TABLE: FREE TRADE ZONES AND INVESTMENT INCENTIVES

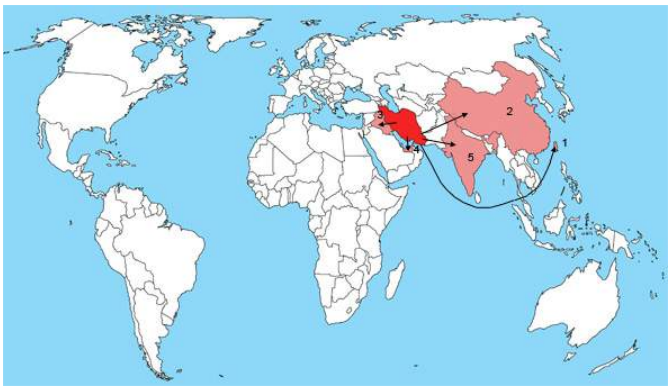
Free Trade Zone/Incentive Programme	Main Incentives Available
FTZs located at Kish, Qeshm, Chabahar, Aras, Anzali, Maku, Abadan	Visa-free entry for foreign nationals.
	Freedom to repatriate profits and obtain foreign currency.
	100% foreign ownership permitted.
	Profit tax exemption for 20 years.
	Customs duties exemption on capital goods.
	Fewer bureaucratic procedures.

Source: Government websites, BMI

is significant potential for expansion of hydrocarbons exports. Indeed, improved access to international markets following the lifting of sanctions has provided a boost to oil and gas exports and helped to support growth, though further gains will be minimal over the medium term.

Western Sanctions Have Led To Asia Trade Focus

Iran – Top Five Export Partners (2011)



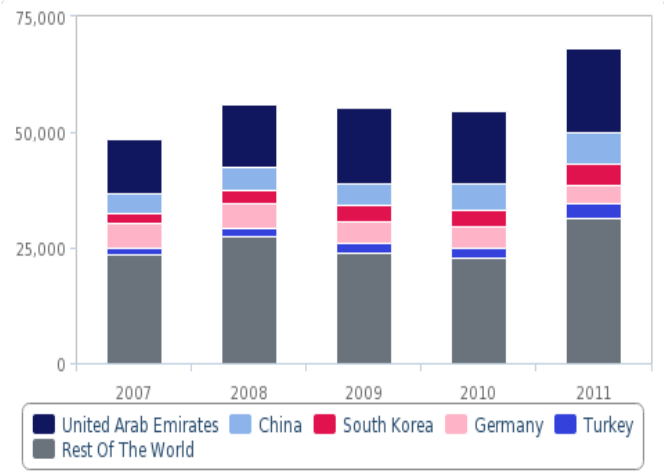
Source: d-maps.com, Trade Map, BMI

Import demand in Iran is also largely driven by the oil and gas sector, which is reflected in Iran's largest import segment in 2011, machinery and complex manufactured products, accounting for 22.6% of total product imports. This is followed by mineral products, with a 16.4% share of goods imports, and base metals such as iron, with 15.4%. Imports are expected to amount to USD84.4bn in 2017, the third highest in MENA, although as a percentage of GDP this represents just 19.6%, the second lowest figure regionally. The relatively high value of imports and exports means that total trade volume is estimated to come in at the third highest out of 18 MENA states, at USD164.4bn in 2017. Iran's vast natural resource wealth nonetheless suggests that potential trade volumes could be far higher than the current level.

International sanctions have presented the major barrier to trade growth and an improvement in Iran's economic fortunes. Although Iran has been under sanctions of varying severity imposed by the US since the Islamic Revolution in 1979, these were significantly widened and joined by the EU and the UN in 2011 as a response to the country's continuing nuclear programme. Sanctions have had a severe and widespread impact on Iran's economy, specifically targeting the development of nuclear facilities and the procurement of arms, while also including a ban on the involvement of Western companies in the oil and gas industry, the prohibition of oil exports to Western states and the exclusion of the banking sector from the international finance industry. Even though most sanctions were lifted in 2016, US primary sanctions continue to obstruct international trade by preventing the use of USD for transactions with Iran. Trade flows are also hindered by considerable average import tariff rates, standing at 15.2%, which is the highest figure regionally and eighth highest globally. Trade barriers will be removed only gradually even though the country's trade partners will likely widen substantially once sanctions are removed.

UAE Plays Increasingly Important Feeder Role

Iran – Top 5 Import Partners & Product Imports, USDmn (2007-2011)



Source: Trade Map, BMI

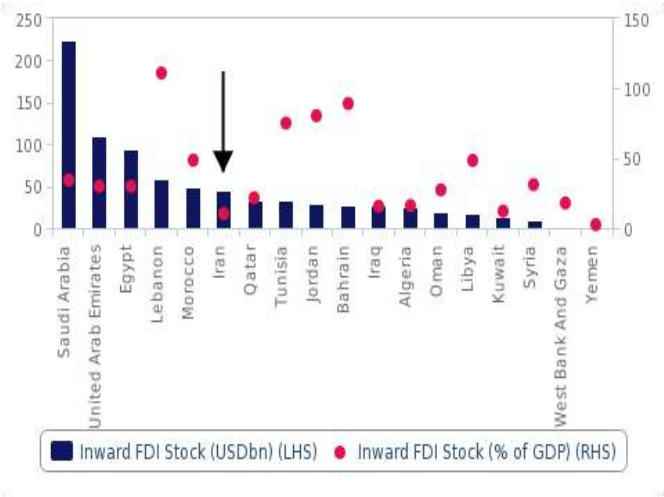
Since H214, structurally lower oil prices have provided a further impediment to trade growth and wider economic expansion. This loss of value has had a significant impact on export volumes in Iran, with lower demand due to oversupply capping the growth of oil export markets. Nevertheless, the lifting of sanctions has allowed the country to considerably ramp up oil production, increasing by 760,000 barrels per day since January 2016. This has given a significant boost to exports over the short term, although further significant production increases are unlikely due to a slow return of foreign investment to the oil and gas sector, as well as increasing signs of agreement among OPEC members to cap production. Consequently, most of the gains from the increase in oil production have already been realised, and further growth in export volumes will be slow.

The agreement over Iran's nuclear programme and the consequent lifting of sanctions has nonetheless provided a crucial and timely boost to trade, investment and GDP growth, enabling the country to further diversify its trade partners and also attract foreign companies to return to the Iranian market. We therefore expect a gradual increase in trade volumes over the medium term (2016-2020), with average expansion of 3.5% y-o-y projected for exports and a slightly faster pace of 3.8% y-o-y on average for imports. The outlook for real GDP growth is brighter, set to average 4.5% y-o-y in 2017-2021, compared to 0% y-o-y on average over the previous five years. Nevertheless, a sustained

economic boom will be restricted by the incremental process of sanctions removal, a slow increase in hydrocarbons production and inflationary pressures on consumer spending, as well as structural impediments to investment.

Moderate FDI Stock Despite Sanctions

MENA – Inward FDI Stock (2015)

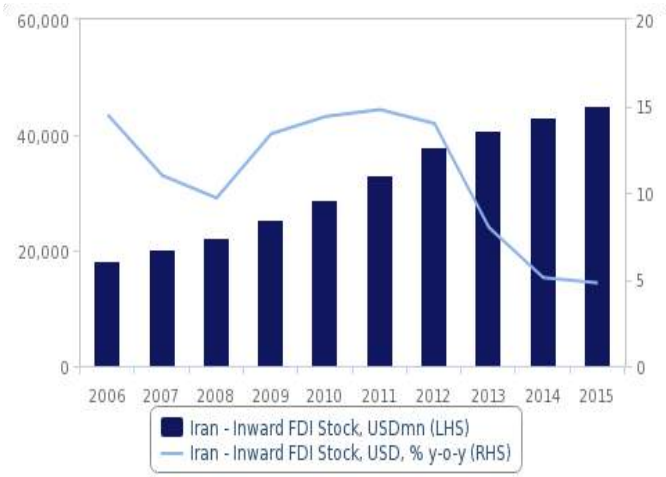


Source: National Statistics

The sanctions regime has severely restricted Iran's options in terms of trade partners, resulting in a closer trade relationship between Iran and Asia, particularly China, in recent years. Iran's top five export partners in 2011 were Taiwan, China, Iraq, UAE and India. The top five import partners are the UAE, China, South Korea, Germany and Turkey, with the UAE playing an important role as a feeder port due to sanctions preventing shipping companies from calling directly at Iranian ports. China has been an increasingly important trade partner, with imports at 8.1% of the total in 2011, up from 6.6% in 2006 – although this expansion is set to moderate somewhat following sanctions removal, which will expand the range of trade partners. However, Iran's limited access to key global markets means that its trade diversification is extremely poor, with Taiwan by far the dominant export partner, and the country has few active free trade agreements.

Growth In FDI Slowing Considerably Under Sanctions

Iran – Inward FDI Stock (2006-2015)



Source: UNCTAD, BMI

Investment Openness

Despite its considerable investment potential, Iran offers one of the most difficult markets in the world for foreign investors to navigate. To a large extent, this is due to the international sanctions placed on the country, which precluded investment

TABLE: BARRIERS TO FDI

FDI Barrier	Sectors Affected	Business Impact
Sanctions	All, but particularly hydrocarbons, banking, shipping and insurance	• **High** – Sanctions primarily focused on the economically vital oil and gas industry and the financial sector. Specifically prevented Western companies from involvement in the financing of oil exploration, production and refining, and essentially excluded the banking industry from global financial markets by banning trade in precious metals from Europe and expelling Iranian banks from SWIFT. • By targeting these sectors in particular, the sanctions essentially imposed a blanket ban on investment in Iran by Western firms. Though most sanctions have now been lifted, US primary sanctions remain in place, causing difficulties for businesses with US interests and preventing the use of USD for transactions.
Local ownership requirements	All, particularly hydrocarbons	• **High** – Ownership of natural resources is confined to the Iranian state, which severely limits the ability of private entities to become involved in the potentially lucrative sectors of mining and resource extraction. • In the oil industry, private investment is restricted to buyback contracts which allow private firms to provide the capital and expertise required for extraction but require production sites to be returned to the ownership of the National Iranian Oil Company after the initial set-up. • Although planned reforms will allow more lucrative production-sharing agreements, the restrictions on private sector involvement in the oil industry will remain extensive.
State-owned enterprises	All	• **High** – The extensive presence of sanctioned entities in the economy, such as the Iranian Revolutionary Guard Corp, will hinder joint venture agreements and other forms of cooperation in certain industries. • Even with extensive due diligence, it can be difficult for companies to gain a full and clear picture of the entities they are dealing with in Iran, exposing firms to risks of penalties for engaging with sanctioned businesses or individuals. • SOEs are also prevalent in many sectors, requiring foreign companies to strike joint-venture agreements in order to invest in some industries, and crowding out private sector competition in others.

Source: BMI

by Western businesses in many sectors, including the valuable oil and gas industry, and severely limited access to financing for firms based in Iran. However, an equally important factor is the country's poor operating environment, with a number of restrictions on foreign investment and a bureaucracy which is burdensome and difficult to navigate. Consequently, even though most sanctions have been lifted, many structural obstacles to FDI remain in place until wider institutional reforms are enacted. Due to these considerations, Iran receives a low score for Investment Openness, at 31.7 out of 100, which places the country 13th out of 18 states.

Investment Trends: Iran's clear potential has attracted investment from entrepreneurs capable of mitigating the country's considerable operational risks. In particular, the automotive sector has traditionally seen considerable inward FDI flows, and French manufacturer Peugeot boasted a significant presence until the impact of sanctions caused the company to suspend operations in 2012. Retail is another sector which offers considerable attractions for foreign investors, due to the country's large consumer market and significant pent-up demand for Western goods which have been inaccessible for several years. In addition, FDI inflows have continued from non-Western states during the sanctions regime, particularly from China, while South Korean and Indian firms have also been among the first to secure investment in infrastructure development following the lifting of sanctions.

Consequently, Iran's FDI stock stood at a not-inconsiderable USD45.1bn in 2015, the sixth highest figure regionally, and above more open MENA states such as Qatar, Jordan and Bahrain. This represents a considerable increase over the previous 10 years, with FDI stock standing at just USD18.3bn in 2006, and has also run counter to the global trend of falling FDI inflows, which was instigated by the financial crisis. The main sectors receiving FDI have been chemicals production, metals, mineral extraction, utilities, tourism and telecommunications. However, inward FDI stock represents just 10.3% of GDP, the second-lowest figure regionally, indicating the vast potential for greater foreign investment in Iran following the lifting of sanctions and reform of oil contracts and other foreign investment legislation.

Foreign investment is currently coordinated under the Foreign Investment Promotion and Protection Act (FIPPA), which was introduced in 2002 in order to simplify and streamline procedures and attract greater FDI inflows. It also ensures that any expropriation or nationalisation will be compensated by the government. Iran has revealed several measures designed to encourage investment, such as abolishing restrictions on the percentages of foreign shareholding within a company and a three-year residence licence for foreign investors, directors and experts. These reforms have been stepped up in anticipation of the lifting of sanctions, with potential measures including tax incentives and reduced administrative obligations for foreign investors. In addition, Iran operates several free trade zones and special economic zones, which offer a range of incentives for investment. There are therefore a number of incentives which foreign investors may take advantage of, though this is predicated on the endurance of the nuclear agreement and more wide-ranging structural reforms allowing greater foreign participation in the economy.

Investment Barriers; Even as sanctions on Iran are lifted, the country remains a hostile environment for FDI. The opaque nature of the government and the economy means there are numerous potential hidden obstacles which investors must overcome, and the risk of falling foul of remaining sanctions or compliance regulations is elevated for companies in all sectors. Local ownership requirements, and the slow pace of reform of hydrocarbons contracts, also cause particular complications for oil companies looking to move into this potentially lucrative sector.

Education

Iran boasts one of the better education systems in the Middle East, with high enrolment rates for both males and females at all levels of schooling, and a particularly strong tertiary education sector which produces a large number of graduates with technical degrees. Improvements to the education system have been under way since the Islamic Revolution in 1979, boosting enrolment rates and the quality of teaching. Although risks remain, in the form of a lack of emphasis on improving the quality of teaching, insufficient job opportunities for skilled workers and challenges to female education, there is a relatively healthy outlook for Iran's education system. This will feed into a higher-quality labour market over the medium term, with Iran already scoring a high 75.3 out of 100 for the Education pillar of **BMI**'s Labour Market Risk Index, ranking it first out of 18 states in the MENA region.

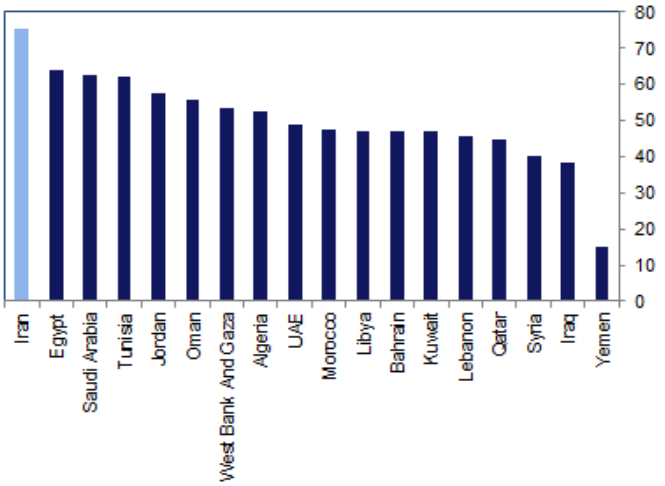
Latest Education Analysis:

- The Iranian government has signed a number of agreements with Western educational institutions following the lift-

ing of sanctions. These include deals with France's École Polytechnique for Iranian students to access the French university's graduate programme, as well as agreements on joint research and student exchanges with institutions in Sweden, Switzerland and Cyprus. These deals will broaden access to renowned international universities for Iranian students and academics, improving the quality of education and boosting the skill sets of the labour force.

Strong Education System Boosts Employability

MENA – Education Risk



Note: 100 = lowest risk; 0 = highest risk. Source: BMI Labour Market Risk Index

- In March 2016 the government raised the punishments imposed on parents for failing to ensure that their children attend school, increasing potential penalties from fines to up to three-month prison sentences. While this is a stringent punishment, the government's attempts to improve school enrolment and retention rates have resulted in a significant reduction in non-attendance over recent years, and this measure will further ensure that enrolment and retention rates remain high.

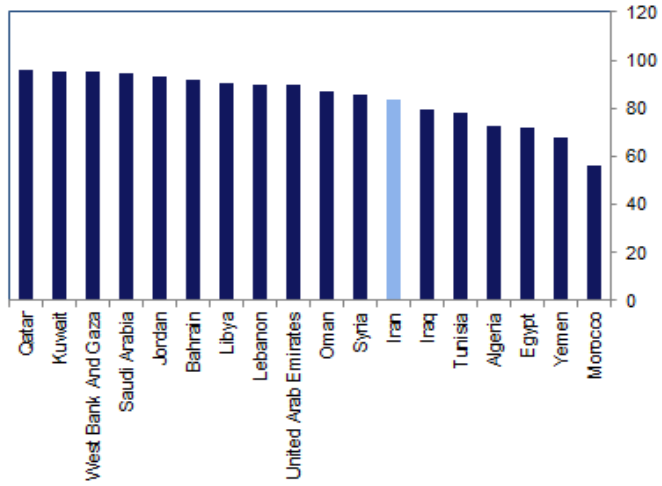
General Education

Iran's education system has seen significant improvements, which have boosted enrolment rates across all levels of schooling and improved the quality of teaching. These advances in the education sector will ensure that Iran's labour market will become increasingly employable over the medium term. Iran consequently scores 68.7 out of 100 for General Education, ranking it fourth in the MENA region. However, we caution that a number of risks remain with regard to the education system, the most pertinent being slow improvement in secondary school enrolment rates, and the limited quality of schooling, which despite recent advances remains poor on a global comparison.

School attendance is compulsory for all children in Iran aged six to 13, and free public schools are provided by the government for all ages up to 18. The education system in Iran is based on four tiers: primary school, middle school (or lower secondary/guidance), secondary school (upper secondary) and tertiary level (university). Primary education lasts for a five-year cycle, followed by a three-year cycle of lower secondary, or guidance, education. It is the aim of this secondary education to prepare students for either further academic or vocational/technical studies in their three years of higher secondary education. Although the minimum attendance for school is eight years, school life expectancy is longer, at 15 years.

Literacy Rate Set To Improve Due To Better Educated Youth

MENA – Education Risk



Note: 100 = lowest risk; 0 = highest risk. Source: BMI Labour Market Risk Index

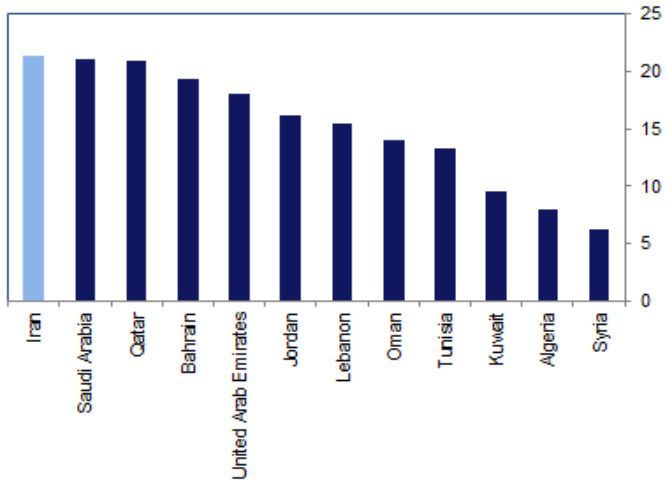
The Ministry of Education is responsible for education policy in Iran up to the tertiary level, which comes under the umbrella of the Ministry of Science and Technology. Tehran has set a high standard for education development over the last few decades, with consistently generous funding awarded to the Ministry of Education in order to improve the coverage and quality of schooling provision. Although it is still significant, standing at 2.95% of GDP in 2014, government expenditure on education has fallen from 4.72% of GDP 10 years previously. Education nevertheless remains a top priority for the Iranian government.

Significant investment in education has resulted in widespread access to schools across Iran, with children in remote rural areas also able to attend. The success of this increase in access to education is reflected in the sharp drop in out-of-school children and adolescents over the last few years. Since 2005, the number of out-of-school children has fallen from 236,685 to just 44,743 in 2014, according to UNESCO data. The number of out-of-school adolescents has dropped by a similar figure over the last five years for which data are available, from 253,210 in

2010 to 33,401 in 2014, indicating that the prevalence of more highly skilled workers in the labour pool will be increasing over the medium term.

High University Enrolment Rates Will Boost Skilled Labour Pool

MENA – Labour Force With Tertiary Education, %



Source: World Bank

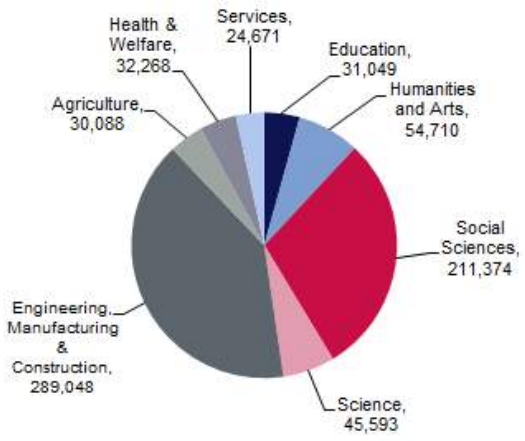
That investment in education has only begun to see rewards in recent years is indicated by the fact that only 83.6% of the population is literate, which ranks Iran 12th in the region in terms of literacy rates. However, youth literacy rates (ages 15-24) are much higher than the overall rate, with 98.2% of males and 97.7% of females being literate. This suggests that the vast majority of the 15% who are illiterate are older members of Iranian society who grew up when education was neither compulsory nor a major priority, and was also lacking in quality and penetration. Therefore, Iran's literacy rate will continue to improve as more of the population receives an acceptable level of education.

Since the Iranian Revolution in 1979, the emphasis on Islamic teaching has increased. This has resulted in educational policies which include an intensive programme of religious study and gender-segregated schools. This influence of Islam on teaching appears to have gained further ground over recent years, in response to a government perception that 'Western' ideas are becoming more widespread in society. The risk is that this focus on religious education, which includes considerable time spent studying the Quran and theology, may detract from students being taught skills which will enhance their employability, or prevent them from being steered towards studying technical degrees which are needed for highly skilled professions.

In addition, the influence of more conservative Islam on the education sector has led to fears that women may become increasingly marginalised, with many universities announcing in September 2012 that female students would be banned from studying a wide range of courses. This threatens to undermine the advances made in Iran in terms of female education, with women currently outnumbering men on university courses. This will restrict further female participation in the workforce, weakening the pool of labour available for businesses.

Large Number Of Graduates With Specialised Skills

Iran – Tertiary Graduates By Discipline (2014)



Source: UNESCO

Primary Education: The availability and standard of primary education in Iran is reasonably strong, leading to a relatively high percentage of the Iranian workforce with a basic education. A strong attendance rate at primary and even pre-primary, education institutions, as well as an increasing literacy rate, is beneficial for the country's labour market over the longer term.

One of Iran's greatest strengths in terms of the education system is its high primary school enrolment rates. At 99.3% in 2014, Iran's primary school net enrolment rate was the sixth-highest in the MENA region. This is indicative of the success of sustained investment in education and expansion of access to schools across the country. Although reforms have only begun to take effect recently, a large percentage of the country's labour force, 98.4%, has benefited from a formal education for at least the primary school cycle, the highest figure in the region. This means that businesses will not face difficulties finding workers with basic skills such as literacy.

Furthermore, in collaboration with UNICEF, the government of Iran operates over 5000 rural Child Care Centres across the country to provide Iranian children with preschool education. Due to these measures, 40.6% of males and 44.7% of females began primary school in 2014 with some preschool education; with over 70,000 villages across Iran, there is potential that such schemes will be made more widely available. This ensures that

more children are prepared to attend primary school and receive teaching from a younger age, benefitting their development and their chances of progressing further in the education system.

Secondary Education: While it has, in recent years, attained a relatively high level of enrolment, from both of males and females, the quality of Iran's secondary education system is somewhat lacking. The major risks for employers are that Iranian students are not being taught the skills they require to gain employment in Iran. In addition, enrolment rates continue to lag behind other countries in the region, despite recent improvements, and there remain urban/rural and gender imbalances.

Lower secondary education in Iran is compulsory, while higher secondary education is not. Lower secondary education lasts for three years from ages 11-13 and is also known as the 'orientation' or 'guidance' cycle. At the end of the three years, students take an examination, the results of which determine the progression of the student into one of three paths available in upper secondary education: the theoretical/academic branch, the technical/vocational branch and the manual skills branch. The first is intended to prepare students for further study and university entrance examinations, while the latter two are oriented towards preparing students for the job market.

The secondary school net enrolment in Iran stood at 81.7% in 2012, which is above the regional average of 74.8%. However, this means that nearly a fifth of students do not progress beyond primary school, and will therefore enter the labour market lacking in more advanced skills than basic literacy and numeracy. Poor attendance at secondary schools is a particular problem in the poorer and rural regions of Iran, such as Sistan-Baluchistan, where all family members are expected to contribute to family income, therefore having a detrimental effect on the enrolment and attendance rates of children in school.

In addition, Iran has suffered from poor transition rates from primary to secondary school, and low secondary school enrolment rates in the past. Consequently, only 46.3% of the labour force has at least secondary education, which places the country third in the MENA region. This means that over half the labour force has only a primary education and the labour market is therefore lacking in more advanced skills than basic literacy and numeracy. Although increasing enrolment rates will improve this figure over the medium term, at present businesses may find that while there is a large pool of low-skilled workers, there is a lack of labour force participants with more advanced skills sets, meaning that labour may have to be imported.

There remain issues with the quality of teaching in Iran. In 2011, the Trends in International Maths and Science Study (TIMSS) found that only 1% of nine- to 10-year-olds and 2% of 13-14 year-olds scored above the 'high international benchmark for mathematics' and 33% and 26%, respectively, above the 'intermediate benchmark'. These proportions are well below average. A recent study also found that about one-third of the inequality in maths and science scores of Iranian 13-14-year-olds were explained by their family background and where they were raised. In addition, the lack of employable skills is continued to higher secondary education courses, where the three most popular modules in 2013 were The Quran, Religious Education and Persian Literature. The key risk here is that Iran's labour force will grow increasingly unskilled in areas such as science and mathematics, leading to more limited options for employers in the labour market.

Tertiary Education

The capacity of Iran's universities to train and educate a large number of students in the fields of engineering, construction, manufacturing and science means that it is able to produce a wide pool of workers with specialised skills which are in high demand by employers. Consequently, Iran is awarded a high score of 82.0 out of 100 for Tertiary Education, placing it first in the region. However, the quality of these graduates has been called into question by many, including President Rouhani, due to concerns that the Iranian university system is more focused on quantity of academic output than on quality of teaching. In addition, many of Iran's graduates will not find suitable employment within Iran, and are therefore forced to leave the country in search of work or further study, which leads to a brain drain and a lack of highly skilled workers in the country's labour market.

There are a large number of universities and higher education institutions in Iran, with a widespread presence ensuring that access to tertiary education is available throughout the country. The main universities – the University of Tehran and the Sharif University of Technology – are located in the capital. This is also the base for Iran's semi-private open university, Payame Noor, which provides access to higher education on a wider scale, with 31 provincial centres and 485 local study centres. This has helped open up the availability of higher education to a broader range of students. The country's highest-ranked institution in international league tables is the Iran University of Science and Technology, which is placed in the bracket 401-500 out of 800 universities covered by the Times Higher Education World University Rankings 2015-2016. The University of Tehran also receives acclaim from the Academic Ranking of World

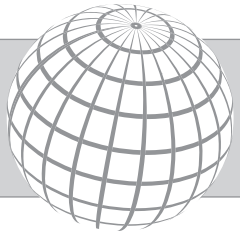
Universities, in which it places in the top 500.

The gross enrolment ratio into Iran's higher education institutions stood at 57.9% in 2013, the third-highest in the region. A recent increase in the number of universities and centres for tertiary education in Iran, as well as the opening of the private higher education sector, has made higher education much more accessible to Iranian students. In particular, women have benefitted from increasing participation rates, with 60% of accepted university applicants in recent years being female, and tertiary participation rates among women doubling over the past two decades. This means that over the medium term there will be an increasingly wide pool of labour available for recruitment with more advanced skill sets. The percentage of the labour force holding a degree – which currently stands at 21.3%, already ranking Iran first in the region – is therefore expected to grow.

Of the students currently enrolled in Iranian higher education institutions, 289,048 graduated with a degree in manufacturing, engineering or construction in 2014. This number of skilled graduates with the qualifications necessary to work in technical or specialised industries is the highest quantity produced in the region. Similarly, 45,593 graduated with a degree in the sciences in 2014, producing the largest number of science graduates in the region. These figures reflect the capacity of Iranian tertiary institutions to train and teach advanced skills and knowledge to large numbers of students. The production of graduates with specialised degrees means that there are more options for businesses requiring highly skilled workers, for example in the oil and gas industry. This is particularly beneficial in Iran, in which the hydrocarbons sector is the key pillar of the economy.

However, the Iranian labour market often does not benefit from these students. In 2013, at least 40% of Iran's top-performing students with undergraduate degrees in science and engineering left the country to pursue advanced degrees abroad, while others left to seek lucrative employment. The number of Iranians studying in the US increased 25%, to more than 8,700, in the last academic year, many of whom will not return. Over 1mn Iranians were living in developed states as of 2015, many of whom are well-educated and have found better employment opportunities abroad. President Rouhani pledged in his election campaign manifesto to take steps to reduce or slow this 'brain drain', but it is unlikely that any measures will suffice for as long as economic conditions reduce employment opportunities for skilled workers. That said, the lifting of sanctions will result in a slow improvement in economic growth and employment rates, and businesses will benefit from the continuing production of graduates with technical degrees, who may be persuaded to stay if there are attractive domestic employment opportunities.

Furthermore, concerns persist about the quality of graduates produced in Iran. There have been several reports that increasing the number of institutions has led to a lack of focus on providing quality research and teaching. In particular, the fields of humanities and social sciences are said to have suffered, due to the practice of self-censorship which prevents both students and faculties from expressing their opinions candidly. In addition, there are those who argue that Iran has created a system which rewards the act of publishing with credit and esteem, without taking into consideration the quality of those publications. Though Iran produces a significant number of science articles in many leading and international journals and is currently ranked 18th in the world for quantity of published output, that these authors are rarely referenced by others indicates the limits of their quality and usefulness. Consequently, even though Iran produces high numbers of graduates, businesses requiring highly qualified staff may still be required to import labour or provide more training for Iranian workers, adding significant operational costs, due to the lower quality of tertiary education.



Emerging Markets Recovery Still In Early Stages

- Global macro conditions continue to improve, while key near-term political risks (ie, European elections) are abating.
- However, the March G20 meeting outcome bolsters our expectation of more a combative US stance on trade.
- US monetary policy will continue to tighten, but only at a moderate pace.
- Many emerging markets are in the 'early acceleration' phase of growth, in the aftermath of a difficult few years.

We continue to forecast global real GDP growth of 2.8% in 2017 and 2.9% in 2018, up from 2.5% in 2016 (an upwardly revised estimate from 2.4% previously, due to incoming Q416 national accounts data). Most of our real GDP growth forecast revisions in the past month have been to the upside, including key eurozone countries (such as France and Italy) and some mid-sized emerging markets (Romania), adding to a broad swathe of upgrades since the beginning of 2017. Emerging market economies in particular are in a cyclical upswing, with many in the 'early acceleration' phase of growth, according to our country analysts (*see Emerging Markets section below*).

Major global political tail risks look less pronounced, with a poor performance by the populist right in the highly anticipated Dutch elections on March 15 possibly signalling an ebbing of euroscepticism ahead of the French presidential elections in

TABLE: GLOBAL MACROECONOMIC FORECASTS

	2016e	2017f	2018f	2019f	2020f	2021f
Real GDP Growth (%)						
US	1.6	2.0	2.2	2.0	1.9	1.9
Eurozone	1.7	1.6	1.6	1.5	1.5	1.5
Japan	1.0	0.8	0.5	0.4	0.4	0.4
China	6.7	6.3	5.8	5.6	5.4	5.4
World	2.5	2.8	2.9	2.9	2.9	2.9
Consumer Inflation (ave)						
US	1.8	2.5	2.0	2.1	2.1	2.1
Eurozone	0.4	1.3	1.7	1.8	1.8	1.9
Japan	-0.1	1.3	2.5	2.8	2.9	3.0
China	1.8	2.3	2.5	2.5	2.5	2.5
World	2.5	3.0	2.9	2.9	2.9	2.9
Interest Rates (eop)						
Fed Funds Rate	0.50	1.00	1.50	2.00	2.00	2.00
ECB Refinancing Rate	0.00	0.00	0.00	0.00	0.25	0.75
Japan Overnight Call Rate	-0.10	-0.10	-0.10	0.00	0.25	0.50
Exchange Rates (ave)						
USD/EUR	1.11	1.03	1.02	1.00	1.00	1.00
JPY/USD	108.81	117.50	120.00	121.00	122.00	123.00
CNY/USD	6.65	7.02	7.25	7.50	7.60	7.60
Oil Prices (ave)						
OPEC Basket (USD/bbl)	40.76	54.00	57.00	61.00	64.00	67.00
Brent Crude (USD/bbl)	45.13	57.00	60.00	64.00	67.00	70.00

e/f = estimate/forecast. Source: BMI

April and May. With macro conditions improving and some key global political risks abating, we now expect the US Federal Reserve to have slightly more room to hike rates in 2017 (see Developed States section below), though we stress that rapid tightening is not our core scenario.

The G20 meetings on March 17-18 sounded a more cautionary note, with the world's finance ministers unable to agree on renewing a long-standing pledge to keep global trade 'free' and 'open'. This change in language came at the behest of the US, whose new presidential administration is still determining its trade strategy and the extent to which it wishes to erect protectionist measures in order to shield domestic industry from foreign competition. We continue to believe that cooler heads will prevail, and an all-out trade war will be avoided. But the G20 outcome reinforced our view that Washington will renegotiate some of its key trade relationships, including with Mexico and with China, with the US imposing limited and targeted measures including tariffs on key traded goods, with trade partners replying in kind. Global trade is hardly on the verge of collapse – cyclical indicators for world exports are turning up – but structural factors and rising protectionist sentiment suggest that the trade recovery will be limited, following on from a fallow five years.

Developed States

We have raised our 2017 real GDP growth forecast for developed markets to 1.8% from 1.7% previously, while still anticipating an acceleration to 1.9% in 2018. This comes mainly on the back of improved growth expectations for key eurozone economies.

The strength of recent economic data suggests upside risks to

TABLE: DEVELOPED STATES – REAL GDP GROWTH (%)

	2016e	2017f	2018f	2019f
Developed States Aggregate Growth	1.7	1.8	1.9	1.8
G7	1.5	1.7	1.7	1.6
Eurozone	1.7	1.6	1.6	1.5
EU-28	1.8	1.7	1.7	1.7
Select Developed States				
Australia	2.5	2.1	2.2	2.2
Austria	1.5	1.6	1.6	1.7
Belgium	1.2	1.4	1.2	1.2
Canada	1.4	1.6	1.9	2.0
Czech Republic	2.4	2.6	2.5	2.4
Denmark	1.0	1.4	1.6	1.4
Finland	1.6	1.3	1.4	1.4
France	1.2	1.3	1.3	1.5
Germany	1.7	1.8	1.8	1.6
Hong Kong	1.9	1.7	2.4	2.5
Ireland	4.5	3.4	3.2	3.8
Italy	0.9	0.9	0.8	0.6
Japan	1.0	0.8	0.5	0.4
Netherlands	2.1	1.8	1.7	1.7
Norway	0.8	1.5	1.7	1.7
Portugal	1.4	1.4	1.2	1.2
Singapore	2.0	1.9	2.2	2.6
South Korea	2.5	2.6	2.9	3.4
Spain	3.2	2.2	2.0	1.9
Sweden	3.3	2.4	2.5	2.5
Switzerland	1.3	1.7	1.7	1.6
Taiwan	1.4	2.0	2.7	3.0
United Kingdom	1.8	1.3	1.4	1.6
United States of America	1.6	2.0	2.2	2.0

e/f = estimate/forecast. Source: BMI

our eurozone real GDP growth forecasts of 1.6% in both 2017 and 2018, particularly if regional elections this year play out according to our relatively optimistic core scenarios. We have revised up our real GDP forecast for Italy in 2017 from 0.6% to 0.9%, and our France forecast from 1.2% to 1.3%, to reflect a stronger near-term outlook. In Germany, meanwhile, we have long been above consensus in our 2017-2018 growth projection of 1.8% in both years, and these now look well placed. Against this backdrop, markets are beginning to price in a less accommodative European Central Bank over a multiyear horizon, including the potential for a rate rise in 2018. However, we maintain our relatively dovish view for the time being. Significant headwinds and tail risks stand in the way of us adopting a more positive stance on eurozone economic activity, particularly as we need to see more confirmation that 'hard' economic data is coming close to matching the very strong 'soft' survey indicators before adopting a much more optimistic view on growth.

Given the increasing urgency expressed by US Federal Reserve officials to raise rates alongside an improving economic environment, we have upwardly revised our US rate hike outlook. We now forecast two 25bps rate hikes for 2017, compared to one previously, bringing the end-year Fed funds range from 0.50-0.75% to 1.00-1.25%. This includes the 25bps hike delivered on March 15, which had been broadly anticipated. However, we remain slightly below consensus, with futures markets pricing in slightly more than two hikes in 2017. This is in line with our below-consensus outlook on US growth, with real GDP expansion of 2.0% and 2.2% in 2017 and 2018 respectively, reflecting an acceleration from 1.6% in 2016 but also the likelihood that fiscal stimulus measures will disappoint (by comparison, consensus is for average expansion of 2.3% over 2017-2018).

TABLE: EMERGING MARKETS – REAL GDP GROWTH (%)

	2016e	2017f	2018f	2019f
Emerging Markets Aggregate Growth	**3.9**	**4.3**	**4.5**	**4.4**
Latin America	-0.5	1.8	2.6	2.7
Argentina	-2.2	3.1	3.6	3.7
Brazil	-3.6	0.8	1.9	2.0
Mexico	2.3	1.8	2.6	2.7
Middle East And North Africa	1.8	2.1	2.6	2.7
Saudi Arabia	1.2	-0.2	1.8	2.0
UAE	2.2	2.8	3.3	3.3
Egypt	2.6	2.5	3.1	4.1
Sub-Saharan Africa	1.8	3.1	4.1	4.0
South Africa	0.5	1.1	1.8	2.1
Nigeria	-1.7	1.7	3.8	3.3
Emerging Asia	6.4	6.1	5.8	5.7
China	6.7	6.3	5.8	5.6
India*	7.0	6.9	6.7	6.7
Indonesia	5.0	5.3	5.6	6.0
Malaysia	4.1	4.7	4.6	4.4
Philippines	6.0	5.9	5.9	5.9
Thailand	3.2	3.0	3.4	3.6
Emerging Europe	1.5	2.1	2.4	2.6
Russia	-0.2	1.2	1.4	1.5
Turkey	2.2	2.3	2.8	3.3
Hungary	2.0	2.6	2.8	2.4
Romania	4.8	3.6	3.4	3.2
Poland	2.8	3.2	3.4	3.2

*e/f = estimate/forecast. *Fiscal years ending March 31 (2017 = 2017/18). Source: BMI*

Emerging Markets

EMs are generally in a growth upswing thanks to strengthening demand in developed markets, gradually rising commodity prices and relative currency stability. Many countries are in the 'early acceleration' phase of growth, in the aftermath of a difficult few years characterised by collapsing currencies, slumping commodity prices, rising debt and fragile global growth. Over the past month, there have been a number of developments which have reinforced the trend for a broad-based recovery in EMs. As mentioned above, the Fed signalled on March 15 that it will only raise rates gradually, implying a relatively supportive environment for investment flows into EMs. Indeed, EM currencies rallied on the back of the dovish commentary.

In China, high-frequency indicators such as industrial production and fixed asset investment have displayed continued stability, pointing to a supportive environment for commodity prices and EMs in general. A speech made by Premier Li Keqiang on March 5 suggested that the government will seek to preserve this stability, albeit in the context of a difficult balancing act encompassing supporting economic growth, controlling risks, and conducting gradual reforms in 2017. In India, the ruling Bharatiya Janata Party completed a resounding victory in the Uttar Pradesh state assembly elections held over February-March, reflecting the party's success in inspiring public confidence in its anti-corruption and pro-development plans, and boding well for its ability to deliver on reforms.

In keeping with this picture of EMs generally picking up, the most significant change to our EM growth forecasts over the past month has been an upward revision, and there have not been any notable downward revisions. For instance, we have notched up our real GDP growth forecasts for Romania to 3.6% for 2017 and 3.4% for 2018, from 3.4% and 3.2% respectively. While these new numbers are still moderate in comparison with growth rates witnessed in previous years, Romania will nevertheless remain an outperformer in emerging Europe on the back of robust domestic consumption and fiscal stimulus.

TABLE: IRAN – MACROECONOMIC DATA & FORECASTS

	2016e	2017f	2018f	2019f	2020f	2021f	2022f	2023f	2024f	2025f	2026f
Nominal GDP, USDbn	403.9	437.8	447.3	475.8	512.7	544.1	565.3	588.3	612.1	636.5	661.8
Nominal GDP, EURbn	365.0	425.0	438.6	475.8	512.7	544.1	565.3	588.3	612.1	636.5	661.8
GDP per capita, USD	5,019	5,376	5,431	5,714	6,092	6,401	6,588	6,794	7,008	7,228	7,455
GDP per capita, EUR	4,536	5,219	5,324	5,714	6,092	6,401	6,588	6,794	7,008	7,228	7,455
Real GDP growth, % y-o-y	6.9	5.0	4.7	4.7	3.7	3.5	3.7	3.7	3.3	3.0	2.6
Private final consumption, % of GDP	53.1	51.1	50.5	49.7	48.8	48.3	48.4	48.7	49.1	49.6	50.2
Private final consumption, real growth % y-o-y	4.0	4.5	5.0	5.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Government final consumption, % of GDP	12.2	11.5	11.3	11.0	10.8	10.7	10.7	10.8	10.8	11.0	11.1
Government final consumption, real growth % y-o-y	1.0	2.5	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Fixed capital formation, % of GDP	23.2	21.8	21.1	20.2	19.4	18.8	18.7	18.6	18.5	18.4	18.3
Fixed capital formation, real growth % y-o-y	5.0	5.0	6.0	6.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Population, mn	80.0	80.9	81.8	82.6	83.4	84.1	84.8	85.4	86.0	86.5	87.0
Consumer price inflation, % y-o-y, ave	8.8	8.0	8.0	8.0	7.5	7.0	6.0	6.0	6.0	6.0	6.0
Lending rate, %, ave	15.0	14.0	13.0	12.0	10.0	8.0	7.0	7.0	7.0	7.0	7.0
Exchange rate IRR/USD, ave	31,500.00	34,000.00	38,000.00	41,000.00	43,250.00	45,750.00	48,250.00	50,750.00	53,250.00	55,750.00	58,250.00
Exchange rate IRR/EUR, ave	34,851.28	35,020.00	38,760.00	41,000.00	43,250.00	45,750.00	48,250.00	50,750.00	53,250.00	55,750.00	58,250.00
Budget balance, USDbn	-10.1	-5.6	-4.0	-1.3	-0.4	0.6	1.4	1.0	1.4	1.7	2.1
Budget balance, % of GDP	-2.5	-1.3	-0.9	-0.3	-0.1	0.1	0.2	0.2	0.2	0.3	0.3
Goods and services exports, USDbn	80.6	85.5	88.7	91.8	94.9	98.1	101.2	104.6	108.1	111.8	115.6
Goods and services imports, USDbn	74.0	76.2	79.1	82.1	85.2	88.4	91.8	95.3	99.0	102.6	106.3
Balance of trade in goods and services, USDbn	6.6	9.3	9.6	9.7	9.7	9.6	9.5	9.2	9.1	9.1	9.3
Balance of trade in goods and services, % of GDP	1.6	2.1	2.2	2.0	1.9	1.8	1.7	1.6	1.5	1.4	1.4
Current account balance, USDbn	7.2	9.9	10.3	10.4	10.4	10.4	10.3	10.1	10.0	10.1	10.4
Current account balance, % of GDP	1.8	2.3	2.3	2.2	2.0	1.9	1.8	1.7	1.6	1.6	1.6
Foreign reserves ex gold, USDbn	125.4	131.7	138.3	145.2	152.4	158.5	164.9	171.5	178.3	185.4	192.9
Import cover, months	21.4	21.8	22.0	22.3	22.3	22.4	22.4	22.4	22.5	22.6	0.0

e/f = BMI estimate/forecast. Source: National sources, BMI

BMI Research
A FitchGroup Company

BMI Research,
2 Broadgate Circle, London
EC2M 2QS, UK
Tel: +44 (0)20 7248 5162
Fax: +44 (0)20 7248 0467
Email: subs@bmiresearch.com
Website: www.bmiresearch.com

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Analyst: Edward Coughlan
Editor: Andrine Skjelland
Sub-Editor: Rachna Raghupathi
Subscriptions Manager: Lyan Chan
Marketing Manager: Julia Consuegra
Production: Umra Khan

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