BMI Research
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Iran

Country Risk Report

Includes 10-year forecasts to 2024

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Q1 2016

IRAN – MACROECONOMIC DATA & FORECASTS

	2014e	2015f	2016f	2017f	2018f	2019f	2020f	2021f	2022f	2023f	2024f
Nominal GDP, USDbn	490.0	396.6	397.7	427.7	461.3	495.6	529.3	559.0	593.8	626.1	659.5
Nominal GDP, EURbn	365.6	360.6	371.7	388.8	401.1	413.0	441.1	465.8	494.8	521.7	549.6
GDP per capita, USD	6,243	4,990	4,942	5,253	5,600	5,951	6,289	6,576	6,919	7,230	7,551
GDP per capita, EUR	4,659	4,536	4,619	4,775	4,870	4,959	5,241	5,480	5,766	6,025	6,292
Real GDP growth, % y-o-y	-0.5	0.6	2.9	3.9	4.6	5.6	4.8	4.1	4.3	4.3	3.9
Private final consumption, % of GDP	35.9	42.8	41.9	42.1	42.7	43.5	43.1	43.4	44.0	44.4	45.0
Private final consumption, real growth % y-o-y	2.0	1.0	3.0	4.0	5.0	6.0	4.0	4.0	4.0	4.0	4.0
Government final consumption, % of GDP	10.0	11.5	11.1	10.9	10.9	10.9	10.8	10.9	11.0	11.1	11.3
Government final consumption, real growth % y-o-y	4.0	-3.0	1.0	2.0	3.0	4.0	4.0	4.0	4.0	4.0	4.0
Fixed capital formation, % of GDP	23.7	25.9	23.9	22.9	22.0	21.5	21.0	20.7	20.7	20.7	20.7
Fixed capital formation, real growth % y-o-y	3.0	1.0	3.0	4.0	5.0	6.0	5.0	5.0	5.0	5.0	5.0
Population, mn	78.1	79.1	80.0	80.9	81.8	82.6	83.4	84.1	84.8	85.4	86.0
Consumer price inflation, % y-o-y, ave	27.2	15.0	11.0	10.0	10.0	9.0	7.0	10.0	10.0	6.0	10.0
Lending rate, %, ave	11.0	11.0	11.0	11.0	10.0	10.0	8.0	8.0	7.0	7.0	7.0
Exchange rate IRR/USD, ave	25,831	31,000	36,000	38,000	40,000	42,000	44,000	46,000	47,000	48,500	50,000
Exchange rate IRR/EUR, ave	34,614	34,100	38,520	41,800	46,000	50,400	52,800	55,200	56,400	58,200	60,000
Budget balance, USDbn	-5.0	-11.9	-11.1	-10.9	-11.9	-12.7	-13.9	-15.5	-17.4	-18.9	-20.5
Budget balance, % of GDP	-1.0	-3.0	-2.8	-2.6	-2.6	-2.6	-2.6	-2.8	-2.9	-3.0	-3.1
Goods and services exports, USDbn	93.7	75.9	77.9	80.4	83.5	86.3	89.2	92.1	95.0	98.0	101.2
Goods and services imports, USDbn	76.7	79.3	82.0	84.4	87.6	91.0	94.4	98.0	101.7	105.7	109.8
Balance of trade in goods and services, USDbn	17.1	-3.4	-4.1	-4.0	-4.2	-4.6	-5.3	-5.9	-6.8	-7.7	-8.6
Balance of trade in goods and services, % of GDP	3.5	-0.9	-1.0	-0.9	-0.9	-0.9	-1.0	-1.1	-1.1	-1.2	-1.3
Current account balance, USDbn	17.7	-2.7	-3.4	-3.3	-3.4	-3.8	-4.4	-5.1	-5.8	-6.7	-7.5
Current account balance, % of GDP	3.6	-0.7	-0.9	-0.8	-0.7	-0.8	-0.8	-0.9	-1.0	-1.1	-1.1
Foreign reserves ex gold, USDbn	39.9	39.9	40.3	41.1	41.9	43.6	45.8	49.0	52.4	56.8	62.1
Import cover, months	6.2	6.0	5.9	5.8	5.7	5.8	5.8	6.0	6.2	6.4	6.8

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

Contents

Executive Summary

Core Views

- Iran's agreement with the P5+1 countries over the former's nuclear programme will result in a removal of almost all sanctions on Iran in Q116.

- Declining oil prices will force the government to cut current spending and investment in the country's infrastructure sector in 2016, which will result in slow expansion of private consumption and fixed investment.

- Downside pressure on the Iranian rial will remain prominent, and the unit will remain sensitive to developments in nuclear negotiations over the coming quarters.

Major Forecast Changes

- We have revised our real GDP growth forecasts this quarter, and are projecting the economy to expand by 0.6% in 2015 and 2.9% in 2016, from previous forecasts of 2.1% and 3.0% respectively.

Key Risks To Outlook

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

Chapter 1:
Political Outlook

SWOT Analysis

Strengths

- Since the overthrow of the Pahlavi family in 1979, there has been some reduction in the level of political corruption, while wealth distribution has improved marginally.
- The Revolutionary Guard and Basij militia are fiercely loyal to the supreme leader, helping to maintain social stability.
- Sanctions relief will boost economic growth notably.

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

Iran and the 5+1 powers (the United States, Russia, China, France, Britain and Germany) clinched an agreement on the Islamic Republic's nuclear programme in July 2015. We expect this will ultimately lead to a deal being reached and for sanctions on Iran being gradually unwound. Still, there are significant risks to a deal holding, especially with presidential elections in both Iran and the US in 2017.

	S-T Political	Trend	Regional Rank	Global Rank
Qatar	84.4	=	1	15
United Arab Emirates	83.1	=	2	20
Oman	79.8	=	3	32
Bahrain	72.9	=	4	55
Kuwait	72.7	+	5	57
Saudi Arabia	70.8	=	6	66
Morocco	63.5	=	7	100
Jordan	61.9	=	8	106
Algeria	60.8	=	9	116
Israel	60.6	=	10	118
Tunisia	60.2	=	11	119
Egypt	55.8	=	12	127
Iran	**49.6**	**=**	**13**	**154**
Lebanon	42.7	-	14	165
Iraq	37.7	=	15	174
West Bank and Gaza	33.1	=	16	181
Yemen	31.0	-	17	182
Libya	27.7	=	18	184
Syria	22.9	=	19	187

Regional ave 56.4 / Global ave 63.8 / Emerging Markets ave 59.9

	L-T Political	Trend	Regional Rank	Global Rank
Qatar	71.0	=	1	52
Israel	70.3	=	2	54
United Arab Emirates	69.0	=	3	56
Oman	68.9	=	4	58
Kuwait	68.4	+	5	60
Morocco	66.9	=	6	65
Jordan	66.6	=	7	68
Tunisia	65.5	=	8	72
Bahrain	63.5	=	9	78
Saudi Arabia	60.0	=	10	98
Egypt	57.8	=	11	109
Algeria	57.3	=	12	115
Lebanon	56.4	-	13	118
Iran	**52.9**	**=**	**14**	**128**
Iraq	34.5	=	15	174
West Bank and Gaza	32.2	=	16	177
Yemen	31.1	-	17	179
Libya	26.5	=	18	184
Syria	22.4	=	19	186

Regional ave 54.8 / Global ave 61.2 / Emerging Markets ave 56.0

Political Outlook I

Iranian Nuclear Deal: Widespread Economic And Geopolitical Implications

BMI VIEW

The Iranian nuclear agreement paves the way for the return to growth of the Iranian economy and the reopening of a crucial market, with consumer and infrastructure companies particularly well positioned to benefit. However, operational and political risk concerns will dampen the growth dividends from sanctions relief. The deal also has significant geopolitical implications, and will exacerbate the existing oversupply in the global oil market.

The landmark Iranian nuclear agreement reached in Vienna on July 14 brings an end to 20 months of negotiations between Iran and the P5+1 powers (the US, Russia, China, France, the UK and Germany) and paves the way for the return of foreign companies into Iran as early as 2016. The Vienna deal also has significant political, regional and global implications, and will be seen as a core element of US President Barack Obama's foreign policy legacy.

Our main views are outlined below:

- The sanctions easing process is far broader than previously thought, and sets the stage for a return of Iranian crude in the global oil market by 2016, as well as a strong uptick in foreign investment. Amongst the sectors that will benefit most, we highlight retail and infrastructure companies.

- However, we caution against excessive optimism: beyond sanctions, hurdles remain for companies looking to tap the Iranian market, most notably the difficult operating environment. The Iranian economy will benefit, but the Vienna agreement does not presage a boom.

- The return of Iranian crude volumes from 2016 onward will exacerbate the existing oversupply in the global oil market. We highlight possible downside risks to our price forecasts for 2016, but maintain for now our below consensus average projections for Brent of USD57 per barrel in 2015 and USD56 in 2015.

- The risks of the agreement breaking down will rise over time, particularly from 2017 onward. Under Obama's suc-

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	Parliamentary – February 25 2016
	Presidential – June 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: Led 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 (economic sanctions), UN (four resolutions against nuclear enrichment), 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 Score	49.6
BMI Structural Political Risk Score	52.9

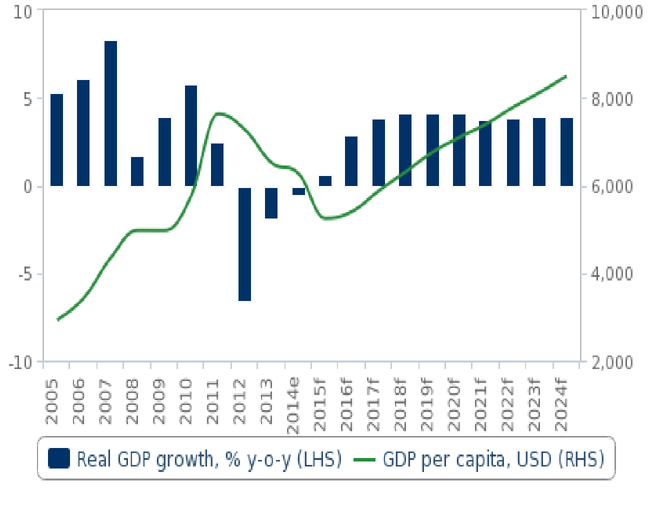
Source: BMI

cessor, the US could decide to abandon it, but we believe that the risks are greater on the Iranian side.

- Regionally, Dubai and Oman are the best placed to benefit economically, due to their longstanding trade and investment ties with Iran.

- In geopolitical terms, Israel and Saudi Arabia have emerged as the main losers, while centrist Iranian President Hassan Rouhani will be bolstered ahead of Iran's 2016 parliamentary elections. The deal also presents mixed implications for Russia, Turkey and Syria.

A Boost, But Problems Remain
Growth Forecasts



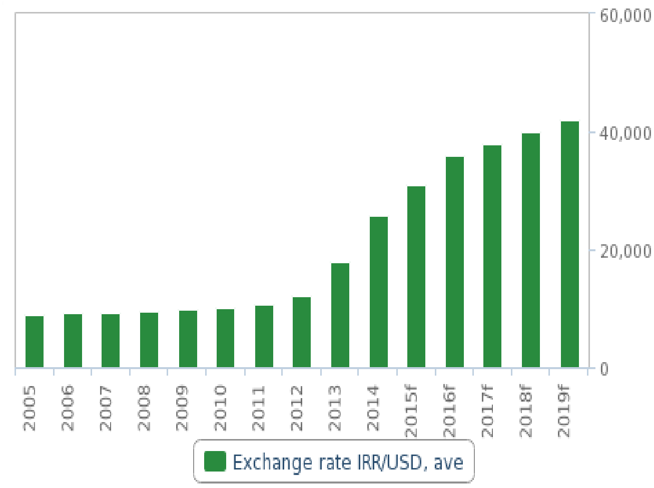
e/f = BMI estimate/forecast. Source: UN, BMI

Sanctions Will Be Lifted By Early 2016

The agreement will be incorporated in a UN Security Council resolution, which will lift UN sanctions on Iran contingent on Tehran taking its agreed steps to disassemble its nuclear infrastructure. The International Atomic Energy Agency (IAEA) will verify the steps taken, and has signed a roadmap with Iran with the aim of resolving all outstanding questions on its nuclear programme by the end of 2015 (a report is due by December 15). Assuming that the IAEA reports back positively, President Obama will grant waivers on economic and financial sanctions, while the EU will vote to lift European sanctions – a process that should happen by the end of 2015.

Crucially, this means that practically all economic sanctions on Iran will be lifted by the beginning of 2016 if Iran complies with the IAEA's requirements. Once the implementation of the deal is confirmed, Iran will gain immediate access to approximately USD50bn in frozen assets; regain access to SWIFT and the international banking system; and see sanctions pulled back on all key sectors such as energy, transport, insurance and mining. Only sanctions on arms sales and missile deliveries, as well as sensitive nuclear related items, will remain in place for longer. This is far broader than expected and a major concession to the

Rial's Long-Term Trajectory Still Negative
IRR/USD Exchange Rate



f = BMI forecast. Source: Bloomberg, BMI

TABLE: MAIN TERMS OF IRAN NUCLEAR DEAL

Uranium Stockpile	Iran will have to reduce its current stockpile of low enriched uranium by 96%, either by diluting it or shipping it out of the country.
Enrichment Capacity	Iran will have to remove two-thirds of installed centrifuges and store them under international supervision. It will stop using its underground capacity at Fordow for enriching uranium. Iran will not produce or acquire highly enriched uranium or plutonium for at least 15 years.
IAEA Access	Iran will have to permanently give the IAEA access to sites, including military sites, when the inspectors believe that undeclared nuclear activity is being carried there. These inspections will continue for at least the next two decades.
Frozen Assets	Once implementation of the deal is confirmed, Iran will immediately gain access to approximately USD100bn in frozen assets.
Sanctions	After a positive report by the IAEA verifies that Iran has taken agreed steps to reduce its nuclear programme, international sanctions will be lifted, and the country will be able to start selling oil again on international markets and use the global financial system for trade.
Arms Embargo	An arms embargo will remain in place for five years and an embargo on ballistic missiles for eight years.
Snapback Clause	If an eight-member panel determines that Tehran is violating the nuclear provisions, sanctions will be restored within 65 days. The members of the panel include the P5+1 powers, the EU, and Iran itself. A majority vote is required, preventing Iran from blocking action.

Source: BMI, Reuters, NYT, Le Monde

Iranians: until now, diplomats had hinted at a far more gradual pace of sanctions easing.

What Impact For The Iranian Economy?

We expect Iran's economy to emerge from recession once the lifting of sanctions begins – yet we warn that significant impediments to growth remain, and the Vienna agreement does not presage a boom.

Our forecasts already factored in the impact of sanctions relief, but see the Iranian economy growing by only 0.6% in real terms this year – although this will pick up to 2.9% by 2016. Consumer and business confidence will be strengthened over the coming months, and we expect a temporary appreciation of the Iranian rial as well as steady gains in the Tehran stock market. The easing of financial sanctions will facilitate project finance and attract greater foreign investment, notably in consumer sectors (such as autos, food and drink, and telecoms) and infrastructure. A large and well educated population, high per capita income and a considerable infrastructure deficit provide significant attractions for foreign investors. Those that already had a presence in Iran prior to the sanctions and have successfully maintained ties with the country in recent years will be the main beneficiaries.

However, we caution against excessive optimism. Even with the gradual relaxation of sanctions, operational and political hurdles remain for foreign companies looking to tap into the Iranian market, and we believe that firms – particularly large Western multinationals – will remain cautious. The difficult operational environment, where corruption, bureaucracy, nepotism, and domestic resistance to opening the economy are rife, will ensure only a slow return of investment. At the same time, low oil prices will ensure weak government spending and private consumption growth. The lack of investment over the past decade will also weigh on growth over the coming years. The longer term trajectory for the rial is negative: the Central Bank's ability to support the currency will eventually be limited by consistent current account and fiscal deficits and this trend will be compounded by a strengthening US dollar versus emerging market currencies.

TABLE: IRAN NUCLEAR DEAL: WINNERS AND LOSERS

The Winners	
Iran's Economy	The Iranian economy will naturally be the prime beneficiary of sanctions easing, and consumer staples and construction firms are particularly well positioned for gains. However, structural impediments to growth and years of underinvestment will prevent a broader economic recovery.
Iran's President Hassan Rouhani	Iran's centrist president had staked his credibility on reaching a nuclear accord and ending Iran's diplomatic isolation. The deal, if ultimately successful, will strengthen his chances in the 2016 elections for parliament and the Assembly of Experts.
Dubai and Oman	Dubai and Oman will be the region's key beneficiaries from the easing of Iranian sanctions, with immediate gains for trade and investment. Oman and Iran have already discussed an array of plans to boost economic ties, while Dubai has historically been a key centre of re-exports towards the Iranian economy thanks to its proximity and significant Iranian diaspora.
Foreign Companies	Foreign companies are obvious beneficiaries of the Iran deal: we expect foreign investment into Iran to pick up over the coming years as multinationals increase their exposure to the country. We are particularly positive towards the autos, telecoms, infrastructure, food and drink, and commercial aviation sectors. That said, Western companies (notably US firms) will likely remain cautious and influenced by political pressures, and will take some time to return to the market.
Neutral	
Russia	Iran and Russia have many shared interests, and both countries have agreed to increase their bilateral trade. However, even if Russia itself were not under sanctions, its relatively statist economy (due to overdependency on its oil and gas industry) offers Iran limited opportunities for the transfer of technology and knowhow in many key sectors. Moreover, a UN embargo on arms – one of the key Russian exports – will remain in place for five years.
Turkey	Turkey could benefit from increased Iranian oil supplies, but will also face increased geopolitical and financial competition from Iran. If Iran begins to adopt a more consensual approach to solving regional disputes, Turkey's importance as an interlocutor to the West could diminish somewhat.
Syria's President Bashar al Assad	Increased diplomatic cooperation between Iran and the West could eventually lead to progress towards an agreement on Syria. However, this might merely result in a quasi-federal solution along sectarian lines, allowing Assad or other members of his regime to retain a prominent role.
The Losers	
Oil prices	The eventual return of Iranian oil in the market presents an immediate downside factor for prices as markets price in the new volumes due. However, the first tangible impact on oil volumes will not be seen until 2016.
Israel	Israel has long opposed engaging in negotiations with Iran and has repeatedly described Iran's pursuit of nuclear capability as an imminent threat to Israeli security. The Vienna agreement will reinforce Israel's sense of isolation, and Israeli Prime Minister Benjamin Netanyahu called it a 'bad deal of historic proportions' on July 14.
Saudi Arabia	Saudi Arabia and Iran have consistently vied for geopolitical influence in the Middle East, and bilateral relations are now at a nadir. Saudi officials worry that a détente between Iran and the West will allow a further expansion of Iranian influence in the region (particularly if hard-line factions such as the Revolutionary Guard remain dominant in Iranian foreign policy), with Riyadh retaining only a subordinate and insecure geopolitical role.

Source: BMI

Regional And Global Implications

Beyond the Iranian economy, the nuclear deal has political, regional, and global implications, which we have summed up in the accompanying table (*see previous page*). In Iran itself, the conclusion of the negotiations strengthens Rouhani's position ahead of the parliamentary elections scheduled for February 2016. Economically, Oman and Dubai are the region's two major beneficiaries, although we expect the stock market reaction to be subdued over the coming days given weak trading volumes during Ramadan and the summer season. The deal also has geopolitical implications for Israel, Saudi Arabia, Syria, and Russia, and of course the Western powers themselves.

A Major Regional Player

Middle East – Regional Map

Source: BMI

Iranian Oil To Sustain Global Oil Glut in 2016

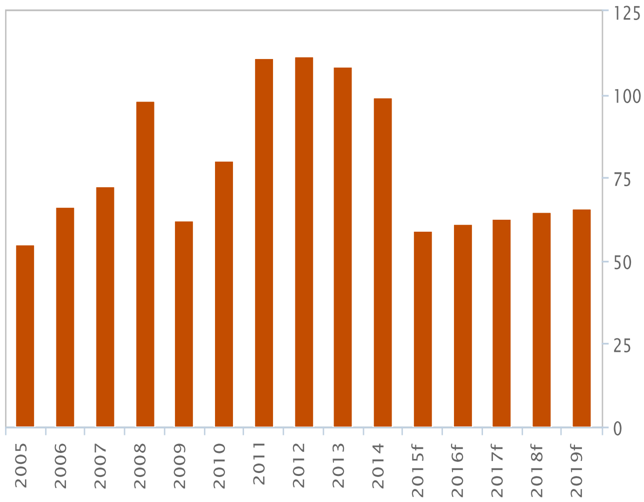
The steep fall in Brent prices since early-July indicates that the market increasingly priced in the implications of an Iran agreement as the deadline approached. We had factored in this outcome since March 2015, and we therefore maintain our below consensus forecasts for Brent of an average of USD57 per barrel (bbl) over 2015 and USD56/bbl over 2016.

In light of the details of the Vienna agreement, we maintain our view that Iran could bring back online some 550,000-650,000b/d of additional crude oil production following the lifting of sanctions. In terms of a time frame, we see the potential of additional oil exports starting in February/March 2016, ramping up quickly to 600,000-650,000b/d by the end of that year.

Considering the existing large oversupply in 2015, the return of Iranian oil volumes to the market will delay a rebalancing in the fundamental global oil markets in 2016. We note that Saudi Arabia alone has added over 1.0mn b/d to global supplies since December 2014, far more than we are expecting from Iran over the coming two to three years. This situation will see a persistent oversupply in 2016, checking price rallies. We therefore highlight possible downside risks to our oil price forecasts for 2016.

Vienna Deal Will Delay Oil Markets Rebalancing

Brent – USD per barrel



f = BMI forecast. Source: Bloomberg, BMI

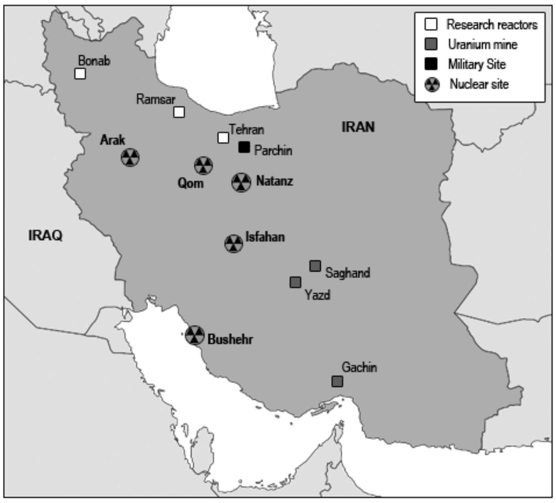
Risks Of A Breakdown Will Rise Over Time

We expect the Iranian parliament to approve the Vienna agreement. Supreme Leader Ayatollah Ali Khamenei – who has significant authority over the conservative parliamentary majority – has consistently expressed his support for the negotiations, and the talks would not have been able to proceed this far without his backing; a volte-face now that the agreement has been reached would hurt his credibility. We believe that the concessions obtained by the Iranians, such as the broad-based sanctions lifting, will be sufficient for Iranian President Hassan Rouhani to present the agreement in a positive light domestically, although some elements of the leadership structure (including the influential Revolutionary Guard) will certainly object.

In our view, the risks to the agreement breaking down will rise over time – particularly from 2017 onward. The deal could still unravel, especially if future political leaders in either the US or Iran decide to abandon it, either formally or by non-compliance. On the US side, Obama's term will end in January 2017 and it is likely that the next President will be more hawkish towards Iran than the incumbent. Given sufficient justification, his successor could therefore seek to overturn the agreement, in combination with a Republican-controlled Congress (although the EU, Russia and China would likely not be easily persuaded to follow the US's move).

The risks are greater on the Iranian side. The failure of Iran to cooperate with the IAEA at any point over the next decade would raise serious problems for the sustainability of the Vienna agreement. Iran has presidential elections in June 2017, and while it is too early to speculate on an eventual winner, alternatives to a Rouhani second term are likely to be more hardline than the incumbent. Rouhani's popularity could suffer if economic conditions fail to improve significantly before the election. In addition, there are concerns over 75-year old Khamenei's health. Again, a potential successor is far from clear but with the Assembly of Experts (which appoints the Supreme Leader) as hardline as any time throughout the Islamic Republic's existence, it is likely that Khamenei's relative pragmatism will fail to carry through to his successor.

Inspections Will Be Key To Agreement Holding
Main Nuclear Facilities



Source: BBC, BMI

We stress that if Tehran and Washington fail to take advantage of the opportunities for cooperation provided by the Vienna deal, at least another decade will be needed before another chance emerges.

Long-Term Political Outlook

Hardliners To Maintain Control, But Power Struggle Likely

BMI VIEW

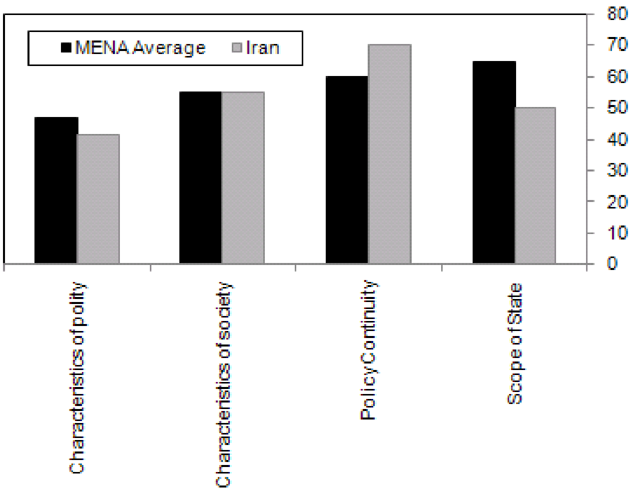
Iran's hardliners will retain their hold on power over the coming decade, although moderates will continue to push for greater political and social liberalisation. Even if the relatively moderate President Hassan Rouhani wins re-election in 2017, the main institutions of power – namely the Supreme Leader, Assembly of Experts and Revolutionary Guard – will remain under conservative control. Economic necessity dictated a nuclear deal between Iran and the West in 2015, but risks to the deal collapsing will rise over the coming years, especially if a hardliner is elected president in 2017 or 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 June 2017 presidential election, in which the relatively moderate Hassan Rouhani, elected in 2013, seeks a second term. Another key event in this struggle would be the eventual death of Supreme Leader Ayatollah Ali Khamenei, who has held that post since 1989. This will be 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. As regards foreign policy, we maintain our view that the process of nuclear inspections and the unwinding of sanctions will not be smooth. The agreement will hold over the coming years, primarily due to economic necessity, but risks of the deal falling apart would 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 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 & Iran – Components Of Long-Term Political Risk Indices



Note: Lower scores correspond to higher risks. Scores out of 100. Source: BMI

Challenges And Threats To Stability

Democratic Shortcomings: Although the Islamic regime was swept to power in a mass uprising in 1979, the clerics who subsequently came to power 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 against 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 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, but has command of the armed forces and judiciary, and is more powerful than the president. Since 1979, Iran has had two such figures: Ayatollah Ruhollah Khomeini (1979-1989), and Ayatollah Ali Khamenei (1989-present). Khamenei, 75, has been 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 takes over 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*).

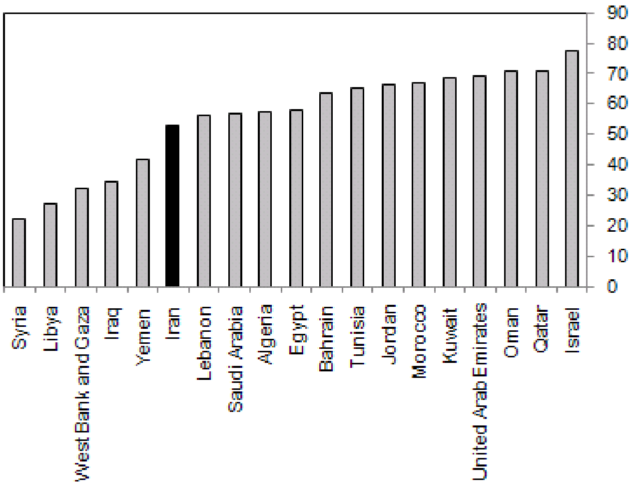
Competing Power Centres: Iran has many powerful institutions, including the Supreme Leader, president, Majlis (parliament), Expediency Council, Assembly of Experts, armed forces, Islamic Revolutionary Guard Corps (IRGC, Pasdaran), Basij militia, and VEVAK intelligence service. Although it could be argued 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 younger than 25 in 2015. Although this was down from an estimated 59% in 2000, it is still high. 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 2015, but unofficial estimates put it closer to 20%, with youth unemployment likely to be 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 comprise 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.

Elevated Risks To Remain
MENA – BMI Long-term Political Risk Index



Note: Lower scores correspond to higher risks. Scores out of 100. Source: BMI

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, which 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 has led to speculation that the US and/or Israel will attack the country to destroy its atomic facilities. The government's refusal to offer concessions on its nuclear programme led to tighter sanctions between 2011 and 2013, which are damaging its economy. 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 an interim agreement on the nuclear programme in November 2013, we flag a significant 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 score for Iran is 52.9 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 41.4/100. This reflects Iran's authoritarian political system. The 'characteristics of society' score is somewhat low at 55/100, owing to a diverse population and high levels of poverty, while the 'scope of state' score is 50/100, reflecting severe external pressure on the government as a result of international sanctions. The 'policy continuity' score is high at 70/100, because Iranian governments generally pursue similar policies.

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 pre-empting the kind of mass unrest seen during the Arab Spring.

The term 'regime transformation' could entail 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 thus 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 greater agreement over a 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 in talks with the West on the country's nuclear programme, or 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 become paralysed in the face of protests. The Iranian opposition currently lacks charismatic leaders who could galvanise the public, but we highlight that the Arab Spring still took place in the absence of such figures. In any crisis triggered by an uprising, the stance of the military will be crucial. 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 deteriorated 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. We still see a possibility that Israel and/or the US could attack Iran to destroy its nuclear programme, particularly if Iran is discovered to be producing highly enriched uranium in secret facilities in breach of a future nuclear deal. Although such action would not necessarily be aimed at 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. Military defeats in Argentina after the Falklands War (1982) and in Serbia after the Balkan wars (1991-1999) eventually helped topple their respective regimes.

Less likely, but still not inconceivable, is that Iran succumbs to a civil war of the kind that took hold in Syria in 2011. This could result from a failed attempt to dislodge the regime through a popular uprising. Under such circumstances, protestors fail to oust the government, but armed unrest continues, with the military seeing desertions and the breakaway elements coming into conflict with pro-regime forces. Eventually, however, we would expect one side to give way.

Economic Outlook

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

The effects of elevated inflation and sanctions on the economy have been drastic over the past four years. Improving relations with the West and better macroeconomic management, coupled with low base effects, have led to an improvement in the macroeconomic outlook in 2016, 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. The macroeconomic outlook will remain highly susceptible to developments in negotiations on the nuclear programme.

	S-T Economic	Trend	Regional Rank	Global Rank
Israel	76.3	=	1	10
Kuwait	67.9	+	2	31
Qatar	64.6	=	3	44
Saudi Arabia	63.1	=	4	49
United Arab Emirates	58.5	=	5	58
Morocco	55.4	=	6	69
Bahrain	52.7	=	7	79
Algeria	52.5	=	8	81
Egypt	52.5	=	8	81
Oman	49.8	=	10	91
Jordan	48.5	=	11	94
Lebanon	46.9	-	12	99
Iraq	40.8	=	13	124
Iran	**40.6**	**=**	**14**	**125**
West Bank and Gaza	37.9	=	15	140
Tunisia	36.3	=	16	148
Libya	34.0	=	17	156
Syria	20.8	=	18	182
Yemen	17.7	-	19	186

Regional ave 48.3 / Global ave 50.5 / Emerging Markets ave 45.9

	L-T Economic	Trend	Regional Rank	Global Rank
Israel	74.9	=	1	9
Saudi Arabia	70.0	=	2	26
United Arab Emirates	60.5	=	3	53
Qatar	59.4	=	4	56
Kuwait	59.0	+	5	59
Bahrain	58.0	=	6	64
Algeria	57.5	=	7	66
Oman	55.7	=	8	76
Egypt	55.2	=	9	80
Lebanon	55.0	-	10	81
Morocco	52.3	=	11	88
Iraq	49.3	=	12	94
Jordan	47.4	=	13	108
Tunisia	44.5	=	14	119
Iran	**39.1**	**=**	**15**	**140**
Libya	37.8	=	16	149
West Bank and Gaza	36.6	=	17	157
Syria	23.8	=	18	183
Yemen	21.4	-	19	186

Regional ave 50.4 / Global ave 51.4 / Emerging Markets ave 47.3

Economic Activity I

Significant Uptick In Growth As Sanctions Are Removed

BMI VIEW

Iran's economy will see a substantial uptick in growth in the coming years as a result of the removal of sanctions. Three years of recession will end, but a long-lasting boom is still a long way off given structural issues in the economy.

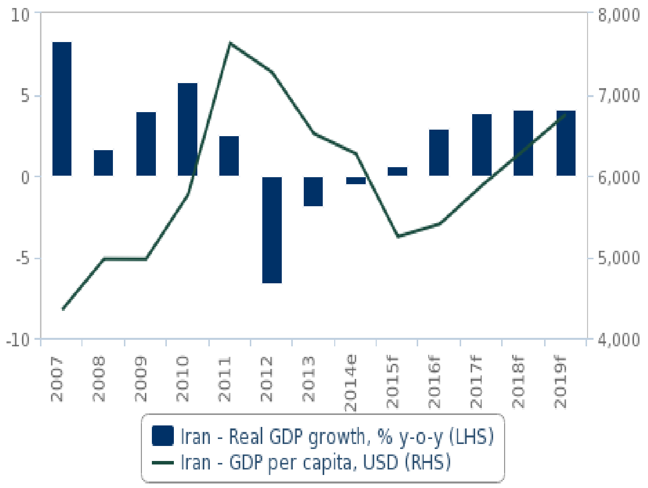
- Removing sanctions on the economy will end recession, but not presage a boom.
- The sustained decline in oil prices over the coming years will weigh on exports and government spending.
- The lack of investment over the past decade will substantially restrain growth over the coming years.
- We forecast substantial growth across a range of sectors. Oil and gas will gain the most attention, but consumer segments are also very well placed.

The removal of almost all sanctions on Iran's economy – which we expect to occur in H116 – will cause a significant uptick in economic growth over the coming years, reaching between 3% and 6%. We expect Iran's economy to emerge from recession as the country complies with demands on its nuclear programme. Iran has huge potential across almost all sectors, not just oil and gas which attracts most of the attention, and we highlight industries related to the consumer – especially autos and food & drink.

Pent-up demand, a youthful population, a skilled workforce and a large hydrocarbon and consumer story all make Iran one of the most positive and relatively well-balanced growth stories in the Middle East over the next decade. That said, there are, of course, major impediments facing the Iranian economy – not least the rampant corruption in the country and the years of underinvestment across almost all sectors – which will prevent it from truly booming in the coming years.

Noticeable Boost From Nuclear Deal

GDP Growth & GDP Per Capita



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

Lower oil prices will play a key role in limiting the impact of the unwinding of sanctions. We forecast oil prices (Brent crude) to average USD57 per barrel (/bbl) in 2015 and USD56/bbl in 2016 as a result of global oversupply. This will ensure that government spending and private consumption growth will be relatively low. Fixed investment and exports will become increasingly important growth drivers, though this will be a slow process as opposed to a sudden jump once sanctions are removed. Indeed, while we expect President Hassan Rouhani's administration to undertake significant efforts to reform to the economy, the effects will be limited by a persistently opaque business environment, domestic resistance to opening up the economy and the slow political process.

TABLE: KEY ECONOMIC INDICATORS

	2013	2014	2015f	2016f	2017f	2018f	2019f
Real GDP growth, % y-o-y	-1.9	-0.5	0.6	2.9	3.9	4.1	4.1
Unemployment, % of labour force, ave	13.0	11.0	10.0	10.0	10.0	10.0	9.0

f = BMI forecast. Source: BMI, CBI

TABLE: PRIVATE CONSUMPTION FORECAST

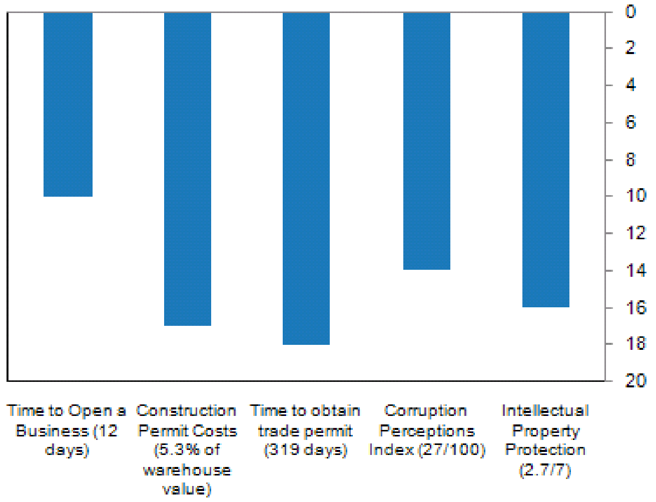
	2014	2015f	2016f	2017f	2018f	2019f	2020f	2021f	2022f	2023f	2024f
IRRtrn	4,573	5,670	6,861	8,096	9,391	10,894	12,092	13,422	14,765	16,241	17,865
% of GDP	36.0	43.9	43.8	44.5	45.2	46.1	46.0	46.4	47.0	47.6	48.2
Real growth, % y-o-y	2.0	1.0	3.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0

f = BMI forecast. Source: BMI, CBI

In turn, the easing of financial sanctions will facilitate project finance and attract foreign investment into the infrastructure sector. International sanctions have severely restricted access to funding for projects, reflected in Iran's average construction industry growth of only -0.1% over the past six years. In fact, in the Financing Risk pillar of our Project Risk Index (PRI), Iran scores only 18.8 out of 100, with a particularly weak score of five out of 100 in the Cost of Financing subcomponent. Iran ranks 79 out of 82 countries globally in our PRI.

Impediments Remain Even Beyond Sanctions

MENA – Rankings Indicators Of Business Environment (2014)



Note: Out of 18 MENA countries, excludes West Bank; for CPI and IPP, a higher number is better. Source: BMI

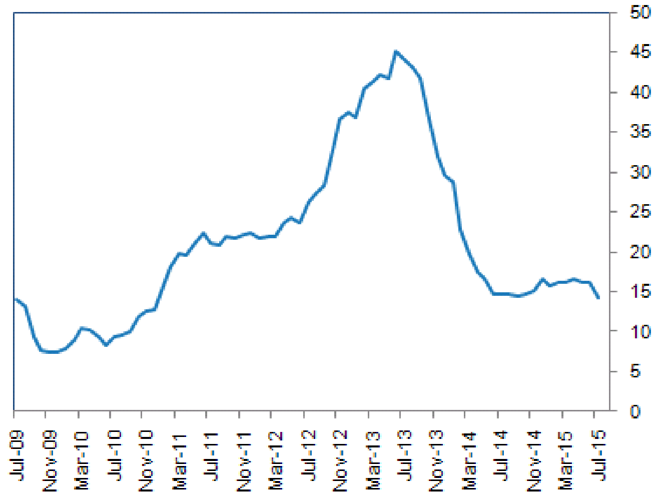
GDP By Expenditure

Iran's economy is dominated by private consumption – 35.9% of GDP in 2014 – a share which has remained fairly constant over the past decade. We expect this percentage to rise 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 (23.7%) will decline over the coming decade. Government consumption (10.0%) will see minimal growth as austerity measures take effect. Net exports (19.9%) 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 positive impact is unlikely to be felt until 2016 at the earliest. Subsidy cuts, high inflation and a depreciating rial - trends which we expect to continue over the rest of 2015 – have dampened consumer demand substantially and will weigh on growth in the coming quarters. We forecast real growth of 1.0% and 3.0% in 2015 and 2016, respectively. The inflationary environment will improve, but persistently elevated price pressures will continue to hit purchasing power.

Inflation Coming Down But Still Elevated

Iran – CPI Inflation % chg y-o-y



Source: BMI, Central Bank of Iran

Iranians' purchasing power 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 increased 14.5% y-o-y in July 2015, although this was a significant drop on the previous

TABLE: GOVERNMENT CONSUMPTION FORECAST

	2014	2015f	2016f	2017f	2018f	2019f	2020f	2021f	2022f	2023f	2024f
IRRtrn	1,272	1,526	1,816	2,107	2,401	2,786	3,092	3,432	3,775	4,153	4,568
% of GDP	10.0	11.8	11.6	11.6	11.5	11.8	11.8	11.9	12.0	12.2	12.3
Real growth % y-o-y	4.0	-3.0	1.0	2.0	2.0	4.0	4.0	4.0	4.0	4.0	4.0

f = BMI forecast. Source: BMI, CBI

TABLE: FIXED INVESTMENT FORECAST

	2014	2015f	2016f	2017f	2018f	2019f	2020f	2021f	2022f	2023f	2024f
IRRtrn	3,005	3,180	3,424	3,716	4,064	4,438	4,839	5,269	5,730	6,224	6,753
% of GDP	23.6	24.6	21.9	20.4	19.5	18.8	18.4	18.2	18.3	18.2	18.2
Real growth % y-o-y	3.0	1.0	3.0	4.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0

f = BMI forecast. Source: BMI, CBI

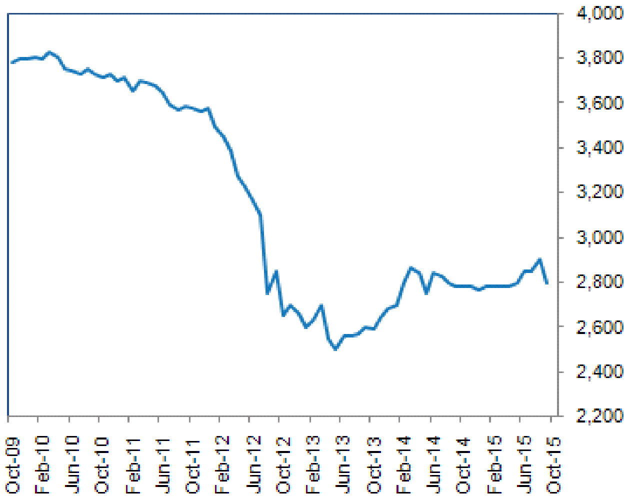
two years. In addition, the availability of imported goods has decreased significantly as a result of the ongoing depreciation of the rial in the black market.

Government Spending Outlook: We forecast sustained fiscal deficits over the coming years primarily on the back of lower oil prices and an only modest reduction in spending. We expect the government will 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 July 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.

Output To Pick Up In 2016

Oil Output ('000)



Source: BMI, CBI

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 41.5 out of 100 ranking 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. Sanctions will be lifted slowly and in a phased manner, limiting the speed and quantities at which additional Iranian oil can reach the market. Most importantly, 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 550,000-650,000 barrels per day (b/d) of additional crude oil production in the one to two years following a lifting of oil sanctions. 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.

Fiscal Policy

Deficits To Worsen, But Still Sustainable

BMI VIEW

Iran's fiscal position will deter i orate further in 2016 as the impact of the nuclear deal is more than offset by sustained weakness in oil prices. We forecast fiscal deficits of around 3.0% of GDP in 2016 and 2017, but given access to unfrozen assets, and foreign reserves, this is more than manageable.

Iran's fiscal position will continue to worsen in 2016 as the positive impact of the nuclear accord will be more than offset by sustained weakness in oil prices. Our Oil & Gas team forecasts Brent to average USD56/bbl in 2016 and USD55/bbl in 2017, far below the USD99/bbl averaged over 2010-2014. While Iran's economy is dependent on oil, the impact

TABLE: NET EXPORTS FORECAST

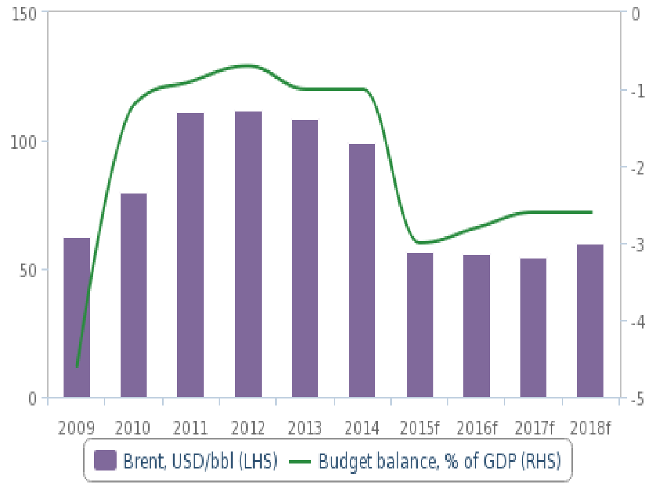
	2014	2015f	2016f	2017f	2018f	2019f	2020f	2021f	2022f	2023f	2024f
IRRtrn	2,524	913	1,616	2,061	2,467	2,739	3,284	3,643	3,720	3,870	4,021
% of GDP	19.9	7.1	10.3	11.3	11.9	11.6	12.5	12.6	11.9	11.3	10.8
Real growth % y-o-y	11.1	1.2	2.8	3.8	3.0	2.2	2.2	0.3	1.1	1.1	1.1

f = BMI forecast. Source: BMI, CBI

of lower prices is not as large as might be assumed, especially compared with much of the Gulf. Oil revenues accounted for 41% of government revenues in FY2014/15 (from March 21 2014 to March 20 2015) – a share which has fallen considerably as international sanctions have taken hold. Nonetheless, given low projected revenues, the budget will remain in deficit, which we forecast to come in at 3.0% and 2.8% of GDP in FY2015/16 and FY2016/17 respectively, compared to an estimated deficit of 1.0% of GDP in FY2014/15. Given significant reserves, our expectation for sanctions to be eased from Q116 as well as cutbacks in spending, we believe these deficits will be manageable for the regime.

Deeper Deficits Ahead

Fiscal Position

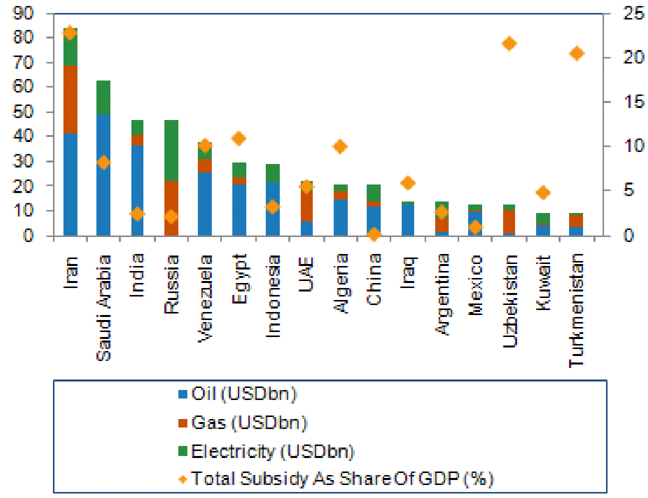


e/f = BMI estimate/forecast. Source: CBI, BMI

Given the deteriorating fiscal position, we believe there is sufficient political will to continue with subsidy cuts. Overall, we expect current expenditure to increase by an average of 15.0% in nominal terms over the next two years; however, given elevated inflation this will amount to almost no growth in real terms. Similarly, public sector salaries are budgeted to increase by around 17% this year, just ahead of our inflation expectations. Capital expenditure projects are likely to be curtailed, with many of the large-scale infrastructure projects set to see further delays in implementation.

Further Cuts In Fuel Subsidies Ahead

2013 Total Subsidy Costs, USDbn (LHS) & Subsidies As Share Of GDP, % (RHS)



Source: IMF

The big risk is that forthcoming cuts to food and energy subsidies will mean that consumer price inflation (CPI) makes a comeback. Given the government's financial position, gradual rationalisation of food and energy prices is essential. Indeed, gasoline prices in Iran are among the cheapest in the world, in spite of the fact that imports (which are subsequently subsidised) make up 30-40% of total domestic consumption. Higher gasoline prices should gradually lead to a drop in consumption (or at least in consumption growth). One posi-

TABLE: FISCAL POLICY

	2011	2012	2013	2014	2015f	2016f	2017f	2018f	2019f
Revenue, % of GDP	18.2	14.7	14.7	12.7	13.7	13.7	13.8	13.8	14.0
Fiscal expenditure, IRRbn	1,166,702.9	1,042,270.6	1,417,804.1	1,737,816.1	2,054,209.8	2,362,341.3	2,665,174.8	3,028,732.5	3,436,683.0
Expenditure, % of GDP	19.1	15.4	15.6	13.7	16.7	16.5	16.4	16.4	16.5
Current expenditure, IRRbn	877,701.9	889,993.2	1,197,646.9	1,438,316.0	1,682,829.7	1,935,254.2	2,186,837.2	2,492,994.4	2,842,013.7
Current expenditure, % of total expenditure	75.2	85.4	84.5	82.8	81.9	81.9	82.1	82.3	82.7
Current expenditure, % of GDP	14.4	13.1	13.2	11.4	13.7	13.5	13.5	13.5	13.7
Capital expenditure, IRRbn	289,001.0	152,277.4	220,157.2	299,500.1	371,380.1	427,087.1	478,337.6	535,738.1	594,669.3
Capital expenditure, % of total expenditure	24.8	14.6	15.5	17.2	18.1	18.1	17.9	17.7	17.3
Capital expenditure, % of GDP	4.7	2.2	2.4	2.4	3.0	3.0	2.9	2.9	2.9
Budget balance, IRRbn	-52,323.8	-45,546.0	-88,353.5	-128,315.2	-367,907.9	-400,490.6	-414,980.1	-474,993.6	-531,974.3
Budget balance, % of GDP	-0.9	-0.7	-1.0	-1.0	-3.0	-2.8	-2.6	-2.6	-2.6

f = BMI forecast. Source: CBI, BMI

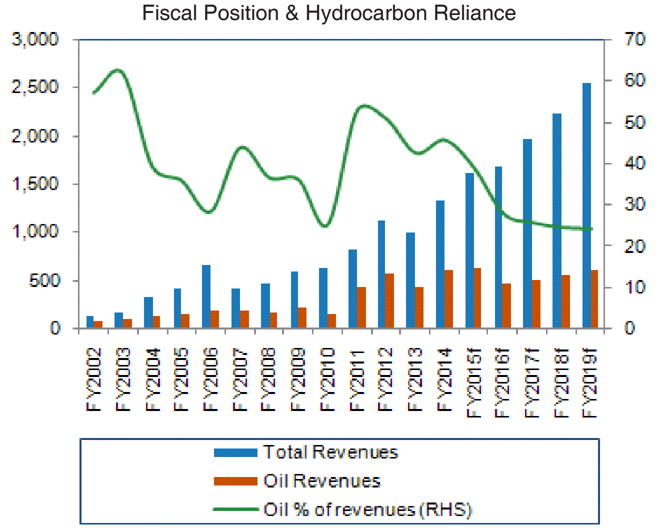
tive for the government is the lack of widespread protests in the wake of subsidy cuts which could indicate the depth of popular support for the government's programme, especially with the economy picking up slowing and inflation falling drastically. This is particularly the case compared with the former President Mahmoud Ahmadinejad's subsidy removal programme at the end of 2010, which had to be enforced with groups of policemen at major intersections.

Deficits Are Manageable

Iran will receive some respite from sanctions being relaxed, which we expect to occur in Q116 as part of the nuclear deal. Following a deal, we believe Iran will be given access to more of its financial assets frozen overseas. Some estimates have placed this figure at around USD100bn, but much of this appears to be highly illiquid and/or tied up in Chinese accounts in return for investment. The most realistic figure appears to be around USD30-50bn, which while considerably smaller gives the country breathing space regarding fiscal deficits.

Reliance On Oil To Wane Further

Fiscal Position & Hydrocarbon Reliance



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

We do not expect cutbacks in current and capital spending to have enough of an impact to match the decline in revenues, and thus we expect privatisation efforts to pick up steam. Privatisation plans were part of the Fifth Five-Year Development Plan (2010-2015), but there is little to show for it given political opposition.

However, the tide now seems to be turning as the government has announced the transfer of about USD330mn worth of shares of state-run companies to the private sector. In addition, Iran Privatization Organization Director Abdollah Pouri Hosseini stated that over 180 state-owned companies will be privatised in the next fiscal year. While this target is unlikely to be met in its totality due to political opposition, it is one of the few revenue-raising options for the Iranian government as it cannot tap international debt markets.

Monetary Policy

Disinflation To Continue

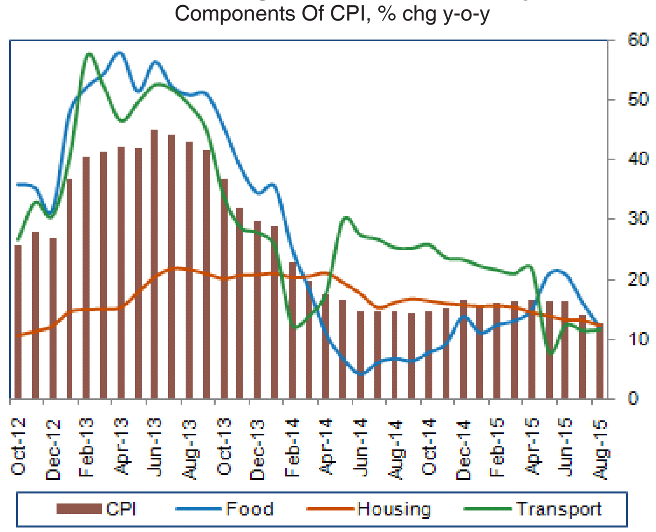
BMI VIEW

High base effects, improving macroeconomic conditions and economic reform will ensure that the ongoing decline in prices in Iran continues over the coming quarters. We project consumer price inflation to average 15.0% in FY2015/16, from 27.2% in FY2014/15.

A combination of high base effects, improving macroeconomic conditions and the government's efforts to tackle inflation will ensure that the ongoing decline in prices continues over the coming quarters. This decline will also be aided by modestly diminishing depreciatory pressures on the Iranian rial, which will contribute to a gradual drop in imported inflation over the coming quarters. We forecast CPI inflation to average 15.0% in FY2015/16 (fiscal year running from March 21 2015 to March 20 2016) and 11.0% in FY2016/17, compared to average inflation of 27.2% in FY2014/15. CPI came in at 12.6% in August 2015, the lowest since the index was rebased in October 2012.

Former Highs A Distant Memory

Components Of CPI, % chg y-o-y

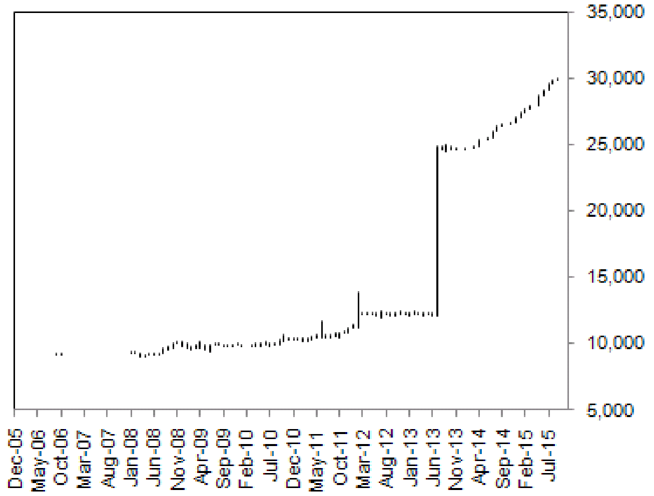


Source: BMI, Central Bank of Iran

Food prices (27.4% weighing in the consumer price basket) have been the major driver of the recent decline in the headline print. We believe the government will gradually cut food subsidies in 2015 in a bid to improve its fragile fiscal position; coupled with the dissipation of high base effects, this will result in a gradual acceleration of food price inflation over the next quarters, though it will remain at much lower levels relative to 2013.

Housing, electricity and fuel prices (32.8% weighting) increased by 12.4% y-o-y in August, having been on a steady decline over the past few months. We believe that housing prices will remain around current levels in 2016, largely as a result of a lack of appropriate housing units. Over the next five years we see housing inflation declining as an improving macroeconomic environment and the government's efforts to promote private sector involvement in the residential construction sector result in an uptick in housing supply.

Pace Of Depreciation To Lessen
IRR/USD Exchange Rate



Source: Bloomberg, BMI

Transportation inflation (9.9% weighting) will remain elevated in y-o-y terms over the coming quarters. Prices within the component increased by 13.3% over H115 as the government raised gasoline and diesel prices by 32% and 16% respectively. The move was part of the government's implementation of the second phase of its subsidy reduction plan, and we expect further cuts to energy subsidies to take place in 2016.

Rouhani Benefitting From Lower Inflation

Iranian President Hassan Rouhani 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. Much of the popular support of the current administration rests on the executive's ability to improve the economic conditions of Iranians.

In 2014, Rouhani said his government plans to decrease the inflation rate to below 15% by the end of 2015 – a goal we believe will be reached. Moreover, we forecast real GDP growth of 2.8% and 4.1% in 2016 and 2016, respectively, from a 2.9% contraction in 2014. This will benefit the moderate faction within the Iranian regime as parliamentary elections take place in February 2016.

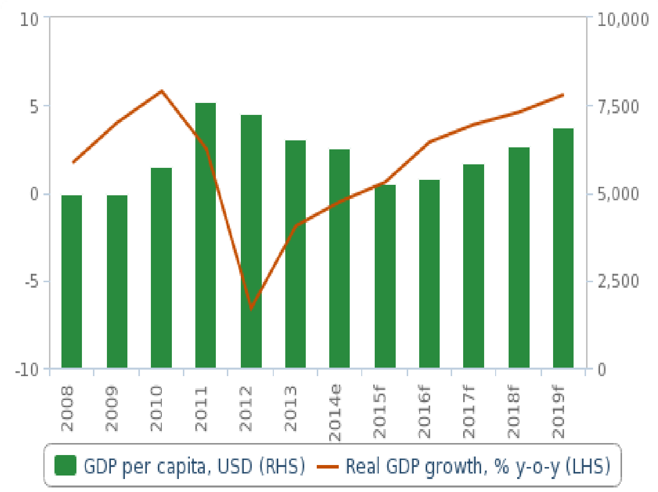
Economic Activity II

Iran's Opening: 10 Charts Showing Huge Opportunities And Risks

BMI VIEW

The unwinding in sanctions on Iran opens up one of the largest emerging markets to foreign investment and trade. There is huge potential across a range of sectors – in particular oil and gas and various consumer markets. However, there are structural impediments to growth, particularly within the business environment.

Noticeable Boost From Nuclear Deal
GDP Growth & GDP Per Capita



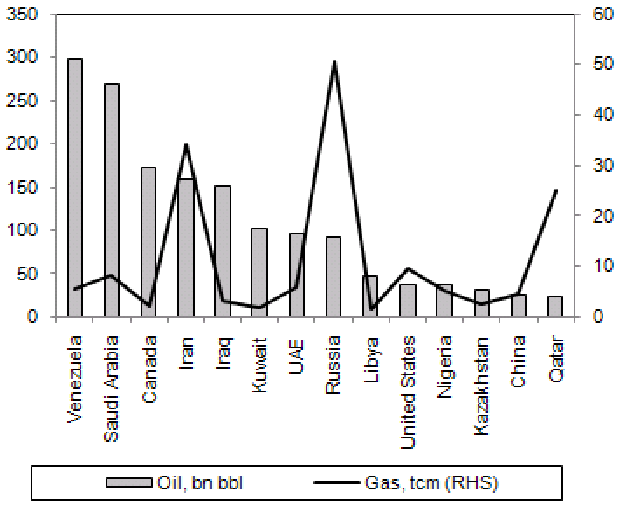
e/f = BMI estimate/forecast. Source: BMI, UN

Iran presents a huge opportunity to investors across almost all sectors, and we hold a bullish outlook for the country's economy over the next decade as sanctions are removed from 2016. In broad terms, Iran is the 29th largest economy globally, its population is relatively well educated despite mass emigration, and its large consumer base and relative wealth offers enormous opportunities to the autos, ICT and food and drink industries, among others. However, the nuclear deal will not remove the enormous structural problems in doing business in Iran, and this will temper the growth outlook (*see 'Iranian Nuclear Deal: Widespread Economic And Geopolitical Implications', July 15*).

Given the huge amount of investment needed, we are not forecasting an immediate boom in Iran's economy following the relaxation in sanctions. However, pent- up demand, positive demographics, a skilled workforce, and a large hydrocarbon and consumer story all make Iran perhaps the most positive and relatively well-balanced growth story in the Middle East over the next decade.

Huge Hydrocarbon Potential

Global – Largest Proven Hydrocarbon Reserves (2014)



Source: BMI, BP

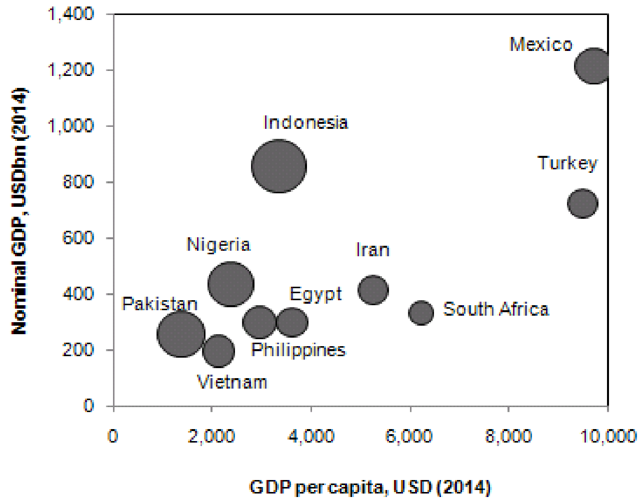
Iran's oil and gas sector presents one of the most exciting opportunities globally. Iran has the fourth largest oil reserves and second largest gas reserves globally, and years of sanctions have kept the industry far below potential. While Iran will certainly not allow unfettered access to its oil reserves given historical suspicion and its desire to protect industries of national security, the government is likely to push for partnership with local firms. Even with these restrictions, as well as substantial investment deficits, the country has enormous potential. Our Oil & Gas team expects Iran's oil production to reach 4.1mn barrels per day (b/d) in 2020, an additional 640,000b/d from current levels – the largest increase in the Middle East over the period.

While Iran's oil reserves have received the lion's share of media interest of late, the country has huge potential as a consumer market, which accounts for 44% of GDP – one of the highest shares in the region. As well as having a population of 80mn (the second highest in the Middle East after Egypt), Iran's GDP per capita compares favourably with similar emerging markets (*see chart below*).

This potential as a consumer market is well illustrated in the autos sector. Our Autos team forecasts vehicle sales and production to grow by 13% and 14% respectively per annum over the next five years – the fourth highest rate globally. We expect **Peugeot** to regain its previous position of dominance, but the arrival of new brands will give consumers the choice they have been lacking in recent years (*see 'Iran Autos: New Faces Challenge Returning Favourites', April 23*). Similarly, we forecast an uptick in foreign investment in the food and drink sector from 2016, thanks to lower insurance and transport costs, the reintegration of Iran into the international banking system and the attractiveness of Iran's largely untapped consumer base (*see 'Nuclear Deal A Boon For European And GCC Food Companies', July 23*).

High Spending Power In Iran

Select Emerging Markets – GDP & Population



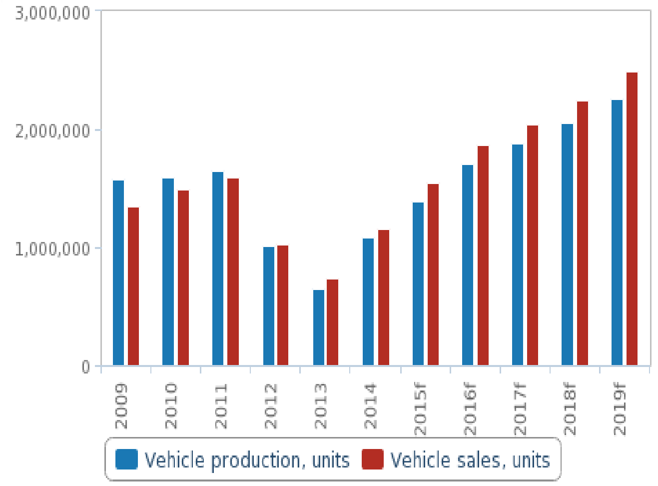
Source: BMI, UN. NB size of bubble indicates population size

On the business environment front, there are a few positives awaiting investors into Iran. Despite the exodus of skilled Iranians in the past four decades (there are at least 1mn Iranians overseas) the country has a relatively skilled workforce by regional standards, with 98% of labour force possessing formal education and a tertiary enrolment ratio of 55.2%, the third highest in the Middle East and North Africa. Furthermore, the improving investment climate in Iran could tempt skilled workers to return to the country.

On the whole, however, the country's business environment presents cause for concern. Years of sanctions and the resulting distrust of foreign companies have ensured local companies gain preferential access to credit and government contracts. In addition, the country's hostile legal environment, characterised by issues including poor rule of law and absence of intellectual property rights, will remain a persistent concern for investors. Entrenched risks are present in all four sections of BMI's Operational Risk Index, for which Iran is behind both the Middle East and North Africa average and emerging market peers.

This is particularly the case for the Trade and Investment and Crime and Security components. Iran's score of 34.4 out of 100 for Trade and Investment Risk places it 14th out of 19 states in the Middle East and North Africa region. With an easing of sanctions, Iran's Trade and Investment Risk score will rise to 40.6 out of 100 over the medium term, but it is still behind countries of similar economic size and population.

Large Consumer Market To Be Tapped
Vehicle Sales & Production



f = BMI forecast. Source: National sources, BMI

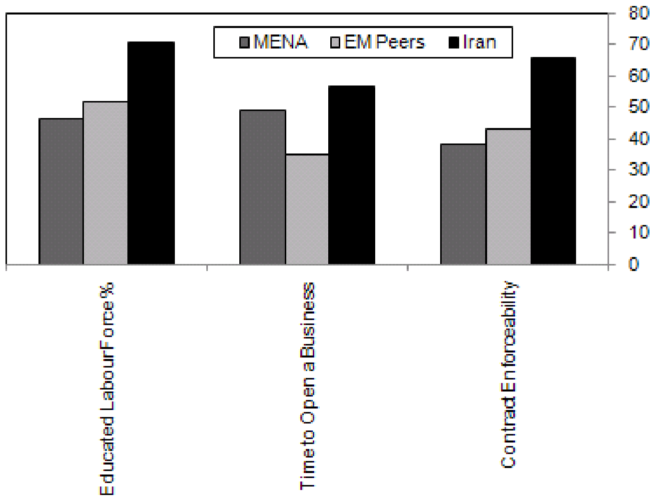
These structural challenges are further illustrated in the ICT sector. Indeed, the high cost of doing business is illustrated by the taxes imposed on ICT products; these taxes are by far the highest in the region. In an attempt to protect the domestic industry, as well as to reap the benefits of better trade relations, we expect the government will keep import tariffs on consumer electronics and other goods high. Therefore, while we expect the relaxation of sanctions to reduce costs and improve purchasing power to a certain extent, high taxes and other operational risks will prevent many players in the technology sector from rapidly moving to exploit the market's potential.

Corruption: Already Bad, Could Get Worse

An endemic culture of corruption appears to pervade all areas of society in Iran, presenting a major obstacle for private and foreign-owned businesses. 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's is ranked joint fifth from bottom regionally in Transparency International's Corruption Perceptions Index 2014 (along with Lebanon) at 144th out of 177 countries globally, alongside such chronically corrupt states as Nigeria and Russia. Given the control 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.

Some Positives For Investors...
Global – Percentile Rank On Operational Risk Components



Source: BMI Operational Risk Index

Indeed, the economic opening will not lead to any political opening such as a reduced role for the unelected Guardian Council, ensuring that Iran lags much of its regional and global peers in terms of political risks.

Currency Forecast

Depreciation To Continue, But Intensity To Lessen

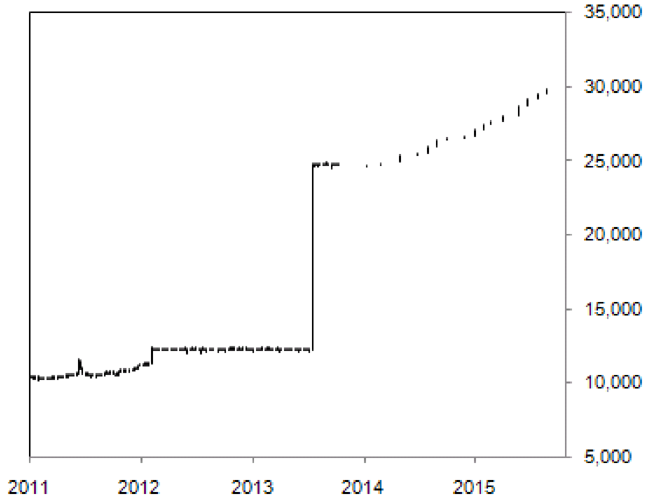
BMI VIEW

The Iranian rial will continue to depreciate over the coming quarters due to its artificial strength, much lower oil revenues and elevated inflation. The pace of depreciation will be lesser as the nuclear deal, greater foreign investment and an improving economy mitigate some of the forces to the downside.

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

We expect the Iranian rial to depreciate modestly over 2016, bringing an end to the sharp depreciations seen over the past few years. The two primary forces acting on the currency are the negative implications of far lower oil revenues (and the concomitant current account deficits) and the positive effects of the nuclear deal which we expect to result in sanctions being removed from Q116. The later factor will lead to Iran gaining access to more of its financial assets held overseas and provide a boon to investor confidence. While this is a positive for the country, we do not expect a deal to presage an appreciation in the currency as the winding of sanctions will be gradual and result in only a slow return of FDI inflows.

Further Depreciation Ahead
IRR/USD Exchange Rate



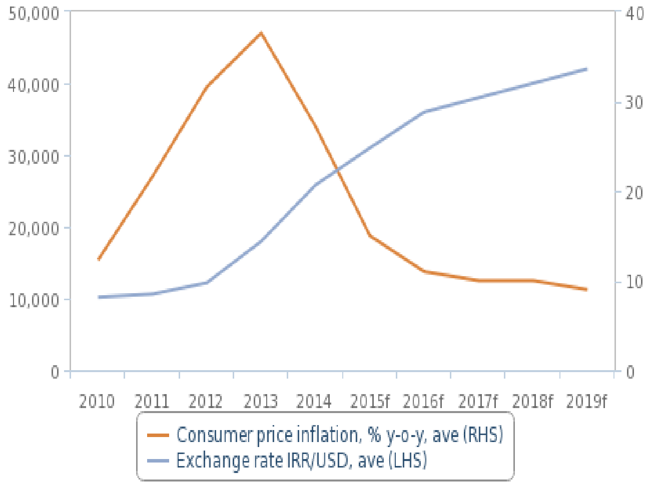
Source: Bloomberg, BMI

We believe that the central bank will continue to devalue the rial, and forecast the unit to average IRR31,000/USD in 2015 and IRR36,000/USD in 2016 on the official market. The pace of devaluation will be gradual, as the authorities seek to prevent a sharp increase in imported inflation. Iran is gradually accessing USD4.2bn in oil revenue held in foreign banks under the current interim agreement with the West on the Islamic Republic's nuclear programme, increasing the central bank's ability to manage the exchange rate.

Downside pressures on the rial have lessened on the back of progress on the nuclear deal. The black market for Iranian rial has moved in line with the spot rate, a sign that the official rate is almost sufficient to meet domestic demand for foreign currency. At the end of September, the black market rate was IRR33,900/USD, one of the lowest differentials over the official rate since early 2011.

In the near term, we expect the central bank to step into the foreign exchange market to help stabilise the value of the currency, and restore a degree of confidence in the unit. Although the economy's balance of payments position remains on less than firm footing, authorities should still possess a sufficient financial arsenal to use in their defence of the rial. According to latest data by the IMF, foreign reserves currently sit at approximately USD111bn, which is equivalent to 12 months of imports.

Inflation Falling, But Still Elevated
Exchange Rate, Official Market &
Consumer Price Index Inflation



f = BMI forecast. Source: BMI, CBI

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

A gradual improvement in the macroeconomic situation will lead to increasing confidence in the currency among traders. We forecast real GDP growth of 0.6% and 2.9% 2015 and 2016 respectively, from a 0.5% contraction in 2014, resulting from improved investor and consumer confidence, more effective macroeconomic management and low base effects. Importantly, recent consumer price index (CPI) readings point to a gradual decline price pressures, which have been a major driver of currency depreciation in recent years. CPI came in at 11.5% y-o-y in August, the lowest level since March 2012, and we expect the headline inflation to moderate over the coming quarters.

Iran's persistent current account surpluses are coming to end, with the first deficit since 1999 set to be recorded in FY2015/16

TABLE: BMI CURRENCY FORECAST

	Spot	2015	2016
IRR/USD, ave	29,315	31,000	36,000
IRR/EUR, ave	32,146	34,100	38,520

Source: BMI, Bloomberg, Last updated: September 28 2015 (fiscal year running from March 21 2015 to March 20 2016). We forecast oil prices to average around USD55-60 per barrel (bbl) over the coming years – a significant decline compared with the USD109/bbl reached over 2011-2014. Given that oil accounted for 67.8% of exports in 2014, this will have a deleterious impact on the current account, which we forecast will post a deficit of 0.7% of GDP FY2015/16, compared with an estimated surplus of 3.6% in FY2014/15. This will result in downside pressures on the Iranian currency – a trend which will be compounded by a strengthening US dollar versus emerging market currencies over the coming quarters.

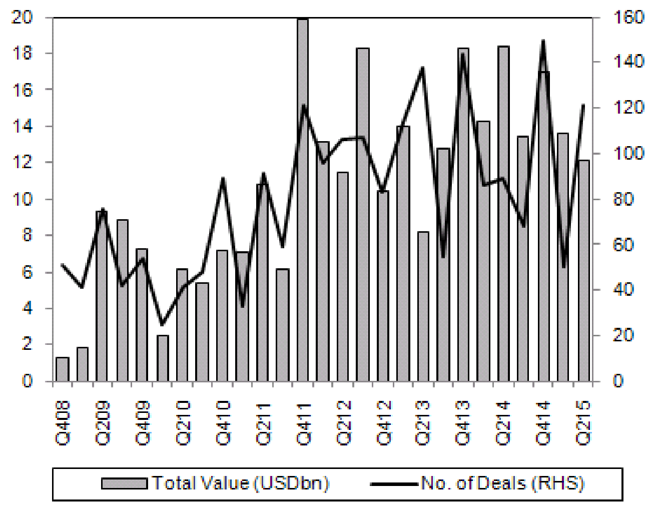
Islamic Finance

Islamic Banking: Slowdown In Place

BMI VIEW

Islamic Banking is set for continued growth over the coming five years as new markets begin to tap demand for Shari'a-compliant offerings. However, we believe that growth rates have peaked, and highlight numerous obstacles to the sector gaining global precedence.

Start Of The Slowdown?
Global – Islamic Bond & Loans Issuance



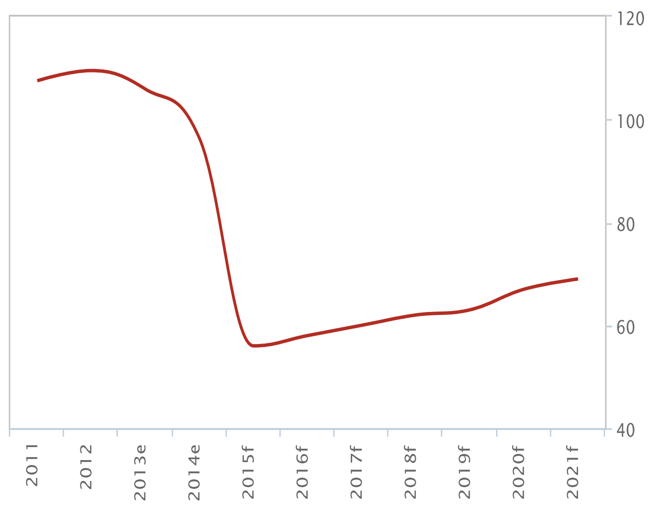
Source: Bloomberg, BMI

We expect growth in Islamic Banking to be increasingly driven by new markets, as more established centres see low base effects wear off. Overall, expansion rates are likely to be lower over the coming years on the back of higher base effects, lower oil prices and several significant impediments. Broadly, the end of the ultra-low interest rates and huge monetary stimuli means that growth in most banking sectors will slow, affecting Islamic Banking as well as conventional finance.

The decline in oil prices has had a marked impact on the Islamic Banking sector. Islamic bond issuance from the GCC has plunged 53%, the steepest decline for the region since at least 2007. About USD5.5bn has been raised, compared to USD11.7bn in the same period last year. While banks in the region have some insulation from lower oil prices, they will still be negatively affected. For example in the UAE, most of the biggest banks have transformed their business models in the past couple of years to get more money from services that command fees, such as asset management, brokerage and trade finance however our expectation for a slight cutback in growth in government spending on the back of lower oil prices will ensure that overall economic activity in the country will slow.

We have certainly expressed our concerns in the past that the rapid growth seen across the global Islamic finance industry could be set to slow over the coming years. A lack of cross-border cooperation between key hubs of Islamic banking in Asia and the Middle East, in addition to policy uncertainty and political risk in several future growth markets, will undermine the industry's expansion in 2015 and beyond.

Oil Prices To Remain Weak
OPEC Basket Price (USD/bbl)



Source: BMI

Islamic finance is less profitable than conventional banking, with Ernst & Young finding shareholder returns are 20% lower as a result of higher costs, complexity of products and operational inefficiencies. Indeed, Islamic banks tend to be much smaller than their conventional counterparts, making it hard to achieve economies of scale. The effects of this was most recently shown in Qatar where regulation prevented banks from offering both Islamic and conventional banking products, leaving most banks to close their Islamic Banking operations in the country.

The lack of standardisation in products offered globally given different interpretations between banks and jurisdictions of what is acceptable under shari'a law. Islamic banks have a relatively poor track record of cross-selling with an average of 2.1 products per customer compared to 4.9 products per customer in conventional banks.

Furthermore, cultural factors present in Islamic Banking, particularly the importance of face-to-face relationships means the branch network is important, but has resulted in an under-development of phone and internet banking. Finally, the vast majority of Islamic banks currently issue in local currencies and only a few offering Eurodollar products which would build their cross-border appeal.

As has been seen all too often however, in many cases there is often considerable opposition to the introduction of Islamic finance, even in markets with a large majority Muslim population. Central Asia and the Caucasus are a case in point, where governments are often hesitant about developing the sector due to their belief that this could encourage Islamist politics (not including Kazakhstan, which is aiming to become the regional hub for shari'a-compliant banking). Indeed, in Azerbaijan, where Muslims account for 93% of the population, the fear of political Islam has prevented any of the necessary legislation from being put into place, with the only bank attempting to offer a full line of Islamic banking products, **Kovsarbank**, having seen its license revoked after the central bank said banking laws had been violated.

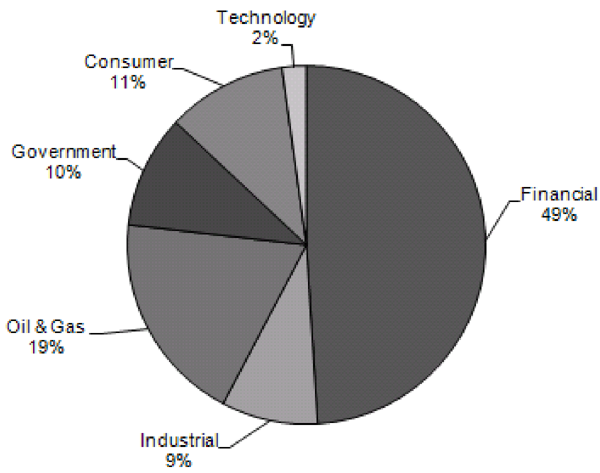
UAE: Established Market Set For Further Growth

We expect the UAE to buck the trend of a slowdown in more development Islamic banking markets. In late-2014, the UAE's Securities and Commodities Authority (SCA) announced plans open up markets to smaller sukuk issuers by cutting the minimum issue size to AED10mn (USD2.7mn), from AED50mn. The SCA also intends to shorten approval of issuance applications to five days, while private placements of bonds not listed on the UAE securities exchanges will not need SCA approval. As well as further incentivising UAE companies to utilise Islamic debt instruments, these measures should also attract issuers from elsewhere in the Gulf. Further government support for Islamic Banking is likely as the country aims to reduce its dependence on hydrocarbons – particularly given the drop in oil prices since June 2014.

While Dubai and Abu Dhabi will continue to dominate the UAE's Shari'a-compliant banking sectors, the northern emirates are eager to tap this growing market, a trend which we expect will continue. Indeed, Ras al-Khaimah is looking to return to the debt capital markets in 2015 with the launch of a potential US dollar-denominated benchmark sukuk issue sized over USD500mn.

Finance To Remain Out Front

Global – Share Of Islamic Bonds (2014)



Source: Bloomberg, BMI

From our standpoint, one of the most exciting markets to watch over the coming years will be Turkey, where the industry is only just beginning to get off its feet following years of suppression due to political sensitivities. As of early April 2015, the country was in the process of establishing new regulations that would allow for more widespread use of sukuk. At the moment, the government and corporates can only issue *ijara*, while the new legislation would approve the use of *istisna*, *murabaha*, *mudaraba*, *musharaka* and *wakala*. With Islamic Banking assets accounting for only 5% of the total commercial banking sector's assets, there is considerable scope to deepen the country's Shari'a-compliant financial markets.

Recent Developments

- UAE: UAE-based Dubai Islamic Bank (DIB) has made an offer of AED1.25 (USD0.34) per share in cash to fully acquire its mortgage unit Tamweel. The offer will expire on April 30 2015. DIB currently owns 86.5% of the unit and is in the process of acquiring the remaining 13.5% stake. The lender bought an initial 57.33% stake in Tamweel in 2010. DIB's board approved plans in January 2013 to completely acquire the unit.

- Malaysia: UAE-based Abu Dhabi Islamic Bank (ADIB) plans to issue capital-boosting Islamic bonds in Malaysia. Details pertaining to the size or currency of the bonds have not been revealed. ADIB announced in January 2015 that it plans to increase its capital base to help support future growth, seeking to strengthen reserves after a period of high lending growth. Dubai Islamic Bank raised USD1bn via its own perpetual sukuk in January 2015.

- UAE: Dubai has hit its first target in its aim to become the global hub of the Islamic economy, according to Sheikh Mohammed bin Rashid al-Maktoum, the UAE's vice president and prime minister and Dubai's ruler. Referring to a report showing that Dubai has overtaken Malaysia and London for the listing of Islamic bonds on its exchanges, the sheikh stated that the emirate had a clear vision to achieve its next target in 2020. 'Today we are the world's biggest centres for sukuk, but our vision is even wider and more comprehensive as it takes in seven major sectors of Islamic economy,' he said during a meeting of the board of the Dubai Islamic Economy Development Centre.

- Qatar: The Qatari stock market could see the listing of two shari'a-compliant banks in 2015 if the country's regulator approves it, according to Qatar Exchange CEO Rashid al-Mansoori. The two banks are **Barwa Bank** and **Qatar First Bank**; the former is a commercial lender while the latter is active in asset management. Al-Mansoori added that the bourse will see listings of four exchange-traded funds in the reported year.

Chapter 3:
10-Year Forecast

The Iranian Economy To 2024

Range Of Problems To Mitigate Impact Of Nuclear Deal

BMI VIEW

A deal over Iran's nuclear programme will bolster the country's economic growth prospects. However, the inability to fully exploit Iran's enormous oil and gas wealth and a challenging operational environment will lead to slow economic growth over the next 10 years.

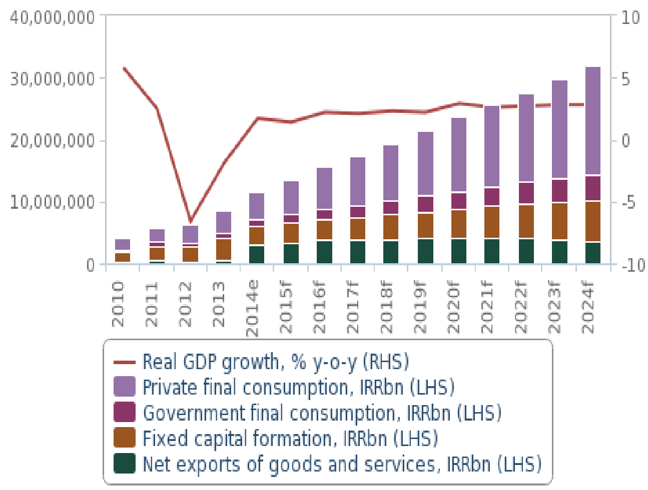
The Iranian economy will benefit from an unwinding of the sanctions regime, which we expect to occur from Q116 onwards. Even with easing sanctions, growth will be below potential as huge impediments, not least years of under investment, weigh on growth. The failure to fully exploit its enormous oil and 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 2.4% over the 2015-24 period, compared to 2.7% over 2005-14.

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, according to **BP**. However, oil production levels have plateaued since 2003.

Much of the lacklustre performance of the hydrocarbon sector over recent years can be ascribed to the US and international sanctions. US pressure has induced all the Western oil majors with interests in the Islamic Republic to announce that they would not be making any new investments in the country. Although companies from states less susceptible to US pressure, such as China and particularly Russia, will continue to invest in Iran, these oil companies in general do not possess the cutting-edge technical ability of Western majors, which will hinder output growth. The 'buy back' contracts that Iran insists upon in its dealings with foreign oil companies also inhibit inward investment.

Difficult Operational Environment Hindering Growth Potential
GDP Growth & Components



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

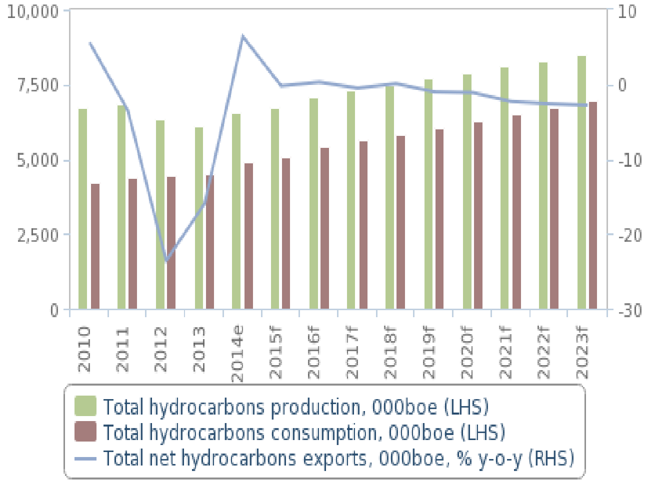
The upshot of these conspiring factors is that our Oil & Gas team forecasts average annual oil production growth to average 0.7% between 2015 and 2024, when it should reach 3.7mn barrels per day. We see natural gas production nearly doubling over the

TABLE: LONG-TERM MACROECONOMIC FORECASTS

	2015f	2016f	2017f	2018f	2019f	2020f	2021f	2022f	2023f	2024f
Nominal GDP, USDbn	396.6	397.7	427.7	461.3	495.6	529.3	559.0	593.8	626.1	659.5
Real GDP growth, % y-o-y	0.6	2.9	3.9	4.6	5.6	4.8	4.1	4.3	4.3	3.9
Population, mn	79.1	80.0	80.9	81.8	82.6	83.4	84.1	84.8	85.4	86.0
GDP per capita, USD	4,990	4,942	5,253	5,600	5,951	6,289	6,576	6,919	7,230	7,551
Consumer price inflation, % y-o-y, ave	15.0	11.0	10.0	10.0	9.0	7.0	10.0	10.0	6.0	10.0
Current account balance, % of GDP	-0.7	-0.9	-0.8	-0.7	-0.8	-0.8	-0.9	-1.0	-1.1	-1.1
Exchange rate, IRR/USD, ave	31,000	36,000	38,000	40,000	42,000	44,000	46,000	47,000	48,500	50,000
Parallel IRR/USD, eop	36,000	40,000	43,000	45,000	47,000	49,000	51,000	52,000	53,500	55,000

f = BMI forecast. Source: National sources, BMI 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.

Elevated Consumption Leading To Declining Exports
Energy Industry



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

Based on long-term supply and demand dynamics, we view USD66.5/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 deficit of 1.1% of GDP in 2024, from a 3.6% surplus in 2014. 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 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 deak. 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 being 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 41.5 out of 100 ranking the country 13th 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

While we expect a deal on Iran's nuclear programme to be found over Q315, we highlight that risks of an agreement collapsing in 2017 (when both the US and Iran has presidential elections) are elevated. Indeed, the West could further tighten sanctions over the coming years, which would lead to even lower capital imports and foreign investment.

There are also 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. 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.

Chapter 4:
Operational Risk

SWOT Analysis

Strengths

- Iran boasts high numbers of skilled graduates in technical fields such as engineering, construction and science.
- The outlook for Iran's economic and trade growth is improving due to the gradual lifting of sanctions, which began in 2013.
- The transport network offers good internal and cross-border connections, and is currently able to meet the country's supply chain needs.
- Low levels of violent crime mean that foreign workers and business property are relatively safe.

Weaknesses

- Costs of employment are increasing because the Iranian Labour Code affords workers a high level of protection and generous benefits.
- The costs of inland transportation, as well as the risk of congestion and traffic accidents disrupting supply chains, is raised due to reliance on the road network as the dominant freight mode.
- Trade bureaucracy is highly time consuming and places an onerous burden on importers and exporters.
- Businesses in Iran face heightened security risks due to the country's involvement in regional conflicts and the presence of several active domestic terrorist groups.

Opportunities

- The literacy rate of the labour force is increasing as the benefits of investment in primary school education are filtering through.
- The development of road and rail connections with neighbours highlights Iran's potential to develop into key transit point for East-West trade.
- Relaxing of sanctions is resulting in greater FDI inflows.
- The threat of IS has increased the urgency of reaching an agreement over Iran's nuclear programme, and offers an avenue for greater co-operation, increased dialogue, and better relations with global powers.

Threats

- The availability of highly skilled labour is restricted as the brain drain results in an exodus of technically qualified workers.
- The risk of electricity and water shortages will be enhanced due to growth in the agricultural, mining and manufacturing industries.
- Lax intellectual property protection carries the threat of patent theft, fraud or infringement, leading to profit losses.
- Even when sanctions are lifted, the impact of cyber and financial crime on businesses will remain significant, requiring investors to provide expensive security and preventative measures.

Operational Risk Index

Four rounds of UN economic sanctions over Iran's nuclear programme, as well as unilateral measures from the US and the EU, mean that foreign investment inflows has remained below potential over the past years. Despite progress in nuclear talks, we are sceptical that FDI inflows will increase significantly until a long-term agreement on the issue is found. This particularly hurts Iran's oil and gas sector, which is in urgent need of increased investment. In particular, foreign expertise in liquefied natural gas production is required for Iran to become a major exporter, but sanctions will slow technology transfer.

	Operational Risk	Trend	Regional Rank	Global Rank
UAE	69.6	+	1	25
Qatar	66.0	+	2	32
Oman	63.7	+	3	38
Saudi Arabia	63.3	+	4	40
Israel	62.9	+	5	41
Bahrain	62.4	+	6	43
Jordan	57.8	+	7	63
Kuwait	56.5	+	8	66
Tunisia	51.5	+	9	89
Morocco	51.2	+	10	91
Lebanon	47.6	+	11	108
Egypt	44.8	+	12	120
Algeria	42.1	+	13	130
Iran	**41.1**	**-**	**14**	**135**
Iraq	33.0	+	15	178
Syria	31.7	+	16	180
West Bank And Gaza	31.3	+	17	181
Libya	30.4	+	18	186
Yemen	27.1	+	19	190

Regional ave 49.2 / Global ave 49.8

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.

Iran is on the cusp of a historic rapprochement with the West which will, over time, result in the normalisation of international relations, alleviation of sanctions on the economy, and opportunities for foreign involvement in the country's vast hydrocarbons

TABLE: OPERATIONAL RISK

	Iran	Global Ranking	Regional Ranking
Operational Risk	**41.1**	**135**	**14**
LOGISTICS RISK	**49.1**	**96**	**13**
Transport Network	53.2	67	7
Extent of Transport Network	51.6	74	3
Quality of Transport Network	54.8	77	10
Trade Procedures and Governance	37.2	146	16
Ease of Trading	26.3	164	18
Costs and Connectivity	48.1	106	15
Market Size and Utilities	56.8	67	12
Electricity and Fuel	70.8	17	7
Telecoms and Water	42.8	118	15
LABOUR MARKET RISK	**47.2**	**121**	**11**
Education	71.7	41	2
General Education	65.8	58	4
Tertiary Education	77.7	30	2
Availability of Labour	41.6	157	12
Size of Labour Force	24.9	180	12
Composition of Labour	58.3	46	13
Labour Costs	28.2	200	18
Cost of Employment	18.7	200	19
Flexibility of Labour	37.7	167	11
TRADE AND INVESTMENT RISK	**34.4**	**162**	**14**
Economic Openness	28.4	175	17
Trade Openness	27.5	175	17
Investment Openness	29.3	163	14
Government Intervention	42.5	139	14
Taxation	57.9	63	12
Financial Barriers	27.1	157	13
Legal	32.2	157	15
Bureaucratic Environment	34.9	157	16
Legal Environment	29.5	156	14
SECURITY RISK	**33.8**	**154**	**13**
Conflict Risk	46.9	104	6
Terrorism and Political Violence	47.3	101	4
Interstate Conflict Risk	46.5	102	12
Crime Vulnerability Risk	32.3	151	14
Violent and Petty Crime	34.5	139	16
Police Force Capability	30.0	154	13
Business Crime Risk	22.4	167	13
Financial and Cyber Crime	20.3	168	14
Business Costs of Crime	24.5	157	13

Source: BMI Operational Risk Index

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 (FDI). These include obstacles to trade and regulatory restrictions on FDI, 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 41.1 out of 100 placing it in 14th position out of 19 states in the Middle East and North Africa (MENA).

The international sanctions imposed on Iran have 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 country into recession in 2012, while the 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 will be gradually lifted over the short term, resulting in an improvement in trade flows and economic growth. However, Iran's appeal to investors will remain limited, despite a range of opportunities for FDI, due to a range of factors 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. Consequently, Iran scores just 34.4 out of 100 in the **BMI** Trade and Investment Risk Index, placing it a lowly 14th position out of 19 states in the MENA region.

Iran's utilities market has also suffered considerably under the sanctions regime, as production of oil and gas has fallen due to the absence of foreign money, expertise and technology required to extract these commodities. This has resulted in energy shortages as the gas supply has been unable to meet demand for power generation, while the electricity network requires foreign investment in order to update and expand capacity. In addition, fuel shortages have loomed due to restrictions on imports and inadequate domestic refining capacity. Sanctions have also further complicated the already onerous process of exporting and importing, which is laden with bureaucratic obligations and subject to long delays. On the positive side, Iran is well placed to take advantage of its potential as a transit route for trade between Asia and Europe, due to an extensive transport network which offers strong internal and cross-border connections. Overall, Iran is ranked 13th out of 19 MENA states in the **BMI** Logistics Risk Index, scoring 49.1 out of 100.

Iran's isolated international position is the main driver behind its major security risk, which is the potential for interstate conflict. The country has poor relations with most global powers, notably the US, the UK and Israel, and its rivalry with the latter has frequently appeared to bring the two states to the brink of conflict. In addition, Iran's sponsorship of illegal organisations (such as Hezbollah), ostracised regimes (Assad's Syria), and rebel groups (Houthis in Yemen), has antagonised its Arab neighbours and increasingly aligned it against Sunni states dominated by Saudi Arabia. Iran also faces risks from non-state actors such as the Islamic State (IS), which it 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 crime is not a major problem for foreign workers and businesses. Overall, Iran nevertheless performs poorly in **BMI**'s Crime and Security Risk Index, ranked 13th out of 19 states, with a low score of 33.8 out of 100 indicating the high level of instability in the MENA region.

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 which produces large numbers of highly skilled workers. However, Iran suffers from a brain drain of its most intelligent and educated citizens, who leave in order to seek more lucrative employment and better prospects broad. This contributes to a dire 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 considerable mandatory social security contributions, a high minimum wage, and generous fringe benefits awarded to workers. Consequently, Iran scores below the regional average in the **BMI** Labour Market Risk Index, with 47.2 out of 100 placing the country 11th out of 19 states regionally.

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 underway since the Islamic Revolution in 1979, boosting enrolment rates and the quality of teaching. There is consequently a relatively healthy outlook for Iran's education system, which will feed into a higher quality labour market over the medium term. The country therefore scores 71.7 out of 100 for the Education pillar of **BMI**'s Labour Market Risk Index, ranking it second out of 19 states in the MENA region.

However, there remain a number of risks inherent in the country's education system. Foremost among these are the emphasis on quantity, in terms of enrolment and academic output, over the quality of teaching, insufficient job opportunities for highly skilled workers, and persistent challenges to female education. In addition, although significant advances in education have been made since the Islamic Revolution, this has not benefitted the people who were of school age before these reforms were enacted, meaning that higher qualifications and even basic literacy skills are lacking among older members of the workforce.

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.

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 3.6% of GDP in 2012, government expenditure on education has fallen from 4.8% of GDP five years previously. This reflects the successes of this sustained investment in achieving widespread access to schooling. Education nevertheless remains a top priority for the Iranian government.

Significant investment in education has resulted in widespread access to schools across Iran, with even children in remote rural areas 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 2003, the number of out-of-school children has fallen from 424,251 to

TABLE: MENA – EDUCATION RISK

Country	General Education	Tertiary Education	Education
Israel	78.1	79.7	78.9
Iran	**65.8**	**77.7**	**71.7**
Saudi Arabia	59.7	70.8	65.2
Jordan	70.2	56.2	63.2
Tunisia	56.0	68.9	62.5
Egypt	46.7	71.4	59.0
Algeria	45.5	66.1	55.8
West Bank And Gaza	52.2	54.1	53.2
Lebanon	45.7	57.9	51.8
Oman	52.4	49.3	50.9
Qatar	65.9	34.6	50.3
Syria	41.4	58.2	49.8
Bahrain	57.3	42.1	49.7
Libya	35.1	63.1	49.1
Kuwait	53.7	37.8	45.8
Morocco	35.0	53.3	44.1
UAE	42.3	45.5	43.9
Iraq	30.1	52.2	41.2
Yemen	21.8	47.5	34.6

Source: BMI Labour Market Risk Index

just 3,468 in 2012, according to UNESCO data. Over the four years from 2009-2012 the number of out of school adolescents nearly halved, from 282,841 to 145,866, indicating that the prevalence of more highly skilled workers in the labour pool will be increasing over the medium term.

That investment in education has only begun to see rewards in recent years is indicated by the fact that only 85% 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 98.8% of males and 98.5% 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 should improve considerably over the medium term.

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 increased over the past few 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 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.

Neither English nor Mandarin, the most commonly used languages of business, are well taught in Iran, although middle school students (aged 11-13) do study English Language. Students have to study privately in order to learn English to a conversational level, which most cannot afford. This will cause problems for foreign businesses hiring Iranian workers as they are less likely to speak a common language, complicating business operations.

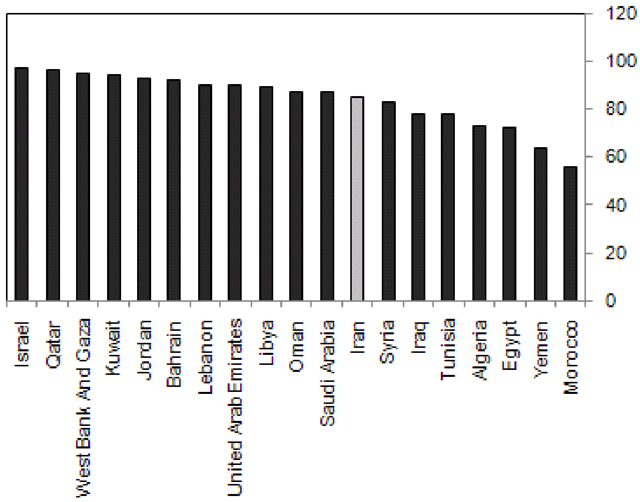
General Education

Iran's education system is characterised by 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 65.8 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.

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.

Widespread Literacy Boosts Employability

MENA – Literacy Rate (%)

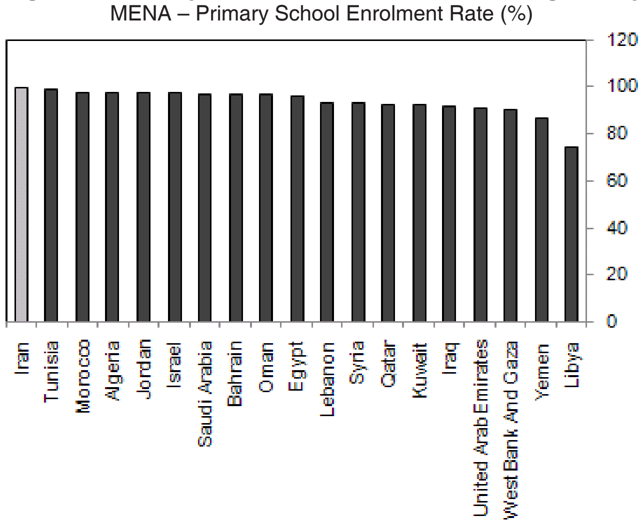


Source: UN

One of Iran's greatest strengths in terms of the education system is its high primary school enrolment rates. At 99.85% in 2012, Iran's primary school net enrolment rate was the 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. Even though reforms have only begun to take effect relatively recently, a large percentage of the country's labour force, 98.4%, has benefitted from a formal education for at least the primary school cycle, the third highest figure in the region. This means that businesses will not face difficulties finding workers with basic skills such as literacy. The 15% of the population in Iran who are not literate, as mentioned above, will mostly comprise the elderly who are not active members of the labour force.

Furthermore, in collaboration with UNICEF, the government of Iran operates over 5,000 rural Child Care Centres across the country to provide Iranian children with pre-school education. Due to these measures, 40.6% of males and 44.7% of females will begin primary school in 2014 with some pre-school education; with over 70,000 villages across Iran there are hopes 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.

Highest Primary School Enrolment Rate Regionally
MENA – Primary School Enrolment Rate (%)



Source: National statistics

The quality of education has also improved as class sizes have fallen and there is consequently more individual interaction between students and teachers. This means that there is more scope for the needs of each pupil to be catered for. The pupil/teacher ratio for primary schools was at 20.6 in 2009 (latest available data) having fallen over the previous five years from 21.7 in 2005. The primary school curriculum covers a range of core subjects including reading, writing, comprehension, mathematics, science and social studies, as well as Islamic Studies and Persian Studies. The national curriculum ensures uniform coverage of these subjects at all public schools.

Secondary Education: While it has, in recent years, attained a relatively high level of enrolment, 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 regional average of 73.5%. 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 do what they can to bring home income, therefore having a detrimental effect on the enrolment and attendance rates of children in school.

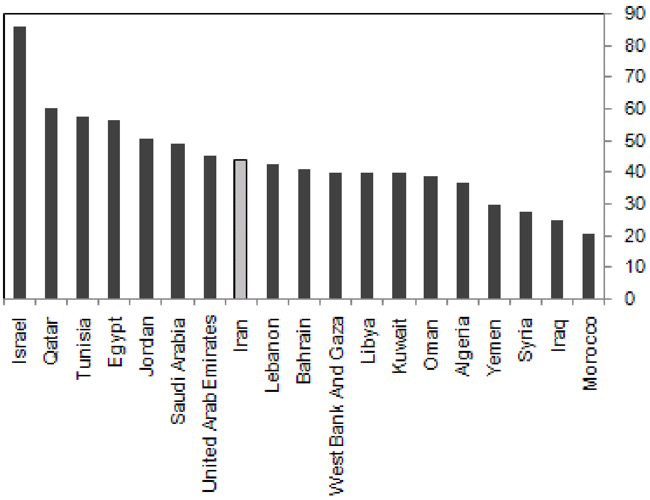
There remains a gender imbalance in secondary school enrolment rates, which is also a result of poorer rural lifestyles. Girls are often required to do the household chores and look after younger siblings. Even in more affluent areas, early marriages and lack of travel security dissuade many girls from continuing to secondary education. UNICEF has also highlighted the lack of female teaching staff as a major impediment to education equality in Iran. Although the secondary net enrolment rate of girls in Iran is not excessively lower than the overall enrolment rate, at 77.4%, it places Iran in the middle of the pack regionally, and demonstrates that there is room for improvement in education equality.

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 44.1% of the labour force has at least secondary education, which places the country eighth in the MENA region. This means that over half the labour force has only a primary education, at 54.3%, 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.

Even though Iran spends a relatively high proportion of its education budget on secondary education, at 40.59% of the total in 2012, there remain issues with the quality of teaching in the country. Iran's education system has been heavily criticised recently for not providing children with the skills they need for employment. Like the rest of the Middle East, Iran has a test-based education system, which limits the set of skills that individuals are encouraged to learn. Iran's system disproportionately rewards the ability to absorb and retain a lot of information at the expense of creativity. However, it is not even particularly efficient at instilling these abilities.

Progression To Secondary Education Traditionally Lacking

MENA – Labour Force With Secondary Education & Above (%)



Source: National statistics

In 2011, the TIMSS found that only 1% of 9-10 year-olds and 2% of 13-14 year-olds scored above the 'high international benchmark for mathematics' and 33% and 26% above the 'intermediate benchmark'. These proportions are well below average. Also a recent study 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. This was somewhat higher than average. In addition, the lack of employable skills is continued to higher secondary education courses, where the three most popular modules in 2013 were The Holy Qu'ran, Religious Education and Persian Literature. Here, the major risk is that Iran's labour force will grow increasingly unskilled in desirable 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 awarded a high score of 77.7 out of 100 for Tertiary Education, placing it second in the region. However, the quality of these graduates has been called into question by many, including President Rouhani, who are concerned 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 employment within Iran, and therefore leave the country in search of advanced degrees and lucrative work, 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. Iran boasts one university in the Times Higher Education World University Rankings, with the

TABLE: TERTIARY EDUCATION GRADUATES ('000)

Graduates	2011	2012
TOTAL	607,121	570,730
Agriculture	25,227	24,125
Education	34,134	31,575
Engineering, Manufacturing and Construction	243,255	233,695
Health and Welfare	29,567	18,521
Humanities and Arts	54,251	46,227
Science	40,195	35,819
Services	19,120	16,883
Social Sciences, Business and Law	161,372	163,885

Source: World Bank, BMI

Sharif University of Technology placed in the top 275 universities globally, while 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 was 55.2% in 2012, 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 18.8%, ranking Iran 10th in the region, is therefore expected to improve.

Of the students currently enrolled in Iranian higher education institutions, 233,695 graduated with a degree in manufacturing, engineering or construction in 2012. This number of skilled graduates is the highest quantity produced in the region. Similarly, 35,819 graduated with a degree in the sciences in 2012, 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, Iran 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. More left Iran 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. 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 within Iran for skilled and education 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, we note that 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 political 'red lines' within Iranian institutions which prevent 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.

Government Intervention

The Iranian economy is characterised by a high degree of government intervention, with a bloated public sector, relatively high taxation levels and an almost entirely state-owned banking industry. Tax rates in Iran pose a significant burden for businesses and for foreign workers, as individual income tax is charged at the top rate of that for Iranian residents. The banking sector has also been particularly targeted by the international sanctions, which have almost entirely cut off Iranian banks from the international finance industry and severely restricted the ability of foreign businesses to operate in the country. On the positive side, tax breaks are available for investments in certain industries. In addition, the agreement over Iran's nuclear programme will result in a huge improvement in access to financing from 2016, and allow greater foreign participation in the country's burgeoning capital market. Nevertheless, Iran currently scores lowly for the Government Intervention pillar of **BMI**'s Trade and Investment Risk Index, with 42.5 out of 100, which ranks the country 14th out of 19 states in the MENA region.

Taxation: The burden of paying taxes in Iran is another factor hindering the country's attractiveness as a destination for investment. Although the government has introduced a simplified flat corporate income tax rate which is applicable to both resident and non-resident entities, this is the third highest figure regionally. In addition, the tax rate applied to non-resident individuals is much higher than for Iranian nationals, while the tax system also favours public sector workers. Furthermore, we highlight that tax administration places a considerable burden on businesses, with a high number of required tax payments taking a long amount of time to process. Overall, Iran scores 57.9 out of 100 for Taxation, well below GCC states UAE, Qatar and Bahrain with very lenient tax regimes, and ranks 12th out of 19 MENA states.

Government income in Iran is deceptively low, at 11.6% of GDP, ranking the country second from bottom regionally. This is due to a number of factors, including the large economy, the small size of the private sector, and the prevalence of employment in the public sphere, where personal income is subject to a lower tax rate. In fact, the tax burden on private entities and individuals in Iran is considerable, due to the range of direct and indirect taxes applicable to businesses.

Corporate income tax is charged at the same rate for both resident and non-resident businesses on all income derived within Iran, at 25% of profits. Resident companies are also liable for income derived from foreign sources. This tax rate represents the third highest figure regionally, indicating that although there is no discrimination against foreign entities, tax liabilities pose a considerable risk for all businesses. In addition, the administration surrounding tax payments is rather onerous, with the seventh highest number of individual payments required regionally, at 20, and the fourth longest time required to process taxes, at 344 hours. This increases the tax burden on businesses in terms of productivity losses due to Iran's complicated bureaucracy.

There are further taxes applicable to businesses in Iran. The main levies of note are the property transfer tax, which is charged at 5% of land value, and value added tax (VAT), which stands at 7% in 2015 and will increase to 8% in 2016. These taxes are also applicable to individuals, adding to the burden of taxation for private sector employees and foreign nationals in particular. Iran's personal income tax regime favours those employed in the country's bloated public sector, who are taxed at a flat rate of 10%. However, those with jobs in private businesses are taxed on a progressive scale between 0% and 35%, with this upper rate representing the third highest top income tax charge in the MENA region. In addition, this highest threshold is applied to all non-resident employees, meaning that businesses will face difficulties attracting foreign workers and will likely have to pay higher wages in order to offset the effects of this high tax rate.

Some tax exemptions and incentives are available for both individuals and corporate entities. Iran has an agreement to

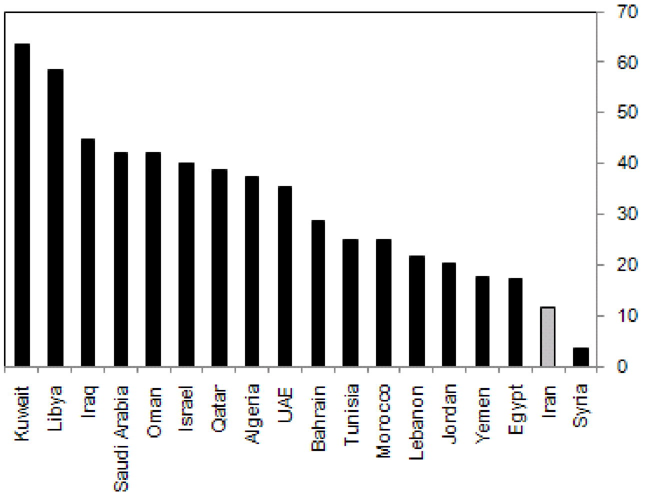
TABLE: MENA – GOVERNMENT INTERVENTION RISK

Country	Taxation	Financial Barriers	Government Intervention
UAE	81.2	59.0	70.1
Lebanon	70.5	60.1	65.3
Qatar	79.6	50.6	65.1
Bahrain	77.7	51.6	64.7
Saudi Arabia	77.1	49.3	63.2
Jordan	74.3	47.0	60.7
Kuwait	64.4	52.9	58.7
Oman	68.5	48.1	58.3
Morocco	55.9	55.6	55.7
Tunisia	64.5	46.7	55.6
Israel	26.2	78.4	52.3
Egypt	54.6	31.1	42.9
Syria	60.2	25.0	42.6
Iran	**57.9**	**27.1**	**42.5**
West Bank And Gaza	60.1	24.2	42.2
Yemen	56.4	7.9	32.1
Iraq	34.6	22.3	28.5
Algeria	34.2	21.5	27.8
Libya	39.9	1.8	20.8

Source: BMI Trade and Investment Risk Index avoid double taxation for income arising in either country with 40 nations including Germany, France, Switzerland, Kuwait and Qatar. Businesses located in free trade zones (FTZs) enjoy income tax holidays for 20 years and exemptions from customs duties and VAT on certain goods. Specific industries also benefit from special tax exemptions. Agriculture, local handmade crafts, and sports and educational services enjoy 100% exemption in perpetuity. Industry and mining in underdeveloped areas is subject to a 100% tax holiday for 20 years, and in other areas for an 80% tax holiday lasting four years. In addition, tourism activities are subject to a 50% tax credit and businesses involved in the export of services and non-oil goods benefit from a 100% tax holiday during the period of the 5th Development Plan (up to 2017). Public companies listed on the Tehran Stock Exchange are exempt from the 10% corporate tax. Although these benefits are quite extensive, they do not mitigate the country's considerable tax burden for private businesses.

Low Revenues Hide Significant Tax Demands On Businesses

MENA – Tax Revenues As % Of GDP, 2013

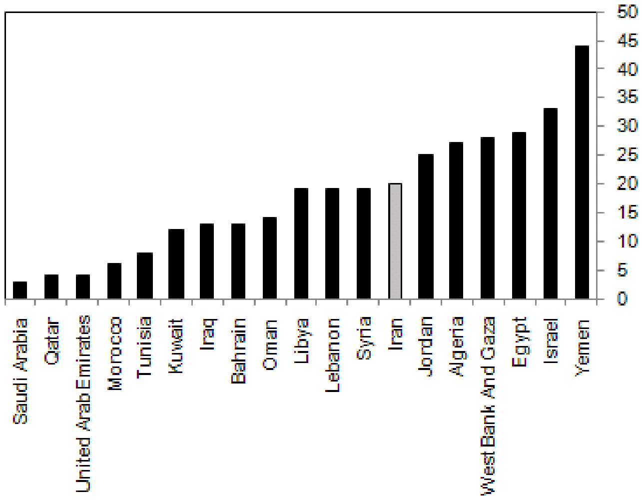


Source: World Bank, National statistics

Financial Barriers: The financial sector in Iran has been heavily targeted by international sanctions, which have essentially cut the country's banks adrift from global financial markets and severely restricted the availability of credit and the ease of capital transfers for multinational businesses. In addition, the domestic banking sector remains almost entirely nationalised meaning the government retains a significant regulatory role. However, the impact of sanctions has not been entirely negative, as the lack of access to international financial markets means that the domestic stock exchange is booming, with Iranians having limited alternative options for investment. Foreign involvement in the capital market will increase once sanctions are lifted, and access to financing will also be boosted as Iranian banks and companies are reintegrated with the global financial system. Overall, however, the impact of the sanctions regime on the banking sector means that Iran receives a very low score for financial barriers, at 27.1 out of 100, which places it 13th out of 19 MENA states.

Considerable Number Of Tax Payments

MENA – Number Of Tax Payments



Source: World Bank

Iran has been hit heavily by international sanctions with regard to its access to international financial markets. Since March 2012, Iranian banks have been blocked from using the SWIFT network for managing and operating financial transactions, and many countries have been banned from undertaking transactions with Iranian institutions. There are eight Iranian banks on the US sanctions list and in 2011 both the UK and France undertook measures to cease trading with Iranian financial institutions

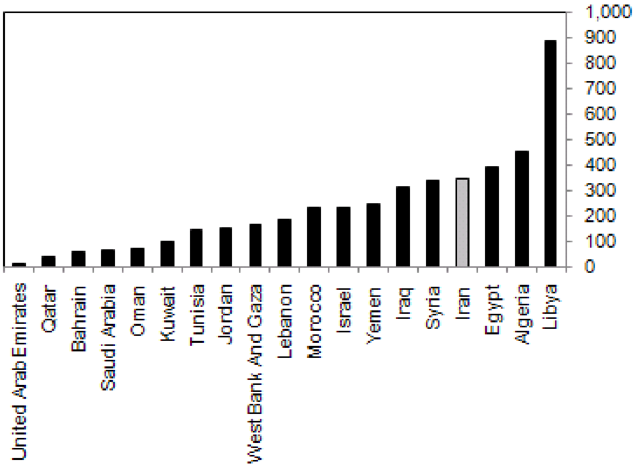
TABLE: PERSONAL INCOME TAX BRACKETS

Personal Income (IRR)	Tax Rate
Up to 30,000,000	15%
30,000,000-100,000,000	20%
100,000,000-250,000,000	25%
250,000,000-1,000,000,000	30%
Over 1,000,000,000	35%

Source: National sources

within their own jurisdictions and to encourage their European neighbours to do likewise. All of these measures will be lifted once sanctions have been removed, which is expected by the end of 2015.

Slow Bureaucracy Associated With Paying Taxes
MENA – Time To Pay Taxes (hours)



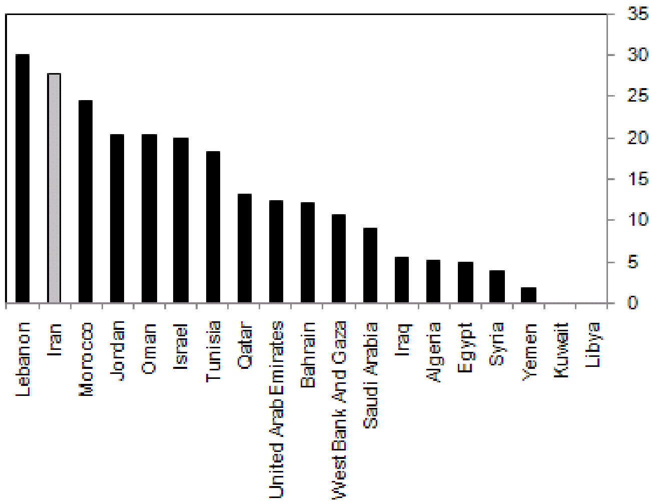
Source: World Bank

The international sanctions have taken their toll on the financial industry, however. The main consequences have been an increase in the use of the Hawala money transfer system, which is unregulated, informal and largely honour-based, and an increase in the use of smaller-scale institutions to conduct financial transactions. These conditions are making it harder for Iranian banks to operate overseas and to transfer money globally as the methods they are forced to resort to are more time-consuming and drive up costs through increased commissions. The ostracising of the Iranian banking system has drastically reduced the availability of credit and the ease of capital flows for foreign businesses, resulting in respondents to the WEF's Global Competitiveness Index 2014-2015 listing access to financing as the most problematic factor of doing business in Iran. In addition, portfolio investment remains a risky prospect due to the lack of protection afforded to minority shareholders, who enjoy only a limited ability to hold directors to account for mismanagement, and are subject to a weak corporate governance structure.

That said, the country's main financial market, the Tehran Stock Exchange (TSE), is becoming one of the most attractive conduits for raising capital. The TSE has benefitted to some extent from the lack of access to international financial markets, as Iranian investors have very limited alternative options for investing capital. Consequently, although the number of listed companies has fallen between 2010 and 2012, from 341 to 284, this still represented more than Italy and Russia. In addition, total market capitalisation has increased significantly, from USD86.6bn to USD140.8bn over the same time period, placing the country above Qatar and New Zealand. This trend has continued since the talks over Iran's nuclear programme began, with the bourse up 130% in 2013. Consequently, businesses in Iran will find that floating on the TSE is one of the most effective ways of obtaining credit at present.

In addition, the TSE has started an ambitious modernisation and sophistication programme aimed at increasing market transparency and attracting more investors, both foreign and domestic. It has installed a new trading system from Atos Euronext Market Solutions which allows the purchasing and selling of stocks on the same day, while also increasing the number of brokerage stations able to operate simultaneously four-fold. The new system also links the stock market to the international bourses. The bourse can now handle 700 transactions per second and 150,000 transactions per day. This increased capacity demonstrates willingness by the Iranian commercial scene to improve its international business standings, and this will improve the ability to attract foreign participation once sanctions are lifted.

Strong Retail Banking Penetration
MENA – Number Of Bank Branches Per 100,000 Adults



Source: BMI, National sources

Iran has a reasonably extensive and efficient retail banking system, although the role of the private sector remains negligible. The country has six major public banks, with the largest being the Central Bank of Iran (CBI) which is charged with the maintenance of the Iranian currency and management of the national balance of payments. Iran also has a number of privately owned banks, but in their management and operation, all privatised banks are under state control. The physical presence of the banking system is regionally excellent, with over 27.7 bank branches per 100,000 Iranian citizens placing the country in second position regionally behind Lebanon. The country-wide distribution of bank branches is reasonably good, although it should be noted that certain banks specialise in either rural or urban areas. For instance, the Bank Keshavarzi specialises in financing agricultural ventures and other commercial activity in rural areas.

Debit cards are common place and electronic paypoints are frequent in shops and markets. In addition, the necessary infrastructures (regulatory, hardware, software) for launching e-money are in place; but these capacities are limited by Iran's poor bandwidth connections. Instead, Iran operates a largely cash-based economy and has an extensive network of ATM withdrawal points throughout the country. Furthermore, Iran's ATM network is linked to those of Bahrain, Qatar and Kuwait as well, allowing customers travelling in these Arab countries access to their accounts. Recently, the issuing of debit cards in Iran has seen dramatic growth, going from almost 20,000 issued in 2006, to over 150,000 issued in 2012. These cards are mostly issued at consumer request, demonstrating increased demand among the Iranian public for easy access to their finances. The issuing of credit cards show similar growth, but the 1.5mn issued in 2012 still falls below the expected volume for the scale of Iran's economy and population. This demonstrates increased demand for access to credit form the country's population and therefore a considerable market for high-end goods requiring non-cash payments, which is yet to be tapped by international investors.

Chapter 5:
BMI Global Macro Outlook

Global Outlook

Global Growth Weak As EMs Squeezed

The US and China are the centrifugal forces of the global economy, and they appear to be going in different directions. Caught in the middle are emerging markets, which are under significant pressure from both weakening Chinese demand and slowly rising US interest rates. None of this is new – these conflicting forces have been at play since mid-2013 – but the rise in US rates is coinciding with a series of apparent blunders from the Chinese authorities, beginning in July, that have undermined both economic activity and confidence. The secular story of a Chinese economic slowdown underlies it all however, and this is a theme that will continue to play out for years to come, as we had long expected, with a concomitant impact upon commodity exporters and regional trading partners in particular.

Against this backdrop, the near-term world economic outlook remains poor, with global real GDP growth now forecast at 2.8% in 2015 (down from 2.9% previously) and 3.0% in 2016 (from 3.1% previously), reflecting downgrades largely in emerging markets and the 'Asian Tigers' of Hong Kong, South Korea and Taiwan that we classify as developed markets. By some metrics, it appears that emerging markets as a whole are either in recession or close to it, with growth in 2015 and 2016 set to be around one quarter below the long-term trend. Emerging markets will grow by 4.2% on average in 2015-2016, below the 5.4% compound annual growth rate in the preceding decade between 2005-2014; for EM ex-China, the drop-off is even more pronounced at 3.0% growth, below the 4.1% long-term rate. While the story varies significantly by country, at least two major EMs are in recession (Russia and Brazil), and several others including Turkey and China face weakening economic momentum.

TABLE: GLOBAL ASSUMPTIONS

	2014	2015f	2016f	2017f	2018f	2019f
Real GDP Growth (%)						
US	2.4	2.5	2.6	2.5	2.6	2.5
Eurozone	0.9	1.6	1.7	1.5	1.4	1.5
Japan	0.0	1.2	0.7	0.7	0.7	0.7
China	7.4	6.7	5.9	5.9	5.9	5.9
World	2.8	2.8	3.0	3.2	3.2	3.3
Consumer Inflation (ave)						
US	1.6	0.4	1.8	2.0	2.1	2.1
Eurozone	0.5	0.3	1.0	1.4	1.6	1.7
Japan	2.7	1.8	2.6	2.4	2.6	2.8
China	2.0	1.3	2.7	2.7	2.7	2.7
World	3.2	2.5	3.2	3.1	3.1	3.0
Interest Rates (eop)						
Fed Funds Rate	0.00	0.25	1.00	2.25	2.75	3.00
ECB Refinancing Rate	0.05	0.05	0.05	0.05	0.25	1.00
Japan Overnight Call Rate	0.10	0.10	0.10	0.10	0.10	0.10
Exchange Rates (ave)						
USD/EUR	1.34	1.10	1.07	1.10	1.15	1.20
JPY/USD	105.89	118.50	119.00	121.00	123.00	123.00
CNY/USD	6.16	6.52	6.87	6.90	6.90	6.90
Oil Prices (ave)						
OPEC Basket (USD/bbl)	96.30	54.00	53.00	52.00	57.00	61.00
Brent Crude (USD/bbl)	99.50	57.00	56.00	55.00	60.00	64.00

f = BMI forecast. Source: BMI

There are some positive dynamics amid a generally weak global outlook. The US private sector continues to show strength, from the labour market to personal income to residential construction. Improving domestic conditions ensure the US Federal Reserve will tighten policy, but it is likely to remain concerned about doing so too quickly, particularly given the potential spillover effects of global economic weakness on US domestic conditions. We now forecast that the benchmark Fed funds rate will rise to 0.25% at the end of 2015, revised from our prior forecast of 0.50%. We expect that the rate will be 1.00% at the end of 2016, and 2.25% by the end of 2017, a downward adjustment from our previous projections of 1.50%, and 2.50% respectively.

In the eurozone growth momentum is picking up, with rising German consumption a highlight both from a cyclical and a structural standpoint. Central and Eastern Europe (CEE; excluding Russia) appears to be relatively well-insulated from both the China slowdown and the rise of the US dollar, and is benefiting from the drop in oil prices. As with CEE, some emerging market commodity importers and those that are relatively insulated to

TABLE: DEVELOPED STATES, REAL GDP GROWTH, %

	2014	2015f	2016f	2017f
Developed States Aggregate Growth	1.8	2.1	2.1	2.1
G7	1.7	2.1	2.1	2.0
Eurozone	0.9	1.6	1.7	1.5
EU-27	1.4	1.9	2.0	1.9
Selected Developed States				
Australia	2.8	2.3	2.3	2.5
Austria	0.3	0.8	1.5	1.6
Belgium	1.0	1.3	1.5	1.5
Canada	2.5	1.5	1.8	2.0
Czech Republic	1.9	4.2	4.0	3.6
Denmark	1.1	1.7	1.7	1.4
Finland	-0.1	-0.1	0.4	0.7
France	0.4	1.3	1.4	1.3
Germany	1.6	2.0	2.0	1.5
Hong Kong	2.3	2.5	2.5	3.6
Ireland	4.8	6.1	4.2	3.8
Italy	-0.4	0.7	1.1	0.9
Japan	0.0	1.2	0.7	0.7
Netherlands	0.8	1.8	1.9	1.9
Norway	2.2	1.3	1.4	1.3
Portugal	0.9	1.5	1.5	1.3
Singapore	2.9	2.5	3.2	3.2
South Korea	3.3	2.8	3.0	3.4
Spain	1.4	2.7	2.2	2.0
Sweden	2.1	2.6	2.7	2.3
Switzerland	2.0	0.8	1.5	1.8
Taiwan	3.7	1.7	3.4	4.1
United Kingdom	2.8	2.6	2.4	2.4
United States of America	2.4	2.5	2.6	2.5

f = BMI forecast. Source: BMI

TABLE: BMI VERSUS BLOOMBERG CONSENSUS REAL GDP GROWTH FORECASTS, %

		US	Eurozone	Japan	Brazil	China	Russia
2015	Bloomberg Consensus	2.5	1.4	0.7	-1.8	6.9	-3.7
	BMI	2.5	1.6	1.2	-2.2	6.7	-4.0
2016	Bloomberg Consensus	2.7	1.7	1.2	0.2	6.7	0.5
	BMI	2.6	1.7	0.7	-0.4	5.9	0.5

Source: BMI, Bloomberg. Last updated: September 17 2015 the global cycle are showing resilience in activity, including India in particular.

If there is good news on aggregate it is that 2016 will see stronger growth in most parts of the world than in 2015, according to our forecasts. Not only is our 2016 global growth forecast higher than that for 2015, but of the 202 countries that we cover, 132 will see faster real GDP growth and just 51 will expand more slowly (19 will post the same growth rate). By comparison, this year, 93 countries decelerated compared with 2014 and just 99 accelerated. While long-term growth is likely to be slower than the preceding decade, our forecasts indicate that 2015 represents a trough.

Developed States

The most significant downgrades to our individual developed states forecasts this month (which have reduced the aggregate growth rate to 2.1% in 2016 from 2.2% previously) have been in three key Asian economies which are suffering from the slowdown in China.

The export-oriented economic model pursued by Taiwan and Korea has resulted in both countries being vulnerable to swings in the global economy. With a heavy reliance on exports, which account for 50.5% of Korea's GDP and 70.0% of Taiwan's, a sharp decline in export demand will accordingly undermine growth in both countries. Furthermore, the growth of regional supply chains has led to the steady integration of both Taiwanese and South Korean economies with the Chinese one. While this resulted in significant benefits during China's period of rapid growth, heavy exposure to China has also led to a sharp decline in export growth as the Chinese economy slows down. We

TABLE: EMERGING MARKETS, REAL GDP GROWTH, %

	2014	2015f	2016f	2017f
Emerging Markets Aggregate Growth	**4.3**	**4.0**	**4.3**	**4.7**
Latin America	1.1	0.5	1.6	2.8
Argentina	0.4	0.7	2.5	2.9
Brazil	0.1	-2.2	-0.4	1.5
Mexico	2.1	2.4	3.1	3.8
Middle East and North Africa	1.0	1.6	3.0	2.7
Saudi Arabia	4.3	3.7	3.2	2.7
UAE	3.9	4.0	3.5	3.4
Egypt	2.2	2.6	4.1	4.8
Sub-Saharan Africa	4.8	3.7	4.3	4.6
South Africa	1.5	1.4	1.9	2.3
Nigeria	6.3	3.6	3.6	4.5
Emerging Asia	6.8	6.4	5.9	6.0
China	7.4	6.7	5.9	5.9
India*	7.3	7.3	7.2	6.8
Indonesia	5.1	4.8	5.6	6.2
Malaysia	6.0	4.7	4.5	5.0
Philippines	6.1	6.0	6.0	5.9
Thailand	0.9	3.2	4.1	4.1
Emerging Europe	1.9	-0.2	2.0	3.1
Russia	0.6	-4.0	0.5	2.3
Turkey	2.9	2.2	2.7	3.3
Hungary	3.6	2.9	2.5	2.7
Romania	2.8	3.6	3.6	3.4
Poland	3.6	3.5	4.0	4.7

*f = BMI forecast; *Fiscal years ending March 31 (2014 = 2014/15). Source: BMI* have maintained our 2015 real GDP growth forecasts for South Korea and Taiwan at 2.8% and 1.7%, respectively. However we now see slower growth in 2016 in those countries, at 3.0% in South Korea (from 3.4% previously) and 3.4% in Taiwan (from 4.1% previously).

For Hong Kong, despite a relatively robust performance in Q215, in which the economy expanded by 2.8% y-o-y, we believe that the balance of forces is stacked against the city-state over the coming quarters following China's stock market crash and amid a weak external demand environment. As such, we have downgraded both our 2015 and 2016 real GDP forecasts to 2.5%, versus 2.7% and 3.3% (respectively) previously.

Emerging Markets

Our bearish outlook for EMs has dimmed further in recent weeks and we have revised downward our growth forecasts for a number of key economies. These changes have pulled down our aggregate growth projection for EMs to 4.0% in 2015, which would make this year the weakest point for growth since 2009. Although things will pick up in 2016, many EMs will continue to post sluggish growth over the coming years as they battle a variety of cyclical and structural challenges.

Regarding the key forecast changes, first and foremost, we are now predicting that Brazil will experience a second year of recession in 2016 as fixed investment and household consumption remain extremely subdued (*see 'Downgrade Will Exacerbate Weak Economic Outlook', September 11*). We expect a 0.4 economic contraction in 2016, following a 2.2% recession in 2015.

We have also made downgrades to our growth forecasts for Mexico, South Africa and Turkey, among others. In Mexico, consumer purchasing power will continue to improve, but sluggish consumer confidence will temper some gains and weak oil sector output will be a drag on the expansion of the extractive sector. We now expect real GDP growth of 2.4% in 2015 (revised down from 2.8%) and 3.1% in 2016 (revised from 3.5%).

As regards South Africa, the economy contracted by 1.3% in Q215 owing to weakness in the mining, manufacturing and agricultural sectors, prompting us to revise downward our 2015 forecast to 1.4% from 1.9% previously. Our 2016 forecast remains 1.9%, predicated on continuing power shortages, industrial action and retrenchment in the mining industry.

In Turkey's case, the growth outlook has deteriorated owing to high inflation, political instability and rising security risks, which will compound capital flight and lira depreciation over the coming quarters. We have downgraded our 2015 and 2016 real GDP growth forecasts to 2.2% and 2.7% respectively, which places us significantly below consensus for both years.

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