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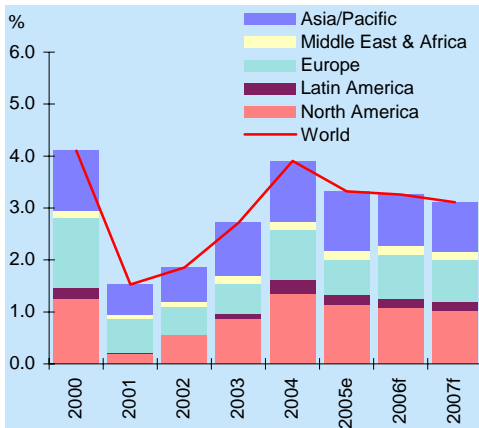
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Global Economic Outlook

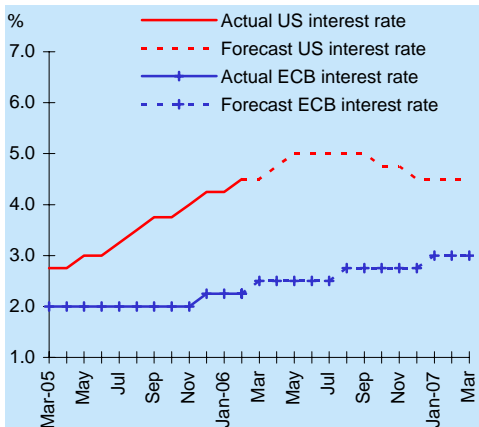
Real GDP growth forecast	2006	Interest rates and oil price	Feb. 2006
World, %	3.3	US interest rate, %	4.50
US, %	3.3	ECB interest rate, %	2.25
Euroland, %	1.9	Japan interest rate, %	0.10
Japan, %	2.2	Oil price (Brent crude), USD p/b	58.2



Sources: International Monetary Fund; D&B

World Growth

We expect world growth of 3.3% in 2006, followed by 3.1% in 2007 on an exchange-rate-based weighting. The main risk that faces the global economy resides in the imbalance between a savings overhang in much of Asia and the US' growing external indebtedness after the debt-financed consumer boom. Should these imbalances unwind in a disorderly way, for example in the form of a sharp drop in the US dollar, this could drag down world economic growth. The growth differential between the US and Western Europe will narrow slightly in 2006 and 2007 as we expect an acceleration of growth in the euro-zone, despite weaker performance in late 2005.

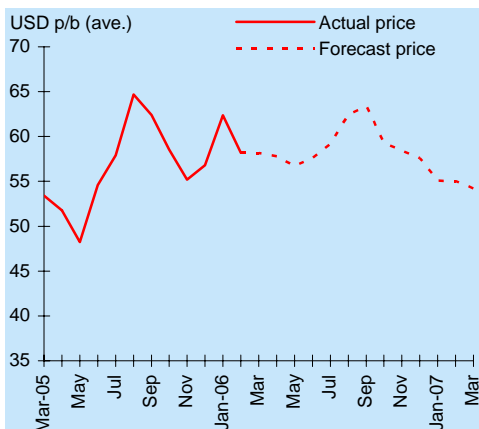


Sources: US Federal Reserve; European Central Bank; D&B

US and Euroland Interest Rates

US: D&B expects the Federal Reserve to raise rates by a further 25 basis points to 4.75% at its next meeting on 27/28 March. Beyond this, the outlook for rates will depend on the inflation level and strength of economic data. Lingering upside risks in both these areas and the new Federal Reserve chairman's possible desire to establish a strong reputation for price stability all increase the likelihood of a further rate hike on 10 May.

Euroland: A 25 basis point hike is likely at the ECB's March meeting despite the recent slowdown in Euroland that fresh data have revealed. We expect one further tightening step in 2006, in the second half of the year, as underlying inflationary pressures remain largely contained.



Source: D&B

Oil Price (Brent Crude)

D&B has raised its forecasts for the average oil price in 2006 to USD59.2 per barrel (p/b) and to 53.4p/b for 2007. In January, prices climbed due to fears that potential sanctions against Iran and escalating violence aimed at Nigerian oil production could affect supply. Prices eased in February as US crude inventories rose and supply fears subsided. However, US refinery maintenance in March and an upswing in demand as the US driving season nears mean that prices are unlikely to reach the lows expected in early 2006. With Iran and Nigeria exporting a combined 5 million barrels per day (bpd) and total excess capacity around 1.5 million bpd, our forecast could rise if supply is disrupted.

Country Risk Indicator

DB5b

For Country Risk Indicator definition see page 58

Regional Risk
Indicators

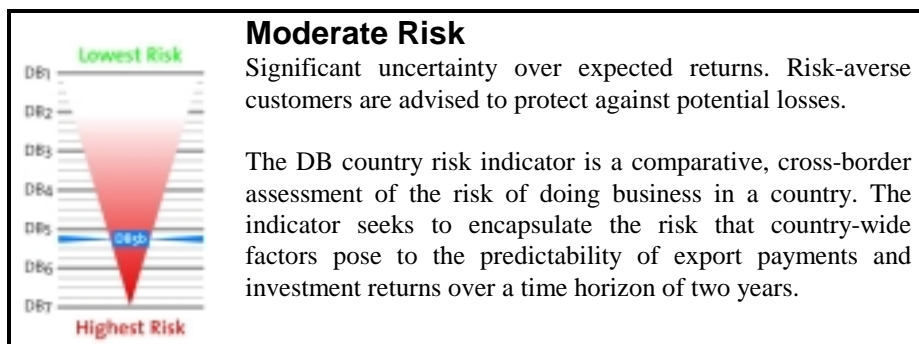
UAE	DB1d
Kuwait	DB2a
Qatar	DB2a
Tunisia	DB2c
Morocco	DB2d
Bahrain	DB3a
Israel	DB3a
Oman	DB3a
Saudi Arabia	DB3a
Jordan	DB3c
Egypt	DB3b
Lebanon	DB4c
Algeria	DB5a
Iran	DB5b
Libya	DB5b
Syria	DB5d
Yemen	DB6a
Iraq	DB7

Iran's Risk
Indicator History

End-2003	DB5a
End-2004	DB5b
End-2005	DB5b

Comparative Risk
Indicators

Argentina	DB5b
Kazakhstan	DB5b
Zambia	DB5b



Overall Outlook

- The outlook for Iran's country risk profile is heavily dependent on world oil prices on the one hand and the issue of whether the country should have its own nuclear capability on the other.
- The nuclear issue hangs in the balance. With the issue now in front of the United Nations' Security Council, sanctions against Iran are a possibility (although any military action against Iran by the West is unlikely in the foreseeable future).
- Should sanctions be imposed there is a danger that domestic support for the conservative President Mahmoud Ahmadinejad could be bolstered, thereby fuelling his brand of revolutionary fervour.

Positive Risk Factors

- + High oil prices delivered buoyant real GDP growth of an estimated 6.0% in 2005. With prices expected to remain strong over the forecast period, D&B is expecting growth of 5.3% and 5.0% in 2006 and 2007 respectively.
- + Oil revenues have improved Iran's external outlook, with foreign reserves increasing and the current account recording impressive surpluses. Against this background, the overall balance of payments is expected to remain firmly in surplus going forward while debt default will continue to be a minimal risk.

Negative Risk Factors

- As both the president and parliament are ideologically conservative, the prospects for much-needed economic and political reform in the foreseeable future are inauspicious.
- Given this, there is significant potential for Iran's relations with the outside world (especially the West) to deteriorate over the short term. Any such weakening will be driven by the nuclear issue and could leave Iran with few supporters in the international community.
- Concerns about the political environment are bound to affect foreign investments in Iran, at a time when the all-important hydrocarbons sector is in urgent need of upgrading.
- The economy continues to be over-dependent on the oil sector. As a result, economic diversification should be a priority for the authorities.
- Serious imbalances exist in the Iranian economy. Most notably, inflation remains in double figures, government spending is excessively high and unofficial estimates suggest that unemployment could be as high as 25% of the workforce.
- Foreign companies operating in Iran face a cumbersome bureaucracy, an antiquated banking system, high levels of corruption and arbitrary changes in regulations. Protection of foreign investments remains inadequate.

Key Information

Economic and Development Information

	2003	2004	2005e	2006f	2007f
GDP (nominal)					
IRR trillion	1,109.5	1,405.0	1,739.8	2,141.8	2,639.6
USD billion	135.4	163.1	194.1	231.5	277.9
Breakdown of GDP					
Agriculture (%)	11.7	11.5	12.7	13.1	13.5
Industry (%)	39.5	41.3	41.3	42.9	44.5
Services (%)	48.8	47.2	46.0	44.0	42.0
Economic indicators					
Real GDP growth (% change)	8.0	4.8	6.0	5.3	5.0
Inflation, annual average (%)	15.6	15.2	13.0	14.0	15.0
Government balance (% GDP)	-2.8	-2.9	-4.3	-4.7	-5.0
Oil price (USD p/b)	28.8	38.3	54.3	56.7	52.7
Current account balance (% GDP)	0.6	2.4	6.2	7.0	5.5

Long-term real GDP growth potential, annual average, 2006-15: 3.0-5.0%

Development indicators	Egypt	Iran	Iraq	Kuwait	S. Arabia
Population, 2005 (m)	69.9	67.5	25.9	2.5	23.9
Population, 2015 (m)	80.9	77.5	31.1	3.0	30.8
Population, 2050 (m)	109.5	102.3	44.7	3.7	53.7
Urbanisation, %	43	66	68	96	88
GNI per capita (USD)	1,390	2,010	n.a.	17,960	9,240
GNI per capita (USD PPP)	3,940	7,000	n.a.	19,480	13,230
Life expectancy (years)	70.2	70.9	64.3	77.8	74.3
Dependency ratio, 2005	0.58	0.46	0.70	0.35	0.74
Dependency ratio, 2015	0.50	0.42	0.54	0.34	0.63
Dependency ratio, 2050	0.53	0.59	0.48	0.64	0.51

Political Information

Head of state	Supreme Leader Ayatollah Ali Khamenei
Head of government	President Mahmoud Ahmadinejad
Political system	Islamic Theocratic Republic
<i>Present constitution adopted</i>	1979, amended 1989
Ruling group	Conservatives
Last elections	Parliamentary: 2004; Presidential: 2005
Next elections	Parliamentary: 2008; Presidential: 2009

Miscellaneous Information

Religion(s)	99% Muslim (majority Shi'ite Muslim)
Capital (population)	Tehran (8.8m)
Timezone	GMT +3.5 hours

Note: ¹Economic data are for fiscal years (21 March-20 March).

Sources: Central Bank of Iran; World Bank, *World Development Report*; United Nations Development Programme, *Human Development Report*; D&B

Executive Summary

Political Risk

The political environment, both internationally and domestically, will come under increasing pressure in the outlook period. Domestically, the conservative parliament (elected in 2004) and President Mahmoud Ahmadinejad (elected in 2005) will continue to block reform. With the reform programme blocked, the risks, particularly economic ones, are likely to increase substantially. A lack of improvement in living standards and job opportunities remains the key area of short-term risk. Although the economy has enjoyed healthy rates of growth over recent years, this has been mostly driven by high oil prices rather than economic policy. Economic reform in areas such as privatisation and the encouragement of foreign investment has been much slower than was once hoped for.

Iran's external relations will depend on how the controversy over its nuclear plans evolves. Despite earlier disagreements among the major powers over how to handle the issue, they agreed in early March 2006 that the matter should go before the United Nations (UN) Security Council after the International Atomic Energy Agency (IAEA) indicated that it could not conclude that there are no undeclared nuclear materials or activities in Iran. For its part, the Security Council is likely to issue an ultimatum that Iran should suspend all enrichment and reprocessing activities. Failure to comply will probably lead to the imposition of low-level sanctions involving restrictions on travel and financial dealings. At this stage, any military action against Iran by the West is unlikely in the foreseeable future.

Macroeconomic Risk

Real GDP growth is forecast to remain robust over the two-year outlook period albeit weaker than in fiscal 2005/06 (21 March-20 March). We forecast real GDP growth of 5.3% in fiscal 2006/07. The main driver of this expansion will be higher government spending, which will boost private consumption and gross fixed capital formation. The budget for 2006/07 will be expansionary, with overall expenditure forecast to increase by 27%. Net exports will also make a positive contribution to real GDP growth, driven by high world oil prices. However, this positive contribution will be curtailed in 2007/08 by a weakening in oil prices, coupled with possible sanctions imposed by the West over the nuclear issue.

Pressure to increase public expenditure will grow as long as world oil prices are high. However, greater spending will mean that the fiscal balance will weaken over the forecast period, resulting in deficits of 4.7% of GDP in 2006/07 and 5.0% in 2007/08. Although high government spending will support economic growth, it will have a harmful effect on inflation, which we are forecasting at a high 14% annual average in 2006/07 and 15% annual average in 2007/08.

The long-term outlook for Iran's economy is uncertain. In the most positive scenario, Iran could achieve an annual real GDP growth rate of around 6% in the medium to long term. However, this outlook depends on the successful implementation of radical economic reforms that open up the economy to foreign investment and create opportunities for domestic investors. The chances of this happening in the medium term are highly unlikely given the conservative parliament and president. As such, if the Iranian economy remains constrained by political factors, its growth potential will be much lower and will remain highly dependent on the oil price. During periods of high oil prices, the economy may be able to achieve real GDP growth of 6-8% per annum. However, in times of low oil prices coupled with the threat of worsening relations with the West, average annual growth is more likely to be in the 3-5% range.

External Economic Risk

The current account surplus is expected to strengthen to 7.0% of GDP in fiscal 2006/07 owing to higher oil prices. However, the threat of sanctions coupled with a forecast weakening in oil prices in 2007 will mean that the surplus on the current account will narrow to 5.5% of GDP in 2007. Reflecting the strength of the current account, import cover is expected to increase to 13 months in 2006. However, in line with lower oil prices, import cover will fall back in 2007, albeit to a still high 11 months. Despite the majority of Iran's external debt stock having a short-term maturity, sizeable foreign exchange reserves will help to avoid a default over the forecast period. Finally, we expect the rial to enjoy greater stability in 2006 and 2007 due to the strong current account and Iran's aforementioned large stock of foreign exchange reserves. However, there could be bouts of weakness if the West decides to impose sanctions over the nuclear issue.

Meanwhile, Iran operates a tightly regulated trade regime. The result is a web of regulations and licences administered by a large and inefficient bureaucracy. Interpretation of regulations can change with little or no notice. The raft of regulations surrounding foreign currency transactions further complicates the situation. The restrictive trade regime was designed to discourage imports, protect Iranian industries and maximise exports. More recently, however, the government has relaxed its stance. Import licences are granted (by respective ministries) according to whether a good is produced domestically and in sufficient quantity. Licences are also dependent on foreign exchange allocations by the central bank; if the foreign exchange is not available, licences may be refused or delayed. Since the end of 1999, licensing requirements have been dropped for around a third of goods (mostly under the remit of the Ministry of Industry). The government has also continued to streamline licensing procedures and the bulk of import items now only require licensing from the Ministry of Commerce.

Meanwhile, Iran continues to pursue its goal of joining the World Trade Organisation (WTO). A first application was filed in September 1996, but was vetoed by the US. Thus despite making it on to the agenda of the WTO's General Council in May 2001, Iran's membership application proceeded no further for a number of years. However, from early 2005 the US began to take a softer stance, which, in turn, led Washington to abandon its veto of Iran's application in May 2005. However, with the nuclear issue now firmly back to the fore, it is unlikely that significant progress on securing membership will be made by Tehran over the forecast period unless the nuclear controversy is resolved amicably.

Commercial Risk

High world oil prices and reduced debt levels have resulted in a more favourable payments environment. At the same time, however, conditions set by credit agencies have tightened over concern surrounding the nuclear issue and the associated deterioration in Iran's relations with the West. Unless the nuclear issue is resolved peacefully, the outlook for the commercial risk environment will remain dim. At the same time, although Iran hopes to attract greater foreign investment, reforms aimed at liberalising the commercial environment are likely to stall in the outlook period. This, together with a lack of reliable credit information, an antiquated banking system, high levels of bureaucracy and widespread corruption, makes Iran one of the most challenging commercial environments in the region.

The government estimates that Iran needs to attract USD10 billion of investment annually over the medium term in order to modernise infrastructure. Strong investment will be particularly important in the hydrocarbons sector and will be crucial if the government is to meet its target of doubling oil production to eight million barrels a day by 2020. However, the government has yet to create an attractive environment for domestic or foreign investors.

Political Risk

Key Point: The election of hardline Mahmoud Ahmadinejad as president in June 2005, coupled with Iran's conservative parliament, suggests that the prospects for reform are weak. Moreover, the nuclear issue will mean that relations with the West are likely to deteriorate significantly going forward.

Recent Developments

In the early 1950s, with strong Western backing, Shah Mohammed Reza embarked on a programme to modernise Iran. The country's oil wealth was spent on huge infrastructure projects and the importation of Western consumer goods. Large sums of money were also spent on military hardware and on creating the structure of a police state that became more repressive as opposition to the shah's policies grew. One of the shah's chief critics, Ayatollah Ruhollah Khomeini, was exiled in 1964. Throughout the 1970s, growing opposition to the shah and his US backers led to a series of strikes, demonstrations and attacks on US targets. A number of opposition groups, including communists, liberals and Islamists, united in a common aim of removing the shah. They succeeded in January 1979 when the shah was forced to flee the country. In February of that year, Khomeini made a triumphant return to Iran to lead the revolution and establish his vision of a theocratic state.

Khomeini articulated a new system of government in which clerics ensured that the country was governed in strict accordance with Islamic principles. He was keen to export his vision beyond Iran, in particular to the Shi'ite Islamic world. The only real success in this regard was in Lebanon, where Iran established the Hezbollah organisation, which won a dominant role in the Lebanese Shi'ite community.

The new regime faced an almost immediate threat when Iraq launched a pre-emptive strike to seize control of the Shatt al-Arab waterway, which forms the southern border between the two states and is Iraq's only outlet to the sea, and therefore an important oil export route. The war with Iraq lasted until 1988, causing a huge number of casualties, severely damaging Iran's oil industry and disrupting tanker traffic in the Persian Gulf. Meanwhile, Iran's strong anti-US stance took on tangible form with the 1979 seizure of the US embassy in Tehran by pro-Khomeini students.

The spiritual and political leaderships that Khomeini held were split after his death in June 1989. The spiritual leadership was given to an elderly Shi'ite cleric, while two new political posts were created: supreme leader and president. The relatively inexperienced Sayed Ali Khamenei was elevated to the rank of ayatollah and made supreme leader, while the then speaker of the *Majlis* (parliament), Hojatolislam Ali Akbar Hashemi Rafsanjani, was elected president. Rafsanjani was perceived as a moderate and more willing to encourage foreign investment and re-orient Iranian foreign policy towards a less isolationist stance. He also facilitated the process that led to the release of Western hostages held in Lebanon. However, Rafsanjani's room for manoeuvre and ability to undertake radical reform was limited by the powerful influence of hardline supporters of Khomeini, who were (and remain) determined to preserve their interpretation of his legacy. The election of Mahmoud Ahmadinejad to the presidency in June 2005 suggests that this legacy is alive in Iran.

Political Environment

The reduction of external threats in the 1990s allowed internal debate to grow on the future direction of the state. This debate is often expressed as a struggle between conservative and reformist elements, but such a bi-polar division simplifies a much

broader range of opinions. The labels 'conservative' and 'reformist' describe two broad coalitions of factions that have come together for electoral purposes:

1. The conservatives advocate a strict adherence to the Islamic system created by Khomeini and support clerical rule. Many are sceptical about foreign participation in the economy and improved relations with the West.
2. Although the majority of reformists are committed to the Islamic system, they want to modernise it and see increased foreign investment as the solution to Iran's economic problems. The reformists also want to strengthen respect for the rule of law. However, the group is not homogenous and in the run-up to the 2004 parliamentary election, a number of banned reformist deputies challenged Khamenei and implied that he played a partisan role in the disqualification of more than 2,000 candidates.

Political Impasse

The struggle between conservatives and reformists reached a new intensity with the parliamentary elections that took place in 2000 when the reformists gained a majority. They hoped to accelerate political and economic liberalisation, key aspirations of Iran's young voters. Meanwhile, as well as loosening restrictions on press freedom and personal liberty, they hoped to strengthen relations with the West. However, the conservatives used their control of key institutions such as the Guardian Council and the judiciary to undermine the reformists' efforts. Even so, the reformists were able to pass some changes, such as the unification of the exchange rate, the establishment of private banks and new foreign direct investment (FDI) legislation (although the FDI law was diluted by the clerics). Furthermore, there was a weakening of the strict moral code. Nevertheless, reform was much slower than needed by the economy and hoped for by voters.

An impasse between the conservatives and the reformist parliament resulted in the reformists being diverted from their reform programme and trying to pass legislation to reduce the role of the Guardian Council while also increasing the powers of the president. The first bill aimed to annul the right of the Guardian Council to vet parliamentary candidates and the second bill would have allowed the president to block political trials deemed unconstitutional and could lead to the dismissal of judges. However, the Guardian Council refused to approve parliamentary bills that would have reduced its powers, along with other bills including one that recognised the United Nations' (UN) conventions on torture and women's rights.

Increasing Frustration of the Youth

There is growing frustration among the youth at the lack of economic reform and poor relations with the US. In September 2002 the official Iranian news agency, IRNA, published the results of a poll commissioned by parliament, which indicated that Iranians would like to see stronger links with the US. Of 1,500 Iranians questioned, 74% favoured restoring ties with the US, while 45.8% believed that Washington's policy towards Tehran is 'to some extent correct'. The poll highlighted a strong feeling of frustration over the lack of progress made by the reformists and Khatami in improving relations with the US and forging ahead with reform.

The frustration felt among the younger generation at the lack of reform eroded support for Khatami and the reformists. The student demonstrations held at the end of 2002 and in mid-2003 highlighted the growing amount of frustration among the younger population. Along with criticising the conservative-dominated clerics for blocking reform initiatives, the students also attacked reformists, including Khatami, for failing to accelerate reform.

The 2004 Parliamentary Election

The parliamentary election held in 2004 delivered a decisive victory for the conservatives, further highlighting the growing level of frustration among the youth. The conservatives won 156 seats of the 290 seats in parliament, with the reformists and independents winning 39 and 31 seats respectively. The move to the right was most profound in Tehran where the reformists did not win any of the 30 seats contested. Looking forward, the conservatives' strong showing suggested that a conservative would probably succeed Khatami in the presidential election scheduled for 2005.

Table 1

Result of the February-May 2004 Parliamentary Election

<i>Group</i>	<i>Seats</i>
Conservatives	156
Reformists	39
Independents	31
Religious minorities	5
Others (elected in second round)	59
Total	290

Source: <http://www.electionworld.org>

The conservative victory followed a campaign by the clerics to increase their influence in parliament; the Guardian Council banned over 3,600 deputies standing for election, including 80 of the then 290 deputies standing for re-election. In a move to resolve the issue, the supreme leader called for a review of the thousands of candidates banned. Despite this, over 2,500 reformists were barred from standing in the election and 550 candidates, who had been deemed suitable to stand, withdrew. The biggest pro-reform faction, the Islamic Iran Participation Front, had most of its top leaders disqualified and did not participate in the elections. Prior to the election, the hardline judiciary closed down two leading newspapers for publishing a letter criticising the supreme leader.

The poor turnout in the election reflected disillusionment with the reformists owing to the lack of progress in the reform programme and the success of the clerics' tactic, rather than the boycott called by the leading reformist groups. The low turnout highlighted the relatively small core backing of the conservatives and questioned their legitimacy. It also pointed to the overall and continuing disenchantment of the population with the wider political system especially among the young.

Meanwhile, the newly conservative-dominated parliament has been strongly anti-economic reform. In August 2004 parliament voted against key aspects of the crucial five-year economic development plan (covering 2005-09), which had been approved by the previous reform-dominated *Majlis* but rejected by the Guardian Council. The members of the newly-elected parliament rejected a proposal that would have allowed the privatisation of over 50% of state-owned banks. The hardliners also rejected a provision that would have allowed foreign banks to open branch offices in Tehran. Parliament also voted against giving oil exploration companies the right to exploit their discoveries. Currently, successful exploration companies have to enter a state-run tender to develop their discoveries, with no guarantee of success. This will hinder Iran's plans to modernise production and double crude oil production capacity to 8 million barrels per day (bpd) by 2020.

The 2005 Presidential Election

Although a record 1,010 candidates registered to stand in the June 2005 presidential election, the Guardian Council approved only six candidates to take part in the campaign. The favourite going into the election was former President Akbar Hashemi Rafsanjani. Rafsanjani was broadly unaligned, advocated economic reform,

social freedom and opening Iran up to the outside world. However, somewhat surprisingly, the presidential election went to an unprecedented second round of voting after Rafsanjani was unable to secure an outright majority in the first round. The second round was contested by Rafsanjani and the hardline mayor of Tehran, Mahmoud Ahmadinejad. Despite fears that a victory for Ahmadinejad would result in an erosion of social freedoms and a lurch to the right, Ahmadinejad won a landslide victory, gaining 61.7% of the vote against Rafsanjani’s 35.9% (although a number of Western countries expressed concern over the conduct of the polls).

Having gained the powers of the presidency, coupled with political support from the conservative Abadgaran group in parliament, Ahmadinejad reiterated Iran’s right to continue with its programme of nuclear research (see **The Nuclear Issue**), although the final decision on this issue, which has developed into a global news story, ultimately rests with Ayatollah Ali Khamenei. Meanwhile, Ahmadinejad has called for the return of the revolutionary purism of the 1980s. As part of this, Ahmadinejad has indicated that the main mission of the revolution is to prepare for the 12th Imam (the 12th descendant of Mohammed), who followers of Shia Islam believe will reappear after disappearing more than a thousand years ago, to usher in a new dawn of peace and justice for the world.

Table 2
Result of the June 2005 Presidential Election

<i>Candidate</i>	<i>1st round (% of vote)</i>	<i>2nd round (% of vote)</i>
Mahmoud Ahmadinejad	19.5	61.7
Akbar Hashemi Rafsanjani	21.0	35.9
Mehdi Karroubi	17.3	-
Mohammad Bagher Ghalibaf	13.9	-
Mostafa Moeen	13.8	-
Ali Larijani	5.9	-
Mohsen Mehralizadeh	4.4	-
Other	4.2	2.4
Total	100.0	100.0

Source: <http://www.electionworld.org>

Meanwhile, Ahmadinejad came under pressure in August 2005 for nominating individuals with a low profile and/or a lack of qualifications to become members of the cabinet (although he did receive broad backing from Ayatollah Ali Khamenei). Most controversial has been the post of oil minister, which had been vacant since August 2005. At the end of November 2005 parliament rejected Ahmadinejad’s third nominee for the position (the previous two nominees had been rejected because of their lack of experience). Moreover, in an unprecedented challenge, it appears that a number of Ahmadinejad’s supporters in parliament voted against him. Parliament finally approved Ahmadinejad’s fourth nominee as oil minister in mid-December.

Political System

Iran is a theocratic republic. The political system is a highly complex network of elected and unelected bodies that compete with each other to establish dominance. The most important of the unelected elements are the supreme leader and the Expediency Council, while elected institutions include the president, parliament and the Assembly of Experts.

The constitution vests ultimate political and religious authority in the supreme leader, who is appointed for life by an 83-strong Assembly of Experts, composed of clerics. The supreme leader is commander of the armed forces, appoints the head of the judiciary and is directly responsible for the *Bonyads* (charitable organisations). The supreme leader is responsible for policy and co-ordinating the executive, legislative and judicial functions of state.

Day-to-day political authority is vested in the president, who is elected for a four-year term by universal suffrage. The president appoints all ministers, subject to ratification by the 290-member *Majlis* (parliament), and is responsible for foreign policy and the budget. A president is limited to serving two terms in office. Between elections, the president can only be removed by a vote of no confidence in the *Majlis*, proposed by a third of deputies and passed by a two-thirds majority.

The split of the executive into two equally powerful branches has hampered the government's ability to address important issues and complicates Iran's delicately balanced political system. The supreme leader has significant power over important organs of the state, giving him a credible power base from which to influence the presidency. The current incumbent, Khamenei, has suffered from the perception that his religious credentials are inadequate. Religious qualifications required to hold the office were downgraded to allow him to take the post and his elevation to ayatollah was opposed by many leading Shi'ite clerics. However, he was viewed as a safe choice, who would not threaten clerics' vested interests, as has proven to be the case.

Although nominally subordinate to the supreme leader, the president has an equally strong power base. The president's control of the bureaucracy and many state-owned companies gives him great scope for patronage. However, the president's ability to implement policy is dependent on the agreement of the supreme leader and parliament.

Legislature: The *Majlis* is elected for four-year terms by universal suffrage. Population determines the number of constituencies per province. A single deputy, who must win at least 50% of the vote to gain election, represents each constituency. Seats are reserved for the Assyrian and Armenian Christian, Zoroastrian and Jewish communities to ensure representation. The *Majlis* acts as a counterweight to the power of the executive. It makes full use of its powers to challenge ministers, amend government-proposed bills and to introduce its own bills.

Legislation passed by parliament must be ratified by the Guardian Council, which acts as an upper house. The 12-member Council vets legislation for compliance with Islamic principles and the constitution; six members of the Council are clerics appointed by the supreme leader and six are lay jurists appointed by the *Majlis* (thereby giving the *Majlis* influence over the Council). The Guardian Council can only return legislation to the *Majlis* for amendment and cannot permanently block it. Therefore, the *Majlis* is in a stronger position and if it insists on passing a particular bill, it usually prevails. Disputes between the *Majlis* and the Guardian Council are referred to the Expediency Council, which will seek to find a compromise. This 27-member body is composed of clerics and non-clerics who are appointed by the supreme leader.

Judiciary: The judiciary takes an active role in politics and is subject to heavy political influence. The head of the judiciary is appointed by the supreme leader and in recent years has been used as an instrument to undermine reformist figures. The judiciary is dominated by conservative clerics, who are appointed for their Islamic credentials or political connections rather than their legal abilities.

There is a four-tier system for civil cases (with one tier devoted to family law), while the criminal division is divided into two tiers: one for petty offences and one for more serious cases. There are also separate court systems to deal with offences committed by the clergy and security-related crimes such as terrorism and espionage.

For the most part, the legal process is slow and inefficient. Commercial law is underdeveloped and has not been sufficiently updated to deal with modern business practices. Foreign companies that resort to legal proceedings are unlikely to receive a fair hearing. Therefore, litigation is a last resort and companies usually use more informal methods in order to resolve disputes.

Policy Agenda

The prospects of economic reform have decreased with the election of the new parliament in 2004 and Mahmoud Ahmadinejad as president in 2005. Indeed, the latter's victory marked the culmination of a successful campaign by the conservatives to re-establish their dominance over the political system. For his part, Ahmadinejad has signalled that he intends to pursue an economic policy that has a greater concern for social justice and is designed to distribute the proceeds from the country's oil wealth to a greater proportion of the population. Indeed, oil revenues often fall into the hands of a privileged (and often corrupt) few. In terms of pushing legislation through parliament, Ahmadinejad should find it easier than his reformist predecessor Khatami, whose efforts to get bills adopted were hampered by the conservatives in the final months of his presidency. Nonetheless, Ahmadinejad's policy programme will be limited by the need to get approval from both the Council of Guardians and the supreme leader, who has the final decision in matters of domestic and foreign policy. Needless to say, a key objective for the government is the establishment of a nuclear programme (see **The Nuclear Issue**).

To a certain extent, Ahmadinejad policy objectives will have to pay at least some attention (even if only in small measure) to Iran's fourth five-year development plan, which started in fiscal 2005/06 and runs until 2009-10. Some of the key features of the plan include:

- to secure economic growth, curb inflation and strengthen the fiscal system;
- to enhance the effectiveness of the banking system and introduce a deposit insurance scheme;
- to reduce external debt to USD30 billion or less by 2009-10; and
- to accelerate privatisation by transferring, liquidating and merging public corporations where appropriate.

Socio-Political Risk

Internal Stability

Given Iran's large size and ethnic diversity (there are at least six major ethnic groups), the country is remarkably stable. There are no serious separatist or terrorist factions and there is little prospect of any emerging. The largest minority group is the Azeris. However, there is little prospect of any significant movement to unite Iranian Azerbaijan with its northern independent neighbour. The Azeris are closely integrated into Iranian society and many prominent Iranians, such as Khamenei, are of partial Azeri descent.

Small Iranian Kurdish groups stage occasional attacks against the security forces in northern Iran. However, the level of attacks is far below that experienced in Turkey or northern Iraq. Another violent group is the Iraq-based Mujahideen-e Khalq (MK), although reports suggest that it has disarmed under the supervision of the US military forces.

Civil unrest is unusual. The student demonstrations and ensuing riots in July 1999, sparked by the closure of the pro-Khatami *Salam* newspaper, were the most serious expressions of dissent since the 1979 revolution. However, the rioting damaged Khatami's position and strengthened his opponents. More recently, there have been bomb attacks in the south-western city of Ahwaz located in Khuzestan province. The latest incident took place in January 2006 and left eight people dead. Although Tehran blamed the blasts on the UK, whose forces are active in neighbouring Iraq, it has denied any involvement. Ahwaz was also the scene of civil unrest in November 2005 when ethnic Arabs held protests against the authorities which they accuse of discrimination.

Meanwhile, Iranians have protested against the publication by a Danish newspaper of cartoons depicting the Prophet Mohammed. Petrol bombs were thrown at the Danish embassy in Iran, while, in addition, the government severed all trade links with Denmark and other countries where the cartoons have been published.

At a broader level, if the pace of reform remains slow under Ahmadinejad, the likelihood of social unrest, especially among the young, could increase. On the other hand, Iranians could rally behind Ahmadinejad if the West isolates Iran over the nuclear issue. This, in turn, might lead to more demonstrations focused on foreign interests in Iran.

Crime levels, particularly violent crime, are low in most parts of Iran. The exception is the extreme east and south-east of the country, where the security forces regularly clash with drug smugglers. One of the main routes for the transport of illegal narcotics from Afghanistan and Pakistan to the West crosses Iran. The government devotes considerable resources to combating drug smuggling. However, these activities rarely impact on the security environment in major towns and cities.

Interest Groups

Clergy: Commonly known as *Mullahs* (clerics), the clergy exercises considerable political and economic power in Iran. The clerics' control of key posts and domination of bodies such as the Assembly of Experts and the Guardian Council means that they control the parameters of political debate. The supreme leader must be a cleric.

The political role played by mullahs is not universally supported within the wider clergy. When Khomeini first articulated his vision, it was a controversial proposal. Doubters remain among the grand ayatollahs based at Iran's theological centre of Qom. However, their muted criticism is tolerated out of respect for their knowledge of Islamic teachings. Many clerics also have substantial business interests and clerics control important economic entities such as the Bonyads. Islam sees no contradiction between piety and profit-making as long as profits are partly used to help the poor and disadvantaged. However, the wealth of mullahs and their lavish lifestyles are the subject of much clandestine criticism and satire.

Security Forces: The hostility directed towards Iran by the US and others, and Iran's perception that it is located in a volatile region, engenders a sense of vulnerability. As a result, the security forces play a significant role in Iranian affairs. This is particularly true of the Pasdaran (or the Revolutionary Guards), which has established a structure parallel to the regular armed forces. The Pasdaran possesses its own armoured divisions, navy and airforce, as well as training camps and other support structures. The success of the Pasdaran and the regular army in resisting Iraq during the 1980-88 war means that there is a high level of public support and respect for the armed forces. In addition, universal conscription (for men and women) means that most Iranians have direct experience of military service.

However, the intelligence and police forces are not afforded the same level of support. This is partly a legacy of the shah's era. His SAVAK intelligence service gained a reputation for brutality. Although the current intelligence services do not have the same reputation, they are viewed as repressive agents of the state. Iran also attracts frequent international condemnation for its abuse of human rights.

The Bazaaris: *Bazaaris* are small- and medium-sized traders who operate in the bazaars of cities and large towns. The bazaaris are the traditional source of economic power and wealth in Iran and remain an important source of funds for the government. They have a reputation for conservatism and short-termism. Their focus is almost purely on trade rather than longer-term investments. Some bazaaris, or groups of bazaaris, operate semi-monopolies on the import and export of some

goods. In the past, their ability to control the availability of some goods has led to shortages and attracted government and popular criticism. The bazaaris' economic power means that efforts to curb such practices have largely failed.

The Bonyads: These 'charitable foundations' have emerged as significant economic players since their establishment in the aftermath of the revolution. The assets of the shah, aristocratic families, other supporters of the old regime and foreign companies were seized and organised along sectoral lines under the control of the Bonyads. As a result, these foundations control huge assets and have considerable economic power. The two or three largest Bonyads, such as Bonyad-e Mostazafan and Bonyad-e Panzdah Khordad, if valued in Western terms, would rank among the world's largest conglomerates. The foundations report directly to the supreme leader and are led by political appointees. There is very little government control or regulation of their activities. They gain access to finance at extremely beneficial rates, enjoy monopolies over some activities (such as hotel ownership) and have low operating costs, thereby discouraging competitors. Most foreign companies operating in Iran have to deal with the Bonyads.

Labour Relations

The labour market is tightly controlled and is regulated by the 1990 Labour Code (amended in 2003). There are no independent trade unions (unions were disbanded in the 1980s) and strikes are rare; strikes in the public sector are illegal. Labour legislation does not apply in Iran's export processing zones. The government sets wage levels in most industries and is the largest employer in the country, accounting for about 40% of the workforce. Industrial disputes are rare. The security forces deal harshly with unauthorised strikes or other action. Any strike or industrial action that takes place is usually politically motivated and organised by the government or other agency of the state. Meanwhile, regulations make it hard to dismiss workers, a situation which has discouraged foreign firms operating in Iran from hiring locals.

External Political Risk

The Nuclear Issue

At the end of October 2003, France, Germany, Iran and the UK reached a deal under which Tehran agreed to co-operation and transparency with regard to its nuclear activities. Iran also signed an additional protocol to the Nuclear Non-Proliferation Treaty (NPT) allowing intrusive inspection of its nuclear sites (Iran had signed the original NPT in 1968 and ratified it in 1970). However, in July 2004, Tehran announced that it had resumed building centrifuges used for enriching uranium, thus going against the 2003 agreement. In addition, at the end of September 2004, Iran carried out tests at a uranium-converting facility and indicated that it had begun converting 37 tonnes of raw uranium into feed material, which is used as fuel for nuclear centrifuges. Enriched uranium can be used for civilian reactors but also as the explosive core for atomic bombs. Iran has repeatedly called on the world to recognise its right to enrich uranium for fuelling power stations.

Positively, Tehran indicated in November 2004 that the enrichment of uranium had stopped as part of a deal with the EU aimed at resolving the dispute over its nuclear programme. The EU offered Iran increased co-operation on the trade and energy fronts (including the supply of nuclear fuel) in exchange for the freeze. Following this, the UN's nuclear watchdog, the International Atomic Energy Agency (IAEA), passed a resolution in November 2004 that did not refer Iran to the UN Security Council. The US had been pushing the IAEA to refer Iran to the Council (which could impose sanctions) if it failed to comply with the agency's demands. After weeks of wrangling, Iran backed down from its demand that some centrifuges should not be included in the freeze. The IAEA resolution welcomed the suspension and did not threaten to send Iran to the Security Council if it resumed enrichment.

However, with the election of the hardline Ahmadinejad to the presidency, attention has returned to the nuclear issue. In August 2005 Iran broke UN seals on nuclear facilities at the Isfahan plant. In response, the IAEA approved a resolution expressing its “serious concern” over Iran’s nuclear activities and demanded that it be halted. More recently, in January 2006 Iran removed UN seals at the Natanz uranium enrichment plant. (There were also reports around this time that Iran’s security forces were accelerating efforts to protect the country’s nuclear facilities, possibly in anticipation of a pre-emptive strike.) Following this, France, Germany and the UK (EU3) ended negotiations with Iran and drafted a resolution that the IAEA refer the matter to the Security Council (although Tehran indicated that it would end voluntary co-operation with IAEA if it is referred to the Council).

In early March 2006 the major powers agreed that the matter should go before the Security Council after the IAEA indicated that it could not conclude that there are no undeclared nuclear materials or activities in Iran. The Security Council started to consider the issue on 12 March. It is widely expected to issue an ultimatum that Iran should meet all of the IAEA’s demands including the suspension of all enrichment and reprocessing activities, reconsideration of the construction of a heavy water reactor and agreeing to stricter inspections by the IAEA. If the US gets its way, the time limit for fulfilling this ultimatum could be as short as one month. Failure to comply will probably lead to the imposition of low-level sanctions involving restrictions on travel and financial dealings (although Russia and China may object to even these measures). General trade sanctions appear to be off the agenda for the time being. Nevertheless, for its part, Iran has threatened “harm and pain” against the West, and in particular the US, if any kind of sanctions are imposed, referring to its ability to influence the world oil supply and thus prices. Meanwhile, any military action against Iran by the West is unlikely in the foreseeable future

Relations with the Middle East

Iran views itself as a regional power and stakes a claim to regional leadership. This claim, combined with its past zeal to export its revolution, its alleged efforts to acquire nuclear weapons and its opposition to the regional Israeli-Arab peace process, has meant that most other Middle Eastern states treat Iran with suspicion. Since 1979, Iran has opposed the influence of global superpowers in the region’s affairs. Since the collapse of the Soviet Union, this has meant opposing US supremacy, opposition which has occasionally involved the use of arms, such as the stationing of Pasdaran units in Lebanon to establish and encourage Hezbollah. The US and its allies in the Middle East (such as Saudi Arabia) have long accused Iran of financing and supporting terrorism. While some of these claims have an element of truth to them, the extent of official Iranian support for terrorism has been exaggerated.

Following Khatami’s election in 1997, Iran’s relations with many Middle Eastern states improved markedly. This was partly due to deliberate efforts by Khatami, but also reflected a willingness on the part of Arab states to improve relations with Iran. Saudi Arabia led the way, to the annoyance of some of its neighbours in the Gulf Co-operation Council (GCC). In mid-1999, the United Arab Emirates (UAE) threatened to pull out of the organisation because of a long-running dispute with Iran over the sovereignty of three Gulf islands.

More recently, Arab states have become worried by Ahmadinejad’s nuclear goals and his attitude towards Israel. The most obvious example of the latter came in October 2005 when Ahmadinejad declared that Israel should be “wiped off the map” and warned Arab countries against developing economic relations with Israel following the withdrawal from Gaza. Reflecting its own deteriorating relations with the West over its alleged involvement in the murder of former Lebanese Prime Minister Rafik Hariri in February 2005, Syria has backed Iran over the nuclear issue.

Realising that it is rapidly losing friends in the international community, Iran has recently been making efforts to strengthen ties with Saudi Arabia. Thus in February 2006 Iran's deputy foreign minister visited Saudi, after the envoy of Supreme Leader Ayatollah Ali Khamenei held talks with Saudi's King Abdullah in December 2005 during which the Iranian delegation expressed a desire to open up a direct channel of communication between the two countries.

Relations with Russia and the Commonwealth of Independent States

Iran is anxious to reap the economic benefits of its proximity to the Central Asian and Caucasian republics of the former Soviet Union (FSU). In particular, Iran sees itself as the natural transit route for the region's hydrocarbon resources; however, this view is not shared by the US or Russia. So far, its efforts to exploit its location have yielded little result. It owns a small share in the consortium exploiting Azerbaijani oil and has built a small pipeline to neighbouring Turkmenistan. Moreover, there is little prospect of any major oil or gas export pipelines being routed through Iran. Relations with the FSU are hampered by the question of sovereignty over the Caspian Sea. Only Turkmenistan agrees with Iran that the sea's resources should be regarded as common property or shared equally; Azerbaijan, Kazakhstan and Russia feel that the Caspian should be divided according to its shoreline.

Russia built Iran's first nuclear power plant at Bushehr, to the dismay of the US. Iran and Russia signed a deal at the end of February 2005 to start atomic fuel shipments for a Moscow-built nuclear reactor in Iran. The US has called on Russia to cancel the plans. Spent fuel will be sent back to Siberian storage units, a condition that Russia thinks will remove US concerns. Meanwhile, in December 2005 Iran agreed to purchase 29 mobile air defence systems from Russia for around USD700 million.

Relations with the EU

Relations with the EU improved under Khatami. In 1999, Khatami made the first visit by an Iranian president to an EU state when he visited Italy. In a further sign of improvement, the UK upgraded diplomatic relations to ambassadorial level. These developments were largely driven by two factors: an assessment in Europe that the nature of the Iranian government had changed; and the ending of the Salman Rushdie affair. Official Iranian support for attacks, mainly in Germany and France, on opponents of the Iranian government impeded better EU-Iranian relations for many years. The assessment by European governments that this policy had ended played a major role in allowing political relations to improve. In 1998, the UK government obtained a pledge from the new administration that it would not pursue Rushdie or encourage his pursuit. At the same time, the EU strongly opposed US efforts to enact sanctions against non-US companies investing in Iran (reflecting Brussels' desire to promote trade links with Iran), and was successful in minimising the effects of US sanctions against companies from member states. Despite an apparent breach of US legislation, the US authorities have not pursued EU companies investing or in Iran.

However, relations have deteriorated significantly as a result of the nuclear issue. In early 2006 this culminated in the EU3 ending negotiations with Iran over a possible solution to the controversy, after three years of talks. Two other issues have also soured bilateral ties: in October 2005 Tehran imposed an embargo on British imports after it accused the UK of being responsible for a number of bombings in the south of the country near the border with Iraq; and in February 2006, trade links with Denmark were indefinitely suspended in response to the publication of cartoons by a Danish newspaper depicting the Prophet Mohammad.

Relations with the US

Without diplomatic representation in Tehran, the US's ties with Iran remained in limbo in the latter half of the 1990s. US sanctions (first imposed in 1995 and renewed in 2001) continue to impede foreign and domestic investment. Despite some Iranian candidates in the 2000 election hinting about moving towards normalising relations with the US and some tentative signs of confidence-building measures, such as the partial relaxation of US trade sanctions and visits by sports teams and academics, relations failed to improve markedly in 1995-2000. Following the inclusion of Iran in US President George W. Bush's 'axis of evil' in January 2002, American rhetoric against Iran increased. The US has accused Iran of supporting international terrorism and of seeking to develop weapons of mass destruction. However, from early 2005 the US began to take a softer stance which, in turn, led Washington to abandon its veto of Iran's World Trade Organisation (WTO) membership application in May 2005.

More recently, however, the nuclear issue and the election of Ahmadinejad to the presidency have soured relations with the US. US Secretary of State Condoleezza Rice has indicated that a US military attack on Iran is not on the agenda at this point. Nonetheless, such a course of action does not seem to have been completely ruled out by Washington. For its part, Iran has indicated that it will retaliate and accelerate its efforts to develop nuclear technology if attacked by the US or Israel. With its armed forces already occupied by operations in Iraq and Afghanistan coupled with the risk of antagonising other Islamic nations which a military strike against Iran could engender (not to mention the possible consequences of even higher world oil prices), it seems that the US is prepared to employ more peaceful means in its attempts to pursue regime change in Tehran. Pursuant to this, in February 2006 the Bush administration asked Congress for an extra USD75 million in addition to USD27 million already allocated to help finance Iranian political dissidents and increase US broadcasts to the people of Iran.

Political Risk Outlook

The political environment, both internationally and domestically, will come under increasing pressure in the outlook period. Domestically, the radical parliament (elected in 2004) and Ahmadinejad (elected in 2005) will continue to block reform. With the reform programme blocked, the risks, particularly economic ones, are likely to increase substantially. A lack of improvement in living standards and job opportunities remains the key area of short-term risk. Although the economy has enjoyed healthy rates of growth over recent years, this has been mostly driven by high oil prices rather than economic policy. Economic reform in areas such as privatisation and the encouragement of foreign investment has been much slower than was once hoped for.

Iran's external relations will depend on how the nuclear controversy pans out. Despite earlier disagreements among the major powers over how to handle the issue, they agreed in early March 2006 that the matter should go before the UN Security Council this after the IAEA indicated that it could not conclude that there are no undeclared nuclear materials or activities in Iran. For its part, the Security Council is likely to issue an ultimatum that Iran should suspend all enrichment and reprocessing activities. Failure to comply will probably lead to the imposition of low-level sanctions involving restrictions on travel and financial dealings. At this stage, any military action against Iran by the West is unlikely in the foreseeable future.

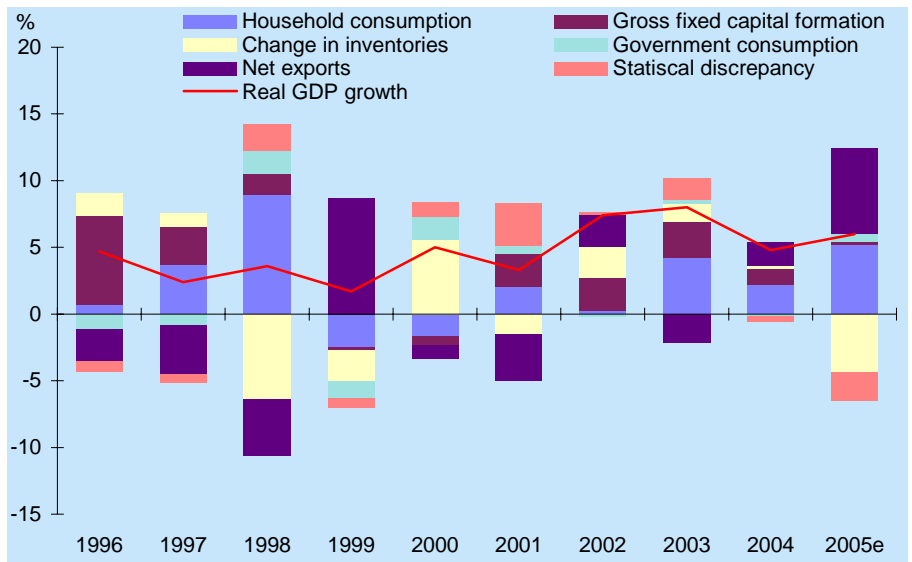
Macroeconomic Risk

Key Point: Although buoyant oil receipts will drive strong real GDP growth over the two-year forecast period, a lax approach to fiscal and monetary policy will mean that inflation remains high. At a broader level, the economy is highly dependent on oil and a number of structural rigidities remain.

Short-Term Economic Performance

Sustained strong oil prices since 1999 have improved Iran’s economic performance. Between 2000 and 2005, real GDP growth was buoyant, external debt fell to below 10% of GDP and international reserves increased. The government pressed ahead with various reforms including exchange rate unification, new foreign investment legislation, changes in tax legislation, the licensing of private banks and changes to the trade regime. However, considerable challenges remain that will continue to undermine the boost to economic growth derived from higher oil prices and the cautious lowering of barriers between Iran and the outside world. Moreover, loose fiscal and monetary policy has kept inflation figures in double digits.

Chart 1
Yearly GDP Growth Contribution by Demand



Sources: International Monetary Fund, *International Financial Statistics*; D&B

Despite the interest shown in Iran by potential investors, including major oil companies, major inward investment plans remain a distant prospect. This is an important factor given that the economy has suffered from years of under-investment. At the same time, the private sector remains underdeveloped. Following its war with Iraq, Iran instigated a highly centralised and planned economy in which the majority of economic resources were allocated by the state, the government controlled prices and financial rates of return, and state-owned enterprises (SOEs) ran large sectors of the economy. Structural rigidities remain in the price system and the labour market, and a lack of competition in many sectors affects productivity and competition.

The weakness of the private sector and low investment will limit economic growth in the short term, leaving the country dependent on oil prices and exports (although the production base is relatively diverse, with agriculture and industry combined accounting for around half of GDP). Moreover, given the conservative parliament

and president, it seems unlikely that a major economic reform programme will be implemented in the foreseeable future.

In fiscal 2004/05 (21 March-20 March), real GDP growth came in at 4.8%, short of the government's target of 6.8%. This weaker-than-expected performance reflected a contraction in construction activity and weaker oil sector growth. Despite the higher oil price, output was limited by capacity constraints, highlighting the need for infrastructure upgrades. However, with the significant uplift in world oil prices, output constraints were not enough to weaken growth in 2005/06 compared with 2004/05. According to central bank figures, real GDP expanded by 6.4% year on year in the first quarter of 2005/06. Given this, D&B estimates that overall growth in 2005/06 will reach 6.0%, strong but below the government's target of 7.1%.

At a broader level, we remain more sceptical about the immediate future of the reform programme in these areas given the conservative parliament and president. Although Ahmadinejad has promised a more equitable distribution of oil wealth and oil prices are expected to increase marginally this year, D&B believes that the authorities' fundamental opposition to economic reform coupled with an acceleration of import demand possibly in anticipation of the imposition of sanctions and a less buoyant world economy will result in a deceleration in real GDP growth in 2006/07 to 5.3%. These same factors coupled with a forecast decline in world oil prices will result in growth of 5.0% in 2007/08.

Components of Growth

Table 3

Contributions to Growth

	2003	2004	2005e
<i>Real growth rate (%):</i>			
Private consumption	9.4	4.8	11.3
Gross fixed capital formation	9.5	4.3	1.0
Government consumption	2.0	-1.4	5.3
Exports	7.3	20.0	37.0
Imports	19.8	12.6	12.0
Real GDP	8.0	4.8	6.0
<i>Share of GDP (%):</i>			
Private consumption	45.6	45.6	47.8
Gross fixed capital formation	28.7	28.6	27.2
Change in Inventories	7.6	7.5	2.9
Government consumption	12.1	11.4	11.3
Net exports	1.5	3.1	9.0
<i>Contribution to real GDP growth (percentage point):</i>			
Private consumption	4.2	2.2	5.1
Gross fixed capital formation	2.7	1.2	0.3
Change in Inventories	1.4	0.3	-4.4
Government consumption	0.3	-0.2	0.6
Net exports	-2.2	1.7	6.4

Sources: International Monetary Fund, *International Financial Statistics*; D&B

Private Consumption

As the state employs at least 40% of the population, the civil service payroll is a key determinant of real income and demand trends. Private consumption has contributed positively to real GDP growth from 2001/02, as the government has increased spending, resulting in strong wage growth. Furthermore, higher levels of private

sector borrowing from the commercial banking sector and favourable weather conditions have supported private consumption. In 2003/04 and 2004/05 private consumption was the main driver behind real GDP growth, contributing 4.2 percentage points and 2.2 percentage points respectively.

Chart 2
Private Consumption



Sources: International Monetary Fund, *International Monetary Statistics*; D&B

Private consumption is expected to make a further strongly positive contribution to real GDP growth in 2005/06, supported by higher government spending, driven by high oil revenues. Looking forward, private consumption is forecast to continue making a positive contribution to growth over the forecast period, driven again by strong public spending helping to raise wages generally (although with some government subsidies due to be relaxed in 2006, the contribution of private consumption may not be as high as it otherwise would have been).

Unemployment

The high level of unemployment remains a key area of risk economically and politically. Due to its very nature, calculation of the true size of the informal sector is problematic, but it may well equate to around 50% or more of total demand. The informal sector also hides the true extent of unemployment and under-employment in the economy. Although official figures put unemployment at around 10-11%, unofficial estimates range up to 25%. In addition, as much as one-third of the workforce may be under-employed, particularly in the bureaucracy and SOEs. Although a statutory minimum wage is in operation, it is broadly considered to be inadequate; Iranians often have to take on two or three jobs in order to earn a living.

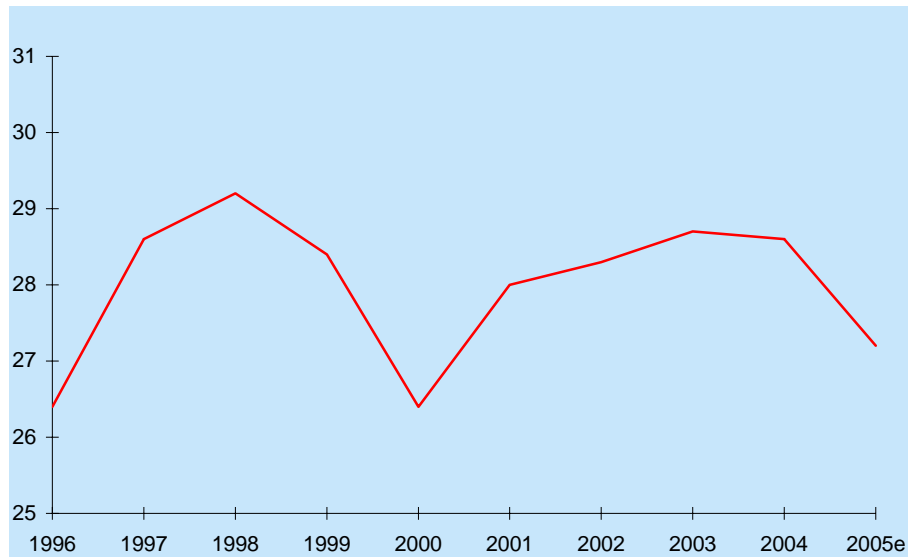
Reducing the rate of unemployment is a key concern of the government; the high level of unemployment limits potential growth in private consumption, subduing the contribution it makes to overall real GDP growth. However, oil-related funding of employment constitutes a risk if there is a fall in oil prices. In addition, higher public spending aimed at reducing joblessness pushes inflation up. At a broader level, the labour market is competitive, with a large number of young people chasing relatively few jobs. Posts with foreign companies are highly prized given that they usually pay better salaries than local firms. However, weaknesses in Iran’s education system mean that there is a shortage of skilled workers, reinforced by the large number of professionals who left the country after the revolution.

Gross Fixed Capital Formation

Most sectors of the economy suffer from years of under-investment. During the 1980-88 war with Iraq, resources were diverted to the war effort and after the conflict were concentrated mainly on rehabilitating the oil sector. As a result, much of Iran's infrastructure and industrial production methods need updating. In addition, Iran's manufacturing capability is generally geared towards low-value goods, which do not meet the requirements of potential export markets. However, the government has emphasised the need to improve the petrochemical industry, with the aim of creating products with higher export earning potential. As a result, petrochemical production has more than doubled in the last five years and Iran has become the second largest petrochemical producer in the region.

Chart 3

Gross Fixed Capital Formation



Sources: International Monetary Fund, *International Monetary Statistics*; D&B

Gross fixed capital formation has made a positive contribution to real GDP growth since 2001/02. As government revenues have increased, the government has been able to spend more on investment. Private sector development has also benefited from the economic boost brought about by higher oil prices. Moreover, with the easing of import restrictions, manufacturers have gained access to foreign inputs that are needed to modernise the productive sectors and manufacture goods.

Higher levels of lending will also have boosted private investment. Although a detailed breakdown of lending data is not available, the Money and Credit Council lending rules dictate that 33% of new credit to the private sector must go towards the industrial sector, with 25% allocated to agriculture and 20% to housing. Public sector policy has also emphasised industrial reconstruction, although this has been less successful than housing, with only around 11% of total domestic investment directed towards industry.

However, we expect investment to make a negative contribution to real GDP growth over the two-year outlook period. This will mostly be as a result of the uncertainty created by Iran's deteriorating relations with the West over the nuclear issue and the associated possibility that sanctions will be imposed. The threat of economic isolation could in addition provide potential foreign investors and governments with a disincentive to invest and may mean that various projects now in the planning stage will be either delayed or cancelled.

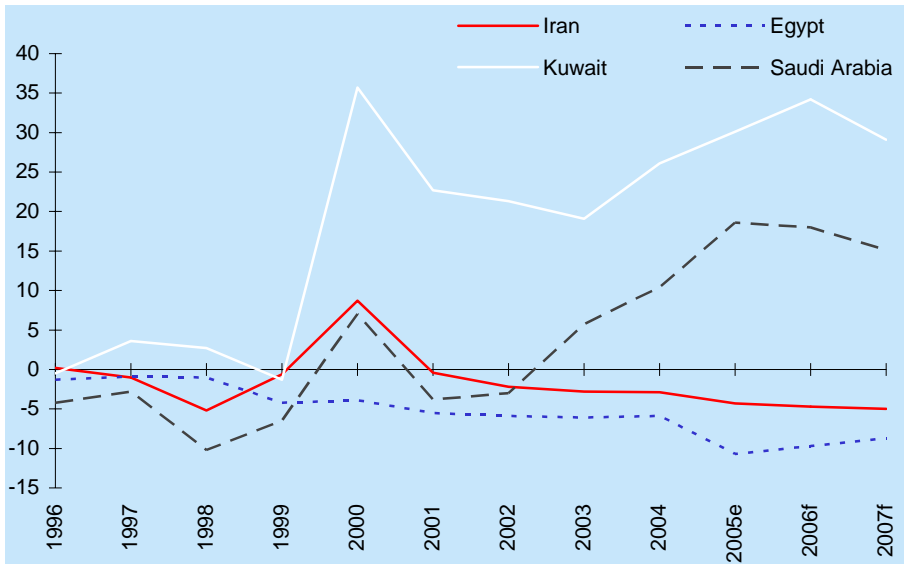
Government Consumption

An expansion in government spending is crucial for Iran’s short-term economic growth prospects given the strong link between public demand and economic growth. However, it is also vital that the government carries out fiscal reform to stabilise the contribution of government consumption to real GDP growth. A number of factors contribute to the uncertainty surrounding government finances:

1. Oil revenues account for over half of budgetary revenue. Higher oil prices have meant that the government has been able to increase expenditure (thereby making a positive contribution to real GDP growth). Any revenue above that designated in the budget is diverted into the Oil Stabilisation Fund (OSF).
2. High levels of current spending. The key demand on the budget is current spending, particularly civil service wages. However, the government also owns most of the other key economic sectors, including the oil industry, manufacturing, transport, telecommunications and utilities. These are either owned directly or through charitable foundations (*Bonyads*).
3. Inefficient tax collection. Revenues from corporate and income taxes account for only around one-fifth of fiscal revenue.

The government has taken a number of steps to reform its financial position. Most importantly, it unified the exchange rates from the beginning of fiscal 2002/03, abolishing the subsidised import exchange rate of IRR1,750:USD (see **Exchange Rate Risk**). The import rate acted as a subsidy and cost the Treasury around USD5 billion per annum. The unification of the exchange rates stopped the practice whereby goods imported at the subsidised rate were sold on at a higher rate, providing a hidden subsidy of cheap hard currency for SOEs. This has been a vital step in moving towards a more efficient, transparent market-based system. In February 2002, the government passed legislation to overhaul the tax system and Bonyads were required to pay tax for the first time (see **Interest Groups**).

Chart 4
Government Balance



Sources: Iranian Ministry of Economy, *Monthly Economic Digest*; Central Bank of Egypt; D&B

Meanwhile, plans to introduce a value-added tax (VAT) were approved by parliament in April 2005, although it is unclear when the tax may be introduced. Steps have also been taken to reduce energy subsidies (although it is doubtful whether President Mahmoud Ahmadinejad will continue with this policy given his desire to spread wealth more evenly among the population). However, Iran must build on the momentum of these moves by reducing government spending on loss-

making SOEs and expanding the revenue base. Elsewhere, poor fiscal management has led the government to withdraw funds from the OSF (established in 2000) in order to fund budget deficits, despite the fact that this money is only supposed to smooth out the effects of volatile world oil prices. Nevertheless, estimates suggest that the OSF still contained a substantial USD40 billion at the end of 2005. Oil revenues were higher than expected in the period April-December 2005 but tariff receipts came in lower than forecast. Current public expenditure was a significant 26% above the level set out in the fiscal 2005/06 budget, while capital spending was 40% short of the target level. Meanwhile, the draft 2006/07 budget unveiled by Ahmadinejad in January 2006 proposed that government spending increase by 27%. Within this there was a measure to raise regional expenditure by 180%, highlighting the central government's desire to lessen Tehran's dominance of the domestic economy. Ahmadinejad also stated that the government wants to increase education spending by 50% and reduce the country's gasoline consumption. Clearly, the government has not lost any of its appetite for high public spending.

With world oil prices so high (the 2006/07 budget unrealistically assumes that prices will be as low as USD39.3 per barrel), it seems as though Ahmadinejad will have the opportunity to pursue his populist agenda. As such, D&B expects the fiscal position to deteriorate over the two-year outlook period as the government increases expenditure: we forecast deficits of 4.7% of GDP in 2006/07 and 5.0% of GDP in 2007/08.

Privatisation

The privatisation process has been slow, with privatisation revenues being lower than planned in the last few budgets: in the fiscal year 2004/05 the government planned to sell assets worth USD2.5 billion but only managed to secure around 30% of this. The government or quasi-state-owned companies are reluctant to sell their profitable companies. The Iranian Privatisation Office (IPO), the government body responsible for the privatisation process, has few real powers. In addition, disputes have arisen between the IPO and other government organisations, especially the Industrial Development and Renovation Organisation, which controls most industries and has its own privatisation campaign.

However, despite the conservative parliament and president, some recent progress appears to have been made on kick-starting the privatisation process. In 2004 the Expediency Council ruled that up to 65% of concerns in downstream oil and gas, mines, banking, insurance, telecommunications, airlines and shipping could be privatised. In May 2005 Supreme Leader Ayatollah Ali Khamenei approved this decision, ordering the government to put out to tender eligible companies by 2010. At the same time, however, Khamenei ruled that companies operating in upstream oil and gas, airwaves and radio and television must remain in state hands. In addition, only a maximum of 20% of the equity of these enterprises could be sold off in any one year.

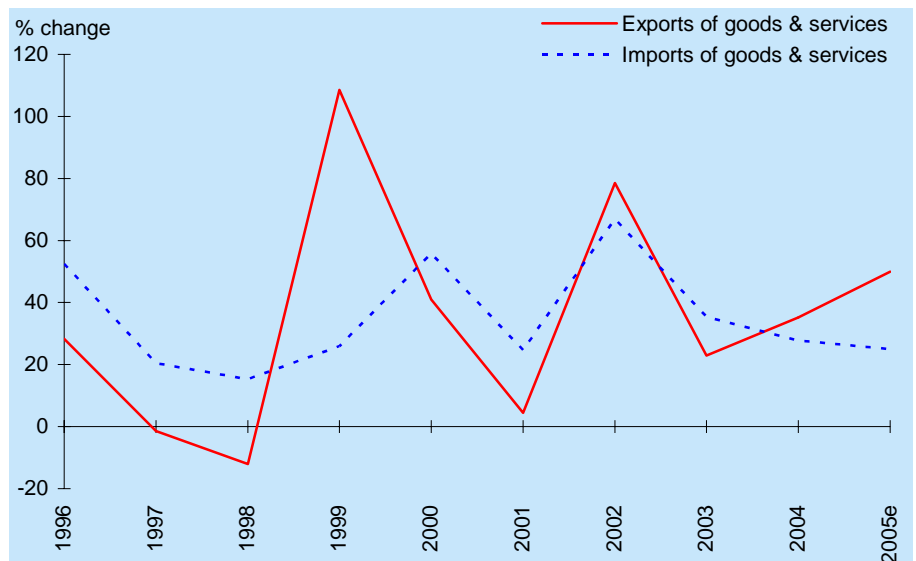
Moreover, the government announced in November 2005 that it planned to issue share options to low-income families. This was approved in February 2006 by the IPO, with the value of shares to be distributed worth around USD375 million. Each eligible family will receive options worth USD550 which can be paid off over a 20-year period. Although this is a positive step, it is unlikely to make much difference when it comes to reducing the overwhelming strength of the public sector. Indeed, we expect the government to continue to being the most important economic player in Iran for the foreseeable future.

Net Exports

The impact of net exports on real GDP growth tends to fluctuate depending on world oil prices and export levels (determined in part by Organisation of Petroleum Exporting Countries, OPEC, quota levels). The oil price has strengthened since

2004, resulting in net exports making a positive contribution to economic growth in 2004 and 2005. In addition, Iran has been producing oil at around its maximum capacity in recent years.

Chart 5

Nominal Export and Import Growth

Sources: International Monetary Fund, International Monetary Statistics; D&B

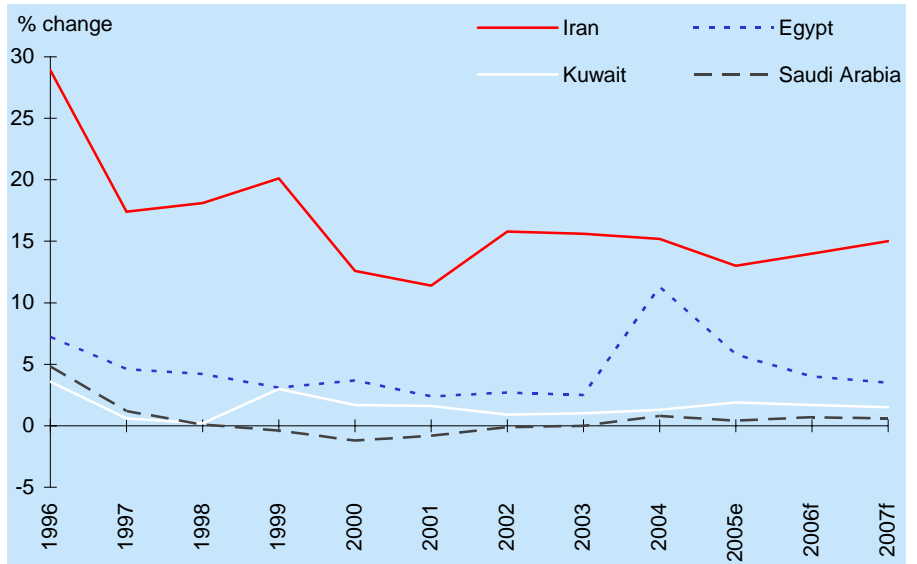
Going forward, we expect oil prices to increase to USD59.2 per barrel in 2006 (see **Global Economic Outlook**). This, in turn, will underpin a further positive contribution of 3 percentage points to overall real GDP growth of 5.3%. However, in 2007 a weakening in world oil prices, coupled with possible sanctions imposed on Iran by the West over the nuclear issue, will see this positive contribution decline to just 0.3 percentage points out of total growth of 5.0%.

Monetary Environment

Although strong upward price pressures continue to affect the economy, the government has had some success in curbing inflation. According to International Monetary Fund (IMF) figures, annual average inflation fell to 11.4% in 2001/02, from 20.1% in 1999/2000 and nearly 50% in 1995. This drop reflected a number of factors, including higher agricultural output (which reduced inflation associated with food prices), removal of import barriers (which reduced supply constraints) and exchange rate stability.

However, inflationary pressure has increased with strong money growth, fuelled in turn by higher government spending. The inflation rate rose in 2002/03 to 15.8% as a result of exchange rate unification: the abolition of the subsidised imported exchange rate pushed up the costs of imports. The continued increase in government spending in 2003/04, along with high levels of credit extended to the private sector, resulted in an inflation level of 15.6% annual average in 2003/04 and 15.2% annual average in 2004/05. More recently, in December 2005 annual average inflation stood at 13.4%. Although this was below the government's target of 14.6% for fiscal 2005/06, it was still excessively high and again reflects excessive government spending fuelled by buoyant oil revenues. Against this background, we are forecasting annual average inflation of 13% in fiscal 2005/06, with a slight uplift to 14% in 2006/07 and 15% in 2007/08 as oil prices stay high (in turn driving government spending and high money supply growth) and subsidies are relaxed.

Chart 6
Annual Inflation

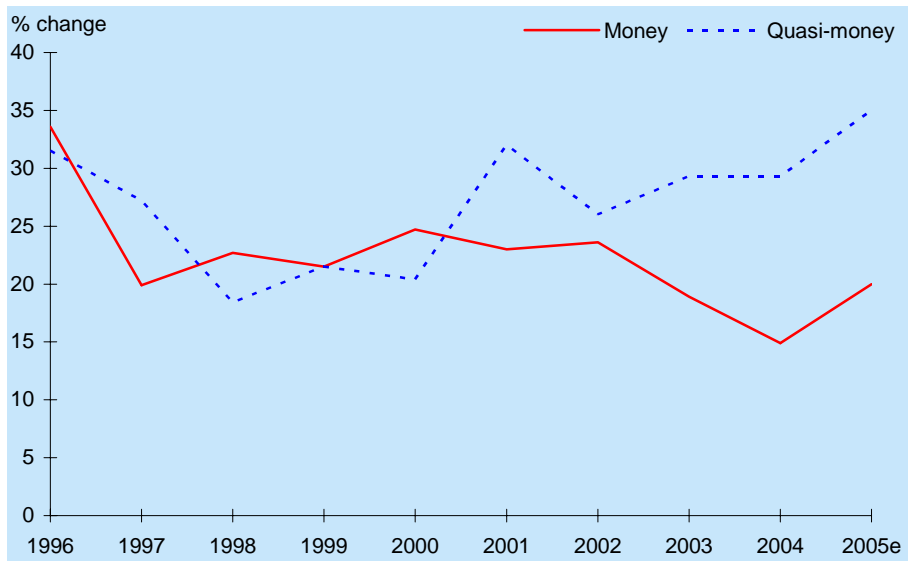


Sources: International Monetary Fund, *International Financial Statistics*; D&B

Money Supply

The money supply has continued to grow owing to an expansion of credit to SOEs and higher government spending. In addition, monetary tools available to the central bank remain limited, especially its ability to independently adjust the interest rate. Monetary policy is also not consistent. At end-2004, the central bank indicated that it would issue more Central Bank Participation Papers of up to IRR5,000 billion and increase the share of credit facilities not subject to sectoral distribution. However, this is inconsistent with the central bank’s decision in early 2004/05 to reduce the rates of return on loans extended to manufacturing companies. Realistic monetary targeting will be essential to anchoring inflation expectations and achieving medium-term disinflation.

Chart 7
Money Supply



Sources: International Monetary Fund, *International Financial Statistics*; D&B

Money supply remains vulnerable to the effects of oil prices on the government budget. For example, a sharp fall in oil prices in 1998 and early 1999 reduced

government revenues. The central bank financed the subsequent budget deficit, prompting money supply growth to accelerate. Stronger oil prices also present a challenge to monetary stability given the usual accompanying increase in government spending. More recently, in January 2006 the governor of the central bank indicated that rapid money supply growth continued to be a problem, driven by buoyant oil revenues and lax fiscal discipline.

Interest Rates

The Islamisation of the financial system in 1984 banned the charging of interest on loans or deposits; Islam considers this to be usury. However, dividends derived from profits made on invested loans or deposits can be paid. The value of these dividends compared with the original capital provides a rate of return, which can be equated to interest rates in the non-Islamic financial system.

Until 1994, the government set rates of return and banned all private financial institutions. As a result, a thriving parallel market flourished, controlled mainly by the *bazaaris* (see **Interest Groups**). In 1994, private financial institutions were legalised for a limited range of transactions and were allowed to set their own rates of return. These reforms were part of a government attempt, which was only partially successful, to eliminate the unofficial market and gain greater control over financial dealings.

In May 2005 the Currency and Credit Council set the lending rate that can be charged by state banks (private banks are unaffected) of 16% against a previous maximum of 25%. Rates on deposits are set by the central bank according to the maturity of deposits, rising to 17% for deposits of five-years maturity. However, the formal financial system has become an irrelevance to many Iranians as high levels of inflation mean that real interest rates are negative or very low.

Short-Term Economic Outlook

Real GDP growth is forecast to remain robust over the two-year outlook period albeit weaker than in fiscal 2005/06. We forecast real GDP growth of 5.3% in fiscal 2006/07. The main driver of this expansion will be higher government spending, which will boost private consumption and gross fixed capital formation. The budget for fiscal 2006/07 will be expansionary, with overall expenditure forecast to increase by 27%. Net exports will also make a positive contribution to real GDP growth, driven by high world oil prices. However, this positive contribution will be curtailed in 2007/08 by a weakening in oil prices coupled with possible sanctions imposed by the West over the nuclear issue.

Pressure to increase public expenditure will grow as long as world oil prices are high. However, greater spending will mean that the fiscal balance will deteriorate over the forecast period, resulting in deficits of 4.7% of GDP in fiscal 2006/07 and 5.0% of GDP in fiscal 2007/08. Although high government spending will support economic growth, it will have a harmful effect on inflation, which we are forecasting at a high annual average of 14% annual average in 2006/07 and 15% in 2007/08.

Forecast	2006f	2007f
<i>Real growth rate (%):</i>		
Private consumption	12.9	6.5
Gross fixed capital formation	-2.5	-4.6
Government consumption	12.9	6.5
Exports	24.0	15.0
Imports	18.0	19.0
Real GDP	5.3	5.0
<i>Contribution to real GDP growth (percentage point):</i>		
Private consumption	6.2	3.3
Gross fixed capital formation	-0.7	-1.2
Change in inventories	-1.9	1.5
Government consumption	1.5	0.8
Net exports	3.0	0.3
Inflation, annual average (%)	14.0	15.0
Source: D&B		

Long-Term Economic Potential

An overwhelming reliance on the production and export of crude oil is the key structural weakness in the Iranian economy. Indeed, oil output is still below its pre-revolutionary levels. Meanwhile, chronic under-investment since 1979 and import compression have left the non-oil industries in need of large-scale modernisation in terms of both plant and know-how. In addition, investment is required in new industries that produce advanced technology and high value-added goods.

Granted, greater public and private sector investment in particular sectors has been fruitful, notably in the steel and petrochemicals industries. However, a sustainable solution to structural weaknesses in the economy will only come about through the creation of a more investor-friendly environment. The attraction of greater private (including foreign) investment would also help to diversify not only output but also the ownership of economic assets. The state remains the dominant economic force in Iran, owning all key economic drivers, such as the oil industry, agriculture, banks and transportation. The implementation of the reforms needed to bring about radical restructuring remains highly contentious.

The other major challenge facing the government is the need to strengthen the rule of law. The lack of respect for laws and the arbitrary and unpredictable way in which legislation is applied act as a major disincentive to foreign companies. The complexity of regulations and the discretion over interpretation afforded to officials creates an uncertain business environment. In addition, state agencies with powerful political support feel able to ignore laws and regulations.

Gas: Iran has the world's second largest gas reserves (a significant proportion of which are located in the South Pars field) and the government has expanded the role of the gas sector in its development objectives. Although most gas production is currently used for domestic use (freeing oil for export), Iran also exports gas (Iran's gas production has risen five-fold since the revolution). For example, a pipeline completed in 2001 carries Iranian gas to Turkey. Other possible export projects are based on pipelines linking Iran and Armenia, Iran and Turkmenistan (the Trans-Caspian pipeline), and Iran and India via Pakistan. Government plans to manufacture liquefied natural gas (LNG) will also boost exports, as Iran would then be able to tap the markets of China, India and East Asia. However, a proposed deal between Petropars of Iran and the Indian Oil Corporation to plough USD3-4 billion into the

construction of a natural gas liquefaction plant in Iran is still awaiting approval from Tehran.

Meanwhile, Iran and India are hoping to sign a USD7 billion deal this year which will see Iran export natural gas to India through a new pipeline running via Pakistan. It is hoped that construction of the line will begin in 2007 and will be completed in 2011 despite strong opposition from the US. Intriguingly, in January 2006 the Indian government denied reports that it was considering pulling out of the project. Against this backdrop, the government hopes that gas exports will earn between USD3-6 billion per annum by the end of the decade.

Petrochemicals: The government has emphasised expansion of the petrochemical sector as a means by which to increase value-added and achieve higher export earnings. Iran's petrochemical output has more than doubled over the last five years such that it is now the second-largest petrochemical producer in the region. The National Petrochemicals Company (NPC) plans to increase production to 50 million tonnes per annum by 2015, from a present level of around 13 million tonnes. As part of this plan, the government has processed the necessary legislation to establish a Special Petrochemical Economic Zone at Bandar Imam to attract foreign investment. Increasing interest in Iran's petrochemical sector on the part of European and Japanese investors has resulted in the NPC raising around USD3 billion in loans so far, with the company counting on raising an additional USD1 billion annually for the next decade. If these plans are successful, petrochemical exports could contribute around USD2 billion a year to Iran's export earnings, some of which, it is hoped, will be generated by sales to Europe.

The government is also trying to upgrade its oil sector, which is in great need of investment, in order to increase output, especially as non-OPEC and Iraqi output is forecast to increase. The government increased its oil reserve estimate to 140.8 billion barrels at the end of 2002. This is 32% above the OPEC estimate for the same period. If this is correct, Iran has the second largest reserves in the world after Saudi Arabia. Reflecting this, Iran was producing 3.9 million barrels of oil a day as of January 2006, the second highest level among OPEC members; Saudi Arabia was the biggest producer on 9.4 million barrels a day.

Meanwhile, the government has work to do in order to meet its environmental responsibilities. A report published by Yale and Columbia Universities in January 2005 examined 21 different factors that go to make up a country's performance with regard to environmental sustainability, including pollution levels, use of natural resources and capacity to improve attitudes and policies towards the environment over time. In a list of 146 countries, Iran came in at a lowly 132nd.

Population

A large and growing workforce will have an uncertain effect on Iran's long-term growth outlook. The majority of the population are under 21 years of age with a major shift in the location of the population from rural to urban areas taking place.

The rapid growth in population and workforce should provide a boost to long-term growth by increasing private demand. The decline in the dependency ratio (those aged 0-14 and over 64 to those aged 15-64) until 2015 bodes well, suggesting additional capacity and demand. However, sustained high levels of investment are required to satisfy the aspirations of Iran's growing population. An estimated 800,000 jobs need to be created annually for the foreseeable future to satisfy the demands of the growing workforce, a demand that the economy does not currently have the capacity to meet. If the economy cannot provide jobs for new entrants, the burgeoning population will act as a drag on growth, increasing poverty and placing a strain on the country's infrastructure, a strain which will be added to by an increase in the dependency ratio forecast to take place after 2015.

Technological Progress

Underinvestment in the economy means that technological progress has been slow and is far behind levels elsewhere in the region. Even if major investment was to take place in Iranian industry and modern technology was introduced, there are doubts about whether the workforce possesses sufficient skills to take advantage of it. Granted, access to education and literacy rates have improved markedly under post-revolution governments. In addition, female access to education and work opportunities has increased significantly. However, the quality of education is low. Since the revolution, Iran has experienced an exodus of highly qualified graduates. Although the government has had some success in convincing Western-educated Iranians to return to the country (many current government ministers have had some Western education), the skills shortage remains an acute problem.

Meanwhile, Iran's isolation from the international community means that it has been denied access to research. With the industrial sector dominated by a few large public enterprises, industrial productivity suffers from technical and managerial weaknesses, as well as delayed privatisation and restructuring. The oil sector is also in need of modernisation and further investment. The government hoped to restore Iran's production capacity to the pre-revolution position of 4.8 million barrels per day (bpd) by 2005, although it was below this at 3.9 million barrels per day in early 2006. Over the long term, the government's objective of raising production to 8.0 million bpd by 2020, at an estimated cost of USD30-40 billion, only appears to be achievable if foreign investors become more involved.

Investment

Despite having higher gross domestic savings and fixed investment rates than some of its neighbours, investment in the Iranian economy remains inadequate. Iran's capital stock is outdated and in acute need of modernisation, with only around 11% of investment directed to the industrial sector. Granted, efforts are being made to direct greater investment into particular sectors such as telephony. In addition, the Iranian car assembly sector was worth USD11.6 billion in 2005, with the number of units produced standing at 984,000, making Iran the biggest such car producer in the Middle East. However, domestic private investment has generally been very low while the majority of foreign investment destined for the oil, gas and petrochemicals industries. The stated aim of successive post-revolutionary governments to achieve self-sufficiency in a number of key areas such as food production has not been matched by the necessary investment. Following the Iran-Iraq conflict, priority was given to the rehabilitation of the oil industry. However, even in this most vital of sectors, the government's targets have yet to be achieved.

Long-Term Economic Outlook

The long-term outlook for Iran's economy is uncertain. In the most positive scenario, Iran could achieve an annual real GDP growth rate of around 6% in the medium to long term. However, this outlook depends on the successful implementation of radical economic reforms that open up the economy to foreign investment and create opportunities for domestic investors. The chances of this happening in the medium term are highly unlikely given the conservative parliament and president. As such, if the Iranian economy remains constrained by political factors, its growth potential will be much lower and will remain highly dependent on the oil price. During periods of high oil prices, the economy may be able to achieve real GDP growth of 6-8% per annum. However, in times of low oil prices coupled with the threat of worsening relations with the West, average annual growth is more likely to be in the 3-5% range.

External Economic Risk

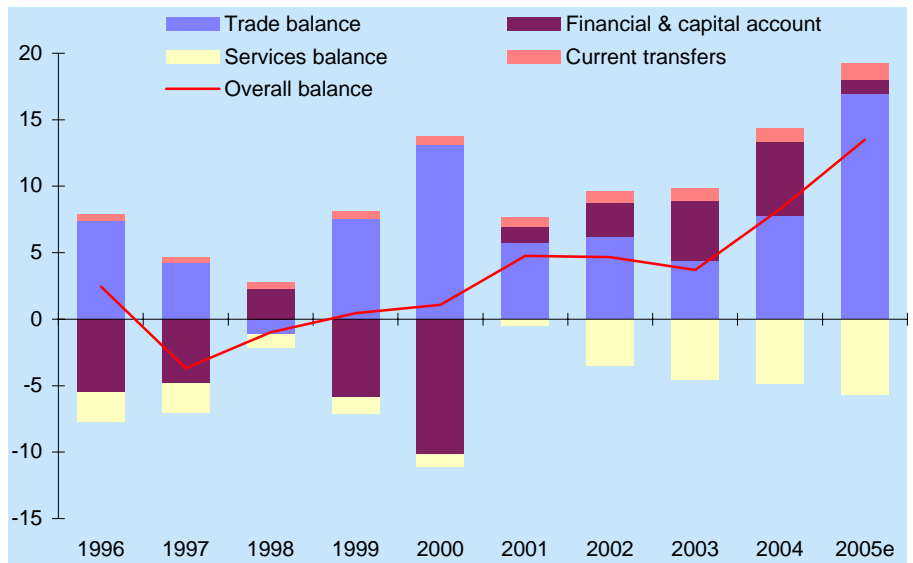
Key Point: Iran is particularly vulnerable to external factors, especially world oil prices. Although the balance of payments is expected to remain strongly in surplus in 2006, a weakening of oil prices and the imposition of sanctions by the West could see this surplus shrink from 2007 onwards.

Balance of Payments Performance

The performance of Iran's balance of payments over recent years has been driven by developments in the trade balance (which is strongly influenced by oil price movements) and financial flows (partly reflecting debt repayment). The balance of payments fell into deficit in 1997 and 1998 as a result of plummeting oil prices and stagnant non-oil exports. In 1998 the trade balance and the current account fell into deficit. At the same time, Iran rescheduled part of its external debt to reduce balance of payments pressure.

Chart 8

Balance of Payments



Sources: International Monetary Fund, *International Financial Statistics*; Central Bank of Iran, *Key Economic Indicators*; D&B

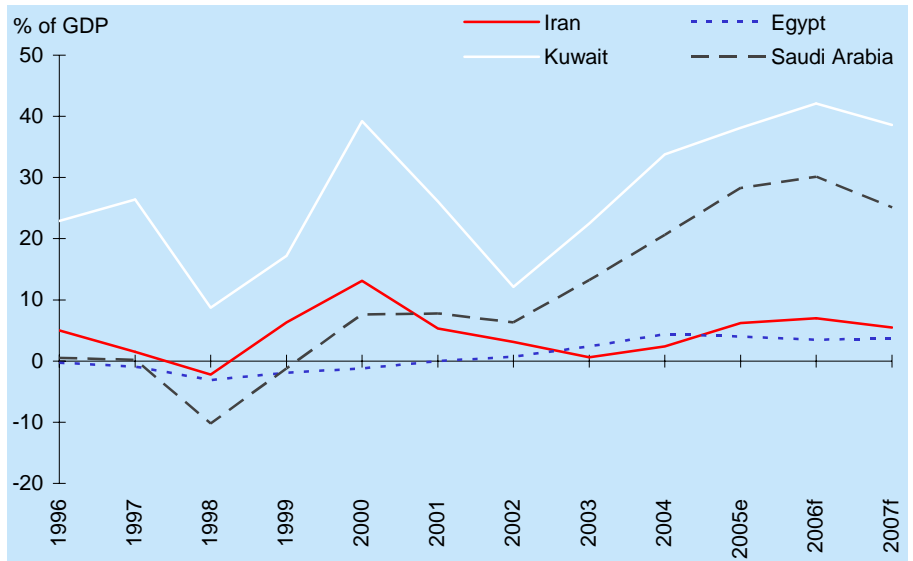
Stronger oil prices subsequently pushed the balance of payments into surplus in 1999 while by 2001 the financial and capital account witnessed a surplus of USD1.2 billion, reflecting the government's issuance of Eurobonds and reduced debt repayments. Supported by higher world oil prices in 2004 and 2005, the surplus on the balance of payments has continued to grow, coming in at USD8.3 billion in 2004 and an estimated USD13.5 billion in 2005. With oil prices forecast to remain strong in 2006, D&B expects the balance of payments to be in surplus by around USD16.7 billion. However, a weakening in world oil prices and the possible imposition of sanctions by the West could see the surplus shrink from 2007 onwards.

Current Account

The trade balance dominates trends in the current account. In turn, oil price volatility has driven significant fluctuations in the trade balance: weak oil prices in 1998 forced the trade balance and current account into a deficit (the first time since the introduction of import suppression measures in 1994). However, stronger oil prices have helped to underpin a current account surplus since 1999. Earnings from oil

exports tend to account for between 80-85% of total exports. Meanwhile, although gas exports are relatively low at present, they are expected to become more important going forward (see **Long-Term Economic Potential**).

Chart 9
Current Account Balance



Sources: World Bank, *World Development Indicators*; D&B

The current account surplus narrowed to 0.6% of GDP in 2003 as import growth outstripped growth in exports. Strong domestic demand and the easing of restrictions supported this expansion in imports. However, exports remained reasonably strong, with non-oil exports being supported by trade deregulation. Meanwhile, oil prices rose further in 2004 and 2005, averaging USD38.3 per barrel and USD54.3 per barrel respectively. Thus a substantial increase in oil earnings more than compensated for reasonably strong import demand over the period. As a result, the current account recorded a surplus of 2.4% of GDP in 2004 and an estimated 6.2% of GDP in 2005. Looking ahead, we expect the average oil price to increase marginally to USD59.2 per barrel this year. This, in turn, will underpin a further increase in the current account surplus to a forecast 7.0% of GDP in 2006. However, in 2007 a weakening in world oil prices coupled with possible sanctions imposed on Iran by the West over the nuclear issue will see the current account record a smaller surplus of 5.5% of GDP.

In terms of invisibles, Iran typically records modest deficits, except for transfers from workers' remittances. The services balance is the most significant deficit (estimated at USD5.7 billion in 2005), mostly as a result of freight and insurance payments, and a lack of tourism. Moreover, the services deficit has been increasing in the last few years as debt repayments have increased and there has been a lack of significant income from investment overseas.

Export Profile

Iran is one of the world's major oil exporters, with oil exports accounting for 80-85% of total export revenues. Oil will remain the main export earner for the foreseeable future, despite attempts to diversify (which has been thwarted, among other things, by an inability to attract significant levels of foreign investment). After oil, Iran is best known for its carpets, which accounted for around a sixth of total exports. Other important export categories include chemicals, leather and hides, and a variety of food products such as pistachio nuts, caviar, cumin and fruit.

At the country level, Japan was the most important market for Iranian exports in 2004, receiving 18.4% over the course of the year, much of which was made up of oil. Other important export destinations in 2004 included China (10.0% of total exports), Italy (6.0%) and South Africa (5.8%).

Table 5

Exports by Destination

% of total exports	2003	2004
Japan	21.3	18.4
China	10.0	10.0
Italy	6.1	6.0
South Africa	3.9	5.8
South Korea	5.3	5.4
Taiwan	5.4	4.6
Turkey	5.3	4.4
Netherlands	3.7	4.0
France	3.4	3.9
Greece	2.8	3.2

Source: International Monetary Fund, *Direction of Trade Statistics*

In mid-2000 the US lifted its sanctions on carpets, caviar and pistachios; however, this has had little effect as there are high tariffs on nut imports to the US to protect domestic growers. In addition, carpets were already reaching the US market through Canada. The EU remains a significant market for non-oil exports along with the UAE. Much of Iran's non-oil trade passes through Dubai for re-export to other countries, particularly the former Soviet Union republics. Around half of Iran's non-oil exports are made up of a variety of manufactured and industrial goods, including domestic appliances, chemical products, textiles, construction materials and metal products.

Import Profile

Following the introduction of an import compression policy in 1994, the annual value of imports stood in the USD12-15 billion range compared with USD19-25 billion in 1988-93. However, the government has been relaxing restrictions from 2000/01. This relaxation coupled with increased government spending has pushed up demand for imports. In 2003/04, imports were boosted by a gradual fall in non-tariff barriers, the elimination of import order fees and the unification of all import taxes and fees into a single tax from the beginning of the fiscal year. Although import demand has been less buoyant since then, imports were up by a high 25% in 2005. Iran's key imports are food items, raw materials and machinery, which together account for around half of total imports. The oil sector is a major consumer of machinery and the country's underdeveloped industrial capacity means that much of this has to be imported. Iran also needs to import significant amounts of grain and other food items.

Iran sources a significant proportion of its imports from the EU and Asia. In 2004 Germany was the largest exporter to Iran accounting for 12.8% of Iran's total imports, followed by France (8.3%) and Italy (7.7%). However, with Iran stepping up its plans to punish those countries that oppose its nuclear plans, coupled with deteriorating relations with those European countries involved in the cartoons controversy, EU exports to the country are likely to fall significantly over the forecast period.

Table 6

Imports by Source

% of total imports	2003	2004
Germany	10.8	12.8
France	8.5	8.3
Italy	8.0	7.7
China	8.5	7.4
UAE	7.8	7.2
South Korea	6.4	6.1
Russia	4.7	5.4
India	3.1	3.3
Brazil	3.1	3.3
Japan	4.0	3.2

Source: International Monetary Fund, *Direction of Trade Statistics*

Financial and Capital Account

Positively, the financial and capital account has posted surpluses since 2001. This has been as a result of increased capital inflows triggered by Eurobond issues, a repatriation of Iranian money, a fall in debt repayment levels and higher FDI inflows. However, the financial and capital account was less strong in 2005 (it recorded an estimated surplus of USD1 billion compared with USD5.6 billion in 2004), reflecting concerns over political developments and the nuclear issue. These same factors are likely to weaken the financial and capital account further over the forecast period. Looking further ahead, substantive economic and regulatory reforms are required to encourage more long-term capital investment.

Foreign Direct Investment Flows

The majority of investment in Iran has been directed toward the modernisation and development of the oil and gas industry and petrochemical projects in the form of buy-back deals (whereby foreign companies invest their own money for a certain period of time in exchange for revenue earned from the completed project for five or seven years). However, although buy-back arrangements have generated billions of US dollars for the Iranian economy, they are not treated as FDI schemes as they do not lead to formal equity stakes. Indeed, formal capital inflows are estimated to have been as low as USD300 million in 2005. Meanwhile, FDI in non-hydrocarbons continues to be low at less than USD50 million per annum.

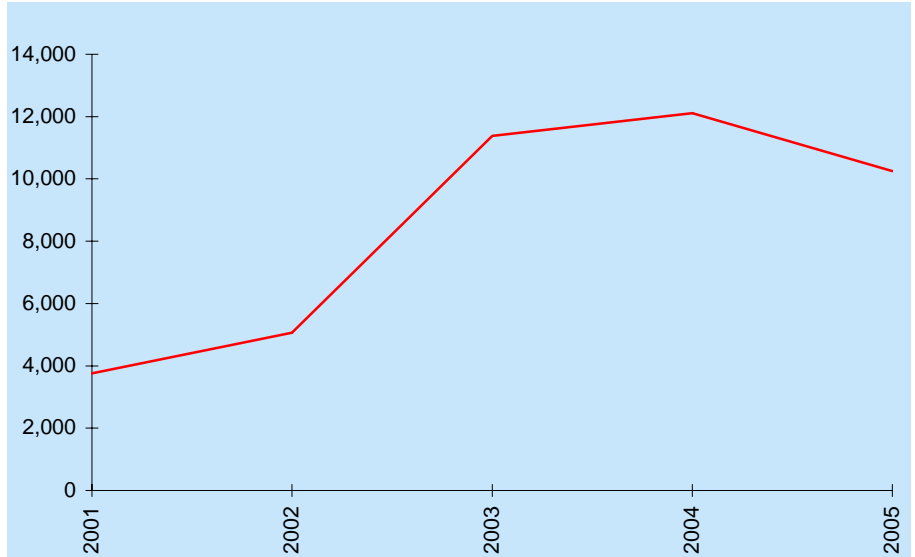
A key problem lies in the fact that the conservative Iranian parliament remains fundamentally opposed to foreign investment. Moreover, President Mahmoud Ahmadinejad has indicated that Iranian investors will be favoured over foreigners, even in the oil sector. In line with these sentiments, in mid-2005 parliament was critical of the award of a USD750 million contract to Ericsson, Nokia and Siemens to expand Iran's mobile telephone network. It appears that the authorities' preference is for foreign investors to be partnered by Iranian firms, as highlighted by the purchase by Turkcell of a 49% stake (originally 70%) in mobile telephone operator Irancell in September 2005. Meanwhile, in June 2005 Indian steel company Tata Steel agreed to pump up to USD1.2 billion into the construction of three steel plants and the development of iron ore mines in Iran commencing in 2008. Tata's stake in the deal will be 49%, with the rest being controlled by the Iranian Mines and Mining Industries Development and Renovation Organisation and an Iranian pension fund.

Equities

Up until 2005, the Tehran Stock Exchange (TSE) performed strongly as investors were encouraged by reform measures such as the unification of the exchange rate (which reduced currency speculation), falling interest rates in the US and EU, high world oil prices and a boom in the construction and cement sectors. The benchmark

Tehran Price Index (TEPIX) All-Share Index grew by 124.8% in 2003 and contributed to a significant increase in market capitalisation. Despite less buoyant growth in 2004, the index continued to increase (up by 6.4% over the year) due to high domestic liquidity (owing to high credit and money growth), in part reflecting strong world oil prices. In addition, the rise in the TEPIX was a result of improved fundamentals (higher corporate earnings) and greater business confidence. However, the market’s strength led to some concern about a bubble developing. As a result, the TSE issued an instruction which restricted daily price movements.

Chart 10
Stock Market Performance, Year-End¹



Note: ¹Data for 2005 are for 28 December.
 Sources: Central Bank of Iran, *Bulletin*; Reuters

Ahmadinejad’s election as president in June 2005 has injected a significant element of uncertainty into the market as reflected in the recent poor performance of the TEPIX. In the month after the presidential election, it lost more than 700 points or 5.6% in value. By November 2005 stocks had lost approximately 20% of their value compared to shortly before the presidential poll. The TEPIX stood at just over 10,000 at the end of November and had been at a two-year low of 9,960 in October despite reassurances by the government that it would support the market. By mid-February 2006 the TEPIX had drifted lower to 9,862, reflecting market concerns over Iran’s standoff with the West over the nuclear issue. With there being little prospect of a rapid resolution to this issue, we expect the TEPIX to weaken over the forecast period.

Debt

Despite regional and domestic tensions, as well as US sanctions against Iran, Teheran successfully issued Eurobonds in fiscal 2002/03 (21 March-20 March). On 10 July, Iran issued its first Eurobond (EUR500 million) since the Islamic revolution of 1979, subsequently adding EUR125 million to the offer owing to strong demand. The five-year bond was priced 4.25 percentage points over European swap transactions, which was slightly higher than the central bank had hoped for. Positively, demand was split equally between the Middle East and Europe, although the government did not meet its target of 50-66% European subscribers, which would have required more attractive pricing. A further EUR375 million issue was made in December 2002. It was oversubscribed and attracted close to EUR500 million, enabling Iran to reach its goal of raising EUR1 billion for the year. At 7.75%, the December issue coupon was slightly lower than the July issue and was priced 4.23 percentage points over European swap transactions. There was strong

demand from the Middle East, which took 64% of the paper, and Europe, which took the remainder.

More recently, in March 2005 there were indications that Iran Khodro, the state-owned car manufacturer, planned to issue a EUR300 million bond. However, in September 2005 the company indicated that it was postponing the issue until it was able to secure a rating from the credit rating agencies. With such ratings influenced by political factors, it would appear that the Khodro issue will not be happening in the foreseeable future. Indeed, at a broader level, there appears to be little prospect of the Iranian bond market receiving a stimulus. At present, there are only around EUR1 billion in outstanding bonds with as little as EUR5 million-worth of business conducted each month at the time of writing. A significant proportion of the bond stock is held by countries in the Middle East that have generally good relations with Iran. With Tehran become increasingly isolated in the international arena, the government will want to do everything it can to maintain its support base in the region. One way of doing this will be to ensure that it does not default on its bond obligations.

Bank Lending

The majority of bank borrowing is undertaken through local banks rather than with international institutions. This reflects the reluctance of international banks to lend to Iranian companies owing to the high level of country risk. The restrictive nature of the foreign exchange system also discourages Iranian individuals and companies from borrowing overseas. The exception is the government, which has borrowed heavily in the past. Extensive rescheduling in 1993 and 1994 and further measures in 1998 allowed short-term debt to fall, although as of June 2005 over half of bank lending to Iran was still on a short-term basis, thus increasing the chances of default.

Table 7

Maturity and Sectoral Distribution of Bank Lending to Iran

USD million	Dec-04	Mar-05	Jun-05
<i>Maturities:</i>			
Up to & including one year	10,643	11,963	13,253
Over one year & up to two years	1,023	1,142	1,349
Over two years	10,182	10,230	9,782
Unallocated	340	0	0
Total	22,188	23,827	24,754
<i>Sectors:</i>			
Banks	13,778	14,910	15,517
Public sector	1,135	1,286	1,491
Non-bank private sector	7,279	7,630	7,746
Unallocated	-4	0	0
Total	22,188	23,827	24,754

Source: Bank for International Settlements, *Quarterly Review*

Foreign Debt and Default Risk

The bulk of Iran's debt is external rather than domestic; Germany and Japan are the main bilateral lenders. Until the debt crisis of 1993, Iran had a good record of debt repayment, despite the revolution and the ensuing Iran-Iraq war. This enabled it to borrow heavily in the immediate post-war period to finance reconstruction. However, the loans were mainly short term, and in 1993 Iran found that it was unable to meet its commitments, forcing it into a series of rescheduling agreements with bilateral creditors. The 1993-94 rescheduling converted much of Iran's short-term debt into medium- and long-term debt. However, economic growth and oil revenues failed to create sufficient reserves of foreign currency, and in late 1998 and early 1999 Iran was forced to seek further rescheduling, albeit on a smaller scale.

Table 8

External Debt¹

<i>USD billion</i>	2002	2003	2004	2005
Short-term	2.1	4.8	10.3	10.5
Medium- and long-term	7.2	7.3	6.6	6.5
Total	9.3	12.1	16.8	17.0
Total (% of GDP)	6.9	8.9	10.3	8.8

Note: ¹Data for 2005 are as of June.

Source: Central Bank of Iran, *Key Economic Indicators*

Stronger oil prices since 1999 have enabled Iran to keep the debt stock at a reasonably stable level as a share of GDP. According to the central bank, outstanding external debt stood at USD17.0 billion as of June 2005. This was the equivalent of 8.8% of GDP, down from 10.3% in 2004. Less positively, the majority of external debt is short term, thereby increasing the risk of a default. Nonetheless, debt servicing should be made easier by the fact that high world oil prices continue to push up Iran's foreign exchange reserves.

Foreign Exchange Reserves

Although the central bank does not release data on its overall stock of foreign exchange reserves, reserves appear to be recovering after being severely depleted in 1997-98 as a result of low oil prices and heavy debt repayments. D&B estimates suggest that, at the time of writing, Iran's reserves stood at around USD45 billion, equivalent to approximately 10 months of import cover. In a related development, in early 2006 there were rumours that Iran had begun to move assets held in European accounts to other foreign banks, reflecting Tehran's concerns that such monies may be confiscated if sanctions are imposed by the West. According to the Bank for International Settlements, Iran had USD23.5 billion held in the international banking system as of June 2005, although unofficial estimates suggest that the actual figure could be as high as USD40-50 billion.

Exchange Rate Risk

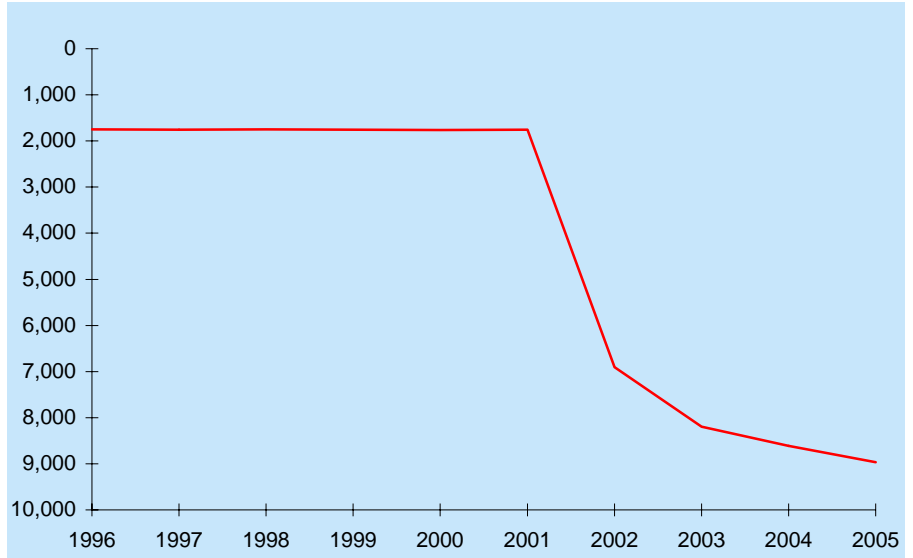
Exchange Rate Regime

According to the International Monetary Fund (IMF), the exchange rate of the rial is determined in the inter-bank foreign exchange market, although the authorities intervene when necessary to maintain orderly conditions. The central bank is the main supplier of foreign exchange and is able to control demand by restricting import licences. Only importers with a valid licence can purchase foreign exchange on the TSE.

Exchange Rate Trends

In March 2000, the central bank abolished the official export rate of IRR3,000:USD. This rate, which had applied to all non-oil and service exports, was replaced with an official floating rate, determined on the TSE by transactions in import certificates based on repatriated earnings from exports. The TSE rate was introduced in 1997 at IRR4,600:USD and has depreciated considerably since then. The government also reformed the exchange rate regime by abolishing the subsidised import rate (IRR1,750:USD) in 2002. This rate applied to the import of essential goods and all oil- and gas-related transactions. The import rate acted as an inefficient subsidy and cost the Treasury around USD5 billion a year. At a broader level, the central bank has allowed the rial to gradually weaken in order to increase the competitiveness of Iranian non-oil exports.

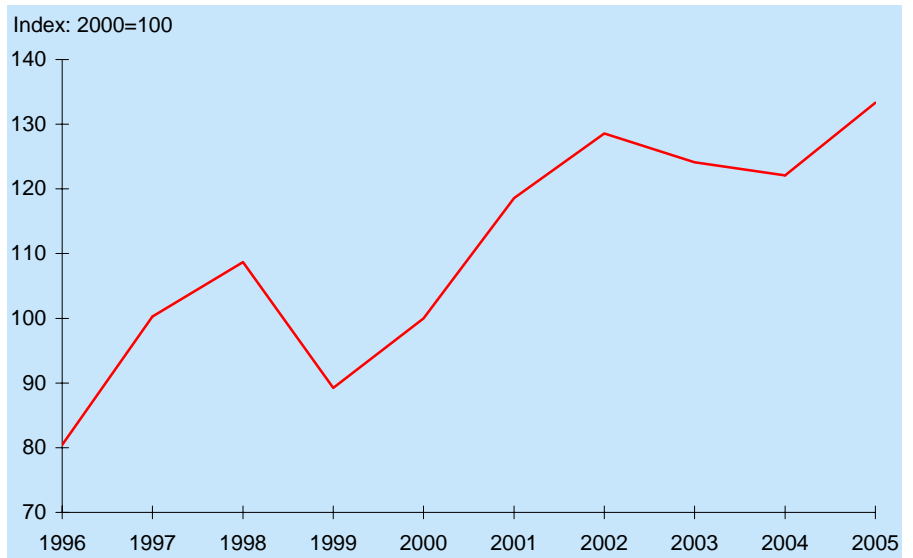
Chart 11
Iranian Rial:US Dollar Exchange Rate



Source: International Monetary Fund, *International Financial Statistics*

However, we are forecasting greater stability in the value of the rial in 2006 and 2007, reflecting sizeable current account surpluses and strong foreign exchange reserves, although there could be bouts of weakness if the West decides to impose sanctions over the nuclear issue.

Chart 12
Real Exchange Rate¹



Note: ¹Data for 2005 are as of October.

Source: International Monetary Fund, *International Financial Statistics*

External Economic Risk Outlook

The current account surplus is expected to strengthen to 7.0% of GDP in 2006 owing to higher oil prices. However, the threat of sanctions coupled with a forecast weakening in oil prices in 2007 will mean that the surplus on the current account will narrow to 5.5% of GDP in 2007. Meanwhile, concerns over the nuclear issue and Iran's worsening relations with the West will result in lower surpluses on the financial and capital account in both 2006 and 2007. Reflecting the strength of the current account, import cover is expected to increase to 13 months in 2006, well above the three-month minimum recommended by the IMF. However, in line with lower oil prices, import cover will fall back in 2007, albeit to a still high 11 months.

Table 9

External Forecasts

<i>% of GDP</i>	<i>2006f</i>	<i>2007f</i>
Current account balance	7.0	5.5
Financial & capital account balance	0.2	0.1
Overall balance of payments	7.2	5.6
Import cover (months)	13.0	11.0

Source: D&B

Despite the majority of Iran's external debt stock having a short-term maturity, sizeable foreign exchange reserves will help to avoid a default over the forecast period. Finally, we expect the rial to enjoying greater stability in 2006 and 2007 owing to a strong current account and the large reserves. However, there could be bouts of weakness if the West decides to impose sanctions over the nuclear issue.

Trade Environment

Key Point: The trade environment is subject to strict regulation and heavy tariffs, which are designed to limit imports. Controversy over the nuclear issue is likely to limit Iran's progress on securing membership of the World Trade Organisation in the foreseeable future.

Trade Overview

Iran operates one of the most tightly regulated trade regimes in the region. The result is a web of regulations and licences administered by a large and inefficient bureaucracy. Interpretation of regulations can change with little or no notice. The raft of regulations surrounding foreign currency transactions further complicates the situation. The restrictive trade regime was designed to discourage imports, protect Iranian industries and maximise exports. Although the government started tentative liberalisation of the trade regime in 1989, the debt crisis of 1993 and the need to maximise foreign currency earnings led to the collapse of these efforts and the imposition of a more protectionist environment designed to suppress imports, particularly of 'luxury' goods, and those that compete directly with Iranian produced goods.

More recently, however, the government has relaxed its stance. Since the end of 1999, licensing requirements have been dropped for around a third of goods (mostly under the remit of the Ministry of Industry). The government has also continued to streamline licensing procedures and the bulk of import items now only require licensing from the Ministry of Commerce. Further moves to liberalise imports are expected in the short to medium term. However, such initiatives will depend on the state of the economy. In addition, vested interests such as the *Bonyads* and the *bazaaris* (traditional market traders) will lobby the government to maintain these measures (see **Interest Groups**).

Iran continues to pursue its goal of joining the World Trade Organisation (WTO). A first application to join the trade body was filed in September 1996, but was vetoed by the US. Thus despite making it on to the agenda of the WTO's General Council in May 2001, Iran's membership application proceeded no further for a number of years. However, from early 2005 the US began to take a softer stance, which, in turn, led Washington to abandon its veto of Iran's application in May 2005. However, with the nuclear issue now firmly back on the agenda, it is unlikely that significant progress on securing membership will be made by Tehran over the forecast period unless the nuclear controversy is resolved amicably (see **The Nuclear Issue**).

Current Account Exchange Regulations

Exchange control authority is vested in the central bank (Bank Markazi). Since March 2002 Iran has adopted a unified exchange rate regime based on a managed float with no pre-announced path. An import licence authorises importers to access foreign exchange. The issuing of a letter of credit is restricted to a number of state banks. Prior to the establishment of a unitary rate, banks were required to demand advanced deposits of 10% to 100% (depending on the product and the creditworthiness of the importer) when opening letters of credit. Since then, the amount of the deposit required for opening a letter of credit is left to the discretion of the bank.

Payments for imports are required to go through the banking system. Imports made with foreign currency must be accompanied by evidence that the currency was obtained from Iranian banks before goods may be released from customs. Freight

charges may only be settled through letters of credit or bills of exchange limited to 30% of the free on board (f.o.b.) value of the goods. Approval of the central bank is required for larger percentages. Iran has eliminated the foreign exchange repatriation and surrender requirement.

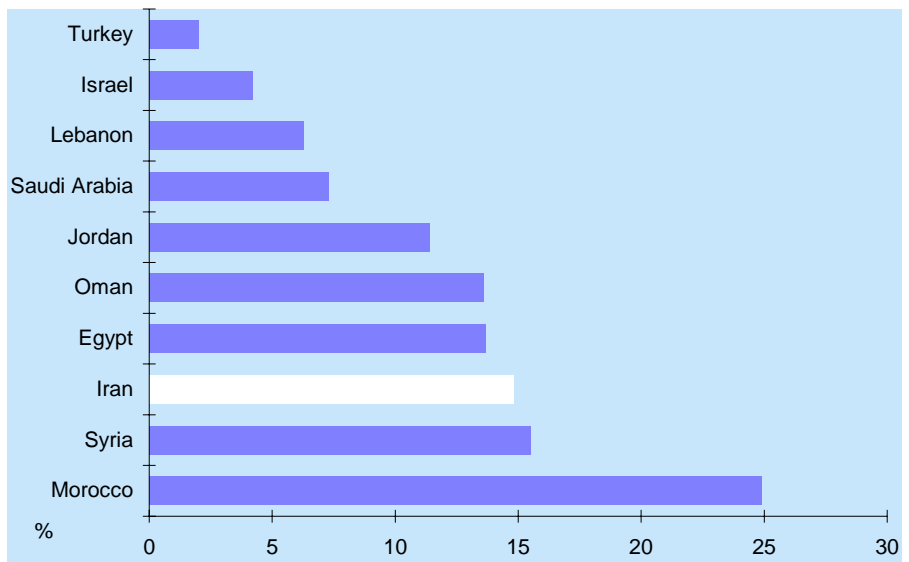
Since 6 September, 2004, Iran has accepted the obligations of Article VIII, Sections 2, 3 and 4 of the International Monetary Fund’s (IMF) Articles of Agreement. IMF members accepting these obligations agree to refrain from imposing restrictions on the making of payments and transfers for current international transactions or from engaging in discriminatory currency arrangements or multiple currency practices without IMF approval.

Tariffs Barriers

Duties are imposed almost entirely on an ad valorem basis using the Harmonised Tariff Code. A new tariff regime is promulgated at the end of each Iranian calendar year and new regulations are effective for the next year. A new customs law is being prepared to replace the current 30-year-old legislation. Iran is in the process of shifting from non-tariff barriers to tariffs as part of its efforts to join the WTO. In addition to customs duties, Iran also levies an ad valorem commercial benefit tax on most goods. The commercial benefit tax has 61 rates ranging from zero to 116%. Efforts are being made to consolidate and simplify customs tariffs. Capital goods and raw materials may be exempt from duties. Similarly, medicines, wheat, and other strategic goods may be exempt. Consumer goods attract 30-50% tariffs while tariffs on intermediate goods are slightly lower. However, most goods are also subject to licensing fees and tariffs, surcharges and taxes.

Iran operates a drawback scheme for products that are later re-exported. Iran grants full or partial exemptions from duties and taxes in accordance with special rules and regulations. These exemptions are primarily granted to those products that are deemed necessary to increase domestic agricultural production or the export of domestic products. Iran may retaliate against any foreign trading partner(s) that discriminates against exports from Iran. The Ministry of Economy has been given the authority to seek permission to introduce an “additional import duty” on goods exported from countries that so discriminate, whether such discrimination is direct or indirect, individual or effected through membership in regional economic groupings.

Chart 13
Weighted Mean Tariffs in Selected Countries, 2002¹



Note: ¹Data is for 2002 except for Israel (1993), Jordan, Morocco and Turkey (2003) and Iran and Saudi Arabia (2004).
 Source: D&B

In April 2004, Iran announced a tariff reduction from 30% to 20% for imports using the south western ports of Abadan and Khorramshahr, while imports entering Iran via the port at Bushehr will be cut from 20% to 15%. In March 2005, parliament reduced and capped the duties for passenger cars at 100% and 20% for trucks, buses and minibuses.

In March 2005, Iran signed its first free-trade agreement with Venezuela. In addition, Iran has a preferential trade agreement with Pakistan. Iran, Pakistan and Turkey have agreed to reduce customs tariffs as a first step towards liberalising trade among the three countries. A 1% cut in tariffs was provided in a protocol signed in Tehran in May 1991 at a meeting of the Economic Co-operation Council of the three countries. In 1995 Iran signed a trilateral trade memorandum with Turkmenistan and Armenia and a trilateral trade agreement with Turkmenistan and Ukraine. In 1997, Iran signed trade agreements with Saudi Arabia and Syria. In December 2003, Iran granted manufactured goods from Uganda a zero tariff rating. Iran has been exploring preferential and free-trade agreements with India, Singapore, the United Arab Emirates (UAE) and the South African Customs Union (SACU).

Most duties are ad valorem, although a few items still bear specific duties. Tariff rates are calculated on the basis of the carriage, insurance, freight (c.i.f.) value plus registration fees plus all other expenses and charges applicable to goods and commodities in question until their arrival. Furthermore, this calculation is done on the basis of the documents submitted by the owner of the goods and commodities and on the rate of exchange given with the import licence.

Non-Tariff Barriers

The government is determined to control imports, maximise the amount of foreign currency retained in the country and encourage the development of local industries. Exporters to Iran face considerable bureaucratic obstacles in gaining permission to import goods and in obtaining financing for imports. The government classifies imports under three categories: authorised, conditional and prohibited. Authorised goods can be imported with almost no restrictions and include a limited range of essential goods. Most imports are classed as conditional and the government's excessive bureaucratic requirements must be met before such imports are allowed. A limited range of goods are banned from import. Since the end of 2002, most import items only need to be licensed by the Ministry of Commerce.

All imports must be authorised by the relevant ministries together with the approval of the central bank for foreign exchange allocation or when opening a letter of credit at participating commercial banks. All imports require the prior approval of the appropriate procurement and distribution organisations, except for goods imported by the Ministry of Defence and certain other military items.

To obtain financing, importers must satisfy the central bank's strict regulations. The central bank has sole responsibility for issuing letters of credit and other forms of payment, giving it the ability to block imports if necessary. Iranian importers face a costly process to secure letters of credit. A deposit in hard currency of 15-100% of the order's value must be placed with the central bank. The exact percentage depends on the nature of the goods and the creditworthiness of the importer. A further hard currency deposit of 20-100% may be required and placed in the local banking system. These deposits are in addition to any money paid to the supplier to obtain shipment of the goods.

Licences

Import regulations are issued by the Ministry of Commerce. The import policy is re-examined at the end of each Iranian calendar year and new regulations effective for the next year are issued. The regulations distinguish between authorised, conditional,

and prohibited goods. Authorised goods can be imported without restriction. Conditional goods can be imported under certain conditions with due consideration for the regulations including permission from the appropriate ministry or ministries. Prohibited goods consist of those whose transactions are forbidden. The importation of goods for commercial purposes requires a commercial card which is issued by the Iran Chamber of Commerce, Industries and Mines, and approved by the Ministry of Commerce. The commercial card allows the importer to request an import licence. Importers without the commercial card are charged an extra 5% tariff.

All imports must be authorised by the relevant ministries together with the approval of the central bank for foreign exchange allocation or at the opening of a letter of credit at participating commercial bank. All imports require the prior approval of the procurement and distribution organisations, except for goods imported by the Ministry of Defence and certain other military goods. In June 2001 the authorities announced the relaxation of import restrictions on 1,400 items; these items are now on the authorised list. High technology items with comparable domestic production still require licensing. Under the regulations, items without domestic product may be imported after obtaining a “No Domestic Production” Certificate. Where production is not sufficient to meet local needs, limited licences will be granted.

Clearance of goods through customs is authorised on presentation of shipping documents endorsed by the Ministry of Commerce (these permits may be issued when letters of credit are opened and need not be reissued). Certain goods, such as pharmaceuticals must be accompanied by a special permit from the Ministry of Health or other relevant ministry, when they are cleared through customs. Iran bans the import of firearms and ammunition, narcotics, alcoholic beverages, psychotropic substances, gambling and related paraphernalia, transmitters, chemicals that deplete the ozone layer, video tapes, and radioactive materials. Also prohibited are magazines, photos, film and any type of writings that are contrary to the religious and national dignity of the country.

Quotas

Restrictions on access to hard currency and the system of import licensing mean that there is little need for formal quotas. No significant quotas exist on imports to Iran.

Bans

Prohibited imports include all goods from Israel, alcohol, pork and any goods related to gambling. Customs authorities are diligent in their efforts to thwart the entry into Iran of prohibited items deemed to be ‘corrupting’. Imports of hand-held radio transmitters, satellite dishes and most vehicles are banned. In the past the government has also imposed bans on some luxury and consumer goods. The government retains the power to impose such bans at short notice. Seasonal bans are frequently implemented to protect Iranian-produced fruit and vegetables.

Documentation

Exporters must, in all instances, follow the instructions of their importer regarding the actual documents required, content of the documents and certification and legalisation requirements. In addition, due to the current situation where the import of many goods by the private sector are either not permitted or are being monitored by the Import Centres, exporters must make certain the goods are not prohibited, that (for applicable goods) the Import Centre is permitting the shipment, and that the central bank has registered the import transaction. Officials at the Iranian Interests Section may assist exporters to Iran regarding various legal aspects of doing business with Iran.

Follow importer’s instructions regarding language to be used in documents, as well as on packages (shipping and retail). Mail and Parcel Post shipments require postal

documentation in place of bills of lading. Regular mail shipments (both surface and air) have no special documentary requirements and do not require consular legalisation (unless this is requested by the importer, etc.); therefore, follow importer's instructions. The documentary requirement for surface parcel post is the commercial invoice showing country of origin which does not require legalisation unless requested by the importer, etc. Air parcel post shipments require legalised commercial invoices in triplicate. It is understood that many items may not be imported via parcel post. This point should be checked with the importer before consigning goods via this mode of transport.

Air cargo shipments require air waybills (in place of bills of lading) with the number of copies issued based on the requirements of the importer and of the airline used. Air cargo shipments (at a minimum) must be covered by legalised commercial invoices, in triplicate, with a declaration of origin signed by the shipper. Currently, Iranian customs officials will not clear goods for import by air if they form part of a consolidated shipment. Air freight imports must be delivered "to not more than one consignee indicated on the airway bill, or the consignee's authorised agent". Clearance of any goods that have been consigned to several consignees on one air waybill will be refused. The importer's registration number (furnished to exporter by the importer) must appear on shipping documents for goods under collection bills and the registration number and/or letter of credit number (appropriate number/s to be obtained from the importer) on shipping documents when goods are imported under documentary letters of credit. Goods should not be shipped until confirmation of registration has been received. Shipments and documents must be marked "Persian Gulf" and not "Arabian Gulf." Any such transgression will result in the refusal of service at Iranian ports. As neither corrections on original documents nor letters of correction are allowed, exporters must prepare a new set of documents and submit these for certification and legalisation.

Bill of Lading: No special requirements. Four copies of the bill of lading are to be prepared and sent to Iran with other documents.

Certificate of Origin: A certificate of origin may be required by the letter of credit or the importer. When required, the certificate is usually prepared in triplicate on a general form obtainable from commercial stationers. It should (at a minimum) give the name of the country of origin of the goods, names of shipper and consignee, and a statement describing the goods as to kind, weight, and quantity shipped. It must be certified by a chamber of commerce, which will retain one copy for its files. Unless requested by importer or letter of credit terms, certificates of origin do not, at this time, require legalisation by Iranian officials. If such legalisation is requested by the importer or contractual documents, then an original and one copy are presented at the Iranian Interests Section of the Embassy of Pakistan. The original copy will be legalised and returned; the duplicate is retained for file purposes by the Interests Section. The exporter is to forward the original to the importer's bank with other documents. In some cases, Iranian importers may ask for an extra copy of the certificate of origin for their own use. Certificates should contain the name of the country of origin, name of manufacturing country, name of shipper, name of consignee, and a statement describing the goods as to kind, weight, and quantity shipped.

Commercial Invoice: Commercial invoices are usually prepared in quadruplicate (minimum), with two copies (original and one duplicate) for the importer (these are sent to the importer via the bank in Iran which has registered the transaction), one notarised copy for the chamber of commerce's files (invoices have to have the below noted declarations certified), and one copy for the files of the Iranian Interests Section (when documents require legalisation). Additional copies may be requested by the importer, by the bank registering the transaction, by clauses in the letter of credit or other contractual documents.

With regard to legalisation, exporters should make certain that their contract or letter of credit covers this point. Unless the importer clearly states that legalisation is not required to clear the goods through customs or to effect payment, exporters should have their documents authenticated by the Iranian Interests Section. The commercial invoice should show all charges and expenses to c.i.f., carriage and freight (c.&f.) or f.o.b., depending on contract, etc. It should give the number(s) in the Iranian Customs Tariff for the item(s) being shipped. The regulations are complicated, involving two declarations as to prices, one of which should be in the following form certified by a chamber of commerce (which, usually, will retain one notarised copy containing this declaration for their files): "I (name) (title) (name of company) hereby swear that the prices stated in this invoice are the current export market prices for the merchandise described therein and I accept full responsibility for any inaccuracies or errors therein." The invoice has to show an itemised statement of the current export price of the goods, including the cost of cartage, ocean freight, and insurance. The country of origin of the goods is to be given.

Consular/Customs Invoice: No known requirement.

Export Controls: The US Treasury Department's Office of Foreign Assets Control (OFAC) administers a comprehensive trade and investment embargo against Iran; it includes prohibitions on export and certain re-export transactions involving Iran, including transactions dealing with items subject to the Export Administration Regulations (EAR). A licence is required for items controlled for CB 1, 2, 3; NP 1, 2, NS 1, 2, MT, RS 1, RS 2, CC 1, CC 2, 3; and AT 1, 2. No person may export or re-export items subject to both the EAR and OFAC's Iranian Transactions Regulations without prior OFAC authorisation. Exports and re-exports subject to the EAR that are not subject to OFAC regulations may require authorisation from the US's Bureau of Industry and Security (BIS). To avoid duplication, exporters or re-exporters are not required to seek separate authorisation from the BIS for an export or re-export subject to both the EAR and OFAC's Iranian Transactions Regulations. If OFAC authorises an export or re-export, no separate authorisation from BIS is necessary.

Insurance Certificate: Insurance may only be taken out in the Islamic Republic of Iran for imports.

Packing List: Required. Usually issued in six copies.

Pre-shipment Inspection: All goods imported into Iran valued at USD20,000 f.o.b. or more must be inspected before shipment. Goods are inspected for quality and quantity, value for customs purposes, and customs classification. An Import Duty Report is issued for customs clearance while a Clean Report of Findings indicates that the goods meet specifications. Pre-shipment inspections for goods valued at less than USD20,000 are permitted and can facilitate customs clearance. The selection of inspection company should be specified in the letter of credit.

Pro-Forma Invoice: The importer must have a pro-forma invoice to support registration of goods and to apply for a documentary letter of credit. Usually required in a minimum of four copies and includes: the supplier's name and title, date and number, quantity, description, unit price and total f.o.b. value of the goods, and estimated inland and ocean freight charges up to the Iranian port, terms of payment and signature of supplier. Follow importer's advice regarding any inclusion of insurance premiums.

Steamship Company Certificate: Follow importer's instructions regarding issuance of a document of this type.

US Shipper's Export Declaration (SED): Required if value is more than USD2,500. SEDs are required for all shipments requiring an export licence.

Other Documents:

Certificate of Free Sale: Iranian importers of pharmaceuticals, medical devices, foodstuffs and cosmetics are frequently required by the Ministry of Health and Welfare to furnish a certificate of free sale issued by the appropriate authorities in the country of origin.

Halal Certificate: Meat and poultry must be slaughtered according to Islamic rules.

Health Certificates: US exporters of veterinary products (including feed concentrates and supplements) to Iran have to furnish a certificate to the effect that the product was produced in and is used and sold freely in the US. This certificate must be certified by the Veterinary Department or Department of Agriculture of the respective state in which the shipment originated and must be authenticated by Iranian consular officials. This certificate is required only at the beginning of each Iranian year (21 March). Subsequent shipments during the year require only a simple health certificate with an analysis of the product and a statement that the product is free from disease and toxication. The health certificate also must be certified by the Veterinary or Agriculture Department of the state of origin, but it does not require consular legalisation.

Consular Fees: Legal documents and various non-commercial certificates (e.g. powers of attorney, sales certificates, price lists, health certificates, etc.) must first be notarised by the Authentication Officer of the US Department of State. After this procedure is followed, such documents may be presented to the Iranian Interests Section of the Embassy of Pakistan for legalisation. A photocopy of the original should also be included. Commercial documents requiring legalisation (e.g. commercial invoices, certificates of origin) must be "sealed and stamped" by a recognized chamber of commerce before being presented to the Iranian Interests Section. A photocopy of the original should also be included.

The legalisation fees for a document valued up to USD629 is USD10 per copy; for documents valued up to USD6,290 the fee is USD47 per copy; for documents valued up to USD31,447 the fee is USD93 per copy; for documents valued up to USD62,893 the fee is USD184 per copy; for documents valued up to USD314,466 the fee is USD370 per copy; and for documents valued over USD314,466 or without a face value the fee is USD742. Processing time takes at least two weeks. All documents covering food and pharmaceutical items, require Food and Drug Administration (FDA) approval. A money order payable for the fees plus USD15 for return postage by FedEx to the Iranian Interests Section must be presented with the documents requiring legalisation.

Sanctions

United States Presidential Executive Order 13059 of 19 August 1997, which clarifies Executive Orders 12957 of March 1995 and 12959 of May 1995, confirms that virtually all trade and investment activities with Iran by US persons, wherever located, are prohibited. There are corporate criminal and individual penalties for violations of the Iranian Transactions Regulations. In September 1999, US sanctions on food, medicine and medical equipment were eased. The sanctions are administered by the US Treasury Department's Office of Foreign Assets Control (OFAC).

The United States Department of the Treasury's Office of Foreign Assets Control issued additional revised Foreign Assets Control Regulations affecting Iran on 26 June 1996. The correction and amendment of final rule is covered by 31CFR Chapter V, published on 23 August 1996 in Federal Register Vol. 61, No. 165. This legislation imposes sanctions on foreign energy companies that make significant investments in Iran. US legislation requires the imposition of penalties against

foreign companies investing more than USD20 million in Iran's hydrocarbons sector in any one year. Penalties include bans on US trade and financial transactions with violators but have hardly been enforced.

On 28 April 1999, the US Treasury Department announced that it would authorise, with appropriate safeguards, commercial sales of food, medicine and medical equipment to Iran on a case-by-case basis. Provided items are not listed on the Commerce Control List maintained by the Department of Commerce, sales of agricultural commodities and products, which are intended for ultimate consumption as food by humans or animals, as well as medicine and medical equipment, will be permitted with a specific licence. Licences will be granted either on an expedited basis for bulk sales of agricultural commodities or under a two step procedure for all other food items, medicine and medical equipment. The regulations limit payment and financing terms, under a general licence, to cash in advance, sales on open account with certain limitations, or financing by third-country banks that are neither US persons nor Iranian, Libyan, or Sudanese government entities.

Commercial Risk

Key Point: The commercial and credit environment continue to improve with the strong oil price and high government spending. However, the antiquated nature of the banking system, high levels of bureaucracy and widespread corruption overshadow the commercial risk outlook.

Credit Risk

The risk of payment delays continues to fluctuate with the state of the economy and particularly with the level of earnings from oil exports. High oil prices and reduced debt levels have resulted in a more favourable payments environment in recent years and conditions set by the credit agencies have eased accordingly. The tight conditions that agencies apply to cover for Iran are partly a legacy of the country's economic problems in the mid-1990s while also being indicative of the perceived high level of risk associated with the current regime in Tehran resulting from tensions with the West over the nuclear issue. Thus despite forecasts of continuing high oil prices, D&B recommends extreme caution when agreeing payment terms, especially with new customers. Companies should also conduct thorough enquiries on Iranian enterprises and individuals that are proposing strategic relationships. This applies equally to the private and public sectors. The government's tendency to alter the interpretation of regulations or the regulations themselves at short notice adds to the risk of non-payment or lengthy delays in payment.

Over the last few years, European export credit agencies have guaranteed a deal that exposes them to Iran's National Petrochemical Company (NPC), while international banks have signed export credit deals to the NPC. Foreign banks have also shown some interest in project financing, mostly in the oil, gas and petrochemicals sectors as well as in the power and mining areas. In December 2003, the National Iranian Oil Company (NIOC) signed an agreement with a consortium of international banks to provide as much as USD1.75 billion in finance for the development of phases nine and ten of the South Pars gas project. This is the first time that foreign banking institutions provided Iranian contractors with credit for a project that has a return period of as long as ten years. Since 2000, the World Bank has provided financial assistance to Iran, despite objections by the US. Thus in late 2005 a delegation from the bank travelled to Iran to discuss a USD700 million loan contract to improve the country's water and sewage facilities.

In terms of the ease or difficulty of doing business in Iran, the World Bank's 2005 survey of commercial conditions around the globe placed Iran in a poor 108th position out of 155 countries. Particular difficulties of doing business in the country identified by the survey include: dealing with licences (it takes companies in Iran an average of 668 days to comply with licensing and permit requirements for ongoing operations compared to a regional average of 216.1 days and an OECD average of 146.9 days); inefficient trading across borders; and weak investor protection.

Payments Experience

Usual Terms: D&B recommends confirmed letters of credit or similar secured instruments when conducting business with Iranian entities. In order to limit and monitor foreign currency usage, the government restricts the issuance of letters of credit to a limited number of state banks. Although the central bank has relaxed its import reduction programme, which should improve prospects for exporters to Iran, there is a risk that import restrictions will be re-imposed if import levels rise.

Usual Terms

Minimum Terms:	Letter of Credit
Recommended Terms:	Confirmed Letter of Credit
Usual Terms:	60-120 days

Transfer Situation: Iran’s foreign exchange reserves are being supported by strong oil revenues. This will help to ensure ready availability of foreign exchange for Iranian importers, thereby lessening the prospect of payment delays (although foreign exchange/bank delays are still lengthy at 3-4 months). Meanwhile, import cover is a healthy 10 months, comfortably above the three month minimum recommended by the International Monetary Fund (IMF).

Transfer Situation

Local Delays:	1-2 months
Foreign Exchange/Bank Delays:	3-4 months
Import Cover:	10.0 months

Export Credit Agencies: The conditions set by the export credit agencies have eased, indicating improved confidence in Iran. In October 2001, ECGD announced that it was resuming medium-term cover and in March 2002, it normalised medium-term cover for Iran, following the settlement of a dispute on pre-revolutionary debt. However, US Eximbank is still prohibited from providing cover. At a broader level, cover is likely to become harder to secure as Iran’s relations with the international community deteriorate as a result of the nuclear issue. Reflecting this, in early 2006 the ECGD decided to change its policy on cover to ‘Refer to underwriter’ from a previous position of offering short- and medium-term cover.

Export Credit Agencies

US Eximbank	Cover prohibited by US law
Atradius	Cover available subject to approved letter of credit, no discretionary limits
ECGD	Refer to underwriter
Euler Hermes UK	Short-term cover available, restrictions may apply

Financial Sector Risk

The central bank (Bank Markazi) plays a more direct role in day-to-day banking operations than most central banks. As well as regulating the banking sector and having responsibility for monetary policy, the central bank oversees the release of foreign exchange and issues letters of credit. The bureaucratic nature of central bank can lead to long delays in the processing of even simple transactions. As well as a complex bureaucracy, the bank and the wider banking system are beset by political interference, lack of transparency, poor regulation and outmoded technical systems.

The banking system was nationalised following the 1979 revolution and foreign banks were barred from participation. The domestic banks were merged into five commercial banks: Bank Melli, Bank Tejarat, Bank Mellat, Bank Sepah and Bank Sadaret, and one specialist bank, the Bank of Industry and Mines. These banks essentially act as agents of the central bank and have limited ability to make independent operational decisions. In 1984, the banking system was Islamised, making the charging or paying of interest illegal. The payment of dividends and the charging of management fees are permitted as long as they do not transgress Sharia (Islamic) law. In reality, however, dividends are paid at a fixed rate of return. Subsequent reforms have done little to change the antiquated and inefficient banking system. In 1994, private savings and loans operations (mainly operated by the *bazaaris*, see **Interest Groups**) were legalised and foreign banks were permitted to

open branches, although neither were allowed to offer a full range of banking services, particularly non-interest cheque accounts.

More recently, financial and banking sector reform has been relatively slow, although a key area of development has been the licensing of three credit institutions to become fully functioning private banks. In 2002 Bank Karafarin started operations as the first private bank. Other private banks include Parsian (which was not a credit institution), Saman and EN Bank. In mid-2003, Parsian Bank alone had 20,000 shareholders, according to government sources. The new banks have to comply with strict central bank criteria; the minimum capital requirement is set at USD25 million and the central bank will generally impose the capital adequacy ratios set by the Bank for International Settlements (BIS). Although private banks play a limited role owing to their small size (even domestically), their main advantage is that they offer non-interest bearing current accounts.

Table 10

Top Ten Iranian Banks by Tier One Capital, March 2004¹

<i>Bank</i>	<i>Tier One capital (USDm)</i>	<i>Total assets (USDm)</i>	<i>Capital assets ratio</i>	<i>Pre-tax profit/loss (USDm)</i>	<i>Return on assets (%)</i>
Bank of Industry and Mine	938	2,315	40.55	152	6.56
Bank Mellī Iran	666	27,524	2.42	538	1.95
Bank Saderat Iran	456	16,200	2.81	221	1.36
Bank Keshavarzi	436	7,067	6.17	110	1.56
Bank Maskan	370	5,010	7.39	148	2.96
Bank Mellat	354	17,923	1.98	69	0.39
Bank Tejarat	346	13,486	2.57	97	0.72
Bank Parsian	305	3,958	7.70	161	4.07
Export Dev. Bank of Iran	292	776	37.55	37	4.79
Bank Sepah	233	9,821	2.37	75	0.76

Note: ¹Data for Bank Saderat Iran are for March 2003; data for Bank of Industry and Mine, and Bank Parsian are for March 2005.

Source: *The Banker*

It is hoped that the establishment of private banks will be accompanied by improved banking supervision. Although this has been slow, the central bank has started to reorganise the internal supervision structure, dividing the Banking Supervision Department into two sections: one to handle bank reporting practices and the other to handle banking regulation. However, the restructuring of public banks has been slow, with only modest increases in their capital base. In addition, there is a risk that loan portfolios will deteriorate further as banks continue to extend credit. According to the IMF, credit growth has already resulted in an increase in credit risk and a deterioration in prudential banking sector indicators. High inflation has kept the rate of return offered by mainstream banks negative or low in real terms, which has deterred savings but encouraged loans. Many of these have been offered on generous terms to state-owned companies and the *Bonyads*, whose ability to repay is doubtful. However, the exact extent of non-performing loans (NPLs) is unclear because of a lack of reliable information from the banks.

As with other reforms, changes in the banking sector are being limited by political developments. Although a number of international banks have expressed their interest in entering the Iranian market, this is not expected to happen in the short term. Opening up banking would be highly beneficial to the sector as well as the wider economy. Domestic banks remain inefficient, bureaucratic and loss-making; they are also dependent on the government's financial support. Parliament voted for a scaled-back version of the privatisation plan (i.e. less than 50%); the original plan envisaged the government maintaining a 30% stake in the privatised banks. Meanwhile, the strong control that the authorities have over the banking sector was

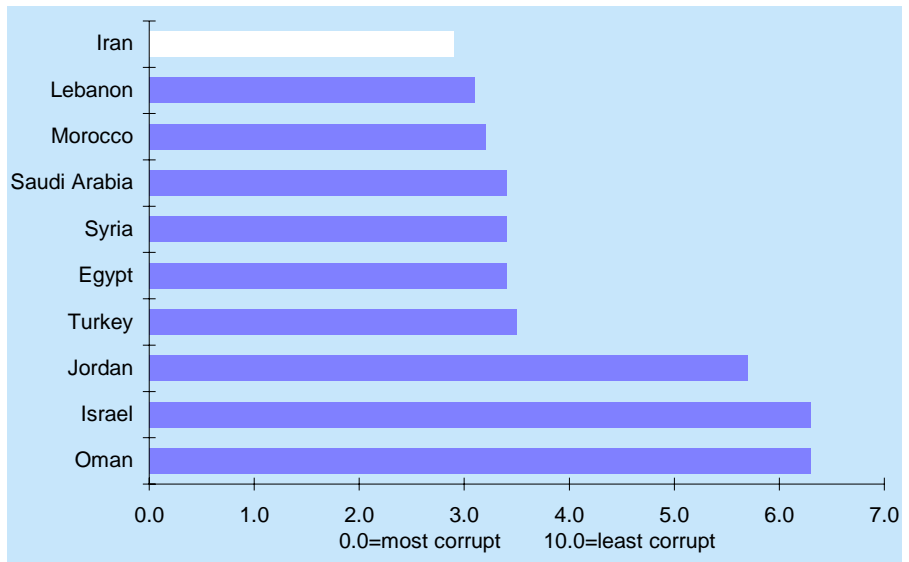
highlighted in May 2005 when the Currency and Credit Council set the lending rate that can be charged by state banks (private banks are unaffected) of 16% against a previous maximum of 25%. President Mahmoud Ahmadinejad has since advocated further reductions in lending rates. Lower rates would have to be accompanied by a drop in deposit rates if banks are to maintain their profitability. However, with inflation currently well into double figures, this would, in turn, mean that real deposit rates become negative thereby lowering the propensity to save. Meanwhile, Ahmadinejad has forced a number of heads of banks to resign, in particular those who do not agree with the government’s ideological outlook.

Corruption

The lack of clarity concerning the role of foreign companies in the economy, the dominant role played by the public sector and the bureaucratic nature of Iranian society create conditions that allow corruption to flourish. There are widespread suspicions that bribes are paid to obtain contracts or to persuade officials to set reasonable contractual terms. In particular, foreign companies have complained of corruption in the oil and gas sector. In addition, many bureaucrats supplement their low wages by demanding small bribes to facilitate processes such as the granting of licences or permits. Although the government is nominally committed to combating corruption, there is little evidence of action being taken. Occasional anti-corruption campaigns and the prosecution of officials for corrupt activities owe more to political manoeuvring than to any real attempt to stamp it out.

There have been some improvements in other areas of commercial risk. The anti-money laundering and combating financing of terrorism (AML/CFT) regulation for banks was approved in fiscal 2002/03. However, comprehensive legislation covering the entire financial sector is still awaiting parliamentary approval. In addition, there has been little progress made in improving the supervision of the insurance sector and the issuance of trading securities.

Chart 14
Corruption Perceptions for Selected Countries, 2005



Source: Transparency International, *Corruption Perceptions Index*, <http://www.transparency.org>

According to Transparency International, Iran scored just 2.9 in the 2005 *Corruption Perceptions Index* (where 0.0 indicates the highest level of perceived corruption and 10.0 the lowest). This was one of the weakest scores in the Middle East and put Iran in 88th place out of 159 countries surveyed, on a par with Armenia, India and Tanzania.

Other Commercial Risks

Iran is a member of the World Intellectual Property Organisation (WIPO) and a signatory to the Paris Convention, the Madrid Agreement and Madrid Protocol for Trademarks. Iran has not adhered to any of the international copyright conventions. Foreign applicants claiming priority registration overseas must provide a certified copy of the registration from abroad. Non-residents desiring to file patent and trademark applications in Iran must do so through an attorney or agent in residence in Iran. The attorney or agent must be given full power of attorney for that purpose. Applications must be prepared in Persian. Patent and trademark regulations are based on a 1931 law plus the 1958 implementing regulations. Patents and trademarks are administered by the Registration Office for Companies and Industrial Property while copyrights are administered by the Ministry of Culture and Islamic Guidance.

Patents: Invention patents are valid up to 20 years after application; addition or improvement patents are conterminous with foreign patents. To be patentable, an invention must be novel and capable of practical use in industry or agriculture. Except for import patents, prior publication in official publications or journals anywhere is prejudicial. Opposition period not specified. Revocation possible five years after grant if inadequately worked. No compulsory licensing provision. The licensing or assigning of patents must be registered to be effective.

Trademarks: Registrations valid ten years from application filing date, renewable for similar periods. First applicant is entitled to registration. Prior user claimant must contest it within three years. Applications made public for inspection. Allowed applications published for opposition within 30 days. Registration, if not used by registrant in Iran or abroad within three years of effective date, may be cancelled. The licensing or assigning of trademarks must be registered to be effective.

Copyrights: While there is no copyright law, the 1970 Law for the Protection of the Rights of Authors, Composers and Artists offers some protection of publications rights. Copyright protection is below the standard provided for in the Berne Copyright Convention.

Contractual Risk

The signing of a contract with an Iranian entity does not necessarily signify the conclusion of an agreement; indeed, it may be the signal for further rounds of negotiations. Iranian companies and individuals habitually attempt to continue negotiations even after signing a contract. This can lead to lengthy delays in the implementation of a contract. However, Iranians will honour existing contractual terms and there is little risk of contracts being totally disregarded.

Commercial Risk Outlook

High world oil prices and reduced debt levels have resulted in a more favourable payments environment. At the same time, however, conditions set by credit agencies have tightened over concern surrounding the nuclear issue and the associated deterioration in Iran's relations with the West. Unless the nuclear issue is resolved peacefully, the outlook for the commercial risk environment will remain dim. At the same time, although Iran hopes to attract greater foreign investment, reforms aimed at liberalising the commercial environment are likely to stall in the outlook period. This, together with a lack of reliable credit information, an antiquated banking system, high levels of bureaucracy and widespread corruption, makes Iran one of the most challenging commercial environments in the region.

Investment Environment

Key Point: The investment environment has worsened with the election of a new parliament in 2004 and a new president in June 2005. With Iran's relations with the West set to further deteriorate over the nuclear issue, the foreign investment environment is set to weaken over the forecast period.

Investment Overview

The government estimates that Iran needs to attract USD10 billion of investment annually over the medium term in order to modernise infrastructure. Strong investment will be particularly important in the hydrocarbons sector and will be crucial if the government is to meet its target of doubling oil production to eight million barrels a day by 2020. However, despite important moves to improve investment conditions, the government has yet to create an attractive environment for domestic or foreign investors.

After the conclusion of the Iran-Iraq war, the government succeeded in persuading some Iranian expatriates to invest in the country. However, much of this investment went on short-term projects. In addition, much of the Iranian expatriate community remains suspicious of the mullah-dominated regime. For both expatriate and resident Iranians there is also the challenge of finding suitable projects in which to invest. The tight control of most economic sectors by the government and *Bonyads* has led to a shortage of viable projects.

However, foreign investors have not ignored Iran. In the 1990s, the National Iranian Oil Company (NIOC) awarded a number of contracts to develop old and new oil fields. A new investment law was passed in 2002 and the tax regime was made more favourable. Nonetheless, all but the bravest investors remain wary. Apart from concerns over the nuclear issue, the investment environment remains difficult and considerable further reform will be required before Iran is seen as an attractive investment environment.

Capital Account Exchange Regulations

The regulations concerning the repatriation of capital, profits and dividends were governed by the archaic 1958 law on protecting and attracting foreign investment. The new foreign investment law passed in 2002 provides for the repatriation of profits in hard currency exchanged at the market rate. However, controls exist on most capital account transactions. In reality, the regulations are decided on a case-by-case basis by the central bank depending on the terms for the investment agreed by parliament, which are also considered on a case-by-case basis. The lack of a standard framework and the wide discretion given to officials has created confusion and greatly increased the risks associated with investing in Iran.

Foreign Direct Investment Environment

Previously, the 1955 Law on Attraction and Protection of Foreign Investment in Iran and the 1958 Law Concerning the Attraction and Protection of Foreign Investment regulated foreign investment in Iran. However, the government took a major step in attracting foreign direct investment (FDI) in November 1999 when it issued a decree amending the approval process for foreign investment projects and establishing the criteria on which they will be approved. The process had been bureaucratic and projects ultimately required presidential approval but this was the first time the procedures required for foreign investment to take place had been clearly set out. The amendment set an 80% limit for foreign equity participation, with the exception

of mineral and mining projects, where foreign ownership was limited to 49%. The government retained the right to override these limits in exceptional cases.

Further major reforms took place in 2002, when the Foreign Investment Promotion and Protection Act (FIPPA) was adopted. After a long debate and rejection by the conservative Guardian Council, the Expediency Council finally resolved the issue. Foreign investors are permitted to invest in any sector open to domestic investors. The government will continue to screen all investments. In addressing the issue of foreign domination, foreign investment is limited to a ceiling of 25% of market share by economic sector and a cap of 35% of individual industries. However, there is no limitation on investments designed for the export market. Under the new law, nationalisation or expropriation of investments are to be reimbursed at fair market value. Repatriation of profits is to be permitted in hard currencies. Applications are to be reviewed and processed within 15 days. In September 2004 parliament reinforced the constitutionally mandated requirement that it approve all investment agreements with majority-owned foreign companies in the fields of power generation, postal services, and telephony.

The majority of investment in Iran has been directed at the modernisation of the oil and gas industry as well as petrochemical projects. More than USD10 billion of investment has gone into the oil and gas sectors on a buy-back basis, a system devised to ensure compliance with Islamic principles. Under it, a foreign company can invest money and develop a field normally to a point where it is ready to begin production. In exchange, the foreign company receives a guaranteed rate of return (usually 15-18%) out of the proceeds of the sale from the field. This system is adequate for smaller, low-risk projects (usually up to five years), but is unsuitable for larger fields, and longer and higher-risk projects. Investing foreign companies have no reward if a field produces above expectation. In addition, foreign companies that successfully execute an exploration phase then have to bid for the development of the field.

Parliament passed a further foreign investment law in 2002. However, it was diluted by the clerics and the measures fell short of the requirements needed by foreign investors. Under the new law:

- foreign investment is allowed in all sectors that are open to domestic companies;
- Iranian expatriates are defined as foreign investors if their capital is from abroad;
- profits (from both domestic activities and exports) can be repatriated in hard currency exchanged at the market rate for the rial;
- fair compensation is offered at market value in the event of nationalisation; and
- processing investment applications take a maximum of 45 days.

However, the investment environment has deteriorated with the election of the conservative-dominated parliament in February 2004 and Mahmoud Ahmadinejad as president in June 2005. In the second half of 2004, parliament voted against giving oil exploration companies the right to exploit their discoveries. Currently, successful exploration companies have to enter a state-run tender to develop their discoveries, with no guarantee of success. This will hinder Iran's plans to modernise production and double crude oil production capacity to eight million barrels per day (bpd) by 2020.

Although investment legislation adopted over recent years has been an important step in attracting FDI especially outside the oil, gas and petrochemical sectors, greater reform of the investment environment is needed. Foreign companies still face risks stemming from the poor application of the law, especially in times of dispute. The Iranian legal system does not contain sufficient expertise to deal with modern business practices and commercial disputes. Continuing suspicion of foreign

investment also increases the risk that foreign companies will not obtain a fair hearing in court.

In December 2004 Iran signed double taxation avoidance agreements with France, Germany, Spain and the Philippines. In November 1998, Iran and Georgia signed an agreement on the avoidance of double taxation. Iran has finalised but not yet signed double taxation agreements with Italy and Pakistan. South Korea and Iran have been holding discussions on implementing a double taxation agreement. Iran joined the Multilateral Investment Guarantee Agency (MIGA) Convention in December 2003.

Major Investment Projects

In October 2004, Iran and China signed a memorandum of understanding to award the project to develop 51% of the Yadavaran oil field to China's Sinopec. In return, Sinopec has agreed to purchase 10 million tonnes of liquefied natural gas (LNG) a year from 2009 for 25 years. Iran has also agreed to sell as much as 150,000 barrels per day of crude oil to China at market price over a period of 25 years once Yadavaran is fully operational. The value of the deal is estimated at over USD70 billion.

Iran signed a US\$40 billion deal to export liquefied natural gas (LNG) to India in January 2005. Iran will supply India with 5 million tonnes of LNG annually over a 25 year period from 2009. India's Oil and Natural Gas Corp's overseas arm has entered into an agreement with the National Iranian Oil Company to develop 20% of Iran's Yadavaran oilfields and an unspecified stake in the Jufeyr field. However, a proposed deal between Petropars of Iran and the Indian Oil Corporation to plough USD3-4 billion into the construction of a natural gas liquefaction plant in Iran is still awaiting approval from Tehran. Elsewhere, Iran and India are hoping to sign a USD7 billion deal this year which will see Iran export natural gas to India through a new pipeline running via Pakistan. It is hoped that construction of the line will begin in 2007 and will be completed in 2011 despite strong opposition from the US. Meanwhile, in January 2006 the Indian government denied reports that it was considering pulling out of the project.

Investment Incentives

Compared to other countries in the Middle East, Iran offers few incentives to foreign investors. However, in October 1998, parliament approved a series of investment safeguards for foreign investment in free-trade zones (FTZs). Iran maintains the following zones: Anzali Free Zone, Aras Free Zone, Arvand Free Zone, Chabahar Free Zone, Jolfta Free Zone, Kish Free Zone, and Qeshm Free Zone. Iran has also developed 14 Special Economic Zones (SEZs) to facilitate trade with the Central Asian and Caucasian states as well as southern parts of the Persian Gulf. SEZs are located mainly in the boarder regions with strategic connections for road, rail and air transportation. Incentives are offered for establishing operations in these zones.

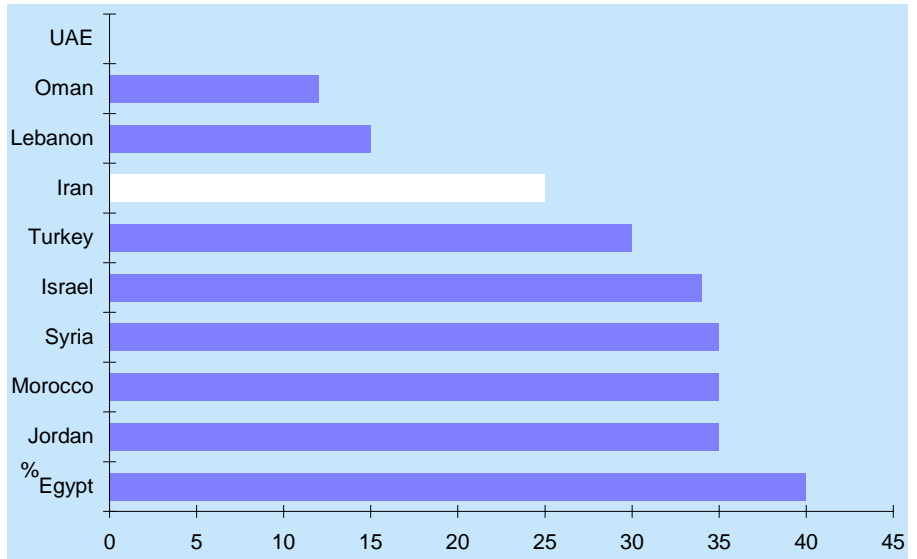
The FTZ law sets out generous provisions for foreign companies that establish a presence in the zones. These include a 15-year tax holiday, low customs duties, full rights to repatriate profits and dividends, and strong investment protection. Companies are also spared much of the bureaucracy and regulations that beset the business environment in Iran: there is no limit to the extent of foreign ownership and no restrictions on foreign currency transactions. Foreign companies operating in the Qeshm Free Zone also gain access to subsidised gas supplies from the Gavazrin field.

The government can experiment with a more liberal business environment in the FTZs without invoking the wrath of more conservative political elements. However, the FTZs have faced a number of problems and have failed to attract substantial levels of FDI. Rather than boosting exports, the zones have sucked in imports. In addition, there has been a problem with corruption, including at senior levels.

Taxation

Most imports are subject to the commercial benefit tax, which is either specific or ad valorem and is imposed in addition to any applicable customs duties. Monopoly taxes, if any, are included in the commercial benefit tax. The rate of the commercial benefit tax is specified each year in the export-import regulations. These taxes are paid to customs before customs clearance. There is a 2% sales tax on all goods to benefit the health and education ministries. Draft legislation proposing the introduction of a value added tax (VAT) was approved by parliament in April 2005. Although it is unclear when the tax may be introduced, it will probably be at a rate of 7%. Municipal tax, port tax, health tax, excise tax and portage are collected in addition to customs duties and the commercial benefit tax.

Chart 15
Corporate Tax Rates in Selected Countries, 2006



Sources: Heritage Foundation, *Index of Economic Freedom*; D&B

The government approved a new tax law in 2002 (effective from March 2002). A flat tax rate of 25% was introduced on the net (or taxable) income of all companies; whether foreign, domestic or government-owned. Previously, the tax burden of investors could reach up to 60%. Despite this reduction, the tax environment in Iran remains extremely hazardous for foreign companies. In particular, the system for assessing tax liabilities is arbitrary, thereby creating inaccuracy and corruption. Under the new law, *Bonyads* have to pay tax for the first time. The top income tax rate in Iran is 35%.

Company Organisation

There is no ceiling on foreign participation in export-producing industries. However, there is a limit on foreign ownership of 25% in agriculture and tourism and 35% for individual industries servicing the domestic market. The vast majority of foreign companies operating in Iran do so through a branch office, which is the least complicated means of establishing a presence in the country (representative or liaison offices are treated as branch offices). Investing equity in a joint venture necessitates complicated lobbying and is a high-risk strategy.

Portfolio Investment

Stock Market

The Tehran Stock Exchange (TSE) has grown rapidly since its launch in 1989 but is plagued by a lack of transparency and suffers from a low level of capitalisation (an

estimated 20.2% of GDP in 2005) and low price-earnings ratio. In 1999, the TSE announced new rules to prevent insider trading, including closer scrutiny of transactions, stiffer penalties for those found guilty of insider trading and measures to ensure equal access to information on listed companies. Meanwhile, legislation passed in June 2005 allows foreigners to participate on the TSE. However, foreign investors can only purchase up to 10% of a listed company and cannot withdraw their main capital and any capital gain for three years from the initial investment. More recently, according to a new Iranian Capital Market Law adopted by parliament in November 2005 the TSE will be restructured. Under the legislation, the TSE, the over-the-counter (OTC) and commodity markets will be self-regulatory, supervision and operation of the TSE will be separated, the primary market will be more regulated and a Central Depository System will be established.

However, the TSE's regulatory framework still falls short of international norms and listed companies frequently flout the regulations regarding regular publication of accounts and other price sensitive information. Those accounts that are issued do not have to adhere to international accounting standards. A few institutions and individuals dominate the market, stocks are highly concentrated and there is a lack of experienced brokers and reliable investment houses, as well as delays in settling transactions. Meanwhile, in November 2005 the head of the TSE Hussein Abdoh Tabrizi resigned. Tabrizi was widely credited with improving operations at the TSE and, although it is only speculation, his departure may have been forced by Ahmadinejad after Tabrizi had criticised his alleged lack of knowledge of stock market operations. Against this background, the benefits that could derive from the capital market in terms of increasing access to investment funds are unlikely to materialise in the near future.

Table 11

Stock Market Profile, Year-End¹

	2002	2003	2004	2005
Market capitalisation (IRR bn)	117,773	309,696	387,547	352,116
TEPIX All-Share Index (1990=100)	5,063	11,379	12,113	10,255
Turnover (IRR bn)	15,262	42,630	104,708	69,982
Number of listed companies	334	370	422	420

Note: ¹Data for 2005 are for 28 December.

Sources: Central Bank of Iran, *Economic Trends*; Mondovisione, *The Handbook of World Stock, Derivative and Commodity Exchanges*; Reuters

Bonds

The bond market is underdeveloped (see **Debt**) and is closed to foreign participation. The market does not act as a major source of finance, either for the government or for corporations.

Additional Sources of Information

Iran Chamber of Commerce

Industries and Mines
254 Taleghani Avenue
P.O. Box 15875-4671
Tehran
Tel: (98) (21) 883 0066
Fax: (98) (21) 882 5111
<http://www.iccim.org>

Ministry of Economic and Finance Affairs

Soresrafil Street
m Bab Homayoun Street
Tehran
Tel: (98) (21) 391 1163
Fax: (98) (21) 390 0528

Ministry of Industry

86 Shahid Kalantari Street
P.O. Box 15745 886
Tehran
Tel: (98) (21) 8801772
Fax: (98) (21) 8893450

Central Bank of Iran (Bank Markazi)

Mirdamad Boulevard
No. 144
Tehran
Tel: (98) (21) 29951
<http://www.cbi.ir>

Ministry of Foreign Affairs

Ebn e Sina Street
Eman Khomeini SQ
Tehran
Tel: (98) (21) 3211
Fax: (98) (21) 311 3149
<http://www.mfa.gov.ir>

Iranian Trade Association

P.O. Box 927743
San Diego
CA 92192
United States
Tel: (858) 586 0560
Fax: (858) 547 0823
<http://www.iraniantrade.org>

Note: All correspondence with an Iranian government department or institution must be copied to the Director-General, International Agencies Affairs, Ministry of Foreign Affairs.

Credit Information

D&B provides information relating to over 10million companies worldwide. Visit www.dnb.com for details. Additional information relevant to country risk can also be found in the following services:

International Risk & Payment Review: Provides timely and concise economic, political and commercial information and analysis on 132 countries. Available as a subscription-based Internet service (www.dnbcountryrisk.com) and monthly update journal, the IRPR carries essential information on payment terms and delays. It also includes the unique D&B Country Risk Indicator to help monitor changing market conditions.

Exporters' Encyclopaedia: Information on 220 world markets to help customers decide where they can safely and profitably do business. Data provided include key contacts, transportation information, legislation affecting export commerce and tips on foreign business travel. Published annually in August plus ad hoc updates. English language edition.

Country Risk Indicator Definition

D&B's Country Risk Indicator provides a comparative, cross-border assessment of the risk of doing business in a country. The indicator seeks to encapsulate the risk that country-wide factors pose to the predictability of export payments and investment returns over a time horizon of two years. The risk indicator comprises a composite index of four over-arching country risk categories:

<i>Political risk -</i>	internal and external security situation, policy competency and consistency, and other such factors that determine whether a country fosters an enabling business environment;
<i>Macroeconomic risk -</i>	the inflation rate, government balance, money supply growth and all such macroeconomic factors that determine whether a country is able to deliver sustainable economic growth and a commensurate expansion in business opportunities;
<i>External economic risk -</i>	the current account balance, capital flows, foreign exchange reserves, size of external debt and all such factors that determine whether a country can generate enough foreign exchange to meet its trade and foreign investment liabilities;
<i>Commercial risk -</i>	the sanctity of contract, judicial competence, regulatory transparency, degree of systemic corruption, and other such factors that determine whether the business environment facilitates the conduct of commercial transactions.

The DB risk indicator is divided into seven bands, ranging from DB1 through DB7. Each band is subdivided into quartiles (*a-d*), with an *a* designation representing slightly less risk than a *b* designation and so on. Only the DB7 indicator is not divided into quartiles.

Indicator Meaning Explanation

DB1	Lowest risk	Lowest degree of uncertainty associated with expected returns, such as export payments, and foreign debt and equity servicing.
DB2	Low risk	Low degree of uncertainty associated with expected returns. However, country-wide factors may result in higher volatility of returns at a future date.
DB3	Slight risk	Enough uncertainty over expected returns to warrant close monitoring of country risk. Customers should actively manage their risk exposures.
DB4	Moderate risk	Significant uncertainty over expected returns. Risk-averse customers are advised to protect against potential losses.
DB5	High risk	Considerable uncertainty associated with expected returns. Businesses are advised to limit their exposure and/or select high-return transactions only.
DB6	Very high risk	Expected returns subject to large degree of volatility. A very high expected return is required to compensate for the additional risk or the cost of hedging such risk.
DB7	Highest risk	Returns are almost impossible to predict with any accuracy. Business infrastructure has, in effect, broken down.