

# chapter 1 Political Outlook

## BMI Core Scenario

Hardline conservative Mahmoud Ahmadinejad has succeeded reformist Mohammad Khatami as president, completing the recapture by conservative forces of all the key positions of power, including the Guardian Council (GC), the Judiciary, the Expediency Council and the country's parliament (Majlis). Ultimate power remains in the hands of Supreme Leader Ayatollah Khamanei, who will continue to dictate policy on key issues, such as foreign relations and the nuclear programme. With the reformists now excluded from the means of peaceful reform, there are significant risks that some of those seeking to change the system could turn to violence.

## SWOT Analysis

### Strengths

- Since the overthrow of the Pahlavi family in the 1970s there has been some reduction in the level of political corruption (although the Supreme Leader undeniably controls much of the oil economy), and wealth distribution has improved marginally.
- In spite of allegations of widespread electoral irregularities, Ahmadinejad's resounding victory on a social justice and anti-corruption platform was the result of genuine popular support.

### Weaknesses

- The Republic has one of the poorest human rights records in the region and the authorities do not hesitate to quell dissidents. A number of journalists are being held in custody.
- The decision-making process remains wholly in the hands of the Judiciary and GC, who are appointed by the Supreme Leader.

### Opportunities

- Ahmadinejad's reputation as an incorruptible who maintained a simple lifestyle while mayor of Tehran suggests that he will work hard to fulfil campaign promises to fight corruption.

### Threats

- Iran is determined to play a major role in Iraq and will continue to offer material support to Shia politicians. There is a risk that this will destabilise the situation further.
- The government's obfuscation regarding its nuclear ambitions remains a key concern. The topic will dominate international relations over the medium term and, possibly, result in a US or Israeli military attack.

*The economic outlook remains healthy, with the economy expected to expand by over 5% throughout the forecast period. **BMI View:** The future health of the economy depends to a great extent on the direction pursued by the new president. Risks are high that Ahmadinejad will loosen fiscal and monetary policy, boosting activity in the short term but also fuelling dangerous levels of inflation.*

*Campaign promises and post-election statements from those close to the new president have raised fears of looser fiscal and monetary policy. **BMI View:** We expect economic growth of 5.4% in 2005, 5.2% in 2006 and 5.1% in 2007, with expectations of expansionary policy measures posing some upside risks.*

## Introduction

### Short-Term Boost, Long-Term Damage?

The economy expanded by a slightly disappointing 4.8% in 2004, down from 6.7% in 2003 and lower than most forecasts, owing primarily to lacklustre growth of only 3% in the final quarter of the year. We forecast steady growth of over 5% throughout the forecast period, with 5.4% in 2005, 5.2% in 2006 and 5.1% in 2007. The possibility that Ahmadinejad will pursue fiercely expansionary fiscal and monetary policies presents some upside risks to these forecasts, although such policies would be damaging to growth in the medium term because of their inflationary effect.

Sky-high oil prices fuelled surging growth of exports in 2004, which outpaced strong import growth to create a large trade and current account surplus. Ongoing high oil prices and plentiful export revenues will keep the current account in comfortable surplus until 2007, when it will dip into deficit. Hydrocarbon revenues will therefore continue to mask the structural deterioration of the trade balance over the forecast period, which will be abruptly exposed when oil prices eventually fall. Non-oil exports have been growing steadily but still only cover one-fifth of total imports and, as such, are not sufficient to reduce the vulnerability of the current account to fluctuations in the oil price.

We have revised our oil price expectations upwards so that our forecasts for average OPEC basket prices now stand at US\$48.5/bbl for 2005, US\$45/bbl for 2006 and US\$40/bbl for 2007. Our forecasts for government revenue have therefore also increased but we do not expect to see an improvement in the budget balance because we anticipate the extra revenue to encourage further expenditure growth. For example, despite a 27% increase in the oil price in 2004, the budget deficit increased, to over 4% of GDP. Broad economic pledges but few detailed proposals during the campaign have engendered much confusion about the new president's fiscal policy intentions. On balance however, risks to expenditure are weighted to the upside, in view of the weight of political expectation created by his election commitments to redistribute wealth and improve the economic situation of poor Iranians.

## Economic Activity

### Expansionary Policy To Fuel Inflation?

Growth will remain high at more than 5% over the next three years, after the economy expanded at a somewhat disappointing 4.8% in 2004. Oil production volumes will plateau and then decline over the forecast period but expansionary fiscal policy and robust private sector activity will continue to boost growth. The expansionary fiscal stance will be financed primarily by high oil revenues but also by borrowing, if the new president pursues an even more extravagant expenditure programme than that outlined by his predecessor. However, higher spending, and the possibility of looser monetary policy, could lead to spiralling inflation, which would be very damaging in the medium term.

According to data recently released from the Central Bank of Iran, the economy grew by 4.8% in 2004/05, which, while still fairly robust, is down from 7.5% in 2002/03 and 6.7% in 2003/04. The figure is also lower than was generally expected, following particularly limp growth in the final quarter of the year. Deepening recession in the construction sector, together with weaker expansion in the oil industry and agriculture, was largely responsible for the drop down from the 2003/04 growth rate. Once again, lively private consumption growth (at 8.6%) outstripped very lacklustre public consumption growth of just 1.3%, continuing a trend visible since 2001, which suggests that robust private sector activity is reducing the importance of the fiscal stimulus in sustaining economic expansion. The news that manufacturing growth in 2004 had remained at a very healthy 11.9%, following 11.9% in 2003 and 11% in 2002, was also encouraging, and presented further evidence that the limited structural reforms implemented by the outgoing government of President Khatami are beginning to bear fruit.

We currently expect healthy growth of over 5% to continue over the forecast period, with 5.4% in 2005, 5.2% in 2006 and 5.1% in 2007. However, we will be keeping a close eye on quarterly data as they are released, in case the 3% growth in Q4/05 proves to be the beginning of a weakening trend rather than an aberration. In spite of soaring prices, the oil sector will have a neutral or negative direct impact on overall growth because oil production will remain constant in 2005 before dropping slightly in 2006 and remaining at that level in 2007. However, while the upward revision of our oil price forecasts does not directly influence our GDP forecasts, the consequent increase in government revenue, and the close historical correlation between revenue growth and expenditure growth, suggest that the anticipated oil price rises will fuel expansionary fiscal policy even further, thereby boosting growth.

## Government Policy Poses Risks To Stability

The election of Ahmadinejad on a populist economic platform has raised expectations of highly expansionary fiscal and monetary policy. Vague and sometimes contradictory pledges have created a great deal of uncertainty around future fiscal policy, although the new president is very likely to at least maintain current high levels of spending. Furthermore, the weight of expectation created by extravagant election pledges is likely to force Ahmadinejad's government to increase expenditure beyond the levels envisaged in the Fourth Five-Year Development Plan (FFYDP), which Ahmadinejad has pledged to implement. Higher levels of spending would become even more likely, if oil prices were to rise beyond our current forecasts, enabling the government to spend more without increasing the budget deficit.

*The new president looks likely to increase spending and lower interest rates. **BMI View:** Such expansionary, and inflationary, policies would fuel growth in the short term but ultimately endanger stability and growth.*

ECONOMIC ACTIVITY								
GDP	2000	2001	2002e	2003e	2004e	2005f	2006f	2007f
Nominal GDP (IRRbn)	576,493.1	664,620.0	916,465.0	1,095,717.0	1,382,608.0	1,683,538.8	2,045,226.4	2,504,849.1
Nominal GDP (US\$bn)	59.7	83.1	114.8	138.3	175.5	217.2	213.0	238.6
Nominal GDP growth (%)	32.7	15.3	37.9	19.6	26.2	21.8	21.5	22.5
Real GDP growth (%)	5.0	3.3	7.5	6.7	4.8	5.4	5.2	5.1

*e/f = BMI estimates/forecasts. Source: IMF/ Central Bank of Iran/ BMI*

In addition, the loosening of monetary policy looks increasingly probable, in the wake of announcements made by those close to Ahmadinejad. At a press conference on the new president's economic policies, Majlis member Mohammad Khoskchereh stated 'we will definitely reduce lending rates to support production and bolster the economy'. This combined fiscal and monetary boost does pose some upside risks to our economic expansion forecasts in the short term. However, with inflation already running at over 15%, such policies could fuel more rapid price rises and even induce an inflationary spiral, which would be very damaging to growth prospects.

## Fiscal Policy

### Oil To Boost Revenues

We have revised our forecasts for government revenue in the wake of changes to our oil price assumptions. We now anticipate average OPEC basket prices of US\$48.5/bbl for 2005, US\$45/bbl for 2006 and US\$40/bbl for 2007. However, as we saw in 2004, high oil prices do not guarantee an improvement in the fiscal position, owing to the very close correlation between revenue growth and expenditure growth. For example, when revenues soared by 89% in 2003, expenditure saw a similar 85% increase. We have therefore raised our expenditure forecasts accordingly and expect the budget deficit to continue to increase, reaching IRR95trn, or the equivalent 4.67% of GDP, in 2007.

This does not give immediate cause for concern because Iran currently holds little debt and could comfortably finance a deficit for a short period of time. Nonetheless, such procyclical policy, with generous levels of government spending when private sector growth is high, resulting in large deficits even when revenues are strong, reduces the capacity of future governments to use spending to cushion future shocks to oil prices and growth. Furthermore, the tendency of successive governments to spend oil revenues immediately represents a persistent failure to save part of Iran's finite oil wealth for future generations, which will hurt economic activity in the very long term.

We have revised our oil price forecasts upwards to US\$48.5/bbl in 2005, US\$45/bbl in 2006 and US\$40/bbl in 2007. **BMI View:** While higher oil prices will boost revenues, the budget balance will continue to deteriorate as expenditure rises to match income growth.

TAX REVENUES								
IRR bn	1381				1382			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Corporate Tax	2999.9	4173.0	3935.1	3650.4	3425	6271	4435.3	6244.5
Income Tax	2259.2	1926.4	1957.4	2104.6	2157.4	2384.9	2181.3	2284.6
Wealth Tax	701.0	601.8	571.5	773.0	594.3	655.6	651.5	748.4
Import Tax	2998.5	3750.8	4180.9	5468.1	3682.1	5097.1	5564.6	8057.1
Tax on Goods and Services	966.0	2063.7	2810.5	2250.0	955.3	1347	1721	6641.1
Total	9924.6	12515.7	13455.4	14246.1	10814.1	15755.6	14553.7	23975.7

Source: Central Bank of Iran