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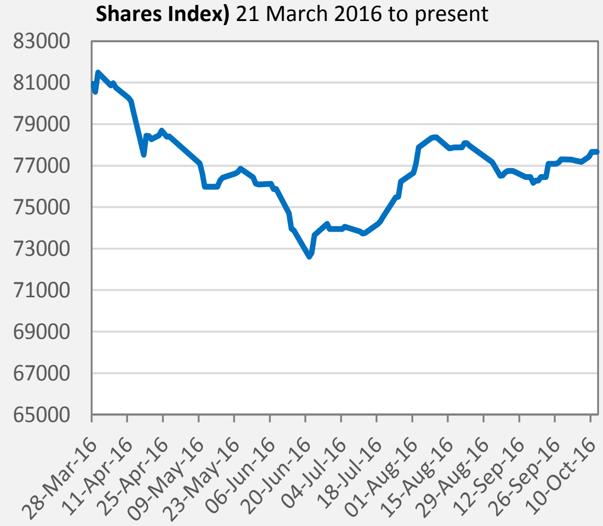
Challenges at home and abroad shape Rouhani's case for re-election

President Rouhani and his team are engaged in a charm-offensive overseas to build banking relations and a fierce battle at home to secure meaningful economic reforms. At home at least, there have been some significant policy wins with the International Petroleum Contract finally settled and momentum towards the unification of Iran's dual exchange rate and the creation of a sovereign bond market. The Rouhani administration will welcome the economic boost in this election year.

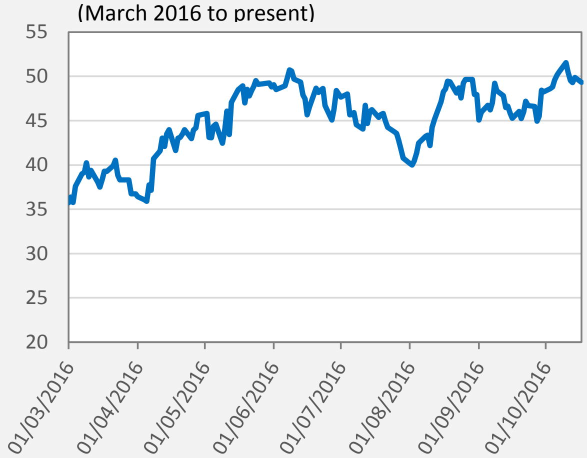
With the passing of a series of important milestones, international investors are encouraged by the gradual normalisation of Iran's role in the international community. Iran joined the P5+1 in New York for the first post-JCPOA ministerial meeting and also took its seat for the first time at the World Nuclear Association meeting in London in September. Meanwhile, President Rouhani used his platform at the first United Nations General Assembly since the signing of the JCPOA to seek international sympathy for the lack of progress in the United States and Europe to honour the spirit of the nuclear deal by facilitating Iran's reintegration into the international banking system. In the side-lines, the Iranian President met with the British, French, Italian and Japanese Premiers to press for greater assurances about strengthening banking relations.

Fig 1. Tehran Stock exchange (TEDPIX All Shares Index) 21 March 2016 to present



Back in Tehran, the government kicked off next year's budget process and set out the challenging reform agenda for the final year of Rouhani's first Presidential term. Central to the budget plan is the creation of a sovereign bond market; a welcome move that will have repercussions for government finances and the financial sector. Like in many major oil producing economies, Iranian government revenues are highly exposed to fluctuations in the oil price. The Finance Ministry has been in negotiations with international ratings agencies in recent months – which withdrew their junk ratings for Iranian bonds almost a decade ago – and is confident that it can capture international demand. The bond market would provide a valuable third source of income for the state and could provide a fillip to the country's infrastructure investment programme. A functional bond market

Fig 2. Brent Crude Oil Price $/barrel
(March 2016 to present)

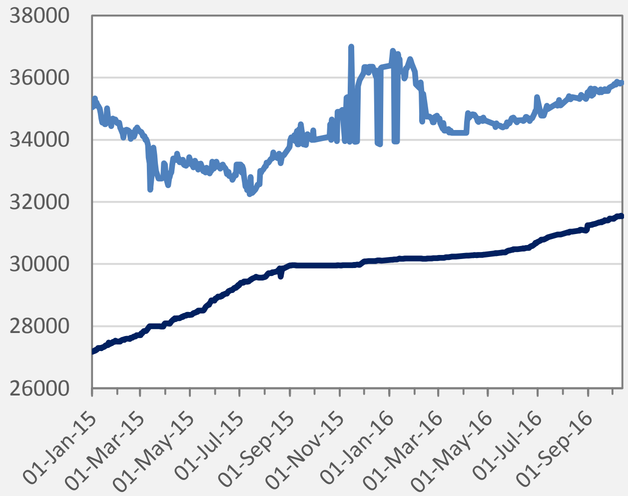


would also free up the burden of public sector debt on the banking sector. The government owes over 170 trillion tomans (US$55 billion) to the banking system. Reducing that burden would free up bank lending, which could potentially stoke demand in this election year.

The Iran Petroleum Contract (IPC), Iran's new oil contract model, was finally signed off by the Majles. There were times when the legal disputes surrounding the legitimacy of the contract seemed they would never end. But the first Heads of Agreement deal was signed between the National Iranian Oil Company (NIOC) and the Persia Oil and Gas Industry Development Company (POGIDC) at the start of October. The deal will increase daily crude output in oil fields in Yaran and Kupal from 185 to 260 thousand barrels per day; requiring US$2.2 billion of investment. A NIOC spokesman also announced this month that Iran was in negotiations with 16 international energy companies to help operate and manage 50 oil and gas projects around the country. The projects are claimed to be viable at US$40 per barrel and will require an estimated US$10 billion to add 600,000 barrels a day to output.

Fig. 3 Iranian Rial to USD, dual exchange rates

1 January 2015 to present



Meanwhile the Males Research Centre announced an uplift in GDP growth expectations, driven by the faster than expected growth in oil output. Growth forecasts for 1396 (the year to March 2017) have risen to 6.6%. The IMF also upgraded its forecast to a less optimistic 4.5% for next year but assessed that the growth dividend from the lifting of sanctions is materializing only gradually, with investors cautious and both reintegration into global financial markets and domestic reforms proceeding slowly. The Central Bank of Iran reported the 12 month inflation rate to have fallen to 8.9% in September, and the IMF forecast a fall to 7.2% in 2017. In its latest report on household finances, the Central Bank claimed that after years of shortfalls in household budgets, average household spend came in below average annual income this year, suggesting some degree of improvement in living conditions.

Iran's dual exchange rates will be unified within the next two or three months, according to the Economy Minister, who stated that the current system "paves the way for corruption". In his announcement he outlined that banks will be able to purchase their customer's foreign currencies at open market rates. This builds on incremental policy changes in recent months allowing banks to open letters of credit in foreign currencies at open-market rates and enabling banks to trade in the parallel open market.

Economy Minister Tayebnia also defended Iran's engagement with the Financial Action Task Force (FATF) in front of an open session of Parliament. He noted the legacy of past administrations that had themselves passed laws against money laundering. The FATF principles are in keeping with an approach to cut off the financial

What is the Iranian Petroleum Contract?

The new Iranian Petroleum Contract is essentially a combination of Iran's traditional upstream "Buy-Back" contracts and a more internationally standard "Production Sharing" contract. The lack of international demand for the buy-back contracts, driven in part by the low dividend share for the operator, led the Iranian authorities to redesign the deal following sanctions relief.

The new contracts last longer, have better cost-recovery features and offer international partners a greater say in the development of oil fields, making investments more profitable. In return, international firms must partner with NIOC or a local designated entity in a joint venture arrangement and must use locally sourced parts when available.

arteries of smuggling, tax evasion, financial corruption and other illegal economic activities which are damaging to the Iranian economy. The minister claimed that smuggling accounts for US$15billion of trade annually and undercuts domestic production.