

# Banking Crisis: A Roadmap For Stability and Reform

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## INTRODUCTION

Iran's banking system is facing a confluence of challenges that collectively threaten the stability of the nation's financial system. Since the end of the Iran-Iraq War, liquidity (M2) and money supply have ballooned at an average rate of 27.5% per year, significantly contributing to an average annual inflation rate of 21%. These issues are rooted in decades of economic mismanagement by the Islamic Republic, its lack of fiscal discipline, and the effective elimination of the Central Bank of Iran's (CBI) independence, making the CBI incapable of performing its tasks and essentially transforming it to the fiscal arm of the government. Systemic corruption and connected lending have further exacerbated the dire condition of the banking system, resulting in a substantial build-up of non-cash flow generating assets, a significant rise in non-performing loans, and massive rollover losses. As a result, these issues have brought the entire banking system to the precipice of a full-fledged crisis.

Structural and fundamental reforms are desperately needed for Iran's banking system. However, as we discuss later, while Islamic Republic authorities appeared to have understood the necessity of these reforms, these policies were never completely implemented and the situation has deteriorated over time, especially during Ebrahim Raisi's time in office (2021-2024).

With the collapse of the Islamic Republic, there is a meaningful opportunity to implement structural reforms in the banking system. However, the collapse of the current regime will also present several risks and challenges that need to be carefully considered, especially given the current fragility of the banking system. Therefore, all policies aimed at revitalizing the banking system must be grounded in established economics and banking research and aligned with global best practices. This approach ensures the stability of Iran's financial market and the predictability of its economy. We strongly suggest avoiding any convoluted and untested policies, as the Iranian economy does not have the capacity to withstand another major shock.

In the short run, the risks immediately after the collapse of the Islamic Republic include:

- **BANK RUN:** This is a significant risk in the short-term, especially given the current bankrupt state of Iran's banking system. It is important to emphasize that in the early days after the regime change, a run on any individual bank would not be confined to that bank itself, but will likely trigger a domino effect across the entire banking sector. The primary mechanism to prevent bank runs is deposit insurance. It may be necessary for the CBI at that time to expand the current coverage of deposit insurance. The transition government could also implement more active policies such as forced banking holidays or deposit withdrawal freezes.
- **CAPITAL FLIGHT:** The inevitable significant rise in uncertainty and risk in the country following the Islamic Republic's collapse could lead to substantial capital outflows. Ex-officials of the Islamic Republic, wealthy investors, households, and businesses may attempt to move their capital out of the country. This can lead to a more rapid depreciation in the value of the Rial, leading to a vicious cycle of currency devaluation and higher inflation, potentially pulling the economy into a deep recession. To counter this, the transition government must impose and enforce limits on bank withdrawals, foreign currency transactions by individuals and firms, and transactions within banks' networks that include their foreign branches. Restrictions on the fire sale of company assets or ownership should also be considered.
- **CURRENCY DEPRECIATION:** The Rial is almost certain to depreciate immediately after the regime change due to heightened uncertainty and political risk. In Iran, inflation expectation is anchored to the exchange rate, so a free fall in the currency's value poses a serious threat. Therefore, given that the ultimate objective is to have a floating exchange rate system, in the early days of the regime change, the transition government should manage this risk by sending credible signals to the market that Iran will be removed from the FATF blacklist and that international sanctions will be lifted. Imposing limits on foreign currency transactions, as described above, would also help manage this risk.
- Other recommended short-term policies include engaging in talks with the FATF to remove the country from its blacklist; engaging in talks with the US and other western countries so that international sanctions are at least partially lifted; and begin efforts to

attract foreign direct investment. All of these steps would help with managing currency depreciation risk as well as mitigating the risk of bank run and capital flight.

In the long term, following the collapse of Islamic Republic, the main risk lies in mismanaging financial liberalization. This risk could jeopardize the country's path to economic growth and lead to a full-fledged financial crisis. The roots of this risk are in Iran's weak credit culture, institutional weakness, and inadequate monitoring and supervision, which could lead to excessive risk-taking by banks, creating a cycle of lending booms and busts. The financial crises in Mexico (1994-1995) and East Asia (1997-1998) serve as cautionary examples of such mismanagement. Therefore, the transition government and the CBI need to make some structural reforms in the banking system. For instance, improving the credit culture and enforcing compliance with the Basel framework through active monitoring are crucial steps. Other recommended longer-term policies include price liberalization, protecting the CBI's independence through law, adopting a floating exchange rate, and foreign trade facilitation.

## 1. CENTRAL BANK OF IRAN: INSTITUTIONAL BACKGROUND

### 1.1 Introduction

The Central Bank of Iran (CBI), also known as Bank-e-Markazi, plays a pivotal role in Iran's monetary and financial landscape. Established in 1960, the CBI's functions have evolved over the years, with significant changes occurring after the 1979 revolution. This section provides an overview of the CBI's institutional background, highlighting key developments in its role and responsibilities.

#### 1.1.1 Pre-Revolution Era

Before the 1979 revolution, the CBI primarily served as the issuer of currency and the government's banker. The expansion of economic activities in the 1960s and 1970s led to the rapid growth of Iran's banking sector, with numerous commercial and specialized banks operating by 1978. However, after the revolution, the nationalization of banks and industries, as detailed in the Banks Nationalization Act and the Law for Administration of the Banks, significantly reshaped the banking landscape. This transformation was accompanied by a contraction in economic activities, leading to extensive bank consolidation, ultimately reducing the number of banks to approximately a dozen and substantially weakening competition in the banking sector.

Iran's banking sector currently comprises 35 private and non-private banks [1], with a total debt of \$10.5 billion [2]. This diverse banking landscape reflects the complex financial ecosystem in which the CBI operates.

#### 1.1.2 Post-Revolution Changes

The post-revolution era witnessed fundamental changes in the structure and governing rules of the CBI. The departure of experts and policymakers from the CBI, along with changes in its governance structure impacted the banking sector's performance during this period. In 1983, Iran's banking rules were amended to adhere to the principles of usury-free Islamic finance, resulting in a non-interest-bearing banking system. [3].

The CBI's objectives, as outlined in the Second Monetary and Banking Act of 1972, encompassed maintaining the value of the currency, achieving equilibrium in the balance of payments, facilitating trade transactions, and supporting economic growth. Moreover, CBI monetary policy must be consistent with the five-year development plans and the government annual budget. To understand the challenges facing the Iranian banking and currency system, it is imperative to consider the evolution of monetary and fiscal policies during each presidential term since the 1979 revolution.

### 1.2. Evolution of Macroeconomic Policies in Iran (1979–2023)

This section provides a chronological overview of how Iran's macroeconomic policies have evolved during each presidential term post-revolution:

### *1.2.1 The Post-Revolution Period (1979-1988)*

Given Islamic Republic's anti-free market views, hostility towards the West, and insistence on independence from both West and East, along with the devastating war with Iraq, the first decade after the revolution saw a marked rise in government involvement in the economy and a decline in income levels. The per capita oil revenue plummeted, leading to a government budget deficit surpassing 50% of total expenditures. This period witnessed significant public debt accumulation due to war costs and subsidies.

### *1.2.2 Rafsanjani's Presidency (1989-1997)*

Rafsanjani initiated structural reforms, including price liberalization, exchange rate unification, industrial privatization, and stock exchange market relaunch. These reforms led to a brief period of economic growth. However, in 1995, major parts of his economic reform, price liberalization and unification of the exchange market, were reversed due to falling oil prices, maturing foreign debt, and new US sanctions that resulted in stagflation in the economy.

### *1.2.3 Khatami's Presidency (1997-2005)*

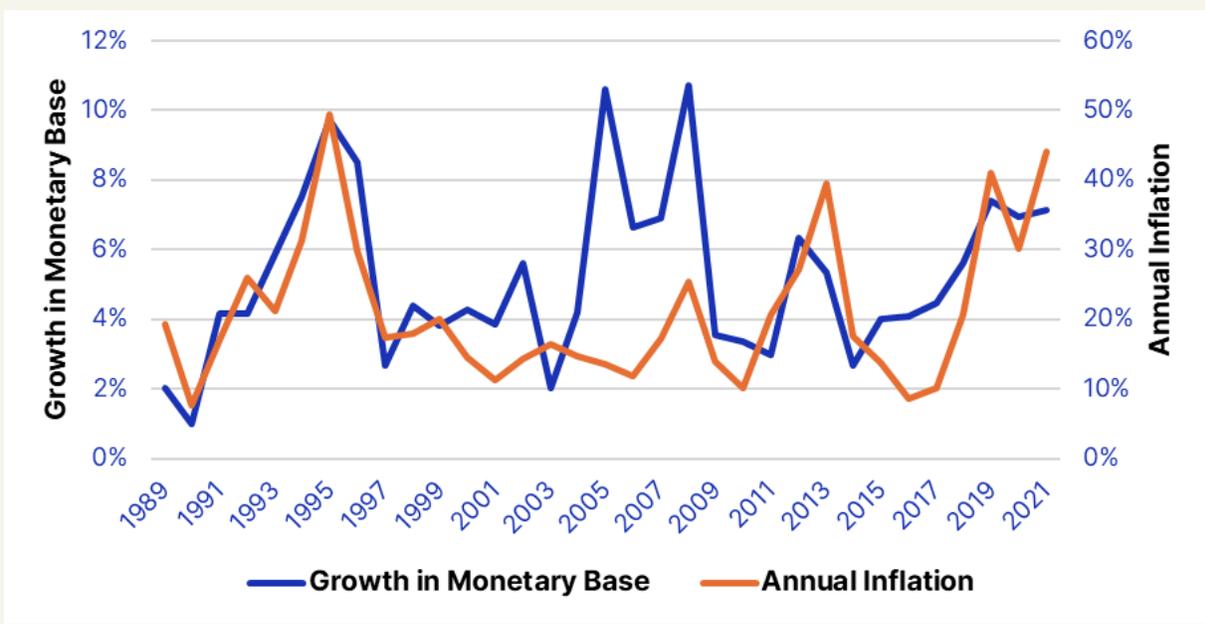
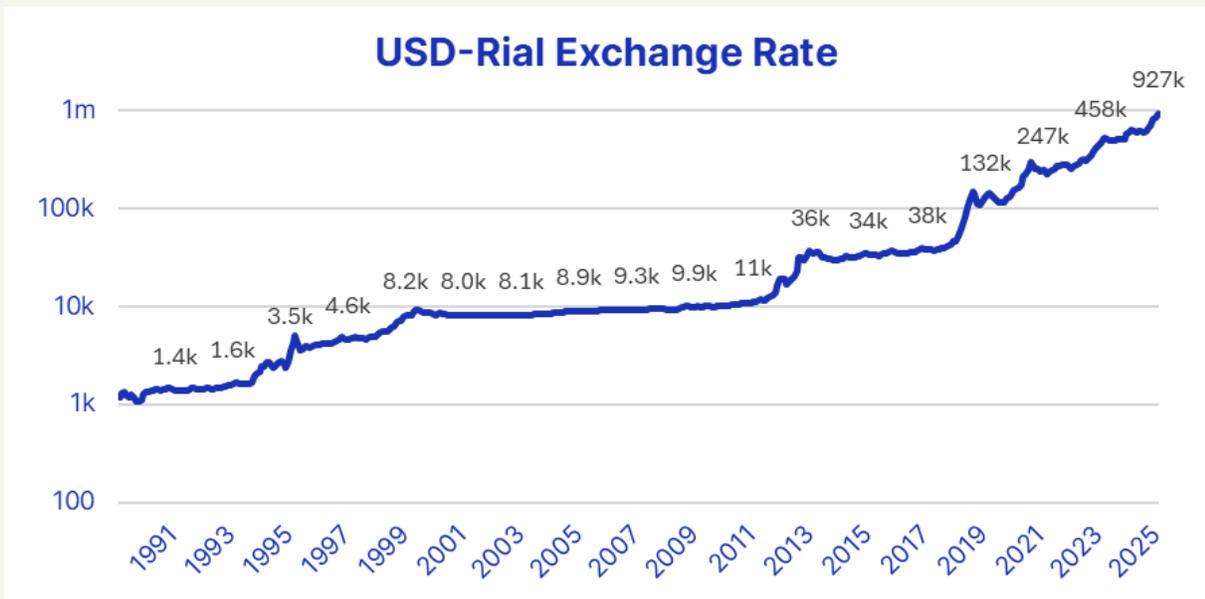
Khatami's era marked steady economic expansion due to reduced tensions with the West and rising oil prices. Real GDP per capita increased, inflation eased, and significant economic reforms included the establishment of the Oil Stabilization Fund, reduced government borrowing from the central bank, and privatization.

### *1.2.4 Ahmadinejad's Presidency (2005-2013)*

Ahmadinejad's presidency witnessed a shift towards populist economic policies characterized by increased government spending, subsidies, and currency interventions. His administration's economic policies have had a long-lasting adverse impact on Iran's financial markets, including the banking sector, and completely reshaped the financial landscape.

His presidency was stained by systemic corruption, lack of planning, and several massive and extremely costly failures—largest in decades—in multiple government projects, which the banking system was forced to fund. As a result, during his presidency, banks' claims on the government increased by more than 4.5 times, from 1.7% to 7.8% of GDP. This significantly weakened the banking system's balance sheet by increasing the size of non-cash flow generating assets due to the rise of non-performing loans. As a result, banks had to borrow heavily from the CBI, leading to a substantial increase in the monetary base, followed by high levels of inflation towards the end of his term in office. This situation was exacerbated by the competition to attract deposits between the banking sector and non-bank financial institutions that were not properly regulated at the time. This dynamic led to a surge in interest rates, which not only further pressured the already weakened banking system, but also increased the cost of capital in the real economy and caused economic activities to slow down. Meanwhile, to control the pace of inflation, Ahmadinejad's administration spent over \$140 billion in petrodollars, doubling imports and kickstarting the Dutch Disease in the Iranian economy. By the time he left office, the economy had entered stagflation, GDP per capita was almost the same as when he took office, the currency had lost half of its value, and inflation was about 40%.

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**FIGURE 1** - The top panels in Figure 1 depict the monthly value of the dollar expressed in Rial from March 1989 until March 2022. The bottom panel illustrates the annual growth in monetary base (MB) and the concurrent rate of annual inflation between 1989 and 2021.

1.2.5 Rouhani's Presidency (2013-2021)

Rouhani's presidency was marked by a shift towards economic pragmatism and engagement with the international community to alleviate sanctions. The Joint Comprehensive Plan of Action (JCPOA), commonly known as the Iran nuclear deal, was reached in 2015, leading to the lifting of some sanctions and a period of relative economic stability. While his administration failed to implement structural reforms in the economy, these breakthroughs in Iran's foreign policy and international relations elevated expectations for a better economic outlook and reduced inflation to about 8.5% in 2016. However, failure to address the fundamental and structural issues

in Iran's economy in general, and in the banking sector in particular, along with the economic devastation brought about by COVID-19 pandemic, led to the re-emergence of old economic problems. By the time Rouhani left office inflation had surged to above 40% and real GDP per capita was almost the same as when he took office.

### *1.2.6 Raisi's Presidency (2021-2024)*

Ebrahim Raisi assumed the presidency in 2021 amid economic challenges exacerbated by the COVID-19 pandemic and sanctions. His administration faced the daunting task of addressing the banking and currency system's deep-rooted problems, including high inflation, non-performing loans, and a lack of central bank independence. More than two years into his presidency, his administration seemed either unable or unwilling to tackle these economic and banking issues. Inflation increased to nearly 50%, and for food items, this figure is well over 70%. Reports of systemic corruption and embezzlements have become a natural part of the news cycle. Almost all macroeconomic indicators point to a looming full-fledged economic and banking crisis on the horizon. The monetary base has grown by about 45% in the year leading up to April 2023, a twenty-year high. During the same period, the CBI claims on the government and the banking system rose by over 58% and 148%, respectively. According to the IMF, the ratio of Iran's government gross debt to GDP is close to 33%. The inflation rate consistently remained well over 40% during Raisi's presidency.

As Iran continues to navigate economic and political challenges, the banking and currency system remains a focal point for policymakers. The need for comprehensive reforms in monetary and fiscal policies is increasingly urgent to stabilize the economy and enhance the resilience of the financial sector.

## **2. CURRENT STATE OF BANKING IN IRAN: A CRISIS ON THE HORIZON**

### **2.1. Background of the Banking System in Iran**

The Iranian banking sector is facing a confluence of challenges that collectively threaten the stability of the nation's financial system. This section conducts a comprehensive analysis of the root causes of the current banking problems in Iran, examining key factors that have contributed to this crisis.

#### *2.1.1 Overview of Fiscal and Monetary Policy Post-1979 Revolution*

The post-revolution era witnessed substantial shifts in fiscal and monetary policies. Chronic fiscal deficits have been a persistent challenge, with the government resorting to seigniorage and money supply expansion instead of tax collection and market borrowing. This approach has led to an average annual inflation rate of about 21% since the Islamic Republic took power. Figure 2 depicts the annual inflation rate from 1979 to 2023 (based on the statistics made publicly available prior to September 2023), illustrating the fluctuations in inflation over this period.

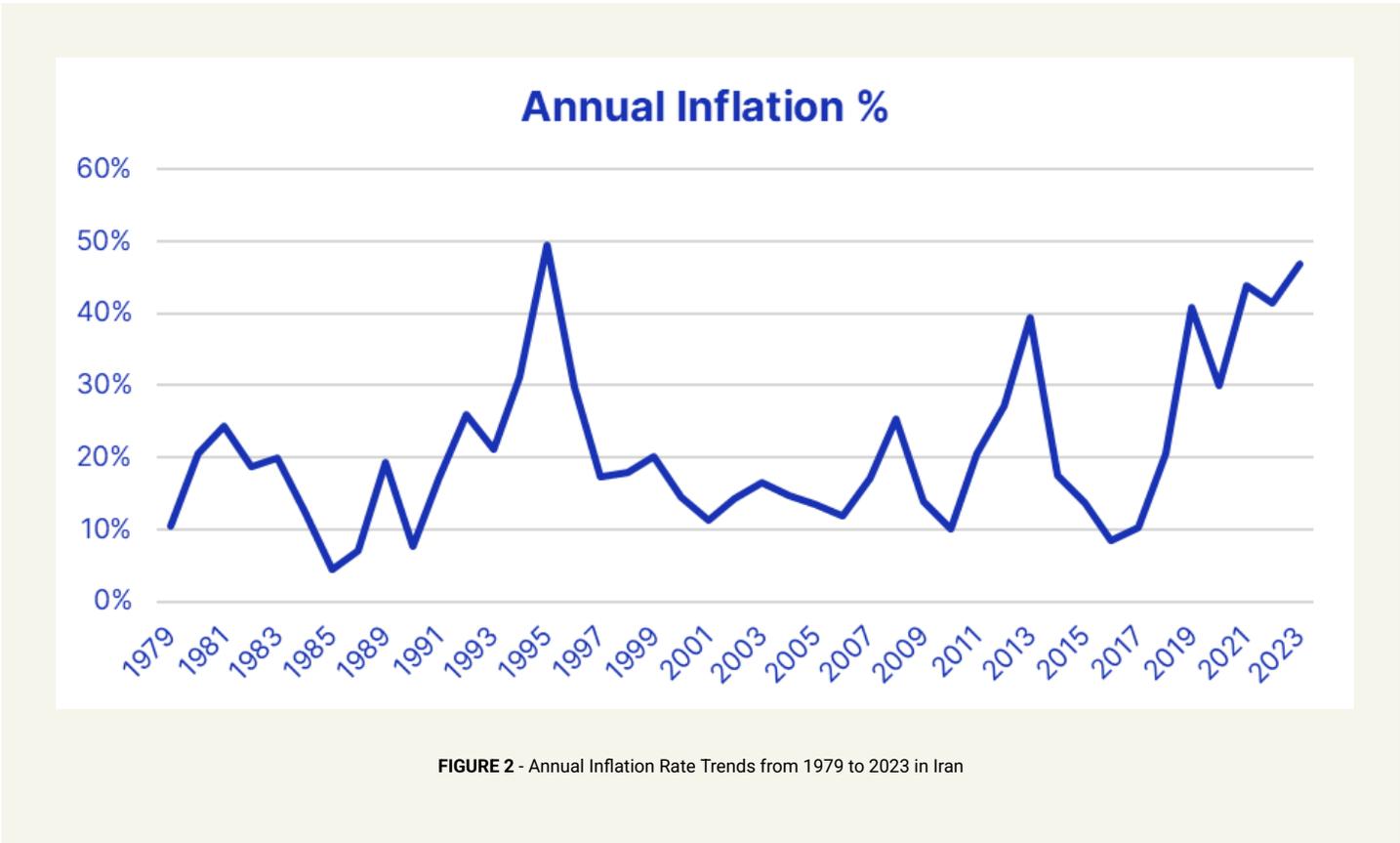


FIGURE 2 - Annual Inflation Rate Trends from 1979 to 2023 in Iran

### 2.1.2 Financial Action Task Force (FATF)

The Financial Action Task Force (FATF) serves as the global standard-setting body for anti-money laundering and the counter-financing of terrorism (AML/CFT). Its primary objective is to safeguard the international financial system from the risks of money laundering and terrorist financing (ML/FT) while promoting greater compliance with AML/CFT standards. The FATF identifies jurisdictions with strategic deficiencies and collaborates with them to rectify these issues, thus mitigating risks to the global financial system.

The FATF includes countries with “serious strategic deficiencies to counter money laundering, terrorist financing, and financing of proliferation” in its “black list”.<sup>1</sup> The first FATF black list was published in 2000, and Iran has consistently been on the list since its initial publication. Being blacklisted by FATF has had severe adverse consequences for Iran’s economy as well as its banking system. It has essentially isolated Iran’s banking system from the global financial markets and has effectively deterred potential international economic partners from doing business with Iran due to the considerable liabilities involved.

The Rouhani administration attempted to ratify and implement FATF-required steps to get the country removed from the black list. As a result of these efforts, in June 2016, Iran received a measure of relief from its blacklisted status as the FATF acknowledged the country’s apparent commitment to addressing its strategic AML/CFT deficiencies. This commitment was coupled with Iran’s expressed intention to seek technical assistance for the effective implementation of the recommended action plan by the FATF. In November 2017, the FATF decided to continue suspending countermeasures against Iran, recognizing the initial steps taken to address its AML/CFT issues. Since November 2017, Iran undertook several measures in line with FATF recommendations, including the establishment of a cash declaration regime and the introduction of draft amendments to its AML and CFT laws. Nevertheless, Iran’s

<sup>1</sup> <https://www.fatf-gafi.org/en/countries/black-and-grey-lists.html>

action plan expired in January 2018, and the plan was not completed. Specifically, the country has not yet ratified the Palermo and CFT conventions. Consequently, it was put back on the black list in February 2020.<sup>2</sup>

### *2.1.3 The CBI's Lack of Independence, Transparency, and Accountability*

Independence, transparency, and accountability are the three pillars of modern central banking governance, and the CBI lacks all three. The CBI's lack of independence has hindered its ability to set and implement effective monetary policy. The CBI's role has often been compromised by fiscal pressures, constraining its capacity to combat inflation and ensure financial stability. In fact, the CBI is unable to independently set or conduct monetary policy. Monetary policy is set by the members of the Money and Credit Council, who are political appointees. Over the past 21 years, the CBI has had 10 governors, reflecting how susceptible the CBI is to the whims of the government and that the CBI has effectively become the fiscal arm of the government. According to the Bertelsmann Stiftung's Transformation Index (BTI), the CBI is not independent from political interference [4]. In the 2019 Global Competitiveness Index, Iran ranked 136 out of 141 countries regarding the soundness of its banks [5].

The CBI also lacks transparency and accountability. Given the CBI's lack of independence, its inability to conduct monetary policy, and the high turnover rate of the CBI governors, it seems natural for the CBI decision-makers to continuously surprise the market without proper justifications, instead of communicating their decisions clearly and in a timely fashion so that market has time to digest the new information. This has not only amplified market fluctuations but has also eroded the credibility of the CBI in the public and created mistrust in the CBI's policies. This is a serious issue because credibility and trust in any central bank by the public is a necessary condition for that central bank to implement policies smoothly.

### *2.1.4 Chronic Government Fiscal Deficit and Growth of Liquidity and Monetary Base*

The government's chronic fiscal deficit, coupled with limited efforts to address it effectively, has strained the fiscal landscape (See Figure 3). Lack of fiscal discipline by the Iranian government and financing the deficit through the CBI, whether directly or indirectly, is the root cause of many economic problems in Iran. It is crucial to emphasize that banking reform in Iran is not possible without resolving the government's chronic budget deficit and restoring fiscal discipline. In other words, fiscal austerity, fiscal discipline, and balancing the budget take precedence over any banking reform.

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<sup>2</sup> <https://www.fatf-gafi.org/en/publications/High-risk-and-other-monitored-jurisdictions/Call-for-action-october-2023.html>

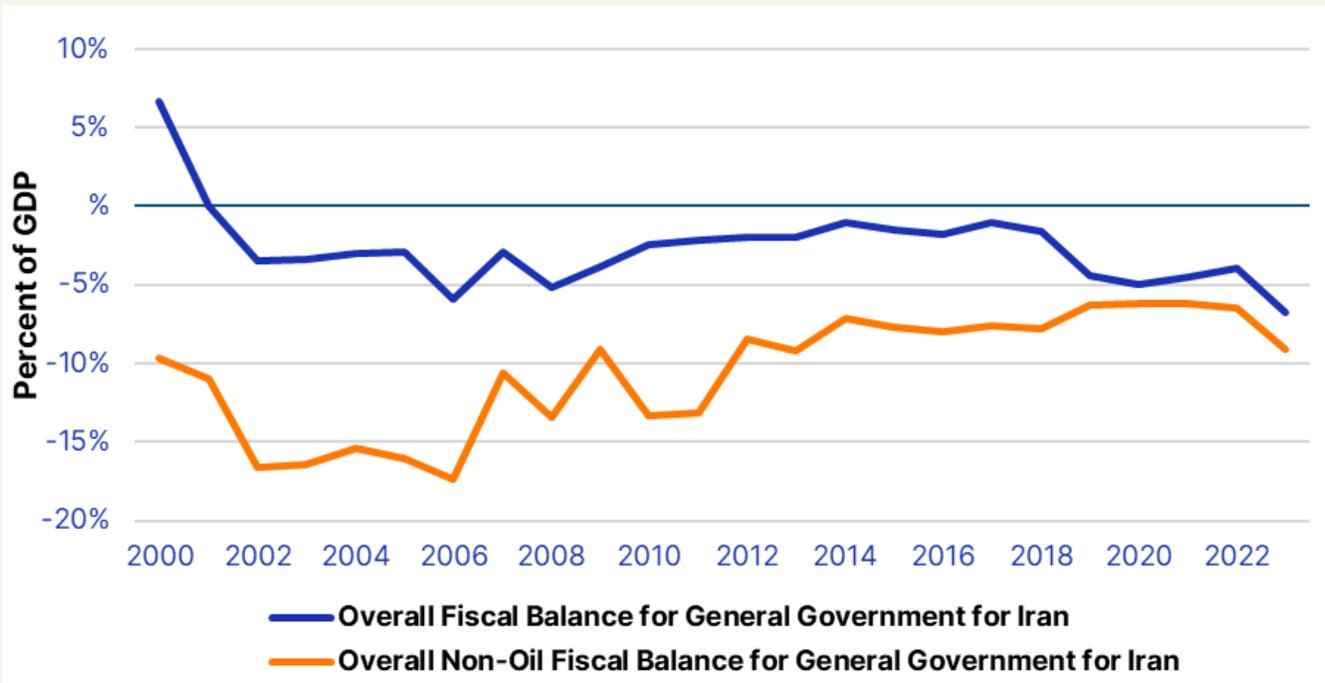


FIGURE 3 - Overall fiscal balance of Islamic Republic governments since 2000

By effectively eliminating the CBI's independence, the Iranian government has effectively made the CBI its bank and has borrowed heavily from it, either directly or indirectly through the banking system, to finance its deficit. This has led to substantial growth in the monetary base and liquidity (M2). In fact, since 1989, the average growth rate in M2 is about 27.5% per year. The ballooning of liquidity and money supply have significantly contributed to Iran's high levels of inflation during these years. The average annual inflation during this period is 21%.

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## M2 Growth vs Annual Inflation

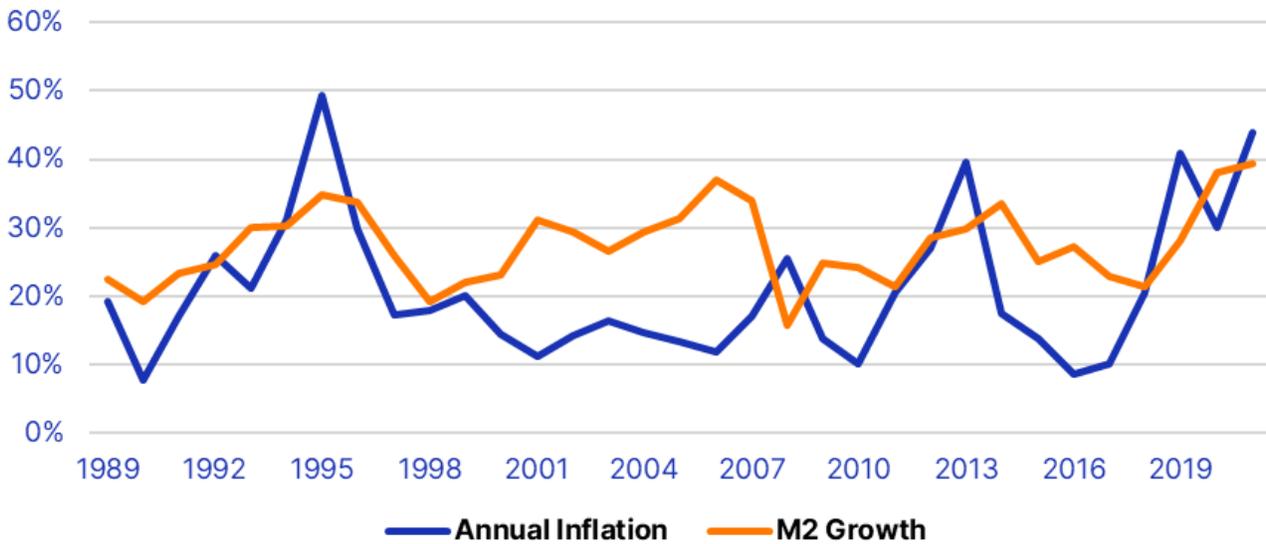


FIGURE 4- Liquidity (M2) growth and annual inflation from 1989 to 2021 4

### 2.1.5 Systemic and Institutionalized Corruption and Non-Performing Loans

The banking sector has long suffered from systemic and institutionalized corruption, which has eroded trust and integrity within the industry. This pervasive corruption has not only hindered the practice of prudent financial management but also exacerbates the issue of non-performing loans and rollover losses in Iran's banking system.

Iran's banking sector grapples with a substantial burden of non-performing loans (NPLs) and considerable rollover losses, many of which are associated with government entities. These loans significantly impact the balance sheets of banks and hinder their ability to extend credit to the private sector. As of March 2023, Iran's NPL ratio stood at 6.9% and rollover losses amounted to approximately \$7.3 Billion (based on the market exchange rate of \$1= IRR 500,000). To provide context, here are the NPL ratio of a few countries: Saudi Arabia 1.8% (2022); Türkiye 2% (2022); Russia 6.1% (2022); Pakistan 7.3% (2022); UAE 6.4% (2022); Malaysia 1.7% (2022); China 1.7% (2021); India 6.5% (2021); USA 0.7% (2022).

According to the World Bank Corruption Index, Iran is one of the most corrupt countries in the world. According to this index, corruption is significantly more pervasive in Iran compared to most countries in the region.

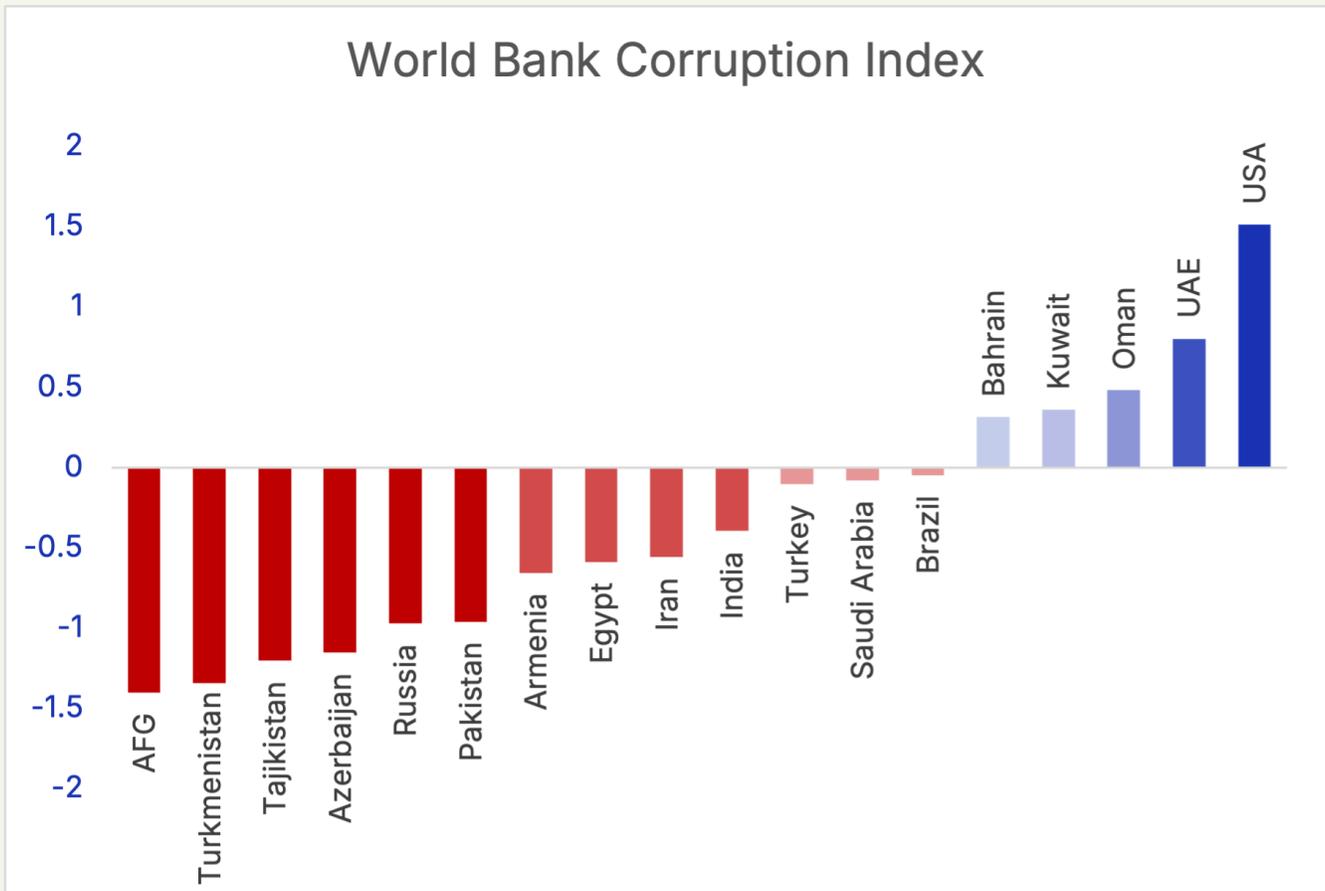


FIGURE 5 - Contrasting the corruption in Iran with other countries based on the World Bank Corruption Index.

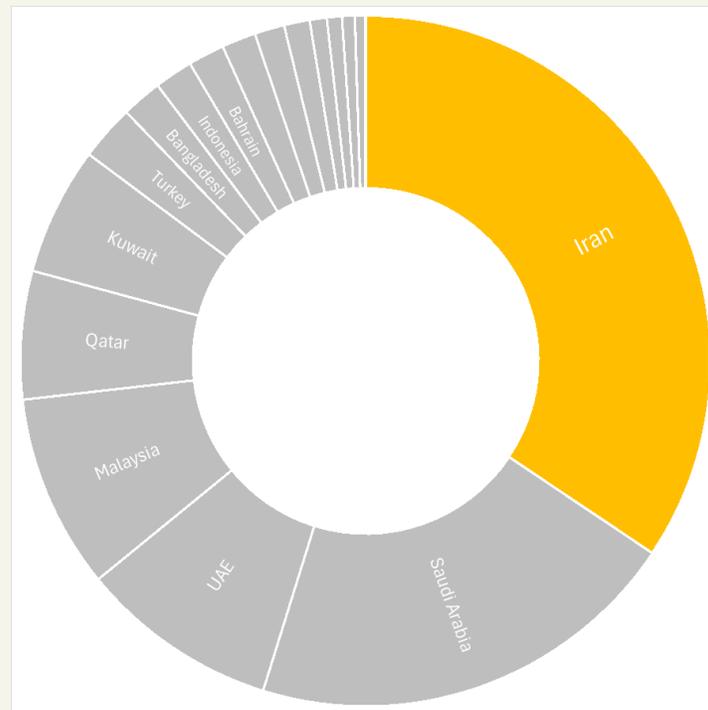
### 2.1.6 Adherence to Islamic Finance

The adherence to Islamic finance principles has also introduced unique challenges to Iran's banking sector. Islamic finance prohibits predetermined payments, such as interest, or *riba*, in all forms of transactions, restricting fund usage solely to profit-and-loss-sharing arrangements. As illustrated in Figure 6 below, Iran has the largest shares of the Islamic banking market with 34.4% of global Islamic banking assets, followed by Saudi Arabia (20.4%) and the United Arab Emirates (9.3%).

While consistent with Islamic principles, this framework has implications for risk management and the development of financial instruments. The most critical challenges facing the Iranian Islamic banking system can be succinctly summarized as follows:

1. **THEORETICAL CHALLENGE:** Islamic banking, as a relatively nascent field compared to conventional banking, presents theoretical challenges. These include defining the exact meaning of *riba* and addressing disagreements among Islamic scholars regarding *riba*. Additionally, questions arise about the permissibility of money creation, the role of money in the new monetary system, and the relationship between profit and loss-sharing contracts (e.g., *musharakah*) and trade-based contracts (e.g., *murabaha*) [6].

2. **GOVERNMENTAL DOMINANCE:** Islamic banking in Iran is a primarily government-initiated and top-down framework, differing from other countries such as Malaysia, where the private sector actively develops Shariah-compliant banking services. The predominant governmental view in Iran often extends to the management of private or privatized banks, limiting private sector involvement.



**FIGURE 6** - Shares of Global Islamic Banking Assets

3. **LACK OF COMPETITION:** In contrast to many Islamic countries employing dual-banking systems, Iran exclusively and comprehensively applies the Islamic banking model. This homogeneity leaves no room for conventional banking, potentially stifling competition and innovation within the Islamic banking sector [7].
4. **UNRESOLVED ISSUES WITH DELAYED PAYMENTS AND ROLLING OVER OF DEBTS:** Islamic banks in Iran cannot impose fees for delayed payments or rolled-over loans, a common practice in conventional banks. Resolving such issues consistent with Islamic jurisprudence remains a challenge.
5. **COLLATERAL REQUIREMENT IN MUSHARAKAH CONTRACTS:** In the absence of prevalent credit ratings, Iranian banks often request collateral from borrowers in various forms, including property or assets, as a means of securing loans. This practice diverges from international Islamic banking standards, where collateral is not typically a part of musharakah contracts [8]. Using collateral as a prerequisite to loan origination can introduce moral hazard and distort banks' incentive to monitor, especially in a country like Iran where the value of the collateral, usually real estate property, grows significantly due to inflation. This, in turn, undermines banks' incentives to monitor and further amplifies the build-up of non-performing loans.

6. **OUTDATED REGULATORY FRAMEWORK:** The Regulatory Framework of Banking Affairs (RFBA), in effect since 1983, has not undergone revisions to accommodate developments in Islamic banking and finance. This dated regulatory framework may not adequately address contemporary financial needs [9].
7. **LACK OF SHARIAH SUPERVISION:** Effective Shariah supervision is essential for ensuring compliance with Shariah law in Islamic banks and financial institutions. However, Shariah supervision is not adequately implemented within the Iranian banking system, despite the presence of over 24,000 Islamic banking branches in the country. The absence of rigorous supervision raises concerns about the Shariah compliance of their activities [8].
8. **OPEN MARKET OPERATION:** Adherence to Islamic finance principles has deprived the CBI from employing one of the most important monetary policy tools used by central banks—open market operation. To conduct open market operations with the goal of conducting monetary policy and changing interest rates, buying or selling government issued debt is required which does not involve a physical product and thus would violate Islamic finance principles as it is inconsistent with Sharia Law, given that it only involves profit and interest. Lack of access to monetary policy tools due to adherence to Islamic finance principles has made controlling inflation even more challenging.

## 2.2. A Looming Crisis on the Horizon

It is clear that Iran's banking system is on the precipice of a twin banking and currency crisis stemming from the government's chronic fiscal deficit, lack of central bank independence, weak credit culture, lack of supervision, and institutionalized corruption. This impending crisis threatens to severely damage Iran's economy unless major reforms are swiftly enacted.

### 2.2.1 Stage One: Initiation Phase

The seeds of this looming crisis are sown in the chronic fiscal deficits run by the Iranian government. Several recent financial crises around the world, such as Argentina's crisis during 2001-2002, have their roots in severe government fiscal imbalance. With an underdeveloped financial market, the Iranian government has continually pressured the central bank and state-owned banks to finance these deficits.<sup>3</sup> For instance, in the most recent budget released in March 2023, the fiscal deficit grew by more than 58% compared to the prior year. This chronic budget deficit and its financing by the CBI have led to a ballooning of public debt held by the banking system, which the IMF estimated to have reached over 33% of GDP as of August 2023. The most recent statistics released by the CBI also paint a similar picture. They indicate that during the 12 months leading up to April 2023, government debt to the CBI increased by more than 55%, while the CBI's claims on other banks grew by about 148%. At the same time, the monetary base grew by more than 41%, a 20-year high. These figures are not outliers but rather the norm in Iran's economy and banking system. Financing deficits by borrowing from the CBI has caused rapid growth in the money supply and liquidity. Between 1989 and 2017, liquidity (M2) grew at an average annual rate of 27%. This monetary expansion has fueled Iran's high inflation, which has averaged around 20% over the past three decades and has been hovering around 50% in 2022 and 2023. In effect, the government's fiscal recklessness has resulted in the ballooning of the monetary base and liquidity, causing inflation to soar and effectively imposing a hidden regressive tax on citizens through that inflation.

### 2.2.2. Stage Two: Banking Crisis

Pressured to finance the government fiscal deficit, the banking system in Iran has developed a significant gap on the asset side of its balance sheet, leading to a considerable decline in its net worth. Furthermore, financing the government deficit, along with lending to other government entities and government-backed projects, has led to the accumulation of a substantial amount of non-cash

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<sup>3</sup> In the early 2000s legislation was passed to prevent the government from financing the deficit directly through the CBI. However, lacking fiscal discipline, the Iranian government began borrowing from the state-owned banks which effectively is equivalent to indirectly borrowing from the CBI as these state-owned banks would tap into their reserves with the CBI whenever they face liquidity issues resulting from financing the government deficit.

flow-generating assets in banks' balance sheets. This has resulted in a rise in non-performing loans, a decline in banks' operating performance and profitability, leaving banks with no option but to rely on the CBI for their liquidity needs (see footnote 3). Conservative estimates put non-performing loans at around 9% of GDP, but the true figure is likely higher.

Grappling with battered balance sheets stemming from the rise in non-performing loans and the contraction of cash flow-generating assets, banks in Iran need to offer high interest rates on deposits to attract more funds and avoid liquidity risk. Paying higher interest on deposits has exacerbated their cash flow problem. Meanwhile, the emergence and proliferation of under-regulated credit institutions and other non-bank financial firms (Moasesat-e-E'tebari) with lax supervision have given rise to fierce competition to attract new deposits, pushing up interest rates on deposits. This surge in interest rates has, in turn, increased the cost of borrowing for businesses in the real sector, adding even more strain to the banks' financial health. The higher cost of borrowing/capital has driven out viable and profitable projects and elevated adverse selection problems. Analogous to the lemons problem in Akerlof (1970), with higher financing costs in the real sector, mostly "bad" projects continue to seek financing. This has resulted in increased default rates, accumulation of even higher levels of non-performing loans, and putting more pressure on the banks' balance sheets, and has set off a vicious cycle characterized by ever-increasing interest rates, higher default rates, and a mounting pile of non-performing loans.

This situation is exacerbated in Iran due to a weak credit culture and systemic and institutionalized corruption. Corruption has played an integral role in the rise of non-performing loans and undermining the stability of Iran's banking system. Connected lending to cronies and those close to the circle of power has significantly contributed to the massive build-up of non-performing loans. One recent example of this systemic corruption is Bank-e-Ayandeh, which loaned about \$12 billion (IRR 400,000,000,000,000 at the exchange rate of \$1=IRR34,000 at the time of loan origination) to Mr. Ali Ansari to finance the construction of Iran Mall, the largest shopping center in Iran. The loan was not paid off, and to keep Bank-e-Ayandeh afloat, the CBI injected liquidity into Bank-e-Ayandeh from its reserves, contributing significantly to the increase in the money supply and its inflationary effect on the economy. Meanwhile, the Money and Credit Council (Shoraye-Pool-va-E'tebar) voted for the Bank-e-Ayandeh to repossess Iran Mall as the loan's collateral. All this may seem innocuous, and one may argue that bailing out banks and repossessing the collateral of a loan are common practices worldwide. However, the issue in this case is that Bank-e-Ayandeh itself is owned by Mr. Ali Ansari himself. In other words, he borrowed from the bank he owned with no apparent intention of repaying the loan, imposing higher inflation on the public in order to finance his Iran Mall project, which he got to keep through Bank-e-Ayandeh, which he owns. This kind of moral hazard issue is ubiquitous in Iran's banking system and is rooted in systemic corruption and the CBI's lack of independence. Essentially, there is a clear conflict of interest between the politically connected individuals who exploit the banking system and the implicit government guarantees to extract rent, and the public that pays the price of this corruption by facing ever-rising inflation.

Making matters worse, under-capitalization leaves Iran's banking system highly vulnerable to loan losses. The IMF estimates the average capital adequacy ratio of Iranian banks has fallen to under 5%, well below the 10.5% recommended under Basel III international standards (8% of risk-weighted assets plus 2.5% capital conversion bubble introduced by Basel III). With declining performance and high levels of non-performing loans, Iranian banks have been unable to recapitalize organically through retained earnings.

All evidence and statistics from both international sources like the IMF and the World Bank, and domestic sources like the CBI and the Statistical Centre of Iran, indicate that the banking system in Iran is, for all practical purposes, broken and on the verge of a full-fledged crisis. The rollover losses of the banking system have grown to a staggering IRR3,660,000,000,000,000 (equivalent to \$7.3 billion based on the exchange rate of \$1= IRR 500,000). This figure is roughly equal to 61% of Iran's expected oil revenue in 2023 and is more than three times larger than the Islamic Revolutionary Guard Corps (IRGC) official budget in 2023.

In sum, the balance sheet of Iran's banking system is characterized by the substantial build-up of non-performing loans and other non-cash flow-generating assets and massive rollover losses. At the same time, the banking system is severely under-capitalized by Basel III standards and is suffering from systemic corruption, substantial adverse selection, and moral hazard problems. The banking

system has been able to mask these losses through loopholes in Iran's outdated accounting system, which is not remotely close to the International Financial Reporting System's level of stringency. When conducting asset revaluations, banks use the appreciation in the value of their real estate, driven purely by inflation, to make it appear that these losses are small compared to their assets and capital, hiding their financial issues. Nonetheless, based on all economic indicators, the Iranian banking system is on the brink of a major collapse.

### *2.2.3. Stage Three: Currency Crisis*

As discussed in the preceding two subsections, the Iranian government's chronic fiscal deficit and the banking system's forced role in financing it have resulted in substantial growth in the monetary base and liquidity in the Iranian economy. This, in turn, has caused persistent and chronic inflation. In fact, Iran is the only country in history to have consistently experienced high levels of inflation for over half a century. Higher inflation is tantamount to lower currency value. As inflation rises relative to that of other countries, the currency depreciates in value against other currencies (purchasing power parity).

At the same time, Iran's hawkish foreign policy and the tensions related to the country's nuclear program have resulted in economic isolation and severe sanctions. Economic policy uncertainty, combined with political uncertainty, systemic corruption, and poor governance structure, has significantly increased the investment risk in the country, depriving Iran of much-needed foreign direct investment. In fact, according to the most recent report by the United Nations Conference on Trade and Development, Iran attracted only 0.1% of the world's total foreign investment in 2022.<sup>4</sup> Additionally, high levels of uncertainty and elevated investment risks have resulted in significant and rising levels of capital flight from the country. CBI statistics indicate that over the past 9 years, nearly \$98.5 billion worth of capital has left Iran. Based on these figures, around \$13 billion exited the country in the second and third quarters of 2022 alone, nearly two and three times the amounts for the same periods in 2021 and 2020, respectively. On the trade side, non-oil exports have largely been outpaced by imports. For instance, recent figures from October 2023 indicate that Iran's balance of trade deficit has doubled since last year, reaching approximately \$8 billion (non-oil exports amounted to \$28.3 billion, while imports reached \$36 billion). Iran's oil exports have also been under crippling sanction for over a decade, and despite an uptick during the Biden administration, access to petrodollars has been limited and difficult.

The evidence indicates that there are almost no economic factors stimulating demand for the Iranian Rial, while numerous economic factors are intensifying its supply. In other words, the supply of the Iranian Rial substantially exceeds its demand, exerting significant pressure from fundamental market forces on the Iranian currency to depreciate. This situation is exacerbated by the fact that inflation expectations in Iran are anchored in the currency market rather than the interest rate. Therefore, when households see high and rising levels of inflation, they withdraw their deposits from banks and exchange that capital for stable foreign currencies, like the US dollar, to hedge inflation risk and maintain their purchasing power. Not only does this dynamic further undermine the fragile banking system and adds even more pressure on the Iranian currency to depreciate.

The Iranian government and the CBI have limited options to counter this dynamic and defend the currency. These options include intervening in the foreign currency market and raising the interest rate. However, as historical examples show—such as Mexico in 1994, Indonesia in 1997, and Russia in 1998—attempts to defend a depreciating currency through market intervention are bound to fail. This is particularly true in Iran's case. Defending a depreciating currency through intervention requires mass foreign currency reserves, which the CBI lacks. Historically, even countries with substantial foreign reserves were unable to overcome market forces. Due to years of continuous sanctions, lack of foreign direct investment, and the CBI's continuous intervention in the currency market, the CBI's currency

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<sup>4</sup> <https://unctad.org/publication/world-investment-report-2023>

level has been depleted. As illustrated in Figure 7, during the Trump administration the CBI's foreign currency reserves declined to below \$15 billion, and while it has risen to about \$21 billion since Biden took office, it is still much lower than its peak of \$128 billion in 2015 and compared to other countries. For context, it is noteworthy that Russia's reserves before the Russo-Ukrainian War were \$630 billion, Saudi Arabia has \$460 billion in reserve, while China and Japan have over \$3 trillion and \$1 trillion, respectively. Iran's exchange rate regime consists of different concurrent rates depending on the purpose for which the foreign currency is intended to be used. The CBI has not even been able to defend the preferential exchange rate (Tarjahi), which is heavily subsidized by the government to import essential products. All different rates in Iran's exchange market ecosystem follow the floating rate, albeit with some lag.

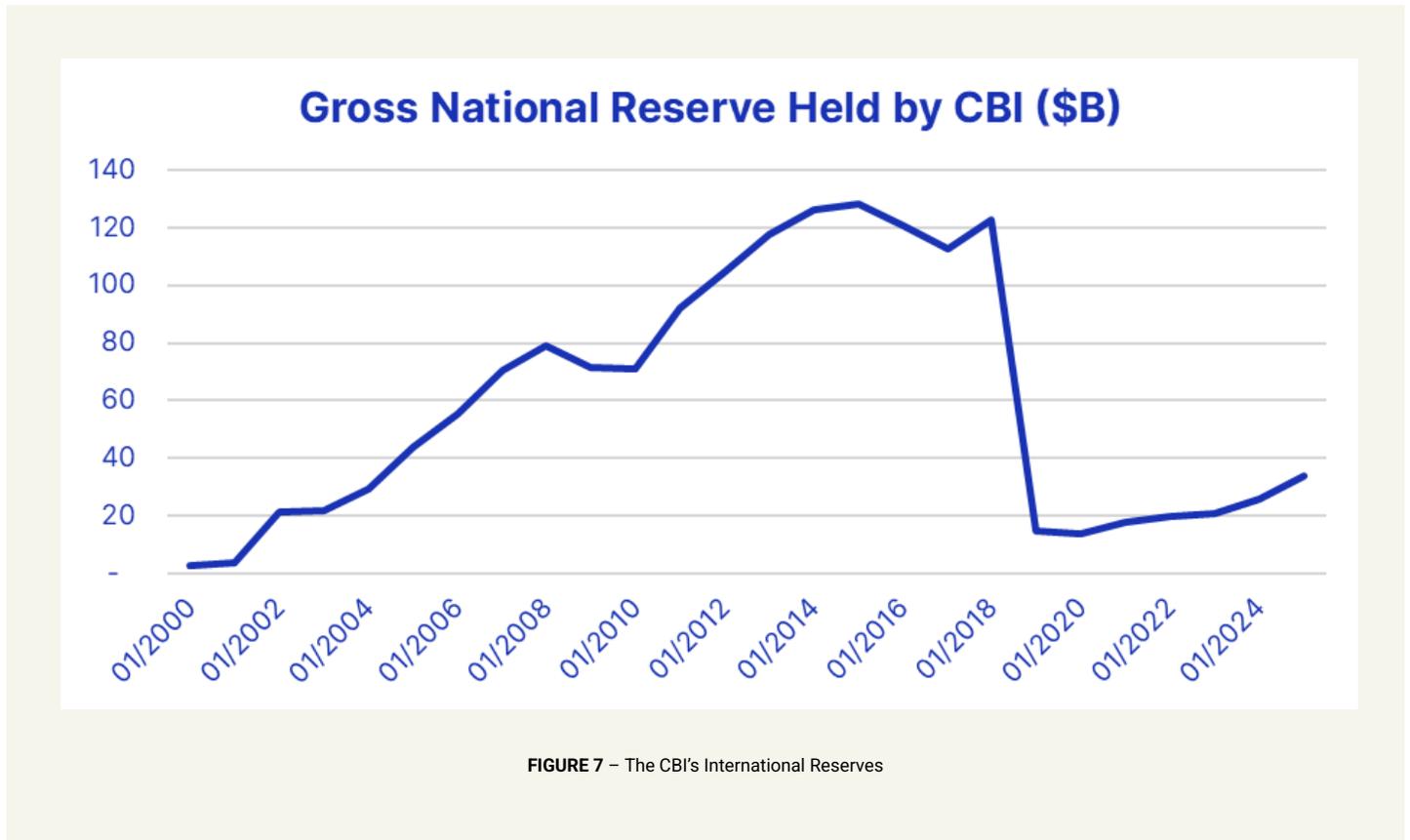


FIGURE 7 – The CBI's International Reserves

The second option for the CBI is to raise interest rates to make the Iranian Rial more attractive, slow down capital outflow, and thus reduce the supply of Rial while encouraging capital inflow. However, sustained high interest rates to defend a currency would increase borrowing costs in the real sector and have a long-lasting damaging impact on the economy. This issue is even more acute for Iran, given its broken and weak banking system. As discussed earlier, due to the weak balance sheets of Iranian banks, it is almost impossible to increase interest rates without exacerbating the situation for the already unstable banking system. Higher interest rates would further reduce the profitability of already unprofitable banks in Iran, amplify adverse selection problems, lead to higher default rates, increase rollover losses, and aggravate cash flow issues. Numerous examples throughout the world—such as Indonesia in 1997, Russia in 1998, South Korea in 1997, the Philippines in 1997, and Malaysia in 1997—demonstrate that governments and central banks, despite their direct interventions and raising interest rates, were unable to prevent currency depreciation and ultimately had to allow the currency to float and depreciate according to market forces. Moreover, given the high level of government debt to the CBI and the banking system, raising interest rates would make it more costly for the government to service debt and finance the deficit, increasing the likelihood of default. Together, the evidence discussed above suggests that raising the interest rates in Iran is highly unlikely to be viewed as a credible signal and would not result in currency stabilization.

In sum, the twin banking and currency crises in Iran have long been in the making, rooted in fiscal imbalance, rampant corruption, lack of CBI independence, poor governance, and a weak credit culture.

### 3. THE ECONOMY POST-ISLAMIC REPUBLIC

The banking system is at the heart of the much-needed economic reforms in Iran. Economic factors are currently among the leading reasons for Iranian people protesting against the Islamic Republic's rule. In this chapter, we first discuss why the current regime cannot successfully implement meaningful economic reforms. Then, we outline the policies that should be carried out from the very first days of transition to a new government through the first five to seven years.

#### 3.1. Islamic Republic's Economic Reform Capacity

The Islamic Republic has been implementing economic reform policies since the early days of the 1979 revolution. However, it is evident that most of these policies are defensive, inconsistent, and lack the political determination or institutional integrity necessary for successful implementation. Take, for example, the small business loans initiative implemented during Ahmadinejad's presidency. In a country where the median age is two years younger than the global average, with one-third of the population living in rural areas on a well-distributed energy infrastructure (high penetration of both natural gas pipelines and the electricity grid) and comprehensive transportation networks (railroads, highways and seaports), empowering small businesses appears to be a sound policy, at least conceptually. It could potentially reduce unemployment, increase domestic product, and leverage a multitude of comparative advantages of the country, such as its diverse geology and weather, to establish itself as a regional hub for trade. However, the initiative's disastrous outcomes still reverberate through the Iranian economy, manifesting in a housing price bubble, a rapid increase in the unofficial (market-based) exchange rate, and sustained inflation. In retrospect, we now know that many government-affiliated individuals, ranging from commanders and generals of the Islamic Revolutionary Guard Corps (IRGC) to the relatives of bank branch heads, allocated resources to their relatives or themselves for short-term investments in less risky assets. With no practical way to assess the business plans of applicants and no key performance indicators (KPIs) in place to monitor progress or track overall loan distribution, the allocated resources flooded the housing market, foreign currency exchanges, and gold markets. This led to detrimental bubbles in these markets, hampered economic output, caused the Rial to depreciate, and contributed to already high inflation since the policy's implementation.

This is just one example of the precedence of economic reforms within the Islamic Republic. The institution of the Islamic Republic has repeatedly shown that its mixed approach, the lack of CBI independence, and rampant corruption are systematic impediments preventing any economic policy reform from succeeding. One could argue that the Islamic Republic is following a similar path to that of the Soviet Union. Initial Soviet reforms in the 1950s focused on heavy industries and agricultural outputs. Similarly, the Islamic Republic attempted industrial growth in the years following the Iran-Iraq war (Doran Sazandegi), with a focus on heavy industries such as Mobarakeh Steel Company and agricultural policies such as the wheat independence plan. In the 1960s, Soviet economists started the Liberman reforms to address slowing growth and central planning inefficiencies. In the Islamic Republic, similar reform activities coincided with Ahmadinejad's tenure, focusing on small businesses and decentralization of many economic activities as part of his populist provincial tours.

The Soviets realized that their command economy had not succeeded in increasing productivity or economic prosperity, prompting gradual reforms in the 1980s under Andropov, Chernenko, and eventually Gorbachev to shift toward a market economy. The Soviets had outdated industry, major productivity issues, and well-known shortages of basic goods. Similarly, Iran is currently experiencing significantly outdated infrastructure, unprecedented poverty, alarming shortages in basic commodities, and protests demanding the Islamic Republic's ousting from power. The parallels between the two countries' economic reform attempts highlight the importance of institutional integrity and show that systematic impediments are rooted in ideologies inconsistent with individual freedom, open economies, and the welfare of citizens.

### 3.2. Short-term Risks and Potential Remedies

In this section, we discuss some of the short-term risks facing the country's economy and the banking system immediately after the collapse of the Islamic Republic, and offer potential remedies. These risk mitigation policies are intended only for the early days of transition and should be adjusted after three to four months, as their prolonged implementation could stifle the economy and create additional shocks to the system.

The primary objective of short-term economic policies following the overthrow of the Islamic Republic is to stabilize the economy and avoid causing further damage, even inadvertently. Immediately after the regime's collapse, there will be an unprecedented level of uncertainty, both politically and economically. If not handled prudently, this uncertainty could have severe and long-lasting adverse effects on the economy. Therefore, in the early days, transitional decision-makers must aim to stabilize the economy and smooth the effect of the inevitable shock. Clear communication and timely, credible signals from decision-makers is the key to stabilizing the economy and preventing it from falling into full-fledged chaos. Whether the collapse of the Islamic Republic is brought about by a relatively peaceful government resignation, as in Sri Lanka in 2019, or a full-scale civil war, like in Sudan, as soon as a transitional decision-making committee is formed, the economic shocks should be addressed with utmost prudence.

#### 3.2.1. Bank Run

One of the major short-term risks facing the country immediately after the collapse of the current regime is a bank run. As discussed earlier, due to years of economic mismanagement, the undermining of the CBI's independence, rampant corruption, and chronic fiscal deficits financed by the CBI and the banking system, Iran's banking system is essentially bankrupt. The banking system has accumulated massive amounts of non-cash flow generating assets, leading to ballooning rollover losses and non-performing loans. As a result, the entire banking system could crumble in the aftermath of a shock to the political system. This is a serious risk in the short term. Given the current dire state of the banking system, a run on any individual bank could trigger a systemic collapse across the entire network of banks. Therefore, it is important that the transition government projects determination, strength, and unity, at least in economic announcements, to assure the public that the banking system will remain stable during the transition. Without this assurance, it will be extremely difficult to manage a bank run, especially given the deep mistrust society has developed regarding the CBI and its policies.

The main mechanisms to prevent bank runs are deposit insurance and clear, effective communications. In the early days of the transition, the CBI should announce that it will honor deposit insurance and intends to enforce it. However, given the inflation and shocks in the unofficial exchange rate market, which anchors inflation expectations, the current level of deposit insurance may be insufficient to prevent bank runs. Currently, the CBI guarantees deposits up to 1 billion Rial (about \$2,000 based on the exchange rate of \$1 = 500,000 Rial). Therefore, the central bank must be prepared to announce a blanket guarantee beyond the current deposit insurance limits. Alternatively, or in addition to blanket guarantees, the transition government could implement more active policies, such as enforced banking holidays or deposit withdrawal freezes. Such active policies have historic precedents, such as in Argentina in 1989, Brazil in 1990, and Uruguay in 2002, and have proven effective in quelling the short-term shocks and public panic that cause bank runs.

Moreover, the transition government must take ownership of the previous regime's accounts. The Islamic Republic is the largest borrower from Iranian banks, and the government's malpractice of financing its fiscal deficit and expenditures through the banking system has left it heavily indebted to banks. Thus, as soon as the Islamic Republic regime collapses, many banks would become insolvent. To prevent this, the transition government's central bank should quickly announce that (a) it will take ownership of all government debt to the banking system and (b) effective immediately, the central bank will implement a regulatory capital forbearance policy for three to six months (during which time a balance sheet analysis of banks, as outlined in Section 4.2, will be conducted). The

purpose of this announcement is to manage the shock in the banking system in the early stages of the government transition. The transition government must do everything possible to keep the banking system operational for the first three to six months for two key reasons. First, the current situation of the Iranian banking system is dire; if one bank becomes insolvent, most other banks are likely to follow in a domino effect, causing widespread insolvency. This would halt the normal functioning of the economy, including paying salaries and purchasing goods and services. Second, the insolvency of banks in the early stages of the transition would not stop at banks, causing pension funds and major industries exposed to the banking portfolio to collapse. This economic meltdown could spiral into anarchy, civil unrest, major asset thefts, and irreparable damage to the country's integrity, especially given the uncertain political environment and potential legal and law enforcement turbulence in the early days of transition. Therefore, it is crucial that the banking system receives a lifeline and remains afloat while the rest of the government forms and the transition government gains enough power to manage the shocks.

### 3.2.2. Capital Flight

Capital outflow generally increases as a country's investment risk or uncertainty rises. Given the inevitable spike in uncertainty and risk following the collapse of the Islamic Republic, a substantial outflow of capital from the country is another serious short-term risk. It is highly probable that ousting the Islamic Republic would result in capital flight to offshore accounts by those close to the current regime who were able to accumulate wealth through rent-seeking and corruption. However, the capital flight need not be limited to individuals affiliated with the regime; other wealthy investors, households, and business owners, even those without meaningful political connections, may also attempt to take their capital out of the country.

#### If Capital Flight Is Not Controlled, The Consequences Could Be Dire:

- (1) The capital flight would flood the exchange market with Rials, increasing the supply of Rials while driving up demand for foreign currency. This would put substantial pressure on the Rial, causing its value to plummet and leading to a skyrocketing exchange rate. As a result, importing basic commodities and essential goods will be much more expensive, leading to shortages.
- (2) To compensate for the lack of capital, the transition government may be forced to create new money, exacerbating the inflation in the economy.
- (3) Without sufficient capital, many semi-private and shadow-state-owned companies (Khosoulati) may cease operations, leading to increased unemployment, loss of economic output, and a deep recession.

To address capital flight, the transition government should:

- (1) Swiftly place a maximum limit on bank withdrawals.
- (2) Freeze the conversion of investment accounts into checking accounts.
- (3) Impose a halt on the (fire) sale or change of ownership of company assets. Legal entities and companies own the highest share of capital deposited in Iranian banks. In the early days following the regime change, it will be unclear which entities or companies have accumulated their assets through healthy, legitimate business operations and which did so through rent-seeking, corruption, and political connection to the Islamic Republic. Therefore, any major change in size or ownership of firms or legal entities' assets:
  - (i) is likely to serve the personal interests of major shareholders or board members/executives with ties to the previous regime who are attempting to liquidate assets and flee the country for fear of prosecution.

(ii) distort the balance sheets of otherwise operational entities, leading to insolvency and triggering shutdowns. On a large scale, this could trigger unemployment, loss of output, and negative economic consequences with no established government entity to mitigate the negative shock and prevent a trickling effect in the rest of the economy.

(iii) could potentially lead to the creation of an oligarch group, similar to what occurred following the collapse of the Soviet Union, with certain individuals or entities taking ownership of major industries and backbones of the economy without proper privatization practices. This could result in the formation of major stakeholders who could easily undermine the new government's agenda or initiatives moving forward. Additionally, fire sales of assets during periods of elevated uncertainty often lead to a downward spiral in prices, contracting the economy and inflicting significant damage.

- (4) Establish a maximum limit on the amount of foreign currency individuals can carry when leaving the country, with robust border enforcement.
- (5) Place a maximum allowable amount that banks, financial institutions, and exchange companies can transfer daily from their foreign-based accounts to other foreign accounts or within their international banking networks or co-operations. For instance, if a bank has branches in Moscow and Tehran, it should be allowed to move only a limited amount of capital from its Tehran accounts to its Moscow accounts. Given the volatility of the early months of regime change, many individuals, including former officials of the Islamic Republic, may attempt to sell off whatever assets they can and transfer the funds to stable currencies deposited in foreign-based accounts. If successful, it would be extremely difficult for the new government to return this capital to the country. To prevent major capital flight through exchange companies with large foreign accounts or branches of Iranian banks abroad, such as those currently in Venezuela or Russia, or their sister banks, the new government should promptly place a ceiling on the maximum daily allowable transfer. The benefits include:
  - Allowing the transition government to track and monitor capital outflows.
  - Establishing a legal basis to prosecute violators domestically or pursue international prosecution and recovery of funds.
  - Making it more difficult for capital to exit the country through established exchange channels or banks.

It is noteworthy to mention that the isolated nature of the Iranian financial system, because of sanctions, presents additional roadblocks that could be leveraged to prevent capital flight.

It is crucial that these policies be communicated as clearly as possible with a practical and clear timeline in place. The enforcement period should be long enough for the transition government to establish its operations, announce the constitution, and set a timeline for general elections, but short enough to avoid stifling the general operation and normal course of the economy. Without effective communication and a clear timeline in place, uncertainty may result in black market formation, misinformation campaigns, or promotion of corrupt action by the transition government. For example, the announcement should clearly state that these measures will expire on a specific date, within three months, following the announcement of a new exchange rate policy, privatization mechanism, and banking system reforms.

### *3.2.3. Currency Depreciation*

A significant portion of Iran's economy relies on exports and imports, with trade accounting for 41% of GDP in 2021. This reliance means that exchange rate fluctuations have a major impact on the overall economy. Years of mismanagement, Dutch disease, and corruption have led to the establishment of a pervasive black market for currency exchange that operates much closer to an open market than the government's official exchange rate. A natural consequence of the regime change shock would likely be a rapid depreciation of the Rial against the USD and other major currencies. As discussed, such currency depreciation would spill over into the

real economy, disrupting the flow of imports of essential goods. Furthermore, inflation expectations in Iran are anchored to the exchange rate rather than the interest rate. Therefore, rapid currency depreciation, combined with existing high inflation, could create a vicious cycle of perpetually rising inflation and depreciating currency value where one reinforces the other.

Communication and credible signaling with a clear timeline are the critical factors in managing this risk. Announcements regarding the transition to a market-oriented economy, the adoption of a floating exchange rate regime, and development plans for the near future are essential for creating a positive economic outlook that may slow-down or ideally stop the depreciation of the Rial. However, for these communications to be perceived as effective and reliable by the public, they must be followed by transparent actions and tangible results. For instance, the transition government must immediately begin negotiating with the FATF to remove the country from its black list, which would bring about a positive shock to the economy and the banking sector. Engaging in foreign policy talks with the US and other major Western countries to lift or ease sanctions would also signal that the transition government may gain partial access to some of Iran's blocked assets, helping to slow the depreciation of the Rial. Initiating talks with the IMF to obtain loans could generate another positive shock to the economy, aiding the transition government in managing currency risk. Additionally, the short-term capital flight restrictions discussed in the previous section will help manage exchange rate risk in the short run. The transition government should also utilize the official currency exchange market to supply sufficient foreign currency reserves for the import of essential goods, with no price change in the short term. For example, the transition government should use the existing list of essential goods importers registered with The Center for Currency and Gold Exchange (مرکز مبادله ارز و طلای بانک مرکزی) and supply them with the currency needed to maintain the flow of essential goods. It needs to be acknowledged that this policy will need a clear timeline in place as well, meaning that these importers must be aware that after a certain date, they will need to adjust their operations to align with free market mechanisms.

#### *3.2.4. Other Recommended Short-term Policies*

**FATF COMPLIANCE** – As highlighted in the previous section, it is critical that the transition government begins talks with the FATF and provides all necessary documentation to signal and demonstrate their firm commitment to comply with the necessary steps to get the country removed from the black list. It is crucial that these talks begin as soon as possible to send a credible signal that Iran's economy is emerging from isolation, delivering a positive shock to the economy and the banking system.

**LIFTING SANCTIONS** – The transition government should immediately work to shift Iran's international relations and foreign policy. Specifically, it should initiate talks with the US and other major Western countries and take necessary steps towards easing sanctions. Again, it is paramount that these talks begin as soon as possible. Any breakthrough or success in lifting sanctions, even partially, would drastically improve the economic outlook, enhance the credibility of the transition government and its (economic) policies, and help manage public expectations, which has significant implications for inflation and exchange rate.<sup>5</sup>

**ATTRACTING FOREIGN INVESTMENT** – The transition government must immediately work on rebranding Iran as a country full of investment opportunities. Due to its isolation from the global economy and financial markets, combined with its young and highly educated population, Iran's market offers numerous investment opportunities across various industries, ranging from gas and oil to tourism and high-tech. While attracting foreign investment will take time to materialize, the groundwork for this policy must be laid as soon as possible.

**DISMANTLING ADHERENCE TO ISLAMIC FINANCE** – As part of the economic and banking reforms, the CBI should no longer be obligated to comply with the Islamic finance framework. As discussed earlier in Section 2.1.6, Islamic finance constraints have deprived

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<sup>5</sup> There is no precise estimate on the value of Iran's frozen assets in the world. Reports suggest they value somewhere between \$100 to \$120 billion. A 2022 IMF report suggests Iran's total frozen assets are about \$115.4 billion. China holds the largest amount of these assets at about \$22 to \$30 billion, followed by South Korea with about \$7B, Iraq \$6B, USA \$2B, Japan \$2B, and Luxembourg \$1.4B (Reuters 2021).

the CBI of important monetary policy tools. After the collapse of the Islamic Republic, the CBI should operate within the Basel framework and according to global central banking standards. The governance of Iran's Central Bank must be based on three main pillars: independence, transparency, and accountability.

### 3.3. Longer-Term Risks and Policies

This section discusses the longer-term risks facing the country's economy and banking system after the collapse of the Islamic Republic and outlines some mitigation policies. Overall, the main objective of medium and long-term economic/banking policies post-Islamic Republic is to move the country towards a market-based (free) economy through price liberalization, a floating exchange rate system, sensible deregulation, and the free movement of capital and other factors of production, with minimal government intervention.

#### 3.3.1. Mismanaging Financial Liberalization

A serious long-term risk facing the country after the collapse of the Islamic Republic is the potential mismanagement of financial liberalization, which could jeopardize the country's path to economic growth and lead to a serious financial crisis. This risk differs from the government fiscal imbalance discussed in Section 2.2.1 and is instead rooted in weak credit culture, institutional weakness, and lack of proper monitoring and supervision, which could lead to excessive risk-taking by banks, creating a cycle of lending booms and busts. The financial crises in Mexico in 1994-1995 and East Asia in 1997-1998 are examples of this mechanism.

While financial liberalization generally promotes long-term financial development and efficiency, its immediate consequences, especially in emerging economies with weak credit cultures and institutional weakness, can be detrimental. In emerging economies like Iran, the elimination of restrictions on financial markets and institutions can lead to a lending spree, known as a credit boom. Financial institutions, lacking proper incentives for risk management and adequate regulatory oversight, may engage in excessive and often risky lending practices. Banks may offer high interest rates to attract foreign capital and increase their lending capacity. The situation worsens if the government is tempted to fix (peg) the value of the currency to the dollar (or another major currency) to mitigate the exchange rate risk for foreign investors. Banks, their shareholders, and management have incentives to take excessive risks because they benefit from potential gains, while the downside risks are distributed among taxpayers due to implicit government guarantees. This creates a moral hazard, where depositors, assured of protection from losses, continue to supply funds to undisciplined banks engaged in risky lending. As a result, risk-taking grows unchecked, leading to mounting losses on loans and a decline in the value of assets relative to liabilities.

This process initiates a deleveraging phase where financial institutions, now with reduced capital due to losses, cut back on lending. Reduced capital also makes banks riskier, causing depositors and lenders to withdraw funds, resulting in a credit freeze, and a lending crash. In environments with weak credit cultures and institutional weakness, this cycle of risk-taking, losses, reduced lending, and economic downturns can be particularly severe, leading to a full-fledged financial crisis. This would be particularly devastating to economies like Iran's, where banks are the primary source of external finance for economic activities. Overall, the combination of financial liberalization without proper risk management, weak credit cultures, and institutions in emerging economies can create a perfect storm, culminating in a destructive sequence of events that adversely impact economic stability and growth.

To avoid the above scenario:

1. **IMPROVE CREDIT CULTURE:** Strengthen the credit culture within the banking system.
2. **ADOPT THE BASEL FRAMEWORK:** Ensure the banking system operates within the Basel framework.
3. **ACTIVE REGULATORY OVERSIGHT:** Banking regulators must actively monitor banks, force risky institutions to increase their capital, and close those that fail to do so.

4. **APPROPRIATE DEPOSIT INSURANCE PRICING:** Ensure deposit insurance is not underpriced to mitigate moral hazard. Riskier banks need to pay higher membership fees to benefit from deposit insurance.
5. **FREE-FLOATING EXCHANGE RATE:** The new Iranian government must adopt a free-floating exchange rate system.

### 3.3.2 Other Recommended Longer-term Policies

**PRICE LIBERALIZATION** - The Islamic Republic's price control policies have been a major impediment to the development of a market economy. Price regulations disrupt the market's supply side, leading to occasional shortages or excessive supply. Moreover, price controls are prone to corruption in resource allocation and distribution, and they encourage the role of intermediaries in the market. In general, regulating prices should be avoided to unleash market power that can provide quality goods and services with affordable price points and foster innovative approaches that contribute to economic growth and welfare.

While the ultimate goal of price deregulation is economic prosperity post-Islamic Republic, the means of achieving it are painful and demand extra attention. Liberalizing prices in the short term means that certain commodities and services may see skyrocketing values, depriving a large portion of the population of access to these goods and services. For example, Iran, one of the top three countries with heavily subsidized fuel costs, spends a considerable portion of government revenue on fuel subsidies annually. Liberalizing fuel prices could lead to a dramatic increase in the cost of gasoline and diesel in the short term. Not only have past fuel price hikes been a major source of civil unrest in the past, but also almost every other good and service in the economy is heavily impacted by such shocks, leading to severe inflation, shortages, and potential civil unrest. To make matters worse, the government should only liberalize prices while maintaining the same wages in order to control market liquidity and its impact on inflation.

Therefore, the transition government must approach the implementation of this policy with caution. First, it should publicly announce an incremental approach to removing fuel subsidies (and other major subsidized and price-controlled commodities). The timeline and the price increases at each step should be clearly defined and communicated to the public from the outset. Simultaneously, the transition government should leverage the existing welfare database in Iran (Paygah Refah) to identify vulnerable populations affected by price hikes and provide them with vouchers or, preferably, cash deposits that will enable them to afford higher costs of living. The government should assure these individuals that they will receive cash transfers or vouchers for a specific timeframe, with a known value, to compensate for foreseeable price hikes.

The difficulties and risks associated with price liberalization are well documented in many countries that have transitioned to market-oriented economies, from semi-socialist contexts like Chile to fully socialist ones like Hungary. Chile's reforms in the mid-1970s, for example, led to major problems in the early 1980s due to international shocks and mismanaged loans, resulting in shortages, unemployment, and severe poverty. To mitigate such problems, Eastern European Bloc countries adopted a more careful approach to social safety nets during their transition to market economies in the early 1990s. Egypt's experience between 2011-2013 also serves as a cautionary tale of a mixed approach to price liberalization, where key elements such as trade liberalization and clear government communication were missing, leading to economic hardship.<sup>6</sup> Therefore, it is important to (a) have a strong government determined to implement price liberalization policy, address corruption, and provide a robust social safety net during the economic transition, (b) clearly communicate plans, timelines, acknowledgment of difficulties ahead, and the desirable outcome to the public, and (c) implement required policies all at once, as Polish economists described when planning Poland's transition from a socialist to a market economy in 1989: "You don't try to cross a chasm in two jumps".

**PROTECTING CBI INDEPENDENCE IN LAW** - The CBI should be independent from the government. One of the main factors undermining the central bank under the Islamic Republic is the president's significant leverage in appointing CBI governors. The new constitution

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<sup>6</sup> These historical examples are discussed in detail in the appendix.

should move away from this practice and establish a mechanism in which CBI governors are selected based on a consensus formed by a group of elites and confirmed by the parliament. Additionally, the CBI should be recognized as the exclusive recipient of income earned by state-owned entities, such as oil and gas revenues. One of the main issues that has led the Islamic Republic into years of Dutch disease and inflationary fiscal policy is the government's influence over the allocation of oil and gas revenues for fiscal policies. Similar to the Bank of Russia, which was granted the role of Russia's "mega regulator" of the financial market in 2013, the CBI should have sole responsibility for making decisions regarding the banking system. It should be authorized to assign one observing member to each bank's board, establish, adjust, and enforce banking regulations, and audit the banking system as needed. No financial institution should be beyond the CBI's reach.

**FLOATING EXCHANGE RATE** - There are three main reasons for the transition government to adopt a floating exchange rate system. First, the combination of independent monetary policy, free flow of capital, and fixed exchange rate cannot coexist simultaneously (the Impossible Trinity). Among the three, it is essential that the Central Bank of Iran abolish the fixed exchange rate system and adopt policies for monetary reforms and ease of capital movement. An active monetary policy is long overdue to reduce inflation, while years of sanctions and a command economy have depleted the real sector of Iran's economy of capital, state-of-the-art infrastructure, and fixed capital growth. Second, Iran does not have sufficient foreign currency cash reserves or per capita revenue from oil and gas exports to peg the exchange rate like Saudi Arabia or the UAE. As a result, any attempt to fix the exchange rate would be temporary and, in the long term, a waste of national foreign currency reserves. In fact, as stated earlier, even the preferential exchange rate used by the government has been following the market rate with some lag. Third, years of such attempts by Islamic Republic have already led to the establishment of a deep and widespread black market that is nearly impossible to eliminate in favor of enforcing the government's exchange rate across the country. Thus, a unified, market-based exchange rate would effectively eliminate these black markets.

However, there is a major risk in the initial stages of dismantling the Islamic Republic's exchange rate policies. Rapid implementation of this policy is likely to lead to short- to medium-term shortages, as seen in Egypt's medical supplies in 2012. As the currency depreciated following exchange rate liberalization, while price controls remained in place, the import of essential medical and pharmaceutical commodities dropped significantly, leading to a healthcare crisis. Therefore, during the economic transition, policymakers should continue utilizing the existing Islamic Republic government currency exchange market for a selected group of major importers of essential goods to make sure the repercussions of a floating exchange rate policy do not create shortages in the country.

Floating the exchange rate and dissolving the existing government exchange market should only occur when there are no impediments to Iranian banks operating internationally, and privatization has begun with an influx of foreign direct investment. Otherwise, the exchange rate could lead to a major domestic recession and distort prices, negatively affecting privatization and the fair value accounting of the banking system.

**FOREIGN TRADE FACILITATION** - The Islamic Republic has imposed extensive tariffs on almost every imported item in the name of independence and supporting the domestic producers. This policy has not only resulted in lower levels of production, lower quality, and higher prices for consumers, while also opening the door to corruption and rent-seeking by those connected to the regime. From foreign-manufactured cars to wheat, government tariffs have been a substantial roadblock to economic reforms toward an open market economy. Therefore, the transition government should remove these tariffs in the medium term. The removal of import tariffs should be carefully planned to prevent adverse shocks to the supply of basic goods in the market. The lifting of these tariffs must be implemented in phases, while the foreign exchange rate is stabilizing after early shocks associated with political turmoil. The transition government should also consider the comparative advantages of major industries in Iran, giving them a reasonable timeline to adjust to international competition and avoid major unemployment issues. Environmental or socially appropriate tariffs should only be evaluated in the years after foreign trade liberalization is well-underway. The transition process itself is already complex, with a plethora of uncertainties that individuals, businesses, and government entities must analyze, learn, coordinate, and adapt to. Adding further

complexity with objectives that do not have immediate or near-term tangible impacts should be deprioritized until the country is successfully positioned as an open market economy. A cautionary example is Sri Lanka's experience after the elected president ousted the former government in 2019 and promised to transition the farming sector from chemical pesticides to organic farming. The abrupt ban on importing chemical pesticides in 2021 led to major economic output loss, farmer-led protests, and significant economic hardship for the country. Therefore, the transition government should clearly set aside idealistic goals until economic recovery is successfully achieved.

## 4. BANKING SYSTEM REFORMS

Before discussing banking reform, it is important to emphasize that the principles of economic and banking reform are independent of Iran's future political structure. While many policies can be delayed until after a general election determines Iran's political structure, the principles associated with a market-oriented economy are well-defined and established. Thus, regardless of the political system governing Iran post-Islamic Republic, the policies that shape a market economy and the path to implementing them will remain the same.

The banking system is a vital component of economic reform policies, especially in a country like Iran, where banks are the primary source of external finance. As discussed earlier, the current banking system suffers from a multitude of problems. While some of these issues may be automatically addressed following the collapse of the Islamic Republic—such as adherence to Islamic finance rules—more important root causes of the banking crisis will need to be fixed by the transition government. The transition government should establish a central bank team in charge of overseeing the CBI and, by extension, the entire banking system. It should be further emphasized that any financial institution currently operating outside of CBI supervision will be brought under the regulation and oversight of the CBI and other relevant banking authorities.

Banking reform must be centered on the three main pillars of modern central banking governance: independence, transparency, and accountability. Moreover, banking reform should not be considered a stand-alone policy. Addressing the government's chronic fiscal deficit and improving its fiscal discipline takes precedence over any banking reform. Given the banking system's role as the financial backbone of the economy and its interconnectedness with every sector, banking reforms must be implemented alongside other necessary reforms pursued by the transition government. Therefore, close coordination and planning between the transition government and the CBI are crucial to ensure that the overall outcome leads to the necessary economic reforms. A well-coordinated effort between the transition government and the CBI will mitigate issues related to the interdependency of the banking system with the broader economy. The following sections outline the core policy reforms that should take place within the banking system.

### 4.1. Monetary Policy and Inflation Targeting

One of the consequences of the CBI's lack of independence is that it is currently burdened with multiple objectives. For instance, Iran's monetary policy must currently align with the five-year development plan and the government budget. We recommend that the CBI be tasked with only two main objectives: price stability and financial stability. To achieve price stability and contain inflation, we suggest adopting inflation targeting as the core monetary policy strategy.

Inflation targeting has emerged as a prevalent monetary policy strategy for achieving price stability, with several countries adopting this approach. New Zealand was the pioneer in 1990, followed by Canada, the United Kingdom, Sweden, Finland, Australia, Spain, Israel, Chile, Brazil, Russia, and others. The key elements of inflation targeting include publicly announcing medium-term numerical targets for inflation, committing institutionally to price stability as the primary goal, adopting an information-inclusive approach to decision-making, increasing transparency in communicating policy plans, and enhancing central bank accountability for achieving inflation objectives.

An advantage of inflation targeting includes heightened transparency, making it readily understandable to the public. Explicit numerical targets increase the central bank's accountability, reducing the likelihood of pursuing overly expansionary monetary policies. It shifts the political debate toward long-term goals, such as controlling inflation, reducing pressure on central banks to engage in inflationary policies. Inflation targeting emphasizes communication with the public, using various channels to explain monetary policy goals, inflation targets, strategies, and reasons for deviations, thereby fostering public debate and reducing uncertainty. Overall, inflation targeting involves a multi-faceted approach to monetary policy, focusing on transparency, accountability, and a commitment to achieving and maintaining price stability.

#### 4.2. Balance Sheet Analysis and Health Check

In the early days after the collapse of Islamic Republic, the CBI must take immediate action to keep the banking system afloat. Considering the dire state of Iran's banking system, as discussed earlier, the central bank's policy should gradually shift from short-term stabilization to a thorough overhaul of the banking system based on the results of a balance sheet analysis. Given the widespread malpractice of banks in Iran categorizing non-performing loans as deferred assets on bank balance sheets, it is difficult to clearly assess how each financial institution is performing in terms of reserve requirements and capital adequacy ratios. Therefore, we recommend hiring external auditors to examine the bank's balance sheets in the first to second quarter following the collapse of the Islamic Republic.

Once the balance sheet analysis and auditing of banks is complete in the first three months, three possible scenarios may arise:

- A.** If a bank meets its capital adequacy ratio (according to Basel III) and reserve requirements, it can resume normal operations as long as the board of the bank agrees to the following terms:

1- Comply with the regulations set forth by the central bank.

2- Have an observing member assigned by the central bank to its board.

3- Adopt the latest IFRS accounting standards and Basel III (or the most recent version by the time of transition) within one year of resuming normal operations.

4- Prior to the implementation of the unified credit rating/assessment system and global banking connections are in place, the bank should regularly review credits issued as declared in loan applications, and should violations occur, the borrower must be reported to authorities.

- B.** If a bank fails to meet reserve requirements or capital adequacy ratios and is already insolvent, the central bank should consider the following actions:

(1) If a bank suffers from severe insolvency and chronic asset mismanagement, dissolving it may be necessary—even though it should remain a last resort because of its impact on employment, systemic stability, and the administrative burden on the central bank. Dissolution is preferable when the cost of recapitalization is not justifiable given the amount of non-performing loans, bad assets, and malpractices. For example, if recapitalizing a bank would take a considerable chunk of an already stressed budget, it is not justified to save such a bank. In such cases, the bank should be publicly declared insolvent, and its assets transferred to the government entity responsible for privatization. Revenues generated through asset sales should be used to reimburse shareholders and account holders of the bank.

(2) Despite its higher expense and fiscal implications, recapitalization is generally the preferred method for correcting systemic issues in the banking sector, as it can lead to a more controlled and less disruptive transition to a free

economy. As such, most global banking reforms since the 1970s have been focused on recapitalization, which has averaged around 6% of GDP in countries that have adopted this strategy. Under recapitalization, the central bank could set forth a set of conditions to ensure that, moving forward, banks comply with all relevant regulations (including the Basel framework) and do not contribute significantly to the build-up of systemic risk, undermining the stability of the financial system. It is advisable to coordinate these efforts closely with the International Monetary Fund (IMF). Given the enormous rollover losses in Iran's banking system, it is likely that a loan from the IMF would be needed for recapitalization efforts. Some of the potential conditions the CBI might set include:

- 1- No payment of dividends to shareholders until the recapitalized loan is paid back.
- 2- No profit recording until the recapitalized principal is paid back.
- 3- Comply with the regulations set forth by the central bank.
- 4- Have an observing member assigned by the central bank to the board of the recapitalizing bank.
- 5- Adopt the latest IFRS and Basel III (or its most current iteration at the time of transition) standards within one year of resuming normal operations.
- 6- Until the implementation of a unified credit system and the Iranian banking system's reconnection to the global banking network, the bank must regularly review any credits issued according to the loan application, and should violations occur, the borrower should be reported to authorities.

(3) Restructuring troubled banks is another viable option, depending on the outcome of balance sheet analyses and other factors at the time of transition. The central bank may choose to initiate and lead a restructuring process of a bank directly. Alternatively, if a sufficiently capitalized bank in Iran is willing to acquire and restructure a troubled institution under central bank supervision, a merger can proceed—provided the restructuring plan fulfills the four conditions set forth in Section A. In the process of debt restructuring, the central bank should transfer bad assets of the bank to privatization entities and use the resulting revenue to recapitalize the troubled bank.

If a bank refuses to comply with these conditions, the transition government should dissolve its board and convene an emergency shareholder meeting to elect new board members who would only be accepted as nominees if they accept the stated requirements. Should the shareholder meeting result in no positive outcome—or the bank's major shareholder is tied to previously dissolved entities, such as IRGC—the central bank should assume direct management of the institution. In this event, it must be publicly announced that the bank will be added to the privatization roster and, until the bank has new owners, no dividends will be paid to shareholders nor profits recorded. Although this approach may appear overly interventionist or in conflict with free-market principles, it is crucial during the initial stages of banking reform to avoid moral hazard. The central bank must not compromise the principles of a sound banking system by rescuing institutions—regardless of their size or management quality—that pose systemic risks or undermine healthy operations.

Russia provides a useful case study here. Structural reforms in its banking system began in 2011 and intensified after Elvira Nabiullina assumed governorship of the Bank of Russia in 2013. Under her leadership, the Bank of Russia implemented several key reforms, including strict adherence to Basel capital adequacy ratios and enhanced risk management practices. The Bank of Russia conducts frequent assessments of Russian banks' risk profiles and has shut down many high-risk institutions. In fact, between 2011 and 2020, the number of banks in Russia dropped from 978 to 370—more than 600 closures—yet the total assets of the banking system grew fourfold (see Figure 8). A similar approach must be adopted in Iran.

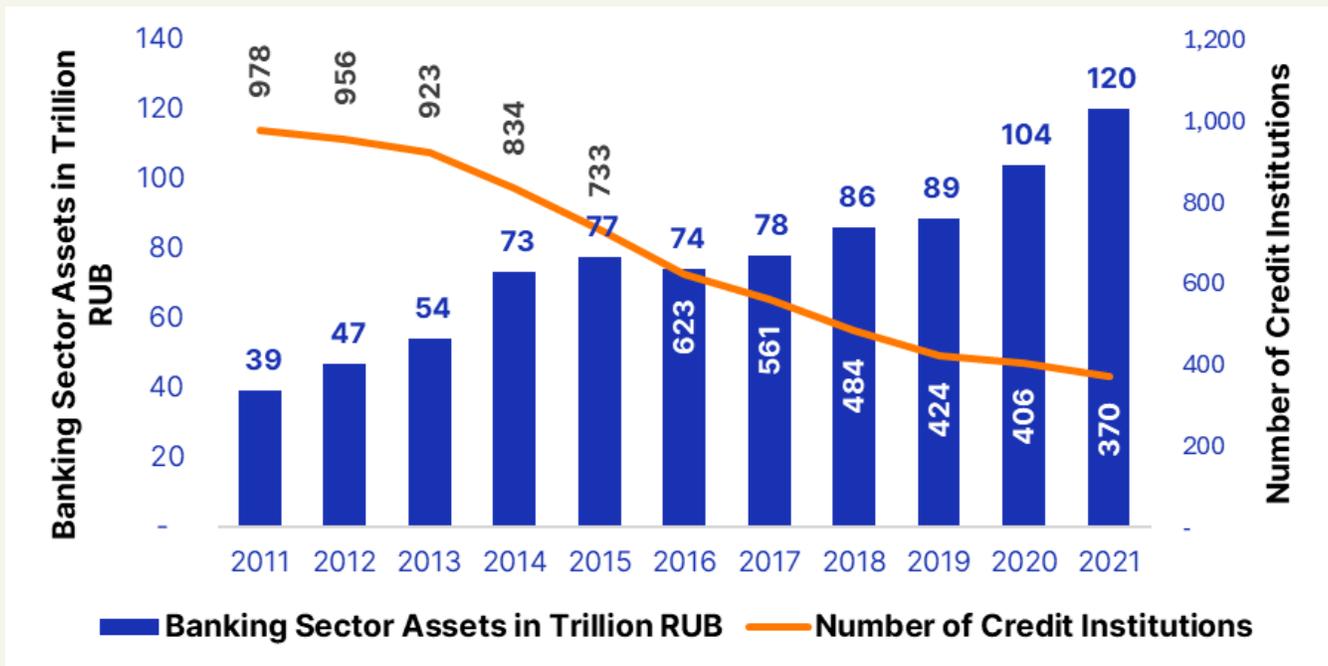


FIGURE 8: The trend in the number of banks and total assets of the banking sector in Russia

### 4.3. Unified Credit Assessment (Rating) System

The transition government’s central bank should establish a unified credit score/rating/assessment system. This system could leverage existing databases, such as “Paygah Refah Iranian,” and integrate banking records of individuals and businesses as a starting point to develop a credit scoring system based on assets, salaries, tax history, and bank account balances. Once this database is established and reliable, each bank must use the unified credit system to evaluate the creditworthiness of its customers. Banks would apply the credit scores generated by the central bank’s database as the basis of their own risk management strategies and set interest rates accordingly, but they must not extend credit to borrowers whose scores fall below a floor set by the central bank.

Developing this system is complex and may justifiably take more than a year. To make the development of this system as fast and reliable as possible, the central bank should allocate resources accordingly and take advantage of existing databases as much as possible. The speed of deploying this credit system will directly contribute to how quickly the monetary policy can begin showing positive results— such as improving the banking system, enhancing credit culture and monitoring, curbing corruption, and managing inflation and unemployment. During the transition, these are among the vital KPIs that could help policymakers take corrective actions in a timely manner.

The central bank should invest in public education regarding the credit score system to increase financial literacy. Individuals need to understand how to manage their finances to improve their creditworthiness, ultimately qualifying for better rates or larger loans. Brazil’s experience offers a useful example: its central bank manages a credit information system while three separate companies oversee data management, reporting, and communication. This structure allows the central bank to monitor the nation’s credit status, helps consumers stay informed about their financial health, and enables lenders to assess loan applicants’ creditworthiness. In establishing

regulations for credit scoring agencies, it is crucial to protect the privacy rights of citizens and ensure effective collaboration among financial institutions.

#### 4.4. International Standards of Banking and Accounting

Compliance with Basel and IFRS is among the most important reforms for Iran's banking system in the post-Islamic Republic era. Currently, there are no established or enforced regulations requiring Iranian banks to adhere to international best practices in banking and accounting. At the time of this report, only one bank—Bank-e Khavarmianeh—is in full compliance with the most recent Basel and IFRS standards. It is equally important for the central bank to overhaul its own accounting system, ensuring it conforms to the most recent IFRS guidelines. The central bank should strive to meet these standards within one year of assuming power.

#### 4.5. Other Banking Reform Policy Recommendation

- In the early stages following the collapse of the Islamic Republic—and until the new banking regulators are confident that the banking system is on solid footing and adheres fully with the Basel framework—banks should be required to maintain at least 20% to 25% of their assets in cash or other liquid assets. Institutions classified as higher risk, based on the assessment in Section 4.2, should maintain an even larger percentage. The penalty for those banks violating this regulation is an increase in their reserve requirement. At minimum, banks must provide a plan to meet these liquidity thresholds over a prespecified period, with the compensation of the CEO and board members tied to this objective and meeting bank performance targets.
- Banks identified as very risky (i.e., those with significantly negative capital adequacy, according to the balance-sheet analysis and Health Check in Section 4.2) should not be allowed to offer interest rates higher than the average interest rate offered by healthier banks.
- Given the persistent government fiscal deficit, massive rollover losses, and non-performing loans in the banking system, raising interest rates could destabilize banks. In the short term, therefore, the central bank is unlikely to use interest rates as the main anchor for inflation expectations. Instead, we recommend limiting the expansion of banks' balance sheets as a monetary policy tool to control and reduce liquidity (M2). It has to be highlighted for this policy to work, it must be applied to all banks with no exception and there must be an up-to-date financial accounting system (IFRS) in place. Furthermore, restrictions on balance sheet expansion must follow a progressive scheme where the highest level of restriction is imposed on the riskiest banks as determined by the assessment process described in Section 4.2.
- Iran's bankruptcy procedures must be reformed and modernized.
- Structural reforms should be introduced to strengthen corporate governance in both corporations and banks. These reforms must address conflicts of interests among various stakeholders in the banking system.

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## Appendix

### A1. Historical Context of Economic Reforms with Banks at Their Heart

There have been as many as 200 examples of banking system reform in the past 40 years. While many banking reforms are initiatives of governments, there are many cases that represent banking system reforms following political turmoil or regime change. This section begins with the economic reforms of the Pinochet government following the 1973 coup d'état in Chile. Drawing from the experiences of Chile, we then explore similar reforms that shifted economies from socialist to market-oriented models in Eastern European countries following their separation from the Soviet Union between 1989 and 1991. Finally, we briefly discuss the case of Egypt in 2011, presenting the perils of populist policies adopted for short-term gains in the aftermath of a regime change.

#### A1.1. Chile

The case of Chile is an example of socialism on steroids. Before 1970, Chile's economy featured two major government-controlled mining industries, with the private sector dominating other areas. President Salvador Allende came to power promising nationalization of industries and land through socialist reforms aimed at addressing income inequalities. However, in 1973 amidst hyperinflation, a successful coup d'état brought General Augusto Pinochet to power. Pinochet enlisted a group of young Chilean economists from the University of Chicago—protégés of Milton Friedman, often called the "Chicago Boys"—to redesign Chile's economy. Shortly afterward, the government introduced a series of neoliberal, market-oriented policies, including:

- Halting or reversing previous nationalizations and returning industries and land to their former owners.
- Trade liberalization and price deregulation. Opening markets to international trade and allowing prices to be set by market forces.
- Fiscal conservatism by restricting wage increases, curbing government spending, cutting subsidies, and overhauling social security through privatization.
- Monetary reforms such as the introduction of a new currency to stabilize prices and control inflation.

- Promoting and facilitating foreign trade by reducing barriers to trade.

While these policies successfully controlled the hyperinflation, deficiencies in policy implementation—coupled with rushed privatizations and reliance on copper exports (subject to volatile global prices)—caused a recession, high unemployment, and a reduced social safety net, pushing many Chileans into poverty. The 1973 oil crisis and subsequent global recession, as well as an accumulation of non-performing loans, finally led to a full-fledged crisis in 1981, causing multiple bank failures. To contain the crisis, Chile enacted further reforms in the banking sector and had largely stabilized the situation by 1984. These actions are often cited as a classic example of macroeconomic policies used to manage a banking crisis:

- Rising interest rates resulted in less domestic borrowing to cool down the effect of many non-performing loans.
- The currency exchange was reverted back to floating exchange rates from the pegged rate established in 1979.
- Selling off state-owned assets enabled the government to generate revenue for reducing the government debt burden as well as recapitalizing troubled banks.
- The government established a new entity, the Banco Central de Chile, to assume central banking duties and enhance supervisory oversight of the banking system.
- To prevent capital flight, the government set limitations for transferring capital out of the country.
- Four severely distressed banks declared bankruptcy and were then taken over and recapitalized by the government. As a condition of this support, no dividends could be paid and no profits could be recorded until the government’s recapitalization debt was repaid.
- The government also restructured the debts of major indebted entities, including the state-owned copper company.

## A1.2. Eastern European Countries

When Eastern European nations began separating from the Soviet Union, economists in the Eastern bloc viewed Chile’s transition from socialism to a market-oriented economy—despite its challenges with hyperinflation and the violent coup—as a qualified success story. One advantage that Eastern Europe and the former Soviet Union had over Chile was a relatively “soft landing,” as transitions in countries such as Czechoslovakia (the Velvet Revolution) and Poland (the 1989 Revolution) did not involve the same degree of upheaval as Chile’s coup d’état. This is an important notion when we focus on the significance of short-term policies and signals of fear or hope that reverberate in an economy as a result of a government change.

Immediately after separation from the Soviet Union, each Eastern European country grappled with high or hyperinflation, outdated industries, and a heavy reliance on Soviet-era supply chains. Despite these challenges, every country in the Eastern bloc was determined to achieve the end goal of a market-oriented economy. As a result, the principles of reforms were similar in every country. These core principles were:

- Employing fiscal austerity measures and undertaking monetary reforms to combat high inflation.
- Opening up foreign trade, promoting investments from abroad, and attracting international capital.
- Privatization
- Price deregulation
- Social safety nets

One of the key lessons drawn from Chile’s experience was the importance of social safety net policies. Although Eastern European countries generally embraced the same principles for transitioning to a market-based economy, each pursued a unique implementation

path. Poland's reform program—known as the Balcerowicz Plan—stands out for its comprehensive and rapid approach, famously encapsulated by the phrase “you can't cross a chasm in two steps.” As a result, Poland experienced severe unemployment, inflation, and a sharp GDP decline in 1990 and 1991, surpassing the initial turbulence faced by other Eastern European nations. Nevertheless, the government's determination to fully implement economic reforms led to sustained GDP growth of about 5% annually for the next five years and continued until Poland joined the EU. At the same time, Czechoslovakia and, to some extent, Hungary took the same measures at a slightly slower pace, which caused heightened inflation, unemployment and GDP contraction for approximately three to four years. By 1996, however, both countries had established market-oriented economic stability, marked by lower unemployment and controlled inflation. The core lessons learned from the experiences of Eastern European countries' transitions to market economies are as follows:

- Government determination to tackle all issues related to the socialist system at once.
- Persistence in applying price deregulation and price discovery at market-clearing levels.
- Facilitating international trade and attracting foreign investment.
- Fiscal austerity, maintaining disciplined government spending, and balanced budgets, even though these constraints can be challenging for a newly formed government.
- Transferring state-owned enterprises to private ownership wherever possible, with minimal barriers.
- Implementing protections for vulnerable populations to mitigate the hardships of economic transition.
- Bold monetary reforms for inflation control.

It should also be noted that the geographical proximity of Eastern European countries to market-oriented and thriving Western European economies acted as a significant incentive in their journey toward economic reform. A symbolic illustration is the opening of a McDonald's restaurant in Prague just four months after the 1989 Velvet Revolution. Western engagement in the region's post-socialist economic recovery was driven primarily by two motives: (1) the desire to stabilize an area historically prone to conflicts, and (2) the business opportunities arising from close geographic ties, which encouraged Western firms and countries to invest in their eastern neighbors.

### A1.3. Egypt

Egypt's experience underscores the importance of a strong, determined executive branch in implementing effective economic and banking reforms. Under President Hosni Mubarak, the government initially pursued a privatization program modeled loosely on Chile's approach. In 1991, his government privatized 314 state-owned companies, accounting for roughly 15% of GDP. A decade later, the only thing the public would recall from that policy is corruption. A shining example is Ahmed Ezz, Husni Mubarak's party secretary in the 1990s, who leveraged political influence amidst privatization and became a business tycoon with a near-monopoly in the steel industry of Egypt. Such malpractices were central factors leading to Mubarak's ouster from power in 2011. With much of the economy effectively controlled by a small, influential group operating beyond normal regulatory oversight, the newly elected government of Mohamed Morsi aimed to introduce more equitable economic policies. In practice, however, these policies neither fully liberalized the economy nor returned it to a purely socialist model. While the economy of Egypt was suffering from high inflation, high unemployment, and fiscal deficit, the economic reforms of Mohamed Morsi's government were questionable at best.

It took Morsi's government nearly a year to provide economic reform plans acceptable to the IMF. Moreover, a complex set of Islamic finance regulations—intended to ban interest payments—was difficult to implement, while court orders overturned some of the earlier privatizations, returning ownership to the state and concentrating power among individuals close to the Muslim Brotherhood. A depreciation in exchange rate led banks to have more stringent exchange control, impeding international trade and financial integration.

Additionally, Morsi's government failed to reduce or eliminate heavy subsidies on wheat and fuel, exacerbating the fiscal deficit and inflation in the years following the 2011 revolution.

It can be argued that a mixed approach to economic reform, along with a populist agenda and religious ideology, led to exacerbated economic conditions and, finally, a coup d'état in Egypt. Today, Egypt under General Abdel Fattah el-Sisi is once again pursuing privatization, though it appears dominated by military-affiliated figures, and economic hardships for much of the population persist. As early as 1990, economists like János Kornai warned of the pitfalls of "mixed" approaches to reform—often referred to as "market socialism." Kornai's work, particularly *The Road to a Free Economy*, emphasized the need for decisive, surgery-like measures and brief but intense periods of difficulty to achieve enduring economic prosperity.

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