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SEAL OF THE CENTRAL BANK OF IRAN

IN THE NAME OF GOD
SECRET

Secret/Urgent

HE Dr. Mohammad Reza Rahimi
First Vice President &
Head of the Economic Special Measures Committee

'Salaam Aliyekom'

With respect, a report concerning the effects and consequences of the impending economic crisis and suggestions for neutralizing their effects is enclosed for your consideration.

Mahmoud Bahmani
(Governor of Central Bank)

Encl.
Other recepients:
HE Mr. Agha Mohammadi
Office of Supreme Leader
HE Dr. Salehi
Minister of Foreign Affairs
He Dr. Saeed Jalili
Head of Supreme National Security Council
HE Dr. Yazdi
Deputy Minister for Economic Affairs, Ministry of Information [Intelligence]
HE Mr. Hossein Mehrab
Director of the Special Economic Committee, Supreme National Security Council
Ms. Minoo Kiani Raad
Deputy Head of the Bank for Currency Affairs

Mahmoud Bahmani
(Governor of Central Bank)

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Economic Problems

The banking sector:

1. The banks' financial situation continues to deteriorate, and overdue public loans from banks and credit institutions are constantly on the rise. As a result, the CBI now has to provide a total of over 500,000 billion Rial in assistance to commercial banks, professional banks, state-owned and private banks.
2. There is a negative real interest rate for deposits and bank credit, which is destabilizing the banking system. In addition, the banks provided overly generous loans to economic sectors that were not matched by their deposits, which were until now covered by loans from the CBI. As a result, the banks have insufficient capital, and depositors will sustain the damage from any cut in CBI assistance.
3. At the same time, the banks are experiencing difficulties with their customers, whose bank debt has increased by over 27%, reaching over 750,000 billion Rial. 34 million citizens owe the banks money, and most of them are having difficulty repaying their debt, resulting in actions taken against 7.2 million citizens.
4. The banking system is contending with an impossible combination of credit and liquidity crisis, negative real interest, and a shortage of capital. The slow-down in economic activity is destabilizing the system even further, and making the banks totally dependent on the CBI. The CBI's budgetary deficiencies, which will undermine its ability to support the banks, are expected to lead to the collapse of the most of the banks, and their inability to repay the public deposits they hold.

Lack of access to foreign currency reserves, and a critical lack of foreign currency in cash:

5. The imbalance between income and expenses in foreign currency caused by a 50% reduction in oil sales as well as a large injection of foreign currency into the market has exacerbated the pressure on foreign currency reserves in addition to the loss of access to a substantial proportion of the foreign currency reserves due to the sanctions. Most of the foreign currency deposits are blocked, in some cases due to frozen bonds, and in others, due to use of

reserves for other purposes, their allocation to projects and the National Development Fund, or the fact that they do not belong to the CBI. A large percentage of the national gold reserves have already been sold to the public as gold coins, and access is blocked to approximately 90% of the country's foreign currency deposits (in China and Bahrain). As a result, the country cannot use the reserves to help resolve its current foreign currency problems.

6. The numerous expenses have presented the CBI, which is responsible for managing foreign currency sources and economy, with a serious problem. If the situation persists, or foreign currency revenue drops any further, the country will have serious trouble paying for the foreign currency it requires to import staples. It is also having a great deal of trouble procuring foreign currency in cash, due to tighter restrictions in Dubai and Turkey, so the possibilities for increasing foreign currency supply to the local market are limited, and this situation will lead to further depreciation of the rial. It is therefore essential that the country limit all its foreign currency consumption, and supervise it closely, and that the CBI continue drastically reducing the amount of foreign currency it transfers to the markets.

Reduced ability to supply basics, due to the sanctions:

7. Due to the drop in foreign currency reserves, it is becoming increasingly difficult to pay for the foreign currency it requires to import basics. Despite the danger involved in the Rial's devaluation, use of foreign currency must be limited to financing imports, including staples imported at a low exchange rate. The mounting difficulty in transferring international payment, and higher commission are also undermining the ability to import staples and other goods, leaving no choice but to cut imports sharply.

Expected depreciation of the rial:

8. The steep decrease in the exchange rate stems from the lack of foreign currency on the markets, the undesirability of other investment channels, loss of public confidence in the economy, procurement of foreign currency that is not for import, international restrictions on transferring foreign currency to the country, increased inflation, and escalating concern among the public and traders that foreign currency transfers will become impossible. Note that the

various steps taken, such as cuts in imports, curbing of demand through changes to the foreign currency sale regulations, and price hikes for foreign currency for imports, have not succeeded in preventing the ongoing depreciation of the rial.

9. The exchange rate therefore has to be adapted to the current reality, which will firstly require a unified exchange rate to be of 47,000 Rial for 1USD.

<u>Lack of raw materials for printing banknotes:</u>

10. According to the SPMO, which is responsible for minting money, the supply of raw materials for producing bank notes has become problematic and expensive, due to the pressure of the international sanctions, and use of raw materials required for this purpose must be restricted. Due to these restrictions, far less money has been produced than the CBI ordered, and public demand is not being met, especially when it comes to coins, generating public criticism of the banks.

11. A serious shortage of bank notes is therefore expected during the second half of the current year, which is already forcing the CBI to reduce the amount of money in the economy. The country lacks the means to respond to an emergency situation demanding massive printing of bank notes. In such a scenario, there would be a huge gap between supply and demand.

<u>Escalation of sanctions and restrictions on financial activity:</u>

12. The international sanctions are expected to escalate this summer, reducing even further the small number of banks now working with us, and raising commissions for financial activity. This financial isolation will make it even more difficult for to carry out routine import activity and utilize revenue from oil export, and will force the to cut back import and reduce the use of foreign currency, and make it even more difficult to use the foreign currency reserves abroad.

<u>Inflation hikes:</u>

13. According to price surveys carried out by the economic analysis and economic policy department at the bank in 20 major cities, the annual inflation rate in 1391 (2012-2013) was 85.4%.

14. According to the survey, the most serious price hikes were for food. For example, the price of a kilo of beef increased from 120,000 Rial to 200,000 Rial, while the price of a liter of oil rose from 14,000 Rial to 36,000 Rial.
15. There has also been a steep rise of approximately 40% in average housing prices, and an even sharper increase of approximately 87% in prices of construction products, which is expected to raise housing prices even further.
16. The planned lowering of the Rial exchange rate is expected to lead to additional steep price hikes for imported goods, including staples such as corn, rice, and wheat.

<u>Sharp rise in unemployment rates:</u>

17. According to research carried out by the economic analysis and economic policy department, the unemployment rate for people over the age of 15 is 25.4%, with especially high rates recorded among people aged between 15–29 (38.8%) and academics. 1391 (2012-2013) was characterized by the dismissal of employees, mainly in the following industries: The automobile, mining, quarrying, textiles, steel, and petrochemicals industries.
18. The significant differences between the figures in this report and those recently published by the central bureau of statistics in the media stem from the following:

a. Different definitions of unemployment. The central bureau of statistics defines the unemployed as people who work less than two hours a week, while our reports refers to the unemployed as people who work less than two days a week (in accordance with accepted international standards).

b. The central bureau of statistics' data does not include dismissals during the second half of 1391 (2012-2013).

19. Most of the factory owners interviewed for the survey said they would be forced to fire many workers during 1392 (2013-2014), due to the grave economic situation.

<u>Failure of the process of privatizing national companies:</u>

20. Despite the early forecasts of high returns from implementing Principle 44, very few national companies were privatized in 1391 (2012-2013), and as a result, the budget's projected income from privatization in 1391(2012-2013) was not realized. Due to the slow-down in the economy, it appears that the

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regime's privatization target will not be achieved in 1392 (2013-2014) either, and the regime will therefore be unable to rely on income from privatization as a significant budgetary source in the upcoming year.

Bankruptcy of major companies:

21. Many of the production and industrial sectors are on the brink of collapse, as a consequence of the sanctions, which are increasing the prices of imported raw materials, and making imports difficult due to price hikes for raw materials in the country, as a result of inflation and the subsidies plan, and the drop in local demand resulting from the economic crisis. 1391 (2012-2013) saw an overall drop of 47% in vehicle production by automobile companies Iran Khodro and Saipa; aviation companies are heavily in debt, which is hampering their activity; many plants are having difficulty paying wages; and a large percentage of them have been forced to lay off employees. These problems are expected to exacerbate in 1392 (2013-2014), leading many plants to the brink of collapse.

Steps recommended for contending with the crisis:

1. Restrictions on public withdrawal of bank deposits, to increase the banks' assets, and prevent a possible scenario in which the banks do not have enough cash to meet public demand.
2. Taxation of public bank deposits (like the Cypriot model): 10%–20% tax on deposits, to bridge the budget deficit projected for 1392 (2013-2014).
3. Implementation of the second part of the new version of the subsidies plan: Price hikes of 80%–300% for energy and other staples, such as water, bread, and wheat, and an accompanying increase of the monthly allowance paid to citizens of only 20%.
4. An increase of 15%–35% in taxation on imported goods from groups 3–10, and 5%–10% for groups 1–2 (foodstuffs and medicines).
5. More taxes and fees collected from the public, including tax on purchasing additional apartments for investment purposes, and a fee for purchasing foreign currency.
6. Enforced payment of electricity and gas bills by citizens and companies to the national companies.

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7. Further major restrictions on the sale of foreign currency cash and credit to citizens and traders, due to the acute shortage of foreign currency, which is expected to escalate in 1392 (2013-2014), as a result of a steep drop in oil revenue, which will require calculated allocation of foreign currency.
8. Additional restrictions on removing foreign currency out of the country: A prohibition on carrying over $1000 without special permission, and stringent supervision at border crossings, to enforce this restriction.
9. Lowering of the Rial exchange rate to at least 50,000 Rial to the dollar, followed by the unification of the open and official exchange rates.
10. Decreased military expenditure and assistance in foreign currency, further to steps recommended for decreasing foreign currency consumption.
11. Rationing of staples: As was the case during the war with Iraq, coupons of predetermined sums will be distributed to the public to purchase staples such as rice and chicken. It will not be possible to buy these products in shops without coupons.
12. Gradual increase of VAT to 15%–22%, to match the rate in many other countries. This step will enable the regime to significantly increase its budgetary resources for 1392 (2013-2014), while also reducing public consumption.
13. Extensive issuing of bonds to the public, to reduce the amount of cash in the economy, and increase budgetary resources.
14. Nationalization of private companies and banks, especially those with foreign currency assets. Compensation mechanisms will be determined separately by the Supreme National Security Council's economic measures HQ. This step will enable the state to increase its budgetary and foreign currency resources.
15. Further cuts in imports of staples, raw materials, and other products: Due to the significant shortage of foreign currency, and the difficulty transporting oil revenues from Asia to Europe, significant cuts will be have to be made to imported staples, such as wheat, rice, and raw materials for industry, especially from Europe and Latin America.
16. In general, it is recommended that these measures be accompanied by a speech referring to the "economic heroism" required of the public during 1392 (2013-2014), which was the expression used by the Leader when referring to the year 1392 (2013-2014) in his Nowruz speech.