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IRAN'S MONETARY SYSTEM A STUDY OF WORKING OF CENTRAL BANK OF IRAN SINCE, 1975

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Abstract: *Since the dawn of modern civilization, money has played a very important role in shaping the economic activities of the human race. In the modern economy, the price level, National Income and employment is highly influenced by money supply, this money supply in itself influenced by intricate financial system which is usually predominate by the banking system where the commercial banks are financial intermediaries. In order to harness the vast potential of the banking system for the planned and co-ordinated development of the economy and to promote economic stability the central bank is the prime institution performing in manifold functions like creation of paper currency, control of bank credit, management of public debt, regulation of foreign exchange and as a banker to the government.*

Keywords: *MONETARY SYSTEM,Central Bank,economies*

INTRODUCTION

Not very long ago, the conventional wisdom of the western economic thinkers used to question the necessity of the Central Bank in a developing economy like that of Islamic Republic of Iran. This typical argument was that the main function of the Central Bank was to control the baking Industry. However, in an under developed economy, banking industry itself is not developed and it is often conspicuous by its absence. So they thought that in such economy the central bank will have nothing to control and will operate in a vacuum.

They ridiculed the endeavor by encouraging third world countries to establish their own Independent Central Bank as only a Status Symbol like a National flag, National anthem or as National airline airline. However, this skepticism about Central Banking in the underdeveloped Countries has now given away to the affirmation that Central Bank is necessary and useful in underdeveloped countries and it has to perform many non-traditional developmental function besides being as monetary authority to control money supply.

This appreciation of the constructive role of the Central Bank has crested interest among academicians bankers about the studies in Central Banking in such countries.

The present study is a modest attempt to critically examine and review the working of the Central Bank of Iran since 1975 against the backdrop of Iran's monetary system.

OBJECTIVES OF THE STUDY

1. To trace the development of monetary system in Iran with an overview of its different constituents and their relationship with the Bank Markazi, that is the Central Bank of Iran.
2. To review the historical development of Central Bank of Iran, underlying main stages in its evolution and landmarks in its progress.
3. To have a critical appraisal of the present working of the Central Bank of Iran since 1975 with a view to evaluate the policy of changes after the Islamic Revolution in 1978.
4. To examine the monerary policy of the central bank its objective efficacy of its instruments of quantitative and qualitative credit control.
5. To suggest policy measures to increase the operational essicienc of Central Bank of Iran.
6. To make a special study of the role, if any played by Central Bank of Iran in accomplishing broad Socio-Economic objectives of the Islamic Revolution which has heralded a new era in a banking industry of the country.

REVIEW OF LITERATURE

There are many research studies available regarding the functioning of Central Bank in both developed and underdeveloped countries. Besides there are official publication by Central Bank's themselves periodically mentioning about themselves with regard to their policies and instruments, they adopted to implement these policies. Unfortunately there is no systematic study of the working of the Central Bank of Iran, since 1975. There are few articles and some government publications about the Iran's Financial System and its relations with the Central Bank.

In this present study a brief review of earlier literature on the theoretical aspect of the Central Bank and the operational problems of Central Bank in some Asian countries like India and Pakistan is attempted. It is hoped that this review of literature can provide guidelines about the nature and scope of the present study.

SCOPE OF THE STUDY

As far as the scope is concerned, even though the Central Bank of Iran was established in the year 1968 it is not possible to cover the entire period of its history. As there is a time and money constraint in research work it is decided to study the time period from 1975 onwards. The choice of the study period has got its own rationality. The Islamic revolution in Iran took place in the year 1978. Since then many revolutionary changes are introduced in the economy of Iran. As a result of that it is meaningful to make a comparison between pre-revolution and post-revolution working of Central Bank of Iran and its monetary policy. The period from 1975 covers both these stages in the Iran's modern history and so provides the opportunity to study stages the impact of revolution of the financial system of Iran. Besides, the period under study witnessed a prolonged military conflict with IRAQ and the war took heavy toll of Iran's man power and other resources. During most of this period the economy of Iran was a war economy, and how the Central Bank could face the problem created by the war is a matter of interest not for Iran but also for many countries interest that was similarly placed.

In the present thesis an attempt has been made is focus a attention on the organizational of Banking system of Iran its different constituents of the Banking System and the various functions performed by the Bank Markazi (The Central Bank of Iran). The study also made an attempt to give some constructive recommendations for the future working of the Central Bank.

RESEARCH METHODOLOGY

To study this topic the researcher collect authentic and up to date information as large amount of secondary data is collected from the official publications of the government. In addition to this, some books published by the Central Bank and its reports were looked into. Moreover, studies by individuals were also examined. And also the reports and studies published by I. M. F and World Bank are used to study this topic.

Apart from this, the researcher made several trips to Iran, contacted bank officials, this secondary data is further supplemented by arranging interviews with bank official and with economists of banks in Iran and India.

In order to analyze the monetary policy of Iran and its effects, statistical techniques like co-relations and regression analysis are used. A modes attempt is also made from the empirical measurement of demand function for money in Iran. Scheme of the present study is give below, with its chapter details, which is as follows.

CHAPTER DETAILS

The First chapter, of the thesis is an introductory chapter, which brings out the relevance, importance, objectives, methodology and scope of the study namely "Iran's Monetary System a study of working of Central Bank of Iran since, 1975".

The Second chapter deals with the Central Banking with special reference to developing countries. It also made an attempt to understand the current thinking on the monetary theories and the theories of finance which provides theoretical formulas of the working of the Central Bank in the country. This chapter analyses relevance of the current theory of finance to the working of the Central Bank of Iran.

The Third chapter, focused on the Islamic financial system which is governed by Islamic law of prohibition of Interest was not originally based on economic theory but on the Devine authority, which considered the payment and receipt of interest as an act of injustice. However, attempts were made to explain the law and rationalize its application. Early Muslim scholars considered money as a medium of exchange, as a standard of value and as unit of account, but rejected its functions as a store of value for which money could be sought an end in itself. Thus hoarding money was considered as an act of injustice. And since hoarding money is injustice it is meaningless to sell money for money except to take money as an end in itself which is injustices. With reference to theories of Interest the modern Muslim scholars place the major emphasis of their explanation of the law squarely on the lack of satisfactory theory of interest. They see all the existing theories of interest as attempts to rationalize the existence of an institution which has become deeply entrenched in modern economies.

Muslim scholars maintain that when a person lends money the funds are either used to create a debt or an asset. In the first case there is no Justifiable reason as to why the lender should receive a return nor is there a Justification either from the point of view of the smooth functioning of the economy nor from the point of view of any scheme of social justice, for the state to attempt to enforce unconditional promise of interest payment regardless of the use made of the borrowed money. If on the other hand, the money is used to create additional capital, this question is raised as to why should the lender be entitle to only a small fraction(represented by interest rate) of the exchange value of the utilities created from the made of his loaned out money. Justice demands that he should be remunerated to the extent of the involvement of this financial capital in creating the incremental wealth. Islamic the Muslim scholars aqua that there is no objection to true profit as a return to their entrepreneurial efforts and their financial capital in fact such profit is encouraged.

An amount of money advanced for the purpose f trade and production can be contracted to receive as share of the profit, because it is the supplier becomes part-owner of capital sharing in the risk of enterprise and is thus entitled to receive a share of profits of the firm. He is partner in the enterprise and not as creditor.

Islam acquiesces in a wide freedom of contract, assuming that the terms of contract are not in violation of the precepts of the Sharih and is disposed to approving any agreement based on the consent of the parties involved. As long as the shared of each are contingent upon uncertain gained. This aspect of the arrangement is crucial since the Sharih condemns even a guarantee by the working partner merely to restore the invested capital intact not only because it removes the element of uncertainty needed to legitimate the bargain for possible profits, but also because the lender will be remunerated to the extent of the productivity of this financial capital in the resulting profit. This is considered as injustices if capital wealth created is to have a highly value as year hence, than the lender should be rewarded for the contribution, his financial capital has made in creating the additional wealth.

Money represents the monazite claim of its owner to properly rights created by assets that were obtained by lending money. As a result it is a transfer of this right and all that can be claimed in return is its equivalent and no more interest on money represents an unjustifiable creation of properly rights unjustified, because interest is a properly right outside the legitimate framework of individual property rights recognized by Islam.

With reference to the Banking System in the Islamic system banks although continue to carry out transaction in accordance with the rules of the Sharih, perform the same essential functions as they do in the traditional system. That is they act as administrators of the economy's payments system and act as financial intermediaries. The need for them in the Islamic system arises precisely for the same reason as that in the traditional system. That is the exploitation of the imperfections in the financial markets. These imperfection include imperfect divisibility of financial claims. Transaction costs of search acquisition and diversification by the surplus and deficit units and existence of expertise and economics of scale in monetary transactions. Financial intermediaries in the Islamic system can reasonably be expected to exhibit economics of scale with respect to these costs as their counterparts do in the traditional system.

In the Islamic system there will also be necessity greater independence and closer relationship between Investment and deposit yields, since the bank can primarily accept investment deposits on the basis of profit sharing and can provide funds to the enterprise on the same basis. This chapter also reviewed primary and secondary markets and the stability of the financial system. The Muslim scholar seem to have little doubt that a financial system based on an Islamic framework of profit sharing would be more efficient in allocating resources as compared to a traditional interest based system.

The Fourth chapter deals with the Islamic Interest free banking, focusing in particular on the issue of elimination of the rate of interest from the financial system. Islam prohibits a fixed or predetermined on financial transactions but not uncertain rated of return deriving from risk taking activities. Consequently a banking structure in which the return for the use of money fluctuates according to actual profits made from it will be consistent with the percepts of Islam. The depositor is treated as if he were a shareholder of the bank and is entitled to share the profits of the bank, made by the bank. This chapter also reviewed the model of Islamic Banking by Merzler (1951).

The Fifth chapter deals with the theory of monetary policy, which covered the theories of demand for money, the Neo classical or Cambridge approach. It also examined the motives for demand for money like transaction motive and the speculative motive and the precautionary motive. The other theories covered Cry Friedmans theory of demand for money, Pigou's quantity theory, Keynesian, transmission mechanism and wealth adjustment process theory by Brunner and Meltzer are reviewed here.

The Sixth chapter deals with the financial system and monetary policy in an Islamic Economy. Here the main issues reviewed are Institutional characteristics of an Islamic Banking System, the source of funds, the lending operation of bank etc.

The Seventh chapter focused on mobilization of monetary resources and Granting of Banking facilities the types of deposits like Qard-Hasanah Deposits, term investment Deposits and the Methods for Granting Banking and other aspects are covered in this chapter.

The Eight Chapter deals with the operations of the Central Bank of Iran. In Iran the Central Bank plays as vital role in implementing government economic policy it has as the privilege in issue of notes and advises government on various monetary policies. Its functions include such as bankers bank, fiscal agent for the government and management of monetary system of the country.

The principles of monetary control by the central bank of Iran focus on to the currency system of the country to its advantage, unwarranted fluctuations in the volume of credit by causing wide fluctuations in the value of money cause great social and economic unrest in the country. The experience of Iran reveal that the need for control of money in order to maintain economic and political stability in the economy.

After the breakdown of International gold standards, price stability as the goal of the economic policy attracted more attention by many countries. In the context of rapid economic growth, the special functions of central bank in a free enterprise economy are as follows:

a) To improve the existing system of financial intermediaries in order to ensure the maximum productive investment of community saving.

b) To provide direct loans in those in those areas where the commercial bank do not find it profitable to operate.

c) To conduct its policy of monetary control in a manner so as to promote the maximum growth rate without causing runaway inflation or external balance of payments. The instruments of monetary control such as bank rate, open market operations, selective credit control, moral situation etc. are reviewed in this chapter.

The chapter Nine deals with the methodology. It covers collection of data, methodological issue, time period covered, techniques employed scope and limitations of the study.

To study this topic the researcher collected data from 1975-76 to 1993-94, this data is pertaining to various balance sheets such as assets and liabilities of the banking system assets and liabilities of central bank of the Islamic Republic of Iran etc. Various statistical techniques employed to analyze the data.

The chapter ten deals with Savings Behavior in an economy without Fixed Interest Rate with reference to Iran. The main focus here on the issue of Islamic prohibition against fixed rate of return on borrowed money lead to an increase in uncertainty that leads to saving reduction. On this issue the researcher reviewed all the aspects of it. Models on saving and uncertainty by Irving Fisher, Hirshleifer, K. E. Building, Marshall, Sandmo and studies are covered in this chapter.

The chapter eleven deals with interpretation of results, with reference to assets and liabilities of the Banking System. The bank balance sheet indicates that variables of assets side such as foreign assets, public sector debt, private sector debt and other are continuously fluctuating. The bank liquidity suggests after 1987 it has a declining growth rate. The public sector deposits growth performance for some year it is negative and for some other year it is positive. Same is the situation with foreign liabilities fluctuations are there.

In the case of Central Bank of the Islamic Republic of Iran the researcher analyzed foreign assets, public sector dept, private sector debt etc. in addition to the analysis was done for asset and liabilities of commercial and specialized banks. Even though there is for some years negative performance and for some year positive performance were found on an average especially after 1978 the policy of the Iran's monetary system and the Central Bank of Iran are moving in the positive direction which can be noticed and recognized in the data.

The chapter Twelve deals with stabilization and growth in an open Islamic economy. Basically Islamic economy based on an extensive system of profit sharing modes of financial behavior has come to the recognized as having established itself in a manner which can prove beneficial to the Iranian economy, the question has been raised whether this system is viable and whether it will continue to grow in a manner that does not regard the future development potential of the economy. A question is that where in an open Islamic economic system without interest rates, is it possible to formulate monetary policy for growth purpose? Therefore in this chapter the researcher would like to review the study by Khan and Mirakhor. Khan results indicate that employing as short-run marco economic model of a closed economy they show that there is apparently no fundamental change in the way of monetary policy affects on the economic variables in an Islamic economy. The authorities can achieve the same result through controlling money supply. If this analysis is extended to open economy it also serves to clarity the relationship between financial and real sectors in an open Islamic economic system. More specifically, the analysis pinpoint the principal channels through which monetary policy alters rates of return of financial and real assets, thereby affecting investment spending output, and the balance of payments. Therefore, the monetary policy can be used to stabilize output in an open economy.

The thirteenth chapter deals with profit sharing contracts and investment in an interest free Islamic economy with regard to profit sharing contracts in which the risks are shared between the lenders and the borrowers. Concern have been expressed that eliminating fixed rate of return would lead to a decline in investment. These concerns can be explained theoretically by suggesting that a major reason for fixed interest rate is that it allows lenders to avoid the costs of monitoring the behavior of the borrowers. Removal of the fixed interest rate from the financial system creates as type of moral hazard problem because monitoring costs may serve as a deterrent to lenders, thus leading to reduction in investment. The existing literature suggest that there is no strong theoretical reason to support the often made as assumption that investment levels would decline if an Islamic profit sharing system were adopted. To avoid adverse effect on investment however the adoption of an economy wide profit sharing system requires the implementation of as legal and institutional framework that facilitates contracting. The Islamic law of contracts provides for such as framework, which has not yet been fully adopted in countries where an Islamic banking system is being established. In the absence of such a framework monitoring costs could be prohibitive and investment could consequently be discouraged. On the other hand the analysis shows that if legal measure is present to the terms of contracts, investment levels may increase following the adoption of an economy wide-profit sharing system. Finally, the studies reveal that in the Islamic system of finance which is gaining increasing importance in Muslim countries requires the replacement of the current and traditional system of guaranteed ex ante fixed rate of return to lender by a system of profit sharing between the lender and borrow. The adoption of this system would therefore result in risk sharing between lender and borrower as well.

The chapter fourteen gives its focus on the analysis of short-term asset concentration in Islamic Banking. The economic objective of Islamic Banking is to have theof return from real activities become the allocation mechanism in the financial sector. To achieve this objective Islamic law proposes as configuration of various modes of transaction as a replacement for interest based activities. The process of implementation of Islamic Banking in Iran is proceeding with relative success.

The chapter fifteen which is the last chapter of the thesis deals with conclusions of the study. This chapter highlighted various conclusions derived from the earlier chapters. The main conclusion here is that the assests and liabilities of the banking system and Central Bank of the of the Islamic Republic of Iran commercial banks and specialized banks and the liquidity of the private sector indicates that the performance of Iran's monetary system especially, after the Islamic revolution that is 1978 is moving in the right direction the data indicates that high fluctuations in the trend of growth before 1978, whereas by and large after 1978 the fluctuation are less and the policy changes made by the Islamic Republic of Iran in its monetary system are moving in the positive direction.