Iran's Banking and Monetary Problems

Naghshineh-Pour, Amir

June 2009

Iran's Banking and Monetary Problems

By: Amir Naghshineh-Pour
June 2009

Iran has had many self-imposed economic crises. Many of which relate to the poorly managed banking system as well as flawed monetary and fiscal policy. Inefficiency of the banking-monetary system in Iran is a well known fact. A complete overhaul of the current system should be one of the essential priorities of any economic reformation and development. The banking-monetary system of any country has a key role in its economic efficiency and strength, price stability, production, and economic growth. The main functions of a banking-monetary system are to provide fiscal resources, to prepare ground for optimal allocation of capital in the economy, to distribute the wealth in the best possible way, and to ease economic development. This is particularly important in Iran because capital markets are underdeveloped.

The Iranian banking-monetary system suffers from both structural and ideo-political (ideological and political) problems. On the structural side, the current scheme is rather primitive. There are neither inter-banking relationships nor appropriate monetary tools to respond to various economic circumstances nor any open market operations to properly control the money supply. On the ideo-political side, there is no free and healthy competition among private and state run banks. Banks are often forced to implement central bank's and government's policies with no regard to their profitability and business objectives. As a result, they are unable to set their own strategy for better performance and higher shareholder benefits. Obsolete ideo-political believes are persistently implemented that have made the economy frail and unstable.

The main focus in this article is to discuss different aspects of current ideo-political policy and their affects on the economy. The current structural problems beg a whole new discussion, which will be postponed to future writings. Although both structural and ideo-political predicaments should be tackled to revive a healthy banking system, addressing only the current ideo-political problems may resolve many current banking and economic issues. In general, the system needs a complete overhaul and modernization.

The origins of these problems are concealed behind the overall belief in central planning, government intervention, and government controls in all affairs. Government dependent central banking in Iran fits in this category. An independent central bank ensures higher performance and economic stability. This important distinction has constantly been abused by the government. It is widely expected that by restructuring the current arrangement between the government and the banking-monetary system a large number of economic problems that have crippled the economy will ease.

A government dependent central bank often tenders short-sighted politicians to try to wangle a temporary economic roar to promote themselves. Studies between the degree of central bank independence and economic stability indicate that the less a central bank is dependent on the government, the more stable the economy is.[1] The government in Iran enslaves the financial system and the central bank at its own service to generate money in order to fulfill its needs and distribute the money according to its will. This approach breaches the independence of the central bank as a self-regulating entity. The government's vision towards the banking-monetary system is the main cause of ideo-political disruption in effectiveness and competence of the financial structure of the country.

Primarily, the relationship between the government and the central bank is arranged the way that the government can impose pressure on the banking-monetary system and hence the economy via: 1- domination of fiscal policy over monetary policy, 2- maintaining a mixed banking system, 3- command interest rate policy, 4- command credit facility policy, and 4- fixed foreign exchange rate policy. Each of which is discussed as follows:

Domination of fiscal policy over monetary policy:

Governments in Iran often oblige the central bank to employ certain monetary policy in favor of catering for their fiscal policy and current affairs. Therefore, the money supply usually stays out of central bank's control. The most important variables in determining the quantity of money are the ways the money is supplied and how the monetary base is controlled. The monetary base includes the net amount of central bank's foreign assets, government's debts to the central bank, commercial banks' and financial institutions' debts to the central bank, and other assets of the central bank. Before the sky rocketing of oil prices, due to increases in government's expenses, the government would regularly encounter huge budget deficits and hence would resort to borrowing from the central bank to fulfill its deficits, which was the main cause of increases in liquidity in the economy. However, in recent years following the soaring in petro prices and the dependence of government expenses to oil earnings, the government used the petro dollars to furnish for its fiscal budget by selling the dollars to the central bank and receiving tomans instead, which provided for increases in the monetary base.

Since 2005, this trend following the unprecedented increases in oil prices and hence government expenses reached its peak. In these years government expenses grew by 40%. These expenses were mainly paid by selling petro dollars to the central bank. In addition, part of the government's debt to the central bank was also paid by the available funds in the Oil Stabilization Fund (OSF). Therefore, the net assets of the central bank encountered a 40% increase. In general, in recent years the monetary base has soared significantly, in the way that in 2005 it grew by 40% and in 2006 grew by 30%.

In fact, during the past two decades the government's debt to the central bank due to budget deficits and central bank's net foreign assets as a result of government's expenses and government's partial payments for its debt to the central bank are the main sources of increases in the monetary base and hence liquidity. Among these sources of the monetary base the central bank has only some control over the debts of commercial banks and other credit institutes to the central bank as well as other assets under its management. In addition, it can also use open market operations (by buying and selling government bonds) to a very limited extend to control the monetary base. Therefore, as long as monetary policy is under the influence of fiscal policy, the central bank does not possess enough power to determine the monetary base and therefore the quantity of money as one of the key variables for an appropriate money management system.

Mixed banking:

Although a mixture of state and private banking in Iran may be partially considered as a structural problem, it is ideo-politically driven. There is still a big deal of state banking support in the establishment that prevents healthy competition, although privatization of the majority of the state owned banks is on the agenda. After the revolution all private banks were nationalized. It is only eight years ago when private banking began its activity again. Its growth has been considerably fast. Today they have a 22% market share.[2] Their productivity and performance are significantly higher than those of the state owned banks. However, they are constantly subject to anti-competitive interference in their affairs by the central bank and government to prevent their rapid market share growth.

Furthermore, state owned banks can slash the profitability of privately owned banks, since they tend to care less about profits in addition to receiving lots of unbalanced benefits from the central bank. The rigidity towards privatization of these banks besides its ideo-political purposes is also rooted in well connected state officials who tend to exploit these banks for financing and rent seeking in favor of their own monetary profits. This issue has caused massive corruption in the banking system. Billions of dollars have been borrowed for development purposes and then invested in unviable projects or deviated to other markets for other intensions. That is why the government owned banks are on the continuous life support system of the central bank for re-capitalization. Billions of dollars have been wasted resulting in billions of dollars of loan delinquencies ensuring high inflation and financial instability.[3] The financial instability has also made the private banks fell victim to considerable loan delinquencies since any economic instability may derail any viable and sound economic activity with which the private banks have been involved.

Currently based on international standards Iran does not have a sufficient number of private banks compared to the number of state run banks. Reality suggests that despite the resumption of private banking in Iran some years ago, due to the bottlenecks with which they typically grapple, the number of private banks is much lower than that of developed countries due to the lack of a competitive state of affairs in the country. There is no doubt that it is imperative to develop the private banking system further at least in a bid to improve the overall banking performance.

However, this has to be done in parallel to economic liberalization and less government intervention; otherwise it will not create a competitive environment and desirable improvement. Any unsystematic expansion of private banking could create unwanted problems due to the non-competitive nature of the economy. In other words, it is likely that in the absence of a free competitive market, private banking may deviate from its original objective.

Command interest rate policy: [4]

The actions of a country's central bank influence the level of interest rates as does the state of the country's economy. An important issue in the banking system is to create a condition that financial resources are allocated and distributed in different economic sectors optimally and efficiently. By achieving optimal and efficient allocation of resources, the results will be a reduction in production costs, improvement in production and employment, and higher economic growth. Otherwise, the results will lead to squandering the resources and triggering economic stagnation. Banks' capital comes from people's deposits. One of the chief variables that determines the amounts of deposited funds is the interest rate. The more the interest rate is, the more destined the people are to deposit their money. Of course one should bear in mind that real interest rates (nominal interest rates – inflation rate) are of the essence for decision making not the nominal rates. Inflation causes differences between real and nominal interest rates and changes the spending and savings behavior of customers and corporations. In addition, unforeseen changes in the rate of inflation make it complicated for firms to plan, which inhibits growth and innovation. Beyond the impact on the domestic economy, differential inflation and interest rates also influence the trade balance between countries and the exchange rate for currencies.

Naturally, demand for financial resources in any economic activity is based on the expectations of investors towards the rate of return on investment as well as the cost of capital. The more the interest rates are the less demand is for the money. It is also evident that in any economic sector in which the return on investment is expected to be more, the demand for capital is also more. Therefore, it can be concluded that the key variable for optimal money creation and allocation is the interest rate. In modern economies setting an appropriate interest rate is the key factor in determining the amount of national savings, investment, and financial resources, which can be absorbed in the banking system to facilitate growth and development in different economic sectors as well as to control liquidity, inflation, and employment.

The interest rate is determined by supply and demand for capital and often reaches to an equilibrium point in proportion to the inflation rate in order for depositors to have enough economical justification to deposit their money in banks. On the other hand, credit facilities should be offered to loan applicants with sound business plans based on free market rates to be able to have the right return on investment. Competitive and balanced interest rates in a free market system will conduct the capital towards the highest performance and most profitable economic sectors. Therefore, the capital will be put into its best practice in addition to preventing wastage. Whereas mandate interest rates less than the equilibrium rate will on the one hand increase the demand for more financial resources and credit facilities and consequently rationing of supplies and creating rent seeking, and on the other hand increase the likelihood of employing resources in economically unjustified projects with low output and insufficient return on investment. The result will be depletion of resources.

This is exactly what has been happening in Iran's economy. The government determines the interest rates without considering the economic conditions resulting in a disruption in free market supply and demand for money. This policy has entirely undermined the banking system. In recent years determining an appropriate interest rate has become a serious challenge for the central bank. In the last two years the government has forcefully set the interest rates disproportional with the rate of inflation in order to support production with little attention to the overall economic performance. This has put the government and the central back at odds that clearly points to a grave condition in the monetary system and massive structural challenges in the economy.

In recent years the average real interest rate (nominal rate – inflation rate) has been either negative or close to zero that implies the existing financial suppression in the economic system. It has caused transformation of wealth from depositors to borrowers. Hence, the depositors had less intensive to save and had more tendencies to spend at these critical times. Instead they allocated their capital in real estate, gold, and durable goods to prevent depreciation of their money. Conversely, negative real interest rates brought about a boost in demand for borrowing in the banking system. On the one hand people transferred their money from banks to other investments and on the other hand the demand for barrowing increased and therefore the banking system lost its capacity to lend funds to applicants. The result has been rationing of resources in the banking system and creation of rent seeking for well connected people.

Command credit facility policy:

In order for the banking system to be profitable and efficient, banks need to maintain their management independently. They need to allocate their resources to sound and cost-effective investments with the aim of decent returns to satisfy their shareholders as well as healthy and strong economic growth.

The banking system of a country is the pillar of its economy. A loss making banking system may cause all sorts of crises not only for the economy but also for the country as a whole. Unfortunately in Iran, there is a different interpretation of banking concepts, which roots in ideo-political believes and populist strategies rather than common proven methods and practices. Governments frequently mandate the banks to assign their resources to projects in which the government prefers rather than what the market demands. If the market does not allocate resources, industries that deserve more capital will not get the needed capital, whereas industries that do not deserve greater investment will. By disrupting the market, market inefficiency in the form of speculative bubbles can affect the financial system and, through that, the entire economy. Therefore, the economy and the banking sector will be left with nonperforming assets and can hinder economic growth. Improper utilization of limited capital means suboptimal use of funds and underachievement in terms of growth and social welfare. Thus, market efficiency that generally is achieved via market supply and demand and appropriate monetary policy is important because optimal investment ensures optimal growth and maximum social welfare.

In recent years, the banks have become an apparatus for distributing money and credit under the command of the government with no regard to soundness and economic logic of the investments. Samples of which are the state-supported fast return economic units in order to boost employment and economic growth in a short period of time. As it was widely expected, these units not only did not aid the economy, but also became a burden for it with no ability to pay back their debts to the banks. Now the banks are at the risk of hefty credit defaults. This policy has significantly weakened the efficiency of the banking system and imposed high costs on the economy.

Fixed foreign exchange rate policy: [5]

When countries do not have well-functioning debt and overnight loan markets, which are key instruments for setting interest rates and determining monetary policy, they resort to fixing or pegging their exchange rates to control their inflation problems. These countries cannot use the policy approach that relies on these features of a banking system. Usually these countries fix the value of their currency against a basket of other currencies or peg it to a strong currency like the USD. But with a fixed or pegged exchange rate, a country has no control over its monetary discipline and inflation rate. The reason is that economic factors vary in different countries; as a result the real exchange rates among the countries often change in unpredictable ways. The value of a currency is highly dependent on fundamental economic factors as well as the average price of goods and services in that country. So the real exchange rate between two countries in a free floating system is determined when the relative prices of goods and services change. With fixing or pegging a currency to a basket of currencies or a strong currency, the country that uses this mechanism would need to identify changes in the real exchange rate and offset them. This task is difficult to accomplish. It may lead to disruption in exports and imports, bankruptcy of many companies, speculative buying and selling, etc.

A country's exports and imports hinge on the relative prices of foreign produced and domestically produced goods. A climb in prices of domestically produced goods (domestic inflation) that is not in tone with those of other countries leads to a depreciation of the domestic currency. The currency of a country with high inflation tends to depreciate and vice versa. If a higher inflation rate exists in a country where its currency is fixed or pegged to another country's currency, its prices appreciate more but the exchange rate remains unchanged that makes the domestic products more expensive and less competitive than those of the other country. This will lead to more imports than exports in the country with the fixed exchange rate resulting in a budget deficit and disruption in the trade balance of the two countries.

Iran has gone through many foreign exchange policies. The latest one that has been in force for nearly ten years, fixed the toman to the USD, but lately the toman has been fixed to a basket of currencies (perhaps the dollar and euro). Therefore, it varies as the euro/dollar pair changes value. However, it does not independently vary with the USD or the euro. This dependence is maintained by the central bank via selling the petrodollars in the market to the applicants based on the fixed rate to the euro/dollar pair. This policy is unstable and has caused many problems for the economy. This strategy could be sustainable, if all the economic factors that affect the value of the toman practically continued to vary in accordance with the economic factors in the US and Europe! Now the central bank would need an inexhaustible source of foreign assets and should be ready to ravage it to maintain the exchange rate at the current levels. Thanks to unprecedented increases in petro prices, the central bank has had enough resources to follow this policy. But at the present time that oil prices have considerably fallen and the government is encountering a massive budget deficit, the oil revenues may not be enough to cater for the fixed exchange rate strategy. In that case, a sudden plunge in the value of the toman against other currencies is expected. However, if the petro dollars will be enough to cater for the fixed exchange rate strategy the oil income that are actually the wealth of the people of Iran will be squandered further. So far, due to this course of action monetary policy has been ineffective.

…

In summary, the main constraint on Iran's growth is its financial system's inability to allocate capital efficiently, with the associated risk of bad loans in the banking system. Iran's recent inefficient domestic investment will soon drag down its growth rate. During the term of the current administration despite considerable injection of capital in the economic system, economic growth has remained practically constant compared to its growth during the previous administration, pointing out that Iran's return on investment has become significantly low. Whereas by infusing this amount of capital, Iran should have experienced much higher economic growth. There has certainly been overinvestment in many sectors, which is the result of mandate interest rate and mandate credit facility policies. Inevitably most of it will prove unprofitable. A reformation of the financial system is unavoidable to improve financial stability and investment decisions.

Accordingly, the first step to address the current banking and economic issues is rid the monetary system of government interferences, although the whole relationship between the banking system and government requires a comprehensive refurbishment. The emphasis of the government on taking unsystematic economic decisions against the views of many economists not only has not had any positive outcome, but also imposed considerable amounts of damage to the economy.

References:

1. The Economist (edited by Simon Cox) "Economics: Making Sense of the Modern Economy," 2nd edition, 2006.

2. Donya-e Eghtesad daily newspaper, 7th year, Number 1797, Thursday May 14th, 2009.

3. Donya-e Eghtesad daily newspaper, 7th year, Number 1799, Sunday May 17th, 2009.

4. Naghshineh-Pour, Amir "A Review and Analysis of Iran's Current Economic Status", October 2008, http://www.payvand.com/news/08/oct/1285.html.

5. Donya-e Eghtesad daily newspaper, 6th year, Number 1678, Thursday November 27th, 2008.

6. Naghshineh-Pour, Amir "Financial Crisis, Iranian-Style", February 2009, http://www.payvand.com/news/09/feb/1321.html.

About the Author: Amir Naghshineh-Pour (MBA) is a financial and business analyst. He works for an investment bank.