The review of financial repression policies and banking system in Iran

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Abstract

The methods of determining the banking interest rate are the main issues in the Iranian economy, this note provides the analysis of banking interest rate and the ways of providing and allocating financial resources in Iran and also, discusses why the financial repression policies in the monetary and banking system do not allow the Iranian economy to growth in its full capacity.

Keywords: Banking Interest Rate, Financial Repression, Monetary and Banking System, Financial Resources

1. Introduction

The financial and monetary system of any country has a key role in, stability and efficiency of economy environment, keeping the stability of general price level, supporting the production affairs and facilitating the development of economy. Moreover, the efficiency and stability of the financial and monetary system can support and boost the real economy sector (Namazi and Salehi, 2010).

In contrast, instability and inefficiency of the financial and monetary system can cause instability and inefficiency in the real economy sector. The basic duties of the financial and monetary system are as follows: Providing financial sources, optimal allocation of financial resources through the economic system to support and facilitate production affairs, expansion of welfare and development of the economy (Hachicha, 2004). The financial and monetary system includes financial markets (especially the stock market) and banking system. Due to lack of proper development of financial markets in Iran the role of banking system becomes more important and vital, thus it undertakes a significant role in providing and mobilizing financial resources. In addition, it can encourage investors to invest financial resources in an efficient and optimal way (Namazi and Salehi, 2010). Therefore, by considering the raised issues the review of financial repression policies and banking system seems to be very important and would shed light on those policies and trends that hinder economic development in Iran, so policy makers may take an action and eliminate these detrimental policies.

2. Providing and Allocating Financial Resources in the Banking System

The main issues in the monetary and banking system are the way of providing the financial resources and optimal allocation of these resources between different economic activist and sectors. Besides, the channels and routes that the provided money injects and circulates in the economy system are the other important issues in the monetary and banking system. According to the task of the banking system in providing and allocating financial resources through the economic system, as many as the banking system tries to provide and allocate financial resources in a competitive environment the production costs will decrease (Musetescu et al, 2007).

Moreover, optimal allocation of financial resources may cause, production improvement, improvement in employment rate and economy development. Otherwise, the lack of efficiency in the banking system in providing and allocating financial resources in a correct manner can lead to waste of the financial resources and the economic downturn (Schalck, 2010).

Naturally, financial resources are provided by people’s deposits. The interest rate on deposits is one the important variables which play a main role in decision making of depositors, it determines the willingness of depositors who wants to deposit their money in banks, so that, whatever interest rate on banking deposits increases, simultaneously the willingness of depositors will increase to deposit their money in the banking system. In contrast, whatever the interest rate on bank deposits decreases the willingness of depositors to deposit their money in the banking system will decrease. It should be noted that, the important criterion for depositors decision making is not the nominal interest rate, but the real interest rate. In other words, the nominal interest rate after deducting the inflation rate would be considered as a real criterion of decision making (B. Ang, 2008).

The demand for financial resources in every economic activity depends on the banking interest rate on financial facilities and the profitability expectation of economic activists on their economic activities. So far, whatever banking interest rate rise, consequently, the demand for financial resources will decrease. In contrast, whatever banking interest rate reduces the demand for financial resources will increase as an outcome. Besides, obviously the demand for financial resources is high, in any boost economic sector with significant expected profitability and efficiency (Dehghan.N, 2010).

3. The Importance of Banking Interest Rate in Monetary and Banking System

Considering the raised issues, clearly the key variable in the banking system for providing and allocating the financial resources is the banking interest rate. Determining the banking interest rate is the crucial variable in the economy of all countries around the world. It has a notable relationship with, national saving, investments, the amount of financial resources that can absorbs in the banking system, providing the financial facilities, development of different economic sectors, controls on liquidity, inflation rate, employment and economic prosperity and recession (Salehi et al, 2009).

Under the terms of demand and supply, the banking interest rate reaches to the equilibrium point, when it is proportional to the inflation rate in a circumstance that it keeps the willingness of depositors to deposit their money in the banking system (A. Dorn, 2006). In Iran, banking facilities allocated to the applicants with an interest rate that causes rationing of financial resources and create economic rant, therefore interest rates must be determined in a competitive circumstances and logically proportional to the inflation rate, so that these facilities can provide to all the eligible applicants and they can access to their needed financial resources with consideration to the banking interest rate equilibrium.

By considering the above discussions, the optimal and efficient way to distribute the financial resources, is to allocate them to the most efficient and profitable economic sectors under competitive and equilibrium condition of banking interest rate, so, the maximum profitability for society will arise from available financial resources and this policy will prevent wasting of financial resources (Woldie and Kolawoleadeniji, 2008).

While determining the banking interest rate by using ordered method[1] much lower than its equilibrium rate, from one hand cause additional demand for financial resources and rationing of financial resources which create economic rant, on the other hand, it increases the probability of using the resources in those projects which are economically unjustified and unnecessary without appropriate efficiency, and consequently cause wasting of financial resources. The natural mechanism of demand and supply for determining banking interest rate is that much important that economist have suggested to governments to control: 1. the size of money supply through fiscal and monetary discipline. 2. The size of budget and the rate of tax. They believe that government should avoid manipulating demand and supply system and prices (A. Dorn, 2006).

4. Financial Repression

The expression "financial repression" was initially created by economists, McKinnon (1973) and Shaw (1973), who described it as the set of government-imposed limitations stopping the financial intermediaries in the economy from operating at their complete capacity level. In general, the

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[1] The determining of the banking interest rate by using ordered method: It means that the government imposes a limitation on the banking interest rate and banks have to obey these regulations. Therefore, in such circumstances the banking system has no authority to determine the interest rate on savings and financial facilities. Consequently there is no competition environment between banks in order to absorb the people's savings.

government impositions generally consist of interest rate ceilings, obligatory credit specifications, and high qualitative requirements. The banking system is forced to keep government bonds and money via the improper position of high reserve and liquidity ratio requirements as it lets the government to finance budget shortages at a low or zero cost. There is no development for private bond and equity. In turn, the banking system is imposed upon the maximum level of interest rate to prevent competition with the public sector fund which earns from the private sector, and to facilitate low-cost investments (R. Bencivenga and D. Smith, 1991).

Firstlly, financial repression limits the level of bank deposits and mobilizes banks resources and reduces the bank's income. Due to limited financial resources of banks in Iran, the major resources in the banking system consists of public deposits. Deposit interest rate is considered as the benchmark and interest rate on financial facilities are determined with regard to the deposits interest rate. Consequently, reducing the interest rate of facilities depends on reduction in deposits interest rate. Secondly, it reduces government revenues by decreasing the number of available facilities (Ghosh, 2005).

5. The Banking System and Determination of Banking Interest Rate in Iran

In a country such as Iran that the government presence is expanded in the economy system the following matters must be considered more than any other economy: 1. the reform of prices system. 2. Respect to demand and supply and avoid determining prices by using ordered method. 3. Banking interest rate must be controlled in a correct manner till the expected efficiency achieved. Since many years ago, the determination of banking interest rate was one of the most important instruments in policy making and leading the banking and monetary system of Iran. Especially, in the current years that the control of banking interest rate is in the hand of government rather than central bank (Namazi and Salehi, 2010).

Determining the banking interest rate has become a big challenge for the Iranian banking system. For example, in recent two years the banking interest rate has been decreased by using ordered method to support production, without considering its proportional to the inflation rate and with low consideration to its economic efficiency. The resistance of central bank against the decrease in banking interest rate and carrying out contractionary fiscal policies, represent a crisis situation in the banking and monetary system and reflect structural problems in this area of the Iranian economy. In additions, the recent years investigations show that the real interest rate on deposits in average has been generally negative or close to zero, and this is an obvious example of the financial repression phenomenon (Nazifi, 2004).

6. The Method of Determining Banking Interest Rate in Iran and Its Impacts on Iranian Economy

In a situation that the interest rates on the weighted deposits and financial facilities are less than the inflation rate, actually the distribution of wealth will flow from investors to the receivers of financial facilities. In the other words, in the presence of government policies the banking system converse to a tool that transfers wealth from depositors to the receivers of financial facilities, so obviously this situation is more beneficial for receivers of financial facilities. Determining such banking interest rate by using ordered method which is not fit to the inflation rate, in addition that can result in irreparable damage to the national economy, also is contradict with justice principals of government (Nili, 1985).

From the investors perspective on the banking system, the real and negative banking interest rate cause a decrease in people's desire to deposit their money in the banking system and they do not presume the savings as an economic phenomenon to justify the present decrease in consumption, therefore it has led the society towards consumerism. Moreover, people decrease their savings in the banking system to its minimum level due to such a situation that savings in the banking system can cause the loss of a part of people's savings or depreciation in its real value, and to maximize their profit or even save the value of their money, they have more tendencies to buy assets such as gold, land, properties and other durable goods. Therefore, there is no meaning for investors to deposit their money in the banks (Naghshineh-pour, 2009).

Additionally, the real and negative banking interest rate causes an increase in demand for financial resources. Its natural consequences would be the additional demand for financial resources in the banking system which causes an imbalance between people's savings and incremental demand for financial resources. Such this situation lead to rationing of financial resources and therefore economic rant will come up for those people who are successful to gain access to this limited financial resources, of course it is obvious that not the government, but a part of the private sector activities is rationed and barred the lack of financial resources (Salehi et al, 2009).

In the recent years, the government of Iran has tried to fill out and compensate the gap between demand and supply of financial resources through incremental supplying money and credit. Although, this policy is on the line of providing low cost financial resources and can display prosperity in the short term (in reality it is an artificial prosperity), but in the medium term and long term pursuing such a policy ultimately will lead to incremental inflation and without taking any prevention strategies this incremental inflation will lead to recession (Taghavi and Esmailzadeh, 2009).

In fact, while government tries to curb incremental inflation, (which is the outcome of incremental supplying money to provide low cost financial facilities) it forced as well to implement contractionary monetary policy, therefore the banking interest rate will increase and those investments that are not profitable and economically efficient looks profitable, because of the presence of low cost facilities such these projects are generally detrimental and they inevitably will become bankrupt. Therefore, it seems that the policies of providing low cost financial facilities to improve production growth cannot achieve its desired goals and whatever the government insists to pursue these policies more severe and longer, no doubt the deeper and longer recession would be as its consequences (M. Tehranchian et al, 2010).

In addition to the negative effects of ordered method for determining the banking interest rate in the area of macroeconomic, these tendencies are coincidence with: Reducing the banking income, increasing the credit and insufficient liquidity risk, over spreading of outstanding demands, increasing the costs of banking network and decreasing its performance in allocating the financial resources to the economy sectors. Therefore, the banking system will face with a crisis and the ordered method for determining banking interest rate will act as an obstacle for the development of banking system (Diaz-Alejaddro, 1985).

Although, in the long term putting no limit on banking interest rate (under the interest free banking) and creating a competitive banking system would be the most efficient solution to getting rid of structural problems of banking system in Iran, but it is uncertain that in the short term and in the current situation of Iranian economy releasing the banking interest rate would lead to what outcomes (McKinnon and Shaw, 1973).

7. Dutch Disease in the Iranian Economy

The dependence of Iranian economy to oil incomes especially in recent years is an important issue which led to the Dutch disease[2]. In other words, escalation in oil revenues followed by an unprecedented increase in government spending led to increases the demand of whole economy. With considering the low tensile strength of supply side and incidence of excess in demand followed by an incremental import of consuming and durable goods, ultimately the profitability and efficiency of economic activities in

[2] The Dutch disease is a concept that gives clear details about the relationship between the incremental exploitation of natural resources and the decrease in the manufacturing sector. It shows that an increase in revenues from natural resources will make a given nation's currency more powers with respect to that of other nations, this fact makes the exports from the country which sell the natural resources become more expensive for the other countries who want to buy goods and because of this issue the manufacturing sector in the country which sell the natural resources will become less competitive with compare to the other countries who buy the natural resources (Larsen, 2004).

business services and real estate sector with respect to industrial and agricultural sector have an intensive increase and it creates a big inequality among economic sectors in Iran (Taghavi and K. Araghi, 2004).

In such circumstances, liberalization of interest rate and its growth in short-term will lead to a significant part of financial resources allocated to the business services and real estate sector. This situation will exacerbate the crisis and relative stagnation in industrial and especially the agricultural sector. Certainly, it is not such satisfactory outcome and will be very costly for the economy of Iran in short-term. Reflects on this issue can be seen clearly in the current and previous policies of central bank. So that, in the past three years of monetary policy package, it is mentioned that: "in order to create a suitable condition to distribute the funds appropriately for a balance growth, the distribution of banking facilities to the different sectors are as follows: 25 percent for the agricultural sector, 33 percent for the industrial and mining sector, 16 percent for the real estate sector, 17 percent for the business services sector and nine percent for the export sector" (CBI, 2010). The referred policies show that due to making abnormal benefits of business services and real estate sector the government wants to hedge against these issues.

Due to the Dutch disease, the demand for financial resources has been increased intensely in business services and real estate sector. Therefore, the liberalization of banking interest rate and the removal of direct control on the way that financial resources distribute in different economic sectors, can conduct most of financial resources to the business services and real estate sector (Macdonald 2007).

However, from the viewpoint of economic logic in the banking system and according to the increasing profitability and prosperity of business services sector, the demand for financial resources would increase more with respect to agricultural and industrial sector. Beside, faster repayment of banking facilities by business services sector with respect to industrial and agricultural sector, would cause this common and nature issue that the proportion of financial facilities to business services sector has an intensive increase. Although, in formal terms the banking system pretends that they obey the central bank rules, but in reality the banking system has not the incentives to distribute the financial resources among these sectors in a fair way, so the banking system does not compliance the requirement of central bank as they desire.

8. Conclusion

Considering the raised issues, continuing the policies such as determination of banking interest rate by using ordered method much lower than its equilibrium rate and providing additional liquidity to meet the additional demand for financial resources ultimately will failure to achieve the desired objectives because of inflationary effects. On the other hand, liberalization of interest rate and removal of the limit on allocating credits among economic sectors, due to their heavy costs in short-term cannot be an appropriate policy for the current situation of Iranian economy. Therefore, this question may arise that what is the solution to release the banking sector from its involved problems?

It seems that the efficient way to solve this economic issue, in one hand is the liberalization of banking interest rate and its determination appropriates to inflation and creating a competitive banking sector, and on the other hand is the payment of facilities and subsides by the government to the banking sector to provide facilities appropriate and balance to agricultural and industrial sector.

In the long-run and in the line of government 20 years economic vision by cutting the government economic dependence to the oil revenues and elimination of Dutch disease with the correct macro-economic policies and also by turning back the inter-sector equilibrium to the Iranian economy, the subsides on economic sectors facilities can decrease step by step and the banking sector will liberalizes completely.

In the short-run, this policy will reduce the costs of ordered method for determining banking interest rate. Furthermore, the Iranian economy will make benefit from the liberalization of the banking interest rate, because implementing such a policy can increase the people's incentive to invest their money in the banking sector and increase the national savings rate.

The competition in the banking sector and its efficiency are depending on the following elements: 1. an increase in the provided and allocated financial resources among economic sectors. 2. Improve in the distribution of the financial resources for supporting the economic sectors. 3. Elimination of rationing and reducing the economic rant opportunities in the banking sector. 4. The improvement of efficient uses of financial resource in different economic sectors and decreasing the incremental trend of supplying money to meet the incremental demand for financial resources, which is common due to low banking interest rate on financial facilities.

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