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# The Experience of an Islamic Financial System in Iran and Its Prospects for Development<sup>1</sup>

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## Abstract

A decade has been passed since Iran chose to experience a combination of a nationalized and an Islamic financial system. Today, the banners reveal the country's pride as having had a

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unique experience in Islamic banking and finance in the world. While, the banking system was nationalized soon after the revolution of 1979, it took a few years before the important Usury - Free Islamic Banking Law Was Passed in 1983.

This paper describes Iran's experience with an Islamic financial system, reviews selected economic and financial indicators, makes an attempt to diagnose the problems in the financial sector and offers a few recommendations for deepening the money and capital markets.

The observations on the performance of the Iranian economic system, however, does not intend to answer negatively the important question of "can the Islamic financial system survive"?

## **I - Introduction and Purpose of the Study**

More than a decade has been passed since Iran chose to experience a combination of a nationalized and an Islamic financial system. Today, the banners reveal the country's pride as having had a "Unique experience in Islamic banking and finance" in the world.

While, the banking system was nationalized soon after the revolution of 1979, it took a few years before the important Usury-Free Islamic Banking Law was passed in 1983. As of yet, however, the banking system is evolving and the public is yet to learn of the new Islamic banking contracts and its related jargon. In fact, a portion of the public questions whether there was really

a change before and after the revolution with regard to the banking practices: Were really banking practices changed to fit the Islamic doctrine, or the jargon was simply changed to pretend its "Islamization?" On the other hand, most ulema who are familiar with the issue believe that while the usury-free law is without fault, the inappropriate execution of the Islamic banking law has been the reason for the deviation of practices with the spirit of the Islamic law.

In the open financial market, while with the election of a new government to the office of the president, the stock market was reactivated much later in 1989, it has since experienced cyclical and structural difficulties. Furthermore, due to the lack of varieties of securities and other shortcomings, this market has remained well underdeveloped.

Unfortunately the Islamic banking practices have been implemented simultaneously while several extraordinary events have occurred. They include eight years of war, a massive increase in the economic role of the public sector due to expropriations and nationalizations, economic boycott by the west and large fluctuations in the price of oil, its exports which constitute ninety percent of foreign exchange earnings of the country. It is the position of this paper that the simultaneous occurrence of these unusual events, together with the multidimensional aspect of the financial system (as will be explained below), has contributed to create an economic system in which for most of the decade,

economic indicators, such as saving and investments, have drastically dropped. However, given the complications of the issues involved, it is difficult at this time to evaluate the performance of the Islamic banking system per se in Iran.<sup>1</sup> Indeed, it is not the purpose of this paper to present such an evaluation at this time and no conclusion will be drawn with regard to the evaluation of the performance of the Islamic banking system in Iran. In fact, the preliminary view of this paper is that the Islamic banking practices have not been properly executed and the usury - Free law has not been given a true test - perhaps due to the lack of political feasibility which in turn may have been caused by the occurrence of the extraordinary events.

Nor is this paper about Islamic economics or Islamic banking - their principles or their strengths or shortcomings. Rather, the objective of the present descriptive paper is to (i) review Iran's experience with an Islamic financial system - the banking sector and the securities market - through a statistical representation of selected economic and financial indicators, (ii) to make an attempt to offer a preliminary diagnosis of the problems in the financial system and (iii) to offer a few possible solutions for deepening the nation's money and capital markets.

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1- For a Preliminary evaluation of the performance of the banking system in Iran and the Problems from an Islamic Economic Point of View Interested Readers can refer to [Hedayati, 1994(b)] and [Pourian, 1994(a)]

The plan of the work is as follows. In the next section a brief history and a description of Iran's experience with the Islamic banking system and the implied securities market is presented. In section III the performance of Iran's economic and financial system is viewed from the perspective of several indicators. Subsequently, an attempt is made to diagnose the difficulties present in this system. In conclusion, some policy recommendations are made for improve the efficiency of Iran's financial system.

## **II- A Description of Islamic Financial System in Iran**

### **A - The Banking System**

Prior to the Islamic Revolution of 1979, the banking system in Iran was composed of about 35 banks and was based on a system which relied on a mixture of government and private institutions - domestic as well as foreign - owned. During the decade of the 1970s, the gross national product and sources and uses of funds rapidly expanded. Our estimates reveal that on an inflation - adjusted basis Iranian economy grew by an average of 8.2 percent per year during the 15 year period prior to the revolution. On the other hand, at its peak, the ratio of gross domestic investment to gross national product amounted to about 35 percent.

Almost immediately, after the revolution, due to a variety of reasons including expropriations, the flight of capital, lack of confidence in the banking system, weak balance sheets and runs

on the banks, in June 1979 the Revolutionary Council passed a resolution nationalizing commercial banks. Shortly thereafter the banks were also "amalgamated".<sup>1</sup> Thus, the banking system was affected by two kinds of monopolies: fewer but larger banks and government - controlled. After the amalgamation and a few years of evolution, the system was reduced to 9 banks, comprising 6 commercial banks and 3 specialized banks.<sup>2</sup>

During the early months after the new revolutionary regime was established, several studies were taken for the Islamizations of the financial system based on the "Sharia" principles, which unequivocally calls for the elimination of interest. Based on these studies and prior to the passing of the usury -Free law, interest was (apparently) abolished and its name was changed to "commissions and minimum guaranteed" payment [cf., Shirazi, 1988, P. 25].

It was not until late 1983 that a bill was passed by the Islamic parliament - the Islamic Consultative Council - regarding abolition of interest and, as needed, ratified by the Council of Guardians.

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1- The Usury - Free Banking Law will be reported in this paper. It is also notable that the Iranian Constitution call for the banking sector to be government - owned and controlled. Furthermore, it specifies that all laws must conform to the Islamic laws. For a description of other laws related to the Iran's banking system see [Hedayate, 1994(a)].

2- Recently, a new specialized bank, the Export Expansion Bank, was established, thus, increasing total number of banks to ten.

This law, which was named the Usury - Free Islamic Banking Operations Law, is known as the pillar of the Islamic banking system in Iran. It was enforced beginning in 1984.

Iranian scholars claim that the essential foundations of the Islamic Banking System is based on the following principles [e.g., Mahdavi, 1990; Shirazi, 1988; also see Pourian, 1994 (a)]:

1. Establishing sovereignty of Islamic values.<sup>1</sup>
2. Elimination of usury. One of the most important instruments for this goal was the "qard-al-hasanah" (interest-free) deposits and loans.
3. Establishment of profits in banking operations. Bank were considered "trustee agents" in the utilization of funds on behalf of the depositors.
4. Setting up a deposit system based on new Islamic form.
- 5- Granting credit facilities according to new Islamic contracts in the "right" (Production) direction.
6. Applying new monetary policies in accordance with Sharia.<sup>2</sup>

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1- Interested readers on Islamic economic should especially consult [Sadr, 1981]; and on the philosophical issues of abolition of interest can review [Monttahary, 1983]. On the role of Islamic banking in economic development see [Sadeq, 1993]. On Islamic banking [Iqba] and Miraknor, 1987] and [Mohsin Khan, 1992] are a must. On the question of stability of the demand for money in Islamic banking see [Zyuberi, 1992].

2- On the issue of monetary policy in an Islamic financial system, interested readers should consult [Mohsin Khan and Mirakhor, 1993] and [Shojaeddini, 1993].

7. Secure economic independence and self-sufficiency and establishing a system founded on "Social justice".

The primary goals of the new Islamic financial system also can be understood from the law itself. A brief description of the major points of this law will follow.

In Chapter 1, the new law stipulates that the goals of the banking system are the creation of a monetary and credit system based on rightfulness and justice, and assistance to economic goals set by the government. It calls for the stability of the value of money, and for serving the domestic payment system as well as international balance of payments. The law also refers to the importance of qardal - hasanah deposit and loans. In the same chapter, the law defines functions of the banking system, including the central bank, to include deposit and investment function, issuing and controlling money, monitoring the performance of the system and monetary policy.

Chapter 2 concerns mobilization and absorption of funds by the system in which allows for interest - free qard - al - hasanah deposits (demand and savings deposits) as well as time deposits (which do earn a return). For latter deposits, the law stipulates that the bank shall serve as an attorney for granting loans out of these deposits. This section of the law also obliges the banks to guarantee the payment of principle of qard-al-hasanah deposits and mentions that banks can guarantee the principle of time deposits. It calls for the profit-loss sharing system and allows for



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promotions and privileges like prizes on qard-al-hasanah deposits and discount on bank fees.

Chapter 3 sets the new credit facilities or Islamic (loan) contracts to which we shall refer below in section III-B. It also discourages investing in "Luxury" commodities.

chapter 4 allows for the control of the banking system and the implementation of monetary policy by the central bank. It also allows for setting minimum and maximum of bank's profit shares, determination of types of investments, and minimum / maximum amount of credits to be granted by the banking system.

In the chapter 5 the law stipulates that banks and the central bank are not allowed interest transactions with each other, collected fees are not for distribution (to deposit holders), and repeals all other contradictory legislation.

It may be interesting to note that most "ulema" believe that the usury-free banking law is without deficiency [e.g., see Rezvani, 1993]. Obviously, there is dissent and there are questions regarding the current interest-rate system especially as practiced (by the government and the central bank). A few ulema question the practices of the banking system [e.g., Azari Qomi, 1993]. Also, the current banking practices in Iran requires payments of a fixed -rate penalty after the due date of installment payments which according to most ulema is not within the sharia framework. The inclusion of inflation premium in the rate of return also seems to be a point of dissent between ulema [see, e.g., Haeri, 1994].

## B. Open Financial Markets

The open financial market in Iran primarily includes a stock market, the Tehran Stock Exchange. Before the revolution, this Exchange traded common stocks of corporations and financial institutions as well as three kinds of government bonds (treasury bills, land-reform bonds and "ownership-expansion" bonds). Share prices began to drop six months prior to the 10-day revolutionary days, at the end of which the regime was changed immediately after the revolution. Volume of trade at the stock exchange drastically dropped. Between 1979 and the enactment of the 1983 Banking Law little trade was executed. After the latter law was passed, trade in kinds of securities was practically halted. No trade was allowed in the bond section.

After the eight-year war and when a new president was elected to the office (1989), and with the enactment of the first five-year plan and initiation of the privatization program, the stock market was reactivated. Currently, almost all trade is done in common stocks of the firms which were offered by the government in the privatization process. The public sector, including the investment subsidiaries of the banking system, plays a large role in transactions.

## C. Privatization and Liberalizations

Also with the election of the new government to the office, new market-and export-oriented policies were drafted. More

autonomy to the banks, current-account liberalizations, attempts in the direction of capital - account liberalization, establishment of non-bank financial institutions (NBFIs), and interest-rate "adjustments" (to include the inflation premium) were parts of the liberalization programs.

As related to the open financial markets, recently the Central Bank, consulting with a group of ulema, academics and private sector representatives, developed a new "non-common-stock" security called the "shared security". Since this author participated in the advising group to the Central Bank regarding the new security, an aspect of the process may be interesting to the reader. Concern over the non-fixed rate at which this security was to be issued was a major issue involved. It was decided to implement the following procedure which was then used by the City of Tehran to issue a four-year security for the purpose of urban development. Based on a business plan, a "tentative" rate of return was calculated for the project which amounted to 25% per annum. Five percent was "held" and each security was issued with six-month, 20-percent (of the par value) coupons attached. The five percent difference is deferred until the project is completed when a "definite" return could be calculated.

### **III. Economic and Financial Indicators of Iran**

During the last 15 years since the revolution, Iran has experienced several simultaneous events including the revolution

itself, the eight-year war with Iraq, economic sanctions by the West, freeze of assets, a transitional change in the financial system itself; and various economic events including the transition from a more centrally-planned towards a more market-oriented system, and from a multiple-exchange rate toward a single-exchange rate system. It is due to the simultaneous occurrence of these events which no evaluation of the Islamic financial system is attempted in this paper. Therefore, we shall only present a review of basic economic and financial indicators. Subsequently, a diagnosis of the problems from a market-oriented perspective will be made.

### **A. Deposits and Deposit Rates**

In nominal terms, the banking system has done well in absorbing the private sector's deposits. During the last dozen years, this measure has increased tenfold. However, as Figure 1 reveals, in real terms Iranian banks have performed less impressive.

As the current practices in Iran's Islamic banking system reveal, with regard to deposit "profit" rates, always a "tentative" rate for each type of deposit is computed at the beginning of the year by the Central Bank. "Tentative" rates are "forecasts" of bank's profitability in the same year. At the beginning of the subsequent year, a "definit" rate for each class of deposits is announced according to which the accounts would be settled. The

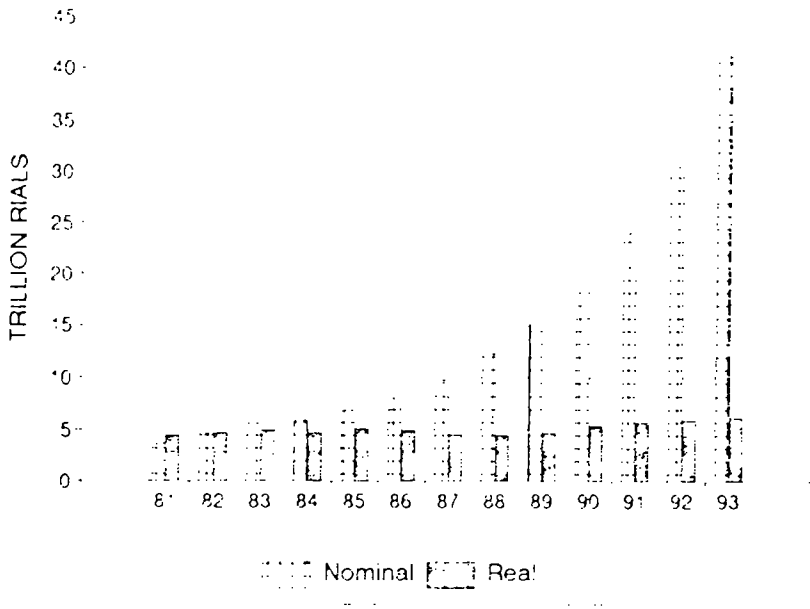


Figure 1 - Private Sector Deposits in the Banking System (Nominal & Real Amount)

Date Source - The 1981-92 nominal values and the implied price indices from the Central Bank of the Islamic Republic of Iran. The real magnitudes and the 1993 nominal values are the author's computations and estimates.

lower part of Table 1 Provides an example of deposit rates for a recent year (1993). However, it should be noted that with inflation running at double digits, institutional - formal rates are negative, most likely contributing to the growth of an already-existing informal - financial sector in which it has been reported that interest rates can go as high as 8 percent per month. The upper part of Table 1 shows the deposit rates during the last several years. Year - to - year changes have been rather small, while inflation rate has been rather volatile ranging from 9 to 35

percent in the recent five years.

	1989	1990	1991	1992	1993
Short Term	6.0	6.5	6.5	7.5	8
1- Year	8.5	9.0	9.0	10.0	11.5
2- Year	---	10.0	10.5	11.5	13.5
3- Year	---	11.0	11.5	13.0	14.5
4- Year	----	13.0	14.0	15.0	16.0

#### Banking System's Deposit Rates (Percent)

Maturity	"Tentative"	"Definite"
Short Term	8.0	8.0
1- Year	11.0	11.5
2- Year	13.0	13.5
3- Year	14.0	14.5
4- Year	15.5	16.0

#### Tentative and Definite Deposit Rates (1993)

Table 1

Data Source: The Central Bank

## **B. Islamic (Loan) Contracts, Loan Rates and Their Behavior**

What was to a large degree of importance associated with the 1983 Usury-Free Law was the design of the "Islamci (loan) contracts". Several types of contracts were defined which are currently used in the banking system in Iran. These contracts are very briefly described below.

1. Installment Sale is the transfer of often a piece of production equipment, at a known price purchased by the bank, to an enterprise in such a manner that all or part of the price of that item be received (by bank) in installments at fixed dates.

2. Civil Partnership is defined as mixing capital of a customer with the capital of a bank for investing on a specific business for a limited duration.

3. Modharabah is an agreement which is signed between a bank and a (legal) person in order to enter into an investment and jobbing transaction.

4. Jo'aalah is an Islamic contract according to which the bank undertakes to pay a specified amount of funds to an enterprise rendering a psecific service.

5. Forward Transaction is advance cash purchase of an enterprises' sproducts at a pre-determined price.

6. Equity participation may be defined as the injection of capital into a new or an existing joint-stock company.

7. Qard-al-hasanah is granting a loan without a charge in special cases.

8. Hire Purchase is a lease with lessee purchasing the financed equipment at the end of the financing term.

9. Direct Investment is supplying capital by a bank for operation and production of developmen.

10. Debt Purchase is the discount of trade documents and commercial papers of businesses.

11. Mozara'ah is a financial transaction between the bank and the owner of a farm.

12. Mosaqa'at is any financail transaction between the bank and the owner of a tree (and the like).<sup>1</sup>

It would be interesting to examine the behavior of these contracts during the last decade. Table 2 shows the amount and Table 3 the percent of each contract from 1984 to 1993. The installment sales contracts have continued to dominate other classes. Surprisingly, the importance of qard-al-hasanah and modharabah has declined, while that of civil partnership has increased. According to rules set for the banking system, total of qard-al-hasanah loans granted by banks must be 10 percent of the total of facilities granted in each year (not exceeding the total of qard-al-hasanah funds absorbed through qard-al-hasanah deposits).

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1- For a deeper treatment of the description of these contracts, the interest reader should consult [Shirazi, 983] and [Iran Banking Institute, 1993].



TABLE 2  
Behavior of Various Islamic Banking Contracts

CONTRACTS	(Amount, Billion Riials)										
	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	
INSTALLMENT SALE	247.5	603.8	990.9	1,675.5	2,454.4	3,532.7	5,469.9	7,668.3	9,947.9	12,486.6	
CIVIL PARTNERSHIP	109.1	244.1	384.2	539.3	608.7	965.2	1,620.6	2,900.7	3,757.6	4,831.0	
MODHARABAH	134.6	293.6	429.2	491.4	540.3	811.0	1,141.9	1,581.9	1,810.6	2,093.1	
JO`AALAH	2.4	25.6	37.9	70.9	143.8	384.2	740.2	1,142.9	1,290.8	1,664.7	
FORWARD DEALS	26.8	58.8	108.9	151.2	255.3	505.0	588.6	809.0	1,424.2	1,924.2	
EQUITY PARTNERSH	26.0	135.8	182.2	276.7	371.6	435.4	509.9	785.0	1,107.7	1,321.3	
QARD-AL-HASANAH	78.4	199.1	321.4	411.9	507.5	564.5	639.8	682.0	775.8	1,288.7	
HIRE PURCHASE	27.9	37.3	51.8	83.0	98.8	106.7	125.0	232.2	232.5	393.6	
DIRECT INVESTMEN	4.4	65.9	74.4	64.3	67.5	97.6	143.5	211.8	409.0	726.4	
DEBT PURCHASE	85.0	186.2	176.5	120.3	52.6	41.9	32.0	16.6	20.4	27.1	
OTHER CONTRACTS	1.7	21.6	46.2	70.4	135.3	168.9	229.6	394.6	751.1	1,202.4	
TOTAL	743.8	1,871.8	2,803.6	3,936.9	5,256.8	6,713.1	11,241.0	16,425.0	21,527.6	27,959.1	

Data Source: The Central Bank.

TABLE 3  
Distribution of Islamic Banking Contract

(Percent)	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
CONTRACTS	33.3	32.3	35.3	42.6	46.7	46.4	48.7	46.7	46.2	44.7
INSTALLMENT SALE	14.7	13.0	13.7	13.7	11.6	12.7	14.4	17.7	17.5	17.3
CIVIL PARTNERSHIP	18.1	15.7	15.3	12.5	10.8	10.7	10.2	9.6	8.4	7.5
MODHARABAH	0.3	1.4	1.4	1.8	2.7	5.0	6.6	7.0	6.0	6.0
JO'AALAH	3.6	3.1	3.9	3.8	4.9	6.6	5.2	4.9	6.6	6.8
FORWARD DEALS	3.5	7.3	6.5	7.0	7.1	5.7	4.5	4.8	5.1	4.7
EQUITY PARTNERSH	10.5	10.6	11.5	10.5	9.7	7.4	5.7	4.2	3.6	4.6
GARD-AL-HASANAH	3.8	2.0	1.8	2.1	1.9	1.4	1.1	1.4	1.1	1.4
HIRE PURCHASE	0.6	3.5	2.7	1.6	1.3	1.3	1.3	1.3	1.9	2.6
DIRECT INVESTMEN	11.4	9.9	6.3	3.1	1.0	0.6	0.3	0.1	0.1	0.1
DEBT PURCHASE	0.2	1.2	1.6	1.8	2.6	2.2	2.0	2.4	3.5	4.3
OTHER CONTRACTS	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Data Source: Computed from Table 2.

**C. Bank Assets and the Capital - Adequacy Issue**

In nominal terms, the banking system's asset growth has been also impressive. From 1981 to 1993, as reflected in Figure 2, it has increased by a factor of 15. However, in real terms (using GNP price deflator), banks' assets have had a negative growth until 1988, moving up in the last few years.

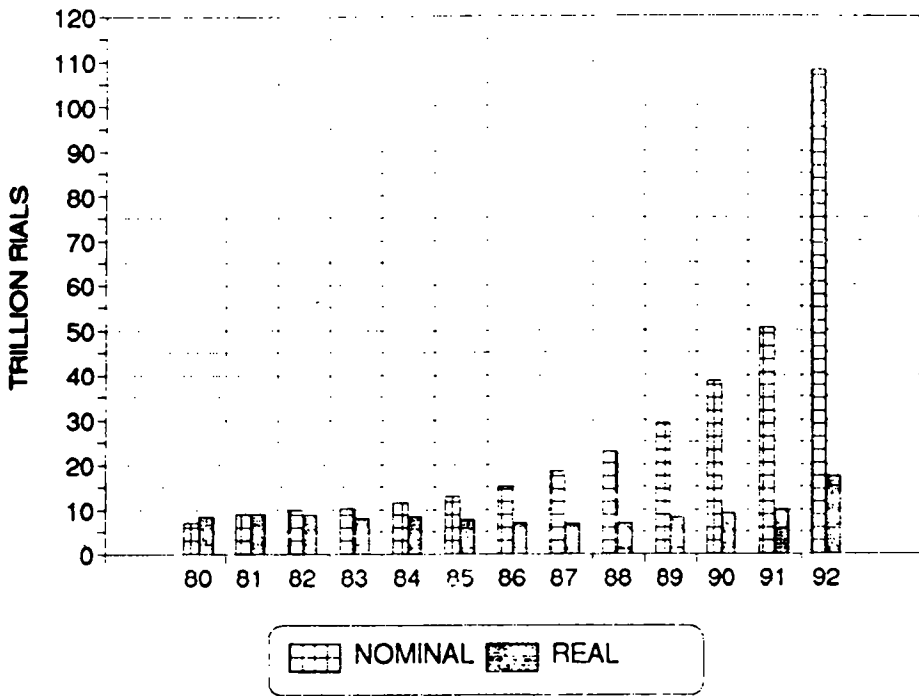


Figure 2- Banking System's Assets (Nominal and Real Amounts)

Data Source: The 1980-92 nominal Values and the implied price indices from the Central Bank.

The real magnitudes and the 1992 nominal values are the author's computations and estimates.

System's capital to total asset ratio has also done poorly until 1990. As can be seen in Figure 3, this ratio has declined from 5

percent in 1980 to about 0.5 percent in 1990. Afterwards, mostly due to the revaluation of assets, this ratio has improved. At the present this ratio is estimated at about 4 percent.

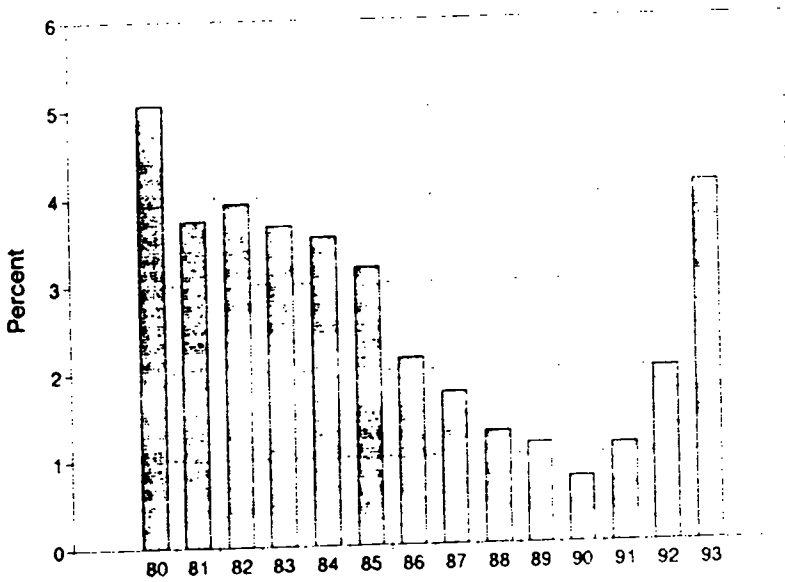


Figure 3- Banking System's Capital to Total Assets Ratio

Data Source: The 1980-92 values are computed as implied from the banking System's Consolidated Financial Statements as reported by the Central Bank. The 1993 background values are estimated by the author.

#### D. Capital Investment, Savings and I/GNP Ratio

The amount of funds channelled into gross private domestic investment during the last several years (from national income accounts) is shown in Figure 4. Only after the war and the election of a new government, investment performance has

improved.

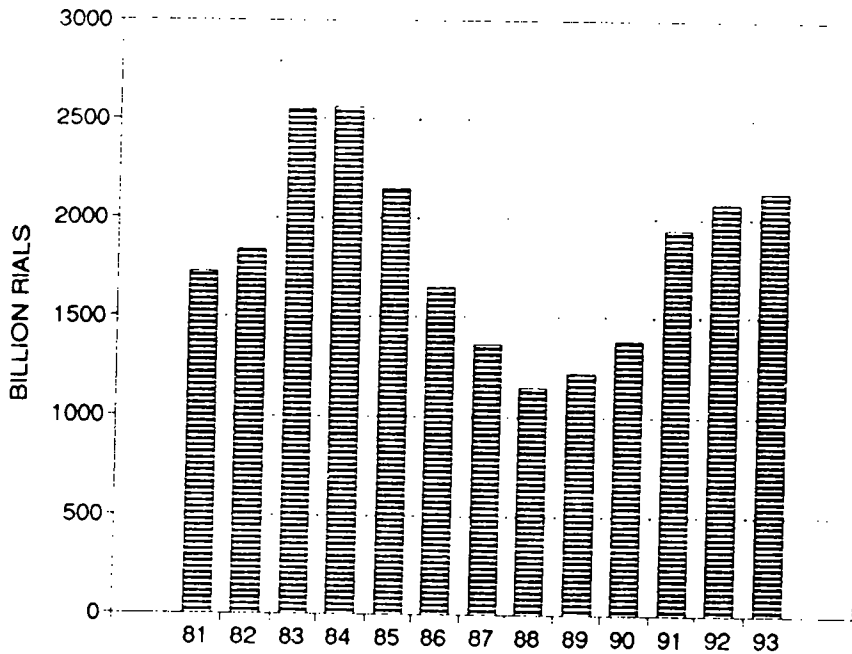


Figure 4- Trend of Investment (Real Amounts)

Data Sources: The 1981-90 values from the National Accounts of the Islamic Republic of Iran as reported by the Central Bank. The 1991-92 values from the plan and Budget Organization. The 1993 investment estimate of the author.

The performance of savings (from survey of families), however, has continued to remain unsatisfactory. The saving ratio reached a negative 42 percent in 1989. It is mentionable that there seems to be a severe problem with definition of income and expenses in these surveys.

Figure 5 shows the ratio of gross investment to gross national

product. By this measure, the financial system has also performed poorly. Our current estimate of this ratio is about 17 percent. In its peak, it was about 35 percent two years before the revolution.

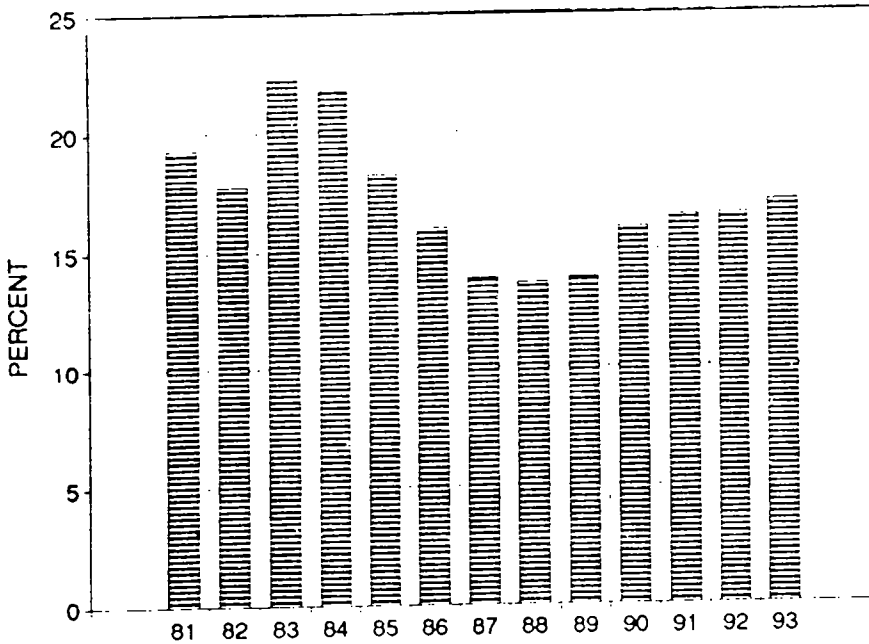


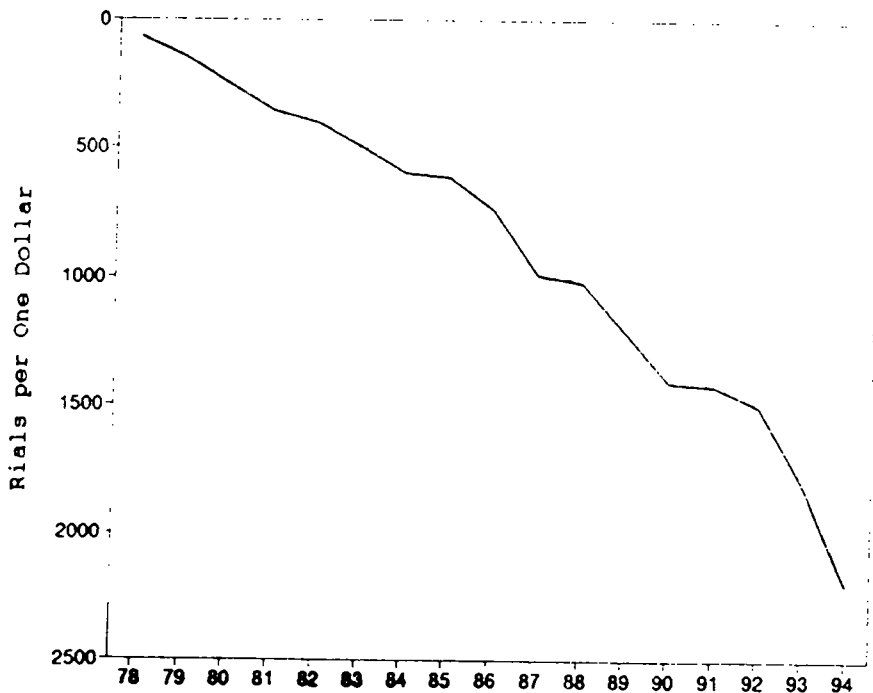
Figure 5- Investment to GNP Ratio (Nominal Amount)

Data Sources: The GNP values (in current prices) and the 1981-90 investment values from the National Accounts of the Islamic Republic of Iran as reported by the Central Bank. The 1991-93 investment values from the plan and Budget Organization. The implied ratios are the author's computations.

### E. The Exchange Rate

The behavior of the "free market" exchange rate (e.g., in terms of the U. S. dollar) reveals a continuous depreciation in the

Iranian national currency. Figure 6 shows the depreciation in the Iranian Rial since the revolution.



Data Sources: Macroeconomic Desk, Plan and Budget Organization; Institute for Technical Information of Iran; the author's sampling for 1994. (Inverted scale.)

Figure 6- History of Foreign Exchange in Iran

## F. Liquidity Growth, Inflation and Unemployment

Figure 7 shows the performance of the "liquidity" (as measured by  $m_2$ ). The inflation and unemployment rates are shown in Table 4. These measures reveal concerns about the control of the money supply and the consequential adverse effects of inflation on other economic variables.

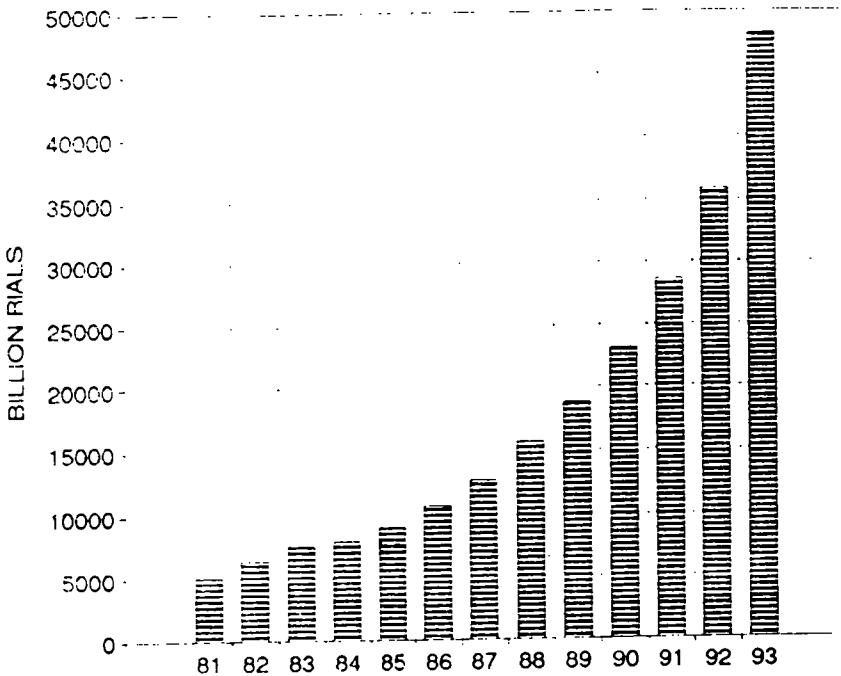
Year	Inflation Rate	Unemployment Rate
1990	9.6	14.4
1991	19.6	13.4
1992	21.6	11.4
1993	30.0	11.0
1994**	36.0	11.2

Table 4: Inflation and Unemployment Rates

Source: the Central Bank and Plan and Budget Organization

Notes: Inflation is measured by retail prices.

\*\* Estimate of the first half by the Author



Data Source: The 1981-92 measures from the Central Bank.  
The 1993 value is estimate of the author.

Figure 7- Trend of Liquidity



#### IV. Difficulties in Iran's Financial System

Since the revolution, Iran has had several extraordinary experiences, including:

1. Massive nationalizations and expropriations.
2. Substantial capital flight.
3. Brain drain.
4. Freeze of its foreign assets.
5. Selected sanctions against Iran's exports and imports.
6. Eight years of war with Iraq.
7. Large fluctuation in its main source of foreign exchange earnings (oil).
8. A very high population growth (about 3.5% per annum).
9. Shift in economic policies--including a switch from an (ineffective) import-substitution policy to (an ineffective) export-promotion policy (in 1989).
10. Implementation of structural adjustment programs (SAPs) including attempts to rationalize the price system, reduce budget deficits, cut subsidies, initiate privatization and move towards a single-exchange rate regime.

From another perspective, the financial system of Iran is a multi-dimensional system in which at least the following dimensions can be identified.

1. An evolving Islamic financial system.
2. a nationalized banking system due to the unavoidable consequences of the revolution.

3. A developing financial system due to the developing economic status of the nation.
4. A largely bank-based, as compared to the securities-based, system.
5. A repressed financial system (RFS).
6. A traditional "bazaar" financial system with a large informal Sector.<sup>1</sup>

The aforementioned extraordinary events and the multidimensional aspect of the financial system makes any problem multifaceted in nature and requires a conservative approach to diagnosing the problems and drawing any conclusion. Nevertheless, the current state of Iran's financial system and its economy make it imperative to present a diagnosis -- albeit crude--of the problems. Therefore, in the next two sub-sections an attempt is made to briefly identify the difficulties in the banking system and the open market.

#### A. Problems of the Banking System

The nationalized, Islamic financial - institutional system of Iran is a repressed one in which the following problems and difficulties can be identified.

1. The banking system operates under a nationalized system, in

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1- For a description of some of these financial dimensions, systems and sectors see [World Bank, 1988] and [Pourian, 1993].

which credit allocation is "administered" largely through an inefficient planning process. Recently, attempts have been made to abolish the credit ceilings, although the progress has been slow.

2. Negative real bank rates are rigidly controlled by the Central Bank, lessening the flow of funds to the formal banking sector and contributing to the growth of an informal financial sector.

3. Financial system is such that competitive forces do not exist and non-bank financial institutions (perhaps except nationalized insurance companies and pension funds) virtually don't exist.

4. In terms of financial personnel, bank employees, who are paid and managed poorly, have no motivation to increase their productivity and seem insensitive to customer satisfaction.

5. Within the context of the structural adjustment programs, in the macroeconomic-policy making scene, industry officials often complain of the banking system being too inflexible and contractionary in credit policies. In response, economic and finance officials blame inflexibility of the industry. Currently, a rising inflation rate is simultaneously occurring with deterioration of the financial condition of the firms.

6. As of yet, the public is not clear with regard to the Islamic (loan) contracts and its related jargon and a majority doesn't seem to believe that the banking system is usury-free as it claims.<sup>1</sup>

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1- See a survey of Public Opinion by [Mesbahi, 1994].

**B- Problem of the Stock Exchange**

In Iran's undeveloped open financial markets the following difficulties can be identified.

1. Until recently only the issuance of common stocks was allowed within the context of capital market in Iran.

2. There is a scarcity of securities and the "investment pyramis" for portfolio management is incomplete.

3. Political and legal risks dictate a large risk premium on common stocks, which would suggest large fluctuations (in response to new information) as well as depressed trend values.

4. Lack of managing the stock exchange (which is a private organization, but practically is under the control of the Central Bank) has generated a serious obstacle to the government's privatization program and has eroded the confidence of the public.

5. In fear of a crisis and "Protection" of values, securities prices are "Controlled" (by the stock exchange and the Central Bank authorities).

6. The unsuccessful and slow-moving privatization program has defeated expectations about quick development of a securities market in Iran.

7. The flow of accounting, micro and macro information is much deficient, hampering quick decision making which is

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required in an efficient open - market system.<sup>1</sup>

## **V - Summary and Policy Recommendations**

During the last 15 years Iran several extraordinary events have affected Iran's economy which have included a massive nationalizations and expropriations, capital flight, sanctions against Iran's exports and imports and eight years of war. On the other hand, the financial system of Iran is a multi-dimensional system which includes an Islamic financial system, a nationalized banking system, a largely bank-based system and a repressed financial system. While no evaluation of the Islamic banking system has been attempted in this paper, occurrence of the extraordinary difficulties and the multidimensional aspect of the financial system. Nevertheless has created a highly inefficient financial system.

What needs to be done? One can recommend an array of policies from the perspective of financial development {see, e.g., world Bank, 1988] and efficient market theory [e.g., Fama and Miller, 1972].

### **A. Recommendations for the Financial Institutions Sector**

1. Credit allocation needs to be left to the banking system to

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1- For a description of other problems of the Stock Exchange and Capital Market in Iran, see [Pourian, 1994(b)].

grant loans for microeconomic reasons as well as comparative advantages of the country, rather than administering it through the macro-oriented planning process. Otherwise, an industrial policy should be developed and funds allocated according to its pre-designed program

2. In order to increase the flow of funds to the banking sector, bank rates need to be gradually increased in order to eliminate the current negative real interest rates which contribute to the growth of the informal financial sector.

3. The public relations of the banking system and the Central Bank needs to be improved especially with regard to explaining the various Islamic banking contracts prevalent in the system.

4. In the spirit of "intrapreneurship", a merit system needs to be developed in order to increase bank employees motivation and productivity.

5. Serious attempts should be made by the system to increase customer satisfaction.

#### **B. Recommendations for the Open Financial Markets**

1. The issuance of other securities than common stocks (like a specially-tailored, Islamic convertible bonds) should be allowed in order to alleviate the "scarcity" of securities, in order to, first, promote the methods of financing by corporations (Private and governmental) and, second, to complete the "investment pyramid" for portfolio management.

2. As much as possible, "signals" which would imply lower political and legal risks should be uniformly given by the three branches of the government (executive, legislative and judicial).

3. The "control" of securities prices by the stock exchange needs to be abandoned.

4. A comprehensive program for privatization (with several years of time schedule) should be established, announced and strictly implemented.

5. The establishment of private investment banks should be permitted and encouraged.

6. Flow of accounting, micro and macro information needs to be improved.

### **C. Recommendations for Supervision and Control**

1. The Central Bank should concentrate on its primary reason for its existence: conduct of monetary policy.

2. The supervision of banking system and other financial institutions should be separated from the Central Bank and be given to a new independent agency. The low capital - asset ratio requires immediate attention. Luckily, recent reports show that this ratio has improved.

3. In order to isolate it from the political, it may be necessary to consider the issue of the independence of the Central Bank.

4. Management of the privately-owned stock exchange should be improved and control of the Central Bank lessened.

5. The supervision of the stock exchange needs to be conducted by establishing a new securities commission rather than by the Cenral bank.<sup>1</sup>

#### **D. Guidelines for Financial Liberalization**

1. In order to increase the efficiency of the system, competition needs to be promoted in the banking sector which then, would most likely, suggests moving towards a privatized (and Islamic) financial institutions sector in Iran.

2. Increasing the efficiency of the financial secor (banks, non-bank, stock exchange) is also important for the success of other government plans and programs, including privatization.

3. The Central Bank should speed up the establishment of non-bank financial institutions, NBFIs.

4. Within the context of the structural adjustment programs (SAPs), Iran needs to maintain an-admittedly delicate balance between development of its industry and restrictive credit policies.

5. Teh sequence of liberalization needs to start with basic macro-stabilization programs and credit controls.<sup>2</sup>

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1- This recommendation was written by the author and is reflected in the Second Plan bill, which at the moment of writing is being considered for ratification by the Iranian Parliament.

2- For discussion regarding the sequence of liberalization and the gradual approach see e.g. [Cho and Khatkhate, 1989] and [Bisat, et. al., 1992].



It may be also necessary for the liberalization to be gradual as to avoid the financial crises which can occur in any financial liberalization process.

We close by suggesting, once again that this paper has not been about evaluation of the performance of the Islamic banking principles per se. Indeed, since in our opinion a true test of the Islamic banking has not as of yet been given in Iran, the inappropriate performance of some of the economic and financial indicators reported here does not intend to answer negatively the important question of "can the Islamic financial system survive"?

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