The Contribution of Islamic Banking to Economic Development (The Case of The Islamic Republic of Iran)

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Abstract

Islamic banking is a new industry which has attracted the attention of many economists in the world regarding its ability to operate successfully and its instruments for mobilising and allocating monetary resources (Deposits). Usually, in the majority of Islamic countries and in some non-Islamic countries, Islamic banking works as one part of a banking system. There are few countries where the banking system is completely Islamic and the Islamic Republic of Iran is one of them. In a country in which the entire system is Islamic there are more questions about its activities. The most important questions are: how can bank managers ensure the *Shariah*-compliance of banking system activities and how can they contribute to economic development? These are the two main questions of this research.

In order to answer the first question, the Law of Usury-Free Banking in Iran was analysed and it was shown that this law is *Shariah*-compliant. However, the most important issue is to make sure that all banks in the country work according to the Law of Usury-Free Banking. In order to explore this semi-structured interviews were carried out with twelve interviewees including managers of the Central Bank and commercial banks and researchers. The result of the interviews was the introduction of several instruments used in the banking system of Iran for the supervision of banking activities and to ensure their *Shariah*-compliance. A new issue in this research is that being *Shariah*-compliant does not only mean utilising appropriate contracts for each project but also using deposits for the most efficient and profitable projects. This is because banks are the agents of the depositors and therefore they must use their deposits for the best possible projects. The vast majority of interviewees believe that Islamic banking system in Iran works in conformity with the Law of Usury-Free Banking in Iran.

Regarding the second main question, this study utilised both quantitative and qualitative methods in order to obtain sufficient data to analyse it. The secondary data was taken from Iran's Central Bank Annual Reports, other Iranian banks' reports, the Ministry of Industry, the Ministry of Agriculture and the Statistics Centre of Iran. Although the main period of the study was 1989-2006, in order to make a comparative study the periods 1961-1978 and 1979-1988 were considered in some parts of the study. For a more accurate study, not only were the amounts of deposits and financial facilities in the periods before and after the Islamic Revolution compared, but their ratio to liquidity (M2) and GDP were also compared. Our finding was that Islamic banking was relatively more successful than conventional banks operating before the Islamic Revolution in Iran. One important aspect of the contribution of the banking system in Iran to economic development is direct investment. The Islamic banking system in Iran has carried out thousands of huge projects directly most of which cannot be undertaken by private sector including: highways, petrochemical industries, wood and paper industries, industrial farming and animal husbandry, automobile manufacture, the cement industry, railways and so on. In addition, primary data was collected via semi-structured interviews. The majority of interviewees believed that Islamic banking in Iran has had a positive effect on economic development.

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Declaration

I hereby declare that this thesis results entirely from my own efforts and confirm that none of the material in this study has previously been submitted by me for a degree in this or any other university.

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Chapter One:

INTRODUCTION

1.1 INTRODUCTION

Today, financial systems and banking play an important role in economic activities in all countries, especially with regard to those activities related to economic development. Indeed, there is a direct relationship between the level of development in a financial system and economic development in general.

While economic growth is an essential condition for economic development, investment is an important factor for economic growth. Thus a financial system, especially banking, which provides credit to investors, plays an important role in financing economic development. As there are two main groups in every society, those who have surplus money but are not able to or do not want to invest and produce, and those who are able to operate as producers, and even originators, but do not have enough money to invest, the main responsibility of banks is to collect surplus money from savers and depositors (mobilization), and allocate it to producers and creators. However, since there is an interest rate, '*riba*', in conventional banks, which is prohibited in Islam, Muslims have a problem with this type of banking; therefore, Muslim thinkers have tried to establish a bank which is able to carry out the main functions of conventional banks without the problem of *riba.*

Islamic banking in its modern form is a new experience in the banking industry. It is approximately 50 years old. "The first Islamic bank was established in Pakistan in the 1950's no interest was charged for the credit, but a small fixed administrative fee was levied to cover the operating expenses of the bank" (Wilson, 1983: 75). However, the first Islamic bank in the Middle East was established in Egypt.

Before the Islamic Revolution in Iran the country had some simple Islamic banks; known as *Qardh-Al-Hasanah* Funds (loan without interest funds), but there were also

many conventional banks too. At that time many religious people preferred not to cooperate with conventional banks.

> After the Islamic Revolution in Iran (1979) concurrently with the steps being taken for the reformation and structural improvement of the banking system, studies were undertaken for the Islamization of the banks. The first step toward the abolition of interest only resulted in the reduction of rate of interest nomenclature to a maximum service charge and a guaranteed minimum profit. As a result, interest on all asset-side transactions was replaced by a four percent maximum service charge and by a four to eight percent minimum profit rate, depending on the type of economic activities. Interest on the deposits was also converted into a guaranteed minimum profit. As these steps could not bring about a fundamental change in the previous banking system, preparation got under way for the submission of comprehensive legislation to bring the operation of the entire banking system into compliance with Islamic principles. The legislation was passed by Parliament in August 1983 as the "Law for Usury-Free Banking" (Hedayati, 1999).

The new banking law was implemented in 1984 and the banking system in Iran was changed completely to an Islamic model. Although there are many Islamic banks with a capital of more than $200 billion in the world, only one country (Iran) has a completely Islamic banking system today.

1.2 MOTIVES FOR THE STUDY

One of the most important goals of the "Law for Interest-Free Banking" of Iran has been to help different sectors of the economy to develop, and the banking system in Iran has been working according to this law for more than two decades. The role of Islamic banking in economic development in general, and Islamic banking in Iran in particular, is debatable however, and according to many books and economic bulletins on banking system activities which have been published and issued by the Central Bank of the Islamic Republic of Iran and the Iranian Statistics Centre and contain a lot of data on this subject, it seems that it is time to consider its role and contribution to economic development. Thus, this study tries to analyse both its being Islamic and its contribution to economic development. So the following research questions will be considered:

1.3 THE KEY QUESTIONS

1- How does the Islamic banking system in Iran work?

2- How do the banks ensure that the deposit and financial facilities they offer are *Shariah*-compliant?

3- What was the effect of the "Law for Usury-Free Banking" of 1983 on Iran's banking system?

4- Has the elimination of *riba* encouraged more people to open bank accounts?

5- Has Islamic banking in Iran had a positive effect on the country's economic development and if so in what way?

1.4 THE SUB-QUESTIONS

1- What is the economic structure in Iran?

2- What was the economic development process in Iran?

1.5 HYPOTHESES

1- The banking system in Iran ensures that the deposit and financing facilities it offers are *Shariah*-compliant by operating in strict accordance with the Law for Usury-Free Banking in Iran and with the supervision of contracts both by the Central Bank and by commercial banks themselves.

2- The banking system affects economic development by mobilizing monetary resources and allocating them to the most efficient projects.

3- Islamic banking in Iran had a positive effect on economic development between 1989 and 2006.

4- Despite their natural ability and potentiality, because of Iran's economic structure and weakness of competition in its banking system, the effect of Islamic banking was not as great as expected.

5- Due to the religious beliefs of the Iranian people and the profitability of Islamic banks in Iran, they have been relatively successful in the mobilisation of monetary resources (deposits).

1.6 AIMS AND OBJECTIVES

The aims and objectives of this research are as follows:

(i) To discuss the Islamic banking system in Iran, its characteristics and model of operation, especially, its financial instruments for mobilisation and allocation of monetary resources (deposits).

(ii) To discuss ways of making sure that banking activities are *Shariah*-compliant.

(iii) To investigate the structure of Iran's economy in general and the banking system in particular.

(iv) To identify the process of economic development in Iran.

(v) To examine the contribution of Islamic banks to economic development in Iran. This will be achieved by using descriptive quantitative analysis and qualitative analysis of semi- structured interview.

This research will have three sections:

1.7 THE THEORETICAL ANALYSIS

In this section the following discussions will be carried out:

(i) Introducing modality of performance of the "Law for Usury-Free Banking" in Iran.

(ii) Review of literature on the role of the banking system in general and Islamic banking in particular in economic development.

(iii) Islamic banking in the Islamic Republic of Iran, its background and circumstance of its activity with regard to the Law of Usury-Free Banking in Iran, especially, financial instruments.

(iv) Ways of making sure that Islamic banking in the Islamic Republic of Iran is *Shariah*-compliant.

1.8 THE EMPIRICAL (QUANTITATIVE) ANALYSES

This section will involve the following:

(i) Examination of the main features of the Iranian economy in general and the banking system in particular by using secondary data on the subject.

(ii) Analysis of economic development financing by the banking system in Iran through the Central Bank of Iran's reports and other related reports.

1.9 THE EMPIRICAL (QUALITATIVE) ANALYSES

This section will involve the following:

(i) Using semi-structured interviews with some managers in the banking system of the Islamic Republic of Iran and some researchers to examine *Shariah*-compliance.

(ii) Using semi-structured interviews with some managers in the banking system of the Islamic Republic of Iran and some researchers to examine the contribution of Islamic banking to economic development.

1.10 METHODOLOGY

The methodology of this research will be discussed in detail in Chapter Four. In this chapter methodology is discussed briefly. As this research has three parts: the theoretical part, the quantitative analysis part, and the qualitative part, three kinds of method should be utilised.

1.10.1 Theoretical Discussion

This section is divided into two sections. The first deliberates on whether or not the banking system of the Islamic Republic of Iran is *shariah*-compliant. In this section analysis will be made using divine sources reflected in the jurisprudents' opinions (*Fatva Al Foghaha*). The second section discusses the potentiality and ability of banking systems in general and Islamic banking in particular to finance economic development. However, in discussing this issue, the opinions of the economists, especially, Muslim economists and also some existing literature in this regard will be utilised.

1.10.2 Quantitative Research Methods

Quantitative research methods are used for collecting and analysing numerical data. These data are called secondary data which is usually collected from official centres and institutes. In order to show a picture of the Iranian economy and also to examine the contribution of Islamic banking to economic development, quantitative research method will be utilised. For this reason secondary data will be collected from different sources such as:

a) Economic Statistics Office of the Central Bank of the Islamic Republic of Iran and its reports and balance sheets for different years.

b) Economic Accounts Office of the Central Bank of the Islamic Republic of Iran, Iran's Economic Changes Report in the Real Sector, first three months of 1385(2006).

c) Economic Research and Policy Department of the Central Bank of the Islamic Republic of Iran.

d) Performance of Iran's banking system during 2005 and 2006 for 2003-2006.

These collected data will be analysed manually and descriptively.

e) Iranian Banking System Report (2006).

f) The Statistics Centre of the Islamic Republic of Iran.

g) Ministry of Industries and Mining reports.

h) Ministry of Road and Transportation reports.

i) The Journal of Banker.

After collecting these data, the researcher will perform some necessary calculations upon them and will analyse them descriptively.

1.10.3 Qualitative Research Methods

There are some important and useful data which do not appear in the statistics because they are non-numerical data. So, the qualitative research methods aim to collect these

kinds of data. The use of this method has grown increasingly during recent decades. In this research the semi-structured interview has been selected to investigate the main research questions. Twelve interviewees were selected from among officials of the Central Bank of the Islamic Republic of Iran, its commercial banks (state-owned and private), researchers in the field of Islamic banking and Islamic scholars. After conducting the interviews their results are analysed manually in Chapters Seven and Eight.

In Chapter Seven questions regarding *shariah*-compliance will be asked. It is worth mentioning that as banks are agents of the depositors and according to the contract they are engaged to utilise deposits in the best profitable projects, profitability of the contracts also becomes one condition of being *shariah*-compliant. So, questions of profitability and efficiency will appear in Chapter Seven. Chapter Eight will be allocated to the contribution of Islamic banking to economic development.

1.11 LIMITATIONS

This study may have limitations as follows:

(i) One of the data sources in this research is secondary data taken from Iran's Central Bank's annual reports, other Iranian banks, the Ministry of Industry, the Ministry of Agriculture, the Statistics Centre of Iran and so on. In this regard we may face two kinds of problem (inadequacy and inconsistency of data).

(ii) Another source of data is the semi-structured interview which may face problems due to time constraints and the difficulty of finding suitable interviewees and making appointments with them.

1.12 ORGANIZATION OF THE STUDY

To fulfil the aims and objectives of the study and answer the research questions, this research is designed to do its job as well as possible according to the ability and knowledge of the researcher and time limitations. This thesis has been divided into three parts as follows: Part One, theoretical approaches and literature survey containing Chapters 1-4, Part Two quantitative approach containing Chapters 5-6 and Part Three, qualitative approach and conclusion containing Chapters 7-9.

In the first chapter, questions, motives, hypotheses, aims and objectives, methodology, limitation of the study and organization of the study are discussed.

Chapter Two presents the literature review and some theoretical issues. In this chapter some theories regarding the role of banking systems in general and Islamic banking in particular in economic development are presented. In addition, to cover the background of the issue more completely, some literature regarding the relationship between financial development and economic growth is reviewed. Also, empirical evidence and case studies on different countries are mentioned. It also contains methodology in Islamic economics in order to prepare the way for the use of divine resources as acceptable and even most important resources in Islamic economics including Islamic banking. Finally, some advantages of Islamic banks compared with conventional banks with regard to their role in economic development are presented.

Chapter Three introduces the Islamic banking system of Iran, the Law for Interest-Free Banking of Iran and its performance. In this regard aims, functions, Islamic banking modes in mobilisation and allocation of monetary resources (deposits) and monetary policy instruments in Islamic banking in Iran are discussed. It is worth mentioning that some critical issues regarding Islamic banking in Iran, such as in-part-payment profit rates, expected profit rates, circumstance of determination of final profit rate and share of each party from the profit and bonus in *Qardh-Al-Hasanah* account, which some people think is the same as a lottery, are discussed according to the *shariah* principles.

Chapter Four provides a survey of research methodology issues with the emphasis on issues related to this research. Therefore, it presents some empirical methods which are utilized in empirical research in general, (apart from being belonging to Islamic economics or conventional economics). In this regard, quantitative research methods and qualitative research methods are introduced in this chapter. Also, the semi-structured interview, which is a tool for collecting primary data in this research, is explained.

Chapter Five provides a picture of the Iranian economy structure and process of economic planning in Iran. For this purpose, the banking system, capital market, metal exchange, agricultural products exchange, participation papers, agriculture

sector, manufacturing, mining and oil related activities, energy, construction and housing, transport and GDP by sector are considered.

Chapter Six examines the contribution of the Islamic banking system in Iran to economic development using quantitative research method. In other words, this chapter offers a descriptive quantitative analysis of the process of economic growth, success of Islamic banking in the mobilisation and allocation of monetary resources (deposits) and their effect on economic development. Although, the main period considered in this research is 1989-2006, for a comparison with the conventional banking system the period before the Islamic revolution is also studied.

Chapter Seven is the first qualitative analysis chapter. In this chapter, using the semi-structured interview method, issues related to the *shariah*-compliance of Islamic banking in the Islamic Republic of Iran, from the interviewees' point of view, is examined. Specifically, ensuring that banking activities in Iran are *Shariah*-compliant, problems with which Islamic banking can be faced, solution to these problems, determination of final profit rates for depositors, determination of final profit rates for facilities applicants, *Shariah* Board, problems which caused the absence of a *Shariah* Board in Islamic banking in the Islamic Republic of Iran and solutions to the problems regarding the *Shariah* Board are asked of the interviewees.

Chapter Eight is the second qualitative analysis chapter. In this chapter, one of the main questions of the research is asked of the interviewees and their responses are analysed manually. Once again the semi-structured interview was chosen to conduct the interview survey in this chapter. Specifically, the issues asked of interviewees in this chapter are:

(i) Effect of performance of the Law for Interest-Free Banking of Iran on the mobilisation of monetary resources (deposits).

(ii) Effect of performance of the Law for Interest-Free banking of Iran on the allocation of monetary resources (financial facilities).

(iii) Effect of performance of the Law for Interest-Free Banking of Iran on encouraging people to deal with the banking system.

(iv) Effect of performance of the Law for Interest-Free Banking of Iran on employment, inflation, economic crisis, liquidity, internal trade, external trade, real GDP and profitability.

(v) Possible disadvantages of Islamic Banking in the Islamic Republic of Iran regarding economic growth.

Chapter Nine includes the Summary, Conclusion and Recommendations.

Chapter Two:

BANKING SYSTEM AND ECONOMIC DEVELOPMENT

(A LITERATURE SURVEY)

2.1 INTRODUCTION

This chapter examines the literature and investigates theories regarding the role of banking systems in general and Islamic banking in particular in economic development. We know that there are some differences between economic development and economic growth (the most important difference is that while in the former the emphasis is on the qualitative aspects, in the latter, the emphasis is on the quantitative aspects). However, it is obvious that not only is economic growth an important factor in economic development but it is also a necessary condition for it. Therefore, because of this and because economic growth can be measured, we will focus on economic growth rather than economic development. In the next part of this chapter I will attempt to define some terminologies such as economic development, economic growth and financial development and I will provide further explanation of them.

In the third part, I will review some selected literature, especially the contribution of Schumpeter, MacKinnon, Shaw, King and Levin, and in the fourth part I will focus on theories and opinions regarding the role of the financial system in economic growth, with emphasis on the banking system. Furthermore, I will put forward opinions on the role of Islamic banking in economic growth.

2.2 DEFINITIONS AND BRIEF EXPLANATION

In this section, we define and explain some terminologies such as economic development, economic growth and financial development and discuss them briefly.

2.2.1 Economic Development

Economic development refers not only to economic growth but also to quality of production. McKinnon (1973: 9) defines economic development as the reduction of the great dispersion in social rates of return on existing and new investments under domestic entrepreneurial control. According to Schumpeter (1983: 66) the concept of development covers several cases as follows:

> (a) The introduction of new goods which consumers are not yet familiar with or of a new quality of a goods.(b) The introduction of a new method of a new production that is one not yet tested by experience in a branch of manufacture concerned, which need by no means be founded upon a discovery scientifically new, and can also exist in a new way of handling a commodity commercially.(c) The opening of a new market that is a market that into which the particular branch of manufacture of the country in question has not previously entered, whether or not this market existed before.(d) The conquest of a new source of supply of raw materials or half manufactured goods.(e) The carrying out of the new organization of any industry, like the creation of monopoly position (for example through fructification) or the breaking up of a monopoly position.

Moreover, there are other opinions regarding the definition of economic development. One is that economic development is a fundamental change in the structure of an economy, such as a change in the share of industry and agriculture in the GDP in favour of industry, moving people from villages and rural areas to live in cities and changing consumption patterns. People no longer spend the majority of their income on necessities; rather, they buy durable consumption goods and have more leisure-time. However, another factor in economic development is people's participation in the process of change; everyone in a country should benefit from changes including, but not solely or even mainly, foreigners.

> A key element in economic development is that the people of the country must be major participants in the process that brought about these changes in structure. Foreigners can be and inevitably are involved as well, but they can not be the all story. Participation in the process of development as well as participation in those benefits. If growth benefits only a tiny wealthy minority, whether domestic or foreign, it is not development (Perkins, *et al*. 2001:9).

2.2.2 Economic Growth

Economic growth, which is defined as an increase in Gross National Product (GNP) or increase in Gross Domestic Product (GDP), has been the main purpose of most economic studies and models from Adam Smith (the father of Classical Economics) until the present time. Even before Smith there were some opinions regarding this issue.

Today growth is still an important topic of serious discussion among economists. Transfer from exogenous to endogenous growth models was in fact a progress toward a better explanation of reality. While in exogenous growth models the focus was on the accumulation of capital and innovations and technological changes were determined outside the model, in endogenous growth models they are determined within the model. For example, in Romer's model (1987) the technology factor is determined by the knowledge spillover effect. He followed Arrow (1962) who reasoned that every investment unit not only increases physical capital stock but also increases the technology level of firms via the knowledge spillover effect. Romer (1990) also developed a new growth model which is a combination of the knowledge spillover effect model and the monopoly power model. Furthermore, Romer (1994) compared endogenous and exogenous growth models according to the five realities which every growth model should contain.

In addition, King and Levine (1993c: 514) developed an endogenous growth model focussing on connections between finance, entrepreneurship, and economic growth. Their model as an endogenous growth model aimed at:

> Featuring connections between finance, entrepreneurship, and economic growth suggested by the insights of Frank Knight (1951) and Joseph Schumpeter (1912). We combine the Knightian role of entrepreneurs in initiating economic activities with two ideas of Schumpeter. First, we build on the well-known Schumpeterian view that innovations are induced by a search for temporary monopoly profits[1]. Second, we incorporate the less well-known Schumpeterian idea that financial institutions are important because they evaluate and finance entrepreneurs in their initiation of

[1] Recent general equilibrium frameworks embed Schumpeterian ideas of 'creative destruction', following Shleiffer (1986). Our model is in the class of endogenous growth models developed by Aghion and Howitt (1992), Grossman and Helpman (1991) and Romer (1990).

> innovative activity and the bringing of new products to market. (King and Levine, 1993c: 514)

In the endogenous growth models there are some factors which affect economic growth, including services provided by financial intermediation which have a positive effect on economic growth.

2.2.3 Financial Development

Every financial system usually provides special functions and services which can affect the mobilization of savings, the allocation of resources and economic development. Whenever they perform their functions better and more successfully, their development improves.

> Financial development occurs when financial instruments, markets, and intermediaries ameliorate – though do not necessarily eliminate – the effects of information, enforcement, and transactions costs. Thus, financial development involves improvements in the (i) production of ex ante information about possible investments, (ii) monitoring of investments and implementation of corporate governance, (iii) trading, diversification, and management of risk, (iv) mobilization and pooling of savings, and (v) exchange of goods and services. Each of these financial functions may influence savings and investment decisions and hence economic growth. Since many market frictions exist and since laws, regulations, and policies differ markedly across economies, improvements along any single dimension may have different implications for resource allocation depending on other frictions (Levine, 2004: 5-6).

2.3 RELATIONSHIP BETWEEN FINANCIAL SYSTEM AND ECONOMIC GROWTH

Instead of discussing the relationship between financial (banking) systems and economic growth, economists usually discuss the relationship between financial development and economic growth, but both state the same reality. However, not all agree with the importance of the financial system in the growth process. Lucas (1988:6) believes that economists 'badly over-stress' the role of financial factors in economic growth, while Robinson (1952: 86) articulated the view of many when she wrote, 'where enterprise leads, finance follows'. According to this view economic growth is the reason for financial development. It creates demands for particular types of financial arrangements and the financial system responds automatically to these demands. However, the idea that there is a positive relationship between financial development and economic growth has attracted many economists since Walter

Bagehot's time. Bagehot (1873) argues that the financial system played a critical role in igniting industrialization in England by facilitating the mobilization of capital for 'immense works' (taken from Levine, 1997:1).

Schumpeter was the most famous theorist who strongly supported the idea that there is a positive relationship between well functioning banks and economic growth by providing credit to the entrepreneurs for the best projects which leads to technological innovation via mobilizing savings, evaluating projects, managing risk, monitoring managers, and facilitating transactions. As we see, Schumpeter believed that entrepreneurs have a critical role in economic development and financial intermediaries and bankers in particular have an important role in their financing. Schumpeter (1983: 89) states that:

> Yet the personality of the have what of a "leader" looks like, so much so that there is some difficulty in realizing that he comes within the sociological category of leader at all. He "leads" the means of production into new channels. But this he does, not by convincing people of the desirability of carrying out his plan or by creating confidence in his leading in the manner of a political leader- the only man he has to convince or to impress is the banker who is to finance him-but by buying them or their services, and then using them as he sees fit.

Schumpeter believes that development is not possible without credit (see Schumpeter, 1983:105-106). He also explicitly rejects Ricardo's opinion about the inability of banking operations to increase wealth. Schumpeter (1983:98) says: "No one can reproach me with offending against, Say and Ricardo's statement that "bank operations" cannot increase a country's wealth".

McKinnon also supports the notion that there is relationship between financial systems and economic development. McKinnon (1973: 2) states that: "Money and finance, as governed largely by the banking system are given a degree of importance much greater than that accorded by most authors concerned with development". McKinnon also believes that capital markets can aid economic development via efficiency by increasing the return rate of existing capital stock. MacKinnon (1973:9) states: "The capital market in a developed economy successfully monitors the efficiency with which the existing capital stock is developed by pushing returns on physical and financial assets toward equality, thereby significantly increasing the average return". McKinnon also provides evidence from Argentina, Brazil, Chile,

Taiwan, Korea, Indonesia, Germany and Japan. He suggests that a better functioning financial system leads to faster economic growth.

Demirguc-Kunt and Levine (1996) in their article, "Stock Markets, Corporate Finance, and Economic Growth: an Overview" focused on four issues as follows:

a) They constructed some new measures or criteria of stock market development comparing liquidity, concentration, volatility, institutional development, and international integration across forty-four industrial and developing countries from 1976 to 1993.

b) Using these data they investigated the relationships between stock markets and financial intermediaries. They found that:

> Countries with better-developed stock markets also have better-developed banks and non-bank financial intermediaries—such as finance companies, mutual funds, investment companies, brokerage houses, and pension funds—and countries with weak stock markets tend to have weak financial intermediaries. (Demirguc-Kunt and Levine, 1996)

c) They also analyzed the relationship between stock market development and long-run economic growth and concluded that "the level of stock market development does a good job of predicting future economic growth. This aspect is important for the World Bank and policymakers in developing countries because it means that in many countries capital market reforms should be high on the reform agenda" (Demirguc-Kunt and Levine, 1996).

d) They investigated ties between stock market development and financing choices of firms. Demirguc-Kunt and Levine (1996) found that:

> In many countries, improvement in the functioning of the stock market produces a higher debt-equity ratio in firms. While stock market development naturally implies greater use of equity markets in raising capital, it also stimulates greater use of bank finance, so corporate debt-to-equity ratios actually rise. Thus, for these countries, stock markets and banks are not substitute sources of corporate finance; stock market development actually tends to increase the quantity of bank loans. Complementing these empirical findings, the research also starts to build a theoretical framework for understanding the interactions among banks, equity markets, and corporate decisions.

There is a large amount of literature that discusses the relationship between financial intermediaries and economic development. We cannot cover all of it or even most of

it in this chapter, so we will try to look at some of the literature briefly. Beck *et al* (2000), Bekaert *et al* (2001) and Beck and Levine (2004) strongly supported the idea that there is a positive relationship between financial development and economic growth.

Levine and Zervos (1998) studied the empirical relationship between stock market development, banking development, and long-run economic growth. Their research shows that stock market liquidity and banking development are both positively and robustly correlated with contemporaneous and future rates of economic growth, capital accumulation and productivity growth.

Levine *et al* (2000) evaluated whether the exogenous component of financial intermediary development influences economic growth and also whether cross-country differences in legal and accounting systems explain differences in the level of financial development. In this regard they used traditional cross-section, instrumental variables procedures and dynamic panel techniques. Their analysis shows that there is a strong relationship between the exogenous component of financial intermediary development and long-run economic growth. They also show that each of the three financial intermediary development indicators (private credit, commercial-central bank and liquid liabilities)[2] is significantly correlated with economic growth at the five percent significance level.

Abu-Bader and Abu-Qarn (2005) examined the causal relationship between financial development and economic growth in Egypt for 1960-2001. They used Granger causality tests. They concluded that financial development promotes economic growth either through increasing investment efficiency or capital accumulation.

Tang (2006) using a modified growth model investigated whether financial development would have facilitated economic growth among the APEC countries from 1981 to 2000. Tang did this by specifically focusing on the effects of three

[2] Liquid liabilities equals liquid liabilities of the "financial system (currency plus demand and interest-bearing liabilities of banks and nonbank" Financial intermediaries) divided by GDP. This is a typical measure of "financial depth' and thus of the overall size of the "financial intermediary sector (King and Levine, 1993a).
Commercial-Central Bank equals the ratio of commercial bank assets divided by commercial bank plus central bank assets.
Private credit equals the value of credits by "financial intermediaries to the private sector divided by GDP.

aspects of financial development on economic growth: stock market, banking sector and capital flow. Tang found that the level of stock market development would have no impact on the growth effect of capital flow increase among the APEC countries. In the banking sector his study shows that a well-functioning banking sector would only boost the growth effect of capital flow on the APEC developing countries.

Beck *et al* (2000) evaluated the empirical relation between the level of financial intermediary development and (i) economic growth, (ii) total factor productivity growth, (iii) physical capital accumulation, and (iv) private savings rates. They used (a) a pure cross-country instrumental variable estimator to extract the exogenous component of financial intermediary development, and (b) a new panel technique that controls for biases associated with simultaneity and unobserved country-specific effects. Beck *et al* (2000) found that there is a robust, positive link between financial intermediary development and both real *per capita* GDP growth and total factor productivity growth. The results indicate that this is not due to biases created by endogeneity or unobserved country-specific effects. Using both the pure cross-sectional instrumental variable estimator and the system dynamic-panel estimator, they found that higher levels of financial intermediary development produce faster rates of economic growth and total factor productivity growth. They also found that while there tends to be a positive link between financial intermediary development and both physical capital accumulation and private savings rates, these results are sensitive to alterations in estimation techniques and measures of financial intermediary development.

Bashir and Hasan (2003) examined the relationship between financial development and economic growth in some Muslim countries (Egypt, Jordan, Morocco, Tunisia and Turkey). They selected the vector auto regressive model, VAR, for their study and they believed that:

> This mode offers an easy solution in explaining and predicting the values of a set of economic variables at any given point in time. VAR is a straightforward, powerful statistical forecasting technique that can be applied to any set of historical data. Like the structural model, the VAR system also generates a system of equations that can project the future path of economic variables by extrapolating from their past values. However, the main difference between the VAR system and structural models is that the VAR system is based entirely on empirical regularities embedded in the data. The structural model is tied closely to the economic theory and has to follow the

> assumption and a priory restriction imposed therein. (Bashir and Hasan, 2003)

They utilised five variables for measuring financial development. (1) The ratio of bank credit to the private sector to total domestic credit (DCPR) with a higher ratio indicating a shift from public to private financing. (2) The ratio of domestic credit to GDP (DC) with a higher ratio indicating a higher level of domestic investment. (3) The ratio of M2 to GDP for measuring liquid liabilities in the economy with a higher ratio meaning higher intensity of the banking system. They stated that "the assumption here is that the size of the financial system is positively associated with the financial services" (King and Levine, 1993). They called this indicator financial depth and showed it as (M2). (4) The ratio of deposit money banks' assets to GDP (DPST). Bashir and Hasan (2003), explained that "like the previous one, this measure also indicates the intensity of the financial intermediaries since it corresponds to more financial services and, hence, more financial development". (5) The interest rate. Bashir and Hasan (2003) pointed out that:

> financial development is expected to benefit from interest rate liberalization in terms of higher savings rate and, consequently, a higher volume of investment." They used the discounted rate[3] (R) to measure the degree of financial liberalization in the economy. Furthermore, they used "the real rate of growth of GDP as an overall indicator of the possible efficiency-enhancing gains from financial liberalization.

Consequently, Bashir and Hasan's conclusions are as follows:

1- For Egypt their main indicator of financial depth (FDEP) had a positive impact on GDP growth. Bashir and Hasan (2003) also concluded that "other measures of financial development have a different impact on the rate of growth, with the interest rate R, having a positive impact for the first four years before becoming negative thereafter. The banking variable, DPST, also has a positive but insignificant impact on the GDP growth rate. Moreover, the FEVD analysis shows that the GDP growth rate accounts for less than four percent of its own variation, indicating that financial development has a strong impact on growth in Egypt. Furthermore, GDP growth has positive impacts on all financial variables included in the equation".

[3] The discount rate is the rate at which the central bank extends credit to commercial banks. The discount rate is used due to the unavailability of either the lending or the deposit rates in their sample countries.

2- For Jordan Bashir and Hasan (2003) concluded that "DSPT, DCPR and FDEP have a positive effect on GDP growth, while R has a negative effect. The FEVD results indicate that the growth rate accounts for 44 percent of its variation, implying a strong effect on the growth rate from the financial variables. It is worth mentioning that GDP growth has a positive impact on the measure of financial depth (FDEP), DCPR and DPST".

3- For Morocco Bashir and Hasan (2003) concluded that "the GDP growth rate has a positive impact on all variables except R. More importantly, the financial depth variable affects growth positively. The FEVDs show that GDP growth rate accounts for 18 percent of its variables, a strong indication that the financial variables account for much of the variation in growth".

4- For Tunisia, Bashir and Hasan's (2003) VAR results show that "all variables affect each other positively except for R. The fact that GDP growth accounts for 39 percent of its own variation indicates a strong linkage between growth and financial development in that country."

5- For Turkey, Bashir and Hasan (2003) found that there is "a positive impact of FDEP on the growth rate, DC, DCPR and DPST. The empirical results also show the positive impact of the growth rate on all variables. The fact that GDP growth rate accounts for 55 percent of its own variation indicates that the linkage between the real and financial variables is not as strong as indicated on the other countries in the sample".

In addition, in order to understand the trend between financial and real variables they examined causality for five countries. Bashir and Hasan (2003) stated their results as:

> the time series analysis and data are more fruitful in investigating causality between finance and growth. When it comes to the question of causality, the answer depends very much on the institutional characteristics, including the type of financial system and the type of financial policies followed. More importantly, the financial indicators used tend to have significant explanatory powers in explaining growth in our analysis.

2.4 FINANCIAL ASPECTS OF ECONOMIC GROWTH

Gurley and Shaw (1955:515) believe that: "conventional theories of income, interest and money have given insufficient attention to the important reciprocal relationship

between real development and financial development". They emphasised that financial systems and financial intermediaries play an important role in economic development. To illustrate this, Gurley and Shaw divided the final buyers of output or spending units into three groups:

a) Spending units with balanced budgets: their spending on consumption, investment or government goods and services are the same as their income. If they save they invest the same amount.

b) Spending units with surplus budgets: If they save their saving exceeds their own investment. Hence, their financial position improves and they are suppliers of loanable funds.

c) Spending units with deficit budgets: Their expenditure is more than their income and their saving is negative. Hence, they are demanders of loanable funds and they are releasing financial assets or issuing debt.

They also stated that loanable funds supplied are equal to loanable funds demanded and the increase of net financial assets for surplus spending units equals increase of net financial liabilities for deficit spending units. They continued their discussion by saying that: "an ex-ante balance between income and spending, saving and investment and surplus and deficit implies ex-ante balance between offers of and bids for loanable funds, offers of and bids for financial assets, willingness to incur debts and willingness to hold debt instruments. Equilibrium of income and wealth is associated with an equilibrium level of debt and its counterpart in financial assets."

According to Gurley and Shaw's article (1955) financing generally takes place in three ways as follows:

a) Self Finance: In this way each person or company invests whatever they save. In fact if they have a balanced budget their expenditure is equal to their income and their investment is equal to their saving. Although, self finance continues in most sophisticated economic systems, its importance has decreased significantly.

b) External Finance: This may take place in two forms:

(1) Direct Finance: In this way the deficit spending units borrow from the surplus spending units. "If spending on capital formation is directly financed, debt tends to accumulate *pari passu* with wealth" Gurley and Shaw (1955: 519).

(2) Indirect Finance: For this an intermediary is required. Indirect finance plays an important role in economic development and growth. Let us return to Gurley and Shaw's analysis. Gurley and Shaw (1955: 535) stated that:

> Economic development is retarded if only self-finance and direct finance are possible, if financial intermediaries do not evolve. The primary function of intermediaries is to issue debt of their own, indirect debt in soliciting loanable funds from surplus spending units, and to allocate these loanable funds among deficit units whose direct debt they absorbed. When intermediaries intervene in the flow of loanable funds, the accumulation of financial assets by surplus spending units continues to equal the accumulation of debt by deficit units. The rise of intermediaries- of institutional savers and investors does not affect at all the basic equalities in a complete social accounting system between budgetary deficits and surpluses, purchases and sale of loanable funds, or accumulation of financial assets and debt. But, total debt, including both the direct debt that intermediaries buy and the indirect debt of their own that they issue rises at a faster pace relative to income and wealth than when finance is either direct or arrange indirectly. Institutionalization of saving and investment quickens the growth rate of debt relative to the growth rate of income and wealth.

It can be seen from their analysis that in the case of the existence of financial intermediaries the rise of total debt is faster than income and wealth which can increase the growth rate, and banks are the most important of all financial intermediaries. They believe that there are some key functions for banks. First, borrowing loanable funds from suppliers and second, transmitting the borrowed funds to the demanders who have deficits in their budget. However, these bank functions ease borrowing and lending by increasing confidence between demanders and suppliers of credit.

King and Levine (1993b) examined whether Schumpeter is right or not. In this regard they designed four indicators of financial development in order to measure the services provided by financial intermediaries and some growth indicators as follows:

a) Financial Depth Indicator: Usually assumes that the size of financial intermediaries has a positive relationship with the financial services provided. This means that whenever the financial intermediaries are larger the financial services will be further expanded. So, King and Levine defined financial depth as "the overall size

of the formal financial intermediary system, *i.e.*, the ratio of liquid liabilities to GDP" (King and Levine, 1993b:3).

b) Bank Indicator: This indicator has been designed to measure the relative importance of a specific financial institution and can be defined as: "the ratio of deposit money bank domestic assets to deposit money bank domestic assets plus central bank domestic assets" (King and Levine, 1993b:6). Despite some weaknesses in this indicator, it is useful if used as a complementary measure.

c) Private Indicator: This indicator and the next one are designed to measure the quality of distribution of domestic assets. A financial institution from which the state sector receives a considerable percentage of its credit is not able to evaluate managers, select investment projects, pool risk, and provide financial services such as financial systems that allocate credit to the private sector. "Thus, we compute the proportion of credit allocated to private enterprises by the financial system. This measure equals the ratio of claims on the non financial private sector to total domestic credit (excluding credit to money banks)" (King and Levine, 1993b:6).

d) PRAVY Indicator: The final indicator for financial development is the PRAVY Indicator which is defined by King and Levine (1993b:6) as: "the ratio of claims on the non financial private sector to GDP". To be clearer, they divided them into two components: the rate of physical capital accumulation and everything else.

e) GYP Indicator: They used this indicator as the growth indicator which is "the average long-run real *per capita* GDP growth (GYP)" (King and Levine 1993b:7). Furthermore, they discussed the linkages between the financial indicators and the sources of growth. King and Levine (1993b) used cross-country evidence by using data from 80 countries for the period 1960-1989. After analysing data using econometric methods, they concluded that various measures of the level of financial development are strongly associated with real *per capita* GDP growth, the rate of physical capital accumulation, and improvements in the efficiency with which economies employ physical capital. Further, the predetermined component of financial development is robustly correlated with future rates of economic growth, physical capital accumulation, and economic efficiency improvements (King and Levine (1993b).

2.4.1 How Financial Systems Affect Economic Growth

In discussing this issue we should look at the factors which lead to economic growth and then investigate the ways which financial systems, especially the banking system, can affect these factors. There are some factors which accelerate economic growth and some factors which are moderators and decelerators of economic growth.

2.4.1.1 Economic growth accelerator factors

a) Physical Capital

Physical capital plays an important role in almost all economic growth models, even in the conventional models; physical capital was introduced as the main and only effective factor. Many economists believed that the main problem for poor countries is their poverty and shortage of physical capital. Today, physical capital also has special importance.

b) Human Capital

The importance of human capital has recently appeared in economic literature, especially economic development literature. In the past, economists concentrated on physical capital and not only declared inequality to be permissible but also encouraged it in the early stages of economic development. They believed that because the poor's propensity to consume is higher than that of the rich, we should permit the majority of national production to go to the rich in order to increase savings and consequently investment and physical capital (see for example Simon Kuznets, 1955). Since the 1970s a new idea has appeared which focuses on human capital. Supporters of human capital believe that although physical capital is a necessary condition for economic development, it is not a sufficient condition. What is more important than physical capital is human capital. This is because humans use and manage physical capital and without specialized workers and proper human capital, the physical capital will be wasted. Therefore these new thinkers and economists place emphasis on equality and justice in obtaining growth and sustainable development (see for example Sen's works). He believes that in a society with a high poverty rate many people who are able to be entrepreneurs will be deprived of education. Consequently the society will be divested of their potential abilities.

c) Efficiency

Efficiency is an important issue in economic activity. Efficiency means a situation in which a firm has maximum production in its activity with a fixed amount of input or has minimum cost with a determined amount of production. Fried *et al* (1993) and Coelli *et al* (1998) explain efficiency as follows:" A production function is efficient, in the Pareto and Hoopman sense, when it represents the maximum output attainable from each input level, or the minimum level of each input leaving the output unchanged, as is well known from the theory of duality" (taken from Maggie Tall, 2003: 5). Without efficiency, in fact, producers waste part of their input. Therefore, the banking system can influence economic growth by both its efficiency and the efficiency of those firms whose operations depend on the banking system.

2.4.1.2 Economic growth decelerator factors

a) Risk

Generally, people are divided into three groups regarding risk: risk averter, risk taker and risk neutral. Most people are risk averters who do not take risks which have a negative effect on their activities. When one is thinking about investment, risk is a determining factor in decision-making. Even for risk takers who love risk it may be a negative factor for decision making regarding investment. Of course they are not as sensitive as risk averters in this regard. Hence, every factor which can decrease risks would be able to cause an increase in investment.

b) Monopoly

It is evident from the economic literature that competition is an important factor in efficiency and growth. When there are many firms which compete with each other by decreasing prices or increasing their efficiency, the rate of growth is expected to increase. Therefore monopoly, which is the opposite of competition, has a negative effect on efficiency, productivity and consequently growth.

c) Government Ownership

One subject which should be considered when discussing the relationship between the financial system and economic growth is the ownership of the banks.

> Government owned (henceforth 'state') banks provide an effective means for politicians to influence the allocation of credit, allowing them to support firms and enterprises that may further their political interests. This view, known as the 'political view of state banks', has a clear policy implication: privatising state banks can improve the efficiency of credit allocation and, consequently, can have positive effects on the quality and quantity of investment. Privatisation of government-owned banks is also likely to promote financial development, since private banks would be in a better position to attract funds into the banking system than inefficient state-owned banks. (Demetriades and Andrianova, 2003:16)

According to the economic literature and most accepted economic theories, state (government) ownership is not generally efficient and the banking system is no exception to this rule. However, despite this fact, there are some advantages to state-owned banks and therefore, we can see these banks even in developed countries. "A study of 92 developed and developing nation as of 1995 finds only seven nations with no state-owned banks, Canada, Cyprus, Hong Kong, New Zealand, South Africa, United Kingdom and United States" (La Porta, Lopez-de-Silanes and Shleifer, 2002, taken from Len N. Berger *et al*, 2004).

One of the most important advantages of state-owned banks is that they finance some small firms which are not able to obtain credit from private banks. Also, because of the lack of a strong and transparent private sector and their opportunistic behaviour in most developing countries, people's confidence in state-owned banks is sometimes more than in private banks and therefore depositors prefer less efficient but safer banks. A number of researchers have investigated the relationship between state-owned banking systems and economic growth and development. For example La Porta *et al* (2002) state that there are some cross-country correlations which show that the degree of government ownership in a banking system has a negative relationship with subsequent financial development and economic growth, and a positive relationship with financial instability.

Also, Andrianova *et al* (2003) provide further insight into the relationship between institutions, state banks and financial development using a locational model of banking in which there are two types of private banks –'honest' and 'opportunistic' – and the state bank. Private banks are assumed to offer more competitive interest rates to depositors than the state bank. In the absence of deposit-contract enforcement problems they are therefore always preferred by depositors. However, if deposit contract enforcement is weak and the number of opportunistic banks is large, then

some depositors would prefer to place their savings in the state bank, which offers a risk-free, albeit lower, rate of return. In the end they concluded that the privatisation of state banks is at best unnecessary, since it is better to build institutions that foster the development of private banks and remove subsidies from state banks. At worst it is detrimental, since when institutions are weak it will almost certainly lead to financial disintermediation (taken from, Demetriades and Andrianova, 2003).

We can conclude that, although, there are many disadvantages in government-owned banking it could still be useful to have a few branches of these banks in every country. However, they should not make up more than 10 to 15 percent of the banking system. So, government ownership can damage efficiency and the productivity of the banking system if it applies to the whole or most of the system.

2.4.1.3 Functions of financial system

There are many channels through which financial institutions affect growth. Banks in particular perform some very important functions for society and, in the process, significantly influence major economic variables. Of these functions two are especially important: one is intermediation between ultimate savers and borrowers and the other is the administration of the payments mechanism. (Iqbal and Ahmad, 2005:1).We will now investigate briefly functions of the financial system as follows:

A) Mobilisation and Allocation of Savings (Monetary Resources)

In every economy and society there are two groups of people. The first are those who have surplus budgets and are savers. The second are those who have deficit budgets and need credit for investment or consumption. The problem is that these two groups are not the same and they have different tastes, motives, desires, information and abilities. So it is necessary for there to be some institutions as intermediaries to join them indirectly.

> This transfer is effected either by means of direct finance through securities markets or through the process of financial intermediation in the financial market, with the latter being more important. The importance of financial intermediation can be seen by the fact that around two-thirds of new investment passes through this in most countries, and even more in less developed countries. Thus development and financial intermediation are very closely linked to each other and financial sector development is a prerequisite for economic development. (Iqbal and Ahmad, 2005:1).

Sirri and Tufano, 1995 describe mobilization as follows:

"Mobilization - pooling - involves the agglomeration of capital from disparate savers for investment. Without access to multiple investors, many production processes would be constrained to economically inefficient scales" (Sirri and Tufano 1995, taken from Levine, 1997: 20).

> Furthermore, mobilization involves the creation of small denomination instruments. These instruments provide opportunities for households to hold diversified portfolios, invest in efficient scale firms, and to increase asset liquidity. Without pooling, households would have to buy and sell entire firms. By enhancing risk diversification, liquidity, and the size of feasible firms, therefore, mobilization improves resource allocation (Sirri and Tufano, 1995).

In addition there are several advantages of mobilisation and allocation of savings which make them necessary in the modern economy. These advantages may include:

a) Acquiring Information and Declining the Information Costs

Acquiring information on firms, projects and market opportunities is very difficult and expensive for savers and could prevent capital accumulation, which is a necessary factor for economic development. It could even prevent savings being used for the best available projects. This problem could also decrease the propensity of people to save. Therefore intermediaries such as banks, by collecting information on behalf of savers and depositors, play an important role in encouraging saving, capital accumulation and consequently economic growth. This was explained clearly by Levine (1997: 9) with the following example:

> Assume, for example, that there is a fixed cost to acquiring information about a production technology. Without intermediaries, each investor must pay the fixed cost. In response to this information cost structure, however, groups of individuals may form (or join or use) financial intermediaries to economize on the costs of acquiring and processing information about investments. Instead of each individual acquiring evaluation skills and then conducting evaluations, an intermediary can do it for all its members. Economizing on information acquisition costs facilitates the acquisition of information about investment opportunities and thereby improves resource allocation.

b) Reduction of Asymmetric Information

As mentioned before, surplus and deficit units are not the same. Therefore they need some information from each other and especially from the projects and they do not have equal access to the information. Investors usually have much more information

about projects. This asymmetric information may lead to moral hazard[4] on one hand and adverse selection[5] on the other hand. According to Iqbal and Ahmad (2005:1) "financial intermediaries can benefit from economies of scale and hence reduce the transaction costs of transferring funds from surplus units to deficit units. For the same reason, they are also in a better position to tackle the problems arising from asymmetric information".

c) Feasibility of Investment in Large and Long Term Projects

Usually depositors are small units and their amount of money is small, while investors are interested in investing in substantial projects. Also, savers are usually interested in leaving their money for short time, while investors need credit for the long term, indicating that:

> Financial intermediaries remove this size mismatch by collecting small savings and packaging these to make them suitable to the needs of the users. In addition, users of funds in general need funds for relatively long-term deployments, which cannot be met by individual suppliers of funds. This creates a mismatch between the maturity and liquidity preferences individual savers and users of funds. The intermediaries resolve the conflict again by pooling small funds (Iqbal and Ahmad 2005: 2).

d) Facilitating Risk Amelioration

Risk is a prevailing factor in economic activities, especially for depositing and investment. There are several types of risk such as: credit risk, idiosyncratic risk and liquidity risk. Liquidity risk plays a negative role in investment and economic development because higher return projects have high liquidity risk.

> Liquidity is the ease and speed with which agents can convert assets into purchasing power at agreed prices. Thus, real estate is typically less liquid than equities, and equities in the United States are typically more liquid than equities traded on the Nigerian Stock Exchange. Liquidity risk arises due to the uncertainties associated with converting assets into a medium of exchange. Informational asymmetries and transaction costs may inhibit

[4] The risk that a party to a transaction has not entered into the contract in good faith, has provided misleading information about its assets, liabilities or credit capacity, or has an incentive to take unusual risks in a desperate attempt to earn a profit before the contract settles.

[5] This refers to a market process in general or in a banking system in particular in which "bad" results occur when buyers and sellers or banking system and interpreniors have asymmetric information (i.e. access to different information): the "bad" products or customers are more likely to be selected.

> Liquidity and intensify liquidity risk. These frictions create incentives for the emergence of financial markets and institutions that augment liquidity. Liquid capital markets, therefore, are markets where it is relatively inexpensive to trade financial instruments and where there is little uncertainty about the timing and settlement of those trades (Levine, 2005: 6).

Banks are able to reduce the liquidity risk and encourage high return projects which speed up economic growth. As Bencivenga and Smith (1991) state:

> Banks can offer liquid deposits to savers and undertake a mixture of liquid, low-return investments to satisfy demands on deposits and illiquid, high-return investments. By providing demand deposits and choosing an appropriate mixture of liquid and illiquid investments, banks provide complete insurance to savers against liquidity risk while simultaneously facilitating long-run investments in high return projects. Banks replicate the equilibrium allocation of capital that exists with observable shocks. By eliminating liquidity risk, banks can increase investment in the high-return, illiquid asset and accelerate growth. (Levine, 2005: 7).

Also, banking systems provide insurance to depositors against the idiosyncratic risk that a single investment pays no return and the liquidity risk that depositors may need to withdraw investments before returns are available. As a result, high-return projects with long gestation periods or high but diversifiable risk are more likely to be funded. These diversification services are provided in part through the unbundling and pricing of risk, which leads to a better allocation of individual risks. In turn, growth and investment may be enhanced through the selection of higher-return investment projects.

Besides the link between risk diversification and capital accumulation, risk diversification can also affect technological change, which in turn can affect economic growth. Agents are continuously trying to make technological advances to gain a profitable market niche. Besides yielding profits to the innovator, successful innovation accelerates technological change. Engaging in innovation is risky, however. The ability to hold a diversified portfolio of innovative projects reduces risk and promotes investment in growth-enhancing innovative activities (with sufficiently risk-averse agents). Thus, financial systems that ease risk diversification can accelerate technological change and economic growth (King and Levine, 1993c).

e) Monitoring Managers and Exerting Corporate Control

Naturally, everybody who lends money to a company is interested in monitoring it and its manager. As there are a lot of depositors who are worried about how their

funds are used, the monitoring cost would be very high, so banks, on behalf of all depositors, monitor the firm and its managers. This in turn reduces the monitoring cost and encourages savings which increases economic growth. Diamond (1984) argues that:

> Besides particular types of financial contracts, financial intermediaries can reduce information costs even further. If borrowers must obtain funds from many outsiders, financial intermediaries can economize on monitoring costs. The financial intermediary mobilizes the savings of many individuals and lends these resources to project owners. This "delegated monitor" arrangement economizes on aggregate monitoring costs because a borrower is only monitored by the intermediary, not all individual savers (taken from, Levin.1997: 697).

f) Creation of Money

Another factor which some economists emphasize as a facilitator of growth is the creation of money by banks. By creating purchasing power, banks enable entrepreneurs to buy capital goods on the one hand and consumers to purchase consumption goods on the other hand. Schumpeter (1983: 72) argues that:

> there is another method of obtaining money for this purpose, which claims our attention, because it, unlike the one referred to, does not presuppose the existence of accumulated results of previous development, and hence may be considered as the only one which is available in strict logic. This method of obtaining money is the creation of purchasing power by banks.

2.4.2 Universal Banking

Before investigating the advantages of Islamic banking, it is important to briefly look at universal banks and their role in economic development. There is another banking system known as universal banking which is closer to Islamic banking. Some economists even believe that it is a component of Islamic banking. For example Al-Jarhi (2003: 5) argues that:

> Some specialists in Islamic monetary and financial economics have insisted that universal banking is one of the main components of Islamic banking. Islamic banks provide finance to enterprises through either sharing directly in the net results of their activities or financing their purchases of assets, goods and services on credit. We can therefore expect Islamic banks to hold equity in corporations and sit on their boards of directors. They use the information obtained from their vantage point to reduce risk from information asymmetry and to fine-tune their finance directed to the same corporations. In addition, they can trade in goods and services, provide Islamic insurance, and operate in financial markets. In other words, they operate like *universal* rather than commercial banks.

Other economists state that:

> Universal banks are allowed to hold equity and also to carry out operation such as trading and insurance, which usually lied beyond the share of commercial banking. Universal banks are better equipped to deal with information asymmetry than their commercial counterparts. They finance their business customers through a combination of share holding and lending. In Anglo-Saxon countries, commercial banks dominate, while in Germany, Switzerland, the Netherlands and Japan, universal banking is more popular (Iqbal and Ahmad, 2005: 3).

It is clear then that it is a manner of financing very similar to that of Islamic banks and its success in financing economic growth could be a sign of the potentiality of Islamic banking in financing economic growth.

Neuburger, (1977: 5) introduces universal banks as follows:

> *Kredit banken* are also referred to as *universal banken* or universal banks. This term is an apt one because these banks combined functions that had never before been united in a single German financial institution. The function of commercial banks, investment banks, development banks and investment trust were all brought together in the *kredit bank*…during the 1880s and most clearly after 1890, the *kredit banken* achieved a complete fusion of commercial and investment banking.

Some comparative studies show that Germany's banking system, as an example of universal banking, was more successful than that of the United Kingdom as an example of the conventional banking system.

> There is a second part to the Anglo-German comparison; involving the relative success of the two banking systems in promoting industrial growth at the end of the nineteenth century and the start of the twentieth. Britain is thought to have lost ground relative to its continental neighbours at the turn of the century, due to a failure to innovate and invest at the forefront of technology (Al-Jarhi, 2003: 24).

Chandler (1990) concluded that "Germany had decisively outpaced Britain in producing and exporting the products of the Second Industrial Revolution" (taken from Al-Jarhi, 2003:24). Al-Jarhi (2003) concluded that "Thus, German banks are thought to have promoted economic growth more effectively and efficiently than the British banks.

2.4.3 Islamic Approaches

2.4.3.1 Islamic economics methodology

Principally, when one is talking about Islamic banking, it should be considered as a part of the Islamic economic system which differs considerably from capitalist and socialist systems. These differences have been shown completely and clearly by Ayat-Allah Sayyed Mohammad Baqir Al-Sadr[6] in his book "*Iqtisaduna*" (our economy)[7]. There are some assumptions in western economics which are debatable from the Islamic point of view. For example, from the western economists point of view: "(i) The basic assumption is that man is selfish by nature and he behaves rationally.(ii) Material progress is a supreme goal.(iii) Every person has an inherent tendency to maximise his material welfare and he also has enough knowledge and ability to decide what is good for him"(Siddiqi, 1982:18). In contrast, firstly, Islam encourages people to sacrifice in favour of other people, especially in favour of poor people.

There are many verses in the Holy Quran and also many traditions from the Holy Prophet (peace be upon him and his respected family) and from the Imams (AS) which encourage people to be altruistic and prefer others to themselves. For example, the Holy Quran, when talking about the Holy Prophet's comrades (*Ansar*) says positively and encouragingly that "they prefer migrants (*Mohajerin*) over themselves even the same things; and those who are secure from the greed of their own souls, (like these assisters) they have indeed attained salvation (the Holy Quran, chapter 59, verse 9). Also, in Chapter Baqarah Glorious God stated :"(The pious are) those who believe in the unseen; are steadfast in performing prayer (five times a day) and spend out (to the needy) of what we have provided for them (the Holy Quran, chapter 2, verse 3). Furthermore, the Holy Quran introduces the righteous as those who "for Allah's pleasure they feed the needy, the orphan and the captive though themselves go hungry and they say: we only feed you to obey Allah's command and for His sake. Therefore, we expect neither your reward nor thanks" (the Holy Quran, chapter 76, verses 8- 9).

[6] Sayyed Mohammad Baqir Al-Sadr was a great Ayatollah who was a strong specialist in jurisprudence and Philosophy. Unfortunately, he was killed by Saddam Hosain when he was young.
[7] Fortunately this book has been translated in English recently by Dr Kadom Jawad Shubber, named "The Islamic Economic Doctrine a comparative Study ".

There are many stories regarding the behaviour of the Holy Prophet (peace be upon him and his respected family) and his family showing that they preferred others to themselves. For example, Aisha, the wife of the Holy Prophet (PUHAHF) narrated: "The Prophet (PUHAHF) had never spent three consecutive days having eaten to his full when he left this world. Although he could have, had he wanted to; but he used to place others before himself [Al-Hamdan, n.d. taken from Mohammadi Rayshari (2009: 2)]. Also, Abu Hurayra narrated:

> A man came to the Prophet (Peace be upon him and his respected family) and complained to him of hunger, so the Prophet (Peace be upon him and his respected family) sent a messenger to the home of his wives, but they said that they had nothing but water. The Prophet asked: 'who can host this man tonight?'Ali Ibne Abi Taleb (AS) said, I will host him, O Messenger of Allah,' he came to Fatima (AS) and asked her,' What do you have, O daughter of the Prophet?' she said, we have only food for tonight, but we would rather give it to our guest.' He (AS) said, 'O daughter of Mohammad, take the children to bed and put off the lamp. [Al-Tusi (1414 AH) taken from Mohammadi Rayshari (2009: 2)]

In addition, Imam Ali Ibne Abi Taleb (AS) said: Sacrifice is the highest level of belief (Hakimi *et al*, 1979: 241). Also, Imam Ali Ibne Abi Taleb (AS) stated that: Sacrifice is the end of goodness (Hakimi *et al*, 1979: 241). It is clear from the above-mentioned evidence that not only is selfishness not accepted by Islam but also, sacrifice is encouraged by both the Holy Quran and the Traditions.

It should be noted that this does not mean that there is no selfishness in human beings, rather that despite the existence of selfishness in human wishes and human behaviour, which is actually necessary to sustain life, Islam (and religions in general) have educated people to prefer others to themselves by hoping for reward in the Hereafter. It should be clear from the above mentioned issues that belief in the Hereafter plays an important role in controlling and adjusting human behaviour even in economic issues.

Secondly, although economic growth, or in other words material progress, is an important issue encouraged by Islam, it is not the main aim from the Islamic point of view. One verse of the Holy Quran states: "and to the tribe of Thamud their brother, Salih, (was sent). He said: O my people! Worship Allah, you have no other God save Allah; Allah is the one who produced you from the earth and has left its reclamation to you" (the Holy Quran, chapter 11, verse 61). God in this verse asks us to inhabit

earth and develop it. What is important is that it is not a final adjective; rather it is a medium adjective.

> Material progress is not the supreme adjective in an Islamic society[8]. It is desirable goal but it is subservient to certain rewards in the here after. The prophet (Peace be upon him and his respected family) led a simple life. Material prosperity is a desirable in so far as it helps man to perform his duties toward God, society, family and himself. Taking material progress as the supreme adjective of life is opposed to the Islamic framework (Makian, 1997: 6).

Thirdly, although, the human being is unique among all creations regarding having the power of thought and even wisdom, which is one of the sources[9] used by jurisprudents for inference of the *shariah* commands and laws, human wisdom is not enough to understand what is best for him and that is why God has sent prophets to show the right way to the people. For instance, after determining the share of inheritance to be allocated to family members, the Holy Quran says:" You do not know which of them, your parents or your children, will be useful to you; these fixed shares are decreed by Allah; and Allah is the Absolute Knowing Decreer" (Holy Quran, chapter 4, verse 11; See also the Holy Quran chapter 7, verse 187). So, according to Islam only God's knowledge is perfect.

As Islamic economics is different from capitalistic economics epistemologically, it needs a special methodology. There are two kinds of assumption in Islamic economics. First, those which are based on divine sources, such as the Holy Quran and *Sunnah* which are completely true and reliable and there is no need for verification at all regarding these, although some scholars' understanding of some of these sources, which are somewhat complicated in meaning, may be different and consequently should be counted as human knowledge. Second, assumptions based on human knowledge which are on a lower level of creditability and subject to criticism. The issue is that economics focuses solely on human knowledge which is not completely reliable and denies divine knowledge which is certain.

> Thus on these basic assumptions Islamic economics has a different position. This provides, in part, need and justification for a separate

[8] The Holy Quran, chapter 6, verse 32; chapter 14, verse 3 and chapter16, verse 107.
[9] There are four sources used by jurisprudents as the authoritative source of guidance for inference of the *shariah* commands and laws, the Holy Quran, the revealed word of Allah, Sunnah, the sayings and practices of the Prophet Muhammad and his successors, Wisdom (*Aql*) and unanimity between scholars (*Ijmaa).*

> methodology of Islamic economics…This is not a contention that the process of criticism and rational examination of economic theories itself is questionable. It only means that economics does not have any hard core of sure knowledge which may be treated as a point of reference and criteria for judging the truth and falsity of various theories. Therefore, there is a need for a methodology which not only provides basis for sure knowledge but also eliminates confusion of contradictory theories by laying down a criterion for judging the contending theories. Since mainstream Islamic economics is divine knowledge, it cannot accept a methodology which relies only on human knowledge (Akram Khan, 1987: 19-20)

The difference between Islamic and secular methods appears mostly in theoretical methods and in the empirical methods; it is expected that there are no important differences between them.

2.4.3.2 Role of Islamic banking in economic growth

Islamic banking can have a positive impact on economic growth. Some economists even believe that because of the elimination of interest (*riba*), working according to Profit and Loss Sharing (PLS) and its similarity to universal banks, Islamic banking has a more important role than conventional banking systems in this regard. There are several empirical works regarding the role of Islamic banking in economic development. For instance: Ahmed (2005) investigated the role of the Islamic financial system in economic development. He first discussed the factors of economic growth and then analysed the role of Islamic financial institutes and instruments in facilitating the growth factors. Ahmed (2005) showed that there are operational problems related to the use of equity-based instruments to finance different financial growth factors, in particular working capital. Ahmed (2005) argued that debt contracts and leasing contracts cannot be used to finance working capital and also that there are no operational models for using *murabahah* and *mosharakah* to finance working capital. Ahmed (2005) believed that in order to solve the problem of financing different growth factors it is necessary to work on developing operational models of corporate finance in general and workable equity-based instruments and institutions in particular.

Al-Hallaq (2005) examined the role of Islamic banks in economic growth in Jordan during the period 1980-2000. He used the Two Stages Ordinary Least Square method (2SLS) to examine the direct and indirect effects of the Jordan Islamic Bank (JIB) on the real *per capita* income as a proxy for the rate of economic growth. His model

contains two endogenous variables [real *per capita* income (log per) and the change in total volume of investment (log I)], and five exogenous variables [the change in transfer from abroad (log Re), the change in total credit by conventional banks (log TCB), the change in the growth domestic product (log GDP), the change in real interest rate (log R), the change in JIB financing and investment as a percentage of total credit by conventional banks (log RAT)].

After estimating the model, Al-Hallaq (2005: 212) concluded that:

> 1) Both the change in total investment and the change in net transfers from abroad proved to have a positive and significant impact on the dependent variables, such that if gross investment increased by one per cent, the *per capita* income would increase by 22 per cent, whereas the increase in net remittances by one per cent would lead to an increase in the *per capita* income by 24 per cent.
>
> 2) The impact of total credit by the conventional banks proved to be insignificant, and showed a positive coefficient. This can be explained by the fact that conventional banks are interested only in getting their predetermined rate of interest regardless of the type of projects borrowers choose to implement. In Jordan, unfortunately, a large portion of investment is devoted to the service sector where it reduces the chances of increasing job opportunities, and thus reduces the level of employment.
>
> 3) The impact of change in financing and investment of the JIB as a percentage of total credit by conventional banks was positive but insignificant. This can be explained by the fact that most of the financing operations of the Jordan Islamic Bank are for the short or medium term, and it has to hold high levels of liquidity in the form of cash to meet any emergencies, while it lacks as many financial instruments as conventional banks.

As the reduced form explains both direct and indirect effects of independent variables on the dependent variables, he used reduced form to analyse the direct effects of the Jordan Islamic bank's financing and investment on total investments, and the indirect effect of JIB financing and investment on real *per capita* income. The result was as follows:

> The volume of investment affects positively the level of gross domestic product, which in turn affects the real per capita income. Thus, the indirect effect of GDP on per capita income will be associated positively with the level of investment. The indirect effect of total financing and investment made by the JIB as a percentage of total credits by conventional banks was relatively small (0.048) on the real per capita income. But this rate must be looked at as a good start by Islamic banks compared to 0.50 by conventional bank's total credits. The indirect effect of the real interest rate on the real *per capita* income was negative and relatively small due to the fact that the real interest rate was fixed and controlled by the monetary authority for a very long period of time (Al Hallaq, 2005: 214).

Sadr *et al* (2000) examined the role of credits of agricultural banks on value added in this sector in the Islamic Republic of Iran during the period 1961-1996. They used the Three Stages Ordinary Least Square Method (3 SLS) to examine the effect of Iranian agricultural banks on value added. The purpose of this research was as follows:

a) To examine the effect of agricultural banks credits on investment flows and capital accumulation in the agricultural sector.

b) To examine the effect of agricultural banks credits on value added in the agricultural sector.

c) To examine the effect of short run and long run credits and also obligatory credits in agricultural banks on value added in the agricultural sector.

d) To determine the effect of the implementation of the Law of Usury-Free Banking on the role of the credits of agricultural banks in value added in this sector.

Their model contains three structural equations (investment function, capital identity and production function). After estimating the model, they concluded that:

(i) It is approved that in the period under consideration, credit had a positive and significant impact on value added in the agricultural sector, such that if credit for physical capital increased by one percent, production would increase by 0.093 percent. However, an increase in credit for working capital by one percent would lead to an increase in value added of 0.046 percent.

(ii) The random variable coefficient for Islamic banking is positive; this could be because of bank participation in production, increase in farmer information, decrease in investment risk, both due to the partnership of banks with farmers and the elimination of usury.

This research concluded that, the implementation of the Law of Usury-Free Banking has a positive and significant impact on the value added in the agricultural sector. However, some economists cite several factors which enable Islamic banking to play a more efficient role in economic development, which is explained below.

2.4.3.2.1 *Response to the different motives of depositors*

Depositors may have different motives for saving and depositing.

a) Spiritual Motives

Some people save to be able to provide worthy needs such as help to charities or lending to the poor without charging. Islamic banking is able to respond to this motive via *Qardh-Al-Hasanah* accounts.

b) Preservation of Assets and Guarantee of Deposit Return

Preservation of assets is possible in two ways (1) nominal value: when one deposits money in a bank he/she expects that at least the initial amount of the deposits will be returned. If these depositors use *Qardh-Al-Hasanah* saving deposits accounts (or current accounts) banks are responsible for guaranteeing the initial amount of the deposits. Problems arise when they deposit in other accounts. In this situation, there are two solutions. First, these people can ask the banks to use their deposits in special contracts such as *Joaalah*, *Salam* and *Ijarah*, in which not only is the initial amount returned to them but they can also earn a guaranteed benefit. Second, as Islamic banks use deposits jointly with other deposits and invest them in many projects, it is expected that they will have an overall benefit. (2) Real value: depositors are concerned with preserving the real value of their assets and expect it to at least remain the same. In conventional banks, where depositors receive fixed interest, if the inflation rate is higher than the nominal interest rate, the real interest rate will be negative and consequently the real value of deposits will decrease and depositors will lose their money. In Islamic banking, in contrast, because of the existence of the profit and loss sharing (PLS) mechanism, the effects of the inflation rate are eliminated automatically and the nominal interest rate is usually higher than the inflation rate or at least equal to it and consequently the real profit is positive or zero.

C) Income

One of the most important motives in depositing is to obtain an income. When people save they in fact substitute present consumption with future consumption and expect to consume more in the future. There are several contracts and accounts in Islamic

banking in which people can deposit and earn profit. Experience, for example in Pakistan during the time of Zia El Haq, shows that Islamic banking is more profitable than conventional banking.

2.4.3.3 Advantages of Islamic Banking

Some Islamic economists cite some advantages for Islamic banking compared with conventional banking. These advantages can be listed as follow:

a) Efficient Use of Money

In an economy based on interest, there is a price for money which leads to some traders using bartering which is inefficient.

> There is a strong school of economists who argue that interest based finance is sub-optimal on purely economic grounds. Despite the fact that the rate of interest operates in conventional economies as a price, monetary economists insist that a zero nominal interest rate is a necessary condition for optimal allocation of resources. The reason is simple. After switching from metallic to fiat money adding one marginal unit of real balances costs the community no real resources. Therefore imposing a positive price on use of money would lead traders to economize on the use of money, in their efforts to minimise transaction costs. They would therefore use some real resources instead of money. (Iqbal and Ahmad, 2005: 2)

In Islamic banking "while the time value of money is maintained, there is no need to handle the complicated question of how to bring the rate of interest down to zero in order to reach the optimal allocation of resources. In other words, Islamic finance is a short-cut to the efficiency in the financial sector" (Al-Jarhi, taken from Iqbal and Ahmad, 2005).

b) Distribution of Risk between Entrepreneurs and Depositors

While in conventional banks all the business risks are imposed on the borrower "Guaranteeing in advance a fixed return on a loan without taking risk into consideration" (Iqbal and Ahmad, 2005: 3) in a banking system based on profit and loss sharing the risk is distributed between the partners.

c) The Importance of the Quality of a Business Plan is Greater Than the Credit Rating of Borrowers

As conventional banks receive a fixed amount as interest and there is no ownership relationship between the bank and the client, banks are not concerned with business plans. What is important for them is the credit rating of the borrowers which guarantees the return of the initial loan plus interest. In contrast, in Islamic banks, because of the existence of profit and loss sharing and because of the changeable profit, the quality of a business plan and the ability of borrowers (entrepreneurs) is more important than the credit rating of the borrowers.

d) Stability

In the conventional banking system the relationship between banks and clients is based on debt. Borrowers have to pay the initial amount plus interest (there is no difference whether they make a profit or not) on the one hand and banks have to pay the initial amount plus interest to depositors on the other hand. As there are usually business cycles in the economy, during periods of recession borrowers are not only faced with problems regarding repayment of their loans but banks also have problems in connection with the repayment of deposits. In contrast, because of the profit and loss sharing factor in Islamic banking depositors automatically share the risk and there is no obligation to pay more than their profit before selling the goods for both investors and banks. Consequently, they are less likely to face major problems, especially bankruptcy.

> In conventional finance, present money is traded against future money in debt or bond markets, which are highly integrated at both the national and international level. Bond market provides an easy and automatic mechanism through which short-term funds flow at will from one country to another. Much of those flows follow factors that are only nebulously related to the economic fundamentals, threatening national economies with instability and contagion. The experiences of the Southeast Asian economies and others have motivated some economist to propose placing restriction on capital movements. In contrast, debt is created in Islamic finance through selling goods and services on credit. The resulting debt instruments are not readily tradable. We can visualize the existence of credit market for each commodity and service in which the demand and supply to buy on credit determines a mark-up rate. Such credit market would be fully segmented; there is no room for sudden and mass movement of funds. Possibilities of instability and contagion would therefore be remote and the need to choke capital movements through imposing restrictions would lose its justification. (Al-Jarhi, 2005: 20)

e) Control of Excessive Credit Creation

In Islamic finance, there is a close relationship between money and the production of goods and services which are connected to each other. So it is not easy for banks to create money excessively. Al-Jarhi (2005: 20) states that:

> All Islamic modes of finance involve money on the one hand and/or services on the other. Monetary flows through Islamic financial modes would have to be tied directly to commodity flows. In other words, Islamic finance removes the dichotomy between financial and real activities. Obvious, this leaves little room for excessive credit expansion, as the financed provided by financial institutions to business units is automatically earmarked for specific use.

F) Decrease of Moral Hazard and Adverse Selection

Since Islamic banks operate as universal banks they are likely to be more efficient in monitoring and surveillance, thereby reducing the risk of adverse selection and moral hazard (Al-Jarhi, 2005:20, cited in, Calomiris, 2000). As there are many finance applicants and banks do not have enough information to select the best, they are usually faced with adverse selection. The more information there is the less the adverse selection. It is obvious that because Islamic banks act according to the profit and loss sharing principle, they are likely to be more able to avoid adverse selection compared to conventional banks through more effective monitoring.

Since the Islamic banking system often acts according to profit and loss sharing, the motivation for moral hazard is stronger than for conventional banks. On the other hand, because of the existence of monitoring in Islamic banks the probability of moral hazard decreases. However, empirical works show that in bank systems such as Islamic banks and universal banks which use debt, equity finance and profit and loss sharing simultaneously, they are more likely to avoid moral hazard and adverse selection. According to Dewenter and Hess (1998):

> Empirically, it has been found that if banks use a combination of debt and equity finance, this seems to carry several advantages to both banks and firms, confirming the theoretical findings. Banking theory would indicate that banks would be relatively more exposed to adverse selection during economic upturns and moral hazard during downturns. Applied research has found that universal banks face lower risk than commercial banks during both upturns and downturns. In addition, the risk differential between universal banks and commercial banks gets wider and more significant during downturns (taken from Al-Jarhi, 2005:21).

Some advantages of Islamic banking can be summarized as follows:

(i) There is a high level of variety and diversity with different levels of risk in the contracts (partnership contracts and exchange contracts) which can facilitate making contracts in Islamic banking for both savers and entrepreneurs.

(ii) It is possible to establish financial institutions with different modes which can increase the stability of a financial system.

(iii) It is expected that competition between Islamic banks with different models will increase the efficiency of the financial system.

(iv)The financial needs of Muslims are a reality as with any nation and faith. These needs can be provided by Islamic banks in accordance with their belief. This public admission can have an important role in establishing a stable and efficient market.

(v) In profit and loss sharing models, in all facility demands, profitability of the project is considered carefully, so the efficiency of Islamic banks would be expected to be greater than that of conventional banks.

(vi) Islamic banks do not finance projects which are not acceptable to Islamic society which reflects its greater responsibility.

(vii) Because of partnership contracts, the liabilities side of the balance sheet tends to become isochronous with the assets side, so Islamic banks are more resistant to external shocks and delayed repayment loans.

(iix) Profit and loss sharing makes depositors sensitive to the operations of their banks, their transparency and their efficiency. On the other hand, banks try to evaluate the projects which they are asked to finance more carefully. According to Iqbal and Ahmad (2005:7):

> (1) Since (in the case of both profit-sharing and sale-based contracts) bank assets are created in response to investment opportunities in the real sector of the economy, and all financing is linked to commodities or assets, the real factors related to the production of goods and services (rather than speculative manoeuvres) become the prime determinants of the rates of return. (2) Debt creation in Islamic finance is generally not possible without the backing of goods and services. Monetary expansion would thus tend to take place in step with the growth of the real economy. This is expected

> to control inflationary pressures. Destabilizing speculation would also be significantly curtailed as would the erratic and mass movement of short-term funds.

2.5 CONCLUSION

This chapter aimed to investigate the relationship between banking systems and economic development, in other words the role of banking systems in general and Islamic banking in particular in economic development. For this reason the relevant literature has been analysed. The vast majority of the reviewed literature showed there to be a significant positive relationship between financial development and economic growth in several countries. Also, some research has confirmed that contribution of Islamic banking to economic development has been reported.

Furthermore, some theories and opinions regarding the role of financial systems, with an emphasis on the effect of the banking system on economic growth, have been discussed. They showed the ways in which banking systems can affect economic development. In addition, advantages of Islamic banking regarding economic development have been considered. According to this review there are several advantages in Islamic banking in this regard including: efficient use of money, distribution of risk between entrepreneurs and depositors, importance of quality of a business plan rather than credit rating of the borrowers, stability, control of excessive credit creation and decreasing moral hazard and adverse selection.

Chapter Three:

ISLAMIC BANKING IN THE ISLAMIC REPUBLIC OF IRAN (ACCORDING TO THE LAW OF USURY-FREE BANKING OF IRAN)

3.1 INTRODUCTION

As mentioned in Chapter One, before the Islamic Revolution in Iran there were some simple Islamic Banks there, known as *Qardh-Al-Hasanah* Funds (loans without interest) but there were many conventional banks too. After the Islamic Revolution, the government of the Islamic Republic of Iran nationalized all the banks and also,

> 37 banks have been merged into six commercial banks including Bank Refah (Welfare Bank), Bank Melli Iran (Iran National Bank), Bank Saderat (Export Bank), Bank Tejarat (Trade Bank), Bank Mellat (Nation Bank), and Bank Sepah (Army Bank) and three special banks including Bank Keshavarzi (Agricultural Bank), Bank Maskan (Housing Bank),and Bank Sanat va Maadan (Mining and Industry Bank), (Bank refah, September 20, 2007).

The government faced a big problem regarding banking system activities after the Islamic Revolution because as the revolution was an Islamic one the government had to eliminate interest. The problem was firstly that a large numbers of banks had to be changed to Islamic ones and secondly, they did not have Islamically-specialised bank staff. It would have been easier to establish new banks than that to convert the existing ones to Islamic banks. This is because, from the outset, the government could establish a proper structure and flowchart for the bank and also select proper staff for it. In contrast, in the second case, the government faces a situation where it has no proper choices regarding structure, flowcharts and staff employment. The staff have already been chosen and it is not possible, or at least it is difficult, to change them.

The greatest problem was that the government could not stop the banking system activities, so they had to think first of a temporary and then a permanent solution.

> The first step taken toward the abolition of interest only resulted in the reduction of rate of interest nomenclature to a maximum service charge and a guaranteed minimum profit. As a result, interest on all asset-side transactions was replaced by a four percent maximum service charge and by a four to eight percent minimum profit rate, depending on the type of economic activities. Interest on the deposits was also converted into a guaranteed minimum profit. As these steps could not bring about a fundamental change in the previous banking system, preparation got under way for the submission of comprehensive legislation to bring the operation of the entire banking system into compliance with the Islamic principles. The legislation was passed by the parliament in August 1983 as the "law for Usury-Free Banking (Hedayati, 1999)

The Law of Usury-Free Banking which was passed by the Iranian parliament in August 1983 shaped the new banking system of the Islamic Republic of Iran. In this chapter I will explain general conditions for contract accuracy which all contracts must fulfil. Also, some general contracts which are used in both the mobilisation and the allocation of deposits will be discussed briefly. In the final section, objectives, duties and financial instruments of the banking system in Iran according to the Law of Usury-Free Banking of Iran will be examined.

3.2 BASIC CONDITIONS FOR CONTRACT ACCURACY AND SOME GENERAL CONTRACTS

As the operation of Islamic banking is based on Islamic contracts, it is worth briefly discussing the contracts themselves. Although each contract has its own condition, there are some conditions which are necessary for all contracts and are vital for contract accuracy.

3.2.1 Intention of all Parties

This is a very important condition, especially in Islamic banking operations. It means here, intention regarding the performance of the special contract. The late Allameh Sheikh Mortadha Ansari (1991: 117) said:

> from conditions is to intend the meaning of the contract. There is no controversy between jurisprudents in this regard that intention is not only a condition for contract accuracy but also in fulfilment of its purport. So the contract does not take place either without verbal intention or without meaning intention.

For instance, if a person says by mistake or in jest, "I sell you my car" it is not really a contract. In the same way, in Islamic banking operations, understanding the meaning of a contract and intention of that meaning is essential. Therefore, the banking

authorities, are responsible for explaining the meaning of the contracts used in their operations clearly either in a leaflet or verbally.

3.2.2 Satisfaction of Both Parties

Another condition for contract accuracy is satisfaction or agreement of both parties. In books of jurisprudence this condition is introduced as option (*ekhtiar*) or authority, which is not in contrast with compulsion (*ijbar*) but is in contrast with reluctance (*ikrah*). It is worth noting that there are three concepts which are similar to each other but different in jurisprudence. The first is compulsion (*ijbar*) which means that the party has no any choice. The second is reluctance (*ikrah*) which means that the party has a choice but a third party threatens him, For example, if an oppressor threatens somebody, saying "you should sign this contract, otherwise I will hurt you or I will kill you". The third is distress (*idhterar*) which means because of some needs, someone accepts a special condition in a contract or sells his commodity cheaper than the market price.

Compulsion and reluctance lead to nullification of contracts but distress (*idhterar*) does not. Imam Khomeini in *Tahrir Al-Wasilah* said: "distress (*idhterar*) does not harm contract accuracy". This brings about the matter that in the case of banking activity, those requiring financial facilities usually find themselves in a situation whereby, because of their need for those facilities they have to accept them even if they do not agree with the conditions imposed on them. The question is whether this constitutes compulsion (*ijbar*), reluctance (*ikrah*) or distress (*idhterar*). The answer is that they are from meanings (*masadiq*) of the distress (*idhterar*). So there is no problem regarding the accuracy of these contracts.

3.2.3 Competence of Both Parties

Both parties should have competence of possession of their properties which is obtained by three conditions, namely: maturity, growth and wisdom. It means that they should be at least fifteen years old for men and nine years old for women according to *shariah* law. It is worth mentioning that according to the civil law of Iran this has been increased to eighteen years for both men and women. Also, they should not be insane or of a state of mind where they are unable to recognize the benefit of the property.

3.2.4 Necessity of Determination of the Subject of the Contract

It is important that not only the subject of the contract is determined but also every adjective which affects the value of the contract subject should also be determined, otherwise the contract would be uncertain (*gharari)* and all jurisprudents believe that uncertain *(gharari)* contracts are null. This condition is very important especially in *salam* transactions (post delivery sale) and sale by instalments which are used in banking activities.

3.2.5 Necessity of the Purpose of the Contract being *Shariah*-Compliant

There is a specific purpose for every contract which takes place. This purpose should be *shariah*-compliant. For example, when somebody buys grapes it is possible to use them to make wine which is prohibited in Islam or it is possible to use them in a *halal* way. Of course, it is not necessary for the seller to ask the buyer their reason for buying the grapes, but if the buyer says that they want them to make wine or the seller understands himself that they want them for this purpose, the seller must not sell the grapes to them.

If we do not know whether the contract fulfils the general conditions for contract accuracy, we should believe in its accuracy because of *Asalat Al-Sehhah* which means any contract of which you are in doubt of its accuracy should be considered accurate. According to article 133 of Iran's Civil Law, "every contract which takes place is correct except those that their corruption is proved".

Before discussing Islamic banking in Iran, it is worth looking at some contracts which are used in Iran's Islamic banking regardless of type of activity. Contracts such as agency (*vekalat*), guaranty (*dhemanat*) and *solh* are used very much in different areas of Islamic banking, not only in Iran but in all Islamic banks.

3.2.6 Agency Contract (*Vekalah*)

Agency (*vekalah*) means that one person or a group of people hand over their affairs to another person to carry out on their behalf while they are still alive. Imam Khomeini in *Tahrir-Al-Vasilah* (n.d: 186) says "agent is giving over an affair to another person to do it for client during the client's life". In Islam jurisprudence, agency (*vekalah*) is for specific contracts, so, all the basic conditions for contract

accuracy must be fulfilled. Agency (*vekalah*) is easier than most contracts as it does not need special words; in fact it does not need any words. Any way that both parties make themselves understood is enough for fulfilment of agency. For example, if person A makes person B his agent to sell his house and person B, without saying anything, starts to sell the house, this starting to work itself is a sign of acceptance and is enough for fulfilment of agency by person B.

Agency is revocable[10] which can be a weakness in this contract, especially in banking activities. However, this weakness can be compensated by "conditions provided in the contract"[11]. Moreover, agency is not normally free, so if it is free that should be made clear. If agency is absolute and without any clarifications it is not free and the agent should be paid the normal rate (*Ojrat- Al–Methl*). In Islamic banking activities, lawyers' fees (honorarium) are usually determined in advance. However, according to article 677 of the Civil Law of the Islamic Republic of Iran, in the case of silence regarding the lawyer's fee, the agent can ask for the normal rate (*Ojrat –Al-Methl*).

In addition, both agent and client should be adult, sane and aware and these conditions must continue until the end of the contract. So, if during the contract either one or both of them lose their sanity or become deprived of possession of their property, it will cause nullification of the agency. Imam Khomeini in *Tahrir Al-Vasilah* (n.d: 187) says "if agent or client become mad or the client is prohibited from possession of his property, the agency would become null. However, if the hindrance is removed, a new agency contract should be created".

Furthermore, agency is divided into two kinds: (1) Specific agency, which means that both case and manner of possession are specific. For example person A tells person B "you are my agent to sell my house". Here the case is his house and the manner is its selling. (2) General agency, which is divided into three kinds. First, it is general in the manner of possession but specific in the case. For instance, person A tells person B "you are my agent to do everything in my house". Second, the case is general but the

[10]All contracts are divided into two types, revocable and necessary. Revocable contracts can be cancelled at any time by parties whereas necessary contracts can only be cancelled in special conditions.

[11] These are conditions provided in a contract which engage one party or both parties more than the contract itself. They may be made within the contract itself or within another contract.

manner of possession is specific. For example, person A tells person B "you are my agent to sell all my properties". Third, both the case and the manner of possession are general. For instance, person A tells person B "you are my agent to do everything in all my properties". In Islamic banking in Iran the first kind of general agency is normally used. Depositors tell the bank authority "you are my agent to use my deposits in all profitable ways".

3.2.7 Guarantee Contract (D*heman*)

This contract is defined as a contract whereby one person agrees to pay the debt of another person. According to *Shiah* (*Jafari* School) jurisprudence, *dheman* means the transfer of debt from debtor to guarantor. In this interpretation, after fulfilment of the guarantee (*dheman*), the debtor does not have any responsibility with regard to paying. However, there is another interpretation of guarantee which is from *Sunni* schools. According to this interpretation, both debtor and guarantor are responsible for paying the debt.[12] The guarantee which is common in the banking system is the second kind; therefore it is not *dheman* according to the *Shiah* interpretation. Thus, *Shiah* jurisprudents such as Imam Khomeini have tried to solve this problem by using conditions provided in the contract itself or in another contract. For instance, person A can stipulate in a contract that if person B does not pay his debt he will pay it for him.

3.2.8 *Solh* Contract

Solh literally means peace (Mahyar, 1991) but in jurisprudence terminology it means "mutual consent on something such as making an owner (*tamlik*) of a thing itself or its benefit or relinquishment (*esqat*) of a debt or right" (Imam Khomeini: n.d, volume 2: 67). It is understood from the jurisprudence definition that the main characteristic of a *solh* contract is mutual consent. There is considerable flexibility in this contract which makes it appropriate for solving some problems, especially in banking activities. In this contract, similarity of price and goods in value is not necessary. For instance, it is possible to pay hundreds of pounds for one bottle of water on the condition that both parties agree.

[12] For more information see Abdollahi, Mahmood, 1994, Jurisprudence Basis of Islamic Economics, Qom, Islamic Publications Office.

Solh is an independent contract which has its own terms and conditions even in the case that its result is the result of another contract. "Solh in the case of transaction, although it is the result of a special transaction, does not have the terms and conditions of that transaction, but has its own terms and conditions" (article 758 of the Civil Law of the Islamic Republic of Iran). In addition, it is not necessary to use special words for *solh*, it can be fulfilled by any words. Furthermore, a *solh* contract is a necessary, uncancellable contract, which can be very useful in banking activities. So, it is possible that *solh* is used instead of a revocable contract in order to have its effect but not its revocability. Having introduced some general contracts used in Islamic banking in Iran, we will now discuss Islamic banking itself in Iran. It is worth mentioning that other contracts used in the Islamic banking of Iran will be discussed in its particular place in the banking system.

3.3 OBJECTIVES OF THE ISLAMIC BANKING SYSTEM IN IRAN

Every banking system has special objectives to which all banking activities should conform. While in conventional banking systems these aims are mainly economic, in Islamic banking, ethical issues are important too. As the banking system in Iran is an Islamic one, it not only has an economic purpose but it also has ethical aims. Some of the chief objectives of the banking system in Iran are as follows:

3.3.1 Establishment of a Monetary and Credit System Based on Rightness and Justice

Before the Islamic Revolution in Iran the majority of people believed that the economic system, including the financial and banking system, was not just and expected that after the Revolution justice would become an unchangeable principle in the economic system. It is worth mentioning that justice in Islam is a very important issue, such that according to the Holy Quran, justice was the main purpose for God sending the prophets.

> We indeed sent our messengers with clear proofs and sent down to them the books and the balance in order for people to act based on justice; we sent iron which has harshness and benefits for people and in order for God to know those who support him and his messengers through (their belief) in the invisible world; surely God is Powerful and Mighty."[13]

[13] The Holy Quran, Chapter 45, verse 25.

There are many verses in the Holy Quran that emphasize justice both in private and social aspects. Furthermore, there are large numbers of traditions from the Holy Prophet (PBUH) and Imams[14](AS) which talk about justice, its meaning and its importance in Islam. For example the Prophet Mohammad (PBUH) said "definitely, the most beloved of people for God in the Hereafter and nearest to him is the just leader." (Nahj Al-Fasahah). Also, Imam Ali Ibn-Abitaleb (AS) said :"Allah, glory be to Him, made justice a support for mankind an elimination of wrings and sins, and a facilitator for Islam"(Al-Amadi.1930, No: 4789) He also said: "Blessings are multiplied through justice" (Al-Amadi. 1930, No: 4211) Moreover, Imam Jafar Al-Sadeq (AS) Imam of the Jafari school (*Shiah*) said: "Justice is sweeter than honey, softer than butter and smells more fragrant than musk" (Koleini, n.d: 147). Because of the above mentioned importance of justice in Islam, the first purpose of Islamic banking in Iran according to Article 1 of the Law of Usury-Free Banking in Iran is: "Establishment of a monetary and credit system based on fairness and justice (as delineated by Islamic Jurisprudence) for the purpose of regulating the sound circulation of money and credit to enhance the health and growth of the country's economy"(part one of Article 1).

3.3.2 Enhancing the Health and Growth of the Economy

One threat which definitely affects efficiency and the effect of the banking system on economic development is corruption. In developing countries, because of a shortage of capital, access to capital and facilities creates an opportunity for investment and consequently for becoming rich. In addition, the only place which provides cheap money is the banking system. Therefore, the banking system exposes corruption better than other economic establishments. Before the Islamic Revolution in Iran, especially in the years leading up to it, corruption in the economic system and especially the banking system was very high and serious[15]. A lot of people close to the Shah's

[14] According to the *Shiah* School of thought, there are twelve successors to the Prophet Mohammad (PBUH) all of whom are from his family (Ahlul Bait). The first is Imam Ali Ibne- Abitaleb and the last is Imam Mahdi, son of Imam Hasan Askari (AS) who is alive with God's permission now, but is hidden from people. When God allows him he will appear and will destroy oppression and will establish a world state based on justice.

[15] For more information regarding high corruption during the Shah's regime see: Fardoost, Hosein.(1369, 1990-1991). Appearance and Deposal of Pahlavi's Monarchy. Volume 1, pp263-274, Political Studies and Research Institute, Tehran.
This book is the memorabilia of Hosein Fardoost. He was the closest friend of the Iranian king Mohammad Reza Pahlavi from childhood until end of kingdom in Iran and occupied many high

regime took out huge loans and transferred the money to foreign banks causing bankruptcy to several banks. For this reason the new banking laws in Iran emphasised not only the health of the banking system but also the health of the economy overall. Economic growth is another aim of the Islamic banking system in Iran and it is closely related to the health of the economy. This is because, when corruption exists in the banking and economic system, resources cannot be allocated efficiently and consequently economic growth is negatively affected. So, according to the last section of clause (1) of Article 1 of the Law of Usury-Free Banking in Iran, enhancing the health and growth of the economy is another aim of the banking system.

3.3.3 Creation of Necessary Facilities for the Extension of Cooperation between Depositors and Investors

It is the aim of any banking system to facilitate cooperation between surplus holders and investors who are in need of financial credit. So clause (2) of Article 1 of the Law of Usury-Free Banking in Iran states that one aim of the banking system is the "creation of necessary facilities for the extension of cooperation and *Qardh-Al-Hasanah* among the general public through the attraction and absorption of surplus funds, reserves, saving and deposits, and the mobilisation thereof in provision of conditions and opportunities for gainful employment and investment".

3.3.4 Maintenance of Currency Value

Maintenance of currency value is a very important issue. It is necessary for every banking system to be able to repel fluctuation in the currency value; therefore clause (4) of Article 1 of the Law of Usury-Free Banking in Iran obligates the banking system to maintain the currency value and equilibrium in the balance of payments and facilitating commercial exchanges.

3.3.5 Facilitating Payment and Receipt, Exchanges, Transactions and Other Services

Facilitating payment and receipt, exchanges and transactions are some of the services provided by a banking system which have an important role in facilitating economic activities and consequently, economic development. According to Article (1) of the Law of Usury-Free Banking in Iran another aim of Islamic banking in Iran is to

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positions in that Regime. In the final years of kingdom he was a general and minister of the King's court.

facilitate payment and receipt, exchanges, transactions and other services "to be performed by the banks, as determined by the law".

3.4 FUNCTIONS

There are many functions in the Law of Usury-Free Banking of Iran which are important, but it may be said that the most important functions of the banking system are the mobilisation and allocation of monetary resources (deposits) and monetary policy. So in this section we will concentrate on them.

3.4.1 Mobilisation of Monetary Resources (Deposits)

Since there is usually resource scarcity, especially in developing countries, the mobilisation of monetary resources plays an important role in the ability of banking systems to finance productive projects. In conventional banks the most important instrument used in this regard is the loan with interest. Due to the prohibition of interest in Islam, the Islamic banking system has had to introduce new instruments for this aim. Therefore, there are several accounts in Islamic banking some which are similar to conventional bank accounts and some which have major differences. The accounts used in the banking system of the Islamic Republic of Iran are as follows:

3.4.1.1 *Qardh-Al-Hasanah* accounts (free loan accounts)

There are two kinds of account in this category, the *Qardh-Al-Hasanah* current account and the *Qardh-Al-Hasanah* saving deposit account.

a) *Qardh-Al-Hasanah* Current Account (Free Loan Current Accounts)

This account is similar to current accounts in conventional banks, in which every depositor is given a cheque book by the bank for withdrawing and paying in and no interest rate is charged. Of course, occasionally, some conventional banks pay interest on this account too. In all countries this account is usually used for transaction and payment purposes. As these depositors do not share the profit, these deposits are guaranteed by the banks. However, this guarantee is reasonable because the ownership of deposits transfers to the bank completely so both profit and loss is accepted by the bank.

b) *Qardh-Al-Hasanah* Savings Deposit Account

In this type of account depositors receive a booklet from the bank and withdraw with this each time. This type of account does not involve any interest rate either. Usually this type of account is opened by those who do not want to receive benefit and their aim is to contribute to the development of their country or to help poor people. Of course, banks can offer some incentives to them such as: non-fixed rewards, discount on some payments and also giving them the right to suggest to the bank to pay the same amount to a specific individual as *Qardh-Al-Hasanah* loan (free interest loan). In addition, the bank is responsible for guaranteeing the initial amount of the deposits as with the previous type of account. Article (4) of the Law of Usury-Free Banking in Iran states clearly that "banks are obliged to repay the principles of *Qardh-Al-Hasanah* (savings and current) deposits and may undertake and/or insure the principles of the term investment deposits". In these two above-mentioned accounts the ownership of the deposits transfers to the bank, so the bank can use and control the funds according to the view of the bank managers, but these deposits are expected to be used as *Qardh-Al-Hasanah* loans by the bank.

3.4.1.1.1 *Bonus in Qardh-Al-Hasanah (is this a lottery?)*

One critical issue in the Islamic banking of the Islamic Republic of Iran is that the bonus paid to depositors is the same as lottery or *riba* (usury). The question is: Are these claims true? To answer this question, the meanings of lottery and *riba* (usury) should first be explained. In a lottery one person pays an amount of money to be considered in the lottery and the money paid by him/her is not returnable while in *Qardh-Al-Hasanah* accounts banks guarantee repayment of the full amount. In addition, in a lottery the lottery authorities have to consider the name of every body who has bought ticket, but in *Qardh-Al-Hasanah* accounts there is no guarantee of this. So it cannot be a lottery.

Regarding *riba* (usury), there are three conditions for any contract to be considered as based on *riba* (usury) as follows[16]:

[16] For more information see: "Imam Khomeini, Roohollah (n.d: 653). *Ketab Al Baia (Booh of Selling*), Vol 2, Ismaeilian institute, Qom". And" Imam Khomeini, Roohollah (n.d). *Tawdhih Al Massael Explanation of questions)*. Explanation number 2283, Qom". Also,"Bahjat, Mohammad Taqi (n.d)). *Tawdhih Al Massael Explanation of questions*). Loan section, Qom". Also, see "Makarem Shirazi,

(i) There should be a loan contract. So, if the contract is not a loan there would not be *riba* (usury) at all.

(ii) There should be a surplus to be paid to the lender.

(iii) This surplus should be predetermined by the contract. So, if the debtor pays an amount more than the loan itself without any contract, not only it is not prohibited in Islam but also it is encouraged.

Now we can analyse whether it is based on *riba* (usury) or not. Although the motive of the depositor in *Qardh-Al-Hasanah* accounts is morality, the banking system in Iran gives some rewards to the depositor. Such rewards are at the banks' discretion and there is no guarantee that any particular depositor will receive them, or even that his/her name will appear on the list of those selected to receive a reward, at the time the contract is made. The reason is that according to the indult of many *Shiah* jurisprudents, including the late Imam Khomeini, any surplus, even fiat surplus, with above mentioned conditions, is counted a fiat *riba* (usury). Because of this, the Law of Usury-Free Banking of Iran states that banks may, "not be obliged", through promotional methods, to give some rewards to the depositors. In order to attract and mobilize deposits, the banks may, through promotional methods, give the following rewards to depositors:

(i) Non-fixed and indefinite bonuses in cash or in kind to *Qardh-Al-Hasanah* deposits.

(ii) Exemption of depositors from or granting discounts thereto, in payment of commissions and/or fees.

(iii) "According priority to depositors in the use of banking facilities…" [Article (6) of Iran's Law of Usury-Free Banking]

In conclusion, it can be said that due to the lack of a guarantee of these rewards, according to the above mentioned conditions it is not counted as *riba* (usury)

Naser (n.d). *Tawdhih Al Massael (Explanation of questions*)" and, "Bani Hashemi, Seyyed Mohammad Hasan(1378,1999-2000,: 338)). *Tawdhih Al Massaele Maraje (Explanation of questions of Great jurisprudents)*. Vol. 2, Islamic Publisher Office, Qom".

3.4.1.2 Term investment deposits accounts

Some people who wish to have an income from their extra money invest in these accounts. Principally, banks guarantee neither deposits nor a predetermined profit rate for these accounts. However they sometimes, as a third party, guarantee both and this is not counted as *riba* but as a kind of *dheman*. Generally, these accounts are divided into two kinds, short term and long term. According to Iran's banking system, short-term deposits should be left in the bank for at least three or six months for "short-term deposits" and "special short-term deposits" respectively, but the period for long-term accounts is one, two, three, four and five years. The most important difference between this bank and conventional banks is apparent in these types of accounts. In contrast with conventional banks, Islamic banks do not own the deposits in this account, rather depositors remain the owner of the deposits and banks are only the agent of the depositors in order to use their money in legal profitable activities. The depositors also allow the bank to use their deposits with other deposits and their own assets in the shape of joint ownership. Another difference between Islamic banking and conventional banking is in their payment to depositors. While conventional banks pay a fixed interest rate to them, payment in Islamic banking is not predetermined, but depends on the profitability of the bank's projects.

However, the bank is required to determine its benefit at the end of every six months in order for it to be divided between the bank and depositors according to their contract regarding the bank's share as its honorarium.

> In the cases where combined resources of the bank and the depositors are invested, the return to depositors is calculated in proportion to the amount of invested deposits after subtracting the required reserve portion from the base amount. The banks are required to announce their profits at the end of each six months of their operation and transfer the shares of the depositors' profits to their accounts. Deposits withdrawn earn no profits before the minimum time required or are reduced below the required minimum, (*Ideology and history*, n.d, *Islamic banking around the world, case of Iran*.).

3.4.1.2.1 *In-part-payment profit rate*

One critical and debatable issue in the Islamic banking system of the Islamic Republic of Iran is that the Central Bank determines a profit rate as in-part-payment profit rate

which all banks have to obey. This means that when the profit rate is not clear the bank announces a rate and pays it to the depositors. It is not a final rate, which means that at the end of the financial year the banking system calculates the real profit rate. After that the in-part-payment profit rate is compared with the real profit rate, if the real profit rate is more than the in-part-payment profit rate the banking system should pay the difference between the two rates to depositors and if the real profit rate is less than the in-part-payment profit rate the banking system should ask depositors to return the difference. Problems arise when the banking system guarantees the in-part-payment profit rate for depositors. Some people think this is a kind of *riba*, especially when they see that for several years that amount is paid to depositors. Here the following questions arise:

(i) Why do banks guarantee the profit rate?

(ii) Is this really *riba*?

(iii) Does it have a positive or negative role in Islamic banking?

The answer to the first question is that banks think some people are risk averters, so they prefer to have a minimum avouched revenue from their money. On the other hand, wherever deposits are more, the benefit of the banks is more. So, banks encourage people to deposit more in their bank in this way.

Regarding the second question the simple answer is "no", because unlike the *Qard*-Al-*Hasanah* account in which the bank and depositors are the main parties, in these accounts the main parties are the depositors and investors (financial facility applicants) and the bank is only the intermediary and agent of the depositor. Therefore the bank, as the third party, can guarantee the principle deposit and a minimum profit expected from the previous year's experience in-part-payment to encourage depositors. For example, in Iran banks announce at least x percent for short term deposits and y percent for long term deposits. This means that, according to their experience, they are sure that banks will have at least such a profit that the share of depositors will be that percentage and guarantee them. However, this percentage is not a final one; rather the final profit rate is determinable only after determining the real profit at the end of the financial year. In the end, there are three probabilities.

(1)The real profit is the same as the expected profit.

(2)The real profit is more than the expected profit

(3)The real profit is less than the expected profit.

In the first case, there is no problem and banks pay the same percentage as the final profit. In the second case, banks have to pay the real profit which is more than in-part-payment. The problem is in the third case in which the real profit is less than in-part -payment. In this case depositors must mainly be paid less than they have expected but, in order to encourage them to deposit more and more, banks pay the difference between real profit and in-part-payment profit from their own recourses and there will be no problem according to *Shariah* law (according to the Jafari school of jurisprudence). The reason is that, as mentioned before, in these accounts the bank is not the main party of the contract, they are only the agent or the depositor's middleman. It is like a situation in which person A says to person B, "if you make me your agent and give me your money to share with person or company C on behalf of you, I predict that you will obtain 20% net profit. Otherwise, I guarantee to compensate your loss with my own money". It should be clear that as person A is not a party to this contract his paying to person B is not counted as interest *(riba)* which is prohibited in Islam. However, the bank (person A in this example) pays the difference between real profit and expected profit in order to encourage depositors (person B in the example) to give their money to the investor (partner) and it becomes available for the bank to get more honorariums (their commission).

In answer to the third question it can be said that although it may attract some depositors and although it is not *riba*, because of some misunderstanding it is better for it to be avoided.

3.4.1.2.1.1 *Root of misunderstanding*

As mentioned before some people may misunderstand in-part-payment profit rate therefore it would be useful to analyse why. As stated before there are three situations regarding comparison of real profit rate and in-part-payment profit rate which in two situations (when they are equal and when real profit rate is less than in-part-payment profit rate) banks pay in-part-payment profit rate to depositors. As most years these

two cases occur, some people who are not aware of the contracts think banks pay a predetermined profit rate which is *riba*. What is important is that in some years when real profit rate is more than in-part-payment profit rate, banks pay real profit rate, not in-part-payment profit rate. In some years banks pay 2% more than in-part-payment profit rate to depositors[17].

3.4.2 Allocation of Monetary Resources (Deposits)

It is assumed that allocation of monetary resources in conventional banks is in the form of a loan with interest, and all individuals or companies that need credit and prefer to use conventional banking system financing, use loan-with-interest contracts. However, allocation of monetary resources in Islamic banking takes place in several ways.

Before discussing how monetary resources in Islamic Banking are allocated it is essential to discuss the general conditions for granting facilities. Since Islamic banks are trustees and agents of depositors and they must strive to protect the deposits of their customers on the one hand, and pursue the objectives of the Islamic Economic System on the other hand, it is essential to explore the following important points:

A) Trustworthiness of Applicants

Basically, since the Islamic banking system must provide prosperity and ethical values and is also responsible for protecting the savings of depositors, it is the duty of managers to provide facilities to credible people and they should be more careful than conventional banks in this regard. However, this will have many positive effects and uses such as:

(i) Dignity of Piety and Trust: Piety and trust is the most valuable objective in Islamic Ideology and the Islamic economic system and consequently the Islamic banking system must concentrate on it in its programs.

(ii) Encouragement of Honesty and Punishment of Bad Behaviour: Honesty is very important in Islam so Islam tries to encourage people to be honest. One way to

[17] This happened several times, especially during period in which Dr Mazaheri was the general security of the Central Bank of Islamic Republic of Iran. It's worth mentioning that this does not mean that there are no infractions in the Iranian banking system.

improve honesty in society is to behave differently toward honest and dishonest people. Therefore, Islamic banks should also behave in a way that leads to the encouragement of valuable account holders and punishment of bad behaviour.

(iii) Distribution of Wealth in Favour of Righteous and Helpful People and Consequently G**rowth of Charity in the Community**

(iv) Optimum use of resources: Prohibition of prodigality is an important issue in Islam; therefore, Islamic Banks must be careful to provide financial facilities to the best projects.

After noting the above-mentioned issues, we can now continue our discussion about the allocation of monetary resources in Islamic banking in Iran. Instruments used in Islamic banking in Iran for this purpose are divided into four major types.

A) *Qardh-Al-Hasanah* contracts.

B) Partnership contracts.

C) Exchange contracts.

D) Direct investment.

3.4.2.1 *Qardh-Al-Hasanah* (Interest-Free Loan)

The only loan that exists in Islamic banking in Iran is *Qardh-Al-Hasanah*. As this loan is free of any charge and cost, the demand for it is much greater than the available resources, so Islamic banks have to allocate some special resources to it to strengthen its supply on one hand and establish some limitation to reduce its demand on the other. 'Banks are required to set aside a portion of their own resources to extend interest-free loans to (i) small producers, entrepreneurs, and farmers who would otherwise be unable to find alternative sources of financing investment and working capital and (ii) needy consumers. Banks are permitted to charge a minimum service fee to cover the administrative costs' (Ideology and history, n.d, Islamic banking around the world, case of Iran.).

In addition, according to the Law of Interest-Free Banking in Iran, this loan is also used for special needs such as: education, marriage and medical needs (Central Bank of Iran, Persian, 1984). It is necessary for loaners (debtors) to repay the principle of the loan, but no interest rate is charged on this loan. Principally, this contract can be used to finance any kind of project and in all economic sectors. However, as this loan is free of any charges and costs, there is a much greater demand for it than there are available resources. Therefore Islamic banks are usually faced with a surplus demand for *Qardh-Al-Hasanah* and they have to allocate resources to special needs. It is worth noting that, as mentioned before, ownership in this loan is transferred, so borrowers can utilize it for any purpose and the relationship between borrower and bank is creditor and debtor which is why there is no interest on these loans. In fact, after the transfer of the loan to the borrower the relationship with its owner is cut and a new ownership relationship between property and borrower is created. So, all its profit and loss are for the borrower and he/she alone is responsible for paying the nominal amount of the loan to the creditor within the predetermined time.

3.4.2.2 Partnership Contracts

These contracts are special features of Islamic banking. These kinds of contracts are so important that, despite the existence of other contracts in Islamic banks, many researchers present Islamic banking as a PLS (profit and loss sharing) system. There is one important problem in partnership contracts, all of which are revocable (*jayez*) which means either one or both parties can cancel them at any time. Revocability creates two problems for contracts. Firstly, it causes instability which is very harmful for banking activities. Secondly, in the case of the death of one party, the contract is cancelled automatically and the other party (here the bank) cannot appropriate the project at all because it is joint owned. In Iranian banks, this problem has been solved by conditions provided in the contract. Banks, by using conditions provided in the contract in a necessary contract, for example *Solh* contract[18], obligate another party, not to use their right of cancellation. Also, a partner can make the bank his/her administrator in order to be able to appropriate the project to the benefit of the depositors. Several contracts are categorised under this subject as follows:

[18] *Solh* contract is a necessary, uncancellable contract, with a lot of flexibility. In this contract similarity of price and goods is not necessary. For instance it is possible to pay hundreds of pounds for one bottle of water in this condition that both parties agree.

3.4.2.2.1 *Modharabah (bailment of capital)*

In Islamic banking in Iran this contract takes place between a bank and a businessman for trading purpose. According to the *Jafari* (*Shiah)* school of jurisprudence *Modharabah* should be used only in commercial projects. "In order to provide facilities required for the expansion of commercial activities, the banks may, within the framework of the commercial policies of the government, put the necessary financial resources at the disposal of the customers on the basis of *modharabah*, according priority to the legally-established cooperatives" [Article (9) of the Law of Usury-Free Banking of Iran]. In this contract, the bank gives capital to a businessman or trader in order to trade with them for a specific time. The owner of the capital is called the '*modhareb'* and the businessman is the agent (*amel*) of *modharabah*. At the end they distribute profit between themselves according to the contract. For example, there may be a mutual agreement between the bank and the businessman that benefit is distributed between them 40/60 respectively. In this case if the bank gives £10,000 to the businessman and, after one year, the trading project has a profit of £1,000, the share of the bank would be £400, which means that the bank's profit from this contract is 4%. It is worth mentioning that this 4% is not pre-determinable, what is pre-determinable is 40% and 60% as their share in the final profit. In other words, it is possible to determine previously the share in the profit of each side of the contract.

However, there are some disagreements between Islamic groups with regard to the meaning and usage of *modharabah.* For example, while some Muslim groups believe that it can be used in trade and industry, another group believes that it can be used only in trade projects. Also, in some Islamic Banks *modharabah* is used in both the mobilisation and allocation of monetary resources. Man (1991:244) states that:

> In the case of *modharabah* principle the bank also accepts deposits under two different accounts: the general and special investment account. Under both accounts the bank accepts deposits from customers for investment. Under the principle of *modharabah* the bank will act as the entrepreneur and the customer as the provider of capital. The bank will utilise the money for investment and share the profit generated in the agreed proportion. In contrast to general investment accounts, in which the customers are the general public, the customer of special investment deposits are confined to corporate and government sectors to which the mode of investment and the distribution of profit may be individually negotiated.

However, *modharabah* in Islamic banking in Iran is used only for trade affairs and for the allocation of deposits. Although from the point of view of *Shariah*, *modharabah* can be used in all kinds of trade, including export and import, the banking system may be limited because of some government policies. Financing import projects via *modharabah* has been prohibited by the government in support of home industries. According to Article 3 of the executive guidelines for *modharabah*, banks have been forbidden from giving financial facilities to the private sector for import purpose.

One additional point regarding *modharabah* is that it is divided into two kinds (1) General *modharabah*, which means that the agent of *modharabah* is able to buy and sell all goods of which their buying and selling is not prohibited in Islam. (2) Special *modharabah*, which means that the agent can buy and sell just those goods determined by the owner of the capital. Where its kind is not determined it is counted as general *modharabah.*

3.4.2.2.1.1 *Problem of engagement of the agent for paying loss*

As there are a lot of applicants for financial facilities and the banking system is not able to respond to all of them, the banking system tries to finance those projects which are most efficient. So, the Central Bank of the Islamic Republic of Iran determines an interest rate called the expected profit rate. This rate is solely for the evaluation of the projects. Any project that is expected to be able to have a profit of which the bank's share will be at least equal to the expected profit rate is accepted to receive financial facilities. As mentioned before, this rate is just for evaluation and banks can apply for their share from the real profit not the expected profit. However, in *modharabah* the banking system enforces the agent of *modharabah* to engage in paying the difference between real profit and expected profit of his/her own sources. This issue is actually debateable and the banking system authority tries to solve the problem by using the "condition provided in the contract".

According to Islamic law if there is no profit in the trade the bank cannot receive any profit from the act of *modharabah*. Even if the trader loses in the transaction, financial losses are born by the capital owner, whereas the agent only loses time and effort invested in the project. As the bank is the agent of the depositor and is responsible for protecting their deposits and profit on the one hand and as there are different people

with different personalities and different levels of belief and honesty requiring financial facilities for *modharabah* on the other hand, banks are responsible for supervising the process of the administration of *modharabah* in order to prevent loss to depositors. Because of the existence of a large number of projects, supervision is very difficult if not impossible, so bank authorities have tried to solve the problem. In this regard the late Dr Noor Bakhsh, General Secretary of the Central Bank at that time, asked the following religious question (*Estefta*) of the late Imam Khomeini:

> Salamon Alaikom. As, because of the existence of huge numbers of clients, banks are faced with problems regarding the supervision of implementation of the *modharabah* contract, they are thinking about adding a "condition provided in the contract". So, please send us your point of view in this regard. The condition is: "The agent (*amel*) accepts and engages not to sell goods with a profit less than that agreed. If for any reason the agent understands that it is not possible to sell the goods at the agreed profit, he/she is responsible for contacting the bank and getting the bank's permission to sell at that price. Otherwise, they should compensate the difference between the agreed profit and the real profit from their own property". The late Imam Khomeini answered: "The above mentioned condition is correct" (Rajaei, 1996:179).

Although this problem was solved by a "condition provided in the contract", and there is no problem regarding *shariah*-compliance, the reality is that it shows which banking system is risk averse which is unnecessary. In fact, it could lead to misunderstanding for some people who are not familiar with this kind of "condition provided in the contract" and think this is the same as conventional banks asking for a fixed interest rate.

3.4.2.2.1.2 *More issues about modharabah*

Furthermore, according to *Shiah* jurisprudence, the capital should be paid in cash, so delivery of goods instead of cash is not acceptable. In addition, all *modharabah* costs should be paid by the owner of the capital but, because some costs are not predictable, the owner of the capital pays predictable costs and the agent *(amel)* is engaged to pay the probable remaining costs by including conditions in the *solh* contract. Anyway, the costs which are paid by the owner of the capital in internal trade are as follows:

1- Price of goods.

2- Transportation costs.

3- Insurance costs.

4- Storekeeper costs.

5- Impaction costs.

These costs are in fact necessary capital in internal trade. However, in international trade, custom duties are added to the above mentioned costs. As mentioned before, if additional costs exist they will be paid by the agent. According to article 9 of the *modharabah* contract, with regard to the *solh* contract, the agent accepts and agrees to pay the remaining probable costs of this contact other than those mentioned in article 8[19].

3.4.2.2.1.3 *Determination of the bank's share in the profit in modharabah*

In the Islamic Republic of Iran, the Central Bank (*Banke Markazi*) determines an expected profit rate for any contract or for any economic sector. The role of this rate appears in the evaluation of the project in order to be selected as accepted for financial facilities. This means that only those projects which have a profit of which the bank's share is not less than the accepted percentage for receiving facilities can be approved. In this regard, the bank predicts the profit of the project and determines its share in the profit in order to gain the expected profit. For example, if we assume that the expected profit rate for *modharabah* in the banking system is 20% we should first determine the probable profit rate. This rate is calculated by using this formula:

R= [(P-C)/C](12/M).100,

R = Predictable profit rate of the project.

P = Total sale price.

C = Total costs (transportation costs, insurance costs, storekeeper costs, impaction costs and custom duties).

M = Duration of the *modharabah.*

[19] Costs mentioned in article 8 are those which are mentioned above as predictable costs.

Let us assume that a trader asks for financial facilities in order to export X goods. If we predict that P = £90,000, C = £75,000 and M = 4 month, the predictable profit rate would be calculated as: R = [(90000-75000)/75000] (12/4) 100 = 60

This means that the total predicted profit will be 60%. Now the bank should decide what percentage of this profit should be its share. If the expectable profit rate is 20%, then the bank's share should be 33.3% which can be achieved by using a simple ratio as follows:

60 100

20 ? = 100 (20)/60= 33.3

After this conclusion, the bank decides to finance the project and determines 33.3% as its share in the total profit. In the end, the bank should ask for its share. So, if the real profit is equal to the predicted profit, the bank will benefit 20%, but if the total real profit is more or less than the predicted profit, the bank will benefit more or less than the expected profit respectively. It is worth mentioning that this rate is the yearly rate of profit and if 12/M is omitted from the formula, the result would show the profit rate for the period of the contract, which in this case will be 6.67%.

3.4.2.2.2 ***Civil partnership (mosharakate madani)***

This is defined as:

> Project-specific partnership of short duration in commercial production and service activities in which each partner provides a share of the necessary capital, and the assets and properties acquired are held as community property until the end of the life of the partnership. In these cases, the bank's share in the capital can exceed the share of the manager-entrepreneur initiating or directing the project' (Ideology and History: Islamic Banking around the World, Case of Iran).

It is possible for Islamic Banks in Iran to use this contract in many cases such as trade or building houses or factories. For example, if a person needs to build a house and wishes to use the bank's facilities, he/she can go to the bank and fill in an application form for bank facilities. In this situation the bank, as the agent of the depositor, considers the project and checks its profitability. Once it is sure of the project, the bank agrees to be his/her partner in the building of the house. According to article 12 of the executive guidelines of the civil partnership, the bank's maximum share in any

project should be 80%. At the end of the project the bank should sell its share to the partner who has the option to buy the bank's share on credit or in cash. The price in the case of purchasing by credit will be higher than the other option.

3.4.2.2.3 *Legal partnership (mosharekate hoqooqi)*

Another kind of partnership in Islamic Banking in Iran is legal partnership. According to the Law of Usury-Free Banking in Iran there are two main differences between civil partnership and legal partnership. Firstly, while the first one follows the civil law, the second one follows Iran's trade law. Secondly, the first one is intended to be short term while the second one is intended for a longer duration. It was reported that "the second form of partnership is a firm-specific venture of longer duration in which the bank provides a portion of the total equity of a newly-established firm or buys into an existing corporation" (Ideology and History: Islamic Banking around the World, Case of Iran). Since banks are agents of depositors they are required to do their best to ensure benefits for depositors. Thus they should consider every plan or project in detail, in terms of their economic, financial and technical issues in order to understand their profitability.

> The banks can participate in the equity of such partnership only after the technical, economic, and financial viability of the firm (or the project) has been appraised and minimum expected rate of profit from the investment appears to be high enough to warrant the undertaking of the venture by the bank (Ideology and History: Islamic Banking around the World, Case of Iran).

For this reason, the Central Bank of Iran, as the mother bank and controller, is responsible for preparing some directions for execution. "The Central Bank (Bank Markazi) determines the maximum amount of equity participation by the bank, and the minimum amount of participation by other partners. The banks are allowed to sell and purchase shares whenever they deem it appropriate" (Ideology and History: Islamic Banking around the World, Case of Iran). At the present time banks can participate up to 80% in many projects in Iran. This contract can be used in industrial, mining, agricultural and services projects and usually in secondary markets.

3.4.2.2.4 *Mozaraah*

This is a contract between two persons or corporations, one of which works on the agricultural land of another. At the end, the production is divided between them according to the contract. According to the Law of Usury-Free Banking in Iran, banks are permitted to give their land to farmers for farming purpose. Despite the existence of this contract in the Law, this contract has not been used in the Iranian banking system until now.

3.4.2.2.5 *Mosaqat*

This contract is the same as *mozaraah* but is related to orchards. "The banks may assign *mozaraah* or *mosaqat* for agricultural lands and/or orchards which are at their disposal or in their possession [Article (17) of the Law of Usury-Free Banking in Iran]. As with the previous contract, this one has not been used in the Iranian banking system until now either.

3.4.2.3 Exchange contracts

Whereas in partnership contracts profit is not pre-determinable; in exchange contracts it can be determined. There are several important contracts in this category as follows:

3.4.2.3.1 *Salam transactions (post delivery sale)*

This is a contract in which the price of a commodity is paid in the present, but the commodity is delivered in the future. Fahim Khan, M. (1983: 264) states that:

> The bank buys certain goods on post delivery and pays the cost immediately or sells certain goods on post delivery and receives its cost immediately. In this sale, the cost of goods is fixed and paid in advance but the delivery of sold items is postponed or delayed up to a certain period. Similarly, the place of delivery, its expenses and quantities of the sold goods should also be fixed and defined as they are conditions for such a sale.

It has also been introduced as a financial instrument in the Law of Usury-Free Banking in Iran.

> In order to create the condition required for the provision of working capital needed by the productive units, the banks may engage in any of the following operations: …b) Upon the request of productive units, to purchase on a forward

> basis, the easy- to -sell products of the said unit. [Clause (b) of Article (13) of the Law of Usury-Free Banking of Iran].

This contract can be used for all productive units, but in Iran it is usually used for farmers. As there is usually a considerable distance between cultivation and harvest in agriculture, the farmers often face some problems with regard to working capital needs and living costs. Therefore, Islamic banks buy their product in advance and pay the price to them immediately. After harvesting the output, which is bought by the bank, farmers deliver it to the representative of the bank, or the farmers themselves sell the product as the deputy of the bank and give the price to the bank.

In addition to the general conditions of contracts accuracy, there are some special conditions for *salam* transactions as follows:

a) In the *salam* transaction, quantity, quality and characteristic of the goods, which affect the inclination of people and prices, should be described accurately, otherwise the contract will be *gharari*[20] and consequently null.

b) The price should be given in the session completely and if a part of the price is paid, the contract will be correct relative to that part and null relative to remaining parts. Moreover, in the case that the seller is in debt to the buyer, if it is not due, it would definitely be null. However, if it is due its abandonment is closer to precaution." (Imam Khomeini, nd, Volume 1:544).

c) Time and place of delivery of goods should be determined and there should be no problem regarding its delivery.

d) Buyers cannot sell goods before the delivery time either to the seller or to others, but after delivery time they can sell goods either to the seller or to others.

e) At the delivery time, if the seller delivers goods with a lower quality than agreed, the buyer has the option of not accepting. If sellers are not able to deliver goods on time due to some problems the buyers have two options. (1) They can wait until the sellers become able to deliver the goods. (2) They can cancel the contract and ask for their initial money but they cannot ask for the present price of the goods.

[20] Gharar means lack of enough information regarding the characteristics of the contract or goods.

3.4.2.3.2 *Joaalah*

This is "a contract of reward by which someone offers a certain amount of money or property as a reward to any person who brings about a desired result" (Frank, E, Vogel and Samuel, Hayes 1998: 149). For example if one person loses his car and announces "if anybody finds my car I will give him/her this amount of money" or a person announces "if anybody repairs my house or builds this building for me I will give him/her this amount of money" these are called *joaalah*. In Islamic banking in Iran, *joaalah* is used for the expansion of productive, commercial and services activities. "In order to provide the necessary conditions for the expansion of productive, commercial and services activities, banks may engage in *joaalah*" [Article (16) of the law of Usury-Free Banking in Iran].

There are two kinds of *joaalah*. The first is general *joaalah* which is not limited to a specific individual. For example, as mentioned before, if one person loses his car and announces "if anybody finds my car I will give him/her this amount of money", it would be called general *joaalah*. The second is special *joaalah* in which the person who wants to do the work must be predetermined. According to the executive guide direction of the Law of Interest-Free Banking in Iran banks can only use special *joaalah*. "Banks may provide or receive services on requirement and charge or pay commission or fees for such services. The service to be performed and the fee to be charged must be determined at the time of the transaction" (Ideology and History: Islamic Banking around the World, Case of Iran, n.d).

For example, if someone decides to repair his house and needs to borrow some money, he can go to the bank and fill in an application form for *joaalah*. After that, they sign a contract and the bank agrees to repair his house for a fixed amount of money. There are some companies which cooperate with banks and carry out the operation of the *joaalah* according to another contract held between the bank and the company. Another example would be if a company wants to import some raw materials, instruments or even a factory, the bank can do it *via* its dependent companies which are active and experienced in exporting and importing. It is also possible for the company manager to import those goods as the bank's representative. In this case, the company manager receives a sum of money from the bank and imports the goods. The bank's benefit in the *joaalah* is from the difference between

the amount of money which is charged by its representative for the price of goods and the honorarium and amount of money which it receives from its customers. *Joaalah* can be used in all economic sectors and all kinds of facilities.

3.4.2.3.3 *Sale by instalment*

This is a kind of credit transaction which is used in several projects, especially in housing activities in the Islamic banking system of the Islamic Republic of Iran. In this contract the time of payment should be determined exactly. Payment in this account can be made in two ways. Firstly, payment takes place completely within a predetermined time. Secondly, payment takes place weekly, monthly, seasonally or yearly in instalments. Moreover, it is allowed in Islamic jurisprudence for the price of a credit transaction to be higher than that of a cash transaction. After selling at a price, if the borrower is unable to pay his debt, the debt cannot be increased, as that would be counted as a kind of *riba, "riba-al-Jaheliyah",* usury from the Period of Ignorance,[21] where the time of payment has been extended by increasing the amount. However, in Islamic banking in Iran the second type, instalments, is used "for the purpose of providing facilities, the banks may in coordination with the Ministry of Housing and Town Planning, construct low-priced residential units for sale by instalments or hire-purchase" [Article (10) of the Law of Usury-Free Banking of Iran]. Banks usually buy or build buildings and then sell them to the customer by sale by instalments. Also banks buy tools and instruments, raw materials and even consumption goods such as automobiles, refrigerators and anything else and then sell them to their customers via this contract. This contract can also be used in all economic sectors.

3.4.2.3.4 *Hire-purchase*

This is a kind of rent by which tenants automatically become the owner of a property at the end of the rental period if they fulfil their conditions. This contract is new in Iran and appeared for the first time in 1982 in the approved byelaw of the Council of Money and Credit of the Islamic Republic of Iran. Furthermore, because of its newness, it has not been discussed by jurisprudents. However, there have been some debates between lawyers regarding its essence as to whether it is actually a sale

[21] The Period of Ignorance is the period before Islam in Arab countries.

contract or a hire contract. The criterion is that if property transfers to another party without any need for a new contract or the decision of one party, it would be a sale contract, but if the aim is not to transfer the property but to transfer the benefit of the property, it would actually be a hire contract. In conclusion here, it can be said that the hire-purchase is actually a hire contract for which there is a resulting condition (*sharte natijeh*) in it which if the tenant fulfils all conditions he/she will become the owner of property. In addition to the general conditions of contract accuracy, there are some special and standard conditions for hire transactions as follows:

(i) Sustainability: The goods which are hired should be sustainable. This is because, according to definition, rent *(ijarah)* is: use of a benefit with the goods themselves remaining. Therefore, goods which are amortized the first time they are consumed cannot be hired.

(ii) Determination of duration: The duration of the hire contract and the hire price should be determined.

(iii) Responsibility of hirer: The hirer is responsible for doing whatever is necessary for the house to be usable, such as repairing and buying necessary equipment." Repairing and all costs which are necessary in order for goods to be usable, should be paid by the hirer unless there exist other conditions or local common law opposes it. Also equipment which is necessary for goods should be bought by the hirer" (Article 486 of the Civil Law of Iran).

(iv) Responsibility of the leaseholder: The lessee is responsible regarding taking care of the goods, unless his/her situation changes from *yade amani* to *yade dhemani* which means that in the case of a commodity being damaged he/she should pay all detriments which occur to the commodity.

(v) Although principally lodgers are not bail, there are different opinions regarding making them bail by using conditions provided in the contract. Some jurisprudents believe that this condition is the opposite of the contract expedient. So, not only is it null itself but it also causes the original contract to be null, see Helli, (nd:317), Hoseini, (1327LC[22]:252), Shahid thani, (1967:331), Shahid thani,

[22] Lunar Calender

(1999:321) Khansari, (nd: 114)[23] and Sheikh Bahaei, (nd:28), cited in Katoozian, (1994:419). Some jurisprudents believe that the condition is null but does not lead to nullification of the contract itself. See Tabatabaei Yazdi, (nda:115); Tabatabaei Yazdi, (ndb:284); Al-Najafi, (1992:528) and Rashti, (nd:52). cited in Katoozian, (1994:419). Finally, some jurisprudents believe that the condition itself is correct by reasoning that the condition provided in the contract is permissible. See Tabatanaei Yazdi, (nd: 277) and Tabatabaei (2002), cited in Katoozian, (1994:419).

(vi) When hired goods and commodities go out of usage or do not have the right conditions, the contract will be cancelled automatically.

(vii) Hire does not become null by the selling of the hired commodities. Neither does it become null by the death of hirers or lodgers except in the case of the ownership of hirers relative to the benefit of property being limited to their life period. Of course, those who become owners of the benefit of the property can permit the hire for the remaining time (Imam Khomeini, nd).

(viii) If there are no conditions in the contract saying that only the lodger can use the property or commodity, the lodger can rehire it at the same price, less or more except in the house and shop. In these two properties hiring at a higher price is permitted only when the lodger has made some improvement to them.

In Islamic banking in Iran, this contract is often used in housing projects. In this regard its usage is the same as sale by instalments. "For the purpose of providing necessary facilities for the expansion of housing activities, the bank may, in coordination with the Ministry of Housing and Town Planning, construct low-price residential units for sale by instalments or hire purchase" [Article(10) of the Law of Usury-Free Banking of Iran].

3.4.2.4 Direct investment

According to the Law of Usury-Free Banking in Iran banks are able to invest directly in any service and productive activities with some conditions such as: (i) it is not permissible for banks to share with the private section in any project via direct

[23] This book is a collection of some lectures delivered by the late Mirza Naeini which was collected and published by his student, Sheikh Moosa Najafi Khansari.

investment and they cannot invest in projects that produce luxury commodities and services; (ii) total essential capital for the execution of these projects must be invested from long-term financial resources; (iii) the bank is responsible for ensuring the profitability of the project and the central bank must control this. (iv) it is necessary for the percentage of the initial capital of these ventures to total required funds is more than 40 percent [Article(10) of the Law of Usury-Free Banking of Iran].

It is worth mentioning that this instrument is usually used in huge projects which are too difficult to be undertaken by the private sector, such as highways, petrochemical factories, cement factories etc.

3.4.2.5 Usage of Islamic contracts in economic sectors and private needs in Islamic banking in Iran

Table 3.1 shows the usage of Islamic contracts in economic sectors and private needs in Islamic banking in Iran. As can be seen in this table *Qardh-Al-Hasanah*, sale by instalments and *joaalah* have the most usage. They can be used to finance all economic sectors and also private needs. Second are civil partnership, legal partnership and direct investment which can be used in all economic sectors but not for private needs. Third are *salam* contracts which can be used in agriculture, manufacturing and mining and for private needs. Fourth is hire-purchase and *modharabah*. Hire-purchase is used just for financing building and *modharabah* is used just for financing trade. Of course, as mentioned before this is according to the Muslim *Jafari (Shiah*) school of thought.

Table 3.1: Usage of Islamic Contracts in Economic Sectors and Private Needs in Islamic Banking in Iran.

Sectors / contracts	Agriculture	I & M*	Building	Services	Trade	Private Needs
Qardh-Al-Hasanah	+	+	+	+	+	+
Sale by Instalments	+	+	+	+	+	+
Hire-purchase	_	_	+	_	_	_
Salam	+	+	_	_	_	-
Modharabah	_	_	_	_	+	_
Civil Partnership	+	+	+	+	+	_
Legal Partnership	+	+	+	+	+	_
Direct Investment	+	+	+	+	+	_
Joaalah	+	+	+	+	+	+

I & M=Manufacturing and mining

Note: Plus (+) sample means that the contract can be used in the sector and minus (-) sample means that the contract cannot be used in the sector.

3.4.3 Central Banks and Monetary Policies

Central banks and their policies play an important role in the stability of economy and economic development. In conventional banking systems, there are some instruments for the performance of monetary policies, such as interest rates and open market operations. Of all instruments, interest rates play the most important role in this matter. In times of inflation, when reduction of liquidity is required, central banks increase the interest rate. As a result the price of bonds decreases and people buy more bonds than before. This leads to a decrease in liquidity and consequently to a

decrease in the inflation rate. In contrast, in times of stagnation when expansionary policies are required, central banks decrease the interest rates in order to increase the price of bonds and people sell more bonds than before. This leads to an increase in liquidity and consequently stagnation decreases and inflation increases.

As in the Islamic banking system interest is prohibited, central banks in an Islamic financial system such as the Central Bank of the Islamic Republic of Iran (*Bank Markazi Jomhouri Islami Iran*) are not able to use this instrument and therefore have to find another instrument as a substitute. However, some new instruments have been devised in the Law of Usury-Free Banking of Iran" and they are considered here briefly.

a) Fixing a Minimum and/or Maximum Ratio of Profit for Bank Share

"Fixing a minimum and/or maximum ratio of profit for banks in their joint ventures and *modharabah* activities; these ratios may vary for different fields of activities" [clause (A), article 20 of the Law of Usury-Free Banking of Iran]. In the *modharabah* contract the share of profit of each party must be determined at the time of the conclusion of the contract. It can be divided 50/50 between the bank and the agent 60/40 and so on. If the share of the bank is high, demand for facilities will decrease, so during the inflationary period the central bank determines a high ratio of profit for banks. In this situation demand for financial facility via *modharabah* decreases and causes a decrease in liquidity. Consequently, by assuming the stability of other factors, it leads to a decline in inflation. In contrast, in times of depression an expansionary monetary policy is carried out by decreasing the ratio of profit to banks share. However, this issue leads to an increase in demand for financial facility via *modharabah* which causes increase in liquidity and consequently a decrease in depression and increase in inflation.

b) Designation of Various Fields for Investment and Partnership and Fixing the Minimum Prospective Rate of Profit

One instrument for monetary policy by the Central Bank of the Islamic Republic of Iran is the "designation of various fields for investment and partnership within the

framework of the approved economic policies, and the fixing of the minimum prospective rate of profit for the various investment and partnership projects; the minimum prospective rate of profit may vary with respect to different branches of activity" [clause (B), article 20 of the Law of Usury-Free Banking of Iran]. One instrument for the performance of monetary policy by the Central Bank is the determination of some fields in which the banking system can invest or share in. In times of inflation these fields are decreased and in times of depression they are increased.

Moreover, as there are several applicants for banking system facilities with different projects at any time, and the bank has to decide to finance some of them on the one hand, and has a responsibility to protect the savings of their depositors on the other, the Central Bank of the Islamic Republic of Iran determines an expected minimum rate of profit which banks have to consider when providing facilities to the projects. This means that banks are responsible for assessing a project to understand how much the profit of that project will be and consequently approximately how much the bank's share will be. After assessment, if the approximate rate of return is the same or higher than the minimum prospective rate of profit it will be accepted, otherwise, it will be rejected. It is clear that the Central Bank of Iran is able to implement its monetary policies by changing the minimum prospective rate of profit.

However, it should be mentioned that the minimum prospective rate of profit cannot be demanded by banks, it is only used as an assessment of the project and the amount which banks can demand as their share depends on the real profit obtained by the project. For example, the minimum prospective rate of profit for *modharabah* in Iran is 12%, so if the approximate rate of return is 12% or more than 12%, a project is accepted as a candidate for bank facilities. However, the final ratio of the profit for bank may be 12% or less and more than it.

c) Fixing a Minimum and Maximum Margin of Profit

"Fixing a minimum and maximum margin of profit as a proportion of the cost price of the goods transacted, for banks in instalment and hire-purchase transactions" [clause(C), article 20 of the Law of Usury-Free Banking of Iran]. In instalment and hire-purchase transactions, banks usually add a percentage to the cost price of the

goods and properties transacted as their profit. The Central Bank of Iran determines the maximum and minimum of this percentage and uses it as a monetary policy instrument. This means that in times of depression when expansionary policy is required, the Central Bank decreases these ratios in order to demand an increase in financial facilities. In contrast, in the inflationary period, when deflationary policy is required, the Central Bank increases them in order to decrease the demand for credit and consequently bring about liquidity and inflation.

d) Determination of Types and the Minimum and Maximum Amount of Commission

Another instrument for monetary policy by the Central Bank of the Islamic Republic of Iran is "Determination of types and the minimum and maximum amount of commissions for banking services (provided that they do not exceed the cost of the service rendered) and the fees charged for putting to use the deposits received by the banks" [clause (D), article 20 of the Law of Usury-Free Banking of Iran]. Determination of types and the minimum and maximum amount of commissions for banking services affect the demand side of credit. Banks provide some services, including *Qardh–Al-Hasanah*, to their customers and receive commission for their services. As we know, no interest can be charged on *Qardh -Al-Hasanah*, but banks receive commission. The amount of commission is determined by the Central Bank. Although it is another monetary policy instrument in the Islamic banking system in Iran, it cannot have an effective role in decision-making by customers because it cannot be more than the cost of the service rendered and usually the changes are not significant.

As mentioned before, banks in the Islamic banking system of Iran are agents of the depositors and receive honorarium for putting to use the deposits received. Because of the determination of this honorarium by the Central Bank it can be another monetary policy instrument in the Islamic banking system in Iran, which can affect savings by changing them by affecting the supply side. When the banking system increases its honorarium the supply of deposits to the banking system decreases. In this situation the effect of this policy on inflation or depression is not clear because when deposits decrease, it is true that supply of credit decreases but it remains in the hands of the people and they may use it for economic activities instead of giving them to the bank

as deposits. On the other hand in this situation they may increase their consumption which can have a positive effect on inflation.

e) Determination of the Types, Amounts and Minimum and Maximum Bonuses

As mentioned before, one account in the banking system of the Islamic Republic of Iran is the *Qardh-Al-Hasanah* account. In this regard the Central Bank performs its policy via determination of the types, amounts and minimum and maximum bonuses "Determination of the types, amounts, minimum and maximum bonuses is the subject of article (6) and the establishment of guidelines for advertisement by banks in the cases referred to" [clause (E), article 20 of the Law of Usury-Free Banking of Iran]. In order to attract deposits, Iranian Banks offer bonuses to depositors according to the draw. This subject takes place in the *Qardh-Al-Hasanah* deposits. Of course its effectiveness, like the previous one, is not clear.

f) Determination of the Minimum and Maximum Ratio in Joint Ventures

"Determination of the minimum and maximum ratio in joint ventures, *modharabah*, investment, hire-purchase, instalment transactions, buying and selling on credit, forward deals, *mozara-ah*, *mosaqat, joaalah* and *Qardh-Al-Hasanah* for banks or any thereof with respect to various fields of activity; also fixing the maximum facility that can be charged to each customer" [clause(F), article 20 of the Law of Usury-Free Banking of Iran]. Another instrument for monetary policy in Islamic Banking in Iran is the determination of some limitations or expansions on facilities which can pay. The Central Bank of Iran usually determines the amount which banks can offer for each kind of contractor and even for each customer. However, the Central Bank of Iran increases the ratio in times of stagnation and decreases it in times of inflation.

g) Open Market Operation

Operating on the open market is another instrument for central banks regarding monetary policy. It is a very important instrument in open market operation (OMO) for both conventional banks and Islamic banks, but some economists doubt its usefulness for Islamic countries.

> Open market operations (OMOs) are among the most important tools of monetary policy in market economies today, since they allow central banks to

> control monetary aggregates easily, and with minima1 unwarranted effects on interest rates. Arguably they may be of special importance in some Islamic countries, since Islamic banks are not directly influenced by interest rate changes. (El-Gamal, 1999:501)

The most common instrument used in (OMO) is government securities. Principally, there are two characteristics in these securities which are selected as main instruments in (OMO); firstly, their risk-free nature and secondly their high level of liquidity.

> The virtually risk-free nature of those securities, together with their liquidity caused by the central banks' readiness to buy them at or near market prices, results in high degrees of market activity. This activity, in turn, enhances the liquidity of the market in government securities and allows central banks to use OMOs as a primary tool of monetary policy. Due to their need for a highly liquid outlet for excess funds, banks have become the major participant in primary auctions and secondary markets where such government securities (especially short-term) are traded. (El- Gamal, 1999:501)

As, due to prohibition of interest (*riba*) these securities do not exist in the Islamic Republic of Iran, it is not possible to use them as an instrument for monetary policy. In contrast, they are able to operate the paper and gold markets in partnership. In periods of inflation in which a contraction policy is required, the Central Bank sells gold coins and partnership paper of secondary market issued by the government. However, in times of depression, in which an expansionary policy is required, the Central Bank buys gold coins and partnership papers.

3.4.4 Central Bank and Maintenance of Currency Value

Despite maintenance of currency value being one of the most important functions of the Central Bank of the Islamic Republic of Iran, it has not been successful in this regard. After the end of the war, especially during President Hashemi Rafsanjani's era, the inflation rate was very high. For instance in 1995 it was at its highest level. In that year the inflation rate was 49%.[24] It showed the devaluation of the currency value to be about 50%. It is worth mentioning that this issue does not depend on Islamic banking rather it depends on the banking system structure and government policies.

The big problem was dependency of the Central Bank of the Islamic Republic of Iran on the government. The main condition for central banks to be able to protect currency value is their independency. Central banks should be able to reject government requests regarding issuing money and increasing liquidity. As the Chair

[24] See table 6.6

of the Central Bank of the Islamic Republic of Iran is selected by the government and is responsible to the government, this caused the Central Bank to be considered as an agent of the government.

However, the main reason for the devaluation of the currency value in Iran has been financing budget deficit mainly through borrowing from the Central Bank. In Iran governments, especially President Rafsanjani's government, tried to rebuild war damaged infrastructure on one hand and compensate the historical backwardness and increase growth rate on the other hand. So, for many years they pursued expansionary policies which led to budget deficit. Deficit is usually financed by tax, government securities and borrowing from central banks. However, in Iran tax culture is very weak and governments do not have enough income via tax, because the majority of people think the country has a lot of oil revenues and they are enough to cover all government costs. As mentioned before, using government securities is prohibited in Islam; therefore the government issued partnership papers instead of government securities. The easiest way to finance deficit is to borrow from the Central Bank because it operates as an agent for the government. Although, there is no data which shows the amount which borrowed by the government from the Central Bank, the high level of liquidity growth rate shows that it was considerable. For example, liquidity (M2) increased from 18753.3 billion Iranian *Rials* in 1989 to 1284199.4 billion Iranian *Rials* in 2006 which shows an increase of about 68 times.[25]

3.5 CONCLUSION

This chapter has aimed to answer some of the research questions including: (1) How does Islamic banking work in Iran? (2) Is the banking system in Iran really an Islamic one? To answer these questions, first of all basic conditions for accuracy of contracts has been considered, including: intention of all parties, satisfaction of both parties, competence of both parties, necessity of determining the subject of the contract and necessity of the purpose for the contract being *shariah*-compliant.

As the second step, the purposes of the Islamic banking system in Iran according to the Law of Usury-Free Banking in Iran were considered. In summary, these purposes were: to establish a monetary and credit system based on fairness and justice; to

[25] See table 6.9.

enhance the health and growth of the economy; to create the necessary facilities for the extension of cooperation between depositors and investors, to maintain the currency value and facilitate payment and receipt, exchanges, transactions and other services.

The third step was to discuss the duties of the banking system. Although the banking system has several functions in the Law of Usury-Free Banking of Iran, this chapter focused on its most important duties, namely the mobilisation of monetary resources (deposits) and the allocation of monetary resources (deposits) and monetary policies by the Central Bank. In the mobilisation of monetary resources (deposits) section, three accounts are highlighted which are used which comply with the *Shariah*, namely: *Qardh-Al-Hasanah* current accounts (free loan current accounts), *Qardh-Al-Hasanah* savings deposit accounts and Term Investment Deposits Accounts.

In the Allocation of Monetary Resources (deposits) section, all contracts used in this section are divided into three types. The first are loan contracts on which no interest or profit is charged. The only contract in this regard is *Qardh-Al-Hasanah* (interest free loan). The second type is partnership contracts which are based on profit and loss sharing, including: *modharabah* (bailment of capital), civil partnership (*mosharakate madani*), legal partnership *(mosharekate hoqooqi*), *mozaraah* and *mosaqat*. However, in these contracts, conditions provided in the contract itself or in another contract have been used to overcome problems caused by partnership. The third type is exchange contracts which include: *salam* transactions (post delivery sale), *joaalah*, sale by instalments and hire-purchase in which a fixed profit rate can be determined in advance. In addition there is another way for allocation of the money resources used in the Islamic Republic of Iran which has an important role in the economic development, namely direct investment. The government has financed a lot of development projects such as highways, ports, petrochemical projects etc.

A main function of the central banks is performance of monetary policy and these policies in conventional banks are mainly based on interest which is prohibited in Islam. The Central Bank of the Islamic Republic of Iran designed special instruments which are *shariah*-compliant as follows:

(1) Fixing a minimum and/or maximum ratio of profit for bank share.

(2) Fixing a minimum and maximum margin of profit.

(3) Prospective rate of profit.

(4) Designation of various fields for investment and partnership and fixing the minimum.

(5) Determination of types and the minimum and maximum amounts of commission.

(6) Determination of the types, amounts and minimum and maximum bonuses.

(7) Determination of the minimum and maximum ratio in joint ventures.

(8) Open market operation. Due to the prohibition of interest in Islam the Central Bank of Iran uses buying and selling gold coins and partnership paper as instruments for monetary policy.

In summary it can be said that the Law of Interest-Free Banking in Iran is *Shariah*-compliant because all its contracts are in accordance with Islamic jurisprudence (Jafari school) approved by parliament and confirmed by the Guardian Council.

Chapter Four:

RESEARCH METHODOLOGY

4.1 INTRODUCTION

This research aims to discuss the contribution of Islamic banking to economic development, in the case of Iran. For this reason first of all we should examine and deliberate whether Islamic banking in Iran is *shariah*-compliant. There are some issues in Islamic banking of the Islamic Republic of Iran which are debatable, such as, in-part-payment profit rate, expected profit rate and giving bonus to *Qardh-Al-Hasanah* depositors. These are actually challengeable; some people believe that these are the same as usury because, when banks promise depositors to pay them in–part-payment and guarantee the amount or when banks impose paying expected profit rates upon credit demanders, this only means they will give a fixed amount to the depositors and ask a fixed rate from credit demanders which is the same as an interest rate. These issues should be analysed carefully in order to avoid misunderstanding.

Secondly, the effect of Islamic banking in Iran on economic development should be examined. This is also a controversial issue among economists. As the banking system in Iran is based on the Law of Usury-Free Banking of Iran which is Islamic, it is important to demonstrate trends of deposits and credits after the replacement of the conventional banking system with the new one (Islamic banking or interest-free banking). Here, there exist some theoretical approaches which refer to whether Islamic banking in its nature improves efficiency and consequently economic development, reduces it or is neutral in this regard. So, in this research both theoretical and empirical research methods will be used. Also, as there are some empirical issues which should be considered in the analyses, both qualitative and quantitative research methods will be utilised. Therefore, several research methods will be used in this research.

4.2 MEANING AND DEFINITION

Methodology means understanding or studying appropriate methods of research. Researchers usually aim to solve problems or to find new phenomena. As Sekaran (2003:3) states "Research, a somewhat intimidating term for some, is simply the process of finding the solution to a problem after a thorough study and analysis of the situational factors". Sekaran (2003:5) also defines research as "an organized investigation into a specific problem, undertaken with the purpose of finding answers or solutions to it. In essence, research provides the needed information that guides managers to make informed decisions to successfully deal with problems". Asutay (2007:1) defines research as "how one will go about studying a phenomenon".

Generally, there are two kinds of research: theoretical and empirical or applied research. While theoretical research principally aims to improve knowledge in different areas, applied research, mainly aims to solve some current problems. According to Sekaran (2003:8) "research done with the intention of applying the results of the findings to solve specific problems currently being experienced in the organization is called applied research."

In every research, researchers should use a method or a set of methods which enables them to reach the answer to their question or a new hypothesis. This set of methods is the methodology. Methodology has been defined as "a set of methods and principles used to perform a particular activity" (Wehmeier and Ashby, 2000:803). It has also been defined by Miller and Brewer (2003:192) as "a set of rules and procedures to guide a researcher and against which his/her claim can be evaluated. It is therefore fundamental to the construction of all forms of knowledge".

4.3 QUANTITATIVE AND QUALITATIVE METHODS

Generally, there are two kinds of research methods: quantitative and qualitative. Quantitative research and methods are usually related to secondary data and numbers. They are also related to statistical and mathematical models. Data which is collected by quantitative methods can be explained descriptively or analytically using mathematical and statistical models. In contrast, qualitative methods are used for research which is not related to numbers, but to qualitative issues. In this kind of research method, primary data are obtained and analysed. The difference between the

two kinds of method goes back to the epistemological issue which creates a general framework for approaching an investigation. According to Cassell and Symon (1994:2) “a key straight-point is the recognition that the two different approaches rely on different underlying epistemologies”.

Philosophically, quantitative methods are related to positivism “The philosophies behind the two sets of techniques are very different. To summarize: the assumption behind the positivist paradigm is that there is an objective truth existing in the world which can be revealed through the scientific methods where the focus is on measuring relationship between variables systematically and statistically” Cassell and Symon (1994:2). Also, Giorgi (1970) and Spiegelberg (1972) point out that adopting qualitative (phenomenological) approaches implies taking a different perspective on human behaviour from that adopted in utilizing quantitative (positive) approaches (taken from Cassell and Symon, 1994:2).

Furthermore, Bryman (1988: 106) states that “there have been two distinct explanations of the differences between qualitative and quantitative research. There is the epistemological account outlined above but there is also the technical account: The alternative standpoint is to suggest that quantitative and qualitative research are each appropriate to different types of research problem, implying that the research issue determines (or should determine) which style of research is employed” (taken from Cassell and Symon (1994:3).

However, despite many papers and books having been published on qualitative methods, there is not an agreed definition for it. According to Van Mannen (1979:520) “the label qualitative methods has no precise meaning in any of the social sciences. It is at best an umbrella term covering an array of interpretative techniques which seek to describe, decode, translate and otherwise come to terms with the meaning, not the frequency, of certain more or less naturally occurring phenomena in the social world.” Also, Fryer (1991:3) points out that “qualitative researchers are characteristically concerned in their research with attempting to accurately describe, decode and interpret the precise meaning to persons of phenomena accruing in their normal social contexts and are typically pre-occupied with complexity, authenticity, contextualization, shared subjectivity of researcher and researched and minimization of illusion.”

Qualitative research genres have become increasingly important modes of inquiry for the social sciences and applied fields (Marshal and Rossman, 1999:1).

4.3.1 Interview: its Advantages and Disadvantages

Interview is one of the most important instruments for data collection in qualitative methods. It has both advantages and disadvantages.

4.3.1.1 Advantages

a) Researchers are able to examine broader issues in interviews. King (1994:33) states that "Qualitative research interviews can be used to examine much broader issues, in areas such as gender, organizational culture and the effect of unemployment".

b) The interview is an accurate and useful way of obtaining people's points of view and even their feelings easily. "It is a very good way of accessing people's perceptions, measuring, definitions of situations and constructions of reality. It is also one of the most powerful ways we have of understanding others" (Punch, 2006:168).

c) In interviews, researchers are able to focus on a particular question. King (1994:33) points out that "It can address quite focused questions about aspects of organizational life: for instance, specific decision processes such as selection decisions or decision about innovation adoption".

d) The interview is a useful tool for collecting large amounts of data quickly. "Interview has particular strengths. An interview is a useful way to get a large amount of data quickly when more than one person participates (e.g. focus group interviews), the interview process gathers a wide variety of information across a larger number of subjects than if there were fewer participants breadth" (Marshal, and Rossman, 1999:108).

e) Interviews can be used in some topics with different levels of meaning all, of which are important for the research. "The qualitative research interview is ideally suited to examining topics in which different levels of meaning need to be explored. This is something that is very difficult to do with quantitative methods, and problematic for many other qualitative methods" (Nigel King, 1994: 33).

f) The interview is a research method which all participants like. Interviewees, especially those who have a particular idea, are usually eager to deliver their opinions somewhere. King (1994: 33) states that "the quality research method interview is a method which most research anticipants accept readily… this is partly due to familiarity with interviews in general. However as important is the fact that most people like talking about their work - whether to share enthusiasm or to air complaints - but rarely have the opportunity to do so with interested outsiders".

4.3.1.2 Disadvantages

a) The qualitative research interview is a method which is time-consuming for researchers and can sometimes be considered a limitation for research which has a deadline. "Developing an interview guide, carrying out interviews and analysing transcripts are all highly time-consuming activities for the researcher. It is essential that the researcher does not attempt to take on more interviews than he or she has time for in a study. (King. 1994: 34)

b) The qualitative research interview is tiring for researchers because they have to find suitable interviewees, arrange appointments with them and then conduct the interview. It is recommended that there should not be more than one interview in a day.

c) The qualitative research interview is a method which is also time-consuming for interviewees which may lead to some problems in them agreeing to be interviewed. "Interviews are a method which is also time-consuming for interviewees, and this may cause problems in recruiting participants in some organizations and occupations. The best recruitment strategy is probably to send a letter with basic details of the study's aim and what will be required of the interviewee, with a follow-up phone-call in which the researcher can explain his or her aims in more depth and answer any queries" (King. 1994: 34).

d) Some interviewees may have a negative view of the topic, which can create some problems in responding to the main questions. "Occasionally, the researcher will experience 'difficult' interviewees who are defensive, hostile or unable/unwilling to focus on the research topic(s). To be told to your face 'that was a ridiculous question', or 'I cannot see why you are asking me these things', is much more uncomfortable

than receiving a questionnaire back from a survey participant with, 'stupid question' scrawled across it" (King. 1994: 34).

4.3.2 Types of Interviews

"Singleton and Straits (2005) and Rager and Petre (2007) argue that there are three main types of interview methods: structured, unstructured and semi-structured interviews. In addition, May (1997) and Collis and Hussey (2003) mention that there is a fourth type of interview method which is in the form of group interview" (taken from Aboo Ravi. 2009).

4.3.2.1 Unstructured interviews

In unstructured interviews, there is no predetermined question. Sekaran (2003:225) states that "unstructured interviews are so labelled because the interviewer does not enter the interview setting with a planned sequence of questions to be asked of the respondent. The objective of the unstructured interview is to bring some preliminary issues to the surface so that the researcher can determine what variables need further in-depth investigation". Some of its characteristics are that flexibility is high and interviewers are neutral. Punch (2005: 170) states that "flexibility and variation are minimized, while standardization is maximised. In this sort of interview, the interviewer attempts to play a neutral role and a neutral manner and demeanour are encouraged in executing that role."

4.3.2.2 Structured interviews

In contrast, in structured interviews, there are several predetermined questions asked of all interviewees. Sekaran (2003:227) states that "structured interviews are those conducted when it is known at the outset what information is needed. The interviewer has a list of predetermined questions to be asked of the respondents either personally, through the telephone, or through the medium of a PC. The questions are likely to focus on factors that had surfaced during the unstructured interviews and are considered relevant to the problem. As the respondents express their views, the researcher would note them down. The same questions will be asked of everybody in the same manner".

4.3.2.3 Semi-structured interviews

The semi-structured interviews are somewhere between structured and unstructured interviews. While flexibility in the semi-structured interviews is lower than in the unstructured interviews, their flexibility is higher than in the structured interview. There are some predetermined questions in this kind of interview, but there is an opportunity to ask new questions which may arise during the interview.

> Semi-structured interviews are conducted with a fairly open framework which allows for focused, conversational, two-way communication. It can be used both to give and receive information. Unlike the questionnaire framework, where detailed questions are formulated ahead of time, semi-structured interviewing starts with more general questions or topics. Relevant topics are initially identified and the possible relationship between these topics and the issues such as availability, expense, effectiveness become the basis for more specific questions which do not need to be prepared in advance. Not all questions are designed and phrased ahead of time. The majority of questions are created during the interview, allowing both the interviewer and the person being interviewed the flexibility to probe for details or discuss issues (Unknown, Januarry 14, 2010).

This kind of interview can be conducted face to face or by telephone. In this research this kind of interview will be used for both the examination of *Shariah* issues and the contribution of Islamic banking to economic development.

4.3.2.4 Group interviews

The group interview is used by researchers to interview a group of people simultaneously. This kind of interview can be divided into several types: unstructured, semi-structured or structured interview. Punch (2005:171) states “there are several different types of group interview, and like other interviews they can be unstructured, semi-structured or highly structured. Since different types of group interviews have different purposes, the type of interview to be used in a particular research situation depends on the context and research purpose." This interview is supervised by the interviewer and is suitable for highly debatable topics. This kind of interview faces the problem of gathering all interviewees in one place, especially when there are more than ten persons.

4.3.3 Case Study

The case study is a very well-recognized kind of research which is used widely today. It can fulfil one of the main purposes of research which is solving problems. Case studies are vital in economics because, by performing this kind of research, economists and governments can identify why economic problems arise and find their solutions. "Case study research consists of a detailed investigation, often with data collected over a period of time, of one or more organizations, or groups within organizations, with a view to providing an analysis of the context and process involved in the phenomena under study." (Hartley, 1994: 208)

One characteristic of the case study is that researchers are able to perform both qualitative and quantitative research methods. Bryman (1995:175) points out that:

> Case studies provide one of the chief arenas in which quantitative and qualitative research can be combined. Most case study research involves more than one method of data collection, but this derives from the tendency for qualitative research, which typically employs two or more sources of data, to be intensively used. The combination of quantitative and qualitative research offer further possibilities. One of the most obvious advantages of developing the two in tandem is to check the validity of findings using very different approaches to data collection.

4.4 METHODOLOGY OF THIS RESEARCH

This research will have two sections: one theoretical and the other empirical. The empirical section is divided into two parts: Quantitative analysis and qualitative analysis. These are discussed below.

4.4.1 The Theoretical Analysis:

The theoretical approach of this study is mostly based on *shariah* principle and divine sources. To confirm that the Islamic banking system of the Islamic Republic of Iran is *shariah*-compliant the jurisprudents' opinions (*fatva)* are used which are based on four reasons (evidences and sources).[26]

[26] According to the Jafari school of Islam (*shiah*), there are four sources which should be considered by jurisprudents (*foghaha*) for any religious decree namely: the book (the Holy Quran, *Sunnah* (the sayings and practices of the Holy Prophet Muhammad (Peace be upon him and his respected family) and his successors [twelve Imams after the Prophet (PUH) first of them is Imam Ali,

> For Muslims the authoritative source of guidance is the Holy Quran, the revealed word of Allah, and the *Hadith*, the sayings and practices of the Prophet Muhammad and his companions, referred to as the *Sunnah*. Since the time of the Prophet over 1400 years ago there have always been differences of opinion in the interpretation of how this guidance should be interpreted and applied. The Islamic scholars who specialised in this interpretation are referred to as the *ulama* or *foqhaha*, the latter being derived from *fiqh*, the study of Islamic law. The study of economic and financial transactions from an Islamic perspective is referred to as *fiqh muamalat*, that branch of Islamic jurisprudence that is concerned with commerce and other economic activities. The leading Islamic bank in Indonesia, the most populous Muslim country, is Bank Muamalat, an institution that tries to apply *fiqh muamalat* in all its financial dealings (Wilson, 2008:177-195).

Furthermore, we will utilise some theories and also the opinions of some economists, Muslim and non-Muslim, in investigating the role of banking systems in general and Islamic banking in particular in economic development.

In this section the following discussions will be carried out:

(i) Introducing modality of performance of the Law of Usury-Free Banking in Iran" in the Islamic Republic of Iran.

(ii) Review of literature on the role of the banking system in general and Islamic banking in particular in economic development.

(iii) Islamic banking in the Islamic Republic of Iran, its background and circumstance of its activity with regard to the Law of Usury-Free Banking in Iran, especially, financial instruments.

(iv) Ways of making sure that Islamic banking in the Islamic Republic of Iran is s*hariah*-compliant.

4.4.2 The Empirical Analyses:

This section is divided into two parts. The first part is quantitative analysis and second part is qualitative analysis.

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the son of Abitaleb (AS) and the last is Imam Mahdi, the son of Imam Hassan Al Askari (AS) who is alive now but disappeared by God's will and will appear and constitute a world state based on Justice], wisdom and unanimity of all great Muslim scholars (mojtahedin or foghaha).

4.4.2.1 Quantitative analysis

In this section the secondary data has been collected from different sources, namely: The Banker (November, 2009), Iranian Banking System report (2006), Ministry of Industries and Mining reports, BP Statistical Bulletin (2005), Ministry of Road and Transportation reports, Central Bank of Islamic Republic of Iran, Economic Accounts Office, Iran's Economic Changes Report in the Real Sector, first three months of 1385 (2006-7), Economic Statistic Office of Central Bank, reports and balance sheets of the Iranian Central Bank (Bank Markazi) for different years, Economic Research and Policy Department, Central Bank of the Islamic Republic of Iran, Economic Statistics Office of the Central Bank and its reports and balance sheets and performance of Iran's banking system during 2005 and 2006 for 2003-2006. This collected data has been analysed descriptively.

This section will involve the following:

(i) Examination of the main features of the Iranian economy in general and the banking system in particular by using above mentioned data on the subject.

(ii) Analysis of economic development financing by the banking system in the Islamic republic of Iran through the Central Bank of Iran's reports and other related reports.

For this reason, firstly the trend of mobilisation of deposits, which is the main factor for the banking system to finance economic development, has been examined. Secondly, the allocation of financial resources to the economic sectors in general and their allocation to the productive economic sectors in particular have been analysed. As the whole banking system of the Islamic Republic of Iran is Islamic and there are no conventional banks there, for comparative study between two banking systems, the periods of before and after the Islamic Revolution in Iran have been compared.

In order to avoid showing an increase for the period after the Islamic Revolution due to inflation, increase in GDP and increase in liquidity, all comparisons have been carried out in real terms and also the ratio of deposits and credit to the GDP and liquidity have been compared for the periods before and after the Islamic Revolution. It is worth mentioning that because of special conditions in the decades immediately after the Islamic Revolution, although comparison was between before and after the

Islamic Revolution, the focus has been on comparisons between 1961-1979 and 1989-2006.

4.4.2.2 Qualitative research method

Islamic banking as a system is a new experience in the world and there is not enough literature to deliberate this system and its effect on economic factors in depth. Therefore, qualitative research method would be useful both in finding new data for our analysis and in creating new literature in this regard. Furthermore, it would permit the researcher to build up an overall picture of the issue. In addition, it is a good instrument for deliberating its compliance with *shariah*. The importance of qualitative research increases significantly because these questions may be asked of banking system officials and researchers directly. Thus, qualitative research has been selected as part of this research to cover answering questions regarding *shariah* and effects on economic development.

Qualitative research can be conducted by several methods each of which is appropriate for specific research. For example it can be conducted using questionnaires or interviews. Also, interviews can be conducted using structured interviews, unstructured interviews, semi structured interviews or group-focused interviews. The choice of method depends on the type and purpose of research and somewhat to the researcher's interest. In this research the semi-structured interview has been selected for primary data collection.

4.4.2.2.1 *Semi-structured interviews*

In this research, the semi-structured interview has been selected rather than other types of interview and questionnaire. This is because: (i) Due to lack of conventional banks in Iran for comparison, the questionnaire is not an appropriate tool for achieving the research aims. (ii) People, especially well-known people, prefer interviews to questionnaires. Saunders *et al* (2003: 123) state that "when the topic is seen by interviewees as relevant to their current jobs, people cooperate and mostly prefer to be interviewed rather than having to complete a questionnaire". (iii) Structured interviews and unstructured interviews have some advantages and disadvantages but semi-structured interviews have the advantages of both of them without having their disadvantages. For instance, while we are able to have

predetermined questions in semi-structured interviews, it is also possible to raise new questions during the interview. (ix) Another advantage of the interview is that it can lead to a good rapport and trust between interviewer and interviewee which is very helpful in obtaining as much information as possible.

4.4.2.2.1.1 *Preparation for the interviews*

In the summer of 2009 I went to Iran and started conducting the interviews. Before that I had been thinking about the kind of interview, questions and interviewees and decided to choose the semi-structured interview as the main technique. Apart from a few questions, in order for interviewees to feel free in the way they answered the questions, open ended questions were selected. The main problem at this stage was finding appropriate interviewees with enough knowledge who would be eager to, or at least interested in, taking part in the interviews. Fortunately because of my background as a researcher in Islamic banking before coming to England for my PhD, I knew several researchers in this field. However, due to considerable changes in banking system personnel I faced more problems finding interviewees from the banking system. Another problem was sensitiveness between the Iranian government and the UK government which made it difficult for me to convince the interviewees that the data would only be used for my thesis and nothing else. However, because of this sensitiveness I needed to be introduced to banking system authorities, especially those of the Central Bank.

I called some of my friends and asked them to assist me with this matter. Fortunately, one of them was able to help me a great deal. He asked me to attend a committee meeting at the Central Bank, of which he was the Chair, which was working on reforming the Law of Interest Free Banking of Iran. Attending that committee was an opportunity for me to become familiar with some members of staff of the Central Bank (Banke Markazi). I made appointments with three of them and after the interviews they introduced me to some members of staff at the commercial banks. It is worth mentioning that interviews were in Persian (Farsi) and translated to English by the researcher.

Before starting the interview, the researcher introduced himself to those who did not already know him and also briefly explained the aim of the interview. He also tried to

conduct a useful interview using following ways: (i) The researcher tried to create a friendly environment which helped the interview not to be tiresome and boring. For example, the first interview lasted about four hours without any feeling of tiredness. (ii) If necessary, he assured interviewees that the interview would be confidential and their name would remain confidential so that they would feel free in giving their responses. (iii) They were said that they feel free to avoid responding to any question they do not wish to answer.

4.4.2.2.1.2 *Sampling*

When discussing qualitative research, Kumar (2005:165) states that: "the issue of sampling has little significance as the main aim of most qualitative enquiry is either to explore or describe the diversity in a situation, phenomenon or issues". However, the researcher tried to select an appropriate combination of interviewees. So some of the interviewees were selected from the Central Bank, of which one of its jobs is supervising the banking system; some of them were from state-owned commercial banks, some of them were from private commercial banks, some of them were researchers in Islamic banking and some of them were *shariah* scholars.

Lee (1993:65) states that: "In network sampling (snowball) the researcher starts from an initial set of contacts and is then passed on by them to others, who in turn refer others and so on". In addition to personal contact with interviewees by the researcher to make appointments and introductions by friends, the researcher used networking or the snow-balling technique in selecting the samples. So, at the end of each interview the interviewee would introduce a number of persons for interview and the researcher would evaluate their suitability and capability for the interview. Twelve interviewees were eventually selected for interview; among them was an Ayatollah who is known as the father of Islamic banking in Iran. One factor which was considered in the selection of interviewees was their education and experience. All of them had at least a Masters degree or PhD, and all of them had significant experience either in working in the banking system or in research in Islamic banking.

4.4.2.2.1.3 *Conducting the interviews*

In order to make the interview easier for interviewees, all interviews were conducted either in their work place or in a place suggested by them. In addition, as the research

has two chapters related to the qualitative research method, one to examine of the *shariah*-compliance of the banking system and the other to discuss the contribution of Islamic banking to economic development, the *shariah* scholar was replaced by a well-known active researcher in Islamic banking for interview regarding the contribution of Islamic banking to economic development.

After returning to the UK and considering the questions and answers again, the researcher realised that he needed to conduct a complementary interview so he returned to Iran in order to do so. Unfortunately, some of the interviewees had changed their place of work, so he faced some problems contacting them again. Consequently, he could not contact one of them and interviewed some of them by telephone and email. After completing the interview their answers were analysed using the interpretative method.

4.5 CONCLUSION

The aim of this research is to analyse the contribution of Islamic banking to economic development. For this reason, the research has been divided into two sections. In the first section the *shariah*-compliance of Islamic banking has been investigated and in the second section its contribution to the economic development has been examined. Thus, this chapter was designed to discuss the methods which are appropriate to these aims.

In the first section the theoretical approach of this study is mostly based on *shariah* principles and divine sources. To prove that the Islamic banking system of the Islamic Republic of Iran is *shariah*-compliant the jurisprudent's opinions (*fatwa)* has been used. Furthermore, to examine the role of the banking system in general and Islamic banking in particular in economic development theoretically, some evidences from literature and from the economists' point of view were was utilised.

In the empirical section two research methods were conducted, namely quantitative research method and qualitative research method. In the quantitative research method, some secondary data was collected from official centres of the Islamic Republic of Iran. Also, in the qualitative research method, primary data was collected by semi-structured interview for both examination of *shariah*-compliance and contribution to the economic development.

Part Two:

Quantitative Analysis

Chapter Five: Structure of the Economic System and the Process of Economic Planning in Iran.

Chapter Six: The Contribution of Islamic Banking to the Economic Development of Iran.

Chapter Five:

STRUCTURE OF THE ECONOMIC SYSTEM AND THE PROCESS OF ECONOMIC PLANNING IN IRAN

5.1 INTRODUCTION

Iran is one of the largest producers of oil and natural gas and these have been the main source of income for the government for many decades. This fact affects almost all aspects of the country's economy, which has a large public sector as a defining characteristic. This chapter introduces the structure of the economic system in Iran. Firstly, focusing on its features and secondly its financial system, in particular the banking system, will be considered. Third, the share of each major sector in the country's economic development will be considered.

5.2 GENERAL FEATURES

Iran is an important country in several ways. First of all is its geopolitical and strategic situation. It is located in an area in which a considerable amount of oil is produced. Second is its size in area and also in population.

> Iran is important for several different reasons. Among them are its geographical location, its natural wealth, and its large size, in both land and population. The huge area occupied by present-day Iran, although much smaller than it historically was,… an area larger than that of Italy, France, Switzerland, West Germany, the Netherlands, Belgium, Luxemburg, Denmark and Great Britain combined (Mofid, 1987:1).

According to the 1385 (2006-2007) Population and Housing Census (the latest census), the total population of the country was 70,495,782, with a population density of 43 persons per square kilometre. Of the total population, 68.4 and 31.6 percent respectively lived in urban and rural areas; 50.88 and 49.12 percent respectively were males and females (Statistical Centre of Iran). Furthermore, Iran benefits from a four-seasonal climate in every season. For example, in the summer, there are some areas with cold weather, such as Khalkhal and some areas with spring weather such as Aab ali and Firoozkhooh. Also, in the winter there are some warm areas such as Ahvaz and

Bandar Abbas and so on. This kind of weather allows Iranian farmers to produce a variety of different agricultural products in each season.

According to the United Nations estimation, the nominal GDP of the country was $543.8 billion, which means that Iran is the 20th economic power of the world. However, in GDP *per capita*, with $7,967 (as GDP *per capita*) Iran is the 71st economy in the world. According to the United Nations Human Development Report (HDR, 2007-8) Iran improved its place from 72 to 71 in 2005. Furthermore, according to the United Nation Human Development Report (HDR, 2009) despite increasing *per capita* GDP in PPP, to US$10,577 in 2007, the country's world ranking remained the same as in 2005.

Like other developing countries, there is a kind of duality in Iran's economy. The agricultural sector is representative of the traditional sector and industry is representative of the modern sector of the economy. Although in many areas machines are used in agriculture, a significant amount of farming is still done manually. However, there is a movement toward modernization in this sector too. In general, the modern sector is predominant in Iran's economy. In recent years the agricultural sector has become more mechanized and its share in industry has increased. There are some factors which are helpful for development in Iran such as:

a) Islamic Culture: This motivates people to learn as much as possible and travel great distances for learning as learning is counted as a form of worship. The Prophet Mohammad (peace be upon him and his family) said: "learning and studying is obligatory for every Muslim, man and woman" (Nahj El Fasahah, 64, N.D) and he also said: "seek knowledge from the cradle to the grave (end of life)" (Nahj El Fasahah, 64). The Prophet also said:" Seek knowledge even by going to China" (China here means any very distant place) (Nahj El Fasahah, 63). The question that arises here is why are most Islamic countries still developing with no Muslim country regarded as an advanced developed country? This is not the place to answer this question but we will just say briefly that the main reason is that Muslims have turned their backs on religion and are not actually practising Islam. Another factor which is important for development is that we should perform our duties as well as possible. In this regard the Prophet Mohammad (peace be upon him and his family) said: "When each one of you performs an action, he (or she) should do it with resolve" (Nahj El

Fasahah, 43). Iran is also an ancient civilization which, combined with Islamic civilization, could result in there being many entrepreneurs.

b) Human Capital: In recent years, the government has invested in education, especially higher education and research. For example, in 2000-2001, 2001-2002, 2002-2003, 2003-2004 and 2004-2005, the number of students studying in state universities was 795,870; 809,520; 923,913; 1,354,279 and 1,191,048 respectively (Science, Research and Technology Ministry, taken from the Central Bank's 2005 Economic Report, p255). The numbers studying in the private university (Islamic Azad University) totalled 806,639, 904,869, 968,206, 1,098,491 and 1,197,521 respectively (Islamic Azad University, taken from Foagh, p256). As we can see there were 2,388,569 university students in Iran in 2005 which is a substantial number. It is worth mentioning that state universities are free; no fees have to be paid. The government has been also trying to raise the research budget to 3% of the GDP by the end of the Fourth Economic Social and Cultural Development Plan in 2009.

c) Oil and Gas: Oil and Gas are a mixed blessing as their contribution to economic development depends on the quality of their use by government. If they are used for capital investment in productive projects which improve the scientific and technological capacity of the country, they would be considered as accelerators of economic growth. However, if they are in the hands of a government which uses oil and gas revenues to finance current costs and consumption goods, this would cause inefficiency in resource allocation and management. For example, when a major part of the budget is financed by oil and gas income, governments do not pay enough attention to economic efficiency and also inefficiency of managers. One reason is that they do not have to finance their budget through taxes which usually decrease in an inefficiency situation. When government revenue comes from tax, they have to try hard to increase efficiency and profitability by selecting proper economic policy. Unfortunately, despite the effort taking place by the government to reduce the dependence of the budget on the oil income, about 60% of the budget still comes from oil revenues. Of course it is worth mentioning that this is lower than the 90% level of the 1970s.

As energy is a necessary factor in the production process today (its availability and its price) there is an opportunity for every country which has oil to use cheaper energy

without being concerned about access to this important factor. However this point creates some problems for these nations, such as intervention of world powers in their internal affairs.

5.3 ECONOMIC PLANNING IN IRAN

Iran has a long history of economic and social development plans which can be divided into two periods.

5.3.1 Before the Islamic Revolution

As this research does not cover this period we will just look at it briefly. The First Seven Year Plan, which was started in 1949, was soon abandoned due to oil nationalization. After the defeat of the national movement, the Second Seven Year Plan was supported financially and technically by the U.S between 1955 and 1962. This plan was based on an expansionary fiscal policy and import substitution to rebuild Iran's economy. However, by the end of 1960 the government had to stop its expansionary policy for stability purposes as this policy had led to stagnation.

The Third and Fourth Plans were executed between 1962 and 1972. The focus of these plans was on industry and manufacturing, thus agriculture was neglected. As a result of this policy, only eight percent of the development budget was allocated to agriculture and about seventy two percent to industry (including transport, water, electricity and building) which led to stagnation in the agricultural sector. Despite acceptable growth in the economy overall, the poor did not benefit from the plans and unemployment increased. During this time the unemployment rate increased from 7% to 9% and the share of the 40% of the poorest people in consumption decreased from 16% to 14% and the share of the 20% of the richest people increased from 50% to 52%.

The Fifth Plan started in 1973. In 1974 the oil price increased sharply and the government's oil income increased from $US 2.4 billion in 1972 to $US 18.5 billion in 1974, therefore the execution of the Fifth Plan was stopped in that year. A new plan was designed, the budget of which was three times more than the previous plan; however that led to a high inflation rate. "The sharp rise in domestic inflation and the need by late 1975 to supplement oil revenues by borrowing in international capital

markets are only two instances of the Iranian economic crisis that began in mid-1975" (Looney, 1977, p 8). Execution of this plan was stopped by the government in 1976.

The Sixth Plan was approved with a higher budget than the previous one but in 1978, the Shah announced that the country no longer needed to plan and stopped its implementation. The decision was based on the naive belief that Iran could import everything using its oil income. Consequently, due to a high increase in demand, the inflation rate increased from 4% in 1972 to 25% in 1977. As the government struggled with inflation via imports, the price of imported goods such as industrial, consumption and agricultural goods increased more than others. As a result, capital moved from these sectors to other sectors with higher profitability, such as building and services. Due to this policy, the agricultural and traditional industrial sectors were weakened and because of their importance to employment and income distribution, despite economic growth, unemployment and inequality increased. For example, the unemployment rate increased to 10% in 1976 and the inequality coefficient increased from 0.47 in 1972 to 0.52 in 1976 as the share of the richest 20% of the population increased from 52% in 1973 to 57% in 1976. Meanwhile, the share of the poorest 40% of the population decreased from 14% to 11%. It is worth mentioning that during the 1973-1978 period import increased about 412%.[27]

5.3.2 After the Islamic Revolution

Before the Islamic Revolution the Shah's regime stopped the plans and the country was managed through annual budgets, but after the Revolution the Government decided to manage the country using Five-Year Plans. Due to the imposed war against Iran by Saddam Hossein, they were unable to execute the First Plan, so they had to wait until after the war.

5.3.2.1 First plan

This Plan had been designed for 1983 but, due to the war, it was implemented from 1368-1372 (1989-1993). As it was the first plan after the Islamic Revolution, which should have led to the implementation of Islamic law both socially and economically, and because, according to Islamic thought social justice is very important, in fact the

[27] - For more information, see Hadi Zamani, 1988, Growth, Employment and Income Distribution: An Input-Output and General Equilibrium Study of Iran, 1959-1986, Ph.D. Thesis, London University

most important goal taught by the prophets after the worship of God, the principle objectives of the plan were set out as follows:

> The ultimate objectives of the Islamic society are man's development and elevation towards freedom from any thing but God, and his movement towards Allah. Economic and social development must constitute an effort to remove any obstacles impeding Man's and the Islamic nation's development and elevation. General objectives and orientation of economic and social development in the Islamic Republic must be drawn up on the basis of Islamic law and principles. The aim was establish Islamic relations in society, which is the objective of Divine instructions. Hence, policies and plans must be drawn up and accepted in this light. (PBO, 1982, p 5 cited by Mofid, p206).

Furthermore, some general objectives were defined as follows:

a) Expansion of education and culture

b) Securing the interest of the *mostadhafin* (the down trodden people)

c) Securing economic independence (but not economic isolation)

d) The realisation of social security, health care and medical care

e) Provision of food and clothing

f) Provision of housing

g) Elimination of unemployment

The Plan's priorities in order to achieve the said objectives were as follows:

a) Prevention of consumerism and emphasis on investment

b) Agriculture as the axis of development

c) Utilisation of current spare capacity in industry and increase in productivity

d) Development of the intermediate machine tool industry

e) Expansion of non-oil exports

f) The integration of the oil industry more closely into the activities of the domestic economy as a whole

g) Preventing the expansion of large cities and implementing settlement policies. (PBO, 1982, p 5 cited by Mofid, p206)

As we can see, the plan focused on social and economic justice by securing basic needs for all people and expanding free education. Although in this plan the focus was on rebuilding following the war damages, the planners tried to increase the capital stocks by increasing investment According to the plan, during the five years investment should have been about 26,452 billion Iranian Rials at the fixed price of 1367 (1988) and investment growth was predicted to average 11.6 percent. The growth rate of Gross Domestic Product (GDP) at the fixed prices of 1367 (1988) was predicted as 8.1 percent and the *per capita* product was predicted to increase by 4.9 percent on average.

One problem in countries which have oil is their reliance on the oil income and their tendency to neglect other sources of income, especially tax. In this plan they would try to increase the proportion of tax income to total income from 47% in 1367 (1988) to 49.4% in 1372 (1993) and its share in GDP from 4.3% to 8.4% in those years. Also, the percentage of tax income in current expenses increased from 28.8% in 1988 to 76.6% in 1993. One aim was to create 394,000 new jobs annually in order to decrease the unemployment rate from 15.9% to 13.4%.

In practice, at the end of the First Plan the unemployment rate decreased to 10.82% in 1993 which shows a considerable improvement in the fight against unemployment. The results also show improvement in terms of income distribution and the struggle against poverty. For example, the inequality coefficient decreased from 0.4092 in 1989 to 0.3976 in 1993 and the ratio of the richest 10% of the population to the poorest 10% of population decreased from 17.6 in 1989 to 16 in 1993.[28]

5.3.2.2 Second plan

This plan was implemented over the 1373-1377 (1994-1998) period. The plan's focus was on social and economic justice by securing the basic needs of all people, free

[28] The Central Bank of the Islamic Republic of Iran

education, even at university level and rural development. Although in the previous plan most of the war damages were rebuilt, there was still a lot of work to be done. The increase of capital stocks by investment was stressed and, according to the plan, during the five years investment should have had a growth rate equal to 6.2 percent on average and increase from 2262.7 billion Iranian Rials to 3,055.5 billion Rials at the fixed prices of 1361 (1982). The growth rate of GDP at the fixed prices of 1361 (1982) should have been 1.5 percent. So it would have increased from 13,766.3 Rials to 17,635.3 billion Iranian Rials and *per capita* product should have increased to 256,000 Rials. As we can see the growth rate of both GDP and investment decreased significantly in comparison with the First Plan.

In this plan total government income was projected as about 237,311 billion Iranian Rials with 50% coming from oil, 26% from tax and 24% from other incomes. One aim was to create 2,019,000 new jobs during the plan period.

The results for the two important factors, employment and income distribution, are as follows: Regarding employment this plan was not successful and the unemployment rate increased from 10.85% in 1993to 15.41% in 1998. However, data on income distribution show a little improvement. For instance, the inequality coefficient decreased from 0.3976 in 1993 to 0.3965 in 1998 and the ratio of the richest 10% of the population to the poorest 10% of the population decreased from 16 in 1993 to 14.2 in 1998.[29]

5.3.2.3 Third plan

The Third Plan covered the period 1378-1382 (1999-2003).The plan focused on social and economic justice by securing the basic needs of all people, but the most important aim was privatization. According to Article 4 of the Law of Third Economic, Social and Cultural Development Plan of the Islamic Republic of Iran, governmental benefitable companies should be transferred to the private or cooperative sectors. During this plan a law was passed on 12/01/1379 (10/04/2000) that allowed the establishment of private banks.

[29] The Central Bank of the Islamic Republic of Iran

Also, the results for the two important factors, employment and income distribution, are as follows: In contrast with previous plan regarding employment this plan was successful but regarding income distribution it was not successful. In this plan the unemployment rate decreased from 15.41% in 1998 to 10.30% in 2004 and the inequality coefficient increased from 0.3965 in 1998 to 0.3996 in 2004 and the ratio of the richest 10% of the population to the poorest 10% of the population increased from 14.2 in 1998 to 14.6 in 2004.[30]

5.3.2.4 Fourth plan

The Fourth Economic, Social and Cultural Development Plan of the Islamic Republic of Iran 1384-1388 (2005-2009) was passed on September 1, 2004 and was implemented in 2005. This plan had many similarities to the Third Plan and many of the Third Plan's articles were revalidated in the Fourth Plan. An aim which seems an overreaching, but probably unattainable target was the elimination of oil revenue from the government's income. Article 2 states that:

> In order to bring about financial and budgetary discipline during the years of the plan, Government is required to increase the share of expense credits provided through the government non-oil revenues in such a way which enables the government to meet its expenses entirely through tax and other non-oil incomes" [The Fourth Economic, Social and Cultural Development Plan of the Islamic Republic of Iran 1384-1388 (2005-2009)]

One important aspect of this plan was to encourage direct foreign investment and increase its ratio to GDP from 0.6% to 3%. Other quantitative goals in the plan included:

- Increasing the ratio of investment to GDP from 28.7% to 31.3%.

- Increasing the ratio of non oil export to GDP from 6.3% to 10%.

- Decreasing the inflation rate from 17% to 8.6% (on average 9.9% during the plan)

- Decreasing the unemployment rate to 8.4% in 1388 (2009)

- GDP growth rate 8%

- Investment growth rate 12.2%

[30] The Central Bank of the Islamic Republic of Iran.

- Agriculture growth rate 6.5%

- Oil revenue growth rate 3%

- Industry growth rate 11.2%

- Services growth rate 12.2%.

Although, the results for this plan had not yet been published, the data presented show some negative results in both unemployment and income distribution. For example, the unemployment rate increased from 10.3% in 2004 to 10.5% in 2007, the inequality coefficient increased from 0.399 in 2004 to 0.40 in 2006 and the ratio of the richest 10% of the population to the poorest 10% of the population increased from 14.60 in 2004 to 14.90 in 2006.

In conclusion, the data show that during the four plans which have been carried out in the Islamic Republic of Iran, both employment and income distribution have improved. For example, the unemployment rate decreased from 12.509% in 1989 to 10.5% in 2007, the inequality coefficient decreased from 0.4092 in 1989 to 0.4004 in 2006 and the ratio of the richest 10% of the population to the poorest 10% of the population decreased from 17.60 in 1989 to 14.90 in 2006.[31] It is worth mentioning that the inequality coefficient and the ratio of the richest 10% of the population to the poorest 10% of the population was 0.4584 and 24.70 in 1978 respectively. So, it can be concluded that an acceptable improvement has taken place since the Islamic Revolution in both areas.

5.4 ECONOMIC STRUCTURE IN IRAN

Economic structure has an important role in facilitating or blocking economic development. It would therefore be useful to look at it briefly.

5.4.1 The Banking System

Modern banking has a long history in Iran.

> The first bank founded in Iran in 1850 was "New East Bank", an originally British owned bank. The "Kingdom Bank" founded in 1872 by a British man named Powell Juluos Reuyter, was among the first banks starting banking

[31] The Central Bank of the Islamic Republic of Iran.

> operations in Iran, up to 1942. Another bank was the "Loan Bank" founded in 1890 by a Russian Jacque Polia Koof which carried out banking operations for over 75 years. "Bank Sepah" was the first Iranian bank established with Iranian capital in 1925 under the name of Bank Pahlavi Qoshun, in order to handle the financial affairs of the military personnel and set up their retirement fund, with primary capital of 388,395 toomans. In 1960, a plan for providing a comprehensive monetary and banking constitution was considered by economic authorities in order to preserve Iranian currency's validity and to enforce monetary policies. It was at this point bank refah was established, in accordance with Note 39 of the previous year's Budget Law (Bankrefah, September 20, 2007).

5.4.1.1 Nationalization and merger of banks

"Iran nationalized all its banks in order to protect the rights of depositors and national funds, to increase industrial production of the country and to guarantee the refunding of deposits" (Bankrefah, September 20, 2007). Another reason for nationalization was the banks' debts, due to their ownership by people who were close to the Shah and their influence upon the bank authorities in terms of patronage. When they had to leave the country, before the victory of the Islamic Revolution, they took a lot of money out of the country.

> After nationalization of the banks in 1979, 37 banks were merged into six commercial banks including Bank Refah, Bank Melli Iran, Bank Saderat, Bank Tejarat, Bank Mellat, and Bank Sepah and three special banks including Bank Keshavarzi, Bank Maskan, and Bank Sanat va Maadan (Mining and Industry) (Bankrefah, September 20, 2007).

Tejarat Bank (Trade Bank) was formed from a merger of 12 banks, Mellat Bank (Nation Bank) from ten banks; Sanat and Maadan (Industry and Mining) Bank from six banks, and Keshavarzi (Agriculture) Bank from three banks plus all credit institutions dependent on the Agriculture Ministry. In recent years some structural reforms have been carried out, including the establishment of an allowance for private credit institutes and banks, in order to improve competition and efficiency of the banking system. For example, the Credit and Money Assembly endorsed the allowance and regulation of non banking credit institutes on 13/4/1371 (4/7/1992) and private banks on 20/9/1379 (11/12/2000). Also, foreign banks have recently been allowed to open some branches in Iran.

5.4.1.2 Quantity and size of banks in Iran

At present there are eleven state-owned banks, six private banks and several credit institutions. Some of them are among the largest Islamic banks in the world. As Table 5.1 shows, the National Bank (Bank Melli) is the largest Islamic bank in the world The Export Bank (Bank Saderat), the Nation Bank (Bank Mellat), the Trade Bank (Bank Tejarat), the Sepah Bank, the Parsiyan Bank and the Agriculture Bank (Bank Keshavarzi) are among the ten largest Islamic banks in the world. This means that of the ten largest Islamic banks in the world seven of them are Iranian.

Table 5.1: The Ten Largest Islamic Banks in the World

Ranking		Country	Date of result	Institution	Type of institution	Total assets US
latest	previous					$ million
1	1	Iran	20-Mar-2008	Bank Melli, Iran	Government-owned	59621.7
2	2	Saudi Arabia	31-Dec-2008	Al Rajhi Bank	Commercial & Investment Bank	43981.2
3	3	Iran	20-Mar-2008	Bank Saderat Iran	Government-owned	43067
4	4	Iran	20-Mar-2008	Bank Mellat Iran	Government-owned	41650.6
5	5	Kuwait	31-Mar-2008	Kuwait Finance House	Commercial	40002.6
6	6	Iran	20-Mar-2008	Bank Tejarat Iran	Government-owned	31807.6
7	7	Iran	20-Mar-2008	Bank Sepah Iran	Government-owned	26378
8	8	UAE	30-June-2009	Dubai Islamic Bank	Commercial& Retail Banking	23941.4
9	9	Iran	19-Mar-2008	Parsyian Bank Iran	Commercial	18319
10	10	Iran	20-Mar-2008	Bank Keshavarzi	Government-owned	16675

Source: The Banker 2009, Nov.

As can be seen in Table 5.2 in 2006 the National Bank (Bank Melli), the Export Bank (Bank Saderat) and the Nation Bank (Bank Mellat) are respectively the largest banks in Iran. Bank Melli's assets would reach more than $US 129 billion if calculated according to the PPP (purchasing power parity) exchange rate and more than $US 41 billion according to the official and nominal exchange rate. Also, the value of Export

Bank and Nation Bank's assets are more than $US 113 billion and $US 100 billion respectively in PPP exchange rates and more than $US 36 billion and $US 32 billion in official exchange rates for 2006) respectively.

Table 5.2: Size of Banks in Iran (2006) (Iranian Rial Billion)

Row N	B & In	Establishment	Branch	B N A	Staff N	F Cap	Assets	Ownership
1	B M	1307 (1928)	3350	11	43478	20342	387027	Government
2	B S	1331(1952)	3263	20	29609	19680	339216	Government
3	B Mel	1358(1979)	1964	4	25019	13158	300109	Government
4	B T	1358(1979)	1964	4	20908	12088	232569	Government
5	B Se	1304(1925)	1696	3	17239	8255	216251	Government
6	B K	1312 (1933)	1847	0	15705	7055	152920	Government
7	B Mas	1358 (1979)	973	0	9188	3825	1336804	Government
8	B Pars	1380(2001)	135	0	2756	1777	117420	Private
9	B R	1339 (1960)	1105	0	9744	1195	52332	Government
10	B E N	1380 (2001)	122	0	1240	1121	40882	Private
11	BS M	1358(1979)	38	0	0775	1097	38391	Government
12	B Pas	1384 (2005)	76	0	882	876	31294	Private
13	B T S	1370 (1991)	28	0	911	864	18765	Government
14	P B	1374(1995)	404	0	2269	647	4330	Government
15	B Sarm	1384(2005)	22	0	301	612	5877	Private
16	B K A	1380 (2001)	45	0	842	380	18472	Private
17	B Sam	1381(2002)	54	0	890	341	24731	Private
18	M C B	1364 (1985)	260	0	1833	287	19294	Private
19	M E T	1376 (1997)	11	0	201	117	7297	Private

Source: Iranian Banking System Report (2006) B & In= Banks or institute

B N A= Branches number abroad F Cap = Fixed capital

B M = Bank Melli (National Bank) B S = Bank Saderat (Export Bank)

B Mela = Bank Mellat (Nation Bank) B T = Bank Tejarat (Trade Bank)

B Se = Bank Sepah B K = Bank Keshavarsi (Agricultural Bank)

B Mas = Bank Maskan (Construction or House Bank) B Par = Bank Parsiyan (Persians Bank)

B R = Bank Refah (Welfare Bank)

B E N = Bank Eghtesad Navin (New Economy Bank)

B S M = Bank Sanat va Maadan (Industry and Mining Bank)

B Pas = Bank Pasarghad B K A = Bank kar Afarin (Work Creator Bank)

B T S = Bank Tawseeh Saderat (Export Development Bank)

B Sarm = Bank Sarmayeh (Capital Bank) P B = Post Bank

B Sam = Bank Saman

M E B = Moasseseh Mali va Etebari Bonyad (Bonyad Finance and Credit Institute)

M E T = Moasseseh Etebari Tawseah (Development Credit Institute)

5.4.2 Capital Market

Both the size and quality of the capital market are important for economic development through the capital base of a country. So, in order to have a more complete picture of Iran's economic structure, it is worth introducing it briefly.

5.4.2.1 Historical background

The Tehran Stock Exchange (TSE) was established in 1966. The organization of the exchange was structured in accordance with proposals by two consultants from the Brussels Stock Exchange and was formalized in the Law on Establishment of the Stock Exchange, approved by the *Majles* in May 1966. Today the TSE still operates under this original law.

> During its first year of activity, only six companies were listed. The number of companies increased to 43 by early 1974. After the first oil price boom and along with the increase in foreign exchange revenues of the country, the activities of the TSE expanded considerably. As a result, the number of firms listed at the TSE reached 102 by early 1978, which 24 were commercial and specialized banks (Albrecht Frischenschlager, 2003).

After the Islamic Revolution, due to the nationalization of banks and insurance companies, the war and the elimination of interest from the financial system of Iran, activity in the capital market reduced for a while.

> On the eve of the Islamic Revolution, in 1978/1979, trade slowed down. Only three new members were added in 1979, and in the following two years many companies were either confiscated or nationalized, which reduced the number of listed firms to only 55. Because all banks and insurance companies were nationalized in 1979 they stopped trading on the stock market. Bond trading ended in 1983. It is notable, however, that despite being portrayed in the early days of the Revolution as a capital profiteering tool, the TSE was never closed down. Finally after a decade of reduced activities the stock market picked up again in 1990 and today 335 companies are listed on the TSE (Albrecht Frischenschlager, 2003).

The TSE has started a modernization program aimed at preparing the market for the 21st century by drawing up a New Capital Market Law and a New Trading System which allows the entry of foreign investment. TSE is now the one of the biggest and the most active capital markets in the Middle East and continues its expansion. During 1383 (2004-2005) the TSE established 11 new floors in various regions. This aimed at expanding its activities to enhance market access and investment opportunities for the public" [Central Bank of Iran, 2006, Economic Report and Balance Sheet]. However, several branches have recently been established in other major cities, including Shiraz, Kerman, Yazd, Rasht, Zahedan, Karaj, Sari, Ahwaz, Zanjan, Ardebil, and Orumiyeh stock exchanges in 1383, the number of active provincial stock exchanges increased to 14 [Central Bank of Iran, 2006, Economic Report and Balance Sheet].

5.4.2.2 TSE size

Although, there has been significant progress in the Capital Market in Iran, it is still far from being an effective and efficient market. In recent years there have been many fluctuations in stock prices and indexes.

> The Tehran Stock Exchange (TSE) activities in 1383 (2004-2005) witnessed two distinguished periods of boom and bust. In the first half of the year, the market was under the influence of the previous year's conditions and TSE indices had an upward trend. Therefore, the volume of trading and share price index rose to their record high. As a matter of fact, the factors responsible for this boom period of 1383 (2004-2005) could be attributed to the rise in demand over supply of shares for trading of some listed companies in 1382 (2003-2004) (Central Bank of Iran, 2006, Economic Report and Balance Sheet).

Due to the boom period in 2003 and 2004, the number of shares and rights trading and the number of buyers increased significantly.

> In 1383, (2004-2005) the number of shares and rights trading was 2.3 million times, up by 85.2 percent. The number of buyers came to 1,570,492 persons. This figure posted a rise of 80.9 percent in 1383 (2004-2005) as compared with the noticeable rise of 141.3 percent in 1382 (2003-2004) (Central Bank of Iran, 2006, Economic Report and Balance Sheet).

The number of listed companies reached 460 in 1383 (2004-2005) [Source: TSE, monthly report]. In 1383 (2004-2005) 3,033 million shares and rights valued at Iranian *Rials* 18,949.6 billion were traded on provincial stock exchanges, constituting 21.4 and 18.3 percent respectively of the total number and value of shares and rights traded on the TSE.

By the end of 1383 (2004-2005), market capitalization, with a growth of 25.1 percent compared to the previous year, reached Iranian Rials 387,547.2 billion, due to the listing of 40 new companies on the TSE and the capital increase of the previously listed ones, albeit a slight rise of price index in this period. At the same time, based on the average interbank exchange rate (1), market capitalization in terms of dollar reached $43.7 billion (Central Bank of Iran, 2006, Economic Report and Balance Sheet) and according to the PPP reached about $US 130 billion. Also in 1383 (2004-2005) the ratio of market capitalization to GDP reached 28 percent by the year-end.

5.4.2.3 Metal exchange

The Metal Exchange was inaugurated in Shahrivar 1382 (August-September 2003). Aluminium, copper, steel and zinc were traded for cash and forward transactions on the Metal Exchange. In that year, a total of 5,223.7 thousand tons of steel, copper, aluminium, and zinc worth Rials. 25,117.8 billion were traded on the Metal Exchange (Central Bank of Iran, 2006, Economic Report and Balance Sheet).

5.4.2.4 Agricultural products exchange

Iran's Agricultural Products Exchange was inaugurated in Shahrivar, 1383 (August-September 2004). By the end of 1383 (2003-2004) about 95 thousand tons of corn, barley, different types of seed remained, sugar, rice, peas, lentils, pistachio, and saffron valued at Iranian Rials. 162.2 billion were traded on this market (Central Bank of Iran, 2006, Economic Report and Balance Sheet).

5.4.2.5 Participation papers

Instead of debt papers which are prohibited in Islam, participation papers are issued by the Government and some companies.

> In 1383 (2004-2005) a total of Iranian Rials, 41,349.6 billion participation papers were issued by the Government, Central Bank, and companies. Of this amount 93.9 percent, Iranian Rials. 38,840.3 billion, were sold, up by 36.5 percent as compared with Iranian Rials. 28,445.7. billion papers sold in the previous year. The approved figure for total papers was Iranian Rials. 50,349.6 billion in 1383 (2004-2005). The profit rate of the participation papers was on a daily basis and redeemable at any time. The provisional profit rate for all types of participation papers was 17 percent and it was tax-exempted (Central Bank of Iran, 2006, Economic Report and Balance Sheet).

These papers should be issued for special projects such as automobile manufacture or such like, in order that people can become partners and shareholders. For example, if the government, or even the private sector, decided to build a large factory and did not have enough money they could issue partnership papers the holders of these papers would actually be the owners of the factory. After that these shares would become like all bonds which can be sold in the secondary market. Sometimes the issuer of the papers buys the shares from the shareholders. The profit of the shareholders is actually from real profit of the project, but a second party, such as the central bank or the government, guarantees the nominal value of the shares and even sometimes a minimum profit for them.

5.4.3 Agriculture Sector

The agriculture sector is important not only for economic development but also for the guarantee of food of every country and, for this reason, countries usually take special notice of this sector and it is often protected. In Iran after the Islamic Revolution, especially in the early years, this sector was given priority following years of neglect under the Shah's rule

5.4.3.1 Size

Because of the variety in its weather, Iran has potential for agricultural activity especially in terms of variety of products. Four seasons can be seen in every season in Iran, in the sense that in one season some parts of Iran are warm and others are cold. In general:

> one-third of Iran's total surface area is suited for farmland, but because of poor soil and lack of adequate water distribution in many areas, most of it is not under cultivation. Only 12% of the total land area is under cultivation (arable land, orchards and vineyards) but less than one-third of the cultivated area is irrigated. About one third of the total land area (35%) is used for grazing and small fodder production. Most of the grazing is done on mostly semi-dry rangeland in mountain areas and on areas surrounding the large deserts ("*Dashts*") of Central Iran.

The non-agricultural surface represents 53% of the total area of Iran, as follows: 35% of the country is covered by deserts, salt flats (*kavirs*) and barren rock. Also 11% of Iran's total surface is covered by woodland and 7% is covered by cities, towns, villages, industrial areas and roads.

One problem for the complete modernization of agriculture in Iran is the small size of the agricultural lands and people's preference for working on their own land. Despite this problem, the government and farmers have done their best to modernise agriculture and improve productivity. Consequently, production of agricultural goods especially, those considered as strategic goods such as wheat, has increased sharply and Iran has recently become one of the world's wheat exporters with production valued at 175,891bilion Iranian Rials (about $US 58.63 billion according to PPP). The share of the agriculture in the GDP was about 10% in (2005-2006) (Central Bank of Iran, Economic Account Office "Iran's economic changes report in real sector", first three months of 1385 [2006]).

5.4.3.2 Subsidy

One important issue in the agricultural sector is subsidy. Governments in many countries, even in developed countries, try to support their farmers. The Iranian government has paid a considerable amount of subsidy to encourage farmers to invest and produce more.

> In 1383(2004-2005), the amount of subsidy paid on major agricultural products grew by 40.9 percent to reach Rials. 21,443.1 billion ($US 7.1477 billion in PPP). The share of this subsidy out of total government subsidy payments declined by 0.9 percentage point from 78.7 percent in 1382 (2004-2005) to 77.8 percent in the review year. (Ministry of Economic Affairs and Finance, Economic Report and Balance Sheet).

5.4.3.3 Guaranteed purchasing price of agricultural crops

There are usually many fluctuations in the price of agricultural crops and farmers suffer because of this. In addition, in order to encourage farmers to cultivate special crops, the government started to buy them at a guaranteed price.

> To encourage farmers to produce basic agricultural crops, to establish equilibrium in the production system, and to maintain farmers' income level, the policy of guaranteed purchase of agricultural crops, which was started in 1368 (1989-1990), continued in the review year. In 1383 (2004-2005) the guaranteed purchasing price increased within the range of 5.9 to 23.8 percent (except for green leaf tea), which was less than the rate of inflation (15.2 percent) for this year. (Central Bank of Iran, 2006, Economic Report and Balance Sheet)

5.4.4 Manufacturing, Mining and Oil-Related Activities

Although Iran is considered a developing country, it has made rapid progress in recent years in industry and the share of industry in the GDP has increased regularly, reaching 45.3%. There is a centre in Iran called the University Jihad (*Jihade Daneshghahi*)[32] which was established after the Islamic Revolution for research in new scientific areas. In the past little research was carried out in Iranian universities in Iran and there was no relationship between universities and industry. However, now the government encourages researchers and a revolution in software development has increased the research budget and promoted a closer relationship between researchers and the industry sector. All of this is being carried out to compensate past backwardness and to bring about technological and industrial modernisation.

As Iran is an oil producing country, the oil industry plays an important role in its economic development. Of course, the authorities try to substitute the export of raw petroleum by exporting petrochemical output. Hence, there is a long-term plan to increase investment in the petrochemical industry.

> Petrochemical products grew by 7.9 percent to 15.1 million tons in 2004-2005 when compared with the previous year. About 82.6 percent of the nominal capacity of petrochemical units was utilized in the review year. In terms of production growth Bou Ali Sina Petrochemical Complex enjoyed the highest growth of 54.2 percent, followed by HD Unit of Amir Kabir Complex (with 17.0 percent), Razi Complex (with 10.8 percent), Isfahan Complex (with 8.7 percent), and Tabriz and Orumiyeh complexes (with 8.1 percent). The Fanavaran Petrochemical Unit, with a nominal capacity of one million tons, was put into operation, producing 447.7 thousand tons. In 1383 (2004-2005) the petrochemical units of Arak, Isfahan, and Khark were privatized. The total capacity of these three units is 2.5 million tons per annum (13.4 percent of the country's total capacity). In 1383, petrochemical complexes produced 1,872.7 thousand tons of various types of chemical fertilizers, showing a decrease of 1.7 percent compared to the previous year. The major share of chemical fertilizer production belongs to Urea fertilizer with 79.4 and Di-Ammonium Phosphate with 14.0 percent. In this year, petrochemical exports, with 14.3 percent increase over the previous year, amounted to 5.2 million tons valuing at $1.7 billion. The highest share of 46.5 percent in petrochemical exports went to Bandar Imam Petrochemical Complex (Central Bank of Iran, 2006, Economic Report and Balance Sheet).

Other important industries in Iran are car assembly and car production which has made rapid progress (starting in 1994) both quantitatively and qualitatively. For example, in 2004-2005,

[32] Terminologically *jehad* means hard effort but from the religious point of view, it means a holy effort for holy purpose

the auto industries raised their production. The production of various types of trucks and vans, minibuses, passenger cars, road construction machineries, and pick-ups increased by respectively 112.4, 88.5, 19.8, 9.5, and 6.9 percent, compared to last year. Moreover, with the participation of foreign companies, in this year, production of the new automobiles was put into the agenda of automobile manufacturers to diversify auto manufacturing industry in Iran (Central Bank of Iran, 2006, Economic Report and Balance Sheet)

Table 5.3: Manufacturing and Mining Products in Iran

		2002	2003	2004	Percentage change	
					2003-4	2004-5
Motor vehicles (1)	unit	531461.0	752387.0	903193.0	41.5	20.1
Cement	Thousand tons	28433.1	29872.7	32199.0	4.7	1.8
Raw steel	Thousand tons	7477.1	7991.0	8989.6	6.9	12.5
Aluminium bars	Thousand tons	158.3	180.9	212.2	14.3	17.3
Copper (cathode)	Thousand tons	142.9	145.7	152.5	2.0	4.7

Source: Ministry of Industries and Mining

(1) Includes different types of trucks, vans, passenger cars, pick-ups, buses, minibuses, and double-differential cars.

As we can see in Table 5.3 the most progress among selected industries has been in the motor vehicle industry with a growth rate in 2003-2004 and 2004-2005 of 41.5% and 20.1% respectively.

5.4.5 Energy

Iran has the world's second biggest proven oil reserves after Saudi Arabia and the second biggest gas reserves after Russia. Iran’s proven oil reserves was 132.5 billion barrels and its proven natural gas reserves was 27.5 trillion cubic meters in 2004. As of 2006 it was producing an estimated 3.8 million barrels per day (bbl/d), equal to five percent of global production. At 2006 rates of production, Iran's oil reserves would last 98 years if no new oil is found.

Iran's geo-strategic position and its already-existing network of pipelines also make it a key player in the energy world. This situation is both an opportunity and a threat for

Iran, both nationally and internationally. The development of oil and gas caused the government to rely heavily on energy revenues which in turn caused inefficiency in the economy. Another negative effect of oil is the waste of energy.

Table 5.4: OPEC Primary Energy Consumption in 2004

(Million tons oil equivalent)

	Oil	Natural gas	Coal	Natural energy	Hydro electricity	Total
Middle East members	185.5	193.9	1.1	0	2.7	383.2
Saudi Arabia	79.6	57.6	0	0	0	137.2
Iran	73.3	78.4	1.1	0	2.7	155.5
Kuwait	13.7	8.7	0	0	0	22.4
United Arab Emirates	15.6	35.6	0	0	0	51.2
Qatar	3.3	13.6	0	0	0	16.9
Other members	91.7	74.7	23.1	0	18.6	208.1
Total	**77.2**	**268.6**	**24.2**	**0**	**21.3**	**591.3**

Source: BP Statistical Bulletin, 2005 (1) Excludes Iraq, Libya and Nigeria.

As Table 5-4- shows, Iran's primary energy consumption is more than other Middle East members. Iran's oil consumption is very high, reaching 1.55 mb/d which accounted for 26.3 percent of total OPEC consumption. [Central Bank of Iran, 2006, Economic Report and Balance Sheet]

Of course, oil can be seen as a source of capital for the country and can be used as capital for investing in economic development. However, unfortunately many oil–producing countries use it for their current costs and to expand consumption of luxury products instead of investing.

In 1383 (2004-2005), generation of electricity grew by 8.1 percent and amounted to 162 billion kw. Of total generated electricity, 159 billion kw (98.3 percent) was generated by power plants affiliated to the Ministry of Energy and 2.8 billion kw (1.7 percent) by other institutions [Central Bank of Iran, 2006, Economic Report and Balance Sheet]. In this year Iran's total energy consumption was 125.5 billion kw.

5.4.6 Construction and Housing

Construction is an important sector in most economies. On the one hand it plays an important role in social welfare and on the other hand it plays a considerable role in economic growth by horizontally affecting many sectors in the society. Despite the business cycle in this sector and the long-term depressed conditions in Iran, it is beneficial to invest in this sector in the long run. Hence, the private sector is usually eager to invest in this sector. For example, in 2004-2005 private sector investment in new buildings in urban areas (Tehran, other large cities and other urban areas was Rials 15,625.7 billion, Rials 2,9987.0 billion and Rials 28,483.7 billion respectively. That means that in that year investment in all urban areas was Rials 74,099.4 billion (about US$ 24.7 billion) excluding the cost of land.

5.4.7 Transport

Iran is a relatively large country with scattered cities and villages, so a widespread transport system is vital for its economic development. For this reason the government has paid special attention to this sector.

> The year 1383 (2004-2005) experienced a rise of investment in transportation sector, in a way that gross fixed capital formation grew by 19.7 percent (at constant 1376 prices) as compared with the previous year. A large portion of this investment was used for machinery, which accounted for 86.5 percent [Central Bank of Iran, 2006, Economic Report and Balance Sheet]

Some efforts have also been made to prepare conditions which increase private and foreign investment in this section recently, including:

> Utilization of external finance to provide machinery and railway equipment, encouragement of the private sector participation for the construction of freeways in the northern area of Mashhad, approval of Articles of Agreement and bilateral and multilateral memorandums of understanding in international transportation, and introduction of new special economic zones to perform external transit operations, are among the measures taken by the government in this sector during the review year. These initiatives are expected to promote service rendering and create new opportunities for investment in this sector [Central Bank of Iran, 2006, Economic Report and Balance Sheet]

Due to these efforts, especially over the last twenty years, Iran now has a relatively widespread network of roads and railways which are a step toward rapid economic development.

5.4.8 GDP by sector

In traditional economies agriculture usually has a high rate of contribution in GDP, while in developed economies services have a high rate of contribution. For example, in the United Kingdom GDP was distributed between agriculture, industry and services respectively as 1%, 26% and 73% in 2006. Of course, sometimes the share of services leads to mistakes. In some developing countries, because of lack of equilibrium between different economic sectors and because of people's desire to be involved in speculative activities rather than production activities, the share of services in the GDP is high. One should note that this is not a sign of progress but of a weak economic structure. In an inflationary economy, especially when people expect that inflation will continue for a long time, they invest in services, especially in trade and speculative subjects, rather than production projects as this is more profitable. As Table 5.5 shows, in 1383 (2004-5) the share of agriculture in the GDP decreased to 10% compared with the previous year when it was 11%, the share of oil and industry increased from about 42% to 44% and the share of service industries decreased from 48% to 47%. A decrease in the share of services is a good signal with regard to economic development, because the expansion of service industries at this stage of development would not benefit economic development. At this stage Iran needs to increase investment in the industrial sector, especially in new technologies. Of course in the future Iran will need to increase the share of service industries.

Table 5.5: Gross Domestic Product in Terms of Economic Activities

(Iranian Rials Billion)

Market price	1383(2004-5)		1384(2005-6)	
	Amount	Share of GDP	Amount	Share of GDP
Agriculture group	155471	11%	175891	10%
Oil group	346673	25%	471520	27%
Industry and mining	245139	17%	283097	17%
Mining	8114		10375	
Industry	156076		181343	
Electricity, Gas & water	20211		22160	
Construction	60739		69220	
Service industries	667252	48%	800916	47%
Trade, Hotels & Restaurants	160862		188552	
Transport, storage & communication	101195		121804	
Financial intermediation	49419		66230	
Real estate and technical services	174145		206305	
General services	143809		173242	
Personal and Social services	37821		44782	
Deduction				
Karmozde ehtesabi	29716		39610	
Gross domestic product	1384819		1691814	

Sources: Central Bank of IROI, Economic Accounts Office, Iran's Economic Changes Report in the Real Sector, first three months of 1385 (2006-7)

5.5 CONCLUSION

The main aim of this chapter has been to consider the structure of the economic system in Iran by focusing on the financial system, especially the banking system. One problem is that despite the attempts made by the government regarding the country's relative independence of the economy of oil, oil still plays an important role in the economy. Another concern is the duality in Iran's economy. The agricultural sector is representative of the traditional sector and industry is representative of the modern sector of the economy. However, in general the modern sector is predominant in Iran's economy.

The first bank founded in Iran in 1850 was New East Bank, originally a British-owned bank. Before the Islamic Revolution there were many banks in Iran. After the Revolution, all 37 banks were nationalized and were merged into six commercial banks and three special banks. However, in recent years some structural reforms have been made in the banking system, such as the establishment of an allowance for

private credit institutes and banks. There are eleven state-owned banks and eight private banks in Iran today and the TSE is one of the most active exchanges in the Middle East.

Regarding the share of economic sectors in the economy, this chapter has shown that the strongest sector in Iran is the service sector which was 47% in 2005-2006. Second is oil which occupies 25% of the economy, third and fourth are industry and the mining and agriculture sector which have a share of 17% and 11% respectively.

Chapter Six:

THE CONTRIBUTION OF ISLAMIC BANKING TO THE ECONOMIC DEVELOPMENT OF IRAN (QUANTITATIVE ANALYSIS)

6.1 INTRODUCTION

It is generally accepted that finance, especially banking, plays an important role in economic development, while in developing countries, shortage of finance is regarded as a major constraint on development.

> There is often insufficient money available to finance worthwhile projects and the price of loanable funds is usually high, reflecting the shortage of savings. In low income countries, it is not surprising that saving rates are low, because most disposable income has to be used to purchase necessities for everyday living, and many families simply cannot afford to make financial provision for the future, even though this leaves them insecure and vulnerable.(Wilson, 1995:76)

Although oil exporting countries are different from other developing countries due to oil revenues, individual savings, deposits and capital accumulation are also important to them for economic development. It is a fact that oil revenues play a dual role in oil producing countries. On the one hand they create a facility for investment by governments, which is useful for economic development, but on the other hand they encourage consumerism and inflation. For example, average consumption in Iran is very high in comparison with other developing countries; it is said that it is near to that of developed countries. An increase in oil revenue usually leads to an increase in liquidity which leads to inflation. As, due to outbreak of speculation during the time of inflation, high inflation rates usually work against economic development, it would be more effective and more sustainable if financing the economy and investment relied on national savings rather than oil revenues,.

Principally Islamic banking, like conventional banking, can affect economic development in two ways: First, by increasing the productivity of the existing capital; second, by increasing the quantities of savings and deposits and allocating them to the most efficient projects. One of the most important roles of banks is to encourage

people to decrease their consumption and increase their savings by giving them a proper reward for saving. Another important role for banks is to allocate deposits to the most efficient projects. Since this chapter discusses the effect of banking on economic development, it is necessary that the trend of economic development is considered. This chapter, therefore, will contain two sections. Economic growth trends in Iran will be discussed in Section One and mobilization and allocation of resources to more efficient projects through banking system will be discussed in Section Two.

In this regard the questions are:

1- What has been the growth rate of GDP in Iran?

2- What has been the trend of savings and investment in Iran?

3- Were the Islamic banks in Iran able to create a regular growth rate in mobilization of savings?

4- What has been the trend of ratio of deposits to GDP and liquidity (M2)?

5- Are the deposits short-term or long-term?

6- How were deposits allocated to the different economic sectors?

6.2 THE PROCESS OF ECONOMIC DEVELOPMENT IN IRAN

In this section we will first look at the trend of overall growth in GDP, with and without oil, in general and then in the different economic sectors.

6.2.1 The Growth of Oil and Non-Oil GDP

When discussing an economic subject in oil-producing countries such as Iran, it is important to pay attention to variables because some variables are a function of world oil prices. Oil prices can affect GDP in two ways. The first is indirectly, which means by creating facilities for investment both in the oil sector and in other economic sectors. The second is directly by increasing the absolute amount of GDP when oil prices are high and decreasing it when oil prices are low, as a part of GDP. In general, oil is a valuable raw material which does not count in a nation’s manufacturing capacity, but instead shows the riches of the country from a natural resources point of

view. For this reason it would be useful, if not essential, to calculate GDP without oil, to show the country's production capacity.

Table 6.1: Oil and Non-Oil GDPs at the Current and Constant 1376 (1997) Prices and their Growth Rate (Iranian Rials Billion)

Year	GDP (cur)	GR %	GDP (cons)	GR %	GDP-oil (cur)	GR %	GDP- oil (cons)	GR %
1989	25079.00	24.2	191503	5.9	23261	21.1	160255	5.7
1990	34506.00	37.6	218539	14.1	30857	32.7	181171	13.1
1991	48428.00	40.3	245036	12.1	44329	43.7	202426	11.7
1992	64502.00	32.2	254822	4	58703	32.4	212200	4.8
1993	100124.00	55.2	258601	1.5	79028	34.6	213844	.8
1994	131771.00	31.66	259876	0.5	105105	33	217760	1.8
1995	188184.00	42.8	267534	2.9	156758	49.1	224805	3.2
1996	248972.00	32.3	283807	6.1	207166	32.2	240762	7.1
1997	291769.00	17.2	291769	2.8	251005	21.2	251005	4.3
1998	328522.00	12.6	300140	2.9	300255	19.6	258404	2.9
1999	434385.00	32.2	304941	1.6	371092	23.6	265426	2.7
2000	576493.00	32.7	320069	5	474788	27.9	277274	4.5
2001	664620.00	15.2	330565	3.3	564229	18.8	292512	5.5
2002	917035.00	38	355554	7.6	707349	25.4	316149	8.1
2003	1095303.0	19.4	379838	6.8	944130	19.3	335144	6
2004	1384819.0	26.4	398234	4.8	1038146	23	352363	5.1
2005	1691814.0	21.9	420928	5.7	1216385	17.2	374784	6.4
2006	2038432.0	20.8	446880	6.2	1498341	23.2	399334	6.6
Ave	_____	29.59	_____	5.2	_____	27.66	_____	5.6

Sources: 1- Economic Statistic Office of Central Bank

2- Reports and balance sheets of Iranian Central Bank (Bank Markazi) for different years

GDP (Cur) =Gross domestic product at the base prices (current prices)

GDP (cons) =Gross domestic product at the base prices (constant 1997 prices)

GDP- oil (Cur) =Gross domestic product without oil at the base prices (current prices)

GDP- oil (cons) =Gross domestic product without oil at the base prices (constant 1997 prices)

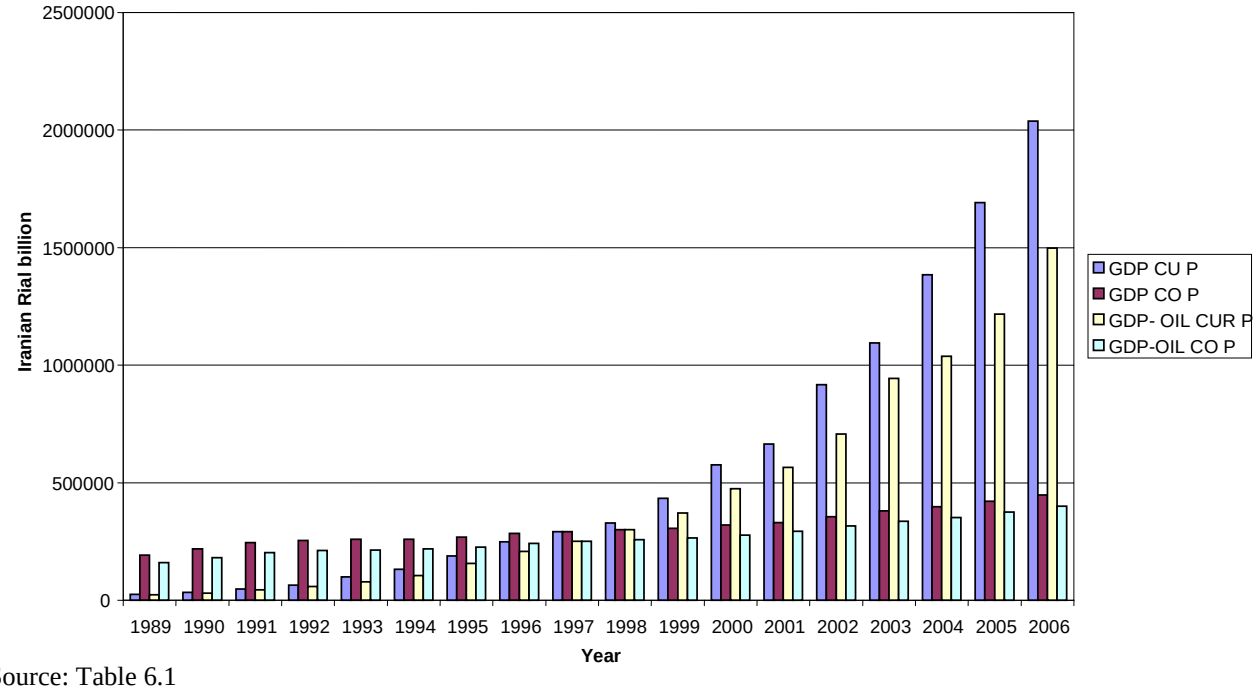
GR=growth rate

Table 6.1 and Figure 6.1, depict trends in oil- and non-oil GDP at current and constant 1376 (1997) prices and their growth rate. As the table shows, oil- and non-oil GDP at the current price has demonstrated a high growth rate. The minimum growth rate in the 1989-2005 periods for GDP with oil and without oil were 12.6% and 17.2% , the

maximum growth rate for these periods were 55.2% and 49.1% and average growth rates were 29.59% and 27.66% respectively. It is worth mentioning that fluctuation in GDP with oil is more than in non-oil GDP, reflecting the effect of oil on the fluctuation of Iran's economy. As can be seen in Table 6.1, the difference between the minimum and maximum in GDP growth rate at the current price with oil is 42.6 %, while for non-oil GDP is 31.9%.

GDP at the constant 1376 (1997) price, i.e. real GDP, shows the real growth rate which is adjusted for the inflation rate. We can see fluctuation in real GDP too, but it is a little less than nominal GDP, which shows the existence of inflation. In 1989 which was the first year of the First Economic, Social and Cultural Development Plan of the Islamic Republic of Iran, the growth rate was 5.9% but in 1990 and 1991, it jumped to 14.1% and 12.1% respectively and then decreased to 4%, 1.5% and 0.5% for 1990, 1991, and 1992 respectively. The point is that the reason for the high growth rate in the first three years, especially in 1990 and 1991 was the existence of free capacity in the economy. During the war between Iran and Iraq, due to a shortage of raw materials and the destruction of factories, firms did not work to their full capacity. One interesting point is that while the growth rate in nominal GDP was at its highest rate (52.2%) in 1993, the real growth rate was relatively very low (1.5%) which shows the existence of a high inflation rate in that year. Minimum and maximum growth rate in real GDP between 1989 and 2006 was 0.5% and 14.1% respectively. The average growth rate during that time was 5.2%. Although this average is relatively acceptable the country needs a higher growth rate to generate employment and get through the developing period. The situation regarding real GDP without oil is a little better than the previous one, but the trend is relatively similar. The minimum and maximum growth rates in real GDP without oil were 0.8% and 13.05% respectively which is similar to the growth of that with oil. It is interesting that the average growth rate in GDP without oil is a little more than that with oil. The gap between the real growth rate and the nominal growth rate shown in figure 6.2 reflects the inflation rate for those years which was very high, especially, for 1993 when the growth rate for nominal GDP with oil and real GDP with oil was 52.2% and just 1.5% respectively. This high inflation rate was due to President Hashemi Rafsanjani's expansionary monetary and fiscal policy which tried to rebuild the war damages. The data in this year also can confirm a negative relationship between inflation and economic growth.

Figure 6.1. GDP with and without oil during 1989-2006



Source: Table 6.1

GDP CU P = GDP with oil at the current prices.

GDP CO P = GDP with oil at the constant 1997 prices.

GDP-OIL CUR P = GDP without oil at the current prices.

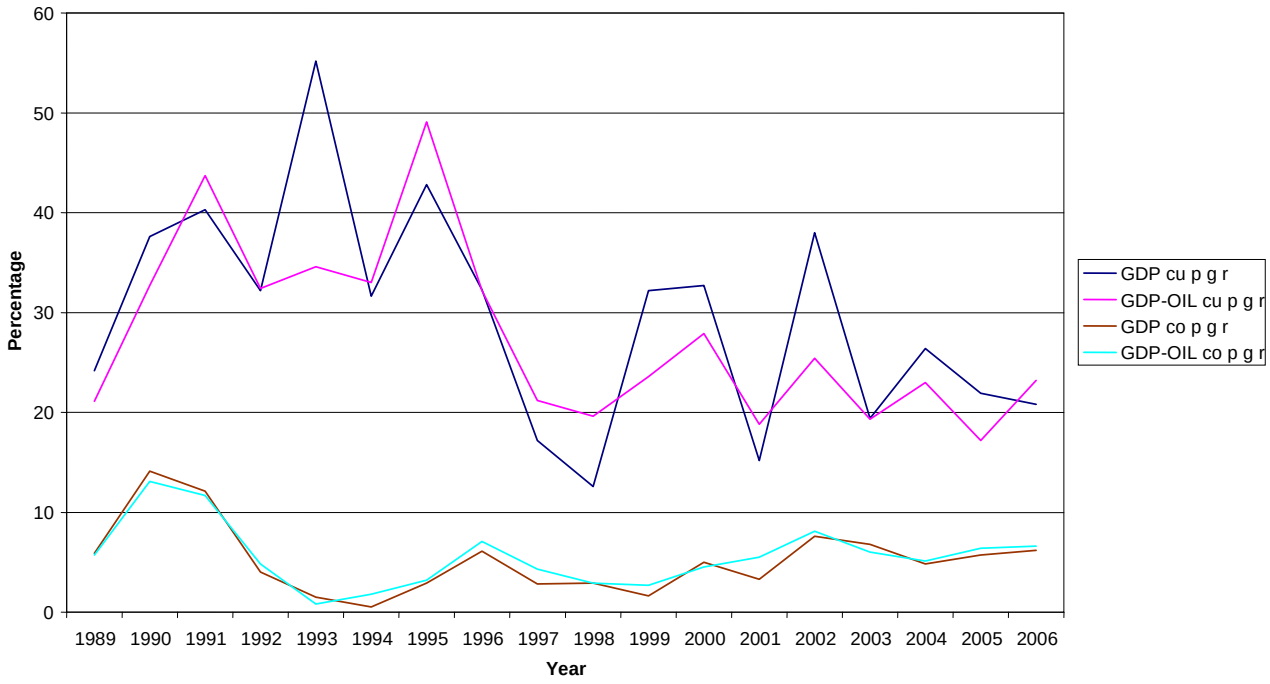
GDP-oil CO P = GDP without oil at the constant 1997 prices.

6.2.2 The Process of Growth in GDP by Economic Sector

A change in the share of economic sectors in GDP can be used as an indicator of economic development. Whenever the share of industry is more than that of agriculture the level of development is higher. Nevertheless, there are some differences between developing countries and developed countries regarding the service sector. In developed countries the service sector share usually increases but that is not necessarily a sign of improvement in the economic development in all countries; instead it may be a sign of economic disease in developing countries. This is because, in developed countries, industries were saturated and the extra resources were employed in the service sector to increase the people's welfare. However, in developing countries, where there is usually shortage of capital, the expansion of the service sector leads to intensification of the shortage and usually comes from disequilibrium in the economy. Therefore, in some developing countries such as Iran, a decrease in the service sector may be a mark of improvement in the economic

development process, especially toward equilibrium. Now we will consider the share of each sector.

Figure 6.2. Growth Rate of GDP with and without Oil During 1989-2006



Source: Table 6.1

GDP cu p g r = Growth rate of GDP with oil at the current prices.

GDP co p g r = Growth rate of GDP with oil at the constant 1997 prices.

GDP-OIL cu p g r = Growth rate of GDP without oil at the current prices.

GDP-OIL co p g r = Growth rate of GDP without oil at the constant 1997 prices.

a) Agriculture

Agriculture is a necessary sector in any country because it meets the food needs of the population of the country but, from the economic development point of view, it should not occupy a large proportion of the GDP. The best idea is to produce for the basic needs of the population. In developed countries a small proportion of the labour force and capital is usually used for the agricultural sector. Of course a large amount of agricultural goods can be produced by increasing productivity.

As Table 6.2 shows, during the development process the share of agriculture in GDP decreased regularly in Iran. Despite an increase in the production of agricultural goods during 1989-2006, its share in the GDP decreased. During this period the production

of agricultural good increased from 5,893 billion rials in 1989 to 211,275 billion rials at the current price in 2006 which is an increase of about 36 times and from 93,391.4422 billion rials in 1989 to 171,142.1682 billion rials at the constant 2004 price in 2006 which shows an approximately twofold increase. However, its share in the GDP decreased from 23.498% in 1989 to 10.365% in 2006 which shows a decrease of about 55.9%. On average, the share of agriculture in the GDP during these years was 15.039%. These data reflect improvement in both quantitative and qualitative indexes.

b) Oil and Gas

Oil and gas have played an important role for several decades in the Iranian economy. The share of oil and gas in Iran's economy is usually subject to its price which is determined on the world market. Fluctuation in the world price of oil creates some difficulties for the economy of oil-producing countries, so governments have tried to reduce the share of oil in their budget.

Table 6.2 shows that the share of oil and gas in the GDP increased during 1989-2006. Of course there were many fluctuations during this period. Three distinct periods can be seen during 1989-2006. First, in 1989-1993 the share of oil went from 7.253% in 1989 to 21.07% in 1993. Second, in 1994-1998 it decreased to 8.604% in 1998. Third, in 1999-2006 the share started to increase regularly and reached 26.495% in 2006. The average share of oil and gas in the GDP over the whole18-year period was 16.949%. The process of the share can be seen in figure 6.4 more clearly. In conclusion, it can be said that this increase in their share in the GDP is not a good thing because this result was achieved despite all the governments claiming to have decreased the share of this sector in GDP. It is also important that we differentiate between selling crude oil and petrochemical products.

c) **Mining and Manufacturing**

The mining and manufacturing sector is very important in the economic development process as industrialization can facilitate economic development because other sectors can benefit if there is an initial industrial base. For example, one important step regarding the development of agriculture is its potential for industrialization which increases productivity and releases extra workers for the expansion of industry.

Furthermore, the oil and services sectors need industry for improvement and oil can add value through industrial projects such as petrochemical projects.

As Table 6.2 shows, during the development process the value added of both mining and manufacturing and their share in the GDP increased in Iran. During this period, the value added of mining and manufacturing increased from 2,515 billion Rials in 1989 to 261,039 billion Rials at the current price in 2006 which reflects an increase of about 104 times and from 40,499.195 billion Rials in 1989 to 211,453.22 billion Rials at the constant 2004 (1383) price in 2006 which shows an increase of about 5.22 times.

Table 6.2: GDP at the Base and Current Prices by Economic Sector

(Iranian Rials Billion)

Year	GDP	AG	Share* %	O&G	Share* %	I&M	Share* %	H&B	Share* %	Service	Share* %
1989	25079.00	5893.00	23.498	1819.00	7.253	2515	10.028	1188.00	4.737	13739	54.783
1990	34506.00	6591.00	16.493	3649.00	10.575	4589	13.299	1666.00	4.828	18204	52.756
1991	48428.00	8977.00	18.537	4098.00	8.462	7171	14.807	2643.00	5.458	26057	53.806
1992	64502.00	12033.00	18.655	5798.00	8.989	9565	14.829	3446.00	5.342	34238	53.08
1993	100124.00	15331.00	15.312	21096.00	21.07	11953	11.579	5208.00	5.201	47455	47.396
1994	131771.00	20482.00	15.544	26666.00	20.237	17959	13.629	6191.00	4.698	61931	46.999
1995	188184.00	34575.00	18.373	31426.0	16.7	24863	13.212	8146.0	4.329	90497	48.09
1996	248972.00	38868.00	15.611	41806.0	16.791	36646	14.719	13394.	5.38	120508	48.402
1997	291769.00	43162.00	14.793	40763.00	13.971	45186	15.487	13262.00	4.545	152761	52.357
1998	328522.00	56751.00	17.275	28267.00	8.604	49025	14.923	13291.00	4.046	185237	56.385
1999	434385.00	65421.00	15.061	63293.00	14.472	63338	14.481	17885.00	4.117	231028	53.185
2000	576493.00	79121.00	12.724	101705.0	17.642	87489	15.176	22616.00	3.923	295101	51.19
2001	664620.00	85238.00	12.825	100391.0	15.105	104710	15.755	30104.00	4.529	353591	53.202
2002	917035.00	110373.00	12.036	209687.0	22.866	123841	13.472	46016.00	5.018	442831	48.286
2003	1095303.0	131134.00	11.972	251174.0	22.932	146740	13.397	50616.00	4.621	535112	48.855
2004	1384819.0	155471.00	11.227	346673.0	25.034	184700	13.337	60739.00	4.386	667251	48.183
2005	1691814.0	175891.00	10.397	471520.0	27.891	213878	12.642	69220.00	4.091	800916	47.341
2006	2038432.0	211275	10.365	540091	26.495	261039	12.806	88408	4.337	994631	48.794
Average	———	———	15.0388	——-	16.949	———	13.754	———	4.644	———	50.727

Sources: Economic Statistics Office of Central Bank

AG = Agriculture

O&G= Oil and gas

M & I = Mining and industry (Manufacturing)

H & B = Housing and building

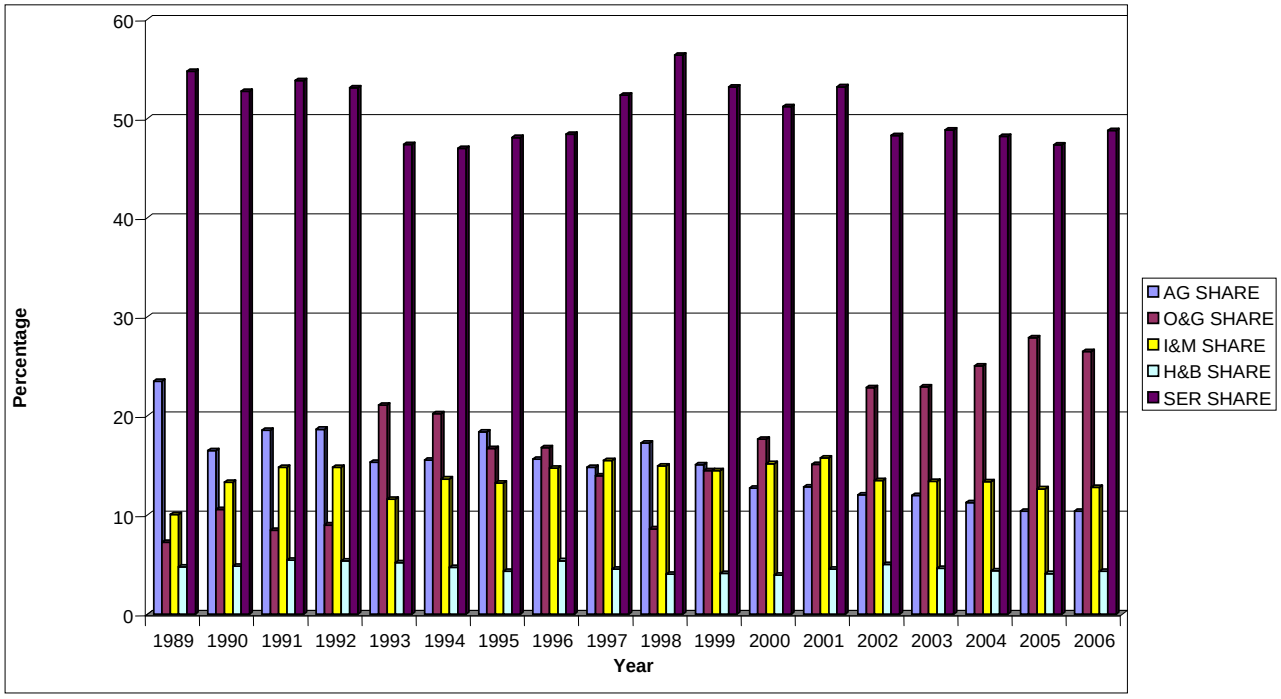
*Calculated by researcher

In addition, its share in the GDP increased from 10.028% in 1989 to 12.806% in 2006 which shows an increase of about 27.7%. However, on average the share of mining and industry in the GDP during the period under review was 13.7543%. Although, these data reflect an improvement in their development process and share, this improvement is not enough and the country needs to invest more in all aspects of industrial development.

d**) Housing and Construction**

Housing and construction play an important role in both economic development and people's welfare, because construction triggers expansion in all sectors. Housing in Iran has been a big problem for all governments during recent decades, both before and after the Islamic Revolution. In the big cities rent prices are very high now and people who do not own their own homes usually have to pay about half of their salary or more on rent. The reason for high rents is that there is a wide gap between supply and demand which is caused by several factors. First of all is the shortage of financial facilities in the construction sector. The second factor is the high price of land and building materials. The third factor is a bad consumption sample for building in Iran. In Iran, houses are very large compared with many other countries, which causes them to be expensive. These factors affect the supply side. The fourth factor is the high population growth rate in the initial years after the Islamic Revolution. The fifth factor is migration from villages to cities and from small cities to big cities. These two factors affect the demand side. Consequently, despite the government's attempts to build houses and encourage people to invest in this sector, and consequently, their relative success in this regard, the problem has remained unsolved.

Figure 6.3. Share of Economic Sectors in GDP During 1989-2006



Source: Table 6.2

AG SHARE = share of agricultural sector in GDP. O&G SHARE = share of oil and gas sector in GDP

I&M SHARE = share of manufacture and mining in GDP

H&B SHARE = share of housing and construction sector in GDP

SER SHARE = share of services sector in GDP

Moreover, many people look at a house as a capital commodity not as a consumption commodity and this also leads to high house prices. This means that the rich usually own more than one house and because of their wealth they are able to pay more. In addition, last but not least is the speculation of some people on building and increasing prices unrealistically. Of course, as will be discussed later, Islamic banking has played a satisfactory role in this sector but, due to an accumulation of problems over several years before and after Islamic revolution, it has not been enough.

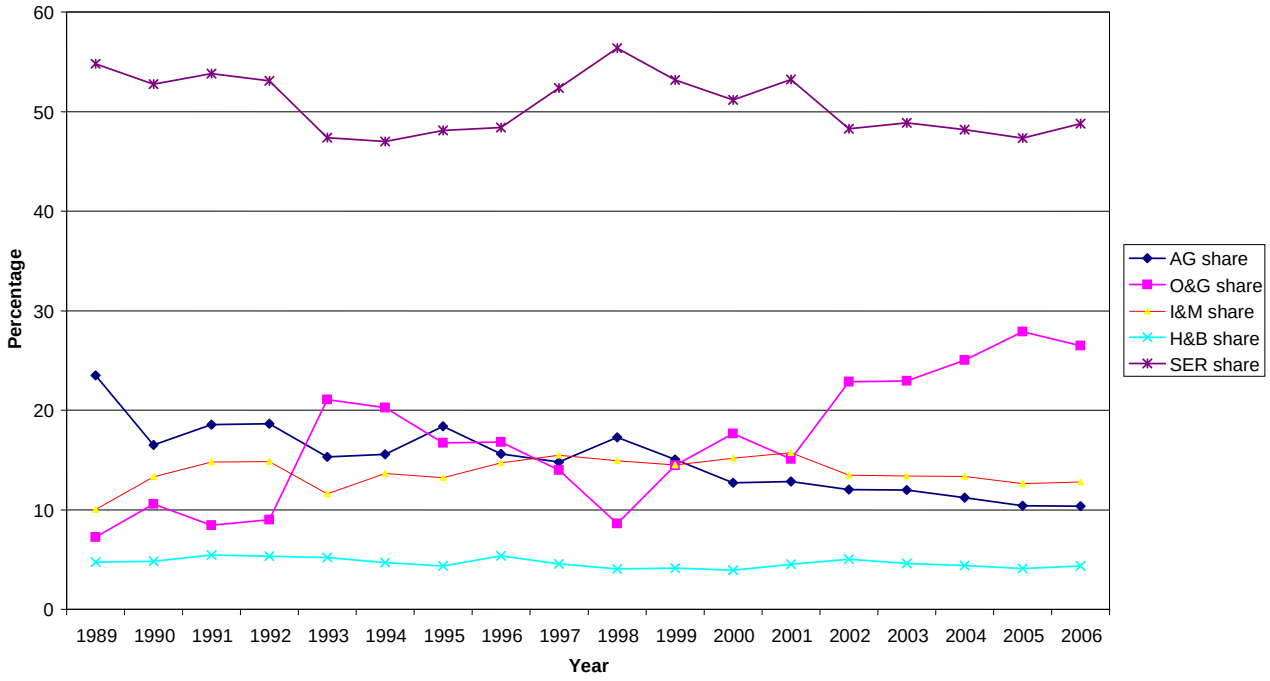
The share of housing and building in the GDP during the period under review has been relatively constant with little fluctuation. It was 4.737% in 1989 and reached 4.337 in 2006. The value added, which was 1188 billion rials in 1989, reached 88408 billion rials in 2006. This shows a growth of about 74.4175 times at the current price.

In terms of constant 2004 price, it increased about 3.7 times. This seems satisfactory but the country needs more investment to solve its accommodation problem. It is worth mentioning that there is a strong desire in families to own their own house instead of renting.

e) Services

As mentioned before, the share of services in the GDP varies in different economies. While it is counted as a sign of welfare in developed countries, in contrast, in developing countries it may be seen as a sign of disequilibrium, anti-development and anti-welfare. The reason is that, despite the need of productive sectors for capital; resources are spent in non product sectors and are often used in brokerage activities.

Figure 6.4. Share of economic sectors trend in GDP during 1989-2006



Source: Table 6.2

AG share = share of agricultural sector in GDP

O&G share = share of oil and gas sector in GDP

I&M share = share of manufacture and mining sector in GDP

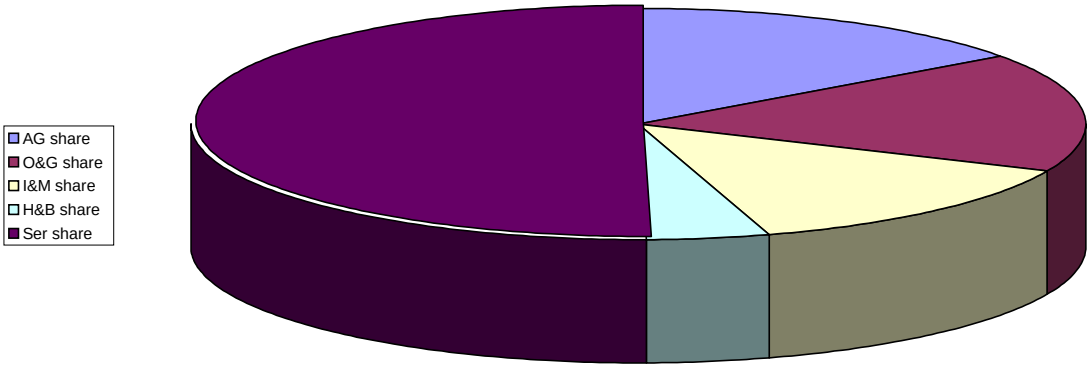
H&B share = share of housing and building sector in GDP

SER share = share of services sector in GDP

The service sector has had a considerable share in the GDP since oil incomes increased. Oil revenues usually cause an increase in foreign trade, especially import activities and hence they also encourage internal trade activities. As trade activities are a substitute for productive activities, instead of being complementary in Iran they are usually viewed negatively by the Iranian people and even by some economists. Thus, every government has tried to decrease the share of the service sector in the GDP.

As can be seen in Figure 6.4, there is a huge gap between the share of the service sector in the GDP and that of other sectors. Its share was 54.783% in 1989 but started to decrease slowly until 1996 when it reached 48.402%. In 1997 and 1998 it increased considerably to 52.357% and 56.385% respectively and then started to decrease. This coincided with the election of Sayyed Mohammad Khatami as President of Iran. During this time the government neglected economic policy and concentrated on political issues. Consequently, the GDP growth rate decreased and some capital went to the service sector. However, the share of this sector in the GDP decreased to 48.974% in 2006.

Figure 6.5. Average Share of Economic Sectors in GDP During 1989-2006



Source: Table 6.2

AG share = average share of agricultural sector in GDP during 1989-2006

O&G share = average share of oil and gas sector in GDP during 1989-2006

I&M share = average share of manufacture and mining in GDP during 1989-2006

H&B share = average share of housing and building sector in GDP during 1989-2006

SER share = average share of services sector in GDP during 1989-2006

6.3 GROSS NATIONAL SAVINGS AND CAPITAL FORMATION

As mentioned before lack of saving is one of the most important problems with which developing countries have been faced (Wilson, 1995) and, despite the shortage of extra revenue in these countries to be saved, the banking system can play an important role in encouraging saving and guiding savings toward investment. So, it will be useful to discuss the process of these two effective variables in economic development.

According to Table 6.3, and Figure 6.6., the Gross National Saving at current price was 3,720 billion Rials in 1989, but jumped sharply to 10,055 billion Rials in 1990, which shows a growth rate of 170.3%. The situation at the constant price was similar, increasing from 59,903.38 billion Rials in 1989 to 148,522.89 billion Rials in 1990 which shows a considerable growth rate of 147.94%. The reason is clear; during the war the growth rate of Gross National Savings was very low, so a high growth rate would be expected after the war. This trend continued until 1994 when the country faced a reduction in oil price and also a high inflation rate.

Table 6.3: Saving and Capital Formation at the Current and Constant 1383 (2004) Prices and their Growth Rate (1989-2006) **(**Iranian Rials Billion)

Year	GNS(cur)	G R*	GNS(con)*	G R*	GFCF(cur)	G R*	GFCF(con)*	G R*
1989	3720	____	59903.38	____	5135	_____	82689.21	_____
1990	10055	170.3	148522.89	147.94	8127	58.27	120044.31	43.97
1991	15564	54.79	190501.84	28.26	15423	89.77	188776.01	57.26
1992	22839	46.72	224572.27	17.88	19396	25.76	190717.8	1.03
1993	39475	72.84	316006.09	40.71	24858	28.16	199182.69	4.44
1994	50026	26.73	296362.56	-6.22	28819	15.93	170728.67	-14.28
1995	68913	37.75	273355.81	-7.76	38954	35.17	154518.05	-9.49
1996	102048	48.08	328445.45	20.15	65626	68.47	211219.83	36.7
1997	110408	8.19	302985.73	-7.75	83765	27.64	229871.02	8.83
1998	101765	-7.83	236497.79	-21.94	96051	14.67	223218.68	-2.89
1999	157918	55.18	305568.88	29.21	124202	29.31	240328.95	7.66
2000	222318	40.78	381989.69	20.01	153462	23.56	263680.41	9.72
2001	233720	5.13	360512.11	-5.62	187999	22.5	289987.66	9.98
2002	344539	47.41	459018.12	27.32	262588	39.67	349837.46	20.64
2003	397811	15.46	458360.41	-0.14	318820	21.41	367346.47	5
2004	525350	32.06	525350	14.61	401765	26.02	401765	9.37
2005	675801	28.64	612415.95	16.57	464532	15.62	420962.39	4.78
2006	796856	17.92	645488.86	5.4	538720	15.97	436387.2	3.66
Average	215507	41.19	340325.44	18.74	157680.11	32.82	252308.99	11.55

Sources: 1- Economic Statistic Office of Central Bank

2- Economic Research and Policy Department, Central bank of Islamic Republic of Iran.

GNS (cur) = Gross National Saving at the current prices.

GNS (con) = Gross National Saving at the constant 2004 (1383) prices.

GFCF (cur) = Gross Fixed Capital Formation at the current prices.

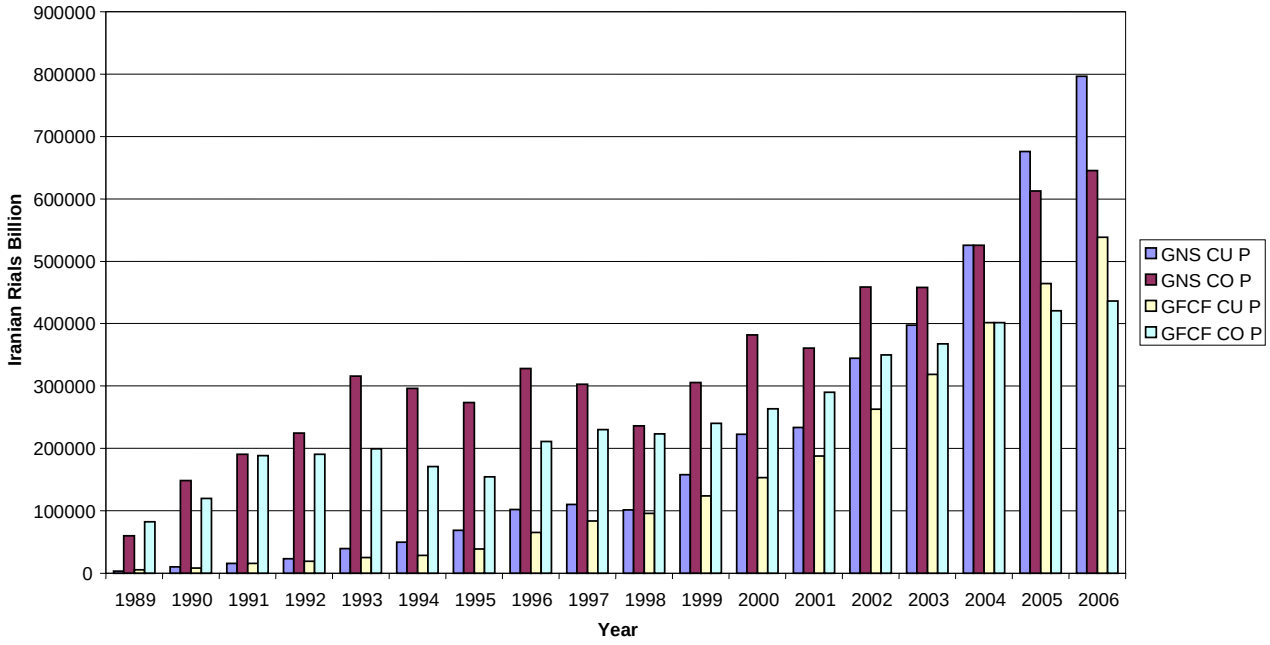
GFCF (con) = Gross Fixed Capital Formation at the constant 2004 (1383) prices

G R = Growth Rare

*Calculated by researcher

The inflation rate in the years 1994 and 1995 was 37% and 49% respectively, therefore, despite a continuing growth rate at the current price in those years, they were at a constant price negative. It is clear from Table 6.3 and Figure 6.7 that the growth rates in those years were -6.22% and -7.79% respectively. In 1996, the growth rate at both prices again became positive (20.15%).

Figure 6.6. Gross National Savings and Investment at the Current and Constant 2004 Prices During 1989 – 2006.



Source: Table 6.3

GNS CU P = The Gross National Saving at the current prices.

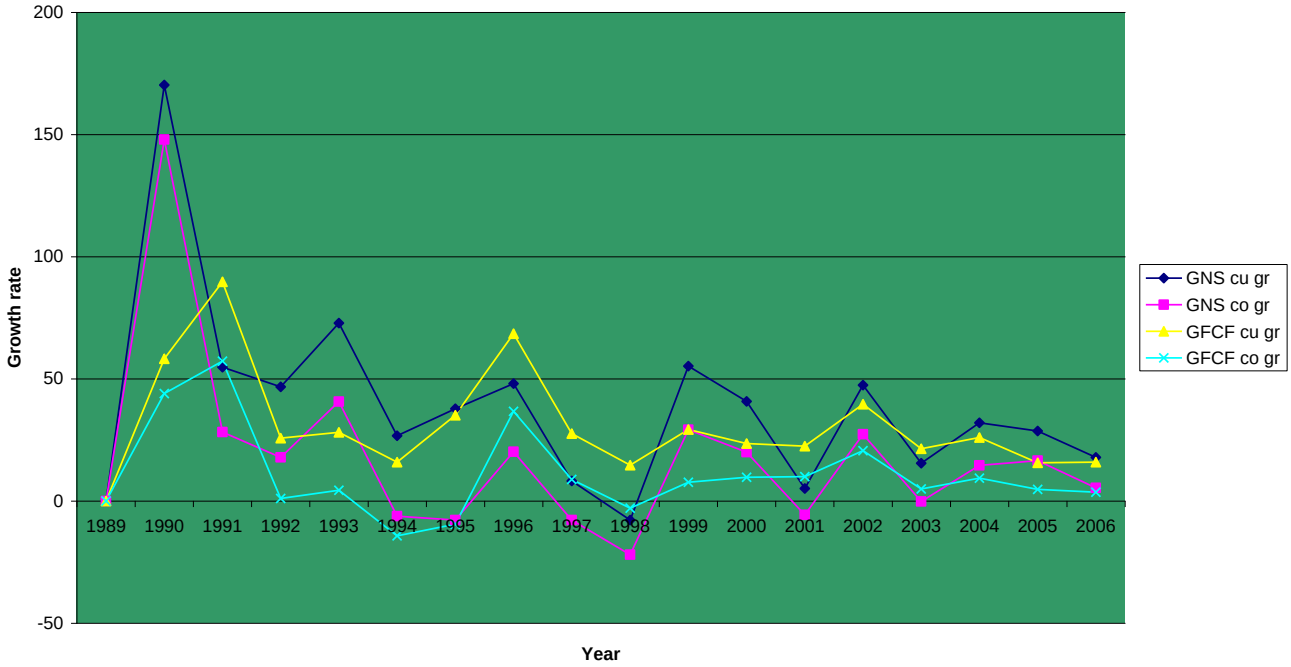
GNS CO P = The Gross National Saving at the constant 2004 (1383) prices.

GFCF CU P = The Gross Fixed Capital Formation at the current prices.

GFCF CO P = The Gross Fixed Capital Formation at the constant 2004 (1383) prices.

Due to the change of government in 1997, a negative growth rate was observed again in GNS at constant 2004 price for two years. Inflation rates for 1997 and 1998 were 17% and 18.08% and growth rates were -7.76% and -21.94% respectively. The only year that Gross National Savings at current price was negative was 1998. In that year the growth rate was -7.83%. During 1999-2006 the growth rates of GNS at constant price were positive, except in 2001 and 2003 when they were -5.62% and -0.14% respectively. The average GNS at current and constant price were Iranian rials 215,507 billion and 340,325.44 billion respectively. Of course, it is worth mentioning that the oil price in this period was below $US 10. Gross Fixed Capital Formation had relatively the same process as Gross National Savings except that

Figure 6.7. growth rate of saving and gross fixed capital formation at current and constant 2004 prices during 1989-2006



Source: Table 6.3

GNS CU g r = The growth rate of Gross National Savings at the current prices.

GNS CO g r = The growth rate of Gross National Savings at the constant 2004 (1383) prices.

GFCF CU g r = The growth rate of the Gross Fixed Capital Formation at the current prices.

GFCF CO g r = The growth rate of the Gross Fixed Capital Formation at the constant 2004 (1383) prices.

fluctuation was a little less than in the previous year. As Table 6.3 and Figure 6.7 show the GFCF at current price had a high growth rate during the period under review, especially in the first years. For example, the growth rate in 1990 was 58.27% followed by 89.77% the following year. The GFCF at the constant price had the same trend except in 1994, 1995 and 1998 when it had a negative growth rate. Their growth rate was -14.28%, -9.49% and -2.89% respectively. The reason for this was the high rate of inflation caused by the expansionary monetary policy carried out by President Hashemi Rafsanjani. On average, GFCF at the current and constant price was Iranian rials 157680.11and 252308.99 billion and their growth rate was 32.28% and 11.55% respectively.

6.4 MOBILISATION AND ALLOCATION OF MONETARY RESOURCES

Before the Islamic Revolution in Iran, despite the existence of many foreign

conventional banks, many people did not like to deposit in these banks because of *riba*. It was expected that after the elimination of *riba*, these people would use the banks and consequently increase the activities of the banking system. Of course the banking system had to attract the people's trust. Another factor after the Islamic Revolution regarding the banks' activities was that their branches extended to the under-developed and rural areas where they had previously not existed. Today, a considerable number of bank branches, especially agricultural banks, serve these areas, and this can have a positive effect on their development. Although our research period does not include the time before the Islamic Revolution, in order to make some comparisons the years just before the Revolution will be reviewed briefly.

6.4.1 Deposit and Credit Trends before the Islamic Revolution

6.4.1.1 Deposit and credit trends

Although the research does not include the period before the Islamic Revolution, for a brief comparison it would be useful to look at the deposit and credit trends in this era. So, in Table 6.4, the trend of deposits and credits has been shown both in current and constant 2004 (1383) prices for 1961-1979 (1340-1357).

As we can see in Table 6.4, although the amount of deposits and credits are not considerable, their growth rate is relatively acceptable. This could be because of relatively small amounts of deposits and credits in that period in a situation where a little increase in absolute value of deposits and credits led to high growth rate. This growth rate is different from a growth rate in a banking system with huge amounts of deposits and credits. For example, in an economy such as the United States or China or other economies where the economy is very large, a growth rate of 2% is not just acceptable but excellent. However, this rate for developing countries is not acceptable. Therefore the growth rate in these countries is usually higher than that in developed countries but that does not mean that their economy is more efficient than those of developed or more developed countries. It is worth mentioning that there is a positive relationship between oil price and the amount of deposits and credits. In 1974 when the oil price increased about four times and reached US$ 12 per barrel, the deposit growth rate increased to 58% and 38% for current price and constant price respectively and after a one year lag, credit facilities' growth rate increased 55% and 41.91% for current price and constant price respectively.

Table 6.4: Deposit and Credit Facilities at the Current and Constant 2004 prices and their Growth Rate (percent) of Private Sector (1961-1978) (Iranian Rials Billion)

Year	C P I	D CU P	G R* %	D CO P*	G R* %	C CU P	G R* %	C CO P*	G R* %
1961	0.32	39	---------	12187.5	---------	50.7	---------	15843.75	--------
1962	0.33	48.8	25	14787.88	19	61.5	21	18636.36	18
1963	0.33	58.9	21	17848.48	21	72.9	18.5	22090.91	18.5
1964	0.35	68.2	16	19485.71	9	88.1	20.8	25171.43	13.9
1965	0.35	80.1	17	22885.71	17	102.2	16	29200	16
1966	0.35	93.3	17	26657.14	16	121.2	18.6	34628.57	18.59
1967	0.35	113.5	22	32428.57	22	142.3	17.4	40657.14	17.41
1968	0.36	141.2	24	39222.22	21	167.2	17.5	46444.44	14.23
1969	0.37	168.6	19	45567.57	16	198.6	18.8	53675.67	15.57
1970	0.38	194.8	15	51263.16	12	230.2	15.9	60578.94	12.86
1971	0.40	246.8	27	61700	20	278.4	20.9	69600	14.89
1972	0.42	333	35	79258.71	28	364.7	31	86833.33	24.76
1973	0.47	429.4	29	91361.7	15	494.2	35.5	105148.94	21.09
1974	0.54	678.9	58	125722.22	38	704.6	42.6	130481.48	24.09
1975	0.59	963.3	42	163271.19	30	1092.5	55	185169.49	41.91
1976	0.69	1344.3	39	194826.09	19	1516.6	38.8	219797.1	18.7
1977	0.86	1771.5	32	205988.37	6	1868.8	23.2	217302.32	-1.13
1978	0.95	1775.1	0.002	186852.63	-9	2199	17.7	231473.68	6.52
average	--------	474.91	25.76	77300.32	17.65	540.37	25.78	88485.2	17.4

Source: Economic Statistic Office of Central Bank and its Reports and Balance Sheets.

CPI=customer price index

D CU P = Deposits at the current Prices.

D CO P = Deposits at the constant Prices.

C CU P = Credit at the current Prices.

C CO P = Credit at the constant Prices.

G R = Growth rate

* Calculated by researcher

6.4.1.2 Trend of ratio of deposits to GDP and liquidity

One important factor in the analysis of success of the banking system in mobilising monetary resources is to consider what ratio of GDP and liquidity has been attracted by banking system as deposits. Tables 6.5, 6.7 and 6.9 show these trends. As Table 6.5 shows, the ratio of deposits to GDP was very low in the early years at just 14.24% but had a relatively positive trend. Despite the variances in growth rate, for example, negative growth rate in years 1965, and 1973-74, the overall trend is positive and this ratio reached 35.59% in 1978, and its average during the years 1962-1978 was 24.53%. Also, the average growth rate was 5.83%. It is worth mentioning that the

sharp decrease in 1965, and 1973-74 was not due to a decrease in deposits but instead was due to a sharp increase in GDP or liquidity. For instance, GDP increased from 1,169 billion rials in 1972 to 1,707 billion rials and 2963 billion rials in 1973 and 1974 respectively. Also, liquidity increased from 400 billion rials in 1972 to 515.8 billion rials and 810.1 billion rials in 1973 and 1974 respectively. This increase was due to a sharp increase in oil prices and the government's injection of a lot of oil dollars into the economy, which led to an increase in these two items.

Column 7 shows the ratio of the deposits to liquidity at the current price. This ratio was much better than in the early years. As we can see in Table 6.5 this ratio was 71.14% and continued to grow during the years 1962-1978, reaching 98% in 1976, but it decreased to 68.84% in 1978. This reduction was due to demonstrations in support of the Islamic Revolution. At that time banks, as examples of non Islamic institutes, were attacked by people who did not believe in them. The growth rate during this period was very slow and with fluctuation. The average growth rate was 1.55% during the years 1962-1978.

Table 6.5: Deposits and GDP at the Current Prices, Liquidity, the Ratio of Deposits to the GDP and Liquidity and their Growth Rates during 1962-1978.
. (Iranian Rials Billion and Percentage)

Year	D CU P	GDP	M2	D CU P/ GDP	GR* %	D CU P/ M2	G R* %
1962	48.8	342.00	68.6	14.27	---------	71.14	----------
1963	58.9	356.00	81.5	16.54	15.9	72.27	1.59
1964	68.2	388.00	92.3	19.21	15.76	73.89	2.24
1965	80.1	441.00	105.5	18.16	-5.02	75.92	2.75
1966	93.3	476.00	120.7	19.6	5.94	76.47	0.72
1967	113.5	528.00	144.3	21.5	9.69	78.66	2.86
1968	141.2	599.00	175.3	23.57	5.1	80.55	2.4
1969	168.6	672.00	205.7	25.09	6.45	81.96	1.75
1970	194.8	751.00	235.7	25.94	3.39	82.65	0.82
1971	246.8	941.00	269.3	26.23	1.12	91.64	10.86
1972	333	1169.00	400	28.49	8.62	83.25	13.61
1973	429.4	1707.00	515.8	25.15	-13.16	83.25	0.0
1974	678.9	2962.00	810.1	22.92	-8.87	83.8	0.66
1975	963.3	3268.00	1145.5	29.48	28.62	84.09	0.35
1976	1344.3	4391.00	1371.7	30.61	3.83	98	16.54
1977	1771.5	5111.00	2097	34.66	13.23	84.48	-13.82
1978	1775.1	4987.00	2578.6	35.59	2.68	68.84	-18.51
average	----------	---------	----------	24.53	5.83	80.64	1.55

Sources: 1- Economic Statistic Office of Central Bank and its Reports and Balance Sheets for years 1989-2002.
D CU P = Deposits at the current Prices. GDP = Gross Domestic product. M2 = Liquidity
G R =Growth Rate. *Calculated by researcher

6.4.2 Deposits and Credits Trend after the Islamic Revolution (1979-88)

6.4.2.1 Deposits and credits trend

The first decade after the Islamic revolution was extremely difficult because of a lack of discipline and some tribal and ethnic intrigues in some parts of the country such as Kordestan, Azarbaijan, Torkamanistan and so on during the first two years and the eight-year war which was started by Saddam Hussein against the Islamic Republic of Iran. So in those ten years the economy was a war economy and the situation was unusual. Therefore, this period requires special analysis which is not related to our subject, although a brief review of the trend of deposit and credit facilities for this period would be useful. Table 6.5 illustrates the trends.

As Table 6.6 shows, in the first year after the Islamic Revolution deposits increased significantly at both current and constant prices. Deposits at the current price increased from Iranian Rials 1,771.5 billion in 1978 to Iranian Rials 2,622.1 billion in

1979 which shows a growth rate of 47.1%. Also deposits in the constant 2004 price increased from Iranian Rials 186852.63 billion in 1978 to Iranian Rials 247367.92 billion in 1979 which shows a growth rate of 32.39%. When one considers that people were very hostile toward banks during their struggle against the Shah's Regime in 1977-8 and attacked them during their demonstrations, this increase becomes more meaningful. It could mean that there were a lot of people who did not believe in interest-based banks, but after the Islamic Revolution and the elimination of *riba* by the Revolutionary Council, the people began to trust the banks and to deposit their savings in them.

Table 6.6: Deposits and Credit Facilities at the Current and Constant 2004 Prices and their Growth Rate (percent) of Private Sector (Iranian Rials Billion)

year	CPI	D CU P	G R* %	D CO P*	G R* %	C CU P	G R* %	C CO P*	G R* %
1979	1.06	2622.1	47.6	247367.92	32.39	2577.4	17.2	243150.94	5
1980	1.31	3276.9	25	250145.04	1.12	3060.4	18.7	233618.32	-3.92
1981	1.61	3828	16.8	237763.97	-4.95	3219.5	5.2	199968.94	-14.4
1982	1.92	4733.1	23.6	246515.62	3.68	3484.9	8.2	181505.21	-9.23
1983	2.20	5600.6	18.3	254572.72	3.27	4256.6	22.1	193481.81	6.6
1984	2.43	5918.3	5.7	243551.44	-4.33	4500.7	5.7	185213.99	-4.27
1985	2.60	6825.8	15.3	262530.77	7.79	5081.9	12.9	195457.69	5.53
1986	3.21	8080.2	18.4	251719.63	-4.12	5578.4	9.8	173781.93	-11.09
1987	4.10	9685.6	19.9	236234.15	-6.15	6348.5	13.8	154841.46	-10.9
1988	5.29	12242	26.4	231417.77	-2.04	7479.2	17.8	141383.74	-8.7
average	------	6281.3	21.7	246182.5	2.67	4558.75	13.14	190240.4	-4.54

Source: Economic Statistic Office of Central Bank and its Reports and Balance Sheets.

CPI=customer price index. D CU P = Deposits at the current Prices.

D CO P = Deposits at the constant Prices. C CU P = Credit at the current Prices.

C CO P = Credit at the constant Prices. G R = Growth rate. * Calculated by researcher

Although, credits increased after the Revolution, their increase was not as much as deposits. Credit at the current price increased from Iranian Rials 2,199 billion in 1978 to Iranian Rials 2,577.4 billion in 1979 which shows a growth rate of 17.5%. At the constant 2004 price, the credit increased from Iranian Rials 231,473.68 billion in 1978 to Iranian Rials 243,150.94 billion in 1979 which shows a growth rate of just 5%. In that decade there was a negative growth rate in credit at the constant 2004 price for most years (-3.92%, -14.4% , -9.23%, -4.27%, -11.09%, -10.9% and -8.7% for 1980, 1981, 1982, 1984, 1986,1987, and 1988 respectively). This could be due to several

factors which could have affected the demand for credit or could have limited credit. The first was the war between Iran and Iraq.

During the war the country faced stagflation which is stagnation with inflation. Stagnation causes a decrease in investment which leads to a decease in demand for credit on the one hand and inflation causes decreasing real value of credits which, despite an increase in nominal amounts, in terms of real value shows a decrease. Another reason which is related to the war is government expenditure with regard to war expenses. A lot of credit was allocated to war expenditure by the government which was covered by bank borrowing. Secondly, there was a kind of fluctuation and uncertainty which is usually seen in revolutions.

6.4.2.2 Ratio of deposits to GDP and liquidity

Table 6.7 shows the ratio of deposits to GDP and liquidity and their growth rates during 1979-1988. This period is an important part of Iran's history in recent centuries when its political system completely changed. In addition, as mentioned before, a lot of unsuccessful armed movement revolt took place and less than two years after the Islamic Revolution a destructive war was started by Saddam Hussein against the Islamic Republic of Iran which lasted about eight years. So despite the importance of this part of Iran's history, the country's economic performance was not satisfactory.

Of course, regarding banking activities the situation is different because, after the Islamic Revolution religious people, who did not accept conventional banks, started to work with banks when *riba* was eliminated. As we can see in Table 6.8 a considerable increase occurred in the growth rate of the ratio of deposits to GDP in the year after the victory of the Islamic Revolution and went from -2.02% in 1979 to 41.53% in 1980. Of course, it is worth mentioning that all of this increase in growth rate is not only due to an increase in deposits, but also to a decrease in GDP in that year. GDP decreased from Iranian Rials 7,521 billion in 1979 to Iranian Rials 6,641 billion in 1980. After the war there were some fluctuations regarding the process of the ratio, but in overall the movement was increasing. At the end of this period the ratio reached from 34.864% in 1979 to 62.478% in 1988 and its average during those years was 49.055%.

The trend of the ratio of deposits to liquidity was not as much as the ratio of deposits to GDP. The reason mainly was increase in liquidity. During these years, the government continually increased liquidity in order to cover the war expenses. For example, in 1980, 1984 and 1986, despite an increase in deposits, the growth rate of ratio of deposits to liquidity was negative. In these years the growth rates were -1.588%, -0.329% and -0.617% respectively. However, the trend was positive and the ratio went from 73.9% in 1979 to 78% in 1988.

Table 6.7: Deposits and GDP at the Current Prices, Liquidity, the Ratio of Deposits to the GDP and Liquidity and their Growth Rates during 1979-1988.
. (Iranian Rials Billion)

Year	D CU P	GDP	M2	(D CU P/ GDP)% *	GR* %	(D CU P/ M2) %*	G R* %
1979	2622.1	7521	3550	34.864	-2.04	73.861972	7.295
1980	3276.9	6641	4508.1	49.343	41.53	72.68916	-1.588
1981	3828	7396	5236.1	51.758	4.894	73.107847	0.576
1982	4733.1	10807	6430.7	43.797	-15.381	73.60163	0.675
1983	5600.6	13075	7514.4	42.834	2.199	74.531566	1.263
1984	5918.3	13675	7966.9	43	1.037	74.286109	-0.329
1985	6825.8	13838	9002.1	49.326	13.975	75.82453	2.071
1986	8080.2	14468	10722.6	55.849	13.224	75.356723	-0.617
1987	9685.6	16902	12668.2	57.304	2.605	76.456008	1.459
1988	12242	19594	15687.6	62.478	9.029	78.036	2.066
Average	----------	----------	----------	49.055	7.107	74.775	1.287

Sources: 1- Economic Statistic Office of Central Bank and its Reports and Balance Sheets for years 1989-2002.

D CU P = Deposits at the current Prices. M2 = Liquidity.

GDP = Gross Domestic product. G R =Growth Rate.

*Calculated by researcher.

6.4.3 Deposit and Credit Trends following the Islamic Revolution (1989-2006)

6.4.3.1 Deposit trends

In 1989, the war between Iran and Iraq officially ended and Iran started to be rebuilt, especially the cities which had been damaged or destroyed by the Iraqi army. As mentioned in Chapter Four, the First Economic, Social and Cultural Development Plan of the Islamic Republic of Iran started in that year, President Hashemi Rafsanjani's cabinet, started a vast range of rebuilding in all parts of the country. For this purpose, an expansionary monetary and fiscal policy was put in place. In this new

situation the banking system was able to play an important role in economic development, so this period is the main period discussed in this research.

As Table 6.8 shows, in 1989 the banking system was able to mobilise 15,108.5 billion Iranian Rials at the current price and 243,290.08 billion Rials at the constant 2004 price. The growth rate of deposits in that year was 23.4% and 5.13% at the current price and constant price respectively. It is worth mentioning that there was a relatively high fluctuation in constant price deposits. For example, while there was a positive trend in the growth rate of current price deposits, the growth rate of constant price deposits was negative in several years and very low in some years.

Table 6.8: Deposits and Credit Facilities at the Current and Constant 2004 Prices and their Growth Rate (percent) of Private Sector. (Iranian Rials Billion)

Year	CPI	D CU P	G R*%	D CO P*	G R*%	C CU P	G R*%	C CO P*	G R*%
1989	6.21	15108.5	23.4	243290.08	5.13	9696.5	29.7	156143.32	10.44
1990	6.77	18850.2	24.8	278437.22	14.45	13156.9	35.7	194341.21	24.46
1991	8.17	24148.5	28	295575.27	6.16	18297.3	39.1	223957.16	30.68
1992	10.17	30506.7	23	299967.55	1.49	23589.8	28.9	231954.77	3.57
1993	12.48	41303	35.4	330953.53	1.03	30775.6	30.5	246599.36	6.31
1994	16.88	53148.2	28.7	314859	-4.86	36447.2	18.4	215919.43	-12.44
1995	25.21	74339.2	39.9	294879.81	-6.34	38779.9	6.4	183827.45	-14.86
1996	31.07	103336.5	39	332592.53	12.79	50312.6	29.7	161933.05	-11.91
1997	36.44	118906	15.1	326306.26	-1.89	59362.3	18	162904.23	0.6
1998	43.03	141628.4	19.1	329138.74	0.87	76353.2	28.6	177441.76	8.92
1999	51.68	170569.9	20.4	330050.12	0.27	108123.9	41.6	209218.07	17.91
2000	58.20	223952	31.3	384797.77	16.59	142909.9	32.17	245550	17.37
2001	64.83	291769	30.28	450051.67	16.96	192710.7	34.85	297255	21.1
2002	75.06	382744	31.18	509917.4	13.3	265070.3	37.55	353145	18.8
2003	86.79	487864	27.46	562120.1	10.24	372868.2	40.68	429621	21.66
2004	100	641095	31.41	641095	14.05	515287.9	38.2	515288	19.94
2005	110.35	870344	35.76	788712.28	23.03	722046.7	40.12	654324	26.98
2006	123.45	1222748	40.49	990480.36	25.58	1023029	41.68	828699	26.65
Average	-------	272908.94	29.15	427956.93	8.45	205489.88	31.77	304895.7	12.01

Sources: 1- Economic Statistics Office of Central Bank and its Reports and Balance Sheets for years 1989-2002.

2- Performance of Iran's banking system during years 2005 and 2006 for 2003-2006.

CPI= Customer Price Index

D CU P = Deposits at the current prices. D CO P = Deposits at the constant prices.

C CU P = Credit at the current prices. C CO P = Credit at the constant prices.

G R = Growth rate * Calculation of the researcher

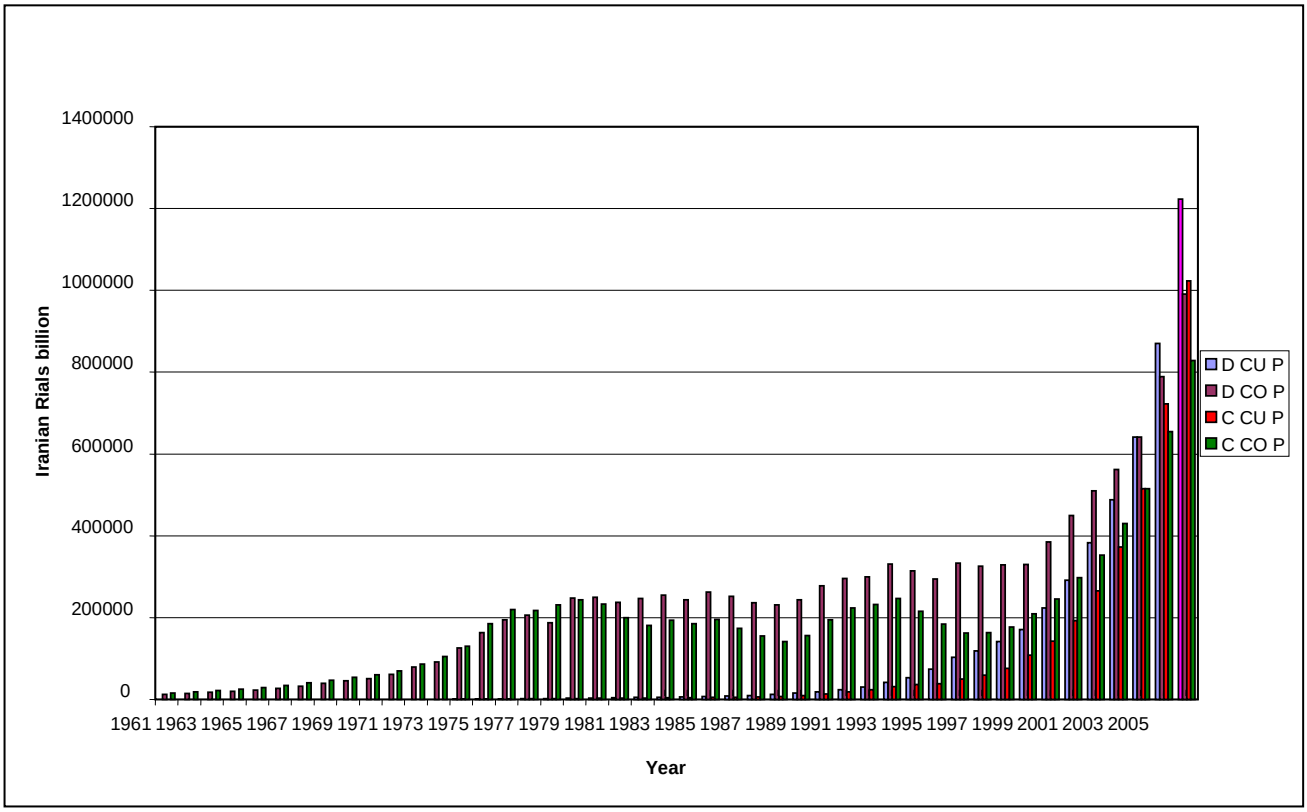
As can be seen in Table 6.8 the growth rates in 1998 and 1999 were just 0.87% and 0.27% respectively and were negative in 1994, 1995 and 1997. From 2000 until 2006

an acceptable increase in both current and constant price deposits took place. The main reason for the low or negative growth rate in 1992-1995 was the high inflation rate which caused the constant price figures to fall. For instance, the inflation rate in those years was 24.5%, 22.71%, 35.26% and 49.35% respectively. For 1997-1999, the reason was different. In that period, in addition to the inflation rate, there was a reduction in the growth rate of current price deposits. As Table 6.3 indicates their growth rate decreased from 39% to 15.1% in 1997. Consequently, the growth rate of constant price deposits decreased from 12.79% in 1996 to -1.89% in 1997 and increased to 0.87% and 0.27% in 1998 and 1999 respectively.

President Hashemi Rafsanjani's economic team (especially Dr Noor Bakhsh and Dr Adeli) believed in liberalization of the economy and Kuznets theory which suggests that in the first stages of economic development increased inequality should be accepted because in the following stages inequality will automatically decrease. Despite the rejection of this theory in Iran by several research projects which were carried out in Iranian universities during President Hashemi Rafsanjani's era, this thought was dominant in Iran's economy. As a consequence, Iran's economy faced a high inflation rate which led to economic pressure on the poor.

President Rafsanjani thought his most important duty was to rebuild that which had been damaged during the war and also erase the backwardness of the other parts of the country. Despite his belief in economic and social justice, he said that it was a time not to think about justice but about our duty to the future. He and his economic team believed that thinking about income distribution meant thinking about poverty distribution. He believed we should create wealth first and then think about its distribution, so he started rebuilding and executing expansionary policies. The main problem was twofold. First, he did not determine how many years would be needed to redistribute income and decrease inequality. Second, he did not consider carefully the endurance of the people. Contrary to so much of the work done by President Rafsanjani, like the rebuilding of many cities and villages and the strengthening of the economy, the consequence was that the majority of people were dissatisfied by the end of his time.

Figure 6.8 Deposits and Credits at the Current and Constant Prices 2004 during 1961-2006



Source: Tables 6.4, 6.6 and 6.8.

D CU P = Deposits at the current Prices. D CO P = Deposits at the constant Prices.

C CU P = Credit at the current Prices. C CO P = Credit at the constant Prices.

There were some economists who believed that Kuznetz's hypothesis was not suitable for Iran. They argued about human capital and its role and contribution to the economic development which suffered from inequality and poverty. Also, some Islamic scholars disagreed with President Rafsanjani's economic and cultural policies. They articulated the idea of economic justice, especially with regard to the Islamic point of view which emphasizes justice. President Rafsanjani was very strong in speaking and rationalising, so he usually convinced criticisers that there was no other way to build the country quickly. During these discussions Ayatollah Khamenei intervened and asked President Rafsanjani to modify the Second and Third Economic, Social and Cultural Development Plans in favour of justice and the poor. In this regard a working party, including some ministers and members of parliament was formed to try to modify the two plans. Due to these adjustments, despite huge investment in that period in the economic substructures (such as electricity, ports,

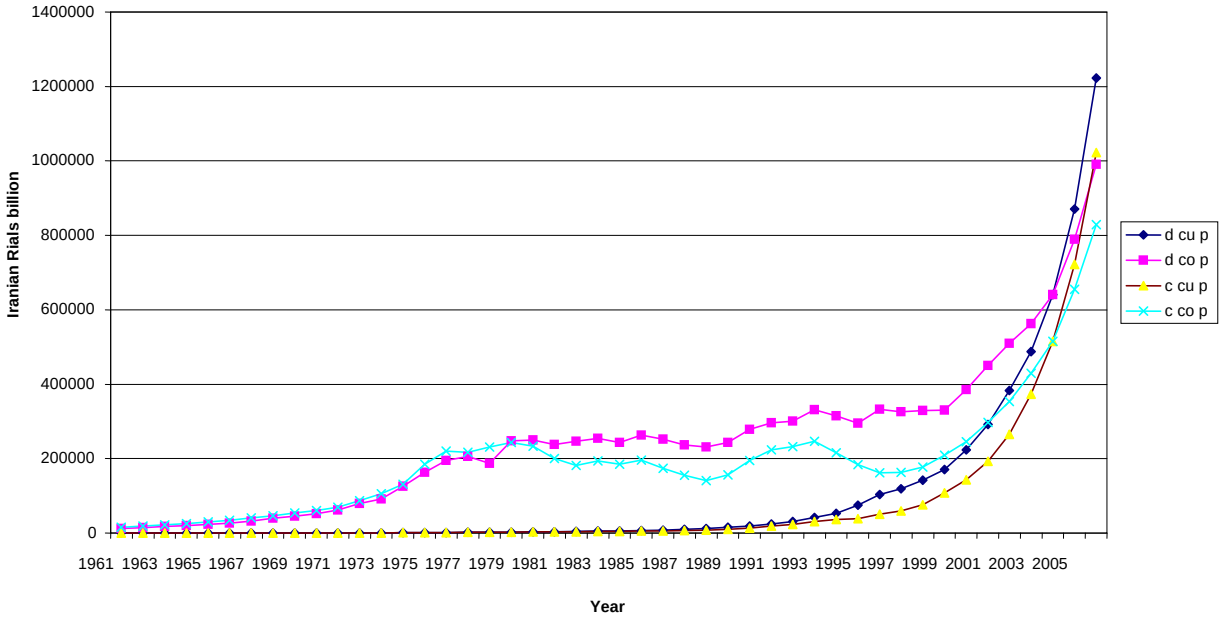
highways, railways, etc) and the existence of high inflation which was caused by expansionary policies and increase of liquidity having a negative effect on the poor, those living below the poverty line decreased from 47% in 1979 to 21% in 1997.

There was one important political change in Iran in 1997 which strongly affected the economy. In that year president Sayyed Mohammad Khatami was selected as President of the Islamic Republic of Iran. His team, who were known as reformists, did not believe that economic activities were a priority for the Islamic Republic of Iran. They concentrated on political development much more than economic development. Some of them even openly stated that Iran's problems were not economic but political. Despite economic problems, such as inflation and unemployment, they really neglected economic problems for the first three years. The consequence of their policy in mobilisation of monetary resources which led to a decrease in the deposit growth rate can be seen in Table 6.6. The growth rate of deposits at the constant prices for years 1997-1999 was -1.89%, 0.84% and 0.24% respectively. However, during1989-2006, average deposits were 272,908.94 billion Rials and 427,956.93 billion Rials at current and constant prices respectively.

In comparison with the 1961-1978 period Tables 6.4 and 6.6 show that, on average, yearly nominal deposits after the Islamic Revolution and the implementation of the Islamic banking system in Iran (between 1989-2006) were 575 times more than those of the 1961-1978 periods. Even in terms of real value the average deposits mobilised at the constant price during 1989-2006 were 5.54 times more than the 1961-1978 period. Thus, in terms of mobilization of resources, Iran moved toward becoming a modern economy. The difference can be clearly seen in Figures 6.8 and 6.9.

In conclusion, in a comparative discussion, it could be said that the interest-free banking system was more successful than the interest-based banking system in mobilising and allocating monetary resources and consequently in the contribution to economic development. Of course, to be more accurate it is necessary to consider some effective factors which are assumed to be constant but which are not, such as GDP and liquidity.

Figure 6.9. Trend of Deposits and Credits at the Current and Constant 2004 Prices during 1961-2006



Source: Tables 6.4, 6.6 and 6.8.

d cu p = Deposits at the current Price. d co p = Deposits at the constant Price.

c cu p = Credit at the current Price. c co p = Credit at the constant Price.

6.4.3.2 Ratio of deposits to GDP and liquidity

Table 6.9 shows the trend of the ratio of deposits to GDP and liquidity at the current prices during the 1989-2006. As this table shows, the ratio of deposits to GDP at the current prices went from 35.59% in 1978 to 60.24% in 1989. This means that during the years 1979-1988 on average this ratio grew 2.5% per year but after that there were several years of negative growth rate. For instance, during the years 1990-1995 the growth rate of ratio of deposits to GDP was negative. Of course, the reason may be the relatively sharp increase in nominal GDP and inflation. During these years deposits experienced a relatively high growth rate. In 1990-1995, the deposit growth rate was 25.77%, 28.11%, 26.33%, 35.39%, 28.38% and 39.89% respectively. During the same period nominal GDP growth rate was 37.59%, 45.35%, 33.19%, 55.23%, 31.61% and 42.82% respectively.

It is worth mentioning here that in those years the country experienced its highest inflation rate which was not related to the Islamic banking policy or its nature, but

instead was related to the expansionary monetary and fiscal policies made by the government for rebuilding war damaged and under-developed areas which was one of the Islamic Revolution's goals. However, the inflation rate during the years 1990-1997 was: 9%, 20.68%, 24.48%, 22.71%, 37%, 49%, 23% and 17% respectively and increased from 9% in 1990 to 49% in 1995[33].

Table 6.9: Deposits and GDP at the Current Prices, Liquidity, the Ratio of Deposits to GDP and Liquidity and their Growth Rates (1989-2006)

(Iranian Rials Billion)

year	D CU P	GDP	M2	(D CUP/ GDP)%*	G R* %	(D CUP/ M2) %*	G R* %
1989	15108.5	25079	18753.3	60.24	----------	80.56	----------
1990	18850.2	34506	22969.5	54.63	-9.31	82.07	1.87
1991	24148.5	48428	28628.4	49.87	-8.71	84.35	2.78
1992	30506.7	64502	35866	47.3	-5.15	85.06	0.84
1993	41303	100124	48135	41.25	-12.79	85.81	0.88
1994	53148.2	131771	61843.9	40.33	-2.23	85.94	0.15
1995	74339.2	188184	85072.2	39.5	-2.06	87.38	1.67
1996	103337	248972	116552.5	41.5	5.06	88.66	1.46
1997	118906	291769	134286.3	40.75	1.81	85.89	-3.12
1998	141628	328522	160401.5	43.11	5.79	88.3	1.2
1999	170570	434385	192689.2	39.27	-8.91	88.52	0.25
2000	223952	576493	249110.7	38.85	-1.07	89.9	1.56
2001	291769	664620	320957.2	43.9	13	90.91	1.12
2002	382744	917035	417524	41.74	4.92	91.67	0.84
2003	487864	1095303	526596.4	44.54	6.71	92.64	1.06
2004	641095	1384819	685867.2	46.29	3.93	93.47	0.09
2005	870344	1691814	921019.4	51.44	11.13	94.5	1.1
2006	1222748	2038432	1284199.4	59.98	16.6	95.21	0.75
Average	---------	---------	----------	45.805	1.1	88.84	0.85

Sources: 1- Economic Statistic Office of Central Bank and its Reports and Balance Sheets for years 1989-2002.

2- Performance of Iran's banking system during years 2005 - 2006 for years 2003-2006.

D CU P = Deposits at the current Prices.

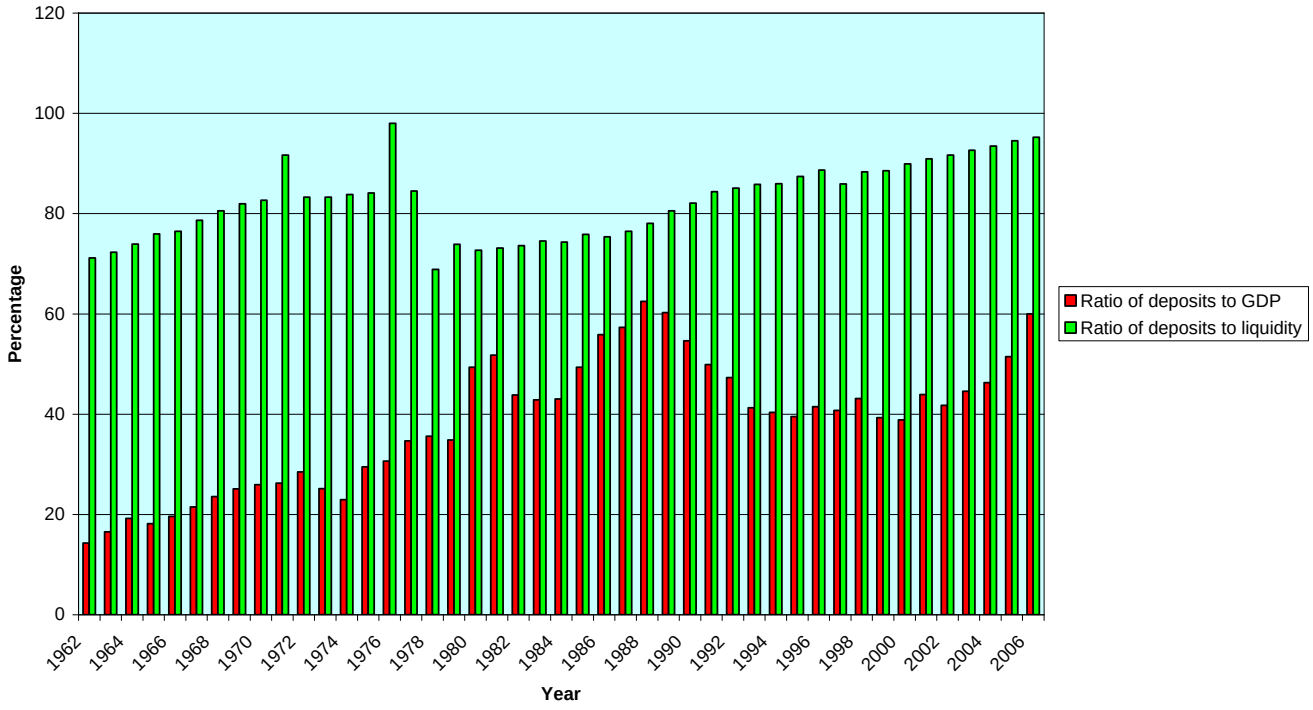
* Calculated by researcher

In comparison with the 1962-1978 period, as we can see in Tables 6.5, 6.7, and 6.9, and also in Figure 6.10, the performance of the banking system during the years 1979-1988 and 1989-2006 was relatively satisfactory because, despite there being 35

[33] Calculated from Table 6.8.

domestic and foreign banks at that time, the average ratio of deposits to GDP was 24.53%, while during years 1979-1988 and 1989-2006 it was 49% and 45.8% respectively which shows an increase of about 100%. However, regarding the ratio of deposits to liquidity the average ratio for 1962-1978, 1979-1988 and 1989-2006 was 1.55%, 1.287% and 0.88%. The reason for the low ratio during those years, especially the 1989-2006 period was probably a high growth rate of liquidity and depositing behaviour of people which is somewhere steady and do not respond to shocks rapidly. In addition, encouragement of consumerism culture even by government can be counted as one reason.

Figure 6.10. Ratio of deposits to GDP and liquidity



Source: Tables 6.5, 6.7 and 6.9.

6.4.3.3 Sight deposits (current accounts)

Sight deposits (current accounts) are used mainly for facilitating exchange activities and usually no interest rate is charged. The account holders do not think about revenue in these accounts so they are highly profitable for the banks which are able to use the deposits for profitable projects. From an economic development perspective they are similar to short-term investment deposits which depositors can withdraw in

the short term. So the banking system should be careful in their usage of long-term credit facilities.

Long term investment deposits in the Iranian banking system, range from one year investment deposits to five years. These deposits are more suitable for financing long-term projects and therefore are more useful for economic development. The profitability of these deposits differs according to the duration. There are two reasons for this difference. First: the ability of the bank to allocate these deposits to long term projects which may be more profitable. Second: discount given by banks on their lawyer's fee for these deposits. In Islamic banking in Iran, the bank is the agent of the depositor therefore they get a lawyer's fee from the depositor. The amount is determined in their contract. In order to encourage people to make long-term deposits, the banks are able to discount their lawyer's fee for this type of deposit.

Qardh-Al-Hasanah deposits are like sight deposits without profit, but are different in the motives of depositors. As mentioned before, while the motive of depositors in sight deposits is to facilitate exchange activities, it is benevolence and charity in *Qardh-Al-Hasanah* in that the interest does not go to the account holder.

As Table 6.10 shows, in 1989 the share of sight deposits was greater than that of total deposits, followed by short term investment deposits, long term investment deposits and *Qardh-Al-Hasanah*, but the trend was to the benefit of long term investment Deposits which are very effective for increasing economic growth. The amount of sight deposits, short term investment deposits, long term investment deposits and *Qardh-Al-Hasanah* was 5,342.4, 5,245.2, 2761.6 and 1,280.6 billion rials respectively in 1989, but this amount reached 353,093.3, 353,666.8, 353433.7 and 133,522.4 billion rials respectively in 2006. This shows that short term investment deposits occupied first place and then long term investment deposits, sight deposits and *Qardh-Al-Hasanah* respectively. The average amount and growth rate of long term investment deposits was more than other deposits during the period under review. This change is to the benefit of economic development.

Table 6.10: Sight Deposits and Non-Sight Deposits at the Current Prices and their Growth Rate (1989-2006) (Iranian Rials Billion)

Year	Sight Deposit	G R*	S I D	G R*	L I D	G R*	Q H	G R*	Other D	G R*	N P b & N B C I	G R*
1989	5342.40	_____	5245.20	_____	2761.60	_____	1280.60	_____	478.70	_____	_____	____
1990	7075.90	32.45	5945.10	13.34	3749.60	35.78	1392.30	8.72	687.30	43.58	_____	____
1991	9060.90	28.05	6809.90	14.55	4929.70	31.47	1868.60	34.21	1379.40	100.70	_____	____
1002	11009.30	21.5	8115.80	19.18	6530.90	32.48	2441.00	30.63	2409.70	74.69	_____	____
1993	15580.70	41.52	10303.90	26.96	8748.80	33.96	2683.10	9.92	3986.50	65.43	_____	____
1994	21731.20	39.47	12084.30	17.28	10432.60	19.25	3494.70	30.25	5400.50	35.47	_____	____
1995	30294.30	39.4	15033.30	24.40	13383.60	32.29	4616.30	32.09	11071.70	105.01	_____	____
1996	43055.80	42.12	19051.10	26.73	16796.00	25.5	6039.10	30.82	18394.50	66.14	_____	____
1997	47923.50	11.3	24289.70	27.50	22814.10	35.83	8693.20	43.95	15185.60	-17.44	_____	____
1998	56011.30	16.88	32046.00	31.93	30383.10	33.18	12420.00	42.87	10768.00	-29.09	_____	____
1999	64631.70	15.39	39564.00	23.46	39968.00	31.55	16296.00	31.20	10110.20	-6.12	206.0	____
2000	89262.20	38.11	50442.80	27.50	52920.80	32.41	22014.40	35.09	9312.20	-7.89	437.1	112.18
2001	113768.0	27.44	66983.00	32.79	74083.50	39.99	29847.50	35.58	7086.60	-56.88	1093.3	150.13
2002	147872.6	29.98	88452.60	32.05	97409.80	31.49	38108.00	27.67	10900.90	53.82	3990.5	265
2003	178624.3	20.74	119809.0	34.45	131929.2	35.44	45706.00	19.94	11795.40	8.20	17175.5	330.41
2004	208043.1	16.47	159867.9	33.43	189281.4	43.47	69806.20	52.73	14096.60	19.51	48607.8	183.01
2005	267243.8	28.45	223291.6	39.67	266401.6	40.74	93230.10	33.55	20176.70	43.13	104086.3	114.13
2006	353093.3	32.12	353666.8	58.39	353433.7	32.67	133522.4	43.22	29031.60	43.89	163946.1	57.51
Average*	19616.29	28.32	68944.56	28.45	73664.33	33.38	27414.42	31.91	10126.23	31.89	42442.83	173.2

Sources: 1- Economic Statistics Office of Central Bank

2- Reports and balance sheets Iranian Central Bank (Bank Markazi) for different years

S I D = Short Term Investment Deposits

L I D = Long Term Investment Deposits

Q H = *Qardh-Al-Hasanah*

Other D = other Deposits

N P b & N B C I = Non public banks and Non- bank credit institutions

* Calculated by researcher

It should be noted that one change in the Iranian Banking system took place in 1999. In that year, private banks and non-bank credit institutions were established. As can be seen in Table 6.10, these banks received just 206 billion Iranian Rials in deposits in 1999, but their growth rate was very fast. For instance, their deposits reached 163,946.1 billion Iranian Rials in 2006 and their average growth rate was 173.2% during 1999-2006. However, private banks can play an important role in economic development.

Private banks in the Islamic Republic of Iran brought with them a new culture of behaviour with clients. They respected their customers more than state-owned banks and also paid more profit to depositors because they did not face some of the restrictions faced by state-owned banks. In general there are several factors which can affect the success of private banks in Iran compared with state-owned banks which can lead to the expansion of private banks including:

a) Being New: Because they are new, they can employ more educated and efficient staff and they are also able to employ according to their needs. They do not have many branches because that would increase their costs. For example, the numbers of their branches are between 80 and 90. Pasargahad, Eqtesade Noawin and Parsiyan have 210,225 and 200 branches respectively.

b) Freedom of Managers in Decision Making: While private banks are free to use their sources wherever they want, in contrast, state-owned banks cannot do that. There are two kinds of contract in Islamic banking: Barter or exchange contracts and partnership contracts. In barter contracts, such as *joaalah*, *salam* and *ijarah*, the profit rate can be determined in advance. In contrast, in partnership contracts this rate cannot be determined in advance, only the expected minimum profit rate can be determined.

The Iranian Money and Credit Council usually determines a minimum and maximum range of profit rate for state-owned banks but recommends that private banks do not exceed these rates by more than 2%. It is worth mentioning that these rates are fixed for barter contracts and expectable minimum profit rate for partnership contracts. During periods of inflation, when the inflation rate is, for example, 25% a financial facility with 12% is not only free but is also subsidized. Furthermore, in this situation, people should not be expected to repay their debts, because even after paying a penalty the rate becomes 18% which is lower than the rate of inflation.

Consequently, private banks have shifted from barter contracts to partnership contracts for which the rate of profit depends on the real profit in the economy. In contrast, state-owned banks have not been allowed to do that so their profit rate is much lower than that of private banks on one hand and their delayed claims are higher than private banks on the other hand.

c) Motivation: Motivation among private bank staff, especially in high-level management, is much higher than in government-owned banks because they are encouraged by high profits. Also, salaries in private banks are higher than in state-owned banks.

d) Evaluation: Evaluation in government-owned banks is very slow. It takes a long time to recognize that special banks or banking systems in general have not been successful or have weaknesses. In contrast, in private banks, this is discovered very quickly because private banks have an annual general meeting at which they have to report their financial operations, including profit and loss. Moreover, in some banks such as: Eqtesade Noawin (New Economy), Kar Afarin (Work Creator), Saman, Parsiyan (Persians) and Sarmayeh (Capital), their major shareholders are members of the directorate so they are made aware of the financial operations on a weekly basis. According to this information they are able to control operations very quickly and easily.

e) Progressiveness: Private banks are frontrunners in many aspects, especially in electronic banking; and due to their efficiency they have better opportunities to grow.

f) Quickness in decision making: Private banks are speedier than state-owned banks. For example, decision making for a purchase may take two days in private banks, while, it may take more than one month in state-owned banks, due to heavy bureaucracy.

6.4.3.4 Trend of credit facilities

The allocation of resources to all economic sectors was 9,697.5 billion Rials at the current price and 156,143.32 billion Rials at the constant 2004 price in 1989. It reached 1,023,026 billion Rials at the current price and 828,699.1 billion Rials at the constant price in 2006. The average at the current and constant prices during 1989-2006 were 205,489.88 billion Rials and 304,895.66 billion Rials respectively. The maximum increase at the current price was in 2006 when it reached 41.68% and the minimum was in 1995 when the growth rate was just 6.4%. In terms of constant prices, the maximum and minimum were in 1991 and1995 which amounted to 30.68% and -14.86% respectively.

In comparison with the 1961-1978 periods, the average amount of allocated resources at the current and constant prices during the 1979-2006 period was 247.48 times and 2.98 times more than those of the 1961-1978 period respectively. By combining Tables 6.6 and 6.8 it can be seen that, the growth rate of resource allocation at the constant prices during 1994-1997 was negative or very small (0.6%). The reason could be the high inflation rate which would affect the values at the constant prices on one hand and decrease of nominal credit growth rate on the other hand. As can be calculated from the second column, the inflation rates for 1994-1997 were 37%, 49%, 23% and 17% respectively.

Table 6.11: Allocation of Resources to the Economic Sectors (Services and Agriculture) by Banking System (1989-2006) (Iranian Rials Billion)

Year	T F	Serv	Share*	G R* %	AG	Share*	G R*%
1989	9697.5	1971.8	20.3331	----------	1691.2	17.4395	----------
1990	13156.9	2557.9	19.4415	-4.385	2133.8	16.2181	-7.0036
1991	18183.3	3234.5	17.7872	-8.5348	2949.1	16.21873	0.0039
1992	23465.7	3983.9	16.97538	-4.5372	3656.8	15.5816	-2.51
1993	30574.8	5108.9	16.70951	-1.5662	4862.9	15.90493	2.0751
1994	37719.8	6395.2	16.95449	1.4661	6041.5	16.01679	0.7033
1995	38779.9	6735.4	17.36828	2.4406	7286.4	18.78911	17.3088
1996	50312.6	8938.9	17.76672	2.2941	9586.8	19.05447	1.4123
1997	59362.3	10839.6	18.26007	2.7768	12066	20.32603	6.6733
1998	76353.2	14376.4	18.82881	3.1147	15157.2	19.85143	-2.3349
1999	108123.9	22422.4	20.73862	10.1430	22621.9	20.9222	5.3939
2000	142910	30765.3	21.52774	3.8195	29653.5	20.74977	-0.8241
2001	192710.7	42438	22.02161	2.2941	37468	19.44262	-6.2996
2002	265070.3	60893.9	23.97274	8.8601	50243.4	18.95475	-2.5093
2003	372868.2	92758.6	24.9	3.8680	63061.7	16.9	-10.8403
2004	515287.9	138805.3	26.9374	8.1715	82763.8	16.0617	-4.96
2005	722046.7	212952.1	29.4928	9.4864	112203.8	15.5397	-3.25
2006	1023029	332426	32.4943	10.177	160192.4	15.6586	0.7651
Average	----------	55422.45	21.2506	2.9346	34646.68	17.7572	-0.3645

Sources: 1- Economic Statistics Office of Central Bank

2- Reports and balance sheets Iranian Central Bank (Bank Markazi) for different years

T F = Total facilities Serv= Services including trade AG = Agriculture G R = Growth rate

*Calculated by writer Note: All shares and growth rates are in percent

Although allocation of resources to all economic sectors positively affects economic development, some sectors are more important than others. This means that the banking system can play an important role in economic development through the allocation of resources to productive sectors rather than consumption sectors and also to more efficient projects rather than less efficient one. Tables 6.11 and 6.12 demonstrate the quality of financing different economic sectors.

a) **Services** (including trade)

From 1989 to 1996 allocation of resources to the service sector was showing a decreasing trend. As can be seen in Table 6.11 and Figure 6.11 the share of the facilities allocated to the services from total facilities was 20.33% in 1989 but it decreased to 17.7667% in 1996. In 1997 it increased to 18. 26% and continued to grow until it reached 32.49% in 2006.

As Figure 6.12 shows, the growth rate in the share of services from allocation of resources in 1990-1993 was negative but in 1994 it became positive and this trend continued until the end of the period. The maximum share and growth rate was in 2006 when it reached 32.4943% and 10.177% respectively and the minimum share and growth rate was in 1993 and 1991 respectively when the former was 16.70951% and the latter was –8.5348%. The average share and growth rate of total credit facilities allocated to service activities were, 55422.45 billion Rials, 21.25% and 2.9346% respectively (Table 6.11).

b) **Agriculture**

After the Islamic Revolution in Iran agriculture was the main priority as it provided the population's basic needs and also the country did not have an industrial base. For this reason it would be expected to occupy a relatively considerable share of credit facilities for at least several years. In 1989 about 1691.2 billion Rials was allocated by the banking system to the agricultural sector which was 17.4395% of all credit facilities allocated to the economic sectors in that year. Despite a regular increase in the amount of credit allocated to this sector, its share in total credit facilities fluctuated and decreased from 17.4395% in 1989 to 15.6586% in 2006. The growth rate of its share in most years was negative. The average amount, share, and growth rate during the period under review was 34,646.68 billion Rials, 17.76% and -0.3645% respectively. However, this shows the orientation of the economy toward economic development.

c) **Manufacturing and Mining**

Industry and manufacturing is a joint goal, not only for developing economies but also for developed ones. However, it is more important for developing countries to pay special attention to it so allocation of resources to this sector can play an important role in economic development. As Table 6.13 shows, the Islamic banking system in Iran allocated 2,027.6 billion Rials to this sector in 1989. It is worth mentioning that that was the first year of the Islamic Republic of Iran's Economic, Social and Cultural Plan which emphasized achieving a high growth rate. As industry is a vital factor in economic development and the banking system in Iran is largely owned and managed by the government, the financing of this sector would be expected to have a special place in the banking system.

In the First Plan the attention paid to this sector by the banking system was more than other sectors. For example, the growth rate of credit facilities allocated for 1990, 1991 and 1992 was 11.9554%, 13.70225% and 11.8206% respectively, This shows the highest rate, not only between other sectors during the period under consideration but also in its sector compared with other years. Of course one should note that these years were exceptional because after the end of the war between Iran and Iraq there were free capacities on the one hand and there was a strong national will to rebuild the war damages on the other hand. Even President Hashemi Rafsanjani's motto was that buildings demolished by the war had to be repaired.

The growth rate of resources allocated to this sector decreased to 0.7917% in 1993 and to -1.0367 in 1994. For the two years after this decrease, in the remaining two years President Rafsanjani was in power, the growth rate increased to 13.38% and 4.6454%. In 1997, a big change took place politically. In that year President Khatami was selected as Iran's President. In the first three years of his presidency, most economic indexes decreased, including GDP growth rate and growth rate of monetary resources allocated to the manufacturing and mining sectors. For instance, the growth rate of the share of credit facilities allocated to this sector was -8.5304%, -5.341%,

Table 6.12: Allocation of Resources to Economic Sectors (Mining & Industry and Housing & Building) by Banking System (1989-2006) (Iranian Rials Billion)

Year	T F	M&I	Share*	G R*	H&B	Share*	G R*
1989	9697.5	2027.6	20.9085	---------	3219.6	33.2003	--------
1990	13156.9	3079.8	23.4082	11.9554	4036.8	30.682	-7.5852
1991	18183.3	4839.6	26.61563	13.7022	5572.6	30.6468	-0.1147
1992	23465.7	6984.7	29.76177	11.8206	6952.2	29.62329	-2.7683
1993	30574.8	9171.4	29.9966	0.7917	8831.9	28.88621	-2.4885
1994	37719.8	11197.7	29.68653	-1.0367	11590.6	30.72816	6.3766
1995	38779.9	13052.7	33.65842	13.3794	11705.4	30.18419	-1.7703
1996	50312.6	17721.1	35.22199	4.6454	14065.8	27.95681	-7.2793
1997	59362.3	19125	32.21742	-8.5304	17331.7	29.19648	4.4372
1998	76353.2	32385.2	30.49669	-5.341	23534.6	30.82333	5.5721
1999	108123.9	30259.2	27.98567	-8.2337	32819.4	30.35251	-1.5275
2000	142910	39913.9	27.93	-0.2	42266.9	29.58	-2.54
2001	192710.7	58191.8	30.19646	8.11	54612.9	28.23932	-4.35
2002	265070.3	81470.6	30.73547	1.785	72462.4	27.33705	-3.1951
2003	372868.2	121267.4	32.52	5.81	94641.9	25.38	-7.16
2004	515287.9	172642.3	33.504	-24.52	121082.5	23.498	-32.165
2005	722046.7	228132.2	31.5952	-5.6972	168757.6	23.3721	-0.5358
2006	1023029	291302.5	28.4745	-9.8771	239108.1	23.3726	0.0021
Average	---------	63486.9	29.72	0.5	51810.7	28.5	-3.36

Sources: 1- Economic Statistics Office of Central Bank

2- Reports and balance sheets Iranian Central Bank (Bank Markazi) for different years

T F = Total facilities

AG = Agriculture

M & I = Mining and Industry (manufacturing)

H & B = Housing and Building

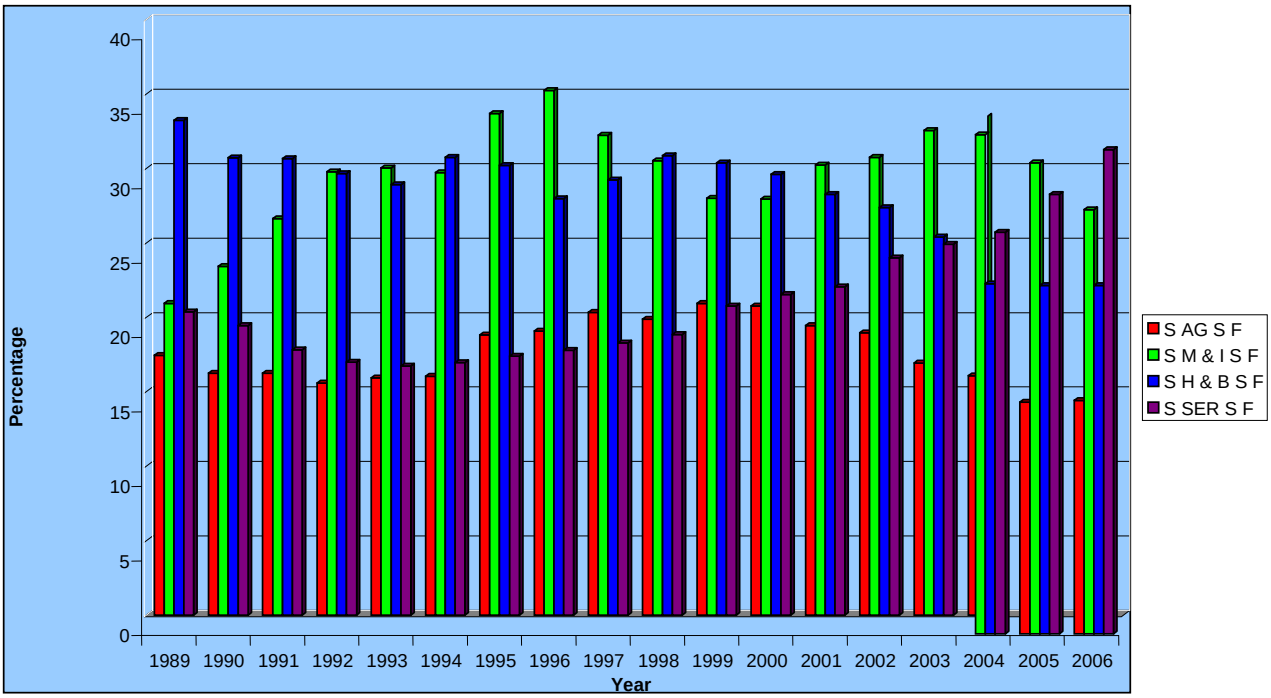
G R = Growth rate

Note: All shares and growth rates are in percent

*Calculated by researcher

-8.2337% and -19.4133% in 1997-2000 respectively and then it increased to 8.11% in 2001. After this jump it again decreased and fell to 5.81% in 2003. This decrease continued relatively in the first year of President Ahmadi Nejad's period too and was 1.5273%, -5.6972% and-9.877% for 2004-2006 respectively. The maximum share was in Rafsanjani's period, in 1996, when it was 35.22199%. It should be noted that every president who came to power made considerable changes. As mentioned before President Khatami's aides believed in political rather than economic change in the early years. President Ahmadi Nejad was concerned with economic justice and redistribution of asset and did not actually believe in economic mechanism. The main problem in Iran is a lack of strong parties with special plans to solve the economic,

Figure 6.11. Share of Economic Sectors from Financial Facilities during 1989-2006



Source: Tables 6.11 and 6.12

S AG S F = Share of agricultural sector from financial facilities.

S M& I S F = Share of manufacturing (industry) and mining sector from financial facilities.

S H& B S F = Share of housing and construction sector from financial facilities.

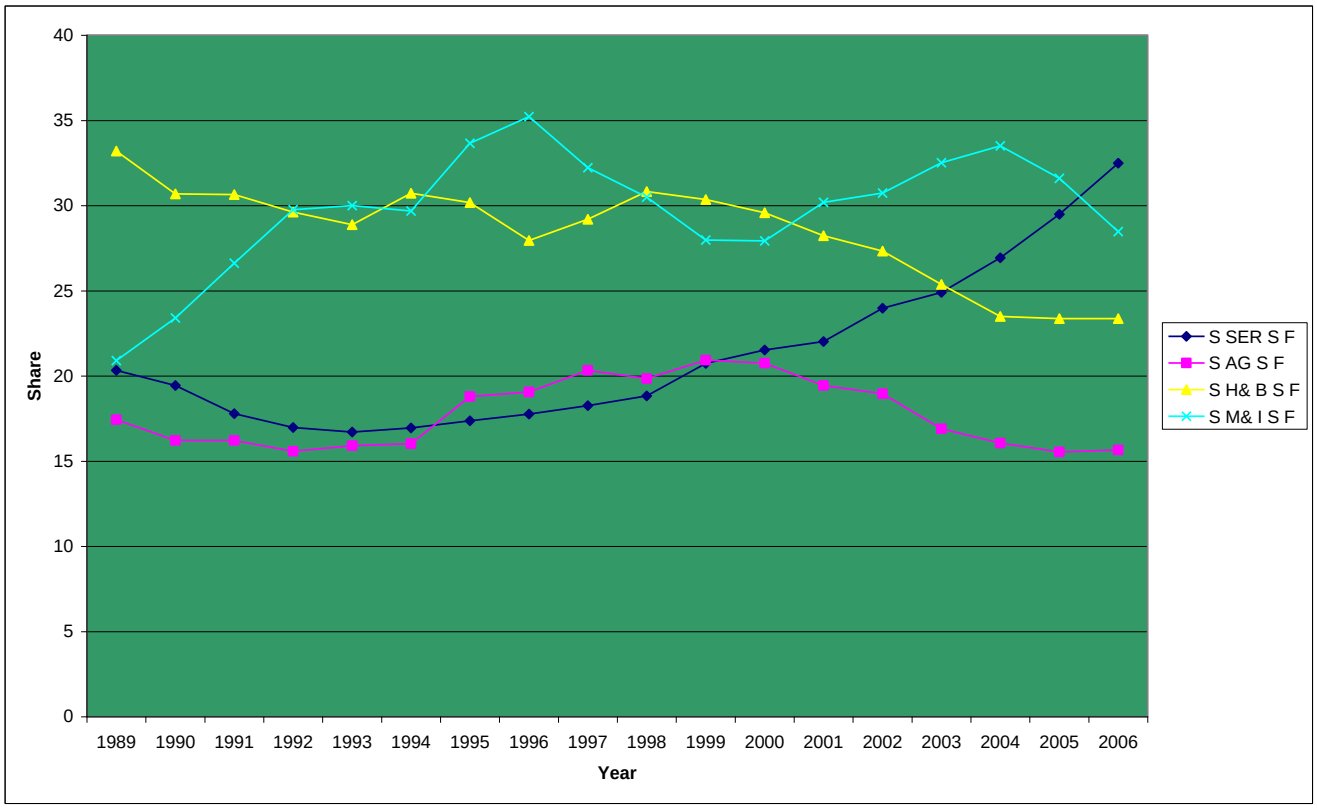
S SER S F = Share of service sector from financial facilities.

social and cultural problems. Despite the democracy and regular elections in Iran, unfortunately, people have not been able to benefit much, because presidents are not usually members of a party which has studied the country's problems and their solutions before coming to power. Therefore, because of lack of experience, in the early years the new presidents caused some confusion and uncertainty in economic activities.

d) **Housing and Construction**

Housing and construction are relatively profitable productive activities in Iran. Therefore, there are some motives in banking system for financing this sector, but there are some fluctuations in this sector which sometimes lead to depreciation and also government policies which create some limitations upon the allocation of the resources to this sector by banking system.

Figure 6.12. Process of Share of Economic Sectors from Financial Facilities during 1989-2006



Source: Tables 6.11 and 6.12

S AG S F = Share of agricultural sector from financial facilities

S M& I S F = Share of manufacturing (industry) and mining sector from financial facilities

S H& B S F = Share of housing and construction sector from financial facilities

S SER S F = Share of service sector from financial facilities

In the early years of the period under review the share of this sector from total credit facilities allocated to different economic sectors was the highest, but during that period it was reduced. As Table 6.12 shows, in 1989 its share was 33.2% but despite a regular increase in the absolute amount of facilities allocated to this sector, its share decreased fairly regularly and fell to 23.4% at the end of the period. The largest fall in growth rate among sectors was in this sector. In 13 years of the period the growth rate was negative. However, as mentioned before, the absolute amount of credit facilities allocated to this sector increased from 3,219.6 billion Rials in 1989 to 239,108.1 billion Rials at the current price and from 51,845.41 billion Rials in 1989 to 193,688.214 billion Rials at constant 2004 price. This means that the amount of credit facilities allocated to this sector at the current price in 2006 was 42 times more than

that in 1989. In constant terms, the amount of credit facilities allocated to this sector in 2006 was 3.74 times more than that in 1989.

6.5. DIRECT INVESTMENT

One important aspect of the contribution of the banking system in Iran to economic development is direct investment. The Islamic banking system in Iran has carried out thousands of projects directly. If not all, at least the vast majority of them were so huge that the private sector was not able to undertake them. They included: highways, railways,[34] petrochemical industries, wood and paper industries, industrial farming and animal husbandry, automobile manufacture, the cement industry and so on. For example some of the projects are as follows:

1- Tehran – Saveh highway, 113 Kilometres.

2- Qazvin – Zanjan highway, 189 Kilometres.

3- Kashan- Natanz- Isfahan highway, 161 Kilometres.

4- Zanjan-Bostan Abad highway, 255 Kilometres.

5- Zanjan – Tabriz highway, 285 Kilometres.

6- North – Mashhad , 70 Kilometres.

7- Tabriz- Oroumieh and Esfahan- Shiraz highway, 340 Kilometres.

8- Esfahan – Shiraz railway.

9- Kerman cement

10- Ardabil cement

11-Sepahan cement

12- Khazar cement

13- Sharq (east) cement

[34] Banks achieve profit from their investment in public-sponsored projects such as highways and railways by getting charges from drivers who use them for several predetermined years.

14- Mazandaran wood and paper industry which created jobs for 6500 people directly and indirectly.

6.6 CONCLUSION

In conclusion, the aim of this chapter has been to discuss the contribution of Islamic banking to economic development in the Islamic Republic of Iran. In this regard firstly the growth rate process of GDP, with and without oil, has been discussed and it has been shown that fluctuation in GDP with oil is more than it is without oil, reflecting the effect of oil on the fluctuation and instability of Iran's economy. The most important issue in the contribution of Islamic banking to economic development is the ability of the banking system to encourage people to save, to attract savings as deposits, and also to allocate deposits mainly to productive sectors.

As the entire banking system in the Islamic Republic of Iran works according to the Law of Usury-Free Banking of Iran and there are no branches of conventional banks in Iran to compare with, I had to compare the banking system in Iran after the Islamic Revolution as representative of Islamic banking with the banking system in Iran before the Islamic Revolution as representative of conventional banking. To make it fairer the ratio of deposits and financial facilities to GDP and liquidity has been considered.

In comparison it could be said that the interest free banking system has been more successful than interest-based banking in the mobilisation and allocation of monetary resources in Iran. Despite there having been 35 domestic and foreign banks at that time, the average ratio of deposits to GDP was 24.53%, while during the years 1989-2006 it was 45.8% which shows an increase of about 100%. Also, the average amount of allocated resources at the current and constant prices during the 1979-2006 period was 274.48 times and 2.98 times more than those of the 1961-1978 period respectively. In addition, the banking system injected a considerable amount into different sectors of the economy as credit, especially the manufacturing and mining sectors. These data show that the Islamic banking system in Iran has created opportunities for the major economic sectors to be developed. Furthermore, Islamic banking in the Islamic republic of Iran has financed directly a lot of huge projects in

all over the country and in different industries having an important role in both regional and overall economic development.

Part Three:

Qualitative Analysis And Conclusion

Chapter Seven: *Shariah* aspects

Chapter Eight: The Contribution of Islamic Banking to Economic Development

Chapter nine: Summary, conclusion and recommendations

Chapter Seven:

QUALITATIVE ANALYSIS (*SHARIAH* ASPECTS)

7.1 INTRODUCTION

Islamic banking in Iran was introduced in Chapter Three where we showed that all contracts which are used in banking activities are correct from the *shariah* point of view. In this chapter assurance of *shariah*-compliance from interviewees' point of view will be examined. We should note that when we are talking about *shariah*-compliance, not only should contracts be appropriate for the projects but there are also many other factors to be considered. According to the Law of Usury-Free Banking in Iran, banks are the agents of the depositor and depositors allow banks to utilize their deposits for profitable projects. Furthermore, according to Islamic jurisprudence, an agent must be honest and do his/her best to protect his/her client's wealth. Hence, the banks are not only responsible for utilizing deposits for profitable projects but also for considering the honesty, capacity and ability of customers who apply for facilities. Therefore, we should note that considering these factors is also a condition of *shariah*-compliance.

This chapter will provide a qualitative analysis of the interview questions regarding the aspect of *shariah*-compliance. The semi-structured interview has been chosen for the interview survey. Twelve managers and advisors from the Central Bank and commercial banks of the Islamic Republic of Iran were selected for face-to-face interviews. I was also fortunate enough to be able to interview a grand Ayatollah (Ayatollah Rezvani) who is known as "the father of Islamic Banking in Iran". He was the representative of the late Imam Khomeini at the Central Bank of the Islamic Republic of Iran at the time of the planning and approval of the law of Usury-Free Banking in Iran. He is now a member of the Guardian Council in Iran. I needed a complementary interview to augment the data collection; therefore I went to Iran to conduct the interview. The collected data was analysed using thematic analysis and coding.

7.2 ENSURING THAT BANKING ACTIVITIES IN IRAN ARE *SHARIAH*-COMPLIANT

Table 7.1 shows the factors which are considered regarding ensuring *Shariah*-compliance according to the opinions of the interviewees

Table 7.1: Results for Question 1 (Overview of Types of Subjects which should be Considered for *Shariah*-Compliance)

Question1	**How do banks ensure that the deposit and financing facilities they offer are *shariah*-compliant?**
Focused coding	
1	By considering and deliberating on the contract.
2	By considering and deliberating on the speciality and experience of the client.
3	By considering and deliberating on the clients honesty
4	By considering and deliberating on the project profitability
5	By supervising the process of the project execution to the end.
6	By proper training of their staff.
Theme	*Shariah*-compliance is ensured in the Iranian Islamic banking system through considering and deliberating on the contract, speciality of the client, client's experience and honesty, project profitability, client's financial credit and supervising the process of the project execution to the end and proper training of their staff.

The way in which banks ensure their activities are *shariah*-compliant was questioned and opinions of interviewees were coded.

Table 7.2 shows the opinions of interviewees with regard to quality of ensuring that banking activities are s*hariah*-compliant and considering and deliberating on the contract.

Table 7.2: Focused Coding Number 1 for Question 1 (Ways of Ensuring that Banking Activities are *Shariah*-Compliant)

Considering and deliberating on the contract.	
Interviewee 1	By Central Bank through supervision bureau and inspectors
Interviewee 2	Trusting in the Law of Interest-Free Banking in Iran and administration sector of the bank and random inspection by the Central Bank.
Interviewee 3	Trusting in the Law of Interest-Free Banking in Iran, executive guide direction and instruction and bylaw and approval of the Guardian Council and banks' disciplinary boards.
Interviewee 4	Trusting in the Law of Interest-Free Banking in Iran and approval of the law by the parliament and the Guardian Council and its approval by the late Imam Khomeini and the late Ayatollah Gholpayeghani and general supervision by people and the head of parliament.
Interviewee 5	Checking by pillars of the credit of the banks and asking clients to bring documents after buying commodities.
Interviewee 6	Some banks are not sensitive to this issue; they are just interested in making profit.
Interviewee 7	Banks do not have enough authority, Central Bank makes their decisions for them and a supervision instrument is not clearly apparent and they looked at it optimistically.
Interviewee 8	Branches administer projects and contracts directly and with skilled sectors, namely technical, financial and civil sectors. They have their specific duty regarding administering the project.
Interviewee 9	By trusting clients and staff.
Interviewee 10	By guiding in the direction which is in accordance with the *Shariah*.
Interviewee 11	By defining a clear relationship between depositors and banks in the law and even determining the format which should be used for contracts.
Interviewee 12	Yes, according to the law they have to consider them, and a few branches may not consider them.

As can be seen in Table 7.2, the majority of interviewees believe that the authorities of the banking system in the Islamic Republic of Iran are able to make sure that banking activities are *shariah*-compliant by considering and deliberating on contracts. Only interviewee number six stated that some banks are not sensitive to this issue and they are only interested in making profit, interviewee number seven believes that banks do not have enough authority, the Central Bank makes decisions for them. In addition, there is no clear supervision instrument apparent in the law and banks looked at it optimistically. Interviewee number nine said that the banking system does not make any special effort to control contracts regarding *shariah*-compliant contracts and just depends on the clients and staff. Other interviewees refer to the following aspects:

First, regarding the contracts themselves they believe that contracts are *shariah*-compliant because the Law of Interest-Free Banking in Iran was unanimously approved by Parliament and the Guardian Council. It was also confirmed by the late Imam Khomeini and the late Ayatollah Gholpayeghani, therefore there is no doubt regarding this matter.

Second, according to the law all new contracts or executive guide directions or instructions and bylaws should be approved by the Guardian Council. In order to make the process easier, the Guardian Council appointed Ayatollah Rezvani as its representative, so banks check all new instruments with him. If he does not approve them they send them to the Guardian Council for deliberation. Furthermore, according to one important interviewee, the head of parliament is legally responsible for them. If he/she notes that they are not *shariah*-compliant, he/she is responsible for sending them to the Guardian Council for approval. According to Iranian law even if just one person recognises that one guide direction or instruction is not *shariah*-compliant, he/she can issue a complaint to the Administrative Justice Court. They inspect the matter and if they see any problem they send it to the Guardian Council for consideration.

Third, regarding the execution of the law according to the executive guide direction or instructions and bylaw, interviewees mentioned several factors which are necessary to ensure and check the conditions regarding the law of Interest-Free banking in Iran which are as follows:

a) Determining the contracts and even the format to be used for them and defining a clear relationship between depositors and banks in the law: This, together with the training which banks give to their staff can ensure that Islamic banking will be followed by the banking system in the Islamic Republic of Iran.

Table 7.3: Focused Coding Number 2 for Question 1 (Ways of Ensuring that Banking Activities are *Shariah*-Compliant)

Considering and deliberating on speciality and experience of clients	
Interviewee 1	Demanding some proof of their speciality and their experience and sending our inspectors.
Interviewee 2	Having some personal knowledge about them, because each branch works in a specific area and knows its customers and demanding some proof of their speciality and their experience and sending our inspectors.
Interviewee 3	Yes they do. It can be done in several ways, depending on the branch.
Interviewee 4	No answer
Interviewee 5	Asking for documents and sending inspectors to their work place.
Interviewee 6	Asking for documents and sending inspectors to their work place in state-owned banks and reports from external corporations in private banks.
Interviewee 7	Speciality no but experience yes.
Interviewee 8	Technical, financial and civil expert sectors and bureau of plan evaluation for big projects.
Interviewee 9	Not exactly, just considering the client's previous record and their credit.
Interviewee 10	Depends on the branches.
Interviewee 11	By checking client's credit.
Interviewee 12	By documents such as job licence, indult and other licences.

b) Supervision by the Central Bank: The Central Bank has two kinds of supervision: First, "on site supervision", which means supervision at the bank. In this case, Central Bank inspectors usually select some branches randomly and go there to scrutinize contracts. They scrutinize all contracts at the chosen branches, both from the technical and the *shariah* point of view. Second, "off site supervision" which means inspection at the Central Bank. In this case, they scrutinize some contracts which have been sent to them for this purpose. Furthermore, there is a board called the Disciplinary Board of Banks. All violations are reported to them for consideration and they are responsible for deliberating on them carefully and precisely. In addition, directorates are very sensitive to any infractions, especially from the *shariah* point of view. For example, in a situation where the partnership is going to be harmed, the bank directorate reacts to this and solves the problem. Also, some big projects go to the Central Bank for deliberation. They consider them carefully and then approve them.

c) Supervision by commercial banks themselves: Branches administer the projects and contracts directly. They have specialist sectors, namely technical, financial and civil sectors. These sectors have their own specific duties regarding the administration of projects.

Table 7.3, shows the quality of ensuring that banking activities are *shariah*-compliant by considering and deliberating on the speciality and experience of their clients. As mentioned before, banks are the agents of the depositor and depositors allow them to utilize their deposits for profitable projects and profitability depends strongly on the speciality and experience of the client. Therefore, making sure that clients have enough speciality and experience is not only a technical issue, but a religious one.

As can be seen in Table 7.3, from the interviewees' point of view banks check speciality and experience by: (1) demanding proof of their speciality and their experience, (2) sending inspectors, (3) having some personal knowledge of them, because every branch works in a specific area and knows its customers, (4) reports from external corporations in private banks. As banks, especially state-owned banks, have several branches in different areas which cover them for all kinds of financial services they usually have enough knowledge about their customers, except for new customers about whom their knowledge may not be sufficient for this purpose. For these customers they should be more careful and use other ways (5) checking job licences and client's credit. In conclusion, the vast majority of interviewees believe that enough care is taken by banks to ensure that their clients who are selected to receive financial facilities have enough experience and speciality regarding their activity. Just one interviewee did not answer this question. Also, interviewee number seven believes that speciality is not considered but experience is. Of course, he explained that there is not a special form on which speciality is questioned. It could be said that this does not actually mean that speciality is not considered.

Table 7.4, shows the opinions of interviewees regarding the ways of making sure that banking activities are *shariah*-compliant by considering the client's honesty. Honesty is very important in Islamic banking, not only because Islamic banking as part of an Islamic economic system is a moral system, but also because of its civil effects. In partnership contracts, for instance the *modharabah* contract, the banking system should trust the agent's word. In other words, if the agent claims a loss, the capital owner – in this case the bank - must accept their claim without asking for proof. In fact it would be the duty of the bank to provide proof against their claim if they disagree with the agent's claim. Therefore, because banks are agents of depositors and are responsible not only for protecting their deposits but also for obtaining profit for

them, it is their religious responsibility to do their best to make sure that those who apply for financial facilities are honest. So, this condition becomes a condition which should be *shariah*-compliant.

Table 7.4: Focused Coding Number 3 for Question 1 (Ways of Ensuring that Banking Activities are *Shariah*-Compliant)

considering and deliberating on the client's honesty	
Interviewee 1	Inquiry from Bureau of the Banking information regarding their delays in payment, deliberation on their past behaviour and understanding of the branch manager.
Interviewee 2	By reports of our staff who go to their business place and check the details given by them and reports of our staff about their credit.
Interviewee 3	By inquiring about their background and their credit.
Interviewee 5	By inquiring about their current account and their credit.
Interviewee 6	By their own reports in state-owned banks and by external reports in private banks.
Interviewee 7	By enquiring about their current account and their credit.
Interviewee 8	We check their honesty ourselves.
Interviewee 9	Not exactly, just considering the client's previous record and their credit.
Interviewee 11	By branches themselves and by credit information system of the Central Bank.
Interviewee 12	By local enquiry.

As can be seen in Table 7.4, only interviewees four and ten did not answer and interviewee number nine believed that honesty was not carefully considered. Other interviewees believed that this issue was considered carefully using several factors as follows: (i) Enquiry from Bureau of Banking information regarding late payments, (ii) Consideration of their past behaviour, (iii) Understanding of the branch chairman. The knowledge of the bank manager plays an important role in this issue (iv) Report by bank staff who go to their place of work and verify their claims, (v) Enquiry about their background, (vi) Enquiry about their current account and their credit, (vii) Through the credit information system of the Central Bank.

Table 7.5: Focused Coding Number 4 for Question 1 (Ways of Ensuring that Banking Activities are *Shariah*-Compliant)

Considering and deliberating on project profitability and ways of calculating and receiving profit.	
Interviewee 1	Their project is evaluated regarding profit. Predicted profit should be at least equal to expected profit which is determined by the Central Bank
Interviewee 2	Their project is evaluated regarding profit. Expected profit should be at least equal to expected profit which is determined by the Central Bank.
Interviewee 3	Profitability of projects is definitely considered carefully.
Interviewee 4	They should consider profitability.
Interviewee 5	Banks evaluate profitability by their specialist and client's claims.
Interviewee 6	Yes, we evaluate the project regarding profitability.
Interviewee 7	Consideration is not deep; we just rely on the information which is provided by clients.
Interviewee 8	Banks evaluate profitability by their specialist.
Interviewee 11	In partnership contracts profitability is considered and expected; profit should be predictable.
Interviewee 12	In order to protect deposits from the risk of loss or unprofitability, banks consider profitability of the contracts except in obligatory facilities.

All economic activities, including banking system activities, usually aim not only to obtain profit but also to maximise their profit. In Islamic banking, obtaining profit is not only the economic goal but is also a *shariah* responsibility because, while conventional banks take a fixed amount or percentage as interest regardless of real profit which investors receive, in Islamic banking profit depends on actual profit and, as mentioned before, in Islamic banking banks are agents of the depositors and promise to utilise their deposits for profitable projects. So, considering the profitability of a project is both an economic and Islamic duty of the banking system.

In order to understand whether banks in the Islamic Republic of Iran consider this issue or not we asked interviewees the question for which their answers can be seen in Table 7.5. As can be seen in this table, all interviewees who answered the question believe that in the banking system of the Islamic Republic of Iran all partnership contracts, except obligatory contracts, are deliberated on regarding profitability.

Also as can be seen in Table 7.5, only interviewee number seven believes that consideration is not very deep. However, he also believes that consideration of profitability exists but for this banks rely on the client's documents and their word.

Table 7.6: Focused Coding Number 5 for Question 1 (Ways of Ensuring that Banking Activities are *Shariah*-Compliant)

Supervising the process of the project until the end	
Interviewee 1	Yes, our payment to the client is step by step.
Interviewee 2	Yes, We control the activity of the client until the end of the contract.
Interviewee 3	Yes, It is one of the most important principles in partnership contracts.
Interviewee 4	Yes, it is necessary to supervise the project until the end.
Interviewee 5	Yes, definitely.
Interviewee 6	Yes.
Interviewee 7	No, they usually agree on part payment profit rate.
Interviewee 8	Yes.
Interviewee 9	Precise supervision is not possible, because their numbers are very high. Of course, in large projects we pay step by step.
Interviewee 10	No answer.
Interviewee 11	According to the executive byelaw and Address Instruction, supervision should be until the end, but practically in the early stages, especially during the time of paying partnership share supervision is more intense. Also, changes in the partnership situation are important.
Interviewee 12	Generally, supervision should exist; for this reason banks pay financial facilities step by step.

As the relationship between Islamic banks and those applying for facilities is usually a partnership, it is necessary for banks to supervise the process of the project until the end of the contract. In order to understand what happens in the Islamic Republic of Iran, a question was asked of interviewees, which is shown in Table 7.6.

As Table 7.6 shows, one interviewee did not answer this question and another one, number seven, believes that there is no supervision and banks and clients usually agree on the part-payment profit rate. Other interviewees believe that supervision exists. One way to control is to pay financial facilities at each stage. This means that they pay one instalment and after confirmation by the bank's expert that the instalment has been spent on the partnership project, *mosharakah*, the bank pays the next instalment.

Table 7.7: Focused Coding Number 6 for Question 1 (Ways of Ensuring that Banking Activities are *Shariah*-Compliant)

Proper training for bank staff	
Interviewee 1	There have been some training courses for staff, especially managers, but they need more training because Islamic contracts are a little complicated.
Interviewee 2	There has been training for staff, especially managers but they need more training.
Interviewee 3	There has been training for staff, especially managers, but they need more training.
Interviewee 4	There have been some training courses for staff especially managers but they need more training.
Interviewee 5	There has been training for staff, especially, managers regularly but they need more training.
Interviewee 6	We have training courses for our staff twice a week.
Interviewee 7	There has been training for staff, especially managers, but they need more training.
Interviewee 8	There has been training for staff, especially managers, but they need more training.
Interviewee 9	There has been training for staff, especially managers, but they need more training.
Interviewee 10	There has been training for staff, especially managers, but they need more training.
Interviewee 11	There has been training for staff, especially managers, but they need more training.
Interviewee 12	There has been training for staff, especially managers, but they need more training.

One main pillar of Islamic banking is contracts. A contract is correct and effective if it fulfils specific conditions. The first condition is to know the contract and its aims and intentions. Training is an important issue for banking system staff because if they are not familiar with Islamic contracts, they will not be able to act according to the *shariah.* The more training they receive the better they will understand and consequently provide a more correct contract. To understand what happens in the Islamic Republic of Iran, interviewees have been questioned on this. Table 7.7, shows their answers.

As can be seen in Table 7.7, all the interviewees believe that previous staff training is not enough and they need more training because, firstly, Islamic banking contracts are more complicated in comparison with conventional banks and secondly, because they are new to them and they need to improve its instruments gradually. Training is vital for Islamic banks in order for them to remain Islamic.

Table 7.8: Results for Question 2 (Overview of Types of Problems Faced in the Implementation of Islamic Contracts)

Question2	**What are the problems with which Islamic contracts are faced in the implementation stage?**
Focused coding	
1	Asymmetric information
2	Moral hazard
3	Adverse selection
4	Low flexibility of contracts; all contracts have been defined strictly and all banks have to act according to them.
5	Impossibility or difficulty of responding to all credit demands, especially, from the demand side (according to the law of Usury-Free Banking in Iran")
6	Lack of updating of laws such as the Monetary and Banking law and the style of management in the banking system.
7	Overdue financial facilities or loans.
Themes	The main problems faced in the implementation of Islamic contracts are: asymmetric information, moral hazard, adverse selection, low flexibility of contracts, impossibility or difficulty of responding to all credit demands, lack of updating of laws and overdue financial facilities or loans.

7.3 PROBLEMS WITH WHICH ISLAMIC BANKING CAN BE FACED

There are some problems that Islamic banking are faced with or have been said to be faced with. They were explored with interviewees and results are shown in Table 7.8.

Asymmetric information exists in all banking systems. This is when one party has more information than another. There are different opinions regarding asymmetric information in Islamic banking. It may be said that, because of partnership in Islamic banking, asymmetric information is more harmful. The reason is that as there is no fixed profit rate in partnership contracts; one party is more able to make the contract in such a way that can obtain more profit.

Table 7.9: Focused Coding Number 1 for Question 2 (Types of Problems Faced in the Implementation of Islamic Contracts)

Asymmetric information	
Interviewee 5	Generally, asymmetric information is less of a problem in Islamic banks than in conventional banks.
Interviewee 7	Generally, asymmetric information is less of a problem in Islamic banks than in conventional banks.
Interviewee 8	There is no difference between Islamic banks and conventional banks; it depends on the client's honesty and the bank staff's awareness.
Interviewee 9	There is no difference between Islamic banks and conventional banks.
Interviewee 11	As Islamic banks obtain more detailed information, they are more able to solve or reduce the problem of asymmetric information.
Interviewee 12	As Islamic banks are project-oriented instead of individual oriented, and applicants are scrutinized regarding their honesty, experience and speciality and projects are scrutinized regarding technical and economical justifications and rationalization, Islamic banks are more able to solve the problem of asymmetric information than conventional banks.

Also one could say that because of partnership and careful consideration of the projects by Islamic banks, asymmetric information is not as hard as conventional banks. The opinions of the interviewees regarding asymmetric information in the Islamic Republic of Iran are shown in Table 7.9.

As can be seen in Table 7.9 half of the interviewees did not answer this question. Of those who answered the question four interviewees believe that Islamic banks are more able to solve or reduce the problem of asymmetric information than conventional banks and two interviewees believe that there is no difference between Islamic banks and conventional banks.

One thing which can exist in all transactions, including financial contracts is moral hazard which occurs when a party to a transaction has not entered into the contract in good faith. This can lead to providing misleading information. If moral hazard exists it could be more harmful in Islamic banks than conventional banks because in conventional banks customers receive a fixed interest rate whereas in Islamic banks, which are mainly based on partnership contracts, the profit rate depends on the actual profit which is generally declared by the client. On the other hand, because of Islamic bank customers' religious faith, banks' careful consideration of projects and clients'

honesty, the probability of moral hazard in Islamic banks is less than that in Conventional banks. The opinions of the interviewees have been shown in Table 7.10.

Table 7.10: Focused Coding Number 2 for Question 2 (Types of Problems Faced in the Implementation of Islamic Contracts)

Moral Hazard	
Interviewee 7	Generally, in Islamic banks moral hazard is less than in conventional banks but in Iran the case differs; in the present banking system of Iran the situation is similar to that of conventional banks.
Interviewee 8	Yes this problem exists in Islamic banks too.
Interviewee 9	Moral hazard in Islamic banks is less than that in conventional banks.
Interviewee 11	Moral hazard in Islamic banks is less than in conventional banks
Interviewee 12	Yes this problem exists in Islamic banks too.

As can be seen in Table 7.10, the majority of interviewees did not answer this question. Only five of them answered; three of them believe that moral hazard in Islamic banks is less than that in conventional banks, but one of the three believe that Iran's banking system has the same problem as conventional banks in this regard. Two believe that this problem also exists in Islamic banks and did not compare Islamic banks with conventional banks in this regard

As table 7.11 shows half of the interviewees did not answer the question. Of those who answered the question, five believe adverse selection in Islamic banks is less than in conventional banks and one believes that this problem also exists in Islamic banks and did not compare Islamic banks with conventional banks in this regard.

Table 7.11: Focused Coding Number 3 for Question 2 (Types of Problems Faced in the Implementation of Islamic Contracts)

Adverse selection[35]	
Interviewee 5	Generally, adverse selection in Islamic banking is less than in conventional banking.
Interviewee 7	Generally, adverse selection in Islamic banking is less than in conventional banking but in Iran the case differs; in Iran's present banking system the situation is similar to conventional banks.
Interviewee 8	Yes this problem exists in Islamic banks too.
Interviewee 9	Adverse selection in Islamic banking is less than in conventional banking.
Interviewee 11	As Islamic banking obtains more detailed information from clients the probability of adverse selection in Islamic banking is less than in conventional banking.
Interviewee 12	As Islamic banks are project-oriented, instead of individual oriented, and applicants are scrutinized with regard to honesty, experience and speciality and projects are scrutinized with regard to technical and economic justifications and rationalization, adverse selection in Islamic banking is less than in conventional banking.

As in the previous question some believe that Islamic contracts in Islamic banking in the Islamic Republic of Iran do not have enough flexibility because they are pre-determined. This can cause problems regarding the allocation of monetary resources. We asked the interviewees' opinions on this and their responses can be seen in Table 7.12.

As can be seen in Table 7.12, two interviewees did not answer the question. Interviewee number three believes that their flexibility is very low and some believe it could be better but is acceptable and others believe the problem is due to the structure of the economy. In sum, 33% of interviewees believe that there is enough flexibility, about 17% did not answer and 50% believe that there is not enough flexibility in Islamic contracts in Islamic banking in the Islamic Republic of Iran.

[35] This refers to a market process in general or in a banking system in particular in which "bad" results occur when buyers and sellers or banking system and interpreniors have asymmetric information (i.e. access to different information): the "bad" products or customers are more likely to be selected.

Table 7.12: Focused Coding Number 4 for Question 2 (Types of Problems Faced in the Implementation of Islamic Contracts)

Low flexibility of contracts in Islamic banks in the Islamic Republic of Iran	
Interviewee 1	There are no problems regarding contracts, the problem is from our macroeconomics, which leads to pressure on the some contracts. When governments order banks to decrease their expected profit rates, they have to shift to partnership contracts for which the interest rate cannot be determined in advance.
Interviewee 2	Yes, there is.
Interviewee 3	Their flexibility is very low. Everything is determined by law and any new instrument has to be approved by parliament and government.
Interviewee 7	At the moment there is not enough flexibility.
Interviewee 8	Yes, there is.
Interviewee 9	Yes, there is but the problem is structure of the economy.
Interviewee 10	It is not good, so we have started to reform all laws regarding the banking system.
Interviewee 11	Some contracts in Islamic banking, such as partnership contracts, *Joaalah* and sales by instalment have a broad usage and flexibility, but there are limitations regarding overdraft, return with flexible rate, float, and derivatives instruments.
Interviewee 12	It seems that, because of the existence of different regulations, the banking system is faced with problems regarding the implementation of contracts.

An important issue in the banking system is the ability to respond to all legal demands for financial facilities from a theoretical and legal point of view. Some people believe that Islamic banking in Iran is not able to respond to all demands. Sometimes this is due to a lack of sufficient resources and sometimes it is due to limitations in contracts or law. We should differentiate between these two cases. Also, if for any reason the government imposes laws on the banking system it does not mean the Islamic banking system has problems with regard to answering all demands.

Table 7.13: Focused Coding Number 5 for Question 2 (Types of Problems Faced in the Implementation of Islamic Contracts)

Impossibility or difficulty of responding positively to all credit demands, especially, from demand side.	
Interviewee 1	There is no problem regarding Islamic contracts, problems are from some limitations caused by law.
Interviewee 2	There are some limitations on Islamic banking in Iran which reduce its ability to finance some projects. For example, they do not allow providing import facilities.
Interviewee 3	There is much diversity in the contracts which can cover all kinds of demand for financial facilities but the government limits their usage to a specific area.
Interviewee 4	It is possible to cover all demands for financial facilities by existing contracts. Limitation is due to government policies.
Interviewee 5	This ability exists in Islamic banking but in our country limitations have been imposed from outside the system.
Interviewee 6	Limitation is not from Islamic contracts themselves.
Interviewee 7	This ability exists in Islamic banking but in our country, limitations have been imposed from outside the system.
Interviewee 8	There are some problems but they are legal, not related to the nature of Islamic banking.
Interviewee 9	It is not possible to provide facility to all applicants due to a limitation of resources and existence of high demand for financial facilities.
Interviewee 10	There are some weaknesses in this regard but this is due to their ownership. The state-owned banks are facing these problems.
Interviewee 11	The banking system at the moment is not able to provide facilities to all applicants due to the structure of economic and monetary policies.
Interviewee 12	It is not possible to provide facilities to all applicants due to limitation of resources and existence of high demand for financial facilities.

All interviewees were asked this question to provide a better understanding of the situation in the Islamic Republic of Iran. As can be seen in Table 7.13, all interviewees believe that there are some problems regarding finance for all applicants, not because of the nature of the Islamic contracts but because of government policies which state-owned banks have to follow. It is worth explaining that according to these policies banks cannot provide facilities for some consumption goods or for buying houses (although they do provide facilities for building houses); this policy aims to combat high house prices.

Also, they cannot provide facilities for importing. However, the main problem in the banking system is the considerable gap between supply and demand of financial resources.

One criticism regarding the Law of Usury-Free Banking in Iran is that it is a little old and needs to be brought up to date. Critics have said that this law was good for the 1980s, but after being in place for about 25 years it is time for its reform. In a trip to Tehran in the summer of 2009 I noticed that one group in the Central Bank of Islamic Republic of Iran had begun to discuss its reform. Fortunately, the head of the group was my friend and he invited me to attend their meeting in the Central Bank and even to participate in their discussion group. Hopefully, the new law will soon be ready for approval by parliament. However, Table 7.14 shows the opinions of the interviewees on this matter.

Table 7.14: Focused Coding Number 6 for Question 2 (Types of Problems Faced in the Implementation of Islamic Contracts)

Lack of updating of the law	
Interviewee 1	Yes, but it is being updated now.
Interviewee 2	Yes, but it is being updated now.
Interviewee 3	Yes, but it is being updated now.
Interviewee 4	Yes, but it is being updated now.
Interviewee 5	Yes, but it is being updated now.
Interviewee 6	Yes, but it is being updated now.
Interviewee 7	Yes, but it is being updated now.
Interviewee 8	Yes, but it is being updated now.
Interviewee 9	Yes, but it is being updated now.
Interviewee 10	Yes, We started rewriting the Monetary and Banking law and also the law of Usury-Free Banking of Iran as a research project In 2000 a council was established of which I was its chairman. We finished twenty articles by 2007. Up to now 130 articles have been finished and two laws have been put together.
Interviewee 11	Yes, but it is being updated now.
Interviewee 12	Yes, we are working toward its reform now.

As Table 7.14 shows all interviewees believe the law needs to be reformed and fortunately, it is being implemented now.

Overdue or late payments are a problem for all kinds of banks. In Islamic banking it can be more serious than in conventional banking because, according to Islamic thought, whenever debtors cannot pay their debt, it is recommended that borrowers give them more time until they become able to pay them. If one corporation receives ten billion Iranian Rials credit or other facilities and claims it is not able to pay its debt, if the profit rate is 10% it would benefit from delay in payment at one billion Iranian Rials per year. This huge amount of money could encourage its staff to claim

that they are not able to pay their debt. It would be interesting if we have interviewee's opinions as a researcher or manager in Iran's banking system.

As Table 7.15, shows, four interviewees (33%) did not answer the question and seven interviewees (58.33%) believe that overdue debts are greater than usual and just one person (8.3) believes that overdue debts were usual until one year ago and then increased. It is worth mentioning that nobody refers to the point which we mentioned before regarding giving more time to debtors whose payments are overdue. This may be due to the existence of a late payment penalty in Islamic banking in the Islamic Republic of Iran.

Overdue debts to all financial facilities to the private sector increased from 7.1% in 2002 to 15% in 2006, while the average ratio world-wide is 5%. This is due to political and economic conditions, exchange rate, profit rate and unexpected events.

Table 7.15: Focused Coding Number 7 for Question 2 (Types of Problems Faced in Implementing Islamic Contracts)

Overdue financial facilities or loans.	
Interviewee 1	Overdue debts are more than usual because the profit rate in exchange contracts and expected profit rate for partnership contracts are very low in the banking system and borrowers are afraid that they will not be able to receive facilities again at all, or soon. This is more common in obligatory facilities.
Interviewee 3	Overdue debts are more than usual because the banking system has been under pressure to provide more facilities than their ability; for example, last year they provided facilities about 110% of their ability by overdrafts from the Central Banks because of economic depression.
Interviewee 5	Overdue debts are more than usual, because of the gap between supply and demand in the financial market and the existence of demand and the existence of obligatory facilities
Interviewee 7	Overdue debts are more than usual because of the gap between supply and demand in the financial market and the existence of demand and the existence of obligatory facilities.
Interviewee 8	Overdue debts are very high due to the economic depression.
Interviewee 9	Overdue debts are more than usual.
Interviewee 11	Until one year ago overdue debts were usual, but during the last year due to structural issues and economic depression they have gone up.
Interviewee 12	Overdue debts are more than usual. According to existing data the ratio of overdue debts to all financial facilities to the private sector increased from 7.1% in 2002 to 15% in 2006, while the average ratio for world is 5%. This is due to the political and economic conditions, exchange rate, profit rate and unexpected events.

7.4 SOLUTIONS FOR THE PROBLEMS WITH WHICH ISLAMIC BANKING CAN BE FACED

In the previous section, the problems with which Islamic banking can be faced were discussed with the interviewees. In this section, solutions for these problems will be discussed according to the responses given by the interviewees. Table 7.16 depicts some possible solutions to the above mentioned problems of Islamic banking.

Table 7.16: Results for Question 3 (Overview of Types of Solutions for the Problems)

Question 3	**What are the solutions for problems mentioned above?**
Focused coding	
1	Changing the structure of banking system in Islamic Republic of Iran.
2	Conditions provided in the contract (condition provided in the contract).
3	Late payment penalty.
4	Reform of the law of Usury-Free Banking in Iran. Monetary and Banking law and Manner of the Banking System Management"
Themes	Solutions to the identified problems are: Changing the structure of the banking system, Conditions provided in the contract, Late payment penalty, Reform of the law of Usury-Free Banking in Iran, Monetary and Banking Law and Manner of the Banking System Management.

Changing the structure of the banking system after defining new responsibilities for it could be one acceptable challenge which has existed for some years between Muslim economists in Iran. What happened in Iran was not simply the establishment of an Islamic banking system; rather, it was a change in the existing conventional banking system to an Islamic banking system, or Usury-Free banking system. In fact, the same building, the same staff and the same specialities were chosen to establish and implement this huge change. Some economists believe that apart from the need for training, it was necessary to change the structure too because, in the past the banking system was interest-based and banking activities were simple. They collected deposits and gave interest to depositors and then provided the deposits to credit applicants and received a higher interest rate than that which they gave to the depositors. They did not need to evaluate and monitor projects and build or repair buildings and do many other things which they do now. In fact, Islamic banks enter the actual economy and need a special structure. Of course, some changes have been undertaken in the structure of Islamic banks in Iran, but it seems that they are not enough. For more information regarding this issue all interviewees were asked about this and their answers appear in Table 7.17.

Table 7.17: Focused Coding Number 1 for Question 3 (Types of Solutions for the Problems)

Changing the structure of the banking system	
Interviewee 1	It is not necessary to change the structure; banks do not need dependant corporation, rather they need experts.
Interviewee 2	It is necessary to change the structure; banks need to establish dependent advisory and productive corporation and establish an information bank.
Interviewee 3	It is necessary to change the structure; banks need to establish dependent advisory and productive corporation and move from state-owned banks to private banks.
Interviewee 5	The structure must definitely change; it must be compliant with the aims and responsibilities of Islamic banking and movement from state-owned banks to private banks and the credit section must be separated from other sections which can explain contracts to clients.
Interviewee 6	It is necessary to change the structure; it should exit from pure intermediary.
Interviewee 7	The structure must definitely change; it must be compliant with the aims and responsibilities of Islamic banking and supervisors should be independent of the banks or at least independent of the branches.
Interviewee 9	Yes, it is necessary.
Interviewee 10	Yes, it is necessary.
Interviewee 11	It should change in a way that leads to the majority of banks becoming private banks.
Interviewee 12	It should change from state-owned banks to private banks and competitiveness should increase.

As can be seen in Table 7.17 two interviewees, 16.6% of interviewees and 20% of respondents, did not answer, one interviewee, 8.3% of interviewees and 10% of respondents, believes that it is not necessary to change the structure of the banking system, ten interviewees, 83.2% of interviewees and 20% of respondents, believe that a change of structure is necessary. There are different opinions among those who agree with changing the structure which can be seen in the detailed interviews.

After completely changing the banking system to an Islamic banking system in the Islamic Republic of Iran, conditions provided in the contract were used to reduce all kinds of financial risks. Some economists believe that these conditions lead to misunderstanding or even some times to a departure from the essence of Islamic banking. For example, in *modharabah*, according to the *shariah*, all losses must be paid by the owner of the capital. So, if the *modharabah* agent claims to have suffered a loss, Islamic banks should accept their claims. Some authorities in Iran's banking system believe that if they did so they would not able to continue their job and would face bankruptcy because, there is only one system and that is a Usury-Free system and its clients are from all kinds of people - believers and non believers, honest and dishonest. In addition, the banking system is the agent of the depositor and, as mentioned before, is responsible for protecting depositors from loss. Therefore, they use a contract-implicit condition which states that, in the case of loss, the appointed *modharabah* agent should compensate from their own funds. Interviewees were asked their opinion on this matter. The question was regarding whether conditions provided in the contract have a positive or negative effect on banking system activities and whether or not they are *shariah*-compliant. Table 7.18, contains their responses.

Table 7.18: Focused Coding Number 2 for Question 3 (Types of Solutions for the Problems)

Conditions provided in the contract[36].	
Interviewee 1	They play a positive role in banking activities and facilitate them.
Interviewee 4	They were a necessity before, but now they can be omitted gradually. However, they are *Shariah*-compliant because conditions provided in the contract are allowed in Islam.
Interviewee 7	They play a negative role, they lead to the client's right to be spoiled and change the nature of Islamic contracts.
Interviewee 8	They make contracts very complicated so they have a negative effect.
Interviewee 9	They play a negative role because they cause the client to pay even in the case of loss.
Interviewee 11	They play a very important role because without them performance of Islamic banking in an expanded level such as Iran, is not possible.
Interviewee 12	I cannot judge their role, but according to the banks they are necessary because they decrease risks. On the other hand some of them harm real partnership.

[36] These are conditions provided in a contract which engage one party or both parties more than the contract itself. They may be made within the contract itself or within another contract. For example, it is possible that an agent of *Modharabah* is engaged to pay all losses by using this condition during the *Solh* contract.

As Table 7.18 shows, five respondents, 41.6%, did not answer the question. Regarding *shariah*-compliance only one answered, saying that they are *shariah*-compliant. Of those who answered the question, one person did not give an opinion, three interviewees, 25% of interviewees and 42.9% of respondents, believe they play a positive role and three more, 25% of interviewees and 42.9% of respondents, said they play a negative role.

Since the banking system in the Islamic Republic of Iran changed to an Islamic banking system in 1984, the Central Bank has determined a penalty from those who do not pay their debt on time. From the early years of its approval there has been some debate regarding its *shariah*-compliance. Some thought it was a kind of *riba* which is prohibited in Islam but some religious scholars, especially Ayatollah Rezvani, representative of the late Imam Khomeini said there was a subtle difference between late payment penalty and *riba*. In short we can say that while in *riba*, the lender is happy to delay payment and for debtors to pay more, here the lender is not happy and really wants debtors to pay their debt and, in the case of non payment, not only ask a penalty from them but also to blacklist them. Here, we asked two questions from interviewees regarding late payment penalty. First we asked whether late payment penalty is *shariah*-compliant and second we asked if late payment penalty can solve the problem of overdue payments in the banking system or at least decrease it significantly. Table 7.19 shows the answers to both questions.

Table 7.19: Focused Coding number 3 for Question 3 (Types of Solutions for the Problems)

Late payment penalty.	
Interviewee 1	Its effectiveness depends on the amount of penalty. If it is higher than the gap between the profit rate in the banking system and the black market interest rate, it would be effective; otherwise it would not be effective.
Interviewee 4	It is *shariah*-compliant, but you should be very careful to understand the difference between it and *riba*. The only way is to have a late payment penalty otherwise the banking system will face loss and bankruptcy. Of course, we should gradually omit it after obtaining complete information.
Interviewee 5	Yes it is useful.
Interviewee 7	No, late payment penalty is not able to solve the problem of overdue loans because they have other reasons. If the banking system observed the benefit of facility demanders, they would not face the problem of delay.
Interviewee 8	Its effectiveness depends on the amount of penalty. The current expected profit rate is 12% if we assume that the actual profit rate is the same and rate of late payment penalty is 6% it becomes 18% which is less than the black market interest rate or profit rate in the open market. So, it would not be effective.
Interviewee 9	At first it was rejected by the Guardian Council, but after its format had been changed it was approved. Overall it was useful but now courts do not vote in its favour.
Interviewee 10	Yes it is useful.
Interviewee 11	Late payment penalty cannot solve the problem of overdue debts alone. The main solution would be supervision. Of course, a late payment penalty could play a role as a deterrent factor.
Interviewee 12	It does not work at the moment because in times of inflation debtor do not want to pay their debt as it is in their benefit not to even if they incur a late payment penalty.

As Table 7.19, shows this issue is controversial. Three interviewees (25%) did not answer; two interviewees, 16.6% of interviewees and 22% of respondents, stated that the amount of penalty determines its effectiveness. If it is higher than the gap between the profit rate in the banking system and the black market interest rate or the open market profit rate it would be useful. Four persons, 33% of interviewees and 44% of respondents said it is, on the whole, useful. Two interviewees believe that it is not useful but one said that because it is less than the gap between the profit rate and the inflation rate and another said it is because we have to find the root of the delay and omit it. He believed that the root of delay is not considering the benefit of facility demanders. One interviewee believed that the main solution for delayed penalty is close supervision and the use of the delay penalty as a deterrent. Only two respondents commented on *shariah*-compliance, with one of them, interviewee

number four, saying that it is *shariah*-compliant and the other one, interviewee number nine, not giving his opinion; he just said that at first it was rejected by the Guardian Council, but after its format had been changed it was approved.

In conclusion it can be said that a high majority of interviewees believe that it was useful but some of them add that it should be more than the gap between the profit rate in the banking system and the black market interest rate in order to be able to solve or reduce delay penalty.

When the Law of Usury-Free Banking in Iran was introduced in 1984, it was a temporary, emergency, experimental law. The bank authority said that they would review it after a few of years and look at its shortcomings before reconsidering and reforming it if necessary. They have now started to review it. We questioned the interviewees on this matter and their responses are set out in Table 7.20. As we can see in table 7.20 all interviewees agree with the reform of all laws regarding the banking system, including the Law of Usury-Free Banking in Iran.

Table 7.20: Focused Coding Number 5 for Question 3 (Types of Solutions for the Problems)

Reform of the Law of Usury-Free Banking in Iran, Monetary and Banking Law and Manner of the Banking System Management Law.	
Interviewee 1	Yes it is necessary.
Interviewee 2	Yes it is necessary.
Interviewee 3	Yes it is necessary.
Interviewee 4	Yes it is necessary.
Interviewee 5	Yes it is necessary.
Interviewee 6	Yes it is necessary.
Interviewee 7	Yes it is necessary.
Interviewee 8	Yes it is necessary.
Interviewee 9	Yes it is necessary.
Interviewee 10	Yes it is necessary.
Interviewee 11	Yes it is necessary.
Interviewee 12	Yes it is necessary.

7.5 DETERMINATION OF FINAL PROFIT RATES FOR DEPOSITORS

As mentioned in Chapter Three, Islamic banks in Iran are agents of depositors and their income comes from honorarium or lawyers' fees so in order to increase their income they have to encourage people to deposit more. For this reason, they announce an in-part-payment rate for term investment deposits, which is in fact a predicted

profit rate. So the banks, as a third party, can guarantee the principal of the deposits and a minimum profit expected from the previous year's experience as in-part-payment. Therefore, where actual profit is more than the expected profit, banks have to pay actual profit not the profit paid in-part-payment. In a case where actual profit is less than in-part-payment profit, depositors must generally be paid less than they have been promised but, because of guaranty, banks have to pay the difference between actual profit and in-part-payment profit from their sources. However, there is no problem according to *shariah* law (at least according to the *Jafari* School of jurisprudence). The reason is that in these accounts the bank is not the main party of the contract, they are only the agents of the depositors, or middlemen. Some people accuse Iran's banking system of paying only the in-part-payment[37] rate in all cases, regardless of the result of a project. In order to clarify this issue in practice interviewees have been questioned about it and their responses can be seen in tables 7.21- 7.23.

Table 7.21: Results for Question 4 (Overview of the Appropriate Ways to Deal with In-part-payment Profit)

Question 4	**How do you behave with "in-part-payment" profit in order not to be in contravention of *shariah*-compliance?**
Focused coding	
1	In-part-payment profit is more than actual profit.
2	In-part-payment profit is less than actual profit.
Themes	In order to be *shariah*-compliant in relation to in-part-payment there are two probabilities: In-part-payment profit is more than actual profit and in-part-payment profit is less than actual profit.

The issues which should be considered are shown in Table 7.21 and are: (1) If in-part-payment profit is more than actual profit, (2) If in-part-payment profit is less than actual profit.

One probability is that in-part-payment profit is more than actual profit which means that the project was not as profitable as expected and predicted. Interviewees' answers regarding the behaviour of banks in Iran are shown in Table 7.22.

[37] In-part-payment is paid when the amount is not determined. So, some amount is paid until the actual amount is determined. For example, because of partnership in Islamic banks, the profit rate which depositors will obtain is not predetermined and therefore they cannot receive any fixed profit rate until the actual profit rate is cleared. Here banks pay the "in-part-payment" which means that it is not the final profit rate and will be adjusted after the real profit rate is determined.

As can be seen in Table 7.22, all interviewees answered this question. Eight interviewees (66%) said that banks pay in-part-payment profit rate, two interviewees (16.6%) said that banks have to pay because they guarantee in-part-payment profit rate and one interviewee (8.3%) said that banks donate the difference between in-part-payment profit rate and actual profit. Sometimes the amount of in-part-payment profit is less than actual profit in which case banks should pay the depositors' share from all profits. So, it can be seen that some banks announced that this year their profit was more than predicted and expected a profit. Table 7.23 shows the interviewees' answers.

Table 7.22: Focused Coding Number 1 for Question 4 (Appropriate Ways to Deal with In-Part-Payment Profit)

In-part-payment profit is more than actual profit	
Interviewee 1	Banks have to pay in-part-payment profit rate because they guarantee that rate.
Interviewee 2	Banks have to pay in-part-payment profit rate because they guarantee that rate.
Interviewee 3	Banks pay in-part-payment profit rate
Interviewee 4	Banks pay in-part-payment profit rate
Interviewee 5	Banks pay in-part-payment profit rate.
Interviewee 6	Banks pay in-part-payment profit rate.
Interviewee 7	Banks pay in-part-payment profit rate.
Interviewee 8	Banks pay in-part-payment profit rate.
Interviewee 9	Banks pay in-part-payment profit rate.
Interviewee 10	Banks have to pay in-part-payment profit rate because they guarantee that rate.
Interviewee 11	The difference between in-part-payment profit rate and actual payment is donated to depositors by banks.
Interviewee 12	Banks pay in-part-payment profit rate.

As can be seen in Table 7.23, five interviewees (41.6%) did not answer this question, four interviewees (33% of interviewees and 57% of responders) said banks pay according to actual profit, one interviewee (8.3% of interviewees and 14% of responders) said that banks usually, by using conditions provided in the contract, try to pay only the in-part-payment profit rate, one interviewee said it depends on the branches and one interviewee believes that banks pay according to the actual profit recently. It appears from the last answer that he believes that, at least sometimes in previous years, banks did not pay actual profits to depositors. In conclusion, it can be said that the majority of responders believe that Islamic banks in the Islamic Republic

of Iran in the case that in-part-payment profit is less than actual profit have been paying actual profit to their clients.

Table 7.23: Focused Coding Number 1 for Question 4 (Appropriate ways to deal with In-Part-Payment Profit)

In-part-payment profit is less than actual profit	
Interviewee 1	Banks pay according to the actual profit.
Interviewee 2	Banks pay according to the actual profit.
Interviewee 7	Banks usually, by using conditions provided in the contract, try to pay just the in-part-payment profit rate.
Interviewee 8	Banks pay according to the actual profit.
Interviewee 10	It depends on branches. Some of them may pay just in-part-payment profit rate, but most of them pay actual profit.
Interviewee 11	Banks pay according to the actual profit.
Interviewee 12	Banks pay according to the actual profit recently.

7.6 DETERMINATION OF FINAL PROFIT RATES FOR FACILITIES APPLICANTS

Another aspect of *shariah*-compliance regarding profit is circumstance of calculation of the profit as to whether it is fixed or dependent on actual profit. As mentioned in Chapter Three, there are three kinds of contract in Islamic banking in the Islamic Republic of Iran, *Qardh-Al-Hasanah* contracts, partnership contracts and exchange contracts. In partnership contracts, both parties share in the profits and losses. According to the Law of Usury-Free Banking in Iran and its executive byelaw and instruction, there is one expected profit rate which is announced by the Central Bank, but it is just as an index for project evaluation. This means that according to the project evaluation, any project which can give the expected profit rate to the bank is approved to receive financial facilities. However, actual profit which banks receive depends on the actual profit which firms obtain.

Islamic banks in Iran are permitted to insure their shares and also to use conditions provided in the contract in order to engage their partner in paying any losses from their property. Some banks make implicit conditions in the *Solh* contract which is a necessary contract in which they can engage their partners. Table 7.24 shows cases which are debateable in this regard.

Table 7.24: Results for Question 5 (Overview of the Appropriate Ways to Deal with Expected Profit)

Question 5	**How do you (banks) deal with expected profit in order not to be in contravention of the *shariah*-compliance?**
Focused coding	
1	Expected profit is more than actual profit.
2	Expected profit is less than actual profit.
Themes	In ensuring that the expected profit does not violate *shariah*-compliance, there are two probabilities: Expected profit is more than actual profit and expected profit is less than actual profit.

Table 7.25, shows the opinions of the interviewees regarding cases where expected profit is more than actual profit.

As can be seen in Table 7.25, half of the interviewees (50%) did not answer this question, two interviewees (16.6%) believe that banks usually ask for expected profit, one interviewee (8.3%) believes that, according to the conditions provided in the contract, clients have to pay the difference between expected profit and actual profit, two interviewees (16.6%) said that. in this case, banks examine the case in order to understand what the reason for the abatement of the profit was. If the client is to blame, they will ask him to pay the difference between the expected profit and the actual profit, and finally one interviewee stated that, according to the condition provided in the contract, clients would have to pay the difference between the expected profit and the actual profit. However, if the client was not to blame he/she should not pay the difference between the expected profit and the actual profit.

Table 7.25: Focused Coding Number 1 for Question 5 (Circumstance of Dealing with Expected Profits)

Expected profit is more than actual profit	
Interviewee 1	According to the conditions provided in the contract, clients have to pay the difference between the expected profit and the actual profit.
Interviewee 2	According to the conditions provided in the contract, clients have to pay the difference between expected profit and actual profit too. But if the client is not to blame he/she should not pay the difference between the expected profit and the actual profit.
Interviewee 7	Banks usually ask for expected profit.
Interviewee 8	In this case, banks examine the case in order to understand what the reason for the abatement of the profit was. If the client is to blame, they will ask him to pay the difference between the expected profit and the actual profit.
Interviewee 10	In this case, banks examine the case in order to understand what the reason for the abatement of the profit was. If the client is to blame, they will ask him to pay the difference between the expected profit and the actual profit.
Interviewee 12	Banks usually ask for expected profit

Table 7.26, shows opinions of the interviewees about a case where expected profit is less than real profit.

Table 7.26: Focused Coding Number 2 for Question 5 (Circumstance of Dealing with Expected Profits.

Expected profit is less than actual profit	
Interviewee 1	Banks donate the difference between expected profit and actual profit.
Interviewee 2	Banks ask for the difference between expected profit and actual profit.
Interviewee 7	Banks usually ask for expected profit.
Interviewee 8	Banks ask for the difference between expected profit and actual profit.
Interviewee 10	Banks ask for difference between expected profit and actual profit.
Interviewee 12	Banks usually ask for expected profit.

As in the previous table, in this table six interviewees (50%) did not answer the question, three interviewees (25%) of interviewees and 50% of respondents believe that banks also ask for the difference between expected profit and actual profit, two interviewees (16.6%) of interviewees and 33.2% of respondents believe that banks usually ask for expected profit and one interviewee (8.3%) of interviewees and 16.6%

of respondents believes that banks donate the difference between expected profit and actual profit. In conclusion it can be said that this issue is debatable or there is not unified behaviour. Banks' behaviour regarding profit depends on the bank or branch authorities.

7.7 *SHARIAH* BOARD

In many Islamic banks, there is a *shariah* board to guide bank staff and also to check banks' activities regarding to *shariah*-compliance. Despite the participation of a *shariah* board in the drafting of the Law of Usury-Free Banking in Iran., it was omitted by parliament because, they believed that, due to the complete change in the banking system to Islamic banking and the existence of thousands of branches, firstly, it was not possible to have a lot of *shariah* boards and secondly and more importantly, a *shariah* board is not necessary. This is because, they saw it as a system not one bank among several banks and there is the Guardian Council that checks all laws regarding *shariah*-compliance. Therefore they are sure that all laws approved by parliament in the country are *shariah*-compliant.

Table 7.27: Results for Question 6 (Overview of the Existence of a *Shariah* Board in Islamic Banking in Iran)

Question 6	**What do you think of a *shariah* board in Iran's Islamic Banking?**
Focused coding	
1	Its possibility
2	Its usefulness.
3	Its necessity.
Themes	*shariah* boards should be considered as possible, useful and necessary.

Moreover, in practice we have several institutions which have a responsibility to check circumstances and implementation of laws, including the Law of Usury-Free Banking in Iran, in particular the Central Bank of Iran control bank's actions. Table 7.27 shows aspects of the *shariah* Board which are under discussion. They are: its possibility, its usefulness and its necessity.

Table 7.28, shows the opinions of interviewees with regard to possibility of the existence of a *shariah* board in the Islamic Republic of Iran.

Table 7.28. Focused Coding number 1 for Question 6 (Existence of a *Shariah* Board in Islamic Banking in Iran)

Possibility of a *shariah* board in Islamic Banking in Iran.	
Interviewee 1	It is possible.
Interviewee 2	It is possible.
Interviewee 4	It is possible.
Interviewee 8	It is possible.
Interviewee 9	It is possible.
Interviewee 11	Yes, it is possible.
Interviewee 12	It is possible.

As Table 7.28, shows five interviewees (41.6%) did not answer the question. and seven interviewees (58, 3%) of interviewees and 100% of respondents believe that it is possible.

Table 7.29, shows the opinions of the interviewees regarding the usefulness of a *shariah* board in Islamic Banking in Iran. As can be seen in this table, as in the previous table five interviewees (41.6 %) did not answer this question. Four interviewees (33%) of interviewees and 57% of respondents stated that it is definitely useful, one interviewee (8.3%) of interviewees and 14% of respondents believes that it is useful because the supervisory offices are not sufficient; two interviewees 16.6% of interviewees and 28.6% of respondents believe that it is not useful, but their reasons were different. The first one said "it is not useful for our country where the whole system is Islamic; rather it is useful for countries with dual systems." The second one says, it is not useful in Iran. If contracts were defined well and staff were educated well, there would be no need for a *shariah* board. In conclusion, 71% of respondents believe that a *shariah* board is useful for the Islamic Republic of Iran.

Table 7.29: Focused Coding Number 2 for Question 6 (Existence of a *Shariah* Board in Islamic Banking in Iran)

Usefulness of a *shariah* board in Islamic banking in Iran.	
Interviewee 1	No. It is not useful for our country in which the whole system is Islamic; rather it is useful for countries with dual system.
Interviewee 2	Definitely, it is useful.
Interviewee 4	Definitely, it is useful.
Interviewee 8	It is useful. Our supervisory offices are not sufficient.
Interviewee 9	Yes, it is definitely useful.
Interviewee 11	No, it is not useful in Iran. If contracts were defined well and staff educated well, there would be no need for a *shariah* board. Of course, just one *shariah* board in central banks may be useful.
Interviewee 12	Yes, it is definitely useful.

Table 7.30, shows the opinions of the interviewees regarding the necessity of a *shariah* board in Islamic Banking in the Islamic Republic of Iran. As can be seen in this table, five interviewees (41.6 %) did not answer the question as in the previous two tables. It is worth mentioning that the persons who did not answer this question are the same ones who did not answer the two previous questions. Three interviewees

Table 7.30: Focused coding number 3 for Question 6 (Existence of the Shariah Board in Islamic Banking in Iran)

Necessity of *shariah* board in Islamic banking in Iran.	
Interviewee 1	No. The Central Bank of Islamic Republic of Iran performs that function.
Interviewee 2	It is necessary.
Interviewee 4	Definitely, it is necessary.
Interviewee 8	Yes, it is necessary. Our supervisory officers are not sufficient.
Interviewee 9	Yes, it is definitely necessary.
Interviewee 11	Yes, but just in the Central Bank.
Interviewee 12	Yes, it is definitely necessary.

(25%) of interviewees and 43% of respondents believe that it is definitely necessary, (25%) of interviewees and 43% of respondents believe that it is necessary, and one of them explained the reason, saying: "Our supervisory officers are not sufficient". one interviewee believes that it is not necessary and he explained that, in fact, the Central Bank of Islamic Republic of Iran both supervises and controls new contracts and bank activities regarding *shariah*-compliance.

In conclusion, the majority of interviewees who answered the question believe that a *shariah* board is possible, useful and necessary for Islamic banking in the Islamic Republic of Iran.

7.8 PROBLEMS WHICH CAUSED THE ABSENCE OF A *SHARIAH* BOARD IN ISLAMIC BANKING IN ISLAMIC REPUBLIC OF IRAN.

Some economists believe that the existence of a *shariah* board would create some problems in Islamic banking of Iran, such as: (1) Inconsistency in banking activities in different branches or banks, especially in Iran where the whole system is Usury-Free, (2) Lack of sufficient specialists in both banking affairs and *shariah* law, (3) Increase in bank costs. Table 7.31 shows these problems.

Table 7.31: Results for Question 7 (Overview of the Problems Regarding a *Shariah* Board in Islamic Banking in Iran)

Question 7	**What are the problems regarding *shariah* boards in Islamic banking?**
Focused coding	
1	Inconsistency in banking activities in different branches or banks, especially in Iran where the whole system is Usury-Free.
2	Shortage of specialists in both banking affairs and *shariah* law.
Themes	Problems which the *shariah* board is faced with are inconsistency in banking activities in different branches of the banks and shortage of specialist.

Some believe that *shariah* boards cause inconsistency in banking activities in different branches or banks because each *shariah* board may have its own opinion. So it is possible that one contract or project could be approved in one branch or bank and rejected in another. This could lead to people not trusting or relying on Islamic banking. Table 7.32 shows the opinions of the interviewees regarding inconsistency in banking activities between different branches or banks.

Table 7.32: Focused Coding Number 1 for Question 7 (Problems Regarding *Shariah* Boards in Islamic Banking in the Islamic Republic of Iran)

Inconsistency in banking activities between different branches or banks.	
Interviewee 1	In Malaysia they designed a central *shariah* board which led to unified methods.
Interviewee 4	I do not agree.
Interviewee 5	As this board would be a policy maker it could lead to unified methods.
Interviewee 7	As this board would be a policy maker it could lead to unified methods.
Interviewee 8	It depends on the organization. If they are well organised there wouldn't be any problem in this regard.
Interviewee 9	If there was a *shariah* board just in the Central Bank, not only would it not lead to inconsistency, it would lead to unified methods.
Interviewee 11	Yes.
Interviewee 12	Yes, if every bank has a *shariah* board.

As can be seen in Table 7.32, four interviewees did not answer this question. Interviewee number one believes that they could create some inconsistency, but the existence of one central *shariah* board could solve the problem, as in Malaysia; interviewees numbers five and seven believe that, as this board would be a policy maker, it could lead to unified methods, interviewee number eight believes that it depends on the organization. If they were well-organised there would be no problem in this regard, interviewee number four does not believe there is inconsistency, Interviewee number nine believes that, if there was a *shariah* board just in the Central Bank, not only would it not lead to inconsistency, but it would lead to unified methods and interviewees numbers eleven and twelve believe that the existence of *shariah* boards leads to inconsistency but interviewee number twelve's opinion is conditional. In conclusion, it can be said that the majority of interviewees who answered the question disagree with the opinion that *shariah* boards lead to inconsistency.

Some bank managers believe that, because of the huge number of bank branches in the Islamic Republic of Iran, it is not possible to have *shariah* boards in banks because members of *shariah* boards should be specialists both in banking affairs and *shariah* law. Of course, this opinion is based on the existence of a *shariah* board in each branch. Table 7.33 shows the opinions of interviewees regarding lack of enough specialists in both banking affairs and *shariah* law.

Table 7.33: Focused Coding Number 2 for Question 7 (Problems Regarding *Shariah* Boards in Islamic Banking in Iran)

Shortage of specialists in both banking affairs and *Shariah* law is a reason for not having *shariah* boards in the Islamic Republic of Iran.	
Interviewee 1	No, the main issue is lack of necessity for *shariah* boards.
Interviewee 2	It cannot be the reason.
Interviewee 4	It is a problem, but it was not the reason. It can be solved.
Interviewee 5	No, it cannot be the reason. It is possible to train some staff and even students.
Interviewee 7	No, it cannot be the reason.
Interviewee 8	No, it cannot be the reason. It is possible to train some staff and even students.
Interviewee 9	If there could be a *shariah* board in every branch, it would be right.
Interviewee 11	No.
Interviewee 12	No, the reason was having Guardian Council instead of *shariah* board.

As can be seen in Table 7.33, three interviewees (25%) did not answer the question; interviewee number one believes that a shortage of specialists in both banking affairs and *shariah* law is not a reason for not having a *shariah* board in the Islamic Republic of Iran. The main issue is lack of necessity for a *shariah* board; interviewees numbers two, seven and eleven believe that: a shortage of specialists in both banking affairs and *shariah* law is not a reason for not having a *shariah* board in the Islamic Republic of Iran, interviewee number four believes that it is a problem, but it is not the reason as it could be solved, interviewees numbers five and eight believe that: it cannot be the reason. It is possible to train some staff and even students and interviewee number nine believes that if there could be a *shariah* board in every branch, it would be good. In conclusion, it can be said that just one interviewee believes that if there was a *shariah* board in every branch, it would be good so it is accepted from the interviewees' point of view that a shortage of specialists in both banking affairs and *shariah* law is not a reason for not having a *shariah* board in the Islamic Republic of Iran.

7.9 SOLUTIONS FOR THE PROBLEMS REGARDING THE *SHARIAH* BOARD

In this section interviewees will be asked about solutions for the problems regarding *shariah* boards in Islamic banking in Iran. Table 7.34, shows these solutions. They are: The existence of one *shariah* board in the Central Bank, the existence of one *shariah* board in the Central Bank and one representative in any province for all

banks, the existence of one *shariah* board in the Central Bank and one representative in any province for any bank, the existence of one *shariah* board in the Central Bank and also in any central branches for all banks in the centre of the country (capital) and one representative in any province for any bank, the existence of descriptions of their duties and the necessity of checking contracts according to the relevant laws, not according to their own point of view.

Table 7.34: Results for Question 8 (Overview of Types of Solutions to the Problems Regarding *Shariah* Boards in Islamic Banking in Iran)

Question 8	**What are the solutions for above mentioned problems regarding *shariah* boards in Islamic Banking in Iran?**
Focused coding	
1	Existence of one *shariah* board in the Central Bank.
2	Existence of one *shariah* board in the Central Bank and one representative in any province for all banks.
3	Existence of one *shariah* board in the Central Bank and one representative in any province for any bank.
4	Existence of one *shariah* board in the Central Bank and also in any central branches for all banks in the centre of the country, and one representative in any province for any bank.
5	Existence of descriptions of duties for them.
6	The necessity of checking contracts according to the relevant laws, not according to their own point of view.
Themes	The potential solutions for the identified problems with the *shariah* board in Islamic Republic of Iran are: existence of one *shariah* board in the Central Bank, one *shariah* board in the Central Bank and one representative in any province for all banks, one *shariah* board in the Central Bank and one representative in any province for any bank, one *shariah* board in the Central Bank and also in any central branches for all banks in the centre of the country and one representative in any province for any bank, existence of description of their responsibilities and the necessity of checking contracts according to the relevant laws, not according to their own point of view.

As can be seen in Table 7.35, five interviewees did not answer this question, interviewee number one (8.3% of interviewees and 14% of responders) believes that : "There is no need for a *shariah* board, because the Central Bank performs the role", interviewees numbers 2,9 and 12 (25% of interviewees and 42.86% of responders) believe in the "existence of one *shariah* board in the Central Bank and having one representative in any province for all banks" but interviewee number nine added that "this representative should be just a link, nothing more", interviewee number four

(8.3% of interviewees and 14% of responders) believes there should be one *shariah* board at least in the Central Bank, interviewee number eight (8.3% of interviewees

Table 7.35: Focused Coding Number 1 for Question 8 (Solutions Regarding *Shariah* Boards in Islamic Banking in Iran)

Existence of one *shariah* board in the Central Bank or the existence of one *shariah* board in the Central Bank and one representative in any province for all banks or the existence of one *shariah* board in the Central Bank and one representative in any province for any bank or the existence of one *shariah* board in the Central Bank and also in any central branch for all banks in the centre of the country and one representative in any province for any bank.	
Interviewee 1	There is no need for a *shariah* board because the Central Bank performs this role.
Interviewee 2	Existence of one *shariah* board in the Central Bank and one representative in any province for all banks.
Interviewee 4	Existence of one *shariah* board at least in the Central Bank.
Interviewee 8	Existence of one *shariah* board in the Central Bank and also in any central branches for all banks in the centre of the country.
Interviewee 9	Existence of one *shariah* board in the Central Bank and one representative in any province for all banks, but this representative should be just a connector, nothing more.
Interviewee 11	Existence of one *shariah* board just in the Central Bank.
Interviewee 12	Existence of one *shariah* board in the Central Bank and one representative in any province for all banks.

and 14% of responders) believes there should be one *shariah* board in the Central Bank and also in any central branches for all banks in the country centre and interviewee number eleven (8.3% of interviewees and 14% of responders) believes there should be just one *shariah* board in the Central Bank.

As interviewee number four believes there should be "one *shariah* board *at least* in the Central Bank", it means that he does not disagree with other options. So, it is possible to add his opinion to all options. Therefore, the above percentages will change to (16.6 % of interviewees and 28% of respondents) and (33% of interviewees and 57% of respondents). In conclusion, the majority of responders believe there should be one *shariah* board in the Central Bank and one representative in any province for all banks.

In addition to above suggestions, another solution to inconsistency could be the introduction of a description of the duties of the *shariah* board. The opinions of the interviewees can be seen in Table 7.36.

Table 7.36: Focused Coding Number 2 for Question 8 (Solutions Regarding *Shariah* Boards in Islamic Banking in Iran)

Introduction of a description of duties for s*hariah* boards and necessity of checking contracts according to them and other relevant laws, not according to their own point of view.	
Interviewee 1	Yes.
Interviewee 2	Yes.
Interviewee 3	Yes.
Interviewee 4	Yes.
Interviewee 5	Yes.
Interviewee 7	Yes.
Interviewee 8	Yes.
Interviewee 9	There is no need for that.
Interviewee 10	Yes.
Interviewee 11	Yes.
Interviewee 12	Yes.

As can be seen in Table 7.36, interviewee number six did not answer the question and interviewee number nine believes that there is no need for it. Other interviewees agree that there should be a description of the duties of *shariah* boards and that contracts should be checked according to it and other related laws, not according to their own point of view.

7.10 CONCLUSION

This chapter has attempted to examine the assurance of *shariah*-compliance in Islamic banking according to interviewees' responses. As mentioned before, by *shariah*-compliance we mean not only using proper contracts for the projects but also considering their profitability. Furthermore, we asked for the opinions of the interviewees regarding the problems with which Islamic banks are faced and their solutions. The vast majority of interviewees believe that banking system authorities in the Islamic Republic of Iran are able to make sure that banking activities are *shariah* -compliant by careful consideration of each contract, and of the honesty, profitability, speciality and experience of their clients and by supervising the process of the project

throughout the entire process. In addition, all interviewees believe that previous staff training, was not enough and more training was needed.

Also, regarding the problems with which the Islamic banking system is faced, the majority of responders believe that although asymmetric information, moral hazard and adverse selection are also problems in Islamic banks, they are more able to solve or reduce these problems than conventional banks. Furthermore, the majority of respondents believe that, there is not enough flexibility in Islamic contracts in Islamic banking in the Islamic Republic of Iran and all interviewees believe that there are some problems regarding financing all applicants, not because of the nature of Islamic contracts but because of government policies which state-owned banks have followed. In addition, all interviewees believe that there should be a reform in the law which, fortunately, has being carried out now and 58.33% believe that there is more overdue debt than usual.

Regarding the solutions for these problems, ten interviewees (83.2%) believe that a change of structure is necessary. There is no majority for usefulness of conditions provided in the contract and late payment penalty. Also, all interviewees agree that there should be a reform of all laws regarding the banking system, including the Law of Usury-Free Banking in Iran.

However, where in-part-payment profit is more than actual profit, the majority of interviewees (66%) believe that banks pay in-part-payment profit rates to depositors and also, it can be said that the majority of respondents believe that, where in-part-payment profit is less than actual profit, that Islamic banks in the Islamic Republic of Iran have been paying actual profit to their clients.

Furthermore, regarding *shariah* boards the majority of interviewees who responded to the question believe that it is possible, useful and necessary for Islamic banking in the Islamic Republic of Iran and that by having limited numbers of *shariah* boards and a description of the duties of those boards, the problem of inconsistency and shortage of specialists could be solved.

Chapter Eight:

QUALITATIVE ANALYSIS (THE CONTRIBUTION OF ISLAMIC BANKING TO THE ECONOMIC DEVELOPMENT)

8.1 INTRODUCTION

In Chapter Two the positive role of Islamic banking in economic development was discussed. In Chapter Four the structure of the Iranian Economic System was introduced and in Chapter Five the contribution of Islamic banking to economic development was shown using quantitative analysis. This chapter will provide a qualitative analysis of the interview questions regarding the contribution of Islamic banking in Iran to economic development, according to the responses of the interviewees.

Once again the semi- structured interview was chosen to conduct the interview survey. Twelve managers and advisors from the Central Bank and commercial banks in the Islamic Republic of Iran were selected for face-to-face interviews. In addition, a complementary interview was necessary in order to augment data collection so I went to the Islamic Republic of Iran to carry out the interviews. I had to carry out the complementary interview with some interviewees by telephone. Also in this chapter I have replaced the jurisprudent with an economist who had carried out a great deal of theoretical and practical research on Islamic banking. Finally, the collected data were analysed using thematic analysis and coding.

8.2 THE CONTRIBUTION OF ISLAMIC BANKING TO THE ECONOMIC DEVELOPMENT

Table 8.1 shows types of effect of Islamic banking on economic development in the Islamic Republic of Iran. These effects include: Effect on the mobilisation of monetary resources (deposits), effect on the allocation of monetary resources (financial facilities), effect on efficiency, effect on encouraging people to deal with the banking system, effect on the internal economic crisis, effect on and of the

external economic crisis, effect on inflation, effect on employment, effect on liquidity, effect on internal trade, effect on external trade, effect on real GDP and Profitability.

Table 8.1: Results for Question 1 (Overview of Types of Effects of Islamic Banking on Economic Development)

Question 1	**What have been effects of Islamic Banking on economic development in Iran?**
Focused coding	
1	Effect on the mobilisation of monetary resources (deposits).
2	Effect on the allocation of monetary resources (financial facilities).
3	Effect on efficiency.
4	Effect on encouraging people to deal with the banking system.
5	Effect on the internal economic crisis.
6	Effect on and affected of the external economic crisis.
7	Effect on inflation.
8	Effect on employment.
9	Effect on liquidity.
10	Effect on internal trade.
11	Effect on external trade.
12	Effect on real GDP.
13	Profitability
Themes	The effect of Islamic banking on economic development in Iran can be defined as its effect on the mobilisation of monetary resources(deposits), allocation of monetary resources (financial facilities), efficiency, encouragement of people, the internal economic crisis, external economic crisis, inflation, employment, internal trade, external trade, real GDP and profitability.

Interviewees were questioned about the ways in which Islamic banking has affected economic development in Iran and their opinions were coded.

Table 8.2 shows the opinions of interviewees with regard to the effect of Islamic banking in Iran on the mobilisation of monetary resources (deposits). As the table suggests one of them, 8.3%, answered “I don’t know” and one, 8.3%, said that it is difficult to say anything positively or negatively.

83.4% of interviewees answered that converting from conventional banking to an Islamic banking system has had a positive effect on the mobilisation of deposits. One of them, 8.3%, answered “I don’t know” and one interviewee, 8.3%, answered that it is difficult to say anything, either positively or negatively.

Table 8.2: Focused Coding Number 1 for Question1 (Effect of Islamic Banking on Economic Development)

Effect of Islamic banking in Iran on the mobilisation of monetary resources (deposits).	
Interviewee 1	Deposits increased.
Interviewee 2	We are in a society in which there are no conventional banks so it is not easy to answer this question, but there is no doubt that religious people have been encouraged to deposit in banks since the elimination of *riba*.
Interviewee 3	It has definitely had a positive effect because believers who did not deposit in banks before have been attracted by banks since the elimination of *riba* but non believers have not left the banks. Non believers are looking to maximise their profit and there is no difference between Islamic banks and conventional banks.
Interviewee 4	Theoretically it should have a positive effect on deposits and practically it has caused an increase in deposits.
Interviewee 5	Yes. It was positive but it relies on explanation to the people. If we explain Islamic banking methods to them more, they will be encouraged more.
Interviewee 6	It was very good. People were attracted after that. Deposits increased considerably as can be seen in the data
Interviewee 7	Our report is different regarding different areas. Sunni brothers often tend toward *Qardh-Al-Hasanah*. Of course, because people believe in the system, they look at it from an optimistic point of view; they trust the banks and are not wary of them.
Interviewee 8	Yes, a lot of people are eager to deposit in banks. First of all, because they want to obtain *halal* profit and since the elimination of *riba*, there is no problem regarding *shariah*-compliance. Secondly, because they trust the banking system rather than unofficial markets. Of course, about 10% to 20% of people go to the unofficial market which is more expensive than the banking system.
Interviewee 9	Religious people, including many businessmen in the markets, did not previously deal with banks as they believed the banking system was not Islamic. After this law, they started to cooperate with banks.
Interviewee 10	Actually, I do not know.
Interviewee 11	I think it was positive. The people were split into two groups; one group was looking just for interest and benefit. There was no difference for them between different banking systems. The other group, which was the majority, was looking for investment in a lawful (*halal*) way. This group was definitely attracted. From an empirical point of view, it can be seen that despite the crisis in other economic sectors, the banking system was profitable. Also as we try to understand our clients, although, we have overdue debt we can say that we do not have unpaid debt and this decreases the bank costs.
Interviewee 12	As there is just one banking system in Iran, it is difficult to give an opinion.

Table 8.3 shows opinions of interviewees with regard to the effect of Islamic banking in Iran on the allocation of monetary resources (financial facilities). As the table shows two interviewees (16.6%) did not answer the question and one interviewee (8.3%) believes that it does not have any effect on allocated facilities. However, nine

interviewees (75.1% of interviewees and 90% of the respondents) strongly believe Islamic banking has had a positive effect on allocated facilities.

Table 8.3: Focused Coding Number 2 for Question1 (Effect of Islamic Banking on Economic Development).

Effect of Islamic banking in Iran on the allocation of monetary resources (financial facilities)	
Interviewee 1	They have increased.
Interviewee 3	It was positive. Since the elimination of *riba*, a lot of believers have been attracted by banks.
Interviewee 4	Theoretically, demand for facilities has increased because: (1) There is no interest rate. (2) Investment risk is divided between investors and depositors. (3) Due to the partnership between them and banks, as agents of the depositor, supervise projects so efficiency increases and leads to an increase in profit which attracts both savers and investors. (4) Banks usually select a portfolio which includes projects with different levels of risk and returns. So, by assuming that facilities have a positive relationship with return and negative one with risk, which was approved in our research for the Agricultural Bank of Iran, and by noticing that due to supervision which is strong in Islamic banks, it is expected that the portfolio would be the best one. In practice, the data shows that the effect was positive.
Interviewee 6	It was very good. People were attracted after that.
Interviewee 7	There was no effect.
Interviewee 8	A lot of people have been attracted to the banks.
Interviewee 9	It was positive.
Interviewee 10	Actually, I do not know.
Interviewee 11	The effect was good.
Interviewee 12	The effect was good because a lot of developmental projects have been financed by the banking system which may not have economic justification, or benefit, in an interest based banking system.

Table 8.4 shows the opinions of interviewees regarding the effect of Islamic banking in Iran on efficiency. As this table shows interviewees three, five, six and ten (33.2%) did not respond to the questions and interviewee seven believes that it has not had a particular effect on efficiency because there is no major difference between the two systems in practice. Interviewee two believes that efficiency according to its conventional definition, percentage of output to input, in Islamic banking in Iran is not very high. That does not mean that efficiency in this system is lower than in the conventional banking system, but we need a new efficiency index for state-owned Islamic banks in Iran because the banking system in Iran is not seen as an economic organisation which tries to maximise its profit but either as a charity or an instrument

by which government can support its developmental policies. Therefore, we should consider these extra qualitative services as part of their output.

State-owned banks have branches in some places which do not have economic benefit, but facilitate banking activities for people. Furthermore, the amount which they receive for their services, such as receipt of electricity, gas, telephone and mobile phone bills, is very low.

Table 8.4. Focused Coding Number 3 for Question1 (Effect of Islamic Banking on Economic Development).

Effect of Islamic banking in Iran on Efficiency	
Interviewee 1	It has been positive.
Interviewee 2	Efficiency is percentage of output to input. I accept that this percentage is not high, but the reason is, as I mentioned before, that the banking system in Iran is not counted as an economic firm which tries to maximise its profit but is considered either as a charity or an instrument by which the government supports its developmental policies so we should not expect this system to work efficiently with this criterion. We should consider these qualitative services as part of their output. In fact, we should design a new efficiency index for state-owned Islamic banks in Iran. In this situation the Islamic banking system will have a positive effect on efficiency because partnership and supervision can lead to a higher level of efficiency.
Interviewee 4	One thing that decreases efficiency is transaction cost. In some contracts such as *joaalah*, transaction cost is high, but it depends on some laws and regulations, not on the nature of contracts itself. In technical efficiency, which is related to efficiency in a productive organisation, principally there is no difference whether they work with Islamic banks or conventional banks. However, due to the partnership between investors and depositors, in partnership contracts banks, as agent of the depositor, supervise the projects regarding the technology which they want to use so this issue has a positive effect on efficiency and increases it. Also, supervision can have a positive effect on efficiency by decreasing asymmetric information.
Interviewee 7	It has not had a particular effect on efficiency because there is no major difference between the two systems in practice.
Interviewee 8	Its effect was very good.
Interviewee 9	The reality is that believers are happy with Islamic banking and non-believers have no problem with it so it can be useful for the economy and can increase efficiency.
Interviewee 11	Its effect was good.
Interviewee 12	Its effect was good for the reasons given in the previous table.

Furthermore, state-owned banking systems limit managers' roles. If they had more authority, they would be able to act more efficiently. Sometimes governments establish one employment group which is responsible for creating new jobs for the unemployed and the banking system is ordered to provide facilities according to

demand. Also, according to article 138 of the Constitution, the crisis committees of productive and agricultural units can extend the period for repaying facilities without banks playing any role in this process. In addition, the General Assembly is the decision maker in private banks, whereas in state-owned banks, the government is the decision maker and they do not consider profit at all. In the case of designing a new index, this would have a positive effect on efficiency and increase it. Also, partnership and supervision can lead to a higher level of efficiency.

Interviewee four believes there are some limitations in relation to some contracts in Iran which increase transaction costs and have a negative effect on efficiency, but they should not be seen as characteristic of Islamic banking. For example, as the *joaalah* contract is counted as the "contract work" in the law of the Islamic Republic of Iran, from the first they must pay 5% as insurance and 5% as tax which increases transaction cost significantly. This is one reason for decreasing the share of *joaalah* after 10 years of its usage in banking system of Iran. However, he emphasises that the nature of Islamic banking is such that it increases efficiency because of the existence of partnership and supervision. In conclusion, 58.3% of interviewees and 87.5% of respondents believe that Islamic banking has a more positive effect on efficiency than the conventional banking system but none of the respondents believe that efficiency in Islamic banking in Iran is at a high level of efficiency with the present efficiency index. All of them believe that the problem is created by government interference.

Table 8.5: Focused Coding Number 4 for Question 1 (Effect of Islamic Banking on Economic Development).

Effect of Islamic banking in Iran on encouraging people to deal with the banking system.	
Interviewee 1	Positive.
Interviewee 2	There is no doubt that religious people have been encouraged to deal with the banks since the elimination of *riba*.
Interviewee 3	It has definitely had a positive effect.
Interviewee 4	Yes, it has had positive effect.
Interviewee 5	Yes, it has had positive effect.
Interviewee 6	Yes, it has had positive effect.
Interviewee 7	It was effective in *Qardh-Al-Hasanah* accounts.
Interviewee 8	It has definitely had a positive effect.
Interviewee 9	A lot of businessmen in the market who believed the banking system was not Islamic, were attracted to the banks after they converted to the Islamic banking system,.
Interviewee 10	I do not know.
Interviewee 11	Its effect has been good.
Interviewee 12	Due to lack of dual banking system, I cannot answer accurately.

Table 8.5 shows the opinions of the interviewees regarding the effect of Islamic banking in Iran on encouraging the people to deal with the banking system. As this table shows interviewee seven believes that it was effective in *Qardh-Al-Hasanah* accounts. Also, two interviewees answered that they do not know or cannot answer accurately. However, 75.1% of interviewees believe that its effect has been good and positive.

Table 8.6: Focused Coding Number 5 for Question1 (Effects of Islamic Banking on Economic Development).

Effect of Islamic banking in Iran on the internal and external economic crisis	
Interviewee 1	Due to the entrance of the Islamic banks into containing of contracts rather than the shaping of contracts, which is common in the conventional banks, Islamic banks, including those in the Islamic banking system of Iran, were more successful than conventional banks.
Interviewee 4	The main characteristic of Islamic banking is the necessity of the production of goods in order to obtain a financial income. In instalment sale, *salam* or in partnership, there should be production. The only contract which does not need production is the *Qardh-Al-Hasanah* contract. In contrast, in conventional banks it is not necessary for production to exist. It is enough to know that the money will return to the bank, and it does not matter where it is spent; it can even be used for gambling. This is a very important matter in banking systems. The recent crisis in the West started because they financed a lot of building and the only guarantee for repaying loans was the building itself as collateral. When the price of building declined and borrowers were not able to pay their loans, banks faced serious problems. In Islamic banks this does not usually happen because they cannot go into partnership with a person who does not have the ability to repay his loan so, Islamic banks were not as badly affected as conventional banks in this regard.
Interviewee 7	It has no effect because the banking system does not strictly adhere to the principles of Islamic banking.
Interviewee 8	I think it has had positive role. Islamic banks were not affected as badly as conventional banks.
Interviewee 9	In Islamic banks, as financial facilities deal with real goods, these kinds of crisis, such as the recent US crisis, do not exist.
Interviewee 11	Their effect against internal crisis was good but their effect on the external crisis was weak.
Interviewee 12	The official banks did not experience any internal crisis at all but some Qardh-Al-Hasanah funds experienced some problems. However, they did not affect and nor were they affected by the external crisis because they do not have a close relationship with foreign banks.

Table 8.6 shows the opinions of interviewees regarding the effect of Islamic banking in Iran on the internal and external economic crisis. It shows that interviewees two, three, five, six and ten (41.5%) did not respond to the questions and interviewee seven believes that it does not have any effect because the banking system does not strictly adhere to the principles of Islamic banking. Interviewee 11 believes that their effect on internal crisis was good but their effect on the external crisis was weak. Interviewee 12 differentiates between official banks and *Qardh-Al-Hasanah* funds and believes the former did not affect and was not affected by the internal crisis at all but the latter was sometimes faced with some problems. However, he believes that the banking system of Iran did not affect and nor was it affected by the external crisis

because they do not have close relationship with foreign banks. Interviewees one, four, eight and nine strongly support the role of Islamic banking in avoiding internal and external economic crisis. Their main reasons for these opinions are: (1) Necessity of the production of goods in order to obtain a financial income in Islamic banking. (2) Not being allowed to partner those who do not have the means to repay their loans. In conclusion, 50% of interviewees and 87.7% of respondents believe that the role of Islamic banks in avoiding economic crisis, especially an internal one is positive.

Liquidity is a factor which plays an important role in inflation. Its movement depends on the government's monetary policies on the one hand and the creation of money via credit by the banking system on the other hand. The government monetary policies are independent of the banking system. Creation of money by the banking system is based on providing credit and loans. As Islamic banking activities are mainly based on partnership, it is expected that its effect on the creation of money is less than that in the conventional banking system and hence, increases liquidity less than that system.

Table 8.7: Focused Coding Number 6 for Question 1 (Effect of Islamic Banking on Economic Development).

Effect of Islamic banking in Iran on Liquidity	
Interviewee 1	Due to partnership contracts, the creation of money is slower, causing reduction in liquidity.
Interviewee 4	In the Islamic economic system, demand for money matches real economic growth. Also, the Islamic banking system is mainly based on partnership rather than loans so growth of liquidity is more limited in the Islamic banking system than in the conventional banking system.
Interviewee 7	No special effect different from the other system because the banking system in Iran does not strictly adhere to the principles of Islamic banking.
Interviewee 8	Principally, it should play a role in the reduction in liquidity growth rate.
Interviewee 9	If money is equivalent with goods, as is the case in the Islamic banking system, there would not be a high growth rate in liquidity.
Interviewee 11	It causes decrease in the liquidity growth rate.
Interviewee 12	Sometimes it has had a negative effect and increased liquidity more than the Central Bank wanted.

Table 8.7 shows opinions of interviewees regarding the effect of Islamic banking in Iran on liquidity. As can be seen in this table interviewees two, three, five, six and ten (41.5%) did not respond to the question and interviewee seven believes that it does not have any special effect different from the other system because the banking system does not maintain the principles of Islamic banking. Furthermore, interviewee 12 believes that sometimes it has had a negative effect and increased liquidity more than the Central Bank wanted. However, five interviewees, 41.5% of interviewees and 71.4% of respondents, believe that Islamic banking in Iran has played a positive role in decreasing liquidity growth rate. This means that by considering expansionary monetary policies by the government', if there was not an Islamic banking system in Iran, the country would have faced a greater growth rate in the liquidity.

Table 8.8: Focused Coding Number 7 for Question 1 (Effect of Islamic Banking on Economic Development).

Effect of Islamic banking in Iran on inflation.	
Interviewee 1	Due to partnership contracts, the velocity of money is slower, so causing reduced inflation.
Interviewee 4	There is a balance between financial income and value added in real economy in Islamic banking. In fact, while there is a one-to-one relationship between value added in the financial sector and real economy sector, there is no such relationship in conventional banks. Of course, classic economists believe that all loans are invested, but Keynes rejected their claim and believed that loans could be used for speculative purposes, even for gambling. Sometimes the price of houses increases and can lead to increased house building but some times the price of shares of houses increase. This happened in America and led to financial crisis. However, in Islamic banking, a one-to-one relationship will lead to decreased inflation. Although, there has been a relatively high rate of inflation in Iran, that was because of the government's expansionary monetary policies, so if there had not been Islamic banking in Iran, the economy would have experienced a higher inflation rate.
Interviewee 7	It has had no effect because the banking system does not adhere strictly to the principle of Islamic banking.
Interviewee 8	It causes decreasing inflation.
Interviewee 9	If money is equivalent to goods there will be no inflation. Inflation in Iran is caused mainly by government expenditure and expansionary monetary policy.
Interviewee 11	The effect of Islamic banking in Iran on reducing inflation was not very significant.
Interviewee 12	It is said that if Islamic banking is implemented properly, it will work against inflation.

Inflation is a factor which makes the process of growth and development slow because during periods of inflation more capital is spent on commerce and speculative projects than on productive projects. So, if the Islamic banking system can decrease inflation, it will support the growth and development process. So, Table 8.8. has been designed to consider this matter from the interviewee's point of view. It shows the opinions of interviewees regarding the effect of Islamic banking in Iran on inflation.

As this table shows interviewees two, three, five, six and ten (41.5%) did not respond to the question and interviewee seven (8.3%) believes that it does not have any effect because the banking system in Iran does not maintain the principle of Islamic banking strictly. Interviewee one believes that, due to partnership contracts, the velocity of money is slower so causes reduced inflation. Interviewees four and nine believe that because of the balance between financial income and value added in real economy in

Islamic banking, inflation would decrease if there were no other factors such as government expansionary monetary policies.

Table 8.9: Focused Coding Number 8 for Question 1 (Effect of Islamic Banking on Economic Development).

Effect of Islamic banking in Iran on employment	
Interviewee 1	In Islamic banking, there is no speculative demand for money so the financial facilities of Islamic banking are used mainly for the production of goods and services leading to increased employment.
Interviewee 2	It has a positive effect on employment.
Interviewee 3	It has a positive effect on employment.
Interviewee 4	Islamic banking not only increases employment but also encourages entrepreneurs because Islamic banks work mainly according to partnership. So, when they are selecting their partners, they select those who are more experienced, more educated and more innovative. Consequently, demand for entrepreneurs increases in society
Interviewee 5	It has a positive effect on employment.
Interviewee 6	It has a positive effect on employment.
Interviewee 7	No special effect more than the other system because the banking system does not adhere strictly to the principle of Islamic banking.
Interviewee 8	It has a positive effect on employment.
Interviewee 9	It has a positive effect on employment.
Interviewee 10	I am not sure.
Interviewee 11	It has a positive effect on employment.
Interviewee 12	It has a positive effect on employment.

In conclusion, four interviewees 33.3% of interviewees and 57.1%of respondents strongly support the role of Islamic banking in the reduction of inflation and two interviewees ,16.6% of interviewees and 28.5% of respondents, support it, but not strongly. However, in general, 50% of interviewees and 85.6% of respondents support the role of Islamic banking in the reduction of inflation.

Employment is a very important issue regarding both economic growth and income distribution so it is necessary to choose a banking system which is able to increase employment over other systems. Due to partnership in Islamic banking, it is expected to play a positive role in increasing employment. Table 8.9 shows the opinions of the interviewees regarding the effect of Islamic banking in Iran on employment. As this table shows, only interviewee seven believes that it has no particular effect above other systems because the banking system does not adhere strictly to the principle of Islamic banking. However, other interviewees, 91.7%, believe that Islamic banking has a positive effect on employment.

Trade is a topic under consideration in economic literature regarding economic growth. It is so important that it has become centre for division of developmental strategies. So, it is important for this research to investigate the role of Islamic banking in Iran in this regard. Table 8.10 shows the opinions of the interviewees regarding the effect of Islamic banking in Iran on internal and external trade. As this table shows only interviewee seven believes that it has had no more effect than other systems. Interviewee nine is not sure that Islamic banking in Iran has had a significant effect on trade and interviewee ten believes that at least it did not have a negative effect. Nine interviewees, 75%, believe that the system has had a positive effect on trade, except import, for which providing financial facilities has been prohibited for banking system by the Central Bank. Clearly this is not related to the Islamic banking system but it is related to the government policies for supporting internal production which, according to interviewee number ten, has been successful.

Table 8.10: Focused Coding Number 9 for Question 1 (Effect of Islamic Banking on Economic Development).

Effect of Islamic banking in Iran on internal and external trade	
Interviewee 1	The system facilitates internal trade activities but there are some restrictions regarding external trade. For example, Iranian banks were prohibited from giving financial facility for import by the Central Bank.
Interviewee 2	In general they finance trade by *modharabah* contract but there are legal prohibitions for import which benefit internal production.
Interviewee 3	It was good except for imports. Of course, that restriction was to support internal production.
Interviewee 4	When growth increases everything related to it, including trade, increases. Furthermore, due to the lack of a fixed interest rate on *modharabah*, investment increases. Of course, some restrictions and prohibitions imposed on imports are not related to Islamic banks, but were the government policies to support internal production which was effective.
Interviewee 5	It was effective, except in import.
Interviewee 6	It was effective, especially in internal trade and export.
Interviewee 7	No special effect more than the other system because the banking system does not strictly adhere to the principle of Islamic banking exactly.
Interviewee 8	It was effective, except in import.
Interviewee 9	I do not think that it had a significant effect.
Interviewee 10	At least, it does not have a negative effect.
Interviewee 11	Its effect on internal trade was good but not on external trade.
Interviewee 12	It had positive effect on trade.

Growth rate of GDP is one of the main aims of the all economic activities so the main aim of the every banking system should be to increase GDP. In order to estimate the effect of Islamic banking in Iran we interviewed some bank managers and researchers

to obtain their point of view. Of course, we are aware that the result is not conclusive, but it can be an approximation, especially, as the interviewees have good knowledge of this matter.

Table 8.11: Focused Coding Number 10 for Question 1 (Effect of Islamic Banking on Economic Development)

Effect of Islamic banking in Iran on real GDP	
Interviewee 1	It should be positive because it has financed a lot of projects and invested directly in hundreds of big project such as highways and petrochemical factories and so on.
Interviewee 2	It has definitely been more effective in Iran than conventional banks before the Islamic Revolution.
Interviewee 3	It has been more effective in Iran than conventional banks before the Islamic Revolution.
Interviewee 4	We said before that Islamic banking, due to partnership, encourages human capital. This means that it encourages new technology and innovation too. Therefore, it definitely leads to economic growth and increase in GDP.
Interviewee 5	It has had a positive effect on GDP compared with conventional banks.
Interviewee 6	It has been more effective in Iran than conventional banks before the Islamic Revolution.
Interviewee 7	No special effect different from the other systems because the banking system does not strictly adhere to the principle of Islamic banking.
Interviewee 8	It has had a positive effect.
Interviewee 9	It has had a positive effect.
Interviewee 11	It has had a positive effect.
Interviewee 12	It has had a positive effect.

Table 8.11 shows the opinions of the interviewees regarding the effect of Islamic banking in Iran on GDP. As this table shows only interviewee seven believes that it had no special effect more than other systems and interviewee ten did not answer the question. However, ten interviewees, 83.4%, believe that Islamic banking in Iran has had a positive effect on GDP. Some of them referred to the projects which have been financed by the banking system and some of them mentioned this effect theoretically. For example interviewee 4 says: "We said before that Islamic banking, due to the partnership factor, encourages human capital. This means that it encourages new technology and innovation too. So, it definitely leads to economic growth and increase in GDP".

Table 8.12: Focused Coding Number 11 for Question 1 (Effect of Islamic Banking on Economic Development)

Profitability of Islamic banking in Iran	
Interviewee 1	The profit is high. At the moment, both state-owned and private banks earn at least 25% , and I think this amount for private banks is real amount
Interviewee 2	The profit rate in this system is low but it has rational reasons such as: being state–owned and being considered as a charity rather than an economic firm which is looking to maximise its profit; being an instrument for the government's development policies; existence of compulsory facilities and existence of some restrictions on involvement involved in profitable activities, such as oil projects, international projects etc.
Interviewee 3	Profitability in private banks is very high but in state–owned banks is not very high because: (1) The government obliges them to reduce their nominal profit. (2) They have to reduce their honorarium to 0% to compete with private banks in collecting deposits. (3) Overdrafts from the Central Bank which had a 34% penalty last year.
Interviewee 5	I believe that its profitability is high because, for example, Post Bank started its work in 1996 with a total capital of one billion Iranian Rials, but it now has 561 billion Rials. This means that over 13 years its capital has increased 561 times. It is worth mentioning that 140 billion *Rials* was from re-evaluation of capital but the rest was profit from internal resources.
Interviewee 6	The profit rate in Iranian banks, especially private banks, is very high.
Interviewee 7	It is no different from conventional banks because the banking system does not adhere strictly to the principles of Islamic banking .
Interviewee 8	I think Iranian banks differ from all other banks in the world because they are state-owned and the government tries to reduce unemployment by employing in its bureaus. Principally, profit is not an aim in the Islamic banking system of Iran. In addition existence of the obligatory facilities reduces profits. So, we should not expect the profit rate to be high.
Interviewee 9	I think the profitability is high. The price of private bank shares is increasing continuously.
Interviewee 10	In the private banks, profitability is high but in the state-owned banks it is low. The reason is government intervention. Also, the banks do not have freedom in using their resources.
Interviewee 11	I think the profitability is good in general but it is different in different banks. Usually it is less in state-owned banks than private banks and less in specialist banks than commercial banks. The reasons for low profitability in state-owned banks are: (1) Existence of expanded branches (2) Political issues (changing the managers) (3) Lack or at least weakness of motivation (4) Legal limitations with which state-owned banks are faced.
Interviewee 12	Their profitability is not clear because sometimes they have to finance unprofitable projects.

Although, profitability of the banking system is not directly related to its role in economic development, it is related to it indirectly because high profitability shows its relative success in its job. Table 8.12 shows the opinions of the interviewees regarding

the profitability of Islamic banking in Iran. As this table shows only interviewee seven believes that it did not have more effect than other systems and interviewee 12 believes that their profitability is not clear because sometimes they have to finance unprofitable projects. However, all interviewees believe that profitability in private banks in Iran, which now cover about 22% of banking activities in Iran, is very high. Also, five interviewees, 41.5%, believe that profitability of state-owned banks is high and the same percentage believes that their profitability is low. It is worth mentioning that this group provides several reasons for this low profit rate. First and foremost is that Islamic banks in Iran have been considered as a charity rather than an economic organisation which is looking to maximise its profits. Second, they are an instrument for the government's development policies. Third, they offer obligatory facilities. For example, interviewee two believes that the orientation of Islamic banking in Iran is different from that of other banks. The banking system in Iran is state–owned, and in fact the government looks at it more as a charity than an economic organisation which is looking to maximise its profit. So, their main purpose is to serve the people's needs, not to make profit. Also, Iran's banking system is an instrument for the government's development policies so they have to obey the government with regard to paying facility and credit. They have to pay compulsory facilities and credits to some governmental corporations and some economic sectors which are supported by the government due to its development strategy, such as the automobile industry, or to strengthen some sectors to help them to become self-sufficient, such as the agricultural sector. Although in this sector the government pays a subsidy, in general the purpose is not maximisation of profit. Furthermore, there are some limitations on Islamic Banks in Iran which do not exist for Islamic banking in GCC countries or other countries that reduce their profit as follows:

1) Islamic banks in GCC countries or other countries are able to share in an oil corporation which usually has a high profit rate, but Islamic banks in Iran cannot.

2) They can invest in foreign countries but Islamic banks in Iran cannot or at least Islamic banks in Iran have restrictions.

3) They are able to enter the capital market, but Islamic banks in Iran are only allowed to buy bonds at most equal to 2% of their deposits.

4) The most important source of income for Islamic banks in Iran is honorarium but it is somewhere between 0 to 3%.

5) Another source of income for Islamic banks in Iran is work fees, which should not be more than the work which has been spent on it. This means that they cannot have a margin as additional income.

6) The return rate in exchange contracts can be predetermined and this rate has been determined by the government at much lower than the rate of inflation, while the return rate in partnership contracts is determined by the real market and therefore the rate of inflation is included in it and consequently it can be higher than the return rate in exchange contracts and even inflation. It is worth mentioning that the proportion of exchange contracts in Iranian state-owned banks is about 70% while this share in private banks in Iran is 10% so it is natural that the Iranian profit rate is low.

In addition, according to Article 34 of the Monetary and Banking Law, some activities have been prohibited in the banking system as follows:

a) Buying and selling goods for trade. This means that they cannot buy goods and ensile them and then sell them. They can buy goods and sell them to the customer immediately as instalment selling.

b) They are not allowed to buy immoveable goods such as land and buildings with the purpose of selling them after several months or years.

c) Iranian banks' ability to buy bonds and negotiable papers and to share with corporations from inside or outside the country is limited to the extent determined by the Central Bank so if we know that the bond market of one foreign corporation is good, we cannot buy their bond. These restrictions cause a great loss of profit.

Interviewee 11 believes that we should firstly make a distinction between private banks and state-owned banks and secondly in state-owned bank between commercial banks and specialised banks. Also in the private banks we should make a distinction on two points. The first is activity antecedent and the second is management. In particular we can count four factors as reasons for relatively low profitability in public banks as follows:

1) Existence of the expanded branches in the state-owned banks. Every state-owned commercial bank in Iran has at least 2000 branches and Bank-e Melli and Bank-e Saderat have 3500 branches all of which are not necessary, especially now that there is electronic banking and customers are also able to go to any branch in the country.

2) Political issues. In the state-owned banks, every government has tried to change high level managers and bring in some who have the same political tendency. This affects their activities and efficiency.

3) Legal limitations with which state-owned banks are faced.

4) Lack or at least weakness of motivation. Managers and staff have a fixed salary, independent of their productivity. Recently, profit rates for Bank-e Saderat (Export Bank), Bank-e Tejarat (Trade Bank) and Bank-e Mellat (Nation Bank) were between 17% and 26%. Bank-e Melli (National Bank) and Bank-e Sepah are also at this level.

Of course, the state-owned specialised banks are different because they are development banks and the aim of their establishment and development is not profit but to give service to the economic sectors. So, sometimes, the Agricultural Bank not only does not make a profit but is faced with loss.

In established private banks their profit rate is high. For example, the profit for any share (every share is 100 tooman) in these banks was as follows: Kar Afarin Bank 70 Iranian Tooman, Eqtesad-e Noawin Bank 62 *Tooman*, Saman Bank 40-50 Tooman and Parsian 37-38 Tooman.

8.3 POSSIBLE DISADVANTAGES OF ISLAMIC BANKING IN IRAN REGARDING ECONOMIC GROWTH

While designing questions for the interviews and during the interviews, some questions arose regarding some disadvantages which may be faced by Islamic banking in Iran regarding economic growth. These disadvantages have been considered for deliberation. Table 8.13 shows these disadvantages as follows:

Being state-owned, legal restrictions regarding financial facilities on the demand side, existence of unnecessary conditions provided in the contract, limitation in financial instruments, fixed regulations and impossibility of innovation, dependence of the

Central Bank on the government, existence of obligatory financial facilities and weakness of competition.

Table 8.13: Results for Question 2 (Overview of Possible Disadvantages of Islamic Banking in Iran Regarding Economic Growth)

Question 2	**What are the possible disadvantages of Islamic banking in Iran regarding economic growth**
Focused coding	
1	Being state-owned.
2	Legal restrictions regarding financial facilities for demand side.
3	Restrictions in financial instruments.
4	Fixed regulations and impossibility of innovation.
5	Dependence of the Central Bank on the government.
6	Existence of obligatory financial facilities
7	Weakness of competition
Themes	Some disadvantages of Islamic Banking in Iran regarding economic growth may be: being state owned; legal restrictions regarding demand for financial facilities; fixed regulations and impossibility of innovation; dependence on the Central Bank; obligatory financial facilities and weakness of competition.

State-ownership in all productive and service firms has been debatable between economists. After the Islamic Revolution of Iran, the government decided to nationalize all banks and since the Law of Usury-Free Banking in Iran this has continued. Today it is accepted that state-owned banks are not as efficient as private banks and the reason is their dependence on the government which make them an instrument for government policies. So, the best way for them is converting to private banks. For this reason in recent years some private banks have been established and some state-owned banks have been changed to private banks in Iran, covering more than 22% of banking activities. What is worth mentioning is that their growth rate is very high. For example their growth rate in average in mobilisation of resources during 1999-2006 has been 173.2%.[38] State- ownership of the banking system in Iran has been seen by interviewees as a disadvantage. Table 8.14 shows the opinions of the interviewees regarding state-ownership of Islamic banking in Iran as a disadvantage to economic growth.

[38] See table 6.10.

Table 8.14: Focused Coding Number 1 for Question 2 (Possible Disadvantages of Islamic Banking in Iran Regarding Economic Growth)

state-ownership	
Interviewee 1	Yes.
Interviewee 2	Yes, it is a disadvantage in general.
Interviewee 3	Yes.
Interviewee 4	When the government determines managers, it is probably based on political issues not on their ability. As the manager should satisfy share holders, the manager of state-owned banks should satisfy the government. This may create some problems in efficiency.
Interviewee 5	Yes.
Interviewee 6	Yes.
Interviewee 7	Due to lack of flexibility in the laws related to state-owned banks and lack of notice to the principles of management science, they are not efficient.
Interviewee 8	Although there is a kind of inefficiency in state-owned banks, it is necessary to have a few state-owned banks. In particular, National Bank (Bank-e Melli) should remain state-owned because there are some developmental and public issues which private banks do not carry out.
Interviewee 9	It depends on the government's behaviour. If the government considers the banks as its fund it is dangerous, otherwise it is not bad.
Interviewee 10	Yes, because the government interferes in their affairs more than those of private banks. The banks do not have freedom in their use of resources. They are not allowed to act according to maximising their profit.
Interviewee 11	It is definitely a disadvantage. The reasons are: (1) lack of freedom of managers in decision making, They are not free to use their resources as they want (2) weakness of motivation: Motivation in private bank staff, especially, in high level management is much higher than in state-owned banks (3) Slowness of the evaluation process (4) Lack of speed in decision-making. The private banks are speedier than government-owned banks. For example, decision making for a purchase may take two days in the private banks, while, it takes more than one month in the government-owned banks.
Interviewee 12	Yes, it is a disadvantage.

As the table shows, only interviewee nine believes that it depends on the behaviour of the government. If the government considers the banks as its fund it is dangerous, otherwise it isn't bad. However, 91.7% of interviewees believe that state-ownership of the banks has disadvantages. Their reasons are: (1) Determining of managers may be based on political issues not on their ability. (2) Lack of flexibility in the laws related to state-owned banks and lack of notice to the principles of management science. (3) Government interference in their affairs is more than that in private banks. (4) Lack of freedom of managers in decision making: They are not free to use their resources as they want. For example, there are two kinds of contract in Islamic banks, barter or exchange contracts and partnership contracts. In the barter contracts, such as *joaalah*, *salam* and *ijarah*, the profit rate can be determined in advance. In contrast, in

partnership contracts this rate cannot be determined in advance, only expected minimum profit rate can be determined.

In 2007 (1386 in the Iranian calendar), The Iranian Money and Credit Council was ordered to determine an expected minimum and maximum profit rate. They determined 17% for 2007 (1386) for state-owned banks and recommended that private banks should not exceed more than 2% of this rate. 1n 2008 (1387) the Council determined 12% and 13% for state-owned banks and private banks respectively, then 12% for both of them. It is worth mentioning that these rates were fixed for barter contracts and is the expected minimum profit rate for partnership contracts.

We can see that when the inflation rate is about 25%, financial facility with 12% is not only free but subsidized. Consequently, private banks have shifted from barter contracts to partnership contracts, for which the rate of profit depends on the actual profit in the economy which is on average 26%. In contrast, state-owned banks have not been allowed to do that so their profit rate is much lower than that of private banks on one hand and their delayed claims are higher than those of private banks on the other hand. As a result the state-owned banks have to pay their depositors from other revenues. This means that they not only do not have any profit from deposits, but they make a loss in non-*Qardh-Al-Hasanah* deposits. (5) Weakness of motivation: Motivation among private bank staff especially in the high level management is much higher than in state-owned banks because they are encouraged to make good profit, Also, salaries in private banks are higher than in public banks (6) Slowness of the evaluation process: Evaluation in state-owned banks is very slow. It takes a long time to realise that a particular bank or the banking system in general is not succeeding or has a problem. In contrast, in private banks, they identify problems very quickly because private banks have an annual general meeting and have to report on their financial operations, including profit and loss. Moreover, in some banks such as: Eqtesad-e Noawin (New Economy), Kar Afarin (Work Creator), Saman, Parsiyan (Persians) and Sarmayeh (Capital), their major shareholders are members of the directorate so they are aware of the financial operations on a week-to-week basis. According to this information they are able to run the operation very quickly and easily. (7) Slowness in decision making: private banks are speedier than state-owned

banks. For example, decision making for a purchase may take two days in private banks, while, it takes more than one month in state-owned banks.

Table 8.15: Focused Coding Number 2 for Question 2 (Possible Disadvantages of Islamic Banking in Iran Regarding Economic Growth)

Legal restrictions regarding financial facilities for demand side	
Interviewee 1	It is government policy and also shortage of financial resources so it can be an advantage for economic growth.
Interviewee 2	They were for encouraging producer so in that time they were not a disadvantage.
Interviewee 3	They are reducing every day.
Interviewee 4	In the agricultural sector it was for support and helped this sector to develop. In the early years of the Islamic Revolution the capacity existed but there was shortage of capital so it depends on the development stage. At that time it was a good decision. Now, during the depression they finance the demand side too
Interviewee 5	There are no considerable limitations in this regard now.
Interviewee 6	We cannot say they are a advantage or a disadvantage. It depends on the economic situation. Today, when the production sector is relatively strong, they should be reduced.
Interviewee 7	There is no considerable limitation in this regard now.
Interviewee 8	It is based on government policy and shortage of financial resources but now restrictions have been reduced. At that time it was useful and encouraged production.
Interviewee 9	These restrictions have been considerably reduced now.
Interviewee 10	When there is shortage of money, the priority would be with the production sector.
Interviewee 11	These restrictions are not actually useful.
Interviewee 12	Yes they exist and are not useful.

In the early years of the implementation of the law of Interest-Free Banking in Iran the problem was related to supply, which means there was a shortage of commodities. So, decision makers in the banking system decided to direct facilities toward the supply side and productive firms. Financing demand was limited to special cases so people who required financial facilities for their consumption needs faced some problems which sometimes led to breaking the law to get financial facilities. For example, some of them obtained facilities for agriculture, but used them to buy a car and so on, whereas it should be possible to request financial facilities directly to buy a car. It also created some problems even for producers because sometimes they were not able to sell their produce because of the low consumption of people. Hence, some economists argued that this issue is against economic growth. Interviewees were asked about this, and. Table 8.15 shows their opinions regarding legal limitation of financial facilities for demand side as a disadvantage to economic growth.

According to Table 8.15 interviewees 11 and 12, 16.6% of interviewees, said that they exist and are not useful. However six interviewees, 50% of interviewees, said that they were useful at that time but at this stage of development they should be reduced and four interviewees, 33.2% interviewees, said that they have been reduced considerably or there are no considerable restrictions in this regard now.

Table 8.16: Focused Coding Number 3 for Question 2 (Possible Disadvantages of Islamic Banking in Iran Regarding Economic Growth)

Restrictions on financial instruments	
Interviewee 2	There is enough diversity in the contracts which are able to cover all needs, but that does not mean that they do not need reform.
Interviewee 3	They have an acceptable diversity.
Interviewee 4	They could be enough but in order to increase efficiency, it would be better to reform the law.
Interviewee 5	Diversity is not bad; some people believe that they are even more than is necessary.
Interviewee 6	The law isn't weak, but we should remember that it was a temporary law and should be reformed after several years.
Interviewee 7	Yes, there are some limitations.
Interviewee 8	They are enough.
Interviewee 9	These instruments are enough for our present needs but we need to introduce new instruments for the future.
Interviewee 10	Yes. We started rewriting the Monetary and Banking Law and also the law of Usury-Free Banking of Iran as a research project in 2000. One council was established of which I was the chair. We completed twenty articles by 2007 and up to now 130 articles and two laws have been put together.
Interviewee 11	Yes, there are some limitations some of which have arisen from international conditions, some from the development level of our country and some from the inflexibility of the laws and regulations of Islamic banking.
Interviewee 12	Yes, there are some limitations.

Some people believe that financial instruments utilized in the Islamic banking system of Iran are not sufficient for all the customer's needs. If this is correct it would be a disadvantage for the Islamic banking system of Iran in relation to economic growth. In order to understand this matter more deeply we asked the interviewees for their opinions. Table 8.16 shows their responses regarding the restrictions on financial instruments in Islamic banking in Iran as a disadvantage to economic growth.

As can be seen in Table 8.16 seven interviewees, 58.3% of interviewees and 63.3 % of respondents, said that the law is good and there is enough diversity in contracts to cover the customer's needs but that does not mean that they do not need any reform. If

we add the interviewees who believe that the limitation exists to those who believe in reform nine interviewees, 75% of interviewees and 81.8% of respondents, believe reform would be useful or is necessary.

Table 8.17: Focused Coding Number 4 for Question 2 (Possible Disadvantages of Islamic Banking in Iran Regarding Economic Growth)

Fixed regulations and impossibility of innovation	
Interviewee 1	No, innovation is possible. But as the entire banking system in Iran is Islamic and every contract is implemented nation-wide, the new contract should be approved by parliament.
Interviewee 2	It is a reality that a law which is implemented nation-wide cannot be changed easily but this is not a weakness or a disadvantage. The way for innovation is open through parliament.
Interviewee 3	They have very little flexibility. The method of providing a service has been determined by law so any new method or instrument should be confirmed by the government and parliament.
Interviewee 4	I think it is natural that flexibility of the law is low, but it isn't a weakness. Sometimes it can be strength. What is important is that innovation is possible via parliament.
Interviewee 7	Yes, flexibility is considerably low.
Interviewee 9	The necessary flexibility exists by which, if bank authorities want; they are able to solve their problems.
Interviewee 10	It is a reality but innovation is possible slowly.
Interviewee 11	Yes, it affects all aspects.
Interviewee 12	Unfortunately, this weakness exists.

As Islamic banking in Iran covers the entire banking system and every instrument introduced is implemented in all banks throughout the country, they should be approved by parliament and then confirmed by Guardian Council for its compliance with the *Shariah* and the Constitution. Therefore, to change it requires a special process which can be time-consuming. So, some researchers and managers count this as a disadvantage of Iran's Islamic banking system. For clarification, interviewees were asked their opinions on this matter and their answers appear in Table 8.17.

As the table shows three interviewees did not answer the question. Furthermore, one interviewee believes that necessary flexibility exists for bank authorities to solve their problems if they want and three interviewees, 24.9% of interviewees and 33.3% of respondents, mentioned that this disadvantage exists. However, five interviewees, 41.5% of interviewees and 55.6% of respondents, believe that low flexibility in a nation-wide law is not a weakness and a new instrument can be approved by Parliament and the Guardian Council if necessary.

Table 8.18: Focused Coding Number 5 for Question 2 (Possible Disadvantages of Islamic Banking in Iran Regarding Economic Growth)

Weakness of competition	
Interviewee 1	No, competition is good.
Interviewee 2	Yes, competition is weak, but it is improving, especially since the establishment of private banks.
Interviewee 3	Yes, competition is low.
Interviewee 4	Competition is not as strong as would be expected, but it is improving.
Interviewee 5	Yes, competition is low.
Interviewee 6	Yes, competition is low, but it is improving.
Interviewee 7	Yes competition is weak.
Interviewee 8	Competition is not very weak.
Interviewee 9	Competition exists, especially since the establishment of private banks, it has been strengthened.
Interviewee 10	Actually, competition is weak.
Interviewee 11	Competition is not enough. By increasing the proportion and number of private banks in the banking system, it would improve.
Interviewee 12	Conditions are not right for competition.

Competition is an important issue in every economy, so if there is no competition in the economy, or it is weak in the Islamic banking system of Iran, it would really be a disadvantage and would need to be solved. In order to understand this issue, interviewees were questioned and their answers are seen in Table 8.18. As the table shows five, 41.5%, believe that competition does not exist; four interviewees (33.3%) mentioned that competition is weak but is improving, especially since the establishment of private banks and three interviewees; 25%, believe that competition exists.

Table 8.19: Focused Coding Number 6 for Question 2 (Possible Disadvantages of Islamic Banking in Iran Regarding Economic Growth)

Existence of obligatory financial facilities	
Interviewee 1	The aim of the government is good and developmental. The aim is usually economic development itself, balanced development or helping the poor. On the other hand, the banking system may face the problem of non-repayment of loans or late payments, so, it is difficult to judge the disadvantages.
Interviewee 2	Although it has been useful in some projects, it has also created some problems for banking system regarding repayment facilities.
Interviewee 4	Although the aim in these facilities is good, this is not a good way to support the target groups.
Interviewee 5	Their negative effects were more than their positive effect.
Interviewee 7	Principally, these issues are against the principle of economics so their disadvantage is clear.
Interviewee 8	Its effect on our bank was negative. The customers sometimes think that this money is free and sometimes they cannot repay it.
Interviewee 9	Its effect was negative. 50% of delayed loans come from this source.
Interviewee 10	They should not exist.
Interviewee 11	It was not useful. The government help should go directly to the target sectors.
Interviewee 12	Unfortunately this is a weakness.

One phenomenon which exists in the Islamic banking of Iran is obligatory financial facilities. The government normally uses this to support special sectors or special projects. This matter has been considered over recent years as to whether this kind of facility is to the benefit of economic growth or whether it has the opposite effect. We asked the interviewees for their opinions and their answers appear in Table 8.19.

As can be seen in the table, two interviewees did not answer the question; four interviewees, 33.3% of interviewees and 40% of respondents, believe that the aim of the government was good. The aim is usually economic development itself, balanced development or helping the poor, but the method is not good or their negative effects were more than their positive effects because they created some problems for the banking system. Six interviewees, 50% of interviewees and 60% of respondents, mentioned that they were harmful to the banking system and should be stopped.

Table 8.20: Focused Coding Number 7 for Question 2 (Possible Disadvantages of Islamic Banking in Iran Regarding Economic Growth)

Dependence of the Central Bank on the government	
Interviewee 1	Global experience supports independence, so dependence of the Central Bank should be greatly decreased.
Interviewee 2	Yes its dependence is very high.
Interviewee 3	Yes it is and it definitely should be decreased.
Interviewee 4	It is completely dependent and is not to the benefit of the economy so it should be decreased.
Interviewee 5	This dependence is very great and harmful.
Interviewee 6	Yes it is.
Interviewee 7	This dependence is very great and harmful.
Interviewee 8	Yes it is and should be decreased.
Interviewee 9	This is one of the biggest problems and if it was solved, many other problems would be solved.
Interviewee 10	Yes it is and it should be solved as soon as possible.
Interviewee 11	It is very dependent and its dependence should be decreased.
Interviewee 12	Unfortunately, this weakness exists.

Independence of central banks is a very important issue. Many economists believe that central banks should be independent of governments in order to be able to perform their duty regarding the sustainability of the economy and constancy of the value of the currency. They mention that in the case of dependence, the government feels free to do whatever it wants and in fact counts the central bank as its fund. The interviewees were asked their opinions regarding the situation of the Central Bank in Iran. Table 8.20 shows their answers. As can be seen in the table all interviewees believe that dependence on the Central Bank of Iran is very high and it should be corrected.

8.4 CONCLUSION

The aim of this chapter was to consider the opinions of the interviewees regarding the role of Islamic banking in Iran in economic development. It has been divided into two sections. In the first section, interviewees were asked about the types of effects of Islamic banking on economic development in the Islamic Republic of Iran. They were asked about: (1) Effect on the mobilisation of monetary resources (deposits). (2) Effect on the allocation of monetary resources (financial facilities). (3) Effect on efficiency. (4) Effect on encouraging people to deal with the banking system. (5) Effect on the internal economic crisis. (6) Effect on and effects of the external economic crisis. (7) Effect on inflation. (8) Effect on employment. (9) Effect on

liquidity. (10) Effect on internal trade. (11) Effect on external trade. (12) Effect on real GDP. (13) Profitability.

Their responses were as follows: (1) 83.4% of interviewees answered that converting from conventional banking to the Islamic banking system has had a positive effect on the mobilisation of deposits; (2) 75.1% of interviewees and 90% of the respondents agreed strongly on the positive effect of Islamic banking on allocated financial facilities; (3) 58.3% of interviewees and 87.5% of respondents believe that Islamic banking has a more positive effect on efficiency than the conventional banking system but nobody believes that efficiency in Islamic banking in Iran is at a high level according to the present efficiency index. All of them believe that the problem is created by government interference; (4) 75.1% of interviewees believe that the effect of Islamic banking in Iran on encouraging people to deal with the banking system has been good and positive; (5) 50% of interviewees and 87.7% of respondents believe that the role of Islamic banks in the economic crisis is quite positive; (6) 41.5% of interviewees and 71.4% of respondents believe that Islamic banking in Iran has had a positive role in decreasing the liquidity growth rate; (7) 50% of interviewees and 85.6% of respondents support the role of Islamic banking in the reduction of inflation; (8) 91.7%, believe that Islamic banking has a positive effect on the employment; (9) 75% of interviewees believe that the system has had a positive effect on trade, except import, for which the provision of financial facilities to this sector has been prohibited by the Central Bank. Of course, that is not related to the Islamic banking system, but to government policies which support internal production, which according to interviewee number ten, has been successful; (10) 83.4%, believe that Islamic banking in Iran has had a positive effect on GDP. Some referred to the projects which have been financed by the banking system and some mentioned this effect theoretically; (11) All interviewees believe that profitability in private banks in Iran, which now covers about 22% of the country's banking activities, is very high. Also, five interviewees, 41, 5%, believe that profitability of state-owned banks is high and the same percentage believes that their profitability is low.

In section two seven questions regarding the possible disadvantages of Islamic banking in Iran regarding economic growth were asked of the interviewees. They answered as follows: (1) 91.7% of interviewees believe that state- ownership is a

disadvantage to banks (2) 50% of interviewees mentioned that legal restrictions regarding demand for financial facilities were useful at that time but at this stage of development they should be reduced (3) 58.3% interviewees and 63.3 % of respondents mentioned that the law is good and there is enough diversity in the contracts to cover the customer's needs but that does not mean that they do not need any reform. If we add the interviewees who believe that the restrictions exist to those who believe in reform nine interviewees, 75% of interviewees and 81.8% of respondents, believe reform to be useful or necessary (4) 41.5% of interviewees and 55.6% of respondents believe that low flexibility in a nation-wide law is not a weakness and new instruments can bee approved by Parliament and the Guardian Council if necessary (5) 41.5% of interviewees believe that competition does not exist, four interviewees mentioned that competition is weak but improving, especially, since the establishment of private banks and three interviewees, 25%, believe that competition exists (6) 50% of interviewees and 60% of respondents mentioned that obligatory financial facilities were harmful to the banking system and should be stopped and (7) All interviewees believe that dependence on the Central Bank of Iran is very high and it should be corrected.

Chapter Nine:

SUMMARY, CONCLUSION AND RECOMMENDATIONS

9.1 INTRODUCTION

This research aimed to investigate two main questions. First, how do the banking authorities in Iran ensure that the deposit and financial facilities they offer are *shariah*-compliant? Second, has Islamic banking in Iran had a positive effect on the country's economic development? In order to answer these main questions some other questions were raised, such as: (1) How does the Islamic banking system in Iran work? (2) What was the effect of the Law of Usury-Free Banking of 1983 on Iran's banking system? (3) Has the elimination of *riba* encouraged more people to open bank accounts? (4) What is the economic structure in Iran? (5) What was the economic development process in Iran?

In order to examine these issues, in addition to the theoretical approach and analysis of the Law of Usury-Free Banking in Iran both quantitative and qualitative analysis was carried out. In the quantitative analysis, secondary data from the Central Bank of Iran and the Iranian Statistical Centre were analysed descriptively in order to show the effect of Islamic banking in Iran on economic development through the mobilization of monetary resources (deposits) and allocating them to the economic sectors. Comparisons were made between the periods before and after the Islamic Revolution, in particular following the implementation of the Law of Usury-Free Banking in Iran. For the qualitative analysis, semi-structured interviews were conducted regarding both of the main questions. It should be stressed that as the banking system in Iran is the agent of the depositor, it has to be sensitive to the profitability of projects as a *shariah*-compliant condition.

9.2 THEORETICAL APPROACH

In addition to the role of the banking system in economic development through the mobilisation and allocation of saving (monetary resources), there are some factors in Islamic banking which facilitate economic development as follows: acquiring information and declining the information costs, deduction of asymmetric information, feasibility of investment in large and long term projects, facilitating risk amelioration and monitoring managers and exerting corporate control by banking system in general, working according to profit and loss Sharing (PLS) and its similarity to universal banks. So, it could be said that Islamic banking has a more important role than conventional banking system in economic development.

According to the discussion in Chapter Two, the advantages of Islamic banking regarding economic development are as follow: (1) It is responsive to the different motives of depositors. (2) There is efficient use of money. (3) There is distribution of risk between entrepreneurs and depositors. (3) The quality of the business plan is more important than the credit rating of the borrower. (4) There is stability. (5) It controls excessive credit creation. (6) There is a decrease in moral hazard and adverse selection, due to partnership factor supervision than conventional banks. (7) There is a high level of variety and diversity with different levels of risk in contracts (partnership contracts and exchange contracts) which can facilitate drawing up contracts in Islamic banking for both savers and entrepreneurs. (8) It offers the possibility of establishing financial institutions with different approaches which can increase the stability of financial system. (9) It provides a facility for Muslims who believe in the prohibition of *riba* (10) It is more resistant to external shocks and delayed repayment loans than conventional banks, due to, partnership and consequently symmetry of the liabilities side of the balance sheet tends with the assets side. (11) There is the impossibility of debt creation without the backing of goods and services.

9.3 ISLAMIC BANKING IN IRAN

After the Islamic Revolution in Iran all banks were nationalised and all 37 existing banks merged into six commercial banks and three specialised banks. In 1983, the Law of Usury-Free Banking of Iran was passed by the Iranian parliament (*Majlese Shawraye Islami*). This law shaped the new banking system of the Islamic Republic of Iran in which interest rates have been omitted completely and not only has the

banking system been changed to an Islamic system but the entire financial system has been converted to an Islamic one.

According to this law some objectives for the Islamic banking system in Iran were defined including: (1) Establishment of a monetary and credit system based on morality and justice. (2) Enhancement of the health and growth of the economy. (3) Creation of necessary facilities for the extension of cooperation between depositors and investors. (4) Maintenance of the currency value. (5) Facilitation of payment and receipt, exchanges, transactions and other services.

Moreover, according to the law three main duties were determined for the banking system. First, the mobilisation of monetary resources (deposits): There are three kinds of account in this sector. (1) *Qardh- El-Hasanah* Current Account (Free Loan Current Accounts): (2) *Qardh- El-Hasanah* savings deposit account. These two accounts are interest free loans with a guaranteed nominal value. (3) Term Investment Deposit Accounts (short-term with a minimum time of three months and long-term with periods of one, two three and five years). In these accounts, the depositor retains ownership of the deposit and the bank is their agent and has to utilise their deposits for profitable projects and obtain honorarium. In Term Investment Deposit Accounts the banks announces an in-part-payment profit rate and guarantees it (as a third party) in order to encourage depositors to increase their deposits, but if the actual profit rate is more than the in-part-payment profit rate, banks would have to pay the actual profit rate.

Second: Allocation of Monetary Resources (financial facilities). There are three kinds of contract in this sector. (1) Loan contracts: the only loan in the Islamic banking system is *Qardh-Al-Hasanah* (interest free loan). There is no interest in this contract and it is used for specific requirements such as essential needs, education fees and medical fees and to support small industries. (2) Partnership contracts: These contracts function in accordance with profit and loss sharing (PLS) including *modharabah* (bailment of a capital), civil partnership (*mosharakate madani*), legal partnership *(mosharekate hoqooqi*), *mozaraah* and *mosaqat*. (3) Exchange contracts. Despite determination of the profit in advance in these contracts, the profit does not count as *riba.* These contracts are: *Salam* transactions (post delivery sale), *joaalah*, sale on instalment and hire-purchase.

Third: monetary policies. The main instruments for the implementation of monetary policies in conventional banking are interest rates and open market operation. As, interest is prohibited in Islam some other instruments have been designed for Islamic banking in Iran. They are: Fixing a minimum and/or maximum ratio of profit for bank share, designation of various fields for investment and partnership and fixing the minimum prospective rate of profit, fixing a minimum and maximum margin of profit, determination of types and the minimum and maximum amount of commissions, determination of the types, amounts, minimum and maximum bonuses, determination of the minimum and maximum ratio in joint venture and open market operation.

9.4 RESULTS OF QUANTITATIVE ANALYSIS

The quantitative analysis was carried out in Chapter Five. Trend of GDP, share of economic sectors in GDP, trend of investment, mobilization of savings, allocation of financial resources and their ratio to the GDP and liquidity were examined.

9.4.1 Trend of GDP and Share of Economic Sectors.

According to data relating to different years from the Economic Statistics Office of the Central Bank and balance sheets of the Iranian Central Bank (*Bank Markazi*), the average growth rate of GDP at current and constant 1997 (1376) prices between 1989-2006 was 11.5% and 5.2% respectively and the average growth rate of non-oil GDP at current and constant 1997 (1376) prices was for that period 26.4% and 5.6% respectively. It is worth noting that the average growth rate of non-oil GDP is higher than that of GDP with oil, which shows a negative effect of oil on the growth rate of the GDP in the country in that period.

Despite increasing agricultural product from 5,893 Iranian Rials billion in 1989 to 211,275 Iranian Rials billion in 2006, its share in GDP decreased from 23.5% in 1989 to 10.365% in 2006. This could be a sign of development in the country. Moreover, mining and industry (manufacturing) products increased from 2,515 Iranian Rials billion in 1989 to 261,039 Iranian Rials billion in 2006, and its share in GDP increased from 10.028% in 1989 to 12.806% in 2006. Furthermore, the share of oil and gas increased from 7.253% to 26.495%, the share of housing and building decreased from 4.737% to 4.337% and the share of services decreased from 54.783%

to 48.794%.An increase in the share of oil is a negative sign, but a decrease in the share of services for the Iranian economy is positive.

9.4.2 Saving and Capital Formation

According to Chapter Five, despite some fluctuations in saving and capital formation during 1989-2006, the trend was relatively good overall. Gross National Saving (GNS) at the current prices and constant 2004 (1383) prices increased from 3,720 Iranian Rials billion and 59903.38 Iranian Rials billion in 1989 to 796,856 Iranian Rials billion and 645,488.86 Iranian Rials billion in 2006 respectively and their average amount during this period was 215,507 Iranian Rials billion and 340,325.44 Iranian Rials billion respectively. Also, their average growth rate at the current and constant prices, during the period under consideration was 41.19% and 18.74% respectively.

Also, Gross Fixed Capital Formation (GFCF) at current and constant 2004 (1383) prices increased from 5,135 Iranian Rials billion and 82689.21 Iranian Rials billion in 1989 to 538720 Iranian Rials billion and 436387.2 Iranian Rials billion in 2006 respectively and their average amount during this period was 157680.11 Iranian Rials billion and 252308.99 Iranian Rials billion respectively. Their average growth rate at the current and constant prices, during the period under consideration was 32.82% and 11.55% respectively.

9.4.3 Trend of Deposits and Credits

According to the discussion in Chapter Five these trends were considered during three different periods: before the Islamic Revolution (1961-1978), after the Islamic Revolution until the end of the war between Iran and Iraq (1979-1988) and after the war (1989-2006). If we ignore the war period and compare the other two periods, it is possible to conclude that, despite the higher growth rate for the period before the Islamic Revolution, the average amount of deposits in current and constant 2004 prices and also credits in current and constant 2004 prices in the 1989-2006 period are 574.64, 5.54, 380.28 and 3.45 times more than those in 1961-1978 period. This shows that Islamic banks were more successful in both mobilisation and allocation of financial resources than conventional banks before the Islamic Revolution.

9.4.4 The Ratio of Deposits and Credits to GDP and Liquidity

Although comparing deposits and credits for two periods can be useful it is not conclusive because there are some factors which should be considered in analysis such as GDP and liquidity. Therefore, the ratios of deposits and credits to GDP and liquidity (M2) have been calculated for comparison.

In comparison with the 1962-1978 period, as discussed in Chapter Five, performance of the banking system during years 1979-1988 and 1989-2006 was relatively satisfactory because, despite there being 35 domestic and foreign banks at that time, the average ratio of deposits to GDP was 24.53% while during the years 1979-1988 and 1989-2006 it was 49% and 45.8% respectively which shows an increase of about 100%. However, regarding the ratio of deposits to liquidity the average ratio for 1962-1978, 1979-1988 and 1989-2006 was 80.64%, 74.77% and 88.84% respectively. Despite a high growth rate of liquidity during 1989-2006, a ratio of 88.64% is a relative success for the Islamic banking system in Iran in comparison with the 1961-1978 period.

9.4.5 Types of Deposits and their Share in Total Deposits

As mentioned in Chapter Five, the effect of different deposits on economic development is not at the same level. Due to the use of long-term investment deposits for long-term projects, which are usually large industries, their effect on economic development is greater than other deposits. Therefore, whenever the share of long-term investment deposits is greater, the effect of deposits on economic development is more significant. Although long-term investment deposits occupied third place after sight deposits and short-term investment deposits, the trend was to the benefit of long-term investment deposits. The average amount and growth rate of long-term investment deposits are more than other deposits during the period under consideration. Consequently they went from third in 1989 to second in 2006.

9.4.6 Trend of Credits and Share of Economic Sectors

As discussed in Chapter Five, resources allocated to all economic sectors at current price and constant 2004 price increased from 9,697.5 Iranian Rials billion and 156,143.32 Iranian Rials billion in 1989 to 1,023,026 billion and 828,699.1 billion in 2006 respectively. In comparison with the 1961-1978 period, the average amount of

allocated resources at current price and constant price, during the 1979-2006 period was 247.48 times and 2.98 times more than that of the 1961-1978 period respectively.

The trend of credits to the economic sectors can determine the orientation of a banking system regarding economic development. As the manufacturing sector has a determining role in economic development, an increasing share for this sector shows developmental orientation of the banking system. In contrast, the agriculture sector's share has an opposite role. However, the share of manufacturing and mining sector from credits increased from 20.91% in 1989 to the 28.47% in 2006, and the share of the agriculture sector decreased from 17.44% in 1989 to 15.66% in 2006.

9.5 FINDINGS OF THE QUALITATIVE ANALYSIS

9.5.1 Analysis of *Shariah*-Compliance

In Chapter Six the opinions of the interviewees were analysed regarding ensuring that banking activities in the Islamic Republic of Iran is *shariah*-compliant. In order to examine this matter three main questions were designed as follows: (1) How do the banks ensure that the deposit and financing facilities they offer are *shariah*-compliant? (2) What are the problems with which Islamic contracts are faced at the implementation stage? (3) What are the solutions for the above-mentioned problems? For each question, there were several sub-questions which interviewees were asked to answer.

9.5.1.1 Consideration and deliberation of the contract

As the entire banking system in Iran has to be *shariah*-compliant, a special law was approved in 1984 in the Parliament and confirmed by the Guardian Council. One way of ensuring that contracts are *shariah* -compliant is their compliance with the Law of Usury-Free Banking in Iran, therefore a relatively high majority of interviewees (75%) believe that it is possible to make sure that banking activities in Iran are *shariah* -compliant by considering and deliberating on the contract which is obtained via several instruments explained in Chapter Six.

9.5.1.2 Considering and deliberating on the honesty, speciality and experience of clients and the profitability of the contract

As mentioned in Chapter Six, being *shariah*-compliant has an additional condition over and above just choosing the proper contract. This is the use of deposits for the best projects with the most profitability because the bank, as the agent of the depositor agrees to utilise deposits for the best projects. Thus, they are responsible religiously not only to consider the profitability of the project itself but also to consider the honesty, speciality and experience of the project manager. Therefore, the vast majority of interviewees believe that there is enough consideration to ensure that clients of the banking system in the Islamic Republic of Iran, selected by banks for receiving financial facilities, are honest and have enough experience and speciality regarding their activities and also the project is profitable.

9.5.1.3 Supervising the process of the implementation project until the end and providing training

The majority of interviewees believe that supervision exists. One way of controlling is to pay financial facilities in stages. This means the bank pays one instalment and, after confirming that it was spent on the partnership project, *mosharakah*, the bank pays the next instalment.

Another factor which plays an important role in the *shariah*-compliance of contracts is the education of staff and even the education of clients. For this reason it is necessary for Islamic banks to have a regular training scheme. Therefore, despite some training course being delivered by banking system for their staff, it would appear to be necessary to provide more training course. This was another question asked of interviewees. All interviewees believed that, despite previous staff training, the training was not enough and ongoing training courses were needed.

9.5.1.4 The problems with which Islamic contracts are faced at the implementation stage.

There are some problems which can affect the performance of Islamic banking such as asymmetric information and moral hazard. These problems also exist in conventional banks. Many interviewees did not answer this question; this may be due their lack of knowledge regarding these issues. However, the majority of respondents believe that it is due to Islamic banks being more able to solve or reduce the problem of asymmetric information than conventional banks. Although, there is a motivation in clients to use moral hazard, their Islamic belief and the strong supervision which exists in Islamic banks can also decrease moral hazard. The majority of respondents believe that moral hazard in Islamic banks is less that in conventional banks so they cannot be problems in Islamic banking in particular.

Another problem which may exist is low flexibility of the contracts in Islamic banks in the Islamic Republic of Iran. The opinions of the interviewees differed on this issue and 50% of interviewees said that there is not enough flexibility in Islamic contracts in Islamic banking in the Islamic Republic of Iran. Of course, it may be the nature of an Islamic banking system operating under a special law approved by Parliament.

One of the strong points of any banking system is its ability to respond to all customers' applications so interviewees were asked about the impossibility or difficulty of positively responding to all applications for credit, especially from the demand side. All interviewees believed that although this problem exists it is not due to Islamic banking but to government policies or shortage of financial resources.

Overdue or delayed credits are one of the most important problems for all banking systems. They should be greater in Islamic banks for two reasons: The first is the lack of interest rates charged of the customer. This can lead to delay in the repayment of credit because they do not pay any cost for their delay. Secondly, the Islamic advice to Muslims is to give more time to debtors. However, 58.33% of interviewees believe that overdue debt is greater than usual. It increased from 7.1% in 2002 to 15% in 2006 while the average ratio world-wide is 5%. It is worth mentioning that some people may abuse this Islamic benevolence so it is necessary to think about ways of solving this problem.

9.5.1.5 Solutions for the problems

There are some possible solutions to the above-mentioned problems. The first could be a change to the structure of Islamic banking. While Islamic banking is relatively similar to universal banking which enters the real economy, sometimes as a supervisor, in partnership contracts, and sometimes even as a contractor, in *joaalah* contracts, the structure of Islamic banking has remained the same as the conventional banking system which existed before the Islamic Revolution in Iran. Due to the importance of this issue, the opinions of the interviewees were asked and more than 80% of them answered that a change to the structure is necessary.

Another solution which has been used for solving some problems in Islamic banking of Islamic Republic of Iran is conditions provided in the contract (conditions provided in the contract). Although these conditions sometimes lead to complications, they usually reduce all kinds of financial risks. However, some critics believe that these conditions lead to misunderstanding or even sometimes to a departure from the essence of Islamic banking. So, this issue is quite debatable and there was no majority opinion among the interviewees.

In order to solve the problem of delayed debt the Iranian banking system uses a late payment penalty. This issue has been questioned regarding both its *shariah*-compliance and its usefulness. As with the previous question, there was no unanimity among interviewees and not even a clear majority in this regard. It is worth mentioning that one interviewee who is a specialist in jurisprudence believes that the late payment penalty as in the Iranian case is definitely *shariah*-compliant. Regarding its usefulness some interviewees believes that if it is more than or a least equal to the gap between the profit rate in the banking system and the interest rate on the black market, or the profit rate in the open market, it could be useful, otherwise, it is not.

9.5.1.6 Determination of final profit rates and *shariah* board

One of the most important issues regarding Islamic banking is the determination of final profit rates for depositors and entrepreneurs. As mentioned in Chapter Six there is an “in-part-payment” profit rate which is secured by the banking system as a third party. When the in-part-payment profit rate is more than the actual profit, the majority

of interviewees believe that banks pay the in-part-payment profit rate to the depositors and they also believe that where in-part-payment profit is less than actual profit, Islamic banks in the Islamic Republic of Iran have been paying real profit to their clients. This confirms that their activities are *shariah*-compliant.

In terms of the profit rate which entrepreneurs should pay there is no majority among interviewees. In both cases where the expected profit rate is less or more than actual profit rate, 50% of interviewees did not answer and the issue is debatable among respondents. Where the actual profit rate is less than the expected profit rate, 50% of respondents believe that banks examine the case in order to determine the reason for the abatement of the profit. If the client is to blame they will ask him to pay the difference between the expected profit and the actual profit. 33% of respondents believe that banks usually ask for expected profit and 16.2% believes that, according to the contract-implicit condition, clients also have to pay the difference between the expected profit and the actual profit. Furthermore, where the actual profit rate is greater than the expected profit rate 50% of respondents believe that banks also ask for the difference between expected profit and actual profit, two interviewees, 33.3% of respondents, believe that banks usually ask for expected profit and one interviewee, 16.6% of respondents, believe that banks pay the difference between expected profit and actual profit. In conclusion, it could be said that there is no unified behaviour among banks regarding profit; it depends on the bank or branch authorities. However, there should be unified behaviour according to the law.

In addition, regarding the *shariah* board the majority of interviewees who answered the question believe that it is possible, useful and necessary for Islamic banking in the Islamic Republic of Iran to have a *shariah* board. They believe that by having limited numbers of *shariah* boards with descriptions of duties the problem of inconsistency and shortage of specialists could be solved.

9.5.2 Role of Islamic Banking in Iran in Economic Development

Opinions of the interviewees regarding the role of Islamic banking in Iran in economic development are discussed in Chapter Seven. In this chapter, some questions regarding the effect of the Islamic banking system in Iran on some factors which affect economic development and some disadvantages of the Islamic banking

system in Iran for economic development were asked which can be summarised as follows:

(1) The majority (83.4% of interviewees) answered that converting from conventional banking to the Islamic banking system has had a positive effect on the mobilisation of deposits.

(2) The majority (75.1% of interviewees and 90% of respondents) strongly supported the positive effect of Islamic banking on the allocation of financial facilities.

(3) The majority (58.3% of interviewees and 87.5% of respondents) believe that Islamic banking has a more positive effect on efficiency than the conventional banking system but none of the respondents believe that efficiency in Islamic banking in Iran is at a high level according to the present efficiency index. They all believe that the problem has been created by government interference. However, as Islamic banking in Iran has some charity aims, a new efficiency index should be designed.

(4) The majority (75.1% of interviewees) believe that the effect of Islamic banking in Iran on encouraging people to deal with the banking system has been good and positive.

(5) The majority (87.7% of respondents and 50% of interviewees) believe that the role of Islamic banks in avoiding economic crisis is quite positive.

(6) The majority (71.4% of respondents and 41.5% of interviewees) believe that Islamic banking in Iran has had a positive role in decreasing liquidity growth rate.

(7) The majority (85.6% of respondents and 50% of interviewees) support the role of Islamic banking in the reduction of inflation.

(8) The majority of interviewees (91.7%) believe that Islamic banking has had a positive effect on employment.

(9) The majority (75% of interviewees) believe that the Islamic banking system in Iran has had a positive effect on trade, except import, for which giving financial facilities to this sector has been prohibited by the Central Bank.

(10) The majority (83.4%) believe that Islamic banking in Iran has had a positive effect on GDP. Some of them referred to thousands of large project which have been financed directly by the banking system such as highways and petrochemical projects.

(11) All the interviewees believe that profitability in private banks in Iran is very high. In addition five interviewees, 41.5%, believe that profitability of state-owned banks is high and the same number believes that their profitability is low.

(12) The majority (91.7% of interviewees) believe that state-ownership is a disadvantage for banks and that most of them should be privatised.

(13) 50% of interviewees believe that legal restrictions regarding financial facilities for demand side were useful in the early years but at this stage of development they should be reduced.

(14) The majority (58.3% interviewees and 63.3 % of respondents) believe that the law is good and there is enough diversity in the contracts to cover the customer's needs but that does not mean that they do not need to reform. Therefore 75% of interviewees and 81.8% of respondents believe that reform would be useful or necessary.

(15) The majority (55.6% of respondents and 41.5% of interviewees) believe that low flexibility in a nation-wide law is not a weakness and new instruments could be approved by Parliament and the Guardian Council if necessary.

(16) There is no majority regarding competition in the Islamic banking system of Iran. It is particularly debateable since the establishment of private banks.

(17 The majority (60% of respondents and 50% of interviewees) believe that obligatory financial facilities are harmful for the banking system and should be stopped.

(18) All interviewees believe that dependence of the Central Bank of Iran is very high and this should be corrected.

In conclusion, it can be said that regarding *shariah*-compliance, despite the existence of some conditions provided in the contract itself or in another contract which

sometimes lead to confusion or misunderstanding, the Law of Usury-Free Banking in Iran is definitely *shariah* -compliant but it needs to be updated. Also, regarding the practical issues, according to the majority of interviewees the banking system usually acts according to the law with some exceptions which in an extensive banking system with thousands of branches is natural. In terms of development, in theory, as discussed in Chapter Two, there is a great deal of evidence that the Islamic banking system is more efficient than conventional banking. In practical terms, as can be seen in Chapter Five, data show that after changing the banking system in Iran to Islamic banking activities improved. Also the majority of interviewees believe that Islamic banking in Iran has had a positive effect on economic development, both by a considerable increase in mobilisation and allocation of monetary resources and effect on the liquidity and inflation. Also, due to profit and loss sharing which leads to more care in the selection of projects and partners, supervision of the project as a partner which cause decreasing asymmetric information, moral hazard and adverse selection affects economic development. Moreover, due to a lack of speculative demand for money in the Islamic economic system, employment and consequently economic development have increased.

9.6 PROBLEMS AND LIMITATIONS

As this research is a case study of the contribution of the Islamic banking system in the Islamic Republic of Iran to economic development, there have been some problems and limitations in carrying out the research. First of all was the limitation of resources, especially in English. There have been few studies regarding Islamic banking and economic development. The second problem relates to data collection. Due to being far from Iran, in the first years of the study there was some difficulty regarding data collection. Of course after that most data became available on line on the websites of the Central Bank of Iran and the Statistics Centre of Iran but they were not comprehensive.

In addition, two of the chapters concern qualitative analysis. For these chapters I interviewed fourteen people including religious scholars (jurisprudents), commercial bank managers, the Central Bank managers and academic researchers. As they were very busy and some of them did not know me it was very difficult to call them and make appointments with them, so I had to ask mutual friends to arrange meetings with

them for me or to introduce me to them. Even after meeting some of them were sensitive regarding the information which I wanted from them. Furthermore, I had to go to Iran twice, the first time for the main interviews and the second time for complementary interviews. Some of them were not available for the second interviews due to having changed their jobs, so I had some problems finding them. Also, because of the time limitation, I had to conduct the complementary interview with some of them by phone or even by email. It took a long time for some of them to respond to my emails.

9.7 RECOMMENDATIONS

1) Reform in the Law of Usury-Free Banking in Iran: As mentioned before, this law was temporary and should have been reformed after it had been in place for several years and on receiving feedback. Now, after about 25 years, it is time to reconsider it and analyse its strength and weaknesses and start reforming it accordingly.

2) Change in the structure of the banking system: As the entire banking system of Iran was interest-based prior to the Islamic Revolution and was changed to the Islamic banking system afterwards, the structure was not adequate for the new system. Despite some changes having been made to the structure, they were not sufficient so it is necessary for a major change to be made to the structure as soon as possible. The most important issue to be considered is restructuring regarding profit and loss sharing needs. As in profit and loss sharing, the bank acts as a partner and profitability of the project is important for them, it is necessary for the banking system to monitor the project carefully. Furthermore, in some contracts such as *joaalah*, banks act as a contractor in which the existence of some skilled and specialised staff or some dependant engineering company is necessary.

3) Independence of the Central Bank: One duty of the Central Bank in all banking systems, especially according to the Law of Usury-Free Banking of Iran, is the implementation and fulfilment of monetary policies for the stability of the economy, protection of currency value and economic development. In the case of dependence on governments, they usually use it as an instrument for solving their problems, especially in budget deficit times. At such times governments are eager to borrow

from central banks leading to inflation and consequently reduction in currency value. The biggest problem in Iran before and after the Islamic Revolution has been a high inflation rate caused by increasing liquidity imposed by government. So, independence of the Central Bank could solve the historic problem of the Iranian economy.

4) The establishment of a *shariah* board: Although, the Law of Usury-Free Banking in Iran was approved by Parliament and then confirmed by the Guardian Council which means that it is in accordance with the Iranian Constitution and is *shariah*-compliant, it is clear that the existence of a *shariah* board which monitors and supervises contracts regarding their *shariah*-compliance is necessary. The question is how many *shariah* Boards does the Iranian banking system need? There are several opinions on this matter, including: one for every bank, one in the Central Bank and one in the central branch of every bank, one in the Central Bank and one in the central branch of every bank and one representative in every province. I think it would be better if there was one *shariah* board in the Central Bank and one or more representatives in each bank in every city in order to monitor and supervise contracts in accordance with the *shariah*.

5) Giving more freedom to the bank managers: In order to provide facilities to the most efficient projects and enter the new market without obtaining permission from the government, the managers need more freedom in decision making. As speed in decision-making is a key factor in utilising deposits efficiently, and freedom is a vital element in speed in decision making, therefore, freedom is a vital factor for bank managers to be able to allocate financial facilities to the most efficient projects.

6) Privatisation: Due to some problems faced by the banking system after the Islamic Revolution regarding a lot of money having been removed from the country by the Shah's family and their dependents, as well as some big capitalists, banks were almost bankrupt. Therefore, the government had to nationalise all banks. Of course, the left thought the environment may be a factor in this decision too. In those days, some scholars and Muslim scientists thought that nationalisation was closer to Islamic economics. It seems that it is time for the privatisation of all or at least the majority of commercial banks.

7) Stopping or at least reducing obligatory facilities: Although the aim of the government from these facilities is to support some special projects or industry for developmental purposes, they have a negative effect on efficiency and should be stopped or reduced.

8) Reducing contract costs: Due to partnership operation and the necessity of more monitoring and supervision in Islamic banks than conventional banks, contract costs are expected to be greater. However, that does not mean that efficiency in Islamic banks is lower than conventional banks because these extra costs are not wasted since they provide some information which is very useful to banking systems' decision makers regarding some kinds of risks such credit risk; furthermore, reducing contract costs while achieving the same information will increase efficiency.

9.8 SUGGESTIONS FOR FURTHER STUDIES

The aim of this research has been to examine the contribution of Islamic banking in Iran to economic development, so it has concentrated mainly on the experimental analysis. However, as Islamic banking is relatively new in the banking industry, both theoretical and empirical researches are necessary. Some areas where more research is necessary are as follows:

1- How efficient is Islamic banking compared with conventional banking and how can Islamic banks improve their efficiency?

2- A comparative study between Islamic banks in different countries regarding the instruments they are using.

3- How can Islamic banks solve or reduce the problems of asymmetric information, moral hazard and adverse selection?

4- How can Islamic banks compensate depositors' losses in times of inflation?

5- How can the profit rate be determined in an Islamic banking system such as Iran and Sudan?

6- What new instruments can be used in Islamic banking?

7- How can Islamic banking systems perform monetary policies successfully?

8- What kind of relationship is possible between Islamic banks and conventional banks?

Appendix

Questions for Semi-Structured Interviews

Q1- How do banks ensure that the deposits and financing facilities they offer are *shariah*-compliant?

Q2- What are the problems with which Islamic contracts are faced in the implementation stage?

Q3- What are the solutions to the problems?

Q4- How do you behave with "in-part-payment" profit rate in order not to be in contravention of *shariah*-compliance?

Q5- How do you (banks) deal with "expected profit rate" in order not to be in contravention of the *shariah*-compliance?

Q6- What do you think of a *shariah* board in Iran's Islamic banking?

Q7- What are the problems regarding *shariah* boards in Islamic banking?

Q8- What are the solutions to the problems regarding *shariah* boards in Islamic banking in Iran?

Q9-What has been the effect of Islamic banking on economic development in Iran?

Q10- What has been the effect of Islamic banking in Iran on the mobilisation of monetary resources (deposits)?

Q11- What has been the effect of Islamic banking in Iran on the allocation of monetary resources (financial facilities)?

Q12- What has been the effect of Islamic banking in Iran on encouraging people to deal with the banking system?

Q13- What are the possible disadvantages of Islamic banking in Iran regarding economic growth?

Q14- What has been the effect of Islamic banking in Iran on efficiency?

Q15- What has been the effect of Islamic banking in Iran on liquidity?

Q16- What has been the effect of Islamic banking in Iran on inflation?

Q 17- What has been the effect of Islamic banking in Iran on employment?

Q18- How was profitability of Islamic banking in Iran?

Q19- What is your opinion regarding independence of the Central Bank from the government?

Q20- What is your opinion regarding the existence of obligatory financial facilities?

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