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Islamic Banking and Monetary policy: Experience of Iran (1982-2006)

Mohammad Hassani[1]

This paper addresses some of the issues and challenges that Islamic banking has been facing in Iran. It also seeks to examine modes of Islamic financing and the commitment of commercial banks to implement the Islamic banking law. This research uses a single country study (Iran) because it has a unique experience in relation to Islamic banking. Although, there is a scarcity of data pertaining to the Iranian Islamic banking experience, wherever possible Statistical data and ratios are used to discuss and support the arguments made in this study. The study reveals that banks' contracts being adversely lengthy are innately exiguous. The contracts speak of partnership between the client and the bank, and at the same time bring up the concept of debt or liability. Disagreements on different aspects of banking in Iran have deformed into a dispute which has extended to banks themselves and this has rendered some of the major concepts of usury free banking.

Keywords: Monetary system; credit; Islamic modes of financing; usury- free banking

1. Introduction

After the 1979 revolution the government of Iran played a primary role in converting conventional banking into Islamic banking. In 1983, the law of usury-free banking was passed, and in 1984, interest free banks started to implement Islamic banking based on the 1983 law. Most of the banks (28 out of 36) were nationalized. The government also managed to merged these nationalized banks. As a result the number of banks was reduced to 6 commercial and 3 specialized banks, a total of 9 banks. In contrast to most countries that have some degree of Islamic banking, has completely transformed it's banking activities to comply with the accepted Islamic principles in Iran. The real issue is to determine what policies and regulations and actions result in a move toward a Islamic banking. In particular, quite often government state goals that are either inherently contradictory, or at least given a particular time frame and limited resources, in conflict with each other.

The remaining of this paper is organized in four sections. The second section examines the literature review on Islamic banking. Section three addresses the Usury–free law of Iran. Section four analyses the structure of banking system of Iran. Section five discusses implementation of Islamic banking in Iran, and its performance and challenges. It is also stresses that rates paid to deposits have not changed compare with high inflation particularly after the introduction of economic liberalization plan of early 1990s. In the last section we produce some concluding results.

[1] Assistant Professor of Economics, Islamic Azad University of Iran, Birjand branch. E-mail: aftab_omid@yahoo.co.uk

2. Literature Review

In recent years a number of both theoretical and empirical studies about the Islamic banking have been published. Most of these studies have been argued that Islamic bank's products must confirm to principles set by *sharia* board and this prevents the emergence of speculative demand for money and Islamic bank also use profit and loss sharing criteria. These advantages help the Islamic banks to cope with instability in the economy. However, there are several questions regarding the practice of Islamic banking which involve among other things, bank activities, the process of money (deposits) creation, bank lending and borrowing, etc.

Mirakhor and Khan (1990) points out that reliance on profit sharing arrangements makes the Islamic system akin to an equity – based system, relatively straightforward theoretical models have been developed analyzing the working of the system. In these models, depositors are treated as shareholders (as in a mutual fund or investment trust, for example) and bank provide no guarantee on the rate of return or nominal value of shares. Symmetrically, banks themselves become partners with the borrowers and accordingly share in the returns obtained from the borrowed funds. An interesting result to emerge from such models is that models is that the Islamic system may be better suited than an interest based system to adjust to shocks that can lead to banking crises. In absorbed by changes in the nominal value of shares (deposits) held by the public in banks. Therefore, the real values of assets and liabilities would be equal at all points in time. In the conventional banking system, since the nominal value of deposits is guaranteed by the bank, an adverse shock to assets of the bank can create a divergence between real assets and real liabilities – leading possibly to negative net worth for the bank – and it is not clear how the disequilibrium would be corrected and how long the process of adjustment would take.

Zangeneh discusses that in a loan based economy instability can arise from two separate sources. One source of instability is refinancing and refinancing of business investment. As long as markets are moving in the right direction loans are available on reasonable terms. But as soon as markets turns against expectations, especially against surplus spending units expectations, refinancing of the old debt and financing no new projects will prove to be difficult and such activities will have repercussions for the economy. This cannot happen in an equity based economy. A second source of instability in a loan based economy comes from the demand for real balances (www.financeinislam.com). Zanganeh concludes that in equity based economy, the speculative demand for money does not exist. As a result, a major source of instability in the demand for real balances and the economy is eliminated since in Islamic banking profit sharing schemes are not applicable. One possible solution for purely personal loans is the use of *zakat* (wealth tax) to provide interest free loans to those who need financial assistance. As for consumer durable goods, one could suggest that banks should finance (or engage in a partnership of sorts) with the producer and share the profits earned by producers. This will provide some income for the bank as well as financing for consumers who would be buying on installment directly from the producer, as in the case of purchase of tools, inventories and etc.

Bunchuan (2006) stresses that the establishment of Islamic banking has the same purpose as those conventional banking to act as financial intermediaries between depositors and borrowing. However, in Islamic banking it was more than depositors and borrowers relationship. It was more of partners where banks are entrusted to invest and any profit generated will be shared. This notion of profit and loss sharing (PLS) is totally a different concept than the conventional banking of depositors and borrowers relationship where the depositors will receive interest based on the fund deposited into the bank account and interest charged to the loan given. The growing concern on the ill-effect of interest rate has led to some extent to the decline of traditional banking activities. This decline has shifted away the role of money as promissory notes and increase activities in profit sharing, equity rates and other similar participatory instruments which encouraged more trade, development and productivity in the society. These alternative activities have become popular among banks of both systems as it has solved some of the issues relating to liquidity and credit risks.

Mojtahed and Hassanzadeh (2009) examines the operational problems of Islamic banking in Iran, which relates to most of the transactions in usury –free banking. In an equity based economy the bank act as the moderator and, legally speaking, the money does not belong to the bank. In this kind of banking the depositor not only does not know the amount of interest in the beginning, but also should be informed about the situation and efficiency of every economic sector, and the nature of different contracts involved so he would be able decide where he wants to invest her money. Mojtahed and Hassanzadeh (2009) also analyses that there are usually several contracts involved and some contracts include multiple deals. The complexity of usury free banking necessitates proper education for the public. Otherwise, the unawareness about the banking system misleads the public about the nature of the system; the result of this unawareness is evident in the public reaction to usury –free banking practices.

3. Conceptual Issues of the Islamic Banking System

Islamic banking activities can be classified into two groups: In one group, their activities are without any competition from conventional banking which is based on interest rate due to the law and regulations which do not allow any activities based on *ribah* for any financial institution, bank or non-bank in that country domestically. The second group, is banking activities in Muslim or non-Muslim countries which banking activities which is based on interest rate parallel with no interest rate on banking activities. The Example of Iran banking system is well known. The process of Islamization of the banking system in Iran had gone through two phases. In the first phase (1979-82), the banking system was nationalized, and reorganized**.** However, internal and external developments in this phase did not allow the policymakers to build an adequate plan for the Islamization of the banking system. The second phase began in 1982, and lasted until 1986. In this phase, the law of usury -free banking (i.e. no interest) was passed in 1983, which went into effect on March 20, 1984. The law described 14 types of operations applicable to assets and liabilities. The banks were allowed to buy debt instruments, supported by real assets, for a period of one year. The Islamic banking system of Iran has the following features:

3.1 Characteristics of bank Liabilities:

According to the law of usury – free banking in Iran liabilities incurred by the banks are basically of two kinds , as follows:

gharz- al- hassanh deposits current and savings deposits. These are similar to those of conventional banks except that they cannot earn any return. Current *qharz al-hassanh* deposits are like demand deposits or current account in conventional banks. This account from the point of view of customers is simply a means of making transactions and payments. The other type of *gharz al- hassanh* is saving account. In this account, depositors are offered non-fixed prizes and bonuses in cash or kind. Other incentives for this kind of account are that the banks exempt depositors from the payment of fees or commissions, and give priority in the use of banking facilities. *qharz al- hassanh* deposits are the main sources of *gharz-al hassaneh* loans.

Investment deposits, which banks are authorized to acquire are of two kinds: short term and long-term investment deposits. These deposits differ with respect to time. The minimum time limit for short term deposits is three months and long term deposits, 1, 2, 3, 4 and five years. No fixed amount, or rate of return, can be guaranteed to the depositors in advance. In practice banks pay the profit of depositors provisionally on a quarterly basis with a condition for final adjustment at the end of the financial year. Depositors can withdraw their money from long term investment deposits before the termination of agreement, if they give notice in advance. In this case, the basis for calculation of the profit will be the next lowest category of deposits, according to the time when the money has been deposited. Withdrawal from short-term deposits is possible at any time without notice.

3.2 Characteristics of Bank Assets:

The law of usury –free banking in Iran provides various modes of operations for financing the contracts between banks and customers. The modes are as follows:

Mudarabah(profit- sharing*):* banks provide initial capital to the commercial sector, both individual and traders who engage in trade and business. By previous agreement the profit from undertaking are divided at the end of the contract.

Musharakah(partnership): the law recognizes two different form of partnership, namely civil and legal partnership. The first, i.e. civil partnership, is a project specific partnership for short and medium periods. It is defined as the mixing of capital from a bank with the capital from a partner or partners (in cash or kind) on a joint-ownership basis for performance of a specific job. The second form, i.e. legal partnership, is a joint venture for the long duration. In the case provides a portion of total equity of a newly established firm or purchases part of the shares of the existing companies.

Direct Investment: banks can undertake to invest directly in any economic activity for a long period. The possibilities for direct investments by banks only exist in the public sector through the creation of companies where legal partnership is not possible.

Direct investment cannot be made in projects that lead to the production of luxury commodities. It must consider the priorities of the country economic development.
Murabahah (mark up or differed payment sale) banks are authorized to purchase raw materials, machinery, equipment, spare parts, and other needs of enterprises in industry, farming, mining and services and resell them by short term installments. Prices in these transactions cover cost, plus profit under specific regulations. Banks have been forbid to purchase items without the existence of a specific customer.

salaf (purchase with differed delivery): banks can purchase goods from productive enterprises in order to provide them with working capital. Thus, instead of lending money, the bank buys part of the future products at an agreed price which must not exceed the market price of the product at the time of the contract.

ijarah be sahrt-e-tamlik (lease-purchase): in this mode of financing banks buy real property or other assets needed by enterprises or individuals and lease the assets to them. The price of the asset is determined on a cost-plus basis. The ownership of the property is transferred to the lessees at the end of the contract.

Jualah (transaction based on commission); this is a project undertaking by the bank (or customer) to pay a specific sum in return for a service as specified in the contarct. *Jualah* is one of the short term facilities which may be granted for the expansion of production, commercial and service activities. The service to be performed and the fee to be charged must be determined at the time of contract.

gharz –al – hassaneh (benevolent loan): this is a non-commercial facility without any expectation of profit. *gharz –al – hassaneh* loans are usually made to small producers, farmers and small-scale businesses and the people who are unable to find financial sources for their peronsonal needs. The ability of banks to grant this loan depends on the *gharz –al – hassaneh* saving deposits.

The other financing methods in agriculture sector such as *muzarah* and *masaqat* are recommended when the above modes cannot be implemented. As in conventional banking, the most important activities in the Islamic banking system of Iran are services. They include clearing cheques, transfers of money, payments, receipts, etc. which banks fulfill free or with a fee, or on commission, depending on the kind of services.

4. Practice of Islamic Banking in Iran

As explained in the previous section under Islamic banking, the lender and borrower share the profits of enterprise (and associated risk) according to some previously agreed upon share. Thus, the actual size of the profit to the lender is determined only after completion of the projects. An increase in risk sharing, as entailed by Islamic banking, encouraged borrowers to adopt more risky projects. Naturally this made the loan portfolios of banks more risky. Hence, banks were persuaded to ration credit more strictly, and to divert a large proportion of their assets away from long term investment loans to commercial and short-term ones.

The central feature of the Iranian monetary system in the 1980s was that the money and credit council administered the interest rates. The underlying purposes of such an administered structure of interest rates were the mobilization of savings and the provision of funds for productive activity to the preferred sectors at concessional rates of interest. Monetary policy was also influenced by the need to raise the domestic savings rate. If there is a larger proportion of savings in the form of financial assets, there is need to offer depositors a positive real rate of interest. The monetary authorities of Iran realized that low interest rates might not be able to generate savings. So they geared policy towards encouraging deposits with long maturities.

The problems of slow growth of the banking sector deposits worsened in the mid-1980s (when conversion of all operations to the new interest free banking was completed) partly due to the lack of familiarity of lenders and borrowers with the new system. The sectoral loan rates, set administratively by the council on money and credit, were upwardly revised. As table 2 show the priority sectors, like agriculture had the lowest loan rates and those for domestic commerce had the highest rates. The deposit rates were also upwardly revised and certificates of deposit with different maturities were introduced. These changes were meant to reduce constraints on the banking system and increase its lending capacity by raising financial savings. This policy was Successful in reducing cash holdings relative to deposits, increasing non-sight deposits and term-investments in the banking system. Nevertheless, fiscal and monetary policies were inconsistent with the new deposits and loan rates. The government of Iran adopted the standard IMF-World Bank structural adjustment program to deal with Iran's economic problems in 1989. The Principal features of the new economic policies contained in the first Socio-Economic and Cultural Development Plan of the country were as follows:
a) Steps to improve the efficiency of monetary policy, through removal of credit ceilings and rising of rates of return on bank deposits and credits;

b) The adoption of sounder monetary and credit policies to stimulate the growth of private saving;

c) The planned privatization of hundreds of state-owned enterprises;

d) The partial lifting of foreign exchange controls, and the activation and legalization of a free foreign exchange market;

g) The regulation of pricing and investment decisions by public enterprises (UNIDO, 1995)

Iran's structural adjustment program paid attention to fiscal and monetary stabilization, the gradual removal of price controls and subsidies, the establishment of realistic interest rates. Although, from the government's point of view the economic reforms were well conceived and forcefully undertaken, in practice they failed to address the fundamental distortions in the economy that developed during the second half of the 1970s and deterioration of the economy during the 1980s. Nor was the program implemented fully in practice. The second five year development plan (1994-99) and third five year development plan (2000-2005) also called for improved macroeconomic management and limiting the rate of increase in the money supply. However, given the rather under-developed nature of the capital and bond markets in Iran, almost all financing needs of the public and the private sectors are met through the banking system. Therefore, the expansion of credits to the private and public sectors are among the most important driving forces behind money supply growth and hence inflation.

Table 1: Trends in Monetary Aggregates and Inflation In Iran
(Rate of change, Percentage)

Year	GDP	M	M1	M2	Private Sector Credit	Public Sector Credit	CPI (1997=100)
1979	-4.23	37.67	34.72	40.39	17.21	44.15	11.4
1980	-6.35	26.99	32.27	22.32	18.74	60.31	23.5
1981	-13.38	16.15	22.88	9.71	5.2	26.6	22.8
1982	12.56	22.81	28.68	16.54	8.24	23.89	19.2
1983	11.07	16.85	11.07	23.69	22.14	18.02	14.8
1984	-2.05	6.02	17.78	-6.46	5.73	14.92	10.4
1985	2.00	13.11	8.03	19.89	12.91	8.35	6.9
1986	-9.15	18.99	18.02	20.16	9.77	23.56	23.7
1987	-1.00	18.14	16.62	19.95	13.81	16.73	27.7
1988	-5.48	23.83	14.48	34.59	17.81	20.17	28.9
1989	5.91	19.54	15.84	23.16	29.66	10.8	17.4
1990	14.12	22.48	24.57	20.56	35.67	9.62	9
1991	12.12	24.64	21.85	27.29	38.2	9.74	20.7
1992	3.99	25.28	20.00	30.09	29.07	12.76	24.4
1993	1.48	34.21	36.92	31.93	30.28	60.71	22.9
1994	0.49	28.48	35.78	22.12	23.37	27.64	35.2
1995	2.95	37.56	34.62	40.41	24.44	34.77	49.4
1996	6.08	37.00	37.36	36.68	30.89	19.7	23.2
1997	2.81	15.22	12.50	17.75	23.28	22.43	17.3
1998	2.87	19.45	18.14	20.62	29.68	36.27	18.1
1999	1.60	20.13	16.00	23.73	40.41	6.49	20.1
2000	4.96	29.28	31.90	27.14	31.15	4.84	12.6
2001	3.28	28.84	24.95	32.16	34.1	12.76	11.4
2002	7.56	30.08	27.76	31.95	34.85	48.94	15.8
2003	6.83	26.12	19.00	31.66	39.05	7.61	15.6
2004	4.84	30.21	16.24	40.04	37.6	6.33	15.2
2005	5.70	34.32	25.84	39.27	38.3	-0.1	12.05
2006	6.17	39.43	30.39	44.20	41.7	8.7	13.62

Source: Central Bank of Iran, Annual and Economic Reports, Various years.

The next section analyses that the Islamic banking law gave the banks additional and more specific regulatory power. Of these four instruments were the most effective. First the CBI (Central bank of Iran) had the power to set the minimum rate of return (i.e. interest charged by banks) in regular or limited partnerships in each sector. These rates effectively eliminated marginal and sub-par projects. Second, by determining the profit sharing ratio between the banks and their clients in each sector of the economy, the CBI could influence the amount of credit allocated by banks to various sectors. Third, by regulating and changing the rate of services fees (i.e. interest) charge by banks on forward transactions, installment sales and lease-purchases, the CBI could regulate the allocation of credit financing for these traders. And, fourth, the CBI had the power to establish minimum limits for participation by banks in the capitalization of long-term investment projects; it thus had the power to influence the allocation of investment funds to different sectors of the economy. An implication of the above is that the government believes that market rates of return are not strong imperatives in providing resource allocation signals for the banking system. Perhaps for this reason the rates of return to the deposits are determined arbitrarily, and do not necessarily reflect the actual rates of return in the economy. The rates paid on bank (term-investment) deposits have changed little in comparison to high rates of inflation. As table 2 shows, over the period 1984 -2006 the deposits rates have ranged between 7-8 percent (on short-term deposits) to 16-18 percent (on five –year investment deposits), while the average rate of inflation rate over this period has been well in excess of 19.7 percent. Thus yielding negative ex post real rate of return of between 1.7-3.7 for five years deposit and 11.7-12.7 for short-term deposits per annum. With a sharp increase in the rate of inflation in the early to mid 1990s the real rate on five-year deposits began to decline substantially. The real return on five-year deposits had become positive again since 1999. But short-term deposits have not enjoyed a positive real return for years. Perhaps the principal contributing factor to the weakness of Iran’s financial reforms was the government’s inability to produce definitive, rational and cohesive policies in the financial and monetary sectors. Bank’s lending rates were also well below the rate of inflation and over the period 1990-2006 ranged between 6 percent to 18 percent for productive activities and exports, and marginally higher (between 18 and 23 percent) for trade and services, as compared to an average annual rate of inflation 19.8 over the same period. Even when investment deposit and bank profit are increased in response to rising inflation. As a consequence, the relationship between real interest rate and inflation had become perverse with real interest rates becoming more negative when inflation has become rising and less negative when the inflation rate has been falling.

Table 2 : Bank Profit (Interest) Rates in Iran

Term- Investment Deposit Rates							Expected Rate Of Profit on Facilities				
Year	Short term	One-Year	Two-Year	Three-Year	Four-Year	Five-Year	Exports	Trade and Services	Construction and Housing	Manufacturing and Mining	Agriculture
1979	7	8/5	NA	NA	NA	8/5	8-12	8-12	4-8	6-10	4-8
1980	7	8/5	NA	NA	NA	8/5	8-12	8-12	4-8	6-10	4-8
1981	7	8/5	NA	NA	NA	8/5	8-12	8-12	4-8	6-10	4-8
1982	7	8/5	NA	NA	NA	8/5	8-12	8-12	4-8	6-10	4-8
1983	7	8/5	NA	NA	NA	8/5	8-12	8-12	4-8	6-10	4-8
1984	7/2	9	NA	NA	NA	9	8-12	8-12	8-12	6-12	4-8
1985	6	8	NA	NA	NA	8	8-12	8-12	8-12	6-12	4-8
1986	6	8/5	NA	NA	NA	8/5	8-12	8-12	8-12	6-12	4-8
1987	6	8/5	NA	NA	NA	8/5	8-12	8-12	8-12	6-12	4-8
1988	6	8/5	NA	NA	NA	8/5	8-12	8-12	8-12	6-12	4-8
1989	6	8/5	NA	NA	NA	8/5	8-12	8-12	8-12	6-12	4-8
1990	6/5	9	10	11	NA	13	17-19	17-19	12-14	11-13	6-9
1991	6/5	9	10/5	11/5	NA	14	18=<	18=<	12-16	11-13	6-9
1992	7/5	10	11/5	13	NA	15	18=<	18=<	12-16	13	9
1993	8	11/5	13/5	14/5	NA	16	18	18-24	12-16	16-18	12-16
1994	8	11/5	13/5	14/5	NA	16	18	18-24	15	16-18	12-16
1995	8	14	15	16	NA	18/5	18	22-25	15-16	17-19	13-16
1996	8	14	15	16	NA	18/5	18	22-25	15-16	17-19	13-16
1997	8	14	15	16	NA	18/5	18	22-25	15-16	17-19	13-16
1998	8	14	15	16	NA	18/5	18	22-25	15-16	17-19	13-16
1999	8	14	15	16	16	18/5	18	22-25	15-16	17-19	13-16
2000	8	14	15	16	17	18/5	18	22-25	15-16	17-19	13-16
2001	7	13	13-17	13-17	13-17	17	18	23=<	15-16	16-18	14-15
2002	7	13	13-17	13-17	13-17	17	17	22=<	14-15	15-17	13-14
2003	7	13	13-17	13-17	13-17	17	15	21=<	15	16	13.5
2004	7	13	13-17	13-17	13-17	17	14	21=<	15	15	13.5
2005	7	13	13-17	13-17	13-17	17	16	16=<	15	16	16

2006	7	7-16	7-16	7-16	7-16	16	14	14	13	14	14

Source: Central Bank of Iran, Annual and Economic Reports, Various Years

The act of usury-free banking operations was ratified on whose basis the executive by-laws and directives were formulated and after a lapse of three decades from having put the act into effect, the phenomenon of interest is still keep possessing state's monetary and banking system. Table 3 shows various methods of financing envisaged for each line of activity. The fact is that the performance of Islamic banking in Iran has not been much different from the previous western style banking. There has been an upward trend for installment sale since early 1980s. So that, this share had raised to one third of credits. On the contrary, table 3 also indicates that other type of contract such as civil partnership, the share of *mozarebeh*, *gharz- al-hassanh* were 29.4% in 1984 had reduced to 11.1 percent in 2006. Although, the law of usury envisages a special social role for banks, for instance Article 1 emphasize on creation of necessary facilities for the extension of cooperation and *gharz-al-hassanh* among the people. And, according to article 14 of law of usury, the banks are obliged to earmark a portion of their resources, as a *gharz-al hassaneh* to the applicant. (www.cbi.ir/simpleist/1457.aspx). From table 3 it is evident that the Share of civil and legal partnership had experienced a steady state growth. But for the last decade this share has dropped to almost half of the previous amount. So that, the share of civil and legal partnership had reached to 12.5 percent in 2006.

Table 3 : Islamic Modes of financing in Iran (1984-2006)											
Year	*Gharz-al-hassaneh*	*Mozarebeh*	Forward Transactions	Civil Partnership	*Joaleh*	Installment Sale	Hire Purchase	Legal Partnership	Direct Investment	debt purchase	properties under islamic contract
1984	10.8	18.5	3.7	15.0	0.3	34.0	1.8	3.6	0.6	11.7	0.2
1985	10.8	15.9	3.2	13.2	1.4	32.6	0.9	7.3	3.6	10.1	1.2
Rate of change	0.0	-14.1	-13.5	-12.0	366.7	-4.1	-50.0	102.8	500.0	-13.7	500.0
1986	11.6	15.5	3.9	13.9	1.4	35.7	0.8	6.6	2.7	6.4	1.7
Rate of change	7.4	-2.5	21.9	5.3	0.0	9.5	-11.1	-9.6	-25.0	-36.6	41.7
1987	10.6	12.6	3.9	13.9	1.8	42.7	0.8	7.1	1.7	3.1	1.8
Rate of change	-8.6	-18.7	0.0	0.0	28.6	19.6	0.0	7.6	-37.0	-51.6	5.9
1988	9.7	11	4.9	11.7	2.8	47.1	0.8	7.1	1.3	1	2.6
Rate of change	-8.5	-12.7	25.6	-15.8	55.6	10.3	0.0	0.0	-23.5	-67.7	44.4
1989	7.5	10.7	6.7	12.8	5.1	46.8	0.5	5.8	1.3	0.6	2.2
Rate of change	-22.7	-2.7	36.7	9.4	82.1	-0.6	-37.5	-18.3	0.0	-40.0	-15.4
1990	5.7	10.2	5.3	14.5	6.6	49	0.4	4.6	1.3	0.3	2.1
Rate of change	-24.0	-4.7	-20.9	13.3	29.4	4.7	-20.0	-20.7	0.0	-50.0	-4.5
1991	4.2	9.7	5	17.8	7	47	0.7	4.8	1.3	0.1	2.4
Rate of change	-26.3	-4.9	-5.7	22.8	6.1	-4.1	75.0	4.3	0.0	-66.7	14.3
1992	3.6	8.5	6.7	17.6	6	46.5	0.5	5.2	1.9	0.1	3.5
Rate of change	-14.3	-12.4	34.0	-1.1	-14.3	-1.1	-28.6	8.3	46.2	0.0	45.8
1993	4.6	7.5	6.9	17.4	6	45	0.7	4.8	2.6	0.1	4.3
Rate of change	27.8	-11.8	3.0	-1.1	0.0	-3.2	40.0	-7.7	36.8	0.0	22.9
1994	4.4	7.3	6.2	18.1	6.6	45.8	0.8	3.6	2.4	0.1	4.7
Rate of change	-4.3	-2.7	-10.1	4.0	10.0	1.8	14.3	-25.0	-7.7	0.0	9.3
1995	4.7	6.8	5.5	19.4	7	45	1	2.7	1.7	0	6.2
Rate of change	6.8	-6.8	-11.3	7.2	6.1	-1.7	25.0	-25.0	-29.2	-100.0	31.9
1996	4.5	6.7	5	19.6	6.6	43.4	1.1	3.8	2.8	0	6.5
Rate of change	-4.3	-1.5	-9.1	1.0	-5.7	-3.6	10.0	40.7	64.7	#DIV/0!	4.8
1997	4.6	6.4	5.2	11.6	1.6	56	0.8	4.7	2.5	0	6.4
Rate of change	2.2	-4.5	4.0	-40.8	-75.8	29.0	-27.3	23.7	-10.7	#DIV/0!	-1.5
1998	5.9	6	6.2	9.7	1.4	58	0.7	3.1	1.8	0	7.4
Rate of change	28.3	-6.3	19.2	-16.4	-12.5	3.6	-12.5	-34.0	-28.0	#DIV/0!	15.6
1999	4.6	6.3	6.7	10.3	1.7	28.3	0.6	2.7	1.5	0	0.9
Rate of change	-22.0	5.0	8.1	6.2	21.4	-51.2	-14.3	-12.9	-16.7	#DIV/0!	-87.8
2000	4.2	6.2	7	9.9	1.6	28.8	0.6	2.2	1.2	0	0.8
Rate of change	-8.7	-1.6	4.5	-3.9	-5.9	1.8	0.0	-18.5	-20.0	#DIV/0!	-11.1
2001	4.5	5.5	7.5	8.6	1.6	31.4	0.7	1.6	0.9	0	0.5
Rate of change	7.1	-11.3	7.1	-13.1	0.0	9.0	16.7	-27.3	-25.0	#DIV/0!	-37.5
2002	7.2	5.7	6.7	6.4	1.4	33	1.1	1.3	0.8	0	0.6
Rate of change	60.0	3.6	-10.7	-25.6	-12.5	5.1	57.1	-18.8	-11.1	#DIV/0!	20.0
2003	5.8	6.2	6.1	6.7	1.6	35.5	1.2	1.6	0.9	0.1	0.6
Rate of change	-19.4	8.8	-9.0	4.7	14.3	7.6	9.1	23.1	12.5	#DIV/0!	0.0
2004	4.7	6.2	5.8	7	2.1	36.9	1.5	2.4	1	0.1	0.5
Rate of change	-19.0	0.0	-4.9	4.5	31.3	3.9	25.0	50.0	11.1	0.0	-16.7
2005	4.4	6.9	5.2	7.5	1.7	33.6	2.4	2.5	1	0.1	0.4
Rate of change	-6.4	11.3	-10.3	7.1	-19.0	-8.9	60.0	4.2	0.0	0.0	-20.0
2006	3.4	7.7	4.8	10.7	1.8	30.7	2	1.8	1	0.2	0.7

Rate of change	-22.7	11.6	-7.7	42.7	5.9	-8.6	-16.7	-28.0	0.0	100.0	75.0

Source: Central Bank of Iran, Annual and Economic Reports, Various Years

On the basis of usury –free banking Act in Iran, the fiscal resources concerned with giving loans by way of *mozarebeh* contract necessarily must be provided by term investment deposits and these are entrusted to banks by people for utilization and banks are authorized to insure the principal deposits and disburse the profit (which has not been specified in advance) accruing from permissible banking operations to the depositors after deducting the costs, and advocates fees. According to this approach, the profit and principal deposit must not be guaranteed because the profit takes an interest nature.

In effect, the purpose of partnership contract with its Islamic tenor is to benefit from investor's cash capital, and *mozarebeh* agent's expertise and management in commercial affairs without the principal and profit thereof is ensured by the agent in *mozarebeh* contract. Indeed, in this kind of agreement, the party of *mozarebeh* agent incorporates his work with capital owner 's cash capital and if any profit accrues, the two parties have it divided between themselves as per the agreement, but if the trade incurs loss, the capital owner is nowise entitled to demand profit or compensation from the opposite party. In this event, in this sort of dealings and agreement interest is nowise received or disbursed. But based on the by-laws and directives concerned with executing *mozarebeh* contract, the contract between banks and loanees is drawn up in such a way that a phenomenon emerges without a direct reference is made to its name.

According to article 15 , while concluding the transfer contract, the object of Article 8, the agent necessarily accepts and undertakes to make up for any loss or decline inflicted on bank principal out of his/her own properties if any arises: Thus, apparently as the party to *mozarebeh* contract has transferred to the bank all the amounts that one should pay later on account of principal and profit expected by bank (even under the circumstances that the agent incurs loss in her/his trade), therefore disbursement of the amounts is not tantamount to interest and usury because it has belonged to the bank itself as it forewent (www.cbi.ir/simpleist/1457.aspx). All contracts through which the bank resources confer loan to natural or legal persons out of the credit of investment deposits partake of the same attribute more or less, are based on interest through the rubric of interest has changed into bank profit. With regard to interest-free saving deposits (*gharz-al- hassaneh* deposits) also, by declaring various and precious prizes which are given to the winners via drawing lots, bank pave the way for attracting financial resources to these accounts which in turn, is a certain sort of deviation from usury-free banking principle.

As a part of the implementation of the new banking law, the council on money and credit established the 'minimum expected profit' in various economic sectors for lending or direct investment by the banks. Rates of charges on bank loans were determined by central bank, according to type of project and sectoral priorities. Thus, the rates in the agriculture sector were set at 4-8 percent and services, 10-12 percent (CBI, 1991). Beginning in 1990, these rates were raised to minimum 6-9 percent for agriculture and maximum of 17-19 percent for trade and service. As of early 1991, the rates for the later two sectors were allowed by market. In 1993, these rates again raised to 12-16 percent for agriculture and 18-24 for trade and services (CBI, 1994). The rates of 9 to 16 percent for other sector also represented to the minimum payable and were calculated retroactively after the end of year according to market condition.

There has been a highly uneven expansion of credits to the service sector. The share of service sector as a percentage of total credits paid to the economic sector experienced an upward trend since late 1980s. Since 2000, this trend registered an increasing trend which continued for the whole period. The aim of Islamic banking was to change the pattern of consumption and production in the economy through reduction of credits to the service sector and increased credit availability to the agriculture sector. However the share of agriculture as a percentage of total credits was the lowest. The share of agriculture rose from 14.2 percent in 1984 to 20.4 percent in 1989, but since then it had registered a declining trend for a decade. It was only between 1996 -2000 that agriculture share experienced a sign of improvement (CBI,2001).

5. Conclusion

The banking system of Iran is being perceived as an effective tool in pursuance of Islamic economic objectives such as : i) the proper issue of money and credit for the creation of a just, healthy and progressive economy; ii) The use of monetary tools to promote the national objectives of the country (including the elimination of poverty and attainment of national self-sufficiency); and iii) the preservation of the national currency value and promotion of balance of payments stability. However, Far from achieving the three-fold objectives of the 1983 banking act, the sector was plagued by slow growth, a large portfolio of non-performing assets and narrow range of products and services. Besides, most of people in charge of economic affairs regarded interest as an objective of non-omitable phenomenon and instead of probing into the real causes of interest entity and working out appropriate devices to eliminate it. For instance, in *mozarebeh* contract, the bank and an agent agree to engage in some commercial activity and earn, a profit, which will be shared between the bank and the agent (customer). However, the bank has received interest from the agent of *mozarebeh* contract and both parties treat the amount excess to the principal as a certain sort of interest.

Of the nine most often used modes of finance by commercial banks in two decades, about on average 40.6 percent has been under the installment sale category which is the closest form to interest- bearing conventional banking. Since interest free loans are the only kind of loan acceptable for personal and consumption needs according to this law and banks have very limited resources for this purpose, in reality, most of the loans demand are fake and the loan itself is financed using other kinds of Islamic contract; besides pushing the bank resources from productive sectors to consumer sector. Therefore, there is a need for introduction of new products and instruments for banking system in line with innovations in modern banking and compliance with financing new activities and with the development of modern banking system.

The advocates of Islamic banking had exaggerated expectations of the benefits from proposed law. Even if there was agreement among policy makers about the elements of a program of policies, the transmission mechanism through which the adoption of policies leads to outcomes was complicated. There were steps in that process of Islamization which was subject to uncertainty and delay with probability of adverse results. The adverse implications of poorly conceived policies exacerbated economic distortions.

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