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NEW MONETARY POLICIES IN USURY FREE BANKING

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ABSTRACT

The aim of this research is to find monetary policy tools in usury free banking. We will review the ideas of Muslims in Iran and outside the Iran for this subject. In this work, we will explain the effects of monetary policies on economy. This article is about explanation of two subjects: In the first subject, reports about usury free banking and ways of absorbing granted facilities is presented from the Islamic thinkers' point of views. The second object elaborates on monetary policies of this system. At the end, this article shows monetary policy tools which have special effects on this mechanism.

Keywords: Monetary policies, Grant facilities, Usury free banking, Tools.

INTRODUCTION

The necessity of existence of banks in economic system in one hand, and contamination of the banks to usury in the other hand caused economic activists and Islamic thinkers to think about establishing a banking system based on the Islamic laws, as a replacing option to traditional banks. So, the first Islamic bank was established by innovation of Dr. Najjar, the leader of Muslim Brothers Society, at the end of 1961s in Egypt. Thereafter other Islamic banks in Sudan, Kuwait, Jordan, Bahrain, and Saudi Arabia were established. In Iran, in the same years, Islamic financial institutes as interest free loan funds were formed and the first of them was officially founded in 1969.

Comparing Two Systems of Usury Free Banking and Usury Banking

Despite of some incorrect actions of usury free banking system in Iran, which caused for huge number of people to consider both systems as same, having a look at nature of the two systems, will reveal basic differences of them, among which are: In traditional (usury) system, the relation of monetary part and real economic part is almost cut; since the basis is upon the loan giving and loan taking, it is possible to gain benefit without involving in an economic activity, which is impossible in usury free banking. Since investment is the inverted function of interest rate and interest rate acts as a charge for investment, interest rate is a limitation for investment in usury systems, and regarding the interest rate, most of the plans lose their economic justifications. But in usury free systems, since the interest rate is zero and only when there is a benefit in economic activity in participatory contracts (which has an important role in usury free banking system) some benefits go to the money owners, the cost of investment is zero and the cost of investment opportunities is lower in this system. So it is expected that considering other factors as same, more investment is conducted in a usury free system, rather than a traditional system. (Branson, 1994)

In Islamic banking system, the actions are in a way that if there is no surplus in the real part of economy, there is no gain in the nominal part of that market. However, there is not such a balance between the circulation of monetary incomes and circulation of goods or value added in economy, in usury system; because interest is paid regardless of economic activity. This balance between monetary incomes and real incomes causes to money supply automatically is a function of total supply and exchange becomes balanced. The result of this situation is stability of purchasing power of money and lack of inflation. One of the characteristics of usury banking is that faces crisis while approaching stagnation, since it has just gained profit regardless of economic function. These banks, at the moment when stagnation conditions start, because of inability in collecting their pledges and sources that they have given as facilities, face bankruptcy. But in the Islamic banking system, when economy changes from improving state to stagnation, according to the cooperation of the banks, bank activities are reduced and this causes the stability of the system. Considering the previous and these characteristics, some Western economists are convinced that performing cooperation system in loss and profit based on Islamic contracts can solve its problems. (Dahmardeh and Izadi, 2011).

Usual Tools in Usury Banking

Change in the Legal Stock Rate

About the legal stock rate, most of the Muslim economists think that it is possible to control the banks' money making power, with changing this rate, as a monetary tool. Of course some economists believe that in Islamic monetary system, the monetary policy has no meaning, and criticizing its believers, they mentioned: Legal deposit in traditional banking system is for controlling the money supply and preventing of excessive making of it by banks. But if the real Islamic bank is developed, it will be as an attorney and partner for depositor in one hand, and can be as a partner for investor in the other hand. In this case, there is no reason to keep legal deposits, since they can be used as investments based on the Islamic contracts and increasing the investment is not a negative factor, but it is useful and constructive (Tutunchian, 1996). There are some conflicts among people who agree with keeping the legal deposits in central bank. For example, one of Pakistani economists believes that: Banks must keep special part of their depts to people, that is deposits, in central bank as stocks. This writer, in another article which is written by help of an Iranian economist, mentions: legal deposit is taken from all deposits. Describing the role of central bank, they claimed: In order to reach its goals which are related to its policies, central bank control the supply of powerful money, reserved ratios for different types of debts (deposits), and the maximum amount of properties that banks could assign to the partnership activities in their profits (direct controlling tools). (Khan, 1998).

Change in New Usury Rate

One of the usual tools in usury banking is changing the usury rate or new usury rate. Since this tool is explicitly related to the interest, is forbidden in usury free banking and there are other options in order to insure the stocks of commercial banks by central bank. Some divide the money taking of commercial banks from central bank into two parts. In the first part, about the way of preparation and consumption of the commercial banks' money, they say: Banks insure their short time demands for cash, as interest free loans from central bank. These demands seasonal and are for responding to depositors who want to withdraw their deposits. For this goal government can publish commercial stocks in the form of cooperation. The major part of this stock can be given to general banks, commercial institutes, and people. If central bank decides to buy these stocks, it could encourage their owners to sell them of the market prices. Stock owners earn their values from central bank and since they generally save their capitals in the banks, these monies finally go to the banks and develop bank's cash amounts (Khan, 1998).

Free Market Operations

One of the tools which has the most use in usury system and is a useful tool for monetary policy is free market operations and dealing debt securities. This trend is forbidden in Islamic banking, for its basis is directly on interest rate. There are some efforts to replace other suitable tools with debt securities in order to play the same role in the free market operations.

For example it is said that: Central bank still can deal securities in financial market which is free market operation; these securities should not have nominal value properties and coupon rate unequal to zero. Paying attention to the characteristics of speculation contract, such as possibility of transferring speculation ownership with all rights to another person, and the point that the investor cannot deal in economic activity in speculation, it could be understood that it is possible to change the share of owner in speculation contract, to negotiable securities in market. Then the case of guaranteeing the main capital and even its profit comes by an independent institute which can be government. Also it is possible to show the ways for its financial support (Sedigh, 1982).

Although it is not mentioned in Iranian usury free banking operations' law but, Muslim researchers tried to find some solutions to overcome this lack. For example they said: If debt securities contain bonuses, the lack of interest will be fulfilled. This is done in Pakistan and was successful (Hedayati *et al.,* 1993). This tool is predicted in a plan by central bank: Since any kind of predetermined bonus rate for debt securities conflict with current regulations, it is suggested that the bonus of debt securities could be equivalent to the annual interest of long term investment deposits plus a specific percentage. Also it is possible to consider this percentage according to the inflation rate and real growth rate of gross domestic product (without considering inflation) in the year before maturity.

Surplus percentage + annual interest rate of long term investments = bonus of interest free debt securities

New Tools

In addition to conventions of traditional banking, new tools are addressed in usury free banking system. We will discuss some of them:

Changing the Ratio of Bank's Profit Share

Most of the researchers have mentioned to this tool and it is mentioned also in usury free banking regulation. According to this, central bank can change the ratio of customers' profit share in partnership and speculation contracts and affect the will of investors and motivation of economic agents for using the facilities of bank, and control the money supply of the society.

Changing the Minimum Expected Profit Rate

According to this tool, banks can investigate the investment opportunities in different parts and gain their expected efficiency. Then according to this prediction, they announce a price as expected profit of the projects which accept their cooperation. Normally such a rate doesn't cover those investments, expected profit of which, and is lower than estimated rate. In other words, by each decision in monetary policy it is possible to eliminate some potential demands with low economic incomes and make other potential demands receive more facilities. It should be noticed that banks only gain profit when the respected profit is met, otherwise they don't earn anything for this. If the achieved profit is more than respected profit, surplus goes to the receiver of credit facilities. This is an encouraging factor for demanders.

Changing the Maximum and Minimum Profit Rate of Banks in Some Facilities

While speaking about profit, the gained profit from credit transaction, installment sales, and hire purchase are meant. Since in these transactions, the profit of bank as a part of the credit sailing price, is added to overall price (cash price), when the profit of bank goes higher, the price of credit sailing increases and the cost of credit facilities will be more expensive to the customer. This results in decreasing the demands for facilities (spastic policy). In the other hand, if the bank's rate of profit be lower, the price of credit is lower, and demands will be increased (tensional policy).

Dispensing Rewards and Special Facilities

This legal tool can act as a flexible instrument in attracting the investments. But the effecting speed of this tool is not as much as interest rate, in attracting investments; because while announcing the rewards, its effect on the income of investor is a factor of probability and is not predictable; so measuring its effect on his decision is difficult.

Changing the Amount of Honorarium of Using the Investment Depositions

Since changing the amount of bank honorarium would lead to mutual change in expected profit of depositor, it is possible to use this tool to attract such depositions and effect on the development of money supply.

Changing the Amount of Demand Deposits of Government in Commercial Banks

If increase or decrease in the deposits of commercial banks is desired, government can put or withdraw its demand deposits. It should be noticed that this trend causes increase and decrease in money supply, since governmental demand deposits are not considered as money supply, despite of people's demand deposits. So when government withdraws an amount from its demand deposits and spends it, it increases the money supply. But on the other hand, this action of government, doesn't change the deposition of the banks, since there is not increasing expansion of money and credit. In addition such an action is done by the government, not the central bank which imposes monetary policies.

The Goals of Monetary Policies in Usury Free Banking

The most important goals of monetary system, which somehow are the final goals of monetary policies, are:

Economic independence
Economic justice
Economic growth
Economic independence

There are some verses in Holy Quran, which prohibit the Muslims of being under authority of foreigners; for example the verse: God does not set a way for disbelievers to the faithful.

It could be understood from this verse that Muslims should do whatever they can, in order to retain their Islamic honor and independence and prevent the overcoming of disbelievers. Since the main way of disbelievers' authority is preparing economic needs, Muslims should have policies in order to be independent in main goods and in general corporations. It is obvious that out of essential goods, such as wheat, it is possible to compete with other countries of the world, retaining some basic rules and obeying foreign marketing principals. That is, independence in the production of all kinds of goods, essential and non-essential, is not necessary.

Economic Justice

One of the important goals of the Islamic economy is conducting general justice, in all of its dimensions. For example, in some verses of Quran the reason of sending prophets is mentioned as conducting justice in the society.

Among the different aspects of the justice, the intended point of this discussion is economic justice, which could be summarized in two axes: eliminating poverty, and adjusting wealth.

A) Eliminating poverty: Poverty is one of the major problems and there are lots of points about its entity, effects, and solutions. Imposing many kinds of Islamic taxes is a case showing the importance of the eliminating the poverty in Islam. Imam Ali (p.b.u.h) in his letter to Malik Ashtar, orders him to pay attention to the poor and says:

B) Adjusting wealth: The basis of creation of the world is on this fact that everyone should use God's gifts. The God-given resources should not belong to a special group of people and there should not be huge gaps between social classes. About this fact, God says:

Wealth should not only be among the rich.

Holy Prophet (p.b.u.h) controls the trophies which are gained in Qarias, in order to give them to the poor, orphans, and miserable. The reason of this distribution is to prevent accumulation of wealth in rich class.

Economic Growth

One of the overall goals of economic policies in economic systems is economic growth, and generally speaking, growth means the increase in Gross National Product. Obviously one of the goals of Islamic economic system is to build up the earth and prepare facilities of wealthy life for Muslims. Quran says: God has created you from the earth and ordered you to build it.

So God blames the people who stop his gift:

O Prophet, Tell who forbade God's clear blesses which are created to his slaves.

Imam Ali (p.b.u.h) tells to Malik-Ashtar, in a part of his letter:

And your effort in building the earth should be more than your effort in gathering taxes.

A) Job Creation and Employment Opportunities

It is obvious that one of the fields of growth in society is preparing employment opportunities and training working elements. In holy Islam, there are many emphasizes to this in both individual and general scales. Holy Prophet (p.b.u.h) while staying in Medina did many things in this field; such as cooperation contract between Friends (Ansar) and Refuges (Mohajerin) in order to develop economic activities, employment of Refuges' working powers and increasing the efficiency of

Friends' fields. Some of other actions of Holy Prophet were: Dividing the houses and gardens of Bani-Nozayr, which were gained in war, between the Friends and the Refuges; dividing the fields among the Refuges for house construction; giving facilities to agricultural activities and house construction from natural resources which were from barren lands which were belonged to Islamic government, and teaching needed technology by Islamic system (Sadr, 1980). Imam Sadegh (p.b.u.h) told one of his relatives that: O the slave of God, keep your honor. He answered: I die for you, what is my honor? He told: Going out to work in early morning and keep your soul from being in need of others and asking them to help. In other exegetes he prevented a person who wanted to stop trading, because of having no need to work.

B) Establishment of the General Level Of Prices

Establishing the general level of prices, doesn't mean to keep them fixed. Since usually in economy, inflation with low rate (two or three percent) causes increase in investment and finally causes the economy to tend to perfect employment and economic growth. A deep research in Islamic optional and obligatory rules shows that Islam has a great concern in struggling with roots of inflation, lack of supply, and general increase of demands. When the prices of foods grew in Medina, Imam Sadegh (p.b.u.h) ordered his servant to sell extra foods in town and buy their needs daily, like other people. The importance of this act is in two aspects: first, the selling of extra foods could have an effect in the amount of food in market, at the small society of that time; second, this act of Imam could be a moral pattern to Shiites. (Izadi and Izadi, 2012).

ALTERNATIVE TOOLS IN USURY FREE BANKING SYSTEM

Buying the Instruments Which Government Needs, and Selling Them in Credit

In this method, private sector buys the instruments which government needs and sell them in a higher price, in credit mode and receives some securities from government which are "government debt securities". In a similar plan, banks buy the commodities which are needed by government, in cash and sell them to the government, in installment sale. In one part of this plan, it is mentioned: in order to pay the credits in its due date, government can prepare securities and give it to the seller of commodity. These securities are named as "government purchase securities". Bank, as the seller of commodity, if needed, can sell these securities in a lower price, and under the rules of discount. So government can cover part of its budget deficit by buying the credit without paying cash for its needs, and if the commodities are salable, can cover another part of budget deficit by selling commodity and gaining cash.

Speculation Securities

One of the tools which can be an alternative to debt securities and can be used to control the money supply is speculation securities. First it is suggested by Sunni researchers, and then mentioned in Iran by economic department of treasury ministry. According to its characteristics, where owner cannot interfere in speculation operations, and agent has complete authority in these operations (but owner can put some conditions in the primary contract) it is mentioned that after contraction between owner and agent, it is possible to transfer the ownership of speculated investment to another person (people) in order for them, to be complete representatives of primary owners. Since speculated subjects have real prices which are different from its nominal price, it is possible to change the owner share in speculation contract into the securities which could be dealt, in order to use this share in free market operations.

The guarantee issue for the original capital and its profits is upon an independent institute. The other point is that the period of these operations is usually short, and although its rapid profitability gives enough motivation to its buyers, but because of its type of activity and its time, it has limitations which reduce its generality. These securities could be used in some ways:

A) Absorbing liquidity: These securities can be used to absorb causeless liquidity of society and direct them towards national and international commercial goals for needed commodities of society. This could be done by banks and they can directly be involved in business as the agent of speculation or as the representative of investors, can give the capital to demanders of facilities in order to doing speculation operations. In both cases bank releases securities and give them to investors, and these securities could be dealt and be transferred to others in stock market or by bank itself. The other way which seems better is that first bank, with its resources starts speculation operations with facility demanders, then give its equity securities to investors for their deposits. Also in this way, these securities can be dealt (can be bought and be sold).

B) Financial supporting of government: if government encounters budget deficit for preparing capital goods and peoples' essential goods, banks can prepare these goods as agents of speculation and give them to the government. Or in order to prevent increase of prices in domestic market, it is covenanted with speculation agents that they should import special goods to the country and sell them in market.

C) Applying monetary policy: central bank can affect the banks' deposits or people's money stock.

D) Financial supporting of banks: in usury system, central bank can give some resources to the banks by rediscounting or direct loan. In this system, buying these securities from banks or signing new speculation contracts with them, central bank increases the money stock of banks in order to give facilities to people.

Corporate Bonds

As told in speculation, this contract has some limitations, and is not applicable to financial support of plans which need long period investments. It is an important factor that using this tool in performing monetary policies has some problems, since the goal reaching time of these policies is long. So it is necessary to use other tools that have not such limitations. One of these tools is corporate bonds of investment plans based on company contract. A company is a contract among two or more people to do something upon their common property. This kind of company is called contracting company or acquisitive company. Its result is that partners can interfere on pallymoney and use it in productive or service activities. Some believe that one result of this contract is changing the specific ownership to the joint ownership among them in order to have permission to such interferences.

Releasing corporate bonds is possible in some ways. In a general classification, these securities are to secure all or a part of new companies' capitals, or to buy a part of shares of existing companies in order to expand its capital and other goals. The procedure could be done in some ways:

A) Banks with their own resources independently invest in specific projects and distribute its shares among the demanders for depositing in bank, after yielding or during the project. That is, depositors should buy corporate bond securities instead of deposit their money in bank.

B) Banks, as representative of deposit owners, with their monies can invest and give its ownership documents as stock, to depositors. This share and the share of part (A) could be dealt by bank or in stock market.

C) Private sector, as well as bank, can invest in industrial, agricultural, and constructional projects in two ways, and then deal its share securities through banks or stock market. It is better to these projects to be planned in a way that is in the directions of economic plan of the country. Also private sector can construct national projects that government controls, like universities, schools, parks, and highways, and then rent them to the government and simultaneously sell the share of these projects in market.

D) Government sector can invest in different projects and release a part of its shares from beginning, or during, or after yielding the project.

E) Also government part can distribute some ready national projects, as shares,to people but while selling, covenant that they should rent those shares again to government. In part (D) government can do the same. When government rent the projects, shares of which are distributed among people, since the amount of rent is distributed as a determined and definitive profit among share owners, people who donot risk so much will have motivation to buy the shares of these institutes.

F)

The Discount of People Debt to Government with the Central Bank

If the central bank is trying expansionist policy, it can discount the credit of the government from the sale of public goods, services, taxes and other state rights- based on the agreement it is periodical. These rates are determined by central bank monetary policy.

Interest-Free Bonds

This is based on interest free loans and according to Islamic sources interest free loans are highly appreciated. Accordingly government has issued interest free bonds and guarantees the payment in specified date of maturity. It would be better if the use of these debts be specified and of matters that are socially and faithfully important for people, and it is better the term maturity of these bonds be considered short. It should be noted that due to some reasons these bonds cannot be used in open market operations as an alternative bonds.

These bonds are without profit, and then it is impossible to add demands by changing the profits. There is no difference between the market price and normal price of these bonds. Then the problem of the central bank to implement monetary policy by buying and selling them is meaningless. Funds achieved by the sale of these bonds must be spending to where it is declared to the people. So the central bank cannot flow out some of money by selling them, otherwise it will miss the confidence of the people and cannot use them as an eternal instrument. Given these problems, using this instrument to control money some ways have been suggested: Bonds with award, one of these ways is prizes for the bonds, in this case, firstly giving award for these bonds naturally encourage those who don't have spiritual motivation to buy these bonds. Secondly, by increasing and decreasing the amount of prizes it may affect the purchase of these bonds.

No Real Return Bonds

Another way is the issuance of the interest free loan bonds with no real return; and it is:

The bond holders expect to gain no return of their investments and they really intend to give interest free loan. Of course, the investor is interested in buying the same amount of goods at the time of returning his capital as he could buy at the time of investment. To maintain the purchasing power, it is necessary that issuing organizations of these bonds compensate reduced purchasing power of his capital for each year. This reduction may be affected by two;

1- Add to a nominal price, proportional with inflation rate during the period. 2- In the second way, some amount of money equal to interest free loan multiplied by the inflation rate is paid to the lenders and pays the original loan back at end of the period. The amount of people who welcome these bonds depend on whether people are now able to prevent the reduced purchasing power of their money by putting money in the bank, purchasing of durable goods and…, and considering that the profit rate that banks pay to depositors is less than the inflation rate it is expected to welcome some of the depositors of these bonds. (Dorunbush and Fischer, 1992)

Effective Instruments in Money Multiplier

The main characteristic of these instruments is that through effect on a component of money multiplier, that component will be changed and change the volume of money. These instruments are as;

Change in the minimum ratio of profit for banks.

Bank performs its activities with depositors and facilities applicants based on contracts noted in details. In some contract such as partnership, investor-agent partnership a contract of crop sharing (mozara) and bank's share as a proportion of their profit can be obtained. Therefore, changing this ratio can be considered as an instrument for monetary policy. Because for example, when this ratio raises less people decide to deposit in the bank and this reduces banks' reserves and ultimately the power of money creation. Similarly, in relation to applicants' facilities, less people call for facilities and banks are faced with excess reserves, then the growth of volume of money decreases. The important point is that these instruments can be used if bank is not only as a mediator and lawyer, because in that case, the proportion of his client profit share –depositors- will change, and this is permissible with their consent and their interest.

Change in Banks Legal Fees

In the previous instrument assumption was based on that banks invest directly or participate with facilities applicants and their relationship with depositors is on the basis of partnership contracts, investor-agent partnership and etc. but banks may only play an intermediary role between depositors and facilities applicants and in fact to be partnership between deposit holder and facilities applicants. In that case the profit will divide between them as the bank specifies as an attorney. The bank is only entitled to earn the legal fee, and because legal fee is of investment costs, it will change the amount of profit. Therefore, the central bank changes the banks legal fees and affects the rates of deposits and also facilities demands and it can be used as a lever to influence the volume of money.

Changes in Expected Interest Rates

As it was said Banks are facing with requests for the facilities to invest in projects with different expected profits and naturally seek to participate in the projects that have the highest expected profits. Hence with determining the minimum expected profit, some plans are excluded from banks facilities. Therefore, the central bank with changing the rate can change the number of projects which can receive facilities from the bank, and can affect the rate of received facilities and the volume of money.

Changes in the Minimum and Maximum Profit Rate of the Banks in Some Facilities

In some of granted facilities by banks such as: lease-option, installment sales, forward transaction and… for, bank profit in the case of installment sale price is added to cash price, the more bank profits the more installment price and facilities costs go up. This means that less interest in facility demand will affect the growth of volume of money. One of the most important parameters in the money multiplier is the ratio of coins and coins held by the people. Therefore, because this instrument is out of the control of central bank it cannot be used in monetary policy. Of course if easier conditions will be provided for the bank exchange and some arrangement be considered for the rate of banks, this ratio will change; and normally will be added to the reserves of the bank and then the volume of the money will change. Demand for facilities also will be decreased (the ratio of precautionary reserves to deposits). When banks face a demand for facilities, less precautionary reserves they will maintain and in contrast they will add to the borrowed reserves from central bank. (JahanKhani, 1954)

COMMON INSTRUMENTS IN USURY SYSTEM (RIBA)

A) Change in Legal Reserve Rate

This instrument has two important aspects for policy makers: first; it is an instrument to ensure the safety of deposits. Second; because of rapid effect on the volume of granted credits by banking system, it is an important lever for the implementation of monetary policy to control the volume of credit facilities and to limit the money multiplier.

Although initially the main purpose of this reserve was to ensure the safety of deposits, now it is used mainly in order to fulfill the second role (controlling the volume of credit facilities, etc.)This instrument for the first time was used in 1946. This year all banks were bound to make deposit 15% of their demand deposit and 6% of their time deposit in the central bank. This ratio approved in the banking act of 1955 and then increased 20% and 30% respectively in the monetary and banking law enacted on 1960. Finally, in monetary and banking law enacted on 1972, this ratio had minimum and maximum of 10% and 30% respectively. Overall, this ratio has had an ascending trend by 1973. (Except in 1962 which compared to demand deposit decreased from 15% to 12% and compared to non-demanddeposits from 15% to 7.5%) in 1973, this rate compared to demand deposits has increased four times from 23% to 30% and as it was said this increase is to control inflation. But in 1974, followed by an increase in oil prices and government funds, in order that banks provide required resources of private sector, central bank has lowered the legal deposit ratio and announced this ratio in exchange for increasing demand deposits to 25% and to non-demanddeposits to 12%. In 1975, this ratio increased again compared to non-demanddeposits but it remained fixed compared to demand deposits up to 1978 at 25%. In 1978, following the political and economic upheaval and people's willingness to withdraw their deposits from bank because of fearing of bank failure these ratios decreased 25%, 15%, 12%, 10% respectively. In other words, if we assign changes in legal reserves ratio in 40s and early 50s in order to apply monetary policy, changes in 1978 was only to prevent banks failure. After Islamic revolution, and increasing confidence in the banking system, the volume of deposits greatly increased, so that from February 78 to July 81 the volume of private sector deposits with the banking system increased about 91%. Despite the fact that, the volume of bank credit to this sector were increased only 40.1%. This surplus in the condition that monetary TAKASORI coefficient was at its maximum it was a potential threat for country's economy. According to recent decisions of the monetary and credit council on September 60, this ratio compared to demand deposit increased from 12% to 17% and for non-demand deposits increased from 10% to 15%.

In July 1983, on the eve of the interest free banking act there was a change in the ratio of legal reserves again and this ratio increased for the demand deposits in commercial banks from 17% to 27% and for non-demanddeposit from 15% to 25%. This ratio reached to its legal limit which was 30% and 10% increase of that indicated a severe contraction policy. After approval of interest free banking act, this ratio during the 60s was fixed and only in 1983 there were changes in the composition of deposits, and interest free loan saving deposits was in the row of the non-demanddeposits. In 1991, the legal deposit rates did not change for specialized banks (17%) but from the beginning of this year this ratio changed compared to all types of deposits in commercial banks. In 1983 and 1984, investment deposits just include two types of short term deposit and one year deposit; but since 1990, in order to strengthen the incentives to long term deposits in banks, deposit with the term of two years, three years and five years were introduced. In 1991, the ratio of legal reserve decreased from 25% to 15% compared to these new deposits in commercial banks and in this regard in 1993, this ratio 10% decreased for deposits of five years. Also in 1993, the ratio of legal deposits had changes in specialized banks. (Izadi *et al.*, 2012)

B) Change in Rediscount Rate

Considering that since 1980 onwards, these instruments are not used, generally we do study that during 1961 to 1980. The study of the amount of banks debt to the central banks indicate that before the Islamic revolution the volume of credits of banking system was significant but the central bank to provide banking resources had no significant role, and among the resources provided by the central bank compared to funds obtained by discount is very low; in other words, the ratio of resources that result from rediscounting to total banks debt to the central bank was not significant and often it is under three percent. Only in 1974, this ratio rose to 20%. Of course this change resulted from increasing discount price and decreasing banks debt to the central bank. In 1975, the volume of discounted price rose to its highest limit that was 14.1 billion Rials. This number decreased sharply in subsequent years, until finally was zero in 1980. Another point is that discount rate during these years had no significant impact on the discounted price; as the discount rate reached 5% from 4%, the volume of discount increased from 0.1 billion to 0.3 billion Rials and when in 1974 and 1975 the discount rate reached 7% and 8% , the volume of discount rose to its highest.

C) Bonds

For the first time it was published in 1941 in Iran. This year the finance ministry was allowed to circulate four hundred million Rials of the treasury documents with the date of maturity which does not exceed four months to gain necessary credibility in the budget each year. This permit was revoked in the following year and due to lack of welcome by people, governmental organizations were obliged to buy it. The interest rate of these documents was 6%. The second paper published in 1951, at time of Dr, Mosadegh government in order to support nationalizing the oil industry. These bonds amounted to twenty billion Rials, with the interest of 6% and published as one hundred Rials bearer papers. Of the characteristic of these bonds was that the holder could pay their taxes and duties. And because of supportive and national aspects, these bonds were welcomed by people. In later years, these papers were published but because of lack of welcome by people all of them were purchased by the central bank.

In 1970 banks were obliged to keep 16% of total increase in deposits during the year as bonds. The main objective of this policy was decreasing in lending power of banks and preventing expansion of monetary base by transferring government debts to the banks. In 1971s the volume of bonds that the banking system obliged to buy was changed several times. For example, this duty abolished in 1972 and in 1974 increased as an increase in legal deposits rates for the prevention of inflationary pressures and it became equivalent to 50% of total non-demanddeposits. In another decision to implement expansionary policies this ratio reached 30% and then increased again to 45%. Before Islamic revolution it can be said that, bonds were not an active and effective instrument in the implementation of monetary policy and controlling volume of money and its implementation has been limited only to banks. After revolution, willingness of individuals and private sector institutions to buy bonds was reduced gradually for various reasons (including illegitimacy of accrued interest on government bonds) and from 1980, buying bonds by the private sector was completely stopped.

Publishing of these papers after Islamic revolution except 1979 simply was for doing legal duties of banks and replacing those bonds that the time of their reimbursement have come and not as an instrument for controlling monetary policy or government finance. And because of government inability to pay the principal amount of the bonds and the prize, each year the debt is added. According to the latest council of money and credit, commercial banks since 1991 have been obliged to buy 36% of their resources allocated to governmental bonds. Generally, among common instruments in usury system, in addition to their religion prohibition, changes in rediscount rate and bonds; in the period that they were used before revolution and before approval of usury free banking system act, have no significant effect on monetary policies.

NEW INSTRUMENTS IN USURY FREE BANKING SYSTEM

Interest Rates for Banks Credit Facilities

In June 1984, money and credit council in accordance with article 20 of the usury free banking operations approved legal limitations and conditions necessary for granting banking facilities. Under this legislation, the ratio of banks profit in investor-agent partnership and partnership is the responsibility of banks. The minimum of expected profit rate in the investor-agent partnership has been determined for imports and domestic trade 12% and for exports 8%. The minimum of expected profit rate in civil and legal partnership has been determined for agriculture sector 6%, mine and industry 8%, housing 10% and commerce and services 12%. In direct investment the minimum of expected profit rate has been estimated for agriculture 4%, mine and industry 6% and housing 8%.

In the case of determining the minimum and maximum ratio of banks in the lease-option condition and installment sale of machinery, equipment and infrastructures, the minimum of profit rate for agriculture is 6%, mine and industry 8% and services 10%. In this case the maximum of profit rate is 8%, 10%, 12% respectively. Compared to forward transaction and (jaale) contract, some rates determined between 8% and 12% in various fields. According to these statistics, these rates have fluctuated between 4% and 12% percent that the lowest corresponds to the minimum of the expected profit in direct investment and in agricultural sector, and also the minimum of the profit rate is in forward transaction and installment sales of materials, spare parts and instruments. And the maximum of the profit rate is for industry and commerce… sectors.

These rates were fixed until 1990, in 1998 in order to create a logical relationship between the minimum rate of return granted facilities with major economic indicators such as return on investment in the economy and inflation rate, the central bank seek to revise the interest rates of banks facilities. These rates did change in the following years; for example in 1992 and 1993, the maximum expected profit rate of granted facilities did not determined in commercial and services sector and banks were allowed to determine the rate by a mutual agreement with their customers. Also there were changes in profit rate of other facilities which caused increase in overall profitability of banks.

Interest Rates for Term Deposits

4- The discount of people debt to government with the central bank

If the central bank is trying expansionist policy, it can discount the credit of the government from the sale of public goods, services, taxes and other state rights- based on the agreement it is periodical. These rates are determined by central bank monetary policy.

Interest-Free Bonds

This is based on interest free loans and according to Islamic sources interest free loans are highly appreciated. Accordingly government has issued interest free bonds and guarantees the payment in specified date of maturity. It would be better if the use of these debts be specified and of matters that are socially and faithfully important for people, and it is better the term maturity of these bonds be considered short. It should be noted that due to some reasons these bonds cannot be used in open market operations as an alternative bonds.

1-these bonds are without profit, and then it is impossible to add demands by changing the profits.

2- There is no difference between the market price and normal price of these bonds. Then the problem of the central bank to implement monetary policy by buying and selling them is meaningless.

3-funds achieved by the sale of these bonds must be spending to where it is declared to the people. So the central bank cannot flow out some of money by selling them, otherwise it will miss the confidence of the people and cannot use them as an eternal instrument. Given these problems, using this instrument to control money some ways have been suggested:

Bonds with award, One of these ways is prizes for the bonds, in this case, firstly giving award for these bonds naturally encourage those who don't have spiritual motivation to buy these bonds. Secondly, by increasing and decreasing the amount of prizes it may affect the purchase of these bonds.

No Real Return Bonds

Another way is the issuance of the interest free loan bonds with no real return; and it is:
The bond holders expect to gain no return of their investments and they really intend to give interest free loan. Of course, the investor is interested in buying the same amount of goods at the time of returning his capital as he could buy at the time of investment. To maintain the purchasing power, it is necessary that issuing organizations of these bonds compensate reduced purchasing power of his capital for each year. This reduction may be affected by two;

1- Add to a nominal price, proportional with inflation rate during the period. 2- In the second way, some amount of money equal to interest free loan multiplied by the inflation rate is paid to the lenders and pays the original loan back at end of the period. The amount of people who welcome these bonds depend on whether people are now able to prevent the reduced purchasing power of their money by putting money in the bank, purchasing of durable goods and…, and considering that the profit rate that banks pay to depositors is less than the inflation rate it is expected to welcome some of the depositors of these bonds.

Effective Instruments in Money Multiplier

The main characteristic of these instruments is that through effect on a component of money multiplier, that component will be changed and change the volume of money. These instruments are as;

Change in the Minimum Ratio of Profit for Banks

Bank performs its activities with depositors and facilities applicants based on contracts noted in details. In some contract such as partnership, investor-agent partnership a contract of crop sharing (mozara) and bank's share as a proportion of their profit can be obtained. Therefore, changing this ratio can be considered as an instrument for monetary policy. Because for example, when this ratio raises less people decide to deposit in the bank and this reduces banks' reserves and ultimately the power of money creation. Similarly, in relation to applicants' facilities, less people call for facilities and banks are faced with excess reserves, then the growth of volume of money decreases. The important point is that these instruments can be used if bank is not only as a mediator and lawyer, because in that case, the proportion of his client profit share –depositors- will change, and this is permissible with their consent and their interest.

Change in Banks Legal Fees

In the previous instrument assumption was based on that banks invest directly or participate with facilities applicants and their relationship with depositors is on the basis of partnership contracts, investor-agent partnership and etc. but banks may only play an intermediary role between depositors and facilities applicants and in fact to be partnership between deposit holder and facilities applicants. In that case the profit will divide between them as the bank specifies as an attorney. The bank is only entitled to earn the legal fee, and because legal fee is of investment costs, it will change the amount of profit. Therefore, the central bank changes the banks legal fees and affects the rates of deposits and also facilities demands and it can be used as a lever to influence the volume of money.

Changes in Expected Interest Rates

As it was said Banks are facing with requests for the facilities to invest in projects with different expected profits and naturally seek to participate in the projects that have the highest expected profits. Hence with determining the minimum expected profit, some plans are excluded from banks facilities. Therefore, the central bank with changing the rate can change the number of projects which can receive facilities from the bank, and can affect the rate of received facilities and the volume of money.

Changes in the Minimum and Maximum Profit Rate of the Banks in Some Facilities

In some of granted facilities by banks such as: lease-option, installment sales, forward transaction and… for, bank profit in the case of installment sale price is added to cash price, the more bank profits the more installment price and facilities costs go up. This means that less interest in facility demand will affect the growth of volume of money. One of the most important parameters in the money multiplier is the ratio of coins and coins held by the people. Therefore, because this instrument is out of the control of central bank it cannot be used in monetary policy. Of course if easier conditions will be provided for the bank exchange and some arrangement be considered for the rate of banks, this ratio will change; and normally will be added to the reserves of the bank and then the volume of the money will change. Demand for facilities also will be decreased (the ratio of precautionary reserves to deposits). When banks face a demand for facilities, less precautionary reserves they will maintain and in contrast they will add to the borrowed reserves from central bank.

COMMON INSTRUMENTS IN USURY SYSTEM (RIBA)

A) Change in Legal Reserve Rate

This instrument has two important aspects for policy makers: first; it is an instrument to ensure the safety of deposits. Second; because of rapid effect on the volume of granted credits by banking system, it is an important lever for the implementation of monetary policy to control the volume of credit facilities and to limit the money multiplier.

Although initially the main purpose of this reserve was to ensure the safety of deposits, now it is used mainly in order to fulfill the second role (controlling the volume of credit facilities, etc.)This instrument for the first time was used in 1946. This year all banks were bound to make deposit 15% of their demand deposit and 6% of their time deposit in the central bank. This ratio approved in the banking act of 1955 and then increased 20% and 30% respectively in the monetary and banking law enacted on 1960. Finally, in monetary and banking law enacted on 1972, this ratio had minimum and maximum of 10% and 30% respectively. Overall, this ratio has had an ascending trend by 1974. (Except in 1962 which compared to demand deposit decreased from 15% to 12% and compared to non-demand deposits from 15% to 7.5%) in 1973, this rate compared to demand deposits has increased four times from 23% to 30% and as it was said this increase is to control inflation. But in 1974, followed by an increase in oil prices and government funds, in order that banks provide required resources of private sector, central bank has lowered the legal deposit ratio and announced this ratio in exchange for increasing demand deposits to 25% and to non-demand deposits to 12%. In 1975, this ratio increased again compared to non-demand deposits but it remained fixed compared to demand deposits up to 1977 at 25%. In 1978, following the political and economic upheaval and people's willingness to withdraw their deposits from bank because of fearing of bank failure these ratios decreased 25%, 15%, 12%, 10% respectively. In other words, if we assign changes in legal reserves ratio in 40s and early 50s in order to apply monetary policy, changes in 1978 was only to prevent banks failure.

After Islamic revolution, and increasing confidence in the banking system, the volume of deposits greatly increased, so that from February 78 to July 81 the volume of private sector deposits with the banking system increased about 91%. Despite the fact that, the volume of bank credit to this sector were increased only 40.1%. This surplus in the condition that monetary TAKASORI coefficient was at its maximum it was a potential threat for country's economy. According to recent decisions of the monetary and credit council on September 60, this ratio compared to demand deposit increased from 12% to 17% and for non-demand deposits increased from 10% to 15%. In July 1983, on the eve of the interest free banking act there was a change in the ratio of legal reserves again and this ratio increased for the demand deposits in commercial banks from 17% to 27% and for non-demand deposit from 15% to 25%. This ratio reached to its legal limit which was 30% and 10% increase of that indicated a severe contraction policy. After approval of interest free banking act, this ratio during the 60s was fixed and only in 1983 there were changes in the composition of deposits, and interest free loan saving deposits was in the row of the non-demand deposits. In 1991, the legal deposit rates did not change for specialized banks (17%) but from the beginning of this year this ratio changed compared to all types of deposits in commercial banks.

In 1983 and 1984, investment deposits just include two types of short term deposit and one year deposit; but since 1990, in order to strengthen the incentives to long term deposits in banks, deposit with the term of two years, three years and five years were introduced. In 1991, the ratio of legal reserve decreased from 25% to 15% compared to these new deposits in commercial banks and in this regard in 1993, this ratio 10% decreased for deposits of five years. also in 1993, the ratio of legal deposits had changes in specialized banks.

B) Change in Rediscount Rate

Considering that since 1980 onwards, these instruments are not used, generally we do study that during 1961 to 1980. The study of the amount of banks debt to the central banks indicate that before the Islamic revolution the volume of credits of banking system was significant but the central bank to provide banking resources had no significant role, and among the resources provided by the central bank compared to funds obtained by discount is very low; in other words, the ratio of resources that result from rediscounting to total banks debt to the central bank was not significant and often it is under three percent. Only in 1974, this ratio rose to 20%. Of course this change resulted from increasing discount price and decreasing banks debt to the central bank. In 1975, the volume of discounted price rose to its highest limit that was 14.1 billion Rials. This number decreased sharply in subsequent years, until finally was zero in 1980. Another point is that discount rate during these years had no significant impact on the discounted price; as the discount rate reached 5% from 4%, the volume of discount increased from 0.1 billion to 0.3 billion Rials and when in 1974 and 1975 the discount rate reached 7% and 8% , the volume of discount rose to its highest.

C) Bonds

For the first time it was published in 1941 in Iran. This year the finance ministry was allowed to circulate four hundred million Rials of the treasury documents with the date of maturity which does not exceed four months to gain necessary credibility in the budget each year. This permit was revoked in the following year and due to lack of welcome by people, governmental organizations were obliged to buy it. The interest rate of these documents was 6%. The second paper published in 1951, at time of Dr, Mosadegh government in order to support nationalizing the oil industry. These bonds amounted to twenty billion Rials, with the interest of 6% and published as one hundred Rials bearer papers. Of the characteristic of these bonds was that the holder could pay their taxes and duties. And because of supportive and national aspects, these bonds were welcomed by people. In later years, these papers were published but because of lack of welcome by people all of them were purchased by the central bank. In 1970 banks were obliged to keep 16% of total increase in deposits during the year as bonds. The main objective of this policy was decreasing in lending power of banks and preventing expansion of monetary base by transferring government debts to the banks. In 1971s the volume of bonds that the banking system obliged to buy was changed several times. For example, this duty abolished in 1972 and in 1973 increased as an increase in legal deposits rates for the prevention of inflationary pressures and it became equivalent to 50% of total non-demand deposits. In another decision to implement expansionary policies this ratio reached 30% and then increased again to 45%. Before Islamic revolution it can be said that, bonds were not an active and effective instrument in the implementation of monetary policy and controlling volume of money and its implementation has been limited only to banks. After revolution, willingness of individuals and private sector institutions to buy bonds was reduced gradually for various reasons (including illegitimacy of accrued interest on government bonds) and from 1980, buying bonds by the private sector was completely stopped. Publishing of these papers after Islamic revolution except 1979 simply was for doing legal duties of banks and replacing those bonds that the time of their reimbursement were come and not as an instrument for controlling monetary policy or government finance. And because of government inability to pay the principal amount of the bonds and the prize, each year the debt is added. According to the latest council of money and credit, commercial banks since 1991 have been obliged to buy 36% of their resources allocated to governmental bonds. Generally, among common instruments in usury system, in addition to their religion prohibition, changes in rediscount rate and bonds; in the period that they were used before revolution and before approval of non-usury banking system act, have no significant effect on monetary policies.

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B) Interest Rates for Term Deposits

According to usury free banking act of operations, banks shall act as an attorney in relation to investment deposits and will pay the benefits of such investment directly to the depositors after deduction of lawyer's fee. Meanwhile, banks have pledged the original of deposits. Banks also based on anticipated benefit be paid to these plans will pay benefits to depositors on account. This interest before usury free banking system and according to changes which was created in the structure of banks in 1979, compared to short term and long term deposits was 7% and 8% respectively. And after usury free banking system, according to law, the period of short-term investment deposits for the first time is at least three months and later can be extended with coefficient of one month. The period of long term investment deposits for the first time is at least one year and more than one year can be extended with coefficient of three months. In 1990, despite one year long-term deposits, two years, three years and five years investment deposits were also introduced, and based on the profits of banks performance, different rates of dividends were paid to term investment owners. With new deposits in this year, the volume of long-term investment deposits grew substantially to 8.35% and reached 6.749.3 billion Rials. During this period there was a sharp drop in short –term deposits of 1.23% in 1989 to 3.13% in 1990. And the rate of investment deposits in subsequent years was gradually increased to 8% -16%.these statistics clearly show that the term deposits just in 1990 had a great growth(8.110%), and this is because shift in the composition of quasi-money. However, quasi-money had negative growth in this year. In other years these deposits had nearly identical growth. In 1992 and 1993, the rate of this growth was increased. But the combination of these deposits was different. In these years, the deposits formed significant amount of the liquidity of the private sector. And it is important for two reasons: People will increase the rate of their deposit, if the rate of banks profit increases and announces higher on accounts rates, and has not great difference with profit rate in other parts. And it causes increase in banks reserves and it is effective to the expansionary policy. The high on account interest rate may also be possible through reducing of the share of bank profits. Changes in expected interest rate have been effective in attracting the resources and can manage these resources with proper planning. But if their aim is merely to attract and manage these resources the expansionary effects can be neutralized with their policies.

The study of components of monetary base in Iran shows that the main components of monetary base net foreign assets and net liabilities to the Central Bank are not under control of Central Bank, because the Central bank forced to buy large quantities of currency (mainly from oil exports) and government bonds (due to budget deficit) through releasing bank notes and increasing monetary base. Only the third component of the monetary base, the bank's liabilities to the Central Bank is under control of this bank and can affect the intended. But this element has small share in the monetary base. It can be concluded that the Central Bank has no significant control over monetary base which is the most important factor of changing the money supply. So, the efforts of the Central Bank in monetary policy, in order to affect the other components i.e. money multiplier is concentrated on deposits and expected rate of investment projects through changing the reserve rate. But as noted above, due to the growth of private sector deposits and excess reserves of commercial banks, these policies have been ineffective or less effective. Then the necessity of using quality tools and direct control of money by Central Bank is obvious. Moreover, these tools will manage the money for investment in necessary sectors.

Before the Islamic revolution in Iran, in addition to implementing monetary policy through quantitative means, regulations to quality control of money can be seen in the country's monetary and banking laws. Among these regulations in the second monetary and banking act passed in 1954 are:

-restricting banks to one or more types of activities temporarily and permanently.

-determining how the use of saving deposits.

-determining of the maximum total loans and bank credit in general or in a different field.

In early years after Islamic revolution, due to the wide range of people who wanted to back their deposits and banks lack of resources the council of money and credit was held in order to increase bank's decisions. In 1981, despite determining credit limit for total credits, good measures were performed in each part of economic sectors.

CONCLUSION

The existence of the constraints arising from risk-averse bankers in Iran partly offset some branches from usury free banking systems. Therefore, reviewing of these conditions can avoid Iran banking system from sinking in unlawful and usury (Rebavi) system. Since we study monetary policy in the context of usury free banking system, understanding of usury free banking system and its operations seemed necessary.

In this system bank plays the role of a lawyer or a partner. Firstly, bank will obtain funds from depositors and commit to the applicants, then after deduction of its legal fees bank will divide the remaining profit among his clients. Secondly, bank will act as a partner of the depositor and facilities applicants and is shared in loss and profit.

Methods and ways have been proposed to attract deposits and facilities. These methods divided into three categories: partnership, investor-agent partnership, a contract of crop sharing (mozara).Purchasing of government required equipment and selling them to the government on credit or installment. According to this government debt instrument are available for buying and selling in the stock market. It seems that the first part is perfect and can be used as a way to offset the budget deficit and to avoid borrowing from the Central bank. But the second part – instrument of monetary policy- is not practical in terms of religion. Therefore we have proposed that the Bank (as a lawyer of depositors) rents the equipment to the government instead of selling them, then puts the ownership documents for sale. The Central Bank will affect the volume of money by buying and selling these documents.

Banks and private sector by the use of investor-agent and partnership bonds can participate in various activities such as trading and production and can buy and sell ownership documents of executed plans in stock. One way is that the government itself sells general plans to the public in stock and then rent them again. So stock buyers of these plans are entitled to certain outputs and also government financial problems will be solved to some extent.
A) Issuance of interest free paper by the government for specific purposes,
B) Issuance of interest free paper by the government with prizes by lot,
C) Issuance of interest free paper without offsetting the inflation,

Re-discount rate in the two previous stages have little impact on the volume of the money. Because firstly, despite the considerable volume of funds in the banking system before Islamic revolution, the Central Bank has a significant role in establishing the banks' resources and among provided resources by the Central Bank, the ratio of funds obtained through discount is inconsiderable. And secondly, discount rate during these years has no significant impact on the discounted price.

Although there was no prohibition to bonds before Islamic revolution, it was not welcomed by the private sector and mostly banks were the buyers. After revolution especially in 1980 buying the securities and bonds was stopped generally by the private sector and since then, issued in limited amount and only in order to banks legal assignments and replacement of expired bonds. Generally speaking this instrument plays no important role-even after Islamic revolution- in the volume of the money. Change in the rate of legal reserve was the only instrument that has been actively use by the banking system and it was useful in some extent in the volume of the money before revolution but despite these arguments on reserve rate, the instrument failed to be effective in controlling volume of money. Firstly, because the monetary base dramatically increased the budget deficit and secondly, banks with excess reserves are always faced. Despite policy making with new instrument, policy making with these instruments and increasing of banks interest rates about the legal reverse rate, the efficiency of these instruments are not necessary. But other problems, such as borrowing from the Central bank to offset the budget deficit, the issue of foreign currency liabilities, the issue of foreign currency reserve commitment, legal reserve rate in its legal limit has faced 30% of these policies with problems.

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