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INVESTIGATING THE ROLE OF PRIVATE BANKS IN ECONOMIC DEVELOPMENT

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ABSTRACT

After the approval and the establishment of private banks in Iran in 2000, people from all walks of life and activists in the realm of economy expected the Iranian economy to recover. Social expectations that follow the establishment of private (non-state) banks are not vague. When state banking fials to sustain the economic cycle, that is, raising funds and increasing non-oil exports, the space opens up to private banking to make up for the deficiencies of state banking. In this situation, officials of state-owned banks on the one hand and managers of the private banking system on the other need to clarify their functions by playing their roles in the economic development of the country, lowering inflation and contributing to the growth of the banking system in terms of quality services and providing adequate facilities to the clients. Therefore, the questions that will be answered in this paper are: Have private banks been successful in attracting investment to the economic cycle with modern, current economic practices at the international level? Have they had an effective role in the quantitative and qualitative growth of economy? Or have they gone the same way as the state banking system had already gone?

KEYWORDS: private banks, the banking system, economic development, the banking sector

Banks are the heart of the national economy and must be managed so as to meet both the goals of establishing banks and national development objectives. A successful private bank is one which, besides having all the benefits of an economic institution and caring for the optimal rotation of the institution toward a balanced profitability for its shareholders, takes national development objectives and the prosperity and welfare of the nation into consideration. The establishment of private banks marked a considerable change in the banking and financial system. This led many scholars and economists to foster hope for development in an economy which was totally controlled by the government, and where there was no competition between state banks to outdo each other and for innovation.

A market-based economy cannot function properly without an efficient financial market. Economic history has proved that industrial developments in countries such as England, United States and Germany were rooted in financial development. Therefore, privatization of the financial market, which is one of the first steps in achieving development, should be taken into consideration by developing countries. In Iran too, according to the new economic approach and based on Article 44 of the constitution, the privatization of the banking system and financial markets has been put on the agenda. Although this is very important, it obviously is not sufficient for growth and development without necessary changes in the management.

Economic history confirms the belief that private financial development has contributed greatly to economic growth. Private financial development has played an important role in the industrial development of countries, like England, by facilitating the mobilization of great financings. However, a weak private financial development seems to have made it difficult for the Iranian economy to develop. To this end, we attempted to examine the effect of private banks on the Iranian economy.

Economic developments and neglected principles of private banking in Iran

The private banking system has helped the Iranian economy maintain consistency by utilizing its capacity and resources and tackling economic problems. A large part of the current economic strength is due to the presence and activities of the private banking system. Certainly, the power and potential of the private banking system can lead to the growth and prosperity of the country and the improvement of Iranian citizens' welfare by solving current problems. It could be argued economic growth and prosperity cannot be achieved without the accompaniment and assistance of a dynamic and capable private

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banking system. Achiving economic goals listed in the Iranian vision document depends on the ability of the private banking system and the fixing of issues associated with it. Major issues of private banking in Iran are presented below for professional discussion and finding solutions.

Major concerns in the Iranian private banking system can be classified as follows [4]

1- Low banking budgets compared with economic and growth requirements

2- Lack of consensus on the need for specialist management

3- Lack of a comprehensive policy concerning bank account interest rates

4- Weak supervision by the Central Bank

5- Interference of non-responsible and non-specialist organizations having an interst in monetary policy

Clarifying the nature of any of these issues helps find solutions to them.

Low banking budgets compared with economic and growth requirements

The financing of economic activities is carried out in three ways: government financing, capital markets and the banking system. Credits of the banking system are about ten times the budget of the banks. Demand for credit from the banking system is now much more than ten times the total capital of the banks. In such circumstances, banks must either refrain from paying credit or respond to the demand and not comply with capital adequacy ratios. This will expose the banks to risk and leaves financial statements invalid and unreliable. An appropriate solution is to increase the capital of the banks. About three years ago, an expert review from the Central Bank of Iran indicated that 300,000 trillion rials is needed for an eight percent growth in Gross National Product. Half of this capital requirement was decided to be provided by state banks and half by private banks. At that time, about 30,000 trillion rials was provided for the Export Development Bank of Iran and the Iranian Bank of Industry and Mine. A bill was prpared and submitted to the parliament for raising the capital of state banks. Simultaneously, a program for raising the capital of private banks and another for establishing new private banks were put on the agenda. This issue is still relevant. It is obvious that encouraging banks to strengthen and increase their capital is more efficient and useful for the establishment of small private banks.

Lack of consensus on the need for specialist management

Lack of consensus about the need for professional and specialist management in banking and its control by supervisory authorities is another issue that underlies the reform of the banking system. The debate that arose over the last few days in the media is a manifestation of such lack of consensus. However, both the Central Bank of Iran and The Ministry of Economic Affairs and Finance did not keep accurate and professional measures in this public issue. The Ministry of Economic Affairs and Finance neglected the principle to approve the professional, specialist and practical qualifications of the banks' board of directors. This principle has always - and in all banks and financial institutions all over the world - been the ctiterion for choosing the board of directors. In the Monetary and Banking Law of Iran too, extensive powers are granted to the Central Bank for formulating and regulating banking affairs. These powers have a rational basis [5]. The combinarion of bank shareholders, whether public or private, does not harm the the task and mission of the central bank. Approving the professional and specialist qualifications of the directors of an institution by a supervising agent is an obvious matter and is not limited to banks or financial and credit institutions. Expertise and professional competence of the directors of a pharmacy must be approved by the Ministry of Health. Managers of municipal services, including food vendors, bakers, etc. should be approved by a supervising organization. Stock broker managers are approved by the stock exchange organization. This is quite an obvious principle, while no consensus has yet been reached concerning banks. Unfortunately, as we have already seen, this controversy manifests itself in society. It appears that despite the rightfulness of the Central Bank in the recent discussion, its method of operation was not commensurate with the Bank's monetary policy and its inherent character and mission because it questioned the competence of practicing managers at some banks and presented the matter in the media. The art of the Central Bank is instilling serenity in the atmosphere of financial institutions and refreining from controversial policies. The Central Bank has to perform its principles in appointing managers.

Even if it is doubtful about the professional qualifications of a practicing manager, it has to announce the issue to the General Assembly without causing anxiety for bank depositors and clients. However, in this case, no great damage was done to that bank for questioning the competence of its directors because public sensitivity has decreased due to the frequency of inter-organizational conflicts and people do not take such controversies very seriously [1].

Lack of a comprehensive policy concerning bank account interest rates

Perhaps more than any other issue, the problem of bank account interest rates has been discussed at expert meetings and communities. Yet, there is no comprehensive policy which is free of the issue of usury in the first place, considers all the three sides of shareholders, depositors, and the facility receivers in the second place, and finally comply with the original premise of the Quran so as to “not treat unjustly and not be treated unjustly” [1, 8].

Weak supervision by the Central Bank

The Central Bank of Iran has experienced the formation of financial institutions with different forms and various origins over the years. Many of these institutions were not willing to uphold the binding principles for a bank or credit institution and saw their interests in non-compliance. These institutions targeted rapid growth by using the power of credit and banking institutions in producing money. With regard to their origin and strength, they skipped obtaining establishment license, management competency approval, and the Central Bank’s supvervision on their performance, and were active without observing the principles. The result was that the Central Bank had become incapable of performing one of its most important missions. In fact, the nation was deprived of the Central Bank’s supvervision on these institutions and the Central Bank’s regulatory power did not grow in consistence with the needs of the country [2]. Over the last three years, with the serious decision of the government, this issue has been put on the agenda for reformation and many of these institutions are obliged to comply with banking regulations. The Central Bank has a great task ahead by bringing these institutions to discipline with minimal side effects; therefore, it has to enhance its technical power and capacity and promote skilled and efficient manpower in the monitoring section [6, 15]. Institutional strengthening and consolidation of the position of the Central Bank should go as far as the central bank finds the power to issue - and easily perform - accurate, technical and stipulating tasks and obligations for banks and financial and credit institutions. All the banks and financial and credit institutions of the country have to perform the decisions of the supervision unit of the Central Bank absolutely and without question. The journey has already started in this direction; but still, there is a long, difficult and troublesome way to achieve this goal. It is a hard way but it is worth it.

Interference of non-responsible and non-specialist organizations having an interest in monetary policy

One of the pillars of the banking system is monetary and credit policy. Monetary and credit policy is a fine and sophisticated yet sensitive matter. The nature of monetary policy requires it to be carried out by responsible organizations and skilled individuals yet disintersested. This issue too is on its way toward reformation and solving the problems. Assistance of the Islamic Consultative Assembly (Parliament) and the Expediency Council to revive the Money and Credit Council was a key step in the field [3]. The decisions of the Fifth Commission on the Integration Program held by the Parliament comprise another important and complemetary step. Still, there is a long way to realize these goals and achieve a balanced and proportionate situation.

The performance of private banks

Banks play a central role in providing the capital for productive enterprises. Therefore, assessing the performance of banks and providing solutions to optimize their functions can make a substantial contribution to the economic development of the country and prevent the squandering of resources. In the area of financing services, private banks have a high potential for directing financial resources toward new markets. Providing the necessary legal and operational infrastructure by the key players (such as the Central Bank and the Stock Exchange organization) will facilitate and accelerate the achievement of this objective. Development of private banking is among the factors that have helped to improve the country’s banking industry. Private banking, due to its high flexibility and diversity in the provision of banking services, can play a decisive role in promoting banking. It is noteworthy that after the establishment of six private banks in the Iranian banking system in the last eight years, they have managed to absorb 22% of banking resources. This is considered a huge success for the private banking system of Iran despite few private banking branches throughout the country that compete with 18,000 state banking branches owning 78% of banking resources. One of the achievements of private banks is the move toward electronic banking. These banks have quickly moved toward integrated and centralized (core) banking systems by providing the necessary infrastructure. Among other developments are deposit activities, variation in paying interests and the introduction of new deposit accounts. Another step in modern banking is the utilization of new banking tools such as internet-based banking, offering a variety of credit, debit, and shopping cards as well as services such as telephone, SMS and fax banking that made customers almost needless of going to the bank and enabled them to easily receive the desired service by various means [4]. Privatization of banks is one of the biggest challenges before most governments all around the world. The unwillingness of governments to relinquish the ownership of banking and credit systems are visible and the manifestations of state banking can be seen in almost all countries with this kind of ownership. However, if the purpose of a country is to have a more efficient and market-based economy, the influence of the government over credit allocation decisions should be limited. The most important issue is that a thorough privatization of state banks is only possible when and where the necessary executive infrastructure is ready besides the political will and public support in the process of privatizing state-owned banks and supporting private banks [12, 14]. Privatization has become a strategic target in Iran due to strong macro-level decisions in the government. The announcement of general policies of paragraph (c) Article 44 of the constitution by the supreme leader of Iran, about the development of non-governmental sectors by transfering governmental activities and agencies, has opened up a new chapter in the Iranian economy [9].

Economic growth of private banks without supervision and crossing economic red lines

The rapid growth of private banks in recent years on the one hand and the weakness of regulatory structures and senior executives of the Central Bank on the other have led banks to recklessly cross economic red lines. Crossing allowed limits in distributing facilities and commitments causes the banks to become dependant on the Central Bank and ask for loans by accepting to pay backbreaking interest rates. The Central Bank, in its own turn, attempts to provide new facilities for banks (to increase the monetary base) and raise the amount of liquidity in the community instead of legally pursuing the criminal banks fearing the consequences of announicing their bankruptcy [16].

This vicious cycle has led to a growing amount of debt by banks to the Central Bank of Iran. In this regard, Bank Maskan is at the top of the table: a remaining debt of 40,000 trillion rials by Bank Maskan to the Central Bank at the end of 2008 has increased to more than 300,000 trillion rials at the end of 2012 [11]. As a result of present faulty structures, heavy economic gains by bankers and their affiliated brokers will result in increased liquidity and inflation and empty pockets of the public.

The role of private banks in the Iranian economy

In today's world, manufacturing units are provided with grants to save the industry from recession and other problems. However, despite the problems encounterd by Iranian manufacturers as a result of the increase in the exchange rate, cross-border issues, problems arising from the implementation of the targeted subsidies law and the increase of energy prices, interest rates on facilities are very high [7]. The important point is that interest rates on bank facilities should be below ten. How much benefit do manufacturers gain to be able to pay a 30% interest rate to private banks and a 21% interest rate to state banks? [14]. the Central Bank of Iran has no control over the performance of private banks: These banks receive high interest rates from manufacturers; people withdraw their money from state banks and transfer it to private banks. Therefore, state-owned banks have reached a standstill and increased the interst rate of their facilities to 21%. The main function of the financial system is to establish a relationship between investors (holders of funds) and investment receivers (those who need financing). The proper execution of this procedure occurs through an efficient financial system including financial institutions, financial markets, financial instruments, and financial policy making institutions and governing regulations in the financial sector. In fact, this system is the link between different markets such as housing, industry, etc. and finances them through one another. From the seventies onwards, financial markets around the world have faced fundamental changes in the economic environment. In these years, intense fluctuations in interest rates made investment returns uncertain. This issue influenced the demand for financial products. Simultaneously, rapid advances in information technology changed supply conditions [13]. Financial regulations were cumbersome and financial institutions found that past ways were not profitable in their activities anymore. Their goods and services were not selling anylonger and they were unable to attract funds with traditional conventional tools. The increase of interest rate risk resulted in the increase of demand for financial products and services that were able to reduce this risk. In addition, the financial industry, which would benefit from the selling of goods, strongly felt the need for financial creativity and a diversity of instrument to reach higher profitability. All these environmental changes triggered research on financial innovation to meet new demands and led to the design of new financial instruments that could help to reduce interest rate risk. The Iranian financing system is Islamic and, based on the principle of sharing the profit and loss and accepting the risks, considers the achievement of justice and prosperity in all social aspects. This system is based on premises such as the rejection of usury, sharing the profit and loss of operations, prohibiting some aspects of currency and stock market speculation, preventing unauthorized practices by religion, and carrying out the obligations stipulated in the contract. With regard to the present situation, the system is faced with challenges such as the lack of diversity in securities, the impressibility of monetary policy by fiscal policy, the banking-oriented system, the lack of resources directed toward productive investments and and government intervention (interest rates and directed credits). One of the most important problems before the system is that it is bank-oriented. Therefore, addressing the challenges of the banking system (such as juratory-legal issues, the lack of proper legal- juridical frameworks, market limitations, Islamic financial instruments, operational problems, the issue of liquidity and risk management) can improve and develop the country's financing system. In addition, solving these challenges can contribute to the economic development of the country, since economic development depends on the efficient allocation of financing resources [10].

CONCLUSION

Bank privatization has an impact on the performance of financial services: Competition leads to improved efficiency, increases the incentive to innovate and does not limit the access of smaller firms to financial resources. The experience of many countries shows that an efficient banking system requires a flexible atmosphere for free entry and exit. It is not necessarily a system with multiple competing institutions. Even in the case of developed financial systems, information-related problems and relatively high costs of small loans limit the access of small firms and companies. Economic and financial development is one of the primary goals of any government in the world because it leads to the improvement of its citizens' economic ansd social welfare. Moreover, studies have shown that countries with greater shares of private economy are more developed. In other words, extensive trade exchanges among private banks are one of the major factors in the economic and financial development of a country. There are key objectives about state commercial banks that make their privatization especially important. Some of the key objectives, which are expected to be achieved by privatization, include: improving the status of human resources, ameliorating the status of branch networks, cutting on the costs of providing services, improving the performance of the banking network, expanding the diversity of banking services, improving the quality of services, and increasing the speed of providing services. Finally, it should be noted that in oil producing countries, the weak relationship between economic growth and financial development is rooted in weak capital accumulation and return on investment. Regarding the role of financial institutions in economic development, it appears that much of the development of the Iranian financial system depends on the development and support of private banks.

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