Monetary Policy Instruments in Iran

In implementing monetary policy, the Central Bank can directly resort to its regulating power or affect money market conditions indirectly as issuer of high-powered money (notes and coins in circulation and deposits held with Central Bank). On this basis, two different monetary policy instruments are being utilized: direct instruments (with no reliance on market conditions) and indirect instruments (market-oriented):

1. Direct Instruments

1.1. Banking profit rates - With the implementation of Usury-free Banking Law and the introduction of contracts with fixed return and partnership contracts, the regulations pertaining to determination of profit rate or expected rate of return on banking facilities and the minimum and maximum profit rate or expected rate of return, as is stipulated in the by-law of the Usury-free Banking Law, are determined by the Money and Credit Council (MCC). Moreover, the CBI can intervene in determining these rates both for investment projects or partnership and for other facilities extended by banks.

1.2. Credit ceiling – According to Article 14 of the Monetary and Banking Law of Iran, the CBI can intervene in and supervise monetary and banking affairs through limiting banks, specifying the mechanisms for use of funds and determining the ceiling of loans and credits in each sector.

2. Indirect Instruments

2.1. Reserve requirement ratio: Reserve requirement ratio (RRR) is one of the CBI's indirect instruments of monetary policy. Banks are obliged to deposit part of their liabilities in the form of deposit with the CBI. Through increasing/decreasing this ratio, the CBI contracts/expands the broad money. According to Article 14 of the Monetary and Banking Law of Iran, the CBI is authorized to determine RRR within 10 to 30 percent depending on banks' liabilities' composition and field of activity.

2.2. CBI Participation Papers: Appropriate implementation of monetary policies by the CBI is done through open market operations, which provide the required flexibility in liquidity management and intervention in the money market. Following the implementation of the Usury-free Banking Law, tailoring appropriate Sharia-based instruments for the development of open market operations in the context of liquidity management and affecting money and capital market became a necessity. Utilization of bonds, owing to its fixed interest rate nature, is prohibited according to Islamic Sharia; however, utilization of participation papers and investors' partnership in economic activities and payment of profit is encouraged. According to the 3rd FYDP Law, the CBI was authorized to issue participation papers through the MCC approval. However, based on the 4th FYDP Law, issuance of Participation Papers by the CBI is authorized upon the approval of the Parliament. By using this instrument, the CBI could affect broad money (M_2) through monetary base, thereby controlling the rate of inflation.

2.3. Open deposit account (ODA): One of the bold measures taken for the efficient utilization of indirect monetary instruments in the framework of the Usury-free Banking Law is to allow banks to open a special deposit account with the CBI. Regulation on ODA was approved by the MCC at the end of 1377 (1998/99). The main objective of this plan was the adoption of appropriate monetary policies to control liquidity through absorption of banks' excess resources. The CBI pays profit to these deposits on the basis of specific rules.