Monetary and Banking Research Institute
Central Bank of the Islamic Republic of Iran

Managing liquidity growth and credit management policies toward productive economic activities

Sajad Ebrahimi

Policy Report

MBRI-PR-1421

www.mbri.ac.ir

Monetary and Banking Research Institute
Central Bank of the Islamic Republic of Iran

Monetary and Banking Research Institute (MBRI) published the Policy Paper on “**Managing liquidity growth and credit management policies toward productive economic activities**"

Monetary and Banking Research Institute

Central Bank of the Islamic Republic of Iran

No.10, Africa Ave., Argentina Sq.,

Tehran.Iran.P.O.box:16765-1654

www.mbri.ac.ir

Monetary and Banking Research Institute
Central Bank of the Islamic Republic of Iran

Managing liquidity growth and credit management policies toward productive economic activities

Sajad Ebrahimi

There are two different problems, one is the high growth of liquidity at the macro level which leads to high inflation and the other is the lack of financial resources ("liquidity") in the manufacturing sector (Microfinance), which has made real sector financing difficult, highlights the importance of setting up dual policies to control inflation and credit flows .On the one hand, given the adverse effects of high inflation in the country, managing liquidity growth resources should be one of the monetary policy priorities, and on the other hand, improving the access of productive sectors of the economy to financial resources through various sources of financing should be considered .Given these two priorities in the monetary policy, in the first part of this report, strategies to control liquidity growth are examined, and in the second part, issues related to credit management are presented.

In the macro dimension, controlling the high growth of liquidity is one of the measures that should be pursued in order to manage monetary aggregates towards macro goals .The problem of liquidity growth rate is a structural problem, which is mainly due to the budget deficit, the increase in net foreign assets, and the financial health of banks. Obviously, the solutions to this problem must be structural and in line with a comprehensive program of financial and monetary discipline .Therefore, for effective and sustainable control of liquidity growth in the medium- and long-term horizon, there is no other way but to solve the structural problems of the budget and banks and better access to foreign currencies to provide foreign exchange for economic activities and imports. Short-term liquidity control strategies can often be implemented through methods to facilitate and improve the performance of "open market operations" such as the following:

- Strengthening the interbank market as an alternative source of overdraft by banks;
- Improving the tools of the Central Bank to receive the balance sheet of the Central Bank with special attention to the problem of lack of access to foreign exchange resources, which has intensified the inflationary burden of increasing the net assets of the Central Bank;
- More accurate monitoring of banks and effective measures to control the growth of banks' balance sheets.

Medium-term strategies for controlling liquidity can be summarized as follows:

- Promoting the financial health of banks;
- Better coordination between the financial sector and the Central Bank to reduce financial dominance and greater independence of the Central Bank;
- Government financial discipline and structural reform of government budget expenditures and government budget revenues

Regardless of how the purpose of monetary policy is determined and how important each goal is, choosing the right monetary policy tools is a question that needs to be answered. Price instruments of the intermediate target of central bank policies are interest rates or exchange rates through which intermediate targets are changed as needed. The impact of interest rates on Iran's economy faces several challenges. In quantitative instruments, monetary policies target monetary aggregates or the amount of credit and try to influence one or more monetary units directly or indirectly .Inflation targeting can be achieved with both price instruments (based on interest rates) and quantitative instruments (monetary aggregates), and the use of monetary policy instruments to control the growth of monetary aggregates is not in conflict with the implementation of inflation stabilization and inflation targeting policies .The question that arises here is which monetary policy instruments (price or quantity) are more effective in terms of the current situation in the country .The interest rate-based monetary policy rule does not work well for countries with high inflation, and experience shows that monetary policy based on monetary aggregates is preferred to control inflation. It seems that focusing on quantitative monetary policy and targeting the monetary base and other quantitative measures in the current inflationary situation in Iran is a better option than the policy rule based on interest rates.

Another dimension of monetary policy is the management of credit turnover and financing of the production sector .Due to internal and external constraints, investing in production sectors (which is a long-term thing) requires a very high-risk acceptance. So, the uncertainty and high cost of capital used in the manufacturing and industrial sectors have led to a sharp decline in investment over the past decade .Although the attractiveness of the real sector for investment has diminished, speculative activity has been active in the financial, foreign exchange, and housing markets .In such circumstances, the implementation of policies to finance the production sector becomes a priority .One of the main problems of manufacturing companies is the financing of fixed capital and working capital, and from this perspective, prioritizing the financing of the production sector of the economy is one of the main pillars of the central bank's credit policy .In this regard, the question arises as to what kind of policies can be used to improve the access of manufacturing companies to banking facilities .There are two ways to do this: First, policies that encourage individuals to increase their financial savings and increase the capacity of financial intermediaries (banks) to provide financing (reducing inflation and slightly increasing interest rates on financial savings are appropriate policies to achieve this goal) .Second, the policy of directing the flow of loans granted by banks to the sectors in question, a category that is inadvertently referred to as liquidity management .In this regard, it should be noted that liquidity management is focused on the debt of the banking system and the direction of credit is focused on the management and composition of the asset .These two policies are sometimes conflicting ;For example, monetary stabilization and inflation control require that liquidity growth slows down ;However, due to rising working capital costs, it is necessary to expand credit and thus expand the banks' balance sheets .

Credit guidance with different titles and forms before the 1980s was implemented in most developed and emerging countries, and governments sought to shift credit allocation to priority sectors .These policies have become practically obsolete in a number of countries, with the issue of financial repression being raised and the fact that the optimal allocation of resources is not achieved by setting the rate and manipulating the allocation by the government ; in the meantime, East Asian countries have had successful experience in implementing credit guidance policies and are cited as successful examples of this policy.

In Japan until 1991, credit management policies were aimed for two purposes: first, to control the quantitative growth of bank credit by setting a specific credit growth rate for each bank .Second, directing bank credits to priority sectors .Banks' non-compliance with these guidelines also resulted in fines ;For example, because the discount rate (central bank lending rate to banks) was lower than the interbank market rate, banks that did not follow these guidelines were barred from benefitting cheap financing from the central bank .The policy was effective as long as Japanese companies were dependent on bank financing .The beginning of the financial liberalization process in this country and the possibility of financing through non-bank channels practically made the control of credits through this policy ineffective, and Japan abandoned this policy .South Korea has had a similar experience .It supported the implementation of this policy and the inflow of foreign capital for Korea's period of industrial growth, but in the late 1980s, these policies were reviewed and eventually phased out.

Credit Guidance Policies introduced after 1998 until now are implemented in China, and it has been very similar to Japan's policies .The central bank of China in these policies has mainly targeted its four major state-owned banks .In these guidelines, in addition to setting a ceiling for the growth of banks' credit and setting it as a criterion in banking supervision, in each quarterly period, the priority sections for granting facilities and the sections to which facilities should not be granted are specified .Regulatory oversight and regular meetings with banks are among the factors that have contributed to the successful implementation of this policy in this country .Considering the implementation of credit guidance policies in Japan, Korea, and China, the strong points that were in the implementation of these policies in these countries can be expressed as follows:

- Continuous and monthly monitoring of the implementation of the instructions by banks has been one of the main pillars of the implementation of these policies.
- Monetary policy pricing instruments were used to set rates and interest rates were not pre-arranged.
- There was a good incentive mechanism for banks to follow the instructions.
- Some of the banks over which the supervisor had more influence were seriously targeted by the credit management policy.

In order to benefit from the experience of other countries, it is necessary to pay attention to the special and different features of the financial system in the Iranian economy .Some points that should be considered in this regard are:

- Determining the rate of bank interest rates: Determining the rate of interest rates and the negation of real interest rates in banks has changed the structure of demand for facilities from other countries and has reduced the acceptability of financial savings.
- The unfavorable financial situation of banks: The situation of banks in terms of profitability, liquidity, and capital adequacy is in a dangerous situation, and the application of restrictions that negatively affect their profitability and cash flow, can lead to deteriorating banking health in the country .Monetary policy based on interest rates loses its effectiveness when the bank's balance sheet is destroyed.
- Weaker supervisory system of the country than East Asian countries: The experience of policies implemented in the banking system shows that the supervisory system in the banking

network is not effective enough to be able to guarantee the goal of facilities for a particular sector**.**

Thus, although the implementation of credit guidance policies in East Asian countries has been a successful experience, given the current state of the banking network for the successful implementation of credit guidance policies, it is necessary to have preconditions for successful implementation of credit guidance policies, including strengthening the regulatory system and reducing financial repression and improving banking health**.**

To solve the problem of financing the production sector, in addition to policies aimed at guiding bank credit, policies to increase the motivation of the private sector to invest in the production sectors can also be helpful. These policies should address both aspects of the issues: reducing speculation through the imposition of taxes and encouraging private investment in production activities **.**In countries that have abandoned credit guidance policies after financial liberalization, taxation is used as an alternative to suppressing speculative activities and indirectly directing capital to production sectors **.**In different countries, the rate of capital gains tax varies in different markets, and in addition, this rate is sensitive to the period of holding the assets**.** Therefore, by raising the capital gains tax rate in the short run and in markets where speculation is more prevalent, their attractiveness can be reduced and the production sector's ability to attract capital and liquidity can be indirectly increased.

Policy proposals

According to the points raised in this report, the country's limited access to its foreign exchange resources and foreign capital, the continuation of inflation of cost pressure, and the observation that the real volume of credit has not increased in the last 12 years, the following strategies in both monetary policy and credit guidance are suggested**:**

A. The policy of reducing liquidity growth rapidly and at once is not desirable, but its implementation in the medium term is necessary **.**Due to the nature of inflation (cost pressure), it is not possible to reduce inflation all at once, but it is necessary for the medium term **.**Reducing inflation, gradually closing the output gap, and limiting real exchange rate fluctuations are the three main goals of the monetary authority**.**

B. In the short term, given the high rates of inflation, the main tool of monetary policy is to control the balance sheets of banks and control exchange rate fluctuations **.**In this regard, the effects of the balance sheets of the central bank's foreign exchange interventions and the formal sale of government currency should be considered**.**

C. After reducing the inflation rate to lower levels (12-15% per year), taking measures to improve the financial condition of banks, an inflation-targeting approach, and interest rate tools will be a more appropriate framework for guiding monetary policy**.**

D- Due to the limited credit capacity of banks and the allocation of credit through the price mechanism in the current economic situation and the frail balance sheet of banks, it is necessary to prioritize the allocation of credit **.**Policies that encourage individuals to increase financial savings and increase the capacity of financial intermediaries (banks) for financing should be given more attention**.**

E- Prioritization or targeting of credits should be accompanied by careful monitoring of its proper implementation by banks and a practical commitment to the efficient allocation of credits based on economic principles as well as providing performance in return for receiving credits **.**Strengthening the infrastructure and regulatory system and reducing the severity of financial repression are essential for the more effective implementation of credit management policies**.**

F- Unintentional expansion of credits and lack of effective supervision over allocating credits to small and large customers and lack of tools to repay debts will not only further destroy the balance sheet of the banking system, but will also oppose monetary growth and inflation policies**.**

G- Formulating and implementing a clear and organized communication policy for informing the public about the policies adopted to control inflation and exchange rate fluctuations, and consequently controlling inflation expectations, will be one of the worthy actions of the Central Bank**.**

Monetary and Banking Research Institute

Central Bank of the Islamic Republic of Iran

No.10, Africa Ave., Argentina Sq.,
Tehran.Iran.P.O.box:16765-1654

www.mbri.ac.ir