A CRITICAL EVALUATION OF THE CENTRAL BANK'S POLICIES DESIGNED TO MAINTAIN THE VALUE OF MONEY*

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After 30 years of experience the Bank Melli Iran was split into two banks (the Central Bank and the Commercial Bank) and the bill authorising this division was presented to Parliament and tentatively approved. It is now time, (two years after passing of the bill) that an impartial appraisal of the Central Bank's various functions is made and the adequacy of the measures adopted for the maintenance of money values evaluated.

Article 28 of the 1960 Act, which authorizes the setting up of the Bank, expressly states that with the object of maintaining the value of money and regulating credit an independent authority to be called « the Central Bank » shall be created with the exclusive right of issue of bank notes and coins.

1. The Act explicitly requires that parity with gold is maintained. Regulation of the value of the rial vis-à-vis foreign currencies has been vested in the Central Bank, which may determine buying and selling rates for foreign exchange. Note issues are to be against surrender of gold and foreign exchange to the extent of 40%; the balance to be against government bills and loans and similar cetificates from government bodies and shall be guaranteed by the Crown Jewels.

It goes without saying that the fixing of gold parity rates does not by itself constitute maintenance of money values, for the Bank will not pay in gold, and gold will not be in circulation. Even if it were, there is no doubt that it would immediately be taken out of circulation and hoarded

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by the public. Thus the legal definition of the rial in terms of its gold content is really meaningless and serves only as a device for ascertaining the amount of gold coverage.

It is generally imagined that a country without adequate gold reserves cannot adopt the gold standard. This is only partially true. It is not necessary that a country should possess gold in large quantities; it is necessary however, that its money maintains its value in terms of a constant weight of gold. The market price of 100 grams of gold today is about Rls. 9600/- against a statutory value of Rls. 8523.

2. As to the maintenance of the value of money in terms of foreign currencies, the failure of the Central Bank has been even more glaring. The monetary system in Iran has no parallel elsewhere. Dealings in foreign currency in Iran are declared illegal and the government has decreed that the recipients of foreign exchange must sell to authorized banks at the fixed price of Rls. 75/- per U.S. dollar for resale at Rls. 76/50 to authorized applicants for specified purposes. Thus is exchange stability supposed to be maintained.

These rates have been fixed without regard to the underlying market forces of supply and demand which in effect determine exchange rates. Alongside this official limited market there exists the so-called free market wherein rates fluctuate in response to the workings of supply and demand. Here the dollar has never been below Rls. 80/- and has quite normally at times topped the Rls. 85/- mark. So extensive is this free market that every year it accounts for $ 19 million for the purchase of gold alone and some $ 100 million in annual transactions, representing 20% of all the Bank's annual foreign exchange transactions. By contrast it must be noted that the total foreign exchange receipts of the Bank from exports other than oil amount to only $ 130 million per annum.

These sums transacted in the free market could not possibly have been provided from invisible capital transfers. The export of capital from Iran is far more than the incidental capital imported into the country. The free market is supplied with exchange by exporters who surrender less than their total acquisitions or importers who apply for more than their exchange requirements, and it facilitates the import of prohibited goods in large quantities.

No attention has ever been paid to the external value of the rial. Except in very small quantities, the rial has never been sought after even in neighbouring countries where the rupee and the dinar have been more in demand.

3. Another test of the maintenance of value of money can be found in its purchasing power at home. The following table, published by the Central Bank, shows the extent to which the cost of living has risen, and the consequent devaluation of money, during the past 10 years.

Year	Index of cost of living
1951	849
1952	909
1953	992
1954	1151
1955	1171
1956	1273
1957	1329
1958	1343
1959	1484
1960	1601
1961 (9 months)	1683

Even after mid- 1960, when with a view to reducing prices the government adopted a policy of restricting credit and imports, prices continued to soar (except in the case of rent).

4. What the Act has endeavoured to provide in the way of maintaining money values is that note issues must be backed to the extent of 40% coverage in gold and foreign exchange. The Bank's balance sheet as at 20th. January, 1962 shows Rls. 11,390 million (or Rls. 9,432 million if irredeemable contributions to international bodies are excluded) in gold and foreign exchange against Rls. 19,322 million bank notes in circulation. this means that a large part of our financial resources has been, and will continue to remain, immobilized in the Bank's vaults without helping to maintain the value of money. There is no doubt that any increase in production or purchasing power and the consequent welfare of the people must come about through an increase in the means of payment. The economic

development of Iran needs capital, and under the present regulations we are in the unfortunate position of having to immobilize a portion of our vitally needed purchasing power whenever an expansion in our economy occurs.

Although the Third Plan's ambitious target of 6% increase in national income is impossible to achieve under the proposed programme, even if the unrealistic forecasts for its implementation provide the necessary finance, a considerable increase in note issues will occur. The expansion of public expenditure, the costs of productive and administrative services and the ever-increasing budget cannot go on with the present volume of note issues. And since tax revenue will be reduced considerably, there is no doubt that circulated money will not find its way back to the Bank quickly enough and a situation will arise whereby against a rising volume of money in circulation the foreign exchange receipts (from which the gold and exchange coverage must be secured) will remain almost stable ,while requirements, whether for normal trade or international commitments and loan repayments, will be on the increase. It is therefore imperative that such a defective system is remedied .

5. The fallacy that to stop prices from rising it is only necessary to restrict note issues has taken firm root in Iran. The rise of prices in Iran in relation to note issues has not been abnormal and the phenomenon has been unduly publicized by those who have capitalized on it. It must be noted that the proponents of the Quantity Theory consider the volume of money, along with other means of payment as well as the velocity of circulation, as factor influencing prices. If money in circulation expands commensurately with an increased volume of goods there need be no inflation.

It is essential that the Central Bank adopts a planned policy which would discourage the merchant from withholding his goods in the expectation of rising prices and which would provide credits in relation to the merchant's stock of goods and not personal requests. Other credit facilities like customs duty and other tax moratoria have been largely responsible for the ease with which it has been possible to increase prices, or prevent falls .

If the Bank's credit management be sound there need be no fear of propaganda from those who object to further note issue on the grounds that it will result in higher prices.

6. The external value of the rial can be considered stabilized only when it enjoys the confidence of foreigners and its value fluctuates within reasonable limits in accordance with the forces of supply and demand.

The method used by the monetary authorities for the stabilization of the rial since exchange control became a feature of the government's policy was to peg its value to sterling and the dollar, at which rate authorized banks would have to buy and sell foreign exchange for prescribed purposes. The Bank's policy has been to maintain this «parity» rate through control on the demand side and through forcing exporters to sell their acquired foreign exchange at official rates which have never matched realistic market rates. The fixing of such artificial rates divorced from considerations of supply and demand has assisted the development of a free market flourishing on the differential and financing large-scale imports of luxury and prohibited goods, which are at times smuggled through without payment of duties. The perpetuation of exchange controls for a country like Iran even despite revenues from oil, is definitely necessary. Neither the government nor the Bank has ever considered bringing Iranian exchange regulations in line with those of the more progressive countries, and finding ways to combat free market dealings in foreign exchange, with the result that never has the flight of capital from Iran been more widespread than during periods of exchange control stringency.

Reliance upon aid from the International Monetary Fund, too, has promoted an attitude of complacency among the Bank authorities which has tended to make them unmindful of the need for a strong stabilization policy. A large part of the government's plans for economic advancement is based on the hope of acquiring funds from the outside. The Bazaar has yet to learn the evils of too much instalment buying and credit inflation. In spite of the policy of balanced payments adopted by a new government formed to combat the 1960 depression, the essential weaknesses of the system remained. More stringent controls merely widened the gap between the official rate and the free market rate without the Bank's adopting any measures other than the policy of import restrictions

While exchange controls are necessary, the establishment of fixed rates wholly unrelated to market forces is bound to create a «free» market through which some 20% of the foreign exchange income and 40% of the country's imports are channelled. Even in spite of the oil income Iran must continue foreign exchange controls to balance her payments, as otherwise it would be impossible to prevent the devaluation of rial both domestically and in relation to other currencies. A proper balance of payments would enable the Bank to free her gold and foreign exchange resources and to maintain rial values in accordance with supply and demand forces, releasing exchange to the commercial banks for sale whenever the price rises unduly high and going into the market to buy exchange when it is plentiful. The adoption of such a gold exchange standard would smooth out short-term fluctuations in exchange rates. Convertibility of the rial with gold and foreign exchange should dispel the fears of those who unreasonably dread an expansion of note issue, for the value of the convertible rial is not manipulated by propoganda, nor does it fluctuate widely in response to increases in the volume of bank notes in circulation.

7. Whether or not monetary policies in themselves are sufficient to prevent price rises is a debatable issue amongst economists. The social and political atmosphere generated by the government, and its tax collection system, are of significance as measures for keeping down prices.

The government's paramount duty is to take steps to bring down prices, for the economy just cannot tolerate present high price levels. High prices are no criteria of economic advancement, particularly when they are artificially propped up. But under the present conditions when ways and means for the stabilization and the reform of the economy are being sought, it would be impossible to follow divergent courses and achieve stabilization as well as the lowering of prices; for the time being priority must go to the stabilization of the rial.

8. The conclusions reached reveal that rial parity with gold and foreign currencies must in practice be maintained through the adoption of a different monetary system. Present metallic coverage and exchange control regulations have not been effective in maintaining the value of the rial and the Bank can, through adopting convertibility with gold and foreign exchange, and the maintenance of actual parity rates as determined by market supply and demand, maintain the value of money. The means for a speedy adoption

of such a policy are available now, provided the Bank is assured that the Treasury, ministries and government organizations will not force it into expanding note issues and that current credits in the private sector will be maintained at their present level, or eventually curtailed. A prime condition which is of paramount urgency is the reform of the budget system and the balancing of expenditure with income, failure of which will lead to national bankruptcy—and culpable bankruptcy at that.