Indicative supervision on the monetary business organizations (Banks): Case study: Iraq

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Abstract

Indicative supervision represents the comparison between direct intervention (acquisition, nationalism) and participation through rules.

The last financial crisis reflected our needs for different approaches of supervision consist with our goals, but the crisis reveals also number of sounds requested and pressured toward direct control (Intervention via forces) through government acquisition and nationalization.

This study attempts to deal with crisis lessons, in the field of choice between indicative and direct supervision which government authorities used to reduce the bad effect on the monetary firms.

Iraqi banks suffered from high levels of direct control from monetary authorities, so the changes and privatization on the new economic policy permit more and new banks' activities.

The study tries to test the reality and effectiveness of control through participation (seals) with comparison with direct governmental control.

Below the paper structure:

- **Introduction (opposite solutions for the crises)**
- **Banking supervision;**
- **Macro- prudential supervision.**
- **Micro-prudential supervision.**
- **Business supervision.**
- **The financial reform.**
- **Macro – indication supervision.**
- **Case study: suggestion for Iraqi bank supervision.**
- **Bank structure.**
- **Central bank independency.**
- **Monitory policy assessment.**

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1-Introduction

Although the beginning of the contemporary of the financial crisis preceded the blowing up of the bubble of Leman's Brothers, but the landmark of the Bankruptcy of the bank considered as the most serious, as well as being unequivocally to blow up the crisis on the international level, even the date of the declaration of the bank crisis (September 2008) had considered as the anniversary of the crisis in 2009.

So that the big financial crises are linked mainly with the banking stumble, then the investigation about the behavior of the banks during the crises times or out of these times will be a practical investigation for the safety of monetary policy as well as the role of financial institutions in economic activity.

The importance of the organizations of the monetary business in the different economics does not stem from its intermediately role of the relationship of the funding process parts (the deficit and surplus units), but also on its important participating in the monetary policy as a part from the economical policies, and on Fiscal policy participating in the stability of the national economy.

The problem of the study centered on the weakness of the supervision approach that the Iraqi banking system practicing which led to the weakness of the role of the financial intermediation beside the weak stimulus capability of the banks in the economic system as well, so Most of the supervision remain through the direct intervention tools.

The study's hypothesis includes "helping the base of Taylor supervision in setting an indicative supervision pattern on the banks in Iraq, which stimulus positively the role of intermediation especially the participating of the interest's rate.

1-1: The contemporary financial crisis revealed about opposite directions for processing:

*** On the two levels: the Micro level (the management of the monetary business organization) and the Macro (the management of the total economy).**

*** On the two levels: the interventional level through the patterns of Acquisition and the merger and the Semi - nationalize (a government which represents the Taxes payers). And indicative through the participation by the contributions of the governmental financial institutions or through administrating the interest rates by the monetary authority.**

*** On the two levels: the national one by the supporting of the private and the local institutions inside the national economy. And the international one through the joint effort to activate the role of the international financial organizations (IBRD, IMF and IBS).**

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In all the cases of the processing and in all of the opposite directions, the monetary (intermediaries') organizations have the priorities.

2-1: A joint agreement emerged through the crisis between the two main players and the secondary ones, the importance of activating the banking supervision and the return to a strict determine to the rules in order to establish regulations for the banks which previously agreed on it at Basel I and ll, and trying to expand it.

3-1: The paper is attempting and selectively to fit with aspects of the current financial crisis and its reflections, and the role of monetary organizations to go inside:

- Banking supervision ⟶ with a macro level ⟶ through the tools of the monetary authority ⟶ in an indicative approach.

2- The banking supervision:

1-2: the pattern of the circular flows reflects the fact that the financial sector represents the heart of the national economy, which connecting with and by it the operations of creating the added value, the Expenditures, and the income as analogues faced for the macro economic activity.

The economical literatures concerned in the relationship between the finance and economic activity, and consider the existence of the financial sector worked with well distribution as incentive to the economic growth (Shaw 1973 and McKinnon 1989).

Also the procedures of the economic administration on its financial part which have effect on macro level (Demand and supply), is representing an important element for the economic stabilization policy and to avoid the financial panic (Tregarthen, 1996, p136)

Although of the expanding of the institutional entity of the financial sector to include various patterns from the intermediates institutions, so the banks and its expansions, and its continues renewing make it cites with the important part of the role of the mediation between the deficit units D.U and the surplus units S.U, and the concept of the multi goals and jobs banks (deposits, non deposits, and contractual) became the most likely in the contemporary banks.

2-2: The bank sector represents one of the most important assimilators for the changes of the economical contemporary international environment, representing by the technical development and the globalization of financial markets and the liberty, and also by the modern risks administration approaches, and the attempt to adopt common standards for regulating the banking performance, which was been reinforced by Basil I and II, especially in what is relating to the adequacy of the capital and then the risk management approach.

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The response of the banking organizations to the attempts of adopting the Basel concepts and establishing a monitoring system was a reflection to the Successive financial crises, and what are the banks forming from the hotbeds of the crises beginning, and the reflections if that in the large losses and the assets value depreciation And what consequent on it because of the shareholders equities decline, governments, and also to the taxpayers.

The bank's supervision represents a set of procedures which the monetary authorities rise to ensure the wellness of the performance of the monetary policy and to permit for the assessment of the banking performance and its safety. (Dr.Aqba Wareem, 2005, P. 149).

The bank's regulation represents the rules which manage and head the attitude of the Banking institutions, while the concepts of the bank's supervision head to the following up and the intervention to impose the regular rules.

And both of the terms are connecting to each other reaching to achieving the safety of the financial performance and to avoid the panic as a main target to the monetary policy.

1-2-2: the accountants prefer the Off-site and the On-Site as a basic to the bank's supervision, and by resorting to the financials' lists, and supervising its appropriating for the accounting rules especially the adequacy of the capital toward the risky assets.

But the quantitative banking processing developed under a financing framework which adopted the bank's supervision through the risk supervision approach which include the activities of (CAMELS)* and then the transition to universal system (Basel) to evaluate the risks (Dr. Al Atabany, 1428 H).

***Abbreviation of:**

-Capital Adequacy – Assets Quality.

-Management

-Earnings.

-Liquidity.

-Sensitivity Analysis for market Risks.

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2-2-2: the economical approaches for the finance and banks adopt an approach to understand the banks' supervision as:

*** Macro-Prudential sup. Which includes the supervision in the impact of aggregate variables in the financial stability through the attitude of the banks, and the central bank leads this type of supervision in the framework of it's following up to the monetary policy.**

*** Micro prudential sup. Which includes the supervision on the Solvency and Sustainability of the bank's operations?**

*** The Business Sup. And it connects with the protection of the consumer and the ensuring the well performance of the businesses sector through its relationship with the banks.**

And some of the main committees that branched from the monetary authority and with the participation of the bank representatives are exercising the performance of the Micro prudential sup. (as well as the business supervision), while the central bank goes to (the)following up the macro supervision. (Loards.2002,p5).

While dividing the supervision to Micro prudential sup, and Macro-prudential sup, the Micro prudential sup goes to check the adaptation of the banks behaviors to the followed financials rules, as well as the source of the information of this supervision is the supervision on the banks lists to form a complete image about the bank risk management, so the Micro prudential sup. Considers as a Bottom-up-sup.

On the other hand the Macro- prudential sup. goes to follow up the Cumulative impacts of the banks behaviors in order to reach an image to the financial sector, so it considers as Top-down sup. (Ibid P.10).

3-2: the activity of the Macro-Prudential sup. On the banks which is managed by the central banks needs requirement.

1-3-2: Reform and financial liberalization for banks:

*** Reforming the interest rates (Creditor and debtor), and on the different loans and deposits, it means the liberalization of the two sides of the financial position (the assets returns and liabilities incentives).**

*** Using indirect means for the markets supervising.**

*** Development and activating the financial market (monetary and capital markets).**

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2-3-2: achieving the independency of the central bank CBI

It includes its ability to set-up and following up the monetary policy, and also supervising the bank system and the governmental performance toward the financial stability, and through indirect tools (OMO)*. It is normal that the independency doesn't mean the isolationism and the none coordinating with the other authorities, it is the contrary, but under a framework of controlling in the macro financials and monetary variables, and by having the ability and the flexibility in the Amendment and facing the crises during its occurrences.

So the CBI goes to:

1- The functional independency, which relates to the ability of the central to decide what relates the monetary policy and the prices.

2- The personal independency, and it relates to his ability to choose the members and the chairman of the Board of Directors.

3- The tools independency: which relates with his ability to use the monetary tools and on the top of it the money supply, in effecting on the prices, and preventing the direct fund of the public deficits (Mbotni, P4)?

4-2-The goal of Macro-Prudential sup. Policy centered in:

*** The market is the central axis of the interest rate and the exchange rate.**

*** The liquidity of the banks' system and its direction led by the OMO.**

*** Institutional structure which helps in the macroeconomic stability.**

Some of writers which interest with this matter may go that the financial reform and what include clash with the necessity of the financial interference during crisis, and it is a wrong concept, because there is a different between the interference with the direct power and through (nationalization, acquisition and administrative ceilings for the interest rates, and the directed lending and until the imposition of reserve ratios and high shares, as well as the strict control on capitals' movements from and to the abroad).

And between the interfering in the participation of the monetary authority in the operations of the open markets and adopting a consistence approach of the macro variables which govern(the real GDP and the targeted inflation) with the interest rates and the money supply.

And under the framework of the indicative Macro prudential sup., the distinguishing should be between the intervening which have the reformist nature of the market failure and between the repressive intervening for the Stimulus financing to the economical action. The financial repression term is been called on the Interventional cases through the tax ceilings, profit, and the financing which is centrally targeted and generating a deviation from the requirement of the customizing and distributional efficiency of the market.

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*Open Market Operations.

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- Indicative Macro- prudential sup.:

3-1 : both of the fiscal and the monetary policies are practicing an effective role in establishing the level of the macro equilibrium, and consider their tools as a basic in Clarifying that level through the contemporary two patterns IS-LM-BP and AD-AS with microeconomic base, and through the Long-and short-term, and in the real values toward the economical stabilization. But the monetary policy which depends on the independency of the central bank is always made by the professional kitchens, unlike the fiscal policy which is made by the kitchens of the effective political forces, and its targets which are responsive to the environment which may not be Consistent with the target of the stability.

So the monetary policy is considered as supervision on the fiscal policy, and Ballasts for the delinquency of the tools of fiscal policy (taxes and government spending) towards instability.

But in the same time, the monetary policy and through its monetary authority which represented by the central bank, is ruling its supervision through the banking structure which represented in the monetary business organizations (led by the banks).

The expanding of the banks' role in the effecting on the money supply as a main tool for the monetary policy and its responsiveness for the practicing of the central in effecting on the monetary rule, the low capacity of the monetary authority to create the suitable monetary reaction when the crises, and that make the role of the banks important in the economical stability.

So the indicative Macro- prudential sup. for the central bank goes from the connecting of the effect of the money supply tools whether directly through the OMO and / or the interest rate (and its more practical) through the monetary business organizations with the movement of the economical activity, and the extent of the output deviation from its potential level, as well as the price changes expressed by the level of inflation.

The choosing of the interest rate as an entrance to the effect in the attitude (behavior) of the bank and through the participation of the central in the market Based on the deviations of price changes (inflation) and the deviations of the macro economic activity (Real GDP) is representing the base of the macro indicative monetary policy.

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3-2 : The previous descriptive entrance was important to clarify the procedural and operational side of indicative supervision of the central bank, and through the monetary rule policy which suggested J.Taylor in 1993 which is unfit to clarify how supervision been achieved in the banks and through the Mechanism of the participant in the market (King p11-45), and it is an approach which many considered it suitable (with on what it carries from the flexibility of the editing with the conditions of the monetary environment) For both of the developed and developing countries. (Fung and Jose, P2-20).

Basically Taylor approaches are based on the attempting to formulate a relationship between monetary and real variables, so the interest as indicative monetary variable is forms basically on:

1- The deviation of the RGDP about the PGDP, as consider the level of the deviation reflects the nature of the recessionary or the Inflationary crisis.

2- The real inflation deviation from the inflation target as consider the product deflator image the crisis's pattern and the monetary response which is preferable on the macroeconomic.

It is an approach of supervision which is diagrammatical reflected by the policy rule line with the AS, AD, and been mathematically formed by the relationship of the interest rate with the deviations. (P 434-435 Taylor).

The mathematical formulation of the macro-supervision model of Taylor:

$$i_t = \pi_t + r^*_t + \alpha(\pi_t - \pi^*_t) + \beta(RGDP_t - PGDP_t)$$

Whereas the i_t: the short-term nominal interest rate is the center of the gravity in the sup. On the banks, and its dependent variations represents the power of the central bank in activating or inhibiting the credit policy of banks and its investing attitude, as well as being a Key Transmission Mechanism to the rest of the other financial markets organizations, domestically and internationally.

π_t : the rate of the current deflator.

π^*_t : the targeted deflator.

r^*_t: the real rate of interest.

RGDP: Real GDP (actual equilibrium) / logarithmic.

PGDP: potential GDP (logarithmic).

β, α: Two parameters with a positive value which Taylor estimated them (0.5) in the year 1993 ($\alpha=\beta=0.5$), and the value is not considered as a Constant value but it varies according to the estimates (PP 195-214 Taylor, P316 Colander).

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During the Inflationary crisis the interest value i_t rises and decreases the expansion through its effect in the variables of the aggregate demand (the investment, the total spending, (the exports- imports), and the consumption) with its effect in the exchange rate of the currency, and in the contradictory when the recession , the interest gets low and motivating, the Macroeconomic Variables and effecting on the Exchange Rates, and also it is possible to process the role of the interest during the Stagflation, Where the weighting is going in the weight of the deviation of the prices and the output.

And the quantitative formula for estimating the indicative interest is possible to modulate to the rates of the variables growth also through the mathematical derivation.

The Mechanism of the indicative Macro- prudential sup. for the central bank through the rule of the policy achieves through the monetary business organizations, and on the top of it the banks are, so the reaction of the ratio of the interest toward the economic crisis is concentrating in the short term inter banks, which called (Repurchasing or overnight rate) also called the Federal funds rate in the united state or the interest rate between the banks in London (Libor) and other.

During the recession the lending is going in a low ratio which encourage on the effecting in the banks' reserves, expanding and motivating the activity for the Macroeconomic Variables , and the vice versa when the inflation.

And the problems of the credibility of the monetary policy and Rational Expectations consider as important in facing the achievement of the effects of supervision, as well as the time lags (the recognition, implementation and the responsiveness) but this supervision entrance still as a guide which is directing the role of the banks achieving its funding role during the economic crises.

3-3 : we should insist that the adoption of an indicative supervisory approach by the administration of the monetary policy is clashing by the Arabic and the developing country, in the segmentation problem in general, for the links between the banks and the shallowness of its abilities and tools as well as the leading concentration to the oligopoly.

On the other side the using of the interest as an indicative supervision tool faces the dilemma of a administrative price justified by the planned growth, which proved its failure and that caused on it a deviation of the resources allocation and the distributional efficiency for the monetary businesses organizations.

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Also the domination of the public sector and financing of the budget deficit, is practicing a role in decrease the ability of the indicative supervision, Note that many of the Arab economies adopted the approach of liberalization and reform since a good time.

But in the applicable side for the Taylors formula of the monetary policy in the Arabic economies, the dereliction of the data whether in the suitable time or the variety and the weakness in the IT system considered as the center of the relative weakness to follow the approach of the supervision on the banks indicatively, also that will be cleared in the study case in the Iraqi economy.

4- The Iraqi experience of supervision after 2004

With the previous analytical Theoretical framework for the indicative supervision, we will try to find possibilities to deal with it in the experience of the monetary policy in Iraq after 2004, and according to the new law 56 of the central bank for the year 2004, which came because of a previous and more complicated economical and political situations(economic embargo, a wide governmental intervention) for long years, which left a terrible effect on the entire Iraqi economy, and also for the financial sector and the trying to deal with the approach of the indicative supervision and that will concentrate on four points whether Explicitly or implicitly as what the reader notice and they are ;

- Inflation targeting
- Product targeting
- Interest rate activate
- Exchange rate activate

With the reaction of these points will create a pattern for the indicative supervision inspired from the formula of building the indicative interest rate in Taylor Formula.

4-1 the Iraqi economy suffered from hyper inflation Since the early nineties, and until after the mid of the first decade of the new millennium, and with a yearly growing ratios which are near from 50 % as an average, and also it reached after the year of 2006 to (77%), and the source of this the money quantity Excess (Dr. Salih, 2008.Pg 2).

- Public expenditure with inflationary funding.

*** Large crack in the real supply sector (the non-oil domestic product) which it is difficult with it the absorbing of the normal levels of aggregate demand, without mentioning the exceptional, because of the war or military effort.**

The defect of the monetary policy in dealing with the hyper inflation since the early nineties until 2003 was because of the total economic paralysis which is resulting because of the embargo in an economic with a rental character.

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While the security conditions and the fragmentation of the government and its institutions after 2003 was the purpose behind the extreme decline in the abilities of the monetary policy.

So the monetary policy was in front:

- Hyperinflation.

- A non-oil real product far away from its potential level.

- A high level of Dollarization in the Iraqi economy because of the loss of the Iraqi dinar its ability to acceptance from public.

4-2: most of the attempts of the central bank (under what are available of the tools) concentrated on fixing processing the inflation by a pure monetary procedures, and help it the Annual surplus in the overall balance for the Iraqi balance of payments (International reserves reached 44.9 billion dollars in 2010 - the Central Bank) especially the independency of the central bank grown under its new law. Where the processing of the inflation and offsetting it will give the chance to the real interest to do its role in the re-accepting to the Iraqi currency, after the ratios of the interest and for long decades were negative because of the inflation, which made the nominal interest rate lose its pivotal role as a stimulating role on the accepting of the Iraqi dinars and by giving it function as a store of the value toward the stability of its value.

So the procedures of the monetary policy in decreasing the core inflation (The record of consumer prices cpi - and the price of fuel and transportation) from 32% as an annual growth rate (2007) to 12.4% (2008) and the rate of the inflation reached 3.5% (2010) which helped in the growing of the performance of the real interest, which stimulate the :

*** improving the level of the Iraqi dinar exchange rate towards stability.**

*** Addressing the phenomenon of the dollarization toward an additional stability for the Dinar.**

As a result, a supervisory direction appeared for the first time (pure monetary because of the loss of the abilities of the non – oil producing sector) which put the exchange price and its stability as an intermediate target to reach the price stability as a goal for the monetary policy.

4-3: the levels of the interest considered as a mechanism for the transition toward a financing activity which stimulate the activity of the real economic sectors and the private investment, because the negativism of the interest due to the continues inflation reduce banks ability for finance, because it biases to the borrowers not the depositors, and weaken the financial mediation, and the ability on mobilizing the small and medium saving as well as pushing it to finance the speculative activity.

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The importance of the interest as a stimulator for the financing is because of the growth rates of the non-oil sectors which is not exceeding the rates of the population growth, it is a bad thing which is continuing till now, the major cause is because of the non-directing the investment to a high returns or the high productivity, therefore the public budget is the reservoir of the wealth in the Iraqi economy. The investing activity depends significantly on the public investment budget, while the private growth which stimulated by the bank's financing doesn't represent anything as compared with the governmental expenditure (the central bank, monetary policy report, Pg4).

4-4: Resulting on the followers of the developing countries fix exchange rate, the inability of the of the monetary authority in tightening the supervision on the rate of the monetary expansion, Because the State's money could be transferred to other state money at a constant rate, In this case this state would not be able to keep on the rate of domestic inflation at a lower level than the global inflation rate , through the restriction of the domestic credit, and most of that is due to the achievement of the inflation abroad is in bigger ratios from the ratio of the local inflation and that will push the prices of the goods and international tradable services toward the increasing, as compared with the prices of the goods and the non-tradable local services, and that lead to the decreasing of the imports and increasing the exports (if it is available with the needed variety), the matter which lead to achieve Surplus and increase the reserves, and that's mean the increasing of the foreign component of the money stock, and that is equal to the money import.

However, it is worth to be mentioned that the inordinate expansion in the money supply will lead to cut a local inflation which may increase in compare with universal one.

But a situation like this won't continue for a long time, because it will lead to the leak of the international reserve, and will be finished by weakening the ability of the preserving on the fixed exchange rate, and will push the authorities to currency devaluation (Dr.Sakar.Ahmed.Sakar, 2005, Pg17).

The attempt to find the integration between the two references of the interest rate and the exchange rate toward stabilization in the prices was a clear formulation for the Iraqi monetary policy and a tool to strengthen the supervision.

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The Iraqi exchange rate(Dinar) has improved and started to take a stable direction, and that is a positive direction when we know that more than Two thirds components of Iraqi consumer price CPI, are tradable goods (the central bank of Iraq, 2010)

Practically the Iraqi dinar exchange rate is stable since the beginning of 2009 till now in 1170 Dinar/Dollar, and the currency auctions were active in supporting the stability of the domestic currency (the central bank, the monetary policy report, Pg5).

But there must a long run equilibrium level for the exchange price which provide the curb of the dollarization, and concentrate On deposit in domestic currency, compared to the direction of the credit in the national currency (Carcia & Sosa, 2011,P4).

4-5: The summary of the indicative supervision in the Iraqi supervision experience could be formulated to:

- **pushing the current inflation toward the targeted, and reform the short run interest to motivate the financial function of the bank organizations.**
- **pushing the real product toward the potential in the non-petroleum sectors, by investing and stabilizing tools create inside the monetary sector (the central bank of Iraq, Declaration about the monetary policy tools, www.CBI.com)**
- **Decreasing the deviation according to Taylor formulation to the price and the product, and the stability of that, will allow a high supervision on the banks system without resorting to direct quantitative tools like the legal reserve and the discount rate and substituting them by the open market tools that what are growing humble in Iraq, by what notice its :**

*** The auctions of notice and the banks bonds for the central banks and the ministry of finance for different terms and that what was achieved in the year 2010.**

***The attempt to activate the interest rate that express about the policy rate and for short run, which leads to the interest rates of the banks.(Ibid, Pg15).**

*** Deviating the banks from the direction of increasing its returns through the investment of its Surpluses in the available monetary tools which weakens its ability in the financial Intermediation, toward achieving the financial stability and through the joining (connecting) by the interest Stabilizers and the exchange rate from one side and the surplus and the deficit units in the Iraqi economy.**

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