CHAPTER - III

JORDANIAN MONETARY STRUCTURE

3.1 Historical Background

Until 1949 the commercial banking system in Jordan was dominated by a single British Bank, viz. the Ottoman Bank Jordan was a member of the sterling standard and its currency was always been tied to sterling Prior to the introduction of the Jordanian Dinar (JD) in 1950, the Palestine Currency Board was responsible for the issue of the 'Palestinian Pound', which was the legal currency for both Palestine and Jordan. In 1950 Jordan Currency Board (JCB) was established and assigned the task to issue and regulate the Jordan Dinar (JD). The exchange value of the Dinar was fixed at par with the pound sterling The new currency JD was issued on July 1, 1950, and the JCB exchanged JD for the Palestine pound, redeeming the Palestine currency against payment in sterling by the Palestine currency board.

During the first seven years of its operation, the JCB had its office in London and Ottoman Bank was its agent in most parts of the country The main functions of the JCB were to issue currency in Jordan against advance payments in sterling in London, and to invest Jordan's asset in foreign financial markets The JCB had to maintain a reserve asset to currency ratio of no less than 100 percent in addition to a special reserve fund sufficient to cover any probable fall in the book value of its assets The function of foreign exchange control was the responsibility of the currency control department of the ministry

of finance. One major limitation of this adjustment was the inability of the JCB to exercise any major influence on the quantity of money and adjust it to domestic economic needs Credit policy of the commercial banks in Jordan played an insignificant role in inducing changes in money supply because of their limited domestic guarantee. This had left the money supply to be solely dependent on the balance of payment position. JCB was unable to assist the economic development programmes of the country by adopting a certain monetary policy. Also, the currency board's had a system of investment of all its foreign assets in London. Money market implies that country's surplus resources had been lent to the U K and the future of this investment was at the mercy of their markets. With this background, the future development of Jordan required a more effective monetary authority and hence the government decided to establish a Central Bank of Jordan in 1960

3.2 Central Bank of Jordan (CBJ) - Creation and Functions

On October 1, 1964, the Central Bank of Jordan (CBJ) resumed its business The CBJ was mainly defined as a corporate body Responsibility for policy and administration was rested in the members of its board Appointments to the board were made by the Council of Ministers

The CBJ was given the sole right of currency issuance, was authorised to buy and sell gold and foreign exchange It was given the authority to supervise banking and other financial institutions, and was given the authority to engage in open market operations to have an effective control of credit and the supervision of banks. The CBJ was empowered

to establish a minimum liquidity asset ratio, with direct control over the volume of credit to customers and had the rights to determine the conditions of commercial bank credit.

According to its law and in its capacity as the banker's banks, the CBJ shall provide all banking facilities for the commercial banks and specialised credit institutions such as inter-bank clearings, exchange of credit information pertaining to their clients and rediscounting facilities. Instruments for financing agricultural and industrial production were made acceptable for longer maturities than those covering commercial transactions

The CBJ is also the banker and fiscal agent of the government and the public institutions It provides them all banking services such as accepting deposits from them and making payments on their behalf It also looks after the issue and management of the government public debt.

Thus at this stage, the CBJ was limited in its power to pursue monetary policy. Not only did it lack the power to impose reserve requirements on commercial bank deposits, but it also had to hold 100 per cent foreign reserve to cover the currency issued. The CBJ at this stage was very similar to the Jordanian currency board.

This picture continued until major changes were made in a series of legislative actions taken in 1967. The objectives of the CBJ were made very clear and the objective of promoting economic development was added in the line of the objectives of the Central Banks of most other developing countries

The CBJ was given the authority to enforce a reserve requirement of upto 25 percent on commercial bank demand and time deposits, and to establish maximum interest rate charged for bank credit and that to be paid on time and saving deposits (based on the

Ottoman Law - Murabahah). The list of assets eligible for backing Jordanian currency was expanded to include securities issued by the government of Jordan The government of Jordan was authorised to issue Treasury bills in an amount not exceeding 15 percent of the average of the government domestic revenue of the previous three years, and longer-term securities of up to 15 years maturity upto an amount not to exceed JD 8 million

By the end of 1970s, the role of the Central Bank in the economic development process became more pronounced[1] In 1971, a new central banking law come into effect, replacing the 1959 and 1966 legislations. As a result of this legislation the maximum rate of reserve requirement on commercial bank demand and time deposits was increased from 25 per cent to 30 percent

Government borrowing from CBJ was raised from 10 to 20 percent of its expected domestic revenues. With the amended legislation of CBJ of 1971, it provided the necessary frame work for better banking supervision The law of the Central Bank, assigning to it powers to regulate the quantity and quality of credit extended by banks and the volume of bank investment both in the kingdom and abroad had been approved Hence, the CBJ has become much better equipped to implement monetary policy more effectively.

The present Jordanian monetary system is relatively small, simple but an active one It is composed of CBJ, fifteen national banks with 285 branches, one Islamic bank with 29 branches, and six investment banks with 47 branches and five foreign banks with 43 branches Six specialised credit institutions also operate in Jordan with 122 branches

Other financial institutions such as insurance companies and the post office saving fund etc do exist in Jordan but they are not under the control of the CBJ.

3.3 Policy Instruments of the CBJ

There is a significant difference between the effectiveness of monetary tools in a developed country and that in a developing country, and this difference arises from their different stages of development and policies adopted by their monetary authorities to adjust these instruments to the country's development strategies[2]

In case of most of the developing countries whose financial system is in the infant stage, central banking has to be thought differently In such cases central bank's priority will be to evolve a sound financial system and work for its development It is the central bank that will take lead in evolving the credit institutions, instruments, and interest rate structure that are essential for the effective mobilisation of saving and the appropriate allocation of resources which will help to achieve the economic development objectives Keeping all these factors in mind on October 1, 1964 the Central Bank of Jordan (CBJ) started it's operations To ensure the convertibility of the Jordanian Dinar along with monetary stability it was obligatory on the part of CBJ to maintain foreign assets the value of which at any time shall not be less than the value of notes and coins in circulation. Except for one year 1974, between 1964 to 1981, CBJ was comfortably able to maintain foreign assets to currency ratio greater than one Between 1982 to 1992 due to unfavourable external conditions the foreign assets position with CBJ deteriorated so much that the foreign asset to currency ratio fell below 1 and remained low for a very long

period, in fact in the year 1988 it went as low as 0 265. In 1988 Jordan was under a heavy pressure from the World Bank to adopt an economic reform package to correct its balance of payments deficit and to stimulate the economy In response, Jordan's authorities resorted to a policy of devaluating the Jordanian Dinar in 1989[3]. Though the situation has started improving after 1991, and in recent years once again the ratio has exceeded one

Article 4 of the CBJ law states that the CBJ objective shall be to maintain monetary stability in the kingdom, to ensure the convertibility of the Jordan Dinar and to promote the sustained growth of the economy in accordance with the general economic policy of the government The CBJ tries to achieve these objectives through various means available to it. Most important instruments available with CBJ are Reserve ratio, Discount rate, Open market operations which are available to central banks in many countries In the following paragraphs an assessment of the effectiveness of the traditional monetary tools in order to show the extent to which the CBJ has been successful in adopting an appropriate monetary policy which could encourage financial development and induce economic growth

3.3.1 Open Market Operations (OMO)

The term open market operations stands for the purchase and sale of government securities by the Central Bank from to the public and banks on its own account In most of the developed countries, open market operation are regarded as technically the most powerful instrument of monetary policy, it has a direct affect on the volume of bank's reserves, the monetary base and the money supply The working of Open Market

Operations (OMO), as an instrument of monetary control is simple. The purchase of government securities by CBJ increases the reserve money by equal amount, and every sale decreases it Therefore, the money multiplier process takes over and influences the supply of money in the system process. In most of the developed countries open market operations are regarded as technically most efficient instrument of monetary policy because they are highly flexible, they can be used continuously in one way or other as required and they are easily reversible in time

The Central Bank of Jordan has been given the power to use open market operations as a mean of controlling credit and regulating the quantity of money, the CBJ has hardly used the instruments very effectively For successful open market operations, the prerequisite is that, the market for government securities should be well developed and organised, that is broad, deep and resilient. The government securities were introduced only on 1969 by the CBJ, and general public has hardly shown any keen interest for these securities. However, the CBJ is trying to broaden the scope of the government securities market by providing various fiscal incentives to general public, and imposing compulsion on commercial banks, investment banks, and financial companies, to participate in the government security market. To add to the degree of liquidity of the government securities the CBJ announced its readiness to purchase government securities from the public at base value at any time, and they are protected against the risk of being lost or being destroyed. However, the public holding of these did not increase significantly. Even banks remain reluctant to hold government securities for profit reasons. During 1969-1995 the total value of government bonds and treasury bills held by the CBJ has

risen from JD 3.9 million in 1969 to JD 19 5 million in 1974, in 1979 it was only 9 3 million From 1979 onwards the total volume of government securities improved, however in the year 1991 the volume of government securities held by the CBJ fell to an all time low level of JD 0 8 million. This is attributed due to the restrictive monetary policy followed by the CBJ to fight the inflationary situation during late 1980s. It is only after the reclassification of government and public entities bonds in the year 1991, the government securities holding of CBJ has shown continuous rise, in the year 1995 the volume touched JD 404 2 million figure

3.3.2 Bank Rate (Discount Rate) Policy

Discount Rate is the rate at which the CBJ is prepared to buy or rediscount eligible bills of exchange or other commercial papers. Since the inception of the CBJ in 1964 the bank rate has not varied much Initially set at 5.5 percent, latter on it was reduced to 5 percent in 1972 However it is to be noted that rate was fluctuated between 5 and 5 5 percent during the period under study[4] The effectiveness of the CBJ's Bank rate policy is questionable.

The commercial banks borrowing from the CBJ has been very small The table 3.1 shows that the relative share of its lending to licensed banks was very negligible up to 1980, it was less than 2 percent share. Only after 1985 the relative of CBJ lending to licensed bank attain some significance in total assets of CBJ By the year 1990 it reached to 29 5 percent share. Once again after 1991 the relative share of central bank lending to

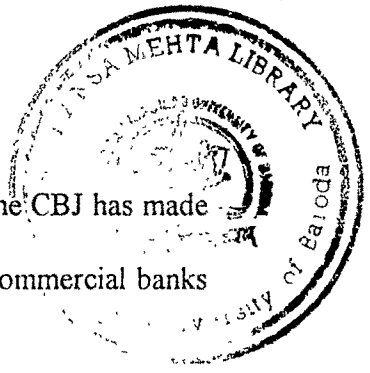
commercial started declining, and by the year 1995 it fell down to 11.2 percent in total assets share

Table 3.1 : Assets of CBJ and its lending to Licensed Banks
(JD Million)

Year	Assets of Licensed Bank	Central Bank of Jordans Total Assets	Loans & Advances of CBJ to Licensed Bank
1970	76 4	107 0	1 7
1980	1070 5	578.5	10 0
1990	4090.0	1631.5	481 5
1995	8430 4	3288.1	369 0

Source Central Bank of Jordan yearly statistical series 1964-95, May 1996

If we look from commercial banks assets - liability aspect we find that except during later 1980s (mainly 1985-90) the commercial banks borrowing from CBJ has been very insignificant when compared to their total assets Because of highly unfavourable external conditions faced by Jordanian economy during 1980s, the ratio went up to 11.8 percent in the year 1990, but once again after 1991 commercial bank, dependence on the CBJ by way of their borrowing. The licensed banks could attract foreign deposits and mobilise internally, large balances from the public in the form of bank deposits.



Such insignificant volume of commercial banks borrowing from the CBJ has made the bank rate policy followed by the CBJ ineffective in influencing the commercial banks credit and its cost.

3.3.3 Variable Reserve Requirement (VRR)

The absence of open market operation and ineffective bank rate policy limit the instruments open to the CBJ to meet its monetary objectives. The use of VRR by the CBJ is more popular The control measure of changes in reserve ratio affect the stock of money by restricting or releasing the bank reserves When the average reserve requirement is revised upward, banks are required to hold larger reserves or balances with the CBJ than before for the same amount of liabilities. Since reserves are a part of high powered money (reserve money), this amounts to a net withdrawal of a part of high powered money from the public equal to the amount of additional reserves maintained with CBJ by the various banks. Just opposite will happen when the VRR is lowered or incremental VRR is withdrawn. While enforcing the monetary authority should note that the VRR policy that it has many limitations and so unless and until these limitations are well covered by supplementary measures, the VRR policy will not prove to be a powerful policy

Banks always keep a certain proportion of their total asset in the form of cash, partly to meet the legal reserve requirement (required reserve) and partly to meet their day to day needs for making cash payments (excess reserves) Excess reserve means that the

commercial banks keep more liquidity than the amount of reserve required, in other words it is the difference between actual reserve and required reserve[5*]

The required reserve ratio, Article 42 of the CBJ Law regulates this matter and requires licensed banks to deposit a compulsory cash reserve with the CBJ as a percentage or percentages of their various types of deposits provided such percentage or percentages are not less than 5 percent and not more than 35 percent However, in view of the imperfections in the economy and capital markets, as in the general economy of the developing countries, banks may not react to a change in the reserve requirements in the same way that one would expect them to do in modern credit markets This due to the existence of large unorganised money markets and also because many commercial banks in the less developed countries enjoy an excess liquidity[6] Some economists are of the opinion that VRR is a discriminatory policy in the sense that a change in the reserve ratio by the central bank will influence the operation of the commercial banks but other non-banking financial intermediaries will not be affected at all.

The CBJ made use of VRR instrument in 1969 for the first time when the minimum reserve requirement was fixed at 7 percent for demand and time deposits At the beginning of 1980s, the CBJ followed a liberal monetary policy where by it allowed commercial banks to expand their domestic loans particularly long-term ones and make maximum use of their own liquid funds To achieve this objective, the CBJ introduced some measures, of which the most important was the gradual reduction of the legal reserve ratio from 14 percent to 11 percent on demand deposits and 11 percent to 8 percent on time and saving deposits Slowing down of Jordan's economy during 1980s, in

the year 1983 the reserve ratio was further reduced to 10 percent in 1987. The differential reserve ratios on demand and time deposits were given up in the year 1989, the CBJ introduced uniform reserve ratio for all types of banks deposits and it fixed 9 percent as the minimum legal reserve requirement on bank deposits and this remains in operation till date

In order to combat rising inflation during late 1980s, the CBJ adopted restrictive monetary policy. In the year 1989 the reserve ratio on banks deposits was increased to 11 percent and continue until 1991, in the year 1992 it was further increased to 13 percent and in the year 1993 and 1994 it was 15 percent while in the year 1995 it was slightly lowered down to 14 percent[7] The minimum liquidity ratio has fluctuated between 25 percent and 35 percent during the whole period of our study, in fact after 1985 till today the ratio is fixed at 30 percent.

As far as the effectiveness of reserve requirement policy in Jordan is concerned - one can clearly see that reserve and liquidity requirements have not proven to be a very effective tools for monetary management in Jordan. This is so, mainly because of the fact that commercial banks in Jordan have maintained large excess reserves and have more comfortable liquidity position than required by the CBJ.

Having evaluated the effectiveness of the traditional monetary instruments in the hands of the Central Bank of Jordan (CBJ), some very pertinent questions raises, if most of the actual monetary regulationary weapons are not functioning effectively, then, how is monetary policy going to work in Jordan? How can the monetary authority regulate and

stabilise the economy? This we will try to answer after analysing the behaviour of demand for money and the supply of money in Jordan along with the factors influencing them.

3.4 Measures of Money : Composition and Change

The composition of narrow money and broad money have undergone substantial change during the course of our study (1964-1995). The narrow money (M_1) comprises of currency and demand deposits and broad money (M_2) includes quasi money along with M_1, i e it is inclusive of currency, demand deposits and quasi money (saving and time deposits). These components differ interms of their degree of liquidity Currency is the most liquid form of financial asset, followed by the demand deposits Of the various measures quasi money is least liquid, though all these are very close substitutes for each other In terms of relative rates of return also these measures differ. Currency does not touch any return, while quasi money attains relatively higher return Hence, over years, if the composition of M_1 or M_2 under goes a change, it means the public preference in terms of different money components have changed which means they have readjusted their liquidity consideration

Whatever measure of money is taken (M_1 or M_2), it is seen that money supply has increased substantially over the period under consideration. During 1964-95 period, M_1 have increased at an average annual rate of 13 36 percent, where as M_2 have registered 16 15 percent average growth rate (Table 3.2) Wide fluctuations in the level of economic

activity was one of the basic feature of Jordan's economy, monetary sector is in no way was an exception to it

During 1964-1974 the rise in money supply resulted mainly from an increase in foreign assets because of rise in Arab aid to Jordan, an increase in government expenditure, propensity to hold Jordan Dinar in the West Bank, and a rise in domestic credit. The preference of the general public was more for liquid assets in the year 1964. It is seen that, of the total money supply (broad money), 42.9 percent was the share of currency, 31 3 percent demand deposit and time deposits. The period between 1974-84 can be termed as a expansionary phase in monetary growth in Jordan At the same time a major shift in preference of the public from highly liquid assets to less liquid assets can be attributed to public awareness in general and improvement in banking system in particular. In addition, banking service in Jordan became more widely available through horizontal expansion During 1974-84 M_1 rose by 18.52 percent, where as M_2 by 23 46 percent on annual average basis The relatively high growth of M_2 was mainly due to an extra ordinary growth registered in terms of saving and time deposits, which grew at the rate of 34 22 percent during this period. The higher growth of saving and time deposits as compared to currency and demand deposits, clearly highlights the shift in the preference of the public form highly liquid to less liquid assets By the year 1980 the relative share of currency, demand deposits and saving and time deposit, in broad money supply were 35 6%, 24 7% and 39.6% respectively, which further changed to 30.2% of cash 19.8% demand deposits and 50% saving and time deposits in the year 1984. All this was a result

of Central Bank policies designed to encourage savings and increased awareness of the public, of the importance of savings

Slowing down of the level of economic activities during second half of 1980s[8] clearly affected the investment and saving decisions of individuals and ultimately depressed the demand deposit and boosted saving deposits. The rate of return on direct investment remained low and so was short term interest rate on saving deposits Thus individuals naturally opted for holding funds in the form of saving rather than demand deposits and this should explain the relative high growth rate of saving deposits and drop in demand deposits. During 1985-95, a period a higher growth in M_2 as compared to M_1 clearly reveals that in recent years people have opted for higher benefit from the high returns offered by banks on saving and time deposits Though during this period, in more recent years (1989-92) monetary policy was directed toward controlling the growth rate of domestic liquidity, especially that arising from the expansion of domestic credit, with a view to restoring monetary stability and stabilising the JD at a realistic level

Compared to 1974-84, expansion in broad money and even narrow money was relatively less in 1984-95 M_2 grew at the rate of 10 23 percent where as in case of M_1 the growth rate was 6 17 percent only This was due to a relatively higher growth rate in saving and time deposit compared to demand deposit and currency held by the public. In fact on relative share of currency fell down to 20 3 percent and demand deposit levelled at 13.5 percent in the year 1995, where as the share of saving and time deposits shot-up to 66.2 percent of total broad money

Jordanian monetary system performed well in the early 1990s, reflecting the recovery of the economy from the financial crises of the late 1980s Looking at the long term prospects monetary system could be more stable and mature as the country is less dependent on foreign aid as it was previously, and its financial markets are strong At the same time the role to be played by the CBJ in this regard is very important, along with its continuous evaluation so that things can be directed in the desired direction

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Table 3.2: Measure of Money and changes during 1964-95 [JD Million]

Year	Currency in Circulation (CU)	Demand Deposits (DD)	M1	Quasi Money (QM)	M2	Annual Average [CU]	[DD]	[M1]	[Q.M.]	[M2]
1964	23.00	16.80	39.80	13.80	53.60					
1965	26.40	20.80	47.20	17.00	64.20	14.78	23.81	18.59	23.19	19.78
1966	30.30	25.70	56.00	19.80	75.80	14.77	23.56	18.64	16.47	18.07
1967	51.50	23.70	75.20	18.80	94.00	69.97	-7.78	34.29	-5.05	24.01
1968	63.50	24.50	88.00	20.90	108.90	23.30	3.38	17.02	11.17	15.85
1969	71.30	25.00	96.30	22.70	119.00	12.28	2.04	9.43	8.61	9.27
1970	82.40	23.00	105.40	23.70	129.10	15.57	-8.00	9.45	4.41	8.49
1971	83.00	25.00	108.00	27.10	135.10	0.73	8.70	2.47	14.35	4.65
1972	81.50	33.50	115.10	31.50	146.60	-1.81	34.00	6.57	16.24	8.51
1973	97.50	40.90	139.30	36.80	176.10	19.63	22.09	21.03	16.83	20.12
1974	115.50	55.80	172.10	47.80	219.90	18.46	36.43	23.55	29.89	24.87
1975	139.00	84.50	224.60	63.80	288.40	20.35	51.43	30.51	33.47	31.15
1976	161.40	114.00	276.90	101.50	378.40	16.12	34.91	23.29	59.09	31.21
1977	188.00	139.80	331.00	136.60	467.60	16.48	22.63	19.54	34.58	23.57
1978	219.50	150.00	375.40	231.30	606.70	16.76	7.30	13.41	69.33	29.75
1979	275.40	182.00	472.70	300.40	773.10	25.47	21.33	25.92	29.87	27.43
1980	351.60	225.20	594.80	390.00	984.80	27.67	23.74	25.83	29.83	27.38
1981	412.30	280.10	701.70	478.20	1179.90	17.26	24.38	17.97	22.62	19.81
1982	470.00	305.10	787.50	615.80	1403.30	13.99	8.93	12.23	28.77	18.93
1983	516.00	338.70	869.40	745.80	1615.20	9.79	11.01	10.40	21.11	15.10
1984	530.50	336.80	878.40	879.30	1757.70	2.81	-0.56	1.04	17.90	8.82
1985	531.80	308.40	848.20	1026.60	1874.80	0.25	-8.43	-3.44	16.75	6.66
1986	583.90	310.70	897.10	1175.30	2072.40	9.80	0.75	5.77	14.48	10.54
1987	655.80	322.90	979.80	1392.40	2372.20	12.31	3.93	9.22	18.47	14.47
1988	811.20	353.70	1181.40	1465.40	2646.80	23.70	9.54	20.58	5.24	11.58
1989	871.10	425.40	1326.50	1644.60	2971.10	7.38	20.27	12.28	12.23	12.25
1990	1006.20	413.90	1432.80	1689.80	3122.60	15.51	-2.70	8.01	2.75	5.10
1991	992.40	583.80	1600.40	2117.10	3717.50	-1.37	41.05	11.70	25.29	19.05
1992	1003.90	685.90	1716.10	2476.90	4193.00	1.16	17.49	7.23	16.99	12.79
1993	1047.90	762.30	1730.10	2748.70	4481.80	4.38	11.14	0.82	10.97	6.89
1994	1072.60	764.50	1746.20	3095.30	4841.50	2.36	0.29	0.93	12.61	8.03
1995	1050.90	772.90	1745.60	3414.20	5159.80	-2.02	1.10	-0.03	10.30	6.57
	Annual Average					Average growth rate				
1964-95	425.54	255.48	679.97	827.15	1507.22	13.80	14.12	13.36	20.28	16.15
1964-74	65.99	28.61	94.76	25.45	120.21	18.77	13.82	16.11	13.61	15.36
1975-84	326.37	215.62	551.24	394.27	945.51	16.67	20.51	18.01	34.66	23.32
1985-95	875.25	518.58	1382.20	2022.39	3404.86	6.68	8.58	6.64	13.28	10.36