

## *An Investigation into Some of the Capabilities and Restrictions of Participation Rate as a Monetary Policy Tool*

*Ali Sadeghi Hamedani\**

*Mohammad Sadeghi Hamedani\*\**

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### **Abstract**

Essence of interest is different between Islamic and conventional monetary systems. This difference as well as prohibition of Riba require an alternate monetary policy tool as substitute. Participation rate in Profit-Loss Sharing (PLS) contracts is one of such substitutes. This paper aims to investigate the participation rate as a monetary policy tool and also identifying its restrictions and capabilities within a theoretical framework. For this purpose, extracting demand and supply functions of PLS funds, we developed a theoretical model for PLS funds market.

The results show that the PLS funds market may collapse under certain conditions. The more opportunity cost of supply of PLS funds is, the more probability of dis-equilibrium and collapse is. This paper introduces a threshold level of expected return that suppliers are not willing to supply their funds for less than that amount. This expected return is a function of expectation of suppliers from return of the project in boom and recession, participation rate and probability of boom. Under this condition, it is obvious that participation rate is no longer efficient as a monetary policy tool in order to influence on employment and aggregate output through investment channel and a new one has to be found.

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\* Ph.D. in Financial and Monetary Economics, Shiraz University, Fars, Iran.

Email: Ali.sad1984@gmail.com

\*\* M.Sc. student in Economics, Iran University of Science and Technology, Tehran, Iran.

Email: Mo.sadeghi1993@gmail.com



Furthermore, the results indicate that the participation rate has an opposite impact on both expected inflation and inflation and if considered as an endogenous variable, it shows a stationary behavior which leads Islamic financial system to be more stable. The monetary policy maker should be aware that participation rate is not always efficient and its efficiency depends on variables and parameters like rate of return in boom and recession, participation rate and expected return

**Keywords:** Participation rate, Monetary policy, Interest, Islamic economy, Participation facilities.

**JEL classification:** E41, E52, E59, P49.

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