

## Conference Paper

# Islamic Monetary Management: A Critical Overview

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## Abstract

The paper aims to provide critical overview of Islamic monetary management. This is literature study based on secondary data taken from some books, articles, and journal discussed related to modern monetary economic and Islamic monetary economic. The references were produced by some authors who are concern in the area of monetary system and monetary policy. The rest of this paper is structured as follow: Section 1 gives an overview of background and monetary policy frameworks where Islamic banks operate; Section 2 explores the monetary management in modern economy; Section 3 gives information about the objective of monetary management; section 4 discusses the monetary policy operational framework for Islamic banks; and Section 5 explains Islamic monetary instrument; meanwhile Section 6 gives a critical overview; and Section 7 is conclusion.

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## 1. Introduction

One of the most important roles of government is to monitor macroeconomic variables movement, like inflation, growth, employment and try to improve economic aspect by using efficient policy tools. Monetary policy is one of the tools available for government to pursuit economic objectives.

The role of money and monetary management in modern economic is necessary. Monetary management is running side by side with fiscal management conducted to achieve a high level of economic growth in a sustainability condition while stability of price is tenable.

Same as existing modern economics, in Islamic economics we also face all macroeconomics issues such as growth and inflation. Because of that, monetary management in Islamic economic is undeniable. In an Islamic economic system monetary have to be organized into the framework of the overall economic system defined by Islam.

There is a border that makes monetary management in an Islamic system differ in a very basic and important way from that in a modern economic system. Meanwhile the

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Qur'an and the Sunnah as a fundamental source of Islam do not provide detailed guidance on the management of money except they are firm in responding condemnation of interest.

In modern economic, interest rate is the most important instrument for executing monetary policy. This is contrary with the Islamic economic view. In Islam, interest rate is classified into *riba*, and it is prohibit in Islam. Prohibition of interest makes the monetary management process in Islamic economics more problematic than modern economic system. Islamic economic follows the system of modern economic although it do disagree whit modern economic instrument.

## 2. Modern Monetary Management

Chapra (1996) said that the discussion of monetary management generally revolves around the determinants of money demand and money supply. It is rather necessary to discuss both and to show how they could be brought into equilibrium in a way that would be conducive to the realization of the desired goals.

Central bank uses a number of methods to control monetary equilibrium and execute monetary policy. Ausaf (2000) assigned that the central bank in an Islamic economic economy would continue to perform all of those functions performed by central bank elsewhere. He toke Siddiqi views that a central bank in an Islamic economy will function under the state's control and its aim will not be to earn profit but to safeguard the public interest. Kiaee (2007) describes, Generally, there are two categorize, monetary aggregat or money supply and interest base control.

### 2.1. Monetary aggregat

Monetary aggregates measure the amount of money circulating in an economy. Central bank controls the volume of money in the economy by affecting the money supply. Total money supplies are generally measured by the sum of currency in circulation, checking deposits, and saving deposits. Central bank organize the amount of money that commercial bank lend to consumer. The two main instruments for this purpose is determining lending ceiling for bank and setting their reserve rate.

Lending ceiling is performed by announcing some instructions to individual commercial bank. Central bank limits on the quality and quantity lending money. These method effect completely predictable result, although it has drawback such as disintermediation and reduce competition. Government only concern about supply side and is unable to

control the demand side. When there is high demand for the money in the economy and central bank sets limit on the lending of individual bank, people will go to illegal financial institution to borrow money. These conditions will affect the health of society economic. The other weaknesses, when central bank sets lending ceiling, this will limit the ability of each bank to offer lower interest rate for attracting customers and at the same level. The result, commercial bank will work with the limited number of customers and at the same level of interest rate. This lack of competition will decline the efficiency of the banking system.

Required reserves is another method for central bank to control money volume that is requirements regarding the amount of funds that banks must hold in reserve against deposits made by their customers. This money must be in the bank's vaults or at the central bank. By increase or decrease of legal reserve rate, central bank is able to effect the lending ability of individual commercial banks.

## 2.2. Interest based control

Central bank also has another way to control money supply in the economy by affecting money demand for credit through interest rate. This method based on this view that demand for money is dependent on its price. Increasing interest rate will also increase opportunity cost of money, because of that, people prefer to hold less money. The higher the interest rate, the lower the money demanded by people.

Actually, demand for money is not only dependent on interest rate. Money demand affected by many other factors, such as future inflation, business expectation and profitability of investment environment. By using interest based control of monetary policy, central bank determines first the level of interest rate in the economy and follows specifies its appropriate amount of bonds that should be sold or bought through open market operation.

## 2.3. Stability analysis under monetary aggregate policy

The economy, when central bank uses only monetary aggregate as an instrument to target macroeconomic variables by declining inflation, central bank supposed to decline total money supply. Central bank will put credit ceiling restriction for the individual commercial bank or increase required reserve for them in order to execute a contractionary monetary policy. When money volume declines by central bank policy, as a result, the speculative demand for money increase. In this situation, central bank should be

increase interest rate to decline the speculative money demand. Higher interest rate causes the investment to decline in goods market and lower the level of total output. Lower level of total output declines transaction demand of money, as a consequence, total output will increase. In this point equilibrium in goods and money markets is occurred.

## 2.4. Stability analysis under interest based policy

When interest based instruments uses for executing monetary policy in which inflation is occurred, central bank will apply contractionary monetary policy by using open market operation for this purpose. As usual, first, central bank announces the level of higher interest rate for target inflation in the economy and then uses open market instrument to adjust the volume of money by new lower interest rate.

## 3. General Monetary Policy Objectives

An Islamic state has an ideological context, namely, spreading the message of the God Almighty to everyone, both inside and outside the state. On the practical plane, this ideological perspective also means keeping working of the economy in line with the Islamic value dictates for economic activity. The general policy objectives divided into primary goals and secondary goals for economic policy at the state level. Islamic economy helps us to provide the Islamic value that support for these goals. Nevertheless, many of these goals can be policy objectives for any economy in this age (Tahir, 2013). Both kinds of goals are listed hereunder:

Primary Goals/Objectives at the State Level:

1. Development and preservation of institutional framework for supporting economic and distributional activity
2. Fulfillment of critical minimum needs (fundamental economic rights) of the citizens
3. Maintenance of credible deterrence against external threats
4. Education

Secondary Goals/Objectives at the State Level:

1. Reduction in interregional disparities
2. Integration of economy into the world economy

3. Development of economic infrastructure such as means for communication and transportation
4. Poverty alleviation

## 4. Islamic Monetary Management

When we use money and its function in the Islamic framework, does not different with other economic system, we should consider monetary policy as an important available tool for government to pursuit macroeconomic goal. In Islamic economics we need to use some policies for targeting important economic variable such as inflation, employment or economic growth. Monetary policy plays an important role for establishing stability and growth in Islamic economics.

The problem emerges when we need to choose our instrument for implementation monetary policy. According to sharia law, we are not allowed to use interest based instrument for monetary policy in Islamic economic framework. Base on theoretical, we permit to apply widely profit rate instruments.

Chapra (2000), argues that the absence of interest rate in Islamic economics, and the existence of some institution like zakah, minimize the speculative demand for money and make total demand for money in Islamic economics more stable. Metwally (1995) believes that, only two reason for demand for money, such as transaction motif and precautionary motif. As a result of this kind of view point, Chapra (1996) suggest that in Islamic economic system, monetary aggregat instrument play the main role for executing monetary policy. In Islamic economics, monetary policy should be executed though control in stock of money and there is no need for using interest based instrument.

Ahmad (2000) affirms using Ahmad views that there is two main difficulties for adoption of open market operation in the Islamic economics. The first is conceptual problem, since the interest rate instrument are incompatible with Islamic economics, and the second one is institutional problem, because in most Islamic countries the financial market is underdeveloped. The second problem, recently, is still a source of concern in many countries and the first problem is almost solved.

There are some Islamic tools involves profit rate instrument as a substitution for interest based instruments. The Islamic government issues commercial shares like musharakah certificate on the base of profit sharing. Kiaee (2007) explains, whenever the government need to declines the money volume in the economy, it sells these certificate to the public and whenever government needs to expand money volume, it

will buy these commercial shares from people. the profit rate from commercial certificate plays the role of interest rate in the monetary policy process and by changing this rate, central bank can persuade people to buy or sell these certificate. Kiaee points that central bank should issue all papers and certificate based on some productive economy project otherwise the profit sharing principle does not work.

## 5. Islamic Monetary Instrument

To study the Islamic monetary instrument uses to execute monetary policy, Kiaee (2007) took case study from Iran. The government of Iran applied Islamic rules and regulation in all aspect of society and banking system comprehensively after the Islam revolution at 1979. Ausaf (2000) also explains some of regulation control that have been applied in Pakistan when embarked upon Islamization of its banking system in 1979. Besides Pakistan, Sudan also became the Ausaf's focus of study to determine the monetary policy instrument in Islamic economic, in which is known that from December 1984, all commercial bank in Sudan have been operating according to Islamic law.

Islam does not find interest to be an appropriate mechanism for the management of money demand in an efficient or equitable manner. Consequently, it tries to regulate money demand by a strategy that relies on a number of instruments, some of which are applied in country that use Islamic financial institution.

### 5.1. Musharakah certificates

At 1983 in Iran, economic experts and Sharia scholars established the interest free banking system that used Islamic contract as instruments for attracting and allocating money in the banking system. From the beginning of the Islamic banking applied in Iran, the bank central of Iran did its best to use monetary policy instrument which have no contradiction to Islamic and at the same time bring macroeconomic stability and growth to the country.

Kiaee explains that, central bank of Iran tries to control the volume of money in the economy by issuing Musharakah certificate. Selling these Musharakah certificate to people allows them to take part in the investment project even with little money and get their profits and at the same time helps central bank to collect money from economy and control macroeconomic variables.

## 5.2. Controlling profit rate of commercial banks

There are two main categories for Islamic contracts are applied in Iran, Musharakah Contracts and fixed rate contract like murabahah and Ijarah. In the Musharakah, bank uses the money of depositors in some investment projects and gives them their share as a profit. But since the investment project are usually long term, bank provides yearly or monthly expected profits to the depositors and after two or three years, when bank is able to calculate its exact profits, it gives the precise profit to the depositors. By determining the profit rate for fixed rate contracts or expected profit rate for Musharakah contract, central bank indirectly controls the banking system deposits.

Case of Pakistan, Time deposits of the interest based system have been converted into Profit and Loss Sharing (PLS) deposits. Central bank determines how profit is to be distributed between banks and PLS depositor. Since the level of profit to be distributed depends upon the outcome of the business activity in which these deposits are invested. Central bank only determine the weight which are assigned to various types of PLS deposits. These weight vary according to the maturity of the deposits.

## 5.3. Legal reserve

Kiaee (2007) explores that, the same as other countries, all commercial banks in Iran must put some percentage of their deposits to the central bank as legal reserve. The legal reserve in Iran is variable between 10 and 30 percent. When central bank wants to increase the volume of money in the economy, it declines this rate and vice versa.

In Pakistan, Ausaf (2000) describes that commercial banks are required to maintain with the central bank of Pakistan reserve equal to five percent of their total demand and time deposits. Under the interest based system, penal interest was recovere from scheduled bank if their cash reserve fell short of the required amount.

In accordance with islamic system, penal interest has been replaced by a system of penalty and fines.

Reserve requirement is also used as an instrument of monetary management and control in Sudan in the form of cash reserve ratio, but changes in the cash reserve ratio have not been frequent. In November 1986, a new credit policy was announced in which the cash reserve ratio for commercial bank was raised to 20 percent from 12,5 percent. However, since 1998, the cash reserve ratio has been around 18 percent.(Ausaf, 2000)

#### 5.4. Special deposits to central bank

Case of Iran, Kiaee explains, from 1998, central bank of Iran used another instrument for executing monetary policy and controlling volume of money in the economy. This instrument allows commercial banks to open an account in the central bank and put their extra money in this account. On the special condition, central bank offers return for these deposits.

#### 5.5. Credit ceiling

Monetary instrument that central bank of Iran uses for controlling the volume of money in the economy is determining the quantity and quality of the money that banks lend to people. For adopting contractionary monetary policy, central bank is able restrict the level that each individual bank lend to people or for supporting agricultural sector.

Sudan applies the credit ceiling becomes the most important tool of monetary management and banking control. It aims to control both the volume and the direction of credit. It is applied to all banks; however, the central bank determines the credit ceiling for each bank separately. The financial resource a commercial bank defined as the total of deposits and capital of the bank are the main criterion for determining the credit ceiling. The higher the financial resource of bank, the higher the credit ceiling imposed on it. Bank with more branches are also usually given a higher ceiling. There is also sometimes, the possibility of having the ceiling expanded. The central bank takes punitive action if any bank exceeds its credit ceiling.

#### 5.6. Lender of the last resort

Central bank of Pakistan only made limited use of the bank rate policy because the borrowing facility from the central bank to commercial banks was restricted to certain specific refinancing facilities. After the Islamization of the banking system, the use of bank rates was abandoned. Instead, a system was adopted under which the central bank could provide funds to commercial bank to ease their temporary liquidity difficulties. The rate of profit for the central bank on these funds is equal to the rate of return which the borrowing commercial bank paid on its saving deposits. If the commercial bank has no savings deposits scheme, then the rate of profit is the return paid on its deposits of six month's maturity.



## 5.7. Determining the maximum amount of service charge

According to the permissible modes of financing determined by the central bank of Pakistan, commercial bank can offer financing to their clients on the basis of loans, not carrying any interest on which the banks may recover a service charge not exceeding the cost of funds and provision for bad and doubtful debt. The maximum service charge permissible to each bank is to be determined by central bank from time to time and qard hasan loans are to be exempted from the service charge.

The maximum amount of service charge on loans other than qard hasan is to be calculated by dividing the total of its expenses excluding cost of funds and expenditure relating to bad assets and income taxation by the means of its total assets at the beginning and end of the year and rounding off the results to the nearest decimal of a percentage point.

The rule also applied for service charge during an accounting year on the basis of a rate determined by the bank. However, after the accounts have been audited, it must recalculate the rate of service charge, on the basis of the actual administrative expenditure using the prescribed method. If the rate is less than the rate charged, the bank will reimburse the difference to its clients within a month and inform the central bank within a specified period.

## 5.8. Purchase and sale of participation term certificates

Under the Islamic banking system, central bank of Pakistan has been authorized to buy and sell Participation Term Certificates (PTAs) which are new financial instrument based upon the concept of profit and loss sharing rather than interest based debentures. PTAs have so far been issued by the Banker's Equity Limited and the Investment Corporation of Pakistan. With PTAs, funds are acquired either from a single financial institution or from a group of financial institutions. The business firm is expected to pay the financial institution or the bank an agreed percentage of expected profit. In the event of loss, the financial institution shall refund the share of profit received on a provisional basis.

PTAs can be traded on the capital market. Hence, there is the possibility that the central bank can use this instrument in an open market operation. As has been mentioned before the central bank has been authorized to buy and sell these instruments. However, it is not known whether the central bank of Pakistan has actually undertaken these operation and what its impact has been on the magnitudes of various monetary aggregates.

## 5.9. Instructions and directives

Central bank of Sudan, time to time gives instructions and directives to commercial banks as well as establishing full-fledge credit policy each year. Commercial banks are expected to fulfill the targets of the credit policy. Selective methods of credit control are used to affect the direction of credit and certain guidelines are provided to allocate available credit to different sectors, consist of exports, industry, agriculture, handicrafts, and medium and long term investment projects are identified as priority sectors. A minimum of 80 percent of the total credit of each bank must go to these priority sectors. A commercial bank's total credit provided to sectors other than the priority sector may not exceed 20 percent of the credit ceiling approved for the bank.

The central bank of Sudan also issues other directives and establishment the ground rules for commercial banks keeping in mind local conditions and national economic interest. For example, the credit policy adopted for 1990 prohibits the financing of export of sesame and peanuts but banks are permitted to finance the working capital and domestic trade for these commodities. Similarly, the refinance of imported goods is prohibited whether the import have been made through official or free market channels.

The main difficulty faced by commercial banks in the implementation of the credit policy of the central bank is that most of the deposits at commercial banks are of a short term nature while the central bank asks them to finance medium and long term projects. The incompatibility of the goals and means of monetary policy has been identified as the main constraint on the efficient implementation of monetary policy.

## 6. Critical Overview

The establishment of an economic system based on Islamic value requires fundamental changes in the operations of financial institution. Since interest rate do not allowed, alternative mechanisms that rely primarily. Truman (2010) said that financial system contribute to monetary crisis. A malfunctioning international financial system contributed to the crisis, and may have been a major cause, but a malfunctioning international monetary system was not a major or a minor cause of the crisis.

Truman affirms that malfunctioning international monetary system a major cause of the crisis. The changes in the international monetary system are unlikely to have much effect on the functioning of the international financial system unless the financial system is changed as well. In the wake of the crisis, changes in the international financial

system are necessary and desirable, much more so than are changes in the international monetary system.

Seen from the economic views, monetary policy is defined as one of the Government's efforts in realizing a better economic stability. Assuming economic stability intended recipients through the money supply circulation setting the circulation of the money supply in order to realize short-term objectives (optimization of production levels and price stability) and long-term goals (social welfare), the government's conduct of monetary policy

This is what underlies the existence of monetary policy, either conventional or Islamic. In a simple way, Islamic and conventional monetary policy looks no different (the same), but when examined more carefully between them (Islamic monetary and modern monetary policy) have many differences, as seen from the fundamental side, the process, or its purpose.

Simply, the fundamental difference between modern monetary policy and monetary policy Islam seen from the main assumption in fundamental understanding about the motives of the demand for money, and the instruments of monetary policy, interest based and no interest based. While in the short-term goals, the conventional-Islamic policies together to improve the optimization of production levels and maintain price stability.

Chapra (1996) emphasizes that the effort to regulate the various components of money demand through the interest rate mechanism tends to squeeze the money demand for need-fulfillment and productive investment rather than for unproductive and speculative uses, thus frustrating goal realization. Moreover, since the demand for money related to conspicuous consumption and speculation tends to be relatively more unstable than that for need-fulfillment and productive investment, a high degree of instability gets injected into the whole economy. No wonder, recent empirical studies have revealed great instability in the aggregate money demand function as well as its major components.

So far, Islamic economic has probably been more successful in offering an alternative perspective on economic system than in providing a substantively different way of economic. The emphasis of its theory on social consciousness is risk-sharing, redistribution of wealth and opportunity. But Islamic economic has found it hard to put theory into practice. The list of reasons ranges from history, law, politics, regulation, human behavior, and beyond. But an important reason is that Islamic economics is generally made to fit into a system designed for modern economics, and in the process of making concessions, it seems to lose what its critics regard as its substance.

Because banks play a central and still expanding role in the monetary and financial system, there has been heavy criticism of Islamic monetary management as it is currently practiced. The gist of the criticisms is that Islamic monetary management, especially Islamic monetary instrument, is nothing but a replication of existing modern monetary management with Islamic labels tagged on. There is much validity to and support for this criticism.

Early attempts in different parts of the world to establish 'pure' Islamic finance institutions not totally succeeded, largely because they were long on religion and short on economics and contemporary realities. They, later, revive by establishing institutions which was different in operation with existing modern economic institution. In the absence of workable models, policymakers and the actors of economic felt it necessary to simply replicate products in the initial years, with the hope that purer, more authentic products would be developed over time. But more than 30 years on, their hope has not been realized.

In the case of Islamic banking development, in the limitation of an Islamic monetary instrument, Islamic banks also benchmarked their fixed-return contracts to the conventional interest rate charged in the interbank market, which is usually based on the Treasury-bill rate. However, the loan supply of Islamic banks is less likely to react to changes in monetary policy because, as mentioned earlier, they have fewer investment opportunities and are more likely to sit on a lot of spare liquidity. In addition, since Islamic banks assets are only indirectly linked to the policy rate, Islamic banks may be less affected by the changes in monetary policy.

Anwar (1987) said no economic system can sustain its health and vigor or contribute positively to the achievement of its socio-economic goals without the support of a sane and equitable money and banking system. The money and banking system should hence be reformed to eschew the excesses and imbalances that promote inequalities, conspicuous consumption, and unhealthy monetary expansion to the ultimate detriment of all it should discourage large-scale business, except where it is absolutely necessary, and in general, patronize small-and medium-sized business.

Monetary policy objectives in the presence of Islamic banks, comprehensively, have to be harmonized to objectives of Islamic economic system. The near future, the function of Islamic monetary operation should be redirected and reoptimize to the ideal applications as being suggested by Moslem scholars. The central bank should be create new Islamic monetary contract, hence, the central bank can engage in the real economic activities and works more than just managing the supply and demand for money supply. This is basically the true purpose of the Islamic monetary management (Ismal, 2009).

## 7. Closing Remarks

The conventional central bank model of monetary operation gives the idea of what variable are involved in the monetary operation model, and contributes to the modelling of Islamic monetary operation model for Islamic economics practice, in which Islamic banking industries give an important role in it. However, despite many of studies was conducted by Islamic researcher to enhance Islamic monetary theory, majority of the studies mainly focus on the conceptual and theoretical aspect of Islamic monetary economic without any empirical validated on the ground. The paper suggest the application of Islamic monetary instrument to implement the ideal purposes of Islamic monetary management.

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