Islamic Development Bank
Islamic Research and Training Institute

INSTRUMENTS OF REGULATION AND CONTROL OF ISLAMIC BANKS BY THE CENTRAL BANK

ISLAMIC RESEARCH AND TRAINING INSTITUTE

The founders of the Islamic **Development** Bank (IDB) fully **appreciated** the role of research, training **and information** in the economic and social development of the Ummah. Hence, "to extend training facilities to **personnel engaged** in **development** activities in member **countries"** and "to **undertake** research for enabling the economic, **financial and banking** activities in Muslim countries to conform to the *Shari'ah* were included among the functions of the IDB in the Articles of Agreement **establishing** the Bank.

OBJECTIVES

In order to discharge its obligations in the areas of research, training and information, at the operational level, IDB established the Islamic Research and Training Institute (IRTI), located at its headquarters in Jeddah, Saudi Arabia; in 1401H (1981). The Institute became operational in 140311(1983).

Purpose and Functions

The purpose of the IRTI is **to undertake research** for **enabling the economic, financial and banking activities** in Muslim countries to conform to *Shari'ah* **and to extend training facilities to personnel engaged** in **economic development** activities in the Bank's member countries.

The major functions of IRTI, as stated in its Statute **approved** by the Board of **the Executive** Directors, **arc:**

- **to organize and coordinate basic and applied research** with a view **to developing models and methods for the application** of *Shari'ah* in the fields of economics, finance and banking;
- to provide for the training and development of professional personal in Islamic economics to meet the needs of research **and Shari'ah- observing agencies;**
- to train personnel engaged in development activities in the Bank's member countries;
- to undertake any other activities which may advance its purpose.

Organization

The President of the IDB is also the President of the Institute and the IDB's Board of Executive Directors acts as its **supreme policy-making body.** The **functioning** of the Institute is supervised by the IRTI Management Committee. The Institute is **headed** by **a** Director responsible for its management and is **appointed** by the IDB President in **consultation** with the Board of Executive Directors.

In response to the recommendations made by the Second Evaluation Committee, appointed by the management to evaluate the performance of IRTI for the period 1408-141611(1987-88 to 1995-96) in order to improve the overall efficiency, and effectiveness of the Institute, IRTI was restructured and is now composed of four technical divisions namely: the Islamic Economics, **Cooperation** and Development OECD) Division; the Islamic Banking and Finance (IBF) Division; the Training Division; and the Information Center (IRTIC); in addition to the Special Assignments Unit (SAU) and the Administrative Services Section.

In the same line of changes leading to improvement, efficiency, and effectiveness, IRTI introduced **a** research screening process, which operates through its Research Advisor as well as IRTI Staff Seminar, to support its Academic Committee in its effort to evaluate research proposals, papers and other academic activities more effectively.

RESEARCH

The IECD and IBF Divisions concentrate on managing and conducting basic and applied research as well as organizing seminars and conferences to meet the research **needs** of **member countries related to the application of** *Shari'ah* in the fields of economics, finance and banking. They also coordinate teaching and research in those fields being carried out by sister institutions all over the world. In addition, they provide advisory services to member countries and their institutions in the fields of interest to IRTI.

TRAINING

The Training Division offers training facilities to officials of member countries in order to develop their professional capabilities in various fields of developmental activities. It also develops training packages in various vital areas and makes them available to member countries.

INFORMATION CENTER

The information center has **three** main functions: First, it **works on the design, development and implementation** of **information systems that** would serve the **Islamic Ummah** in the fields **of Islamic economics, banking and finance, Second,** it **cooperates** with national, regional and international institutions **towards enabling** Islamic **countries** and the Muslim communities to realize the benefits of information technology and modern **communications.** Third, it provides IRTI with necessary technical support in the field of information technology.

ADMINISTRATIVE SERVICES SECTION

The Administrative Services Section is responsible for **providing back-up facilities and support services to** the whole of IRTI and produces and disseminates IRTI's publications.

ISLAMIC DEVELOPMENT BANK
ISLAMIC RESEARCH AND TRAINING INSTITUTE

INSTRUMENTS OF REGULATION AND CONTROL OF ISLAMIC BANKS BY THE CENTRAL BANKS

AUSAF AHMAD
Research Division

King Fahd National Library Cataloging-in-Publication Data

Ahmad, Ausaf
INSTRUMENTS OF REGULATION AND CONTROL OF ISLAMIC BANKS BY THE CENTRAL BANKS - Jeddah

48 P, 17 x 24 cm- (Background Paper No.10) ISBN:
9960-32-097-9 -
1- Islamic economy 2- Banks and banking I- Title
331.121 dc 3357/21

Legal Deposit No. 3357/21 ISBN:
9960-32-097-9

First Edition 1413 H (1993) Second
Edition 1421H (2000)

CONTENTS

FOREWORD

The paper is another effort of IRTI in implementing one of the functions assigned to it by its Statute, i. e. to organize and conduct basic and applied research for application of Shar'ah in the field of economics, finance and banking.

Although many studies have recently been carried out in the area of central banking in Islamic framework, little work has been done on the examination of the practices of Central Banks, especially in the regulation and control aspects of Islamic banks. This study is significant in so far as it is specifically directed towards the latter issue.

The objectives of the study are to review the contemporary literature on central banking in Islamic framework, identify what instruments of monetary control are adopted, study the practices of central banks in regulating and controlling Islamic banks, ascertain whether or not the tools of control applied to Islamic banks are the same as those applied to traditional banks, and to undertake comparison of central bank practices in regulating and controlling Islamic banks in different countries.

Methodogically, the study is divided into two parts. The first deals with theoretical issues. The second part deals with current practices of central banks in regulating and controlling Islamic banks. Two cases of regulation and control of Islamic banks have been discussed.

It is hoped that this paper will be useful not only for policy makers in the Muslim countries who intend to apply Shari'ah in their economies but also benefit those who are actively involved in research or teaching in the areas of Islamic economics, banking and finance.

Prof. Dr. Abdel Hamid El-Ghazali
Director, IRTI

CHAPTER 1

INTRODUCTION*

Central banking performs an important role in regulating commercial banks and their various activities. The functions of a central bank are well known. A central bank is the government's bank as it keeps the deposits of the government and advances loans to it. It controls the supply of high powered money by having a monopoly on the issue of currency notes as well as by taking other measures. It is also a banker's bank as commercial banks keep their deposits with the central bank and it may advance loans to them at the time of a need by functioning as the lender of the last resort. While all of these functions constitute important dimensions of central banking operations, probably the most important task of a central bank is to control the credit created by commercial banks. This is a lever through which the monetary policy of the country is devised and implemented. The techniques to which central banks resort to control commercial banks' credit creation are also well known and include: legal reserve ratio, bank rate or discount rate policy, open market operations, qualitative or selective credit control and moral suasion.

With the emergence of Islamic banks in several countries belonging to the Organization of Islamic Conference (OIC) and with some countries committing themselves to the full scale Islamization of their banking sector, the following question has arisen : How should central banking operations be conducted in an interest free environment? It would be naive to emphasize too strongly that central banking operations in a modern economy hinge upon the concept of interest. The central bank pays interest, no matter how minimal or how nominal, to commercial banks on their deposits and charges them interest on the advances made to them. Interest rates are also the main vehicle through which monetary policy is implemented and monetary management and control are manipulated. For example, the variation in the bank rate or the discount rate is an important tool for the implementation of monetary policy in almost all interest based monetary arrangements whether they are in advanced industrial countries or in not-so-advanced developing countries. The central bank not only manipulates interest rates through various means but also adopts certain other measures such as the purchase and sale of government securities in the open market which have indirect links with interest rates. In addition to these techniques, the central bank also uses selective methods of qualitative and quantitative credit control, either in order to influence the final uses of credit or to channel it in certain desirable directions.

---

* The author is thankful to Dr. M. N. Siddiqi (King Abdul Aziz University, Jeddah) and Dr. Ridha Sa'adallah (Islamic Research and Training Institute, Jeddah) for reading an earlier draft and making useful suggestions. However, only the author is responsible for any remaining errors and shortcomings.

It is usually expected that by changing the interest rate and other relevant monetary variables, the central bank is able to influence the overall magnitude of credit creation in the economy. These techniques of credit control may have to undergo certain changes and modifications if the commercial banks start operating on a non-interest basis.

The regulation and control of Islamic banks by the central banks raises a number of serious issues. The financial operations of Islamic banks will have to be reviewed carefully in order to ascertain which of these operations create credit and need to be controlled and regulated. It is well known by now that Islamic banks perform a number of functions and undertake a number of financial operations[1]. Hence, only those operations which add to the money supply of the economy need to be controlled. Furthermore, what should be the battery of tools which may be used for controlling Islamic banks? Obviously, those techniques which involve interest in any respect, shall be out of question, as their use would be in conflict with the very nature of Islamic banks. Hence, some innovations in the techniques of credit control have to take place.

It may be held that present scene of Islamic banking consists of mainly two types of banking institutions:

(i) Islamic banking institutions operating mainly in the financial markets which are dominated by the interest based banking institutions and transactions. These are the Islamic banks operating in the Middle East and elsewhere.

(ii) The other category of Islamic banks belongs to those countries where efforts are underway to reorganize the whole banking system along the Islamic lines i.e. on an interest free basis.

In both categories, by now, sufficient experience has accumulated to warrant a study on the regulation and control of Islamic banks by central banks. In the first case, Islamic banks are subject to rules and regulations of central banks which grant them permission to operate in the money market and reserve the right to control and supervise their activities. However, these banks are also bound by their own statutes and Articles of Associations which require them to conduct their activities in accordance with the requirements of Islamic *Shari'ah.* It is possible that

1. For details of functions of Islamic banks and financial operations undertaken by them, see Ausaf Ahmad, Development and Problems of Islamic Banks, 1987, Islamic Research and Training Institute, Jeddah. Also see Ausaf Ahmad, Contemporary Practices of Islamic Financing Techniques 1989) Unpublished Research Paper, Islamic Research and Training Institute, Jeddah.

there might be certain situations in which the two sets of rules may not be completely compatible with each other. Any possible conflict or incompatibility between these two sets of rules and regulations might give birth to strained relations between Islamic banks and central banks.

In the second category, where all commercial banks operate on an interest free basis, the regulation and control of Islamic commercial banks assumes the form of conducting the monetary policy of the country on an interest free basis.

Furthermore, from the point of view of relations between Islamic banks and central banks, three cases can be distinguished: Firstly, there are some countries where Islamic banks are accommodated within the framework of the existing banking laws. This is the case with Islamic banks operating in Western Europe. Secondly, there are countries where special laws have been enacted allowing Islamic banks to function. This is the case in Jordan, Egypt, Turkey, Malaysia and several other Islamic countries. However, this legislation is mostly confined to the working of only a few Islamic financial institutions where the bulk of the money market is still controlled by conventional financial institutions. Thirdly, there are some countries where a comprehensive legal framework has been created for the Islamic banking system. This is the case in Pakistan and Iran and to some extent in Sudan.

In light of this it is felt that there is a need to examine how central banks regulate and control Islamic banks which claim to function differently in comparison to interest based commercial banks. It would be interesting to discover what techniques have been adopted by different central banks to deal with Islamic banking in their respective countries. Do central banks use the same techniques which they used before the Islamization of the banking system or have they modified their credit control techniques to suit new requirements? If yes, then what new modifications and innovations have been introduced? Are the new techniques capable of achieving the goals of monetary policy? This study has been conceived to examine these and other similar issues.

1.1 OBJECTIVES OF THE STUDY

The objectives of this study may be stated as follows:

i. To undertake a selective review of contemporary literature on central banking in the Islamic framework and to see what instruments of monetary management and control have been suggested at a theoretical level to deal with central banking in an interest free environment;

ii. To study the practices of central banks in regulating and controlling Islamic banks, particularly in those countries where Islamic banks operate in a mixed environment side by side with interest based banks;

iii. To ascertain whether or not the tools of control applied to Islamic banks in the above cases are the same as those applied to traditional commercial banks. If different, then how are they different and why?

iv. To undertake a comparison of central bank practices in regulating and controlling Islamic banks in different countries.

1.2 SIGNIFICANCE AND RELEVANCE OF THE STUDY

The significance of the present research study is based on the importance of the topic with which it deals. Although some research papers, mostly dealing with various theoretical aspects of central banking in an Islamic framework, have appeared in the recent past, no study exists which is devoted to an examination of the current practices of central banks in the regulation and control of Islamic banks in different Countries.

The relevance of this study to the member countries of the Islamic Development Bank (IDS) is obvious in that almost all Islamic banks, except a few which function in Western Europe, are located in IDB member countries. Those countries which have undertaken steps toward the Islamization of their entire banking system are also members of the Islamic Development Bank. Hence, it is reasonable to believe that these member countries and other relevant institutions may be interested in the outcome of the present research.

1.3 RESEARCH METHODOLOGY

This paper is divided into two parts: one dealing with theoretical issues and the other with the current practices of central banks in regulating and controlling Islamic banks. The second part is more empirical and adopts a case study approach.

Two cases of the regulation and control of the Islamic banks by central banks can be distinguished. The first case is comprised of those countries where the whole banking system is being restructured along Islamic lines and where efforts are underway to develop a legal framework for the conduct of central banking in an interest free framework. In this case, the regulation and control of Islamic banks (which includes all the commercial banks operating in the country) is essentially a question of conducting monetary policy on an interest free basis. Three countries, Pakistan, lran and Sudan are included in this group and the interest free instruments of monetary management and control used in these countries are discussed.

The other case consists of those countries where Islamic banks are functioning in a mixed environment, i.e. they exist side by side with interest based banks. The central banks in these countries are entrusted with the responsibility of control-ling and regulating the entire commercial banking system (including Islamic banks) and conducting the monetary policy of the country. In this case the regulation and control of Islamic banks in Egypt and Jordan have been studied.

CHAPTER 2

REGULATION AND CONTROL OF ISLAMIC BANKS: THEORETICAL CONSIDERATIONS

2.1 INTRODUCTION

Modern commercial banking activity, for a variety of reasons, can not be left uncontrolled. Commercial banks create credit and increase the money supply which in turn affects the level and magnitude of aggregate economic activity as measured by income, employment, price level etc. Because of its ability to create additional amounts of money, the commercial banking sector, occupies a strategic but precarious position in the economy. If left uncontrolled, it is possible that the banking sector may introduce destabilizing factors in the economy by adopting unsound credit policies. Hence, in almost all market economies, commercial banking activity is controlled and regulated by the central bank of the country, although the degree of control may vary from economy to economy.

One of the most important functions of a central bank, *inter alia,* is the regulation and control of the commercial banking system of the country. In a modern economy a number of tools and instruments are used by the central bank to exercise control over commercial banks. Some of the most widely used methods are: the legal reserve ratio, open market operations and the bank rate or the discount rate policy.

The purpose of imposing a legal reserve ratio (which is also sometimes referred to as the required reserve ratio) is not to make deposits safer or to keep banks liquid. Rather, its main purpose is to control the credit creating capacity of commercial banks. The commercial banking system has the capacity to create credit at several times the reserve ratio. If the reserve ratio is 10 percent, the banking system will be capable of generating 10 times more credit than its deposits. Thus, by raising or lowering the reserve ratio, the central bank can reduce or increase the credit creating capacity of commercial banks.

Open market operations refer to the purchase and sale of government securities by central banks to commercial banks, other financial institutions and individuals in the open market. By buying and selling securities in the open market, the central bank can expand or contract the reserves of commercial banks, and thus, influence their credit creating capacity.

The discount rate or the bank rate is the interest charged by central banks on any advances made to commercial banks. By introducing variations in the bank rate, the central bank, in a way, controls the price of the credit created by commercial banks. It is assumed that if commercial banks have to pay a higher (lower) interest rate themselves, they will charge an even higher (lower) interest rate to their clients. Thus, the demand for credit can be lowered (increased) by increasing (decreasing) the bank rate.

In some countries the methods of credit control include qualitative or selective methods of credit control, moral suasion and direct orders from central banks such as credit rationing.

With the emergence of Islamic banking, the following question is being raised: How should central banking operations be conducted in an interest free environment ? Can the same instruments of monetary management which are commonly adopted in the interest based financial system also be used in the interest free banking system or will new instruments have to be devised? What would be the nature of these new instruments and how. would they work? Would there be a need to control Islamic banks? What financing techniques of Islamic banking create credit and need to be controlled and how should they be controlled? All of these questions need to be dealt with when one speaks of central banking in an interest free environment.

Fortunately, the problem of central banking in the Islamic framework was addressed in the initial phases of the theoretical research on Islamic banking. In fact, as early as 1967, M. N. Siddiqi included a chapter on central banking in his book Banking Without Interest.[1] The emergence of Islamic banks in the mid 1970s and the adoption of an Islamic banking system by Pakistan and Iran in the early 1980s led to renewed interest in this area and several papers appeared on monetary policy and the central banking system in the Islamic framework. In this chapter a brief survey of these contributions will be undertaken with emphasis on the instruments of monetary management which can be used in an Interest free environment.

2.2 FUNCTIONS OF A-CENTRAL BANK IN AN ISLAMIC ECONOMY

Almost all economists writing on the subject, are in agreement that the central bank in an Islamic economy would continue to perform all of those functions performed by central banks elsewhere. Siddiqi accepts at the very outset 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" [Siddiqi, *Banking Without Interest* 1983 p.97.] He assigns almost all of the functions of a modern central bank to the Islamic central bank: it would be the government's bank and the government

1. This book was originally published in Urdu. An English translation was made available in 1973 with an improved version appearing in 1983.

would open all its accounts with it, it would conduct transactions domestically as well as internationally on behalf of the government, it would issue currency, it would be a bankers' bank, etc. However, its most important function would be conducting the economic and monetary policies of the State as "the central bank will keep a close watch on the general trend of business, employment, income and price spiral in the country and will take necessary steps to promote their general standard and maintain them at the desired levels." [Ibid., 1983, p.98.] Siddiqi also attaches immense importance to the "sincere advice and guidance of the central bank" in the conduct of monetary policy. [Ibid,. p.99.] The central bank will not only determine the priority sectors where loan finance or *Mudarabah* finance is required but it will also "inform all the banks regarding any additional capital investment being conducive or detrimental to the common interest so that they may refrain from the wastage of common resources" [Ibid, p.99.]

Uzair points out that among the seven functions usually undertaken by modern central banks three main functions will have to undergo significant change when the banking system is reorganized on an interest free basis. [(1])These functions are:

i. Controlling and regulating of credit,
ii. Acting as a lender of the last resort, and
iii. Promoting banking development in the country

Uzair thinks that the promotion of interest free banking and the conversion of interest based banks to interest free financial institutions would will be one of the prime functions of an Islamic central bank. It can perform this function by providing commercial banks with financial, technical and personnel assistance. Unlike Siddiqi, Uzair does not rule out the possibility that the central bank in an Islamic economy might be organized on the basis of profit. He suggests that an Islamic central bank might acquire equity share in the capital stock of commercial banks as does the Federal Reserve in the United States. This will ensure the central bank a permanent source of revenue and profit in the form of dividends received from commercial banks. There are other advantages in having central banks hold shares in commercial banks. Firstly, there would be no need to charge the commercial bank interest on discounting bills as the central bank would be entitled to a part of the profits of the commercial bank. Secondly, central banks would find that there would be more compliance with their instructions as they would have their representatives on the boards of directors of commercial banks. Thirdly, central banks as the highest

1. Uzair lists the following functions of an Islamic central bank. (i) Issue of currency (ii) Preservation of internal position and value of the currency of the country (iii) Preservation of external value of the currency and the necessary foreign exchange control and regulation (iv) Control and regulation of credit in the country (v) Acting as a lender of the last resort (vi) Promotion of banking development in the country along the lines desirable in the national interest, and (vii) Advisor to the Government in economic and financial matters. [Uzair, 1978, p.38]

banking authority would have a commanding position over commercial banks. [Uzair, 1978, pp. 38 - 43.]

Chapra while emphasizing all the traditional functions of a central bank, asserts that the Islamic central bank "should not confine its regulatory role merely to commercial banks. The central bank will also have to play a positive role in *the promotion, regulation and supervision of all financial institutions* with the objective of helping them and making them healthier and stronger." [Chapra, 1985, p.149, emphasis added.] However, he regards the central bank as a "primary institution responsible for implementing the country's monetary policy" and he considers legitimate the use of "whatever methods are necessary and not in conflict with the *Shari'ah."* [Ibid, p.148.] Crisis management in the face of liquidity and solvency crises, the supervision of commercial banks as well as of other financial institutions, the allocation of credit to fulfill social priorities, the translation of the monetary system of an Islamic State into specific actions and programs and the promotion of sound and healthy banking practices among Islamic banks are among other functions of a central bank mentioned by 6t Chapra. [Ibid., pp. 149 - 154.]

2.3 OBJECTIVES OF MONETARY POLICY IN AN ISLAMIC ECONOMY

The regulation and control of commercial banks by the central bank must take place within an overall policy framework. The central bank exercises the control over commercial banks to achieve certain predetermined goals. The main justification for the existence of a central bank and a well thought out, deliberate and discretionary policy to be implemented by the central bank is that each of the commercial banks cannot be allowed to go its own way. Instead, a mechanism should be present to coordinate the credit and investment policies of different banking institutions. This is done through the monetary policy of the central bank. Therefore, the regulation and control of commercial banks is always within the framework of a monetary policy in which certain instruments and tools are used to achieve predetermined goals.

Maintaining price stability, achieving a balance of payment equilibrium, promoting the growth of the economy, and assuring a reasonable amount of distributive justice are said to be the objectives of monetary policy in any modern economy. They need not be any different in an Islamic economy. However, the specific goals of monetary policy in an Islamic economy would be derived from the general goals of economic policy which are summarized by Chapra as follows:

i. Broad - based economic well being with full employment and an optimum rate of growth;

ii. Socioeconomic justice and the equitable distribution of income and wealth;

iii. Stability in the value of money to enable the medium of exchange to be a reliable unit of account, a just standard of payment, and stable store of value;

iv. Mobilization and investment of savings for economic development in an equitable manner such that a just return is ensured to all parties concerned;

v. Effective rendering of all services normally expected from the banking system. [Chapra, 1985, p.34.]

Chapra himself has conceded that "it may be argued that the goals and functions of the Islamic money and banking system as stated above are the same as those under capitalism." [Ibid, p.34.] but he is quick to point out that the goals of monetary policy in an Islamic economy will be qualitatively different from those in a capitalist economy as "there is a significant difference in emphasis, arising from the divergence in the commitment of the two systems to spiritual values, socioeconomic justice and human brotherhood." [Ibid, p.34.]

Most writers on the subject agree that "the major objectives of monetary policy of the central bank in an interest free banking system will be basically the same as those that are found elsewhere viz. (i) to promote a sustained and balanced economic growth in the country (ii) to maintain economic stability, so as to avoid periodic fluctuations of excessive inflation and severe recessions (iii) to maintain stability in the external value of currency, and (iv) to promote an equitable distribution of income and wealth. [Uzair, in Mohammad Ariff, (ed.), 1982, p.223.] Hence, the monetary policy makers of an Islamic economy will have to find the policy instruments which can be used to attain these objectives. However, at this point it may be relevant to take note of the famous Mead Tinbergen principle that the number of policy instruments should equal the number of policy objectives, if multiple objectives are to be achieved. Otherwise, there might be conflict in policy goals. Keeping this in mind, Ariff points out that redistributive justice etc. should be tackled by other policy tools and monetary policy should confine only to those goals which it can achieve. [Ariff's comment on Chapra's paper in Ziauddin Ahmad et.al.(eds.),1983, pp.47-48].

In light of the above, it could be said that the maintenance of stability in the internal and external values of money and the provision of finance for productive investment and other economic activities would be the chief goals which the monetary policy of an Islamic economy would strive to achieve. These goals per se may not be specific to an Islamic economy but the qualitative emphasis put on them would be significantly different.

Similarly, the instruments through which monetary policy is implemented may undergo significant changes in an Islamic economy as compared to a capitalist economy.

2.4 INTEREST FREE INSTRUMENTS OF MONETARY MANAGEMENT

It is generally believed that, in a free enterprise economy, commercial banking and other financial activities and transactions are linked by interest rates. There-fore, it is only natural that interest rates should play an important role in central banking particularly in the regulation and control of the commercial banking system. Bank rate policy as well as open market operations are geared toward influencing the market rate of interest. Following classical and neoclassical economic theory, it is expected that changes in the market rate of interest will control the quantum of credit, the supply and demand for money and other monetary variables which, in turn, will influence other aggregate variables of macroeconomic activity.

With the emergence of Islamic banking, the following question arises: What tools of central banking can be used in the absence of interest rates? Professional economists who have been concerned with the evolution of monetary policy in an Islamic economy have advanced several proposals for devising new tools of credit control while advocating vigorous use of some already available instruments which do not involve interest. In this section such interest free instruments of monetary management and control will be reviewed.

I. LEGAL CASH RESERVE RATIO

Also known as the Required Reserve Ratio (RRR), this is a standard technique of credit control. The central bank requires commercial banks to reserve a fixed part of their total deposits. The ratio of these compulsory or required reserves to total deposits is called the legal or required reserve ratio. The inverse of the reserve ratio is known as the money multiplier and measures the capacity of the commercial banking system to create credit. For example, if the required reserve ratio is 10 percent, then the commercial banking system would be able to create an amount of credit equal to 10 times the value of its deposits. Thus, the money multiplier would be 10.

By changing the required reserve ratio, the central bank aspires to change the value of the money multiplier as well as the monetary base which is used to create credit.

Since the Required Reserve Ratio (RRR) does not involve interest in any way, it could be one of the techniques which the central bank might use for regulating and controlling Islamic banks. However, one would need to redefine the RRR with respect to the accounts operated by Islamic banks. In Siddiqi's scheme of interest free banking, commercial banks would operate loan accounts and *Mudarabah* accounts. Interest free commercial banks would be required" to reserve a fixed part of the capital deposited in their loan and *Mudarabah* accounts." [Siddiqi, 1983,

p. 101.] This is defined as cash reserve and its ratio to total bank deposits is called the cash reserve ratio. The central bank would be in a position to influence the lending and *Mudarabah* operations of interest free banks by changing the cash reserve ratio. If the central bank wishes to expand the supply of money, it would lower the cash reserve ratio which would increase the amount of loan able resources with commercial banks. Consequently, commercial banks would take the necessary steps to advance more funds on the principle of *Mudarabah .* This would increase the supply of money in the economy. The central bank would raise the RRR if it wishes to reduce the supply of money.

With regard to the application of the cash reserve ratio to the interest free banking system, two main ideas have emerged. The first is the proposal that the legal cash reserve ratio should be 100 percent. The other idea is that the system of cash reserves should be made applicable to demand deposits only. Both of these ideas will be briefly examined here.

Some Muslim economists have proposed doing away with the system of fractional reserve by introducing a 100 percent reserve requirement in the Islamic banking system[1]. Their argument is that the fractional reserve system leads either to the creation of multiple deposit which introduces instability in to the system or leads to either inflation or recession. Furthermore, the fractional reserve system is said to be unjust in that it gives the power of credit creation to commercial banks, where as this power should belong to society as a whole, represented by the central bank. Thus, in the event of a 100 percent reserve requirement being implemented, only the central bank would be authorized to create additional purchasing power by issuing new currency. However, this proposal has not convinced every one and many writers on the subject do not agree with it. air observes that "Such a requirement will, however, impose unnecessary rigidity which will cripple the entire system....there is no reason why a 100 per cent reserve requirement should be the corner stone of the central banking policy in an interest free economy" [Uzair, in Mohammad Ariff (ed.), 1982, p.226.] Similarly, Ariff has strongly opposed the proposal asserting that "this (the proposal of a 100 percent reserve requirement) really means that the commercial banks would be reduced to safe - keeping institutions.

---

1. Some of the writers who have advocated a 100 percent reserve requirement include Kahf, 1978 p.73 and At Jarhi, 1983, pp.69-71. The reason that these and some other economists have proposed 100 percent reserve requirement is that they are opposed to excessive credit creation by the commercial banking system. For example, Mahmoud Abu Saud observes, that "Banks gain a lot out of thin air or no air at all. They create an artificial purchasing power and take advantage of the demand for it. This demand is also illicitly created by those who have managed to liquidate their assets and preferred to enjoy a guaranteed income against their withheld money" (Abu Saud, 1981, p.91). Some other *writers* who have opposed *credit* creation by the interest free banks on various grounds include: S.M. Yusuf, (Economic Justice in Islam, S. M. Ashraf, Lahore 1971) and M. Uzair, An Outline of Interest Free Banking, (Raihan Publications, Dhaka, 1965).

For then, the commercial banks can not even invest the funds deposited with them, let alone "create" deposits." [Mohammad Ariff, in Ziauddin Ahmad et.al. (eds.), 1983, p.48.] In fact, if a 100 percent reserve requirement is imposed on the commercial banks then the amount of credit in the economy would be reduced to zero and high powered money would consist of only the currency issued by the central bank which commercial banks would channel into investments.

The proposal of imposing the cash reserve requirement only on demand deposits has been put forth by Chapra who is in favor of the fractional reserve system but wants to exempt *Mudarabah* deposits from this requirement. [Chapra, 1985, pp. 197-991 Putting cash reserve requirements only on demand deposits is justified by him on the grounds that *Mudarabah* deposits (or investment deposits in the terminology of Islamic banks) are held in the form of equities. Since other forms of equities are not subjected to cash reserve requirement, there is no justification for *Mudarabah* deposits being subjected to such a condition.

Chapra has also argued that the objectives of maintaining the safety of deposits and of ensuring adequate liquidity should be achieved through a means other than the cash reserve system such as "a higher capital requirement, well conceived and properly enforced regulations, including a suitable liquidity ratio, supplemented by an effective bank examination system." [Ibid., p. 198.].

There are several arguments against these proposals. Firstly, Chapra proposes that the main control point of the money supply should be right at the source, i.e. the high powered money issued by the central bank. In other words, the central bank should exercise restraint in the issue of currency. Without disagreeing with the suggestion, it may be argued that mere restraint in the issue of currency will not enable policy makers to devise a sound policy for the control of the money supply in an Islamic economy.

It has been noted that high powered money constitutes only a small portion of the total money supply in the economy, which includes both cash and demand deposits in commercial banks. In fact, demand deposits in commercial banks are so liquid that there is hardly any distinction between them and hard cash. Hence, no policy of money supply control would be likely to succeed unless it controls both components of money supply, i.e. cash and demand deposits in commercial banks.

Secondly, the twin objectives of the cash reserve system (i.e., ensuring reasonable levels of liquidity and control on the overexpansion of credit) cannot be effectively achieved by imposing the statutory reserve requirement only on demand deposits. Ariff has correctly pointed out that the statutory cash reserve requirement "becomes all the more important and necessary for the *Mudarabah* deposits. Since *Mudarabah* deposits can not be withdrawn immediately, the banks will tend to commit these funds on long term projects which are profitable, at the expense of liquidity considerations. In such circumstances, the statutory reserve requirement against the *Mudarabah* deposits will force the banks to keep a part of these deposits in liquid form and limit their scope of credit expansion." [Mohammad Ariff in Ziauddin Ahmad et al. (eds.), 1983,p.50]

Thirdly, Chapra also proposes the transfer of 25 percent of all commercial bank deposits to the government as a means of financing public expenditure alongside the imposition of a 10 to 20 percent cash reserve requirement. This would amount to "cutting the wings" of the commercial banking system as it would be deprived of 35 to 45 percent of its demand deposits. Although Chapra is in favor of the fractional reserve system,it appears that the proposal of a one hundred percent reserve requirement has deeply influenced his thinking.

The Council of Islamic Ideology (CII) of Pakistan in its report on Elimination of Interest from the Economy (hereafter referred to as the CII Report) recommended that a legal cash reserve requirement could also be used in an interest free economy "with minor changes". The change suggested by the CII was as follows: in the interest based system if at the close of any working day the balance held by any commercial bank with the central bank was below the minimum required, then the commercial bank has to pay the interest on the amount of short fall to the central bank at a rate which is 3 to 5 percent higher than the bank rate. The council suggested that this system could be replaced by a system where the central bank would be in a position to impose fines per day related to the amount of default.

II. REFINANCE RATIO AND LENDING RATIO

Siddiqi suggests several-innovative tools which would enable central banks to control and regulate commercial banks operating on an interest free basis. In order to control the creation of multiple deposit, he suggests the use of a refinance ratio and a lending ratio which would be controlled by the central bank. The refinance ratio would move in the opposite direction from the cash reserve ratio. If the central banks wishes to reduce the expansion of credit, it would lower the refinance ratio and to increase the supply of credit, it would increase this ratio. Similarly, appropriate changes in the lending ratio would be able to manipulate short term credit in the desired directions.

III. PROFIT SHARING RATIO

Uzair, following an age old tradition in monetary economics, makes a distinction between the "general" or "quantitative" and "selective" or "qualitative" methods of credit control. [Uzair, 1978, p.45.] Standard methods of credit control such as the bank rate, the legal reserve requirement, open market operations, etc. are designed to control the magnitude of total credit. Hence, they are called quantitative methods of credit control. Selective or qualitative methods, on the other hand, control the direction and purpose for which credit is advanced.

Uzair thinks that "in the interest free banking where commercial banks are operating not on the basis of interest but on the basis of profit sharing" the bank rate policy as an instrument of credit control "is completely irrelevant. A new tool of credit control will have to be substituted, namely the "Ratio of Profit Sharing" between the banks and its clients" [Ibid, p.48.)

According to this scheme the central bank would regulate the profit sharing ratio in place of the bank rate. The profit sharing ratio between commercial banks and depositors shall be called the depositors' share ratio or depositors' dividend and shall be analogous to the rate of return on deposits. The profit sharing ratio between the bank and entrepreneurs shall be called the investors share ratio. The regulation of the depositors' share ratio will determine the supply of money and the investors' share ratio will influence the demand for money and the volume of investment in the economy. It is also possible to introduce selective credit control through the discretionary use of the profit sharing ratio. The central bank will announce different profit sharing ratios for different sectors, giving favored treatment to priority sectors. Uzair asserts that the use of the profit sharing ratio as an instrument of monetary management and control in an interest free economy is both feasible and desirable. [Uzair, in Mohammad Ariff, (ed.), 1982, pp. 220-222.]

The CII Report also recommended that "the bank rate weapon would need to be replaced by the power an the part of the State Bank (central bank in Pakistan) to fix its profit sharing ratio or ratios in respect of its own financial assistance to banks and other financial institutions as also the power to prescribe maximum and minimum profit sharing ratios for scheduled banks in respect to finance provided by them" [Ziauddin Ahmad et al.(eds.), 1983, p.197.].

However, some economists, like Chapra, do not consider it desirable to use the profit sharing ratio as an instrument of monetary policy. They prefer "to leave the determination of the ratio to the negotiating parties in conformity with their perception of market conditions and of profitability" [Chapra, 1985, p.203.] Chapra accepts the possibility that the central bank being a nonprofit institution, may be willing to accept a lower share of profit in the interest of achieving certain social objectives, but he sees no reason why commercial banks and depositors should be compelled to accept a lower share of profit than market conditions would allow. [Chapra, 1985, p.203.]

IV. OPEN MARKET OPERATIONS

In an interest based economy, the central bank can also lower or raise bank reserves by selling or buying long term government securities. This is referred to as open market operations.

In most central banks which use this technique, there is an operations committee which holds its meeting at regular intervals to review the money and credit situation and the overall monetary requirements of the economy, keeping an eye on the macro economic situation. Thus, the central bank decides what corrective measures it should take. For example, if the central bank feels that inflationary pressure is building up in the economy and this is the time to reduce the monetary reserves of commercial banks, then it would sell the securities in its portfolio. These government securities are bought by dealers in government bonds, financial institutions, commercial banks, and individual investors. The payment to the central bank is usually by means of cheques which are presented to commercial banks for clearance. Thus, the reserves of commercial banks are reduced.

Similarly, if the central bank wishes to pump more money into the system, it will buy government securities from the open market.

There are two main difficulties in the application of open market operations in an Islamic economy. One of these difficulties is conceptual and the other is institutional. The conceptual difficulty is that almost all financial instruments such as government securities, short-term bonds, treasury bills etc. are interest based instruments and are incompatible with Islamic banking. Hence, "the open market operations will require fundamental changes to become applicable in the Islamic setup". [Uzair, in Mohammad Ariff (ed.), 1982, p. 219.]

The institutional difficulty is the rather underdeveloped nature of the financial markets in Muslim countries. In fact, there are only a few Muslim countries in which the central bank could make use of open market operations. Considering the state of the financial markets, it is held that the scope of open market operations is "much more limited" in Muslim countries than in developed countries. [Uzair, 1978, p.45.]

Siddiqi in his first book on interest free banking, envisaged that the government could issue commercial shares based on the principle of profit sharing. The central bank of the country may be authorized by the government to deal in the sale and purchase of these commercial shares. The purchase and sale of commercial shares by the central bank would be analogous to the open market operations of the central bank in the interest based system. If the central bank decides to expand the supply of money in the system, it would announce the purchase of commercial shares which would be held by individuals and business institutions including commercial banks. The central bank may purchase these commercial shares either at the current market price or may even offer a price higher than the market price. The shareholders would be paid in cash for their shares by the central bank. This would increase the supply of money in the system. Similarly, the supply of money could be contracted by selling commercial shares. Thus, in Siddiqi's model of interest free banking, the open market operations of the central bank could be conducted without much difficulty [Siddiqi, op.cit., 124 - 127.]

The CII Report also accepts that there is little scope for the use of open market operations in an interest free context, at least for the present, because of under developed security markets. With the abolition of interest, open market operations in the traditional sense of the term would cease as fixed interest bearing securities would be abolished. However, the CII does not rule out the possibility of devising financial papers and securities which would not be based upon a fixed rate of interest. The Report asserts that it may be feasible to resort to open market operations again when the central bank issues its own "variable dividend securities" in which" the holders of the securities would share with the State Bank (central bank in Pakistan) in the profit / loss arising from its domestic transactions on the basis of the daily product of the capital deployed by the bank from its own sources and the amount of funds received through the sale of securities." [Ziauddin Ahmad, *eta/. (eds.),* 1983, p.175.]

However, Chapra again has serious reservations about the possibility of commercial shares (or profit and loss sharing certificates which would be identical to commercial shares if business corporations were organized on the basis of *Mudarabah) as* a substitute for open market operations.

Basically, there are three objections:

(i) It is not desirable for the central bank to buy and sell the shares of private sector companies. At best, it can be allowed to buy and sell the shares of public sector companies.

(ii) The buying and selling of commercial shares will not have the necessary depth which is enjoyed by government securities. Furthermore, these operations, if undertaken on any significant scale, would influence the market prices of shares. If it is decided that the prices of shares should remain unaffected, the scale of operations would have to be reduced drastically with the result being that open market operations may lose their relevance as an instrument of monetary policy.

(iii) Lastly, the intervention of the central bank in the stock market will unnecessarily reward or penalize the holders of commercial stocks, the prices of which would change as the result of the central bank's action.

Chapra's objections, while pointing out to the limited scope of open market operations in an interest free economy, are not insurmountable. With a little ingenuity, it is possible to devise financial papers and securities whose yield is related to some productive enterprise. These securities may be used in the open market operations of the central bank.

V. PUBLIC SHARE OF DEMAND DEPOSITS

This is an entirely new tool for the central bank's control over commercial banks. It has been suggested by Chapra who has proposed that a certain proportion of demand deposits of commercial banks, (up to a maximum of 25 percent under normal circumstances) should be diverted to the public treasury to enable the government to finance socially beneficial projects. Chapra has advanced three main reasons as the rationale behind this proposal: "that commercial banks act as agent of the public for mobilizing the society's idle resources; the banks do not pay any return on demand deposits; and the public does not bear any risk on these deposits if these are fully insured." [Chapra, 1985, p.197.]

In an earlier paper, Chapra provided further details regarding this proposal. The amount obtained by diverting a certain portion of the demand deposits of commercial banks to the public treasury is to be used mainly for social projects where no measurable economic return accrue and where profit sharing is not feasible. These projects will help achieve such Islamic economic goals as: the eradication of poverty, the establishment of social and economic justice, and the equitable distribution of **income and** wealth. The amount diverted from demand deposits to be considered as a *Riba* free loan *(Qard Hasan)* to the government against which the government will issue non interest bearing and nonmarketable securities. The securities will have a **maturity** date and will be redeemed on that date. The government will also pay "a service charge on this amount equivalent to 25 per cent of the operational cost of **banks** in **mobilizing** demand deposits. The service charge will not be in the nature of *Riba* because the government would only be reimbursing the commercial banks on a pro-rata basis..." Chapra, in Mohammad Ariff (ed.), 1982, p.165-66.]

Although Chapra has advanced this proposal mainly to finance public expenditure of a social nature where returns are nonpecuniary, there are indications that he also has some notion that the public share of demand deposits could be used as a tool of discretionary monetary policy. In this connection he has made three points: (i) that the ratio of 25 percent has been suggested as a maximum under the normal circumstances. "It may be exceeded only in exceptional circumstances when there is a national emergency or when the government has to play the role of a locomotive in an economic slowdown". (ii) He has suggested that in a recession when commercial banks are stuck with excess liquidity, the use of the larger share of commercial banks demand deposits by public authorities would be beneficial for both commercial banks and the national economy. (iii) He also observes that "in normal situations the ratio used by the government may be smaller than 25 percent unless it is used as a mechanism to siphon off a part of the extra profit of banks in an economic boom and to reduce the liquidity of the private sector" [Chapra, 1985), p.197.]

It appears that, in Chapra's opinion, the public share of demand deposits exhibit much potential as a tool for discretionary monetary policy. However, there are some problems with this proposal. The following objections may be advanced against the use of the public share of demand deposits of commercial banks:

(i) If, under normal circumstances, a low proportion of the demand de-posits of commercial banks is claimed by the government, as has been suggested by Chapra, it may defeat the purpose of this provision as it may not be sufficient for providing adequate finance for socially beneficial projects.

(ii) The main purpose of the proposal seems to be to provide a method of financing public expenditure without requiring to the government re-sort to deficit financing rather than to exercise control and regulation over commercial banking activities, particularly credit creation activities.

(iii) Sometimes situations in the money market change quite quickly which calls for quick policy responses. If the share. of demand deposits claimed by the government is used as an instrument of monetary policy and changed too frequently, it may not provide the government a reliable source for finance for socially beneficial projects. It should be kept in mind that the government finance required for such purposes is mostly long term.

(iv) The suggested tool has an inherent bias towards a larger public share of demand deposits. Chapra himself suggested that under recessionary conditions, the government will use a greater share of commercial bank demand deposits in order to reduce excess liquidity with banks. He has not elaborated the mechanism of the tool under inflationary conditions, but it may turn out that the government finds itself compelled to claim an even larger share of demand deposits to reduce the liquidity of the private sector in periods of inflation. So, in both cases, the government ends up with a larger share of demand deposits.

(v) There may be other reasons as well which may lead to a higher share of demand deposits claimed by the government. Once the government has been given access to the demand deposits of the commercial banks, it may turn out to be as tempting for the government as deficit financing is to day. Although Ariff considers this proposal to be "a non inflationary way of financing government expenditure" [Ariff's comment on Chapra's paper, in Ziauddin Ahmad et al, (ed.) 1983, p.49] other economists have their reservations arguing that it could be as inflationary as deficit financing. [Mohammad Sager' comment in Mohammad Ariff (ed.),1982, p. 185.]

(vi) Chapra has also observed that it may be used "as a mechanism to siphon off a part of the extra profit of banks in an economic boom" [Ibid., p.197]. One wonders how the public share of demand deposits could manage this. The demand deposits belong to the general public. If a certain proportion of these deposits is claimed by the government, how does it "siphon off the part of the extra profit of the banks?"

VI. CREDIT CEILING

The credit ceiling is yet another method through which the central bank controls the operations of commercial banks. This method is quite popular in most developing countries because in the case of undeveloped (or even nonexistant) financial and money markets, other methods of general credit control such as bank rate and open market operations are not likely to be very effective.

This is a direct method of credit control in which the central bank of a country sets separate credit ceilings for each commercial bank. Because of its non interest nature, the technique may be applied in the interest free banking system.

Chapra advocates the use of a credit ceiling for an Islamic economy for two main reasons: First, it is not possible to determine the flow of funds to the banking system accurately. Secondly, in his opinion the relationship between commercial bank reserves and credit creation is not very precise. Therefore, credit ceilings may be used in consonance with monetary targets. However, he caution that the allocation of credit ceilings must be done in such a way that healthy competition among various commercial banks is not adversely affected. [Chapra, 1985, p.200.]

The CII Report also approved the credit ceiling as a method of monetary control in an interest free banking system. In Pakistan the central bank used to fix quarterly credit ceiling for a commercial banks. Under the interest based system, if a commercial bank exceeded its credit ceiling, it was required to deposit with the central bank an amount equal to the excess. If the bank failed to deposit such an amount, a penal interest rate was charged. The CII Report recommended the continued use of credit ceilings with the suggestion that penal interest should be replaced with "a system of penalty such as fine related to the quantum of excess over credit ceiling" [CII Report in Ziauddin Ahmad, et. al (ed.) 1983, p.164].

VII. VALUE ORIENTED ALLOCATION OF CREDIT

This scheme has also been proposed by Chapra. The basic premise of this proposal is that bank credit is created on the basis of deposits belonging to society, hence credit should be used to achieve social goals. In terms of the banking sector, social goal have been defined by Chapra as an arrangement by which the allocation of credit could lead to the optimum production and distribution of goods and services required by the majority of society. [Chapra, 1985, p. 200.]

In order to achieve these goals, Chapra recommends the preparation of a value oriented plan which will identify the goals, priorities and credit requirements of different sectors of the economy. This value oriented plan would be given to commercial banks for implementation. According to Chapra, an elaborate system of "rigid controls" and "excessive intervention" is not required for the efficient implementation of this plan. An appropriate institutional framework and a proper incentive mechanism should be able to achieve the targets and goals of the value oriented plan. [Ibid., p.201.]

Although not as formal as the value oriented plan of Chapra, the CII Report has recommend a similar system in the form of mandatory targets for priority sectors. In Pakistan, an institutional mechanism exists for determining the mandatory targets which are prescribed for commercial banks by the central bank (State Bank of Pakistan) on the recommendation of the National Credit Consultative Council. The present priority sectors are business, industry, agriculture, and low cost housing. The CII Report recommended the continuation of this practice but wanted to change the penal interest clause so that it would conform to the interest free system.

VIII. SELECTIVE METHODS OF CREDIT CONTROL

Almost all writers on the subject agree that selective or qualitative methods of credit control would play a more important and significant role in an Islamic economy than general or quantitative methods. [Chapra, 1985, p. 202; Uzair, 1982, etc.] It is generally known that quantitative methods of credit control are designed to control the volume of credit while the purpose of selective methods of credit control is to influence the direction of credit. It is generally held that the strategic role of selective methods of control will add allocate and distributive dimensions to the functions of an Islamic central bank. Several methods of selective control suggested by Muslim economists can be listed here:

(i) Refinance Scheme: Under this scheme, the central bank first identifies the priority sectors and then extends special matching credit to those commercial banks which have extended finance to the weakest sectors. In the interest based system, the central bank extends matching credit at a lower rate of interest. Under the interest free system, matching credit would be offered either as an interest free loan (*Qard Hasan)* or on the basis of profit sharing. If it is offered on the basis of profit sharing, the central bank would share in the profit with commercial banks when they offer finance with the help of central bank funds. In order to make it concessionary and to encourage further financing in the priority sectors, the central bank may itself opt for a lower profit sharing ratio. [Uzair, in Mohammad Ariff (ed.), 1982, pp. 218 - 219.]

(ii) Other Methods of Selective Control: The central bank of the country may also employ certain other methods of selective credit control in an Islamic economy. For example, it may determine the minimum and maximum profit sharing margin requirements, it may fix and change from time to time the maximum periods for which advances may be granted by commercial banks for certain priority sectors, etc.

The CII Report has also approved of these methods of selective credit controls arguing that most of these methods do not involve interest in any way [CII Report in Ziauddin Ahmad et al.(eds.),1983, p.165.]

IX. LENDER OF THE LAST RESORT

The central bank also functions as the lender of the last resort to commercial banks, i.e. if any commercial bank faces a liquidity problem and is short of cash, the central bank may bail it out by providing it with an appropriate loan. In an interest based economy, such loans are provided on the basis of interest. In an Islamic economy, the central bank could perform this function either by providing an interest free loan *(Qard Hasan)* with or without a service charge.

X. ISSUE OF DIRECTIVES

Most central banks also have the power to issue direct instructions to all commercial banks or to any particular bank. This power is used by the central bank to regulate the interest rates on various kinds of deposits, to provide credit for any specific purpose etc. In an interest free system, the central bank would continue to enjoy this power, and would regulate the profit sharing ratio on investment and saving deposits by issuing guidelines for the maximum and minimum profit sharing ratio for different kinds of deposits.

XI. MORAL SUASION

Moral suasion refers to informal contacts, consultations, and meetings between central bank officers and commercial bankers, by means of which the central bank may explain its policies to commercial banks and urge them to exercise restraint in their activities, or to guide them towards achieving certain goals which the central bank considers desirable. This technique would also remain the same in an interest free system although some Muslim economists are of the opinion that moral suasion will have to play an even more significant role in interest free economies than it does in interest based economies.

XII. OTHER TECHNIQUES

In addition to the techniques of monetary management and control discussed above, there are several other suggested techniques through which the central bank in an interest free economy may exercise control over the commercial banks. Some of these techniques are as follows:

a. The central bank can control the *Qard Hasan* ratio which is defined as a percentage of demand deposits which commercial banks advance as interest free loans.

b. The central bank can determine the maximum and minimum amount of service charge which commercial banks are allowed to charge their clients.

c. The central bank can determine the weights given to saving deposits of different maturities for profit sharing ratios. This would replace minimum interest rates on different kinds of saving deposits.

d. The central bank can prescribe the specific modes of finance to be used in specific sectors.

e. The central bank can also determine the range within which the markup rate for *Murabahah* operations may vary depending upon market conditions.

f. The central bank can use appropriate methods to regulate the proportion of bank finance going to different modes of finance, such as *Murabahah, Musharakah, Mudarabah,* leasing, etc.

This shows that there are enough policy tools which can be used by the central bank of an Islamic economy to devise an appropriate policy package to implement its monetary policy and to achieve its predetermined goals.

CHAPTER 3

REGULATION AND CONTROL OF COMMERCIAL BANKS IN AN ISLAMIC BANKING SYSTEM

3.1 INTRODUCTION

In the early 1980s, some countries decided to switch from interest based commercial banking to Islamic banking. The Law of Usury Free Banking was passed in Iran in 1983 and the necessary institutional framework was created by early 1984. The process of Islamization of the banking sector in Pakistan started earlier but remained gradual and partial as, in the beginning, only some specialized credit institutions in the public sector were asked to reorient their activities along Islamic lines. In 1981, all commercial banks in Pakistan were permitted to accept deposits on the basis of Profit and Loss Sharing (PLS). In July 1985, Pakistani banks were instructed not to accept any interest bearing deposits and to convert all deposits into PLS deposits. In Sudan, all commercial banks were prohibited to operate on the basis of interest on 10 December, 1984.

The purpose of this chapter is to examine the instruments of monetary control and monetary management which these countries adopted after changing to an Islamic banking system. These instruments will be different from what they were in the interest based system, and they will also differ from the instruments used in those countries in which Islamic banks and interest based banks exist side by side.

In a country where all commercial banks operate along Islamic lines on a non-interest basis, the question of the control and regulation of the commercial banking system, becomes basically a question of the evolution and implementation of monetary policy in an interest free environment. It is a case closest to theoretical formulations of Islamic banking in which it is assumed that all commercial banks in the system are operating on interest free basis. At a practical level, a legal framework is provided to conduct monetary policy in an Islamic framework. Thus, there are theoretical and empirical reasons for the study of these cases.

However, the intention here is not to study monetary policy as such which requires an analysis of goals, instruments and effects in an integrated framework. The purpose here is confined to a close examination of the instruments used for the control of Islamic commercial banks which can later be contrasted with the instruments used for Islamic banks functioning in a mixed environment in which the legal framework has not been especially designed for the requirements of Islamic banking.

3.2 REGULATION AND CONTROL OF COMMERCIAL BANKS IN IRAN

The legal framework for the functioning of the Islamic banking system in Iran is provided by the Law for Usury (interest) Free Banking 1983 which was ratified by the Islamic Consultative Assembly (Iranian Parliament) and approved by the Council of Protectors. While in Pakistan, the existing rules and regulations were legislated and modified, usually by executive orders to suit the requirements of Islamic banking, in Iran, completely new laws were enforced. Thus, banking institutions in Iran were completely overhauled after the Islamic Revolution of 1979. The law outlines the objectives and duties of the banking system, and the methods of the mobilization of its resources and provides for central bank and the conduct of its monetary policy.

The central Bank of Iran is called *Bunk Markazi Jomhouri Islami Iran* (BMJII), i.e. the Central Bank of the Islamic Republic of Iran. According to Article 21 of the Law of Usury Free Banking, the BMJII is not authorized to engage in banking operations which involve usury (interest). Similarly, commercial banks are also not supposed to indulge in such activities among themselves. The BMJII is empowered by Articles 19 and 20 of the Law to supervise monetary and banking activities by using the following instruments:

" Fixing a minimum and/or maximum ratio of profit for commercial banks in their joint venture and *Mudarabah* activities. These ratio may vary for different fields of activities.

ii. Designation of various fields for investment and partnership within the framework of the approved economic polices, and the fixing of a minimum prospective rate of profit for the various investment and partnership projects; the minimum prospective rate of profit may vary with respect to different branches of activity.

iii. Fixing a minimum and maximum margin of profit, as a proportion to the cost price of the goods transacted, for banks in installment and hire purchase transactions.

iv. Determination of the types and the minimum and maximum amounts of commissions for banking services, provided that they do not exceed the expense of service rendered and the fees charged for putting to use the deposits received by the banks.

v. Determination of the types, amounts, minimum and maximum bonuses to different kind of deposits.

vi. Determination of the minimum and maximum ratio in joint venture, *Mudarabah,* investment, hire purchase, installment transactions, buying and selling on credit, forward deals, *Muzara'ah, Musaqat, Joa'alah,* and *Qard Hasan* for banks or any thereof with respect to various fields of activity; also fixing the maximum facility that can be granted to each customer." [Article 20 of the Law for Usury Free Banking.)

The Islamic Republic of Iran has also enforced various regulations pertaining to the functions and activities of the BMJII which have been made for designing and implementing the money and credit policies of the country in consonance with general economic policies. In order to achieve the goals of economic and money and credit policies, the BMJII is empowered by Article 3 of the regulation relating to Chapter 4 of the law for Usury Free Banking to supervise the commercial banking system. The BMJII has been accorded the necessary powers to determine (a) the legal reserve requirement for various types of bank deposits; (b) the various fields of investment and partnership; (c) the minimum and/or maximum share of profit for banks in *Mudarabah* and *Musharakah;* (d) the minimum and maximum expected rate of return to commercial banks from various facilities; (e) the minimum ratio of liquid assets to asset liabilities; (f) the maximum amount of credit facility granted to each client whether a real or a legal person; (g) the ratio of credit facilities granted by each bank to that bank's capital. [Regulation Relating to Chapter 4 of the Law for Usury Free Banking.]

3.3 REGULATION AND CONTROL OF COMMERCIAL BANKS IN PAKISTAN

Pakistan when embarked upon Islamization of its banking system in 1979, its banking and financial structure was relatively well developed in comparison to other Islamic countries, The process of Islamization in Pakistan has been gradual. Instead of establishing an entirely new legal framework for conducting banking business along Islamic lines, a course of action was chosen which involved the modification of the then existing laws to the extent required. Even before the Islamization of banking, the State Bank of Pakistan (SBP), which is the central bank of the country, used direct and selective methods of credit control. Annual credit plans and targets were formulated in accordance with the development plans of the country and credit was allocated accordingly. Under these circumstances, general methods of credit control were used mainly for "Prudential Purposes" [Igbal and Mirakhor, 1987, p. 21.] In this section, we shall explore the methods of credit control employed by the SBP after the Islamization of the banking system in Pakistan.

1. **LEGAL RESERVE REQUIREMENT**

Under Section 36 (1) of the SBP Act of 1956, all scheduled commercial banks in Pakistan are required to maintain with the State Bank of Pakistan (SBP) cash reserve equal to five per cent of their total demand and time deposits. Under the interest based system, penal interest was recovered from scheduled banks if their cash reserve fell short of the required amount. In accordance with the recommendation of the CII Report, the system of penal interest has been replaced by a system of penalty and fines. [Zaidi, 1987, pp.118 -120.]

II. **WORKING AS LENDER OF THE LAST RESORT**

been before the Islamization of the banking system, the SBP only made limited use of the bank rate policy because the borrowing facility from the SBP to commercial banks was restricted to certain specific refinancing facilities. Thus, there were not frequent changes in the bank rates. [Igbal and Mirakhor, 1987, p.21.].

After the Islamization of the banking system, the use of bank rates was abandoned. Instead, a system was adopted under which the SBP could provide funds to commercial banks to ease their temporary liquidity difficulties. The rate of profit for the State Bank of Pakistan on these funds is equal to the rate of return which the borrowing commercial bank paid on it saving deposits. If the commercial bank has no savings deposits scheme (as in the case of Development Financing Institutions), then the rate of profit is the return paid on its deposits of six month's maturity. [Ibid, **p.21.]**

III. DETERMINING THE MAXIMUM AMOUNT OF SERVICE CHARGE

According to the permissible modes of financing determined by the State Bank of Pakistan, commercial banks 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." [Circular No. 13 dated June 20, 1984 issued by the Banking Control Department of the State Bank of Pakistan]. The maximum service charge permissible to each bank is to be determined by the State Bank from time to time and *Qard Hasan* loans are to be exempted from the service charge.

Through Circular No. 26 dated November 26, 1984, the SBP determined that 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 result to the nearest decimal of a percentage point." The law also provided that a commercial bank may recover a 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, so worked out, is less than the rate charged, the bank will reimburse the difference to its clients within a month and inform the State Bank accordingly within a specified period. [Circular No. 26 dated November 26, 1984, issued by the Banking Control Department of the State Bank of Pakistan].

IV. CONTROL OF MAXIMUM PROFIT SHARING RATIOS

Time deposits of the interest based system have been converted into Profit and Loss Sharing (PLS) deposits in Pakistan. The State Bank .of Pakistan deter-mines how profit is to be distributed between banks and PLS depositors. Since the level of profit to be distributed depends upon the outcome of the business activity in which these deposits are invested, the SBP only determines the weights which are assigned to various types of PLS deposits. These weights vary according to the maturity of the deposits. For example, special notice deposits requiring a notice of up to 30 days are assigned a weight of 0.65 and notice deposits requiring a notice of 30 days or more are assigned a weight of 0.75. The weight assigned to savings deposits is unity while those assigned to time deposits for less than six months is 1 + 0.05 for each month of deposit. For time deposits exceeding one year, the weight used is 1.3 for the first six months plus 0.01 for each subsequent month of the term of the deposit, subject to a maximum of 2.08.

The weights used in borrowing on a PLS basis are the same as those used for term deposits of different maturities. The available documents do not suggest how the State Bank of Pakistan arrives at these weights.

V. PURCHASE AND SALE OF PARTICIPATION TERM CERTIFICATES

Under the Islamic Banking system, the State Bank of Pakistan has been authorized to buy and sell Participation Term Certificates (PTAs) which are new financial instruments 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. .

Participation Term Certificates 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 SBP has been authorized to buy and sell these instruments. However, it is not known whether the State Bank of Pakistan has actually undertaken these operations and what its impact has been on the magnitudes of various monetary aggregates.

3.4 REGULATION AND CONTROL OF COMMERCIAL BANKS IN SUDAN

The central bank in Sudan, which is known as the Bank of Sudan, came into existence in 1959 after the approval of the Law of the Bank of Sudan, 1959 Bank started its activities in February, 1960. The primary objectives of the Bank of Sudan are issuing paper currency and coins, developing the banking system, and adopting of a sound credit policy for the balanced economic development of the country, besides performing the other traditional functions of a central bank.

Article 51 for the Law of the Bank states that "it is not allowed for any person to undertake, in full or part, any banking activity, except under a licence from the Bank of Sudan, (which is issued) with the approval of the President of the Republic". Article 6 (1) of the same law also states that the Bank of Sudan shall have authority to issue instructions to any bank or to any person undertaking the banking activity, and it shall be compulsory for that bank or person to accept these instructions and implement them".

The instructions of the central bank are usually contained in its circulars and directives which are issued from time to time to execute the money and credit policy of the central bank.

In the absence of a well developed money market, the Bank of Sudan, uses the legal reserve requirement ratio, credit ceilings and other direct methods of credit control as the main instruments to implement its credit policy. Article 44 of the Bank of Sudan law empowers the Bank to keep the Special Required Reserves of commercial banks. Similarly, Article 45 of the law authorizes the bank to determine the credit ceiling for the banks and to lay down the principles governing minimum loans to be provided to different sectors of the economy.

Commercial banks in Sudan can be placed into three broad categories:

i. Nationalized commercial banks

ii. Foreign banks

iii. Joint venture banks

Nationalized commercial banks control almost 60 percent of the money market in terms of the mobilization of deposits and the advancement of loans. There are six foreign banks operating in Sudan but their share in the total market is not more than 5 percent. Most of the Islamic banks, operating in Sudan are in fact joint venture banks, which have been established by the collaboration of Sudanese and foreign capital particularly from the Middle East. There are six banks in Sudan which declare themselves to be Islamic banks: Faisal Islamic Bank, Tadamon Islamic Bank, Islamic Bank for Western Sudan, Sudanese Islamic Bank, Al Barakah Islamic Bank, and Islamic Cooperative Development Bank.

Before December 10, 1984, only the Islamic banks in Sudan operated in accordance with the Islamic *Shari'ah.* However, from December 10, 1984, all commercial banks in Sudan have been operating according to Islamic law. Therefore, it may be interesting to see how Islamic commercial banks are being controlled and regulated in Sudan, particularly after the change over to the Islamic banking system.

The Bank of Sudan does not make any distinction between Islamic banks and other commercial banks. It establishes its money and credit policy keeping in mind the requirements of the economic development of the country and other macro economic situations. The objectives of the credit policy are stated in the circulars of the central bank issued to the commercial banks from time to time, (usually each year). For example, the objectives of the credit policy operative in 1990 are said to be: stabilizating the exchange rate, developing exports and maximizating revenue through exports, bridging the balance of payment deficit, encouraging investment, organizing the role of the private sector in expanding domestic production and limiting the imports of luxury and other non basic commodities.

Because of the undeveloped nature of financial institutions and money markets, interest rates were not a significant tool of monetary policy even before the introduction of Islamic banking. At present the Bank of Sudan uses the following instruments to control and regulate the banking system in the country including Islamic banks:

i. Credit Ceiling
ii. Cash Reserve Ratio
iii. Directives and Direct Instructions

I. CREDIT CEILING

The credit ceiling is the most important tool of monetary management and banking control in Sudan. 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 resources of 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 resources of bank, the higher the credit ceiling imposed on it. Banks 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.

The objectives of credit ceiling are:

i. to provide incentives to production
ii. to improve the balance of payment position
iii. to help regulate the money supply and control inflation.

The credit ceiling determined by the Central Bank of Sudan takes into account the following factors: The resources of the bank including paid up capital and total deposits, the bank's financing expectations, the bank's previous credit performance, the bank's share in various subsidiary public companies and the nature of the bank concerned. Subsidiary companies are also included in the credit ceiling established by the central bank.

II. CASH RESERVE RATIO

The cash reserve ratio is also used as an instrument of monetary management and control in Sudan, but changes in the reserve ratio have not been frequent.

In November, 1986, a new credit policy was announced in which the cash reserve ratio for commercial banks was raised to 20 percent from 12.5 percent. However, since 1988, the cash reserve ratio has been around 18 percent.

III. INSTRUCTIONS AND DIRECTIVES

The Bank of Sudan also, from time to time gives instructions and directives to commercial banks as well as establishing full-fledged 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.

In the present credit policy, five sectors, *viz.* 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 in Sudan also issues other directives and establishes the ground rules for commercial banks keeping in mind local conditions and national economic interests. For example, the credit policy adopted for 1990 prohibits the financing of exports 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 imports have been made through official or free market channels.

It is also worth noting that the only permitted techniques of providing finance are *Murabahah* and *Musharakah. Mudarabah* as a means of finance is prohibited.

The main difficulty faced by commercial banks (all of whom work on an interest free basis) 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.

CHAPTER 4

REGULATION AND CONTROL OF ISLAMIC BANKS IN A MIXED ENVIRONMENT

4.1 INTRODUCTION

In the previous chapter, practices of central banks in regulating and controlling Islamic banks in countries where all commercial banks function in accordance with Islamic injunctions were reviewed. In this chapter, the regulation and control of Islamic banks in a mixed environment shall be discussed. Mixed environment refers to situation in. which Islamic banks and traditional interest based banks exist side by side.

In many Muslim countries today, a large part of the money market is controlled by interest based banks. However, in the last decade, a few Islamic banks have appeared and are increasingly claiming a growing share of the money market. During the past fifteen years or so , Islamic banks have been established in Egypt, Jordan, Malaysia, Bangladesh, Qatar, Bahrain, Kuwait, U.A.E., and in some European countries. Several of these countries (Malaysia, Qatar, Kuwait, and U.A.E.,) have only one Islamic bank while others (Bangladesh, Egypt and Jordan) have two or more Islamic banks. The presence of Islamic banks in these Countries has raised the following question : How should Islamic banks be controlled and regulated in a mixed environment which consists of traditional interest based banks and Islamic banks? The question is being debated among Islamic bankers, central bankers and economists although not much documentation exists on the subject.

Islamic banks insist that they should not be subjected to the same controls as interest based banks because their financing techniques are much different than those of traditional banks. Interest based banks, it is argued by Islamic banks, advance their funds on the basis of loans, thus creating credit and adding to the money supply. Hence, any attempt by the central bank to keep the credit creating activities of these banks in check, seems to be justified. However, Islamic banks point out that their own financing activities are not in the nature of loans but take the form of investment. Hence, any control on them is not desirable. Some arguments which have been pressed by the Islamic banks in this connection are listed below:

a. It is argued that reserve requirement should be enforced only on demand deposits. The imposition of reserve requirements on investment deposits hampers the investment activity of Islamic banks and deprives them of the opportunity to earn profit on the reserved portion of investment deposits.

b. It is also argued that the financing activities of Islamic banks such as, *Murabahah, Musharakah* and *Mudarabah,* are not loan making activities. They resemble investment more than they do lending. Hence, they should not be subjected to the same controls which are devised to control credit.

In contrast to these views, the central banks of most of these countries treat Islamic banks in the same way as traditional interest based banks. Their main argument is that so far Islamic banks finance their activities using the deposits of the general public, they create credit and at least in this respect there is no substantial difference between the operations of traditional banks and Islamic banks. Hence, their activities are to be regulated in the same way as the activities of traditional interest based banks.

As Siddiqi has pointed out, the truth probably lies some where in the middle of these two extreme positions [Siddiqi,1989.] An important point to keep in mind is that credit (or additional money supply) is not created by any bank (traditional or Islamic) in isolation. It is the commercial banking system as a whole which creates credit. In a traditional system, the advance made by one commercial bank does not leave the banking system. It comes back to other commercial banks in the form of new deposits and other receipts. The presence of Islamic banks does not alter this fact in any way. The advances made by Islamic banks, either in the form of *Murabahah,* or letters of credit or any other form, are also not likely to leave the banking system. They will come back to either the same Islamic bank, or to another Islamic bank, if there are more than one, or they may even go to other non - Islamic commercial banks.

However, there is some merit in the argument that the financing operations of Islamic banks are different from the financing operations of interest based banks. The monetary authorities should consider the fact that Islamic banks cannot convert their financial assets into liquid assets with the same ease as interest based banks which keep a large portion their total assets in interest bearing financial papers. Hence, in order to remain liquid, Islamic banks have to keep a large portion of their assets in the form of cash on hand. In other words, the cash - asset ratio of Islamic banks is usually higher than that of traditional interest based commercial banks. This means that the capability of Islamic banks to create credit is lower because of their inability to invest in short term financial assets and the absence of an Islamic financial papers market.

Furthermore, Islamic banks provide finance through *Musharakah* and *Mudarabah.* Unlike interest based banks, they also participate in real investment. Hence, there is a case for evolving and adopting new methods of credit control for Islamic banks in a mixed environment.

In light of these considerations, this chapter presents Jordan and Egypt as case studies of the regulation and control of Islamic banks by central banks in mixed environment.

4.2 REGULATION AND CONTROL OF ISLAMIC BANKS IN JORDAN

The Central Bank of Jordan does not make any distinction between ordinary commercial banks and Islamic banks. The Jordan Islamic Bank, like other commercial banks operating in the country, has to send fortnightly reports to the central bank with a statement of investment and guarantees. Generally, the central bank insists on a high degree of guarantees and security to be maintained by all commercial banks. The instruments of monetary regulation and control as they apply to the Jordan Islamic Bank are discussed below :

I. LEGAL RESERVE REQUIREMENT

The Central Bank of Jordan requires all commercial banks to keep a 10 percent compulsory legal reserve. This condition is applicable to the Jordan Islamic Bank as well . However, the changes in the legal reserve ratio have not been very frequent which shows that the main purpose of the enforcing the legal reserve requirement in Jordan is to ensure liquidity and security in the banking system. It is not used as an important tool of monetary policy to affect the total volume of credit generated by the commercial banking system.

II. DEPOSITS WITH THE CENTRAL BANK

The Jordan Islamic Bank keeps its excess liquidity in the form of deposits with the Central Bank of Jordan on a voluntary basis. It does not receive any interest on these deposits while interest is paid by the Central Bank to other commercial banks which keep their deposits with it. No other compensation or concession is given in lieu of interest.

III. INSTRUMENTS OF CREDIT CONTROL

Credit ceilings are not used by the Central Bank of Jordan as a method of credit control. It mostly relies on policy guidelines. The central Bank of Jordan requires that no commercial bank should make advances (investment in the case of the Islamic Bank) exceeding 70 percent of its total deposits. There is a penalty by the central bank if this limit is violated.

No situation has arisen in Jordan in which the Central Bank of Jordan has had to function as a lender of the last resort to the Jordan Islamic Bank. Bank rate policy is not used by the Central Bank of Jordan as an instrument of credit control. However, open market operations are used but the Jordan Islamic Bank does not participate in them.

4.3. **REGULATION AND CONTROL OF ISLAMIC BANKS IN EGYPT**

At present there are three Islamic banks in Egypt: The Faisal Islamic Bank, the Islamic Bank International for Investment and Development and the Nasser Social Bank. Commercial banks as well as Islamic banks in Egypt are governed by the Banking and Credit Law of the Republic of Egypt. Islamic banks, like commercial banks, are faced with various kinds of restrictions. They have to keep 25 percent of their total deposits with the central bank. While interest is paid to other commercial banks on their deposits with the central bank, no return of any kind is paid to Islamic banks. The banks are not allowed to invest more than 60 percent of their total resources including paid up capital and total deposits. They are not allowed to have more than 25 percent of equity capital in subsidiary companies.

The Banking and Credit Law No 163 also stipulates that. no more than 65 percent of the deposits of the bank should be loaned out and that no more than 25 percent of the paid up capital of the bank should be committed to a single client at any one time.

Islamic banks in Egypt maintain that the creditor - debtor relationship is not present in Islamic banking which is based on a participatory relationship between the provider and the user of finance. Furthermore, turnover is quicker in Islamic banking than in interest based banking. The banks hold the view that the central bank probably does not take these factors into consideration while subjecting Islamic banks to same regulations that are applied to ordinary commercial banks. Islamic banks also feel that they have to operate in a hostile environment. The main argument of Islamic banks is that they do not create credit, hence, they should not be subjected to the same measures of credit control which are applied to interest based commercial banks.

In Egypt the central bank has used various techniques of credit control, including bank rates, reserve ratio requirement, moral suasion, direct orders from the central bank and other qualitative controls. Open market operations have only been used in a limited way. However, Islamic banks do not participate in them. In using qualitative measures of credit control, the central bank suggest differential interest rates for different sectors in accordance with the developmental priorities laid out in the development plan of the country. This measure is also applicable to Islamic banks. It should be pointed out that the central bank does not grant any concession or exemption to Islamic banks in this respect because of their special nature. In fact, they have to observe the national priorities, even while being unable to make use of differential interest rate,.

Commercial banks in Egypt, including the Islamic banks, are required to deposit 15 percent of their foreign currency deposits with the central bank. While interest is paid to other commercial banks, no return is given to Islamic banks on these deposits. There has been no attempt by the central bank to control the markup rate in *Murabahah* transactions, or to control the profit sharing ratio going to Islamic banks in *Musharakah* or *Mudarabah* transactions.

CHAPTER 5

CONCLUSIONS AND SUGGESTIONS

The concept of interest rate occupies a pivotal place in neoclassical economic theory. It is considered to be a bridge between the real and monetary sectors of the economy. Hence, it provides the basis for discretionary monetary policy which aims at achieving desired changes in the real magnitudes of macroeconomic activity, such as income, employment, investment etc by manipulating the variables in the monetary sector of the economy. Since the commercial banking system along with the entire financial system is based upon interest, the control of interest rates assumes a prominent position in the conduct of monetary policy.

The central bank of the country aspires to affect the market rate of interest through the use of a number of instruments such as the bank rate, open market operations, changes in the required reserve ratio etc. These instruments affect the supply of money in the system. Assuming the demand for money depends upon factors which cannot easily be manipulated, changes in the supply of money will influence the market rate of interest which in turn will influence the real variables of the macroeconomic system.

Based on the above economic theory, most developing countries adopt the framework for conducting their monetary policies which is used by most industrially advanced countries despite mounting empirical evidence that the neoclassical paradigm of economics may not be of any great relevance to developing countries.

The issue of the interest responsiveness of savings and its impact on investment and growth is an article of faith in neoclassical economic theory. However, the empirical evidence in support of a high interest responsiveness of saving is far from convincing. [Gonzales Arrieta, 1988].

Similarly, the relationship between interest rate and other macroeconomic variables is also of questionable validity. Deena R. Khatkhate studied the impact of the interest rate on certain macroeconomic variables such as the rate of growth of real gross domestic product, real financial assets, the savings income ratio, the investment income the ratio and rate of return on investment for 64 less developed countries (LDCs) during the period 1971-80. On the basis of his studies, Khatkhate concluded that "there is no difference with any statistical significance between the two groups of LDCs above and below the mean real interest rate. This implies that the *level of the real interest rate by itself* has *little or no impact on the selected macroeconomic* variables added, Khatkhate, 1988, p.586.]

In the absence of the effectiveness of the interest rate as a tool of monetary policy, most central banks in developing countries use more direct methods of credit control. Central banks also find limited scope for conducting open market operations because of the undeveloped nature of financial markets in the developing countries. This situation has helped those countries where the Islamic banking system has been adopted on an economy-wide basis in the sense that it is not too difficult for them to use those monetary policy instruments which are not based on interest. This is the reason why Iran and Pakistan did not have any substantial difficulty in conducting their monetary policy after switching over to the Islamic banking system. [Iqbal and Mirakhor, 1987, pp.19 - 22.]

In fact, a number of devices are available for the regulation and control of the commercial banking system ranging from the legal reserve ratio requirement to the direct allocation of credit among various sectors. In chapter II no less than seventeen methods have been presented which can be used by central banks in regulating the commercial banking system in an interest free framework. Some of these have been put into practice in Pakistan, Iran and Sudan,. The control of the maximum and minimum profit sharing ratio has emerged as an important tool of monetary policy in Pakistan and Iran. Credit ceilings are the most important tool used in Sudan. Therefore, any fear that the Islamic banking system may introduce inefficiency in the system because of the unavailability of the interest rate as an instrument of monetary policy appears to be unfounded.

Regulation and control of Islamic banks in the mixed environment where Islamic banks and interest based banks function side by side presents a mare challenging situation. Experience has shown that in most cases central banks, subject Islamic banks to the same controls, conditions and regulations which they apply to the interest based banks. So far as these instruments of credit control are free of interest, no objection can be advanced against them at least on Islamic grounds. However, there are certain cases in which there seems to a conflict between central banks and Islamic banks. Some of these include:

a. Islamic banks keep their deposits with the central bank. The central bank pays interest to commercial banks but Islamic banks have to forego this income.

b. The central bank function as lender of the last resort. However, this loan, should the need arise for it, is granted on the basis of interest. There have not been many cases in which Islamic banks have had to face a liquidity problem. However, a case occurred in Egypt in which an Islamic bank approached the central bank for additional cash to face a run on the bank. It is reported that the central bank was not willing to lend the required amount free of interest. Consequently, the bank had to borrow from the central bank on interest obtaining a Fatawa from its religious board on the plea of need *(Darurah)* .

c. In countries, where the central bank conducts open market operations, Islamic banks are not able to participate in these operations because of the interest based nature of the securities bought and sold. Thus, Islamic banks are constrained by the fact that financial assets which could be liquidated quickly are unavailable.

d. It has been noticed in some countries that central bank authorities do not fully comprehend the nature of Islamic financing techniques. This is particularly true in the case of *Mudarabah* and *Musharakah* financing whose nature is entirely different from interest based debt financing. In debt financing, the granting of a loan is a one time activity, no matter what the size of the loan. But *Mudarabah* and *Musharakah* are ongoing activities and the participation of Islamic banks has to last as long as the project remains in operation. It was pointed out by an Islamic bank that the concerned central bank insists on separate approval for different stages of the same *Musharakah* operation. This kind of situation results because there is little appreciation of the techniques of financing used by Islamic banks.

In light of the above, the following suggestions could be made for a healthier relationship between Islamic banks and central banks:

a. It may be observed that Islamic banks, at present, control a very small portion of the total money market in mixed environment countries. At best this share is around 10 percent of the market. If Islamic banks are established in these countries and they claim a substantial share of the money market, the central banks in these countries will be compelled to take notice of Islamic banking. Then it may be hoped that central banks would resort to those techniques of regulation and control which would be more conducive to Islamic banking.
b. Islamic banks may persuade their respective central banks to offer them some facilities in lieu of interest free deposits they maintain with central banks. One particular facility may be the provision of interest free loans from central banks to Islamic banks in time of need. It can be argued that as Islamic banks do not receive interest on the deposits which they keep with the central bank, the central bank should return the favor by providing loans on an interest free basis *(Qard Hasan)* whenever the central bank has to function as a lender of the last resort to Islamic banks.
c. Central banks in those countries where the entire banking system has been reorganized along Islamic lines, may experiment with open market operations bearing non-interest based financial papers. These may be in the form of Participation Certificates, Investment Certificates, *Muqaradah* Bonds, etc. This will go a long way towards developing secondary market for Islamic banks and providing Islamic banks with financial assets which they will be able to liquidate quickly when necessary.

Central banking in the Islamic framework and the regulation and control of Islamic banks in a mixed environment also deserve more attention from researchers.

This study has taken note of some of the tools which are being used in Pakistan, Iran and Sudan to regulate interest free banks: There is further need for more empirical studies, particularly to evaluate the effectiveness of monetary policy and the tools of monetary management against the objectives and goal which have been set for them. Similarly., studies are also required to assess. the, impact of Islamic banking in mixed environment countries on macro economic magnitudes.

BIBLIOGRAPHY

Abu Saud, Mahmoud, "Interest Free Banking" Paper presented at the First International Conference on Islamic Economics, Makkah, 1981.

Ahmad, Ausaf, Development and Problems of Islamic Banks, Islamic Research and Training Institute, Islamic Development Bank. Jeddah 1987.

------------------------------, Contemporary Practices of Islamic Financing Techniques, (Mimeograph) Islamic Research and Training Institute, Islamic Development Bank Jeddah, 1989.

Ahmad, Khurshid, Studies in Islamic Economics, The Islamic Foundation, Leicester 1980.

Ahmad, Ziauddin et al (eds.) Money and Banking in Islam International Centre for Research in Islamic Economics, King Abdul Aziz University, 1983.

Akkas, Ali "Problems of Credit Creation by Commercial Banks" in Thoughts on Islamic Banking, Islamic Economics Research Bureau Dhaka, 1982.

Ariff, Mohammad (ed.) Monetary and Fiscal Economics in Islam, International Centre for Research in Islamic Economics, King Abdul Aziz University, Jeddah, (1982).

----------------------------"Monetary Policy in an Interest Free Economy" in Ariff (ed.) 1982.

Chapra, M. Umar, "Money and Banking in an Islamic Economy" in Ariff (ed.) 1982.

---, Monetary Policy in an Islamic Economy" in Ziauddin Ahmad et.al (eds.) 1983.

---------------------------------, Toward a Just . Monetary System, Islamic Foundation, Leicester 1985.

Council of Islamic Ideology, Report of the Council of Islamic Ideology on the Elimination of Interest from the Economy, Government of Pakistan, Islamabad 1980. Reproduced in Ziauddin Ahmad et al. (eds). 1983.

Gonzales Arrieta, G.M. "Interest Rates, Savings and Growth in LDCs: An Assessment of Recent Empirical Research", *World Development,* Vol. 16, No. 5, 1988.

Iqbal, Zubair and Abbas, Mirakhor, Islamic Banking, Occassional Paper No. 49, International Monetary Fund Washington D.C.: 1987.

Al Jarhi, Ma'bid, "A Monetary and Financial Structure for an Interest Free Economy: Institutions, Mechanism and Policy" in Ziauddin Ahmad, et,al.(eds.) 1983.

Kahf, Monzer, The Islamic Economy: Analytical Study of the Functioning of Islamic System, The Muslim Students' Association of the United States and Canada Plainsfield, Indiana, 1978.

--------------------------------, "Fiscal and Monetary Policies in an Islamic Economy" in Ariff (ed.) 1982.

Khatkhate, D.R., Assessing the Impacts of Interest Rate in Less Developed Countries, World Development, vol. 16, No. 5. 1988.

Khan, M. Fahim, "Islamic Banking As Practiced Now in the World" in Ziauddin Ahmad, et al. (eds.) 1983.

Siddiqi, M. Nejatullah, Impact of Islamic Modes of Finance on Monetary Expansion, Paper presented at the 5th Expert Level Meeting on Islamic Banking Studies, Central Bank of United Arab Emirates, Abu Dhabi, 18-20 March, 1989.

------------------------------, Issues in Islamic Banking: Selected Papers, The Islamic Foundation Leicester, 1983.

-------------------------- , Banking without Interest, The Islamic Foundation Leicester 1983.

Uzair, Mohammad, Interest Free Banking, Royal Book Company, Karachi, 1978.

---------------------------------, An Outline of Interest Free Economy National Bank of Pakistan, 1980

------------------------------- "Central Banking Operations in an Interest Free Banking System" in Ariff (ed.) 1982

------------------------------ "Some Conceptual and Practical Aspects of Interest Free Banking" in K. Ahmad (ed.) 1980.

Zaidi, Nawazish Ali, Eliminating Interest from Banks in Pakistan, Royal Book Company Karachi, 1987.

■ ■ ■

ISLAMIC DEVELOPMENT BANK (IDB)

Establishment of the Bank

The Islamic Development Bank is an international financial institution established in pursuance of the Declaration of Intent by a Conference of Finance Ministers of Muslim countries held in Jeddah in Dhul Qa'da 1393H (December 1973). The Inaugural Meeting of the Board of Governors took place in Rajab 1395H (Jul 1975) and the Bank formally opened on 15 Shawwal 1 395H (20 October 1975).

Purpose

The purpose of the Bank *is* to foster the economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of *Shari'ah:*

Functions

The' functions of the Bank are to participate in equity capital and grant loans for productive projects, and enterprises besides providing financial assistance to member countries in other forms of economic and social development. The Bank Is also required to establish and operate special funds for specific purposes including a fund for assistance to Muslim communities in non-member countries, in addition to setting up trust funds.

The Bank is authorized to accept deposits and to raise funds in any other manner. It is also charged with the responsibility of assisting in the promotion of foreign trade, especially in capital goods among member countries, providing technical assistance to member countries, extending training facilities for personnel engaged in development activities and undertaking research for enabling the economic, financial and banking activities in Muslim countries to conform to ***the Shari'ah.***

Membership

The present m Membership of the Bank consists of 53 countries. The basic condition for membership is that the prospective member country should be a member of the Organization of the Islamic Conference and be willing to accept such terms and conditions as may be decided upon by the Board of Governors.

Capital'

The authorized capital of the Bank is six billion Islamic Dinars. The value of the Islamic Dinar, which is a unit of account In the Bank, Is equivalent to one Special Drawing Right (SDR) of the International Monetary Fund. The subscribed capital of the Bank is 3,654.78 million Islamic Dinars payable in freely convertible currency acceptable to the Bank.

Head Office

The Bank's headquarters is located in Jeddah, Saudi Arabia and it is authorized to establish agencies or branches elsewhere.

Financial) Year

The Bank's fi financial *year* Is the Lunar Hijra year.

Language

The official language of the Bank is Arabic, but English and French are additionally used as working languages;

ISLAMIC DEVELOPMENT BANK
ISLAMIC RESEARCH AND TRAINING INSTITUTE
Postal Address: P.O.Box 9201. Jeddah **21413**
Kingdom of Saudi Arabia
Cable Address:BANKISLAMI- Jeddah Telephone: **6361400**
Telex: 6011371601945 Facsimile: 6378927 16366871
E. Mail Address : ARCHIVES@ISBD.ORG Home Page: http://www.IRTI.ORG
Legal Deposit No. 3 7

Printed by Gulf Printing & Packaging. Tel 6550922 Fax 6