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Impact of Islamic Modes of Finance on Monetary Expansion

MUHAMMAD NEJATULLAH SIDDIQI
Centre for Research in Islamic Economics,
King Abdulaziz University, Jeddah, Saudi Arabia

ABSTRACT. This paper focuses on the different perceptions about the likely impact of Islamic banks' operations on money supply. Since investment accounts with the Islamic banks carry some withdrawal facility, new money is created when the funds in these accounts go to entrepreneurs on profit sharing or *murabaha* basis. The paper argues that as compared to the conventional banks money creation by Islamic banks is more closely associated with the creation of additional wealth in the real sector. The resulting expansion in money supply will be smaller compared to that resulting from conventional banks' lending Out of their time and saving deposits. The Islamic banks should, therefore, be subjected to a reserve ratio smaller than that applied by the central bank to the conventional banks[*].

Introduction

Since the emergence of Islamic financial institutions in several Islamic countries, the issue of their relationship with the central banks of these countries has been in focus. It has now assumed added significance because of the growing importance of these institutions and the realisation by the monetary authorities that they have come to stay.

Generally speaking, it is through the activities of the commercial banks that monetary expansion takes place. Hence, the central banks' relationship with the commercial banks is dominated by the need to control the supply of money and to prevent inflation. The central banks would like to treat the Islamic banks at par with the

[*] This note was submitted to the 5th Expert level meeting on Islamic Banking Studies held at Abo Dhabi. from l8-20 March, 1989.

conventional banks, subjecting them to the same regulations relating to reserves against deposits. The Islamic banks which adopt modes of finance different from the debt finance practiced in conventional banking, regard this attitude to be unwarranted as their activities do not result in monetary expansion. This brief note examines this issue with a view to resolving the controversy. We have argued that the truth lies somewhere between the two perceived positions of treating the Islamic banks at par with conventional banks (viz, the position of the central banks) and negating the possibility of money creation, hence of monetary expansion, by the Islamic banks (viz, the alleged position of the Islamic banks represented by the International Association of Islamic Banks, IAIB). Islamic modes of finance do result in monetary expansion but with a difference. Money creation by Islamic banks is more closely associated with the creation of additional wealth in the real sector. Also, monetary expansion through some Islamic modes of finance (e.g. *mudarabah* and *musharakah*) is even quantitatively less than it would be in case of debt finance in a similar situation. Moreover, Islamic banks cannot liquidate their assets as easily as the conventional banks, hence they keep more cash in their vaults than the conventional banks to meet withdrawal obligations. These two differences call for a different treatment of Islamic banks by the Monetary Authority than that it accords to conventional banks. But the need for regulations to control the money supply and ensure liquidity and solvency through appropriate measures, including reserve ratios. remains.

Views of the Islamic Banks

It has not been possible for this writer to get the documents stating the views of the central banks and the monetary authorities in the OIC countries. There is no doubt, however, about the position they take[(1)].

As regards Islamic banks, it appears that they were led to believe that their activities do not result in money creation or monetary expansion. The most they admitted was that acceptance of demand deposits by Islamic banks justified central bank supervision to the *extent of these deposits only*, out of which a fractional reserve could be required by the central bank[(2)]. The implication was clear: accepting deposits into investment accounts and investing the funds so mobilized did not call for central bank regulations or fractional reserve requirement. Indeed, some writers did make the erroneous claim that the activities of the Islamic banks would not result in money creation[(3)].

The view that the Islamic modes of finance did not result in monetary expansion was sought to be buttressed by a number of arguments, chief among them being the following.[(4)]

(i) Since Islamic banks do not allow overdraft on current accounts, they do not create money.

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1. **Gamal al Din Atiyah**, *al Bunuk al Islamiyah bain al Hurriyah wa'l Tanzim, al Taqlid wa'l Ijtihad, al Nazariyah wa'l Tatbig.* Qatar, Kitab al Ummah, 1407/1987, pp. 60-64; also see pages 19, 25, 28 and 54.
2. **Ahmad Abdulaziz Najjar**, *etal*., *100 Su'al wa 100 Jawab Haul al Bunuk al Islamiyah*, Cairo: International Association of Islamic Banks, 1978, p. 93 (question 79).
3. **Gharib al Gammal**, *al Masarif wa Buyut al Tamwil al Istamiyah*, Jeddah: Dar al Shuruq, 1398, p. 72.
4. **Atiyah**, *op. cit.* p. 65.

(ii) Investment accounts in Islamic banks differ from conventional savings and time deposits in not being guaranteed. The need for keeping a reserve against any deposit arises essentially from the return of that deposit to the depositor being guaranteed. In the case of investment account what the Islamic bank owes to the depositor is what actually results from the investment. This may be more than the amount deposited (i.e. in case of profits) or less than the amount deposited (in case of losses).

(iii) Investment of peoples' savings by the Islamic banks often results in these banks owning physical assets, both movable as well as immovable. The commercial banks do not have this type of investment. In some way this feature of the Islamic banks is also seen to be a justification of not keeping a reserve against investment accounts.

(iv) Another argument advanced against the central banks subjecting Islamic banks' investment accounts to reserve requirements is the Islamic banks' 'obligation' to 'use' the entire amount deposited into these accounts(5). The idea behind this claim seems to be that unless the full amount is actually invested the account holder will be deprived of some profits he could have earned e.g. the profits which could accrue on that fraction of his deposits which had to be kept in reserve with the central bank. This argument conveniently ignores the fact that in order to attract deposits some Islamic banks have entered into another obligation of allowing withdrawals from investment accounts at short notice. This obligation calls for some regulation by the central bank to ensure that it will in fact be fulfilled and the public's confidence in the banking system will remain unimpaired. If an Islamic bank is obliged to keep 3% of an investment account in reserve with the central bank, the profits it earns on the remaining 97% will be treated as the profits earned on the entire deposit.

The Literature on Islamic Banking

Let us now turn to the literature on Islamic banking and see what positions were taken on this issue which became a subject of discussion, in the early eighties, between the central banks and the Islamic banks.

Early Arabic literature on the subject has mostly discussed how a financial institution could work without interest adopting the contracts mentioned in Islamic *fiqh* like *mudarabah, shirkah*, etc. With the exception of the Egyptian study(6), it did not address itself to the larger question of how the entire financial system of a country could be organized free of interest and working according to *shari'ah.* It does not mention central banking and does not discuss the relationship between the individual Islamic banks and the central bank of the country. This is quite understandable in view of the political realities and the actual possibilities in the Arab world at that time.

In contrast, the literature on Islamic banking originating in the Indian sub-continent generally addressed itself to the latter issue: banking without interest at the national level. The emergence of Pakistan with the promise of establishing an Islamic state and the possibility of introducing there a financial system free of *riba* had provided a

5. **Abedin Ahmad SaIamh,** *al Bunuk al Islamiyah wa aslamat al Nizam al Masrafi fi al Sudan,* Khartoum**:** Faisal Islamic Bank, 1983, p. 26.
6. *The Egyptian Study on the Establishment of the Islamic Banking System,* Cairo, 1972.

realistic need for such an approach. Hence the operational details of Islamic banking were worked out in the framework of a country's financial system as a whole and central banking as well as the relationship between individual banks and the central bank also received some attention(7). This literature recognizes the fact that financial intermediation through Islamic banks would result in money creation and monetary expansion and that there is a need for central bank regulations to control money supply as well as to ensure liquidity and solvency of the system. However, there is some difference of opinion regarding the details.

As regards the demand deposits most of the writers recommend fractional reserves while some recommend 100 percent reserves(8) Regarding investment accounts all writers agree that Islamic banks should keep some liquid reserves against these deposits so that withdrawals from these accounts could be made smoothly according to the terms and conditions under which investment accounts are accepted. There is, however, a difference of opinion regarding the need for statutory reserve requirements against investment deposits.

Chapra argues that "the *mudarabah* deposits are treated in the Islamic system like bank equity and, since there is no statutory reserve requirement against other forms of equity, there is no reason why *mudarabah* deposits should be subject to reserve requirements."(9) Mohsin Khan also recommends the same: "No official reserve requirements would be necessary for these investment deposits, although presumably for prudential reasons banks would maintain some minimum level reserves."(10) Earlier, Siddiqi had argued "It is advisable that the bank should keep a fixed percentage of *mudarabah* accounts as reserve, so that normal return of money to the depositors need not depend on the return of bank capital from business concerns."(11) Most writers on the subject seem to be in favour of statutory reserve against all bank deposits,(12) even though the ratio of reserves against *mudarabah* accounts should be very small.

Nature of Investment Accounts

It is necessary in order to resolve this controversy to review briefly what is money and how it is created and then to consider what would be the appropriate reserve requirements with respect to the investment accounts which the Islamic banks operate. In making this review there is no need to discuss the proposal relating to 100 percent

7. **Muhammad Nejatullah Siddiqi,** *Muslim Economic Thinking*, Leicester: The Islamic Foundation**,** 1988, pp. 29-39.
8. **Muhammad Nejatullah Siddiqi,** *Issues in Islamic Banking*, Leicester: The Islamic Foundation, 1983, pp. 19; 21-22; 46-47. Also **Mohsin S., Khan**, Islamic Interest-Free Banking: A Theoretical Analysis, p. 33 in **Mohsin S. Khan** and **Abbas Mirakhor**, *Theoretical Studies in Islamic Banking and Finance*, Houston. Texas: The Institute for Research and Islamic Studies, 1987.
9. **M. Umer Chapra,** *Towards a Just Monetary System*, Leicester, The Islamic Foundation, 1985, p. 161, also see pp. 198-99.
10. **Mohsin S. Khan,** *Op. cit*., p. 33; also see footnote 9 on page 4 in **Zubair lqbal** and **Abbas Mirakhor**, *Islamic Banking*, Occasional Paper 49, International Monetary Fund, Washington DC, 1987.
11. **Muhammad Nejatullah Siddiqi,** *Banking Without Interest*, Leicester. The Islamic Foundation. 1983. p. 43.
12. Some of these views can be studied in **Ariff, Mohammad**, *Monetary and Fiscal Economics of Islam*, Jeddah, International Centre for Research in Islamic Economics, 1982, pp. 14, 298, 219, 252. **Khan**, **Shahrukh Rafi,** *Profit and Loss Sharing: An Islamic Experiment in Finance and Banking*, Karachi: Oxford University Press, 1987, p. 78.

reserves against demand deposits (current accounts) since it is within the framework of the current practices in the countries where Islamic banks are operating that the controversy is to be resolved.

Money is many things, but it is primarily a means of payment. Coins, currency notes and demand deposits against which cheques can be written or from which transfers can be made, act as means of payment, hence they are unanimously regarded as money. Whenever a new checking account comes into being without entailing a corresponding cancellation of any other deposit, that much money is created. Lending by commercial banks in a fractional reserve system results in monetary expansion because of this fact. Peoples' banking habits being what they are, much of the money lent out by banks eventually finds its way back to current accounts in some bank or other.

A crucial question for the purpose of our inquiry is whether investment activities of the Islamic banks do or do not result in the creation of additional demand deposits, i.e. whether some part of the money given out of investment accounts does or does not find its way back to current accounts in some banks. Another important question is about the nature of investment accounts themselves. Should they be treated like time deposits and some categories of savings deposits of the conventional banks, and therefore, be included in a broader definition of money supply, M_3? It is on the answer of these two questions that the answer to our present query, whether Islamic modes of finance contribute to monetary expansion or not, depends.

In our view investment accounts in the Islamic banks have close similarity to savings and time deposits in conventional banks. It is true that their return is not guaranteed and they are vulnerable to losses.. But this is not relevant to the issue under consideration. What is relevant is that some Islamic banks allow investment account holders to withdraw money from their accounts subject to two conditions. Firstly, they must give prior notice (three days or one week) and secondly, they do not get the profits of the accounting period in which withdrawal is made (the accounting period being one month, three months or six months, as the case may be). This makes these accounts partially to share the peculiar characteristics of a conventional bank deposit, i.e. while the deposit is still owned by and operated by its original owner it be comes possible to place the same funds at the disposal of others. It will be more realistic therefore to include into M_3, in an Islamic banking system, all investment de posits from which withdrawals are allowed subject to certain conditions. Only those investment accounts can be excluded from the broader definition of money from which it is impossible to make any withdrawals for a given period of time because in this case the other man's right to dispose of these funds merely replaces the rights the original owner has surrendered. Bank equity or shareholders' money bears this characteristic and is therefore not included in M_3. Due to non-availability of relevant data it is not possible for us to specify what percentage of the total investment accounts with the Islamic banks is actually subject to withdrawal facilities.

Expansion Through Islamic Banks

Let us now examine the Islamic modes of finance with a view to ascertaining how far they contribute to monetary expansion through creation of additional deposits, current as well as investment.

There can be no doubt about interest-free loans given out of demand deposits resulting in monetary expansion. A bank loan creates a new property right in money without prejudice to the rights of the depositors from out of whose money the loan is given. That the loans granted by Islamic banks carry no interest is not relevant. How ever, this new money is a transient phenomenon, being cancelled when the loan is repaid. Nevertheless, what makes banks' lending a source of monetary expansion is the empirical fact that there are always so many loans outstanding. Since lending does not bring profits to Islamic banks, it is not expected to be very significant in quantitative terms. Actual practice of the individual Islamic banks confirms this view.

Some of the funds accumulated in Islamic banks' investment accounts are invested in industry, trade or agriculture in partnership with businessmen, or are handed over to them on profit sharing basis in order to finance a specific project. As these monies are received by some people as salaries, wages, prices for raw material, rents etc. some of it finds its way back to banks, how much depending on the banking habits of the people concerned. Also dependent on certain propensities of the people is the ratio in which the monies flowing back into bank accounts are distributed between current and investment accounts. Anyway, what is important is the fact that investment based on *musharaka*h or *mudarabah* results in the appearance of some new bank deposits while the funds so invested continue to be credited to their owners in their respective accounts. The fact that the nominal values of these accounts are not guaranteed does not alter the fact of their existence.

As the projects financed by Islamic banks mature and are wound up, the sale of their products recoups the monies invested with some profits (or losses). Some de posits somewhere in the banking system are run down as monies are paid or transferred to the Islamic banks, being the capital invested plus the banks share in the profits earned (or minus the losses incurred). New money created by the investment on profit sharing basis is also a transient phenomenon, like all bank money. But the empirical fact that invested funds are always in the possession of their new owners while they continue in the accounts of their original owners is responsible for the fact that investment activities based on profit sharing do contribute to monetary expansion. There is, however, a big difference between debt finance and participatory finance, so far as monetary expansion is concerned. Firstly, all profit-sharing investments are based on a potential for additional production, as reflected in the expected profitability of the project being financed. As argued elsewhere this does not necessarily apply to debt finance in which the borrower's ability to repay takes precedence over the project's expected profitability. Secondly, in case the projected creation of additional wealth fails to materialize, i.e. the business runs into losses, so much less is returned to the Islamic bank. In its own turn the Islamic banks debit the amount of the loss, *pro rata*, to the investment accounts. This means there is reduction in investment accounts, and therefore in M_3, in consequence of the Islamic banks investment activities' failure. On the other hand, when the investment brings profits, part of these profits is credited to the investment accounts resulting in an increase in M_3. It will be noted that there is some additional production of real wealth corresponding to this increase in money. The conclusions to be drawn from the above is that monetary expansion through profit sharing investment activities is not inflationary. A similar claim cannot be made in favour of debt finance[(13)].

When Islamic banks finance trade through *murabaha*-buying goods ordered by customers and selling it to them at higher prices to be paid in installments over a period of time-the same story is repeated. The pool of deposits out of which money for *murabaha* financing comes continues to be there, credited to the respective account holders. But much of the money paid out to sellers is bound to flow back to bank accounts, peoples' banking habits being what they are. *Murabaha* financing too results in creation of additional bank deposits and, therefore, contributes to monetary expansion.

There is a difference between *murabaha* financing and participatory financing. The former is a short term operation resulting in regular periodical inflow of cash to the bank, as the installments fall due. An Islamic bank practicing *murabaha* financing in a big way will be receiving a continuous stream of repayments. Hence the out flow and inflow of cash can be more closely synchronized in *murabaha* financing than in case of financing based on profit sharing because the latter is generally longer term. This implies that Islamic banks whose dominant mode of finance is *murabaha* can afford to offer more generous withdrawal terms than those who mostly practice participatory finance. This is confirmed by the current state of affairs in most of the individual Islamic banks as well as in the PLS cum mark up banking system in Pakistan.

Murabaha financing also directly links financing with real productive activity through trade. But unlike participatory financing it creates a loan obligation on the part of the customer. As a result the customer pays back the agreed price even when he incurs a loss in his trade. This means that no cancellation of monetary assets takes place due to failure in creating additional value. The capital investment by the bank in *murabaha* returns augmented by the agreed mark up on purchase price even though the corresponding real wealth is smaller in value.

One may dispute monetary expansion through *murabaha* financing by pointing out that if a private person buys some goods and sells it to a customer on a higher price to be paid in installments no money creation takes place. How could a similar activity on the part of a bank result in money creation? But the analogy is fallacious. When a private person buys goods in order to sell it with a mark up he runs downs his own bank account, so that the creation of new deposits, as the money he paid out flows back to the banks, does not imply a net addition to money supply. When a bank buys goods for sale with a mark up no accounts need be run down. As pointed out earlier, the monies spent by the banks in *murabaha* financing continue to stand in the name of their original depositors in their respective accounts. That is the big difference between the activities of financial intermediaries and private traders.

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13. **Muhammad Nejatullah Siddiqi,** Issues in Islamic Banking, *op. cit.*, p. 84, and pp. 55-57.

Conclusion

Above we have examined the three main modes of financing practiced by Islamic banks viz, lending, participatory financing (*musharaka* and *mudarabah*) and *murabaha*. We have seen that all three contribute to monetary expansion in so far as they result in creation of new bank deposits while the ones which brought in the funds in the first instance continue with varying degrees of withdrawal facilities. Creation of money is linked to the condition of account from which the bank finances its operations. Demand deposits as well as investment deposits with withdrawal facilities, when used to finance bank operations, result in creation of money. Investment deposits out of which no withdrawal is possible do not result in money creation. With out going into the details of some other activities of Islamic banks like leasing and direct investment in trade, industry or agriculture, it can easily be seen that these too partake in the process to varying degrees. The extent of their contribution to monetary expansion depends mainly on the speed of turnover and the degree of synchronization between cash inflow and outflow as these are the factors which enable the banks to offer less or more generous withdrawal terms to their investment account holders.

At the macroeconomic level the extent of monetary expansion through the activities of Islamic banks in a country where all banks are Islamic will depend, apart from depending on the banking habits of the people, on two factors: the ratio between current deposits and investment deposits and the ease with which withdrawals can be made from investment accounts. We do not have any empirical data to arrive at more specific conclusions.

The contribution of Islamic banks' activities to monetary expansion in a mixed system, especially in a system overwhelmingly dominated by interest-based banks, is more difficult to ascertain. The only thing that can be affirmed with certainty is that while they do contribute to monetary expansion, it is likely to be less than that of the conventional banks. There are two main reasons why Islamic banks' activities are less expansionary than that of the conventional banks. Firstly, the ratio of current deposits to total deposits is smaller in Islamic banks than it is in conventional banks. Secondly, as explained above, Islamic financing is linked to real productive activities whereas some of the conventional bank financing is merely for speculative purposes and other unproductive uses.

As we have seen above there is no difference of opinion regarding the need for keeping some liquidity reserves against investment accounts in order to be able to meet the withdrawal requests according to the terms of the contract. It is the need for a statutory reserve to be deposited with the central bank which is disputed by some Islamic economists, as we have noted above. In the opinion of the present writer it is advisable to subject the investment deposits from which withdrawals can be made before the completion of the contractual period to some statutory reserves. The ratio should be smaller than that applicable to time deposits in the same economy or a similar one. Such a requirement is justified on the ground that financial intermediation through operating investment accounts does take part in monetary expansion and the Monetary Authority should have some lever directly impinging on these accounts. Since the absence of the Bank Rate' has already deprived the Monetary Authority of one instrument of monetary policy, and in view of the problems surrounding the frequent use of the power to manipulate the 'profit sharing ratios' by the Monetary Authority, it will not be prudent to give up another instrument conventionally available for controlling the money supply, namely the statutory reserve ratio, with respect to what is expected to be the predominant form of deposits in the Islamic banking system. However, to be fair to Islamic banks which cannot 'rediscount' at a central bank window any of their assets, they should be granted interest free loans by the central bank, to the extent of their reserves, when they are in need of cash. This loan should be repayable within a reasonable period of time, to be determined by the Monetary Authority taking into consideration all the relevant circumstances.

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أثر صيغ التمويل الإسلامي على التوسع النقدي

محمد نجاة الله صديقي
مركز أبحاث الاقتصاد الإسلامي، جامعة الملك عبدالعزيز
جدة ، المملكة العربية السعودية

المستخلص : يركز البحث على التصورات المختلفة عن الأثر المحتمل لعمليات البنوك الإسلامية على عرض النقود. وحيث أن حسابات الاستثمار لدى البنوك الإسلامية تسمح غالبًا بقدر من حرية السحب منها، فإن تقديم التمويل من هذه الحسابات لأصحاب الأعمال، سواء على أساس المشاركة أم على أساس المرابحة، سيولد نقودًا جديدة (مشتقة).

ويبين البحث أن توليد النقود من قبل المصارف الإسلامية هو (بالمقارنة مع المصارف التقليدية) أكثر ارتباطًا بتوليد مزيد من الثروة في القطاع الحقيقي.

كما أن الزيادة الناتجة عن ذلك في عرض النقود ستكون أقل من تلك الناتجة عن عمليات الإقراض من الودائع الادخارية والآجلة في المصارف التقليدية. لهذا، فإن على المصارف المركزية أن تطبق على المصارف الإسلامية نسبة احتياطي قانوني أصغر من تلك المطبقة على المصارف التقليدية.