

Monetary Policy in an Islamic Economy: The Central Bank's Role

The Annual Intellectual Symposium of Islamic
Financial Economics
University of London
London, UK
May 28th, 2014

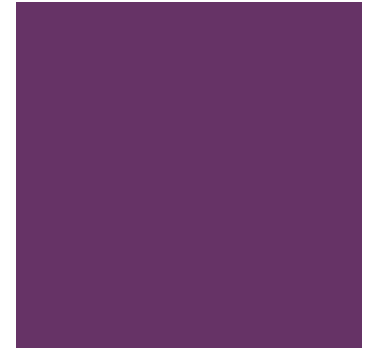
Gabriella Crimi
Mount Holyoke College and
American University of Sharjah
crimi22g@mtholyoke.edu

George Naufal
American University of
Sharjah
gnaufal@aus.edu

Ismail H. Genc
American University of
Sharjah
igenc@aus.edu

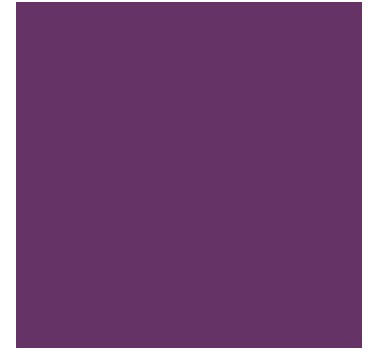
Introduction

- Islam has had the largest average annual rate of increase of adherents (2.10%) of the five major world religions in the 21st century
- Islamic banks currently serve over 38 million customers
- Two distinct scenarios in which Islamic banks exist
 - Dual system vs Islamic system
- Empirical examples of Islamic economies
 - Pakistan, Iran, and Sudan



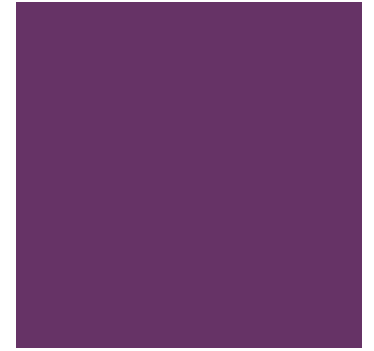
Our Questions

- What are the principles of Islamic economics?
- What is the role of the central bank in an Islamic economy?
- How do Islamic banks that exist in a conventional economy differ, in practice and principle, from their counterparts in an Islamic economy?
- What is the prevalent method of Islamizing the economy?
- Do our theoretical conclusions align with the empirical examples of Islamization?



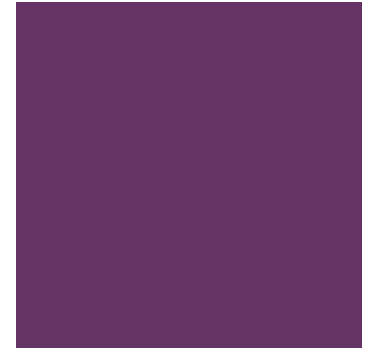
Paper's Objective

- To assess the feasibility of the dual system versus the purely Islamic system through theoretical monetary policy



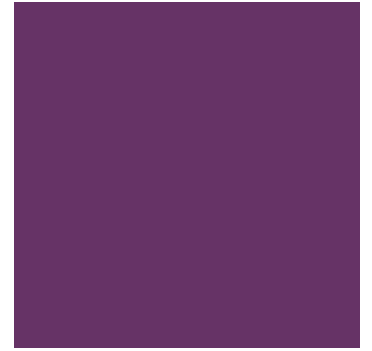
Related Works

- Khan and Mirakhor (1989)
 - The permissibility of monetary policy instruments
- Anwar (2003)
 - The central bank's role in controlling the money supply in an Islamic economy
- Shaikh (2009)
 - The methods and tools of Islamic central banking
- Ismal (2011)
 - The guiding principles of Islamic central banks

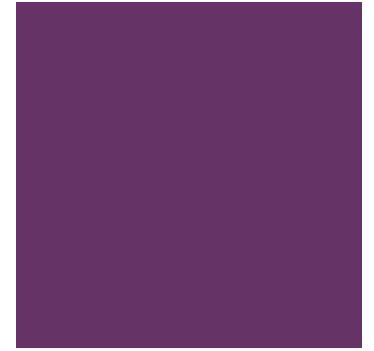


The Goal of Islamic Economics

- Individuals' basic needs are met
- Socio-economic progress occurs
- People are able to use their endowed abilities to contribute to the economy

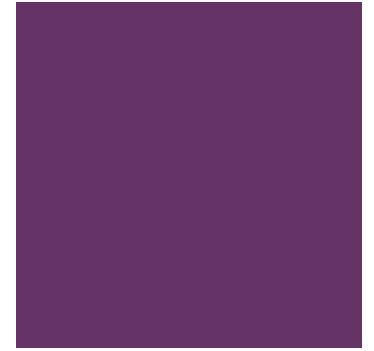


The Principles of Islamic Economics



- Prohibition of interest
 - Effortless profits
 - Based upon “money-for-assets” transactions
- Islamic redistribution
 - Zakah
 - Laws of inheritance
- Islamic economic norms
 - Active participation of an individual
 - No free economy

The Role of the Central Bank in an Islamic Economy



- To regulate and supervise banks and financial institutions in an Islamic economy
- To determine the conditions in both banks' assets and liabilities
- To control market conditions while following the commands of Allah as stipulated in the principles of the Quran and traditions of the Prophet (PBUH)
- To perform their role as a lender of last resort

Monetary Instruments in an Islamic Economy



Forbidden Instruments

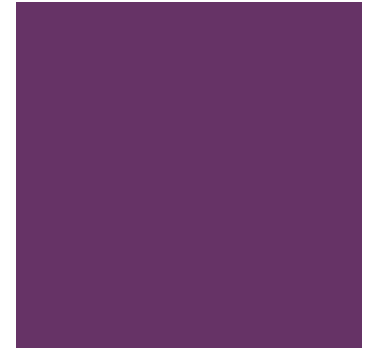
- Discount rate
- 0% interest rate

Permissible Instruments

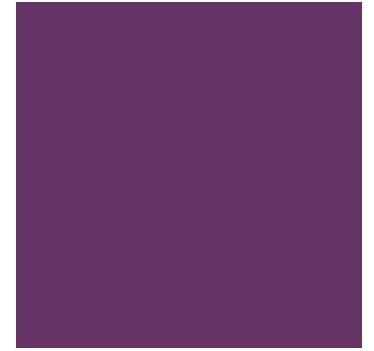
- The reserve requirement
 - 100% reserve requirement
- Open market operations with non-interest bearing securities
- Profit-sharing ratios of mudarabah loans
- Certificates issued by the central bank
 - Wakalah wa Ijarah (agency and leasing)

Modeling Central Banking in an Islamic Economy

- IS-LM model
- No change on monetary policy's effect on economic variables
- Money supply and mudarabah ceilings lead to the same rates of return and national income levels



Complete Islamized State



- Three empirical examples: Pakistan, Iran, and Sudan
- Islamization has taken two courses:
 - Gradual transformation, begins in the banking sector
 - Complete and sudden reconstruction

Pakistan

Phases

- 1979- 1985
 - House Building Finance Corporation Ordinance of 1979
 - Commercial banks' PLS counters
- 1985- present
 - Legal ban on interest

Instruments

- Musharakah certificates
- Wakalah
 - Investment management contract



Iran

Phases

- 1979- 1982
 - Nationalization of banking system
- 1982- 1986
 - Law for Riba-Free Banking
- 1986- present
 - Central bank and government are seen as complements

Instruments

- Musharakah certificates
- Special central bank deposits
- A control on the profit rate of commercial banks
 - Reduce rate → expansionary monetary policy

Sudan

Phases

- 1970-1979
 - Low inflation
 - Increasing gov. debt
- 1980-1989
 - High inflation
- 1990- 2001
 - Interest banned
 - Money supply growth at 440% per annum

Impact of Islamization

- Elhiraika (2004) found no change on monetary policy
- Switch from the Sudanese pound to the Sudanese dinar had larger impact



SWOT Analysis- Islamic Banking

Strengths of Paper

- Widens scope of this field
- Determines permissible monetary instruments

Weaknesses of Paper

- Lack of data/ evidence of dual system

Opportunities for Researchers

- Debt management in an Islamic economy
- Need for global Islamic bank

Threats for Researchers

- Microscopic perspective
- Lack of empirical examples of completely Islamized economies

Positive

Negative

Internal

External