

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

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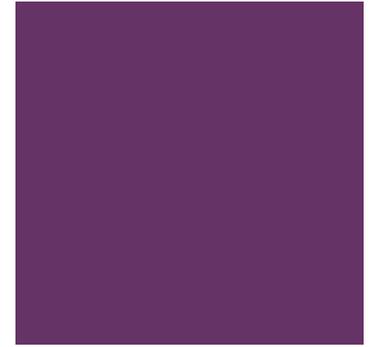
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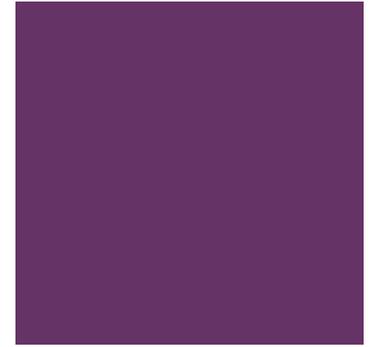
# Introduction

- 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



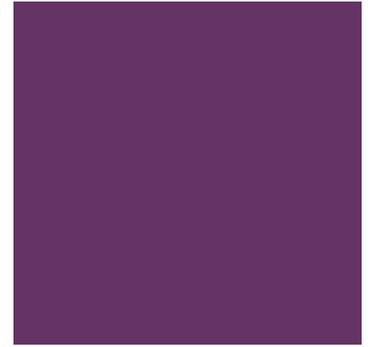
# Related Works

- 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

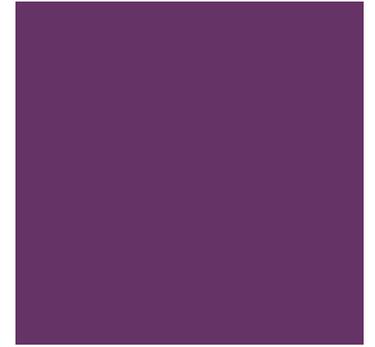


# The Goal of Islamic Economics

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

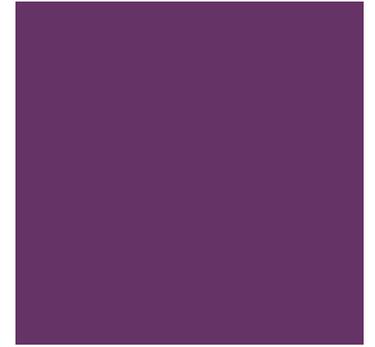


# The Principles of Islamic Economics



- 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

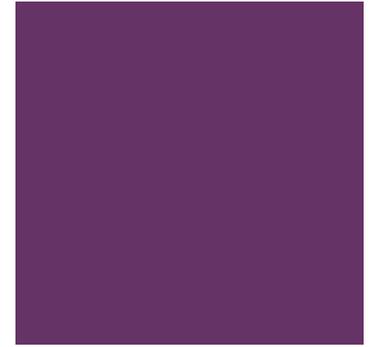
- Discount rate
- 0% interest rate

## Permissible Instruments

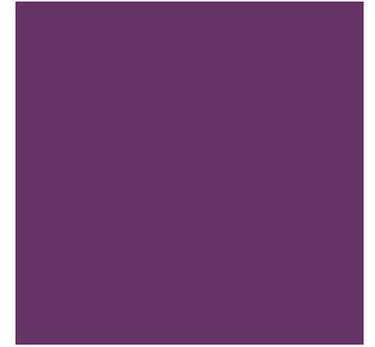
- The reserve requirement
  - 100% reserve requirement
- Open market operations with non-interest bearing securities
- Profit-sharing ratios of mudarabah loans
- Certificates issued by the central bank
  - Wakalah wa Ijarah (agency and leasing)

# 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

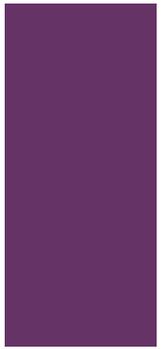
# Pakistan

## 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

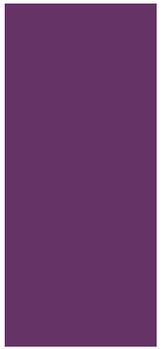
# Sudan

## 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