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Monetary Policy in Selected Islamic Countries: Added Value or Mimicry?

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ABSTRACT

In the last three decades, Islamic financial institutions have grown in size and number around the world. Most publications on Islamic finance focus on the instruments: how they are different from traditional ones and to what extent they replicate the well-known instruments based on interest rate. The goal of this paper is to look closer on the consequences of the Sharia rules for the functioning of central banks, especially the monetary policy performed by them. It was shown; that the declared goals and functions of the central banks are partly different than in non-Islamic countries and the ban on *riba* (usury) has consequences for the applied monetary policy instruments. On one hand, the traditional instruments are modified to conform to the *riba*-free economy, on the other hand – new instruments are proposed. For the analysis, the author selected two countries where the banking system is fully Islamic: Iran and Sudan.

Keywords: Islamic finance, Islamic banking, monetary policy, monetary policy instruments

INTRODUCTION

In the last three decades, Islamic financial institutions have grown in size and number around the world. Total Islamic finance assets grew to an estimated $1.8 trillion by the end of 2013, representing a compound annual growth rate of 17% between 2009 and 2013 [Islamic Financial Services Industry Stability Report 2014, p. 163]. Nevertheless, the Sharia compliant assets make up only about 1% of the world's financial assets. The potential for growth is still high considering the *number* of Muslims worldwide (approx. ¼ of population).

In some of the countries the Islamic banks are strongly promoted and supported (e.g. Malaysia, Bahrain), in others they are viewed as a potential threat to social stability (e.g. Egypt). A government's or central bank's attitude towards the sector is mainly influenced by politics. Therefore, it is mainly the state intervention that drives the development of Islamic banking, and not market processes.

Most publications on Islamic finance focus on the instruments: how they are different from traditional ones and to what extent they simply replicate the traditional instruments based on interest rate. The goal of this paper is to look closer at the consequences of the Sharia rules for functioning of central banks, and especially the monetary policy performed by them. The author identifies the goals and functions of central banks in selected Islamic countries, along with monetary policy instruments applied. It is shown that the declared goals are partially different than in non-Islamic countries and the ban on riba (usury) has consequences for the applied monetary policy instruments as well. On one hand, the traditional instruments are modified to conform to the riba-free economy, on the other – new instruments are proposed.

For the analysis, the author selects two countries where the banking system is fully Islamic: Iran and Sudan. It is worth remembering that Iran is obviously a much more developed country ($12,800 GDP per capita, purchasing power parity) than Sudan ($2,600).

Many Muslim countries apply currency boards (Djibouti, Brunei Darussalam) or peg their currencies to the United States dollar (e.g. Bahrain, Saudi Arabia, United Arab Emirates), euro or a composite. Other countries use stabilized arrangement1 (e.g. Maldives, Iraq), other management arrangements

[1] Classification as a stabilized arrangement entails a spot market exchange rate that remains within a margin of 2% for six month or more and is not floating [IMF 2013, p. 65].

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(e.g. Iran2 - currency basket) and do not pursue a very active monetary policy. There are also countries that opt for more flexible arrangements, like Malaysia and Sudan [IMF 2014, p. 5-6]. Keeping this in mind, we may move to analyzing the financial instruments and the scope of the monetary policy instruments and compare them with the traditional ones.

The Pillars of Islamic Finance

It is not necessary to describe all the rules governing Islamic financial institutions in detail. These rules are well known and described in the literature (e.g. Ayub 2007, Abdul-Rahman 2010). The Islamic financial framework is based on the following principles:

- prohibition of paying or receiving interest (more general: *riba*), while profit and loss sharing between lender and borrower is promoted[3],
- avoidance of involving in speculative activities,
- prohibition of speculation or gambling (maysir), e.g. futures or simply zero-sum games, traditional insurance,
- prevention of investing in any products or services which are forbidden in Islam (e.g. pork, casinos, alcohol),
- backing of financial transactions by tangible assets, usufructs or services,
- prohibition of selling and buying debt,
- Giving of alms (zakat).

In addition to these religious-based "technical" issues, it is worth noting that the adherents of the Islamic finance opt for socio-economic development, social justice and welfare among Muslim communities by mobilizing savings that are kept outside interest-based financial institutions [Mouawad 2009, p. 75].

It also should be noted that at least a part of these restrictions might influence the way the monetary policy is conducted. The consequences for the goals and role of central banks are less straightforward, but they should also act according to the Sharia rules.

CENTRAL BANK GOALS AND FUNCTIONS IN ISLAMIC COUNTRIES

In general, Islamic central banks aim at achieving similar goals and perform similar functions as non-Islamic ones. Theoretical considerations on the role of Islamic central banks certainly indicate the importance of price stability but also supporting "prosperity of the whole people" (Ismal 2011, p. 51)4. In addition, we observe some specific goals and functions that need clarification.

In **Iran**, after the revolution of 1979, the banking system was nationalized. Shortly thereafter the Law for Usury (Interest) Free Banking [1983] was passed, and in March 1984 interest-free banks started to implement Islamic banking.

The Central Bank of Iran (CBI)5 has set the following objectives: maintaining the value of the currency and the equilibrium in the balance of payments, facilitating trade transactions, and assisting the economic growth of the country.

In addition to these "typical" goals, CBI (or the state) should aim at establishing a monetary and credit system "based on rightness and justice", as delineated by Islamic jurisprudence, for the purpose of

[2] Effective July 3, 2013, the rial was devalued (12,260 rial per US dollar to 24,790). The exchange rate in Iran is by no means stable, however: 27,994 rial per US dollar on 20 March 2015, compared to 25,102 exactly one year earlier [www.cbi.ir/ExRates/rates_en.aspx].

[3] However Ibrahim and Sukmana [2011, p. 4-19] show that the behavior of Islamic financing in Malaysia is affected by the interest rate probably because the Islamic banks have to follow the pricing strategy of the conventional banks.

[4] Before criticizing such a general attitude one should consider the Federal Constitution of the Swiss Federation (Art. 99): "The Swiss National Bank, as an independent central bank, shall pursue a monetary policy that serves the overall interests of the country".

[5]The Central Bank Markazi Jomhouri Islami Iran.

regulating the sound circulation of money and credit to enhance the health and growth of the economy. The monetary and credit mechanisms should support the economic goals, policies and plans of the Iranian government.

A special characteristic of the Iranian banking system is known as the gharz-al-hasaneh – a charity / beneficent loan (without interest, but the bank may charge a 3 per cent fee maximum).

The functions of CBI are rather typical: notes issuance, carrying out the monetary and credit policy, management of foreign reserves, supervision of transactions in foreign exchange and gold and services to the government, among others.

Sudan is an example of a state that following South Sudan's secession fully turned to Islamic banking. This relatively poor country faces severe economic problems, especially after the secession, as it is South Sudan where oil resources are located.

The basic responsibilities of the Central Bank of Sudan (CBOS) are: to ensure price and exchange rate stability as well as the efficiency of the banking system.

The CBOS also performs the typical functions of a central bank: issuance of the currency, formulation and implementation of the monetary policy (in consultation and coordination with the government), organization and supervision of the banking system and acting as a bank of the government [http://www.cbos.gov.sd/en/node/110].

The Three Year Programme (2012-2014) has introduced four policy pillars, which should lead to restoration of the internal and external equilibrium and thus promote economic growth. The Achievement of Economic Stability pillar concentrates on monetary and fiscal policies. CBOS has decided to target a nominal rate of growth in money supply at 15%. A strategy of influencing (short term) interest rate cannot be a solution in the interest rate (or riba) free economy. However, this statement does not have to be 100% true, which will be shown below.

MONETARY POLICY INSTRUMENTS IN THE SELECTED ISLAMIC COUNTRIES

There are two broad groups of monetary policy instruments: monetary aggregate control and influencing the interest rate level, which correspond to two major strategies of central banks. Of course, the instruments aimed at determining interest rates have liquidity effects, and vice versa.

If monetary policy instruments that rely on the interest rate (first of all: traditional open market operations) were removed in the Islamic economies, suitable substitutes would have to be found. Otherwise financial intermediaries, whose behavior is not affected by interest rates, could dominate the Islamic countries' financial sectors and traditional monetary policy could become totally ineffective [El-Gamal 1999, p. 519].

Fortunately, this problem has been more or less solved. In practice, the government or the central bank issues special certificates based on profit sharing to absorb the liquidity. The certificates have to be based on the real, productive projects; otherwise the profit sharing principle does not work. The profit rate of the certificates corresponds to the conventional interest rate. An open question remains: how can the authorities influence the (residual in its nature) profit rate? Another more technical question is whether the monetary contraction is actually achieved (what happens to the funds received by the central bank or government in exchange for the certificates).

Ismal [2011, p. 53-64] describes innovative Islamic instruments resembling open market operations. One of them is based on wakalawaijara (agency and leasing). The certificates are issued by the central bank and sold to banks. The proceeds (funds) are then used to buy a leasable asset for them in order to be leased to a third party with a rental rate in an agreed period. The holders of the certificates (banks) get regular payments of returns, which come from the returns on the leased asset. At the end of the period the holders of a certificate get the principal based on the market value of the asset when it is sold by the central bank.

Other instrument, musharakamutanaqisawaijara certificate, assumes that the central bank and depositors contribute some funds to share the ownership of a project. The asset is being leased to a third party then. After some time the depositors are the only owners of the asset, because they give their leasing income up to the central bank (means: liquidity absorption).

Next scenario assumes that the central bank owns an asset and sells a part of its full ownership to the investors in exchange for certificates. This constitutes the Islamic securitization. A third party then

leases the asset and the rental income is shared between investors and central bank according to the portion of ownership. However, the central bank redirects the ijara income to the investors (means: monetary expansion) in order to repossess the asset at the end of transaction.

In every case the transaction parameters are set in a way that makes it profitable for all parties. Please note that these are not typical open market operations. The main purpose of such Islamic monetary instruments is to utilize the idle funds or support real business activities.

Unlike in the case of the traditional banking system, commercial banks in the Islamic system cannot borrow from the central bank at a given official rate. Any such borrowing has to be based on a profit and loss arrangement. We assume here that banks can borrow from the central bank only on an equity-participation basis. That is, the central bank purchases equity in the bank when it wishes to expand reserves in the system, and vice versa. Therefore, the sale of equity shares to the central bank becomes an additional source of funds for commercial banks. The rate of return on equity shares depends on the overall profit position of banks, so that, in contrast to an official discount rate, it is not determined directly by the central bank [Khan, Mirakhor 1989, p. 48].

Other instruments not relying on the interest rate, but available for domestic liquidity, might still be used. These include: reserve requirements (minimal reserves), credit controls and moral suasion.

The Islamic banks face the problem of using the resources according to the Sharia rules. That is why either their liquidity is too high or they do not obey the rules and invest the capital with conventional banks (banks in Egypt are an example [Mouawad 2009, p. 82]). In order to address the (too) high liquidity problem of banks, Central Bank of Indonesia6 imposes a lower minimum reserve rate (5%) for Islamic banks that have a high financing-to-deposit ratio7. This is a kind of incentive for Islamic banks as conventional banks have other investment opportunities than financing the real sector (e.g. bonds, derivatives). High financing-to-deposit ratio (in case of Indonesia: ≥80%) is more preferable as it fulfils the core objective of Islamic banks to support the real sector. Conversely, if Islamic banks have moderate or low financing-to-deposit ratio (<80%), they are required to maintain "normal" (higher) reserves, as conventional banks [Sukmana, Kholid 2013, p. 127-132].

In **Iran** commercial banks face some restrictions that are typical not necessarily only for the Islamic countries, but for developing countries in general. Some specific activities are supported by the state (e.g. construction of low-priced residential units, projects included in the State Annual Budget Bills) or supported because they serve the economy as a whole (e.g. financing purchase of raw materials and spare parts needed by productive companies). Others are just forbidden ("the banks are by no means entitled to invest in the production of luxury and non-essential consumer goods") [*Law for Usury (Interest) Free Banking* 1983, Art. 7-13].

Islamic credit contracts take two forms: participatory and non-participatory facilities. Contracts are structured around the notion of rates of profits and in reference to the financing of real assets. Some contracts entitle the banks to a share of profits (and losses; profit and loss sharing) on the investment being financed (participatory facilities). Non-participatory facilities are similar to leasing structures or installment sales, where the bank's remuneration is a mark-up on the acquisition value of the good being financed. Housing facilities are structured as long-term instalment sales. Usury is not allowed in relations between CBI and Iranian banks as well as between banks themselves. However, charging and payment of interest among government entities is not considered usury (!) [Maysami 1999, p. 43].

As of April 20148 Iranian banks and credit institutions extended financing to their customers using predominantly partnerships9 (39.3%), instalment sale10 (29.1%) and gharz-al-hasaneh loans (5.1%) [http://www.cbi.ir/category/3392.aspx].

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[6] Indonesia has the largest Muslim population in the world.

[7] In case of traditional banks: loan-to-deposit ratio.

8End of Farvardin 1392 (Persian calendar).

9 Partnership or mosharekatmadani is a business contract by which two or more real or legal entities including a bank combine their cash or non-cash capitals in a common mode in order to make profit.

10 Interestingly, Iranian banks are not allowed to finance consumer durable goods on installment.

The Central Bank of Iran may conduct monetary and banking policy using the following instruments [*Law for Usury (Interest) Free Banking* 1983, Art. 20; Maysami 1999, p. 43-44; Hassani 2010, p. 430-444]:

a. fixing a minimum and / or maximum banking profit rates in their joint venture and mozarebeh11 activities,
b. fixing a minimum and maximum margin of profit as a proportion of the cost price of the goods transacted in instalment and hire-purchase mode,
c. determination of the types and the minimum and maximum amounts of commissions charged for banking services,
d. restrictions on areas of investments and partnerships of banks, and fixing of a minimum prospective rates of profit for the various investment and partnership projects12,
e. determination of the types, amounts, and the minimum and maximum bonuses for gharz-al-hasaneh deposits13,
f. determination of the minimum and maximum ratio in joint ventures, mozarebeh and other modes of investment14,
g. determination of the maximum aggregate amount of overall loans and credits granted by banks or the maximum amount of their loans and credits in each specific sector or even customer – a credit ceiling.

Table 1 is an illustration of the above-mentioned limits.

Table1. *Rates of profit on bank assets and liabilities (2011-2012)*

Assets		Liabilities	
Instrument	Ceiling	Instrument	Ceiling
Minimal reserves at CBI	1%	CBI overdraft	34%
Non-participatory modes	11-14%	Demand accounts	0%
Participatory modes	14-17%	Saving accounts	Bonuses in cash or in kind
		Term deposits	6 to 15%, depending on maturity (6M-5Y)
		Participation paper	100 bp over term deposits

Source: *IMF [2011, p. 7].*

Participatory modes on the asset side were also subject to a floor of 12%, given their greater risk. The general rule is that the limits are provisional, with the final rates of profits on bank assets being finalized a year later, after external auditors confirm the bank's profits. According to 5th Development Plan (2010-2015), the Money and Credit Council sets the remuneration of term deposits to yield no less than the average of the previous year's inflation and the CBI forecast for the current year. From January 2012 the provisional term investment deposit rates may be set on banks and credit institutions' discretion.

Iranian Money and Credit Council (MCC) recommends that banks allocate 80% of their increase in deposits to priority sectors (allocated as follows: 37% to manufacturing and mining, 25% to agriculture, 20% to construction and housing, 10% to trade, and 8% to export). The remaining 20% of the increase in deposits could be used freely, although there are sub-limits on credit for consumer durables or home improvement. The limits concerning credit allocation support job creation as the economy's access to foreign capital became more restricted [IMF 2011, p. 4-7].

The Central Bank of Iran also decides about the issuance of non-governmental participation papers (similar to sukuk, but also to project finance). These papers resemble conventional bonds, but remu-

11 According to mozarebeh contract the bank provides the capital in cash and other party uses it for the commercial purposes. The profits are shared at a specified ratio between the two parties at the end of the contract.

12 For example, in 2010 the minimal rates were: 6% for agriculture projects, 8% for mining and industrial projects, 10% for housing and construction, 12% for commerce and services [Zarrokh 2010, p. 189]. The priority sectors had obviously the lowest rates.

13Gharz-al-hasaneh deposits may be current or saving deposits. These are non-profit-sharing and accordingly the banks do not pay any remuneration to the customers, but may offer non-fixed bonuses in cash or in kind.

14 For example, in an agriculture project, up to 90% of the capital may be provided by the bank.

neration is not determined in advance. Holders of these papers are entitled to their shares of profit, proportionate to nominal value and the period of participation. With participation papers, at the end of the project the profit must be calculated and can then be distributed among the shareholders. The participation papers do not constitute debt and may be traded on organized exchanges. The maximum amount of issuance is determined annually by the MCC, under consideration of monetary and financial policies [Law for the Issuance of Participation Papers 1997, Art. 1-4].

The participation papers may also be used in open market operations; CBI could affect broad money this way, thereby controlling the rate of inflation. This instrument was used in the past, e.g. 2008, but is not used nowadays. Similar effects may be achieved by opening special deposit accounts with the CBI to absorb excess liquidity from the banking system. CBI pays profit (not interest!) to these deposits "on the basis of specific rules".

The reserve requirement ratio is one of the CBI's indirect instruments of monetary policy. Banks are obliged to deposit part of their liabilities in the form of deposit with the CBI. Through increasing/decreasing this ratio, the CBI contracts/expands the broad money. According to the law, CBI is authorized to determine the ratio within 10-30% band, depending on banks' liabilities' composition and field of activity [Monetary Policy Instruments in Iran]. In practice, the reserve requirement in April 2013 amounted to 648,456.9 billion rial, 11.3% of deposits of non-public sector or 5.0% of assets of Iranian banks [http://www.cbi.ir/category/3392.aspx].

In **Sudan** the Central Bank of Sudan applies the following instruments of monetary and financing policy:

a) liquidity management, consisting, among others, of the statutory cash reserve with the CBOS (13% of current deposits in local and foreign currencies, 10% of investment and savings deposits), which corresponds to minimum reserve requirements;
b) uses of resources management; the Sudanese banks should use their resources to support rural areas (not less than 70% of total deposits attracted from these areas), agricultural and industrial production for boosting exports and replacing imports, financing production of gold and other minerals, as well activities with a social dimension;
c) cost of financing management; the Central Bank of Sudan specifies that the profit margin of the murabaha mode shall be 12% p.a., as an indicative rate, for both local and foreign currency. The banks are encouraged to use the musharaka mode; the CBOS determines the musharaka percentages. These measures may be considered as a hidden embedding of interest rate in a riba free economy. However, each bank is free to determine the mudarib's percentage share in the profit in case restricted mudaraba mode15;
d) prohibition of financing of specific activities or entities, like purchase of foreign currencies, shares, securities, repayment of non-performing loans [Central Bank of Sudan Policies for the year 2012].

In 1997, CBOS approved the central bank's musharaka certificates, which are equity-based instruments, issued against the government or central bank ownership in commercial banks. The certificates may be viewed as an instrument of managing excess reserves. Due to the character of the securities (ownership, not debt) they were allowed to be traded on the secondary market [Sundararajan, Marston, Shabsigh 1998, p. 11-13].

The above analysis allows us to make the following statements / remarks:

1. central banks / governments in the (developing) Islamic countries obviously do not believe that market rates of return are proper indicators for resource allocation. Probably for this reason indicative rates of return are determined arbitrarily and do not necessarily reflect the actual (short-term, purely economic) sectorial rates of return. The financial resources are redirected to the projects with long-run social benefits, like agriculture or water supply. This kind of state intervention is an

[15] In the restricted *mudaraba* mode the bank acts as an agent for the investment account holders and is subject to specific restrictions as to how it will invest their funds and in what types of investments. In this case the funds available to the bank from investment account holders are not entirely under the control of the bank, because the customers have the right to determine the details of investing their funds. *Mudaraba* profits are distributed to the bank and customer according to the agreed profit sharing ratio.

instrument of the economic policy rather than the monetary policy and support the view that Islamic economies are marked by statist policies;

2. the minimum rates of return in bank-customer partnerships effectively eliminate unprofitable projects;
3. if the system gets more market oriented and the authorities give up the determination of profit rates, central bank would influence the economy by controlling the money supply;
4. by regulating the profit sharing ratio between the banks and their clients in each sector of the economy, the central bank may influence the amount of credit allocated by banks to various sectors;
5. establishing minimum limits for the participation of banks in the capitalization of long-term investment projects influences (arbitrarily) the allocation of funds to different sectors of the economy;
6. In the long run the real rate of return in the Islamic banking system may be more or less the same as the average depositors' interest rate plus the cost of banking intermediation. Even if so, by no means are the conventional and Islamic systems equivalent. The individual profit rates may differ and influence the profits earned by the depositors; a disclosure of profits by banks is an added value (if really applied), to name just two reasons. An open question is also how the fully Islamic system would work in the absence of state intervention.
7. The instruments used in open market operations are participatory rather than debt instruments. They serve predominantly the liquidity management purposes.

SUMMARY

Implementation of Sharia rules has consequences also for the central banking. Central banks' goals and functions are being modified and monetary policy instruments adjusted or developed to comply with the restrictions. So far only a few countries fully applied Islamic finance. Nevertheless, their example shows that monetary policy in a usury-free environment is possible.

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