

**A MONETARY AND FINANCIAL  
STRUCTURE FOR AN  
INTEREST-FREE ECONOMY:  
INSTITUTIONS, MECHANISM &  
POLICY**

**UPDATED VERSION**

**MABID ALI AL-JARHI**

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# PREFACE

This paper attempts to outline a possible financial structure for an interest-free economy, which would conform to the Islamic principles.

The basic characteristics of that economy are not new. Pioneers in Islamic economics have mentioned them previously<sup>1</sup>. However, they were scattered in many writings and under diverse Topics<sup>2</sup>. Yet those attempts have opened a path to this topic to be handled in an effective manner.

The first draft was prepared in June 1979. It was later presented to a seminar at the International Center for Research in Islamic Economics, University of King Abdel-Aziz, Jeddah. The revised edition was later published in February 14, 1980. In connection with that version, the writer is grateful for the comments and encouragement of the seminar participants, including Professors M. Nejatullah Siddiqi and Anas Zarqa.

The writer is also grateful for the comments of many colleagues and friends for taking the trouble to go through the initial handwritten manuscript. Ezzeddin Ibrahim Hassan, Anton S. Kattan and Salam Hleihel, staff members at the Arab Monetary Fund deserve special mention.

The writer is also grateful to Mrs. Suzan Omar El-Karaksi for secretarial assistance during the preparation of the first and older version, and two Abdelrahman Yousef during the preparation of the current version.

The current version contains updating and editing of the old version without changing the original structure

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1. A survey of that effort has been attempted by Siddiqi, 1978. Other writers have contributed to the subject, M. Baqer Alsadr, Mahmoud Abusaud, Ahmad Al-Naggar, M. N. Siddiqi, M. Omar Chapra, Monzer Kahf, and many others.
  2. A pioneering attempt to place the Islamic financial system under the limelight, from which this paper has benefited substantially is that of Chapra, 1978.

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# INTRODUCTION

Economists, while investigating the traditionally known functions of money, have not challenged the fact that the serving as a means of exchange is the most important function of money. Although this has sometimes been hinted, carrying on the analysis on this basis to its logical conclusions has been less pronounced.

The importance of money as being a means of exchange is due to the nature of our world, where transactions are costly. Without transactions costs, money as a means of exchange would be unnecessary. This means that money can be described as an asset from which a stream of transactions services emanates, just like real assets. In this capacity, money enters the net worth of the individual as an asset.

The inclusion of money into the net worth of individuals nullifies the concept of money as a veil. Monetary changes will therefore have real effects. Those real effects will have to be viewed within the realities of costly transactions which imply costly information, but not through the Pigouvian "real balance effect".

The current institutional structure of banking did not draw its pillars from economic theory. Yet the prevailing doctrine gives such structure the necessary blessings. Ironically, the prevailing doctrine makes insufficient use of studying economic activities on the basis of costly transactions. Unfortunately, much of monetary analysis has been done with little explicit dealing with the function of money as a means to reduce transactions costs. Instead of utilizing frictional models in which transactions costs play an explicit role, the easy case of perfect market models has been often used.

If a friction like transactions costs is the *raison d'être* of money, it becomes, fruitless to study money in a frictionless economy. By doing so, the prevailing economic theory exposes itself to the accusation of analyzing monetary transactions in a model within which rational individuals would not hold money. However; this is exactly the kind of theory from which the current banking system, which is based on interest, draws support.

An area of research avails itself to economists hence, especially those who are initially inclined in favor of interest-free banking. Any effort to restructure the perfect-market model currently used for monetary analysis, so as to include the ingredients necessary for the holding of money to be rational, would be a contribution in itself. It could also expose the weaknesses of allowing money to be issued by banks exchanged at a price equal to the rate of interest (Al-Jarhi, 1975).

Theoretical discussions related to the issues of what "Price" money should have cannot be separated from the monetary institutional arrangement. It is rather difficult, when discussing such issues, to start specifying in every detail what institutions the writer has in mind. Up to the end of the twentieth century, those who adhered to the prevailing doctrine were at an advantage, since they always refer in their arguments to the conventional state of banking practices. Those who try to show shortcomings in the prevailing doctrine had no existing deep-rooted institutional setup to which they could refer. They had to specify in each discussion all the necessary details of what system they may have in mind.

Now the situation has radically changed. Islamic banking has been practiced at the microeconomic level for longer than a quarter of a century. At the macro level, it has been running for more than a decade mainly in two countries, Iran and Sudan. However, critics of the existing practices of Islamic banking and finance, both at the micro and macro levels point out to several defects.

This Paper is designed as an attempt to surmount this problem. A skeleton of an institutional structure of monetary and financial system that is interest-free is presented. The skeleton is accompanied by an attempt to specify its mechanism as well as the policy within which it could be usable.

It remains to be seen whether this suggested structure has gained acceptability as a basis for discussing the theoretical aspects of pricing money, as well as the practice of Islamic banking and finance. Yet, it is hoped that it will be a step forward toward some clarification of the issues involved.

# CHAPTER I: THE CONVENTIONAL FINANCIAL STRUCTURE: BASIC CHARACTERISTICS

The current financial structure has acquired its features through historical developments in the Western World. Writings of economists on money and banking have had their share in influencing its institutional developments to a lesser extent than the practices by bankers and government treasurers.

Modern Western economists never had an interest-free institutional framework against which to compare their interest-based financial structure. On the one hand, the Marxist inspired systems offered little alternative. On the other, the Muslim world has lost the basic pillars of its indigenous economic institutions with the turn of the twentieth century. This made such institutions of little interest to modern monetary theoreticians.

One, therefore, can appreciate the difficulty of evaluating the current system, which is supported by the contemporary doctrine, and taken for granted by economic agents in day-to-day activities. Yet such evaluation can be made easier when the limitation of the current doctrine, outlined in the introduction, are recognized. However, such evaluation would be incomplete, unless it is made against an alternative institutional setup.

This motivates a line of thinking, at this stage, which depends a great deal on comparing the performance of the current system against an imaginary institutional framework, which would be devoid of the rate of interest, but which would be assumed, for the moment, to be workable.

Against that background, we can describe the current financial structure to be lending-centered. This means that a significant amount of resources is handed down from their owners to investors through lending institutions.

We can distinguish between those who invest their financial resources directly into an enterprise; and those who place their financial resources with lending institutions in the form of monetary assets, e.g., deposits, bonds, certificates, etc. Lending institutions in turn provide (some of) those financial resources to investors. However, because of the asset-liability structure of banks, lending institutions maintain the claims they hold against investors in the form of monetary asset, rather than titles to real assets.

We can therefore distinguish between two kinds of decision-making

processes related to allocating resources to investment. The first kind is the *lending-based process*, and the second kind is the *productivity-based process*. The lending-based process encompasses the rational behavior of lenders, while the productivity-based process includes the rational behavior of investors,

A lender is basically a holder of monetary assets, which are claims to fixed sums of money. He is therefore interested in the solvency of the borrower, in the sense that the present value of the borrowers' net worth is at least sufficient to cover the value of his debt. To ascertain the solvency of borrowers requires information collection and follow-up in which financial institutions specialize.

The important aspect of lending is that it is an allocation process in which the solvency of borrower is of utmost important, and the "productivity" of the borrowers undertaking is of secondary value. Therefore, individuals would place their funds with financial institutions of highest interest rates, given their ability to meet repayments and other conditions. In the same ways, banks offer funds to consumers as well as producers, as long as they are expected to meet repayment obligations.

All lending-based allocative processes in the economy provide for the interaction between demand and supply forces in such a way that sets an equilibrium interest rate. This rate serves as the opportunity cost of liquidity which would in turn play an indirect role to influence the productivity-based process.

Another important characteristic of the conventional financial system is that the process of money creation is lending-based. Money is created by the central bank to be lent to the government. It is also created by commercial banks, in the form of derivative deposits, to be lent to the public. This process, as will be seen in Ch. VI, influences the mechanism of price expectations. In addition, it establishes the rate of interest on government securities as "the" interest rate, through which the productivity based process is influenced by monetary factors.

It is those two processes: a lending-based allocation of investment, and a lending-based creation of money that distinguish the conventional system from an interest-free economy<sup>3</sup>. It will be argued later on that the interest-free monetary economy draws its relative strength from that distinction.

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3. The reader will notice that discussion here has been confined to the efficiency side of the economy, and the equity side has so far been ignored.

## CHAPTER II: A BANKING STRUCTURE FOR AN INTEREST- FREE ECONOMY

The banking structure usually refers to the central bank, which represents the monetary authority as well as the commercial banks, which work under its supervision, in addition to 'Specialized banks and financial intermediaries'. However, under the system of Interest-free banking the role of those institutions will change. This section will review this structure in the light of the absence of a rate of interest.

### I. THE CENTRAL BANK

The central bank is the institution entrusted with the management of the supply of money, which involves the issue of fiat money as well as the control of commercial banks.

#### A. FIAT MONEY CREATION:

Under the system of commodity money, the supply of the metal (gold and silver) controlled the money supply. Monetary authorities played no role in determining the rate of monetary expansion. Policies were developed later to promote the importation of gold through the realization of trade surpluses. In addition, governments practiced currency debasement as well as issuing coins made of non-precious metals. Despite that, bimetallism imposed an external limitation on monetary expansion by monetary authorities.

When fiat money became prevalent, it was thought of being more efficient than commodity money, because of its lower cost of ascertaining quality, transporting and storage. However, the external limitation on the power of the monetary authority to expand the money supply was lost with the retirement of the gold standard and convertibility to gold. In theory at least, monetary authorities can (and sometimes did) issue fiat money at will. Literature on monetary policy concerns itself with the rules to which the monetary authority must adhere in changing the supply of money. Most of those rules are based on the relationship between monetary balances, growth on the one hand and prices on the other hand. Money affects growth as it facilitates transactions because it reduces transactions costs. It influences prices because the change in monetary balances is directly reflected into excess supplies and demands for commodities.

Ordinarily, in a conventional economy, the central bank stands ready to

issue money against interest-bearing claims on the government<sup>4</sup>. The central bank creates money in two cases, hence. Firstly, when the government borrows directly from it and, secondly, when the central bank decides to carry out an “expansionary open-market operation”.

In the first case, governments borrow to finance a deficit in the budget, which is politically determined. In the second case, the central bank attempts to stabilize the economy through open-market operations.

As for the first case, the decision to borrow from the central bank is politically easier than raising taxes and less costly than borrowing from the public. This would make it relatively more attractive for governments to extend their hands to the central bank, which has always to oblige. Financing politically unpopular undertakings as well as an important fraction of the activities of politically weak governments, or governments with inefficient taxing structure is always done through this method. Even democratic governments with strong tax systems find it easier to overspend simply because the legislative does not have full control on government internal borrowing.

While in both cases the government obtains the resources it desires, borrowing from the public and borrowing from the central bank are not similar in economic effects. Borrowing from the public keeps the current (nominal) money supply at the same level. However, to the extent it raises future tax liabilities it redistributes wealth from future to present generations<sup>5</sup>

Borrowing from the central bank, however, changes the nominal supply of money. This has ramifications on price and, consequently, on the distribution of wealth. If price increases continue, an inflationary process ensues, with its negative implications on efficiency. Borrowing from the central bank could therefore influence both efficiency and equity. Further effects of changes in the money supply on the real sector cannot be ruled out *prima facie*, and under certain conditions, can be significant.

To make the central bank a lender of last resort to the government is not critical to the stability of the economy. Besides, there is an alternative which is economically, if not politically, superior, i.e., to borrow from the public. However, if the central bank does not issue fiat money against interest-bearing assets, it may be thought of as not exercising its authority over the control of the money supply and, consequently, on the price level. We will show below that there are alternative means to doing so

## B. THE DETERMINATION OF THE MONEY SUPPLY

The function of the management of the money supply is, in a nutshell,

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4. issuing money against foreign assets as well as the effects private borrow on the money supply will be dealt with later on

5. The wealth of the holders of new government debt will not change except through future tax liabilities.

to provide for the transactions needs of the community, especially in a growing economy. While the central bank must set the money supply at the level, which provides the “maximum” amount of transactions services at a certain level of income, it must keep the level of prices stable.

It is important to note that it is the real and not the nominal unit of money that produces transactions services. This implies that an increase in the supply of (Nominal) money will afford greater transactions services for the community only to the extent that the price level stays stable; or increased less proportionately than the money supply

### C. MONEY, GROWTH AND PRICES

An increase in the rate of growth of money creates excess demand for goods (excess supply of money) at faster rates. Assuming markets to be stable, equilibrium will be regained. However, the new rates of growth of prices will differ from the old ones depending on price speeds of adjustment as compared to quantity speed of adjustments in all markets

Speeds of adjustment can be related to three factors: the institutional framework of the economy, the degree of complementarity and substitution between goods, and the rate of growth of the economy.

To illustrate the first point, the rate of growth of prices can be written as

$$P = P(p_i ; i = 1, \dots, n) \quad (1)$$

Where  $(p_i)$  is the rate of growth of the price of the  $i^{\text{th}}$  good, which is equal:

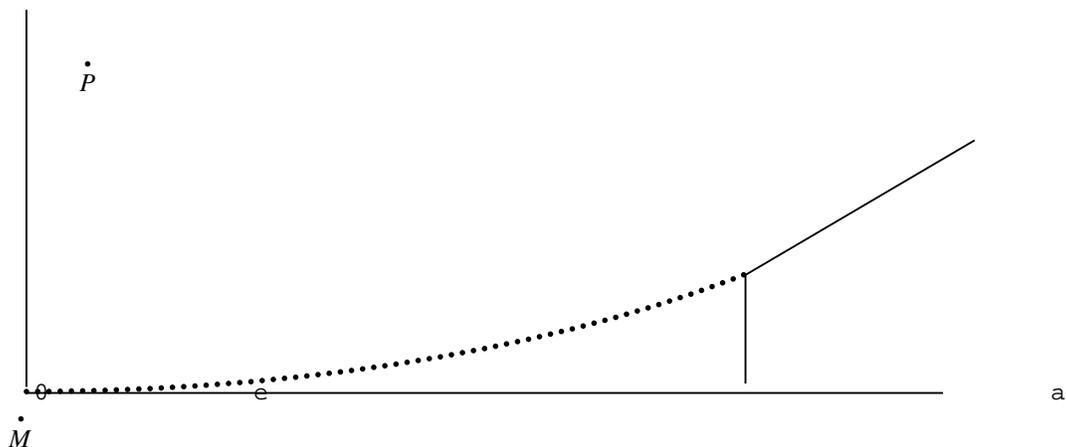
$$p_i = \frac{dp_i}{dt} / p_i = \left\{ \frac{\partial p_i}{\partial s_i} \cdot \frac{ds_i}{dt} \right\} / p_i \quad (2)$$

Where  $(s_i)$  is the excess demand for the  $i^{\text{th}}$  good:

Equation (2) shows that the rate of growth of the  $i^{\text{th}}$  price can be decomposed into two factors. The first is the responsiveness of the price of the good in question to changes in its excess demand. The second is the extent to which that excess demand is increasing or decreasing over time. While the first term refers to the price speed of adjustment, the second refers to the quantity speed of adjustment.

Speeds of adjustment can be hindered by non-competitive elements on the institutional side of the market, e.g., government regulations, monopolies, etc. They also depend on the degrees of substitutability and complementarity between goods.

Given the institutional arrangement as well as the degree of substitutability between goods, speeds of adjustment depend on the rate of growth. This is so because the quantity speed of adjustment is faster with higher rates of growth, as it becomes easier to satisfy excess demands in this case.



**FIGURE (1): THE RELATIONSHIP BETWEEN INFLATION RATE AND THE RATE OF MONETARY EXPANSION**

Therefore, we can say that, *ceteris paribus*, the higher the rate of growth, the lower the rate of inflation<sup>6</sup> resulting from a certain increase in the rate of growth of money ( $\dot{M}$ ), or the rate of monetary expansion.

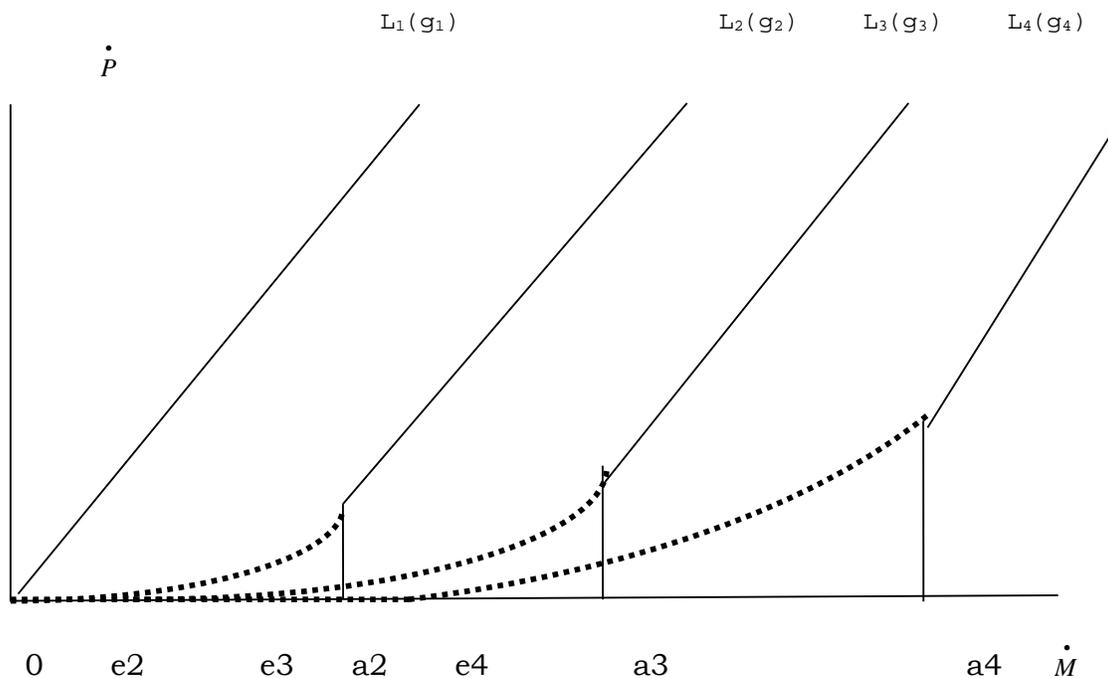
The optimal supply of money is the rate of monetary growth, which maximizes the transactions services for the community; and the optimal monetary policy is that which equates monetary growth to that rate. Since we are concerned with the services of real money units, a comparison between monetary growth and inflation rates is necessary. The comparison between the rate of growth of the money supply ( $\dot{M}$ ) and the rate of growth of prices ( $\dot{P}$ ) could be based on a postulated relationship between the two variables like the one depicted by Figure (I). The faster the growth of money, the stronger is its effect on the real sector in terms of raising demand schedules and, consequently, the faster prices must rise.

We can therefore perceive of rates of monetary expansion low enough not to produce any inflation, given the real growth of the economy and the state of expectations. Such rate fall within the range of (oe) in figure (1). As ( $\dot{M}$ ) rises, ( $\dot{P}$ ) will increase in response, but less proportionately in the beginning. Sooner or later, increases in ( $\dot{M}$ ) produce equip-proportional increases in ( $\dot{P}$ ). This is depicted by the portion of the

6. Notice that higher rates of growth means decreasing excess demands over time, i.e., negative ( $ds_i$ ) in equation (2) above.

curve in Figure (1) beyond oa.

It is possible that increases in  $(\dot{M})$  produces more than proportional changes in  $\dot{P}$ , when higher monetary growth gives reason to expect more of the same, in the future. This case is not depicted graphically.



**FIGURE (2)**

We can consider the proposition that economic growth attenuates the effects of monetary expansion on prices. Figure (2) shows the monetary expansion lines  $L_1$  through  $L_4$ , which are associated with the rates of growth  $g_1$  through  $g_4$ , respectively. The proportion of the expansion curve within which prices respond less proportionately to monetary expansion is larger with higher rates of economic growth. Along  $L_4$  ( $g_4$ ) the rate of growth is so low that any monetary expansion produces equi-proportional change in prices<sup>7</sup>

The portions of the expansion lines, which coincide with the horizontal axis, show that monetary expansion is being fully reflected in growing real balances. As indicated by Figure 2, such non-inflationary monetary expansion would be equal to  $oe_1$ , when the economy grows at  $g_1$ , and  $oe_2$  when it grows at  $g_2$  - Higher, rates of monetary expansion would lead to positive rates of inflation.

7. This is where the quantity theory of money strictly applies

An economy in which strict price stability, viz.,  $\dot{P}=0$ , is preferred, the monetary authority should choose  $\dot{M}=oe_1$  or  $oe_2$  when real growth is equal to  $g_1$  or  $g_2$ , respectively. Otherwise, the rate of monetary expansion should equal zero. Rates of monetary expansion higher than  $oa_1$ ,  $oa_2$  or  $oa_3$ , when corresponding rates of growth are  $g_1$ ,  $g_2$ , or  $g_3$ , respectively would cause correspondingly equal rates of inflation.

Since we are attempting to delineate the banking structure for an interest-free monetary economy, we must remember that the central bank cannot issue money against interest-bearing securities, the mechanism for monetary expansion or contraction must be outlined.

#### D. VARIATION IN THE SUPPLY OF MONEY

The central bank can open investment accounts in its member banks, in which it deposits whatever money it creates and from which withdraws whatever money it retires. Member banks, as will be seen below, will invest those deposits in the real sector in accordance with the investment policy of each. Profits earned on such deposits could be used in part to cover the cost of central bank operations. Such deposits will be termed central deposits, or CD's.

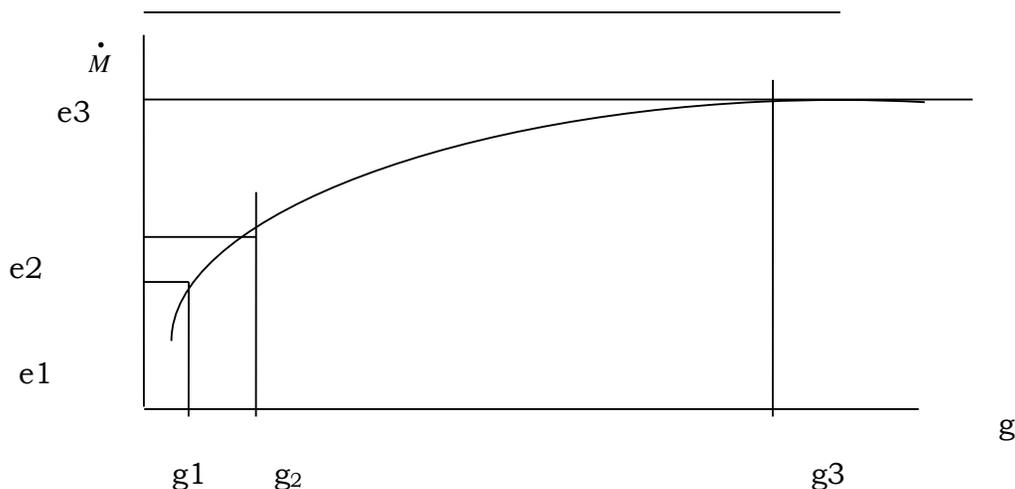
While CD's can be used as a tool of monetary policy, they can also be used as a means of financial intermediation, which would amount to additional monetary services. The central bank would create an instrument, which could be termed "central deposit certificate". CDC's would be sold to the public and their proceeds be invested in CD's throughout the banking system. Obviously, the CDC's provide the lowest degree of financial risk in an interest-free economy, since each carries with it a title to a more diversified investment portfolio than any member bank by itself can provide. The rate of return on the CDC's will approach the average rate of profit on investment for the whole economy.

As a substitute for the conventional process of money creation, which is based on issuing money in return for government debt instruments, we have just outlined a non-lending based process of monetary expansion. Such process has several advantages. It is an investment-based process. Since central deposits are invested in the real sector by banks, their rate of return would gauge monetary policy performance. It is totally independent of government budget, meaning that the process monetary policy would be depoliticized. The monetary authority will depend solely on monitoring the relationship between both prices and output in deciding upon the (optimal) rate of monetary expansion.

#### E. THE OPTIMAL PATH OF MONETARY EXPANSION

Let us now assume that the monetary authority is bound by absolute price stability (zero inflation rate), and has been carefully monitoring

the relationship between the rate of monetary expansion, inflation and the rate of growth. The monetary authority will face a frontier of rates of growth, each associated with a maximum rate of monetary expansion that can be implemented without increasing prices. We can term that rate the optimal rate of monetary expansion or the optimal supply of money. This frontier is represented by the curve in figure (3) and can be termed the optimal path of monetary expansion or the optimal path of monetary policy. As the rate of growth increases, the maximum rate of monetary expansion rises up to a limit after which no further increase in the rate of monetary expansion without increasing the rate of inflation.



**FIGURE (3) : THE OPTIMAL PATH OF MONETARY EXPANSION**

When the rate of growth is  $g_1$ , the optimal rate of monetary expansion is  $e_1$ . when growth rises to  $g_2$ , the optimal rate of monetary expansion rises to  $e_2$ . when the rate of growth is  $g_3$ , the optimal rate of monetary expansion is  $e_3$ , which is the highest possible rate of optimal monetary expansion. Any further rise in growth will not be associated with higher rates of monetary expansion above  $e_3$ .

#### F. EXTERNAL INFLUENCES AND THE MONEY SUPPLY

In an open economy with no foreign exchange controls, we expect traders across the borders as well as the banking institutions themselves to hold foreign assets. Variations in foreign asset holdings, accompanied by the absence of offsetting monetary policy will have effects on the supply of money.

When residents receive foreign exchange, they will either use it to cover purchases abroad, sell it to other residents who use it for the same purpose, or exchange it from the banking system for domestic currency to finance domestic spending.

Naturally, the change in net foreign assets held by the banking system will have a direct effect on monetary expansion. This could distort the optimal supply of money rule, which we have proposed above, namely to tie the path of monetary expansion to the path of real growth, given the relationship between money and prices. The monetary authority will have few options to avoid such distortion. First is to neutralize completely all changes in net foreign assets, so that they would have no effect whatsoever on the money supply. This means that the monetary authority will stand ready to absorb any increase in the money supply resulting from an increase in net foreign assets. It will also inject an amount equivalent to any decrease in money supply resulting from a decline in net foreign assets. Both absorption and injection would be carried out through the sale and purchase of CDC's, respectively.

Another option is to neutralize only the changes in the money supply that would cause the path of monetary expansion to deviate from its optimal path.

As a third option, the monetary authority can stand ready to sell and purchase foreign exchange at daily declared prices, which would be set at levels that would enable the monetary authority to keep the level of net foreign assets at levels consistent with the optimal path of monetary expansion. Net purchases of foreign exchange by the central bank can be invested in foreign or domestic projects through member banks. The central bank can therefore keep CD's in foreign currencies with member banks for this purpose. Meanwhile, it can issue CDC's denominated in foreign currencies or domestic currency equivalents. The proceeds of selling those CDC's can be used to finance foreign currency purchases.

## II. MEMBER BANKS

Member banks in an interest-free system cannot follow the traditional modes of operations developed by commercial banks. Since they cannot charge interest, they cannot operate on the basis of taking loans from fund owners and lending them back to fund users. They must undertake direct investment, take equity in the firms they finance and provide the rest of customary banking services as well. Such banks have come to be known in the past as business banks or Banques d'Affaires. They are commonly known today as relationship or universal banks<sup>8</sup>.

### G. BANKING SERVICES

#### 1. Demand Deposits

These are similar to the checking accounts usually held in commercial

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8. Relationship or universal banks are "large-scale banks that operate extensive networks of branches, provide many different services, hold several claims on firms (including equity and debt), and participate directly in the corporate governance of the firms that rely on the banks as sources of funding or as securities underwriters," (Al-Jarhi, 2003).

banks. They carry no rate of return, but give their holders the right to write checks against them. They could be insured against bank insolvency in a manner similar to that of the FDIC.

The existence of demand deposits raises the question of whether the central bank should enforce a 100 percent or a fractional reserve rate. It is obvious that with fractional reserves, when traders switch from "high powered money" to "deposit money" and vice versa, the total supply of money will change. However, with one hundred percent reserves, such a switch will change the composition of money, leaving its total supply constant.

Friedman uses the above reason to suggest the abolition of fractional reserves (Friedman, 1959). He argues that fractional reserves caused the monetary system to suffer from an "inherent stability". While Friedman's argument is correct, it should not be the only basis for abolishing fractional reserves.

In contrast to many writers who believe that the "production" of money is costless (Mints, 1950), Tolly, 1957, Friedman, 1959 and 1969, Samuelson, 1968, and 1969, Tobin, 1968), the approach presented here suggests that adding real balances to the existing stock is more costly than just operating a printing machine. The central bank has to watch for the changes in prices while keeping an eye on economic growth. Traders would require assurances of the relative price of money and its future developments, so that their expectations would not misread whatever monetary policy is adopted. Such a process of "asset characterization" is costly (Al-Jarhi, P. 373 ff).

In a fractional reserve system, the process of creating derivative deposits is accompanied by changes in the money supply resulting from substituting deposits and cash for each other. Both processes change the cost of producing real balances. Specifically, such changes in the money supply resulting from banking as well as depositors' behavior under fractional reserves make it more costly to maintain the existing stock of real balances or to add to it.

We consider both reasons, the inherent instability and the cost of producing real balances to warrant the adoption of 100 percent reserves.

## 2. Investment Activities

Member banks can establish equipped with experts in project appraisal and financial analysis can make three kinds of investment.

### ◆ Direct Investment:

Banks can establish new firms providing their full capital initially or acting as catalyst to attract other equity holders. They can also hold shares in existing enterprises and participate in their management. The bank can use its expertise to give technical assistance to those

companies, in order to enable them to be more profitable. Geographic proximity to the projects involved, possession of first hand information about their activities, and relative familiarity with people operating them all afford banks excellent opportunities for profit. Considering their expertise, banks can increase the degree of business success in their communities.

#### ◆ Profit-And-Loss-Sharing Finance

Banks can use their vantage point in the firms in which they hold equity to monitor their operations cheaply and assess their finance needs, which can be provided on a profit-and-loss-sharing (PLS) basis. This category of finance provides short-term funds to finance business needs for liquid capital for the duration of the production cycle. It is also a good outlet for funds to be employed in commercial activities.

The earnings of firms financed by banks would be netted out of costs, and the remainder is shared with banks according to an agreed upon formula.

The time length of such operations could vary from six to twelve months for industrial and agricultural projects. Yet it could be as short as 60 or 90 days for commercial ventures.

#### 3. Leasing Activities

A bank in this scheme can purchase means of transport (ships, planes, etc.), industrial equipment, buildings, and others to lease them to users in return for periodical installments. The lease agreement may terminate with a title transfer to the user.

While leasing contracts can provide a means to serve customers in a way that is flexible enough to cater for varying need, they provide the bank a way to invest in an equity, which transfers itself into liquid cash gradually over a certain period of time.

#### 4. Credit-Purchase Finance

Banks can finance purchasing commodities on credit. This would entail purchasing the commodities from suppliers for cash and selling them to customers on credit. Such activity appears to be rather unique, as it would require banks to act in trade.

#### 5. Acting As a Holding Company

We have seen above that banks take equity in firms, deal in leasing and provide credit-purchase finance. Such activities may be considered by far outside traditional banking activities. In order to keep a reasonable amount of division of labor in the banking industry, for the sake of economic efficiency, banks can establish specialized subsidiaries to handle their equity holdings, carry out PLS, leasing and credit purchase finance. Banks need only to hold part of the equity of their own subsidiaries and attract the rest from other shareholders. They also

would have an opportunity to provide interim financing to subsidiaries.

#### 6. Other Services

Banks can provide the same services, which commercial banks usually provide, like selling foreign exchange, issuing letters of credit, and other services. Such services are provided for a fee.

The bank may have to establish correspondence relationships with foreign banks to facilitate the provision of those services. It may keep interest-free deposits with its correspondents on a reciprocal basis, or may pay its correspondent for whatever services it requires

#### 7. Lending Activities

Since banks do provide long and short-term capital to enterprises on equity or profit-sharing basis, borrowing by business enterprises would become unnecessary. In addition, the provision of credit-purchase and leasing finance would cover most of the needs of households. Yet some borrowing may still be needed to balance one's income stream with his consumption stream. This is the case when individuals face emergency situations or special needs that would require short-term bridge financing. Such individuals would be expected to fall in low-income brackets. A modest amount of interest-free lending must be provided as a philanthropic activity.

The central bank can inject into a system a regulation that each "bank would devote a small percentage of its resources for interest-free lending. The central bank can supplement such resources from its CD earnings. Naturally, since loans would be interest-free, funds have to be rationed according to some social criteria.

Some members of the community would be interested in making a part of their financial resources available for interest-free lending. While this would be motivated by altruistic reasons, it could be encouraged by stable prices. Some individuals may hesitate to lend for being unable to assess the borrowers' future earnings. In addition, since they are non-specialists, it would be relatively more costly for individuals to do so.

The central bank can overcome this problem by issuing central lending certificates, CLC's, which carry no return, but are guaranteed to be paid on maturity. Proceeds of CLC's can be made available to member banks, which would lend them to borrowers after proper assessment of future income, and application of social criteria, if rationing is required.

## CHAPTER III: THE TREASURY: AN ISLAMIC PERSPECTIVE

The monetary side of any economy would be incomplete without describing the operations of the public sector. It is commonly known that interest is prohibited in Hinduism, Judaism, Christianity and Islam. However, only in Islam we can find specific rules that govern the public sector that would be associated with interest-free banking.

The functions of the public sector have been traditionally divided into what is known to be the allocative branch (Musgrave, 1959) and the distributive branch. While this would bear similarity to the Islamic structure, there are some differences still.

The distributive branch in the Islamic system is based on the collection as well as the distribution of AL-Zakah. The allocative branch takes responsibility of the mineral resources, which are generally considered to be a social property. This adds another feature to the allocative branch, which is traditionally known to be in charge of the finance and production of public goods.

Handling monopolies, insuring orderly markets, correcting for externalities, and the like can be placed in another branch, which would be termed the "market-corrections branch."

### A. THE DISTRIBUTIVE BRANCH

A distributive tax, called Al-Zakah is levied on the following:

- ◆ Monetary asset holdings for one year, including cash, demand deposits and debt, when held for a year.
- ◆ Titles to real assets held for a year, e.g., shares, profit sharing funds, etc, when held for a year.
- ◆ Gold, precious metals, and diamonds, on the basis of their current market value, when held for a year.
- ◆ Net earnings of assets not included in the above categories.

The tax rates, which differ from one category of assets to another, are applied on total holdings over and above a certain level, called Nissab that reflects the cost of living of the taxpayer. The proceeds are earmarked for certain purposes on the top of which poverty reduction. This is done through two kinds of redistributive policies: wealth maintenance and income maintenance policies.

Those whose income (and wealth) is below a certain "minimum" level, are classified into two categories, those capable and those incapable of work. Those capable of work are given sufficient productive assets to use in order to earn income that would place them outside the poor.

Those incapable must be guaranteed a minimum level of income to cover their basic needs.

It is commonly understood that the process of redistribution continues every year and poverty is reduced gradually and eventually eliminated in the long run for all capable of working. Banks would play a role, as wealth maintenance policies can be implemented through the finance of micro enterprises, which the poor own and manage.

## B. THE ALLOCATIVE BRANCH

### 8. Division of Mineral resources:

The state ownership of mineral resources does not necessarily imply state production. The state can involve itself in the production of minerals through state-owned enterprises although it would be more efficient to enfranchise private producers for this purpose..

The mineral Resource Division assumes the responsibility of mineral production, directly or indirectly, the proceeds of which are added to the Treasury to be used in financing government operations.

#### 1. Division of Public Goods

Public goods are generally known to be those goods whose consumption is carried out collectively, e.g., defense, basic education, certain categories of health services, and so forth. While the details of their provision are determined through the political process, the state stands responsible for providing public goods to its citizens.

Public goods may be produced directly by government-owned enterprises or, more efficiently, by private-sector enterprises. They are financed by the net proceeds from the mineral resource division and from other taxes. Some of the public goods, like defense, can be financed from Al-Zakah proceeds given enough funds from that source.

#### 2. Division of Market Order

The working of free markets can always be disturbed by the rise of monopolies, the existence of externalities, and other market "disorders". Dealing with such problems could involve a certain tax subsidy network or direct regulations by the government. Most of the time, what is required is a tax subsidy scheme. In extreme cases, direct control may be called for. The finance of such operations could be accomplished through balancing tax services with subsidy payments. It may also call for special taxes to finance the maintenance of "orderly markets".

# CHAPTR IV: THE FINANCIAL MARKET:

## INSTRUMENTS

A review of the balance sheets of the central bank as well as member banks will show the different financial instruments, which compose the "demand side" in the financial market. The "supply side" is considered later in order to obtain a complete picture of the financial market

### I. BANK BALANCE SHEETS

#### A. THE CENTRAL BANK

##### **BALANCE SHEET (100% REQUIRED RESERVE RATIO)**

ASSETS	LIABILITIES
Cash in Vault	Central Deposit Certificates
Central deposits with banks, restricted and unrestricted	Central Lending Certificates
Lending Accounts with Member Banks	Member Bank Reserves
	Investment Accounts for Government and Public corporations
Net Foreign Assets	Monetary Base = Money in Circulation

The central bank holds central deposits and loan accounts with member banks, which, in addition to net foreign assets and cash in vault, constitute the central bank assets. On the liability side, the public holds central deposit and central lending certificates.

Unlike the traditional process of money creation, issuing money by the central bank is not a liability that is offset by holding debt instruments (government securities). In our case, such process increases central bank deposits with member banks. Retiring money has the opposite effect of decreasing the central bank assets.

#### B. MEMBER BANKS

Member banks place their resources in equity (direct investment), in profit-sharing accounts, leasing and credit purchase accounts. In addition to cash in vault and reserves with central bank, that makes the asset side.

On the Liability side, member banks take demand deposits, open

deposits for restricted or unrestricted investment. Investment deposits can be restricted to a specific project, a number of projects, or a specific sector. They can also be restricted to special modes of finance, like profit-sharing, leasing and credit purchase. All investment deposits would be attached to specific maturities. The length of maturities for unrestricted deposits should be rather flexible and could presumably be as short as a one week. However, banks should strictly observe maturity dates and never allow withdrawal before maturity, at least for maturities below one year. Longer maturity deposits can be withdrawn but with heavy penalty. Maturities of restricted investment deposits should depend upon the nature of the investment to which they are attached. Their withdrawal before maturity should be out of question.

Issuing certificates in a variety of maturities would suit a wide spectrum of tastes for savers. Their profits would be distributed on maturity and can be plowed back in the same deposits.

### **BALANCE SHEET**

<b>ASSETS</b>	<b>LIABILITIES</b>
Cash in Vault Reserves with Central Bank	Demand Deposits
Equity In Subsidiaries, And Other Enterprises	Central Deposits, Restricted And Unrestricted
	Unrestricted investment deposits
Accounts With Fund Users: PLS Accounts Leasing Accounts Credit-Purchase Accounts	Restricted investment deposits Mode restricted deposits Project(s) specific deposits Sector specific deposits
Assets owned by special funds and portfolios	Unrestricted Investment Deposit Certificates
Net Foreign Assets	Restricted Investment Deposit Certificates: Project(S) Specific Certificates Sector Specific Certificates Mode Specific Certificates
Lending Accounts	Fund Shares
	Central Lending Funds

In addition, member banks could issue unrestricted and restricted investment certificates. Restricted certificates can be limited by project(s), sector, and finance modes. Deposit certificates provide a more liquid alternative to deposits themselves. They could be sold in a secondary market before maturity. Their market prices would depend on profit expectations related to the general investment pool of the bank

in case of unrestricted certificates, and to the specific investment to which they are attached in case of restricted deposits<sup>9</sup>.

## C. THE FINANCIAL INSTRUMENTS

Savers in the model presented have three investment alternatives each of which is discussed in what follows:

### 1. Corporate Stocks

A saver can buy stocks directly and becomes a stockholder. This affords him the direct participation, to the extent of his capital, in the management of the company. If his savings are substantial, he can divide them on holdings in different companies. A proper diversification scheme can be applied in this respect.

In an economy where private enterprise has a significant degree of freedom, stocks would be easy to trade and change hands between different holders. To the extent this is true stock prices should reflect a "market consensus" on the expectations of the future earnings of each respective enterprise.

### 2. Fund Shares

Banks and other financial institutions can form special funds with special objectives, regarding risk, return and liquidity. Such funds would hold a variety of stocks as well as investment deposits and certificates. Instead of holding few shares in enterprises, fund shares give individuals an opportunity to choose the combination of financial asset holdings that suit his preferences by just holding those shares.

### 3. Member Bank Certificates

Member banks offer two categories of certificates.

#### ◆ Unrestricted investment certificate, UIC's.

The proceeds of unrestricted investment certificates would enter the general pool of member bank investment. Its holder would be entitled to an average rate of profit on all operations done by the member bank. It is the closest thing to holding a stock in the bank itself. In addition to the expertise and the block-vote power, the UIC's provides a greater degree of diversification. This could mean lower risk for savers.

UIC's can be issued for terms to maturity. They could be as short as one week and as long as several years, depending on the range of bank operations. Restricted investment certificates, SIC.

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9. Investment certificates can be restricted by modes of finance. They can be restricted to PLS and leasing modes. however, they cannot be restricted to credit-purchase modes, for this would make them nontradable. Their trade would be tantamount to trading monetary assets or debt, which would run contrary to the prohibition of interest. they can alternatively be restricted to a combination of credit purchase and one or more of the other two modes, PLS and leasing.

#### ◆ Restricted Investment Certificates

Investment certificates can be restricted by object of investment or finance modes. As to the object of investment, they can be restricted to investment in one or more projects, or a specific sector<sup>10</sup>. When restricted to certain finance modes, they can be PLS, leasing or a mixture of any two or more finance modes in proportions that suit the preferences of savers.

#### 4. Central Deposit Certificates, CDC

As mentioned above, a CDC gives its holder a share in the central bank deposits, which are being invested with all member banks. This makes it the most diversified investment in the economy. In addition, since it involves two layers of financial intermediation, namely banks and the central bank combined, it should be the safest instrument available in the whole economy.

The central bank allocates its CD's among banks according to profitability, liquidity, and risk. By using traditional investment criteria, the central bank would encourage both investment and banking efficiency in the economy, as relatively more efficiently operating member banks will obtain relatively greater shares of the CDC proceeds. This ultimately leads to high rates of economic activity for the whole economy, especially if the aggregate amount of CD's is significant.

Being relatively more familiar with banks than individual households are, the central bank can make a more reliable judgment on the performance of each. This further reduces the financial risk to the CDC holder.

Obviously, CDC's would have a wide secondary market, for they are readily tradable. Moreover, since they are titles to CD's, they can be redeemed for their face value plus dividend through the central bank.

#### 5. Central Lending Certificates, CLC's

As mentioned before, CLC's are titles to a fixed sum of money. Their proceeds from their sale are used by the central bank to lend borrowers whose future income expectations warrant their solvency. Besides, the CLC's do not give any rate of return to their holder.

It may be doubted that people would want to hold "barren" assets, when a wide spectrum of financial assets are available. Altruistic reasons would explain that. In addition, the central bank could guarantee the instant encashment of CLC's<sup>11</sup>. This makes them both safe and liquid.

Considering that a holder would have to pay AL-Zakah on CLC's (2.5%) it would appear that people will hold them for very short periods as

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10. Perceivably, project-restricted investment certificates would carry the name of the project, ultimately an enterprise in which the value of the certificate would be invested. They would be close to stocks held by a member bank as in investment-agent for a particular customer.

11. Islamic teachings would not allow the same for other certificates.

good cash substitutes; that is considering the cost of demand deposits and of safe deposit boxes. Only philanthropic motives could make the amount of CLC's significant.

## CHAPTER V: THE FINANCIAL MARKET: EQUILIBRIUM

### I. ALTERNATIVE USES OF MONEY IN AN ECONOMY WITH A MONETARY INTEREST RATE

In the conventional economic system within which we live, the alternative uses of money are centered not on the function of investment but on the function of lending. When money is directed to any alternative use, its opportunity cost is considered to be the rate of "return" on the safest and most liquid financial asset, *viz.*, government securities. Since those securities are interest bearing assets, their rate of interest is the opportunity cost of placing money in other uses <sup>12</sup>

It may be noted that "lending" as a process is distinct from "investing". The former is based on solvency assessment, while the latter is based on production opportunity appraisal. Both can be influenced by future price expectations. Yet, a saving process, which is lending centered, creates a mechanism of price expectations, which would be different from the corresponding process created by an investment-centered saving process. This is because the mechanics of money creation differ between the two cases.

In a lending-centered economy, economic agents tend to associate changes in the price level with monetary growth. This is so because the government method of monetary expansion or contraction is influenced, in the first instance, by the desired level of government expenditures. This has consequences on the price level. The central bank tries to moderate such consequences through the use of available tools. However, its ability to do so is by no means free from constraints.

When the government expands the money supply by using its prerogative to sell securities to the central bank, the latter can attempt to offset such a move by selling back some of those securities to the public. Yet, even with a fairly wide market, such an action will raise the monetary rate of interest. The cost of money would rise, and economic activities would be restrained in the private sector while expanded in the public sector.

The rate of interest, as the cost of borrowing would therefore become a chariot of price expectations. The rate could rise by a magnitude that is sufficient to discourage any inflationary expectations. However, this magnitude can be reached only when the central bank is capable of

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12. It may be pointed out, at the risk of circularity, that to place money in government securities has as the opportunity cost the rate of return on the asset with the highest possible yield.

completely offsetting the initial government monetary expansion.

Although total offsetting is hardly conceivable, it could lead contraction of the private sector and an expansion of the government sector. This leads government expansionary policy to frustration. People will compare the rate of monetary expansion with the rise in the rate of interest. An excess of the former over the latter would justify price inflation, until both are equalized. We therefore can postulate that in lending centered economies price expectations compare the rate of monetary expansion with changes in the rate of interest.

When there is no "monetary" rate of interest, the government carries its monetary expansion in a way similar to that outline in Ch. II. In this case, the central bank would not allow any monetary expansion, which would not lead to a justifiable expansion of real balances. Moreover, all monetary expansion is invested in CD's, which has ramifications on prices as well as on production.

Such a method of monetary creation in investment-centered economies forces economic agents to look into investment activities in general, and factors markets in particular, for a cue to price expectations. Therefore, we can safely claim that in investment-centered economies, price expectations are productivity oriented

We can also add that the familiar equalization of opportunity cost of money and the rate of return on investment, at the margin, is only illusionary. Savings are channeled through the banking system on the basis of interest rate expectations. Meanwhile, the production sector absorbs those savings on the basis of productivity expectations. When the saving process is lending-centered, interest rate expectations dominate productivity expectations; a case of a tail wagging its dog.

## II. ALTERNATIVE USES OF MONEY IN AN INTEREST-FREE ECONOMY

In contrast to the previously outlined system, an interest-free economy gives a minute role to the process of lending. Money is issued and allocated to different uses on bases that are related to growth and productivity and far removed from the political pressures connected with public sector requirements. Lending plays an insignificant role in the interest-free economy. Considering safety, central lending certificates, CLC's, are quite safe. They are also liquid, due to their encashability, but so is money. Yet, to hold a barren asset, like CLC's for a full period of a year, implies getting no yield while having to pay Al-Zakah rate of 2.5% that is usually levied on monetary balances. This means that the net rate of return on those assets is negative. Such applies to money hoardings as well. In general, it applies to all monetary assets, i.e., claims to fixed sums of money. Therefore, lending or holding monetary assets in general is not the "next best" alternative

to investment

In an interest-free economy, the investor considers placing his money into central deposit certificates, CDC's as his next best alternative. Diversification exercised in the management of CD's gives a high degree of safety, and the lowest degree of risk for income-earning financial assets. In addition, CDC's with short-term maturities should be encashable with a notice that is shorter than other Income-earning assets. This places them in liquidity next to CLC's

Since central deposits are allocated to banks according to efficiency criteria, their rate of return approximates the average rate of return on investment for opportunities lying on the production frontier of the whole economy. It is therefore possible to say that this rate of return becomes in itself the opportunity cost of money and the benchmark for all uses of money. Noting that the proceeds of central deposit certificates are invested in productive uses, this makes the interest-free economy an investment-centered economy.

Investors consider the safest possible investment opportunity, rather than the safest possible lending opportunity, as their next best alternative. They do not consider the safest possible lending opportunity at all. In this way, money and investment markets are effectively interconnected, for money holdings are considered in relation to investment undertaking directly and not through a scheme of financial intermediation based on lending.

### III. THE DEMAND FOR MONEY IN A CONVENTIONAL ECONOMY

The study of the demand for money in a conventional economy starts with distinguishing between transactions, precautionary and speculative demand for money. Ultimately, all three kinds of demand are added together in one aggregate called the demand for money (Keynes, 1936). Whether treating this demand was done through the inventory approach (Baumol, 1952) or the portfolio approach (Tobin, 1958), all analysts agree that the quantity demanded for money is inversely related to the rate of interest.

One of the pillars of monetary analysis under the conventional monetary structure is what is called "inelastic expectations". This means that agents believe in the existence of a natural rate of interest that reflects economic fundamentals. When the rate of interest rises above or declines below the natural rate, agents believe that it will return back to its original level.

When the rate of interest rises, bond prices decline. Since agents expect the rate of interest to decline in the future and consequently bond prices to rise, they find an opportunity to make profit. Speculators

switch from cash balances to bonds. When the rate of interest rises, they switch from bonds to cash balances. Therefore, we find that the demand for money increases when the rate of interest declines and vice versa. This analysis represents the theoretical basis for the downward sloping liquidity preference curve.

We can therefore conclude that people in the conventional system hold money for speculative purposes either when they expect prices to decline or they expect the rate of interest to increase. Both reasons, in an interest-based economy are interrelated. Expectations of lower future prices or higher interest rates will both lead to a shift from real and financial assets into money, thereby causing a decrease in real asset and bond prices, which is equivalent to an increase in the rate of interest.

## IV. THE DEMAND FOR MONEY IN AN INTEREST-FREE ECONOMY

### A. THE ROLE OF THE RATE OF RETURN ON CENTRAL DEPOSITS

We can now ask how the demand for money would like in the structure we have so far proposed for an interest-free economy. Such question could be answered through understanding the nature of the rate of return on short-term central deposit certificates, RCDC. We have previously stressed that holding those certificates represents the next best alternative to holding cash. We can therefore infer from this that the RCDC can perform the following functions:

- ◆ A benchmark for investment. In this regard, we can consider the whole spectrum of maturities and use the RCDC on the CDC's of the comparable maturity to the investment in question.
- ◆ A rate of discount for future income streams expected to accrue on financial and real assets.
- ◆ A tool and an indicator for feasibility studies and business planning.
- ◆ A market price for the allocation of resources.

We can therefore conclude that the demand for money must be directly related to the RCDC. When that rate rises, agents will find that they must economize on the use of monetary resources in transactions and switch some cash balances to investment. When it declines, agents will find that holding money has become less costly, thereby encouraging them to increase their money holdings. In other words, the demand for money would be such that the quantity demanded is inversely related to the RCDC.

## B. SPECULATIVE DEMAND FOR MONEY

It is true that in an interest-free economy RCDC replaces the rate of interest. Yet, speculative demand for money should not increase with expectations of higher rate of return on CDC's. Such expectations would automatically be translated by the market into higher prices of investment instruments.

The rate of CDC's is used to discount the stream of future earnings of other instruments into their present values. When it is higher, the expected returns of such instruments must be higher, since the latter is some kind of an average of the former. Moreover, and for the same reason, the rise in the expected returns of investment instruments will always be higher than the rise in the CDC rate. The final conclusion is not a decline but a rise in the prices of investment instruments.

An expected decline in the CDC rate must be associated, because of reasons similar to above, with a decline in the prices of investment instruments. However, expectations of such decline will not lead to a rise in speculative demand for money unless it reduces their rates of return to zero.

In an interest-free economy, prices should be stable, since monetary growth is tied to the rate of change in prices - Nevertheless if prices are expected to decline, because e.g., some policy error, people would revert to money. They sell some of the investment instruments they hold and either hold cash or buy CLC's.

While the economy can adjust itself back to equilibrium through changes in the prices of investment instruments, the effects of a rise in speculative demand for money can be easily reversed through monetary policy. This is more assured since all monetary growth is automatically translated in CD's, which flow through member banks to investors.

### D - MARKET EQUILIBRIUM

From the above discussion, we can define the following functions.

$$S = S(\rho, Y) \quad (3)$$

$$I = I^h(\rho, Y) + I^g[Y, (\pi - \pi^e)] \quad (4)$$

Where S is savings, the rate on PC of shortest maturity, Y is real national income, and I is investment. Superscripts p and g refer to private and government, respectively. Equation (3) expresses savings as a function of the average rate of return on investment as well as on the level of real national income. Meanwhile, equation (4) expresses private investment as a function of the average rate of return on investment. A part of public investment, namely investment in the exploitation of mineral resources, is included in private investment, as it is decided upon in light of its profitability.

The other type of public investment is done by the monetary authority through the issue of new money and adding it to central deposits with banks, i.e., through monetary expansion. Now we must ask about the basis upon which the decision of monetary expansion or contraction is made. Remembering from above, money creation in an interest-free economy is totally free from political pressures regarding the finance of the budget. It is bound by fulfilling the needs of the economy to money holdings for transactions purposes, while observing price stability. We can follow the accepted doctrine in this regard and assume that transactions demand will depend on the level of real income  $Y$ . In order to present a more general case, we can assume that the monetary authority targets a rate of inflation, whereby the rate of monetary expansion or contraction depends on the difference between the target  $\pi^*$  and the expected rate of inflation,  $\pi^e$  or  $(\pi^* - \pi^e)$ . This formula includes that case of absolute price stability when the target inflation rate is equal to zero. In this case, rate of monetary expansion will not increase unless keeping it at the current level would lead the economy to deflation.

We can therefore state that public investment (through the issue of money) would be subject to the following conditions:

$$I^s = 0 \quad \text{if} \quad (\pi = \pi^e) \quad (5a)$$

$$I^s > 0 \quad \text{if} \quad (\pi < \pi^e) \quad (5b)$$

$$I^s < 0 \quad \text{if} \quad (\pi > \pi^e) \quad (5c)$$

Equilibrium in the investment market would require:

$$S(\rho, Y) = I^h(\rho, Y) + I^s[Y, (\pi^* - \pi^e)] \quad (6)$$

A rise in  $\rho$  would increase savings on the one hand. It would also increase investment, as investment opportunities become more attractive. We can therefore conclude that the equilibrium frontier of the saving-investment market can be represented by a positively sloped curve that rises between income and the rate of return on CD's. This is similar to the IS relationship that is commonly known in Keynesian economics.

Moving to the money market, we can notice that the supply function of money is the same as the function of public investment. In other words:

$$M^s = I^s[Y, (\pi^* - \pi^e)] \quad (7)$$

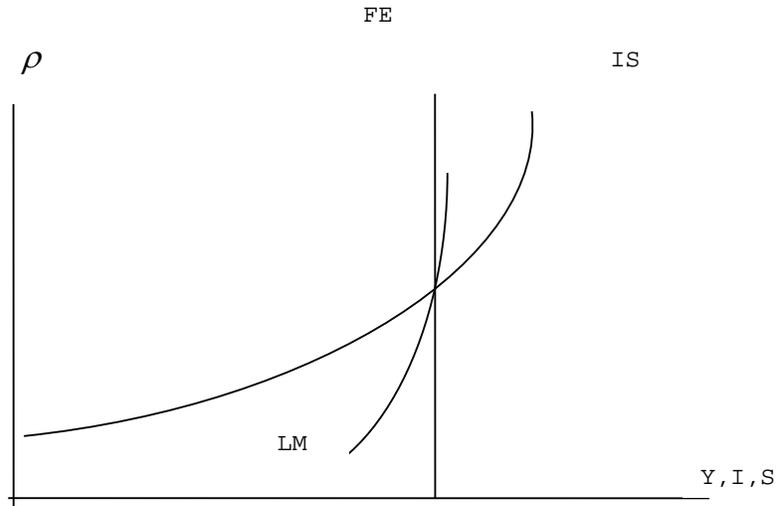
The demand for money can be written to depend upon the rate of return on CD's, as the cost of holding money, the level of real income, as well as the expected rate of inflation

$$M^d = M^d(\rho, Y, \pi^e) \tag{8}$$

Where  $M^d$  and  $M^S$  refer to the demand and supply of money. We can now write the equilibrium condition for the money market as follows:

$$I^s(Y, (\pi - \pi^e)^*) = I^s[Y, (\pi - \pi^e)^*] \tag{9}$$

When  $\rho$  increases, the monetary authority gets a signal that the real sector is performing better than before and aggregate supply is rising. The expected rate of inflation goes down and the gap between target and expected inflation widens. The monetary authority finds it safe to increase the supply of money without violating its inflation target. The increase in base money translates itself into an increase in central deposits and ultimately in investment. Therefore, the equilibrium frontier of the money sector can be represented by a positive relationship between real income and RCDC.



**FIGURE (4): FULL EMPLOYMENT EQUILIBRIUM**

Such relationship would be parallel to the LM curve in Keynesian economics, but with a different slope, because all money issued is automatically plowed into the real sector from the start.

Figure (4) represents the full employment equilibrium for the whole economy, using the equilibrium frontier of the investment and saving market, IS and that of the money market LM, in addition to the full employment level of aggregate supply FE.

While both frontiers are positively sloped, the IS frontier is more elastic than the LM frontier. Along the former frontier, increases in RCDC leads to higher savings and investment then to higher income. As would be expected, income is more responsive to increases in investment below the level of full employment aggregate supply. Meanwhile, it becomes relatively inelastic beyond the level of full employment. The same applies to the LM curve but to a lesser extent. As higher RCDC's motivate the monetary authority to issue more money and increase central deposits, the expected inflation rate gets closer to the target inflation rate, inhibiting further increases in monetary expansion. The responsiveness of income along the LM curve is therefore constrained by both the rate of inflation and the full employment level of aggregate supply. That is why the LM should be less elastic everywhere than the IS curve. Interestingly, the elasticity of the IS relative to the LM frontier appears from Figure (3) to be an equilibrium condition.

## V. MONETARY POLICY IN AN INTEREST-FREE ECONOMY

The monetary authority in the economy described above can change money supply through two means. The first is the addition of new cash to central deposits, or the destruction of cash by withdrawal from those deposits. The second is the sale and purchase of central deposit certificates through open market operations.

It is obvious that neither the required reserve ratio nor the discount rate exist in such an economy as policy tools. Yet, the smaller number of tools should not in our case, be taken as a disadvantage.

The expansion must always be justified by a possible contribution to real balances. Therefore, the matter is not left totally to the discretion of the monetary authority.

The central bank will have to monitor the real growth of the economy through the investment performance of its member banks. Growth as well as past performance of the general price level will provide the central bank with necessary information on whether a faster expansion of the money supply can contribute to real balances.

An interesting consequence of the above is that monetary policy could be viewed as closely intertwined with development policy. Through

the central bank, some would hasten to think that the government could encourage investment in certain regions or sectors, as may be needed (Al-Jarhi, 1983). This runs contrary to what we have proposed above, that the central bank should allocate its newly created money among banks according to some efficiency yardstick. Using and other criteria for allocation would introduce serious inefficiencies in the national economy. It is best that the monetary authorities' main concern should be that of stabilization rather than development.

It is clear from above that monetary expansion in an interest-free economy is effectively constrained by the rate of inflation. The reason is that the monetary authorities in this economy visualize themselves as creators of real and not nominal balances. It can therefore be said that stability is not just an objective to be sought by policy tools. Stability becomes also a mandatory precondition for the use of monetary policy tools.

The role of the Treasury reinforces the importance of stability. Since the monetary authorities leave no opportunity to create real balances forsaken, there is no need for government deficits financed by monetary expansion. Such inflationary impulse is neither necessary nor useful. Nonetheless, the government has sufficient flexibility to cover the expenditures of its economic activities, including public goods provision, through taxation and Al-Zakah. Income earning government activities can be financed through the market mechanism with no need to borrow or incur a deficit.

# CHAPTER VI: TRANSFORMING AN INTEREST-BASED MONETARY AND FINANCIAL SYSTEM TO AN ISLAMIC ONE

Moving from a conventional to an interest-free monetary and financial structure cannot be done instantly or overnight. It must be done gradually with conscious planning and preparation (Al-Jarhi and Iqbal, 2003). Yet, we can attempt to list some of the most important steps to be taken for such economic transformation.

## A. THE CENTRAL BANK

1. Restructuring domestic and foreign assets and liabilities on a non-interest basis
2. Liquidation of government and public sector debt
3. Changing government and public sector deposits

## B. RESERVE REQUIREMENTS

Gradual transformation into 100 percent reserve requirements would be advisable, since sudden switch would create real hardships for banks. Increases in the required reserve ratio should be accompanied by injection of additional resources to banks through central deposits.

## C. TAX REFORM

Al-Zakah plays a central role in the interest-free financial system. In addition, direct taxes are more consistent with equity than indirect taxes. A new system would be needed in which wealth and income taxes are main features. In addition, overly high rates of taxation must be avoided and those with wealth below the minimum necessary to cover for basic needs must be exempted. Such approach would minimize tax evasion.

## D. UNIVERSAL BANKING

the banking system needs to switch from commercial to universal banking. This requires retraining bankers into this new type of business. Particularly, feasibility studies, investment evaluation and follow-up, management of holding companies and monitoring of subsidiaries would all be some of the new skills required by bankers.

## E. REAL SECTOR REFORM

the state should concentrate on taking care of mineral wealth and provision of public goods, while divesting itself from public enterprises through gradual privatization.

## F. LIQUIDATION OF PUBLIC DEBT

The new resources, which the State is bound to obtain, especially from higher central bank profits, which would include larger seigniorage, could be used to repay the public debt. Some of the debt can be swapped against equity in public enterprises.

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