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The Nature of Money in Modern Economy – Implications and Consequences

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10 May 2016

Online at <https://mpra.ub.uni-muenchen.de/72238/>

MPRA Paper No. 72238, posted 28 June 2016 10:17 UTC

**ZARLENGA AND POTEAT, THE NATURE OF MONEY IN MODERN
ECONOMY, A COMMENT
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Reforming the contemporary monetary and financial system has come under the limelight with the onset of the last international financial crisis. Zarlenga and Poteat focus on the elimination of credit money and the return to of the exclusive right of issuing money to the government as a key to reforming the system. In this comment, I argue that they are right, but reform should be wider and more comprehensive. My arguments are inspired by Al-Jarhi's model of an Islamic monetary system (1981).

The authors and I are in agreement that the essence of the medium of exchange lies neither in the law nor in the physical attributes of money, but rather in its general acceptability. The physical attributes as well as law enforcement do not create but may reinforce general acceptability but neither would be sufficient to keep public interest in using money.

An interesting point the authors make is debunking the old textbook concept of derivative deposits being created from primary deposits¹. They claim that banks create money out of thin air through the process of lending, based on profitability expectations. The availability of reserves is of little concern, as the central bank accommodates the supply of money desired by banks through its discount window and

¹ This could render the concepts of reserve money, high-powered money and the monetary base out of fashion.

open market operations, paying attention solely to setting its target level of interest rate.

The authors focus on the redistributive effects of credit money creation. I have for a long time adopted this view that credit money creation is a channel through which banks usurp seigniorage, which should be the exclusive right of the public who gave money its ability to serve as a medium of exchange through general acceptability.

The authors highlight bankers' "transgressions" as a result of such wealth redistribution, using savings and loan associations as an example. I would add to this the record of banks practicing predatory lending as well as the devious ways of securitizing subprime debt, especially during the years preceding the international financial crisis. Wealth redistribution from the public to banks is carried to extreme, when the instability of banks, which is a self-inflicted backlash of the system, costs the public astronomical amount of resources to save banks from downfalls.

The authors, however, ignore how money, once created is used. Conventionally, money even when created exclusively by government will be used to finance the deficit, encouraging unjustifiable expansion of government expenditures which is often subject to tremendous waste². Al-Jarhi's model (1981) proposes that such newly issued money would be placed in profit-and-loss-sharing, PLS, investment accounts with banks, which would be used to finance private and government investment and

² It is astonishing that in an Islamic state, Awqaf, or charitable foundations providing health and education services and supporting scientific research are encouraged. Past experience in old Muslim societies indicate that the burden of government in this field has been significantly reduced. This would undoubtedly reduce the need to of the government to incur a deficit.

consumption activities, based on economic feasibility (or investment) criteria.

The government can obtain seigniorage in the form of a profit share on its invested funds. In addition, the government can issue central investment certificates, or CDC's whose proceeds would also be allocated between banks according to efficiency criteria to be invested. The rate of return on CDC's would replace the nominal rate of interest, which would be market (and not policy) determined. CDC's would be traded in open market as an interbank tool and a monetary policy instrument, replacing government bonds. Such arrangements would make money serve as equity-shares in national output. Its rate of growth would be tied to the real rate of growth of the economy. Monetary policy will finally break loose of political factors.

Limiting the problem of the current monetary system to the fact that banks create money indicates that the authors have not gone far enough³. The most important issue that I have repeatedly emphasized is that the system creates and allocates financial resources, based on borrowing criteria.

According to the classical loan contract, a deposit with the bank is a loan, which the bank guarantees to repay in principle and interest. Payment of a positive interest rate entices economic agents to reduce the monetary balances they use in transactions in order to increase their interest income. This is compensated for by using real resources withdrawn from the commodity sector to increase the velocity of money used in transactions. Substituting real resources for money reduces total output and efficiency. This point was made by Milton Friedman (1969), upon which

³ Many things happened since the Chicago plan that served as eye-openers for making the plan more comprehensive and effective.

he based his optimum monetary policy rule. Based on the Fisher's equation, Friedman proposes to deflate the economy at a rate equal to the real rate of interest, in order to bring the nominal rate down to zero.

When this matter was investigated within general equilibrium models, it was found that a zero interest rate is both necessary and sufficient for allocative efficiency (Cole and Kocherlakota, 1998; Wilson, 1979). Though these theoretical results are dependent on some simplifying assumptions, they are robust in a variety of models (Correia and Teles, 1997). They imply that the long forgotten Christian and Jewish teachings as well as those of Islam, Buddhism and Hinduism that prohibit the charge of interest on loans are not an aberration. It is amazing to see such religious teaching stay valid after so many centuries.

However, Friedman's "final" *rule for optimum quantity of money* served as a red herring to direct attention from the fact that the monetary system based on interest is basically flawed. Reducing the nominal rate of interest to zero will not solve the problem, but will surround the economy with liquidity and saving-investment traps. It is interesting that in Islam, providing interest-free loans is an act of charity that cannot be suitable for financing investment and consumption.

In addition, the classical loan contract itself is subject to inherent risks because of its association with information asymmetry. It makes it especially exposed to the risks of adverse selection and moral hazard in addition to the usual credit risks. Why economists have not directed their attention to alternative finance contracts is puzzling.

Islamic economists propose 16 contracts to replace the classical loan contract⁴. Some are based on partnership in profit and product. Some are based on investment agency and the rest are based on sale and lease arrangements. Five of such contracts are subject to information asymmetry, while the remaining eleven are not. This means that information asymmetry can be easily avoided by mixing and matching between the 16 contracts. This is similar to the behavior of universal banking, as originally practiced in some non-Anglo-Saxon countries, where equity finance is matched with debt finance.

Another side of the current system relates to the fact that debt markets are integrated into one, where debt in the forms of bonds is freely tradable. This market serves as an attractive space for hot money, which eventually becomes a hotbed for instability and contagion. An added feature is the liberty to trade in risk, which blows up the size of the financial sector out of proportion, to become the tail that wags the dog.

Islamic economics prohibits trading in debt, as it amounts to trading present against future money. The debt resulting from Islamic finance cannot be gathered for trading in one integrated market. Added to this, when Islamic finance results into debt owed by one of the parties, the amount of debt is fixed from the very beginning and is not subject to increase even in cases where debtors face temporary illiquidity and require rescheduling. Only delinquent debtors are subject to penalties to be paid to charities and not to banks.

⁴ Providing such contracts as alternatives to the classical loan contract, and their use in the Islamic world for hundreds of years is perhaps the reason behind the name of “Islamic economics.” Otherwise, calling it “Jewish” or “Christian” economics would have been appropriate.

Financial markets under the proposed reform will contain only equity-based instruments, like shares, Sukuk, investment certificates, fund shares, etc. Such financial instruments are issued by government, central banks, corporations, Awqaf foundations and Zakah institutions. Market trading would be limited to spot and deferred price or delivery contracts but not futures or derivatives. Financial markets would cease to be the gambling casinos and the financial sector would cease to dwarf the commodity sector.

Perhaps the most unfortunate thing about Islamic economics that it has not been in practice for decades. Limited attempts for its revival in the area of Islamic finance have been marred by anomalies due to malpractice. The major culprit is the lack of interest on the side of central banks to properly regulate the Islamic finance industry. In addition, the establishment of foundations to provide health and educational services has been curtailed by governmental jealousy of an Islamic revival.

We can therefore propose the expansion of the Chicago plan to include the features explained above. This would improve economic efficiency, stability and compactness and close most of the many doors through which crises break into the economy. We can summarize the proposed reforms inspired by Islamic economics as:

1. Replacing the classical loan contract by the 16 Islamic finance contract,
2. Exclusive monopoly of the issuing of money through a government-owned central bank,
3. All issued money is to be placed in PLS investment accounts with banks,

4. The central bank issues central investment certificates, to be held by banks and the public and traded in an open market as an interbank and monetary policy instrument,
5. Debt trading as well as the use of all risk-trading contracts is prohibited in financial markets,
6. Debtors would be granted free rescheduling in case of temporary illiquidity, but penalized in case of delinquency.

This would be a radical transformation of the current system to another system that is more efficient, stable and compact. In order to illustrate this point. Suppose this modified system faces a natural catastrophe, how would it confront it?

First, debtors facing temporary illiquidity would be granted free rescheduling, aggregate demand would not significantly fall. The danger of recession is minimized.

Second, since predatory finance is non-existent, investors who obtained finance will be able to recover gradually.

Financial instruments may suffer some price reduction, but financial markets would remain resilient.

The central bank can increase its central deposits with banks to relief liquidity problems without have to spend billions to bail out banks.

In summary, the economy would face such catastrophe much better and with less pain than the current structure.

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