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Credit creation and control: an unresolved issue in Islamic banking

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CREDIT CREATION AND CONTROL: AN UNRESOLVED ISSUE IN ISLAMIC BANKING

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Abstract. This paper deals with a still unresolved issue - credit creation and control - in an interest free banking system. The available literature on the subject is scanty, controversial and inconclusive. The paper holds that credit creation per se is not un-Islamic; the essential point is how credit is generated and used. It argues that credit creation cannot be banished; it is an imperative for frictionless adjustment of money supply to unavoidable fluctuations in its demand in modern economies. It seeks to correct the misunderstanding in the literature that banks create credit ex nihilo. Demand for money apart, fiscal policies and foreign exchange transaction erode the credit controlling power of the central banks. The paper blames major difficulties including those of credit creation and control on the evolution of Islamic banking on the same pattern as its mainstream counterpart and suggests some structural modifications. Finally, it finds the conventional weapons of credit control inefficacious for use in an interest free banking system and suggests the inclusion of a ratio of cash to bank advances among them. The paper has some important technical and policy implications.

1. INTRODUCTION

Commercial banks are essentially dealers in credit. Interest is the price that guides them in making business decision. They were initially started as institutions for meeting the short term credit requirements of trade industry and commerce and it remains their primary function even today[1]. In view of that requirement, the legal framework never put restrictions on the credit creation power of these banks. However, legislation did require the central bank of each country to oversee and control that power so that it may not be used to the detriment of social well-being.

Islamic banks were conceived of to be organized on the same structural pattern as conventional banks. The use of interest alone was to be eliminated from their operations (Siddiqi, 1983). The choice unwittingly became source of much confusion at the

(1) It may well be argued that over time the structure and functions of conventional banks have undergone radical changes. We are living in an era of *universal banking* where banks now combine various sort of functions – deposit taking, investment, mortgage, leasing, units etc. under a unitary control. Islamic banks can also follow suit. The argument is ill-conceived. Conventional banks took centuries to evolve from commercial into universal sort of banking. Most Islamic banks are yet in their infancy. They in general lack experience, skills and expertise as well as resources to short circuit the process. More than that, universal banking has not obliterated the issue of credit creation and control. Rather, it has made the issue all the more complicated. Credit management still remains the primary function of central banks, worrisome too.

conceptual level and led the progress of these banks in some wrong directions (Hasan 2005, 22). In Islamic banking the abolition of interest, the insistence on sharing business risks with the owners, the longer lock-in of investment funds and the social responsibilities the system is supposed to shoulder raise some ticklish issues that its structural constraints could rarely help resolve.

The misdoing raises many puzzling questions relating to credit creation. Can Islamic banks in the first place create credit like the conventional banks to enhance their earnings? If yes, what must replace interest as *price* for the funds they would provide to their customers? How would the central bank put, if need be, a tab on their credit creation activities from a social viewpoint? Shall it be using the same weapons for the purpose in their case also as it has been using in the case of conventional banks, or it will have to modify them in some way? What amendments, if any, the current regulations will require? The literature on Islamic banking does show awareness of such sort of issues; in fact, they were amply debated during the 1980s. But the discussion created more confusion than light and remained agonizingly inconclusive. To our knowledge, it has since seldom been reopened for discussion.

We believe that Islamic economists must look at the issue of credit creation and control afresh in a more definitive way and this paper is intended to set the ball rolling. After attending to some preliminaries, we shall look at the question of credit creation from two angles that seem to have escaped the attention of the learned. First, we find that there has been an uncalled for alarm about the possible misuse by the banks of the credit creation power they enjoy. True, this power of the system as a whole is vast, but one must not ignore the constraints that put a tab on it in practice. The alarm has been overdone because the demand side of the credit market has almost completely been ignored in the discussions on the subject. Credit is not a free gift of nature; it has a cost, even in an interest free Islamic system. Cost apart, the legal environment for banking in a country also impacts the volume of credit the system can create (Hoshi 2006, 2). It follows that the power to create credit the banks carry does not imply that they could use that power to generate any amount of lending they wish unless there is a corresponding demand for the same. Given the rate of interest, conventional banks together *have* power to keep the supply of credit perfectly elastic, but what amount of it would actually be generated depends on the demand side of the market as Figure 1 shows.

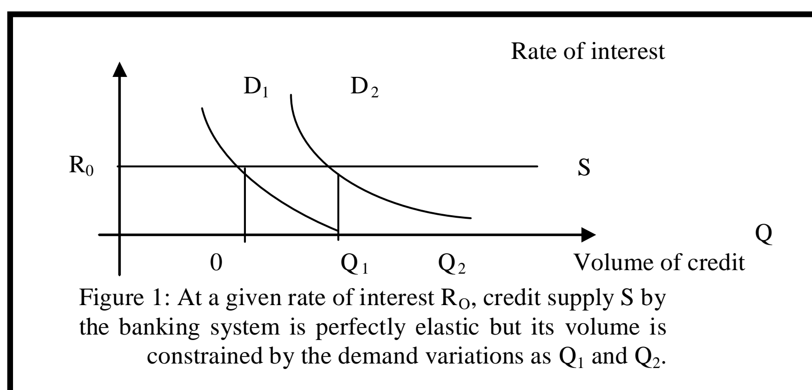

Figure 1: At a given rate of interest R_O, credit supply S by the banking system is perfectly elastic but its volume is constrained by the demand variations as Q_1 and Q_2.

The opinion by default seems be that the Islamic banks can also create credit in the same manner as conventional banks. Thus, it is pertinent to ask – and this is our second point -- what instruments the central banks could use for controlling credit creation in the case of Islamic banks. The objectives, credit creation modes, nature of advances; and security cover demands in Islamic banking would all be much different from those of conventional banks. The matter becomes all the more serious if countries allow, as in Malaysia, the opening of Islamic windows in conventional banks. How would a central bank apportion total credit created between the Islamic and non-Islamic operations in this sort of mixed banking? Can there be a blanket application of rules or they must differ?[2]

The paper is divided into six Sections including the introduction. In Section 2 we shall attend to some preliminaries concerning credit forms and its various sources. Section 3 presents an overview of the literature for evaluating the current position of credit creation issues In fact; it has been a bewildering experience. Concepts have been vague, definitions infirm and arguments rarely convincing. Any theoretical edifice was rarely raised; empirical evidence seldom presented. To save time and space, we shall discuss broad positions taken rather than comment on individual contributions. In Section 4, we shall explain briefly the theory and process of credit creation with reference to its domestic and foreign bases of expansion. Section 5 discusses if Islamic banks could create credit and if yes what credit control measures the central bank can use in their case. Here we may propose some structural reforms for Islamic banking and argue for a dualistic credit control mechanism Section 6 summarizes the argument of the paper and contains some residual remarks.

2. CREDIT: DEFINITION SIGNIFICANCE AND SOURCES

We may define the term credit in a broad or narrow sense. In broad terms, credit is finance made available by one party – lender, seller, or shareholder / owner – to another party – borrower, buyer, or a business firm. The former could be a pure lender – a financial institution or a private money lender, a seller / supplier of goods on the promise of the buyer to make payment in future, or a shareholder / owner of a firm making funds available to the firm recognized as a separate entity.

More commonly, the term credit is used in a narrow sense that is only for debt finance. Credit is simply the opposite of debt; both are created instantly by the *same* contract. It is a special sort of exchange transaction involving future payments, interest added to debt as its time value. It is this view of credit that lies at the heart of modern commercial banking. The abolition of interest must make such transactions non-existent in an Islamic financial system. Amazingly, the abolition of interest and the remaining features of commercial banking were assumed to harmonize!

(2) No such distinction is being presently made in Malaysia, and Bank Negara applies the same rules uniformly to credit creation by all banks, Islamic or non-Islamic. Presumably, this is so because credit generated by the Islamic banks is still a drop in the ocean. Central banks will surely face a challenge as and when the share of Islamic banks in the pie assumes significance. Will it not be advisable to foresee the inevitable and prepare for pre-empting the oncoming challenge?

Credit must not be confused with money. Their nature and role in an economy differ. Money may be issued by the government or the central bank of a country and serves as a legal tender and unit of account for payments. It consists of notes and coins which together are called cash or *currency*. Money is an asset of the holding public but it is a liability of the banks (or the government). In contrast, credit is a liability of the borrowing public (or the government) but an asset of the banks. The public keeps part of their cash holdings as demand deposits in the banks. We shall see that bank help multiply cash deposits manifolds through their credit creation activities. Such deposits work as *bank or credit money*.

But what is the need if at all for creating credit (money) some Islamic economists ask? Here is the answer. The volume of currency and its growth is determined by the volume of exchange work in an economy. But demand for money work in an economy usually has a *seasonal* pattern. For example, in South Asian countries agriculture accounts for the major portion of national output and the sector needs relatively larger amount of money for transactions at the harvesting time. Likewise, demand for woolens, umbrellas, festival items and so on is also seasonal in character. Changes in the currency volume of a country have to follow legal formalities and cannot be adjusted readily to short-term seasonal variations in money demand. In contrast, credit money, we shall see, can be as easily destroyed as it can be created. It is this flexibility of credit that lends commercial banks so much significance in modern societies. Islamic banking has yet to provide an alternative for meeting the seasonal money demand. The issue is important because seasonal factor in financing is a characteristic of the *running* businesses while Islamic finance is generally conceived as geared to self liquidating one-off projects.

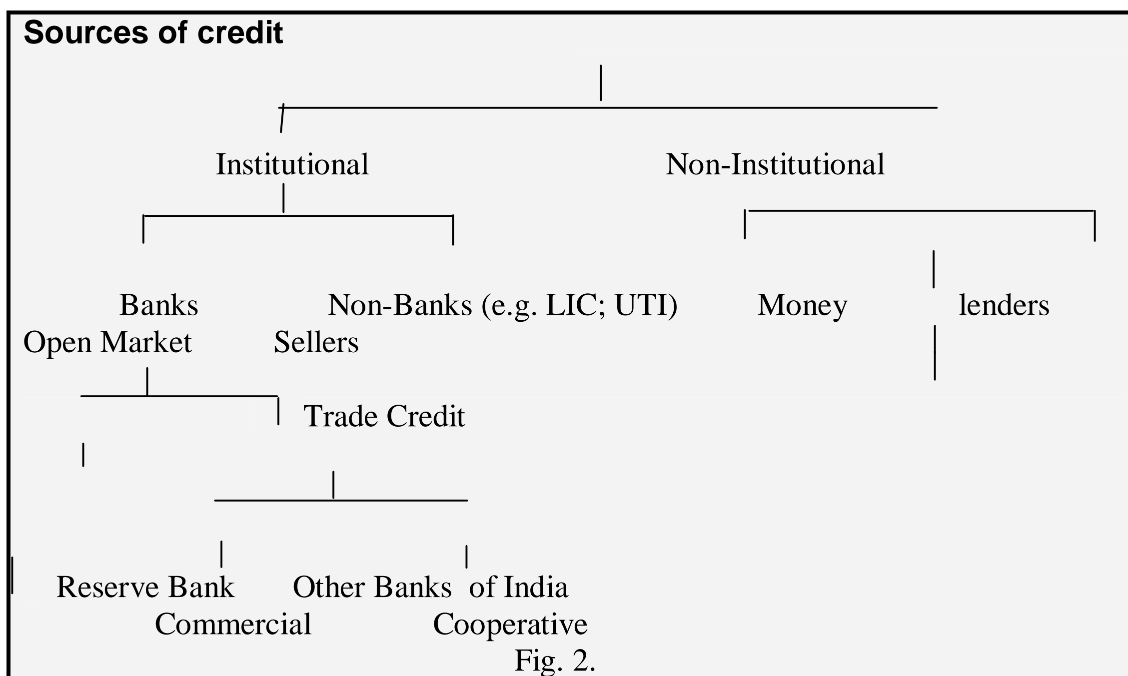

Fig. 2.

Credit is provided in an economy also by sources other than banks. These sources vary from country to country in form, price, and allocation. To illustrate, in India at present Figure 2 provides their broad classification. All these sources of credit taken as

a whole constitute the *financial system* of an economy. The end users of credit the system creates may also vary much across nations, but they in general include consumers and producers in various sectors of the economy at home and abroad. Here we shall be dealing only with the creation of credit by commercial banks rather than its users. Notice that Figure 2 also reflects indirectly that credit creation is not entirely independent of the overall financing environment of a country.

3. LITERATURE OVERVIEW[3]

Trade industry and commerce have three sorts of capital requirements with reference to time.(i) long-term investment needed for acquiring basic infrastructural assets including land, buildings, plant and machinery that usually last for a number of years and determine the production capacity of a firm. (ii) Medium-term requirements that relate to fixtures and furniture, lighting arrangements, communications and the like which may not need replacement for a few years, and (iii) money needed to hold inventories comprising raw materials, spares and stores, work in progress, and finished goods for short periods of 3-4 months to ensure smooth running of business.

The relative proportions of funds to meet these requirements vary with the nature of business. However, financial capitalization principles suggest that in general requirement (i) and a major part of (ii) must be financed by equity in the first place but can be supplemented by long-term debt, if unavoidable. The remaining part of (ii) plus (iii) constitute the working capital of a firm for which it may resort to debt financing. Commercial banks – their structure, modus operandi, and legal framework – were all geared to meet the *working capital* needs of the expanding business firms[4].

Islamic economists could not see the roots of commercial banking lying in the short-term financial requirements of business. The abolition of interest was inevitable, but it raised the issue of pricing bank finance to help meet a firm's financial needs. The attempt to provide an answer led to the premise that Islam allows financing of business only on a participatory basis. In support, the 'no risk no gain' rule was paraded as the guiding star of Islamic finance.[5] Participatory finance could take one of the two forms: *musharikah* or *mudarabah*. The first was akin to equity financing where profit and loss between the parties could be shared in the same ratio as their contributions to the equity of the firm. Mudarabah was preferable as it had romance. Here, the profit sharing ratio for the financier would necessarily be smaller than his loss sharing ratio; the magnitude of divergence depending on negotiation between the parties (Hasan 1985, 15).

In that was seen the solution to the pricing issue: the sharing of profit ratio for the financier could take the place of interest. In fact, diagrams and macro-models were

(3) The position on credit creation and control in the mainstream literature is well-known and going over it here would be an unfruitful digression. This Section, therefore concentrates on explaining the position in the literature on Islamic banking.

(4) After 1950s profit rates in general ran much higher than the rates of interest in most economies and business firms increasingly went for short-term bank finance to meet even their long term financial requirements. Excessive use of leverage fuelled profits and business expectations. That created bubble economies which came to grief sooner than later with the collapse of businesses and the setting in of recessions.

(5) For a refutation of this exclusion principle see Hasan (2005)

produced replacing interest rate with the sharing ratio to arrive at the equilibrium positions. It was not realized that profit sharing ratio was not a price of funds like the rate of interest; it indicated the part of profit going to the financier even as it could impact the demand and supply of funds under certain assumptions (Hasan 1985, 16-21). The end consequence of this all is that today around 90% of business in Islamic banks is in terms of fixed return transactions, participatory finance - the much esteemed form - constituting just the tail of the elephant in the system (Hasan 2005, 12-13).

The structural mismatch led to confusion in Islamic banking concerning the deposit forms and the reserve requirements to safeguard customer interests. Following the conventional pattern, the scholars had to classify deposits in Islamic banks too into demand deposits and time deposits. But it was seldom realized that even time deposits of these banks could not be for periods as long as investment in a *running* business normally demanded. Consequently, mudarabah instrument could be employed mainly to finance piecemeal projects. This factor combined with others led to the failure of mudarabah to emerge as a tool of Islamic finance (Hasan 2002).

Discussions on reserve requirements contain mostly arbitrary suggestions: any thing between 5 to 100 percent that hit one's imagination. We are not sure if central banks even today make a distinction between the Islamic and conventional banks on the point. Doubtless, such a distinction has wide ranging implications and might invoke much debate and controversy. But one has to cross the bridge when one has reached it. We can no longer have an ostrich like approach to the issue.

Another problem one comes across in the literature on credit creation is the treatment of the term seigniorage. The literary meaning of the word is any claim by the sovereign or a feudal lord as his prerogative in relation to society. In the history of money, it referred to the percentage share of the crown in the bullion people brought to the royal mint to get converted into coins. Now-a-days the term is applied to *all* money, including banks credit.[6]. Until the world went off the gold standard, the issue of currency notes was in some way backed by the yellow metal but today it is backed only by the government and other securities. Economists now treat as seigniorage the interest a central bank earns on securities against the issue of notes. It is refunded to the Treasury as a central bank is government agent and the profit on its operations belongs to the government (Economic Research Council 1981, 3).

(6) Such application of the term is a bit intriguing, for people can neither take paper to the central bank to get printed the notes they would use nor do they pay for their printing.

Economists have long been arguing that the credit creation power of the banks is a societal asset and the profit they earn because of it must be shared with the Treasury to promote common good. They even propose that the mechanism of credit creation should be re-examined to see if it can be made the sole prerogative of the state so that the seigniorage it generates becomes available for public purposes[7]. Islamic economists subscribe to the mainstream position. In fact, the concern on the point seems to be growing for the reason that in recent decades the volume of financial transactions in modern economies expanded at a much faster pace than the expansion of real output. Notice that the volume of money involved in just spot transactions in the foreign exchange markets is estimated at more than 70 times of world expenditure on real goods and services. There has been a phenomenal rise in speculation-related transactions which have little to do with the real sectors of economies. We know that it is bank credit that primarily fuels speculative activities[8]. No data is presently available on the credit creation activities of Islamic banks, if they were (at all) indulging in such activities.

4. CREDIT CREATION PROCESS

How do banks create credit? We have already made a distinction between (i) currency or legal tender money and (ii) bank credit or money. The two together constitute the M_1 version of money supply. The relationship between them lies at the heart of the credit creation process the commercial banks follow. The volume of (i) in an economy serves as the *base* for generating (ii). Part of the base money always remains *inside* the central bank while the remaining part of it is held *outside* by the public[9]. People deposit a part of the *outside* money with them in commercial banks as demand or time deposits. Together they constitute the *cash* deposits of the bank. A portion of deposits, say 10%, the banks have to keep with them as statutory reserve to meet the daily withdrawal needs of the depositors; the remaining they can lend on interest. However, the sum loaned is credited to the account of the borrower. Thus, loans generate what we call *credit* deposits. These loans and deposits appear one for the other as contra entry in the bank balance sheets. The banks make no distinction between the two sorts of deposits – cash or credit – in their lending operations. For any deposit of 100 they must have 10 in reserve. To illustrate, if a bank has 100 as cash deposit, at 10% the amount can serve well to support an inverted pyramid of deposits worth 1000: 100 cash + 900 credit. However, when central bank issues new currency adding to base money the estimation

(7) We reproduce below from the Economic Research Council Report (1981, 3) what Abraham Lincoln so cogently summarized as the principle on credit creation.

"Government possessing the power to create and issue currency and credit and enjoying the right to withdraw both currency and credit from circulation through taxation and otherwise, need not and should not borrow capital at interest as a means of financing Governmental work and public enterprise. The Government should create , issue and circulate currency and credit needed to satisfy the spending power of the Government and the buying power of the consumers of the consumers. The privilege of creating and issuing money is not only the supreme prerogative of the Government, but it is the Government's greatest creative opportunity."

(U. S Senate Document No. 23)

(8) It is estimated that one trillion US dollars go round the world stock markets every twenty four hours

(9) The classification of currency into outside and inside money is of recent origin and some economists have found it a useful explanatory tool in their discussion of the credit creation process of commercial banks.

of credit creation does not remain so straight forward. The formula for estimating the credit creation potential of the system incorporating the relevant factors then is as under.

$$M = \frac{I}{R + C - RC}$$ *where both R and C are less than one but more than zero*

Here, M is the value of the *credit deposit* multiplier, R is the ratio of deposits the banks are required to maintain as reserve with the central bank and C is the proportion of money the public desires to keep with them as currency[10]. Since R and C are both less than 1, their product will be smaller than either of them. Thus, the denominator will always be positive and less than 1. M being the reciprocal of a positive fraction is more than one. It will vary inversely with changes in R or C[11]. The assumptions of the model are: (i) there is no increase in the demand of the public for currency such that the reserves available to banks are reduced and (ii) the banks do not hold any excess reserves. To illustrate, if R = 20% and C = 25%, M will be 2.5.

Notice that the model is independent of the new issue amount. It can help a central bank to predict the effects of open market operations impacting C or a change in reserve requirements R on the money stock of the economy if (i) it is able to control the monetary base and (ii) the behavior of the public and the banks were predictable. It is difficult to meet these requirements; they limit the credit controlling power of the central bank.

The stock of money in an economy does not depend solely on what a central bank does. It also depends on the behavior of interest rates; the relationship between them and the coefficients R and C of the multiplier model can hardly be predicted or measured. Furthermore, the fiscal policies of a country and its balance of payments position are significant sources affecting the monetary stock. Let us have a brief look at these additional sources of base money expansion in an economy.

1. Fiscal policy and currency volume

Base money or cash in modern economies is created mainly by the central bank of a country, the amount being decided in agreement with the Treasury and is formally subject to a degree of Parliamentary control. Under monarchy or dictatorship this control is often more than formal. The issue of notes was in the beginning duly backed by holdings of gold, but now it is backed largely by securities of the government. New issues of currency are a source of finance for the central government of a country for covering budget deficits. Deficit financing may be used to boost economic development

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(10) Suppose the central bank increases the base money supply by 100 units; the public keeps 20% cash with them and deposits 80 with the banks. The banks do not want to hold any surpluses except meeting the central bank reserve requirement of say 20%. Thus they have additional base money equal to 72. At 20% reserve requirement this can support 72 x 5 = 360 as deposit (cash 80 + credit 280). Putting the ratios in the formula we have M = 2.8 (approx.) Now, 100 (increase in base money) x 2.8 = 280 is the credit deposit. Thus, *citrus paribus* the formula is verified.

(11) If an individual bank creates credit at a faster rate than other banks in the system, it will soon find itself losing its base money (cash) to them in the clearing house. The loss will make it fall in line with the behavior of the system. Each individual bank is tied like a balloon with a string to a group of them. It cannot run away from them more than the length of the string: the cash it has. But the bunch virtually has no limit to soar in the skies.

but it may also be abused for instance to cover inefficiency or unproductive expenditure as on wars In any case, it expands the credit creation base and may fuel inflationary pressures in the economy.

New notes issued against government securities entail only printing and management costs to the central bank. This cost is a tiny fraction of the interest the bank receives on the face value of securities held. Note issuing is indeed a highly profitable activity. However, a central bank being a public institution, the profit as hinted earlier, goes to the government and is spent for promoting the social good.[12]

2. Exchange rate and base money linkage

Exchange rate stability is one of the important monetary policy goals; more so, in countries like Malaysia, where foreign trade works as the engine of growth. The authorities maintain a foreign currencies' reserve to buy or sell domestic currency for foreign money to achieve the objective. If imports exceed exports more of domestic currency losses in value against foreign money exchange rate tends to rise. To arrest the depreciation of the local currency the authorities buy it for foreign money in the exchange market. The volume of base money in circulation is reduced and contraction of credit must take place. On the other hand, when exports exceed imports the Ringgit is climbing up. For preserving the rate, authorities have to sell it in the market for dollars. Base money increases in circulation allowing credit expansion.

It follows from the above discussion that the central bank cannot determine the monetary base exogenously and the credit multiplier models like the one discussed above do not *completely* specify the factors operating on the money supply unless the rates of interest and exchange rates are left entirely to market forces for their determination. Evidently this is not possible for a variety of reasons.

5. ISLAMIC BANKS: CREDIT CREATION AND CONTROL

We may begin with a broad summary of what we have learned from discussion in the preceding Sections. It may help clear some of the cobwebs to have a clearer view of the issues involved. Briefly, we may take note of the following facts

1. Commercial banking is essentially trading in money to meet short-term financial needs of trade industry and commerce. Credit creation is an imperative to meet these needs and adjust money supply to seasonal variations in demand. It was inappropriate to adopt the model for interest free Islamic financing. We have to see how this flaw can be remedied.
2. The conventional banking system has vast power to create credit; yet this power has limits; the demand side constraints cannot be overlooked. Currency or base money is the foundation on which the superstructure of credit is raised. Banks do not

(12) For example, the budget support to the government from the interest on securities paid by the Bank of England during the seventies averaged to 130 million pound sterling a year. (Estimate based on Economic Research Council Report 1981, Table 13, p.33) The total cost to society eventually was no more than money spent on the printing and management of notes and securities involved in public borrowings from the central bank.

manufacture currency and they cannot create credit *ex nihilo*. Rising budgetary deficits, often fuelled by wars and expanding foreign currency trading have become sources of base money proliferation. Increasing undercapitalization of businesses and speculative demand for money has tempted the banks to expand credit often beyond the limits of safety. Banks alone cannot be blamed for the scenario.

3. Profits from credit creation are huge relative to costs. It is a legitimate demand that society must have a claim on them. How or how much is the issue. Islamic economists have to search for an answer.
4. The central banks have powers and instruments to control creation of credit by banks. However, it has limitations and does not always have the desired results. If Islamic banks are to create credit what techniques of credit control can be used in their case?

Let us begin with the observation that the term Islamic banking is a misnomer for Islamic banks cannot do and are not doing all what is the lifeblood of modern commercial banking. The adoption of that nomenclature unthinkingly committed us to the paraphernalia intrinsic to the system and printed its image on the common minds. Thus, instead of building something original rooted in Islamic ethos, we spend and shall be spending our energies in patchwork seeking modification here, and submitting as *facility* there. The result is that in Islamic banking we tend to bank more on the mainstream and less on Islam. The legal framework, regulatory norms, benchmarking, rating norms, transaction forms, and instrument structures all derive their basics from the mainstream.

One consequence is that conventional banks had to be allowed the opening of Islamic windows. Shari'ah scholars tell us that the money deposited in the 'windows' is kept and accounted for separately; it can be used only in approved ways. May be, but is it not like claiming that if a clean stream joins a mighty polluted river, its water can safely be kept separate and pure? Presumably, Islamic banking shall eventually be run by the mainstream bankers and we shall learn from them what is Islamic and what is not.

We shall turn to the issue of structural modification later Demolition of the present organizational setup may not be expedient; it will rather expand. For that reason, credit creation and control remains a significant but unresolved issue for Islamic banking. Islamic banking today is in fact thriving on credit financing in the form of deferred payment transactions. But can they generate, if they are not doing so far[13], *credit* deposits in the same way as explained earlier? The question requires a categorical answer with reasons. If the answer it in the negative, scholars must explain how the *temporary* expansion and contraction in money supply can smoothly take place in a bigger picture when Islamic banking will be a force to reckon with in an economy? Islamic bankers will have to demonstrate its feasibility.

(13) To my knowledge, Islamic banks are not generating credit deposits and some Shari 'ah experts sitting the Advisory Boards of Islamic banks including windows inform me that there are specific instructions to the management that advances unlinked to *real goods* are prohibited. If it were the case, compliance with Shari'ah norms of credit to be denied for purely speculative purposes is ensured. See also n. 14.

It seems to us that the answer must be a positive one if we are running a *banking* system and that too in competition with the mainstream commercial banks. Presumably, there could in principle be little Shari'ah objection to multiple credit creation by the banks. The banks' contract with the depositors gives the latter right to withdraw their money as per the terms agreed upon between the parties. So long as the banks fulfill their part of the contract and put money to Shari'ah compliant uses, no one can insist that they keep a 100% reserve for deposits. The point at issue is not credit creation *per se* but how the deposit money – currency or credit – is used[14]. This may well be decided by the Shari'ah scholars.

If the above argument were acceptable, the next question must concern the control of credit creation by the central banks. The usual methods – bank rate policy, open market operations, variation of reserve ratios, quality control and moral suasion are well known. Their explanation need not detain us here. Since interest is prohibited in Islam the use of bank rate policy as a tool is out of question. Earlier Islamic economists had suggested the sharing of profit ratio to take its place. It was and remains a naïve proposal. Interest is a price for loan able funds which profit sharing ratio is not. Such ratios can sparingly be attached to government securities available for open market operations making this instrument also unusable for Islamic banks. Above all, the underlying assumption of profit sharing ratio was that participatory financing will be dominant – some innocuously thought exclusive – form the Islamic banks would use. Experience has long belied that hope. Fixed return instruments have been overdone in Islamic banking and finance.[15]

It comes about that the credit control measures for the mainstream and Islamic banks cannot entirely be the same. This raises the question: Can the existing legal framework of central banks be amended to incorporate a separate set of rules applicable to Islamic banks and if yes in what way? Or we take out Islamic banks from the purview of the central banks and credit creation and control be dealt with in the Islamic Banking Acts. The matter is to be considered on the assumption rather realistic that in Muslim countries Islamic banking is going to be the dominant component of the financial system. The second alternative looks rewarding.

In any case, the correction of the structural misdoing is an imperative for the Islamic financial system to meet the long-term requirements of trade industry and commerce. To advocate universal banking for Muslim countries looks premature in

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(14) Take the case of a mainstream commercial bank having an Islamic window. Assume that the window has a cash deposit of 1000 and the credit multiplier M is 9. The bank can have a total deposit of 10,000 cash plus credit. Why should a Shari'ah advisor stop it and if he wants how he can? The bank can always show him the accounts with 1000 cash deposits in the window remaining untouched. Why cannot an exclusive Islamic bank do the same?

(15) Not a few, including the present writer, have questioned the efficacy of this development. Taken Individually, these instruments may be shown as rooted in the Shari'ah but their en mass use today is probably violative of its *maqasid* (objectives). What may look conducive at the micro level could be damaging at the macro level. One should not behave like a frog in the well instead of seeing the bigger picture. Permissibility cannot override the overall spirit of the Islamic law.

view of their current levels of economic development and knowledge status.[16] Promotion of specialized interest free financial institutions like investment houses, unit trusts, refinance companies, housing societies, mortgage banks, cooperative societies and so on seems to be the answer. One may notice some movement in that direction but its being the consequence of a declared policy plank is yet to emerge. A blue print in each country suited to local conditions and needs has to be prepared.

6. CONCLUDING REMARKS

Islamic banking must harmonize not only in form with the Shari'ah but also with its intention and spirit. The current practice of Islamic banking leaves much of concern on this score. A major issue is of credit creation and control which is vital for the future development of Islamic banking along the right course. Creation of credit money has become an imperative not only for smooth running of trade industry and commerce but for fiscal requirements as well.

It is easy to see that there can hardly be any Islamic objection to the act of credit money creation per se. How and in what quantities such money is generated is the crux of the issue. The conventional instruments the central banks use have serious limitations within their own frame work; they are additionally deficient to deliver in an interest free economic system. One way to overcome the deficiencies of the central banks in controlling credit can be the fixing of a maximum ratio between currency and advances made subject to periodic review.[17] This can be all the more effective in an interest free system. The central banks then can oversee if the banking system is observing the norm.

Finally, one must take a long-run view of the matter when interest free financing must be the leader not the follower of conventional forms. This view demands consequential structural modifications in Islamic banking as it operates today. There is need to add more specialized long-term financial instruments and institutions to the existing ones in planned manner.

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(16) The aggregate GNP of Muslim countries despite oil boom and recent economic upsurge in some remains less than that of France and their scientific output falls short that of a tiny nation Switzerland.

(17) In the past it has been usual to limit credit expansion by fixing a ratio of deposits to a base defined in terms of cash or reserves. The suggestion is a modification of this practice as the point of concern is neither money nor deposits; it is 'advances'. See Economic Research Council Report (1981, 41).

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"توليد" ومراقبة الائتمان: إشكال عالق لدى المصارف الإسلامية

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المستخلص: تتناول هذه الورقة مسألة عالقة لدى المصارف القائمة على غير أساس الفائدة؛ إنها مسألة "توليد" ومراقبة الائتمان، فالكتابات المتوفرة في الموضوع هزيلة ومثيرة للجدل وغير مقنعة. تنطلق الورقة في تناولها لهذه المسألة من تقرير أن عملية "توليد" الائتمان في ذاتها لا تخالف الشريعة؛ لأن النقطة الهامة في الموضوع هي كيف تتم عملية التوليد هذه وكيف يستخدم الائتمان. وتمضي الورقة لتحاجج أن عملية التوليد لا يمكن نفيها؛ لأنها ضرورية لتعديل المعروض النقدي الذي يستجيب لطلب نقدي شديد التقلبات في الاقتصاد المعاصر. إن الورقة تسعى لتصحيح المفهوم الخاطئ القائل بأن البنوك تقوم بعملية توليد للائتمان من لاشيء، لأنه ما عدا الطلب على النقود فإن السياسة الجبائية وعمليات النقد الأجنبي تحد من قدرة المصارف المركزية من مراقبة عملية الائتمان.

إن الورقة توجه اللوم في التوصل لهذا الفهم الخاطئ إلى الصعوبات البالغة بما فيها عملية توليد ومراقبة النقود التي رافقت تطور البنوك الإسلامية بنفس النمط الذي تطورت به نظيرتها التقليدية، وبناء عليه تقدم الورقة مقترحات ببعض التعديلات الهيكلية المطلوبة.

وأخيراً خلصت الورقة إلى أن استخدام الوسائل التقليدية لمراقبة الائتمان في نظام مصرفي خال من الفائدة عديمة الجدوى والمفعول، ولهذا فقد تم اقتراح استخدام النسبة التي تفرضها البنوك على المبالغ المقدمة فيما بينها. إن الورقة تحتوي على بعض الآثار التقنية والإجرائية الهامة.