



# Monetary Policy for the Real Economic Sector in Muslim Majority Countries: A Transitional Solution

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**Abstract.** The paper examines the issue of monetary policy from an Islamic perspective and offers a transitional solution given the existing circumstances in the contemporary Muslim economies, dominated by financial institutions, fiat currencies, and fractional reserve banking. Qualitative research with a “complex systems” perspective is used to determine the state of monetary policy in several Muslim majority countries, to study the issues and challenges, as well as to point out the most problematic areas that need urgent addressing. The paper will argue that central banks are the main institutions that have the power and responsibility to maintain the country’s economic stability and the value of a local currency, as well as to affect the inflation and unemployment rates. It will be argued that in the current circumstances central banks can act within the given system to (1) encourage financing of small and medium enterprises; (2) initiate the growth of small local financial institutions, such as cooperative and savings banks; and (3) allow “monetary democracy.” The paper is therefore divided into three main parts. After the introduction, the first section will provide a historic overview of ideas on monetary policy by several influential Muslim economists over the last forty years and will offer a critique of their views. The second section will deal with the issues of money and banking from a “complex systems” perspective and demonstrate common misconceptions that lead to improper understanding amongst the general public and the academic community. And before concluding, the paper will offer intermediate solutions within the current financial system. This section will argue that central banks can use the power of the banking system to create money to finance SMEs while curbing speculation and limiting the purchase of financial assets.

**Keywords:** Monetary policy, Central banking, Credit guidance, Complex systems

**JEL Classification:** B59, E40, E40, E50, E52, G21

The difficulty lies, not in the new ideas, but in escaping from the old ones, which ramify, for those brought up as most of us have been, into every corner of our minds.

(Lord Keynes, *The General Theory*, p. xxiii).

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## Introduction

Monetary policy refers to the actions of monetary authorities (usually central banks) to control the supply of money and the cost of borrowing (interest rates) which affect the country's monetary base, inflation, and unemployment. The monetary policy is primarily conducted via (1) the interest rate, which is used to either expand or contract the quantity of money in the economy; (2) open market operations, whereby the monetary authority buys and sells the government bonds, which also affect the monetary base; and (3) the reserve requirement, whereby the central bank requires commercial banks to keep a certain reserve in their vaults or with the central bank, which is used to affect the quantity of loanable funds. These operations are extremely important as their function is to ensure economic stability, development, optimal price levels, and low unemployment.

Besides the above-mentioned main tools of monetary policy, central banks have other, unconventional, ways of managing the monetary side of the economy. One such tool is quantitative easing, which means purchases of financial assets by the monetary authorities with the aim to increase liquidity in the financial system and, consequently, stimulate the economy. This tool is part of the expansionary monetary policy. Another tool, used by central banks, is forward guidance, which means a type of communication by the authority about its future policy directions. This tool is believed to influence businesses' decisions on spending and investments.

However, there is one more tool that gets little attention from the press and is less known to ordinary people, and that is credit guidance (also known as window guidance or moral suasion). By using their authority, central banks can influence commercial banks' decisions about where to focus their lending activities. In other words, the central bank has the power to issue guidelines whereby commercial banks may be compelled or persuaded to lend to certain sectors of the economy. Despite the low profile of this tool, its effectiveness has been proven by the success of the Japanese, Taiwanese, South Korean, and the Chinese economies, which have very quickly transformed from agriculture-based to highly successful technology and manufacturing-based economies thanks to credit guidance by their respective monetary authorities.

Hence, the paper is going to discuss monetary policy from the perspective of implementing this 'old' tool to achieve economic growth in the real sector. The paper is therefore divided into three main parts. The next section will provide a historic overview of ideas on monetary policy by several influential Muslim economists

over the last forty years and offer a critique of their views. The following section will deal with the issues of money and banking from a “complex systems” perspective and argue that the current financial system in Muslim countries suffers from a “too big to fail” syndrome whereby the banking industry is growing at the expense of the rest of the economy. And before concluding, the paper will offer intermediate solutions within the current fractional reserve and fiat currency system. This section will argue that central banks can use the power of the banking system to create money to finance SMEs while curbing speculation and limiting the purchase of financial assets.

### **Monetary Policy: Explanations by Muslim Economists**

At the beginning of the Islamization of economics project, Muslim economists tried to envision an Islamic economy that was supposed to be different from and better than capitalism and socialism. They attempted to offer solutions based on their understanding of an ideal Muslim community where the interest-free banking system, based on *mudaraba* and *musharaka*, was supposed to promote equitable distribution of wealth and justice. In this section, the paper will first present the ideas of Muslim economists based on an ideal and imaginary Islamic economy. Gradually, as Islamic banking and finance grew in importance and size, Muslim finance experts and economists wrote on monetary policy as part of the existing financial system and offered solutions based on *sukuk* for open market operations, profit rate benchmarking, and so on. Lately, however, the reality of a dual financial system as the basis of financial analysis has gained prevalence.

Siddiqi (1982, pp.36-37) suggests that the goals of monetary policy in an Islamic economy coincide with that of a conventional interest-based one. He proposes that the following tools would be available to central banks in an interest-free economy: (1) reserve ratio; (2) direct controls on the supply of credit; (3) open market operations based on sale and purchase of share and loan certificates; (4) refinance ratio that supports commercial banks offering interest-free loans; (5) lending ratio – a percentage of demand deposits that commercial banks are obliged to lend out as interest-free loans; and (6) moral suasion or mutual consultation between central and commercial banks.

According to Kahf (1982, pp.136-137), the monetary authority in an Islamic economy would use (1) the reserve requirement to effect the supply of money, (2) the *Zakah* fund to create demand deposits from excess funds after redistribution of *zakah* proceeds, (3) a form of open market operations.

Chapra (1982, pp.170-173) argues that, due to the ban on usury (*riba*), interest-based tools, such as the discount rate and the open market operations of buying and selling bonds at interest, would not be available in an Islamic economy. Instead, continues Chapra, the central bank should be the main regulator and supplier of money in the economy (and not commercial banks), ensuring that it is neither inadequate nor excessive but sufficient to reach the goals of “full employment, stable prices, and balanced economic growth.” He further argues that the supply of money depends on the availability of “high-powered money,” which is obtained through (1) government fiscal deficit; (2) central bank credit to commercial banks, and (3) balance of payments surplus. However, he also expresses the idea that central banks have to use their power to direct commercial banks “to ensure that its [*money supply’s*] sectoral distribution is consistent with the national plan and that its distribution among businesses is equitable and in harmony with the Islamic goal of socio-economic justice.” This would be done in several ways, especially through guidance and credit controls. Lastly, Chapra strongly advocates against speculation, or what he calls “inflows of hot money.”

A year later, Chapra (1983) continues in a similar fashion with regards to monetary policy, especially with regards to monetary expansion via government fiscal deficit and credit creation by commercial banks via deposits (primary and derivative) (Chapra, 1983, pp. 6-7). He proposes that central banks should have a targeted growth of the base money (M0) and make it available partly to the government and partly to commercial banks. Also, part of the demand deposits of the commercial banks should be made available to the government to support socially beneficial projects. Additionally, the statutory reserve requirement of 10-20 percent, credit ceiling on commercial banks, and value-oriented credit allocation are stated among other important qualitative monetary policy tools.

Uzair (1982) agrees that the main functions of central banks in an interest-free economy would be similar to that of an interest-based system, viz. “(a) promotion of sustained and balanced economic growth; (b) maintenance of economic stability in the country; and (c) maintenance of stability in the external value of the currency of the country” (Uzair, 1982, p. 228). With regard to the tools used by the central banks in achieving those functions, he proposes the use of various forms of profit-sharing ratios, such as “Investors’ Share Ratio” or “Depositors’ Share Ratio.” The usual reserve requirements may remain the same as in the conventional system because he does not favor the 100 percent reserve requirement. However, he places greater importance on “selective” credit controls and moral suasion as

monetary policy tools, which are needed to ensure the flow of funds into sectors of high priority to the economy.

Khan (1982) argues in favor of the following monetary policy tools in a riba-free banking system: (1) various reserve ratios, such as *qard hasan* ratio, profit-sharing ratio, legal reserve ratio, cash reserve and refinance ratios; (2) special deposit system to manage excess liquidity of commercial banks; (3) special accounts system; (4) some form of open market operations, but in a very limited fashion; (5) credit controls, such as a ceiling on advances, and moral suasion (Khan, 1982, pp.251-255).

Ariff (1982) first defines monetary policy as “any deliberate action undertaken by the monetary authority to alter the quantity, availability, and cost (i.e. interest rate) of money,” then goes on to argue that quantity and availability of money can happen without manipulating interest rates. He supports his analysis with empirical evidence from studies on the ‘quantity theory of money.’ According to Ariff, Fisher’s equation of exchange ( $MV=PT$ ) does not include interest but is concerned with money, as well as goods and services. Hence, he remarks, “[t]here is fairly reliable empirical evidence to support the view that investment demand is generally insensitive to changes in the interest rate. It even appears that the cost of capital hardly enters into investment decisions” (Ariff, 1982, p. 290). Finally, the author suggests that the monetary authority in an interest-free economy may “have to rely heavily on selective controls and moral suasion” (ibid., p. 302).

Khan & Mirakhor (1989) also view Islamic banking as based on profit-loss sharing. The central bank in an Islamic economy would be responsible for the supply of high-powered money and control the reserve ratios and credit ceilings. It would also buy and sell securities in the financial market as long they are not interest-based. They continue to form a theoretical model of an Islamic banking system with the use of the IS-LM model (“investment-savings” and “liquidity preference-money supply” – a Keynesian macroeconomic model showing the relationship between the market for economic goods and the money market). The model assumes *mudharaba* as the main instrument of monetary policy to affect the money supply.

Chapra (1996) analyses the monetary management from a Keynesian perspective and states that money, following Keynes’ theory, has three purposes: (1) transactions related to consumption, investment, and import-export; (2) precautionary; and (3) speculation in commodity, stock, foreign exchange, and financial markets. Such demand for money is determined by real output and the rate

of interest. According to Chapra (1996), the economies that show great volatility and economic and financial instability/crises have the problem of misallocation of money due to interest as much of the money supply goes towards unproductive and inessential purposes. Consequently, to offer a solution, Chapra (1996, pp.14-19) writes that the money supply in an Islamic economy should be managed using several strategies/ways: (1) enabling the environment that makes possible the allocation and distribution of resources according to the objectives of the Shari'ah; (2) price mechanism; (3) prohibition of interest, which reduces the money demand for unproductive and speculative purposes; (4) levy of zakah on idle cash balances, thereby inducing savers to invest productively; and (5) equity-based financial intermediation rather than loan-based. These strategies can be achieved via the following monetary policy tools: (1) statutory reserve requirements; (2) credit ceilings to ensure consistency with total monetary targets; (3) government deposits in commercial banks, which could perform the same function as open market operations; (4) a common pool by commercial banks at the central bank, which is established on a cooperative basis together with the central bank to manage liquidity; (5) moral suasion; (6) equity-based instruments for open market operations; (7) changes in the profit-and-loss sharing ratio for advances from the central bank to commercial banks. Lastly, to realize socio-economic goals, the central bank may allocate a portion of its created money for financing projects to reduce poverty and income inequality (due to seigniorage) (Chapra, 1996, pp.25-26).

Meera (2004) puts forward a strong argument in favor of commodity money and return to the gold standard. He criticizes the modern fractional reserve banking system (which is also practiced by Islamic banks) and shows that through seigniorage banks extract enormous wealth from the real economy. He also argues that because the Islamic and conventional banking systems exist side by side, it created opportunities for arbitrage whereby conventional interest rates do affect the Islamic banking operations. In addition, he argues that the creation of fiat money by the banking system in the form of debt and charging interest is a form of injustice. Therefore, the author suggests that (1) the government should create money and allocate it in the economy; (2) the money should be in the form of or backed by precious metals, such as gold and silver; (3) 100% reserve requirement. These measures mean that the monetary policy would seek to manipulate the monetary aggregates directly instead of through interest rates, and disallow money creation in the form of debt "out of thin air" by commercial banks.

Tahir (2013) writes that banks in an Islamic economy would not function as financial intermediaries but rather as economic agents acting as “traders, lessors and partners” (Tahir, 2013, p. 10). According to the author, banks will attract demand deposits and partnership-based deposits. Whereas the former would have reserve requirements from the central banks, the latter may not have any such requirements. Tahir (2013, pp.16-19) also argues against the separation of fiscal and monetary policies and urges for closer cooperation between the government and monetary authority to achieve the goal of full employment without inflation while not carrying the weight of pensions and welfare payments. These are to be encouraged to be taken up by private initiatives, such as *waqf* funds.

El Alaoui & Jusoh (2013) argue that in an Islamic economy the central banks should refer to the rate of return in the real sector instead of the interest rate. Such a rate of return “should be market-determined and directly related to the productivity of capital. It is simply the rate of profit of the economy.” (ibid., p. 425). They also suggest having a 100% reserve ratio to eliminate the possibility of money creation “out of thin air.”

Lastly, Hossain (2015) offers an interesting insight into central banking and monetary policy in nine Muslim-majority countries. The author’s main emphasis in the issue of monetary policy is price stability and zero-inflation (Hossain, 2015, pp. 6-7). He believes the monetary system based on profit-and-loss sharing is counter-inflationary, promoting the real-sector, reducing the gap between the rich and the poor and enhancing the distribution of resources within the economy. In terms of the actual tool used to achieve this target, the author envisions a monetary targeting tool that can be designed using the “classical monetary policy” tools with the exception of the discount rate. In other words, Hossain (2015) suggests that manipulating the supply of money and bringing down the interest rate to zero would be close to the ideal Islamic concept of macroeconomic stability. He states that “[a]n Islamic monetary policy can be implemented with a policy framework that makes the most modern monetary policy tools available” (Hossain, 2015, p. 13).

Thus, there are many views on monetary policy from the Islamic perspective, or rather from the view of Muslim economists and finance experts. There are several points common to all authors mentioned above: (1) their analysis mainly concerns a non-existent Islamic economy; (2) they believe in the profit-and-loss modes of financing and its usage in central banking as well; (3) they advocate a 100% reserve ratio to avoid money creation by commercial banks; (4) monetary policy includes such tools as profit rate, open market operations using *sukuk*, and credit guidance

(moral suasion). My main contention with the views above is that their analyses concern an economy based on ideal Islamic principles. The reality, nevertheless, is that the world economy is dominated by the conventional financial system based on interest and money created by banks out of nothing. There are reality-based studies which largely analyze efficiencies, differences between jurisdictions, issuance, and use of *sukuk* (including as a monetary policy tool), or monetary policy transmission mechanisms. However, such studies and the ones reviewed above are based on misconceptions about banking and finance, rendering their conclusions somewhat questionable. Those misconceptions will be presented and discussed in the next section.

### **Misconceptions about Banking and Finance**

There are certain assumptions about the financial industry that need to be addressed to understand the issue of monetary policy and how to go about it. The main misconception is about banks serving as financial intermediaries. Financial intermediation presupposes the primacy of depositors as providers of funds. The financial intermediation theory of banking, which many Muslim scholars accept (e.g. Saleem, 2013, p. 248), assumes that the ‘savings surplus units’ (SSUs), which are usually households, deposit their surplus funds in banks, which lend these funds to ‘savings deficit units’ (SDUs – usually businesses). Banks, being intermediaries, charge SDUs interest for borrowing from it while paying SSUs a lower interest rate in lending to it, earning a profit on the difference. The same theory is applied to Islamic banking as well. This is the main theory of banking that most people, particularly economists, are familiar with (see, for example, Hasan, 2015, p. 355). The rest of society is also made to believe in this myth.

This myth corresponds with the exogenous money supply theory, according to which the base money is created by either the monetary authority or the government; that is then given to households/individuals/businesses, who deposit this money in their bank accounts. In turn, banks can lend those deposits and create multiple loans via the fractional reserve system.

There is a growing number of scholars in finance and economics who are trying to correct this misconception. One such scholar is Richard A. Werner – a professor of international finance at the University of Southampton, UK. He became famous after publishing a book entitled “Princes of the Yen: Japan’s Central Bankers and the Transformation of the Economy” (Werner, 2003), which was later made into a documentary. In this book, Professor Werner tells the story of the Japanese ban-



king system, the economy, the central bank, and the monetary policy it had pursued in the post-world war II era up until the end of the 1990s. He writes that Japanese “war planners preferred bank funding as the main conduit of resource allocation was that the banks create most of the money in the economy. And they make the crucial decision of who will get this money” (Werner, 2003, p. 50). He also states that “economic growth can be accelerated if the inputs used – land, labor, capital, and technology – are increased....The banks served as the main tool to maximize capital and technology inputs, direct resources, and steer growth” (ibid.). So, banks have enormous power of money creation and credit allocation, which could either be used for speculative purposes and asset purchases or economic growth via credit allocation to critical sectors of the economy. Today, most of the money in all economies globally is created by banks via lending/financing and exists in electronic form. Every time a loan/financing is approved, new money is created; because of the double-entry accounting, the newly created money must be recorded as deposits (McLeay, Radia, & Thomas, 2014). So, during the lending/financing process, no money is debited from anywhere but, rather, created in the computer system. The newly created money is then credited into the client’s account as a deposit.

Another misconception that leads to monetary instability is the idea that market forces determine the right amount of money to be created by banks in order to effect the optimum functioning of the economy. (One example is the Arrow-Debreu model as part of the general equilibrium theory). Such blind belief in markets causes financial instability in economies due to the high concentration of capital in unproductive assets, which are primarily traded for speculative purposes. Unfortunately, the commercial banks (as the main creators of money in an economy) create too much money during good times, chasing high-growth financial assets and creating bubbles that inevitably burst, leading to the devaluation of those financial assets. Banks respond to the resulting recessions by restricting the money supply at the very time when it is needed most, dampening demand and locking the economy into a deflationary spiral. Thus, their rational behavior contributes to and prolongs the general economic instability. Hence, the idea of market efficiency has been proven false, and it has become clear that the current financial system is inherently pro-cyclical. (For a great discussion on financial instability, please see Minsky, 1982, and Keen, 2017).

Related to the above is another misconception which states that financial deepening enhances economic growth. Actually, as financial institutions grow in size and importance, they significantly reduce lending/investment in productive capa-

city while increasing “intra-financial intensity” (Turner, 2014). Writing about the growth of finance, Turner (2010) states that the assumption about complexity and scale of finance adding economic value was wrong; instead, it was simply extracting rents from the real economy. Van den Berg (2016, p. 840) characterizes financialization as “(1) the disproportionate expansion, (2) the monetization of financial arrangements, (3) the privatization of the financial sector, (4) de-socialization of financial transactions, (5) shaping individual economic, social and political behaviors, (6) political influence, and (7) separation of finance from real provisioning activity.” So, the assertion about financial deepening as contributing to economic growth is not entirely true.

The above-mentioned misconceptions also contribute to monetary policy; monetary authorities have gradually shifted their focus from active regulation and guidance to a more passive approach. Hence, deregulation has led to a relaxed financial environment and created systemically important financial institutions whose activities have increasingly been leading to harmful crises. Even though central banks have been implementing Basel Accord policies of macro-prudential controls in the banking system, they have not been able to slow down credit creation for existing asset purchases, financial transactions (speculation), and individual consumption.

In the next sub-section, the paper will discuss monetary policy from a systems perspective, arguing that finance, being part of the larger economic system, must be regulated and guided to assist and enhance, rather than extract, value.

### **Monetary Policy: A Systems Perspective**

Financial institutions, including commercial banks, are systemically important in the architecture of modern economies. Their failure or mismanagement brings about distress to society at large. Therefore, the regulation of this industry is of utmost importance for the authorities. Being ‘systemically important’ means that their regulation must reflect their position in the economy and society because their health and effectiveness not only influences prices and employment but also political and social conditions as well. Thus, monetary policy must ensure the health of large sections of the society by channeling financial flows to where they are needed the most. Consequently, a systems perspective is necessary to understand the complexity of modern economies and how one section affects others. Thus, a short introduction to the concept of ‘complex systems’ is in order.

Complex systems are systems characterized by connected networks, which are connected at various levels in a non-linear fashion. The network consists of agents that act and react to each other's behavior. Networks self-organize, which means agents' behaviors synchronize and adapt to each other. This is done via a feedback loop between agents and the macro environment, whereby agents and the system affect and are affected by each other. This is also how agents choose either to cooperate or to compete. Also, complex networks are characterized by redundancy, which means information, feedback or action can pass through many alternative channels and if one element underperforms, another element(s) in the network can perform the same task. Complex systems evolve to optimize, whereby their elements with better features tend to survive while weaker ones die off and disappear. Lastly, systems are characterized by 'emergence,' which means that the whole system has unique characteristics that are different from those of its constituent parts. Hence, 'emergence' is the process of creation of a whole out of its parts. In addition, some parts can be larger or more critically important than others. Such systems are vulnerable to destruction if their critical component fails, or if they are characterized by inequality.

Economies are complex systems having millions of agents that communicate with one another and affect each in many various ways, such as (inter alia): money, price, buying and selling, production, distribution, consumption, etc. Systemically important parts can collectively support or destroy the whole system. Presently, financial institutions carry a heavy burden of keeping the system from collapsing. However, such design, when one sub-system can bring destruction to the whole, is quite weak and unstable. As is evident from the past financial crises, the financial system can affect entire economies when erosion of trust in the financial institutions brings cascading negative effects, and the only way to stabilize the failing system is through massive government support via liquidity injection. Quantitative easing was designed not so much for bailing out the failing financial institutions but to sustain the system and bring back stability and trust. However, when the system is structurally unstable, it affects the whole economies and societies, which respond with higher rates of disease, depression, dissatisfaction, unemployment, crimes, unrest, etc. What has been happening in Paris lately (the 'yellow vests' riots) and the anti-austerity protests in Greece in 2011 are just two symptoms of a failing system. If we know that the financial system and its services cause boom-and-bust cycles, and if we also know that bailing out that system and taxing the population for the banks' bad behavior is having adverse economic and political consequences, then we should realize that that sub-system needs urgent reform.

So, the discussion of monetary policy should be in the context of complex systems, whereby ultimately the central banks' policies affect individuals and businesses, the business and investment climate, the expectations of the future, the general mood within the society, etc. We have seen that the monetary authorities' toolbox contains a limited number of tools. Some of these tools have been used more often than others (viz. interest rate, open market operations, and reserve requirements). Only in case of crises do central banks use the tool of liquidity injection/asset purchases (quantitative easing). Nevertheless, the levels of public and private debt keep on rising, threatening to destabilize the economies once again (Chappatta, 2018). Meanwhile, near-zero interest rates are not causing higher economic growth.

There is enough evidence to show that "credit that supports productive investment and spending raises incomes by enhancing productive capacity and aggregate demand" (Bezemer, Ryan-Collins, van Lerven, & Zhang, 2018). Meanwhile, quite the opposite happens when credit goes towards speculative transactions, leading to boom and bust cycles. Hence, studies show that it is not credit (debt) on its own that is problematic; rather, it is the type of credit that creates instability.

Therefore, from the systems perspective, when an agent in a network becomes too large, threatening all other agents, it must either be reduced in size and influence or its activity must be directed so that it no longer threatens the whole system. This is where the 'old' tool of credit guidance (a.k.a. window guidance or moral suasion) must be employed to ensure the long-term sustainability of the banking industry and financing of the real productive economy. This can also be achieved through the 'democratization' of the banking business whereby many small local banks supply credit/financing to local businesses. Once the cause of the bubble is eliminated via regulation, the economy would not experience shocks due to inflated asset prices in the real estate or financial markets. Stability would set in once the productive capacity in an economy is raised and the concentration of credit creation is dispersed among many smaller financial institutions.

## **An Intermediate Solution for Central Banks in Muslim Countries**

Resulting from the above discussion on misconceptions about the financial industry and on systems thinking, it is proposed that the immediate solution for central banks in Muslim countries is that they should use more credit guidance because this is one monetary policy tool that had been used effectively in the past

all over the world. Bezemer et al. (2018, p. 11) report that after World War II up until the 1980s “most advanced economy central banks and finance ministries used forms of credit guidance as the norm, rather than the exception.” Bezemer et al. (2018) cite numerous cases across the world where various forms of credit guidance were used successfully. Among such forms were credit ceilings and quotas for particular sectors of the economy (especially export, agriculture, and manufacturing), while restricting credit for imports and household mortgage and consumption. Central banks of the East Asian countries (Japan, Taiwan, and South Korea) used ‘window guidance’ to lead commercial bank lending to the manufacturing sector. Commercial banks were compelled to lend for productive uses, whereby firms used bank credit for capital investment (especially for technology development and innovation) rather than capital markets. The People’s Bank of China has been using credit guidance extensively to target “shantytowns, micro- and SMEs, infrastructure, agriculture, ‘poor areas of the economy’, ecological conservation and green energy” (Bezemer, 2018, p. 11). In the same work, Bezemer (2018, p. 9) present the list of the various credit guidance tools, which are divided into tools affecting demand for credit and tools affecting supply of credit. The former includes such tools as loan-to-value ratios, debt-to-income ratios, loan-to-income ratios, margin requirements, loan maturities, affordability test scenarios, credit subsidies for exports, agriculture and SMEs. The latter includes credit ceilings and quotas, interest rate ceilings, portfolio restrictions, supervisory pressure and moral suasion, sectoral discount rates, loan-to-deposit ratios, proportional lending ratios, and others.

Now, why do I call these measures intermediate solutions for monetary authorities in Muslim countries? Primarily because the financial system in the majority of Muslim countries is using the same architecture as the rest of the world. Despite countries like the GCC, Malaysia, Indonesia, and Turkey having a dual system, the banking and financial regulations issued by their central banks have to maintain the same architecture as everywhere else. However, the advancements in financial technologies and the emergence of fintech companies are disrupting some of the old banking practices, and the financial landscape is gradually changing in the post-crisis environment. Monetary authorities will also have to adapt and think of new solutions. At the moment, it seems that guiding commercial banks to allocate more financing for productive purposes is a better solution because there is still a lot of credit/financing going towards asset purchases in the property sector. Practically all major banks throughout the world, including in the OIC countries, concentrate substantial portions of their lending/financing activities in properties (purchase of existing ones and construction of new ones), personal consumption,

credit cards, and automobile hire-purchase, while significantly smaller amounts are dedicated to business (especially SME) financing. Consequently, we see increased debt levels in the world, not much deleveraging and stagnant (and in some countries lower) productivity. At the same time, ICT usage has increased and unemployment has improved since the 2008-2009 financial crisis.

The World Bank Global Productivity Trends (Dieppe, 2020, p. 9) reports that despite the considerable post-financial crisis recovery, productivity has been in decline. This is also confirmed by the Gallup report (Gallup, Inc., 2017, p. 2) which states: “When the world’s productivity is in decline, so is the availability of good jobs with a living wage. Poor productivity stunts societal and economic growth.” Monetary policy can be used to improve that. Particularly, monetary authorities can direct commercial banks to lend more for capital investment by firms and have better financing options for SMEs.

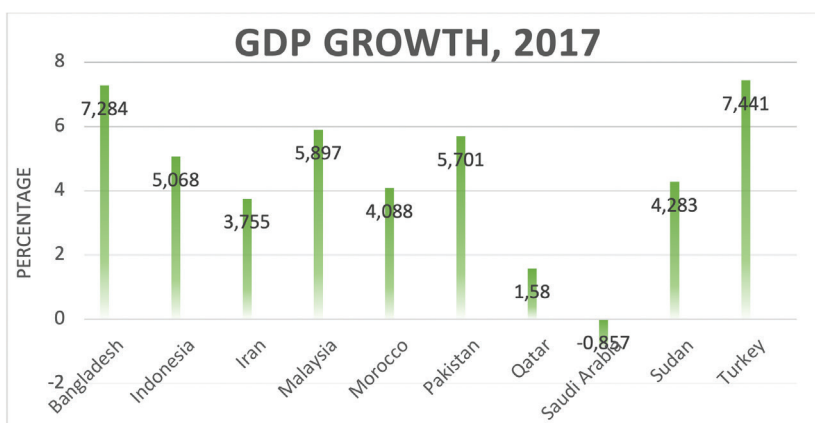
The following table shows monetary policy tools used by central banks in certain OIC countries.

**Table 2.**  
**Monetary policy tools in ten OIC countries**

|                         | Bangladesh   | Indonesia              | Iran   | Malaysia | Morocco        | Pakistan | Qatar  | Saudi Arabia | Sudan | Turkey |
|-------------------------|--------------|------------------------|--------|----------|----------------|----------|--------|--------------|-------|--------|
| Policy rate (overnight) | 6% and 4.75% | 6%                     | 18%    | 3.25%    | 2.25%          | 10%      | 2.5-5% | 2-3%         |       | 24%    |
| Reserve requirement     | 5.5%         | 3%                     | 10-30% | 3.5%     | Daily amount   | 5%       | 4.5%   | 7%           | 18%   | 12%    |
| Open market operations  | Yes          | Yes                    | Yes    | Yes      | Yes            | Yes      | Yes    | Yes          | Yes   | Yes    |
| Credit ceiling          | Yes          | No                     | Yes    | No       | No             | No       | No     | No           | No    | No     |
| Credit guidance         | Yes          | MSME loan ratio of 15% | Yes    | No       | MSME incentive | No       | No     | No           | Yes   | No     |
| Capital adequacy ratio  | No           | 22.9%                  | No     | No       | No             | No       | No     | No           | No    | No     |
| Liquidity ratio         | No           | 19.2%                  | No     | No       | No             | No       | No     | No           | No    | No     |

Source: Respective countries’ Monetary authority websites

The above is the latest data (at the time of writing – January 2019) taken from the websites of the monetary authorities in ten OIC countries. The selected countries represent low-income, medium-low, medium-high, and high-income countries. Their monetary policies do not differ significantly; they mostly rely on overnight policy rates, open market operations, and statutory reserve requirements. However, with regard to credit guidance, half of the central banks surveyed use this tool. What is important to note is that these countries are low-income or medium-low income groups, and so they use credit guidance to support the real economy, especially the micro, small and medium enterprises (MSMEs). Consequently, government efforts to support the real economy are evident in the GDP growth rates, which can be partially attributed to the central bank policies.



**Figure 1.** OIC Countries' GDP Growth in 2017

*Source:* Respective countries' monetary authority websites

Targeted sectoral credit allocation automatically results in higher output in those sectors due to increased availability of credit/financing. Even though some studies point to the lower effectiveness of credit guidance policy in the long run (Angrick & Yoshino, 2018), it is very important for low to medium-income countries, such as the majority of OIC member states. This tool can be used immediately and does not require changes in the financial system architecture. So, in the short term, the central banks of Muslim countries can utilize this tool to increase financing of micro, small, and medium enterprises, which are also the largest employer in any country. Hence, this will also lead to an improvement in the employment situation and overall economic conditions.

In addition to the above, there are other solutions for the real economy that can be offered through the financial system. One such solution is to ‘democratize’ the banking business, which is dominated by large institutions that seek to grow even larger through mergers and acquisitions. As they grow larger, they shift their focus to larger clients whereas micro, small, and medium businesses often struggle to obtain financing due to the absence of collateral or guarantees. Governments should encourage setting up smaller local banks that cater to local banking needs. This can be done in the short to medium term.

In the long term, however, governments should aim at deep structural changes in the financial system. Such changes should address the issue of money creation and a complete shift to an interest-free system with limited-purpose banking. As this is not the focus of this paper, it will not explore this issue any deeper, but it is worth mentioning that without de-financialization and with continued financial speculation, the real economies will continue to suffer from boom and bust cycles affecting the lives of millions of people.

## **Conclusion**

A well-regulated financial industry is a necessity in today’s complex economies. Monetary authorities/central banks have an obligation to promote stability in prices and employment with good access to credit/financing, especially for critical sectors that employ large numbers of people. They do that through monetary policy, which uses a few tools, namely: interest (profit) rates, buying and selling of securities (both government and private), statutory reserve requirements, and several credit guidance tools.

The paper presented arguments that the modern Muslim economies are an essential part of the global economic system and, therefore, cannot and do not operate in a completely different manner. As Muslim scholars and economists argue against interest as forbidden usury (riba), they have presented many alternatives of Islamic financial architecture. All the scholars mentioned in the first sub-section of this paper argued in favor of having a monetary authority that would be engaged in providing stability to monetary matters. With regards to monetary policy, they presented various views including the use of profit rates, open market operations to buy and sell Shariah-approved sukuk, credit ceilings, and other forms of regulation and control. Many mentioned moral suasion as one of the tools of monetary policy.



The paper illustrates that the modern financial system is a very complex one, and banks are systemically important. It further argues that the traditional monetary policy tools, such as interest rates, open market operations, and reserve requirements, are not sufficient. Historically, central banks throughout the world used credit guidance (a.k.a. moral suasion or window guidance) to direct commercial bank lending for productive purposes. The paper argues that, in the short term, credit guidance should be used more extensively by monetary authorities. The aim is to stimulate the real economy, especially the micro, small and medium businesses that employ the largest number of the working population. However, in the long term, Muslim countries should seek structural changes, especially with regards to money creation and financial speculation.

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