Chapter Three: Monetary Policy in Islam

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Meaning of monetary policy

Monetary policy is concerned with the changes in the supply of money and credit. It refers to the policy measures undertaken by the government or the central bank to influence the availability, cost and use of money and credit with the help of monetary techniques to achieve specific objectives. Monetary policy aims at influencing the economic activity in the economy mainly through two major variables, i.e., (a) money or credit supply, and (b) rate of return

Factors (variables) influenced by monetary policy

(a) Money or credit supply, and (b) rate of return

Objectives of Monetary Policy

The monetary policy in developed economies has to serve the function of stabilization and maintaining proper equilibrium in the economic system

As the objective of monetary policy varies from country to country and from time to time, a brief description of the same has been as following

(i) Neutrality of money

(ii) Stability of exchange rates

(iii) Price stability

(iv) Full employment

(v) Economic growth

(vi) Equilibrium in the **balance of payments**

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Objectives of Monetary Policy in Islam

1. Stability in the value of money;
2. Economic well-being with full employment and optimum rate of economic growth; and
3. Distributive justice.

For a proper appreciation of the above-mentioned objectives of monetary policy and how these may be realized, they are explained below.

Stability in the Value of Money

In an Islamic economy it is almost mandatory on the central bank to preserve the value of money. Thus the central bank should allow expansion of money supply to the extent it is justified by a possible contribution to growth in real balances. The stability in the value of money should be accorded high priority because of the unequivocal stress of Islam on honesty and fairness in all human dealings, and because of the negative impact of inflation on socio-economic justice and general welfare.

Economic Growth and Employment

While inflation is incompatible with the goals of an Islamic economy, prolonged recession and unemployment that cause human sufferings are also unacceptable. Monetary policy has, therefore, to aim at a high rate of economic growth with full employment and utilization of productive resources. However, maximization of economic growth *per se* and at all costs is not the objective of monetary policy in an Islamic economy.

Distributive Justice

Monetary policy should be used actively to promote the goal of distributive justice and prevent concentration of wealth and economic power in an Islamic economy. However, too much concern with distributive justice in formulating and implementing monetary policy may adversely affect its overall efficiency and effectiveness in attaining the other goals of monetary policy. e.g. growth, employment and development. Reduction in income inequalities and necessary redistribution should be an important policy objective of an Islamic state and hence the domain, mainly, of its fiscal policy. Monetary policy can contribute to this objective.

The techniques/ tools/ methods of monetary policy

1. Quantitative Techniques
   a. Target Growth in money supply
   b. Cash reserve requirement
   c. Credit Ceiling
   d. Allocation of credit
2. Qualitative Technique
   a. Moral persuasion

Discussion:

a. <u>Target Growth in Money Supply:</u> The central bank should determine annually the growth desired in the money supply (M) in the light of national economic goals, including the desired but sustainable rate of economic growth and the stability in the value of money. This target growth in M should be reviewed quarterly, or as often as necessary, in the light of the performance of the economy and the trend of important variables. However, the targets should not be changed frequently but only when justified to accommodate economic shocks, both domestic and external.

b. <u>Cash Reserve Requirements</u>: Statutory Reserve requirements against the commercial banks' deposit liabilities usually consist of two parts: (a) Compulsory Cash Reserve Ratio (CRR), and (b) Liquidity Ratio (LR). Commercial banks may be required to deposit with the central bank in cash as CRR a certain proportion, say 5-10 percent, of their total deposits from the public. In addition, the banks may be required to keep with themselves shortly maturing liquid assets, say 10-15 percent, against their deposits. These reserves serve the twin purpose of security and control of the banks' capacity to create credit.

c. <u>Credit Ceilings</u>: It may be desirable to fix ceilings on commercial bank credit to ensure that total credit creation is consistent with monetary targets. Ins the allocation of this ceiling among individual commercial banks, appropriate care should be taken to ensure that it does not harm healthy competition among banks.

d. <u>Allocation of Credit</u>: Since bank credit comes out of funds belonging to the public, it should be so allocated that it helps to realize general social welfare. The criteria for its allocation, as for other Allah given resources, should be, first, the realization of the goals of the Islamic society, and, second, the maximization of private profit.

<u>Selective Credit Control</u>:

a. <u>Moral Suasion</u>: Moral suasion or persuasion should acquire an important place in Islamic central banking. The central bank through its personal contracts, consultations and meetings with the banks could keep itself abreast of the strengths and problems of banks and suggest to them measures to overcome difficulties and achieve the desired goals.

Conventional Tools of Monetary Policy

Central banks use various tools to implement monetary policies. The widely utilized monetary policy tools include:

Interest rate adjustment

A central bank can influence the interest rates by changing the discount rate. The discount rate (base rate) is an interest rate charged by a central bank to banks for short-term loans. For example, if a central bank increases the discount rate, the cost of borrowing for the banks increases. Subsequently, the banks will increase the interest rate they charge their customers. Thus, the cost of borrowing in the economy will increase, and the money supply will decrease.

Change reserve requirements

Central banks usually set up the minimum amount of reserves that must be held by a commercial bank. By changing the required amount, the central bank can influence the money supply in the economy. If monetary authorities increase the required reserve amount, commercial banks find less money available to lend to its clients and thus, money supply decreases.

Open market operations

The central bank can either purchase or sell securities issued by the government to affect the money supply. For example, central banks can purchase government bonds. As a result, banks will obtain more money to increase the lending and money supply in the economy.

Expansionary vs. Contractionary Monetary Policy

Depending on its objectives, monetary policies can be expansionary or Contractionary

Expansionary Monetary Policy

It is a monetary policy that aims to increase the money supply in the economy by decreasing interest rates, purchasing government securities by central banks, and lowering the reserve requirements for banks. An expansionary policy lowers unemployment and stimulates business activities and consumer spending. The overall goal of the expansionary monetary policy is to fuel economic growth. However, it can also possibly lead to higher inflation.

Contractionary Policy

The effects of contractionary policies are the opposite of expansionary policies. They cause a reduction in bond prices and an increase in interest rates. When the central bank wishes to lower the money supply, it can do the following:

- sell securities in the open market;
- increase the discount rate; or
- increase the reserve requirements of commercial banks.

High interest rates cause the levels of capital investment to decrease. Further, interest rates make domestic bonds more enticing. This causes an increase in the demand for domestic bonds while the demand for foreign bonds declines. As a result, the supply of domestic currency decreases in the foreign exchange market.

Central Bank and Monetary Policy

Central banks use monetary policy to manage economic fluctuations and achieve price stability, which means that inflation is low and stable. Central banks in many advanced economies set explicit inflation targets. Many developing countries also are moving to inflation targeting.

Central banks conduct monetary policy by adjusting the supply of money, usually through buying or selling securities in the open market. Open market operations affect short-term interest rates, which in turn influence longer-term rates and economic activity. When central banks lower interest rates, monetary policy is easing. When they raise interest rates, monetary policy is tightening.

How has monetary policy been used recently?

After the global financial crisis that started in 2007, central banks in advanced economies eased monetary policy by reducing interest rates until short-term rates came close to zero, limiting options for additional cuts. Some central banks used unconventional monetary policies, buying long-term bonds to further lower long-term rates. Some even took short-term rates below zero. In response to the COVID-19 pandemic, central banks took actions to ease monetary policy, provide liquidity to markets, and maintain the flow of credit. To mitigate stress in currency and bond markets, many emerging market central banks used foreign exchange interventions, and for the first time, asset purchase programs. More recently, in response to rapidly growing inflation, central banks around the world have tightened monetary policy by increasing interest rates.

Monetary policy and exchange rates

A country's monetary policy is closely linked to its exchange rate regime. A country's interest rates affect the value of its currency, so those with a fixed exchange rate will have less scope for an independent monetary policy than ones with a flexible exchange rate. A fully flexible exchange rate regime supports an effective inflation-targeting framework.