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Chapter Four: Central Banking in an Islamic Framework

The central bank has the sole authority to issue money (currency) and the responsibility to regulate the banking system in order to secure the value of money and realize the other objectives of monetary policy. Money serves as the medium of exchange and the commonly accepted means of payment, and as such as a measure of value.

Central bank definition

Central bank, reserve bank, or monetary authority is the institution that manages the currency, money supply, and interest rates of a state or formal monetary union,[1] and oversees their commercial banking system.

Functions of the Central Bank

Work as a banker of banking System: The central bank should be the pivot of the Islamic Banking System, because only through its conscientious and creative efforts and eternal vigilance can the Islamic money and banking system function properly and achieve its objectives. It should be an autonomous government institution responsible for the realization of the socio-economic goals of the Islamic economy in the sphere of money and banking.

Issue of Currency: Like all central banks, the central bank in an Islamic economy should be responsible for the issue of currency and, in coordination with the government, for its internal and external stability. It should act as banker to the government and the member banks

Stabilization of the Value of Money: Stabilization of the real value of money should be an important function of the central bank in order to realize the healthy sustainable growth of the Islamic economy and to ensure socio-economic justice. For this purpose, it would have to keep a close watch on money supply, to ensure that the growth in money is not out of step with that in real output.

Implementation of Monetary Policy: The central bank should be the primary institution responsible for implementing the country's monetary policy. For this purpose, it should use the instruments and methods that are not in conflict with the teachings of the Islamic *Shariah*. Further, since the central bank cannot realize the goal of monetary stability without cooperation from the government, a harmonious fiscal - budgetary policy would be indispensable.

Promotion, Regulation and Supervision: The central bank will also have to play a positive role in the promotion, regulation and supervision of all financial institutions with the objective of helping them and making them healthy and strong. For this purpose it may have to review all existing laws and amend or reconstitute them in the light of Islamic teachings. The reformed banking legislation should reflect the different needs of the Islamic financial system.

Ensure health and Development of Public Interest: The central bank should not confine its regulatory role merely to the commercial banks. Its vigilance and assistance must envelop all other financial institutions to ensure their health and development and to safeguard the public interest. If some other government agencies are responsible for promoting and regulating non-bank financial and auxiliary institutions, then there should be proper coordination between the Central bank and other regulatory authorities to bring on harmony in their promotional and regulatory functions.

Lender of the Last Resort: As in conventional banking, the Islamic central bank would also have to act as the lender of last resort to ensure sufficient liquidity and to sustain the banks in case of liquidity or solvency crisis.

Current Account and Clearing House Facility: Islamic banks may be allowed to maintain current accounts with the central bank and to participate in the bank's clearing house operations. If the current account is occasionally overdrawn, the central bank may provide this facility without any charge. Alternatively, such facility may be extended on the basis of sharing of the profits of the bank.

Regulation and Supervision of Islamic Banks: Islamic banks may be subjected to regulations and controls by the Central bank in respect of (a) permission to establish banks and to open new branches; (b) minimum share capital; (c) the terms governing the constitution of Boards of Directors and appointment of Chief Executives and auditors; (d) tariffs for banking services; (e) measures regulating foreign exchange transactions; (f) submission of periodical statements and operational data to the central bank and (g) Compliance with the working hours.

Inspection of Banks: Islamic banks may be subjected to periodic inspection by the central bank to ensure their operational soundness. The central bank personnel may be adequately trained in *Shariah*-based operations of Islamic Banks. Detailed guidelines for inspection of the Islamic banks should be prepared and set by the central bank, as it should carry out research and training of personnel.

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Credit Control methods of CB

These measures directly affect the quantity of money supply in the economy:

1. **Open market operations:** This is the most frequently used instrument or the routine practice to control the money supply. However, its effectiveness depends on the perfection of the capital and money markets. The central bank sells government securities (called treasury bills) to the general public if a contractionary policy is desired. In contrast, it buys back these bonds and diffuses extra money into the economy if an expansionary policy is to follow. This is the medium of government borrowing at the market rate of interest.
2. **The bank rate policy:** The rate of interest at which the central bank offers loans to commercial banks or discounts their bills is called 'Bank Rate' and the rate at which the commercial banks extend loans to the general public is called the 'Market Rate'. A change in the bank rate is followed

by a corresponding change in the market rate. Thus it is another powerful instrument of credit control; however, it is rarely used.

3. **Variation in Capital Reserves:** All commercial Banks are required (by law) to keep a fixed proportion of deposits as reserves with the central banks. This is known as a reserve ratio; the power of the commercial banks to extend loans is reduced. This instrument is also rarely used.
4. **Variation in Cash Reserves:** The commercial Banks are also required to keep a fixed proportion of their total deposits in cash form, standing ready to honor the Checks of customers and to avoid solvency problem. By increasing this cash-reserve proportion, the central bank can limit the autonomy of the commercial banks to credit. However, the banks may not strictly follow the advice of the central bank in this case.

These measures do not affect the quantity of money/ credit percent, rather these can redirect the flow of credit to particular purposes/ channels. These include:

1. **Moral Persuasion*:*** The central bank can advise the commercial banks to follow either a loose or tight credit policy, i.e. to extend loans on easy terms for one purchase/time and on tight terms for some other purchase/time. However, the commercial banks are not obliged to follow such instructions very strictly. If this is the case, then credit rationing may be applied.
2. **Direct Action:** The central bank may take a direct action in case the commercial banks do not respond to its instructions carefully. It may refuse to discount the bills of a particular bank or even may blacklist it /debar it from the business.

Role of Central Bank in Economic Development:

The central bank in a developing country aims at the promotion and maintenance of a rising level of production, employment and real income in the country. The central banks in the majority of underdeveloped countries have been given wide powers to promote the growth of such economies. They, therefore, perform the following functions towards this end.

Creation and Expansion of Financial Institutions:

One of the aims of a central bank in an underdeveloped country is to improve its currency and credit system. More banks and financial institutions are required to be set up to provide larger credit facilities and to divert voluntary savings into productive channels. Financial institutions are localised in big cities in underdeveloped countries and provide credit facilities to estates, plantations, big industrial and commercial houses.

Proper Adjustment between Demand for and Supply of Money:

The central bank plays an important role in bringing about a proper adjustment between demand for and supply of money. An imbalance between the two is reflected in the price level. A shortage of money supply will inhibit growth while an excess of it will lead to inflation. As the economy develops, the demand for money is likely to go up due to gradual monetization of the non-monetized sector and the increase in agricultural and industrial production and prices.

A Suitable Interest Rate Policy:

In an underdeveloped country the interest rate structure stands at a very high level. There are also vast disparities between long-term and short-term interest rates and between interest rates in different sectors of the economy. The existence of high interest rates acts as an obstacle to the growth of both private and public investment, in an underdeveloped economy.

Debt Management:

Debt management is one of the important functions of the central bank in an underdeveloped country. It should aim at proper timing and issuing of government bonds, stabilizing their prices and minimizing the cost of servicing public debt. It is the central bank which undertakes the selling and buying of government bonds and making timely changes in the structure and composition of public debt.

Credit Control:

Central Bank should also aim at controlling credit in order to influence the patterns of investment and production in a developing economy. Its main objective is to control inflationary pressures arising in the process of development. This requires the use of both quantitative and qualitative methods of credit control.

The bank rate policy is also not so effective in controlling credit in LDCs due to:

(a) the lack of bills of discount;

(b) the narrow size of the bill market;

(c) a large non-monetised sector where barter transactions take place;

(d) the existence of a large unorganised money market;

(e) the existence of indigenous banks which do not discount bills with the central banks; and

(f) the habit of commercial banks to keep large cash reserves.

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