The Role of the Central Bank in Islamic Banking

By Dr Iraj Toutounchian

In economics, we are basically dealing with two interrelated concepts — one legal (or conventional), the other real. All contractual agreements such as marriage, ownership, organizational hierarchy, money and interest fall into the first category; while human-beings, commodities, buildings, amenity and the like are in the second.

Each of these concepts is able to produce the other or be transformed. Money, being a legal concept, is capable of producing another legal concept (actually its derivative) called ''interest'' or a real concept such as capital equipment.

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Money as potential capital is a legal concept capable of being transformed into actual capital. For example, in a Mudarabah contract, as soon as one person's money is legally combined with another person's labor, the nature and the function of money is changed into capital. The higher the speed at which the stock of money is transformed into the flow of capital, the higher will be the rate of economic growth. This is the most important task of the Islamic central bank.

The various modes of contract available to Islamic banks are the major means of transforming the money deposits of individuals and firms into capital (or assets). Financing under any mode of contract will essentially increase the value of the economy's assets. However, some modes of contract (Musharakah and installment sales originated by firms), for example, increase the productive capacity of the economy.

Again, any positive change in a firm's asset values can be called ''investment.'' Following this practice, it is easy to calculate with a high degree of precision the amount of investment which has taken place in an economy in any specific year.

This can be done by reading the asset values off the current balance sheets that firms submit to the tax authorities. Putting asset values, rather than capital, into the production function makes it more precise and meaningful.

A firm's rate of profit is, hence, logically defined as the ratio of profit to assets. Since the value of the assets is normally greater than that of capital, using the ratio of profit to the value of capital would underestimate the true rate of profit.

Speculation, which entails artificial risk, is not permissible in an Islamic setting. A corollary of this is that stocks are expected to be exchanged in an Islamic stock market based upon their book values. In a stable price system, the market to book value becomes unity, because in an efficient Islamic stock market, the book value of shares reflects all relevant facts about a firm based on its assets.

Tobin's Q (a ratio comparing the market value of a company's stock with the value of a company's equity book value) then becomes irrelevant.

One implication of this is that in a world with perfect markets, valuing the firm would be easy; that is, we could read the economic value of the firm off the current balance sheet. Risk is essentially interwoven with investment. It can be considered ''natural'' and can be accounted for, and thus is permissible in Islam.

However, the impermissibility of artificial risk is grounded upon the fact that income received by a speculator will cause excess demand for goods/services, and this, in turn, can cause inflation.

The unique and powerful tool of financial policy in Islamic central banking is to determine the share of profit relative to that of capital for all investment projects submitted to Islamic banks. This is probably the most important role a central bank can play, because if effectively used, it could channel the bank's financial resources into asset-building without having to worry about the emergence of a money whirlpool.

The ratio determined by the Islamic central bank is especially useful in cases where different risks are involved. Another task of the central bank would be to list the different risks involved in various investment projects.

Western economists have always and justifiably been worried about unnecessary expansion of money supply, the volume of which is hard to control. Nevertheless, as Islamic banks are prohibited from lending on interest, the different modes of contract available to them enable them to finance the specific needs of both firms and individuals.

Through effective supervision by the central bank, the chances of a money market developing are very slim. By providing accurate, accessible and symmetrical information, the central bank would be able, to a certain extent, to prevent moral hazard.

The fact that money is not a tradable entity and its production and volume will be closely monitored by the central bank makes it appropriate for classification as an impure public good in an Islamic state. Other properties of such goods which also apply to money include:

- Demand can be constructed by vertical summation of individual demands.
- Externality can be derived from its capability to become actual capital; hence, government (that is, central bank) intervention. Furthermore, it benefits each person simultaneously and is thus equally available to each person. Additional individuals looking for money may be added at zero marginal cost.

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- The indivisibility of money refers to its purchasing power and not its physical character.

- Its velocity is greater than unity, implying that it is not supposed to be withheld, contrary to the case with private goods.

Money has two distinct attributes. At the micro level, it is part of the assets of the individual possessing it. But at the macro level, it cannot be added to the assets of the economy.

To count money as the wealth (or asset) of a nation will lead both to the fallacy of composition and to double-counting. This factor makes it distinct from other public goods and may well be the consequence of it being the medium of exchange.

The removal of interest and all its derivatives will lead Islamic banks financing investment projects through profit and loss sharing (PLS), based on the profitability and feasibility of the projects.

Potential investors evaluate projects based on the internal rate of return (IRR). The role of the central bank in determining the IRRs for various activities in different sectors is valuable for effectively channeling resources.

After the feasibility and profitability have been confirmed, projects become eligible to obtain finance. Furthermore, the projects themselves become collateral for finance.

As long as there are appropriate factors of production available for investment, projects have to be financed by Islamic banks, irrespective of how much money is required. In Islam, it is the right of labor not to be kept unemployed.

In the final analysis, everything coming out of an Islamic bank in response to financing an investment project can be called a certificate of asset building (CAB). These CABs are appropriate to both the production and household sectors.

The appropriateness of projects is to be determined by the central bank with a close eye on social welfare. However, to determine which projects are more profitable to finance is the task of the individual bank. The central bank's task is to instruct the banks to give priority to projects which are more compatible with the country's overall economic plan.

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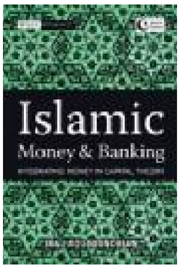

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