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Perspectives on Islamic Banks Activity in light of Money Creation and Cash Reserve Ratio (CRR)

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Abstract:

Islamic economics principles state that Islamic banks are economic institutions that must comply with the rules of Islamic economic legislation, whether in terms of financing, or in terms of monetary policy. The Sharia stipulates that money does not generate money, and that profit and money increase are linked to production, or trade through Murabaha, or Mudharaba and Musharakah, and the like. Given that the Islamic economy depends on what may be called the real economy that is based on production, these principles do not agree with the policy of central banks and their financial/monetary policy, whether in terms of the policy of the cash reserve ratio (CRR), which must be available (deposited) in the central bank, or in terms of the bank's creation of money without a reciprocal or productive process. This paper aims to identify and address these issues according to an economic, legal and Islamic analysis.

Keywords: *Cash reserve Ratio; Islamic economics; Islamic banks; Money creation; Regulations and Sharia rules.*

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Introduction:

Dealing with gold, which was considered a cash reserve for any paper currency, has long ceased now, and according to experience and customs, depositors do not withdraw all their money at once. That made banks benefit from these deposits, and through this process of accepting deposits and then lending them, banks are able to generate (create) money, which is derived from deposit money. This process is dependent on the following factors: (a) The percentage of cash reserves imposed by each country (central bank), (b) the monetary and financial position of the bank, and (c) the volume of deposits accepted by the bank from depositors.[1]

It has been decided that money is a tool to be used for its functions, as decided by the scholars of Islamic financial thought. It is a tool adopted by the community to get out of the barter system, says Ibn Rushd: "...when it was difficult to comprehend the equality of different things that are singular, He made the dinar and the dirham to evaluate it: I mean to appraise it"[2] and the efficiency of the performance of this role inherently requires the stability of its value.

The process of development in the paper money system facilitated the expansion of money issuance, but disturbed its value, which made it imperative to have an institutional monetary system to protect cash and money, and immunize the general public institutionally. Moreover, the paper money (deposit money) exposed the banks' exploitation of the public, and called for more banking culture and awarness. There are many issues that arise from the problems of inflation and the imbalance between monetary, trade and production exchanges, but the solution remains to find a balanced, accurate and disciplined system, which is monitored at the highest optimum level.

The volume of money circulation must be proportional to the volume of products, and the tampering with money in what is called "money creation" represents a breaking of this rule of proportionality at the economic, legal and Islamic (sharia) levels, and this raises an urgent main question: Can (/are) Islamic banks operate under the current adopted financial and banking systems? This in turn raises the following questions: Are private banks institutions of a common nature of ownership, or are they private institutions, and do the power of the regime and the authority of the law have the right to create money on the grounds that it has the right to initially print, count, and measure currency? How does (and should) the Islamic economic thought, based on financing operations with Musharaka, Murabaha and such, deal with/under these systems?

Adopting a descriptive analytical approach, the research problematic will be addressed as follows: First, the paper looks into the concept of exchange and efficiency in money from a legal and economic point of view. Then in the second part, the article explores the rules of monetary reserve and money creation from an economic and legal point of view. Finally, the third part examines the legal, legitimate and Islamic jurisprudential framework (tracing the Sharia's roots and references) for money creation, and the Islamic banks' operating mechanisms.

Chapter I: Money exchange and efficiency from the legal (jurisprudential) point of view:

The Islamic financial system relies on the rule of justice and relative stability in value as a basis for exchange. Justice and honesty in all humane transactions require a relative balance and stability between the value of money and the equivalent supply, and this principle is consistent with the Qur'anic text: "And to the people of Midian we sent their brother Shu'aib. He said, "O my people! Worship Allah—

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you have no other god except Him. A clear proof has already come to you from your Lord. So give just measure and weight, do not defraud people of their property, nor spread corruption in the land after it has been set in order. This is for your own good, if you are ˹truly˺ believers.” Surah 7:85.So providing just measure and the right balance, and not depreciating people’s things is a Qur’anic standard for the concept of justice. The process of true exchange only takes place with a supply of real value, and this can only be done by protecting money, and its efficiency, and in order to maintain this balance, Sharia laid down a number of rules, the most important of which are: Allocating the issuance of money to the ruler of the Muslims, and this matter was established early in the Islamic financial system, and then it was followed by modern civil banks. One of the evils embedded in the depreciation and creation of money, which violates the central financial system, raises an urging question: Is the process of banks generating money (including its permission, regulation, management, and control) actually carried out by the Central Bank, which represents the guardian of the people in this aspect (acting in the name of the ruler), and in this case, the money-generating process does not infringe upon the authority of the ruler(3). Moreover, this verse means, in its first part, that no one has the right to depreciate the property or effort of others, either by measure or weight, and as a result, the measure of value must have value. This is what the Islamic Sharia stipulates, so for the exchange to be legal, value must be exchanged for value, and any violation of this principle is considered fraud and a form of fraud according to the noble verse, and accordingly the “computer inputs” created by the fractional reserve system are in violation of Sharia. Therefore, it is forbidden, because it is used as a measure of value without containing any intrinsic value.

1- <u>The functional concept of money and its impact on its efficiency</u>:

Money was defined by definitions that focused on its functions. Perhaps the most comprehensive definition of money is that: “Anything that is generally accepted by law in the fulfilment of obligations, and is used as an intermediary in the exchange, as a unit of account, a store of values, and a tool for settling deferred or future payments”(4). Some define it as: “anything that serves as a medium of

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exchange. A medium of exchange is anything that is widely accepted as a means of payment"(5). It is also defined as: "A standard unit, which people know use to measure the values of goods and services, and generally accepted by them, whatever their material and form"(6). Through the functional definition of money, we might say that digital money has legal acceptance, it is considered a custom, because what is known is customary just like what is conditional is a condition.

2- The power of obligations' fulfilment and its effect on efficiency:

"Governmental money or cash that has debt-resolution power and may be coins, or paper currency." It appears from the definition that the currency gains its strength from the imposing of the state to deal with it(7), and this is in contrast to some money that derives its value from itself, such as coins minted from gold and silver, and therefore the term money is broader than the term currency; So every currency is 'imposed' money but not every money is currency(8).

2- 1- Power of exoneration or discharge:

It means that the currency minted by the state is basically a discharge or exoneration of liability (debt obligation fulfilment) in the event of repayment of debts and payment of fees and wages for efforts, unless they are canceled or replaced, and this meaning is grasped from the saying of Al-Shafi'i: "Alfolous 'low value currency' is not a price 'thaman: what is used to compensate for the purchase of goods in kind' except with a condition. Do you not see that if a man had a debt (Danek) with another man, he would not force him to pay him with currency, but rather with silver"(9). (Alfolous=currency, silver=money).

2- 2- Types of clearing (debt obligation fulfilment) power:

There are two types; limited power and unlimted power.

The limited power is related to the obligatory banknotes, as they are issued by the Central Bank of the country and people are obligated to accept these banknotes in the performance of their rights, i.e. to absolve them. The paper currency has no commercial value in itself, because its acceptance, elevation and adoption as a currency was based on a law.

That is why, simply, the law that created it have the right to nullify it, and if it was revoked, then only a piece of worthless paper with no

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clearing power would remain in the hand of its owner... Hence its limited fulfilment of the debt obligation.

The unlimited power is inherently found only in gold and silver coins, for their value is the same everywhere, whether they are money or commodities, as in our days. If the law repeals metal as money, then the owner of the coin does not lose everything, but the value of the coins, gold and silver, remains in his hand.

3- <u>The concept of credit and its impact on the efficiency of money:</u>

The characteristic of money is that it is a source of credit, whether at the level of its enforcement, or what it entails in terms of paying off debts and tasks, based on contracts, records and agreements(10). The use of money as a bond indicating that the bearer owes a certain party an amount written on that bond, is an old occurence. Ibn Battuta mentioned in his book the masterpiece of sightseeing in the Strange Cities and the Wonders of Travels that he witnessed government paper money in China(11).

<u>Chapter II: Cash reserve and money creation from an economic and legal point of view:</u>

In order to understand the inherent issues embedded in the process of money creation and the cash reserve ratio, we must look into them sepeartely.

1- <u>Cash Reserve Ration (CRR)</u>:

Cash Reserve Ratio (CRR) is the amount of cash that commercial banks have to keep in the form of reserves in the current account that they keep with the central bank (reserve bank). In fact, banks deposit this amount with the Reserve Bank rather than keeping this money with them, the reserve cash ratio is used as a tool in monetary policy, to influence the borrowing and interest rates by altering the amount of cash available to banks in order to provide loans to their customers.(12) So cash reserve is the percentage of money that commercial banks must keep with the Central Bank with regard to the volume of deposits that flow into those banks (see for example Algeria's money and credit law 03-11).(13)

Therefore, if the central bank wanted to increase the money supply by increasing the ability of commercial banks to create money or create deposits, then the bank in this case would reduce the legal reserve ratio, for example, from 40% to 20%. If the central bank

ISSN: 2352-975X EISSN: 2588-2368

wanted to reduce the money supply by reducing the ability of commercial banks to create money or create deposits, then the central bank in this case would raise the legal reserve ratio from 20% to 40%.Thus, the ability of commercial banks to grant credit and create money decreases, so the money supply decreases, and here the change in the legal reserve affects the deposit multiplier.(14)

2- <u>Basel III and cash reserve</u>:

The members of the Basel Committee met in Basel/Switzerland in September 2010 and developed principles for Basel III to be presented to the G20 leaders which was held in Seoul, the capital of South Korea, in November 2010.

This agreement approved a set of regulatory standards related to the supervision of banks, and is considered the most strict in the subject of capital adequacy without distinguishing between conventional or Islamic banks, As this agreement approved raising the minimum reserve capital ratio from 2% to 4.5%. In addition to a ratio of 2.5 of other reserves of ordinary shares in proportion to the assets as a reserve for any potential crisis That is, a total of 7%, knowing that it has given a deadline until 2019 for the banks to be able to correct their situation.(15)

3- <u>The general philosophy of money creation:</u>

The process of money creation stems from an economic philosophy of balanced constant ratio between depositors' withdrawals and deposits by new depositors. Holders of current deposits do not withdraw their money at the same time, and the bank receives current deposits continuously. This process led to the relative stability of what is called the monetary value in the commercial bank, through which it can create credit, we must realize that this ability to create credit is not absolute, as the credit policy can control it, increasing or decreasing it, with the changing conditions in the economy. This is done through the legal reserve ratio that commercial banks are committed to. When the reserve ratio increases, the capacity to create credit shrinks, unlike the case in which the reserve ratio decreases, where commercial banks can create more credit to be injected in the economy.(16) This money is generated through the sum of what commercial banks hold out of the money in current deposits, from which withdrawals do not tend to exceed 10% or 20% (in the case of Algeria it is 12%)(17)

Accordingly, commercial banks lend these funds to those seeking credit (lending) in return for usurious interest, so they deal with these funds as if they were their own. This is the meaning of what they call generating bank, written, internal or credit money, and these are usually traded by checks or electronically.

However, the main problem with the fractional reserve system is the creation of money out of thin air without the slightest effort or risk. And since this money has purchasing power, this means creating wealth out of nothing, and in fact what banks are doing in creating money in this way is not real wealth. Rather, they are only numbers or inputs into the computer that have no intrinsic value or are backed by real goods. But the law imposes its validity and acceptance, along with notes and auxiliary money, as an instrument of exchange and the only unit of accounting in the economy. Islamic banks, like other interest-based banks, use the fractional reserve system to create money out of nothing. Part of the success of Islamic banks is due to the fact that they claim to apply Islamic law in their various transactions, which brings Muslim consumers who refuse to deal with usurious banks. But Muslims do not know that all money created by the fractional reserve system, the way it enters the economy and the way banks own wealth through this money is forbidden in Islam, and since Islamic banks also use the fractional reserve system, all transactions and contracts associated with this system are in breach of the law.

4- <u>The most important economic benefits expected from generating money</u>:

Economists divide money into paper money and credit (derivative) money. Economists state that the benefit of money creation gives the economy the power to produce these two types of money. The central bank, through the cash reserve, can make money (bank) notes, and commercial banks, through the central bank granting them credit, can generate cash or credit money.(18) The generation of money also (allgedly) helps in giving commercial banks an opportunity to fund economic projects. Moreover, the generation of money contributes to resources by providing the money that is used as a cover in the issuance of banknotes and coins because the use of credit methods in settling payments reduces the use of money (cash).

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Chapter III: The problematic of cash reserves with Islamic banks:

The central bank plays two important roles for commercial banks:

First: an oversight and monitoring role: Credit control is the central bank's use of certain methods and tools to control banking activities and investments made by the commercial banks and direct them in light of the laws in force to achieve specific goals.

The second: a financing role: Which is represented in the financial transactions between the central bank and other banks, as it is the bank of the banks and their last resort when needed. The central bank requires all banks to have a specific percentage of liquidity, whether conventional or Islamic, and the Islamic bank finds this procedure incompatible with the specificity of Islamic banking.

The Islamic Bank faces a serious problem regarding the mandatory cash reserve ratio, for two main reasons:

First: Islamic banks do not deal in usury, give or take, and thus lose a return that would have been obtained had this percentage not been deposited with the Central Bank.

The second: that this cash reserve does not enable the Islamic bank to use all the money in investment projects, Islamic banks do not deal in government bonds, which are one of the components of the numerator of the ratio, and they suggest that shares should be considered among the components of the numerator of the ratio instead of government bonds. Shares are different from bonds in that they cannot be claimed by the shareholders until we calculate them in the liquidity ratio.

1- The problems that exist between Islamic banks with central banks:

Islamic banks are closely linked with Islamic banks; it is part of the country's public financial/monetary policy, which has resulted in a number of problems, including:

1. Central banks apply the same liquidity ratio to Islamic banks (19), despite the different components of calculating the ratio, some researchers believe that Islamic banks do not deal in government bonds, which is one of the components of the numerator of the ratio. This appears to restrict the Islamic banks, because the value of the shares cannot be claimed by the shareholders until we calculate it in the liquidity ratio, they are not debt like bonds, and since the elements for determining the liquidity ratio differ between an Islamic bank and

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a conventional bank (bonds and treasury bills are absent in Islamic banks), the central bank must understand this issue and consider this difference and reduce the percentage of liquidity required by Islamic banks in their dealings with it, due to the specificity of its legislation (from an Islamic point of view).

2. The application of the same ratio of mandatory cash reserves to Islamic banks by central banks: Researchers and Islamic bankers noted the following regarding this:

- Maintain a full reserve. 100% (Full Reserve Banking)
- Difficulty to apply the cash reserve ratio as it is applied to conventional banks.[20]

3. The difficulty of obtaining financing from central banks when needed: This problem can be avoided by placing a deposit of the central bnak in Islamic banks as a percentage of money, provided that it takes a profit margin from it based on the Mudharaba.

4. Islamic banks not benefiting from re-discounting: to expedite the value of commercial securities before their maturity, owners must pay interest, therefore, it is necessary to find an alternative, such as re-discounting these securities without interest, but a commission or a fee could be imposed if it does not breach the Sharia rules (this needs to be further studied and discussed).

5. Central banks' open market operations are in conflict with the nature of Islamic banks' work, because government bonds are issued at an interest rate, so some researchers in Islamic economics believe that the central bank should use legally permissible Muqharadah or Murabaha bonds instead of government bonds.

6. The problem of applying to Islamic banks what is applied to conventional banks regarding the amount of deposits in relation to capital.

7. The use of the interest rate in imposing financial penalties and fines, such as a shortage in the mandatory cash reserve: This explicitly collides with the principle of the prohibition of interest dealing in Islamic banks.

8. Determining a specific capital for the bank’s acceptance and licensing: This may be considered by some as compulsion, but it is a fundamental and inevitable issue, in fact, the capital of an Islamic bank must be greater than the conventional bank’s capital and equity capital, So that it can engage in Mudharaba and the rest of the

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methods of Musharaqa, Murabaha and Alqard Alhassan (loans with no interest).

9. Limit the size of credit with respect to deposits: For example, if the value of deposits is one billion dinars, the central bank requires banks not to exceed the value of deposits in their transactions and credit allocations.

10. Restricting the ownership of fixed and movable assets that are not needed for their activity in order to protect small investors and prevent these banks taking over the markets because of their strong solvency. If we find an Islamic bank with all its requirements, especially if it is non-profit and affiliated with the state, where its goal is to revive the economy, then this restriction becomes harmful and needless, but now it cannot be canceled because of the greed that is blatantly visible on the face of today's Islamic banks.

Conclusion:

The only reason behind the resorting of people to Islamic banks is that they believe and trust these banks are dealing according to the Islamic laws and regulations, with regards to finance and money. However, this paper was able to shed light on the numerous incompliances with Islamic economic and financial regulations recorded within the financial and banking systems under its current format. Evidently, the fractional reserve system and the cash reserve ratio are in breach of Islamic financial jurisprudence. The paper showed the extent to which Islamic banks are unable to operate and work properly under the current banking structure, starting with the nature of their interactions and relationship with central banks, along with how they are submerged in the process of money creation through the fractional reserve banking system and the cash reserves ratio. Finally, this paper tried to suggest some solutions and remedies with regards to the central bank's interactions with Islamic banks. But the fractional reserve banking and the cash reserve ratio systems remain to be reformed and revamped in order to accommodate genuine law abiding Islamic banks.

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