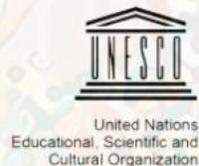


**Certificate of Islamic Economics Online Course
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The Role of Central Bank and Monetary Policy

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Topic Outline

- Monetary Policy
- Types of Monetary Policies and Impact on the Real Economy
- Tools of Conventional Monetary Policies
- Tools of Islamic Monetary Policies
- Roles of the Central Bank in Establishing Islamic Monetary Policy



Monetary Policy

- Economic policies (monetary policy, fiscal policy, industrial (real sector) policy, and financial sector policy)
- Monetary policy (MP) - an attempt to manage money supply and demand with monetary instruments and approaches to balance the liquidity in the economy and stabilize prices.
- In some countries, MP is used to achieved the inflation target instead of liquidity targeting.
- The amount of money in the economy is very important, since the optimal amount would maximize trade and exchange.
- Too much money in circulation may result in inflation, while too little money may cause deflation, recession.



Mechanics of Conventional Monetary Policy Tools

Monetary Policy Tools	Description
Open Market Operations	Buying and selling government bonds (securities) to commercial banks and the general public
Reserve Requirement	Regulations on the minimum amount of reserves that banks must hold against deposits and kept at the central banks
Discount Rate	The interest rate on loans that the central bank makes to banks. Banks borrow from the central bank to fulfil reserve requirements
Term Auction Facility	Used when the interbank markets are under stress. Central bank auctions term funds to depository institutions eligible to borrow under the primary credit program
Interest on Reserves	Newest tool used by the US Fed Reserve after 2008 financial crisis. Interest paid on excess reserves held at the Reserve Bank



Types of Monetary Policies and Impact on the Real Economy

Monetary Policy

Expansionary Monetary Policy

- A policy by monetary authorities to expand money supply and boost economic activities by keeping interest rates low (or buy securities) to encourage borrowing by companies, individuals and banks
- Can cause inflation
- Used to lower unemployment and avoid recession

Contractionary Monetary Policy

- A policy by monetary authorities to reduce money supply and keeping interest rates high (or sell securities) to reduce inflation
- Slows the rate of growth in the money supply
- Central bank raises the CB interest rate or selling securities through OMO, reducing the banks' capacity to lend

Tools of Islamic Monetary Policies (IMPs)

- Crucial for the central bank in the Islamic economy to ensure all policies and instruments used are in line with Shariah and maslahah of the ummah
- Observation from the conventional monetary policy tools; some of them fulfil the requirements of Shariah, some may not.
- Discount rate is ruled out due to its relation with riba.
- OMO is useful in managing monetary policy in an Islamic economy, if the securities traded are Shariah compliance.
- Current development on Islamic money markets operations has paved the way to address certain issues on instruments.



Shariah-Compliant Instruments of Islamic Interbank Market in Malaysia

Instrument Type	Description
Wadi'ah Acceptance	Used by BNM to absorb liquidity the IIMM. Islamic banks place their surplus funds with BNM based on the concept of wadia'ah. No obligation on BNM as the custodian to pay any return on the account.
Government Investment Issues (GII)	Government securities issued to the domestic capital market to finance development expenditures. Uses bay' al-'inah (sales and buyback transaction) concept.
Malaysian Islamic Treasury Bills (MITB)	Issued by BNM to raise short-term funds financing government expenditure. Structured based on bay' al-'inah principle.
Central Bank Ijarah Certificates	Sukuk Ijarah issued by BNM and only Islamic banks (IBs) can hold such certificates. Tenor takes up usually a year
Islamic Negotiable Certificate of Deposit (INCD)	Issued by IBs to investors for direct financing in the real sector. INCD is a short-term money market instrument (maturity < a year) and tradable.
Mudarabah Interbank Instrument (MII)	A mechanism whereby a deficit IB can obtain investment from a surplus IB based on Mudarabah. Period ranging from overnight to 12 months. Profit sharing ratio is negotiable among both parties
Interbank Musharakah	Short –term restricted (muqaiyyadah) partnership where banks are invited to invest in a special pool of assets on a pre-agreed profit-sharing ratio agreed upon at the outset.

Roles of the CB in Establishing IMP

Maintaining economic stability

Harmonizing real sector and financial sector to reallocate the unutilized funds to the productive economic activities

Achieving macroeconomic targets

(price stability, high economic growth, full employment)
Promote real economic activities via involvement of all economic agents (regulators, investors, suppliers, customers, etc.)

Using Islamic monetary instruments

Managing economic liquidity (monetary expansion and contraction) by applying Shariah compliant contracts in investment or trade

Ensuring the equality of economic development

Determining projects in the real sector in coordination with the government and related authorities

- The abovementioned roles may not be fully applicable, most countries operates on conventional economic framework, even for countries having dual banking system.
- Some challenges:

1. International practices do not allow CB to directly deal with real sector investment activities.

May only hold excess liquidity. Contradict with IMP, urges economic entities to directly deal with the real sector.

2. CB is neither a commercial authority nor a social or charity authority.

Whereas IMP positions CB as an active 'economic-agent'. Even if some central banks issue sukuk as IMP instruments, the usage of sukuk is not for direct financing of the real sector, but for liquidity management.

3. A MP is commonly designed to manage short-term to medium-term liquidity.

Difficult for CB to issue LT securities. Real sector projects may be ideally financed by LT Islamic securities.

4. CB is considered a risk-free institution.

Monetary instruments (including the Islamic ones) are risk-free instruments in the money market. As CB gets involved in real economic transactions, it may be exposed to various economic and business risks.

5. The dominant MP is still the conventional one.

In most countries having dual banking system, IMP is 'the follower or a complementary' of the conventional monetary operations. Complement the liquidity expansion or contraction without any clear and direct connection with the real sector



- Even with these challenges/constraints, the roles of CB in applying IMP should at least aim at:

1. Creating Islamic monetary instruments (complementary to the conventional ones) and offering them to potential investors. Issuing CB's sukuk or other securities' e.g, the State Bank Pakistan, BNM, Central Bank of Bahrain, Central Bank Sudan.

2. Facilitating trading of Islamic monetary instruments for liquidity management. E.g, Islamic interbank repurchase agreement (repo) and Islamic repo to CB, done by BNM and Bank Indonesia.

3. Deepening the Islamic money market (developing a liquid market, attracting more investors, providing market structure and other facilities).



Conclusion

- Money plays important role to facilitate exchange of goods and services among different units in economy (consumers, producers, etc).
- To ensure mobilization of money is secured and lead to development of real sector, CB plays a prominent role together with intermediary role of banking sector
E.g, VBI policy to promote microfinance
- In Islamic economy setting, CB responsible to maintain economic stability, achieve macroeconomic targets, and use Shariah compliant monetary instruments



References

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