Certificate of Islamic Economics Online Course
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MONEY AND FINANCIAL SYSTEM

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INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

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TOPIC OUTLINE

- Definition of Money
- Functions of Money
- Types of Money
- Money Creation and the Fractional Reserve Banking System
- Basic Concept of Financial System
- Structure and Components of the Financial System
- Conventional Financial System and the Financial Crises
- Islamic Finance: A Better Alternative

What is Money?

- Role of trade to improve well-being
- Inefficient for individuals to produce all that they need by themselves
- Need to exchange goods and services
- Barter trade: requires double coincidence of wants
- Many transactions would be impossible under barter system
- Necessary to introduce money for development of societies
- Historically, people used rocks, leather, salt or shells as money. Later replaced with gold, silver, other precious metals
- Bimetallism. During the medieval period, Europe's monetary system was dominated by silver coins up to the 13th century while gold dominated later.

- Further development, deposit precious metals with some trustees and use paper deposit certificates. Certificate is convertible to gold at any time.
- Later developed to fully covered paper money, then replaced with fiat money system, not convertible to gold anymore
- **Money**: anything that is generally accepted in payment for goods and services or in repayment of debts
- Not just notes and coins; includes demand and savings deposits
- Anything that is permitted is acceptable from Islamic perspective, as long as it acts in the interest of the public and does not cause harm

Functions of Money

- **Medium of Exchange**
- Avoid inefficiencies of barter system; high transaction cost
- Increase volume of transactions; fulfil the demands of modern economy
- Promotes economic efficiency, specialization, through indirect exchange of goods and services
- **Unit of Account**

- A standard numerical unit and a measure of value in an economy

- **Store of Value**
- The value must remain stable, otherwise, it cannot be an acceptable means of payment
- Foodstuff are perishable, fail to be a good store of value, not an ideal form of money
- **Standard of Deferred Payment**

- Must be a reliable standard for the payment of future obligations, e.g, settlement of a credit sale, and settlement of debt

Characteristics/Attributes of Money (to function effectively)

- **Durable**. Last long without being worn out
- **Portable**. Mobile, easy to carry
- **Divisible**. Can be divided into smaller homogeneous units
- **Uniform or homogeneous**. Uniform and standardized, easy to determine its value
- **Fungible**. All monetary units must be of equivalent value

- Ex., Every one-Ringgit bill is worth RM1, every five-Ringgit bill is worth RM5, and so on. You can use all cash to pay for the same things.

- **Not counterfeitable**. Should not be easily faked

- Must have some security features

Types of Money

- Commodity Money

- Various physical commodities, e.g, clay tokens, iron bars, bronze coins, woods, standardized gold and/or silver coins (bimetallic coinage)
- Objects that have values, and value in their use as money

- Earliest currencies in the Muslim world during the rise of Islam were precious metals bullion, i.e. the dinar (gold) and dirham (silver)
- The monetary standard in the early days of Islamic civilization was the bimetallic system with dinar and dirham circulating simultaneously
- These coins did not originally come from the Arabs, but from the Romans (dinar) and Persians (dirham), two superpowers of the time.
- During his time in Medina, the Prophet did not make any changes to the already circulating foreign currencies and no new coin minting occurred.
- Umayyad Caliph Abd al-Malik ibn Marwan minted gold coins (4.25g) and silver (2.975g)

Picture: Money Used by Srivijaya Empire during 7th – 13th centuries, in Malay Archipelago, Malay Heritage Museum, Universiti Putra Malaysia

- Representative Money

- A claim on a commodity such as gold and silver certificates and involves a commodity-backed money
- Ex., During the gold standard, bank notes are redeemable with gold. US dollar was redeemable for gold before 1971. Went off gold due to over-printing

- Fiat Money

- Derives its value from a government decree that all creditors must accept the money in settlement of debts (legal tender)
- A medium of payment recognized by a legal system to be valid in the settlement of a financial obligation.
- Accepted by Muslim scholars (OIC Fiqh Academy Resolution No. 6), if people agree to use a certain object as a medium of exchange, it is money
- Critics argue that fiat currency is subject to exponential decay. Excessive increase in money supply can cause increase in prices. In 1404H, half of population in Egypt died from hyperinflation-related depression due to monetary mismanagement (al-Maqrizi, 1994)

- Digital Money

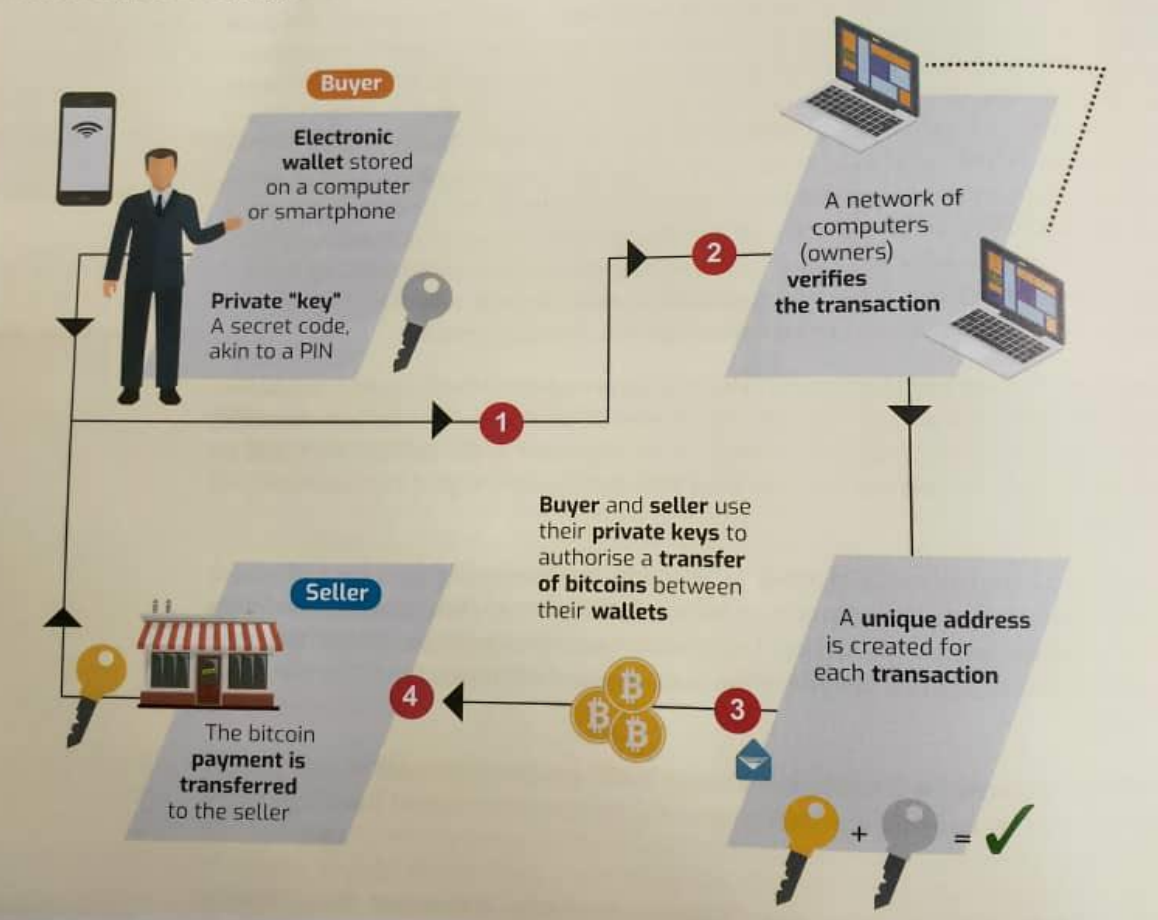
- Fintech contributed to the evolving roles of money and payment services (e-money)
- In 2013, Bank of England revealed a simple 2-step process with lower capital requirements for establishing new banks. UK's digital banks: Atom, Monzo, Starling, and Tandem – without any bank branches
- In 2007, Vodafone introduced M-Pesa, a mobile phone-based money transfer, financing, and micro-financing service in Kenya and Tanzania. Spread to other African countries, India and Eastern Europe. Customers deposit and withdraw money from a network of agents
- Cryptocurrencies (Bitcoin, virtual currency) involving blockchain technology, initially developed by Satoshi Nakamoto in 2009 as peer-to-peer electronic cash systems without the need for financial institutions.
- Virtual currencies are issued privately, not a legal tender

- Credit Money

- Broad definition of money. Includes any types of medium of exchange, notes, coins, demand and savings deposits
- Involves any claim against a person that can be used for purchase of goods and services
- Is formed when banks create money through approving loans

Figure 15.1 Bitcoin Transaction Mechanism

Bitcoin
A digital currency that can be used to buy products online or be exchanged for other currencies.
How to buy items using bitcoins:



Source: The Star (2017, 1 July)

Money Creation and the Fractional Reserve Banking System

- Under the fiat money system, creation of money lies upon the highest monetary authority in a country, government through a central bank (CB)
- Commercial banks also play a significant role
- How is money created within the economy of countries adopting the fractional reserve banking (FRB) system?
- What is FRB?

- A situation where a commercial bank needs to keep only a certain fraction of the deposits of its customers as reserve at the CB, the rest can be loaned out.

- CB uses required reserve ratio (RRR/SRR) to manage liquidity or credit creation in the banking system

- If the RRR is 10%, for each RM100 million deposits, a commercial bank will need to keep RM10 million at the CB and loan out the rest.

Bank A

Assets	Liabilities
RM90 mil (Loan) RM10 mil (reserves	RM100 mil

Bank B

A	L
81 mil (L) 9 mil (R)	90 mil

Initial money supply: RM100 million
Total money supply after loan creations: RM343.9 million
Money multiplier (m) = 1/RRR
If RRR = 10 %
m = 1/0.1 = 10
Deposits = Excess reserve (E) X m
RM900 = RM90 million X 10

Bank C

A	L
72.9 mil (L) 8.1 mil (R)	81 mil

Bank D

A	L
65.6 mil (L) 7.3 mil (R)	72.9 mil

Bank E

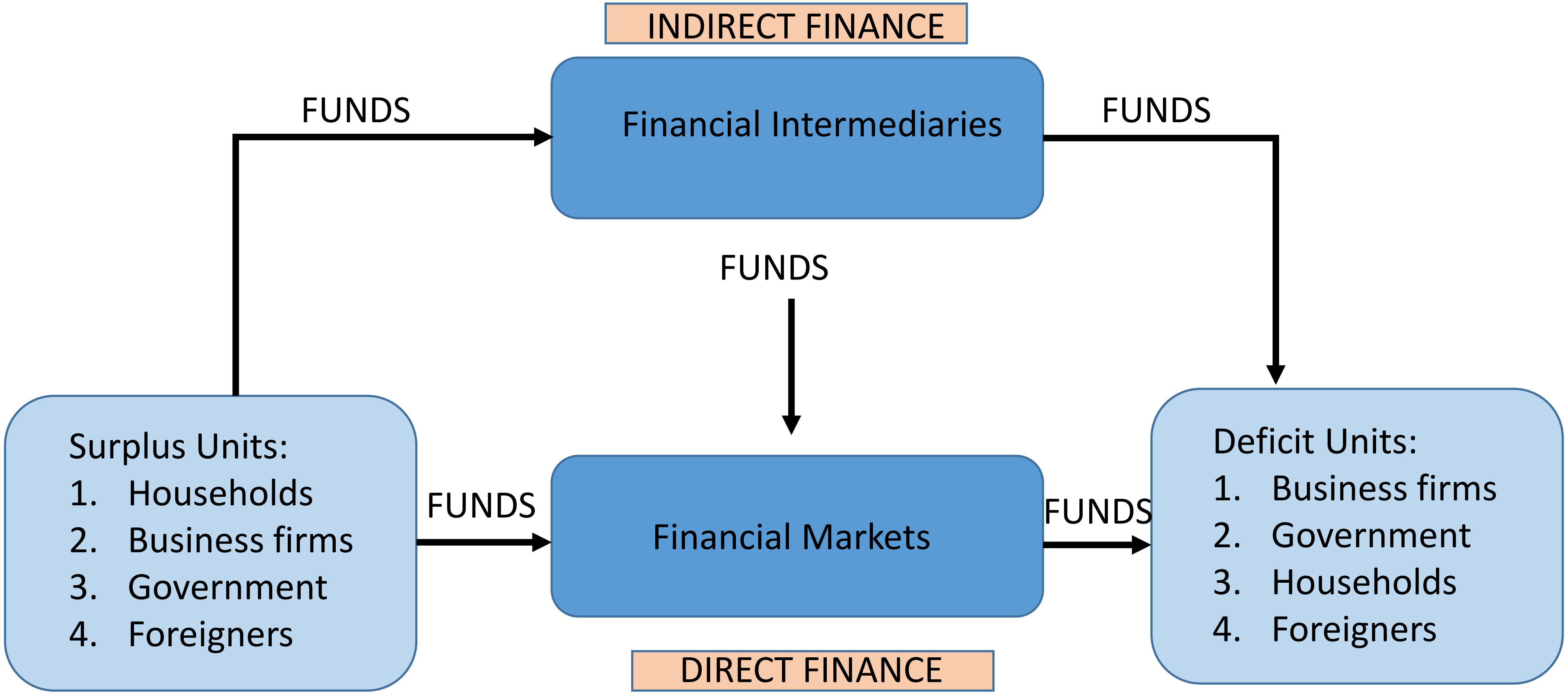
Danger of fiat money system: Power of money creation given to bankers

Financial System

➢Basic Concept of Financial System

- An integral part of any economy
- Facilitates flow of funds between economic agents, boost the real economy
- Without proper financial system, economy is not able to function effectively
- A financial market connects investors and capital providers according to market forces, effectively channel funds from surplus units to deficit units.
- A healthy economy largely depends upon the efficiency of its financial markets
- Financial intermediaries are: banks and non-bank entities (insurance/takaful, unit trust/mutual funds, pension funds; facilitate the channeling of funds from surplus unit (households) to deficit units (businesses)

Flow of Funds in the Financial System



Source: Islamic Economics: Principles and Analysis, ISRA (2018)

Structure and Components of the Financial System

Structure of the Financial System

Financial Institutions

1. Banking Institutions (Commercial banks, Investment Banks, Cooperative Banks

2. Non-bank Financial Institutions (Takaful, Pension Funds, Unit Trusts, Hedge Funds)

Financial Markets

1. Money Markets (Interbank Money Market
2. Capital Markets (Stock and Bond Markets
3. Other Financial Markets (Commodities, Foreign Exchange, Derivatives Market

Development and Social Finance Institutions

1. Development Financial Institutions (Bilateral, Multilateral DFIs[IsDB, AfDB])
2. Social Financial Institutions (Microfinance, endowments, Trusts, NGOs, Waqf, Zakat

Financial Regulators

1. National Regulators (Central Banks, Securities Commission
2. International Standard Setters (Bank for International Settlement,AAOIFI, IIFM, IFSB, International Organization for Securities Commission

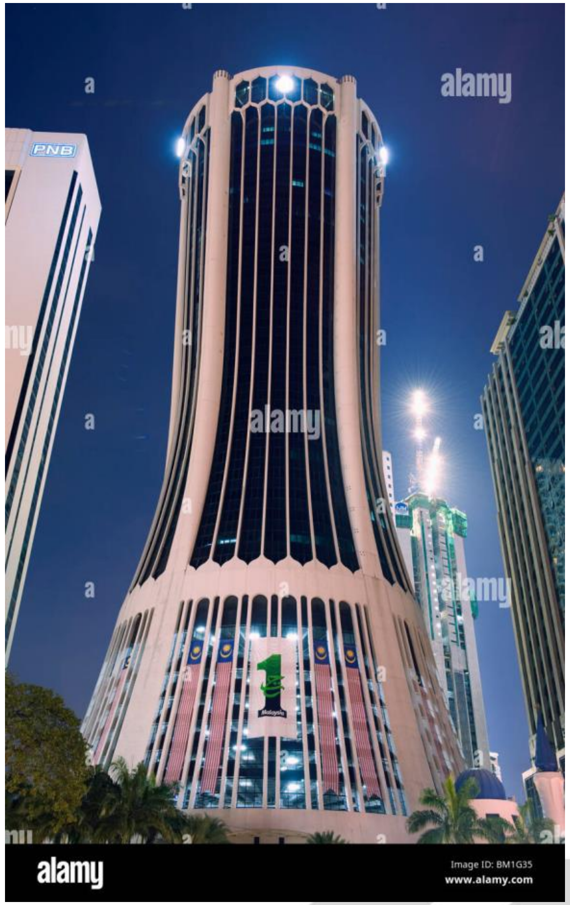
➢Conventional Financial System and the Financial Crises

- Most of current financial systems are interest based
- Some marginal benefits, but overall effect is harmful
- Problem of financialization, separating of financing from real economic activities. Ex. Financing for forex for speculation
- Contributed to frequent occurrence of financial crises. Ex., Asian Financial Crisis 1997-1998, Financial Crisis in 2007-2008 (excessive financialization and commodification of debt)
- How to resolve the deficiencies of the conventional financial system?

Islamic Financial System (IFS): A Better Alternative

- Islamic financial system envisioned to be closer to the real economy, better positioned to serve the people, ensure higher social welfare
- Non-existence of full-fledged Islamic financial system in practice
- Still new. Only 10-20 ago Islamic finance (IF) began to increase its presence

- Malaysia is the global leader, world's most sophisticated market in IF
- Establishment of Lembaga Tabung Haji (Pilgrims Management and Fund Board of Malaysia) in 1963 paved the way for the development of IF in the country
- Establishment of Bank Islam Malaysia Berhad, the first Islamic bank in 1983.



Source: https://www.alamy.com/stock-photo-tabung-haji-building-designed-by-hijas-katsuri-kuala-lumpur-malaysia-29538073.html

Philosophy of the IFS

- Aims at facilitating the exchange of goods and services in the economy
- Its conduct must comply with Shariah that prohibits interest-based dealings, highly considers the social and ethical aspects of a transaction
- Aims to achieve economic and social justice in society
- Essence of IF is the concept of risk sharing rather than risk transfer or risk shifting in conventional finance
- Risk-sharing concept is embedded in the Islamic partnership contracts; *mudarabah* and *musharakah* (PLS).
- Concept of risk sharing enriches the brotherhood among the contracting parties, they must share the risks and returns together.

Distinctive Features of Islamic and Conventional Financial Systems

Distinctive Features	IFS	CFS
Interest rates	Prohibited	Core element
Underlying asset	Must be present	Can be absent
Ethical investment	Core value	Voluntary
Gharar	Prohibited	Accepted
Profit-and-loss sharing	Core principles	Choice
Maysir	Prohibited	Accepted

Source: Islamic Economics: Principles and Analysis, ISRA (2018)

Islamic Financial Instruments

Instrument	Description
Murabahah	Cost-plus or marked-up sale contract
Ijarah	Leasing
Mudarabah	Partnership contract where one party takes the role of the investor (rabb al-mal) and provides 100% of the capital and the other party as the entrepreneur (mudarib) and manages the investment. Profits are shared based on pre-agreed ratio.
Musharakah	Partnership contract where all contracting parties must contribute to the investing capital equally or unequally. Profit ratio is negotiated among the parties
Qard hasan	Benevolent loan where the financier provides loan without expecting any return from the borrower. Expect rewards and blessings from Almighty Allah (SWT)
Salam	Forward sale. Payment is made in advance and delivery is determined at a future date at a determined price
Istisna’	Contract to manufacture, construct or build an asset based on customers’ specifications. Price of the contract must be agreed upon before the work starts. Payment can be made in advance, based on progress of completion, lump-sum, or on instalment basis

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