Issuance and Circulation of Money:
A Comparative Study of Islamic and Conventional Monetary Policy

Research Thesis

Ph.D. Islamic Studies

Researcher

Hafiz Moazzum Shah

Roll No: PD-F-17-092

Department of Islamic Studies

NUML, Islamabad

Supervisor

Dr. Syed Abdul Ghaffar Bukhari

Associate Professor

Department of Islamic Studies

NUML, Islamabad

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بسم الله الرحمن الرحيم

Thesis and Defense Approval Form

The undersigned certify that they have read the following thesis, examined the defense, and are satisfied with overall exam performance and recommend thesis to the Faculty of Higher Studies for acceptance

Dissertation Title:

ISSUANCE AND CIRCULATION OF MONEY:
A COMPARATIVE STUDY OF ISLAMIC AND CONVENTIONAL MONETARY POLICY

Submitted by: **Hafiz Moazzum Shah**

Reg No: **710-PhD/IS/F-17**

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Dr. Syed Abdul Ghaffar Bukhari: ________________________

Name of Research Supervisor **Signature of Supervisor**

Dr. Noor Hayat Khan ________________________

Head Department of Islamic Studies **Signature of Head**

Prof. Dr. Mustafeez Ahmad Alvi: ________________________

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Candidate Declaration Form

I, **Hafiz Mozzum Shah**

Son of: **Fazal Rahim**

Registration No: **710-PhD/IS/F-17**

Department: **Islamic Studies**

Candidate of Ph. D at National University of Modern Languages do hereby declare that the thesis titled: **ISSUANCE AND CIRCULATION OF MONEY: A COMPARATIVE STUDY OF ISLAMIC AND CONVENTIONAL MONETARY POLICY**

submitted by me in partial fulfillment for PhD degree in Islamic Studies is my original work and has not been submitted or published earlier. This thesis in its present from is the original work of the author except those acknowledged in the text.

Name of Candidate: **Hafiz Moazzum Shah**

Signature of Candidate: ________________

Date: ________________

National University of Modern Languages
Islamabad

Issuance and Circulation of Money:

A Comparative Study of Islamic and Conventional Monetary Policy

ABSTRACT

Sustainability of modern economies requires active and prudent macro-management through fiscal and monetary interventions by the regulators. Regulators attempt to influence real economy through monetary policy instruments which target a desired level of money supply in economy. Monetary policy instruments observe different restrictions and conditions on various financial markets and institutions, particularly on banks, to achieve monetary and economic stability at internal and external levels. Monetary policy instruments and their efficiency is largely linked with operationality of interest rate either directly or indirectly. Invention of money is the most striking achievement in human history. Through the process of innovation, money has evolved from barter to digital form in hands with evolution of human civilization. The circulation of money in the economy affects key factors of the economic activities and social features like production, distribution, and consumption of goods and services. According to the modern economists the role of money is not limited to medium of exchange rather it significantly impacts the real economy. Therefore, study of money and monetary policies is one of the basic and important fields of economics and is considered to be the most important to achieve the goals of successful economy. For this purpose, every country has a central bank that is charged with the responsibility to issue and regulate money in the economy for a sustainable economic system. Islamic monetary system is no exception. The importance of money and monetary policies cannot be over emphasized in modern Islamic monetary system. Therefore, shariah issues in money issuance and its circulation has attracted the focus of Muslim jurists in juristic debates. Modern monetary policies are generally based on interest and other factors prohibited by Islam. However, in international global financial system, the economies of Muslim countries cannot remain indifferent towards the monetary system and policies as applied in most of the countries of the world. Hence, there is need of Shariah analysis of conventional monetary policy and its comparison to Islamic monetary policy as introduced by some contemporary Muslim jurists. The research aims to choose the extent of the applicability of financial and monetary policy tools within the framework of Islamic economic system in the light of Islamic legal instruction. This study proceeds with the discussion on concept of money in conventional and Islamic economic system. Moreover, a comparative study of supply and demand for money has been examined. The concept of an Islamic central bank and monetary policy tools in comparison with conventional monetary policy has also been discussed. The research methodology that has been used in this research is analytical, qualitative, and comparative study between conventional and Islamic thought followed by the deductive and inductive approach together to arrive at the results of the study. The study found that an Islamic central bank can work and implement monetary policies compatible with shariah avoiding interest and other practices prohibited by shariah. There are sufficient monetary policy tools and ways for a modern Islamic economic system. The authorities of the Muslim countries should implement Islamic monetary policy and avoid interest and other non-shariah compliant practices.

Keywords: Money, Monetary policy, Central bank, Issuance of currency, Supply of money, Demand for money,

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Comparative Study of Conventional and Islamic Monetary Policy

LIST OF ACRONYMS

IMF	International Monetary Fund
IDB	Islamic Development Bank
ME	Monetary Economics
CB	Central Bank
SBP	State Bank of Pakistan
ECB	European Central Bank
IS	Islamic Sukuk
MP	Monetary Policy
ISP	Islamic Monetary Policy
MB	Monetary Base
IB	Islamic Banks
VC	Virtual Currency
PIDE	Pakistan Institute of Development Economics
CM	Credit Money
DRP	Discount Rate Policy
RR	Reserve Ration
LR	Liquidity Reserve
REPO	Repurchase Agreement

Dedication

This Humble effort is dedicated to Prophet Muhammad.

صلى الله عليه وآله وسلم

Acknowledgment

Praise be to Allah who has guided us to the right path and granted me ability and chance to present this humble effort. I would like to express my deep gratitude to my parents who have always supported me in my educational career. I would also like to extend my sincere thanks and heartful gratitude to all my teachers who, with their patience and determination enabled me to contribute to the research work.

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This research could not have been accomplished without the support of my brothers. They always encouraged me when the times got rough. Their help and support are much appreciated and dully noted.

Hafiz Moazzum Shah

INTRODUCTION

Islam is a complete code of life. Its commands are not restricted to some modes of worships or to some rituals. It provides its complete guidance in all fields of life.

The twentieth century has witnessed economic revolution and economic system in the whole world has become very complicated, especially after the world has changed into a global village. The most important factor that has played a vital role in the modern economic system is monetary system and money markets. Therefore, monetary policy of a country is considered to be the most important to achieve the goals of successful economy. For this purpose, every country has a central bank that is charged with issuance of currency and its regulation in the economy for a stable and sustainable economic system.

Money has played a vital role in this regard. various imbalances and changes, that affect the macroeconomic variables and indicators, resulted in emergence of different and contradictory ideas about monetary policies. This divergence of point of view about monetary policies led to introduction of various new aspects of monetary policy. Such new aspects had a great impact on highlighting the increasing importance of monetary policy as well as the ability of monetary authorities to influence the required growth rate. This is because the state has monetary powers and Legal authority, which enables it to enact laws and make decisions that would define the critical aspects of the National economy. These decisions may be related to already available monetary instruments or to the volume of credit granted to economic institutions or the interest rate.

Monetary policy is the process by which monetary authority controls supply of money, usually through interest rate targeting to promote economic growth and stability.

Being the central bank of Pakistan, the state bank of Pakistan along with its other responsibilities, uses interest rate, direct market operations and regulatory policies to increase or decrease the inflation in the economy as per requirement and circumstances. To achieve the goal of decrease in inflation It increases the interest rate of loans given by the commercial banks, thereby decreasing their power to lend money. On the contrary, to achieve the goal of increase in inflation by circulating more money in the economy, it decreases the rate of interest to enable the commercial banks to lend more money.

The measures taken by the monetary authorities are either to target the monetary variables like credit, exchange rate and interest rate or to intervene in the money market and influence the volume of credit creation by banking and non-banking financial institutions involved in credit creation.

Moreover, there are some intermediate targets and some ultimate goals of monetary policy. There are some intervening variables between the goals and instruments of monetary policy. For example, central bank needs to reduce aggregate demand in the economy if it wants to decrease inflation. The reduction in aggregate demands requires reduction in consumptions and/ or investment. Consumption and/or investment may be reduced through increase in the market interest rate. Thus, these intervening variables are intermediate targets.

The intermediate targets provide a link to the ultimate goals. They can be influenced by the central bank and the central bank can take necessary steps and timely decisions regarding them. Generally, they can be accurately measured. The example of intermediate targets is annual aggregate demand in money supply.

Monetary policy has evolved according to economic developments and has undergone various important changes. The concept of monetary policy in classical thought is different from modern thought. The circulation of money as a social phenomenon is directly related to its purchasing power and to the relative stability of the real value of money as medium of exchange. In other words, the circulation of money is related to the liquidity of money or the speed of transformation of money into goods and services and various factors that result from a change in its real value or purchasing power and its implication on the overall economy. Economists even judge the liquidity of any type of good or wealth by its speed of conversion into cash or money. Therefore, money is liquid enough to be used as a criterion for determining the liquidity level of other types of wealth.

IMPORTANCE

In modern economic system the objectives of macroeconomic policy are very important which can only be achieved through an effective monetary policy and using monetary policy tools. After the invention of fiat money or paper currency that has no intrinsic value, the importance of monetary policy has increased. It would be very difficult to achieve the objectives of a sustainable economy and socioeconomic well being without an effective monetary policy. Monetary policy is considered a tool in the hands of the monetary authorities, which is used to influence money supply by monitoring the banking system in general and banks in particular and imposing restrictions and conditions on the activities of banks and by using certain means to achieve monetary and economic stability at the internal and external levels. The monetary authorities take necessary steps and prudential decisions about money supply in line with the prevailing economic conditions and the goals already set by the government.

Monetary policy is a major integral part of the economic policy. The other main part is the financial policy that is controlled and implemented by some budgetary tools like revenues and expenses to influence savings and investment.[1] Thus, there is difference between monetary and financial policy. Financial policy is related to the budget, revenues and expenses while monetary policy is mainly related to money supply and its control.

The goals of monetary policy generally vary from country to country as per different levels of economic development, the different banking and financial structure and other economic and financial policies. The authorities also take into consideration various other factors that change with the passage of time and accordingly change the respective monetary policies to keep pace with the economic and financial developments.

One of the primary objectives of central bank's monetary policy is to achieve full employment level. Over the history, central bank has used interest rate as a tool to achieve the goal of full employment. Usually, the central bank lowers the interest rate to increase the credit facility to businesses which definitely lead to an increase in employment. Full employment means the level of employment at which the demand for labor equals to the supply of labor. This level is called natural rate of employment.

The other important objective of the monetary policy is to ensure economic growth. Economic growth generally means more jobs and better living conditions. It is related with an increase in business activities. Economic stability is also one of the

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[1] Muhammad, Yousuf Kamal, *AL Masrafiyyah Al Islamiyyah* (Beirut: Dar ul Nashr Lil Jamiaat, 1996), 19.

important objectives of the central bank. This objective is related to full employment objective and depends on it. If there is full employment there will

Price stability is another important goal of monetary policy. it means stability in the domestic purchasing power. Over the past few decades, the central banks of different countries have viewed the price stability as one of the most important and basic objectives of the central bank's monetary policy objectives

Financial stability is also one of the prime objectives of monetary policy. Central bank acts as lender of the last resort for banks and financial institutions. Central bank plays its role to ensure continued adequacy of liquidity. The banks sometime face liquidity problem in fulfilling their financial obligations towards their customers.

The above-mentioned role and objectives of monetary policy indicate the importance of the monetary policy in the modern economic system.

STATEMENT OF RESEARCH PROBLEM

Although Islamic central banking is not different from conventional central banking as a whole, but the role of an Islamic central bank in conducting monetary policy is restricted to use interest-free Islamic monetary instruments.

Islamic central bank, like conventional bank, will play the same role to maintain price stability and achieve macroeconomic goals, control liquidity and supervise banking operations.

As most of the conventional monetary system tools are interest based, therefore there is need to investigate the concepts and operational methodologies of the Islamic monetary policy instruments. Some Islamic monetary policy instruments have been introduced like commodity *Murabaha* and Islamic Sukuk. Yet there is need to examine the shariah compatibility and effectiveness of these instruments as compared to the conventional monetary policy instruments in modern economic system.

Central bank, on behalf of the federal government, sometimes, resort to deficit financing for its development projects and meeting public expenditures. Access money in the market devalues the currency. Sometimes government devalues the currency to boost exports, shrink trade deficits and reduce foreign debt burdens. This action of the government affects the receivables and creditor bears loss.

To regulate and control the banking system the central bank determines ceilings for credit financing and profit ratios to be distributed among customers. The credit ceiling in regulatory procedures is to limit the money supply or to keep it at a secured level and also to distribute loans towards sectors deemed essential for development or requiring large financial resources.

These steps of the central bank in monetary policy need to be discussed from shariah point of view. Several Shari'ah issues in conventional monetary policy need to be reviewed from Shari'ah perspective. In fact, conventional monetary policy is based on the use of interest rate as a primary tool to achieve the monetary policy objectives. The main tools of monetary policy that are discount rate, open market operation and reserve ratio requirement also involve interest. There are also other factors and reasons that will make these conventional practices of monetary policy unlawful form Shari'ah point of view. Therefore, conventional monetary policy assumes special importance from Islamic perspective because of strict prohibition of *R*iba.

In the above discuss, deficit financing and fixation of credit ceiling cause loss to public, so there is need to discuss the concept of system of issuance of currency form Islamic perspective. Some of these monetary tools violate the condition of free consent between contracting parties (bank and the customer), one of the basic conditions of shariah complaint contract.

Statutory reserve ratio required by the central bank form Islamic banks also needs to be discussed from shariah point of view as depositing a portion of the amount invested by the customers with the central bank means keeping this portion idle without prior free consent of the investors.

LITERATURE REVIEW

The issue of money and monetary policy is not a new phenomenon. Fortunately, this issue has been addressed comprehensively by the Muslim jurists, but it is scattered in different classical books. Some Muslim scholars such as Ibne khaldoon and Ibnul Qayyam have explicitly touched the topic in their books.

As far as contemporary literature is concerned, many learned scholars have made attempts to discuss this issue and explored the depth, width and intensity of the issue. Some of the famous Muslim scholars of the day like Nijatullah Siddiqui have dealt with the modern connotations of the issue.

Aiman al Subahi in his M.Phil. thesis " alzawabit al iqtisadialilisdar al Naqdi"in Sudan has discussed the rules and regulations of issuance of currency from Islamic perspective he has also discussed the possibility of application of gold standard system in modern economic system for a sustainable economy.

Yahya Muhammad Hussainshawer AL Tamimi in his M.phil thesis "NahwaMasrafmarkaziIslami"has discussed the monetary policy. The author analyzes the role and responsibilities of a central bank in an Islamic economic system. He also discusses the relationship of an Islamic central bank with other banks.

Musa Adam Iesa, in his Ph.D. thesis Al *tawazu AL NaqdiWalHaqiqifilIqtisad AL-*Islami has discussed the components of supply and demand for money.

Imrān N. Hosein in his book "*THE GOLD DINĀR AND SILVER DIRHAM: ISLAM AND THE FUTURE OF MONEY*" has discussed the effects and exploitative nature of the current monetary system in world and emphasizes on the use of Gold Dinār and a true Ribā-free economy.

Yousaf Kamal Muhammad in his book "*AL-Masrafiaalislamia-alsiasa al Naqdia*"has discussed the role of central bank, conventional monetary policies, supply and demand for money and base for issuance of currency in conventional and Islamic economic system.

Dr. Aof Muhammad kufrawi from Muhammad bin saud Islamic university Riyadh in his book "*Al SiasaAlmaliaWalNaqdia fi ZillilIqtisad AL-Islami*"has presented a comparative study of Islamic and conventional monetary policy and proved that conventional monetary policy tools have failed in achieving their targets either because of their dual effects or because they are not acceptable form shariah point of view.

Dradnankhalid al turkamani from Muhammad bin Saud University Riyadh has written a book "*al siasa al NaqdiawalMasrafiaFilislam*" The author defines monetary policy and then explains its development. The author also explains causes and effects of inflation phenomenon and emphasizes that the best system that maintains the greatest economic currency stability is the gold standard system.

Mr. Ausaf Ahmad of Islamic Development bank has written a book "*Instruments of Regulation and Control of Islamic Banks By The Central Banks*". The author identifies the instruments of monetary control adopted by Islamic banks and studies the practices of central banks in controlling and regulating the Islamic banks. The study also undertakes comparison of central banks practices in regulating and controlling Islamic banks in different countries.

Sheikh Imran Hosein an Islamic researcher has compiled a book by the name "*Islam and the Future of Money*". This book explains that how Dollar has become the dominant and a stable currency in international monetary system and how it controls and exploits the economy of developing countries. The study further clarifies that Muslim world can get rid of this dilemma only through use of gold and silver as currency.

Salman Shaikh in his research article "Role of Central Bank in Islamic Finance reviews and analyzes the practices followed by central banks for liquidity management and monetary management in countries where Islamic banking is prevalent. The author also presented the evidence on statistical equivalence of nominal Interest rates (being used in conventional banking) and Nominal GDP growth rate (recommended by the author to be used).

A research article *AL SiasaalMaliawaZawabituha Fi Itari al Iqtisad Al-Islami*written by MunzarKahaf examines the types of public revenuesof the State within the framework of Islamic economy, including zakat and the controls on these revenues

Another research paper with the topic "The Central Bank of Jordan and Its relationship with Other Islamic Banks in Jordan" written by SaeedMikhled Ahmad Al-Naimat presents an analysis of single monetary policy for both Islamic and conventional banks and its negative impacts on Islamic banks profit distribution ratio. This study also undertakes Comparison of laws of different arab countries with those applied in Jordan and figures out ways that can solve the Jordanian Islamic banks problem. The author emphasizes that the central bank must develop its monetary control Instruments to be used for Islamic banks taking into consideration the nature of the activities based on the principle of partnership.

DrabdulhaleemIbada in his research paper "AL Siasa AL NaqdiaZawabituhawaMujatuha fi IqtisadIslami" in Yarmook University Jordan has discussed the reserve ratios and Qarzhasan as tools of monetary policy from Islamic perspective.

A renowned Islamic scholar Dr. Nijatullah Siddiqui has also discussed the monetary policy of Islam in his research paper "AL Idara Al MaliayFil Islam" and have shed light on modern Islamic monetary policy.

However, issues mentioned in statement of problem above have not been focused yet. This research is a focused study of the monetary system of statebank of Pakistan and has discussed the issues referred above in statement of problem.

OBJECTIVES OF RESEARCH

1. To elucidate the Islamic concept of money as compared to conventional concept in modern economic system.
2. To compare the Islamic concept and rules of issuance of currency with conventional economic system
3. To expound the theory of demand and supply of money in Islamic economic system and corelate this concept with modern conventional concept.
4. To evaluate the role and functions of central bank in Islamic economic system in contrast with conventional interest based central banking system.
5. To examine shariah compatibility of conventional monetary policy tools.
6. To compare Islamic monetary policy with conventional monetary policy
7. To Contribute to the efforts of developing Islamic economic system in the country

RESEARCH QUESTIONS

The proposed study and the thesis statement revolve around questions such as:

1. How the concept of money and issuance of currency in Islamic economic system is different as compared to conventional economic system?
2. How the rules of issuance of currency in Islamic economic system are different from conventional economic system?
3. Why the concept of supply and demand for money in Islamic economic system is different from conventional economic system?
4. How the nature of relation of central banks with Islamic banks is different from conventional banking system?

5. How Islamic monetary policy tools are different and effective enough as compared to conventional monetary tools to be applied in the modern economic system?

SCOPE/LIMITATION OF THE RESEARCH

The study is focused on comparison of Islamic and conventional monetary system and the role of central bank is Islamic economic system. The research is limited to the issues of Islamic monetary policy in the present economic system. However, for reference purpose monetary policy of the state bank of Pakistan has been mentioned.

BACKGROUND STUDY

Monetary policy is the process by which monetary authority controls circulation of money to ensure economic stability in the country. In early Islamic ages this task was done through Baytul-Mal (treasury) operations. Monetary policy was not distinguished form Fiscal policy at that time. Since money at that period composed of gold coins (Dirham and Dinar) and supply of gold had always been stable, fiat money and credits were not applicable. The monetary expansion mechanism did not actually exist as it is in recent and current times.

Modern banking system has brought a revolution in economic world. This is an important tool that has played a vital role economic system in the modern era. This important system generally deals with money and currency.

RESEARCH METHODOLOGY:

This is comparative research with qualitative approach and is focused to search the theories of Muslim Jurists regarding Islamic monetary system. Therefore, the Islamic research methods such as Istaqrā` (induction), Istadlāl (deduction) and Qiyās (Analogy) has been used for elaboration, explanation, interpretation, and derivation of rulings from sacred Islamic texts. As well as the criteria of Maqasid e shariah (objectives of shariah) has also been used.

The rules and principles of Sharīʿah and opinions of the Muslim jurists regarding this issue has been extracted and quoted on the basis of principles of Islamic jurisprudence. Theories regarding money and monetary policies frameworks have been analyzed to assess their appropriateness, strengths, and weaknesses. The comparative research methods from classical methodologies of Sharīʿah has been used to complete various component of this research. This research has examined various writings of classical and contemporary Muslim scholars on the money and monetary policy.

The Concept Of Money In Islamic And Conventional Economic System

Introduction

There is no doubt that invention of money is one of the most important innovations in the history of mankind. It has brought a revolution in human life and is equally important for both consumer and supplier. On the one hand it allows the consumer to save and mobilize his purchasing power according to his needs and wishes. The consumer is easy to use his purchasing power when and where he prefers. On the other hand, it enables the supplier to decide what to produce and when to produce to supply in the market.

The study of money is one of the basic and important fields of economics. The circulation of money in the economy reflects key factors of the economic activities and social features. If we look at the society in which we live today, we will find that money plays a significant role as unit of account, store of value and medium of exchange.

Before we discuss the functions and role of money in the economy, it is pertinent to shed light on the nature and concept of money.

1.1 Concept of Money

I. Concept and Nature of Money in Economics

As mentioned above money is not only a medium of exchange and store of value but it has an impact on the economic activities and reflects the economic growth. Its role is important from many aspects. Due to its multiple roles in the economy, there is difference of opinion among the economist about the nature and concept of money. Several famous economists have defined money and each definition gives different concept. This is because money is easy to understand but difficult to define.

However, a deep study of these definitions indicates that despite the difference of opinion about the money, the economists seem to be agreed on attributes and functions that money performs in the economic system.

Prof. Walker defined money as "money is what money does"[1]

[1] Walker, Farancis A, *Money* (New York: Henry Holt and Company, 1878), 2.

This is not a clear definition of money because this definition does not explain the nature of money rather it reflects the functions of money. What money does is the role of money in the economy and not the concept of money.

Another definition of money is "Anything generally accepted as payment for goods, services, resources and debt" [1]

The famous economist Fredric S. Mishkin defined money as "anything that is generally accepted in payment for goods or services or in the repayment of debts".[2]

A deep analysis of the above mentioned definition derives the following concept of money.

a) Anything Can Play Role as Money

One thing that is obvious from these definitions is that anything that has the characteristics of money can be called money. The use of expression "anything" is very important here because the number of things used as money in the human history is not limited. The money may be an eatable thing, a plant, an animal, or a metal. Even it may be nothing at all. We can see that banking money is nothing than a book entry in a bank account. There is no restriction for money to be in a specific shape or be of a specific metal or any other thing. Various assets have performed this role in the history.

According to Mālik bin Anas, a famous Muslim Jurist, if people agree to use a monetary unit made up of animal leather, it would be considered money and relevant shariah rulings would be applied.[3]

b) General Acceptability

Money is something that must have the characteristic of general acceptance. It implies that it is used as a medium of exchange without any hesitation. General public must have a trust on it to use it in their day to day transactions and feel free to keep their wealth in the form of money. Even individuals want to give up all types of goods and property, they posses, to get money. Due to its ability to satisfy humanitarian needs, people want to accept even an unlimited amount of money as a consideration for the goods they possess and services they can provide. So, this is a fully liquid asset and can be converted into any form of wealth.

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[1] Edward Robert Raupp and Danna Vance Raupp, *A Brief Dictionary of Economics Terms* (New Hampshire: Blue Impala Press, 2018), 210.

[2] S. Mishkin Frederic, *the Economics. of money Banking and financial markets* (Canada: 7th edi), 44.

[3] Mālik bin Anas, *Al-Mudawwana al-Kubra* (Beirut: Dar al-Kutub al-'Ilmiyah, 3: 5.

Economists also judge the liquidity of any type of good or wealth by its speed of conversion into cash or money. So, money is liquid enough to be used as a criterion for determining the liquidity level of other types of wealth.

c) Medium of Exchange

Thirdly, these definitions emphasize on two basic functions of money. One of these functions is that money is used as a medium of exchange. It means that it has the ability to be used to buy any type of good, service or property offered for sale in the market. As money is a liquid asset and there is no transaction cost on its exchange, therefore it is easily and preferably used as a medium of exchange in the market. Transaction cost is the time and wealth spent in exchange of goods or services. In the absence of money, which is the medium of exchange, barter system would be adopted for exchange of goods and services. In barter economy goods and services are exchanged without any medium of exchange and generally goods are exchanged for goods or services.

The other basic function of money referred in the above definition is the ability to store the value for future use. It means that the purchasing power is stored between the times income is received until the time it is spent. This feature of money is definitely very important. Because most of the people after generating income do not want to spend the money, rather they want to wait and spend it when they desire or need to purchase something. Although value may be stored in other forms, like in the form of goods, but these goods are not liquid enough to be converted into desired good or service without spending enough time and facing hurdles in this process. The characteristic of liquidity means the ease and speed with which the asset may be exchanged to get the desired good or service at a specific time. Thus, money enables us to calculate the actual and potential costs and benefits, debts, prices and profits and losses.

d) Means of Repayment of Debts:

Another characteristic of money in the above mentioned definitions is that it is used in repayments of debts.

Although debts may be repaid in shape of goods or property as well, but in this way, it will be difficult to settle debts because the debtor may not feel easy to receive his debt in shape of goods or property. Even sometimes he will be reluctant to lend money if he thinks he will be repaid in shape of goods or services. The reason behind this behavior about lending money is that he may not need this specific good he possesses, at a later stage, because its season would be passed at the time of repayment by the debtor. Furthermore, the risk of devaluation is always there. Although there is risk of devaluation of money as well, but the percentage of its devolution can be forecasted easily unlike other goods.

One other important factor in repayment of debt in shape of money is that it is easy for borrower to borrow money from anyone ready to lend money and can use it to meet his needs. However, if he borrows something in any shape other than money, he will have to search for a person who has the required commodity and also is willing to lend it.

The above detail proves that money is important not only as medium of exchange and store of value but also as facilitator in borrowing and lending process in the economy.

Terms Relevant to Money

The word Money is frequently used synonymously with some other words. It would be better to mention some relevant terms and compare it with money.

Money and Wealth

The word wealth is synonymously used with money. However, there is difference between the two. Money represents the monetary assets. On the contrary, wealth generally represents real assets. Any valuable thing may be called wealth while money may be the part of this wealth. One can have wealth in the form of goods, property, or money. However, generally wealth is in the form of material goods.

Prof. Dewett Kewal Krishan[1] has mentioned three features of wealth. That are utility, limitation in supply and transferability. Utility is the ability to satisfy human wants. Anything that is desired or wanted to satisfy human needs would come under the definition of wealth because it has utility.

Another important feature of wealth is limitation in supply. Anything that is called wealth is limited in nature. If something is unlimited it would not be called wealth. So, air and water cannot be called wealth because their supply is not limited. The third feature of wealth is transferability. Thus, nontransferable things do not come under the definition of wealth.

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[1] Krishan, dewett. Kewal, G, S. Sharma, *Manager* (Delhi—Lahore: S. Ghand Co 1946), 38.

Another important fact about wealth is that a thing may be wealth in some circumstances and under specific conditions, in a certain Place or at a certain time. The same thing may not be wealth in some other conditions or circumstances or at different place. Unlike wealth, money is something that is used as medium of exchange. Money itself is not useful but when it is used in a transaction to purchase goods or services, it becomes useful. Its utility is its use.

Money, used in the modern era, does not have intrinsic value. In fact, sometimes it is only cognitive deposit in the record books.

Money and Income

There is difference between income and money. Income is flow of earning per unit of time. What is earned in a specific unit of time is income. For example, if a person earns one thousand rupee in a day, in week or in a month, this is his income. On the other hand, money is the wealth in the form of monetary asset that has been earned and is present in the stock. Although earnings are generally in the form of money, but it may be in other forms like goods or property. However, money is something which is used in transactions as a medium of exchange. [1]

[1] Mishkin, *the Economics of money, Banking and financial markets*, 38.

Money and Currency

Before we discuss the difference between money and currency and have a comparative analysis of both, it is pertinent to define the currency as we have defined the money.

Currency is generally in the form of paper and coins. It is used as medium of exchange, store of value, in repayment of debts and is generally accepted. It is issued by a government. It is obvious from the definition of currency that currency has same characteristics as money has. But what makes difference is its issuance from a government or a legal entity.

Money derives its purchasing power and the ability of general acceptance from different factors. There may be any reason for its general acceptance. It may be because of mutual agreement, custom of a specific area or people of a specific area or civilization of an era or area. Generally, money has its intrinsic value like gold and silver. They are the forms of money. So, money relies upon the behavior of the people.

On the contrary, currency generally does not have intrinsic value. If it has an intrinsic value, its face value would generally be higher than its real value. The characteristics of money i.e., general acceptance, store of value and medium of exchange are conferred upon it by the law or government. It is the legal authority that provides it the status of legal tender.

The other difference that distinguishes the currency from money is that currency is a legal tender. Therefore, it is legally binding to accept it as medium of exchange. If a person denies accepting a currency as medium of exchange, his behavior would be considered against the prevailing law of the country.

In this sense, only banknotes and coins that are legally declared as currency can be used as currency. So, money is not necessarily a legal tender while currency is generally a legal tender.[1] The term money is applicable to anything that plays role as medium of exchange and store of value in the economy. This term includes items other than currency that are used as medium of exchange like gold and silver. However, conceptually currency has a relevance to money. The essential characteristic that distinguishes each from other is being a legal tender issued by the government and legal acceptance in the public. Yet, both are same in the sense that

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[1] Ismatullah, Dr, *Zar ka tahqiqi mutala* (Karachi: Idara tul Maarif, 2009), 45.

money, like currency, is used as medium of exchange for determining the value of commodities.

Narrow and Broader Concept of Money

Economists need to know the supply of money in the market for current and future decision to determine the path of the economy and to take necessary and timely decisions. For this purpose, they measure the amount of money circulating in the economy. But due to behavioral definition of money, they find it difficult to determine what money exactly is in our economy or which instrument is playing role that affects the economic activities.

It is because, if we have a look of our economic activities, we will find that there are many other instruments that are playing role like money. These instruments are used as medium of exchange and are, to some extent, generally accepted in the market. They also act as store of value for short-run. People frequently use them in their day today transactions. These instruments include traveler's checks, demand deposits and other checkable deposits. Should these financial instruments be included in the definition of money? There are two concepts.

One is orthodox concept, and the other is modern concept, also called narrow and broader concepts.

The basic concept of money as defined above is the orthodox monetary theory or narrow definition of money.[1] In which money is only in the form of currency in circulation, traveler's cheques, and demand deposits. Thus, money is associated with these two only. According to the orthodox concept or the narrow definition of money, supply and demand of money is measured by the currency circulating in the economy, traveler's cheques, and the demand deposits.

However, modern economists like Friedman and Schwartz, the famous economists, do not accept this definition of money. Their point of view is that money is not all that we have in our economy in the form of currency or demand deposits. They are of the view that, in modern economy, there are many other financial instruments, checks and promissory notes. At times, these financial instruments can be used as substitute for money as a short-run store of value and play their role just like currency. The economists of the modern era have included these financial instruments in money definition as well because, the circulation of these instruments

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[1] Handa, Jagdish, *Monetary economics* (New York: Routledge, 2nd edition), 6.

reflects the economic performance of a country and has an effect on the economy as whole. Therefore, their role and importance in predicting the future economic performance to make policies cannot be neglected.

According to them, there are categories of money which they call monetary aggregates. First category, which is called M1, includes currency and some instruments like demand deposits or cheque able deposits. These assets are money because they can be easily used as money.

The M2 aggregate includes M1 and some other financial instruments having features found in instruments included in M1. These assets or instruments are similar to currency because they are liquid enough to be converted into cash quickly and at a very low cost. These assets are saving deposits, money market deposits, and money market mutual fund share.

M3 Monetary aggregate consists of M2 and some other assets that are, to some extent, less liquid than those included in M2. These less liquid assets are large denomination time deposits and repurchase agreements, money market mutual fund share (institutional) Eurodollars.[1]

We can summarize the money aggregates as following:

M1, M2 and M3. Where:

- M1 is = currency+ traveler’s cheques+ demand deposits+ other chequeable deposits.
- M2 is =M1+ small denominations time deposits and repurchase agreements + money market mutual shares (non institutional

M3 is = M2+ large denominations time deposits and repurchase agreements+ Euro dollars

The Nature of Money

Goods that satisfy human needs are called economic goods. Usually, economic Goods are divided into two classes, consumption goods and production goods. Consumption goods are those that can directly satisfy human needs like eatables, clothes etc. These goods are consumed to fulfill humanitarian needs.

[1] Mishkin, *the economics of money, banking and financial markets*,40.

Production goods are goods used by industrial firms in manufacturing of consumption or finished goods. Thus, these goods do not directly fulfill the needs of mankind and are not consumed.

The question is which of the above mentioned two types include money. Does money lie under the category of consumption goods or production goods? This question arises because money cannot be put under consumption goods as it is not consumed and also difficult to put it under production goods because it has no intrinsic utility, while production goods have intrinsic utility.

According to many economists, money is a production good. It is obvious that they have put money under production goods as they did not have any other option. They cannot call it consumption good.

These economists restricted themselves to the two-fold division of the goods, consumption goods and production goods. One of the most famous economists who hold this view is Wilhelm Georg Fried rich Roscher.

Keynes, a famous economist has opposed the two-fold division view. According to Keyne’s point of view, money should not be put under any of the above mentioned two types. Rather, goods may be divided into three categories or may be classified into three classes, that are consumption goods, production goods and goods used as medium of exchange. He argues that money is not itself a production good and it is only a medium of exchange. The exchange of money for money does not produce anything. It is not an act of production.

Those who try to prove that money is production good do not provide a sound logical argument for what they claim. They have restricted themselves to two-fold division and thus have no option but to put money under production good.[1]

Those who maintain the view that money is a production good often use this type of division of goods in favor of permissibility and legitimacy of interest. They say that as money is production good therefore can be used to give birth to more money. Money can be exchanged for money to earn profit. But unfortunately, this point of view is not supported by any sound and logical argument.

Thus, money is neither a consumption good nor a production good, rather it is a medium of exchange.

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[1] Ludwing Won Mises, *The theory of Money and Credit*, trans. j.E. Batson (Alabama United States:LVMI Mises Institute, 2009) , 79.

1.2 Historical Development of Money

It is obvious from the aforementioned details that money is a complex social phenomenon with multiple dimensions and role. To better understand its characteristics that are reflected in its functional role and factors affecting them, there is need to have a look of its historical development. Its history is associated with three main continuous transitional phases. In its first phase there was a Barter System. In second phase there was commodity money system and in third Phase there was Metallic Money System. The third phase than witnessed several different stages through the history. Following the metallic money system, paper currency was introduced. With the passage of time and due to the technological developments electronic transactions has given birth to electronic money. This is record of money in computer system. Now, virtual currency has been introduced. In the following lines, an analysis of the historical development of money will be discussed.

1. Self Sufficient Tribal Societies:

In primitive Societies, the tribal people lived different life. They lived scattered in different areas in their terrain. It was a tribal society and was self sufficient. According to prevailing situation at that time, they would produce what they did need. They had no surplus commodities to sell or trade, hence did not need to enter any type of economic relationship with others. Every family of that society was self sufficient.

But the human being found it difficult to cater his all needs in isolation with others. They faced many difficulties and hurdles in their economic activities. At times some of them needed commodities which they could not arrange without the help of others. These difficulties and needs forced them to think about a different system to fulfill their economic needs.

2. Barter System

With the development of human societies, increase in the population, the growth of productive forces, the increasing needs of humankind and the expansion of the specializations, people started to produce surplus goods and became ready to provide services to others according to their needs, circumstances and economic environment. These factors caused a historical transition from self-sufficient society to specialization in production. However, circumstances of that era forced them to remain limited to the production of only one good. This was just like distribution of responsibilities within the family and within the tribal people. This specialization resulted in creation of economic relation between people and tribes.[1] People started to exchange commodities to fulfill their economic needs. They would sell the surplus commodity for what they did need. If A had rice and he needed wheat, he would look for a person who needed rice and had wheat for exchange for rice.

This system of exchange of goods for goods was known as barter system. In Arabic language the system of exchange of goods for goods is called *Muqayadha* as explained by the prominent Islamic jurist Ibn Aābidīn ash-Shāmī.[2]

However, the use of the barter system for exchange resulted in several difficulties that made this system unable to cope with the persistent economic development and continuous expansion of commercial activities. Some most important of these difficulties were the following:

1. lack of Double Coincidence of Wants:

Double coincidence of wants is a pre assumed condition in a barter system, that is, the desire of each party to obtain the commodity provided by the other party. Thus, each party demands the commodity of other party and provides his commodity to him.

Perhaps, this practice is possible when there are few parties in the market with a limited number of commodities. Then it can directly measure the compatibility of desires. But as the number of parties or the number of commodities needs to be exchanged increases, more and more difficulties are to be faced.

This contradiction of interest increases with an increase in the number of good available for sale in the market because when thousands of goods are produced and are available for sale, the exchange ratio of these goods will increase. The difficulty of double coincidence of wants increases with increasing ratio of the exchange that takes place in the market.

2. Lack of Common Measure of Value

One of the most complicated problems of the barter system is the lack of common measure of value. There is no common measure of value in this system on the basis of which, mutual exchange could be assessed. Even after finding a person

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[1] Sanosi, Dr.Ali, *Muhazarat Finnuqood wal sysa al naq dia* (Algeria:University of Muhammad Boudiaf Msaila, 2009), 5.

[2] Ibn Aābidīn, Muhammad Amīn ash-Shāmī , *Radd al-Muhtār 'ala al-Durr al-Mukhtār* (Beirut: Dar al-Fikr, 1992), 5: 129.

who is willing to exchange his commodity for a particular commodity, the problem of common measure of value exists. The Problem is what would be the exchange rate of each commodity for another? How to deal with various exchange rates of each commodity that itself is subject to change in characteristics of each commodity. The rate of each commodity may change with the change of season, environment, and place. A particular commodity may have a price in an area that is far high than its price in another area or city.

In the barter system, the value of each commodity in the market is not determined in a simple and easy way as a single quantity, but its value must be determined in relevance with other goods and services. This is much difficult task and perhaps impossible if there are thousands of goods and many types of services.

The purpose of specifying exchange rates is to find a simple and accurate method to measure the value of each commodity relative to other commodity.

3. Difficulty of Transfer of Wealth

There is difficulty of transfer of wealth from one place to another. Even if we assume the coincidence of wants and presence of an exchange rate, it is difficult to transfer goods or wealth from one place to another because of size and storage problem. There is risk of loss as well in transfer of wealth.[1]

4. Indivisibility of certain Goods:

One of the most prominent problems of the barter system is indivisibility of some goods. To complete the transaction in a barter system, the commodities should be equal in value. However, it rarely happens to be equal in every barter transaction. Any one of the two parties, who is entering into an exchange transaction, may need to divide its commodity into separate parts in order to complete the transaction. If a person wants to exchange his cow for goats, he must exchange his cow for example for 2 or 3 goats. He has no option to exchange his cow for three and half goats. The same situation may be faced by the person who wants to exchange his goats for a cow.

5. Difficulty in Storing Value:

Since ancient times, people used to store wealth for future use. Some commodities are perishable and other need space and time for look after. So, it was

[1] Muhammad Khalil Barhi and Ali Hafiz Mansoor, *Muqaddima Fi iqtisad Al Nuqood Wal Bunook,* (Cairo: Maktaba Nahza Al Sharq, 1982), 15.

difficult to prevent these commodities from loss and deterioration for a long period of time.

6. Difficulty in Making deferred Payment:

Another problem of the barter system is that it is difficult to make deferred payment. It is often impossible for the parties to agree on a specific commodity to be paid in future because the specifications of each commodity would be different from the other. Furthermore, the risk of unexpected change in value of the commodity to be paid in future is always there for both parties. [1]

Commodity Money System:

The difficulties resulted from the use of the barter system as mentioned above, led the people to think about a facilitator for transactions that could help them to overcome these difficulties and hurdles in exchange transaction. In order to address these issues, the people voluntarily would choose a commodity to use it as medium of exchange. Different types of commodities have been used in history as medium of exchange including iron, copper, corn, salt whale teeth, tobacco, fish feathers, snail shells leather gold, rice, cigarettes, beads, shells, spices, etc. In addition, every society and tribe has chosen the commodity that was best suited to its circumstances and was generally acceptable among all members of society.[2] The use of a specific commodity as medium of exchange was like a social contract among the people of societies.

In pastoral areas, livestock like camels, cows, and sheep were used as commodity money. In coastal areas, shells and moths that were extracted from the sea were used as medium of exchange. In the northern regions, animal skins and In the tropics, however hunting tools were used as medium of exchange.

The type of money adopted by a specific society or tribe reflects, to some extent, the civilization, inclinations, preferences, and standards of living of that particular society. It also tells us about the imaginations of ancient people.

This selected commodity was called “Commodity Money”. Commodity is something that has intrinsic value and can be used in production or can be consumed. This money was called commodity money because it had intrinsic value and could be

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[11] Muhammad Khalil Barhi and Ali Hafiz Mansoor, *Muqaddima Fi iqtisad Al Nuqood Wal Bunook*, 15.

[2] Miller, Roger LeRoy , VanHoose, David D, *Money, Banking and Financial Markets* (America: Cengage Learning, February 9, 2006), 13.

used for production or consumption. This type of money is probably the oldest type of money in the history of money.

The important point about commodity money is that its value is determined by its intrinsic value. It means the commodity itself becomes money. There is no need of any other process or approval from any authority to declare it as money or to change its status. It was an unwritten social contract among users of that commodity as medium of exchange.

However, commodity money system was able to overcome only some of the difficulties found in barter system. It only overcame the problem of double coincidence of wants and common measure of value. Furthermore, this system was not in line with the progressive changes and rapid economic development as it could only fulfill the needs of local trade because the commodity money of each tribe was not necessarily acceptable as medium of exchange for other tribe.[1]

Hence, People started to look for some other medium of exchange capable of minimizing the difficulties in exchange transactions and should face the rapid economic changes in the society.

Metallic Money System:

As societies advanced and people were able to get scarce metals like gold, silver and copper, they came to know that they could get rid of hurdles and difficulties of commodity money system by using these scarce metals as medium of exchange. These metals had some prominent characteristics. They were durable, portable and recognizable by everyone. It was easy to measure their purity, therefore could be used as a standard by weight and degree of purity. Precious metals of gold and silver occupied the forefront position in this use because of their qualities that made them outperform other minerals.

According to a prominent Islamic scholar Shāh Walīullāh al dahlwi people looked for precious and durable metals to be used as medium of exchange. The gold and silver were the most suitable of these precious metals, due to their durability, suitable size and similarity in their units.[2]

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[1] Ismatullah, *Zar ka Tahqiqi Mutala*, 47.
[2] Shāh Walīullāh, Quṭb-ud-Dīn Aḥmad Walīullāh, *Hujjatullah-il-Baligha* (beiruit: Dar Al-Jil,2005), 90.

These uniquenesses definitely make these metals risk free to be stored for future use because it was proved through physical experiments that these metals are divisible and can be melted for any purpose other than its use as medium of exchange.

Thus, the money moved to a more advanced stage, which is the stage of the metallic money.

Phases of Metallic Money:

Metallic money system has gone through several phases. These phases are being summarized in following points:

1.In the beginning, precious metals that are gold and silver, were used as medium of exchange in the form of ingots. These ingots were different form each other in size, weight, and purity. Even they were different in shape, like sometimes in the shape of utensils or jewelry etc. However, in mutual financial transaction, weight was important.

2. Yet there were some difficulties at this stage because the weighing process and checking the purity of gold and silver in each transaction was difficult in a society undergoing gradual economic changes and expansion.

As societies gradually progressed and developed, the government of various countries took the responsibility of issuance of coins as the formal medium of exchange. Therefore, since the onset of the industrial revolution, they have been the predominant commodity monies. In some countries or areas gold coins or silver coins were issued while in other countries and areas gold and silver both coins were issued to be used as medium of exchange, later, called Monometallism and bimetallism respectively[1]. These coins were equal in size, weight, and purity. To increase the level of confidence of the people on the issued coins and to guarantee their purity, weight, and size, they were stamped by the issuing authority. In other word they were stamped to ensure its conformity with legal specifications set by the government.

It is reported that the first who formally issued the coins was the king of Lydia Croesus in southern Asia in 7th Century BC and other countries followed him in issuance of coins. When the Greek civilization flourished, the Greek government issued gold coins called Darakhim, the word later arabicized as al Darahim. [2]

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[1] Akhtar.S.M and Dewett k.k. *Modern Economic Theory* (India: S.Chand Publishers, 1946), 314.
[2] Sara B.Pomeroy, et al, *A Brief history of Ancient Greece :Politics Society and Culture* (New York: Oxfor University Press, 2004), xvii---Almunayyah, Abdullah, *Al Warq An Naqdi Haqeeqatan wa Hukman(Saudi Arab:*1984), 25.

The value of each coin was equal to its metal content or to its intrinsic value. This system was called Gold Specie Standard.

In this system people were free to use these formal coins or use gold, silver, metal content in their day to day financial transactions. They were allowed to export and import these coins. Moreover, they were also free to convert the gold or silver they possessed into formally issued coins. So, people would get their gold bullions minted into coins through government minting houses. Also, people had right to convert their coins into bullions through these houses.

Countries with bi-metallic system had to determine exchange rate of gold and silver for exchange of gold coin for silver coins. These countries would use gold coins for high value financial transaction or large denominations while silver coins for normal transactions or smaller denominations.

Keeping in view their preferences and economic conditions, some countries adopted Bimetallic system while others mono metallic system. Later on, the use of gold coin prevailed in most parts of the world until the First World War 1914. While the use of silver coins was limited since late nineteenth century because of the excess supply and continuous decrease in the value of silver in national and international market. In some places they were used as a secondary medium of exchange along with gold coins.

3. Anyhow, now the money was at a stage where people had a trust in it and it could play its role as medium of exchange. Yet it was not capable enough to deal with the consistent economic developments and especially international trade.

This system has faced a problem. The problem was that the rate of exchange that was fixed by the issuing authority for exchange of gold coins and silver coins was not same in every area or country. Different countries fixed different exchange rates for exchange of gold and silver coins. This difference of rate of exchange resulted in trading of currencies in market as it was a source of profit for these traders. For example, in America the rate of gold coin was 15 silver coins. While at the same time rate of gold coin in Europe was 15.5 silver coins. People started to purchase gold coins from America and would sell them in Europe for silver coins. They would sell again these coins in America to earn profit in both places.[1]

In this way most part of the gold was transferred from America to Europe.

[1] Ismatullah, *Zar ka Tahqiqi Mutala*, 49.

Due to the above mentioned situation, America changed the exchange rate for gold and silver coins in 1834. The new determined rate was 16 silver coins for 1 gold coin. Now the situation was reversed. The traders shifted the gold from Europe to America through currency trade.

Another problem in metallic money system was risk in carrying these coins and transferring them during national and international trade. There was risk of loss and theft. Furthermore, those who wanted to save these coins for future use were afraid of its damage, theft and wear and tear with the passage of time.

To avoid these disadvantages of use of coins, People would deposit their coins with goldsmiths and Money changers. In response they would issue a receipt for the coins deposited with them as a proof of owing the coins to be payable to the receipt bearer. Furthermore, the merchants in most of their commercial travels would prefer to travel without money with them. For this purpose, they would prefer to deposit their coins with a local merchant and would receive a receipt of the same. They would take this receipt as a traveler cheque to their destination and would present it to the person who would accept this cheque because of good financial reputation of the issuer of this receipt.

Over the time, the people's level of trust on these receipts increased and they started to exchange these receipts among them in financial transactions instead of using coins. In this way these receipts became a medium of exchange in day to day transactions. General public would accept these receipts because they had trust in the issuer of these receipts.[1] Their general acceptability increased with an increase in its use and level of trust of the people. This was the simple beginning of the paper currency. In this stage the issuer would specify the person who had right to resort to the issuer for encashment of the receipt. We can call it the first phase of the paper currency.

It is believed that the first formal paper currency was issued in 7th century in china during the era of Xuantong, one of the emperors of China in the ninth century AD and this process of issuance of paper currency continued during the era of kings of China who followed Emperor Xuantong.

4. In second phase of paper currency, the goldsmiths and money changers who were the issuers of receipts began to issue these receipts without specifying the name

[1]Almunayyah, *Al Warq An Naqdi Haqeeqatan wa Hukman*, 25.

of holder of this receipt which means that anyone holding this receipt had the right to receive gold or silver coins from the issuer. This was due to the frequent use of these receipts in the market. However, they were issued against the coins deposited with the issuer.

5. As the circulation of these receipts increased in the market and issuers of these receipts were did know the level of trust of people in them, their economic concept about these receipts changed. Through the previous practice and experience, goldsmiths and money changers were sure that depositors do not come at once to demand the conversion of paper instruments into precious metals and that a large part of these metals remains unused in their wallets. So, they issued more receipts against the already available volume of gold and/or silver. The value of these receipts was greater than the volume of coins deposited with them.[1]

6. Some money changers availed this opportunity of issuing these instruments to achieve the maximum possible profit. Eventually, the amount of these paper notes increased significantly from the precious metals that were considered a cover for them, which led to high prices in the market. Furthermore, in some cases, some of these goldsmiths and money-changers were unable to meet the requests of the depositors of converting these paper instruments into gold and silver. This situation undermined the confidence of individuals in these receipts and rendered the financial transactions uncertain. Hence the behavior of the public caused the government intervention in the matter.

Later on, the government specified some institutions like commercial banks to issue these receipts that were called bank notes. Goldsmiths and money changers were banned to issue them. The banks were obligated to issue these notes only against the amount of gold deposited to them. These notes were convertible into gold. The bearer of this note had right to encash the note and receive gold bullion on demand. Therefore, this system was called gold bullion standard.

Perhaps, Stock home bank of Sweden is the first bank formally issued the bank note. In 1833 when the circulation of these banks' notes increased, the government declared it as legal tender. Now its acceptance as medium of exchange in any financial transaction or obligation was compulsory. The authority of issuing

[1] Almunayyah, *Al Warq An Naqdi Haqeeqatan wa Hukman*, 25.

currency was conferred to central bank only. The specified institution or commercial banks were banned to issue them.

To keep pace with rapid economic growth, in 19the century, the governments needed more resources to fulfill their responsibilities towards people of its country. Especially the development projects in the country demanded large financial flows. Moreover, the government had to meet their expenses for financing civil wars.

For this purpose, more bank notes were issued against the same quantity of gold. The ratio of gold against the issued currency became less than the already settled ratio. With the passage of time ratio of gold against currency in circulation decreased. Now the most part of the currency in circulation was not backed by gold. Although as per law the government was obligated to convert the currency to gold if demanded so by anyone of the holder of the currency, yet the government believed that there will be no demand or less demand for conversion due to the trust of people in currency issued by the government.

The bank of England allowed the authorized note issuing institutions to issue fourteen million pound sterling without gold reserves.

As time passed, the circulation of these bank notes, that were partially covered or backed by the gold, increased exponentially and the ratio of gold against the issued currency decreased. The government felt that it may default because it was unable to redeem these bank notes.

To deal with this situation, governments of many countries imposed conditions on conversion of these notes into bullions. For example, the bank of England, on the break of First World War, stopped and refused the conversion of notes into bullions. Later, in 1925, the bank once again allowed the conversion for those who wanted to convert at least 1,700 ponds. Any demand for conversion of less than this amount was not acceptable[1]. As a result of this condition, most of the people became unable to convert their notes into bullions as 1,700 ponds was huge amount at that time. However, this condition did not affect the confidence of the people on these notes and they continued to accept these notes as medium of exchange as these notes were generally acceptable and played the same role in national trade and earning profit.

[1] Almunayyah, *Al Warq An Naqdi Haqeeqatan wa Hukman*, 92.

In 1931 the gold standard system was totally abandoned. The government of England, due to financial crises and huge unemployment, changed the law. Now conversion of these bank notes into gold bullion was stopped even for those who presented 1,700 pounds for conversion. The bank of England was now unable to redeem a small part of the issued notes. The same step was taken by America in 1934. Now circulating notes, being a legal tender, would derive their value only form law.[1] This unconvertible money was called fiat money.

However, yet at international level, in transactions between countries, every country continued to allow foreign government to exchange its currency for gold. For example, if America would receive some sterling ponds in international market and wanted to convert them into gold bullions, England was obligated to convert it.[2]

Although, conversion of banknotes into gold was banned by the governments for their own people, however the currency was partially backed by gold reserves.

Breton Wood Agreement and the Establishment of IMF

7. In 1944, Breton wood agreement was signed. As per the provisions of this agreement It was agreed to declare gold as a reserve for issuance of currency. Moreover, according to the Breton wood agreement an international monetary fund (IMF) was established. It started its financial activities on 1 march, 1947. One of its responsibilities was to monitor the international monetary system of the member countries and to implement the Breton wood agreement. IMF set out guidelines for a fixed exchange rate. This rate was 35 US dollars for one ounce of Gold. It was also agreed that only US dollar would be redeemable. In other words, only us dollar could be converted into gold and no other currency had this right. It was, astonishingly, an integral part of the Breton wood agreement. The member countries were obligated to keep reserves in the form of gold and in the form of US dollar, as US dollar was redeemable or convertible into gold, against currency according to already set fixed exchange rate. Thus, all currencies were tied to US dollar and US dollar was tied to gold.[3]

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[1] Ludwing Won Mises, *The theory of Money and Credit*, trans. j.E. Batson, 16.
[2] Ismatullah,Dr, *Zar ka tahqiqi mutala*, 53.
[3] Gupta, C.B, *International busines* (New Dehli: S.chand publishing, Ram Nagra, 2014),122.

The End of Gold Standard

8. This situation continued for decades until 15th august, 1971, when America, abruptly refused to allow foreign governments to exchange the dollar for gold and announced that any demand for exchange of gold for dollar would no longer be honored, thereby completely abandoning the gold standard. The journey of gold standard came to an end. America took this step due to the considerable depreciation in dollar price, financial crises, and continuous demand from other countries for exchange of gold for dollar.

Introduction of Special Drawing Rights

To meet the shortage of funds for foreign payments, IMF also introduced Special drawing rights (SDR). SDR was artificial money consisted of a basket of major currencies. The member countries had right to avail this facility for current account deficit.

The member countries agreed to use SDR as a reserve for their currencies. The agreement of IMF was amended. Now there was no fixed exchange rate. Every member country was free to choose its own exchange rate system.

Eventually, the relationship of gold and currency also came to an end. Now the currency derives its value from law and its value is determined relative to other currencies in the market through demand and supply rules.[1]

Virtual Currency

The word virtual here refers to digital currency that are created in computer system through solving logarithmic formulas and puzzles. These currencies have no physical existence.

In the last few years, new technologies are driving transformational changes in the global economic system. These technologies are supported by developments and advances in encryption and networking computing. The ways and mechanisms of exchange of goods and services have also witnessed such technological developments. The mainstream banking system has adopted computer system to use digital cash and make transactions through electronic money. The payments are made through electronic transfer of cash from one account to another. These transactions that take place between individuals and financial institutions are supervised and

[1] Gupta, C.B, *International business*, 124.

settled by a centralized banking network like SWIFT network. This centralized system is necessary to avoid manipulations in transactions as there is possibility of spending the same funds multiple times. However, this is costly and is managed through a centralized banking network.

During last few decades, some economists thought that to minimize the transaction cost, the role of centralized banking system must be replaced by a new system in which transactions do not need any intermediary and centralized banking system. This system must be able to make it extremely difficult to fraudulently manipulate transactions. This idea has given rise to the use block chain technology.

In modern world digital currency is in the form of crypto currency. The word crypto refers to encryption on which this digital instrument is built and then added to the block chain database. One of the famous crypto currencies is Bit coin. Bitcoin is used through block chain database. The system of block chain was envisaged and developed by Satoshi. [1] Actually, the system of block chain keeps the records of the circulation of bitcoin. This system is used to avoid the use of same funds in more than one transaction.

The European Central Bank has defined virtual currency as

"A digital representation of value that is neither issued by a central bank or a public authority, nor necessarily attached to a fiat money or currency, but is accepted by natural or legal persons as a means of payment and can be transferred, stored or traded electronically"[2]

This is a clear and precise definition of crypto currency.

International Monetary Fund has defined virtual currency as under:

"VCs are digital representations of value issued by private developers and denominated in their own unit of account"[3]

Thus, virtual currency is a digital representation of value. This is not a legal tender and not backed by any asset. This is developed by private developers, not issued, and not guaranteed by any government.

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[1] Satoshi, Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System*, 1.

[2] The European Central Bank, *Virtual currency schemes: a further analysis (2015)* (Germany: The European Central Bank eurosystem, 2015) , 10.

[3] International Monetary Fund: *Virtual Currencies and Beyond: Initial Considerations* (Washington ,US: 2016) ,7.

Blockchain System:

Blockchain system is a system which connects many computer systems with each other and ensures manipulation in transaction eliminating the double-spend problem. This process is done through cryptography of public key. Each user of the system or the agent is provided with two keys. One is private key and the other is public. Private key is used like a password in these digital transactions and public key is used like a bank account number. Block chain provides the service of a public ledger containing the record of all bitcoin transaction that have ever been performed.[1]

Virtual currencies use this block chain system to ensure fairness in the transaction and it is impossible to perform a secret transaction. It also ensures anonymity because there is no link between the wallet address of the holder of the virtual currency and his personal identity, hence, the transaction stays anonymous.

Thus, blockchain is database that keeps the record of all transactions of virtual currency.

Bitcoin

Bitcoin is a most successful type of crypto currency in blockchain system. It has emerged in recent years and has received a great deal of attention of the people at international level. Bitcoin is mad through precise systematic mathematical puzzles and calculations.it has a database in which its transaction record is stored and saved.

How can a person get a bitcoin? It can be owned by anyone physical or legal person. A person who wants to own it just needs to download the relevant software and install the programs. This software will allow him to have a wallet to store the bitcoin inside this wallet. He can purchase bitcoin against fiat money like Rupee, Riyal and U.S dollars.

Bitcoin may also be generated by downloading special software and installing the relevant programs. The person who wants to get bitcoin has to solve the mathematical puzzles, calculations and equations called hash and are generated by the bitcoin system.

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[1] Marc Pilkington, *Blockchain Technology: Principles and Applications*, Research Handbook on Digital Transformations, ed. F. Xavier Olleros and Majlinda Zhegu. Edward Elgar (Edward Elgar Publishing, 2015) , 4.

If he solves the hash he will be rewarded by a bitcoin. The process of generating bitcoin is called mining; the word gives the impression of mining something valuable like gold. Too much time and large amount of electricity is required to be consumed in mining process.

1.3 Kinds of Money

Money can be broadly classified into money and credit money. Money can further be classified into metallic money and paper money. Metallic money is classified into metallic standard and metallic currency. There are two kinds of metallic currency, full bodied and token. Each of full bodied and token may be in the form of limited legal tender or unlimited legal tender. On the other hand, metallic standard can be classified into monometallism and Bi-mettallism. While paper money is classified into paper currency and paper standard. Paper currency may be divided into convertible and inconvertible.[1]

As for as the matter of Credit money or Credit instruments is concerned, it may be classified into three basic kinds, Cheque, Drafts and Bill of Exchange.[2] Another classification of money is that it can be divided into three kinds. These are Commodity money, Representative money, and Fiat Money.

Now, in the following lines, the concept of each kind of money will be discussed. We have shed light on the concept of money. We can summarize detail about concept of money that Money is anything that is generally accepted as medium of exchange and store of value. Money may be divided into Metallic and Paper money.

1. Metallic Money and Paper Money

Metallic Money:

Metallic Money is money made up of precious metals, also called coin and is stamped by the issuing authority. In other words, they are stamped to ensure its conformity with legal specifications including purity and weight. To save these coins from deterioration higher value coins were milled.

Metallic Money is further divided into Metallic Standard and Metallic Currency.

Metallic Currency is a type of money made up of precious metal like gold and silver formally stamped by the issuing authority. If the face value of the coin or metallic currency is equal to the metal it contained, it is called full bodied money. If the face value of the coin or the metallic currency is higher than the metal it contained, it is called token coin.

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[1] Akhtar.S.M and Dewett k.k. *Modern Economic Theory*, 310.

[2] AlJaeed, Satr Bin thob, *Ahkam ul Awraq Al tijariyyah* (Taef Makkah: al Siddique Publisher, First Edition), 22.

Token coins are issued because there is less risk and are useful for the economy. If the face value of a coin is equal to its intrinsic value, there will be risk of hoarding and melting. People will melt them to use it for any other purpose and or hoard them for future use. In this way the necessary circulation of these coins in the economy will be disturbed and monetary policy will be affected. In this situation, the government has to issue new coins to ensure the adequate volume of coins in the market. Therefore, to avoid the risk of melting and hoarding, token coins are preferred as compared to full bodied coins.

2. Unlimited and limited legal Tender:

Each of full bodied coin and token coin may be limited legal tender or unlimited legal tender.

Legal tender means it is legally binding to accept it as medium of exchange in deferred payment or Debts. If a person denies accepting this currency as medium of exchange, his behavior would be considered against the prevailing law of the land.

Defining the legal tender, it is said that debts can be legally paid in this type of money. The question is why it is legally binding to accept it in deferred payment and not in spot payment.

It is because in an exchange transaction where both parties fulfill their obligations immediately and both cash and the subject matter is delivered on the spot, there is no need of judicial intervention. The parties may agree on mutual exchange of any type of good or commodity. They may exchange commodity for commodity or commodity for a generally acceptable medium of exchange. The intervention of legal tender is not necessary in every exchange transaction, as it is customary business practice to accept money substitutes in business transactions.

However, if one party fulfills his obligation under the exchange transaction while the other party promises to pay in future and the exchange is of a present good for a future good, then it may happen that one party may fail to fulfill his obligation under the contract. Now the law will intervene. The law has to decide that what is to be meant by money in financial transactions that is to be paid in future. The law will determine the money or legal medium of payment to be paid in a future date to fulfill obligation under a transaction to avoid any disputes between the parties that may arise in future in the settlement of debts. This is because every medium of exchange is not a legal tender, therefore if a person refuses to accept cheque in settlement of a debt, he has right to do so because cheque is medium of exchange but not legal tender or legal medium of payment.

Thus, legal tender is money that is declared as medium of payment in deferred payments. [1]

Unlimited legal tender is a kind of money through which any amount of debt can be paid. There is no limit of payment in this type of money. While limited legal tender is a kind of money through which only limited payment may be made. For instance, twenty four *anna* pieces or eight *anna* pieces were limited legal tender because legally only limited amount of debt can be paid through these pieces.

3. Standard Money:

Nowadays money consists of some specified units and has a definite significance in terms of value. Therefore, the concept of money standard is that by “money” we mean here the token as discussed above. It represents the units that function as a measure of value. While we mean by “standard” the units of value adopted as measure of value. Thus, standard money is that through which the value of other kinds and forms of money is measured. [2] The example is the Pakistani rupee before 1970 was gold standard money. The value of rupee was measured by the gold.

The selected metal may be a precious metal like gold and silver called gold standard or silver standard, respectively. Sometimes the money standard may be in the form a foreign currency. For instance, dollar has been used as money standard for rupee after 1947. In this situation the country will fix the exchange rate between the foreign currency and local currency.

4. Paper Money:

The term paper money refers to money in the form of paper issued by the government and generally acceptable as a medium of exchange.[3] Paper money may be representative money or may be a legal tender or fiat money. In other words, it may be convertible into standard coin or currency or may be uncover table. So the unconvertible is called the legal tender because it derives its value from law and the issuing authority while its intrinsic value is far low than its face value.[4]

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[1] Mises, *The theory of Money and Credit*, 69.
[2] Ibid: 63
[3]Akhtar.S.M and Dewett k.k, *Modern Economic Theory*, 312.
[4]AlJaeed, *Ahkam ul Awraq Al tijariyyah*, 58.

For example, Pakistani rupee is unconvertible into standard gold. However, there is a promise on these currency notes that the government will pay the bearer of this note on demand and that this note is issued with guarantee of the government. This promise is just for the trust of the people in this note so that they may use it as a medium of exchange without any hesitation or uncertainty.

5. Commodity, Representative and Fiat Money

Another classification of money is that money may be a commodity or may a representative of valuable commodity or may be in the form of fiat money.

a. Commodity Money:

Any valuable commodity or precious metal that is used as medium of exchange is called commodity money. Its face value is equal to its intrinsic value. Different types of commodities have been used in history as medium of exchange including copper, iron, teeth, salt, spices, tobacco, corn, rice, whale, fish feathers, gold, cigarettes, snail shells, leather, beads, shells etc. Every society and tribe has chosen the commodity that was best suited to its circumstances and was generally acceptable among all members of society.[1]

b. Representative Money:

Representative money is money that represents valuable commodity or precious metal. Its own value is less than its intrinsic value and is easily convertible into the metal represented by this money. For example, convertible paper money or convertible metal money is the example of representative money.

c. Fiat Money:

Fiat money is money that has value higher than its intrinsic value but is not convertible into precious metal. It derives its value from the law and by the guarantee of the issuing authority. Today most currencies of different countries are the examples of Fiat money.

6. Electronic Money:

Electronic money refers to a type of money that exists in electronic form in the computer system of bank only and is used to facilitate electronic transaction. This development is due to the advancement in the technology. However, this currency is backed by fiat money that distinguishes it from crypto currency. Electronic money

[1] Miller, Roger LeRoy , VanHoose, David D, *Money, Banking and Financial Markets*, 13.

exists in form of debit card stored value card and e-cash. The use of this money helps in cashless transaction hence diminishing the use of physical cash.[1]

7. Virtual Currency

Virtual currency is a digital representation of value. This is not a legal tender and not backed by any asset. This is developed by private developers and not issued and not guaranteed by any government.

In modern world digital currency is in the form of crypto currency. The word crypto refers to encryption on which this digital instrument is built and then added to the block chain database. One of the famous crypto currencies is Bit coin. Bitcoin is used through block chain database. The system of block chain was envisaged and developed by Satoshi. [2] Actually, the system of block chain keeps the records of the circulation of bitcoin. This system is used to avoid the use of same funds in more than one transaction.

The European Central Bank has defined virtual currency as

"A digital representation of value that is neither issued by a central bank or a *public authority, nor necessarily attached to a fiat money or currency, but is accepted by natural or legal persons as a means of payment and can be transferred, stored or traded electronically"*[3]

This is precise and clear definition of virtual currency.

8. Credit Money or Bank money:

In the modern economies there are some other instruments that play their role like money plays, but they are not considered money as they are not generally as acceptable as money is. However, they can be called medium of exchange or credit instruments or credit money. Some economists like Mises, Ludwig von also call them bank money.

Credit means a good opinion about a person's integrity, ability and virtue. However, in economics it refers to a confidence in a person's ability to pay. Credit money is a kind of money that constitutes a claim against a physical or a legal person.[4]

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[1] . Mishkin, *the Economics. of money Banking and financial markets*, 48.
[2] Satoshi, *Bitcoin: A Peer-to-Peer Electronic Cash System*, 1.
[3] The European Central Bank, *Virtual currency schemes: a further analysis (2015)*,14.
[4] Mises, *The theory of money and Credit*, 61.

Another definition of credit money is “these are written legal instruments including an obligation to pay a specific amount of money at a specific time. The right to receive the amount may be transferred by endorsement or handing over”.[1]

The main forms of credit money are bill of exchange, Bonds, Chaques, Promissory Note and Draft.

Bill of exchange:

it is an order payable at a fixed time or on demand issued by one person the creditor or drawer in favor of another person the debtor or drawee to pay a certain amount written on the bill to bearer or to third person.

There are three parties in bill of exchange. The drawee is the party who is responsible to pay the amount specified by the bill of exchange. The payee is the one who receives the amount written on the bill. The drawer is the third party that obligates the drawee to pay the specified amount to payee.

This instrument helps in deferred payments due to its legal status that ensures the payment in future dates. It is also a medium of payment and helps in payment without carrying money from one place to another. Its maturity period is normally 1 month to 3 months. However, an international the maturity period of a bill of exchange may be 6 months. During this period, it is transferred by way of discounting or endorsement and becomes a negotiable instrument.

Cheque:

Cheque is a written dated and signed order to the bank to pay a sum by a person who is the client of the bank and has an amount equal or greater than the sum of cheque in his account with the bank.[2]

The word check is derived from the “Suk’ which is a credit instrument. The check is a document that includes a written order in which the drawer requests the drawee (the bank) to pay as soon as he receives it a certain amount of money to a certain authorized person or bearer.[3]

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[1] Shafi, Muhammad Zakkin, *Muqaddima Fi alnuqood wal bunook* (beruite: dar ul Nahza Alarabiyya, 7th edition), 43.--- Shabbier, Muhammad Usman, *almuamalat almaliyya alasriyyah fil Fiqh al Islami*, (Jordan: Dar ul Nafais, 2007), 238.
[2] Akhtar.S.M and Dewett k.k. *Modern Economic Theory*, 341.
[3] Shabbier, *almuamalat almaliyya alasriyyah fil Fiqh al Islami*, 243.

There are three parties in cheque. One who has an account in the bank with sufficient amount in it for payment against the cheque issued. Second party is the bank who will pay the amount and third party the receiver of the amount or the payee.

Promissory Note:

A promissory note is a written instrument, according to a legally defined form that includes an obligation of a certain person called the issuer to promise to pay a certain amount on a specific future date to a certain authorized person or the beneficiary.[1]

Draft

draft is also a kind of credit money. It is a cheque that is drawn by one bank upon another. It is used for remittances.[2] For example, if A lives in Islamabad and wants to send an amount to his relative B in Karachi he may go to a bank and give the bank the amount to be sent to Karachi. The bank will receive the amount and give the sender A a draft addressed to a bank in Karachi working as an agent of the bank in Islamabad. B will present this draft to the bank in Karachi and will receive the amount.

Difference between Bill of Exchange and Cheque:

A bill of exchange may be drawn on anyone who is ready to accept it however cheque can be drawn only on a bank. Unlike a bill of exchange, it can be crossed to deposit in account maintained with the bank.

Difference Between Promissory Note and Bill of Exchange:

In bill of exchange there are three parties, drawer, drawer and payee. In promissory note there are only two parties, drawer, and payee. The liability of drawer of a bill of exchange is secondary and conditional while the liability of drawer of promissory note is primary and absolute. Furthermore, bill of exchange is an order to pay while promissory note is a promise to pay. The acceptance of bill of exchange is a presumed condition while there is no need to accept the promissory note by the other party. Bill of exchange may be drawn by a foreigner and used at international level while the promissory note is issued and used at national level.

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[1] Shabbier, *almuamalat almaliyya alasriyyah fil Fiqh al Islami*, 242.

[2] Akhtar.S.M and Dewett k.k. *Modern Economic Theory*, 343.

Difference Between Promissory Note and Cheque:

The significant difference between Promissory note and cheque is that promissory note is a promise to pay while cheque is an order to pay. Unlike promissory note in cheque there are three parties.

Functions of Money

Money is a facilitator that helps to increase transaction volumes in the economy by increasing the circulation of goods and services. Moreover, it also helps in credit transactions that lead to an increase in the volume of trade in the economy. Thus, money plays an important role in enhancing the economic activities.

The money plays its role as generally acceptable medium of exchange, store of value, unit of account, and medium of deferred payments., we will discuss each of these functions in the following lines in order to have a deep examination of its role in the economy.

Medium of Exchange:

As money is a liquid asset and there is no transaction cost on it therefore it is easily and preferably used as a medium of exchange in the market. Transaction cost is the time spent in exchange of goods or services. In the absence of money, which is the medium of exchange, barter system would be adopted for exchange of goods and services. As we know the invention of money is the result of the hurdles faced in the barter system. One of these inconveniences was lack of double coincidence.

Now the money plays its role as medium of exchange. It is used to pay for goods and services. if a person who has a car and wants to purchase a horse does not need to look for a person who has horse and want to purchase car. He just has to look for a person willing to purchase a car. Similarly, problems of indivisibility of the barter system are also eliminated because money has different units of all denominations with different values easily compatible with the price of any good or service offered for sale. After the invention of money people are easy to purchase anything at any time and of any quantity of various kinds and various combinations. The use of medium of exchange has reduced the cost of transaction by eliminating the problem of time that was spent in exchange of goods and services.

It has also provided the opportunity to the people to specialize in what they do best because they can get other goods and services from other people by using this medium of exchange.[1]

This function is called medium of exchange but does, in modern context, this term apply on transactions made through credit cards? Obviously, in this transaction it

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[1] Mishkin, *Economics. of money Banking and financial markets*, 45.--- Shabbier, almuamalat almaliyya *alasriyyah fil Fiqh al Islami*, 154.

cannot be called medium of exchange because there is no exchange. Therefore, it should be called medium of payment rather than medium of exchange.

According to some economists the function of medium of exchange is the basic and primary function of the money. Other functions are considered secondary functions.[1] Therefore they are of the view that anything that lacks this role in the economy cannot be designated as money. Nowadays in a developed economy there is main medium of exchange along with other secondary mediums like other financial instrument that play their role like a medium of exchange.[2]

Unit of Account:

The value of goods and services is measured in term of money. It is used as common measure of values of economic goods and services to determine the ratio of the value of each good or service as compared to other good or service. This role of money as unit of account facilitates the process of exchange of goods and services and measurement of their values. Money is used for the measurement of value of goods and services just as we measure distance in miles, weight in Kilo Grams and size is measured in cubic meters.

As we noted that one of the main problems of the barter system was lack of common measure of value to be used as a scale to measure the value of other goods and services. There was no common measure of value in this system on the basis of which the mutual exchange could be assessed. The problem was that there was no exchange rate of each commodity for another? It was too difficult to deal with various exchange rates of each commodity that itself is subject to change in characteristics of each commodity.

For example, in barter system we assume an economy with only three commodities. These are apple, mango, and banana. So, to determine the price of apple its exchange rate will be determined as compared to mango and banana thus the price of an apple, for example is equal to three mangoes or four bananas. It means that price of each of three items would be expressed in two different ways. If we assume that there are 10 goods than there will be 45 prices in order to exchange one good for another. If there are 100 goods in an economy, there would be 4,950 prices for each good if we need an exchange of that good for another. So, what about an economy with thousands of goods?

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[1] Mises, *The theory of Money and Credit*, 79.
[2] Handa, *Monetary economics*, 5.

The importance of the role of money as unit of account is obvious when we have a look of these complicated accounts that appear in the absence of a common measure of value. The problem is more complicated when we take into consideration the rate of each commodity that is subject to change with the change of season, environment, and place. A particular commodity may have a price in an area that is far high than its price in another area or city.

A famous economist Mises Von has denied the role of money as measure of value. He, applying the subjective theory of money, says that value of anything cannot be measured. Adding that value of everything is not inherent rather it is different for every person.[1] The value of an object may increase or decrease with change of owner, place and season. A car, offered for sale, is more valuable to a person willing to purchase and less valuable for seller and after some time the situation may be reversed for the same car. The value can be determined in relevance with other good or service. However, it cannot always be measured.

After establishing the argument that value cannot be measured, Von says that role of money here is limited to expression of price of everything. It only expresses the price and not measures the value that is a subjective phenomenon. He holds the view that money plays its role as price index and not as common measure of value.

However, on the contrary most of the economists are of the view that money is a common measure of value and a standard value as well.[2]

Therefore, it is better to declare money as unit account or unit of expression of prices rather calling it measure or standard of value. As money does not measure it just expresses the price of each commodity. This is because we cannot compare the role of money as standard of value with, for example, Gram as a measure of weight. There is no change in Gram as a scale for weight however the purchasing power of money changes with time.

1. Store of Value:

The other basic function of money referred in the above definition is the ability to store the value for future use. It means that the purchasing power is stored between the times income is received until the time it is spent. This feature of money is definitely very important because most of the people after generating income do not

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[1] Mises, *The theory of Money and Credit*, 47.

[2] Mishkin, *the Economics. of money Banking and financial markets*, 46.----- Handa, *Monetary economics*, 5.

want to spend the money, rather they want to wait and spend it when they desire or need to purchase something. Money performs this service to enable the person to keep a portion of his income in cash form.

The value may be stored in other forms as well, like in the form of goods, bonds and property. These assets, in most of the times, pay more to the owner as their prices appreciate with the passage of time. However, there are two reasons for why people prefer to store their value in the form of money.

Firstly, it is difficult to store value in the form of goods Because of risk involved in their care and look after. There are goods that may get damaged and some of them cannot be preserved for a long time.

Secondly, everyone wants to save value for future use and for emergency expenses. If the value is stored in the form of goods like real assets, it will not be easily convertible into cash. If someone needs to pay his bills or to pay for expenses of hospital and he has a house, he cannot easily convert this asset into cash. He needs time and must bear cost in order to change the asset into cash. Cost may be in the form of commission paid to the dealer and in the form of compromise on the price that is to sell the property at a price lower than the market price. These goods are not liquid enough to be converted into desired good or service without spending enough time and facing hurdles in this process. The characteristic of liquidity means the ease and speed with which the asset may be exchanged to get the desired good or service at a specific time.

For this reason, people will prefer to save their value and purchasing power in the form of money. That is the most liquid asset and can be directly used for payment without involving another transaction as required in other assets.

It is worth mentioning her, that this function of money is assumed true when the purchasing power and price levels are stable and there is no significant change in the supply and demand in the market. In this situation it is preferred to store value in the form of money. However, if the currency depreciates and price level increases rapidly in the markets, then the people will be reluctant to save value in the form of money. The money will lose its importance as store of value.

It will not be inappropriate to quote here the market situation after First World War in Germany and in many other countries when a great general price deflation occurred, and the price level had risen by hundreds of times. A very high quantity of money needed to purchase an item. People started barter system and no one wanted to keep money with him.

Thus, money enables us to calculate the actual and potential costs and benefits, debts, prices, profits, and losses.[1]

Standard of Deferred Payment:

we have discussed above that money plays its role as medium of exchange. This exchange may be at spot where both parties fulfil their obligations immediately after the sale purchase agreement or one party may fulfill his obligation and the other party promises to fulfill his obligation in some future date. Thus, money is a medium of exchange for spot payment and as well as for future payment.

So, its role is as important in future payment as in spot payments.

Therefore, many economists do not highlight this function separately and consider this function under medium of exchange.[2] Some other economist like Mishkin, even did not mention this function of money at all.

However, its role in defer payments is important because the defer payments are integral part of the modern economy.

Although debts may be repaid in shape of goods or property as well, but in this way, it will be difficult to settle debts. Because the debtor may not feel easy to receive his debt in shape of goods or property. Even sometimes he will be reluctant to lend money if he thinks he will be repaid in shape of goods or services. The reason behind this behavior about lending money is that he may not need this specific good, he has at a later stage, because its season would be passed at the time of repayment by the debtor. Furthermore, the risk of devaluation is always there. Although there is risk of devaluation of money as well, but the percentage of its devolution can be forecasted easily unlike other goods.[3]

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[1] Ahmad Hassan, *Al auraq al Naqdiyya Filiqtsad Al Islami* (Beirut: Darul FIkr,1999), 52.
Akhtar.S.M and Dewett k.k., *Modern Economic Theory*, 307.
[2] Mises, *The theory of Money and Credit*, 35.
[3] Shabbier, *almuamalat almaliyya alasriyyah fil Fiqh al Islami*,155.

1.4 Islamic Concept of Money

Money has received a great deal of attention among Muslim jurists, because of its relevance to shariah issues such as zakat, usury, and sale, etc. These issues are definitely of great importance for all Muslims. Therefore, it is important to understand the classical concept of money as envisaged by early Muslim Jurists and their different point of views about the application of the term money. In following lines, the concept and conditions of money according to modern Muslim Jurist and emergence of Islamic currency will be discussed. This study will also cover the comparative study of the role and functions of money in both conventional and Islamic economics system. Most of the functions mentioned by the modern economists have been discussed by the early Muslim Jurists in detail.

Early Muslim Jurists and Money

Keeping in view the evolution of money and many other historical considerations, we find that some Muslim jurists divided money into two kinds.

1. Natural Money or real Money or Athman Mutlaqah
2. Constructive Money or Athman Muqayyadah

This classification is obvious from the texts of the different books of Muslim Jurists. For example, imam Zailaee syas:

أَنَّ الْفُلُوسَ لَيْسَتْ بِأَثْمَانٍ خِلْقَةً......... بِخِلَافِ الدَّرَاهِمِ وَالدَّنَانِيرِ؛ لِأَنَّ ثَمَنِيَّتَهَا بِأَصْلِ الْخِلْقَةِ فَلَا تَبْطُلُ بِالِاصْطِلَاحِ[1]

Contrary to the Gold and Silver coins, copper coins are not natural money, because gold and silver coins are money by nature. Therefore, any type of general consent cannot nullify their status.

Linguistic Meaning of Naqd (نقد):

In Arabic literature the word Naqd (نقد) is used for Money. Its plural is Nuqood نقود. It is used for different meanings. Literally it means distinguishing or separation of fine coins of dirham from gold or silver coins mixed with inferior metals. This term is also used for spot payment and for gold and silver coins itself as well.[2]

We do not find the word (نقد) in the text o f Quran or Hadith of the prophet SAW. The reason is that the people of Arabian Peninsula used the word “Dinar for currency made up of gold and the word Dirham for the currency made up of Silver.

[1] Zayla'i,Usman Bin Ali, *Tabyin al-Haqa'iq* (Cairo: al-maktabah al kubrah, 1313 Ah), 4: 90.

[2] Alfairoz Abadi, “ نقد “ *Alqamoos Almuheet*, ed. 8th,Muhammad bin Yahqoob (Beiruit: Muassa tu Risalah, 2005,) 1:322.

Furthermore the word "Wariq" was also used for silver currency and *Aeyen* (العين) for gold currency. These terms have been used in the following Verses of the Holy Quran:

"وَمِنْ أَهْلِ الْكِتَابِ مَنْ إِنْ تَأْمَنْهُ بِقِنْطَارٍ يُؤَدِّهِ إِلَيْكَ وَمِنْهُمْ مَنْ إِنْ تَأْمَنْهُ بِدِينَارٍ لَا يُؤَدِّهِ إِلَيْكَ إِلَّا مَا دُمْتَ عَلَيْهِ قَائِمًا"[1]

"Among the people of book are some, who if entrusted with hoard of gold will pay it back and there are others who if entrusted with a single silver coin, wil not repay it to you until you constantly stood demanding"

"وَشَرَوْهُ بِثَمَنٍ بَخْسٍ دَرَاهِمَ مَعْدُودَةٍ وَكَانُوا فِيهِ مِنَ الزَّاهِدِينَ"[2]

"The (brothers sold against a miserable price, for a few dirhams counted out in such low estimation did they hold him".

"فَابْعَثُوا أَحَدَكُمْ بِوَرِقِكُمْ هَذِهِ إِلَى الْمَدِينَةِ فَلْيَنْظُرْ أَيُّهَا أَزْكَى طَعَامًا"[3]

"Now send one of you with this Wariq (Money) to the city and let him find out which is the best food".

The word Dirham, Dinar and Wariq have also been used in hadith.[4]

The Muslim Jurists have used the same terminology in their books. They also use the word "Naqdian" (نقدين) and Athman (الأثمان) for gold and silver currency and Fals (فلس) for bronze coins.

The famous Muslim Jurist Imam Shaibani says:

"وإذا اشترى الرجل عشرة دراهم بدينار من رجل ونقده الدينار فلم يكن عنده الدراهم فاستقرضها من الذي نقده الديناروقبضها منه ثم دفعها إليه فإنه جائز"[5]

If a person purchased from another ten Darahim against one dinar by spot payment and the seller did not have Darahim and took ten Darahim as loan from the buyer and delivered the same to him after taking possession, the transaction is permissible from shariah point of view.

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[1] Alimran:75
[2] Yousuf: 20
[3] alkahf: 19
[4] Abū Dā'ūd Sulaimān ibn al-Ash'ath, *Sunan Abī Dāwūd* (Beirut: Dar Al Kitab Al Arabi), Kita bul Luqtah, Hadith 4544.
[5] Al shaybani, Mohammad bin Hasan, *Al Asl* (Beirut: Daruk Fikr Alarabi, 2012), 2: 603.

Terminological Meaning:

What is Naqd (نقد)? After going through the classical literature on the term, we find three different points of views of early Islamic Jurists.

1. According to some Ḥanafī and Maliki and majority of Shafi and Hanbali Jurists, the use of the term Naqd (نقد) is not limited to the gold and silver minted coins rather the term is applied to all types and forms of gold and silver, whether minted or not.[1]

2. According to majority of Ḥanafī Jurists[2] and some other jurists of Malki[3] and shafi school of thought[4], the term Naqd (نقد) is applied only to the gold and silver minted coins. Thus, the Bullions or raw gold is not Naqd (نقد).

The Ḥanafī Jurists are of the view that the capital of partnership and Modaraba contract must be in monetary form. However, they do not allow raw gold or bullions as capital of partnership or Mudaraba contracts. It means that they do not apply the term Naqd (نقد) to the raw gold and gold bullions.

Anyhow, both of these two opinions apply the term Naqd (نقد) only to the gold and silver, the natural money, and do not apply it to copper coins.

3. The third opinion is that, although the term Naqd (نقد) is originally applied to gold and silver, however it can be applied to other things used as medium of exchange if certain conditions are fulfilled.

Of those who hold this opinion are the famous Muslim Jurists Muhammad Bin Al-Hassan Al Shaibani,[5] some Maliki[6] Jurists, ibn Taimiyya[7] and Ibnul Qayyam[1] of Hanbali school of thought.

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[1] Zailaei, *tbyyn ālḥqāiq sharḥ kanz āldqāiq* , 1: 88-----Ib nul Hummam, Muhammad bin abdulwahid, *Fathul Qadeer* (Beirut: Darul Fikr, 7 , 16.
Al Haithami, Ahamd bin Muhammad bin Ali Bin Hajr, *tuhfatul Muhtaj Fi Sharhi Minhaj* (Egypt: Al Maktabah AL Tijariyyah,1983), 4: 279.--- Al khirshie, Mohammad bin ‘Abdullah, *sharah Mukhtasar Khalil Lil Khirshi* (Beruit: Darul Fikr), 5:262.
Al Sharbinee, Mohammad Bin Ahmad Al khateeb, *Mughnil Muhtaj Ila Maarifa ti Al fazil Minhaj* (Beirut: Darul Kutub AL Ilmiyyah, 1994), 2: 368 .

[2] Al Sarakhsi, Mohammad bin Ahamad, *Al Mabsoot* (Beirut: Darul Maarifa,1993), 11 :159.
[3] Alesh, Muhammad Bin Ahamad, *Minhuljalil sharah Mukhtasar Khalil* (Beirut: Darul fikr,1989), 4: 493.
[4]Al Bujairami, *al tajreed linafhil abeed (Hashiyat ul Bujairami)* (Egypt: Matbaah Al Halbi, 1950), 3 :146
[5] Al shaybani,*Al Asl*, 5, 57- --Al Alkāsānī, ‘alāūddīn, abūbakr bin masūd alḥanafī, *badā’‘ūssāna*’‘ (Beirut: Dārūlkūtūb al ‘lmiyyaḥ, 1406 AH), 6: 59.
[6] Mālīk bīn anās, *al Mudāw Wānā, alkūbrā*, 3:5.
[7] Ibne taymiyyaah, Ahmad Bin Abdul Haleem, *Majmu ul Fatawa* (Saudia Arabia: Majma ul Malik Fah, 1995), 29: 469.

According to this point of view the term can be applied to bronze coins (fulus) as well because they call it "thaman" which also means a medium of exchange. These Muslim Jurists also apply all the rules of shariah related to money to the coins and currency made up of copper metals.

Analysis of Different Views:

In general, we can say that there are two main schools of thought. One school of thought limits the application of the term money to gold and silver. The other school of thought do not restrict its application to gold and silver rather apply it to other mediums of exchange like *Fulus* (bronze coins).

The reason for their different points of view about money is the customary practice. In the early Islamic era only gold and silver coins were mainly used as medium of exchange. Fulus, the bronze coins, were used as secondary medium of exchange in small financial transactions for cheap goods and services. Therefore, according to early Muslim jurists, money is only gold and silver. They do not apply the shariah rulings related to money to medium of exchange other than gold and silver.

However, with the passage of time, when the use of fulus (currency made up of bronze) became common and it was used in most transactions, the jurists considered them money and applied all the shariah rulings related to money, to these *Fulus*.

Thus, the Islamic terminology *thamaniyya*, which means the ability to be used as medium of exchange is actually related to the customary practice. Therefore, anything that is used as medium of exchange can be called money if certain conditions are fulfilled that will be discussed later.

This application of the term money is supported by the views of famous jurist Al Imam Al Sarakhsi, who says.

"فَالْحَاصِلُ أَنَّ هذَا يخْتَلِفُ باخْتِلَاف الْعرْفِ فِي كُلّ مَوْضِع. فَإِنْ كَانتْ الْمبَايَعات بَيْنَ النّاسِ فِي بَلْدةٍ بِالتّبْرِ؛ فَهوَ كَالنّقُودِ لَا يَتعَيَّنُ بالتّعْيِين، وَيجُوزُ الشَّرِكَةُ بهِ، وإِنْ لَمْ يَكُنْ فِي ذَلكَ عرْفٌ ظَاهِرٌ؛ فهُوَ كَالْعروضِ لَا تجُوزُ الشَّرِكَةُ بِهِ،"[2]

Summing up,it (the application of the term money) depends upon the customary practice and varies from place to place. If the transactions among the people generally take place through gold bullions and ingots or than these bullions

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[1] Ibn Qayyim al-Jawziyya, Abd Allāh Muḥammad ibn Abī Bakr , *I'lam al-Muqi'in 'an Rabb al-'Aalamin* (Beruit: Darul kutub al ilmiyyah, 1991),3: 96.

[2] Al-SaraK̲h̲sī, *Al-Mabsoot*, 11: 1160.

and ingots would be similar to money and can be used as capital of partnership contracts. However, if there is no any customary practice than these ingots are similar to goods and not money, thus cannot become initial capital in the Musharakah contract.

Here it is mentioned that if the ingots are considered as money, it can be used as an initial capital in Shirkat agreement. This is because according to Ḥanafī point of view a necessary condition for partnership contract is that its initial capital must be in monetary form.

Another argument for the assertion that application of the term money is based upon customary practice can be quoted from Imam Malik, who says “if people started to use the currency made up of skins, I would dislike selling them against gold or silver with deferred payment. [1]

Now it is obvious from the foregoing discussion that a number of Muslim jurists did not limit the application of *thamaniyya* to gold and silver in particular, rather they have extended the concept of this term to include everything that plays its role as a medium of exchange, in addition to gold and silver thus apply the relevant shariah rulings to them accordingly.

Definition of Money in Modern Islamic Economics:

After the world has left the gold and silver standard and paper money that has no intrinsic value, is introduced because of unlimited number of things that performs the functions of money, it would be, to some extent, difficult to find an inclusive definition of money. However, the following definition by some Muslim economists may be quoted.

Money has been defined as

"أي شيء يتمتع بقبول عام في الوفاء بالإلتزامات"[2]

Anything that enjoys the status of general acceptance in fulfillment of (financial) obligations (will be called money)

Definitely, here obligation means financial obligations.

Another definition is

"كل شيء خال من الموانع الشرعية يتمحض للثمنية بحكم خلقته أو بحكم الإصطلاح العام لدى المتعاملين"[1]

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[1] Mālīk bīn anās, *Al Mudāw Wānā, alkūbrā*, 3: 5.

[2] Shaafi , Muhammad zakki, *Muhqaddima fi al-Nuqood wal Bunook* (Beirut: Darul Nahza Al Arabia, 1982), 32.

Anything that has no shariah impediments and is used only as medium of exchange by virtue of its creation or by the general convention of those people who are dealing with it.

It means anything that is permissible from shariah point of view and is generally acceptable by everyone of the society in all types of transactions is called money whether, it has got this status by virtue of its creation like gold and silver or because people have agreed to use it as medium of exchange like *Fulus* and paper currency.

This is a suitable definition of money that includes all types of money for the purpose of shariah rulings related to money. Anything that is called money according to this definition will be having characteristic of *"thamaniyya*", and the rulings related to *Riba*, *Zakat* and *Sarf*, that is exchange of currencies, will be applied.

However, this definition does not include some other instruments used as medium of exchange and called credit money like cheques and bill of exchange. Because, from shariah point of view credit money is not money itself, rather it is generally a promise to pay. Therefore, they do not have *thamaniyyah*, hence, rulings related to Zakat, Riba and *Sarf* will not be applied.

Nevertheless, when measuring the total supply of money in the modern economy, the Islamic economists include credit money in the definition, because credit money plays its role in the economy like real money and reflects the economic activity. Therefore, for this purpose, the following generalized definition is better to include the credit money.

"كل شيء خال من الموانع الشرعية يصطلح عليه الناس ليكون وسيطا لإستبدال ومقياسا للقيمة ويلقى قبولا عاما بين الناس"[2]

Anything that has no shariah impediments and people agree to us it as medium of exchange and measure of value and is generally accepted amoung the people.

In this definition credit money like cheques and bill of exchange is included. However, this definition is only to measure the supply of money in the economy. The shariah rulings related to money cannot be applied to cheques and bill of exchange

[1] Musa aadam Eisa, *Al-tawazun al-Naqdi wal Haqiqi Fil Iqtisad Al-Islami* (Ph.D diss., Ummul Qura University,1990), 185.
[2] Ibid, 188.

because these instruments are not money itself rather, they are documents of promise to pay.

Hence, it can be concluded from the above discussion that the nature and concept of money in Islam is just like its concept in economics because the main point is general acceptance and medium of exchange.

Evolution of Islamic Currency:

To better understand the reasons and bases of the application of this term and to have a clear concept of the money in Islam, it is pertinent to mention here a short history of the evolution of Islamic coins.

During the early era of Islam, the Arab did not have their own specific money or any medium of exchange. Ahmad Ibn Yahyā al-Balādhurī, a 9th-century famous Muslim historian, has mentioned that the People of Arabian Peninsula used the Persian Darahim and Roman Dinar in the Pre-Islamic-era and during the era of Prophet Muhammad (Peace be Upon Him). However, when the first Islamic state of Madina was established, the prophet S.A.W continued the use of Dirham and Dinar as a medium of exchange in day to day transactions which were issued by Byzantine and Sassanid Empire.[1]

Even though, some changes were adopted by the prophet Muhammad S.A.S that was already adopted by the people of Makkah. The people of Makkah used Darahim and Dananir as a medium of measurement by weight and not by counting due to possibility of fraud in the fineness and valuation of these Darahim and Dananir because it was foreign currency. So, these coins were used like ingots or raw gold without considering them a minted currency.[2]The prophet S.A.W ordered to use these Darahim and Dananir by weight. It is supported by a *Hadith* narrated by Ibn e Umar (Allah may please be with him)

"الْوَزْنُ وَزْنُ أَهْلِ مَكَّةَ وَالْمِكْيَالُ مِكْيَالُ أَهْلِ الْمَدِينَةِ"[3]

"The weight (which is accepted in shariah) is the weight of people of Makkah and measurement (which is accepted in shariah) is the measurement of the people of Madina."

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[1]Ibn e Khaldoon, Abdurrehman Bin Muhammad, *Tariekh Ib e Khaldoon* (Beruit: Darul Fikr,1988), 1 :323.
[2] Al Bilaziri, Ahmad ibn Yahyā, *Futoohul Buldan* (Beruit: Dar wa Maktabaht Hilal, 1988), 488.
[3] Abu dawood, *Sunan Abi Dawood*, Kitabul Buyooh, Hadith 3342.

The Modern application of what we can understand from the change adopted by the prophet S.A.W, in the use of Darahim and Dananir, is that the material to be used for money or a medium of exchange was accepted however specific standards and descriptions were not accepted. In other words, gold and silver standard were accepted to be used as medium of exchange.

Another problem with these Darahim and Dananir was that they were of different shapes and weight. Therefore, for the purpose of shariah rulings related to Zakah and interest, average weight of these Darahim and Dananir was adopted. The Persian Darahim were of different weights some of them were twenty carats, some were of twelve carats and some others were of 10 carats. It was determined that Dirham would be of fourteen qirat (carat) and the weight of this Dirham was six *Dawaniq*. The Dirahm was also equivalent to the weight of twenty-five wheat grains while ten daraham were equivalent to the weight of seven *Mithqal* of Gold. One *Mithqal* of Gold was equivalent to the weight of seventy-two wheat of grains.[1]

Thus, there was no Islamic currency minted by Muslims in the era of the Prophet hood. However, some measurements and weights were determined for the already available currency minted Byzantine and Sassanid Empire.

After the death of prophet S.A.W, the caliphs continued to use the same gold and silver coins. However, and despite their preoccupation with Islamic conquests, they thought about some changes in these coins. Hazrat Umar bin khattab the second Caliph ordered to add some Islamic inscriptions. The name of hazrat Umar (may allah be please with him) was added to them. Hazrat Usman (may Allah be please with him) during his era ordered to add the word “Allah Akbar” to them.

The printing of Islamic currency was important for an Islamic stat. Even Hazrat Umar (R.A) is reported to have thought about making a currency of camel skins but he did not take step to do so because he was told that the state may face lack of camels, a necessary means of transportation at that time.[2]

After the era of first four Caliphates, during the early days of Omavid Caliphate the use of the same coins continued with the addition of Islamic scripts like Arabic words till the era of fifth Omavid caliph, Abdul Malik Bin Marwan who

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[1] Salmy Edawati Yaacob and others, “Gold Dinar As A Supreme Currency: Review Based On The History Of Islamic Civilisation”, *Advances in Natural and Applied Sciences* 6, (2012): 3503.
[2] Al Muqraizi, abdulqadir, *shauzurula uqood Fi zikri al Nuqood* (Riyadh: Riyadh University), P: 3.

reigned from the year 65H (685AD) to 85H (705AD) and his era of caliphate is known for development, prosperity and expansion of commercial activities.

Abdul Malik bin Marwan is the first caliph in Islamic history who formally minted gold and silver coins in 76AH called al-Dinar Al Islami and Al-Dirham Al-Islami. Marwan also ordered the use of only one currency in the whole Islamic state. Before his era the currency was locally issued in different provinces of the Islamic state by some governors. He also restricted the process of minting coins to the central government. For this purpose, he assigned the task of minting currency to Hajjaj Bin Yousuf, the governor of Iraq at that time.[1]

Islamic Dinar was equal to one *Mithqal* and was a bit lighter as compared to Roman Dinar which was 4.25 grams. The weight of Byzantine *Dinar* was 4.55 grams. The weight of Dirham that was minted by Marwan was 6 *Dawaniq*. He also issued *Fulus*.

Thus, Islamic currency was in three denominations.

1. *Dinar* (gold coin)
2. *Dirham* (silver coin)
3. *Fals* (bronze coin)

Bronze coins were used as medium of exchange for cheaper goods and services.[2]

After the monetary reforms and minting of Islamic money during the reign of the Umayyad Caliph Abd al-Malik, Islamic money remained free from any fraud like mixing of inferior metal, until the era of the Abbasid Caliph Al-Mutawakkil. After his death, political situation got worse. Due to political unrest some governors of the Islamic state started to issue currencies and would mix inferior metals in the gold and silver coins to meet the needs of public finances. These mixed coins were better to meet expenses because their face value which was fixed by the government authorities was higher than the real value.

Due to this mixing of inferior metals with gold and silver coins and absence of central currency issuing authority, different types of Darahim were introduced in the market. They were called *al-Darahim al Maghshusha* (coins mixed with inferior

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[1] Al Muqraizi, abdulqadir, *shauzurula uqood Fi zikri al Nuqood*, 3.
[2] Salmy Edawati Yaacob and others, *Gold Dinar As A Supreme Currency*, 352.

metals). As per quality of their fineness they were given different names like *Darahim Zuyuf*, *Darahim Naqira, Darahim Bahraja* etc[1]

Although some currencies made up of other metals like bronze were also used in cheaper transactions, the gold dinar and silver dirham remained the dominant currency throughout the Muslim history, until the era of *Othoman* caliphate.

The use of these gold dinar and silver Dirham continued in Othman caliphate. However, when the Othmani caliphate collapsed in 1942, the gold dinar and silver dirham vanished, and it had marked an end of them in classical Islamic world and financial system.

Conditions for Money in Islam:

After going through the principles of Shariah and practices of the Companions of the Holy Prophet and the views of early Muslim Jurists, it may be concluded that the following conditions must be fulfilled to consider something as a currency or medium of exchange.

1. *Maal* (Property)

The fundamental requirement for a counter value in financial transaction is that it must be *Mall*, an Arabic term and may be translated as Property. The word *Maal* has been frequently used in Quran and Hadiths. For example:

"وَآتَى الْمَالَ عَلَى حُبِّهِ ذَوِي الْقُرْبَى"[2]

"And gives his wealth, in spite of love for it, to the kinsfolk. The prophet (PBH) is reported to have said"

"لَا يُؤْمِنُ عَبْد حَتَّى أَكُونَ أَحَبَّ إِلَيْهِ مِنْ أَهْلِهِ وَمَالِهِ وَالنَّاسِ أَجْمَعِينَ"[3]

"No one will have faith till he loves me more than his family, wealth and all mankind."

Here the word Mall has been used which gives the meaning of wealth or property.

Literal Meaning of *Maal*

Literally, the word *Mal* refers to something which can be possessed.[1] According to AL Asfahani, mall is something which is desirable and transferable from one person to another.

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[1] Ahamad Hassan,*Tatawwur al Nuqood Fi zau Al shariah Al islamiyyah*, (Ph.D diss., Ummul qurah university, 2015), 82.
[2] Al-Baqarah: 177.
[3] Muslim, Muslim ibn al-Hajjaj al-Naysaburi, *Ṣaḥīḥ Muslim* (Beiruit: Daru İhyai-Türasi'l-Arabi), Kitabul Ieman, Hadith 44.

Thus, literally, everything which is valuable, transferable, and desirable, can be possessed, and transferred is called mall or Property.

Juristic Meaning of *Maal*

As for as the views of Muslim Jurists about *Maal* is concerned, they have laid down several definitions of mall that imply approximately the same understanding. According to some early Ḥanafī Jurists, the term *Maal* is limited to corporeal and tangible things.[2] Intangible things like rights and benefits do not come under the definition of *Mall.*

Imam Haskafi Says

"المراد بالمال عين يجري فيه التنافس و الإبتذال"[3]

Maal (property) means a tangible thing which is desired, competed for and is strived for.

According to this definition *Maal* must be a tangible thing. However, other Ḥanafī Jurists did not mention this condition. Some other Hanafi Jurists are of the view that if non-tangible things, like rights and benefits, become valuable thing as per Customary practice and *Urf,* then these things will be treated as *Maal* and would come under its definition.

The famous Ḥanafī Jurist Ibn 'Abidin says:

"المراد بالمال ما يميل إليه الطبع ويمكن ادخاره لوقت الحاجة"[4]

"Maal is what human instinct inclines to, and which is capable of being stored/ hoarded for the time of necessity".

According to this definition anything that is desirable and capable of being stored or hoarded will come under the definition of Maal. Human instinct inclines to useful things. Therefore, in these definition things which are inclined to refer to those things which are useful. Ibn 'Abidin has mentioned that if something becomes valuable as per the practice and custom of the general public, it would be considered *Maal*.[5]

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[1] Ibn Manẓūr, *Lisan ul Arab 2cnd ed.* (Beirut:Dar Sadir),11: 324
[2] Ibn Aābidīn, *Radd al-Muhtār 'ala al-Durr al-Mukhtār*, 4: 501.
[3] Al-Haskafi, Muhammad bin `alla, *Al Dur-al-Muntaqa Fi Sharh al-Multaqa* (Beirut: Dar al-Kutub al-'Ilmiyah, 1993), 3: 4.
[4] Ibn Aābidīn, *Radd al-Muhtār 'ala al-Durr al-Mukhtār*, 4: 501.
[5] Ibid.

However, these early Muslim Jurists of Hanfi School of thought have allowed the sale of some rights like right to use the path which means that Ḥanafī Jurists also accept the sale of usufruct or right.

Unlike early Ḥanafī Jurists, the other major Jurists of different Schools of thought like Maliki, Shafi and Hanbali, are of the view that the application of the term *Maal* is not limited to tangible things only rather it includes rights and benefits with certain conditions as well as.

As for as Shafi Jurists are concerned, according to them anything that gives benefit is considered *Maal* (Property).[1] According to Hanbali school of thought anything that has a lawful and permissible benefit is *Maal*. [2]

The famous Maliki Jurist Imam Al-Shatibi has defined Maal as "*Maal* is the thing on which ownership is conferred and the owner excludes others from interference[3].

The summary of all these three definitions is as under:

- Mall is something that has a benefit
- The benefit must be lawful
- It must be capable of being owned in a way that excludes others from interference.

Shariah Status of Currency Other than Gold and Silver

Is it permissible in Islam to use a medium of exchange other than gold and silver in mutual transaction?

The majority of jurists are of the view that it is permissible to buy and sell using a medium of exchange other than gold and silver. It means that it is allowed to use anything as medium exchange other than the gold and silver. The only difference between the two is that the value of gold and silver is by virtue of their creation, while the value of medium of exchange other than the gold and silver is because of the convention or agreement of the public.

Islam, when introduced the rules of buying and selling, did not impose the gold and silver as the only tool of medium of exchange. Rather, it is declared permissible to exchange goods, benefits, and services with anything as far as the thing

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[1] Al-Zarkshi, Muhammad bin Bahadur, *Al-Manthur fi al-Qawa'id* (Kuwait: wazara tul Awqaf wa Al shuoon Al Islamiyyah,1405), 222.
[2] Al-Kharqi, Umar bin Hussain, *Matan al-Khirqi* (Kuwait: Darul Kutub al ilmiyyah, 1993), 71.
[3] Al-Shatibi ,Abu Ishaq Ibrahim bin Mosa, *Al-Muwafaqat fi Usul al-Shari'ah* (Egypt: Mdatba'ah al-Rahmaniyyah, 1997), 2: 17.

is permissible. Lease agreement is permissible in Islam without imposing a specific good or a specific medium of exchange to be used in lease agreement.[1] It is permitted to buy a sword against dates or goat or buy cloth against meat or camel against Dinar and milk against *dirhams* and to by wheat against the services of plowing a specific land[2]. Hence, Islam did not specify any type of medium of exchange.

However, is it permissible for an Islamic state to issue a currency other than gold and silver to be used as medium of exchange in measuring services and goods?

We will discuss this question in the following lines.

The Status of Paper Currency

As discussed above under the topic evolution of money, we found that there was no concept of paper currency in the era of early Muslim Jurists, therefore it was not known to them, hence did not discussed explicitly in classical *Fiqh* literature. Later on, the contemporary Jurists have discussed it because of its relevance to shariah issues such as zakat, usury, sale, etc. These issues are of great importance for all Muslims. It was necessary to determine the nature of paper currency to apply the relevant shariah ruling on it. However, the discussion and difference in the point of views of Jurists about paper currency, led to the emergence of different and contradictory opinions about the nature of this type of currency. Having a look of the juristic literature, we find that there are following four different opinions.

1. Paper money is a debt instrument or a debt certificate and is not money itself. It is not just like goods and do not represent gold or silver.
2. According to second opinion, paper currency complies the definition of *Mal* or property and its value has increased as a result of its general acceptance and due to its use as medium of exchange.
3. The third opinion about paper currency claims that paper currency is a substitute of gold and silver. It is neither a debt instrument not like other goods.
4. According fourth opinion, paper currency is itself money like *Fulus* (bronze and silver coins)

First Opinion

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[1] Ibn Nujaym al-Hanafi, Zayn al-Dīn, Muḥammad ibn al-Ḥusayn *Baḥr al-rā'iq, sharḥ Kanz al-daqā'iq*, (Beirut:Dar al-Kitab Al Islami, 2nd Edition), 7: 297.

[2] Zallūm, Abd al-Qadīm, *Al Amwal Fid aula tul Khilafah* (Beirut: darul Ilm lilmalyeen, 1988), 186. Al sibahi, *al zawabit al iqtisadiyyah lil isdar al Naqdi*, 58.

According to first opinion, paper money is a debt instrument or a debt certificate and is not money itself. It is not like goods and do not represent gold or silver. Thus, the issuer of this note has to pay the value to the holder of this note. As per this opinion it not allowed to purchase gold and silver against paper currency, because purchasing gold against money comes under *Bai sarf* which requires spot payment from both parties under the agreement. While paper currency is not money itself it is certificate of debt.

Those who hold this view support their claim by the statement mentioned on the currency note that promises the payment of value of the not to the holder. It is therefore, the government is responsible to pay the value of this note, if the government order to stop using this currency note. Moreover, this note has no intrinsic value. Its face value is far high than its real value. For example, a thousand rupee note value has no real value as compared to it face value. According to this point of view, paper currency is debt instrument therefore all relevant rules of debt instrument will be applied.

Among those who hold this view is the famous Indian scholar, Maulana Ashraf Ali thanwi[1]

Second Opinion

According to second opinion, paper currency complies the definition of *Mal* or property and its value has increased due to its general acceptance and due to its use as medium of exchange.it will be treated as goods or commodity and not money, like precious metals that carry high value but yet treated as goods and not money.

Among those who hold this view is Abdurrahman Sa'di.[2]

The Rationale of Second Opinion:

The definition of *Mal* is applicable to paper currency. Moreover, the transaction is concluded through payment of these paper notes and not through gold or silver. In a financial exchange transaction, the parties entering transaction do not think about gold and silver. It is just a piece of paper. Although, it is used as a medium of exchange like gold and silver, but this limited similarity with gold is not enough to apply relevant shariah ruling of gold and silver on these currency notes. The example of other precious metals like diamond may be quoted to explain that only increase in value of a commodity does not make it similar to gold and silver in application of shariah ruling. Furthermore, gold and silver have their intrinsic value and their value is by virtue of nature. Therefore, if the government stops to use them as medium of exchange, yet they will remain

[1] Thānwi, Ashraf Alī, *Imdādul fatāwa* (Karachi: Maktaba Darul Uloom), 2: 5

[2] Al Sa'di, Abdurrehman Nasir Al Sa'di, *al fatwa al Sa'diah*, (Riyaz Saudi Arabia: Maktaba tul Ma'arif, ,1982), 324.

precious and valuable. On the other hand, if the government stop to use currency note as medium of exchange, it will lose all its value and will become of no use for people.[1]

Thus, shariah ruling of gold and silver cannot be applied to paper currency.

Third Opinion

The third opinion about paper currency claims that paper currency is a substitute of gold and/or silver. It is neither a debt instrument not like other goods. It is a kind of money itself. Moreover, as it is a substitute of gold and silver, therefore, relevant shariah rulings of gold and silver will be applied to these paper currency notes.

Among those who hold this view is the famous Scholar of Subcontinent Maulana Abdul Hai Al lakhnawi, he says:

"پس پیسے (فلوس)، اگرچہ عرفا ثمن ہیں مگر عین ثمن خلقی نہیں سمجھے گئے ہیں بخلاف نوٹ کے کہ یہ عین ثمن خلقی ہیں گو ثمنیت خلقیہ نہیں بلکہ ثمنیت عرفیہ ہو"[2]

Thus, although bronze coins have been considered customary money however, they are not natural money, unlike currency notes which are considered like natural money although they are customary money and not natural money.

This opinion has been adopted by Islamic Fiqh Academy Jeddah in decision as well:

"العُملَاتِ الوَرقِيَّةَ نُقُودُ اِعتِبَارِيَّةٍ فِيهَا صِفَةُ الثَّمَنِيَّةِ كَامِلَةٌ، وَلَهَا الأَحكَامُ الشَّرعِيَّةُ المقَرَّرَةُ لِلذَّهَبِ وَالفِضَّةِ مِن حَيثُ أَحكَامُ الرِّبَا وَالزَّكَاةِ وَالسَّلَمِ وَسَائِرِ أَحكَامِهِمَا"[3]

"Currency notes are constructive money with complete attribute of Samaniyyah and all the rules of Riba, Zakat and Salam related to gold and silver will be applied to them.

According to this opinion, currency notes will come under *Ribawi Items* and the relevant rules of Riba (interest) will be applied to them.

Arguments of Third Opinion

Currency notes are used as substitute of gold and silver. It has replaced the gold and silver. They are reliable and acceptable in market like gold and silver. Therefore, all the relevant rules of gold and silver must be applied to these currency notes. Moreover, shariah matters are considered keeping in view their objectives. In the light of objectives, different matters are treated in different ways. There is a shariah maxim quoted by Jurists:

"الأمور بمقاصدها"

"Matters are considered in the light of their objectives."

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[1] Al Sa'di, Abdurrehman Nasir Al Sa'di, *al fatwa al Sa'diah*, 324.

[2] Lakhnawi, Moulānā 'bdul Hai, *Majmoo 'l Fatwā* (Pakisatna Chwk: H.M Saeed) , 2: 137.

[3] Majma' al-Fiqh al-Islāmī, "Qarar 9" *Majallat Majma' al-Fiqh al-Islāmī* 3 (1409) :2261.

It means that only appearance is not important in shariah. Every action and matter will be judged in the light of its objectives. Keeping in view this shariah rule, paper currency is actually the medium of exchange and has the attribute of *Samaniyyah,* therefore all the relevant rules of gold and silver must be applied to paper currency.

Thus, paper currency will be liable to Zakat being a Zakat able asset and Zakat may be paid through paper currency. The rules of Riba will be applied to paper currency. Any increase form either side is not allowed in exchange transaction of paper currency of the same country. Moreover, it is not allowed to delay payment from either side as well.

Fourth Opinion

This point of view claims that note itself is a customary money. It is not a debt instrument and will not be treated as goods or commodity. Moreover, it is not a substitute of gold and silver. It is money itself like *Fulus* and all the relevant rules of *Fulus* will be applied to these currency notes. Among those who adopted this point of view is the Muhammad taqui Usmani[1] and sheikh Abdullah bin salman[2].

Arguments of Fourth Opinion

1. Currency note is not a debt instrument because it is legal tender and is compulsory to be accepted in day to day transactions. It is different from other debt instruments which are not declared as legal tender and it is not compulsory to accept them in day to day transaction. A creditor cannot be compelled to accept cheque issued by the debtor to pay back the debt. However, he is bound to accept the currency note. It is also an unlimited legal tender. Moreover, debt instrument may be issued by anyone accepting any obligation of payment like creditor, while it not allowed for anyone other than the government or its authorized representative to issue currency notes.
2. Currency note is generally accepted as medium of exchange and is treated as money in day to day transaction. It means that it is not a commodity and not substitute of gold and silver.
3. People are using these currency notes and do not think about the gold and silver which is kept against the issued currency notes.
4. As we discussed under the topic of evolution of money, nowadays currency notes ar not backed by gold or silver. Therefore, we cannot say that curreny note is a substitute of gold and silver.

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[1] Usmani, Muhammad Taqui, Fiqh ul Buyooh, ‘lal Mazāhib Al arba’ha) Karachi: Quranic studies Pulishers,2015), 2: 733.

[2] Qasmi, Mujahid Islam, *Jadeed Fiqhi Mabahith* (Karachi: Idarah al-Quran wa al-ulomal-islamiah), 2:56.

5. The definition and conditions of money in Islamic concept as mentioned above are applicable to these currency notes. Therefore, there is no reason to exclude currency notes from money.
6. Currency notes carry out all the functions of money, mentioned above.

Analysis of the First Point of View

The first opinion that claims that currency note is a debt instrument, cannot be accepted, as nowadays, currency note is not backed by gold and silver. Therefore, the promise mentioned on these notes regarding payment of the value of the note is not fulfilled. It is written on the note just to ensure its value and to maintain the confidence of the public in these notes. This is like a guarantee statement by the government. There is no financial obligation against the currency note issued by the government. In addition to this, most of the transactions in the market are made through these notes. If they are considered as debt instruments, it will lead to harm and difficulty for the public. According to shariah harm must be eliminated and difficulty must be removed. Thus, this point of view is not applicable in current scenario.

Analysis of Second Point of View

If currency notes are treated as commodity and goods, it will give free hand to usury and interest. This is because most of the commodities do not come under *Ribawi* item and it is allowed to exchange non-Ribawi items with an increase from either side. If note is declared as no-Ribawi item it will be allowed to exchange hundred rupees for two hundred rupees. This ruling would be against the objectives of shariah. According to most of the Muslim Jurists shariah has prohibited any increase from either party in the exchange transaction of gold and silver, because of attribute of *Samaniyyah*, which means the ability of something to be used as medium of exchange and standard of value[1]. This decision of shariah is definitely based on some reasons and is made to achieve some objectives. The attribute of Samaniyyah, is found in currency note. If note is excluded from this category, the outcome will be dangerous and will be against the objectives of shariah. This outcome is clear from the writings of the those who hold this view. It is written in Fatwa Sa'adia:

" فتعين أنها سلع.........و جواز بيع بعضها ببعض متماثلا"[2]

Thus, it is proved that currency notes come under the category of commodity and it is allowed to sale currency a note against another currency note with an increase from either side.

This statement from famous Muslim scholar indicates that proponents of this point of view allow exchange of currency notes with an increase from either side.

Critique of Third Point of View

Several contemporary scholars[3] have raised some questions on declaring the currency notes as substitute of gold and silver and do not accept the idea of applying all relevant rules of gold and silver to currency notes. According to these scholars the use of currency notes as medium of exchange and its general acceptance do not provide a sound ground to apply all the rules and regulations of gold and silver to currency note. Moreover, *Fulus* (bronze coins) were also used as medium of exchange in the early era of Islam, however, all the jurists are unanimous about the difference in shariah ruling related to bronze coins and gold and silver. They did not apply the rules of gold and silver to the bronze coins. Furthermore, even if it is accepted that currency notes are substitute of gold and silver, then which note will be considered equivalent to gold and which note to silver. Hence, this is a vague statement. There is no clarity about this substitution.

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[1] Al- Matrazi, Abdul Sayyed Bin ʻali, *AL-Maghrib fi Tartīb al Muʻrab* (Beirut: Darul Kitab alʻarabi),399.
[2] Al Sa'di, Fataw Sa'dia, 325.
[3] Usmani, *Fiqh ul Buyooh*, 2:733. , Asmatullah, Dr. *Zar ka Tahqiqi Mutalah*, 112.

Critique Of Fourth Point of View

Currency notes cannot be treated as Fulus (Bronze Coins) as there is difference between the two. Firstly, bronze coins were not substitute of gold and silver, rather they were used as a secondary medium of exchange in the market. Traders and public would use these Fulus (bronze coins) in cheap transactions at a limited level. These coins did not remain as permanent medium of exchange. Secondly, these Fulus were generally tied to gold and silver and their value would fluctuate with fluctuation in the value of gold and silver. They were not separate and independent. Thirdly, these coins were not legal tender and there was no regulatory body to issue and control its supply in the market.

Thus, there is difference between Fulus (bronze coins) and paper currency. the bronze coins were strictly tied to gold and silver and were valued with respect to gold and silver. Therefore, it was easy to determine the exact value of a Fals (bronze coin) in terms of gold or silver. However, it is very difficult to determine the exact value of paper currency in terms of gold and silver.

The Preferred Point of View

According to author's point of view, the third point of view is preferred as it provides sound arguments and rationale to consider the currency note as a substitute of gold and silver. This point of view is compatible with shariah objectives and is preferred because:

1. Currency note does not represent gold and silver. Many other factors like economic position and exports of the country determine its value.
2. The promise, written on currency note to pay its value, is only to maintain the confidence of the people in this note to use it as medium of exchange. There is no financial obligation on the issuer of this note.
3. Currency note has replaced the gold and silver. Now it is used as a standard of value for all goods and commodities. Even the value of gold and silver is determined by currency note. It will not be an exaggeration that gold and silver, nowadays has left this function because of the frequent use of paper currency as standard of value. Therefore, all the relevant rules of gold and silver must be applied to paper currency.
4. It is preferred to treat currency note like gold and silver in Bai Sarf, a contract in which money is exchanged for money. Special rules and regulations have been issued by shariah for this type of contract so that exchange of money may not manipulated for the purpose of interest bearing loans which are strictly prohibited in Islam. Taking possession by

both parties before leaving each other and spot payment is necessary in this contract. If paper currency is excluded from application of Bai Sarf rules and deferred payment is allowed, as adopted by fourth point of view mentioned above, it will not be compatible with shariah objectives and will open the door for interest.

5. The jurists who adopted fourth point of view on the basis that early Muslim Jurists have always applied separate rules to customary money and made difference between natural and customary money, does not seem a sound argument. As, unlike Fulus, bank note is an independent medium of exchange regulated by regulatory authority and the government. While Fulus (bronze coins) were used as a secondary medium of exchange in cheaper transactions and were generally tied to gold and silver.
6. According to majority of contemporary scholars1 paper currency has the status of currency, and all the relevant rules of Zakat and other relevant contracts will be applied. This is because it is now valuable and desirable and come under the definition of Mal.

[1] Majma‘ al-Fiqh al-Islāmī, *Majallat Majma‘ al-Fiqh al-Islāmī*, 2261.

Shariah Status of Virtual Currency

There are two points of view about the virtual currency. According to some contemporary scholars it is not allowed to use cryptocurrency as a medium of exchange while others allow it, subject to some conditions.

Views and Arguments of the Opponents

The grand Mufti of Egypt opines that bitcoin are not a shariah compliant currency. Because its trade is like a gambling where the outcome of transaction is uncertain. According to him it is intangible and may be used in illegal activities like money laundering etc., as it is not backed by any asset and does not enjoy the status of legal tender.[1]

The Palestine Fatwa center is also of the view that the use of bitcoin is not acceptable in shariah, because there is no regulatory body to issue and regulate the bitcoin. According to the scholars of this fatwa center, the process of mining bitcoin involves gambling as well. The miner invests his money to create bitcoin however, its creation is not guaranteed, rather it depends upon an uncertain result, that is the possibility of solving the puzzle. Moreover, bitcoins involve speculation which is strictly forbidden in shariah. [2]

Views and Arguments of the Proponents

Some other contemporary Jurists are of the view that the reasons mentioned for the impermissibility of crypto currency are not sufficient and does not provide any sound ground to declare crypto currency as impermissible. This is because these reasons have nothing to do with the permissibility of crypto currency.

According to sheikh 'Abdullah Al Zahrabi, crypto currencies are a result of rapid changes and evolution in economic and technological world. The medium of exchange has also gone through the process of evolution from barter system to electronic money and now crypto currency. As bitcoin is used as medium of exchange, there is no reason to declare it impermissible.[3]

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[1] Egypt's Grand Mufti Bans Bitcoin Trading, January 14,2021, https://aboutislam.net/muslim-issues/middle-east/egypts-grand-mufti-bans-bitcoin-trading/,

[2] Mufti Abubakar, "virtual currency", 17, January 14,2021, https://blossomfinance.com/bitcoin-working-paper.

[3] January 14,2021,https://www.youtube.com/watch?v=OyG5YYY-4D4

The famous contemporary scholar dr. Manzar kahf has allowed the trading of bitcoins like any other currency subject to the condition imposed by shariah for trading in currencies.[1] These conditions are: 1) spot payment by both parties and 2) taking possession before leaving the other party of transaction. If currencies which are exchanged are of the same country than the amount to be exchanged from both sides must be equal.

Analysis of the Views

After going through the arguments of both point of views about crypto currency it is understandable that views and arguments of proponents of bitcoins and virtual currencies are sound and compatible with shariah objectives.

The basic question about the permissibility of the use of crypto currency is whether it is allowed to sale or purchase virtual currency or not? This question depends upon another question that whether it comes under the definition of *Mal* or not.

It is obvious from the discussion about Mal under the topic conditions for money in islam that if virtual currency comes under the definition of mall and it may be exchanged for any other currency or goods and/or services because it is valuable and desirable thing. The famous Hanafi Jurist Ibn Aābidīn has mentioned criterion of *Mal* as following.

"والمالية تثبت بتمول الناس كافة أو بعضهم"[2]

The attribute of wealth is proved if that thing is accepted as a wealth by some specific or all people.

Nowadays people are accepting virtual currency as a valuable property therefore it is *Mal* and may be exchanged for goods and services.

Once it is accepted that it is allowed to sale and purchase virtual currency and it can become one of the counter values in an exchange transaction, there is no shariah issue in using it as a medium of exchange. The use of this currency in illegal activities is not a sufficient argument to declare it as impermissible. It may be used as legal tender if regulated by the government. It is recognized in Germany as a legal currency thus qualifies the criteria of a currency acceptable in shariah. Even in countries like

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[1] Yousuf Sani Abubkar and others, "Bitcoin and its Legality from Shariah Point of View", *SEISENSE Journal of Management* 4, (2018) :53.

[2] Ibn Aābidīn, *Radd al-Muhtār 'ala al-Durr al-Mukhtār*, 4: 501.

U.S where it is not recognized yet, it is used by the government as a medium of exchange. We have discussed earlier that anything that fulfils the criteria of *Maal* and is used by a community as a medium of exchange, it will be considered money, hence acceptable in shariah as well.

The summary of the above discussion is that the sale and purchase of the virtual currency is allowed. Moreover, it may be used as medium of exchange. However, if it is used as medium of exchange, should the specific rules for exchange of currencies be applied on these virtual currencies? A deep study of the specifications and role of these currencies indicate that the rules for exchange of currencies cannot be applied on these currencies unless they are declared as legal tender by the government. Once virtual currency is declared as legal tender, it would be considered currency, thus the rules of *Riba* and *Bai Sarf* will be applied.

The reason mentioned by some scholar, that mining process of virtual currencies involve gambling, is not a sound argument to declare it as non-shariah compliant because many people work hard and struggle to get a value able thing and their struggle does not guarantee its result. Moreover, gambling and uncertainty is prohibited in exchange transactions. A person working hard and investing money is not entering into a contract with other party. Therefore, the question of gambling and *Gharar* would be irrelevant in this matter.

The above mentioned arguments of the proponents of the virtual currency would be true if the currency is regulated by the government. However, if it is not regulated by the government than the arguments of the opponents of the virtual currency seems to be sound as the practices related to digital currencies are expected to lead to gambling activities.

Gold and Silver:

As discussed previously, some jurists apply the term Naqd (نقد) only to the gold and silver, the natural money, and do not apply it to copper coins. According to these jurists, money must be in the form of gold or silver. The condition of minting as expressed by some other jurists is not effective in Riba and obligation of Zakat.

As those who stipulate that money or *Naqd* must be in minted form are of the view that Riba and Zakat is obligatory in bullions of gold because of characteristic of thamaniyya that is found in them by virtue of creation.

Rawaj (circulation)

The second condition for money in shariah as determined by the Islamic jurists is that it must be in *Rawaj*. Literal meaning of *Rawaj* is circulation. However, in Islamic Fiqh the term Rawaj has a specific meaning.

According to Jurists the term Rawaj refers to general acceptability of a thing. The medium of exchange or currency must be generally acceptable. Circulation is necessary condition for money to apply relevant shariah rulings on it.

Rawaj also means that people must have an interest in it and it must be an attractive wealth for them. It must be a dominant currency so that when any financial transaction is concluded it is understood that the medium of payment would be in that currency even if it is not expressed in the contract agreement. The famous Muslim Jurist Ibnul Hummam says

"لأن المتبادر من كون النقد أروج كونه أغلب وأشهر حتى ينصرف المطلق في البيع إليه"[1]

"Because what suddenly comes to our mind from the condition, that money must be generally used as medium of exchange, is that it must be a famous and dominant currency so that in an absolute sale agreement this currency would be considered as medium of exchange".

Furthermore, this condition is for currency made up of anything other than gold and silver because gold and silver are thaman (medium of exchange) by virtue of their creation even if they are not in circulation.

It is pertinent to mention here that in contracts like *Mudharabah* or *Musharakah* some Muslim Jurists stipulate that the initial capital of these contracts must be in cash form and do not accept gold bullions as initial capital of these contracts. However, it does not mean that gold bullions are not *thaman*. There is a bit difference between *thamaniyya* and *Naqdiyya*. What can be understood form the expressions of Jurists is that *thaman* means medium of exchange while Naqd (نقد) means medium of exchange in a most liquid form. Thus, Gold bullions are *thaman,* but they are not *Naqd* (نقد) because they are not in cash form. Therefore, if gold bullions are used as generally accepted medium of exchange and they are in the form of Naqd (نقد) than they may be used as initial capital of *Mudharabah* and *Musharakah* contracts.

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[1] Ibn al-Hammam, *Fathul Qadir*, 2: 220.

The Functions of Money in Islamic Economic System:

We have already discussed the functions of money in conventional economic system.in this system money plays its role as medium of exchange, unit of account, store of value and Standard of deferred payment.

Did Muslim jurists analyze these functions, and did they talk about them?

After going through the writings of Muslim jurists about money we find that they have discussed the functions of money under the topics of Zakat, Interest, and other relevant topics. The functions of money mentioned by Muslim Jurists conventional economists are almost same.

The famous Muslim Jurist Ibnʿ Arabī says:

"وَكَسْرُ الدَّنَانِيرِ وَالدَّرَاهِمِ ذَنْبٌ عَظِيمٌ ; لِأَنَّهَا الْوَاسِطَةُ فِي تَقْدِيرِ قِيَمِ الْأَشْيَاءِ وَالسَّبِيلُ إلَى مَعْرِفَةِ كَمِّيَّةِ الْأَمْوَالِ"[1]

And breaking the Dinars and Darahim is a great sin; Because it is the mediator in measure the values of things and the way to know the quantity of wealth.

Ibnul Hummam, a famous Ḥanafī Jurist says

"وقولهم في النقدين خلقا للتجارة معناه أنهما خلقا للتوسل بهما إلى تحصيل غيرهما............. فخلق النقدان لغرض أن يستبدل بهما ما تندفع الحاجة بعينه "[2]

The Jurist when say about Money (Gold and Silver) that it is created for trade they mean that they (gold and silver) are created to be used as medium of exchange to acquire things other than these two. Thus, gold and silver are created to substitute them for something that itself fulfils the need.

Imama Malik says

وَإِنَّمَا تُقَوَّمُ الْأَشْيَاءُ كُلُّهَا بِالذَّهَبِ وَالْفِضَّةِ.[3]

The value of all things is measured through gold and silver.

Ibne Rushd says:

"وأما الدينار والدرهم فعلة المنع فيها أظهر إذ كانت هذه ليس المقصود منها الربح وإنما المقصود بها تقدير الأشياء التي لها منافع ضرورية".[4]

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[1] ibnʿArabī, Muḥammad ibn ʿAbdallāh ibn al-ʿArabī, *Ahkamul Quraan* (Beirut: Darul kutub Al ilmiyyah, 1994), 5: 29.

[2] Ibnul Hummam, *Fathul Qadeer*, 2: 155.

[3] Mālik bin Anas, *Al-Mudawwana al-Kubra*, 4: 527.

[4] Ibne Rushd al hafeed, Muhammad bin Ahmad, *Bidaya tul Mujtahid Wa Nihaya tul Muqtasid* (Egypt: Darul Hadith,2004), 3: 152.

"As for as Dinar and Dirham are concerned, the underlying cause of the prohibition is evident, since these are not intended for profit, rather they are intended to determine the value of things that has necessary benefits".

Ibn Qayyim al-Jawziyya says that Darahim and Dananir are medium of exchange. Medium of exchange is something that is used as measurement of value to know value of different things.[1]

Furthermore, Allama Ibne Taimiyya sys that Darahim and Dananir are medium of exchange and they are used as standard of value for mutual transactions and they are not sought for themselves.[2]

The above mentioned writings of the Islamic Jurists reveal that Islamic jurists have mentioned the almost same functions of money as mentioned by the economist.

It is evident from the above writing of famous Muslim Jurists that money is used as medium of exchange, unit of account and measurement of value. As for as the function of money as store of value is concerned, some contemporary Muslim economists do not accept this function of money arguing that accepting this function of money means to allow money storage that will open the door for Riba. Furthermore, storage of money is against its function as medium of exchange because if it stored it will disturb its normal required circulation, hence disturbing its role as medium of exchange.[3]

However, this point of view ignores the reality that function of money as store of value is the result of its role as medium of exchange, as anything that plays its role, as medium of exchange must have the ability to store the value. If it does not store the value how will people keep it with them for near future use.

Therefore, Ibn e khaldoon, a famous jurist and historian says:

"ثمّ إنّ الله تعالى خلق الحجرين المعدنيّين من الذّهب والفضّة قيمة لكلّ متموّل، وهما الذّخيرة والقنية لأهل العالم في الغالب"[4]

Moreover, God Almighty created the two metallic stones of gold and silver as a value for every rich person, and they are generally a medium of store of value for the people of the world.

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[1] Ibn Qayyim, *I'lam al-Muqi'in 'an Rabb al-'Aalamin*, 2: 105.
[2] Ibne taymiyyaah, *Majmu ul Fatawa*, 29: 469.
[3] Abu Saud, Mahmood, *Khutoot Raiesiyyah Fil Iqtisad Alislami (*Kuwait: Maktaba Al Manar Al islamiyya, 1968), 27,28.
[4] Ibn e Khaldoon, *Tariekh Ibne Khaldoon*, 1: 323.

So, all these functions that are mentioned by the economists have already been discussed by the early Muslim Jurists, thus acceptable by shariah.

We can summarize the above discussion in the fallowing points.

1. In Arabic literature the word Naqd (نقد) is used for Money. However, we do not find the word (نقد) in the text of Quran or Hadith of the prophet SAW. The reason is that the people of Arabian Peninsula used the word “Dinar” for currency made up of gold and the word “Dirham" for the currency made up of Silver. Furthermore, the word Wariq was also used for silver currency and *Aeyen* (العين) for gold currency.

2. There are two main schools of thought. One school of thought limits the application of the term money to gold and silver. The other school of thought do not restrict its application to gold and silver rather apply it to other mediums of exchange like fulus (bronze coins). The reason for their different points of view about money is the customary practice

3. There was no Islamic currency minted by Muslims in the era of the Prophet. However, some measurements and weights were determined for the already available currency minted by Byzantine and Sassanid Empire.

4. Abdul Malik bin Marwan is the first caliph in Islamic history who formally minted gold and silver coins in 76AH called al-Dinar Al Islami and Al-Dirham Al-Islami. Islamic Dinar was equal to one Mithqal and was a bit lighter than the Roman Dinar which was 4.25 grams. The weight of Byzantine dinar was 4.55 grams. The weight of Dirham that was minted by Marwan was 6 Dawaniq. He also issued Fulus.

5. The necessary condition for money in Islam is Rawaj which means that the money must be in Circulation and generally accepted to apply relevant shariah rulings on it. people must have an interest in it, and it must be an attractive wealth for them

6. The early Muslim Jurists have almost mentioned the same role and functions of money as mentioned by the conventional economists.

Chapter: 2

Issuance of Currency and Demand and Supply of Money

2.1 Issuance of Currency:

In the previous chapter we have discussed that money has evolved throughout the history from commodity money system to the bank note. In the beginning these bank notes were backed by gold or silver, or both. However, with the passage of time the relationship of gold and paper currency came to an end and now the currency derives its value from law and its value is determined relative to other currencies in the market through demand and supply rules.

Under the topic issuance of currency, the process of issuance of currency in both conventional and Islamic financial system will be discussed.

Source of the Value of Paper Currency

Although, in modern economic system, paper currency derives its value from law and there is no any precious metal in the back of the paper currency, yet there must be some factors that make paper currency a valuable and attractive wealth for the people and on the basis of which value of the currency of each country is determined and compared to other currencies. For example, why dollar or riyal is more valuable as compared to Pakistani rupee? To answer this question, we now mention some factors that are considered as source of the value of paper currency.

1. Gold: Gold is still used as a reserve in central banks and as an international payment instrument.

The gold reserves consist of bullions and gold coins in the central bank in addition to the gold certificates issued by the government. The gold certificates become part of gold reserve when the government buys gold from individuals in exchange for a check drawn from the central bank and then the government sells gold certificates to the central bank.[1]

Thus, in this way, the central bank issues more banknotes against the quantity of gold.

[1] Shafi, *Muqaddima Fi alnuqood wal bunook*, 46.

2. Foreign Currency Reserves:

Foreign currencies are the mainstay currencies, and they are strong currencies, such as the US dollar, Japanese yen, German mark, British pound, and French franc. These currencies are an obligation upon the issuer. Countries who issue these currencies are obligated to fulfill obligation towards those who hold them. For example, if Pakistani government has hundred thousand US dollars, the issuer of this currency, America, is obligated to fulfill its obligations toward these hundred thousand dollars owned or held by Pakistan. The main source of these foreign currencies is the exports of a country as they are the means of payment in international trade.

Thus, the government issues its local currency against these foreign currencies. In this way, foreign currencies are also considered as source of value of paper currency.[1]

3. Special Drawing Rights (SDRs):

It is an international credit facility. The International Monetary Fund has introduced a special system called special drawing rights used as a means of settling debts between central banks of the member countries. This credit facility is also used to facilitate member countries if they face lack of liquidity problem.[2]

Actually, SDR is an artificial currency instrument and a supplementary reserve asset. It is created by a basket of most dominant and important key international currencies like US dollar, Euro, Chinese Yuan, Japanese Yen, and pound Sterling. International community thought about this system, following the decision of the American President Nixon to stop the conversion of dollar to gold on August 15, 1971.

When this system came into operation, one unit of special drawing rights was equivalent to 0.888671 gram of gold, which was also equivalent to one dollar, and was called paper gold. The value of each unit of SDR is revised every five years.

Thus, the Fund provides Member States with foreign exchange against their national money, in order to assist them in the event of a budget deficit.

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[1] Muhammad khalil Barhi and Ali Hafiz Mansoor, *Muqaddima Fi iqtisad Al Nuqood Wal Bunook*, (Cairo: Maktaba Nahza Al Sharq, Alqahira, 1982), 48.

[2] Al Umar, Ibrahim Bin Salih, *Al nuqood Al ietimaniyyah* (Riyaz: Darul Aasima, 1414 AH), 258.

Government Securities

The central bank directly or indirectly purchases new government debt by purchasing government securities with the aim to eliminate the negative impact on bond prices that results from the sale of large number of treasury bills in the market. The central bank controls the circulation of money in this way. When the central bank purchases these government securities it issues more currency notes to fulfill its obligation to pay the amount either to government in case of direct purchase or to the public in case of indirect purchase. This process is called deficit financing.[1]

Thus, the central bank issues currency notes against these government securities which may be considered a source of value for paper currency.

Economic Conditions

As the value of banknotes depends upon the amount of goods and services available in a country, therefore if the national economy is strong, the value of money rises, but if the economy weakens, the value of money weakens as a result of decrease in the gross domestic products.[2]

Actually, the economic conditions are not considered as a direct source of value of paper currency, however, in favorable economic conditions and powerful economy, the exports of the country increase which bring more foreign currency in the country. Foreign currency is, as discussed above, a source of value of the paper currency.

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[1] Bari Segal, *Al Nuqood wal Bunook wal Iqtisad*, trans. taha abdullah Mansoor and abdul Rehman (Riyaz: Darul Mareikh, 1987), 227.

[2] Crowther, Jeff, *Almoojaz Fi iqtisadiyatunnuqood*, trans. Mustafa Kamal Farid (Cairo Egypt: Darul Fikr), 307.

Issuance of Currency in Conventional financial system

In the early periods, almost every bank had the right to issue notes. However, the empowerment of banks to issue currency notes led to excess supply of currency notes, inflation and economic instability. However, gradually this important role was entrusted to central bank and other banks were stopped to issue notes.

Paper money is a legal tender issued by the government. It has no intrinsic value and is not backed by any precious metal. Therefore, there must be a system to control the supply and demand of currency notes to avoid excess supply or deflation in the economy. There are various currency issuance systems in the modern economic system that control the quantity of currency notes and the circulation of money in the economy. The central bank is generally responsible for the money supply that mainly includes the issuance of paper currency and supervision of commercial banks operations in the economy.

There are four most important methods or systems of issuance of currency.

1. Maximum Fiduciary System.

In Maximum Fiduciary system the central bank of a county is authorized to issue currency notes without any gold reserves up to a certain limit. The ceiling is defined by the law. The central bank is not allowed to issue currency notes beyond the defined limit. At the same time, the central bank is authorized to take decision regarding the form and quantity of reserves to be kept against the currency in circulation. The ceiling defined by the law or government is generally above the normal requirements of the country's economy. The law related to determination of ceiling may be revised from time to time as per requirements of the industry and other economic activities.

This system was first adopted by France between 1870 and 1928 which was followed by England since 1971. Japan also has adopted this system since 1941. The decision making authority on the determination of maximum limit for currency notes in circulation may be different from country to country. It may be the central bank or treasury or the legislature.[1]

[1]Nadar, E. Narayana*, Money and banking*, (Delhi: PHI learning Private limited, 2013), 37.

This system is elastic to towards the requirements of the economy and not a rigid system. This system is economical because it requires only limited quantity of gold as reserve for the currency notes.

However, the main problem of this system is the risk of inflation if the maximum limit for issuance of currency notes is kept very high.

2. Fixed Fiduciary System

Under the fixed fiduciary system, the currency issuing authority, like central bank, is authorized to issue a fixed amount of currency notes against reserves in the form of government securities. If there is need of issuing currency over and above the already fixed limit, the issuing authority is required to do so against hundred percent reserves of precious metals like gold and silver.

This system was initially introduced in England in 1844. The bank of England was empowered to issue fourteen million currency notes without any gold reserves and to keep hundred percent gold reserves for the currency issued beyond the fixed limit.[1] This system ensures safety against inflation. The government expenditures can be checked and assessed through this system, as it does not allow overprinting of currency notes in normal situation.

However, this system, sometimes, does not keep pace with the requirements of emergency when there is need of currency notes beyond the fixed limit. Moreover, some quantity of currency must be redeemed or withdrawn from circulation in case of reduction in quantity of gold reserves. This may have an adverse effect on the general level of prices, industry, and trade.[2]

3. Proportional Reserves System

In proportional reserves system a certain amount of currency note must be backed by gold reserves and the trade bills and government securities must cover the remaining quantity of the notes in circulation. This proportion has varied from time to time between twenty five to forty percent. The law of this system has a provision that the reserve limit may be dropped below the fixed limit if certain conditions are fulfilled, and special situations require so.

This system was simple and elastic toward the needs and requirements of the modern economy.

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[1] Nadar, E. Narayana*, Money and banking*, 37.

[2] Akhtar.S.M and Dewett k.k. *Modern Economic Theory*, 353.

4. Minimum Reserve System

Under the minimum reserve system, the central bank or currency issuing authority is required to keep a minimum amount of gold and foreign currency as reserve and issue currency after keeping government securities and approved commercial papers as reserves. This system was adopted by India in 1956.

This is also an elastic system. It allows the central bank to issue currency notes as and when required. The deficit financing is easy for government under this system. However, on the other hand this system may cause high inflation in the economy that may lead to loss of people's confidence on the monetary system. [1]

Which of the above mentioned four systems is best? The answer is that the importance of each system may vary for each economy. Therefore, every country will adopt the system that will best suit to its economic and sometimes political conditions.

Issuance of currency in Islamic economic system.

There is no disagreement among Muslim jurists that the state - and only state - is the authority in issuance of currency and it is not permissible for anyone to perform this task.

The famous Muslim historian and Jurist Ibne Khaldoon says:

"The head of the state is charged with repairing of coins and is responsible to save them from any type of loss or damage."[2] According to Imam Ahmad coins must be minted in Islamic minting house with the permission of the head of state because if public is allowed to mint the coins it will lead to harm to them.[3]

Another Muslim jurist of Hanbali School of thought Imam Ibne taymiyyah is of the view that the head of the Islamic state is responsible for minting of coins for the people.[4]

Abdul Malik Bin Marwan is the first caliph in Islamic history who formally minted gold and silver coins in 76AH called al-Dinar Al Islami and Al-Dirham Al-Islami. He also restricted the process of minting coins to the central government.[5] The Jurists of that period did not oppose Abdul Malik bin Marwan in decision.

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[1] Al Subahi, Anwar Muhammad, *Al zawabit Al iqtisadiyyah, lilisdar al Naqdi* (M.Phil. diss., University of Quran and Islamic sciences, Sudan, 2014), 62.

[2] ibn Khaldūn, *Tariekh Ibne ibn Khaldūn*, 1: 721.

[3] Al-Buhūtī, Manṣūr Ibn Yūnus, *Kashaful Qannah en Matni Iqnah* (Beirut: Darul kutub Al Ilmiyyah), 2: 232

[4] Ibn Taymiyyah, *Majmoo' al-Fatawa*, 29: 469.

[5] Ibid, 10.

We can also find the evidence for this assertion in famous shariah legal maxim that is

"ما لا يتم الواجب إلا به فهو واجب"[1]

what is necessary to perform a shariah obligation, is itself obligatory.

Another shariah maxim says:

"الضرر يزال"[2]

"Harm must be eliminated."

Thus, Islamic state is responsible for issuance of currency. Any individual or private institution is not allowed to issue currency to ensure the purity of coins and to avoid mixing of inferior material in the currency. Furthermore, in modern economic system currency derives its power from the law and guarantee of the government, therefore government is responsible to issue currency to save public interest. paper currency has no intrinsic value. It is value able and accepted as medium of exchange because government has guaranteed it value. Moreover, Throughout the Islamic history Islamic state has paid great attention to this task and performed its responsibilities towards issuance of currency.

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[1] Sidqui, Dr. Muhammad, *al-Wajiz fi Eizahi Qawaed al fiqh al Kuliyyah* (Beirut: Muassasah al-Risalah, 1996), 1: 393.

[2] Sidqui, *al-Wajiz fi Eizahi Qawaed al fiqh al Kuliyyah*, 1: 251.

Issuance Of Currency in Islamic Economic System:

The system of issuance of currency in Islamic economic system is different from that of conventional economic system. This difference may be summarized in following two points:

1. A considerable quantity of money is created by the financial institutions dealing in disbursing loans on interest which is called credit creation or money creation by banks. The process will be discussed in money supply. However, this is not allowed in Islamic economic system.
2. Secondly, the process of issuance of currency by the central bank in conventional economic system is a loan-based process, as the central bank issues the money that the government borrows from it.[1]

However Islamic economic system does not rely on the loan based system. It has its own rules and process of issuance of currency.

Currency Reserves System Is Islamic Economic System:

Some of the economists are of the view that central bank must be given full and final authority to decide the quantity of currency to be issued without any conditions or instructions from the government. However, this point of view could not get acceptance among economists as it has some negative effects on the economy.

The other point of view is that there must be some rules, regulations set, and some conditions imposed by the government on the central bank with respect to issuance of currency. Those who hold the second view have introduced different systems for issuance of currency. These are, Maximum Fiduciary system, Proportional Reserves System, hundred percent gold reserve system, Fixed Fiduciary System, and Minimum reserve system. The detail of each system has been discussed above.

Now, keeping in view the above mentioned applicable monetary systems, where paper money is not convertible into gold or any other precious metal, it has become a prerequisite for Islamic economic system to determine a currency issuance system and present measures to control supply of money in the economy.

In Islamic economic system, the central bank is an institution that acts on behalf of the central government in the process of issuance of currency. As it has a significant impact on development and distribution of wealth in the society, therefore,

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[1] Al Jarihi, M'abad, *Nahwa Niazam Naqdie wal Mali Islamic (toward Islamic financial and monetary system)* (Jeddah: king abdulaziz University, international center for international economic research), 21.

there must be some restrictions and limitations on issuance of currency. An Islamic central bank must observe the following basic important rules.

1. to maintain the true value of money, which is the purchasing power of monetary unit, equilibrium must be ensured between the volume of money issued and the volume and rate of the real exchange between individuals and institutions of society, considering the rates of steady growth of the economy in general while ensuring the relative stability in the general price level.[1]

2. In case of deficit financing, the new quantity of the issued currency must play an important role in financing development activities and must have a positive impact on general employment rate in a way that the deficit financing does not affect the stability by disturbing the equilibrium between quantity of money in circulation and the real exchange rate.

3. In an Islamic economic system the central bank must adopt the *Musharakah* model in deficit financing rather than loan-based conventional model[2]. Musharakah model would limit the flexibility of the money supply by the central bank, which is necessary for the increasing rate of steady growth in the economy and would help in maintaining the increasing volume of real exchange rate in the market at a suitable desired level.

Therefore, it seems appropriate that currency issuing system that the Islamic central bank can adopt is the system in which there is no relationship between the issued banknotes and the gold reserves, taking into consideration the aforementioned rules. This system is flexible in deciding the amount of currency to be issued and type of reserves to be kept to ensure the value and purchasing power of the currency at certain required level.

General Rules and Regulation of Issuance of Currency in Islamic:

What are the factors, in Islamic economic system that will decide the quantity of currency to be issued? Generally, there are three basic factors that will decide the quantity of currency to be issued.

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[1] Almisri, Rafique younus, *al Islam wa Al Nuqood*, 181.
[2] Al Jarihi, *Nahwa Niazam Naqdie wa Mali Islamic* , 25.

1. Demand for Money in Islamic Monetary Market.

The basic factor that will decide the quantity of currency to be issued by the central bank is the demand for money in the market. The concept of demand for money will be discussed later. However, the demand for money, in Islamic economic system will not include financial transactions that involve factors which are not allowed in shariah like interest, gambling and hoarding.

2. Ensuring Economic Interest and Avoiding Monetary crises:

In issuance of currency the economic interest must be considered by providing the appropriate means of payment for the expected exchange volume taking into consideration the annual rate of increase in the gross national products and avoiding the monetary crises such as inflation and deflation.

3. Monetary Reserve:

Monetary reserves in the Islamic economic system can play a more important and effective role in controlling the money supply by central bank. It plays two basic functions.

- Restricts the central bank's authority to issue currency to prevent excess supply to protect the economy from inflation or deflation.
- Ensures the equilibrium between volume of the financial transactions and the amount of money issued.[1]

Islamic Concept of Deficit financing:

In conventional economic system, when the government needs additional quantity of money to meet public expenditure or to execute development projects, it generally, gets loan either from the public by issuing bonds or orders the central bank to issue additional quantity of currency as a long term loan from central bank to the government against credit instrument. This process is called deficit financing.

However, both of these two processes involve interest which is not allowed in Islamic economic system. Furthermore, the government loans are a burden upon public who are liable to pay these loans in the form of taxes.

To avoid these factors in deficit financing, the process of deficit financing in an Islamic economic system will be based on *Qarz Hasan*. To fulfill the need of

[1] Al-Tamimi, Yahya Muhammad Hussain Shawar, *Nahwa Msraf Markazi Islami*, M.phil diss.,Ummul Qura University Makkah, Saudi Arabia), 353.

additional quantity of money, the central bank, after printing the required additional quantity of currency will provide interest free loan to government which will be returned to the central bank in the long run. The central bank may also disburse interest free loans to other banks on the condition that the amount of loan will be invested in projects or sectors of public interest specified by the central government.

Although this process, being an interest free transaction, is permissible from shariah point of view, however economic effects like inflation will be the same as of conventional deficit financing.

Therefore, in Islamic economic system any step taken by the government that harm public interest, is not permissible. The scholars have clearly mentioned that

إنَّ التَّصَرُّفَ عَلَى الرَّعِيَّةِ مَنُوطٌ بِالْمَصْلَحَةِ[1]

The (ruler's) management (of his subjects' affairs) for the public is bound with the Maslahah (public interest)

Thus, deficit financing, that leads to extra ordinary devaluation of money and decreases the purchasing power of currency, is not allowed in shariah because the acts of the government in shariah are acceptable and permissible as long as they do not conflict with public interest.

Musharakah Model for Deficit Financing

Some of the modern Islamic economists have suggested *Musharakah* model for deficit financing.[2]

In *Musharakah Model* the central bank will issue currency notes. The central bank will open investment accounts with other banks on the basis of *Musharakah* agreement, where it can deposit or withdraw the issued currency. The banks will invest this amount in development sector, definitely in accordance with shariah rules and with the investment policy adopted by each bank. A part of the profit gained from these deposits can be used to cover the expenses of the central bank. Another part of the profit may be provided to central government as loan, and rest of the profit may be reinvested in the same way. This investment account may be supported by issuing a credit instrument like *modaraba sukuk* or *Musharakah*

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[1] Afandi, Ḥaydar, 'Alī,Khwaja, *Durar al-ḥukkām sharḥ Majallat al-aḥkām* (Beirut: Darul Jeel, 1991, 2: 288.

[2] Al Jarihi, *Nahwa Niazam Naqdie wa Mali Islamic* , 31.

Sukuk, to collect money from the public. Sukuk actually represent share in a project. It is issued, by the project owner, to raise capital to fulfill financial needs of the project. this is a shariah compliant instrument. Sukuk holder deserves his profit share as the ratio agreed after the maturity of the *Sukuk*.

The amount deposited with the commercial banks by the central bank on *Musharakah* basis can be used to achieve socio economic goals of the economic system. For this purpose, Special instructions may be issued to these banks to invest these amounts in a specific sector to achieve the economic goals. These accounts may also be operated on *Mudharabah* model in same way as mentioned above.

However, would these Islamic models help to control the inflation and deflation? The answer is yes, it will, because the amount will be used in development sector that would lead to an increase in gross domestic product, thus creating the demand for additional currency issued by the central bank. Furthermore, the head of the stat would adhere to the Islamic teachings regarding saving the public interest and would not issue any extra quantity of money that may cause financial crises.

Moreover, the role of Islamic banks in expansion of money supply cannot be ignored and must be accepted and recognized as a natural phenomenon although its role in this respect is limited as compared to conventional interest based banking system because this is an unavoidable reality that Islamic banks activities result in credit creation to some extent due to the nature of some Islamic modes of financing. However, the impact of such modes of financing may be minimized through Musharakah or *Mudharabah* model as mentioned above.

Issuance of Currency Notes in Pakistan by State Bank of Pakistan

The state bank of Pakistan is responsible for regulation of currency in accordance with requirement of prevailing economic situation. Under Section 24 of the State Bank of Pakistan Act, 1956, The state bank of Pakistan has the sole right in country to issue currency[1]. As per the state bank of Pakistan's act 1956 under section 30 the assets of issue department should not be at any time less than its liabilities. The liabilities here mean the total notes issued. The assets that must be kept against notes issued are gold, coins gold bullion, silver bullion, approved foreign exchange, and special drawing rights held with International Monetary Fund. After fulfilling the minimum required criteria of the above mentioned assets, the bank can also keep rupee securities, rupee coins, and some other commercial papers.[2]

A question may be raised that is it necessary from shariah point of view to keep such assets against currency. The answer is no, because once Pakistan currency or rupee has been declared as medium of exchange and that it does not represents any asset and not a debt instrument, there is no requirement of such assets that is reserved against issuance of currency. However, this is the requirement of economic system. The government is responsible for ensuring the stability in the value of money. Thus, this is one of measures taken by the monetary authorities for the stability of the value of currency and is not a shariah requirement. From shariah point of view, Government is responsible to maintain the value of currency. Shariah does not specifies any way or any type of reserve as necessary requirement for paper currency.

[1] 19 nov, 2020, https://www.sbp.org.pk/about/sbpact/sbpact56/sbpact12.htm.
[2] Ibid.

2.2 Supply of Money in Conventional and Islamic Economic System

Following the failure of the Marxist thoughts in addressing the financial crises of 19th century, there were three other waves of evolutionary thoughts in the macro economy. Each thought has their decision makers and promoters. The first school is the classical school who envisaged the economic system as a system managed by hidden power, and that any interference in this automatically managed system will disturb it. the defect or imbalance, that may occur, will be automatically fixed by natural market forces. This theory prevailed until the financial crisis in 1930 that resulted in great depression and general unemployment.

The second school of thought that emerged after the 1930 financial crises and represented by Keynesian school of thought, called for a greater role of the state by making fiscal and monetary policies. This school of thought presented the idea of interference by the government, even they allowed deficit financing through issuance of currency or creating debt. Keynes has built his theory supposing rigidity of prices and wages in the short run which means that prices and wages do not change in the short run. He also believed that natural market forces are unable to deal with financial crises. It means that Keynesians have accepted the monopoly as a fiat accompli and a real fact of the modern economy and treated this disease by another disease that is increasing inflation through deficit financing.

This thought was followed by another financial crisis happened in the seventies of the 20th century, when Keynesian monetary tools were unable to treat the imbalances that were caused by their tools and resulted in the stagnant inflation since 1970.

The third wave was the wave of monetarists that moved the pendulum of thought back to classical school of thought and called for restricting the role of the state in monetary and fiscal policy[1] and controlling the money supply without interfering in interest rate. According to this school of thought, state has to play its role in money supply while leaving the interest rate to be determined by the natural market forces.

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[1] Muhammad, Yousuf Kamal, AL Masrafiyyah Al Islamiyyah,second edition, 1416AH-1996 , Dar ul Nashr Lil Jamiaat, P: 10

Supply of Money

The development that accompanied money throughout the history led to an ambiguity in the concept of money supply, especially in the last stage of development, which is the stage of credit money created by the banking system, to which the whole world in general and the capitalist world in particular have resorted to, since the first quarter of 20th century. The reason for this ambiguity lies in the answer of the fundamental question that is “what money is”?

Actually, economists need to know the supply of money in the market for current and future decision to determine the path of the economy and to take necessary and timely decisions. For this purpose, they measure the amount of money circulating in the economy., However, they find it difficult to determine what money exactly is in our economy or which instrument is playing role that affects the economic activities. This is because definition of money determined by its functions which leads to confusion in determining the supply of money.

This is because if we have a look of our economic activities, we will find many other instruments that are playing role like money. These instruments are used as medium of exchange and are, to some extent, generally accepted in the market. They also act as store of value for short-ran. People frequently use them in their day today transaction. These instruments include traveler’s checks, demand deposits and other checkable deposits. Should these financial instruments be included in the definition of money? There are two concepts.

One is orthodox concept and the other is modern concept, also called narrow and broader concepts. The orthodox concept accepts only currency as medium of exchange. However, modern economists, when calculate money supply, include other financial instruments as. We have discussed this topic in first chapter in detail.

Nevertheless, one of the most generally accepted definitions of money supply today among economist is that it is the average amount of money at the disposal of society at a specific period[1]. It means that money in circulation is called the money supply.

This definition indicates that the existing money supply includes all things that enjoy the feature of general acceptance and is usually used as a medium of exchange.

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[1] Musa aadam Eisa, *Al-tawazun al-Naqdi wal Haqiqi Fil Iqtisad A_Islami*, PHD diss., Ummul Qura Univeristy Saudi Arabia, 1410-1990), 9.

It acquires the character of money regardless of its legal status. In accordance with this criterion the money supply is called "available means of payment" to distinguish it from some other terms that will be discussed later on.

The available means of payment is the accepted definition of money supply in its broader concept, which is generally accepted by the capitalist economists and this definition is used by the International Monetary Fund in its accounts and calculations.[1]

The Components of The Money Supply:

It is clear from the foregoing discussion under the topic concept of money in first chapter that according to economists, “money is anything that is considered a medium of exchange, a standard of value and has a general acceptance in fulfilling of the financial obligations. Accordingly, the term money supply refers to the total amount of money in circulation other than the amount of money with the government, treasury, central bank, or commercial banks”.

Thus, the supply of money at a specific time is the total amount of money available at that specific point of time.

Determinants And Players of Money Supply.

There are determinant and players that play their role in process of money supply.

1. Players in the Money Supply Process:

There are four players in the process of money supply. These four players play their role to increase or decrease the money supply.

1. The central bank of the country: the central bank of a country is responsible for supervision over the banking system and for monetary policy.

2. The banks: the banks receive deposits and disburse loans from the public and institutions.

3. Depositors: individuals and other institutions who deposit their excess money with the banks.

4. Borrowers: the institutions and individuals who borrow money from banks on interest based agreements.

The change in the central bank’s policies or change in the behavior of commercial banks will affect the money supply either by decreasing or increasing. Likewise, the

[1] 17 may, 2020, https://www.imf.or.g/external/p.ubs/ft/fandd/2012/09/ba.sics.htm

behavior of the depositors and borrowers will affect the money supply either by increasing or decreasing.[1]

Components of Money Supply

The determinants of money supply would be as under:

1. Metallic Coins Denominations:

This is a currency of small denomination issued by the government to be used in small financial transactions and is generally in shape of coins.

2. Bank Note:

Bank note is the updated form of money in the history that it went through during its evolution and until it became a legal tender. It now and nonconvertible to gold or any other precious metal and is in full liquid form. The central bank in the country issues these notes according to specific issuance standards and methods discussed previously.

3. Deposits with Banks

For the purpose of calculation of money supply, we have determined that money is anything that is used as medium of payment regardless of its legal status. Thus, cheques and other means of payment or credit instruments are not a legal tender or not legally declared money. However, for the purpose of calculation of money supply these instruments are considered money. Here the deposit means current deposits. This is because the circulation of these instruments has the same effect or role in the economy as legal money or banknotes have. As for as the matter of termed and saving deposits is concerned, they will be discussed later on.

In the following lines we will discuss the creation process and impacts of the credit money

Islamic Concept of Money Supply

Islamic concept of money supply can only be discussed once we have discussed the status of the money supply components in Islam. We will shed light on the shariah point of view about the amount of money issued by the government through its designated agency like central bank and on the credit money created by the banks.

[1] Mishkin, *the Economics of money Banking and financial markets*, 380.

Islamic Concept of the First Component of Money: Money Issued by the Central Bank.

There is no disagreement among Muslim economists that legal tender with its both forms that is bank notes and copper money of small denominations are the main and basic components of money supply in the Islamic economy.

As we have discussed in first part of this chapter under the topic issuance of currency that there is almost consensus among Muslim Jurists that the state - and only the state - is the authority in issuance of currency and it is not permissible for anyone individual to perform this job.[1] After going through the opinions of the Muslim Jurists in this regard it seems that they have taken a firm stance on the issue of issuance of currency and have clearly mentioned that only stat has the right to issue currency.[2]

Muslim Jurists have taken this firm stance about the issue because:

1. Money, with its full liquidity and ability to be exchanged with all types of goods and services, has become the primary source of wealth and the Islamic State is directly responsible for preserving the people's wealth by ensuring its transfer only by legitimate means. This is one of the five purposes of the Shariah.

2. Secondly, money is nowadays in the form of fiat money and has to be issued taking into consideration the amount of money in circulation and the affect of new quantity of money to be issued. It is also a legal tender by the guarantee of the government; hence anyone other than the government cannot issue it.[3]

Thus, the first component of money supply as per shariah guidelines is money issued by the central bank.

The Second Component: Credit Money

In interest based banking system the banks create money, and the role of these banks is not less important than the central banks in creating and providing means of payments or medium of exchange in the economy.

What is the process of creation of money by these banks?

[1] Ibn Khalduūn al-Ḥaḍrmī, *Tariekh Ibne ibn Khaldūn* ,721.

[2] Al-Buhūtī, Manṣūr Ibn Yūnus, *Kashaful Qannah en Matni Iqnah* (Beirut: Darul kutub Al Ilmiyyah 2004), 2: 232, ------ Ibn Taymiyyah, *Majmoo' al-Fatawa*, 469.

[3] S. Mishkin, *the Economics. of money Banking and financial markets*, 366.

Individuals deposit their savings with commercial banks in current deposits if they think they would need them for emergency use or in saving deposits if they want to invest them.

The commercial banks receive deposits from public. They keep a portion of these deposits with them as required by the central bank of a country called required reserves and another portion of these deposits is kept to meet the daily cash requirement of the depositor's excess reserves. There is no demand for with drawl of all the cash deposited with the bank. Furthermore, some depositors keep this money in saving accounts. Banks give this money on interest to the people who need this money for their daily use or for expansion of business activities. For example, if a bank receives a hundred thousand deposits, it will keep twenty thousand with it and will make loan of the eighty thousand. The remaining eighty thousand will become an asset for bank because receivables are considered assets of the bank, and this will be a part of the money supply which has now increased by eighty thousand.

Now, there is no real money. The same amount has been recorded as asset and liability, thus no real increase in money. However, the money supply in the economy has increased by increase in circulation of money and recording debts. Therefore, this process is called creation of money by the banks.[1] In this way the commercial banks in the interest-based system create money and participates in providing the means of payment in the economy.

There is no doubt that there are some negative effects of creating money and increasing the money supply by commercial banks. First of all, increase in money supply leads to the high price level and lowers the purchasing power of currency. Consequently, those who have fixed income are badly affected. In addition, the increase and decrease in the purchasing power of money as a result of an increase or decrease in the money supply of deposits through banking system affects the role of money as a measure of values. Money also plays its role as measurement of value. Therefore, its value must be maintained. In case of fluctuation in its value, it will lose the confidence of the people.

Furthermore, by giving the right to commercial banks to create credit money, we will be giving them a right to participate in the money supply which is the sole right of the

[1] S. Mishkin, *the Economics. of money Banking and financial markets*, 366.

state. Another problem is the huge profits that commercial banks achieve from acting as money supplier in the economy and leads to gap between different classes of society. Actually, banks receive deposits from individuals with nominal and ordinary income and give loan to businessmen. A very small portion of the returns or profit earned is given to the depositors and a large portion of this profit is goes to businessmen and the bank. In this way, the gap between rich and poor becomes wider.

Credit Money and Islamic Concept of Money Supply

The credit money creation system is based on interest which is prohibited in Islam. This is because, the banks disburse loan and receive interest on these loans. If for example the credit money supply is deemed necessary for smooth supply of money in the economy, would it mean that there is an obstacle in smooth money supply in Islamic banking system?

In Islamic banking system, there is no obstacle in the process of money supply. Rather, the absence of interest provides mechanisms for money supply with stability which will be more beneficial for economic activities. There is no reason to say that the Islamic banking system is unable to create enough liquidity for the economy. Rather, Islamic banks will continue to perform the function of financial intermediation between savers and investors and the way in which Islamic banks operate will address the issue of excess liquidity creation, because it links financing operations to the expected profit rate, as the financier is a partner and not a creditor.

As for as the process of generating credit money is concerned, so it does not necessarily depend on charging interest, on sharing profits or on paying a specific percentage of the profits to deposit holders. Rather, it depends on the amount of cash balance that banks hold for deposit holders and on the awareness about the banking system, dealing in checks and other factors that govern the contemporary banking system.

If we assume that Islamic commercial banks continue to work on the principle of partial reserve, that is to keep a part of deposits as reserves and lending the other part to customers, they will be able to expand credit and create money, but this money will not appear in the form of interest-bearing loans, rather this money will be in the form of bank money requiring a share of the actual profits of the project and will be creating money when both the debtor and the bank have that real expectations for creating additional wealth or increase in the supply of goods and services.

If there is loss in the project financed by the bank, the principal amount would be returned to the bank after deducting the amount of loss. Thus, the modern Islamic banking system which is based on *Musharakah* will not allow the money supply to exceed the real supply of goods and services.[1]

There is no doubt that linking the derivative deposits with participatory contract like *Musharakah* would make the profit an important internal variable in determining the money supply according to the pace of economic boom. The money supply linked to the market through profit makes monetary expansion and contraction stable and returns the money to the neutral role as a medium for exchange only, as envisaged by the classical concept of money[2]

There are some Muslim economists who are of the opinion that the banks must not be allowed to create money through banking system as discussed above[3] because this will lead to inflation and instability in the economy.

Another group of economists is of the view that banks should be allowed to create bank money because it is necessary for the smooth activities of the economy. Moreover, the loss that some economists perceive and will occurs as a result of credit creation by the banks, may not be of the same size and effect as in the interest based system. [4]

Therefore, credit money may be considered a necessary part of the modern economy and must be allowed for the smooth activities of the economic system. However, it must be in an interest free economic system.

Quasi Money and Money Supply:

Quasi money is a form of financial asset that may, to some extent, play the role medium of exchange**.**[5]

In the start of money supply discussion, we have mentioned that some forms of quasi money are also considered a part of money supply according to some economists who adopt a broader definition of money. However, some other economists who adopt the narrow definition of money which means that only M1 is

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[1] Al Jarihi, *Nahwa Niazam Naqdie wa Mali Islami* , 15.
[2] Mishhal, Abdulbari Dr, *"Aaliyyat ul Tawazun Alkulli Fil Iqtisad Alislami"* (Phd thesis., Muhammad bin Suad Islamic University, Riyaz Saudi Arabia 2009), 117.
[3] Al Jarihi, *Nahwa Niazam Naqdie wa Mali Islami* , 15.
[4] Kahf, dr monzer, *Al Iqtisad Al Islami*, (Kuwait: Darul Qalam,1979), 146.
[5] Musa aadam Eisa, *Al-tawazun al-Naqdi wal Haqiqi Fil Iqtisad Al-Islami*, 207.

called money, they do not include term and saving deposit in money supply process, as they are not a part of M 1. It is agreed that current account is the part of money supply. So, what is the view of Muslim economists about the term and saving deposits?

In an Islamic economy, what we can understand is that it is necessary to exclude fixed deposits from the money supply components, as these are definitely investments of the people and are usually deposited with the bank either without specifying a specific period of time or with specific period of time. The holders of these deposits authorize the bank to invest them either directly or through the financing of projects. This money may generate profit or cause loss to the bank.

Moreover, the concept of money supply refers to the amount of money at the disposal of society at a specific period of time[1]. This concept requires the exclusion of fixed investment deposits from the money supply components because these amounts are included in certain investment commitments with banks. In addition to that they are not at the disposal of society because it is not allowed to withdraw them before the expiry of the period specified for their investment. Furthermore, our focus is in fact, on the choice of individuals between investing their money and carrying them as a liquid asset in their hands. Therefore, it is necessary to exclude these deposits associated with the investment from the money supply components.

As for as the matter of saving deposits is concerned, there is ambiguity in its nature, due to the difference of conditions rules of these deposits set by various Islamic banks. Some banks treat them as a current deposit, by giving the right to depositor to withdraw any amount at any time and give profits as well. However, some other Islamic banks treat them like term deposits. Thus, it is difficult to adopt a final view about including or excluding the saving deposits from money supply components.

However, based upon the treatment of saving accounts by the banks and volume of these deposits in a country, a decision may be taken about these accounts. If most of the banks treat them like current account by giving rights to depositors to withdraw any amount at any time and also give profit on them, they may be included in money supply components in an Islamic economic system and otherwise not.

[1] Mishkin, *the economics of money Banking and financial markets*, 358.

The Control of Money Supply

The high-powered money also called monetary base, which is equal to the currency in circulation C plus the total reserves in banking system may be referred to as R. So, the equation is

MB= C+R

The central bank controls monetary base to control the money supply. It controls the monetary base by sale or purchase of government securities in the open market. This process is called open market operation. It also controls money supply through extension of discount loans to banks. However, there are some other factors that affect the money supply and are not fully controlled by the central bank. Float and treasury deposit undergo substantial short run variations and may be considered an important source of fluctuation in the monetary base[1]. Similarly, the central bank sets the discount rates or interest rate on discount of loan for bank. After that bank have to decide whether to borrow or not. Although the amount of discount loans is influenced by the central bank, however it is not completely controlled by the central bank. To what extent central bank can exercise control over money supply.

Is Money an external variable?

The view about money supply, from the time of the traditional school of thought till the recent times, has been based on the fact that the money supply is an independent external variable determined centrally by the monetary authorities represented by the central bank through its control of the monetary base or high-powered money[2]. This point of view is still adopted by the Chicago School of thought.

On the other hand, some recent trends have emerged that are trying to draw attention to the fact that the money supply cannot be controlled by the monetary authorities according to the previously prevailed situation. Although the government authorities can control the amount of money it issues from time to time and the number of reserves as well, but there are some other factors that play their role in increasing or decreasing the amount of money. There are behavioral relationships that depend on the behavior of individuals and their customs. [3] It also depends upon the

[1] Mishkin, *the Economics. of money Banking and financial markets*, 365.
[2] High-powered money means the legal money through which banks can create credit money.
[3] Al Jarihi, *Nahwa Niazam Naqdie wa Mali Islami*, 33

behavior of the banks, and credit and reserve policies they follow. All these factors affect the money supply. These behavioral relationships that affect the money supply call for the formulation of a money supply theory that will depend on the behavior of economic key factors.

However, in an Islamic economic system, we do not find clear legal evidence from Islamic sources of law, supporting the view that money supply is an internal variable, and the monetary authorities cannot control.

As for the matter of second opinion is concerned according to which the money supply is an independent external variable, it depends on the definition of the external variable. According to some economists the external variable is a variable that is not controlled by some factors, while others consider that the external variable is the variable that is determined outside the model and may be controlled by external factors.

The first opinion that considers the money supply a variable controlled by the monetary authority and is on its discretion, irrespective of rational economic calculations cannot be supported and accepted.

As for as the second opinion is concerned, we can find some evidence that support the opinion that the supply of money in the Islamic economy is an external variable, and the government authorities try to control it. However, the Islamic monetary authorities must adhere to the principles of economic rationalization in the field of investment. It should issue money only in accordance with economic indicators and prevailing situation. Thus, the money supply may be increased by ratio of an increase in annual growth rate or by increase in the national income.[1]

In other words, the Islamic monetary authorities will increase the money supply by increasing the national income.

[1] Daghir, Dr, mahmood Muhammad, *Al ittijahat Alhaditha Fi Tahlil Arz Al Nuqood*, Journal of economics and management, King Abdul Aziz University Jeddah, 1 (1988), 136.

2.3 Demand for Money in Conventional and Islamic Economic System

So far, we have discussed the supply of money. Demand for money is also an essential part of this study to understand the monetary policy. Now we will discuss the demand theories of money. We will also analyze these theories and we will discuss the Islamic concept of demand for money.

Before the recent monetary revolution when the gold and silver era has come to an end and the use of paper currency was made mandatory that also accompanied the existence of derivatives from bank accounts to obtain interest, the economists were of the view that economic activity is limited to the volume of goods and services that are produced. They thought that the role of monetary side is confined to measuring of values and performing as medium of exchange. Thus, money was considered neutral towards economic activity which has no effect. [1] They reach a conclusion that there is direct relationship between the volume of money and the price level. An increase in money supply will directly affect the prices and a decrease in money supply will also affect price level.

1. Quantity theory of Money

One of the oldest theories explaining the relationship between money and income is the quantity theory of money that emerged in the year 1500 AD and formulated an equation that was later called the Fischer equation to show the neutrality of money and establishes a watershed line between real economic activity and the monetary side. This equation is:

$M\,V=PY$

Here P is the price level, M is Quantity of money, V is velocity, and Y is aggregate output. Aggregate out put is also called income or nominal GDP. This equation states that the quantity of money multiplied by the velocity of money must be equal to nominal income. Velocity of money means the number of times that this money is spent in a given year.[2]

As quantity theory of money tells us that how much money people hold for specific amount of aggregate income, therefore it is called demand for money theory.

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[1] Yousuf Muhammad, *Al Masrafiyyah al Islamiyya, Al Siyasa Al Naqdiyyah* (Beirut: Darul Nashar Liljamiaat, 1996), 43.

[2] S. Mishkin, *the economics of money Banking and financial markets*, 518.

Those who hold this view like Irving Fisher suppose that velocity of money remains constant in short run. According to this classical approach of money demand, it is assumed that individuals hold money to use it as medium of exchange to carryout daily transactions.

This theory was according to the prevailing situation at that time. As there was no formal banking system rather there were only money exchangers. Moreover, individuals could keep their savings only in the form of money or other assets like animals or real assets. Furthermore, they could not liquidate their asset as easily as we can do now. Therefore, the velocity of money was constant, as they would need money only to use it as medium of exchange. This theory was applicable during 19th century.

2. Keynes's liquidity Preference Theory

In his famous book "The General Theory of Employment, Interest and Money" Keynes developed a theory of money demand that emphasized the importance of interest rate in the monetary economic and abandoned the classical theory of money. In his theory which he called "liquidity preference theory", he raised the question that why people demand for money to hold it with them. He answers this question by emphasizing on three points. He says that people hold money for three purposes or three motives. These motives are the transaction motive, the precautionary motive and speculative motive.

Transaction Motive

Transaction motive means demand for money for financial transactions. In addition to the transactions that individuals perform to purchase consumer goods, transactions here also mean everything that institutions carryout to provide production factors to complete the production process.[1]

The demand for money for transactions motive depends on the volume of transactions in the economy as well as on the size of the national income. The higher the volume of transactions in the economy or the greater the national income is, the higher the total demand for money for the transactions motive would be. If the leve of national income is higher, it means there is economic boom and there would be more demand for goods and services. This situation requires more financial transactions.

[1] Yusri, Abdurrehman, *Iqtisadiyyat al Nuqood* (Egypt:Daruljamiaat Almisriyyah, 1979), 40.

An increase in financial transaction requires more quantity of medium of exchange. In this way there will be increase in demand for money.

Unlike the classical approach in which money is demanded only for transactions, Keynes holds the view that primarily, transaction demand for money is determined by the level of people's transactions. This is because he believed that these transactions were proportional to income. So, there are some other reasons for demand for money and transaction demand for money is a component of the total demand.

Precautionary Motive

Demand for money for precautionary motives means individual want to keep some amount of money for emergencies. This demand for money arises mainly from the lack of certainty of individuals and institutions about the economic situation. They think that the money required for the purpose of transactions is insufficient to meet the upcoming spending on transactions. Therefore, this type of expected future need compels individuals and institutions to keep an amount more than the amount arranged for expected daily routine transactions.

Keynes believed that in addition to demand for money for daily transactions, people want to hold money for an unexpected need. This may be an emergency need or may be an opportunity to be availed for higher profit. A person may need to hold money for a fancy store, or a car offered for sale on 50% discount.

A number of economists consider that the demand for money for precautionary motive is actually part of the demand for transactions motive because it ultimately becomes a part of portion of demand for transaction motive.

Nevertheless, the demand for money for precautionary motive is determined as a result of the psychological conditions that surround individuals. In times of recession, when pessimism and uncertainty prevail in the economy, the demand for money for precautionary motive rises, and vice versa in case of economic boom and revitalization.

Moreover, the growth in the volume of demand for money for precautionary motive is affected by the size of the national income, which increases with an increase in national income and decreases with a decrease in national income.[1]

[1] Jamih, *Al Nazariyyah, AL Iqtisadiyyah*, 2: 260

Speculative Motive

Speculative demand for money arises out of the desire of individuals and institutions to keep cash in its liquid form in order to benefit from market fluctuations, especially in the interest rate, to benefit from price differences. This benefit is achieved by getting profits or preventing loss. Thus, the demand for cash balances for the transactions motive is different from the demand for cash for the speculative purpose, as the cash required for transaction motive is money in circulation while the cash required in speculative demand is considered idle. [1]

The importance of monetary policy in relation to speculative demand for money lies in changes in interest rates, which inspired Keynes to think that if there is no speculative demand, there will be no importance of the open market operation.

In addition, speculative demand for money depends upon the choice of individuals and institutions for money between keeping money in cash form and keeping money in the form of other financial assets such as stocks and bonds.

Thus, when individuals and institutions prefer to hold money in cash form and want to prevent loss, the demand for cash increases. On the other hand, if individuals and institutions prefer to obtain regular limited income against risk they bear, in this case their demand for bonds increases, which guarantees a certain percentage of interest for them. As for shares are concerned, the individual or the institutions will invest their amount in stocks if they want to obtain higher income, keeping in view the consequent risks of loss generally anticipated in this type of investment.

And if the individual or institution want to invest, then he is supposed to be willing to bear the risk, and thus he will have a choice between keeping money on the one hand and investing in stocks and bonds on the other hand. This fact made Keynes to develop the theory of demand for money for Speculative motive with respect to preference of a person between money as a most liquid asset and between short term guaranteed bonds. This behavior of an individual or institution towards bond and shares is due to the fact that these securities are most liquid assets in addition to generating income.[2]

From the above discussion, it is found that demand for money for transactions and precautionary motives depends upon some factors like national income, the

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[1] AL Syed Ali, Dr Abdul Munem, *Dirasat Fil Nuqood Wa al Nazayiyyah Al Naqdiyyah* (Bughdad: Al AANi Printers, 1970), 191.

[2] Yusri, *Iqtisadiyyat al Nuqood*, 70.

prevailing pattern, and stages of spending and payments. Moreover, the demand for money for speculative motive depends on fluctuations in the interest rate. Thus as both transaction and precautionary demand for money are not affected by interest rate fluctuation, therefore the amount of money required for these two purposes remains relatively constant.

Friedman's Modern Quantity Theory of Money

The Chicago school of thought, led by Melton Friedman, reformulated quantity theory of money in a modern form now called the modern quantity theory of money.

Milton Friedman, in 1956, presented another theory of demand for money. In his theory, although, it seems that he refers to the famous economist Irving Fisher and quantity theory however his analysis of demand for money is closer to that of Keynes than it is to Irving Fisher's.[1] Friedman also started his theory by raising and trying to answer the question "why people want to hold money and keep it with them." However instead of concentrating on specific motives for keeping money, as Keynes did, Friedman mentioned that "demand for money must be influenced by the same factors that influence the demand for money for any asset. Friedman actually applied the theory of asset demand to money. Asset demand theory tells us that the demand for money should be a function of the resources (wealth) available with individuals and the expected return on other assets relative to expected demand on money".[2]

The following points will distinguish between the Friedman and Keynesian theories.

1. Friedman included many assets as alternative of money. Thus, he has accepted that more than one type of interest is important for the operation of aggregate economy.
2. Freidman is of the view that money and goods are substitutes. it means that people choose between money and other assets when they decide how much money is to be hold and what type of asset in which quantity is to be held.
3. According to Freidman expected return on money is not constant as Keynes envisaged.[3]
4. Friedman's theory will work in the long run as well.

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[1] Milton Friedman, *the Quantity. theory. of Money* A restatement in Studies in the Quantity theory of money (Chicago : University of Chicago. Press,1956), 4.
[2] Mishkin, *the economics of money Banking and financial markets*, 531.
[3] Ibid.

The above mentioned differences between the two theories are because of difference in the concept of money demand. Keynesian theory refers to transaction and speculative motives in demand for money that change with income and to speculative motives that change with the interest rate. An increase in income will lead to increase in demand for money for transaction and speculative demand for money. Similarly, if interest rate of bonds and returns on shares is high, the individuals will prefer to invest is savings in stock market. On the contrary, if returns of bands and shares are relatively lower, individuals will prefer to hold money in the cash form.

As for as the modern monetary theory is concerned, it does not differentiate between circulating and idle cash balances and does not give any importance to the role of interest in demand for money. Moreover, according to modern theory the demand for money is like demand for any other asset.

Demand for Money in Islamic Economic System

In the Islamic economy, the demand for money exists for all three types of demand that are transaction, Precautionary and speculative motives, but it is governed by various instructions already set by shariah that determine preference for demand for cash. However, in an Islamic community, the demand for money is narrower in scope than in other societies.

Money Demand for Transactions Motive

The demand for money for transactions motives exists in Islamic economic system to finance various consumer and investment operations. A Muslim is required to make good use of his wealth and spend it in suitable and rational way. He is not allowed to waste the wealth. Many verses of the Holy Quran indicate this concept.

"لينفق ذو سعة من سعته"[1]

"Let the rich man spend from his wealth."

إن المبذرين كانوا إخوان الشياطين[2]

"Indeed, the wasteful are the fellows of the devils."

وَكُلُوا وَاشْرَبُوا وَلَا تُسْرِفُوا إن الله لايحب المسرفين[3]

[1] Al-Talaq: 7
[2] AL-Isra: 27
[3] Al-A'raaf: 31

"And eat and drink but be not by extravagance. Indeed, He do not like extravagant"

Imam Muslim, has mentioned a Hadith of the prophet (peace be Upon Him), in which it mentioned that Allah do not like the waste of wealth.[1]

However, it is worth mentioning here that the demand for money for transactions motive may be significantly higher in an Islamic economy due to the fair income distribution. According to the economists, the more equitable and fair income distribution is, the more demand for money at a certain level of national income. There is no doubt that Zakat, law of inheritance, spending for the sake of God and other tools for distribution of wealth introduced by Islam will redistribute national income, both in the short or long run. This fair distribution of wealth reflects its impact on the volume of money demand for transactions motives.[2]

The demand for money for transaction motive depends upon tow factors. The first one is the income. Therefore, in conventional economic system it is a set rule that demand for money is the function of income.[3] The correlation between the two variables is positive. This means that higher the income, higher the percentage of money held in order to satisfy transaction motives of demand for money. The second factor is the demand for money for projects. The businessmen hold some of their wealth in liquid form in order to meet the emergency needs or spending before the sales revenue is generated.

It is worth mentioning here, that what makes difference between change in demand for money because of change in income in Islamic economic system and change in demand for money because of income in conventional economic system is the consumption theory. In Islamic economic system there is not only personal consumption, but a Muslim has to consume his money for other in charity work as well. This theory will definitely affect demand for money unlike conventional economic system, where such motives for demand for money are not available.

In Islamic economic system, this demand is also affected by the return on investment. The returns may be from participatory modes of financing like *Musharakah* or *Mudharabah,* or by direct investment by individual. The higher

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[1] Muslim, *Sahih Muslim*, Kitabul Buyooh, hadith 1715.

[2] Chapra, Dr Umar, *Nahwa Nizam Naqdiy AAdil*, Trans. Nihad syed Sakar (America: International Institute of Islamic Thought , 1988), 250.

[3] Mishkin, *the economics of money Banking and financial markets*, 518.

the amount of these profits, the higher the amount of funds directed towards the investment. The lower the expected profits, the greater would be the desire of individuals to hold money with them in cash form.[1]

In addition to income and its distribution, there are other factors that affect the volume of money, including the payment system and the pattern of payments for different projects in society, as mentioned above in conventional money demand theory. These factors play the same role in affecting money demand in Islamic economic system, as they have no shadows related to doctrine or religion. What is important to focus is the main relationship between income and money demand for transactions motives.

Demand for Money for Precautionary Motives

The demand for money for precautionary measures means to hold money in liquid form for unexpected circumstances that may occur in future. For example, there is the possibility of a decrease in income, sudden increase in expenditures because of any reason like disease or retirement from job.

As for the demand for money for precautionary motives is concerned, an economy based on Islamic economic system, allows an individual to hold money for their family's need. The following *Hadith* may be quoted in this regard:

عن عمر رضي الله عنه أن النبي صلى الله عليه و سلم كان يبيع نخل بني النضير ويحبس لأهله قوت سنتهم[2]

"It was narrated by Umar Al-Khattab, may God be pleased with him, that the Prophet, peace be upon him, used to sell the palm trees of the tribe Bani Al-Nadir and would save food for his family for a year."

This Hadith proves permissibility of holding food and hoarding it for one year to fulfill basic needs of the family. As long as it is permissible for an individual to hold food for his family for a year, it is permissible for him to hold and store the value of this food in cash as well. Therefore, to hold money in anticipation of an emergency is not objectionable in an Islamic economy.

However, some economists are of the view that there are limitations to such demand which will affect this type of demand. For example, one of these factors is *Zakat*. If a person holds an amount equal to the minimum level for obligation of Zakat for a Lunar year, he is liable to pay 2.5% of the total value of that amount as

[1] Al Jarihi, *Nahwa Niazam Naqdie wa Mali Islamic* , 67.

[2] Al Bukhari, Muhammad Bin Ismaeel, AL jamih Al Sahih Al Mukhtasar (Beirut: Aru Tauq Al Jajah, 1422), Kitab Al Nafaqat, Hadith 5042 .

Zakat. Now it is the choice of the individuals to hold Zakatable assets with him or to invest or spend them. The behavior of each individual would be different towards this situation. Some individuals may be satisfied with paying Zakat and holding a certain amount as reserves for unanticipated circumstances, while others may prefer to invest that money to earn profit and prevent a decrease in the financial assets by paying Zakat.[1]

It is worth mentioning here, that this factor has an impact on the nature of demand for money for precautionary motives in the long run that is more than a year, but individuals can hold cash for less than a year without being affected by this factor.

Thus, considering the factor of *Zakat,* the demand for money for precautionary motive has relatively narrower scope in Islamic economic system.

Demand for Money for Speculative Motive

As for as the demand for money for speculative motive is concerned, there are following two basic factors that will determine this type of demand.

The first one is the ratio of the prevailing profit rate of current investment to the expected rate of profit in the future investment. If individuals are optimist about the high profit rate in the future investment, the demand for money for speculative motive will increase. The individual or the institutions will also prefer to invest the amount taking into consideration the possibility of a decrease in the value of money if it remains idle.

The second factor that will affect is the percentage of zakat imposed on idle cash.

These two factors are taken into consideration in demand for money for speculative motive in Islamic economy, however the type of investment in which money is to be invested is also important in demand for money for speculative motives. The individuals and institutions are not allowed to deal in interest-based bonds, as bonds are generally a debt instrument. However, if it is sold on face value than it is permissible to buy and sell them. In this case the transaction will be allowed on the basis of Qarz Hasan or Hawala agreement.

It is allowed to invest in shares. This is because the share represents a share in the capital of the company, which is subject to profit and loss. If that share belongs to

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[1] Afar, Dr Abdul Munim, *Nahwa Al Nazariyyah Al Iqtisadiyyah Fil Islam* (Jeddah: International Association of Islamic Banks, 1401 Ah), 270.

a company that runs its business with adherence to rules and regulations set by Sharia, then it is allowed to sale or purchases these shares.[1]

It is also allowed to invest the amount in sale or purchase of financial instrument. Another investment venue is currency trading. The money may be invested in money market to gain profit through exchange of different currencies of different countries. However, these transactions or trading is allowed as long as the transactions do not involve *Riba* or interest. Moreover, other rules and regulations set by shariah must be adhered to, like spot payment by both parties in trading of currencies.

Thus, the interest free economy is an investment-focused economy. The investors focus on safest and most liquid investment opportunity. They do not pay attention to interest based loan in this regard. This itself creates a link between money markets and investment markets in a way that is very affective for the economy as it increases productivity. Money is invested in productive activity and not in a series of financial intermediation based on loan and usurious transactions.

To summarize the above discussion, we can say that demand for money for all three motives that are, transactions, precautionary and speculative motives as envisaged by conventional economic system exists in Islamic economic system. However Islamic economic system there are some factors that will, unlike conventional economic system, affect the demand and these factors will play their role in determination or increase and decrease of demand for money.

One of these factors is the prohibition of *Riba.* When Riba or usurious transactions are not allowed, the demand for money for interest motive like bond will not be affected by such motive. The second factor is *Zakat. Zakat* is a factor that will also play its role in determining the demand for money. If individual want to hold money in cash form that is idle cash, he will have to pay Zakat. Therefore, he will sometime prefer to invest the cash instead of keeping it in cash form. This factor also does not exist in conventional economic system.

The third factor that will make difference is consumption theory of Islam. According to teachings of Islam an individual is supposed to spend for others in charity works or sponsor other family members and poor people. This factor does not

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[1] Al-Tamimi, Yahya Muhammad Hussain Shawar, *Nahwa Msraf Markazi Islami* (M.phil diss., college for shariah and Islamic Studies,Ummul Qura University Makkah, Saudi Arabia 2009), 342.

play its role in conventional economic system. However, this will affect the demand for money in Islamic economic system.

2.4 Effects of Changes in the Value of Money

The issue of changes in the value of money is one of the most important contemporary issues that has been discussed and widely disputed. Devaluation of currency or a decrease in its purchasing power causes sometimes great loss to the holder of the money, debtor, and/or creditor.

To identify the problem, we can take the example of a person who lends 1000 PKR to another for a short or long term. When, after a specific time, the lender receives his money back, he finds the amount is less than that he lent in terms of purchasing power, although it is equal to it in terms of number or nominal value. This is actually inflation or devaluation of currency. The economists and Shariah Scholars have different points of view about its meaning and they have identified different solutions to address this issue.

After the invention of paper money or bank notes, the effects of this phenomenon have increased on individuals and even countries. The economists have discussed this issue in detail to determine its nature and presented different solutions to come up with a viable way out. Likewise, the Islamic economists and shariah scholars have also discussed this issue to identify the problem and to present a viable solution based on the teachings of Quran and Sunnah.

Under the topic “effects of changes in the value of money” we will discuss the meaning of inflation and its effects. We will also discuss the solutions presented by different scholars to minimize its effects on the economy. Moreover, we will examine various situations of devaluation of currency and shariah appraisal of each situation.

The Value of Money

The paper currency in the beginning had a relation with gold and silver or both. Therefore, the value of paper currency was measured by gold and silver. An increase in the value of gold or silver would lead to an increase in the value of paper currency and vice versa. However, after passing through different stages as mentioned in the previous chapter, the relation between gold and silver and paper money has come to an end. Now the paper currency derives its value from other factors. The value of money is actually its purchasing power. In other words, we can say that value of money is measured by the prices of goods and services. If prices of goods and services are increased, it means the value of money has decreased and if there is a decrease in the prices of goods and services it may be because of an increase in the value of money.

Thus, value of money is its purchasing power. Moreover, there is difference between nominal and real value of the money.

Nominal Versus Real Value of Money

If we consider money as the measuring unit, that is the value of money in terms of money itself. This is the nominal value of money. Thus, the nominal value of 1 rupee is 1 and of 100 rupee is 100.

On the other hand, the real value of money is its purchasing power against services and commodities. So, the real value of money is the amount of commodities and services that a specific unit of money can buy.[1] If we can buy 1 kilogram wheat by paying 100 rupees, it means 100 rupee is worth 1 kilogram wheat. The statement that 1 kilogram wheat is worth 100 rupee is also true. Thus, the real value of money is the reciprocal of the price level of commodities and services exchanged in an economy.

When we use the term "value of money" we generally mean "real value of money". Nominal value is the value of money in terms of money itself as the measuring unit. However, the real value is with respect to its purchasing power against services and goods. therefore, the nominal value of a two rupee note is 2 – and that of a twenty rupee note is 20. The real value of money is the amount of commodities and services a unit of money can purchase.

It would be appropriate to discuss the term "inflation" before discussing the shariah rulings and views of the shariah scholars on changes in the value of paper currency.

[1] Handa, *Monetary economics*, 7.

Inflation

Inflation is one of the modern economic issues that have been widely discussed by economist to determine its meaning and provide appropriate solution to save the economy and individuals from its negative effects. However, economist could not provide a viable solution for this problem.

According to Prof. Dr. Morais Alia the major problems of the economies of western markets that remain unsolved until today are economic fluctuations and changes in the real value of money, which hinder the efficiency of the economy, the fair income distribution, the use of economy resources and finally social peace. The truth is that the great injustices that, our Western societies are facing, to a large extent, is because of imbalances in income distribution arising from changes in the real value of money.[1]

From the above statement of a European Economists, we can imagine and understand the importance of the phenomena of inflation and critical situation that may arise out of this problem. Moreover, the most affected people in the period of inflation are creditors, banks, and workers with limited income. The most beneficial people are debtors, businessmen, business owners, and property owners.

Concept of Inflation

Inflation is actually a situation in which the price level is continually rising for substantial period at a rapid rate.[2]

This definition indicates that according to economists, inflation is not just an increase in prices but this is a rapid increase for a long period. The price must increase continuously. If there is shock of increase in prices leading to imbalance in aggregate output and aggregate price level, this imbalance would be affected by other factors of economy and aggregate demand and supply would be balanced. Whenever there is any type of imbalance in the market, the natural market forces will play their role to bring the economy to natural equilibrium level. For example, if there is 1% increase in a month it does not mean that there is 1% inflation.

According to Friedman, a famous economist, “inflation is always and everywhere a monetary phenomenon. It means that inflation occurs only due to

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[1] AAlia, Dr Mores, *Al Shurut Al Naqdiyyah Liqtisadil Aswaq Min Durus Al Ams Ila Islahat al ghad* (Jeddah: Islamic Institute for research and Training Islamic Development Bank, 1993), 13,14.

[2] Mishkin, *the economics of money Banking and financial markets*, 634.

increase in supply of money. Access supply of money leads to inflation. Therefore, if prices are increased due to other factors like increase in demand for goods or services or because of decrease in supply of commodities and services this situation has nothing to do with inflations. Because this situation generally causes an imbalance in the equilibrium of aggregate demand and supply. The aggregate demand and supply would equal after the market situation is normal. Thus, inflation is only a monetary phenomenon.

Moreover, any change in the prices due to change in Fiscal policy or government expenditures are not inflation. For example, if the price level is at the natural level and government expenditures increase. This will lead to an increase in general price level because of an increase in demand. This situation will call for an increase in supply as well. [1]

Apparently, there is inflation because of a rise in price. However, the inflation rate returns to zero after the equilibrium of supply and demand. Thus, temporary increase in the inflation rate due to one shot increase in government expenditures leads to only a temporary increase in inflation rate. This is not the inflation in which the price level continuously increases.

All the monetarist and Keynesians are agreed that inflation is only due to an increase in money supply. An increase in prices due to any other factor cannot be called inflation.

Kinds of Inflation

There are two types of inflation one is cost push inflation and the other is demand pull inflation.

In cost push inflation prices are pushed up because of an increase in cost of any or all of the four factors of production that are land, labour, capital or entrepreneurship. For example, if the cost of raw material rises the cost of production rises which lead to an increase in prices of the products.

Demand pull inflation occurs when there is an increase in aggregate demand in the economy. This aggregate demand in the economy will rise because of an increase in demand by households, foreign investors, businesses, and governments. For example, an increase in government expenditures will lead to an increase in aggregate demand which will lead to a rise in aggregate price level. This also causes inflation.

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[1] Mishkin, *the economics of money Banking and financial markets*, 634.

In both, the above mentioned, situations of const push and demand pull inflation, the government has to increase the wages of employees and eventually the government has to increase the supply of money to address this issue.[1]

Another type of inflation is the inflation because of budget deficit. When the government faces deficit in its budget it sometimes uses the policy of deficit financing. It issues more currency notes to fulfill its financial responsibilities. An increase in currency notes that will definitely circulate in the market will cause an increase in the prices. In this way this deficit financing will cause inflation.

The Concept of Inflation in Gold and Silver

The inflation is a new phenomenon in its present situation and was found only after the invention of paper currency. Although gold and silver has also faced some fluctuations in its value throughout the history. However, this fluctuation in their value cannot be called inflation. Their value has remained stable throughout the history with miner fluctuations at times. For the purpose of better understanding we can quote some examples.

1.Hazrat Jabir Bin Abdullah (RA) Al Ansari is reported to have said that Prophet (PBUH) purchased a camel from him against one "*Awqiyah*" of Gold. Hazrat Jabir says:

"ثم قال (بعينه بأوقية) . فبعته"[2]

Then the prophet PBUH asked me to sell the camel against one Awqiyah, then I sold it (against one Awqiyah

An *Awqiyah* is equal to 7 *Mithqal* which is equals to 4.25 gram of gold. So, this transaction was made between prophet (PBUH) and Hazrat Jabir (RA) against 30 gram gold. The price of a camel nowadays is, more or less, the same.

2. The Prophet (PBUH) once gave the companion Urwa Al Bariqi (RA) 1 Gold Dinar to purchase a goat. However, the companion Urwa (RA) purchased goats against 1 Dinar. Then he sold the one goat against one dinar and brought one Dinar and 1 goat to prophet (PBUHI). The Prophet (PBUH) prayed for him for *Barakah* (increase) in his transactions.

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[1] Mishkin, *the economics of money Banking and financial markets*, 634..

[2] al-Bukhari, *Ṣaḥīḥ al-Bukhārī*, Babu Istizan Al Rajul Al Imam, Hadith 2185.

"أن النبي صلى الله عليه و سلم أعطاه دينارا يشتري له به شاة فاشترى له به شاتين فباع إحداهما بدينار

وجاءه بدينار وشاة"[1]

It means that the price of a goat at the time of Prophet (PBUH) was between half and 1 Dinar. One Dinar was equal to 4.25 gram gold. We can purchase a goat against 4.25 gram gold which equals 40 or 50 thousand rupees nowadays. The above two example reveal that the value of the gold at the time of prophet (PBUH) was approximately the same as nowadays.

Thus, there was no noticeable fluctuation in value of gold throughout the history.

Apparently, the value of silver was not as stable as of gold in terms of purchasing power. The hadith of Urwa al-Barouqi indicates that the value of the goat at the time of the prophet was ten dirhams as one dinar was equal to 10 Darahim. If the silver dirham weighed approximately three grams, the value of the sheep was thirty grams of silver which, nowadays, is equal to, more or less, 4000 PKR. This is definitely not the price of a goat in present days.

So, the value of silver has been decreased with rapid rate as compared to gold.

However, yet we can say that the value of silver is stable as compared to paper currency of the most countries of the world because the silver has witnessed the above mentioned decrease in its value during a period of more than 1435 years. While this decrease can be noticed in the value of paper currency during 30 to 40 years.

It is obvious from the above discussion that fluctuation in the value of paper currency cannot be compared with the fluctuation in the value of gold and silver.

Islamic Concept About Changes in the Value of Money

If there is a rapid and continuous decrease in the value of paper currency as can be witnessed in the value of Pakistani Rupee, then what is a shariah compatible solution for this problem.

Fortunately, the early Islamic scholars have discussed in detail the effects and situations arising out of a decrease in the value of money. They have also discussed the situation where the currency disappears from the market and called it *Hala tul Inqitah* "حالة الإنقطاع"moreover, they also discussed the situation when people stop to use some specific currency use as a generally acceptable medium of exchange and

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[1] al-Bukhari, , Ṣaḥīḥ al-Bukhārī, Kitabul Manaqib, Hadith 3443

they called this situation as *Hala tul Ksad* حالة الكساد. However, these tow situations are apparently out of our discussion as we are discussing the changes in the value of paper money which is a legal tender. There is little possibility of disappearance of modern currency from the market and losing its quality of general acceptance as medium of exchange. Therefore, we will concentrate on the decrease and increase in the value of currency.

Changes in the Value of Natural money

Money made up of gold or silver is natural money. As we have examined above that the value of these tow precious metals remained relatively stable throughout the history as compared to paper currency. Therefore, the Jurists of all four schools of thought are unanimous that any change in the value of gold and silver will have no effect on payments or rights of debtor or creditor. The other party will not compensate any loss to creditor or seller.[1]thus, devaluation of gold and silver is considered a natural phenomenon and there is no any concept of compensation.

Changes in the Value of Bronze Coins

To discuss the status of devaluation of paper currency and expected effect therein, we have to compare the situation of paper currency with a medium of exchange other than gold and silver. Fortunately, this situation has been discussed under shariah provisions of *Fulus.*

The early jurists have discussed the issue of changes in the value of *Flus* (bronze coins). All the Jurists of early Islam except Imam Abu yousuf from Hanafi School of thought are unanimous that if the value of bronze coins *(Flus)* fluctuates by an increase or decrease in its value, it will have no effect on the legal rights and obligations arising out of the financial transactions. The other party will not compensate any loss. Therefore, if someone takes loan from another, the debtor will have to return its loan in the same currency and any change in the value of that currency will not be considered or compensated. However, Imam Abu yousuf opines that if there is any change in the value of lent bronze coins (*Fulus*), it will be compensated by measuring the value of those coins with respect to Darahim (silver

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[1] Ibn Aābidīn, *Radd al-Muhtār 'ala al-Durr al-Mukhtār*, 4: 538.

ibn 'Arafa, Muhamma Bin Ahmad, *Hashiyat ad-Desouki 'ala ash-Sharh al-Kabir* (Beirut:Darulfikr,), 3: 45.

'alish, *Minhul Jalil Syarhi 'Ala Mukhtasar al-'Allamah Khalil*, 2: 534/

Al-Bahūtī, *Kashaful Qannah*, 3: 301.

Ibn Qudāmah, 'Abdullah ibn Ahmad, Al-Mughni (Beirut: Dārūlkitab Al 'Arabi, 1392 AH), 4: 207

currency)[1]. For example, if someone has purchased, on deferred payment, a cycle against 100 bronze coins. At the time of this sale agreement 100 bronze coins were equal to 10 silver coins or 10 Darahim. Now if after some time these bronze coins devalued and now 100 bronze coins are equal to 9 Darahim, in this situation the buyer will have to pay 111 bronze coins for the cycle he purchased.

It means that Imam Abu Yousuf has considered the change in value of bronze coins in loan transactions and according to his opinion the devaluation will be compensated.

Some Jurists of the Maliki School of thought have opined that if there is abnormal increase or decrease in the value of bronze coins, it will be considered for compensation in financial transactions. However, normal fluctuation in the value of these coins will not be considered.[2] Imam Rahuni al Maliki, has mentioned that unexpected fluctuation in the value of bronze coins may be compensated in financial transactions. this is to save one of the parties from unexpected loss on the basis of shariah Maxim no harm is to be inflicted and nor reciprocation harm.

Changes in the Value of Paper Currency

The concept of value and process of issuance of paper currency is different from that of gold, silver, or bronze coins. Modern Muslim Jurists have discussed the issue of inflation or devaluation of paper currency. Some of these Jurists are of the view that inflation or devaluation of paper currency must be considered, and they have presented suggestions to overcome the loss may be faced by any of the party entering into a financial transaction. While some other Jurists did not accept this idea. They stress upon taking measures to control the inflation and ensure the stability of the value of currency.[3]

Those who considered the inflation as a new phenomenon, related to paper currency which causes loss to people and must be compensated, have presented following suggestions.

[1] Ibn Aābidīn, *Radd al-Muhtār 'ala al-Durr al-Mukhtār*, 4: 538.

[2] AL Rahooni, Muhammad Bin Ahmad, *Hashiya tul Rahooni 'ala Sharh al-Zarqani* (Egypt: bolaq, 1406), 5: 122 .

[3]Shabbier, *almuamalat almaliyya alasriyyah fil Fiqh al Islami*,170.

1. Compensation in Term of Percentage

Some contemporary Jurists[1] are of the view that any change in value of paper currency during a specific period of time, may be measured in terms of percentage. The change in percentage would be considered for compensation. For example, if there is 7% inflation, the creditor may be compensated by paying 7% extra added to his principal amount.

However, this solution is not compatible with Shariah as this transaction is tantamount to *Riba*.

2. Indexation:

Indexation is a system in which prices and assets values are connected to each other. It actually means linking the future rights and obligations to changing prices which are determined based on an appropriate indicator of the purchasing power of money.[2]

In indexation the value of currency is measured by its purchasing power. To know the fluctuation in the value of currency, a number of goods and services are selected may be called a basket of goods and services. To identify the importance of each item, each of these items is assigned a weight age. Then their prices are determined at a specific period of time. Generally, the prices during a year are determined. For example, five items, that are considered basic need of the people, like floor, rice, cooking oil, meat and wage of an ordinary worker. The prices of these items and services are recorded for a year. These prices are compared to the next year prices of the same basket of goods and services. Any change, decrease or increase in the prices of these goods and services, is a change in the value of that currency. In this process the real value of the currency is determined through examining the purchasing power.

[1] Ibid, 171.
[2] Rafiq, Dr, Al Misri, *al Jamih Fi Usool Al Riba* (Damascus: Darul Qalam, ,1991), 248.
Muhammad, Yousuf Kamal, *AL Masrafiyyah Al Islamiyyah* (Beirut: Dar ul Nashr Lil Jamiaat, 1996), 127.

Arguments of the Proponents of Indexations

Those who suggested indexation as solution to cover the negative effects of changes in the value of currency have supported their point of view by the following arguments. [1]

1. This system will provide an opportunity to achieve the goal of social justice by distributing wealth in society and safeguarding the rights of people having limited income.
2. If someone has faced loss because of inflation or devaluation of currency and he is not compensated than this would be against the concept of Islam based on

"لا ضرر و لاضرار"[2]

"*No harm for yourself and do not give harm to others.*"

3. This system will enable monetary authorities to equate between the real values of different currencies.

According to them keeping in view the above arguments rights of creditors and sellers may be saved in deferred payments through indexation in which real value of the currency is determined.

Arguments of the Opponents of Indexations

On the other hand, there are some scholars who opposed[3] this point of view and they have supported their view with the following arguments.

1. Most of the arguments opposing the indexation are based on an important shariah rule which deems it necessary to return loan in the same currency and units in which loan was taken and must be equal in nominal value. If the loan was, for example, 20 kilo gram wheat, then it is necessary to return 20 kilo gram wheat and incase of any discrepancy from any side this loan transaction would be tantamount to *Riba*. Similarly, if the loan transaction consists of 50,000 PKR, the same amount must be returned, the increase or increase in the value of the 50,000 Rupee in respect of its purchasing power cannot be considered.
2. The loss or damage that results from the inflation is not the result of the lending process or disbursing loan, nor are they the result of the act of the borrower or the debtor, rather this loss or damage is beyond his control. Moreover, had these savings

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[1] Hashmi, Dr. Muhyuddin, *Effects of Inflation on Deffered Payments* (موخر ادائیگیوں پر افراط زر کے اثرات) (Islamabad: Islamic Research Institute, International Islamic University, 2014), 76

[2] al-Hakim al-Nishapuri, Muhammad ibn Abd-Allah *Al-Mustadrak 'ala l-ṣaḥīḥayn* (Beirut: Darul kotob AL 'lmiyyah,1990), Kitabul Buyooh, Hadith 2345.

[3] Usmani, *Fiqh Ul Buyooh*, 768.

were not lent by the creditor, yet they would have been devalued even in hands of the creditor. Then why the creditor may be allowed to ask for compensation from debtor for his loss which is the result of general inflation and debtor has nothing to do with it.

3. Yes one may raise a question that creditor may be allowed to recover his loss from the debtor on the basis of opportunity cost. Which means the creditor might have an opportunity to invest this amount and receive profit on it to save himself from loss of devaluation in currency. The answer is that the shariah concept of Qarz Hasan is basically based on sacrificing the opportunity cost for others. If the opportunity cost is recovered from the debtor than this transaction would not be Qarz Hasan which is a support of other for the sack of Allah and Allah SW has promised to give reward for this support.

4. No doubt that justice and fairness are the basic rules of Islamic law and must be adhered to in financial transactions, however, in indexation in which creditor is compensated on account of debtor is not a justice, as debtor did not cause the loss to creditor. If debtor is forced to compensate creditor it would mean debtor is harmed which is also against the saying of the prophet PBUH as mentioned above.

Analysis of Opinions on Indexation

In author's opinion, various situations call for compensation for either party of the transactions.

i. **Debt Transaction**

1. In case of debt transaction in which one person lends his money to another on Qarz Hassan Basis, it seems that the opinion of the opponents of indexation is preferable. This is because if indexation is applied the transaction would be tantamount to Riba. The creditor will be receiving amount or any other thing without any consideration from his side and Jurists are unanimous that in Qarz or loan transaction the nominal value must be equal. Therefore, the Jurists are unanimous that Any loan that draws profit/interest is usury.[1]

Some contemporary Jurists[2] have allowed the indexation and compensation in loan transaction. Their point of view is based on the opinion of Imam Abu yousuf, mentioned above, in which he allowed the compensation for creditor in loan transaction if the bronze coin value is decreased.

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[1] Ibn Aābidīn, *Radd al-Muhtār 'ala al-Durr al-Mukhtār*, 5 : 166.

[2] Usmani, *Fiqh ul Buyooh*, 2: 768.

However, this argument does not look sound. As there is a difference between Fulus (bronze coins) and paper currency. The bronze coins were strictly tied to gold and silver and were valued with respect to gold and silver. Therefore, it was easy to determine the exact value of a *Fals* (bronze coin) in terms of gold or silver. On the contrary, paper currency has nothing to do with gold and silver with regard to its value. There are many other factors that play their role in determination of the value of paper currency and therefore it is very difficult to determine the exact value of paper currency at a specific period time to compare it with a value determined at another period of time.

So, as the exact value of paper currency at a specific period of time cannot be determined to know the real change in its value therefore theory of indexation cannot be applied as it is loan transaction and will be tantamount to *Riba*. Moreover, there is no criteria for selection of items for comparison. If we select rice, why we do not select oil or CNG? We do not have a sound argument for the selection. The price of one item may change, while the price of other may remain same.

Another important point is that the price of the item may change due to increase its demand in the market or due to decrease in the supply of that item. This situation has nothing to do with inflation and is not a monetary effect. If creditor is compensated in this situation, it will mean that he has been compensated for supply and demand shocks. This is against the justice system of Islam and objectives of shariah because here debtor is harmed for an act he did not commit.

Similarly, in deferred sale transaction, any compensation for seller due to decrease in the value of currency will be considered *Riba*.

ii. Salaries and Wages

As for as the salaries and wages are concerned, the system of indexation may be used just to revise the salaries and wages, rather this is preferable behavior from shariah point of view. However, is it permissible to pay the wages or salaries on the bases of indexation in which salaries and wages are connected with an indicator derived through indexation process?

Apparently, this is also not permissible, as in this way the wage and salary of every month or any specified period would be different. Those who receive the wages and salaries would be uncertain about their income. This uncertainty in financial transaction is called *Gharar* which is also not permissible. The prophet (PBUH) forbidden any sale transaction that contains *Gharar* (uncertainty)[1]. According to shariah rules and regulation the wage or salary must be fixed and clear. Any ambiguity in the wage is not allowed as it will lead to dispute between the parties or will cause an unexpected loss to anyone of the parties entered into an agreement.

In authors point of view if the indicator derived from indexation or from any other way, is clear and there is no ambiguity in its derivation and is agreed between the parties entering financial transaction than it may be allowed. The uncertainty is prohibited in financial transaction because it leads to disputes and conflict between the parties entering a financial transaction. If the indicator for fixation and payment of wages and salaries is clear and there is no expectation of abnormal fluctuations in it than, as per authors opinion, it may be allowed. For example, if it is agreed that wage will be paid as per dollar rate at the end of the month in normal situations.

Moreover, people have accepted the paper currency, despite that it has no intrinsic value, because they had a trust on government guarantee which has declared it a legal tender. Now, when it is devalued by act and steps taken by the government, the government will be responsible for this loss. the acts of the government are acceptable as long as they are performed in best interest of the public. Most of the monetary and other tools used by the central banks to perform its duties and carry out its functions include Riba. Thus, an Islamic central in a modern economic system has to achieve the same objectives and perform same duties as a conventional bank performs. However, it has to use tools which comply with conditions laid out by shariah.

Government Role and limitations to Change the Value of Currency.

We know that the change in the prices occurs due to:

1. Market forces that is change in the supply and demand of commodity leads to change in its price. If there is an increase in supply of a commodity, the price of that commodity will decrease and vice versa. Similarly, if demand of commodity increases, the price of that commodity will increase and vice versa.

2. Excess supply of currency in the market. This excess supply may be due to routine expansionary monetary policy, which will be discussed in the next chapter, or due to the credit creation process by the commercial banks discussed earlier in this chapter.

[1] Al-Nawawī, *Al Minhaj Be Sharh Sahih Muslim*, 3: 156.

3. Sometimes, to fulfill the need of budget deficit, the government resort to deficit financing by printing extra currency notes. This step of the government leads to devaluation of currency.

3. A change in monetary policy regarding the control of currency price. For example, if the country is using the policy of managed exchanged rat in which the exchange rate of local currency is determined by the government authorities. They fix the exchange rate at a certain level and try to use policies to keep it on the same level. At times, the government decides to change managed exchange rate system and adopts the floating exchange rate system.[1] A floating exchange rate is rate which is determined and or set by the supply and demand forces in foreign exchange open market.[2]

Recently Pakistan has changed its policy from managed exchange rate system to floating exchange rate system and the value of Pakistani currency has devalued from 120 against 1 Us dollar to 164 against 1 Us dollar. This change in the policy was aimed at achieving the goal of increase in the exports and economic stability. However, in this way of change in policy the people have faced a great loss because of sudden devaluation in the value currency.

The question is "is it allowed for government to take such steps that lead to devaluation in the local currency and what are the limits of a government in this regard"?

The economic system of Islam is based on justice. The approach of Islamic law to establish justice between people requires the stability in the prices and value of currency to save the people from harm or loss. Therefore, in general, it is one of the basic responsibilities of the government of Islamic state to take steps for the stability of the value of currency. The famous jurist Imam Ibnul Qayyim says:

"والثمن هو المعيار الذي به يعرف تقويم الأموال فيجب أن يكون محدودا مضبوطا لا يرتفع ولا ينخفض إذ لو كان الثمن يرتفع وينخفض كالسلع لم يكن لنا ثمن نعتبر به المبيعات بل الجميع سلع"[3]

Money is the only standard to measure the value of wealth, therefore it is necessary that it must be determined and controlled, its value must not fluctuate, if there would

[1] Mohammad Ahmad, "Pakistan Exchange Policy: an Econommetric investigation",*The Pakistan Development Review* 31,no. 1, (Spring 1992): 49.

[2] August 8 ,2020, https://www.investopedia.com/terms/f/floatingexchangerate.asp

[3]Ibn Qayyim al-Jawziyya, *I'lam al-Muwaqqi'in 'an Rabb al-'Alamin*, 105.

be fluctuation in the value of money like the value of goods, we will have no medium of exchange to measure the value of goods rather all will become in the category of goods.

The above statement of a famous jurist indicates that stability in the prices and the value of currency is necessary. It means that medium of exchange must be something that has a stable value, and its value should not fluctuate like the value and prices of goods and services.

Fiqhi encyclopedia of Kuwait has clearly mentioned that

"مِنَ الْمَصَالِحِ الْعَامَّةِ لِلْمُسْلِمِينَ الَّتِي يَجِبُ عَلَى الإِْمَامِ رِعَايَتُهَا الْمُحَافَظَةُ عَلَى اسْتِقْرَارِ أَسْعَارِ النُّقُودِ مِنَ الاِنْخِفَاضِ؛ لِئَلاَّيَحْصُل بِذَلِكَ غَلاَءُ الأَْقْوَاتِ وَالسِّلَعِ وَيَنْتَشِرَ الْفَقْرُ،" [1]

One of the public interests that the head of an Islamic state must take care of, is to maintain the stability of the value of money to save it from devaluation so that it may not lead to rise in the prices of food and goods and let the poverty to spread.

He further clarifies in his book that this stability in prices is necessary to ensure peace of mind for the people by letting them enjoy the stability of the value of what they got by struggling hard and earning. There must not be uncertain situation and unexpected fluctuation in the value of medium of exchange.

Thus, it is one of the basic responsibilities of an Islamic state to take steps to keep the currency stable and save it from fluctuations.

We have mentioned above different situations in which the value of currency fluctuates.

One of these situations is a change in the prices of foods or any other item due to a change in its supply or demand. This is generally a natural phenomenon and is a temporary situation therefore this situation is out of our discussion. There is no increase in the supply of money thus, no effect on the value of money. This is just an increase or decrease in the prices of food because of a disorder in supply or demand of that item. Such type of fluctuation is acceptable by shariah as a natural phenomenon.

As for as the other three situations are concerned in which money devalues due to the policies or steps taken by the government, the government is responsible for the loss faced by the public. The government should avoid from taking any such steps that causes devaluation of currency. Instead of pumping the economy with extra

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[1] Ministry of Awqaf & Islamic Affairs, *Mausu'ah Al Fiqhiyyah Al Kuwaitiyyah*, 41: 196.

currency notes it must adopt the *Musharakah* model as discussed earlier under the topic issuance of currency. The same model may be adopted to save the economy from the effects of credit creation process in which banks activities cause an increase in money supply.

If there is an excess in supply of money due to printing of extra currency notes or due to expansionary monetary policy or due to credit creation by the commercial banks, the government must compensate the people for devaluation in currency. The government should increase the wages and salaries. Moreover, the government should increase money supply only when there is increase in overall GDP. When there is increase in the production of goods and services, the government should increase money supply as per the increase in GDP. This is because people have accepted the paper currency, despite that it has no intrinsic value, because they had a trust on government guarantee which has declared it a legal tender. Now, when it is devalued by act and steps taken by the government, the government will be responsible for this loss. Moreover, the acts of the government are acceptable as long as they are performed in best interest of the public as we have mentioned above that the ruler's management (of his subjects' affairs for the public is bound with the *Maslahah*, public interest.

Thus, to avoid the negative effects of devaluation of currency, the government must take steps to make the currency purchasing power stable. As per the general instructions of shariah it is not allowed for the government of an Islamic state to resort of deficit financing in any case as it causes loss to public. This is because deficit financing causes devaluation of currency and increase in general price level.

However, if the printing of extra currency notes is deemed necessary by the government authorities, the new quantity of the issued currency must play an important role in financing development activities and must have a positive impact on general employment rate in a way that the deficit financing does not affect the stability by disturbing the equilibrium between quantity of money in circulation and the real exchange rate.

Moreover, the government must use *Musharakah* model in banking system as discussed in previous discussions to avoid credit creation which lead to increase in the supply of money and raise in general price level.

Central Banking in Islamic and Conventional Economic System

Introduction

The central bank stands at the top of the banking hierarchy in every country and is empowered to perform important functions such as issuing and regulating currency notes, monitoring banks operations and their credit policies. In most countries, it is also authorized to formulate and implement monetary policy according to the guidelines provided by the government. Central banks are among the most important players in financial markets throughout the world.

There are many factors that affect the economic stability at national and international level. Apart from the modern banking system and their crucial role in the economy, the invention of derivatives, future and forward sales, future markets capital markets and money markets has brought an evolution in financial world. Moreover, there is conflict between the role, functions and objectives of these newly introduced instruments and markets. There must be an institution that regulate them and minimize the negative effects of such economic activities in money and capital markets. Many of these factors affect the supply of money

The nature of the role that central banks play in various monetary and banking systems has resulted in certain degree of similarity between all the other functions they carry out, various operations they perform and different steps they take to achieve their goals in different parts and economies of the world. Thus, over the time, some common parameters, rules and principles related to management of the central banking have emerged.

Nevertheless, it will not be an exaggeration to say that due to freedom and independence in application of the rules and regulations, each monetary system has some salient features. The features of the central banking system and monetary policy vary from time to time and from country to country according to the different nature of the credit structure and the characteristics of the economic environment in which the central bank conducts its activities.

In this chapter we will discuss the role, functions and importance of central bank in a conventional interest based economy. We will also discuss the concept of an Islamic central bank and will analyze its role and functions from Islamic perspective.

3.1 The Rise of Central Banking

Central bank is relatively a newly established institution in modern world. It emerged shortly after the emergence of commercial banks. This is because the functions and role of the central bank are related to these commercial banks as its role is as a regulator and supervisor in banking system of an economy.

The system of central banking, like any other system, has gone through development process. The functions of the central bank have grown and expanded with the passage of time because of a dire need to establish a system and apply some limitations to banking activity that prevailed at that time.

Most of the tasks that a central bank undertakes today, and it is impossible to envisage a central bank without them, have been recently added to its core responsibilities. In defining its functions, responsibilities, and powers, the central bank underwent a gradual development that could not be explained without a reference to the economic and intellectual development over two and a half centuries.[1]

The central banks first emerged as commercial banks, and then they were assigned the role of a central bank, so they became independent and integrated bodies that carry out distinct and advanced functions. With the passage of time and due to persistent change in its role, the importance of modern central bank increased specially after Keynes opinion about the interference of monetary authorities to maintain equilibrium in money market.[2]

Keynes developed and presented his view following the classical school of thought who envisaged the economic system as a system managed by hidden power, and that any interference in this automatically managed system will disturb it. In case of any defect or imbalance that may occur will be automatically fixed by natural market forces. This theory prevailed until the financial crisis in 1930 that resulted in great depression and general unemployment. Keynes presented his view of interference by government authorities to maintain equilibrium in money market to achieve monetary policy goals. Keynes has presented the idea that money is not a neutral factor in the economy. it plays its role and affect the economy just like goods and services.

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[1] Zaki Shafi, *Muqaddimah Finnuqood wal Bunook*, 228.

[2] Zyad Ramdhan, *Edarah alaa 'mal Almasrafiah* (Beirut: Darul Fajr Linnashr wa Tauzeeh, 1998), 175.

The history of central bank begins from 17th century. The first institution recognized as a central bank was the Swedish Riks bank which was establish in 1668 as a joint stock bank. This bank was given the authority to lend the government to act as clearing house for commerce[1]. After a few decades in 1694[2], it was followed by the establishment of famous Bank of England, which was initially established as a commercial bank, but the government selected it for placing its accounts with it and thus it became a bank for the government and started to provide banking services to it. Then government authorized this bank to issue currency notes and became an issuing bank. With the passage of time, it gained the confidence of other banks and they started to deposit some of their cash balances with this bank, and thus it became a bank for banks.

later on, In Europe other central banks were establish for the same purpose and goals, although some banks were established to control monetary disorders, like deflation, in the economy. The example of Napoleon could be referred here who established the central bank of France "Banque De France" in 1800 to control the hyper inflation of banknotes during the French revolution and to help government in financing its expenditures.

Central Banking in America

There was no Central bank in the United States of America until 1913. The concept of central banking in America emerged in 1913[3] and well established in 1916[4] which was followed by establishment of central banks in independent countries of the world.

And perhaps, nowadays every state in the world has a central bank to supervise and regulate its banking system. The first central bank in Canada was established in 1934.

European Central bank.

The gradual increase in relations and eventual merger of most European countries into European Union in 1990s resulted in their monetary unifications in post war era in those decades. The European System of Central Banks (ECB) was established which is based in Frankfurt. This bank has a federalist structure. The

[1] D. Bordo Michael, *A Brief History of Central Banks* (Cleveland: Federal Reserve Bank of Cleveland, December 2007), 1.

[2] Samair, Hussin Almisri, Salahuddin Mahmood, *Iqtsadunnuqood wal Bunook* (Jeddah: Dar al Shurooq, 1400AH), 125.

[3] *Ibid.*

[4] Handa, *Monetary economics*, 339.

Governing Council of European central bank consists of the governors of the national central bank and Executive Board of the ECB. This council is also the decision making authority. [1]

Central banking in Muslim Countries

During the nineteenth century and in the beginning of the twentieth century, the monetary systems of Islamic countries were completely dependent on the monetary systems adopted in those developed countries that colonized these Islamic countries, so there was no specific monetary policy in practice in these countries.

Resultantly, there were no central banks in its present sense, rather there were some banks assigned the task of issuance of currency. The example of Egypt, Algeria, Tunisia and Morocco, as well as Ottoman Empire may be quoted here. They were usually commercial banks that were authorized to issue currency in addition to dealings in money and money markets with some limitations imposed on them. Moreover, these banks were generally owned by foreigners or they were the main shareholders of these banks. They had the final decision power. They would hardly think about the local national interest. In Egypt, for example, a group of British financiers founded the National Bank of Egypt in 1898. The bank had a monopoly over the issuance of currency notes which, in 1914, became fully legal tender in the country, and the bank, in the absence of gold, was authorized to cover these notes with British treasury Bills.

The situation was not different in other countries like Tunisia, Algeria, Morocco, and Sudan. In sum, there was no central bank in the true monetary and banking sense in the Islamic world.

Depicting the above mentioned situation Dr Abdul Minim Al Syed says.

"لم يكن هناك أي بنك مركزي , بالمعنى النقدي والمصرفي الحقيقي في أي جزء من أقطار الوطن العربي . ...

و بنوك إصدار يهيمن عليها رأس المال والإدارة الأجنبيان و بنوك تجارية هي كلها أجنبية عمليا"[2]

There was no central bank, in the real monetary and banking sense, in any part of the Arab world. .... Currency issuing banks dominated by foreign capital and management, and commercial banks were all practically foreigners............

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[1] Handa, *Monetary economics,* 339.

[2] Al Syed Ali, Dr. Abdul Munim, *al tatawwar al tarikhi lil Anzima Al Naqdiyyah Fil Aqtar Al Arabia,* (Beruit: Arabic Monetary Fund, 1986), 63.

Although he has mentioned the situation of Arab countries, but the circumstances were not different in other Islamic countries that were colonies of European and some other countries.

The above mentioned early central banks would help the government to fund their debt based activities. They also worked as private entity and were engaged in banking activities. They played their role as bank for banks by holding their deposits, facilitating interbank transactions, and providing other banking services. With the passage of time, they became lender of the last resort during financial crisis as they had large amount of gold reserves. Other banks would resort to this bank in emergencies. [1]

Evolution of the Role of Central Bank

The emergence and development of the central bank was not just the result of development in banking process, rather it is the result of the development based on need, as its functions have grown and expanded with the increasing requirements of changing banking system.

Actually, the central banking system arose as a result of instability in monetary policies and economic conditions of the states. This instability was the result of lack of control over commercial banks who were assigned the task of issuing of currency notes. Every commercial bank would issue currency notes and even without a full cover of gold that led to excess supply of money and instability in the economy as a whole. Moreover, because of issuance of currency without gold reserve, some of these banks failed to fulfill their financial obligations towards their depositors. This situation led to economic crises and problems and dysfunction of the banking system as a whole,[2]

To overcome the above mentioned situation, the government restricted the process of issuance of currency and assigned the task of issuance of currency to one of these commercial banks and obligated him to issue currency only against legally defined reserves, whether full or partial. The government would support this bank to enable him to fulfill its obligations towards depositors or the public in general.

Actually, before the introduction of the Central Bank, every commercial bank would follow its own policy in granting credit and disbursing loan. These policies, as

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[1] D. Bordo Michael , *A Brief History of Central Banks*, 1.

[2] Al-Tamimi, *Nahwa Msraf Markazi Islami*, 61.

a whole, were contradictory to the general economic interest and the requirements of the states at that period of time. Therefore, the existence of the central bank as an observer and implementer of monetary policies became necessary.

In this way the central bank in the beginning emerged as a currency issuing authority with a monopoly on issuing currency notes. The importance of the central bank increased after the paper currency was declared a legal tender guaranteed by the government and controlled and issued by government representative authority that is the central bank.

In addition to its role as a currency issuing authority and being a public institution and having monopoly on one of the most important functions of economy that is issuing of currency, the central bank was also required to provide banking services to the government.

In its role as a bank for the government, the central bank is considered a financial depository institution for the treasury surplus and provides the same facility to various other institutions of the government, as well as it worked as lender for the government and plays its role as agent for it in the settlements of international rights and obligations. In addition to being the financial and monetary advisor to the state it also played its role as agent for state in all matters related to finance and money, including the sale of public bonds and other financial instruments. In this way it carries out its responsibilities as a bank for the government.

Transitional Phase of the Central Banking

Before 1914, the role of central bank as currency issuing authority was limited to ensure the gold reserves against the currency in circulations to fulfill its responsibility towards the currency holders as, at that time, most of the currencies of the world were pegged to gold. Hence the prices were also pegged to gold value and future expectations about the prices were based on future gold value. It means that central banks were strongly committed to price stability. They did not worry about the stability of the real economy which is one of the main goals of the modern central banking system. Their obligation was only to adhere to gold standard.

In the beginning the central banks were independent and private. They were free to choose their own policies and tools, as they deemed suitable. The only constraint, they had to adhere to, was ensuring the gold reserves against the currency, and also ensuring the convertibility of cash into gold.

After the great depressions during the period 1920s to 1933 following the second World War, which led to unemployment and other economic problems, the government of different states of the world started to think about preferring the policy of ensuring stability of real economy rather than ensuring the gold reserves. This thinking of authorities led to nationalization of the central banks and most of the central banks lost their independence. Now they were given the task of implementing the policies prepared by the government. Thus, their role as supervisor of the banking system and as a regulatory authority to ensure economic stability increased.

Commenting on the above situation and explaining the behavior of UK central bank in response to the situations prevailed during 19th century Michael D. Bordo writes:

> *"The lesson began early in the nineteenth century as a consequence of the Bank of England's routine response to such panics. At the time, the Bank (and other European central banks) would often protect their own gold reserves first, turning away their correspondents in need. Doing so precipitated major panics in 1825, 1837, 1847, and 1857, and led to severe criticism of the Bank. In response, the Bank adopted the "responsibility doctrine," proposed by the economic writer Walter Bagehot, which required the Bank to subsume its private interest to the public interest of the banking system as a whole. The Bank began to follow Bagehot's rule, which was to lend freely on the basis of any sound collateral offered—but at a penalty rate (that is, above market rates) to prevent moral hazard"*[1]

It is mentioned that the bank has accepted the responsibility which he referred to as "responsibility doctrine" towards economic stability in the economy and left the policy of concentrating only on price stability by ensuring legally defined gold reserve ratio.

In America, before 1913, there were two central banks. Due to contradictory policies of both, that would often go against the national interest, both Banks of the United States were closed and the Federal reserve bank of America was established in

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[1] Capie, Forrest and others, *the Future of Central banking* (Cambridge: Cambridge University Press, 1995), 9.

1913 and was assigned the task of issuing a uniform currency and fulfill its responsibility towards economic stability.[1]

Other countries of the world generally adopted the same policies either because they were colonies of these countries or were influenced by them. the economic situation in some other countries was not developed enough to formulate and implement their own policies so they would depend on policies adopted by the developed countries.

Subservience of Central Banks

Following the above mentioned situation, the central banks were fully brought to government control. Why has it happened so?

The occurrence of great depression and the collapse of gold standard were considered a failure of the central banking system. After the economic depressions during 1920s, that led to the emergence of a new theory. This theory was to abandon gold standard in issuance of currency. The newly developed idea was that level of supply of money may be determined according to the real economy and GDP of the country. This theory was based on the suggestion of the economists, as mentioned above, that the central bank should ensure stability of the real economy rather than ensuring the gold reserves to maintain price stability.

Another factor that called for a control over central bank was dominance of socialist theories. Socialistic approach requires all the sources of productions and every institution of country to be fully controlled by the government. This idea of the socialists worked at that time because the world has faced the great economic depression as a result of capitalistic approach in economic policies.

Moreover, during Second World War powerful economies of the world like England, America, France, and other countries were in dire need of financial resources for war expenses. They ordered the central banks of their countries to print more paper currency to meet the needs and expenses of war. The overprinting of currency caused inflation. The government had to give instruction for prudent interest rate to deal with inflation in the economy. In this way, over the time, the control of the government over central increased.

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[1] Capie, Forrest and others, *the Future of Central banking*, 9.

In the above mentioned circumstances, despite the full control over them, the central banks would make policies and worked as an advisor for the government.[1]

It is worth mentioning here that Most of the countries of the world adopted the Keynesian policy. Keynesian school of thought, called for a greater role of the state by making fiscal and monetary policies. This school of thought presented the idea of interference by the government, even by deficit financing through issuance of currency or creating debt. Keynes has built his theory supposing rigidity of prices and wages in the short run which means that prices and wages do not change in the short run. He also believed that natural market forces are unable to deal with financial crises[2].

Evolution of the Goals of Central Banks

In the beginning many goals and targets were set to be achieved by the central banks. However, with the passage of time the economists realized that a concentrated role of the central banks would be more affective to achieve the goals and targets of the economy.

An Expansionary monetary policy was adopted by most of the countries during the period of 1970s. However, this policy caused persistent high inflation accompanied by unemployment and stagnant demand. This situation is called stagflation. As the expansionary policy was the result of the ideas presented by Keynesians in which government expenditures are increased to achieve employment in the economy, therefore Milton Friedman presented another theory. According to him, there was no long run trade-off between inflation and unemployment. There is only short run tradeoff between t unemployment and inflation rate.

Trade-off means a situation in which two opposing situations are balanced. There is tradeoff between inflation and unemployment because if there is a rise in aggregate demand in the economy, it will cause an increase in supply or output. When there is increase in demand there is increase in demand from employees which leads to increase in employment. The increase in aggregate demand and employment causes an increase in inflation.

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[1] Goodhart, C.A.E., *The Changing Role of Central Banks* (London: Financial Markets Group, School of Economics), 5.

[2] Yousuf Kamal, *AL Masrafiyyah Al Islamiyyah*, 10.

The above theoretical discussion resulted in changing the goals and target of the central bank. 1n 1980s the economists thought that multiplicity of goals of central banking is affecting the role of central banks in achieving its primary and main goals. Therefore, a concentrated target policy was introduced. The monetary authorities started a considerable reduction in emphasizing on using the monetary policy to manage unemployment and output in the economy. They started to concentrate on management of inflation rate, although unemployment and output were also targeted indirectly. This, when adopted by some countries of the world, it achieved remarkable results. Because of the success of this policy, most of the banks of world started to adopt this policy.

The bank of England adopted inflation targeting policy in 1992 while Canadian central bank adopted the same after 1991. Earlier, these banks were assigned to achieve multiple goals and targets through monetary policy. However, after the introduction of new concentrated policy, they started to concentrate on inflation targeting after the change in policy in 1990s.[1] Thus, the role of central bank and its goals changed over the time to keep up with contemporary challenges and need of the day.

Actually, after the gold standard, which was abandoned by most of the countries in 1930s, and because of the need to finance war expenses it became difficult for governments and monetary authorities of the most countries to deal with the economic and monetary problems. Therefore, it seems that the evolution of the central banks policies enhanced after this period and every economist has presented different point of view to address the issues and problems resulted from paper currency.

To summarize the above discussion, we can say that the history of central bank began in 17 th century. The first institution recognized as a central bank was the Swedish Riksbank it was established in 1668 as a joint stock bank. After a few decades in 1694, the Bank of England followed it. Most of the central banks were established as commercial banks. With the passage of time and according to the need of central government, they were assigned the task of issuance of currency notes to control the excess supply of money in the economy. Later on, it became as bank for government and bank for other commercial bank and lender of lost resort to help the

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[1] Handa, *Monetary economics,* 341.

banking industry to nourish and become trustworthy financial institutions for the general public. In the era of gold standard, they were more concerned about the price stability and ensuring the gold reserves. In 1930s when gold standard was abandoned, there role to manage economy and monetary policy increased because of inflation that was the result of issuance of currency without gold reserves. The central banks were assigned the task managing interest rate to save the economy from economic fluctuations and shocks. They came under full control of the government after the Keynesian approach was adopted by the most countries. However, their role and targets were to achieve full employment and output by managing the inflation rate.

After 1970s their goal was concentrated, and they adopted inflation targeting policy to play an effective role for the development of the economy.

3.2 The Central Bank in Conventional Economy

Concept and Definition of The Central Bank

There are many definitions of central bank mentioned by a number of economists. However, most of these definitions did not specify the central bank and are not considered précised, comprehensive and clear definitions. The reason is that the work and functions carried out by the central bank is multidirectional. Every economist has focused on the factor which he deemed as most significant and important among the functions and characteristics of central bank.

For example, some of them defined the central bank as an institution assigned the task of issuance of currency.[1] This is very short definition and do not depict the reality of the central bank. Therefore, some of these economists have expanded the definition of central bank and have set more accurate and comprehensive definitions. One of these definitions which is mentioned by. Dr. Zakki Shafi is as follows:

"إنه الهيئة التي تتولى إصدار البنكنوت و تضمن بوسائل شتى سلامة النظام المصرفي و يوكل إليها الإشراف على السياسة الإئتمانية في الدولة بما يترتب على هذه السياسة من تأثيرات هامة في النظامين الإقتصادي و الإجتماعي"[2]

It is the institution that undertakes the responsibility of issuance of the banknote and ensures, by various means, the soundness of the banking system. It is (also) entrusted with supervision over the credit policy of the country as these policies have important impacts on the economic and social system.

In this definition Dr. Zakki Shafi has highlighted most important functions of the central bank. The first function which he has highlighted is that central bank is responsible for the issuance of currency to be used as medium of exchange in the economy. This function is the most important and significant functions. This was the first task of central bank since its establishment in different countries as discussed earlier.

The second task which is assigned to central bank is supervision over the banking system in the country. Banking system includes the other activities of various banks that include commercial banks and specialized banks like microfinance banks etc. This is also the most important function of the central bank because the banking system is the backbone of the modern economies. If it collapses the whole economy

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[1] Sami Khalil, *AL Nuqood Wal Bunook* (Kuwait: sharikat Kazima Linnash re wal Tarjama wal Tauzeeh, 1982), 530.

[2] Shafi, *Muqaddimah Finnuqood wal Bunook*, 228.

will collapse. Therefore, every government uses its best skills and resources to regulate the banking system enabling it to work in accordance with the prudential regulations set by the government and implemented through central bank.

The third important function highlighted in this definition is the supervision of credit policies of the banking system. The central bank controls the supply of money through change in credit policies. Commercial and other banks working in country are the most important partners of central bank in implementation of the credit policies. Similarly, they have significant effects on the economy as a whole and on the supply of money particularly.

The last function added in this definition appears to be unnecessary detail of the above mentioned second function as this task is covered under the supervision of central banking system. The credit policy is also a part of central banking system. However, one of the basic functions which this definition lacks is the control of supply of money. Although this function may be covered under credit policy however it would not be as clear as required in the definition of a central bank.

S.M Akhtar and K.K. Dewett, have defined central bank as follows:

> *"A central bank is an institution which is responsible for safeguarding the financial stability of a country. It holds the ultimate reserves of the nation, controls the flow of purchasing power- whether currency or credit and acts as banker to the state"*[1]

In this definition the focused point is the safeguarding the financial stability of the country. Although this is the basic function of the central bank and is very important but mentioning it in the definition of the central bank seems unnecessary. As, there are many other institutions that are responsible for the safeguarding of financial stability. This is one of the goals of the operations of central bank and not a part of the definition.

The other points mentioned in this definition are that it holds the ultimate reserves of the nation, control the purchasing power and acts as a bank for government. These are the basic functions and addition of these points to the definition of central bank seems necessary and important. Central bank is responsible for managing reserves of the country. It is also responsible for the control of supply of money and for providing banking services to the government. It is also mentioned in

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[1] S.M Akhtar and K.K. Dewett, *Modern Economic Theory*, 251.

this definition that central bank controls the supply of medium of exchange. Controlling the supply of money by implementing various policies is also an important function of the central bank.

Thus, we can say that central bank is a governmental institution which is assigned the task of issuance of currency notes, controlling the supply of money and supervision over the banking system.

It is obvious from the above detail that why this institution is called central bank. It plays a central role in the economy which apparent from the functions it carries out. [1] The word "center" also refers to its importance and the power it is given in the country.

Characteristics of the Central Bank

In the light of the above mentioned definitions and detail we can summarize the characteristics of central bank in the following points.

1. The central bank is the currency issuing bank, thus it is considered the monetary institution which is capable of converting real assets into cash. It can create payment instrument, has the ultimate ability to fulfill financial obligations and is a dominant player in monetary and credit affairs in the national economy.[2]
2. The Central Bank does not carry out the normal banking activities which are carried out by commercial banks, rather it has its own functions related to general economic interest.[3] Therefore it does not deal primarily with individuals and does not open deposit accounts for them in any shape and at any time.
3. The central bank holds the ultimate reserves of the nation. It is considered a store for the reserves of the nation as mentioned by S.M Akhtar and K.K Dewitt in their definition of central bank referred above.
4. The central bank is a public institution through which the state controls the economy of the country. It is considered a governmental institution due to significance and impacts of the task assigned to it .Therefore the objective of

[1] Sami Khalil, *AL Nuqood Wal Bunook*, 530
[2] Rushdi, Mustafa, *AL Iqtisad AL Naqdi Wal Masrafi* (Beirut: AL Dar AL Jameyyah, Littaba at Wa Al Nashr, 1981), 179.
[3] Shafi, *Muqaddimah Finnuqood wal Bunook*, 235.

the central bank is different from the objectives of commercial banks and private financial institutions

5. The central bank represents the supreme control authority over commercial banks and stands at the top of the banking hierarchy in every country.
6. The central bank is the only institution in the country that undertakes the responsibilities of central banking. Each country has one central bank, so at present, more than one central bank in a country cannot be imagined. Although some countries enjoy a system of multiple central banks, such as the United States, this does not contradict the principle of unity of central bank, because this diversity is nothing more than a division of specializations only.[1]

These are some of the characteristics of the central bank highlighted by various economists as referred above. Every central bank in the modern economies has the same characteristics. Their role and authorities may differ from each other. In some countries, central bank may have more authorities than other central bank in other countries. The role of some of the central bank may be limited as compared to another central bank. However, the basic characteristics are same as mentioned above. These characteristics must be fount in every central bank in the modern economies of the world.

Difference Between Central bank and Commercial Banks

What makes difference between commercial banks and central banks is as follows:

1. Profit-earning is not considered the main goal of the central bank. Rather, its primary goal is safeguarding the public interest while profit earning is the main goal of financial institution and private banking institutions.
2. The Central Bank enjoys the powers of issuance of currency and regulating the banking system that no other banking and financial institution enjoys.[2]
3. The central bank is considered financially a stable institution as the smooth running of the central banking depends on confidence of the public and other financial institution in the ability of the central bank to fulfill its financial obligations. Therefore, it prefers not to announce its loss if it occurs. Rather, this loss is covered in coordination with the government using different ways

[1] Shawar Al-Tamimi, *Nahwa Msraf Markazi Islami*, 36.
[2] Sami Khalil, *AL Nuqood Wal Bunook,* 227.

of financing. Any other financial or monetary institution does not have this right. Generally, all the private financial institutions have to disclose their financial status to the public.

4. The central bank does not involve in public dealings. For example, it does not open an account of an individual. While commercial banks involve in public dealing and open individual depository accounts for public.
5. The policies adopted by the central bank are for the public interest while the policies of the commercial banks are for profit maximization. Therefore, the policies of both are quite different from each other.

Importance of Central Bank

After reviewing the various definitions that define the features of the Central bank and stating the difference between central bank and the commercial banks, we the significance and importance that the central bank enjoys in the banking system may be. The banking system without this organized and a supervisor institution becomes nothing but a group of unconnected units, each following its independent policies. these policies, often as a whole, would be contradictory.

However, some of the economists do not accept the importance of the existence of this institution which is considered by some others at the top of the hierarchy of the banking system. There are three main points of views. We will summarize their view in following lines.

First Opinion:

According to this point of view, the existence of a central bank is necessary and important for currency management and providing means of payment in the economy. There must be an institution having monopoly over issuance of currency and its management to ensure the provision of means of payments to the public.[1]

Second Opinion

According to the second point of view there is no need of an institution like a central bank in its present form. The supporters of this opinion among economists argue that the state can dispense with the central bank. According to them there is exaggeration about the importance of existence of a central bank. The central bank carries out the functions of issuance of currency, acts as a bank for government, acts as the lender of the last resort and the bank of banks. All these functions may be carried out by other specialized institutions. [2] The central bank in its present form is not necessary because it is an institution imposed on the banking system. This point of view also says that the dumping of gold and reserves with the central bank is not reasonable. Naturally, each bank should maintain its reserves. Moreover, the central bank imposes its decisions, which are the decisions of the government, on the commercial banks. This imposition of decision is inconsistent with principle of free and competitive market.

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[1] Sami Khalil, *AL Nuqood Wal Bunook*, 548.

[2] Ibid: P: 549

Third Opinion

The supporters of this opinion believe that central banks are not necessary in developing countries for many reasons. Firstly, the economy in these countries is weak and with limited exports and are subject to terms and conditions of exchange. These terms and conditions are not compatible with the internal economic conditions of their economy. Trade and export industries are based on an informal credit network and a monetary authority that is no more than a monetary council. Therefore, many of the functions of the central bank in these countries are not practical and thus, many developing countries have not established full central banks, rather they have established institutions that are authorized to take decisions when there are urgent needs.[1]

For these reasons, some have suggested a regional central bank that will include a group of developing countries that will perform the functions of the central bank for all the participating member countries. The European central bank may be a precedent for such decisions.

The central banks of the developing countries face some unnecessary constraints and complication in international trade. Due to their weak economic position, they cannot compete with developed countries. Therefore, they suggest a regional central bank that will make it easy for the member countries to participate in mutual trade and avoid unnecessary complications of the international trade.

Analysis of The Above Mentioned Opinions

After going through the above mentioned three opinions and their arguments, it seems that there are no ways but to adopt the first opinion that insists on the existence of an institution like a central bank in its present form. The arguments of second and third point of view may have some weight in the era when this point of view emerged. However, after the recent inventions in the financial world and the complication it accompanied, one would never neglect the importance of a central bank in a country.

The argument that there must be multiple specialized institutions rather than one central bank is not reasonable, as there would be less complication if there is only one institution as compared to the existence of multiple institutions and each with different responsibilities. In modern financial and monetary system things and

[1] Charles Collyns, *Alternative to the central bank in the developing world* (Washington. D.C: International Monetary Fund, July, 1983), 1.

practices are interrelated. Any decision about dealing or a transaction would affect another one. Therefore, there must be one decision making authority to supervise all the activities and analyze the impacts of a decision taken at one point or in one direction.

The argument that the existence of central bank is inconsistent with the principle of free competitive market is not logical because there is free competition among the commercial banks. As for as the central bank is concerned, its role is like a supervisor and not like a competitor of commercial banks.

The argument of the third opinion is not logical because, nowadays all countries are independent in their decisions and they are in dire need of an institution like central bank to control the supply of money to insure economic stability. There are many issues to be settled by the central bank of a country with other local and international financial institutions. There is a key role of the central bank in settlement of financial matters at international level.

However, a separate regional central bank may be established along with country central bank. This idea of separate regional central bank may help member countries in smooth transactions. this type of central bank will help each member country to export his goods and earn foreign reserves easily by through a central decision making authority.

Central Banks Importance in Modern World

In modern world the financial system of a country is considered to be the most complicated science. There are many factors that affect the economic stability at national and international level. Apart from the modern banking system and their crucial role in the economy, the invention of derivatives, future and forward sales, future markets capital markets and money markets has brought an evolution in financial world. Moreover, there is conflict between the role, functions and objectives of these newly introduced instruments and markets. There must be an institution that regulate them and minimize the negative effects of such economic activities in money and capital markets. Many of these factors affect the supply of money. So the importance of central bank has increased in the modern world. Now this is not an institution whose main objective is to issue and manage the currency, rather it plays its vital role achieving the goals of economic growth maintain economic stability.

Keeping in view this importance of the central bank, no country can dispense with the central bank.

Central Bank's Role in Economic Development

Central bank plays an impotent role in economic development of the country. It is assigned the tasks that are necessary to be performed for economic stability and development. A country without central bank cannot achieve the target of economic development. Central bank plays its role to maintain the value of money by controlling the money supply in the economy. It also takes timely steps to control inflation and develops monetary and credit policies to manage the overall level of economic activities. It also formulates credit policies to promote national goals.

Central bank also plays a distributive role in the economy. Distributive role means it develops different policies for various sectors of the economy. Each policy may have different effect on each of the different sectors of the economy. Discussing this role of the bank Gerald Epstein says:

> *"Central banks' policies can have differential impacts on different classes and groups: workers and capitalists, debtors and creditors, finance and industry, those operating in traded and non-traded goods. Linking this to the political economy of central banking, for example, bankers may oppose expansionary monetary policy because it might lower real interest rates and raise inflation, whereas workers and industrialists may prefer looser policy"*[1]

Thus, in this way central bank plays its distributive role in the economy. It takes steps to achieve the common economic goal and ensure economic stability in the country.

Objectives of the Central Bank

As we have discussed earlier that central bank is an institution which is different in its role, functions and objectives from any other institution in the country. It is different from commercial banks and other financial institutions.

The main objective of the central bank is issuance of currency and maintenance of its value.[2]To maintains the value of currency central bank has to take some steps and adopt some policies that may vary from country to country. Therefore, there is difference in the objectives of central bank in different countries. However, following objectives may b considered as common for all central banks.

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[1] Epstein, Gerald, *Central Banks as Agents of Economic Development*, (Massac husetts Amherst: political economy research institute, University of Massac husetts Amherst, September, 2005), 6.

[2] Capie, F. and others, *The development of central banking* (Cambridge: Cambridge University Press),1.

These common objectives are objectives of monetary policy, Financial Stability objectives and objectives of payment system.

1) Monetary Policy Objectives

There are three main policy objectives of the monetary policy adopted by the central bank. These are Full employment, Economic growth and Price stability.

a) **Full employment.**

One of the primary objectives of central bank's monetary policy is to achieve full employment level. Over the history, central bank has used interest rate as a tool to achieve the goal of full employment. Usually, the central bank lowers the interest rate to increase the credit facility to businesses which definitely lead to an increase in employment. Full employment means the level of employment at which the demand for labor equals to the supply of labor. This level is called natural rate of employment.[1]in this situation all types of labor, like skilled and unskilled, are available in the market. There is sufficient demand for the skilled and unskilled labor. According to supply and demand rule, the wages of labours remain at reasonable level in market.

b) **Economic Stability:**

Economic growth generally means more jobs and better living conditions. It is related with an increase in business activities. Economic stability is also one of the important objectives of the central bank. This objective is related to full employment objective and depends on it. If there is full employment there will be more production in the economy which will lead to economic growth.[2] This is because where there is production, it means there is demand for that production. For every supply there is demand and for every demand there is supply. The economy will be stable.

c) **Price Stability:**

Price stability means stability in the domestic purchasing power. Over the past few decades, the central banks of different countries have viewed the price stability as one of the most important and basic objectives of the central bank's monetary policy objectives. This is usually considered a dominant policy objective and is generally specified in laws and statues of the central

[1] Mishkin, *the economics of money Banking and financial markets*, 412.
2 ibid

bank. [1] After the Second World War, most countries started to finance development projects by borrowing from the public. The central bank also started to help governments by increasing the volume of paper currency by deficit financing. This increase in the volume of currency led to inflation problem. This problem became a concern to economists during that period and is still one of the most difficult problems of the modern economies.

2) . Financial Stability

Financial stability is also one of the prime objectives of the central bank. Central bank acts as lender of the last resort for banks and financial institutions. Central bank plays its role to ensure continued adequacy of liquidity. The banks sometime face liquidity problem in fulfilling their financial obligations towards their customers. They often face this problem either because of mismanagement of their liquidity or because of mortgaging their assets in financial transactions. they also face lack of liquidity problem during financial uncertainty in the market when customers of the bank rush to withdraw their deposits. It is usually difficult form bank to manage their liquidity and face these unexpected and sudden withdrawals by the customers. In this situation central bank helps such banks to fulfill their financial obligation by giving loans. This role of central bank is not only necessary to save that particular bank from default but also to maintain the confidence of the general public in the banking sector which is a backbone of modern financial system.

Central bank also ensures financial stability in the financial markets. The development of a stable financial system to avoid financial crises is considered an important objective of the central bank.

The tool which is used to ensure stability in the financial markets is interest rate. So, interest rate is important tool in many modern financial systems and especially in monetary policy adopted by the central banks. if there is an increase in the interest rate, businesses having long term bonds and mortgages will face loss. Therefore, prudent decisions are necessary to ensure financial stability in financial markets.

1 Central Bank governance group, *Issues in the Governance of central Banks* (England:A report from the Central Bank Governance Group, May 2009, P: 6.

3. Payment System Objective

The acceleration in transfer of funds as a result of an increase in the financial transactions in global financial markets across the world requires a greater role of the central bank to ensure a sound and efficient payment system by minimizing potential risk[1]. To achieve this goal the central bank will have to establish an operating payment system. Moreover, it has to supervise the payment system. It is the responsibility of the central bank to determine basic guidelines and principles to ensure smooth and risk free payment system. It has to issue, from time to time, necessary relevant regulations in this regard.

4. Issuance of currency and Maintaining Its value.

The issuance of currency and to maintain its value is also one of the important objectives of the central bank. As we have discussed earlier under the topic evolution of the central bank, most of the central banks were established to assign them the task of issuance of currency and maintain its value and fulfill the reserve requirement as set by the government.

Factors Determining the Objectives of Central Bank

The objectives of central banks mentioned above are common objectives of central banks. Although all central banks have some common objectives, however the details and methods of these objectives may vary from one country to another according to the criteria and preferences set by the government[2]. These preferences and criteria include:

- The level of general economic growth of the country
- The volume of the available financial resources
- The extent of the expansion and development of the money market and the capital market. The composition of the credit structure prevailing in the country
- The type of monetary system under which the central bank operates
- The nature of the country's international financial relations in general.

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[1] Central Bank governance group, *Issues in the Governance of central Banks*, 40

[2] Al Syed Ali, Dr. Abdul Munim, *al tatawwar al tarikhi lil Anzima Al Naqdiyyah Fil Aqtar Al Arabia*, 245.

Objectives of the State Bank of Pakistan

State bank of Pakistan is the central bank of the country. Since its inception in 1948, despite challenging circumstances faced by the newly born country, the central bank has faced all the challenges with a great zeal and commitment. It has played its vital role to overcome the financial difficulties in the country. The main objectives of the state bank of Pakistan are as follows:

1) Maintaining Price Stability with Growth

This includes the Enhancement and the effectiveness of monetary policy and price stability. The main objective of the state bank of Pakistan is Development and management of monetary policy. This objective of the state bank has been mentioned in the act as under

"Formulate and monitor monetary and credit policy and, in determining the expansion of liquidity, take into account the Federal Government's targets for growth and inflation and ensure that the Bank conducts monetary and credit policy in a manner consistent with these targets and the recommendations of the Monetary and Fiscal Policies Coordination Board with respect to macro-economic policy objectives"[1]

In this act it has been clearly mentioned that formulation of monetary policy is the responsibility of the state bank of Pakistan. So, to ensure and effective monetary policy is also on of primary objectives of the central bank of the country.

2) Ensure the Financial System Stability.

Financial system stability is also among the core responsibilities of the state bank of Pakistan. Perhaps this is in wider sense than ensuring sound banking system in economy. In every economy there may be large players of the financial institutions whose failure would lead to failure of the whole economy or at least will have adverse effects on it. The state bank of Pakistan, along with other measures taken to ensure the overall financial stability, provides an important system for such financial institutions that warrants additional security for them.

3) Improve the Effectiveness and Efficiency of the Banking System.

Through its regulatory framework that includes overall supervision and implementation of the risk based approach in banking sector, the state bank of

[1]The state bank of Pakistan act, 1956, chapter iii – management, 8.

Pakistan is committed to ensure the effectiveness and improve the efficiency of the banking system. The state bank adopts rationalized regulatory framework to avoid unnecessary barriers in smooth performance of banking sector. The regulatory framework of the state bank provides appropriate protection to the customers of the different banks working in the country.

4) Exchange Rate and Reserve Management

One of the objectives of the state bank of Pakistan is to supervise and maintain the exchange rate of local currency. Keeping in view the local and international economic circumstances the state bank of Pakistan is also responsible to maintain the internal and external value of the currency. The central bank maintains reserves against the currency issued.

5) Issuance of Currency

Under the State Bank of Pakistan Order 1948, the state Bank of Pakistan was assigned the task to

> *"Regulate the issue of Bank notes and keeping of reserves with a view to securing monetary stability in Pakistan and generally to operate the currency and credit system of the country to its advantage".*[1]

Therefore, issuance of currency and protection of its value is also one of the basic objectives of the state bank of Pakistan. This was the first objective to be achieved after its inception in 1948. The state bank of Pakistan is responsible to control the supply of money to maintain its value.

6) Strengthening Payment System

The state bank also plays its role to strengthen the payment system in Pakistan. Keeping in view the acceleration in transfer of funds as a result of an increase in the financial transactions in global financial markets across the world the state bank of Pakistan takes timely steps to play greater role as a central bank to ensure a sound and efficient payment system by minimizing potential risk[2]. To achieve this goal the central bank has established an operating payment system. It has determined keynotes, guidelines and principles to ensure smooth and risk free payment system. It also issues from time to time necessary relevant regulations in this regard.[3]

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[1] 21 Sept, 2020, https://www.sbp.org.pk/about/Lf.asp

[2] Central Bank governance group, *Issues in the Governance of central Banks*, *40.*

[3] SBP Vision 2020, State bank of Pakistan, 10.

3.3 The Role and Functions of the Central Bank

The central banks generally play the same role and carry out the same functions that represent the traditional functions of the central banks. However, these similarities are not as general as is considered. Along with the traditional functions, there are some other functions that depend upon the environment of each country. The economic, social and political conditions also play role in determination of the functions of a central bank is expected to carry out. These factors cannot be ignored in determination of the functions and the role that a central bank is expected to play in an economy. The main factors that affect the role and function of central bank are economic conditions, social environment, and political conditions. Moreover, the economic strategies and policies will also influence the role and functions of the central bank.[1]

The pace of economic growth of a country is one of the factors that will be kept in mind in determination of the role and functions of central banks. For example, in developing countries, which are in dire need of financing for development projects and activities, the central bank is required to achieve this financing by various means, like deficit financing. Thus, this function will be an important function of the central bank as this type of financing represents one of the basic goals of developing countries.

Conversely, this function does not carry much importance in advanced industrial countries or in the rich countries, because they have enough economic resources and strong currency to execute and implement development projects. Therefore, the role of the central bank in these countries is not more than a regulatory authority with its traditional central banking functions. This difference is in terms of the economic conditions of a country.

To explain the difference of functions, based on social conditions we can give the example of Islamic countries where Riba or Interest in not allowed. In such countries interest, which is considered the most important tool for formulation and implementation of monetary policy, cannot be used by central banks of these countries. So, the functions of these countries would be different from the conventional interest based central banks of other countries.

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[1] Shawar Al-Tamimi, *Nahwa Msraf Markazi Islami*, 67.

All of these are important factors in determining the objectives of the central bank that will definitely affect the functions that the central bank performs to achieve these goals. Thus, the central bank of any country does set its goal and functions from theories in the books, rather, it strives to achieve the economic goals of the country in which it works and in line with the priorities of that country.

However, despite these differences of priorities based on economic and social conditions, there are some common functions of central banks.

Primary Function of a Central Bank

What is the primary function of central bank? This is a widely discussed question among economists. Economists have different point of view about the basic and primary function of the central bank. According to Hawtrey,[1] lender of the lost resort is the primary function of the central bank. Lender of the lost resort means when there is no option with a bank to borrow from anywhere and it faces the lack of liquidity problem, central bank helps such bank and provides it loan as per the terms and conditions already set by the central bank.

On the other hand, according to Vera Smith,[2] central banks primary function is monopoly over note issue. Issuance of currency is the basic function of the central bank. Some other economists have different point of view. Some[3] of them stress upon the economic stability. They think that central bank's basic function is to ensure economic stability in the country. The primary functions of a central bank are as following:

1. Currency Issuing Bank

The central bank performs the function of issuance of currency, which represents legal tender and the final currency. It is considered full liquid asset.[4] The central bank is responsible for the money supply that mainly includes the issuance of paper currency in modern ages and is not convertible into any other metal or asset. The central bank follows a special mechanism and some rules and regulations already set by the central bank or government authorities. In the early periods, almost every bank had the right to issue notes. But this empowerment of each bank to issue note led to

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[1] British civil servant and monetary theorist 1879-1971

[2] Vera C. Smith, *the rationale of central banking and the Free Banking Alternative* (Springville: Liberty Press Edition, 1990), 3.

[3] S.M Akhtar and K.K. Dewett, *Modern Economic Theory*, 352.

[4] Qanawi, Dr, Izzat, *Asasiyyat Fi Nuqood wal Bunook*, Kuwait Holi: Darul Ilm Linnashr Wa Tauzeeh, 2005), 22.

access supply of currency notes, inflation, and economic instability. However, gradually this important role was entrusted to central bank and other banks were stopped to issue notes. Paper money is a legal tender issued by the government. It has no intrinsic value. Therefore, there must be a system to control the supply and demand of the currency notes to avoid access supply or deflation in the economy. So, to control the circulation of money there are different currency issuance systems in the modern economic system that control the quantity of currency notes in a country.

This function of central bank has a great impact on economic activity, as it determines the amount of liquidity in the society, thus directly affecting the total volume of means of payment in the economy and economic growth and employment level.

There are four most important methods or systems of issuance of currency[1]. They are Proportional Reserves System, Fixed Fiduciary System, Maximum Fiduciary system and Minimum reserve system. All these systems have been discussed in detail in chapter 2 under the topic "Issuance of Currency".

2. Bank of the State

The second important function of a central bank is that it acts as bank for the government. The central bank is the government's bank and this function is one of the basic functions that have arisen since the establishment of the central bank. It is derived from two characteristics of the central bank, the ownership of the central bank and centralization of the decisions. The ownership of the central bank may be private, or public or mixed ownership that is public and private. In any case it acts as bank for the government. This situation has led to establishment of special and distinct relationship between the central bank and the government authority.[2]

In its role as a bank for the government, the central bank undertakes following responsibilities.

I. Government keeps all its balances with the central bank. It acts as the government's financial treasury.
II. The central bank provides cash management services to the government. It provides short term funding to the government which the central bank, often, receives from open market operations.

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[1] Akhtar.S.M and Dewett k.k. *Modern Economic Theory,* 353.
[2] [2] Qanawi, *Asasiyyat Fi Nuqood wal Bunook,* 22.

Sometimes it issues new currency by the process of deficit financing to help government to meet its expenditures in emergencies like war. However, this process of deficit financing leads to inflation in the country. Therefore, in some countries the central banks are established as an in independent entity and are prohibited by law to provide advance financing to government[1]. However, this law is required to be relaxed in cases of emergencies.

III. In some countries the central bank acts as a debt management agent for the government. These countries have established debt and some time asset management office under the ministry of finance or as an independent agency.[2] Thus the central bank acts as a financial agent for the government. In capacity as agent, it is responsible for managing the public debt, making new loans, and issuing treasury bills on behalf of the government. It also guarantees government bonds that have not been sold yet. Moreover, the central bank also pays interest on government bonds. It also pays the amount which is due after the maturity of bonds and sometimes renews such matured bonds as per the instructions and policy laid down by the government.

IV. Apart from being a major funder of the government, the Central Bank sometimes collects government revenues, such as taxes, from various institutions, and fulfills its obligations towards these revenues at the internal and external levels.[3]

V. The central bank manages the state's foreign assets such as foreign currencies and foreign commercial paper. It also provides foreign currencies to the government that it needs to meet its external obligations. The central bank makes payment on behalf of government at local and international levels being a financial treasure for the government.

[1] S.M Akhtar and K.K. Dewett, *Modern Economic Theory*, 355.
[2] Central Bank governance group, *Issues in the Governance of central Banks*, 45.
[3] Sami Khalil, *AL Nuqood Wal Bunook*, 540.

3. The Bankers Banks

A traditional relationship exists between the central bank and commercial and specialized banks. The function of central bank as a bank for banks has arisen as a result of this relationship.

In fact, the central bank has some rights and obligations that attract other bank to rely upon it. It has monopoly over issuance of currency, it enjoys a strong financial position and acts as a main source for liquidity for commercial and specialized banks. It also has the right to formulate the monetary policy and implement the same[1]. These distinctions make the central bank as bank for other banks in the country.

The central bank as banker's bank carries out the following functions.

I. The central bank acts as custodian of the commercial banks cash Reserves. This function developed slowly and is closely associated with the central bank's functions as issuer of currency and as banker to state. Because of these two functions the commercial banks confidence over the central banks increased. In the beginning depositing of cash reserves with central bank was optional however with the passage of time, cash reserves became statutory obligation for all commercial banks and is used as a monetary policy tool.

II. The central bank being the banker's bank acts as a lender of the lost resort to the commercial banks. When commercial banks face the lack of liquidity in their account and are unable to fulfill their financial obligations by their outside resources, they resort to the central bank. The central bank either gives loan to the bank or manage the commercial bank's liquidity problem through discounting facility available with central bank for commercial banks.

The commercial banks, according to some economists, borrow from the central bank when they feel that the borrowing is profitable for them. To clarify this situation by an example, we assume that bank has treasury bills with a yield of 5% and discount rate is 4%. If the commercial bank is exposed to withdrawal of large amounts from the deposits, it has two options: either to sell treasury bills or borrow

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[1] Ibid.

from the central bank. According to this theory, the commercial bank chooses the second method of borrowing from the central bank and thus it makes a profit of 1%.[1]

The central bank also plays an important role as a clearance house. All the central banks provide the facility of central clearing house. In some countries it may be adopted as tradition or as facility of settlement of debts, in some other countries, however, it is a duty imposed by statues and law. It is easy for the central bank to provide this service because it is the custodian of the cash reserves of all the commercial banks and therefore maintain an account of every bank. Thus, any debt transaction that may arise among various commercial banks of the country may easily be settled through clearing house of the central bank.

This service of the central bank is not only convenient but also economical for the entire banking sector. Every bank has to receive and pay various types of payments to other bank on daily basis which are settled by the central bank.

4. Supervision Over the Banking System

Credit creation is the backbone of the banking business and it is the basic function of commercial banks. A commercial bank is considered a trader of credit, as credit creation is the main source of profit for it.

Credit creation process is also important for the economy. Actually, in this process the banks collect small amounts from different depositors and lend it to the businessmen who use these funds in productive economic activities. So, it has a positive effect on the performance of overall economy. Moreover, credit creation means an increase in the means of payment that is an increase in money circulation and increase in money supply. Normally increase in money supply will increase economic activities in the country. However, an increase in volume of money more than already available products and services of the country or gross domestic products of the country, will have a negative effect on the economy. On the other hand, if the process of credit creation is too much reduced it will have a negative effect on the economic activity of the country.

Therefore, there should be an equilibrium that must be maintained and observed to ensure positive effects of the credit creation process. Central bank

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[1] Dr. Subhi, Tadris, *alaqqad, Dr. Midhat, Al Nuqqod wal Bunook wal alaqat Al Iqtisadiyyah Al duwaliyyah* (Beruit: Dar al Nuahzah AL Arabia,1983), 151.

of the country undertakes this responsibility to ensure and maintain the supply of money or credit creation at a suitable desired level. The central bank supervises the credit creation process and controls the money supply by using monetary policy and its various tools.

The central bank controls the supply of money by imposing some conditions to be fulfilled and issuing strict instructions to be followed, to commercial banks in its capacity as a supervisor over the banking system of the country. [1]

Methods to Control the Credit Creation by Banks

The central bank uses two methods to control the money supply in the economy. These are qualitative method and quantitative method. [2]

Quantitative Method

In quantitative method the central bank controls or influences the total volume of credit in the whole banking system. In this method the bank is not concerned with the direction of flow of money. The central bank uses three main tools to control the credit supply through this method. These are Bank rate, Open market Operation and cash reserve ratio.

Bank Rate

Bank rate is the rate of interest that is charged by the central bank from commercial banks for rediscounting of bills. When a commercial bank faces the problem of lack of liquidity to fulfill its obligations toward its depositors, it resorts to central bank and central bank rediscounts the bills of exchange presented by the commercial bank and charges a rate of interest from commercial bank.

Open Market Operation

Open Market operation refers to action of central bank in which it directly buys and sells the securities in money market. The central bank sells and purchases the government securities in money market. In contractionary monetary policy it sells the securities and in expansionary monetary policy it buys the securities from the market.

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[1] Shafi, *Muqaddimah Finnuqood wal Bunook*, 242.

[2] Mishkin, *the economics of money Banking and financial markets*, 412.

Reserve Ratio

Reserve ratio refers to the portion of liabilities of the commercial banks that they must keep with them rather than lending it out. To achieve the goal of contractionary monetary policy this reserve ratio is increased while targeting the expansionary monetary policy goals this reserve ratio is decreased.

Qualitative Method:

In qualitative method the central bank takes steps to regulate the flows of credit into a particular direction of the economy with an aim to support a specific sector of the economy or to decrease the credit flows to specific sector. This aim is achieved by determining a ceiling for credit disbursement to a sector or by differentiating the price for credit to each sector. That is why it is called selective method of supervision or monitoring. It does not affect credit as a whole; rather it affects some aspects of use of credit, or some sectors of the economy.[1]

These tools of credit control will be discussed in next chapter under monetary policy topic.

[1] Sumair. AL Misri, Hussain,Mahmood Dr Salahuddin, *Iqtisadiyyat al Nuqood*, 143.

Assets and Liabilities of a Central bank

After discussing the role, functions and history of the central bank in conventional economic system, it seems appropriate to mention the components of the balance sheet of the central bank. As we will discuss an Islamic central bank in the next topic, therefore it is necessary to examine the components of a conventional central bank's balance sheet for a better understanding of shariah analysis of the role and functions of central bank.

Assets of the Balance Sheet of a Central Bank

There are generally four main components of the assets of a central bank. These are Gold, foreign reserves, special drawing rights, and local currency.

a) Gold Reserves:

Gold is considered a part of the reserves of the central bank. In the past,100% gold reserves were kept against the issued currency. However, now the paper currency is not convertible into gold. Only in some countries it is kept as reserves for the currency in circulation to maintain the value of the currency. Gold becomes part of the assets of the central bank either as a part of paid up capital of the bank or central bank, representing the country, receives it as a part of receivables from foreign countries through financial transaction take place with foreign countries.

b) Special Drawing Rights

SDR is an artificial currency instrument. It is created by a basket of most dominant and important currencies like US dollar, Euro, Chinese Yuan, Japanese Yen and pound Sterling. It is an international credit facility. The International Monetary Fund has introduced a special system called special drawing rights used as a means of settling debts between central banks of the member countries and to facilitate lack of liquidity problem.[1] When this system came into operation, one unit of special drawing rights was equivalent to 0.888671 gram of gold, which was also equivalent to one dollar, and was called paper gold. The value of each unit of SDR is revised every five years.

Thus, the Fund provides Member States with foreign exchange against their national money, in order to assist them in the event of a budget deficit.

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[1] Al Umar, Ibrahim Bin Salih, *al nuqood Al Ietimaniyyah (*Riyaz: *Darul Aasima*, 1414 AH), 258.

Foreign Currencies:

Any currency other than the local currency of the country is foreign currency. It is considered an asset of the central bank. All the foreign currencies are a claim of the holder of that currency against the issuer country of that currency. Therefore, they are recorded under assets of the holder of that currency.

Assets in the Form of Local Currency

Local currency is the legal tender of that country. The central bank keeps this currency in different forms. It keeps it in the form of bonds of public institution, short term government bills, Advances and discounted loans to commercial and specialized local banks, loan to the government and deposits with local banks etc.

These are the four main components of assets generally mentioned on the balance sheet of a central bank. There may be some other assets however, these are important among all other assets. The other assets will be different for each central bank of the country according to financial instruments issued, sold and purchased in that particular country.

Liabilities of the Central Bank

1. Capital

It is the balance of gold or gold certificates. In modern central banking system, it is replaced by foreign currency which is valued in local currency. The legal body that assesses and determines the volume of capital of the central bank varies from country to country. In some countries it is determined by the government authorities and in some other countries by legislative authority depending upon the independence status of the central bank.

2. Issued Currency.

It is the legal tender issued by the Central Bank, and in some countries the Central Bank issues the “coins”. This issued currency is one of the most important items of liability side of the central bank’s balance sheet. It is issued against reserves on assets side, which maybe gold and convertible foreign currencies, treasury bill etc.

3. Current Deposit Accounts

These are governmental and non-governmental agencies accounts with the Central Bank. Various governmental institutions deposit some of their allocated amount with the Central Bank being a bank for the government, and the Central Bank in turn provides banking services to these institutions.

4. External Financial Obligations

These are external debts usually in foreign currencies[1]. They are considered among the liabilities items as they are obligations of the Central Bank. The Central Bank is an agent for the state in receiving its revenues and in fulfilling its financial obligations.

These are the main components of the liability side of the central bank's balance sheet. However, there are some other items that may appear on liability side of the balance sheet of central bank like insurance of letter of credit etc.

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[1] Garreth Rule, *Understanding the central bank balance sheet* (England: Centre for Central Banking Studies, Bank of England, 2015), 8.

3.4 The Role and Functions of Islamic Central Bank as Compared to Conventional Interest Based Central Bank

Islamic central bank wills apparently play almost the same role as a conventional central bank. However, the main factor that makes difference between the two is interest which is prohibited in Islam hence, connate be practiced by an Islamic central bank.

Most of the monetary and other tools used by the central banks to perform its duties and carry out its functions include *Riba*. Thus, an Islamic central in a modern economic system has to achieve the same objectives and perform same duties as a conventional bank performs. However, it has to use tools other than those generally used by a conventional central bank.

Before we discuss the functions and role of an Islamic central bank, it is pertinent to discuss the concept of an Islamic central bank to determine that how it is different from a conventional central bank.

The Concept of Islamic Central Bank

Various contemporary Muslim scholars have defined Islamic central bank.

Dr Umar Chapra says:

"It should be an autonomous government institution responsible for the realization of the socioeconomic goals of the Islamic economy in, and through, the money and banking field"[1]

This definition says that an Islamic central bank must be an autonomous body and is responsible to achieve the socioeconomic goals through money and banking field. This is the definition of a central bank by highlighting the goals and objectives of central bank. If we compare this definition with the definition of a conventional bank as mentioned above, we can assume that this is not a clear comprehensive definition. The definition of a conventional bank is:

"It is the institution that undertakes the responsibility of issuance of the banknote and ensures, by various means, the soundness of the banking system. It is (also) entrusted

[1] Chapra, Dr. Muhammad Umar, *Towards A Just Monetary System* (Dhaka: The Islamic Foundation, 1985), 147.

with supervision over the credit policy of the country as these policies have important impacts on the economic and social system"[1]

This definition is better and depicts a complete picture of the central bank. The definition of conventional bank may be applied to the Islamic conventional bank as an Islamic bank undertakes all the responsibilities mentioned in the definition of the conventional bank.

For example, in the definition of conventional bank it is mentioned that this institution undertakes the responsibility of issuance of currency and ensures the soundness of the banking system using various means. This concept does not contradict with shariah principles and does not violate any shariah rule. Moreover, the role of a central bank mentioned in this definition is also expected from an Islamic central bank in the modern economic system. Thus, the concept of a central bank is same as of a conventional central bank.

However, what make difference are the tools used and ways that are practiced by the central bank. Once we are convinced that the concept of a central bank is same in both Islamic and conventional monetary system, then the definition presented by Zakki Shafi is more comprehensive and clearer.

Analysis of the Definition

Yet we can deduce the most important characteristics of a central bank from the definition of Dr Umar Chapra.

Firstly, it must be autonomous body. It means it must have its internal management system and governing body. This is necessary to ensure the efficient performance of the Islamic central bank. Moreover, it must be an independent body. This is a necessary condition for an Islamic central bank to perform its duties and take decisions in the best interest of the economy and there must not be any type of political interference or pressure from any authority.

To ensure its independence in taking decision it must have its own resources and income sources. These sources may be in the form of remuneration received by the central bank against provision of different types of agency and other services to government and other banking institutions. It may also invest the funds received as reserve ratio on the basis of *Musharakah* or *Modaraba* from commercial banks and get its share of profit from such investments.

[1] Shafi, *Muqaddimah Finnuqood wal Bunook*, 228.

Secondly, it must be a public entity owned by the government. The reason why it must be owned by the government is that it performs an important duty of issuance of currency. All the Muslim Jurists are unanimous that authority of issuance of currency in Islamic economic system must remain with the government and it must have a monopoly over it. Any private entity must not be allowed to issue currency as this will lead to economic instability. The famous Muslim historian and Jurist Ibne Khaldoon says:

"The head of the state is charged with repairing of coins and is responsible to save them from any type of loss or damage."[1] *We have shed light on this issue in detail in second chapter under the topic "issuance of currency."*

Moreover, it has to formulate and implement policies to achieve the objectives of socioeconomic goals. These objectives cannot be achieved by a private entity.

Thirdly, what can be deduced from this definition is that there must be only one institute entrusted with the authority of issuance of currency. This is because more than one institute cannot formulate and implement the policies. It will be difficult to formulate and implement harmonized policies if there is more than one institute performing same role. However, the central bank may be allowed to establish branches in various regions and regions, in order to facilitate and perform its duties through division of tasks and responsibilities.

Functions and Role of an Islamic Central Bank

The functions of a conventional central bank have been mentioned above. The Islamic central bank will play almost the same role and carry out same functions. Dr Umar Chapra says

"Like all central banks, the Islamic central bank 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 commercial banks"[2]

The main role and assumed functions of an Islamic central bank are same as of a conventional central bank. Islamic central bank will coordinate with government to take steps to ensure internal and external economic stability. It will be responsible for issuance of currency keeping in view the economic condition and monetary policy requirements.

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[1] Ibn e Khaldoon, *Tariekh Ibne Khaldoon*, 1: 721.

[2] Chapra, *Towards A Just Monetary System*, 148.

It must act as banker for banks and must make necessary and suitable arrangements for settlement of debts and clearance of checks. It will also take all necessary measures to supervise the commercial and specialized banks. It will ensure the soundness of all banking system.

We will discuss the supervisory function of the central bank in detail.

Supervisory Function of an Islamic Central Bank

The main objective of a central bank's supervision over the banking system is to ensure the safety of the interest of the general public and the bank's share holders. The central bank takes steps and issues instructions to save the commercial and specialized banks from default risk.

The risks, faced by any business, are primarily related to the nature of that business. Islamic banking has a different nature from the nature of conventional banking. The basic difference is that the relationship of a conventional bank with his customer is a loan based relationship. The bank does not share the risk of loss with the customer. There is only risk of default or bad debts. As for as the Islamic banks are concerned, the relationship between bank and customer is based on investment and risk sharing. The investment activity represents the core and essence of its nature and is a backbone of Islamic banking system. The investment activity has a methodology and mechanism of action that is different from the methodology and mechanism of the loan based system on which the conventional banking system activity depends. The nature of relationship of a supervisor, like central bank, with both banks through these two different activities is different in terms of its nature, methods and provisions. This difference in the nature of the investment activity and the nature of the supervisory relationship with its customers in the Islamic bank results in existence of different types of risks that an Islamic bank may be exposed to.

The customer himself may be a source of many risks for bank if he does not have the required level of administrative and investment experience essential to ensure the efficient and successful implementation of the project. Moreover, if he lacks proper professional conduct of business necessary to preserve the bank's funds from any loss, it will be a risk for Islamic bank. These types of risks arise due to the nature of relationship between an Islamic bank and his customer. This relationship is based on profit and loss sharing. Unlike the loan based relationship that makes the conventional bank safe from these types of risks, because the amount given to customer is a debt owed by the customer that must be repaid to the bank in all cases.

On the other hand, funds provided to the customers of Islamic bank are not guaranteed. There is risk of loss which the bank has to share with the customer.

Since the nature and level of the risks to which the Islamic banking business is exposed to is different from the nature of the risks to which the traditional banking business is exposed to as mentioned earlier, and since the Central Bank establishes its methodology of supervision on the basis of this nature of risks, the methodology of supervision for conventional banks must be different from the Islamic banks. A methodology adopted for conventional banks cannot be considered appropriate for Islamic banks, and the methods that the Central Bank relies on to reduce these risks are not suitable for achieving this goal in the case of Islamic banks.

Credit Guarantee Policy of Central Bank for Islamic Banks

The central bank issues instructions to commercial and specialized banks to ensure the guarantee of the loans given to customers in the form of collateral or pledges. This policy, if applied on the Islamic banks, is not suitable for controlling the risks of Islamic banking, except in the event that the relationship between the bank and the customer turns to debt relationship which happens very rarely when the customer guarantees payment of the bank's funds. This situation happens when the there is Qarz Hasan contract between bank and the customer. The portion of such contracts in Islamic banking activities is very low.

Another case, where the principal amount is guaranteed for the bank and is to be returned by the customer, is when the contract of *Musharakah* or *Mudharabah* becomes void. For example, this case may occur, if the partnership relationship between the bank and the customer turns into a void contract, when he violates the terms of the relationship or make misuse of the bank's funds. These types of cases are actually exceptional cases.

Actually, Islamic banks are more concerned about the profit rather than the guarantee of the loan provided to the customer. If a customer is going to invest funds in a business which is expected to return high profit, the Islamic bank will be willing to create partnership relation with him even he does not have the traditional forms of guarantees.

Hence, this policy is not suitable to achieve the goals for which it is applied in the case of Islamic banking, which is to control the risk of default. In addition to the fact that its application to these banks limits their ability to grant financing to certain sectors and people of the society who meet the requirements for obtaining this financing according to the methodology work of these banks, however, they are unable to provide these types of traditional guarantees required by the central banks.

The Policy of No Ownership of Fixed and Moveable Assets For Investment Purpose

The banks are not allowed to own fixed and moveable assets for investment purpose.

This policy, of not allowing the ownership of fixed and movable assets, is not appropriate for the Islamic banking business as well, as Islamic banking business depends on investment as a main activity for the employment of funds, which requires the ownership of these assets. Restricting Islamic banks from such type of ownership would be a major obstacle in performance of this activity. This is because Islamic bank does deal in money only, rather it is a business entity. It owns and sells goods. It enters into partnership contracts with customers.

Thus, application of this policy to Islamic banks is not consistent with the nature of their activities and the nature of the risks to which their activity is exposed. Dr Abdul Munim says:

"إن إختلاف طبيعة و نوعية المخاطر التي تواجه العمل المصرفي الإسلامي عن المخاطر التي تواجه العمل المصرفي التقليدي تجعل منهجية و أساليب الرقابة التقليدية للبنك المركزي غير ملائمة للتطبيق على حالة المصارف الإسلامية وغير قادرة على تحقيق الأهداف المطلوبة كما أنها تمثل معوقا رئيسيا لأنشطة هذه المصارف في كثير من الحالات"[1]

The difference in the nature and quality of the risks in Islamic banking business from that of the conventional banking business makes the traditional methodology and methods of control of the central bank, inappropriate for application in Islamic banks and is unable to achieve the required goals, as it is a major obstacle to the activities of these banks in many cases.

Here dr. Munim has emphasized on the importance of adopting different methodology for the supervision over Islamic bank due to difference between the nature of the Islamic and conventional banking system. The nature of the risk faced by Islamic bank is different from the risk the conventional bank is exposed to. If the supervision methodology applied on conventional banks is applied on Islamic banks, it will be an obstacle in the way of Islamic banking system. Thus, methodology of

[1] Al Syed Ali, Dr. Abdul Munim, *al tatawwar al tarikhi lil Anzima Al Naqdiyyah Fil Aqtar Al Arabia*, 73.

conventional central bank to supervise the banking system would be different from that of conventional central bank.

Islamic Central bank as lender of the lost Resort

In addition to the above mentioned supervisory aspects, the central bank is required to perform the function of lender of last resort in a way that is consistent with the nature of the activities the of Islamic banks in case of both liquidity and solvency crises. We have discussed above, under the functions of conventional central bank, that the central bank plays its role as lender of last resort. The Islamic banks may feel, sometimes, lack of liquidity problem.

Liquidity crises may arise because, the Islamic bank, after investing an amount in a project, may not be able to receive that amount and profit as per planned and expected maturity period and gets late. In this situation, the bank may face the liquidity problem. Insolvency on the part of an Islamic bank may occur, however, the possibility of occurrence of such insolvency is very low, because of substantial volume of *Mudharabah* deposits. *Mudharabah* is an agreement in which funds are provided by one party for investment and the other party is responsible to use his labor and professional skills to generate profits[1]. Thus, deposits with bank on *Mudharabah* bases are generally sufficient to protect demand deposits.

Yet, if the central bank deems it necessary to help an Islamic bank facing liquidity problem, it will help him on the basis of Qrz Hasan contract which means giving loan without interest as interest is prohibited in Islam.

Credit Allocation

A conventional Central bank also plays a distributive role in the economy. Distributive role means that it develops different policies for different sectors of the economy. Each policy may have different effects on each of the various sectors of the economy. credit allocation means that the central bank determines ceilings over the credit facility extended to different sectors of the economy. For example, the central bank may put a condition that a commercial bank cannot provide credit facility for car purchasing or for construction purpose. The main objective of such instruction is to achieve the goal of stable economy through its distributive role by concentration on each sector of the economy.

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[1] Al-Kāsānī,, *Bada'i' al-Sana'i' fi Tartib al-Shara'i'*, 4: 236.

As for as an Islamic banking is concerned, one may raise the question, is it allowed for a central bank from shariah point of view to put such conditions upon an Islamic bank? Is it consistent with the basic rule of Islam which says that everyone is free to spend his wealth and invest his money in any sector as long as it is not against the shariah rules?

Apparently, it is not allowed to stop someone from investing his amount in a field of his choice, so central bank is also not allowed to put condition on banks preventing them from investing his funds in a specific sector of the economy. This is against the right of individuals to dispose of his wealth as, when and where he wishes as long as it does not contradict the shariah principles and public interest.

In fact, one of the main objectives of shariah that can be derived and deduced from the shariah provisions related to every field of life, is interest of public.

The Muslim Jurist Ibnul Qayyim says:

"إِنَّ الشَّرِيعَةَ مَبْنَاهَا وَأَسَاسُهَا عَلَى الْحِكَمِ وَمَصَالِحِ الْعِبَادِ فِي الْمَعَاشِ وَالْمَعَادِ"[1]

Islamic Shariah is based and built on wisdoms and public interest in this world and the world hereafter.

It is the responsibility of an Islamic state to intervene in the economic activities to ensure safety of public interest. If any sector of the economy is being ignored by the investors and this ignorance may result in economic instability in the country, the government is responsible to take necessary steps and measures to save that sector of economy. The government is allowed to intervene and impose some conditions upon individuals to save that sector to ensure public interest even if the action goes against right of individual interest in their use of wealth according to their will and preferences, an already accepted right by Islam[2]. This is because public interest and rights have preference over private rights. Therefore, Monopoly is not allowed in Islam because it is against the public interest.

There is Hadith of Prophet

"لايحتكر إلا خاطئ"[3]

"No one withholds goods till their price rises but a sinner."

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[1] Ibnul Qayyim, i'laam al-mouwaqi'in 'an rabb il-'alamin, 3: 11.

[2] Ismat Bakar Ahmad, "tadakhkhul AL Dowlah li tahqeeq al Kafaah AL Iqtisadiyyah", Majallah Takreet liluloom AL Idariyyah wal Iqtisadiyyah 5, no. 15 (2015) : 107.

[3] Abū Dā'ūd, *Sunan Abī Dāwūd*,Kitabul Buyooh,hadith 3449.

In the light of above discussion, government is allowed to issue instructions to the banks to ensure economic stability in the country even if they are deprived of their right of freedom with regard to the use of his wealth according to his will. Thus, this intervention by the government is not against the provisions of shariah.

However, it would be preferred to attract investors to invest in the sector which the government want to prefer over the other and should avoid direct instruction to prevent form investing in some sector of the economy or imposing conditions to prevent them from investing in some sectors of the economy.

Issuance of Currency and Money Supply Control:

One of the basic functions of an Islamic central bank is to issue currency and maintain the value of money at a suitable, stable and desired level. There is no disagreement among Muslim jurists that the state - and only the state - is the authority in issuance of currency and it is not permissible for anyone to perform this task.

According to Imam Ahmad coins must be minted in Islamic minting house with the permission of the head of state because if general public is allowed to mint the coins it will lead to harm to them.[1]

Another Muslim jurist of Hanbali School of thought Imam Ibne Taymiyyah is of the view that the head of the Islamic state is responsible for minting of coins for the people.[2]

As we have mentioned before, Abdul Malik Bin Marwan is the first caliph in Islamic history who formally minted gold and silver coins in 76AH called Al-Dirham Al-Islami and al-Dinar Al Islami. He also restricted the process of minting coins to the central government.[3]

An Islamic central bank is also responsible for issuing of currency and maintaining its value. It will also insure steady economic growth. It is a primary institute in the state to formulate and implement the monetary policy. It will use whatever instruments, tools and method necessary for a successful monetary policy as long as they are not in conflict with teachings of shariah. For example, Islamic central bank is not allowed to use interest as a tool for monetary policy as interest is prohibited in Islam.

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[1] Al-Bahūtī, *Kashshaf al-qina` `an matn al-Iqna`*, 2: 232.

[2] Ibne taymiyyaah, Majmooh Al fatawa, 29: 469.

[3] Ibid, 10.

Allah Says in the wholly Quran:

"أحل الله البيع و حرم الربو"[1]

"But Allah hath permitted trade and forbidden usury".

Likewise, it cannot take any a step that is considered against the public interest or have a positive effect only on specific class of the society ignoring other classes as this is against the social justice doctrine of Islam.

Allah sys in the Quran,

"إِنَّ اللَّهَ يَأْمُرُ بِالْعَدْلِ وَالإِحْسَانِ وَإِيتَاء ذِي الْقُرْبَى"[2]

"Indeed, Allah orders justice and good conduct and giving to relatives."

Moreover, if a policy is formulated which benefit only rich people it will also be considered against the teachings of Islam. Islam emphasizes on distribution of wealth and does not want wealth to be concentrated in few hands of society. Another verse in the Quran says:

"كَيْ لَا يَكُونَ دُولَةً بَيْنَ الْأَغْنِيَاءِ مِنْكُمْ"[3]

"So that it will not be a perpetual distribution among the rich from among you."

According to the teachings of Islam, the deprived and poor people of the society must be given priority and special attention by the state to ensure equitable distribution of wealth. Thus, the central bank should formulate monetary policy, keeping in view the basic concepts and teachings of Islam as referred above.

[1] Al-Baqarah: 275
[2] AL Nahl: 19
[3] Al-Hashr: 7

The Functions of the State Bank of Pakistan

The state of bank of Pakistan being the central bank of Pakistan performs all the traditional and non Traditional Functions in order to achieve the objectives of a stable economy set by the government of Pakistan.

There are two types of functions that the State Bank of Pakistan performs. These are primary and secondary functions. Primary functions include issuance of currency notes, regulations of the financial system of the economy. It also acts as lender of the lost resort and undertakes the formulation and implementation of a sound monetary policy. The secondary functions of the state bank of Pakistan include management of public debt and foreign exchange management. Acting as a financial advisor also comes under the category of secondary functions of the state bank of Pakistan. Secondary function also includes development and supervision of a stable payment system. The state bank of Pakistan remains in coordination and in close relation with international financial institutions.

Macro and Micro economic Functions of the SBP

The functions of the state banks may also be categorized as macroeconomic functions and micro economic functions. Macroeconomic functions are those related to objectives of the overall economy. Under this function, state Bank looks at the economy as a whole and tries to determine its course and nature. Under the macroeconomic function the state bank of Pakistan is responsible for preserving the value of the currency and maintains the price stability in the economy. Under microeconomic functions it takes steps and ensures banking system stability.

The state bank of Pakistan also performs some non-traditional promotional functions[1]. These are some responsibilities, which do not come under the core responsibly of the bank. Performing such functions helps the state bank to achieve its objectives. Such Functions include provision of training facilities to bankers, provision of credit to a sector on priority bases. Development of financial framework is also a nontraditional promotional function of the state bank of Pakistan.

[1] Arbi, Muhammad Farooq, *State bank of Pakistan Evolution Functions and Organization*, State Bank of Pakistan, 2019), 4.

State Bank of Pakistan and Islamic Banking in Pakistan

Having a look of the countries where Islamic banking has been adopted as a part of their economic system, we can conclude that there are three models of central banks all over the world.

The first model is one that has removed Riba based banking system and has completely implemented Islamic banking system. Thus, there will be no contradiction of policies between Islamic banks and central banks of such countries. Sudan and Iran[1] are the countries where such model has been adopted.

There are some other countries that have adopted or implemented Islamic banking system as a part of their banking system. The central banks of such countries have issued special laws to regulate Islamic banks apart from the laws regulating traditional interest based banking system. Thus, due to existence and implementation of separate regulating framework for both, no question of contradiction in policies will arise and the central bank can smoothly continue its regulating function for both. The example of Pakistan may be quoted here for such model.

The central bank of Pakistan is playing a leading role in promoting and developing Islamic banking system. Keeping in view the increasing demand for shariah complaint various solutions of financial needs of the public, the state bank of Pakistan has established Islamic banking department.

This department is responsible for developing a shariah complaint framework, taking targeted research initiatives, collaborating with local and international stake holders to come up with competitive and innovative solutions to meet the financial needs of masses.[2]

Some countries have adopted Islamic banking as a part of their banking system by issuance of license of work to some Islamic banks.

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[1] Ammar Gharbi, Dr, Abdulhaleem, *Al wajeez Fil Iqtisad AL Naqdi Wal Masrafi* (KIE: KIE Publications, January, 2018), 186.

[2] Arbi,*State bank of Pakistan Evolution Functions and Organization*, 23.

However, there are no separate rules and regulations consistent with the nature and work of these Islamic banks. Because of these inadequate legal conditions, Islamic banks face difficulties that impede their work and development, especially in their relations with the Central Bank through regulatory process.

Chapter 4

Comparative Study of Conventional and Islamic Monetary Policy

4.1 Introduction to Monetary Policy

The world has witnessed continuous development in second half of the 20the century. Many changes and developments have emerged in the economic world as well. These developments include emergence of global financial and economic crises and the exacerbation of some economic problems like Inflation, unemployment, increased external indebtedness, public debt, budget deficit and imbalances in the balance of Payments of the various countries and the occurrence of recession in the global economy. Money has played a vital role in this regard. All these imbalances and changes, that have affected the macroeconomic variables and indicators, resulted in emergence of different and contradictory ideas about monetary policies. This divergence of point of view about monetary policies led to introduction of various new aspects of monetary policy. Such new aspects had a great impact on highlighting the increasing importance of monetary policy as well as the ability of monetary authorities to influence the required growth rate. This is because the state has monetary powers and Legal authority, which enables it to enact laws and make decisions that would define the critical aspects of the National economy. These decisions may be related to already available monetary instruments or to the volume of credit granted to economic institutions or the interest rate.

Emergence of the Term Monetary Policy

The term monetary policy is relatively a modern term that appeared in the economics literature during the nineteenth century. A number of economists like Keynes and Alfred Marshal have written scholarly articles research books etc. Their research writings appeared from time to time during crises and periods of economic instability. This century also witnessed the start of the systematic study of various monetary policy issues that were highlighted and discussed in various modern economic theories, as well as by those interested in applied or practical economics. This development arose out of the problems that resulted in the repeated economic cycles[1]. With the passage of time, in the twentieth century, monetary policy and its study from its various aspects became an integral part of the state's general economic policy to achieve the goals of a stable economy.

Concept and Definition of Monetary Policy

Different economists have defined monetary policy from different aspects.

It has been defined as *"Monetary policy is defined as policy-induced changes in the money supply or/and in interest rates"*[2]

The point that has been highlighted in this definition is that the main role in monetary policy is played by money supply and interest rate. It means monetary policy is implemented by using two tools that are supply of money and interest rate. Therefore, money supply and interest rate both are very important in monetary policy.

However, this is not a clear definition, as it does not give a picture of the complete concept of monetary policy. It does not mention the purpose for which this policy is used or formulated. Dr Abdul Munim Efr has defined monetary policy as

"التحكم في كمية النقود المتاحة للتدول وهي الإجراءات و الأساليب المتعددة التي تتخذها السلطات النقدية في الدولة في إدارة كل من النقود و الإئتمان وتنظيم السيولة"[3]

It is Controlling the volume of money available for circulation, (these monetary policies are) the various procedures and methods adopted by the monetary authorities of the state to manage money, credit, and regulate liquidity.

In this definition Dr Efar has referred to some monetary tools as well. He mentioned that monetary policy is the control of money supply. Further he mentioned ways to control the money supply. Money supply is controlled by managing money, credit and liquidity to achieve the goals of economic stability of the state.

Another definition of monetary policy is

"الطريقة أو الطرق التي تتبعها السلطات النقدية في الدولة و المتمثلة بالبنك المركزي لتوجيه كمية النقود في التداول إلى التوسع و التقلص بقصد الوصول إلى هدف من أهداف السياسة النقدية"[4]

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[1] Al Douri, Zakriyya, al Samrae, Dr. Yusri, *AL Bunook Al Markaziyyah, Wal Siyasat AL Naqdiyyah*, (Omman: Yazori Scientific House for publication and distribution, 2006), 18.

[2] Handa, *Monetary economics*, 30.

[3] Efar, *Al siyasat Al Iqtisadiyyah Fil Islam*, 117.

[4] Al Bikri, Anas, Walid Safi, *al Nuqood Wal Bunook Bain AL Nazriyyah Wa altatbeeq* (Oman: Darul Mustaqbil, 2009), 112.

The method or methods used by the monetary authorities in the country to direct the amount of money in circulation towards expansion and contraction to realize one of the goals of monetary policy.

After discussing the above mentioned definitions, we can conclude that a comprehensive and complete definition of monetary policy must include some important element. They are:

1- Procedures and actions undertaken by the monetary authorities.

2- These procedures are used to influence monetary variables and influence the behavior of banking and non-banking agents.

3- Monetary policy aims to achieve the goals set by the monetary authorities.

Thus, monetary policy is considered a tool in the hands of the monetary authorities, which is used to influence money supply by monitoring the banking system in general and banks in particular and imposing restrictions and conditions on the activities of banks and by using certain means to achieve monetary and economic stability at the internal and external levels. The monetary authorities take necessary steps and prudential decisions about money supply in line with the prevailing economic conditions and the goals already set by the government. These goals generally vary from country to country as per different levels of economic development, the different banking and financial structure and other economic and financial policies. The authorities also take into consideration various other factors that change with the passage of time and accordingly change the respective monetary policies to keep pace with the economic and financial developments.

Monetary policy is a major integral part of the economic policy. The other main part is the financial policy that is controlled and implemented by some budgetary tools like revenues and expenses to influence savings and investment.[1] Thus, there is difference between monetary and financial policy. Financial policy is related to the budget, revenues and expenses while monetary policy is mainly related to money supply and its control.

Targets of Monetary Policy

The measures taken by the monetary authorities are either to target the monetary variables like credit, exchange rate and interest rate or to intervene in the

[1] Muhammad, Yousuf Kamal, *AL Masrafiyyah Al Islamiyyah* (Beirut: Dar ul Nashr Lil Jamiaat, 1996), 19.

money market and influence the volume of credit creation by banking and non-banking financial institutions involved in credit creation.

Moreover, there are some intermediate targets and some ultimate goals of monetary policy. There are some intervening variables between the goals and instruments of monetary policy[1]. For example, central bank needs to reduce aggregate demand in the economy if it wants to decrease inflation. The reduction in aggregate demands requires reduction in consumptions and/ or investment. Consumption and/or investment may be reduced through increase in the market interest rate. Thus, these intervening variables are intermediate targets.

The intermediate targets provide a link to the ultimate goals. They can be influenced by the central bank and the central bank can take necessary steps and timely decisions regarding them. Generally, they can be accurately measured. The example of intermediate targets is annual aggregate demand in money supply.

On the other hand, final goals are those which are affected by the intermediate monetary variables, such as rate of inflation growth rate, and external balance of payment, the stability of the national currency exchange rate etc.

Difference Between Monetary Theory and Monetary Policy

The term “monetary theory” is also used in monetary economics. However, monetary policy differs from monetary theory. Monetary policy means a set of procedures and practical measures carried out by the monetary authorities, usually the central bank, to solve existing economic problems or to protect against the occurrence of economic crises. While monetary theory explains those economic problems and identifies ways to treat them. It looks at the economic problems with a scientific view, and in certain circumstances, it recommends what the economic system should be and what measures should be taken to achieve the goals of a stable economy.

Evolution of Monetary Policy

Monetary policy has evolved according to economic developments and has undergone various important changes. The concept of monetary policy in classical thought is different from modern thought. The circulation of money as a social phenomenon is directly related to its purchasing power and to the relative stability of the real value of money as medium of exchange. In other words, the circulation of money is related to the liquidity of money or the speed of transformation of money

[1] Handa, *Monetary economics*, 307.

into goods and services and various factors that result from a change in its real value or purchasing power and its implication on the overall economy. Economists even judge the liquidity of any type of good or wealth by its speed of conversion into cash or money. Therefore, money is liquid enough to be used as a criterion for determining the liquidity level of other types of wealth.

Monetary policy has evolved through the following stages. .

Classical Theory of Monetary Policy

The first school is the classical school who envisaged the economic system as a system managed by hidden power, and that any interference in this automatically managed system will disturb it. In case of any defect or imbalance that may occur will be automatically fixed by natural market forces. This theory prevailed until the financial crisis in 1930 that resulted in great depression and general unemployment.

This classical analysis is theoretically based on the law of Say. This law says that every supply creates its own demand, so production creates the demand for purchasing. This is because the production factors will be used again to buy production. In other words, production creates spending equal to it and spending will be equal to output or real GDP. Aggregate supply is always equal to aggregate demand and if there is increase of one over the other it will be a temporary situation that will soon be adjusted by virtue of the effectiveness of the market forces. It is assumed that there is perfect competition in the market. The natural forces of supply and demand push to the efficient allocation of Resources and thus achieve economic equilibrium because of flexibility in wages and prices of goods and services.

This theory also assumes that there is correlation between changes in the general level of prices and changes in the quantity of money supplied. It means that changes in the quantity of money supplied in economy are equally reflected in the general level of prices[1].Increase in money supply will lead to an equal increase in general price level. The velocity of money remains constant in the short run.

Moreover, nothing in economics is more insignificant and trivial than money. Money has no role in the economic equilibrium as it only the role as medium of exchange and has no effect on real economy, hence cannot affect the economic equilibrium. Thus,

[1] Keynes, John Maynard, *The General Theory of Employment, Interest, and Money* (Hesburgh: International relations and security network, Feb, 1936), 177.

role of money is neutral according to classical point of view. It does not affect output or employment level.

Keynesian Theory of Money

The second school of thought that emerged after the 1930 financial crises and is represented by Keynesian school of thought.[1] In his famous book "The General Theory of Employment, Interest, and Money (1936),he called for a greater role of the state by making fiscal and monetary policies. He rejected the classical model. This school of thought presented the idea of interference by the government. this theory even allowed the deficit financing through issuance of currency notes or creating debt. Unlike the classical theory that claims that wages and prices are flexible in short run, Keynes has built his theory supposing rigidity of prices and wages in the short run which means that prices and wages do not change in the short run. He also believed that natural market forces are unable to deal with financial crises.

It means that Keynesians have accepted the monopoly as a fiat accompli and a real fact of the modern economy and treated this disease by another disease that is increasing inflation through deficit financing.

Keynes rejected the classical model due to failure in dealing with the depression that occurred in 1936 and the world was undergoing economic crises and problems. This is because the allocation of resources was not efficient, with much idle capital and labor.

The main points of the Keynesian theory may be highlighted as under:

1- Short term data analysis.

-2 Demand creates supply.

3- There is no perfect competition in market all the time because the purchasers and the sellers are not with the same capabilities. There is lack of information in some areas which lead to monopoly on the part of some people.[2]

Modern theory of Monetary Policy

The above mentioned theory was followed by another financial crisis happened in the seventies of the 20th century, when the Keynesian monetary tools

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[1] Keynes, John Maynard, *The General Theory of Employment, Interest, and Money*, 177.

[2] Mishkin, *the economics of money Banking and financial markets*, 545.

were unable to treat the imbalances that were caused by monetary tools introduced by Keynesians and resulted in the stagnant inflation since 1970.[1]

The Chicago School of thought, led by Milton Friedman, reformulated the quantity theory in a modern form, now called the Modern quantity theory, which emphasizes on the importance of monetary policy. Monetarists argue that if the economy is operating below the full employment level, an increase in money supply will affect aggregate income and spending in the economy.

This theory moved the pendulum of thought back to classical school of thought and called for restricting the role of the state in monetary and fiscal policy and controlling the money supply without interfering in interest rate. According to this school of thought, state has to play its role in money supply while leaving the interest rate to be determined by the natural market forces. According to this theory Changes in the supply of money can redress the economic imbalances and eventually will lead to economic stability.

This theory also says that countries that issue their own currencies and have complete control over their own fiat currency will never face lack of currency problem. It means that government should issue currency through deficit financing to meet its expenditures. This has no adverse effect on the inflation and overall economy. The effect will be redressed by imposing taxes by the government. Thus, the fiscal policy will play its role to control the inflation and will affect the monetary policy.

This theory believes that as the expectation of inflation leads to a continuous increase in demand. The effect of increase in the money supply ends with a rise in the interest rate and not with a decrease in the interest rate. So they believe that the monetary authority should not take into consideration the interest rates due to their inability to manage them in the desired direction. Therefore, focus must be placed on managing the money supply. Furthermore, in addition to monetary policy, fiscal policy can be used to influence the supply of money through various means like tax and public debts.

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[1] Yousuf Kamal, *AL Masrafiyyah Al Islamiyyah*, 10.

Monetary Policy Tools

Monetary policy tools are the monetary instruments that fall under the direct control of the monetary authorities. The monetary authorities, using these instruments, try to achieve the ultimate goals of monetary policy. These instruments may be qualitative and quantitative in nature.[1]

Quantitative Tools of Monetary Policy

Quantitative tools of monetary policy are related to the quantity or volume of the money regardless of the use and venues of such use. These tools are also called general tools. They are considered indirect in nature. The purpose of such tools is to control the bank credit and to influence total reserves available with the banks. Quantitative tools of monetary policy include following monetary instruments:

[1] Shaiha, Mustafa Rushdi, *AL Iqtisad Al Naqdi, wal Masrafi* (Beirut: Al dar Al jamieyyah, 1985), 244.

1. Discount Rate Policy

Mustafa Rushdi has defined discount rate is as:

"سعر الفائدة الذي يعيد به البنك المركزي خصم الأوراق التجارية التي سبق وأن خصمها البنك التجاري وهو عبارة هن الثمن الذي يتقاضاه البنك المركزي مقابل تقديم القروض، .وخصم الأوراق التجارية وأذونات الخزينة في المدة القصيرة"[1]

The interest rate at which the central bank re-discounts the commercial papers that were previously discounted by the commercial bank, this term is used to refer to central bank charges against making loans and discounting commercial papers and treasury bills in the short run.

This rate is also called rediscount rate because commercial bank has already discounted these commercial papers. Thus, re-discount rate is the interest rate, or the price charged by the central bank in exchange for providing loans and discounting commercial papers in the short run.

The commercial banks when face lack of liquidity in the short run they resort to the central bank to take loan to fulfill their financial obligations towards their customers. The central bank takes charges against such loan which is called interest rate. The commercial banks some time present the commercial papers and treasury bills to central banks to rediscount them against the credit facility from the central bank to these commercial banks. Rediscounting of such commercial papers means that the Central Bank replaces the commercial bank to receive the loan payable against that commercial paper.

The institutions that deal with the central bank in this regard are the commercial banks. Keeping in view the opportunity cost and modern prevailing practices, central bank charges them the price of this borrowing in the form of interest rate. This is the standard rate which the bank is ready to by or rediscounts commercial papers.

It is worth mentioning here that this rate of interest is not determined through general rule of supply and demand. In other words, this rate is not determined keeping in view the supply of the quantity of commercial paper presented for the discount or the demand for liquidity, rather it is determined in a more general way, taking into account the effect on the money market and the ability of commercial banks to create credit.

Effects of Discount Rate Policy

[1] Shaiha, Mustafa Rushdi, *AL Iqtisad Al Naqdi, wal Masrafi*, 244.

The objective of the re-discount policy is to influence the ability of commercial banks to expand or limit the volume of its loans, or influence the monetary market trends as a whole, especially with regard to the prevailing interest rates, i.e., the rates of borrowing money for a short period. Any change in this interest rate will definitely cause a change in cost of credit available to the commercial banks. If the loans are available at cheaper rate to the commercial banks, they will be able to enhance the credit facility to customers. This will result in a boast in money circulation and will cause inflation. On the other hand, if the interest rate is high, commercial bank's ability to get loan facility will be reduced. This will reduce the ability of commercial bank to disburse loans or provide credit facility to customers. The reduced ability of commercial banks will result in a reduction in credit circulation and will decrease inflation.

However, the efficiency of the discount rate as monetary policy tool will also depend on the availability of credit facility from sources other than the banking system, elasticity of investment demand, and the network of the banking system. This policy will not be effective If commercial banks can avail the credit facility from sources other than the central bank and that facility is sufficient to fulfill the credit needs of the commercial banks because the commercial bank will manage its liquidity problem from other sources ignoring the option of rediscounting of bills.

2. Open Market Operation

Open market operations refer to sale and/or purchase of government securities treasury bills, financial and commercial securities by the central bank in the open market[1]. The aim of this operation is either, by selling them, to convert such securities and assets into cash, thereby decreasing money supply in the market and affecting the liquidity of the money market, or by purchasing these assets which will lead to increase money circulation and money supply in the market. The central bank enters into the financial markets as a seller or buyer of these securities and to the money markets as a seller or buyer of treasury bills, commercial papers or the foreign currencies. The central bank aims, through this policy, to influence the volume of credit in economy.

If the central bank wants to achieve the targets of expansionary monetary policy that is to increase the money supply it will purchase the bonds, securities,

[1] Mishkin, *the economics of money Banking and financial markets*, 545.

treasury bill and other commercial papers from open market. This action of the central bank results in increase in money supply in the market[1]. On the other hand, if the central bank wants to achieve the goals of contractionary monetary policy that is to decrease money supply in the market, it will sell the bonds, securities, Treasury bill, and other commercial papers in the open market. A huge amount of money will be received by the central bank and circulation of money will be reduced. This process results in reduction in money supply.

The effectiveness of the open market operation depends upon level of liquidity of the money market as a whole. The role of commercial banks is also important to achieve the goals expected from the open market operations. For example, the central bank may, applying expansionary monetary policy, purchase the securities from the market to increase money supply, however this money may not be used to increase credit creation in the economy because of conflict of interests between central bank and the money market players like commercial banks.

3. Reserve Ratio:

Commercial banks used to deposit some of their cash balances with the Central Bank if they deemed suitable. It was not legally binding upon them to do so. Generally, such reserves with the central banks would help them to fulfill their obligations towards their customers if they faced liquidity problem. The central bank was a safe place for keeping unused cash balances. Commercial banks did not receive any interest on such deposits. However, they would provide services to commercial banks like keeping their funds in safe custody, managing their accounts, and acting as a lender of last resort.

The rapid change in the volume of credit provided by commercial banks, due to changing conditions of demand for loans, would cause a disturbance in the overall economic activities. In the event of economic boom, commercial banks would increase the volume of credit. This increase in credit volume would sometime cause unexpected.

inflation on the other hand, in the event of economic recession, the volume of demand for loans would decreases to a level that would often threaten a depression in the economy. In addition to the above mentioned reason, some commercial banks would fail to fulfill their financial obligations towards their customers due to liquidity

[1] Akhtar.S.M and Dewett k.k. *Modern Economic Theory*, 363.

mismanagement and providing credit facility without proper management of the default and other expected risks involved in such disbursement of funds.

All the above mentioned causes called for taking appropriate and necessary measures to protect the economy from unexpected inflation, deflation and to secure the rights of the various parties dealing with commercial banks and to maintain the confidence of public over banking system. Banking laws were amended, and new laws were made requiring commercial banks to keep a certain percentage of the deposits they had with the central bank in liquid form. This amount deposited with central bank is called cash reserves. Technical definition of reserves is as following:

"النسبة من الودائع التي لدى المصرف التجاري و التي يلزم القانون / المصرف التجاري بإيداعها لدى المصرف المركزي و تتغير هذه النسبة حسب الظروف الإقتصادية و أهداف السياسة النقدية"[1]

It is the percentage of deposits with the commercial bank that the law obliges commercial bank to deposit with the central bank and this percentage changes according to economic conditions and monetary policy objectives.

Objectives of Reserve Ratio

Reserve ratio policy is necessary to achieve two objectives. Firstly, the central banks want to protect the rights of depositors of commercial banks. This was the primary goal of this process. The cash reserve that is required to be kept with central bank is actually a guarantee with the Central Bank from the commercial bank to fulfill its financial obligations towards the customers.

Secondly, this reserve is required to control and influence the volume of credit provided by commercial banks by decreasing the reserve ratio in the event of deflation and by increasing it if there is inflation in the economy. In the present time this is the main objective of this process as this policy provides a strong position to central bank in controlling the volume of credit.

The Mechanism of this Policy

If there is an increase in the volume of credit by the banks that causes inflation, the central bank increases the cash reserve ratio. This increase in the cash reserve ratio causes an increase in liabilities of commercial banks, as they are required to deposit more money with the central bank as reserves. This liability reduces the

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[1] Dr. Subhi, Tadris, alaqqad, Dr. Midhat, *Al Nuqqod wal Bunook wal alaqat Al Iqtisadiyyah Al duwaliyyah*, 167.

capacity of banks to grant loan facility to the customers. Thus, as a result the volume of currency in circulation decreases which reduces the inflation in the economy. On the other hand, if the prevailing economic situation is the result of deflation and the economy is undergoing recession, the central bank decreases the amount of reserve requirement that reduces the financial liability of banks enabling them to grant more amount as loan to their customers.[1] The increased amount of loan given to the customer causes an increase in currency circulation and helps monetary authorities in controlling the prevailing situation of deflation. In this way reserve ratio is used as a monetary policy tool to control inflation or deflation.

Qualitative Tools of Monetary Policy

The target of specific use of credit is achieved by using same quantitative monetary tools through these techniques. Actually, In qualitative method the central bank takes steps to regulate the flow of credit into a particular direction of the economy with an aim to have impact on certain sectors rather than upon the overall economy. It aims to support a specific sector of the economy or to decrease the credit flows to a specific sector. This aim is achieved by determining a ceiling for credit facility to a sector or by differentiating the price for credit to each sector. That is why it is called selective method of supervision. It does not affect credit as a whole; rather it influences some aspects of use of credit or some sectors of the economy.[2] The examples of such selective methods are as following:

1. Monetary authorities may determine different discount rate for different sectors. Thus, the Central Bank may reduce interest rate on industrial, agricultural and housing loans and may raise on commercial loans or on the import of luxuries or may puts a ceiling on the loan given for the import of luxury items.
2. The central bank may put restrictions on consumer loan like raising the amount of down payment or decreasing the limit of credit or period of loan.
3. The central bank may change the legal reserves ratio for different types of investments.
4. It may determine different maturity periods for different types of loan as per the preferences of the monetary authorities.

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[1] Mishkin, *the economics of money Banking and financial markets,* 547.
[2] Sumair. AL Misri, Hussain,Mahmood Dr Salahuddin, *Iqtisadiyyat al Nuqood*, 143.

However, these types of qualitative measures make the market forces ineffective and rule of supply and demand will become ineffective.

Moral Suasion as Monetary Tools

These are often moral instructions by the monetary authorities to the banks. The central bank uses its influence upon commercial banks to follow its recommendations and suggestions. For example, advising banks through enticement to prevent from involving in negative activities such as gambling etc. Although such suggestions are not enforceable by law however, there is always a threat for commercial bank of converting these recommendations into legal orders. Moral suasion too will be effective where there is respect for the judgment and extra-legal authority of the central bank.

These recommendations may include the following:

- The central bank may determine the minimum level of capital for the bank.
- The central bank may also make Periodic inspection of accounts and assets of the banks and may carry out evaluation of management methods followed by the banks.
- It may also take direct measures such as issuing orders to stop lending or to raise the cost of lending for banks etc.

Thus, these are some helping monetary tools. The central bank may control the circulation of money using these helping tools. However, such types of tools will depend upon the powers of the central bank given it by the law. If the law has given the central bank unlimited powers to control the banking system, these helping tools may be effective. Otherwise, if the central bank does not have sufficient authority and powers, then these tools will not be as effective as may be expected.

Objectives of Monetary Policy

After discussing the various types of monetary tools that are used by the central bank to achieve certain goals to ensure a stable economy, it would be appropriate to mention the objectives of the monetary policy.

In fact, the objectives of monetary policy are linked to the prevailing monetary theories and have evolved with development of these theories. Therefore, the goal of monetary policy under the quantity theory of money is to achieve price stability objective. However, according to Keynes' theory, the objectives of monetary policy include influencing economic activity by creating effective demand and encouraging the investor to increase production. According to this theory, a lower interest rate is preferred to achieve the goal of full employment with a minimum rise in the price level.

There are some other factors as well that determine the objectives of monetary policy. These factors vary from country to country and include the level of economic development and progress and the overall economic condition of economy. Thus, objectives of monetary policy of an economy facing higher inflation would be different from an economy undergoing recession.

1. **Full Employment.**

   Full employment means the level of employment at which the demand for labor equals to the supply of labor. This level is called natural rate of employment.[1]To achieve the level of full employment is one of the primary and important objectives of monetary policy. This objective of monetary policy is more important for developing countries that are suffering from lack of efficient and productive use of resources. Throughout the history, central bank has used interest rate as a tool to achieve the goal of full employment. This objective is achieved by increasing the flow of investment funds towards economic sectors that can make efficient use of available resources of the economy. Usually, the central bank lowers the interest rate to increase the credit facility for businesses which definitely lead to an increase in employment.

2. **Stability of The External Value of The Currency**

   Monetary policy also aims to insure stability of the external value of the national currency. This objective may conflict with the objective of internal price stability because, if a country tries to stabilize the external value of its currency, it requires increase or decrease in the general price level in the country, as per the requirement of the international prices level. This requirement may result in internal instability of prices.[2] Generally, economists prefer the policy of internal price stability. However, decision about the internal price stability or external price stability will depend on the conditions of each country with respect to its level of exports. If the large portion of the

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[1] Mishkin, *the economics of money Banking and financial markets*, 412.

[2] Sami Khalil, *AL Nuqood Wal Bunook*, 584.

national GDP of the country is from foreign trade, external price stability will be more important for that country.

3. **Economic Stability**

Economic stability is also one of the important objectives of the monetary policy. Economic stability generally means more jobs and better living conditions. It is related to an increase in business activities. This objective is related to and depends on full employment objective. If there is full employment there will be more production in the economy which will lead to economic growth.[1].However, only full employment cannot guarantee long term economic stability if other indicators of the economy are not positive.

4. **Price Stability**:

After the Second World War, most countries started to finance development projects by borrowing from the public. The central bank also started to help governments by increasing the volume of paper currency by deficit financing. This increase in the volume of currency led to inflation problem. This problem became a concern to economists during that period and is still one of the most difficult problems of the modern economies. In this situation price stability and inflation control became a goal of monetary policy. Price stability means stability in the domestic purchasing power. Over the past few decades, the central banks of different countries have viewed the price stability as one of most important and basic objectives of the central bank's monetary policy objectives. This is usually a dominant policy objective and is generally specified in laws and statues of the central bank. [2]

5. . **Financial Stability**

Financial stability is also one of the prime objectives of the Monetary Policy. Central bank acts as lender of the last resort for banks and other financial institutions. Central bank plays its role to ensure continued adequacy of liquidity. The banks sometime face liquidity problem in fulfilling their financial obligation towards their customers either because of mismanagement of their liquidity or because of mortgaging their assets in financial transactions. In this situation central bank helps such banks to fulfill their

1 Mishkin, ibid

2 Central Bank governance group, Issues in the Governance of central Banks, 6.

financial obligation. This role of central bank is not only necessary to save that particular bank from default but also to maintain the confidence of the general public in the banking sector.

Central bank also ensures financial stability in the financial markets. The development of a stable financial system is considered an important objective of the central bank to avoid financial crises. How is this objective achieved? S.Mishkin says:

"the stability of financial markets is also fostered by interest rate stability. Because fluctuations in interest rate create uncertainty for financial institutions"[1]

Thus, here the tool which is used to ensure stability in the financial markets is also interest rate. Therefore, interest rate is important tool in many modern financial systems and especially in monetary policy adopted by the central banks. If there is an increase in the interest rate, businesses having long term bonds and mortgages will face loss. Therefore, prudent decisions are necessary to ensure financial stability in financial markets.

[1] Mishkin, *the economics of money Banking and financial markets*, 414.

4.2 Shari'ah Analysis and Critical Study of The Conventional Monetary Policy

Several Shari'ah issues in conventional monetary policy need to be reviewed from Shari'ah perspective. In fact, conventional monetary policy is based on the use of interest rate as a primary tool to achieve the monetary policy objectives. The main tools of monetary policy that are discount rate, open market operation and reserve ratio requirement also involve interest. There are also other factors and reasons that will make these conventional practices of monetary policy unlawful form Shari'ah point of view. Therefore, conventional monetary policy assumes special importance from Islamic perspective because of strict prohibition of *R*iba.

The following discussion is related to Shari'ah analysis of these monetary policy tools. Each one of the monetary policy tools will be discussed separately to identify the reason for making these practices unlawful in shariah. The possibility of using these tools by an Islamic central bank will also be discussed.

1. Shari'ah Analysis of Discount Rate Policy

As we have mentioned in the previous discussion under monetary policy tools, that commercial banks when face lack of liquidity in the short run they resort to the central bank to take loan to fulfill their financial obligations towards their customers. The central bank takes charges against such loan in the form of interest. The commercial banks some time present the commercial papers and treasury bills to central banks to rediscount them against the credit facility from the central bank to these commercial banks. Rediscounting of such commercial papers means that the Central Bank replaces the commercial bank to receive the loan payable against that commercial paper.

After expansion and enhancement of international trade and international financial services, the importance of discounting of commercial papers is not beyond comprehension. Undoubtedly, it is one of the most important tools that has played a vital role in expansion of international financial services. Now it is easy for exporters and importers to provide and avail various products and services at international level. They can use commercial papers as a medium of exchange. They can also receive the amount payable against that paper before its maturity date. Being an acceptable medium of exchange in international trade, the commercial banks deal in such commercial papers to provide services to traders. However, the discounting process involves debt selling and interest which are strictly prohibited in Islam.

Before discussing the discounting process and Shari'ah provision related to the same, it is pertinent to mention the definition of commercial paper to make it convenient to understand the Shari'ah provisions regarding it.

The definition of commercial papers is as following:

"صكوك تمثل حقا واجب الدفع في ميعاد معين و قابلة للتداول بالطرق التجارية على أن يستقر العرف على قبولها كأداء وفاء بدلا من النقود"[1]

A paper instrument that represents a right to be paid on a specific future date and is negotiable through commercial practices, provided it is generally accepted in common trade custom as a payment means instead of currency.

It is defined in Investopedia as

"Commercial paper is a commonly used type of unsecured, short-term debt instrument issued by corporations, typically used for the financing of accounts payable *and inventories and meeting other short-term liabilities. Maturities on commercial paper typically last several days, and rarely range longer than 270 days".*

Thus, it is a debt instrument issued by debtor with a promise of payment of certain amount at a specific future date.

After discussing the concept and definition of commercial paper now we will discuss the concept of discounting.

Dr Rizkullah has defined discounting of commercial paper as under:

هي عبارة عن عن تقديم العميل للمصرف سندا تجاريا قبل حلول موعد إستحقاقه من أجل الحصول على قيمة السند حالا بعد خصم الفوائد و العمولات التي يتقاضاها المصرف حسب الإتفاق[2]

Discounting commercial papers means "presenting of commercial securities to the bank before it gets matured to obtain its price (payment due as per the promise mentioned on the security)immediately after deducting already agreed interest and fee amount charged by the bank.

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[1] Al-Qalyub, Samiha i *al-Qanun at-Tijari 'Amaliyat al-Bunuk al-Awraq at-Tijariyyah*, 7.

[2] Anṭākī, Rizq Allāh, Sibāʻī, Nihād., *al- Wasīṭ fī al-ḥuqūq, al-tijārīyah al-barrīyah* (Damascus: Maṭbaʻat Jāmiʻat,1964), 164.

Hence, the presenter of securities or commercial papers sells the paper to the bank before its maturity at a smaller price than its par. The amount of discount is calculated keeping in view the time value of money and risk involved in receiving the amount due as per the commercial paper.

Looking at the process of re-discounting, we note that it is nothing more than a form of discounting with difference of the parties involved in rediscounting process. In the process of re-discounting, the commercial bank is the one demanding the re-discounting of its commercial paper and the central bank will rediscount. Whereas in the discount process, the customer "demanding discounting" is generally private institutions and individuals, and the commercial bank will discount the paper presented by the customer. So discounting and rediscounting process is same. Thus, Shari'ah ruling will also be the same for both.

The actual process of rediscounting is that the commercial bank presents its commercial papers to the Central Bank and asks for rediscounting them in exchange for a certain percentage of interest obtained by the Central Bank. Through this process, the commercial bank aims to increase its ability to grant loan by improving its liquidity.

Payment Received by the Central Bank Against Re-Discounting Facility.

The central bank receives two types of income from commercial bank demanding re-discounting facility.

1. Interest rate
2. Service fee
3. Any other expenses incurred by the central bank in process of providing re-discounting facility.

Shari'ah Ruling Regarding Discounting of Bills.

We have mentioned above that central bank charges interest, service fees and other expenses incurred in the process of re-discounting. As far as the matter of charging fee and expenses from the commercial bank demanding re-discounting, there is no Shari'ah objection on these charges if the fee is charged against services other than the loan facility and expenses are reconverted as per actual expenditure incurred by the central bank. However, the extra amount deducted from loan in the form of interest is a controversial act among Muslim scholars. There is difference of opinion about discounting of bill of exchange, whether it is Hawala Contract or selling of debt or loan agreement with a security in the form of commercial papers from debtor.

Some of the contemporary scholars are of the view that If the commercial papers presented to the central bank are actually issued by central bank itself than it means the central bank is actually the debtor and commercial bank is creditor. Now creditor wants to receive the debt before the period agreed between the parties for repayment of debt. Furthermore, the commercial bank is ready to compromise on debt amount and asks to deduct some amount from the total debt and pay early. This situation is called Zah wa ta'ajjal (ضع و تعجل) as discussed by the early Muslim Jurists. It means to reduce some amount of debt against early payment of debt. There is difference of opinion of scholar regarding its permissibility. According to some Jurists this is permissible from shariah point of view if such reduction and early payment of debt is not stipulated in the agreement of loan. However, If the reduction of a portion of debt is stipulated in the agreement of loan, the Jurists are unanimous on the illegality of such condition. [1]

However, if the commercial papers presented by commercial bank demanding re-discounting, are issued by a third party and not the central bank itself than this problem may be discussed as under.

1. Analysis of Discounting of Bill Based on *Hawala* Contract.

Hawala Contract is a contract in which the responsibility of payment of debt is transferred from the liability of the principal debtor to the liability of another person.[2] Thus there are three parties in *Hawala* Contract. One is *Muheel* who transfers the liability of debt and he is the principal debtor. The second one is the creditor who is called *Muhal*, and the third one is the new debtor to whom transfer of liability is made or who undertakes the responsibility of payment of debt is called transferee or *Muhal Alaih*.

In rediscounting process, the commercial bank receives amount of loan from central bank against the commercial papers presented to central bank. Then bank who asks for discounting is debtor and transferor or *Muhil* of debt and the central bank who discounts the commercial paper of the bank is creditor or *Muhal. The one who*

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[1] al-Marghinānī, *Al-Hidayah fi Sharh Bidayat al-Mubtadi* (Beirut: Dar Ihya' al-Turath al-'Arabi 2003), 3 : 195.

[2] Zayla`i, *Tabyin al-Haqa'iq*, 4: 1717.

has issued this paper and undertaken the responsibility of payment of amount mentioned on the bill is called Muhall Alaih or transferee.

If the central bank gives, to the bank who demands credit facility against Commercial paper or bill of exchange, the same amount mentioned on the bill than there is no objection from shariah point of view. However, bank deducts some amount from the banks. for example, if the amount payable by the bill is 10,000 (ten thousand), the central bank will give less than 10,000 and the deducted amount will be a profit of central bank against the credit facility provided to the commercial bank. This extra amount received by the central bank is interest or *Riba which* is prohibited in Islam because in loan transaction any extra amount charged by the creditor is Riba. Riba as defined by Abubakr Al Jassas is

"هو القَرضُ المشرُوطُ فيه الأ جل وَزِيادَة مالٍ على المستَقرِ ضِ"[1]

It is a loan in which a period (of repayment) and an extra amount are stipulated on debtor.

Here in rediscounting process an extra amount is charged by the central bank for credit facility provided to the commercial bank which make this transaction unlawful from shariah point of view.

2. **Analysis of Discounting of Bill Based on Selling of Debt.**

If the rediscounting of commercial papers by central bank is considered selling of debt by the commercial bank to central bank, then it would be selling of debt to a third party. The sale of debt to a third party is controversial. According to Hanafi, Hanbali and Zahir School of thought it is not allowed to sell the debt to someone other than the debtor. Kasani in his book Badaeh ul Saneh says:

"ولا ينعقد بيع الدين من غير من عليه الدين؛ لأن الدين إما أن يكون عبارة عن مال حكمي في الذمة، وإما

أن يكون عبارة عن فعل تمليك المال وتسليمه، وكل ذلك غير مقدور التسليم في حق البائع"[2]

The sale of debt to anyone other than the debtor is not a valid sale contract. Because the debt is either constructive valuable thing owed or it is the act of transfer of ownership of valuable thing and delivery of the same, while the seller is unable to deliver any of them.

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[1] Al-Jaṣṣāṣ- Abū Bakr Aḥmad ibn ʿAlī al-Rāzī, *Ahkam-Ul-Quran ,dar ul Kutub al ilmiyyah*, (Beirut: ،1994), 1 : 569.

[2] al-Kāsānī, *Bada'i' al-Sana'i' fi Tartib al-Shara'i'*, 5: 148.

The famous Hanbali Jurist AL-Mardawi says

"لَا يَجُوزُ بَيْعُ الدَّيْنِ الْمُسْتَقِرِّ لِغَيْرِ مَنْ هُوَ فِي ذِمَّتِهِ. وَهُوَ الصَّحِيحُ مِنْ الْمَذْهَبِ. وَعَلَيْهِ الْأَصْحَابُ"[1]

It is not permissible to sell stable debt to someone other than who owes. And it is the correct point of view in (Hanbali) Mazhab and is an acceptable pint of view among (Hanbali) Jurists.

Here stable debt means a debt that is owed and payable. There is no possibility of its Extinguishment.

Imam Ibne Hazm have also mentioned the same point of view in his famous book AL Muhalla[2] . Although some Maliki[3] and Shafi jrusits[4] have mentioned some conditions for permissibility of selling of debt to someone other than the debtor, however they do not allow the selling of debt to someone other than the debtor in situation mentioned above regarding discounting of bills.

Even if the rediscounting process applied by the central bank for provision of credit facility to commercial bank is considered under selling of debt to someone other than the debtor and according to the point of view of those who allow the selling of debt to other than the debtor, yet the discounting process as applied by the central bank is not allowed. This is because Riba is involved in this transaction.

Jurists, who allow the selling of debt to a third party (other than debtor), stipulate that the goods that are exchanged must not be Ribawi goods. If counter values of exchange transactions come under Ribawi goods than selling of debt must be at par. Paper Currency also comes under Ribawi goods as has been clarified by the contemporary scholars.[5] In rediscounting process commercial bank pays more than it receives from central bank and currency is exchanged for currency, therefore this transaction is not allowed.

MuftiTaqi Usmani in his book Fiqhul Buyooh, says

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[1] Al-Mardawi, Ala' al-Din, *al-insaf fi ma'rifat al-rajih min al-khilaf* (Beirut:Dar-u İhyai't-Turas el-Arabi 2003), 5 : 112.

[2]Ibn Hazm, Ahamad bin Saeed, *al-Muhallā bi'l Athār* (Beruit:Dar Al-Fikr For Printing Publishing & Distribution 1993), 9: 6.

[3] al-Zarqānī, *Sharḥ al-Zarqānī 'alá Mukhtaṣar sīdī Khalīl* (Beirut: Dar al Kotob al-Ilmiyah, 2002), 5: 147.

[4] Shirbini. *Mughni al-muhtaj ila ma'rifat ma'ani alfaz al-Minhaj*, 2: 466.

[5] Majma‘ al-Fiqh al-Islāmī, *Majallat Majma‘ al-Fiqh al-Islāmī* , 5: 2919.

"و بما أنه بيع للدين بأقل من قيمته الإسمية فإنه تعامل ربوي بحت لال سبيل إلى جوازه"[1]

And since it is a sale of the debt for less than its face value, it is a purely usurious transaction; there is no way of its permissibility.

In Fact, re-discounting transaction involves Riba al Fazl and Riba al Nasa. Ribal Nasa is a kind of Riba and it takes place when in an exchange transaction, Ribawi goods are exchanged by way of deferment from either party entering into the exchange transaction.[2] While Riba AL Fazl is an excess stipulated in counter values of Ribawi goods of the same kind in a transaction of exchange.[3] The central bank pays less and receives higher amounts, thus its Riba al fazl. Moreover, the payment from one side that is from commercial bank is deferred. The central bank will receive the amount of bill at some future date that is the maturity date of security bill. Therefore, it is Riba Al Nasa as well.

To summarize the above discussion, we can conclude that it is not allowed for a financial institution or and an Islamic central bank to enter into re-discounting transaction as being practiced nowadays because it is not a permissible way of selling of debt and it involves usurious practice which is strictly prohibited in Islam.

3. Analysis of Discounting of Bill on the Basis of Ju‘alah Contract

Ju‘alah refers to rendering a service against a reward. Actually Ju‘alah is a contract in which one party called the Jua‘il undertakes to give some specific reward called the Jua‘l to anyone who may be able to achieve a specific or uncertain required goal or result. Ju‘alah contract is different from Ijara tul Ashkhas which is to employee someone for a job. As in Ijra tul ashkhas the remuneration is fixed and is necessary to be paid in all cases. However, in Ju‘alah contract payment of reward is subject to realizing results or achieving certain goal or goals.

A number of contemporary scholars[4] have suggested to apply the rules of Ju‘alah contract to the re-discounting process to declare it permissible from shariah point of view. According to these scholars, the extra payment received by the central bank is a reward for collecting the loan from the principal debtor who has issued the

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[1]Usmani, *Fiqh al-Buyu* , 1: 357.

[2] Al-Kasani, *Bada'i Al-Sana'i Fi Tartib Al-Shara'*, 5: 183.

[3] Shirbini. *Mughni al-muhtaj ila ma'rifat ma'ani alfaz al-Minhaj*, 2 :336.

[4] Ali, Abdur Rasool, *Bunuk Bila Fawaed* (Mekkah al Mukarramah: international Confrerence on Islamic Economis, 1395 AH), 10.

bill of exchange and has undertaken to pay the amount payable after maturity of the bill. The commercial bank will get loan from central bank and will become a debtor to central bank. Then the commercial bank will transfer the liability of loan payment to a third party who has issued the bill of exchange and is liable to pay the amount payable under the bill.

However, after reviewing the conditions of Ju‘alah contract we find that the reward under Ju‘alah contract is payable only after completion of the task or realizing the results required by the Jua‘il (جاعل). Ibne Rushd has written in his famous book Bidāyat al-Mujtahid:

"وَلَا خِلَافَ فِي مَذْهَبِ مَالِكٍ أَنَّ الْجُعْلَ لَا يُسْتَحَقُّ شَيْءٌ مِنْهُ إِلَّا بِتَمَامِ الْعَمَلِ"[1]

There is no difference of opinion in Maliki School of thought that reward is payable only after completing the task.

Nevertheless, in this situation where central bank receives reward may not, in some cases, collect the loan rather may return the commercial paper to the commercial banks and get its amount back. Therefore, it does not seem appropriate to apply the rules of Ju‘alah contract to re-discounting process.

4. **Analysis of Discounting of bill on the Basis of Wakala Contract**

Various contemporary scholars have allowed the discounting process on the basis of agency contract. In agency contract one person employs another person and assigns him a task to perform or to act on behalf of employer or represent him in a matter. In this case the employer is called the principal and the employee is called agent.[2] The agent may be paid remuneration against the services he provides. According to Hanafi School of thought such agency contract comes under Ijarah Tul Ashkhas and all the relevant condition of Ijara contract must be fulfilled.

If we analyze the re-discounting process on the basis of wakala or agency contract, then there will be two different contracts. One is loan agreement and the other is wakala (agency) agreement. The commercial bank will take loan and it will appoint the central bank his agent and will assign it the task of collecting loan payable under the commercial papers presented to central bank by the commercial bank. The amount deducted by the central bank will be considered wakala fee.

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[1] Ibn Rushd ,*Bidāyat al-Mujtahid*, 4 : 20.

[2] Al-Kasani, *Bada'i Al-Sana'i Fi Tartib Al-Shara'*, 6 : 19.

In this way re-discounting process may be allowed. However, two necessary conditions are not fulfilled in process of re-discounting as being practiced by the central banks.

The first condition is that there must be two separate agreements. One is wakala agreement and the other is loan agreement.

The second condition is that anyone of the two agreements must not be contingent upon the other[1]. Thus, collecting debt amount from the issuer of the bill must be a separate matter and the task must be performed by the central bank under a separate agency contract against a specific fee already fixed and agreed between the parties. The payment of loan by the central bank must be a separate agreement and must not be stipulated under agency agreement.

Conclusion of the Discussion About Re-Discounting

The opinion that may be drawn from the above discussion is that the re-discounting process from central bank is in fact Qardh (interest free loan) contract between commercial bank demanding re-discounting and the central bank. The commercial papers that are rediscounted will be considered as a security for debt called *Rahn* (رهن) in shariah.[2]

The payment under loan contract is called *Qardh* which is an interest free loan of consumable good extended on goodwill basis and similar property is returned.

"عقد مخصوص يرد على دفع مال مثلي لآخر ليرد مثله"[3]

It is a specific contract about giving a homogeneous thing by one person to the other who will return the similar thing.

. In re-discounting process, the commercial bank takes this loan to manage the lack of liquidity problem or to increase its ability to provide loan to its customers. The central bank acting as a lender of the last resort extends loan facility to the commercial bank and pays the requested amount to commercial bank which will be returned at some future date. The central bank itself does not usually collect the amount payable under the commercial paper presented to it for re-discounting as they

[1] Usmani, *Fiqh al-Buyu*, 2 : 1124.

[2]Ibn 'Abidin, *Radd al-Muhtār 'ala al-Durr al-Mukhtār*, 6 : 477.

[3] ibid, 5: 161.

may have been issued by an individual or institution the central bank is not allowed to deal with.

Thus, the process of discounting commercial papers is nothing but a Qarz by the Central Bank to commercial banks with a stipulated increase on the principal amount of the loan and this is Riba as defined above thus, not permitted in Shari'ah.

Direct Loan Facility by Central Bank

In addition to the loan facility provided to commercial bank through re-discounting of commercial papers as mentioned above and being the lender of the last resort, the central bank provides direct loan to commercial banks at their request in special cases. The conventional central bank receives interest on such loans as per amount and term of the loan. The central bank generally fixes upper limit for direct loans provide to commercial banks keeping in view the financial position and activities of the requesting bank. The upper limit of loan is changed from time to time according to the requirements and targets of the monetary policy. These direct loans may be conditional or unconditional. The central bank may provide loan facility with a condition to use the funds in a certain type of investment to provide loan for a specific sector as per the requirements and targets of monetary policy.

Muslim Jurists are unanimous on declaring the extra amount taken by the creditor in loan transaction as Riba, strictly Prohibited in Islam.

Imam Ibne Hazm has mentioned:

"أما إذا كانت الزيادة مشروطة في العقد فتحرم إتفاقا"[1]

If the increase over and above the principal amount is stipulated in the agreement, (the dealing) is prohibited (according to Jurists) unanimously.

Therefore, the process of direct loan provision as being practiced by central bank is not permissible from shari'ah point of view due to the interest taken by the central bank on provision of loan.

Shari'ah Analysis of Reserve Ratio

As we have mentioned above that Commercial banks used to deposit some of their cash balances with the Central Bank if deemed it suitable. It was not legally binding upon them to do so. However, with the passage of time banking laws were

[1] Ibn Hazm , *al-Muhallā bi'l Athār*, 6 : 363.

amended and new laws were made requiring commercial banks to keep a certain percentage of the deposits they had with the central bank in liquid form. This amount deposited with central bank is called cash reserves.

Thus, technically, the cash reserve is the percentage of deposits that a commercial bank is required to keep with the Central Bank. The central bank wants to achieve two main objectives through this legal requirement of reserve ratio.

- The central bank wants to use these reserved amounts as tool of monetary policy to control the credit creation by controlling the amount of credit provided by the commercial banks to individuals and institutions.
- To help depositor to save their rights with the commercial bank by securing their money.

From shariah point of view, possibly, the amount deposited with the central bank as reserve ratio, may be treated as Rahn (security) or Qardh (Loan) or Wadi'ah (safe custody as trusty)

In the following line we will analyze each of the above mentioned contracts and the possibility of the consistency of their rules with the amount deposited with the central bank as a Reserve ratio under legal requirement.

a) Analysis of Reserve Ratio Based on Wadi'ah Agreement

Before we apply the rules of Wadi'ah agreement to the Reserve amount deposited with central bank by the commercial bank, it is pertinent to mention the basic concept and basic rules of Wadi'ah agreement. Literally, the word Wadi'ah is derived from the verb wada'a, ((و دع. It means to deposit or to leave. According to Ibn 'Abidin al shami its technical definition is

"تسليط الغير على حفظ ماله صريحا أو دلالة"[1]

It is explicit or implicit empowerment to someone for safe keeping the owner's property.

It is clear from the above mentioned definition that it is difficult to consider the amount deposited with central bank as a Reserve ratio under Wadi'ah contract as it is empowerment by the owner to someone for safe keeping the owner's property. This empowerment is at the will, free consent and option of the owner and he has the repossession option. The repossession of the property is at his discretion. However,

[1] Ibn 'Abidin, *Radd al-Muhtār 'ala al-Durr al-Mukhtār*, 5: 662.

as per practice and law depositing reserve ratio with the central bank is not an option. The commercial bank is legally bound to deposit this amount with the central bank, and it is compulsory for the bank. Moreover, the amount cannot be withdrawn without the consent of the central bank. Furthermore, the property under Wadi'ah contract is considered as trust and thus it is not guaranteed as per Shari'ah rules.[1] When it is not guaranteed, it means that if the amount under Wadi'ah contract is lost in the possession of central bank without any deliberate negligence on the part of central bank, the central bank will not be responsible for that amount. However, it is inconsistent with the actual practice. The amount deposited with central bank as legal reserve is guaranteed by the central bank and is liable to pay in all circumstances. It is therefore, the central bank, when receives the amount from the commercial bank, credits the account of that commercial bank and considers this amount a liability to be fulfilled.

Hence, the amount deposited with the central bank as a reserve ratio cannot be considered under Wadi'ah contract. The rules of Wadi'ah contract are inconsistent with the real position of reserve ratio amount.

[1] Ibn Rushd ,*Bidāyat al-Mujtahid*, 4 : 98.

Analysis of Reserve Ratio on the Basis of (*Rahn*) Pledge

Rahn is a contract in which an asset is kept as a collateral to secure debt. The asset which is kept as collateral is called *Marhun*. Usually, creditor or financer ask for collateral and is called *Murtahin* which means one who holds the asset provided by the debtor as a security of debt. The debtor or one who receives financing facility against collateral is called *Rahin*. Imam Zayla'i, in his book Tabyin al-Haqa'iq defines Rahn as

"هُوَ حَبْسُ شَيْءٍ بِحَقٍّ يُمْكِنُ اسْتِيفَاؤُهُ مِنْهُ كَالدَّيْنِ"[1]

To hold something against a right can be forfeited against that thing like debt.

It may be understood from the above mentioned definition that an asset may be kept as collateral against a right such as a debt. It means if there is no any financial obligation or right, there will be no collateral because rationale behind keeping the asset as collateral is to secure the right or debt. Otherwise, no one has right to keep an asset with him without the consent of the owner of that asset. Looking into the matter of reserve amount deposited by the commercial bank with central bank as legal requirement, it seems inappropriate to consider it as rahn or pledge as there is no any specific right or debt of central bank, the commercial bank is liable to pay. This is because the *Rahan* contract requires the existence of a right for the mortgagee at the mortgage.

One can say that as the central bank generally acts as a lender of the last resort in provision of loan facility to commercial banks, therefore the amount deposited by the commercial bank with the central bank may be considered as collateral against that debt that may arise between the parties in future. However, after a deep study of the situation it is obvious that collateral is allowed only against an existing specific right or debt and not against a debt may be incurred in future.

[1] Zayla'i, *Tabyin al-Haqa'iq*, 6 : 62.

Analysis of Reserve Ratio on the Basis of *Qardh* (loan)

Qardh is an interest free loan extended by a lender to a borrower on goodwill basis. *Bahooti* has defined Qardh as following:

"دَفْعُ مَالٍ إرْفَاقًا لِمَنْ يُنْتَفَعُ بِهِ وَيُرَدُّ بَدَلُهُ"[1]

To pay a valuable thing on goodwill basis to someone who will benefit from it and will return the similar thing.

If we apply this definition to the reserve ratio, we may understand that the amount deposited by the commercial bank with the central bank as reserve ratio is a loan which is called Qardh in Islamic economic system because the amount is refundable as the central bank credits the account of the depositing bank due to increase in the liability of central bank. Moreover, the amount is guaranteed, and the central bank can use these funds or lend it to the government or any other institution. However, *the creditor gives Qardh (loan) with a free consent*, while reserve ratio is compulsory amount to be deposited by the commercial banks with the central bank. Apparently, this compulsion is inconsistent with the principles of Shari'ah as it is an established right of a person to use anything in his ownership as and when he wants and no one has right to prevent him from exercising his powers over his property as long as he uses it according to Shari'ah guidelines.

It is clearly mentioned in the Quran:

"يا أَيُّهَا الَّذِينَ آمَنُوا لَا تَأْكُلُوا أَمْوَالَكُمْ بَيْنَكُمْ بِالْبَاطِلِ إِلَّا أَنْ تَكُونَ تِجَارَةً عَنْ تَرَاضٍ مِنْكُمْ"[2]

"O Ye who believe! devour not your substance among yourselves unlawfully, but let it be a trading among you by mutual agreement."

Therefore, the reserve amount can be considered a compulsory loan.

This compulsion is necessary to achieve the goal of public interest. The shariah base for the obligation of this loan on commercial banks is Maslaha Mursala. Muslaha means seeking of benefit and repealing of harm for the welfare of human through the attainment of goals already set by shariah.[3] In simple words this principle when an

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[1] Al-Bahūtī, , *Kashaf al-Qana' Matn* al-Iqna', 3 : 312.

[2] Al-Nisah: 29.

[3] Al-Ghazali, 'Muhamad bin Muhammad, *Al-Mustasfa* (Beirut: Darul Kotob AL 'lmiyah, 1993), 1: 286.

action is allowed to achieve a public interest that is deemed necessary by the Muslim government this is called giving shariah ruling on the basis of *Maslaha Mursalah*

The public interest that is meant from the compulsion of this loan is to ensure availability of sufficient funds in case of liquidity problem with the commercial bank and to enable the central bank to control the circulation of money to maintain price stability. Moreover, it is allowed to enable the central bank to achieve the monetary policy goal to ensure economic stability in the country in the best interest of the general public.

Based on the above analysis we can say that compulsion by the central bank to deposit a part of their deposits as statutory reserve is permissible from shariah point of view keeping in view the public interest. However, this is permissible only if the following conditions are fulfilled.

- There must be a genuine need for the statutory reserves to prevent inflation and ensure economic stability. If there is no need and the economy is stable without obligation of statutory reserves, then it is not allowed to make it compulsory for commercial banks to deposit amount as a reserve with central bank.
- This tool of statutory reserves may be used only according to the genuine need and not more than it. If the prevailing economic situation requires 5 percent reserve ratio, it is not allowed to obligate the commercial bank to deposit more that 5 percent. Because if a prohibited act is allowed on need basis, it is allowed only to fulfill the genuine and not more than that. The Jurists have set a rule in this regard that is:

"والضرورات تتقدر بقدرها"[1]

"Necessity is determined according to its degree"

- This tool may be used only if it is confirmed by the professionals that this tool is effective and is able to achieve the goal and target expected from such type of steps. Thus, if there is no need to use this tool, it is not allowed to use it.

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[1] Nizamuddi,'Abd a 'Ali, *Fawātiḥ al Rahamut* (Beirut: Darul Kotob AL Ilmiyyah, 2002), 1 : 413.

- It is also not allowed to use this tool of statutory reserve if there is any other way to achieve the economic goals to make it sure that there is a genuine need.

However, one may raise a question that commercial bank is liable to deposit a portion of modaraba accounts with the central bank as required reserve ratio, while the investor or the account holder has paid the amount for the investment and not for depositing with central bank. This also means that a portion of the investment amount is kept useless which causes a decrease in the profit of investor without his consent.

The answer is that the contracts are formed as per the law of land. If Any contract or any clause therein, is formed in contradiction to the law of land it will not be enforceable by law. Therefore, the parties entering the contract of Modaraba, when opening an account with Islamic bank, must know that a portion of his amount is to be kept with the central bank as a reserve ratio. However, it is preferred that a clause must be added in the account opening form that a portion of this amount is to be deposited with the central bank as reserve ratio.

Shari'ah Analysis of The Qualitative Tools of Monetary Policy

We have already discussed those qualitative tools of monetary policy which aim to direct the funds to a specific sector of the economy. Actually, in qualitative method the central bank takes steps to regulate the flows of credit to a particular direction of the economy with an aim to have impact on certain sectors rather than upon the overall economy. It aims to support a specific sector of the economy or to decrease the credit flows to specific sector. This aim is achieved by determining a ceiling for credit facility to a sector or by differentiating the price for credit to various sectors of the economy. That is why these are called selective methods of supervision. They do not affect credit as a whole; rather they affect some aspects of the use of credit, or some sectors of the economy.

These methods are as follow:

a. Credit Ceiling

Credit ceiling means the limit of credit determined by the central bank for the commercial banks. The commercial bank is obligated not to cross the limit of credit specified for a specific sector of the economy. The central bank takes such steps and decision to diversify the risk and to insure the availability of credit facility to largest possible number of various sectors of the economy within a period.[1]

Thus, credit ceiling is used as a tool to control the expansion of credit in the light of credit policy and as per requirement of the objectives already set by monetary authorities.

Shari'ah analysis of the credit ceiling is same as mentioned above under statutory reserve requirement. As per basic principles of Shari'ah it is not allowed to intervene in the personal matters. The owner of the property has the right to use his property according to his wish, as long as it does not affect others interest, and is according to Shari'ah rules and guidelines. However keeping in view, the public interest and preferring the general public interest over the personal interest the central bank may be allowed to determine credit limit for specific sectors and certain people to achieve the goal of a stable economy and to prevent the occurrence of economic crises. It is worth mentioning here that the conditions mentioned above for doing an act on the basis of public interest must be fulfilled. There must be a genuine need to determine limits on credit. The tool may be used only if it is confirmed by the professionals that this tool is effective. It is also not allowed to use this tool of determining credit limit if there is any other way to achieve the economic goals to make it sure that there is a genuine need, keeping in view the principal of necessity set by Muslim Jurist that is any prohibited act if allowed on the basis of necessity will be determined according to its degree.[2]

b. Shari'ah Analysis of Profit or Interest Rate Determination

The central bank determines interest rate or profit rate for commercial banks therefore, the credit facility vary for one sector of the economy from the other. The interest or profit rate is kept lower for business activities encouraged by the government and is kept higher for sectors less important to the overall society. Interest rate is determined for conventional banks and profit rates are determined for the products provided by the Islamic banks like *Murabah* and *Musharakah*. Islamic banks are financial institution providing Shari'ah compliant investment facility to the customers.

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[1] AL-Hazza', Iyas Bin Ibrahim, *ahkam al tashilaat al eitimaniyyah fil Fiqh AL Islami* (Beirut: Darul Maiman Lil-nash re wa AL tawzih', 1440 (AH)), 91.

[2] Nizamuddi, *Fawātiḥ al Rahamut*, 1 : 413.

As Riba is prohibited by shariah therefore there is no question of determination of limit for interest rate from Shari'ah point of view. As for as the matter of profit determination by the central bank for Islamic banks products is concerned, Muslim Jurists have discussed this issue under the topic *Taseer* (تسعير). The word تسعير is derived from the root word سعر which means price. While تسعير means price fixation. There is difference of opinion about price fixation. According to some Jurists it is allowed while other Jurist do not allow such price fixation as per following detail.

First Opinion

According to Hanafi school of thought[1] it is permissible to fix price on the basis of the principle of Muslaha or Public interest and on the basis of genuine need. It is also permissible on the basis of the principle

"يتحمل الضرر الخاص لدفع ضرر عام"[2]

"A specific harm is tolerated in order to prevent a more general one."

It means that if there is an expected harm to some specific people because as a result of decision made to prevent harm from public, the harm to specific people will be tolerated to prevent a more general harm to many people. Here in this situation, if a profit rate is fixed by the central bank, some banks or their customers may incur loss, or their profit ratio may decrease. However, fixation of price if deemed necessary by the banking professionals for overall economic stability and especially the banking system as a whole, it would be permissible to prevent a general loss. Ibne Taiymiyyah, a famous Muslim Jurist, has also adopted this point of view.[3]

Second Opinion

According to Maliki[4], Shafie[5] and Hanbali[1] school of thought, it is not allowed for the government authorities to fix prices of goods in the market. They supported their

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[1] Haskafi, Muhammad Ala-ud-Din, *al-Durr al-Mukhtār* (Beirut: Dar Al-kotob al-Ilmiyah , 2002), 622.

[2] Lajna mukawwanah min al Ulama, *Al-Majallah al-Ahkam al-'Adaliyyah* (Karachi: Noor Muhammad Karkhana 1991), 19.

[3] Ibn Taymīya, Aḥmad ibn 'Abd al-Ḥalīm ,*al-hisbah fil'al-islam*, (Beirut:Dar al kotob al ilmiyah, 1st Edition), 22.

[4] al-Bâjî, Abû al-Walîd Sulaymân ibn Khalaf, *Al-Muntaqâ sharh al-Muwatta* (Egypt: Matbah tul Assa'adah , 1st Edition, 1432), 5 : 18.

[5] Al Ramli, Ahamad Bin Hamza, *Nihaya tul Muhtaj ela Sharhil Muhtaj* (Beirut: Dar Al-Fikr, 1984), 3 : 473.

view by the following Hadith quoted by Anas Bin Malik (RA) in which it is mentioned that once prices of goods gone up in life of the prophet (SAW), some people came to the Prophet (SAW) and complained about the increase in prices of goods in the market and requested to fix prices in the market. Responding to their request the Prophet (May peace be upon him) said:

"إِنَّ اللَّهَ هُوَ الْمُسَعِّرُ الْقَابِضُ الْبَاسِطُ الرَّازِقُ"[2]

"Allah is the one Who fixes prices, Who withholds, gives lavishly and provides "

It can be deduced from this Hadith that the price fixation is not desirable from Shari'ah point of view. These are the market forces that will fix prices.

Those who hold second opinion also support their view by the general rule of Shari'ah that no one is allowed to take the wealth of others without his free consent.

After a deep analysis of the argument of both opinions, we can say that in normal situation price fixation or profit fixation is not allowed. However, if there is a genuine need and special circumstances, prices may be fixed keeping in view the public interest. This is because the paper currency introduced in the modern ages has no intrinsic value and it has negative effects on the overall economy if it is not controlled properly. Therefore, fixation of profit may be allowed in special cases.

However, in modern banking system the profit is fixed on the basis of interest rate which is not desirable because price fixation is allowed on the basis of necessity. The monetary authorities should estimate the profit on the basis of actual market situation and not on the basis of interest rate which is set for conventional banks. Islamic banks are different from conventional banks. Islamic banks act as a business partner of the customers and bear the risk of loss. When there is more risk there must be more profit. Their nature of business is totally different from conventional banks. Conventional bank only receives deposits and disburse loan. They are not a business partner. Therefore, the rules of conventional banks should not be applied on the Islamic banks. Their profit rate must be determined according to the market forces and they should be allowed to determine their profit rate as per the prevailing situation of the business.

Thus, fixation of price is allowed on the basis of necessity. Therefore, the authorities must determine the genuine need and actual market situation. If the price is fixed just because to treat Islamic banks like a conventional bank and profit is

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[1] Al-Bahūtī, *Kashshaf al-qina` `an matn al-Iqna`*, 3 : 187.

[2] Abu Dāwūd, *Sunan Abī Dāwūd*, Bab Fi Al Taseer, Hadith 3453.

determine according to the interest rate of conventional banks, it means the prices have been fixed not on the basis of necessity and a necessary condition for the permissibility of fixation of prices has been ignored. In this way such determination of prices is not allowed according to any of the two opinions mentioned above.

c. Shari'ah Analysis of Moral Suasion as Monetary Tools

In the banking system, the central bank enjoys a moral authority over commercial banks. Due to this moral position, it can persuade commercial banks to follow its moral instructions, advice to achieve monetary policy goals and objectives set by the central bank. Thus, the central bank uses its influence upon commercial banks to convince them to follow its recommendations and suggestions. Although such suggestions are not enforceable by law however, there is always a threat of converting them into legal orders. Moral suasion will be effective where there is respect for the judgment and extra-legal authority of the central bank.

This use of influence seems permissible from shariah point of view if they are consistent with the rules and regulations of Islamic economic system and falls under the supervisory domain of the central bank. This is because central bank issues license to the commercial bank for working in the banking sector. This license is actually an agreement between the central bank and the commercial bank. The commercial bank is supposed to fulfill its responsibilities under the agreement with the central bank. Thus, these types of recommendations are to be accepted by the commercial banks as per the provisions of the agreement between the parties, the commercial bank and the central bank as long as they are in the domain of that agreement.

Sometimes, the central bank issues clear compulsory orders to be followed by the commercial bank. This is also permissible from Shari'ah point of view. As there is an agreement between the two. As per the agreement the commercial bank is bound to follow such orders.

Allah Subhnhu wa ta ala says in the Holy Quran.

"يأأيها الذين آمنوا أوفوا بالعقود" [1]

"O ye who believe! fulfil (all) obligations"

[1] Al-Maeda: 1

It is obligatory upon Muslim to fulfill his obligation and contract. If the commercial has entered into an agreement with the central bank and has given his free consent to abide by the rules and regulations issued by the central bank, it has to follow those rules.

4.3 Islamic Monetary Policy

We have mentioned above that monetary policy is the method or methods used by the monetary authorities in the country to control the circulation of money and keep it at a desirable level as per requirements of the economy and different economic situations to achieve and realize the objectives and goals of a stable economy. We have also explained the goals and objectives of monetary policy. These objectives include economic stability, full employment, and balance in the balance of payments. Various monetary policy tools are used to take measures to regulate liquidity and money supply in the economy.

We have discussed above the critical study of the tools of monetary policy from Shari'ah perspective. In this chapter Islamic monetary policy objectives and tools will be discussed.

Some objectives and tools of monetary policy in an Islamic economic system may be similar to conventional monetary policy. However, there is significant difference between the tow. Some targets, goals, and monetary policy tools are entirely different from that of conventional monetary policy. In Islamic economic system some qualitative and quantitative instruments of monetary policy are apparently same as the instruments of conventional monetary policy. However, a deep study of both instruments will find that the nature of Islamic monetary policy tools is different from that of conventional monetary policy tools.

For example, the main tool that is used in conventional monetary system is interest. Most of the dealings of conventional central banks, like open market operation and discounting of bill, are based on interest. While interest is strictly prohibited in Islam including its all forms as discussed earlier. On the other hand, Islamic monetary policy is based on partnership and profit and loss sharing.

Most of the economists[1] are of the view that the effective critical variable is the supply of money and not the interest rate, which is considered a fundamental variable in conventional monetary policy. This assertion by the economists is considered important from Islamic perspective. Since the Islamic central bank has a distinct ability to change the volume of money using different ways and methods, such as an

[1] Mohammad Arif,*Al siyasa al-Naqdiyyah,Fi Iqtisad Isami La Ribawi*, Trans. Nabil AL Rubi (Jeddah: king abdulaziz University, 1982), 4.

increase or decrease in issuing deposit certificates, or an increase or decrease in the rate of profit ratio in partnership contracts with commercial banks.

Thus, the way is open for the Islamic Central Bank to increase or decrease the money supply. Now we will discuss the objectives of Islamic monetary policy and will also discuss that how Islamic monetary policy can be proved a sustainable alternative to the conventional monetary policy.

Monetary Policy Objectives in Islamic Economic System.

Following are the objectives of Islamic monetary policy.

i. Economic Well Being

We believe that man is the vicegerent of Allah on this earth. The inevitable result of this belief is that man should live with a reasonable status. The Muslim Jurists are unanimous on the view that the welfare of the people and relief of their hardships is one of the basic objectives of Shari'ah , Allah says in the Holy Quran

"وَيَضَعُ عَنْهُمْ إِصْرَهُمْ وَٱلْأَغْلَٰلَ ٱلَّتِي كَانَتْ عَلَيْهِمْ"[1]

"And he relieves from them their burden and fetters which were upon them"

This point of view demands the economic well being of the man by ensuring the availability of all basic human needs. All major sources of discomfort and hardships must be removed to impart to human being the dignity demanded by their status being Allah's vicegerent. Thus, well-being of humanity is one of the objectives of Shari'ah and government of a Muslim country is responsible to make policies in line with this objective of Shari'ah.

How the objective of economic well being may be realized? This goal may be realized by two ways. One is by achieving full employment level in the economy and the other is enhancing the rate of growth. Full employment is an indispensable. Full employment is a desirable objective from Islamic point of view because it is related to the fulfillment of the basic needs of the people. As for as economic growth is concerned, it is not a primary objective of shariah. It is required to the extent to which it contributes to full employment and to economic well being. It means production of only those items and goods is encouraged which are necessary for economic wellbeing. Any production that has no positive effect on the wellbeing of the mankind

[1] AL-ARAF: 157

is not desirable as only maximization of profit, ignoring its implications and impacts on the overall economy and society, is not a shariah compatible practice.

ii. **Equitable Distribution of Income and Wealth and Socio-economic Justice**

Equitable distribution of wealth is one of the objectives of shariah when we talk about the economic system of Shariah. Allah has clearly mentioned this point in Holy Quran.

"ما أَفَاء اللَّهُ عَلَى رَسُولِهِ مِنْ أَهْلِ الْقُرَى فَلِلَّهِ وَلِلرَّسُولِ وَلِذِي الْقُرْبَى وَالْيَتَامَى وَالْمَسَاكِينِ وَابْنِ السَّبِيلِ كَيْ لَا يَكُونَ دُولَةً بَيْنَ الْأَغْنِيَاء"[1]

"What Allah has bestowed on His Messenger (and taken away) from the people of the townships, - belongs to Allah, - to His Messenger and to kindred and orphans, the needy and the wayfarer; in order that it may not (merely) make a circuit between the wealthy among you"

In above mentioned verse it has clearly been mentioned that the wealth must not be concentrated in the hands of some particular people. A system is to be established to ensure the equitable distribution of wealth. Thus, equitable distribution of wealth is an integral part of the Islamic philosophy about economics. The monetary policy in Islam aims to uproot the causes of gross inequalities to bring about a distribution of income which is in conformity with the teachings of Islam.

iii. Stability in the value of Money

The economic system of Islam is based on justice. The approach of Islamic law to establish justice between people requires the stability in the prices and value of currency to save the people from harm or loss. Therefore, In general, it is one of the basic responsibilities of the government of Islamic state to take steps for the stability of the value of currency. The famous jurist Imam Ibnul Qayyim says:

"فإن الدراهم والدنانير أثمان المبيعات والثمن هو المعيار الذي به يعرف تقويم الأموال فيجب أن يكون محدودا مضبوطا لا يرتفع ولا ينخفض إذ لو كان الثمن يرتفع وينخفض كالسلع لم يكن لنا ثمن نعتبر به المبيعات بل الجميع سلع"[2]

Darahim and Dananir are the price of the sold goods and services and Money is the only standard to measure the value of wealth, therefore it it must be limited and regulated, its value must not fluctuate, if there would be fluctuation in the value of

[1] Al-Hashr: 7

[2] Ibn Qayyim, *ihlamul mooqieen an Rabbil AAlamin*, 2 : 105.

money like the prices goods, we will have no medium of exchange to measure the value of goodsand services (in exchange transactions) rather all will become in the category of goods.

The above statement of a famous jurist indicates that stability in the prices and the value of currency is necessary. It means that a medium of exchange must be something that has a stable value, and its value should not fluctuate like the value and prices of goods and services.

Fiqhi encyclopedia of Kuwait has also mentioned that one of the public interests that the head of an Islamic state must take care of is to maintain the stability of the value of money to save it from devaluation so that it may not lead to rise in the prices of food and goods and let the poverty to spread. This stability in prices is necessary to ensure peace of mind for the people by letting them enjoy the stability of the value of what they got by struggling hard and earning.

Thus, monetary authorities are responsible to take steps to ensure the stability of the value of medium of exchange. The unexpected fluctuation in the value of money is not acceptable in shariah. Therefore, government is not allowed to fulfill its financial obligations by deficit financing until and unless prudential and reasonable steps are taken to offset the negative impact of increase in the currency volume.

Other Objectives of Monetary Policy in Islam

The objectives mentioned under the topic conventional monetary policy are also the objectives of Islamic monetary policy as long as they are consistent with the objectives of shariah. Hence, full employment, Economic Stability, stability of the external value of the currency, and financial Stability are also the objectives of monetary policy in an Islamic economy.

4.4 Monetary Policy Instruments in Islamic Economic System

As discussed above, monetary policy is the management of money. The supply and demand of money is controlled and managed in a way that ensures the achievement of economic growth and stability.

The conventional monetary policy is interest based policy. That is why interest is one of its most important tools in monetary policy. Moreover, prevailing commercial papers are interest based. These practices and securities caused the exacerbation of inflation and economic instability.

Islamic monetary policy is the use of several tools to target supply and demand of money. Islamic monetary policy is formed by filtering the conventional monetary policy tools through a deep shariah analysis and accepting those conventional tools that fulfill the shariah requirements. In addition to that several other monetary tools are also added. Along with other goals set by the conventional monetary policy, the Islamic monetary policy aims to achieve the socio economic goals of Islamic economic system. Moreover, Islam has always discouraged the concentration of wealth in few hands of the society. In contrast, it has encouraged the flow and smooth circulation of money in the economy. This instruction of Islam has a direct relation with monetary policy because the speculation of money and its concentration in few hands severely affects the financial and money market, and causes supply and demand shocks, thus not allowed in Islamic monetary policy.

In an Islamic monetary system qualitative and quantitative tools of monetary policy may be used. However, the nature and application of these monetary policy tools would be different from those used in conventional monetary policy system. These different types of tools compatible with shariah guidelines are mentioned below.

Quantitative tool of Islamic Monetary policy

Quantitative tools of monetary policy are related to the quantity or volume of the money regardless of the use and venues of such use. These tools are also called general tools. They are considered indirect in nature. The purpose of such tools is to control the bank credit and to influence total reserves available with the Islamic banks. [1]

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[1] Shafi, *Muqaddimah Finnuqood wal Bunook*, 243.

Quantitative measures are as following.

1. **Issuance of Currency and Security Bill**.

The central bank can control the supply of money by using two methods. When there is need of expansionary monetary policy that is when it wants to increase the supply of money due to economic recession, it can issue more currency notes as per the requirement of the economy. On the contrary, if the central bank deems it necessary to adopt contractionary monetary policy, it can issue new shariah compatible security bills or sell the already available securities issued on the basis of *Musharakah* or Modaraba as mentioned in the Chapter 2, under the topic issuance of currency in an Islamic economic system. The central bank can increase or decrease the supply of money in this way. it can also issue interest free bonds to use them to increase the supply of money by purchasing them from the market and sell them when there is need to control inflation in the economy. These interest free debt based securities may help the central bank to use it as open market operation. To use such types of instruments the central bank initially will have to determine the desired level and growth in money supply. Decision about the desired level and desired growth in money supply may be made on annual basis.[1] The decision may be reviewed on quarterly basis as per fluctuation and trends of different economic variables.

Definitely, an increase in the supply of money will have a greater impact on the overall economy due to the credit creation process by the commercial banks, therefore, the credit created by the banking system must be properly controlled. For this purpose, the central bank must take qualitative measures to divert the flow of such credits to those sectors of the economy that have positive impact on the economic wellbeing of the general and deprived people. In this regard, the central bank must take into account the inflationary effects of such monetary policy.

[1] Chāprā, *Towards a just Monetary System* , 193.

Statutory Reserve Ration

Central banks are required to deposit a portion of their demand deposits with the central bank as statutory reserves as mentioned above. We have discussed the shariah permissibility of such requirement with some conditions that must be adhered to. This ratio of statutory reserve requirement may vary in accordance with the dictates of monetary policy. Using a Contractionary monetary policy, the ratio may be increased to reduce the ability of commercial bank to give loans. On the other hand, if the central bank wants an expansionary monetary policy, the ratio may be decreased to enable the commercial banks to give more loans.

According to some contemporary scholars, *Mudharabah* accounts should not be liable to statutory reserve ratio as they are not a loan based contract rather, they are naturally like equity[1] and all equity accounts are not liable to statutory reserve requirement.

Qualitative tools of Islamic monetary policy

Qualitative tools are techniques through which the target of specific use of credit is achieved using same quantitative monetary tools. Actually, In qualitative method the central bank takes steps to regulate the flows of credit into a particular direction of the economy to influence certain sectors rather than the overall economy. [2] It aims to support a specific sector of the economy or to decrease the credit flows to specific sector. This aim is achieved by determining a ceiling for credit facility to a sector or by differentiating the price for credit to each sector.

a. Credit Ceiling

The central bank determines profit rate for commercial bank. Therefore, the credit facility varies for one sector of the economy to other. As for as the matter of profit fixation by the central bank for Islamic banks is concerned, providing shariah compliant investment facility to the customers. Muslim Jurists have discussed this issue under the topic Taseer (تسعیر) which means Price fixation. Juristic meaning Taseer (تسعیر) is fixation of price by the government. This topic has been discussed in detail under the topic critical analysis of conventional monetary policy.

[1] Chāprā, *Towards a just Monetary System* , 193.

[2] Shafi, *Muqaddimah Finnuqood wal Bunook*, 247.

The central bank, according to some Muslim Jurist[1] like dr Uamr Chapra, is allowed to fix credit ceiling on commercial banks credit to achieve the monetary policy goals. However, this credit ceiling should not harm the healthy competition among different Islamic banks. Credit ceiling is necessary because it is not possible for the monetary authorities to determine accurately the desired level of money supply and cannot insure the desired flow of money to the banking system. The central bank has to take some other measures to control the money supply in the economy and fixation of ceiling on the commercial banks credit is one of these tools.

b. Change the Profit Ratio.

As mentioned above the central bank determines ceiling for profit ratio and this comes under Taseer (تسعير) which means profit fixation. The central bank may increase the ratio of profit of central bank in projects if it wants a contractionary monetary policy.[2]When the profit of the commercial bank is increased the profit of depositors will decrease, hence the investment would be less in such sectors and eventually will reduce the money circulation. On the contrary it can decrease the profit ratio of commercial banks if it wants to increase the money circulation.

Council of Islamic ideology of Pakistan has suggested the instrument of varying the profit and loss sharing ratio of Mudharabah deposits of central bank with the commercial banks.[3]

c. Conditions for Credit Facility

The monetary authorities can change the conditions for credit facility. For example, to achieve the goals of expansionary monetary policy the conditions for providing credit facility may be relaxed. For example, the requirement of security of debt may be relaxed. On the other hand, if the central bank wants to apply Contractionary monetary policy the central bank may impose conditions for credit facility that are difficult to be fulfilled.

d. Public Share of Debt.

In countries like Pakistan, where interest free banking is preferred a major portion of the commercial banks deposits consists of demand deposits.

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[1]Chapra, *Towards A Just Monetary System*, 147. Shawar Al-Tamimi, *Nahwa Msraf Markazi Islami*, 354

[2] Ibid.

[3] Council of Islamic ideology Pakistan, report, 1981, 17.

Commercial banks do not pay any amount to customers on these deposits. As these are idle sources of public deposited with the bank and only banks are benefiting from these resources, therefore a portion of these deposits, say 15 per cent may be diverted to the government. The government should invest this amount in socially beneficial projects in which profit sharing is not desirable.

Monetary authorities can increase or decrease the percentage of demand deposits to be diverted to the government to use it as monetary tool to control the money supply. During Contractionary monetary policy, the percentage of such portion of demand deposits may be increased which will reduce the lending ability of commercial banks. If there is need of expansionary monetary policy the percentage of such portion of demand deposits may be decreased to enable commercial banks to lend more to increase money circulation.

e. Salam Contract as Monetary Tool.

Salam contract may be used as monetary policy tool. Salam (سلم) is Arabic word which means to advance. Salam is a contract whereby the seller undertakes to supply some specific goods to the buyer and the purchaser pays the price in advance.[1] The specifications, quality, and quantity of the goods must be specified. Moreover, the exact date and place of delivery must be specified

Thus, In *Salam* contract advance payment is made and delivery of subject matter is made on some specific future date. Therefore, to achieve the goals of contractionary monetary policy, monetary authorities can restrict commercial banks from dealing with Salam contract. On the contrary if monetary authorities want to apply expansionary monetary policy, such restriction on Salam contract may be relaxed for commercial banks.

However, the effectiveness of these monetary tools will depend on the total volume of Salam contracts in the banking systems which are generally very low.

f. Zakat as Monetary Tool.

Some Muslim economists[2] have suggested the use of Zakat as a monetary tool. In Fact, there is difference of opinion among Muslim Jurists about the form in which Zakat is to be collected. According to some jurists it is compulsory to collect zakat in the form of goods and not in cash. However, Hanafi Jurists are of the view that zakat

[1] Al-Kāsānī, *Bada'i' al-Sana'i' fi Tartib al-Shara'i'*, 5: 206.

[2] Kahf, Dr. Monzer, AL iqtisad AL – Islami (Damuscus: Dar-ul-Qalam, 1st Edition, 1399-AH), 210.

of assets and goods may be collected in form of cash as per market value of that good or property.

Thus, monetary authorities can make it compulsory to pay zakah in the form of goods rather than cash to reduce the circulation of money to control inflation. On the contrary if there is need to increase money circulation zakat may be paid in the form of cash to increase circulation of money.

Practically it would be difficult to use Zakat levies as monetary policy. This is because the collection of zakat does not come under the authority of monetary authorities. Moreover, in zakat it is necessary to give priority to the interest of deserving people and not the interest of the economy as whole.

Moral Suasion as Monetary Tools

The central bank can use its influence upon commercial banks to follow its recommendations and suggestions. For example, advising banks through enticement to prevent from involving in negative activities such as gambling etc. although such suggestions are not enforceable by law however, there is always a threat of converting them into legal orders. The central bank can give suggestions through consultations, meetings, and personal contacts to achieve the goals of monetary policy.

Shariah Compliant Monetary Policy Instruments in Muslim Countries

Several Islamic countries have introduced some shariah compliant monetary policy instruments to control and manage money supply in the economy. The process of Islamization of monetary policy began as result of struggles mad for the islamization of overall financial system in 1975. The first step that was taken in this regard was the development and introduction of shariah compliant products as substitute of conventional interest based products. Islamic development bank has made valuable efforts in this regard[1] it is pertinent to have a shariah analysis of some of these monetary policy instruments.

Shariah Compliant Monetary Policy Instrument in Pakistan

State bank of Pakistan has introduced a shariah complaint instrument on the basis of Bai Muajjal used in the process of open market operations.[2] This instrument

[1] Basharat Hossain, "Islamization of Monetary Policy of 27 OIC Muslim Countries in Asia: The Successes.The Barriers and The Future Directions", *Global Review of Islamic Economics and Business* 7, no. 2 (2019) 091-104.

[2]14 Jan, 2021 https://www.sbp.org.pk/DFMD/FM-role.asp

is actually introduced for Islamic banks. In this operation state bank of Pakistan can purchase Ijara Sukuk issued by Government of Pakistan through Bai Muajjal, the term refers to a contract in which something is sold or purchased on deferred payment. The state bank purchases such sukuk for a tenure of 1 year and sells these sukuk on spot payment.

Mechanism of *Bai Mu'ajjal*

The government of Pakistan has issued Ijarrah Sukuk to collect money from public and financial institutions. *Sukuk* are:

"Certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity, however, this is true after receipt of the value of Sukuk, the closing of subscription and the employment of funds received for the purpose for which the Sukuk were issued"[1]

The State Bank of Pakistan uses these Sukuk as a tool in Open Market Operations. When SBP wants to apply expansionary monetary Policy, it invites quotations from Islamic banks to sell the Ijarah Sukuk they are holding to SBP on deferred payment (*Bai Muajjal*) and it is agreed that payment will be made after one year. State Bank of Pakistan after evaluation of these quotations accepts and approves one or some of them on the basis of cut-off price. Those whose quotations are accepted transfer their Sukuk to SBP. The price is paid to sellers of Sukuk on an agreed future date.

If state bank of Pakistan wants to apply contractionary monetary policy, it sells the Ijara Sukuk to IBIs and collects money from the market. Using this policy, the State Bank of Pakistan wants to control supply of money and minimize the inflationary effects.

This is a shariah compliant monetary policy instrument and may be effectively used as a substitute of interest based Treasury bill and other securities.

Shariah Compliant Monetary Policy Instruments Introduced in Malaysia.

Monetary policy system and framework of Malaysia has evolved over the time to keep pace with rapid changes and developments in the economic world. A number

[1] accounting and auditing organization for Isl.amic financial institutions, *Shariah standards for Islamic Financial Institutions* (Omman: accounting and auditing organization for Islamic financial institutions 1432-AH-2010AD), 370.

of monetary policy instruments have been introduced in Malaysia to manage the liquidity of the banking system which enables the central bank of Malaysia to meet market liquidity needs along with using it as monetary policy instrument.[1] Keeping in view the increasing share of interbank surplus liquidity of Islamic banking industry, the central bank of Malaysia has increased the use of commodity Murabaha Program.

1. Commodity Murabaha Program

The central bank of Malaysia has used commodity Murabaha program as monetary policy tool. This instrument is based on *Tawarruq*. Literally the term Tawarruq comes from warq ورق which means silver Dirhams. Technically Tawarruq is to purchase a commodity on deferred payment and selling it to a third party on cash at a price lower than purchase price. It is called monetization. It has been defined in shariah standard as under:

"Monetization refers to the process of purchasing a commodity for a deferred price determined through Musawama (bargaining) or Murabaha (mark-up sale), and selling it to third party for a spot price so as to obtain cah"[2]

Thus, monetization or Tawarruq refers to a process in which a person, who needs cash and wants to avoid interest, will agree with another person who is willing to sell a commodity, to purchase it on deferred payment basis. He will sell it in market on cash and will receive cash to fulfil his needs.

How monetization or tawarruq is used as liquidity management tool and as a monetary policy instrument?

Let suppose an Islamic Financial Institution is facing lack of liquidity problem. It will recourse to central bank for help in this regard because central bank acts as lender of the last resort. The central bank will purchase a commodity from the market on cash and will sell it on Murabaha basis to the financial institution facing liquidity problem on deferred payment basis. The Islamic Financial Institution after taking the possession will sell the commodity in the market on cash and will manage its liquidity problem.

The central bank can use this instrument as a monetary policy tool and will be used as a substitute of discounting of bill in conventional monetary policy. The central bank will increase the mark up in Murabaha using contractionary monetary policy.

[1] Bank Negara Malaysia, Annual Report, 2014,

[2] Accounting and auditing organization for Islamic financial Institutions, *Shariah Standards for Islamic Financial Institutions*, 525.

When the price of commodity which is sold to the Islamic financial institution is increased, more funds will be used by the IFIs in overnight loan facility which will decrease its capacity to disburse loan. On the other hand, if the central bank is applying expansionary monetary policy, it will decrease the mark up price in Murabaha enabling the Islamic financial institution to have more funds available for disbursing loan to the customers.

Shariah Compliant Sale and Buy Back Agreement

This instrument is used in shariah complaint banking system as alternative to repurchase agreements (REPOs) in conventional banking system.

When an Islamic Financial institution faces liquidity problem, he offers to sell the shariah complaint securities he holds to the central bank of Malaysia. The Islamic Financial institution subsequently, makes a unilateral promise to repurchase or buyback the very next day, the securities already sold to the central bank6+. of Malaysia. The buyback promise also includes the price of securities. The central bank pays the price of the securities to the Islamic financial Institution. This transaction enables IFI to manage the liquidity problem.

In this process, the central bank will definitely agree on different price for purchase and sale. The purchase price will be lower and sale price will be higher. This is because the central bank wants to earn profit on the amount he paid to Islamic financial institution.

The central bank of Malaysia uses this product as monetary policy instrument by decreasing or increasing the rate of Sukuk as per requirement of the monetary policy. It is used as a substitute of discounting of Bills in conventional banking system.

Analysis of Shariah Compliant REPO Introduced in Malaysia

If we examine the monetary policy instrument introduced in Malaysia as mentioned above, we find that it is shariah complaint. A permissible subject matter is sold against legitimate money and price. The parties are entering into the contract with their free consent and are eligible to enter into a contract. In the REPO process, there are tow contracts that are contract of sale and contract of purchase. However, each contract is independent, and no one of them is contingent upon the other. A separate unilateral promise is made to buyback the subject matter that are *Sukuk.*

Thus, all the necessary relevant shariah rules and regulation are adhered to and conditions of valid contract are fulfilled.

However, a deep study of this monetary policy instrument reveals that selling or purchasing the Sukuk only for one night is tantamount to Riba. This is a way to receive extra amount on the loan. Although, a real asset is involved in the transaction, but as the transaction is only for one day or night and is used as overnight lending facility by the central bank of Malaysia, therefore, it seems to be a trick to receive extra amount lending facility.

The preferred way from shariah perspective for this monetary policy instrument is to create an active secondary market for these Sukuk where they can be sold and purchased speedily. The central bank may purchase the Sukuk from Islamic Financial Institution, facing liquidity problem, and may sell the same in the secondary market.

Wadi’ah Certificate Issued by the Central Bank of Malaysia.

The central bank of Malaysia has issued Wadi’ah Certificate to collect funds from public through Islamic banks and other Islamic financial institutions[1]. The central bank accepts deposits from these institutions on the basis of Wadi’ah. The certificate is the evidence of amount deposited with the central bank on the basis of Wadi’ah agreement. Literally the word wadi’ah is derived from the verb wada’a, ((و د ع.) It means to deposit or to leave. According to Ibn 'Abidin al Shami its technical definition is

"تسليط الغير على حفظ ماله صريحا أو دلالة"[2]

"It is explicit or implicit empowerment to someone for safe keeping the owner’s property."

When the central bank of Malaysia accepts deposits for safe keeping, it means it is not bound to pay any return or profit on these accounts. However, according to the central bank, , *Hiba* may be given to the holders of Wadi’ah certificates or the depositors as a token of encouragement and appreciation. This monetary policy instrument is used to absorb extra amount of money in the economy.

Shariah Analysis of the Wadi’ah Certificate

If the central bank does not pay any return on these certificates, then there is no shariah objection on them and are considered as shariah compliant. However, if central bank gives return on these certificates, on regular basis and to all the depositors, then it would not be shariah complaint. The extra amount paid on these deposits would be considered as Riba and usuary. This is because in reality it is loan agreement although it is called Wadi’ah agreement. What matters in shariah in financial transactions is reality and not the word. Even if this agreement is called Wadi’ah it would not be considered Wadi’ah agreement in true sense. It is a set principle of shariah that:

"العبرة في العقود بالمقاصد والمعاني، لابالألفاظ والمباني"[3]

“Shariah ruling, in contracts is based on purpose and outcome and not merely on the words.”

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[1] SARKER,MD. ABDUL AWWAL, “An Evaluation of Islamic Monetary Policy Instruments Introduced in Some Selected OIC Member Countries”, *Islamic Economic Studies* 24, no. 1, (June 2016): 1-47.

[2] Ibn 'Abidin, *Radd al-Muhtār 'ala al-Durr al-Mukhtār*, 5 : 662.

[3] Hassan, Muhammad, Al-qawāʿid al-fiqhīyah, 1: 3.

Thus, shariah ruling is based on the real situation, merely change of words do not change the shariah ruling regarding a situation.

and another principle of shariah says:

"المعروف عرفاً كالمشروط شرطاً"[1]

"What is known as a common practice is similar to an imposed conditioned."

Here in Wadi'ah certificates if the central bank pays return to all the depositors and principal amount is guaranteed, as required by the Wadi'ah agreement, it would be a loan based agreement where extra amount is paid which is Riba.

If the central bank pays return to some of the depositors, then this situation is tantamount to al-maysir or gambling, in which profit is given to some investors and some others are deprived.[2] deposits would be uncertain about their profit.

One may raise a question that this is a Wadi'ah agreement in which the central bank is not bound to pay any interest, therefore no question of uncertainty will arise. However, a deep study of the situation reveals that once it is known to investors, the Islamic financial institutions, that profit may be paid, the number of depositors would definitely increase because of expectation of profit. It would be known to them that there is profit. We have mentioned above a shariah principle that what is known and become a common practice in financial contracts is similar to a condition put in that agreement.

[1] Hassan, Muhammad, Al-qawāʿid al-fiqhīyah, 7: 2.

[2] Kuwait Ministry of Awqaf & Islamic Affairs ,Al- Mausu-ah al-fiqhiyyah (Kuwait: Darul Salasil, 2nd Edi), 16 : 168.

Comparative Study of Conventional and Islamic Monetary Policy

There are many reasons that why an Islamic monetary policy would be more effective as compared to conventional monetary policy.

Firstly, we have examined that in Islamic monetary policy goals and targets are achieved by influencing the total volume of money supply and not the interest rate. This is definitely the more effective way to serve economic development programs and the overall economy of the country. A Number Of economists of monetarists' school of thought[1] are of the view that influencing and changing the total money supply is more effective way to achieve the goal of a viable monetary policy and a stable economy.

Secondly, most of the monetary tools in Islamic monetary economics are based on profit and loss sharing. This is a form of investment that will have a positive impact on various sectors of the economy and will help to ensure overall socio-economic wellbeing. While in conventional monetary policy, interest rate is used as monetary tools that has a negative impact on various sectors of the economy.

Thirdly, the central bank plays its role as a partner with other commercial bank in issuing of commercial securities. These commercial papers are generally issued on the basis of *Musharakah* or *Mudharabah* When the commercial banks are also partner, it becomes easy for the central bank to achieve the goals of a stable monetary policy.

There are many sufficient monetary instruments that will replace the traditional monetary instruments. Thus, unavailability of some conventional monetary instruments like discounting of bill and bonds will not affect the efficiency of Islamic monetary policy.

It is worth mentioning here that, to realize the goals of Islamic monetary policy, cooperation and close coordination between banks and government is very necessary. This is because government expenditure must be controlled and must be consistent with indispensable monetary policy goals. It will be impossible to have an effective monetary policy unless the government is determined to-ensure price

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[1]Cheide, Joachim *S A K, Percent Rule for Monetary Policy in West Germany* (Germany: Kiel Institute of World Economics D-2300 Kiel, Diisternbrooker Weg, 1988), 4.

stability by controlling its expenses. Moreover, the government should help monetary authorities to control the credit creation as per the requirement of the economy.

The external value of currency also plays an important role in monetary policy. However, if internal value of money is stabilized, this will to some extent help stabilize the external value of currency.

As a result of the above discussion about monetary policy instruments it is also observed that in Islamic economic system precautionary and transactions needs would create demand for money which means that demand for money will be related to these tow types of needs. Moreover, the demand for money for precautionary and transaction needs depends upon the level of income and its distribution.

The elimination of Riba from the economic system and levy of Zakat will not only decrease the speculative demand for money but also play a greater role in fair income distribution and stability in the total demand for money. Keeping in view this level of demand an Islamic central bank will ensure suitable required level of supply of money to finance the potential growth in out put and also ensure the stability in prices.

Relation of Central Banks with Islamic Banks

Financial sector is one of the most important sectors among various economic sectors that have witnessed remarkable development. The banking sector is also considered subsector of the financial sector of the economy. This financial sector has undergone several changes and developments in the recent years.

Islamic banking system is the fruit of those valuable struggles made for the application of Islamic law in the Islamic countries. The activities of conventional banking system are mostly interest based which is strictly prohibited in Islam. Therefore, there was need of an interest free banking system. In recent years, interest free banking system has emerged. However, this interest free system has to work in an environment and market created and dominated by the conventional banking system. These banks have also to follow the instructions and guidelines of the central banks. These central banks are, in most countries, established to control and supervise the conventional interest based banking system. Thus, their rules, regulations and instructions are in harmony with the nature of interest based conventional banking. After the emergence of Islamic banks in the recent years and where these Islamic banks have to work under the conventional central banking system, in some countries special regulations have been issued for Islamic banks keeping in view the nature of their work. However, in other countries they have to work under a complete conventional system.

Having a look of the countries where Islamic banking system has been adopted as a part of their economic system, we can conclude that there are three models of central banks all over the world.

The first model is one that has removed Riba based banking system and has completely implemented Islamic banking system. Thus, there will be no contradiction of policies between Islamic banks and central banks of such countries. Sudan and Iran[1] are the countries where such model has been adopted.

Some other countries have adopted and implemented Islamic banking system as a part of their banking system. The central banks of such countries have issued special laws to regulate Islamic banks apart from the laws regulating conventional interest based banking system. Thus, due to existence and implementation of separate regulating framework for both, no question of contradiction in policies will arise and

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[1] Ammar Gharbi, Dr, Abdulhaleem, *Al wajeez Fil Iqtisad AL Naqdi Wal Masrafi*, 186.

the central bank can smoothly continue its regulating function for both. The example of Pakistan may be quoted here for such model.

The central bank of Pakistan is playing a leading role in promoting and developing Islamic banking system. Keeping in view the increasing demand for shariah complaint products of various solutions of financial needs of the public, the state bank of Pakistan has established Islamic banking department. This department is responsible for developing a shariah complaint framework, taking targeted research initiatives, collaborating with local and international stake holders to come up with competitive and innovative solutions to meet the financial needs of the people.[1]

Some countries have adopted Islamic banking as a part of their banking system. In this regard they have issued license of work to some Islamic banks. However, there are no separate rules and regulations consistent with the nature and work of these Islamic banks and compatible to shariah provisions. Because of these inadequate legal conditions, Islamic banks face difficulties that impede their work and development, especially in their relations with the Central Bank through regulatory process.

The Need of Relationship Between Central Bank and Islamic Bank

The Islamic bank may either be located in a country where the new laws of the monetary and banking sector have been enacted in accordance with the shariah teachings or may be located in a country where the monetary and interest-based banking system prevails. In both cases the Islamic bank needs a close relationship with the central bank in its country of location. Islamic banks, that are located in countries where the new regulations of the monetary and banking sector have been issued in accordance with the provisions of shariah, would definitely be working in an environment helpful for them.

However, in the prevailing framework, the banking and monetary system is based on interest in most of the country.[2]. The Islamic banks need the help of the central bank in the event of lack of liquidity. It cannot manage its liquidity problem without recourse to central bank. The Islamic bank needs the confidence of the public

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[1] Arbi,State bank of Pakistan Evolution Functions and Organization, 23.

[2] Siddiqi, Muhammad Nejatullah, *daor ul bank al markazi bil Nisbah Lil Masraf Al Islami*, (Kuwait first international conference 1413 (AH), 1993), 10

and customers. It cannot maintain this confidence without the support and supervision of central bank. Actually, central bank is like a guarantor for the people dealing with Islamic banks. If a bank is not registered with central bank, it cannot earn and maintain public trust.

It is worth mentioning here, that the central bank cannot ignore the existence and activities of the Islamic bank, because its responsibility is to control the money supply and to ensure the stability in the economy. All this can only be achieved by taking into consideration the role of Islamic banks. Islamic banks also play their role in credit creation and influencing the circulation of money. The central bank can achieve this goal through monitoring and by issuance of instructions and regulations related to reserves, credit ceilings, and profit margins etc. despite the fundamental differences between the modes and methods of Islamic finance as compared to the methods of interest-based financing, and despite the fundamental differences in the nature of deposits with the Islamic bank as compared to deposits with the interest-based banks, some activities of the Islamic banks result in an expansion in the money volume.

Nature of Relationship of Central Banks with Islamic Banks

The nature of activities of Islamic banks is different from conventional banks. Islamic banks are working on the basis of profit and loss sharing. They have partnership modes of financing, where Islamic bank shares loss with customer. Therefore, nature of supervision by the central bank over Islamic banks must be different. The central bank is concerned about the control of credit creation and money supply. Conventional banks play a vital role in credit creation which causes inflation in the economy. The central bank controls the money supply and credit creation using various monetary policy tools to control inflation and ensure economic stability of the country.

Does Islamic banking system play role in credit creation that requires the application of conventional monetary policy on them? A very important question has often given rise to controversy among Muslim economists.

According to most of the economists,[1] the ability of Islamic banks to create credit that causes inflation is very limited as compared to the ability of conventional banks, due to reasons mentioned below.

Firstly, volume of demand deposits at conventional banks which are considered the primary source of credit creation is relative very high as compared to saving deposits. In Islamic banks the volume of demand deposits is very low as compared to saving and investment deposits.

The activities of Islamic banks have no such negative impact on the economy because Islamic banks do not deal in money. It is asset based banking system. Every mode of financing in Islamic banking system involves an asset also called commodity financing.

For example, if someone needs money for purchasing a car or house, he will just take loan from conventional bank and will have to return the principal amount with an additional amount of interest already agreed between the parties and as per the instructions and regulations issued by the central bank. If the customer of the bank defaults bank has to face hundred per cent loss. Therefore, conventional banks are at risk. Moreover, the impact of credit creation is always there as discussed earlier in chapter 2. However, if customer recourses to an Islamic bank for loan facility, the Islamic bank will purchase the car and will deliver it to the customer under lease contract. In case of house finance, the bank will be the partner in ownership of the house.

Thus, there is no just money circulation from hands to hands and from accounts to accounts rather, there is an asset in every mode of financing. One form of financing that is not asset based is *Qarz Hassn* which is an interest free loan. However, the volume of this type of financing is negligible in Islamic banks.

According to Dr. Nijatullah Siddiqui Islamic modes of financing may result in decrease in money supply rather than expansion in money supply, as deposits with Islamic banks are not guaranteed and the depositor may receive less than what he has deposited with an Islamic bank due to loss in the business.[2]

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[1] Sulaiman Nasir, *Alaqa tul Bunook Al-Islamiyyah Bil bunuk Al-Markaziyyah* (Phd diss., faculty of economics Sciences, 2004-2005), 119.

[2] Siddiqi, *daor ul bank al markazi bil Nisbah Lil Masraf Al Islami*, 10.

One of the modes of financing being applied by the Islamic banks and may cause credit creation and inflation is saving account on the basis of Musharakah or Mudharabah where customer is allowed to withdraw the amount from his account through check or otherwise at long intervals as determined and agreed upon between the customers and the Islamic bank. The Islamic bank uses such funds to benefit from it and causes expansion of money in the economy.

Some other economists accept the role Islamic banks in credit creation at a limited level and accept this phenomenon as a natural result of present banking practices including Islamic banking system despite the difference in the overall impact between conventional interest based banking system and prevailing Islamic banking system. Dr. Umar Chapra has allowed the credit creation with tow following conditions:

a. Take appropriate measures to ensure that credit creation process is according to the economy's non-inflationary financing needs
b. That the profit derived from such accounts must be useful for the whole society and only to the owners of money.

As a conclusion of this debate, the role of Islamic banks in expansion of money supply cannot be ignored and must be accepted and recognized as a natural phenomenon. Although its role in this respect is limited as compared to conventional interest based banking system. Because this is an unavoidable reality that Islamic banks activities result in credit creation to some extent due to the nature of some Islamic modes of financing. However, the impact of such modes of financing may be minimized as mentioned above. The credit flows may direct to desired direction in a way that preserves the soundness of the economic and banking system and enable the economic authorities to achieve the goal of public interest.

Findings

Theis research study has found that:

1. There was no Islamic coin minted by Muslims in the era of the Prophet (PBUH). However, some measurements and weights were determined for the already available and adopted currency minted by Byzantine and Sassanid Empire.
2. Abdul Malik bin Marwan was the first caliph in Islamic history who formally minted gold and silver coins in 76AH called al-Dinar Al Islami and Al-Dirham Al-Islami.
3. In conventional economic system money is anything that is generally accepted as medium of exchange and can be used as store of value and standard of deferred payment.
4. As per Islamic worldview on money, anything that is to be used as medium of exchange must comply the definition of Mall (property). The other necessary condition for money in Islam is Rawaj which means that the money must be in circulation and generally accepted to apply relevant shariah rulings on it.
5. Same criteria of money can also be extended to virtual currencies Virtual currency comes under the definition of Mall, therefore can be traded as per precepts of shariah.
6. The system of issuance of currency in Islamic economic system is different from that of conventional economic system. The conventional monetary policy is interest based policy. Islamic monetary policy is the use of several tools to target supply and demand of money.
7. In Islamic economic system, three basic factors will decide the quantity of currency to be issued. These are demand for money in Islamic monetary market, ensuring economic interest, and avoiding monetary crises and monetary reserve.
8. An Islamic central bank must observe two basic important rules. A) There must be equilibrium between the volume of money issued and the volume and rate of the real exchange to maintain the true value of money which is the purchasing power of monetary unit. B) In case of deficit financing, the new quantity of the issued currency must play an important role in financing development activities and must have a positive impact on general

employment rate. In an Islamic economic system, the central bank will adopt the Musharakah model in deficit financing rather than loan-based conventional model. which would limit the flexibility of the money supply by the central bank

9. The demand for money for all three motives that are transaction, precautionary and speculative motives, as envisaged by conventional economic system, exists in Islamic economic system. However, in Islamic economic system there are some factors that will, unlike convectional economic system, affect the demand and these factors will play their role in determination of demand for money. These factors include Riba, Zakat and spending for the sake of Allah. The demand for money for transactions motive may be significantly higher in an Islamic economy due to the fair income distribution.
10. To hold money in anticipation of an emergency is not objectionable in an Islamic economy. Moreover, considering the factor of Zakat, the demand for money for precautionary motive has narrower scope in Islamic economic system. The demand for money for transactions motives exists in Islamic economic system to finance various consumer and investment operations.
11. The demand for money for transactions motives exists in Islamic economic system to finance various consumer and investment operations.
12. Change in the prices of goods and services because of the factors other than devaluation of money such as supply and demand of goods and services, is accepted in shariah as a natural phenomenon. In case of debt transaction, in which one person lends his money to another on Qarz Hassan basis, it seems that the opinion of the opponents of indexation is preferable.
13. This study reveals that if the indicator derived from indexation or from any other way, is clear, avoids ambiguity, carries definitive value and is mutually agreed, then it may be allowed just to revise the salaries and wages, rather this is preferable behavior from shariah point of view.
14. If the bills of exchange presented to central bank for discounting has been issued by the central bank itself, the transaction may be allowed on the basis of Zah wa ta'ajjal (ضع و تعجل) .However, if the bill of exchange is issued by a third party, matter may be allowed on the basis of Hawala Contract and not on

the basis of selling of debt and Ju‘alah contract. However, interest must be avoided in all these transactions.

15. The amount deposited with the central bank as a reserve ratio cannot be considered under Wadi’ah or Rahan. However, the statutory reserve amount may be considered as a compulsory loan. Compulsion by the central bank to place a part of bank’s deposits is permissible from Shari’ah to procure public interest and on the basis of shariah principle *Maslaha Mursalah*.
16. There are sufficient monetary instruments that will replace the traditional monetary instruments. Thus, unavailability of some conventional monetary instruments discounting of bill and bonds will not affect the efficiency of Islamic monetary policy.
17. In Islamic monetary policy goals and targets are achieved by influencing the total volume of money supply and not the interest rate as most of the monetary tools in Islamic monetary economics are based on profit and loss sharing. This is definitely the more effective way to serve economic development programs and the overall economy of the country. A number of economists of monetarists’ school of thought are of the view that influencing and changing the total money supply is more effective way to achieve the goal of a viable monetary policy and a stable economy.

Recommendations

This study recommends that:

1. The government should take steps to make a regulatory framework to deal with virtual currency as early as possible.
2. The central bank of Pakistan should issue currency keeping in view the Islamic concept of demand and supply and should ensure equilibrium between the volume of money issued and the volume and rate of the real exchange.
3. The situations in which money devalues due to the policies or steps taken by the government, like excess in supply of money as a result of printing of extra currency notes or due to expansionary monetary policy or because of credit creation by the commercial banks, the government is responsible for the loss faced by the general public. The government should avoid taking any such steps that causes devaluation of currency. Instead of pumping the economy with extra currency notes it must adopt the Musharakah model as discussed.
4. The government should increase money supply only when there is increase in overall GDP. When there is increase in the production of goods and services, the government should increase money supply as per the increase in GDP.
5. Since the nature and level of the risks to which the Islamic banking business is exposed to is different from the nature of the risks to which the traditional banking business is exposed to, the methodology of supervision adopted for conventional banks must be different from the methodology adopted for Islamic banks.
6. The government should take steps to ensure stability in the value of money. The central bank should work in a framework compatible with shariah provisions.
7. The central bank should use Islamic monetary policy tools and avoid interest based transactions and other prohibited practices in performing its supervisory and regulatory duties.
8. To enhance the islamization process of monetary policy, the national and international financial institutions and other relevant institutions like Organization of Islamic Countries and Islamic Development Bank should work in collaboration. For this purpose, they should expand their working area and establish branches in Muslim countries.

9. Conferences should be held at national and international level to examine the current research related to Islamic monetary policy and to open the door to new areas of research in this field.
10. The Muslim countries should carry out collaborative activities through mutual exchange of academia and researchers to share experience and research of on country with other.
11. Keeping in view the importance of monetary policy in modern financial system, specialized institution should be established at national and international level for the purpose of research in the field of monetary policy.
12. Since the nature and level of the risks to which the Islamic banking business is exposed to is different from the nature of the risks to which the traditional banking business is exposed to, the methodology of supervision adopted for conventional banks must be different from the methodology adopted for Islamic banks. In this regard the condition of Reserve Ration may be relaxed for Islamic bank.The condition of credit ceiling for Islamic banks may relaxed because the profit earned by the Islamic bank is on the basis of profit and loss sharing.

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Personalities

1. Abu Bakar Al-Jassas

Al-Jaṣṣās (305 AH/917 AD - 370 AH/981 AD), his full name is Abū Bakr Aḥmad ibn ʿAlī al-Rāzī al-Jaṣṣāṣ. He was a Hanafi scholar and compiled many works. His work al-Fu@l fi al-Upif, known as Upil al-Jag@. is the first systematic attempt which treats comprehensively the principles of Hanafite jurisprudence. His second work Abkiim al-Qur'cin, in three volumes, is another important contribution not only to the science of Tafsir but also to the science of the principles of jurisprudence.[1]

2. Umar Chapra

Muhammad Umer Chapra (born 1 February 1933) is a Pakistani-Saudi economist. he served as Advisor at the Islamic Research and Training Institute (IRTI) of the Islamic Development Bank (IDB) in Jeddah, Saudi Arabia. Prior to this position, he worked at the Saudi Arabian Monetary Agency (SAMA), Riyadh, for nearly 35 years, as Economic Advisor and then Senior Economic Advisor. He has also taught as Assistant and Associate Professor of Economics at the University of Wisconsin (Platteville), the University of Kentucky (Lexington), as Senior Economist and Associate Editor of the Pakistan Development Review at the Pakistan Institute of Development Economics, and as Reader (Associate Professor) at the Central Institute of Islamic Research Pakistan). He has lectured widely at a number of universities and professional institutes in different countries around the world, including the Harvard Law School, Loughborough University, UK, the Oxford Centre for Islamic Studies, the London School of Economics, Universidad Autonoma de Madrid, the University of Malaga, Spain, and Kyoto University, Japan. He is on the editorial board of a number of professional journals and has acted as referee for a number of others, including the Economic Journal of the Royal Economic Society, UK, the Journal of Socio-Economics and the Thunderbird International Business Review.[2]

3. John Maynard Keynes

John Maynard Keynes, (5 June 1883 – 21 April 1946), was an English economist, whose ideas fundamentally changed the theory and practice of macroeconomics and the economic policies of governments. Originally trained in mathematics, he built on and greatly refined earlier work on the causes of business cycles and was one of the most influential economists of the 20th century. His ideas are the basis for the school of thought known as Keynesian economics, and its various offshoots. During the

[1] **SAEEDULLAH, LIFE AND WORKS OF ABŪ BAKR AL-RĀZĪ AL-JAṢṢĀṢ,Journal of Islamic Studies, Vol. 16, No. 2 (SUMMER 1977), pp. 136, Published By: Islamic Research Institute, International Islamic University, Islamabad**

[2] https://www.goodreads.com/author/show/1810972.Muhammad_Umer_Chapra. 24-01-2021

Great Depression of the 1930s, Keynes spearheaded a revolution in economic thinking, challenging the ideas of neoclassical.[1]

4. Muhammad Taqui Usmani

Muhammad Taqi Usmani (born 3 October 1943) is a Pakistani Islamic scholar and former judge who is Vice President and Hadith professor at Darul Uloom Karachi. An intellectual leader and has authored more than 80 books, many multi-volumes, in Urdu, Arabic and English, including a translation of the Qur'an in both English and Urdu as well a 6-volume commentary on the Sahih Muslim in Arabic, and have written and lectured extensively on hadith, and Islamic finance. He chairs the Shariah Board of the Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). He is also a permanent member of the Jeddah-based International Islamic Fiqh Academy, an organ of the OIC. In Pakistan, Usmani served as a scholar judge on the Shariat Appellate Bench of the Supreme Court from 1982 to 2002, and on the Federal Shariat Court from 1981 to 1982. From 1977 to 1981 he was a member of Zia's Council of Islamic Ideology and was involved in drafting the Hudood Ordinances.

5. Dr. Monzer Kahf

Dr. Monzer Kahf is a Consultant/Trainer/Lecturer, Islamic banking, finance and economics. He received Ph.D., Degree in Economics from University of Utah, Salt Lake City, Utah, in March 1975. And a High Diploma in Social and Economic Planning from UN Institute of Planning, Damascus, Syria, 1967. He has also worked as **Senior Research Economist at** Islamic Research and Training Institute (IRTI) of the Islamic Development Bank (IDB). Jeddah, Saudi Arabia, 1995 - 1999.He also worked Head of Research Division: IRTI of IDB, Jeddah, Saudi Arabia.1989-1991. His responsibilities included organizing and conducting training courses in Islamic Banking and Islamic Economics, evaluating papers, writing original research as well as other papers and reports, and generating ideas for research projects. He served a Professor of Islamic Economics and Banking in the graduate program of Islamic economics and banking, School of Shari’ah, Yarmouk University, Jordan, 2004-2005. He has written Several books on Awqaf, Zakah, Islamic finance and banking and other areas of Islamic economics. [2]

6. Milton Friedman

Milton Friedman (July 31, 1912 – November 16, 2006) was an American economist who received the 1976 Nobel Memorial Prize in Economic Sciences for his research on consumption analysis, monetary history and theory and the complexity of stabilization policy. With George Stigler and others, Friedman was among the intellectual leaders of the Chicago school of economics, a neoclassical school of

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[1] https://www.britannica.com/biography/John-Maynard-Keynes 24-01-2021
[2] http://monzer.kahf.com/about.html 24-01-2021

economic thought associated with the work of the faculty at the University of Chicago that rejected Keynesianism in favor of monetarism until the mid-1970s, when it turned to new classical macroeconomics heavily based on the concept of rational expectations. Several students and young professors who were recruited or mentored by Friedman at Chicago went on to become leading economists.[1]

7. Anna Jacobson Schwartz

Anna Jacobson Schwartz (November 11, 1915 – June 21, 2012) was an American economist who worked at the National Bureau of Economic Research in New York City and a writer for The New York Times. Paul Krugman once said that Schwartz is "one of the world's greatest monetary scholars. Schwartz collaborated with Nobel laureate Milton Friedman on A Monetary History of the United States, 1867–1960, which was published in 1963. This book placed the blame for the Great Depression at the door of the Federal Reserve System. Robert J. Shiller describes the book as the "most influential account" of the Great Depression. She was also president of the Western Economic Association International in 1988. Schwartz was inducted into the National Women's Hall of Fame in 2013.[2]

8. Dr Zakki Shafi

Dr. Zakki Shafi was an Egyptian economist. After completing his secondary education, he joined the Faculty of Law, Cairo University, where he completes graduated and received a bachelor's degree in 1942, then obtained a diploma in private law, followed by a diploma in economics in 1944 and 1945. Then he was sent to the United States of America, where he obtained two degrees master's and doctorate degrees in economics from Princeton University in the years 1948 and 1950 AD, and then returned home as a professor of economics at the Faculty of Law. He became the first dean of the Faculty of Economics and Political Science in 1959, when he had not yet reached the age of forty. He laid down its rules, regulations and traditions until it became among the most prominent Faculty of the university that aspired young people to join this faculty. In the year 1945AD, Al-Shafei was chosen as Minister of Economy, but he soon returned in next year to his favorite science niche, so he remained a professor and then a full-time professor at the Faculty of Economics and Political Science[3]

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[1] https://www.investopedia.com/terms/m/milton-friedman.asp 24-01-201

[2] Marjorie B. McElroy, A Celebration of the Life of Anna Jacobson Schwartz, NEWS, American Economic Association, Fall 2013, P: 1

[3] https://www.m-a-arabia.com/vb/showthread.php?t=10363 24-01-2021

Places

1. Sassanid Empire

The Sassanid Empire or Sassanian Dynasty is the name used for the Iranian dynasty which lasted from 224 to 651 AD. The Sassanid Empire, which succeeded the Parthian Empire, was recognized as one of the two great powers in Western Asia, alongside the Roman Empire and later the Byzantine Empire, for more than 400 years.

2. Byzantine Empire

The Byzantine Empire, also referred to as the Eastern Roman Empire, or Byzantium, was the continuation of the Roman Empire in its eastern provinces during Late Antiquity and the Middle Ages, when its capital city was Constantinople. It survived the fragmentation and fall of the Western Roman Empire in the 5th century AD and continued to exist for an additional thousand years until it fell to the Ottoman Empire in 1453. During most of its existence, the empire was the most powerful economic, cultural, and military force in Europe.[1]

3. Sweden

Sweden, country located on the Scandinavian Peninsula in northern Europe. The name Sweden was derived from the Svear, or Suiones, a people mentioned as early as 98 CE by the Roman author Tacitus. The country's ancient name was Svithiod. Stockholm has been the permanent capital since 1523.[2]

4. Othman Empire

Ottoman Empire, empire created by Turkish tribes in Anatolia (Asia Minor) that grew to be one of the most powerful states in the world during the 15th and 16th centuries. The Ottoman period spanned more than 600 years and came to an end only in 1922, when it was replaced by the Turkish Republic and various successor states in southeastern Europe and the Middle East. At its height the empire encompassed most of southeastern Europe to the gates of Vienna, including present-day Hungary, the Balkan region.[3]

5. Algeria,

this country is located in Northern Africa, bordered by the Mediterranean Sea in north, Tunisia in northeast, Libya in east, Morocco in west, Western Sahara, Mauritania, and Mali in southwest, and by Niger in the southeast.

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[1] https://en.wikipedia.org/wiki/Byzantine_Empire date 28-01-2021
[2] https://www.britannica.com/place/Sweden date 28-01-2021
[3] https://www.britannica.com/place/Ottoman-Empire date 28-01-2021

Algeria is now Africa's largest country, covering an area of nearly 2.4 million km, compared, it is 4 times the size of France or slightly less than 3.5 times the size of the U.S. state of Texas. But the country is almost only populated in the small coastal region, because its southern part is covered by the Sahara, the largest subtropical hot desert.[1]

[1] https://www.nationsonline.org/oneworld/algeria.htm date 28-01-2021

Terminologies

1. Float

In financial terms, the float is money within the banking system that is briefly counted twice due to time gaps in registering a deposit or withdrawal. is duplicate money present in the banking system during the time between a deposit being made in the recipient's account and the money being deducted from the sender's account. These time gaps are usually due to the delay in processing paper checks. A bank credits a customer's account as soon as a check is deposited. However, it takes some time to receive a check from the payer's bank and record it. Until the check clears the account it is drawn on, the amount it is written for "exists" in two different places, appearing in the accounts of both the recipient's and payer's banks.

2. Special Drawing Rights

SDR is an artificial money consists of a basket of major currencies introduced by International Monetary Fund. are supplementary foreign exchange reserve assets defined and maintained by the International Monetary Fund (IMF). SDRs are units of account for the IMF, and not a currency per se. They represent a claim to currency held by IMF member countries for which they may be exchanged.

3. Sukuk

Sukuk actually represent share in a project. It is issued, by the project owner, to raise capital to fulfill financial needs of the project. this is a shariah compliant instrument. Sukuk holder deserves his profit share as the ratio agreed after the maturity of the *Sukuk*.

Certificates of equal value representing undivided shares in ownership of tangible assets, usufruct, and services or (in the ownership of) the assets of particular projects or special investment activity, however, this is true after receipt of the value of Sukuk, the closing of subscription and the employment of funds received for the purpose for wihich the Sukuk were issued[1]

4. High-powered money

High-powered money means the legal money through which banks can create credit money.

5. Musharakh

Musharakah is a word of Arabic origin which literally means sharing. In the context business and trade it means a joint enterprise in which all the partners share the profit or loss of the joint venture[2]

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[1] Shariah sta.ndards for Islamic Financial Institutions, accounting and au.diting organization for Isl.amic fin.ancial institutions, 1432-AH-2010AD, P: 370

[2] Usmani, Muhammad Taqui, an Introduction to Islamic Finance, Quranic Studies Publishers, P: 17

6. Diminishing Musharakah

Diminishing Musharakah is a mode of Financing in which a financier and his client participate either in joint ownership of a property or an equipment, or in a joint commercial enterprise. The share of the financier is further divided into a number of units of the share of the financier one by one periodically, thus increasing his own share till all the units of the financier are purchased by him so as to make him the sole owner of the property, or the commercial enterprise as the case may be.[1]

7. Mudharabah

Mudharabah is a special kind of Partnership in which investment comes from one partner who is called Rabbul Mall while the work and management is an exclusive responsibility of the other who is called Mudharib.[2] Both parties share loss and profit. The profit is shared as per agreed ratios while loss is born by the Rabbul Mall only. In case of loss the Mudharib is deprived of his profit only.

9. Hawala

Hawala of debt is the transfer of debt from the transferor (Muheel) to the payer (Muhal Alaihi). The transfer of right, on the other hand, is a replacement of a creditor with another creditor. The transfer of debt differ from transfer of right in that in transfer of debt a debtor is replaced by another debtor, whereas in a transfer of right a creditor is replaced by another creditor.[3]

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[1] Ibid: P : 57
[2] al-Kasani, 'Ala' al-Din ,Bada'i Al-Sana'i Fi Tartib Al-Shara'I, Vol, 6 , P : 79
[3] AAIOFI, Shariah Standards, under Hawal standard.

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