The Evolution of Monetary Policy: Analyzing Reserve Ratios and Their Shari'ah Implications

Dr. Hafiz Moazzum Shah
Lecturer Shariah Department Allama Iqbal Open University, Islamabad
Email: smoazzum@gmail.com

Abstract
The concept of monetary policy, emerging prominently in the nineteenth century, has evolved into a fundamental aspect of economic governance, especially during times of crisis and instability. Influential economists, including Keynes and Alfred Marshall, contributed significantly to the literature, addressing monetary issues through scholarly articles and research during periods of economic turbulence. The systematic study of monetary policy gained momentum throughout the twentieth century, reflecting the need to understand and manage recurrent economic cycles. This paper explores the multifaceted nature of monetary policy, focusing on key concepts such as the reserve ratio, its objectives, and the mechanisms underlying this policy. Additionally, it provides a Shari'ah analysis of the reserve ratio, examining its implications within various frameworks, including the Wadi'ah agreement, Rahn (pledge), and Qardh (loan). The discussion also encompasses the statutory reserve ratio, highlighting its role in achieving stable economic goals. Through this comprehensive analysis, the paper underscores the integral relationship between monetary policy and the broader economic objectives of the state.

Historical Background and definition

The term monetary policy is relatively a modern term that appeared in economics literature during the nineteenth century. Several 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 of 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 rates. 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.

Several monetary policy tools have been developed and are used to manage money circulation in the economy to achieve the targets of economic growth. However, these monetary policy tools need to be discussed from shariah point of view to confirm it conformity with shariah principles.

One of the monetary policy tools is the Reserve ratio. Reserve ratio tool is used by the monetary policy authorities to control monetary supply in the country.

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 be unexpected.

inflation on the other hand, in the event of economic recession, the volume of demand for loans would decrease 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 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 the 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"[4]

It is the percentage of deposits with the commercial bank that the law obliges commercial banks 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 the central bank is 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 the liabilities of commercial banks, as they are required to deposit more money with the central bank as reserves. This liability reduces the capacity of banks to grant loan facilities 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.[5] 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.

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 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 the 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 credit creation by controlling the amount of credit provided by the commercial banks to individuals and institutions.
- To help depositors 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"[6]

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 will, free consent and option of the owner and he has the repossession option. The repossession of the property is at his discretion. However, 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.[7] 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 the central bank as legal reserve is guaranteed by the central bank and is liable to be paid 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.

Analysis of Reserve Ratio based on (Rahn) Pledge

Rahn is a contract in which an asset is kept as collateral to secure debt. The asset which is kept as collateral is called Marhun. Usually, creditors 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"[8]

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 not any financial obligation or right, there will be no collateral because the rationale behind keeping the asset as collateral is to secure the right or debt. Otherwise, no one has the 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 not 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 mortgage 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 that may be incurred in future.

Analysis of Reserve Ratio based on 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"[9]

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 them 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 if 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"10

"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.[11] In simple words this principle when an action is allowed to achieve a public interest that is deemed necessary by the Muslim government this is called giving shariah ruling based on 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 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 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 a 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 a 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"[12]

"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.
- 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 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 the 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.

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 banks 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[13] and all equity accounts are not liable to statutory reserve requirement.

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