Preface

In the contemporary monetary literature, there is the suggestion that Islamic banking and finance (IBF)-oriented monetary-financial systems make open economies more resilient, since equity-based banking systems cope better – in the sense of behaving more stably and resiliently – than the mainstream debt-oriented systems when an economy comes under pressure. Equity-based IBF has established a significant presence in the world financial system since its modern-era emergence, traceable from the late 1970s. Its evolution has indeed passed through several phases, to the point where it is now recognized as a complementary banking and finance sub-sector within any society irrespective of that society's religious and philosophical foundations and contemporary economic orientations. IBF has features highly desirable to borrowers and lenders of investable funds operating in environments beset with asymmetric information and agency problems.

The basic tenet of IBF is the prohibition of interest, nominal or real, in all transactions, whether financial or non-financial (that is, real sector transactions). Far from being blindly religious in nature, however, this and other principles of Islamic finance are consistent with fundamental principles in philosophy, ethics and social justice, as well as in economics. As such, they can happily operate side-by-side with, and indeed overlap, the well-established principles and practices of conventional banking and finance.

The recent experience of Muslim-majority countries shows that Islamic banks and financial institutions are able to operate either as independent specialist firms or as specialist windows of conventional banks and financial institutions. This represents a positive development in global banking and finance at a time when conventional banks and financial institutions have come under criticism because of their aggressive risk-taking behaviour, especially in a low-inflation environment. Within an increasingly globalized financial system, they develop and market complex financial products with little or no linkage to real sector activity. Critics therefore view many derivative financial products, for example, as devices for gambling rather than for fulfilling the well-known legitimate economic roles of financial products such as risk management for all parties to a credit

contract or raising the efficiency of resource allocation. In contrast, IBF specializes in the supply of financial intermediation and services that are closely related to real sector activity and, as such, contributes directly to raising the real wealth of the community.

In undertaking business activity within the Islamic banking paradigm, both borrowers and lenders of investable funds remain involved with one another and connected to their planned investment projects as they unfold. Together they bear the risks and share the profits and losses from their real investment joint ventures. Within this framework the sharing of risk, in the form both of profits and losses, by free and willing participants implementing socially desirable real investment projects, is considered both ethical and moral.

The basic presumption in IBF is that stability, both in price level growth (that is, inflation) and in output growth is the foundation of the equity-driven Islamic financial system. This system is pledged to eschew the use of 'conventional' interest-driven instruments of any kind, both in nominal and real terms and regardless of whether or not the system's component contracts use the word 'interest' to denote the returns on investable funds.

This brings the issue of macroeconomic stability to the front and centre of policy discussion. All business investment and profitability depends, among other things, upon the macroeconomic environment and the prospects of the economy. It is axiomatic throughout this series of case studies that the rate of investment in profitable projects – and by implication the very rate of economic development itself – is maximized in a stable economic environment and compromised in greater or lesser degree by actual, expected, or even merely feared, instability. As business risk enters into investment decisions, and investment returns are linked to economic efficiency and growth, macroeconomic stability is considered critical, not only to the prosperity of IBF but to that of the broader macroeconomy.

However, these fundamentals of monetary theory and policy have been largely absent in Muslim-majority countries – which, having adopted IBF in recent decades, consequently have a special interest in achieving, once and for all, sustained macroeconomic stability. A situation of internal contradiction has emerged, however, whereby Islamic financial institutions operate concurrently with interest-driven conventional banks in an environment of high and volatile inflation.¹ These countries operate largely under either the fixed peg or the managed float exchange rate systems. Both systems create and magnify output growth volatility from all sources, including from monetary or real shocks, or from some combination of the two. The profit and loss-oriented business model of Islamic banks and financial institutions is neither designed to function in an unstable economic environment nor equipped to do so efficiently.

Consequently, in the attempt to survive competitively with the conventional institutions, which are equipped to devise products for the purpose of dealing with an economic environment of uncertainty (that is, an economic environment in which economic policy is failing in its public service function), Islamic banks and financial institutions have compromised their fundamental principles of business ethics. In the process, they shed their distinctive character. Critics suggest that a significant share of the Islamic financial products and services now offered by Islamic banks and financial institutions mimic conventional banking products and services; hence they are arguably not Islamic according to the *shariah* principles. The central feature of this is the emergence of dubious similarities between Islamic and non-Islamic financial products and services, only thinly disguised by terminology. A major consequence has been a diminution of the economic benefits accruing from wealth-holder product diversification. The *raison d'être* of IBF is thus lost before it reveals its usefulness in the modern economy and society. It is important to note that policy-neglected or encouraged economic volatility is also significantly sub-optimal for the conventional banking and finance sector. A tiny minority of this sector's players benefits disproportionately from economic volatility, opening up the question of whether the significant (hedging) costs to the host economy of severe distortion to the functioning of its entire financial sector are greater than the beneficial resources reallocated to this minority as a result of the volatility, which is almost entirely avoidable with good policy.

Although the Islamic banking literature, especially the popular writings, sketches a 'rosy picture' of Islamic financial institutions and their prospects, the reality is different for most Muslim-majority countries. Except in two countries operating at the frontier of the modern industry – Bahrain and Malaysia – there is concern over the long-term prospects for an IBF sector worthy of the name. If absolute figures for banking assets are discounted, the expansion of Islamic financial assets has been moderate from a low level in these countries. The market shares of Islamic financial institutions have remained at less than 10 per cent and have exhausted the niche clientele base in some of the countries. Muslim customers have generally kept their banking business in the conventional financial sector even in conditions of high and volatile inflation accompanied necessarily by low or negative and volatile real interest rates.² It is ironic that, while Islamic financial institutions are gaining acceptability and significance in low-inflation Western countries, many Muslim-majority countries remain uncommitted to achieving the sustained low and stable inflation, with consequent steady economic growth, which remain fundamental to the establishment of a healthy and prosperous IBF sector.

In the context of open-economy macroeconomic management, the key

theme emerging from the literature is that, in a positive sense, the principles of Islam are inconsistent with policy-generated inflation and macroeconomic instability originating in policy-induced and structural shocks, domestic or external or both. On the contrary, Islam is consistent with the findings of mainstream monetary economics that high and volatile inflation adversely affect economic growth. Inflation compromises efficient resource allocation by redistributing wealth from consumers to savers and from creditors to debtors. According to Islamic principles of equity and social justice, macroeconomic stability is therefore critical for sustained economic growth and comprehensive stability in both social and political terms. Monetary stability is a core requirement of macroeconomic stability in all modern economies, regardless of the depths to which religious-ethical precepts influence monetary-financial systems and their workings.

The contemporary literature has developed the key themes on the monetary origins of inflation and its volatility within a political-economy perspective. This is adequately reviewed in Hossain (2009). The present book argues that this literature is consistent with the fundamental principles of what may be called 'Islamic monetary theory and policy', emphasizing price stability, meaning zero inflation on average, as the core requirement of Islamic social and economic justice. An implication is that Islamic banks and financial institutions can operate ethically and morally only in an environment where price stability, as the essential foundation of stability and certainty, is enshrined in the public policy charters, preferably rooted as deeply as the society's constitution.

This book of case studies of *Central Banking and Monetary Policy in Muslim-Majority Countries* is intended to be used as a supplementary companion book to my reference text *Central Banking and Monetary Policy in the Asia-Pacific* (Hossain, 2009). The selected nine Muslim-majority countries in this volume are Bahrain, Bangladesh, Egypt, Indonesia, Iran, Malaysia, Pakistan, Saudi Arabia and Turkey.³ In these countries a partial Islamic banking and financial system operates, with some degree of success, side-by-side with conventional banking. The selected countries have varied characteristics along several dimensions, including: the strategy of development adopted and the level achieved; economic openness; inflation history; and the monetary policy strategy response.

The book, *The Evolution of Central Banking and Monetary Policy in the Asia-Pacific* (Hossain, 2015), includes case studies of central banking and monetary policy for 12 non-Muslim countries. The 2009 text surveyed the major theories, models and approaches to inflation and monetary policy with a focus on selected developing countries of the Asia-Pacific, highlighting contemporary issues in monetary policy for price stability using the benchmark definition of 'price stability' in monetary policy practice

as 'low and stable inflation'. The present book reviews and analyses, in an historical context, country-specific experience and issues in inflation and monetary policy. In doing so, the key ideas and views on the sources and dynamics of inflation and monetary policy behaviour are investigated after taking into account those institutional arrangements that impinge upon the formulation and conduct of fiscal and monetary policies in each country studied.

This book does not focus on a narrow set of analytical themes other than highlighting some core issues in inflation and monetary policy for investigation under different monetary policy arrangements. Furthermore, this book and Hossain (2015) avoid becoming strongly prescriptive in tone and substance. The focus is on highlighting key policy issues and investigating some of these econometrically, in limited form, to draw policy implications. One recurring theme of this book is that although IBF may have created some complexities in central banking and monetary policy in Muslim-majority countries, its emergence has created opportunities for improving, firstly, the infrastructure of central banking and monetary policy and, secondly, application of the principles of Islamic banking. These countries can maintain monetary and financial stability better when conventional banking systems are susceptible to shocks and crises. The presence in an economy of IBF strengthens the argument for low and stable inflation and rule-based monetary policy for price stability. In an economy hosting such a hybrid conventional-Islamic banking and financial system, this macroeconomic policy takes on the microeconomic characteristics of an industry policy aimed at creating a level competitive playing field for all participants of both types in the banking and finance sector.

This book does not suggest that IBF supplant conventional banking in Muslim-majority countries; rather, it suggests that existing central banks play an essential role in fostering IBF to complement conventional banking and finance and improve the financial system against standard economic benchmarks such as economic efficiency, competitiveness and the rate of development progress. In doing so, some *shariah*-compatible changes can be identified in the way central banks presently operate and conduct monetary policy in Muslim-majority countries. To begin with, the main task of central banking in a partial Islamic financial system is the provision of an institutional framework for the smooth operation of financial markets in compliance with the *shariah*. Central banks can take the lead in promoting financial institutions, deposit and loan instruments and a yield structure conducive to efficient mobilization of savings and allocation of resources. In particular, central banks need to undertake the task of fostering development, consolidation and deepening of all primary and secondary debt

and equity markets. This is considered crucial because a mere adoption of Islamic rules of finance does not of itself create significant impetus for financial and economic development. Irrespective of whether it is Islamic or non-Islamic, shallow financial markets and the absence or dearth of attractive financial instruments limit financial intermediation and retard economic growth.

The case studies in this book are not organized following a pre-set format or theme, except that the countries selected are presented in alphabetical order. The case analysis for each country is organized to reflect the evolution of inflationary trends and movements; and to discuss the framework of monetary policy targeting stated objectives – usually price stability and economic growth. Each country chapter analyses the available data to yield dynamic information on several key macroeconomic variables, and reports empirical findings on some key monetary relations that have implications on monetary and exchange rate policies. However, the empirical analysis is suggestive and exploratory, not exhaustive given the limited scope of this study. The overall analysis is concise and informed by received economic theory, policy issues and some lessons of experience that the countries may draw. Importantly, institutional issues with respect to the design and conduct of rule-based monetary policy, especially the closely related phenomena of exchange rate arrangements, interest rate controls, credit allocation policy and capital flow policy.

For econometric analysis, the data are drawn from domestic and international publications. The main source of data informing the analysis and conclusions is the International Monetary Fund's (IMF) *International Financial Statistics*. Depending on the context of analysis, the historical data are reported in a summary form for individual countries and for the time periods for which data have been collected and are available. To streamline the analysis, econometric techniques are applied to investigate some aspects of inflation, together with the underlying relations in monetary theory and policy determining inflation. While the econometric analysis is undertaken to provide evidentiary and illustrative findings,⁴ this book as well as Hossain (2015) are in no way applied econometric treatises. Econometric analysis is secondary to, and supportive of, analytical discussion on policy issues that are all-encompassing in a macroeconomic sense.

The major findings of the book lead to the following policy implications. Islamic financial institutions would perform more efficiently and with greater product integrity given three conditions. Firstly, that the monetary authorities in the selected countries make a firm commitment to using the available economic policy theory and instruments to achieve the targets of sustained stability in both inflation and real gross domestic product (GDP) growth. Secondly, that the monetary authorities follow

the commitment through and apply the available instruments to achieve the stated targets. A third requirement is complementary, supportive fiscal policy. The comparative advantage strategy for the first and second conditions itself has two components:

1. Rule-based monetary policy that considers price stability as the primary, if not the sole, objective of monetary policy. 'Price stability' implies low, preferably zero, average inflation with low volatility.
2. An essential part of the rule-based monetary policy model is an appropriate degree of exchange rate flexibility. In most of the selected countries, this would require the adoption of more flexible exchange rate systems to create a 'buffer' capable of insulating their economies to some degree from the economic shocks that the increasingly globalized world will inevitably generate.

Together with Hossain (2009, 2015), comprising the 2009 reference text and the book of case studies on central banking and monetary policy for 12 non-Muslim countries in the Asia-Pacific, this book of case studies can be adopted as a complementary text for courses on money, banking and finance, especially IBF. Although the literature on monetary macroeconomics in general, and on inflation and monetary policy in particular, has expanded rapidly in both quantity and sophistication since the early 1970s, these three books cover the concepts and principles in a moderately rigorous, but not 'too mathematical', form needed for expository purposes.⁵ To make the work accessible to non-specialist readers with some interest in monetary policy issues, this book, like Hossain (2009, 2015), is written in a precise and matter-of-fact style with empirical orientation and policy focus. Policy issues are analysed and illustrated with real-world events and examples. Readers requiring more in-depth analysis are referred to specialized readings such as journal articles that cover analytical issues or contain advanced empirical analysis.⁶

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Finally, I will feel amply rewarded if students, policymakers, central bankers and researchers working in and on the Asia-Pacific in particular find this book, along with Hossain (2009, 2015), useful to improve the understanding of inflation and its dynamics and to the design and implementation of appropriate monetary policy strategy to achieve and sustain low and stable inflation in a rapidly changing international economic environment.

Any remaining errors and shortcomings of this book are my sole responsibility. Productive comments and suggestions are welcome from readers for updating this volume, if any opportunity arises, and for future research on related topics and policy issues in the Asia-Pacific, especially with respect to IBF.

NOTES

1. Muslim-majority countries have generally maintained either the fixed peg or the managed float exchange rate systems since the 1970s, with varying degrees of capital mobility. Although the stated idea of such exchange rate systems is to keep inflation low and stable, in practice they have created excessive volatility in inflation and output growth. High-inflation volatility is reflected in high volatility of real interest rates and real exchange rates, which generate excessive volatility in real output growth through both the demand and the supply channels.
2. Muslim customers, when pressed, rationalize their acceptance of interest on deposits as compensation for loss of money's purchasing power when, as it usually does, the inflation rate exceeds zero. This rationalization violates the Islamic principle that any 'nominal or real' reward in the form of interest, even if it is in compensation for the loss of money's purchasing power, should be treated as *riba* (usury) and, as such, strictly forbidden (Iqbal and Mirakhor, 1987). The government of a Muslim country is therefore considered 'morally' responsible for price stability, to the extent that it is technically possible, so as not to create an environment in which people feel that the only way to protect their income and wealth is to engage in unIslamic activities. Furthermore, a responsibility in Islamic law may obtain. A corollary of this principle suggests that the inflation tax is unIslamic, since it represents unauthorized taxation on money holdings. This is not much different from the Monetarist objection to the collection of 'seigniorage' (the inflation tax).
3. Egypt is included in the study. Geographically, it resides in the North African region. Likewise, Turkey, in Asia Minor, straddles Asia and Europe. Despite such anomalies, the Asia-Pacific region is used in a broad sense to cover the sample countries given similarities in evolution of monetary policy, policy focus and institutional arrangements.

4. The conventional econometric techniques deployed include the multiple regression analysis, unit root tests, ARCH-GARCH (autoregressive conditional heteroskedasticity-generalized autoregressive conditional heteroskedasticity) modelling and VAR/VECM/SVAR (vector autoregression/vector error correction model/ structural vector autoregression) modelling. The key references are Hill et al. (2011) and Stock and Watson (2012).
5. The mathematical symbols used in this book are not standardized but are chapter- or model-specific. They are defined as frequently as needed for exposition at the risk of repetition. This allows the reader to navigate through the text without any risk of distraction by having to refer back to the symbols and their meanings defined earlier.
6. In drafting the text I have drawn on and synthesized materials from a wide range of published sources, including specialist texts, journal articles and other publications, such as working papers and raw drafts. While I have given references for materials drawn from sources that can be identified and attributed to certain authors, I have avoided providing detailed references, given the space constraint, on themes and ideas that are generic and have been developed by many scholars in different contexts over time. Any specific material drawn from any identifiable source without appropriate acknowledgement or citation is an entirely unintentional oversight.

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