ISLAMIC MONEY CREATION

In a world where economies need to inject more money but cannot afford more debt, **Dr Armen V Papazian** proposes Islamic or equity-based monetisation

THE GLOBAL financial crisis has raised a variety of questions regarding the banking industry. It has also unleashed a rethinking momentum that has not spared the very model of capitalism that we live with today. The recent sovereign debt crisis in the Eurozone has reinforced the need to reassess and reinvent the financial architecture that underpins money and money creation. Indeed, the current model used to create and inject money is the very root of the problem we face.

The principles of Islamic finance can contribute a great deal to the rebuilding of our financial system. However, we should distinguish the principles from the industry as it exists today. Simply put, the Islamic finance industry is very young, and currently operates within a broader conventional framework. A quick survey of the Islamic world would reveal that money creation, to date, is still based on a conventional equation. In other words, in the Islamic world, money creation and issuance still follow conventional non-Islamic methodology.

This is revealing as it indicates that the principles of Islamic finance have not yet been applied to the very process of money creation and issuance. In other words, the plethora of Islamic

Balance sheet of Bank of England issue department (2007)

Assets (£m)		Liabilities (£m)	
Securities of, or guaranteed by, British Government	13,370	Notes issued	38,449
Other assets, including those acquired under reverse repurchase agreements	25,079		
Total assets	**38,449**	**Total liabilities**	**38,449**

Source: Bank of England, financial statement 2007-2008

financial products that are approved as Shariah-compliant face an important paradox. If money is not created based on Islamic finance principles, i.e., if the money earned is not Shariah-compliant, what is the value proposition of a Shariah-compliant product?

Indeed, what would an Islamic money creation process look like? I propose the concept and mechanics of an Islamic money creation process, or Islamic monetisation. The proposed equation need not be called Islamic. As a matter of fact, the proposal made here is about shifting the principles and logic of money creation from debt to equity. As such, it could be called equity-based monetisation.

Islamic money creation would use an equity-like product to back currency issuance instead of a debt security

Money and debt creation

States and state institutions create and manage the economic game of nations. The two arms of the state that are responsible for economic management are the government and the central bank. Both are part of the State, and they are the key entities whose relationship and mode of interaction is the underlying equation that supports the printing and creation of money.

Monetisation, fashionably referred to as quantitative easing, describes the process through which the central bank replaces government bonds with high powered money. As such, it is directly linked with a fundamental premise of money creation, i.e., the central bank uses government bonds as assets that back the issuance of currency, which is a central bank liability. While this fact has to do with central bank accounting, it also reveals a money creation process which is fundamentally an institutional arrangement between two arms of the State.

While currency issued is a liability of the central bank, government securities are an asset. This, in short, is the equation through which fiat money is injected into an economy. The Bank of England issue department's balance sheet substantiates these arguments.

Indeed, debt is omnipresent in money creation and expansion as well. Credit is the key engine through which the money multiplier has its impact and drives the growth in money supply. The money multiplier is the key concept that describes the central role of debt in the money supply process.

$$m = \frac{1+c}{r+e+c}$$

The reserve requirement ratio r, the excess reserve ratio e, and the currency ratio c, together determine the money multiplier which is a key component of the fractional banking system. Indeed, today's monetary architecture is setup in such a way that almost all deposits, whatever their size or currency, are indeed the mirror image of someone else's credit to one bank or another.

As issued and managed today, money is primarily made up of debt, and only a small proportion is actual currency.

Why do we create money via debt? There are many theories and interpretations that can be used to explain this practice. My purpose here is to propose a new alternative route that can allow a shift in the way we imagine and practice money creation.

I propose Islamic money creation as an alternative, although it is not practiced in the Muslim world where currency creation follows non-Islamic conventional methodologies.

When we look at the Saudi Arabian Monetary Agency's balance sheet, we find that currency issuance is backed by gold and foreign currencies. Interestingly, 98.4% of the assets used to back notes and coins issued by SAMA are foreign currencies; gold is only a small fraction. Given the USD-Saudi Riyal exchange rate peg, it is quite reasonable to assume that the vast majority of foreign currencies used are actually US dollars.

The dollar is a currency backed by conventional government securities. The most Shariah sensitive economy in the Middle East, indeed in the Muslim world, backs its currency with US dollars, which in turn is backed by interest bearing government bonds. Thus, in Saudi Arabia domestic currencies are backed by debt indirectly via the US dollar and the liabilities of the US treasury. In fact, given the lack of domestic currency monetisation and the dominant presence of the Dollar Standard in the region, GCC countries are an ideal candidate to pioneer Islamic money creation.

Another important and highly tangible opportunity exists in Malaysia. Malaysia has been and still is a crucial player in the Islamic finance industry, and the State of Malaysia has played an unprecedented role in promoting, developing, enhancing and materializing the promises of Islamic finance. Interestingly, even in Malaysia, as of today, Islamic finance has stopped short of transforming the very equation of money creation.

Islamic money creation

I propose Islamic money creation as an alternative methodology to the current mainstream and orthodox methodology of linking creation of money with issuance of debt. Following the principles of Islamic finance, an Islamic money creation process would use an equity-like product to back currency issuance, instead of a debt security as it is common today across many countries and

Balance sheet of Saudi Arabian Monetary Agency (SAMA) issue department, SR

Assets (£m)		**Liabilities (£m)**	
Gold	1,623,502,620	Notes issued	107,897,106,915
Foreign currencies	106,509,903,540	Coins issued	236,299,245
Total assets	**108,133,406,160**	**Total liabilities**	**108,133,406,160**

Source: SAMA balance sheet, as of June 2008

central banks. Indeed, given that the government and the central bank are the ultimate creators of money, there is no reason they could not actually share the risks and rewards of macroeconomic management.

If an Islamic instrument, I propose public capitalisation notes (PCNS) as an example, were to be used for money creation and issuance, central banks could capitalise the government, rather than lend to the government when necessary. As such, an equity-like monetisation tool does not promise a fixed interest. It promises a return which is paid out in the form of a dividend sharing surpluses and profits where they are earned.

PCNS would have to be issued by the government treasury, and offered for sale to the country's Central Bank. Without transforming this paper into a financial engineering exercise, and leaving the legal structures and term sheets involved to a later discussion, one of the key features of PCNS is worth mentioning here. The underlying real assets/activities that support these Islamic instruments would be the tangible and intangible resources of the state and their productive management in the pursuit of economic growth.

PCNS can also be earmarked to specific projects and spending plans, such that the liquidity injected into the government and thus the economy is directed and targeted, involving a business plan and a profit potential. Indeed, when earmarked to projects, PCNS could also be sold to other private and institutional investors.

PCNS can be initially be used in parallel to government bonds. The key issue is to allow money injection into the system without additional government debt. This is very relevant in times of crises. There are times when a recapitalisation of governments is basic economic arithmetic. In such circumstances; to inject new money through new government debt is simply absurd and unnecessary. After all, we are the creators of the system, and the government and the central bank are the ultimate source of money.

Islamic instruments can also play a crucial role in the money expansion process, once money is created and issued. Indeed, using instruments that are required to involve real assets and real people can lead to a scenario where money supply growth is strongly linked to productive capacity build up.

The prohibition of interest in Islamic finance is simply a requirement to involve more than just time and capital in the earning mechanism of an instrument. When real activity is used as a key structural element of a financial product, from a macro perspective, the money expansion process is linked to the productive activity build up, thus ensuring that finance remains real, and paper based correlations do not undermine the system.

An Islamic money creation process is not yet practiced in the Islamic world. As suggested here, Islamic monetization uses an equity-like instrument to back currency issuance, without fixed predetermined interest payments. The structure of the instrument is grounded in a risk-sharing principle where government and central bank share the risks of macroeconomic management.

Equity-like is defined not in terms of share ownership, but rather in terms of the nature of cash-flows and commitments that are exchanged between the government and the central bank. The new equation would allow central banks to capitalize governments rather than lend to governments. Naturally, this change boils down to a change in the instruments used to back local currency issuance, which are also used to inject new money in the an economy. It should be noted, however, that this is not an exclusively Islamic opportunity for Islamic economies, but rather a broader opportunity that could transform monetization and money creation in non-Islamic economies as well.

Indeed, using Islamic instruments in the money creation and expansion process allows for a closer link between the monetary and real dimensions of the economy, and entrenches money supply growth into productive capacity build up.

Given that the state is the ultimate source of money, Islamic monetization could be a key architectural innovation, allowing human societies to print and manage their monies, which they already do, in a logic of existence and ownership, rather than a logic of survival and debt. Moreover, given that we are creating money through an institutional arrangement between governments and central banks, public debt is a paradox and a self-inflicted burden that could be resolved through a shift in the way we imagine money. ■

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Government bonds	**Public capitalisation notes**
Interest bearing	Dividend paying
Different maturities	Different maturities
Not earmarked	Earmarked to projects and investments
Available for trading	Available as buy and hold
Offered to all participants	Offered to Central bank