

Interest Rate in the Open Market Operation Mechanism: Is It Also Subject to Prohibition by Shariah?

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According to the principles of Islamic jurisprudence, lending money to an individual with the condition that guarantees receiving some additional benefit is known as Riba. But, unlike commercial banks that act as an economic enterprise, the central bank in all countries works as a government agency that seeks only to create monetary equilibrium condition in the business space without any profitability intention. Therefore, it can be concluded that using open market operation is a new phenomenon and it should be examined whether it is also subject to prohibition the same as the well known Riba. For this, we must first notice that none of the philosophies about Riba prohibition, expressed in Quran, apply to this matter. Secondly, this kind of interest is related to the role of money in the macroeconomic management that did not exist in the early period of Islam. In other word, lending and borrowing money by central bank in monetary policy mechanism has completely different goals and processes comparing with the traditional Qard contract that is subject to Riba.

Keywords: Islamic Economics, Central Bank Monetary Policy, Interest Rate, Open Market Operation, Riba Prohibition.

1. Introduction

Considering that the economic problems like inflation and unemployment exist in all countries, the importance of monetary policy and the necessity of its application to come over these problems is absolutely clear. One of the main tasks of governments in Islamic economics, like any other economic system, is to guide economic activities to maximize people's welfare using appropriate monetary policies. Muslim economists also acknowledge this fact. Chapra (1983) introduced the welfare increase, due to full employment and high economic growth, as the first goal of monetary policy in Islamic economic system. Then, considering the nature of Islamic economy, he expressed the other goals of monetary policy, which does not exist in conventional economics, as social justice and fair distribution of wealth.

In conventional economics, there are two groups of instruments for monetary policy. The first one is based on interest rate such as open market operation and discount rate and the second group directly controls the volume of money such as credit ceiling and legal reserve rate. The prohibition of Riba made Muslim economists to adopt two general approaches for monetary policy instruments.

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As the first approach, some Islamic scholars believe that the total focus in the Islamic economy should be on the group of instruments which control directly the volume of money. Chapra (1985) argued that the absence of interest rate in Islamic economics, and the existence of some institutions like Zakat, minimize the speculative demand for money and make total demand for money in Islamic economics more stable. In this way, demand for money in Islamic economics consists of only transaction demand and speculative demand. As a result of this kind of view point, Chapra (1985) suggested that in Islamic economic system, monetary aggregate instruments play the main role for executing monetary policy. Similarly, Mohamed Ariff (1982) believed that in Islamic economics, monetary policy should be executed through controlling stock of money and there is no need to use interest based instruments.

But the dominant approach among Muslim economists is that, despite the prohibition of interest rate, in order to achieve ultimate objectives of monetary policy, we could not rely only on the instruments which control the volume of money. Accordingly, Islamic economics should also use the common tools used in conventional economics, but in order to adapt these instruments by Islamic criteria, the interest rate should be replaced with some Shariah compatible contracts. In this approach, for adopting open market operation, central banks issue Musharakah and Mudarabah certificate, based on some projects or issue Sokuk on its physical assets. As we will discuss later, this approach has some limitations, since central bank has no commercial or production project to issue these kinds of certificates based on that project and also the physical assets of central bank is not too much for issuing adequate Sokuk required for monetary policy.

This paper proposes a new approach to monetary policy instruments which is more fundamental and different from the above two approaches. This paper attempts to demonstrate the nature of interest rate in the open market operation mechanism and shows that it is completely different from interest rate in the Qard³ contracts which is prohibited by Islam as Riba.

The remainder of this paper is organized as follows; Section 2 provides the exact introduction of Qard, and philosophies of Riba prohibition expressed in Quran. In Section 3, it will be shown that the interest rate used in the open market operation, in terms of applications and ultimate goals is completely different from what is prohibited by Shariah. Finally some concluding remarks are given in Section 4.

2. Qard and the Philosophy of Riba Prohibition

What is prohibited by Shariah as the Riba is borrowing with the condition of paying back some additional benefit⁴. The concept of Riba exists when Qard exists. Thus, it is important to study the meaning of Qard now and in the early Islamic ages. The definition of Qard in Islamic jurisprudence is "Transferring the ownership of an asset to another one with the grantee that he/she would pay it back" (Iravani, 1999). In fact, the main difference of sales and Qard is that, the transfer of asset in the sales is in exchange of its price while in Qard, it is in exchange of grantee to pay it back. There should not be any condition in Qard contract that push borrower to pay back something more than what he/she has borrowed. According to Islam, Qard is just

³ Debt

⁴ There is also another kind of Riba (Riba in transaction), which is not related to our discussion.

acceptable when the lender do that for the sake of Allah without any expectation to receive more and this kind of Qard is called Qard Al-hasan in Shariah.

Some Islamic scholars (such as Grand Ayatollah Saneie, 2009) provide two classifications for Qard: Consumption Qard and production Qard. If a person borrows for his consumption needs, he is using consumption Qard and if he used what he has borrowed for a production project he is using production Qard. These scholars believe that only consumption Qard is due to Riba prohibition since the production one is used to earn profit and interest on production Qard is nothing but a share of lender from the profitability of that production project. But according to the dominant view between Islamic economists, the production Riba is also prohibited by Islam since the lender is no longer the owner of money and so deserves no share from the profitability of production project.

Now, after a brief introduction to Qard as the key concept in Riba issue, we start to study the evidence of Riba prohibition expressed in Quran. There are seven verses in Quran which is about Riba⁵. To give a simple classification of these verses, we could say that there are three bad social effects in the Qard with Riba which cause this phenomenon to be prohibited by Quran. The first one is the oppression and injustice that has been expressed in 279th of Baghareh. It means pushing borrowers to pay much more than they had borrowed would defiantly cause the wealth transfer from poor to rich groups in the society. The second social effect of Riba which has been introduced in 276th of Baghare and 39th of Ar-rum is fading the goodness and decreasing the Qard Al-hasan in the Islamic society. In fact, Islam, by prohibiting the Riba, wants to lead Muslims to help their Muslim brothers just for the sake of Allah in the form of Qard Al-hasan. The third reason that Quran tells about Riba prohibition is stated in 161st of Al-Nisa, that as Riba income is earned without any effort, it keeps away people from doing economic valuable businesses. So, prohibiting the Riba is a way to encourage Muslims to entre real economic activities.

Now, we could ask the main questions of our discussion that we will focus on them during the next session. What is the concept and purpose of debt in the open market operation? When central bank borrows or lends in open market operation process, could we say that the Qard here is for consumption purpose or could we say that it is for financing the production projects? More important, which of the bad social effects of Riba do exist in central bank operation? Dose it cause injustice, leaving Qard al-hasan and economic depression?

3. Interest Rate in the Monetary Policy Mechanism from Shariah Perspective

The most important theoretical basis for adopting monetary policy, in conventional economics, is the Taylor Law. According to this law, which is currently used by the U.S. central bank for monetary policy, central bank first announces one interest rate as a target, then, tries to use monetary policy instruments such as open market operation to make market interest rate close to that target. The deviation of inflation and growth rates from the optimal ones in the economy are the most important factors in determining the target interest rate (Taylor, 1993). Accordingly, when inflation goes above the desired level, the central bank uses contractionary monetary policy

⁵ Baghareh; 275, 276, 278, 279. A'l-Emran; 130. Al-nisa; 161. Ar-rum; 39.

by raising the target interest rate and when economic growth rate is less than favorable one, expansionary monetary policy is applied by lowering the target interest rate.

Now it is obvious that to examine the interest rate used by central bank for its monetary policy from Islamic viewpoint, we must distinguish between two main subjects. These two subjects are target interest rate and the instruments that change the economic variables according to this target. The target interest rate itself is only a tool that is announced by central bank just for directing the economy to the equilibrium point and has got nothing to do with Qard to be subject to Riba. Even in Islamic economics, that interest rates does not exist in the similar way to conventional economics, still the target interest rate is announced by the central banks and help banks and financial institutions to determine the share of each parties in the profit of Musharakah contracts. Since in the Islamic economics, the relative share of capital owners and project manager in the Musharakah profit is one of the fundamental variables for determining the total investment in the economy, central bank adopts its monetary policy by changing this variable. When the central bank, during a contractionary monetary policy, announces higher target interest rate, it means that the banks and financial institutions should increase the share of capital owner relative to project manager in the profit; this means investment will be reduced which is exactly the goal of central bank. In fact, the target interest rate, which is announced by central bank, is nothing but an index that makes it possible for all the banking agencies to take an integrated measure for the realization of monetary policy.

For the second subject, we must evaluate whether the instruments that central bank uses to enter the target interest rate into the decision making process of investors and entrepreneurs for changing the direction of the economy, could be considered as a form of prohibited Riba? Here, to reach the appropriate conclusion, we examine the open market operation as the main instrument of monetary policy in a step by step analysis.

- (a) **Financing tools are different from policy making instruments.** As we discussed in the introduction, some Islamic scholars believe that it is possible for Islamic countries to apply monetary policy, using some Islamic finance instruments like Musharakah and Sokuk certificates. The important point here is that this kind of tools are basically designed for financing projects and it is not possible for central bank to use them for applying monetary policy. The first reason is that the central bank, in all countries, has no profitability goal to start or enter in the production projects and issue these certificates according to those projects. The second reason is that, if central bank dose have any project, issuing these certificates, collecting money and spending in that project is by no means a contractionary monetary policy since no decrease in the volume of money happen by this policy.
- (b) **Central bank has no production or consumption intention by borrowing and lending.** In the previous section, we mentioned that there are two types of Qard: Consumption Qard and production Qard. Actually when central bank borrows from people and banks during open market operation, the only purpose is to keep some volume of money away from the economy for some period and when lends to people and banks it does not lead to solve anyone's consumption needs or production needs. So, it is not far

from reality if we say that this kind of Qard in the central bank operation is different from the one that could be subject to Riba.

- (c) **Central bank securities and banknotes have the same place in the balance sheet.** Looking at the central bank balance sheet, we could find out that central bank securities that are issued for monetary policy, the same as the banknotes, are placed in the liability side of central bank balance sheet. Since banknotes are the medium of exchange, they could create demand for goods and services in the economy but central bank securities, as the other kind of liability, could not create demand. Accordingly, central bank, by selling and purchasing the securities during the monetary policy, exchanges one kind of liability to the other one to affect total demand in the macroeconomic space. This fact that central bank balance sheet remains unchanged during open market operation is the other reason for the natural difference of ordinary Qard with central bank operation.
- (d) **Interest on the central bank securities is just an incentive for the policy to be successful.** As was explained in the previous paragraph, open market operation, from central bank view, is nothing but changing one kind of liability to the other one to lead the economy to the optimal point. But, from the people and banks viewpoint, which are the other side of transaction, both banknotes and central bank securities are assets. But why should people in the society and banks, exchange one asset that has purchasing power with the other one without purchasing power, for free? Maybe they would, if they were nonprofit organization the same as central bank. So, from this viewpoint, interest rate on the central bank securities is just a tool to encourage other parties in the economy to help central bank for the realization of monetary policy. In fact, those who have helped this process to be successful, deserve this kind of appreciation and compensation.

These steps show us that the interest rate in the open market operation is basically different from the interest rate on the traditional Qard which is prohibited by Islam. Since, first, the nature of borrowing and selling in the open market operation is deferent from traditional Qard, Second, central bank does not seek any profit from this process that we could name it prohibited benefit on the Qard and third, since people and banks, by purchasing the central bank securities, depriving themselves from purchasing power of their assets, they are deserved to be appreciated and the interest rate here is nothing but a grant to encourage them to cooperate with central bank for applying monetary policy.

4. Conclusion

Open market operation is one of the main instruments of monetary policy which extensively used by central banks all over the world. Even central banks in Islamic countries, which believe that the open market operation in its original form is prohibited, use some Islamic finance instruments like Musharakah or Sokuk certificates for open market operation. However, since central bank has no profitability intention, it has no project to issue these financing certificates based on it. Moreover, if central bank does have any project, issuing certificates based on that, collecting money and spending in the project is by no means the contractionary monetary policy. So, this kind of policy making would be for sure unsuccessful in the Islamic countries.

What this paper tried to show was focusing on the fact that since monetary policy, as a new phenomenon, is related to the role of money in the macroeconomic management, we have to distinguish between interest rate in the open market operation and interest rate in the Qard contracts which is prohibited by Shariah. The reasons we discussed in this paper were (a) none of the philosophies of Riba prohibition expressed in Quran exist in the policy making process of central bank, (b) the target interest rate which is determined by the central bank is just an index that leads economic parties to act in the way that the intended policy works, (c) selling and purchasing the securities by central bank for the realization of policy targets, are basically different from the traditional borrowing and lending (Here we expressed several evidences like central bank seeks no profit, central bank has not production or consumption intention and there is no change in the total liability of central bank), (d) the parties who buy central bank securities are changing one type of their assets to the other type and lose some purchasing power in this process. These parties deserve compensation because they are contributing central bank to reach to its policy goals. Hence, we could consider interest on the central bank securities as a compensation for these parties.

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