

# **RESERVE REQUIREMENTS IN ISLAMIC BANKING SYSTEM: A CRITICAL SURVEY**

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## **Abstrak**

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*The discourse of westernization and liberalization had been spread to Muslim ummah nowadays. To decrease the impact of both problems, Muslim scholars seek for a solution called Islamization of knowledge. This effort took place in every sphere in human life, including economics, and specifically in banking sector. One concern in Islamization's effort on banking sector is reserve requirements policy, which the muslim economists have different opinions on it, between imposing fractional reserve requirements or 100% reserve requirements. In case of reserve requirements, muslim economists are divided into two major groups. The first, which represented by Umer Chapra, Nejatullah Siddiqi, MonzerKahf, Afzalurrahman and Mohamed Ariff, they saw that fractional reserve requirements is a right way for Islamic banking system. The reserve used for ensure bank's ability to fulfill its obligation to the depositors. In addition, it could be used by Islamic central bank as a tool of monetary policy to control money supply. The second, represented by Mabid Ali Al-Jarhi, Mohsin S. Khan, Abbas Mirakhor and Mahmoud Abu Saud recommend the use of 100% reserve requirements. According to them, fractional reserve system could suffer such an inherent instability. Over expansion of credit is often occurring this system that imply to unstable inflation. Their assumption is 100% reserve requirements will bring to more stable economy.*

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**Keywords :** *Reserve Requirements, Credit Creation*

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## Introduction

In this modern era, the liberalism and westernization has been a problem for the implementation of Islamic teachings, even in muslim countries. Beginning from the little aspect of life, such as food and fashion, until the big aspect such as economics, social justice and politic<sup>1</sup>, was affected by liberalism. In this condition, many muslims do not feel upset and uncomfortable, but they are enjoying it.

Nevertheless, many muslim scholars also pay attention to this problem. They begin to discuss the new discourse called Islamization of knowledge. Their aim is definitely the same, to bring back the glory to Islam and to realize Islamic civilization all over the world.

One of their discussions in Islamization of knowledge is about the Islamization of economics. An attention given to this term because it plays a big role in human life. The human definitely have a behavior in relation to scarce resources employed to satisfy ever increasing human wants<sup>2</sup>, so that this knowledge is very important.

One aspect of economics which attracts much attention in Islamization is banking. This financial intermediary institution has a big impact in human life. It distributes the fund from the surplus side to the deficit side. And its duty made a turnaround economic continuously. Hopefully with banking Islamization, the mankind can live in this world under the auspices of principles of sharia reduced from Al-Qur'an and As-Sunnah.

In spite of that, many people doubt the Islamization banking effort. They argued that the conventional bank impossibly modified into the Islamic bank. One of their reason is a reserve requirement that already

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<sup>1</sup> The liberalism in economic begun with the rise of *laissez faire* policy from the Scottish Adam Smith through his book *The Wealth of Nations*. From this point, capitalism had been developed rapidly and became an economic system in this world. In politic, the liberalism begun with the emergence of Montesquieu while he separated state power into three parts, executive, judicative and legislative. For further information, see Hamid Fahmy Zarkasyi, *Liberalisasi Pemikiran Islam: Gerakan Bersama Misionaris, Orientalis dan Kolonialis*, 1<sup>st</sup> edition (Ponorogo: CIOS Publishing 2008), p.26-27.

<sup>2</sup> Zubair Hasan and Habibah Lehar. *Macroeconomics*. 1<sup>st</sup> edition. (New York: Oxford University Press, 2009), p. 2

being a compulsory deposit of the commercial bank. Zaim Saidi<sup>3</sup>, one of dinar practitioner in Indonesia, said that the bank could not detach from the riba derived from *fractional reserve requirement*. Moreover, Ahamed Kameel Mydin Meera<sup>4</sup> said that fractional reserve requirements system is anti-thetical to Islamic Economics and Finance.<sup>5</sup> With this instrument, bank can create money above its real worth until twice from it.<sup>6</sup>

Related to this matter, many muslim scholars had been discussed in this problem. The International seminar on monetary and fiscal policy held on Mekkah was looking for the solution of the problem in economic. Some economists attended in that seminar are Umer Chapra, Monzer Kahf, Nejatullah Siddiqi, Syed Nawab Haider Naqvi, Muhammad Uzair and Mohammad Ariff. Each of them had their argument and had the solution to solve the problem of reserve requirement. There are some differences and similarities in their thought.

The discourse of reserve requirements was very old<sup>7</sup> and already begun since the western economics at 19<sup>th</sup> century, as Fisher as an economist who has a deep think in this case.<sup>8</sup> When Islamic banking system is introduced in the third-quarter of 20<sup>th</sup> century, the discussion of it also happens. Many seminars were held in order to discuss money, banking and monetary system in Islam, such the International seminar on the monetary and fiscal economics held in Mekkah under the auspices of the International Centre for Research in Islamic Economics

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3 Zaim Saidi is a founder and director of Wakala Induk Nusantara, the organization that established to produce dinar and dirham coin in Indonesia. He is very active in issuing dinar and dirham in Indonesia. He also wrote some books, such *Tidak Islamnya Bank Islam* and *Lawan Dolar dengan Dirham*.

4 Ahamed Kameel Mydin Meera is an expert in gold dinar. He is currently the Head of Finance Department, International Islamic University of Malaysia. He is an author of several books, such *The Islamic Gold Dinar* and *The Theft of Nations*.

5 Ahamed Kameel Mydin Meera. *Real Money*. 1<sup>st</sup> edition. (Malaysia: IIUM Press, 2009), p. 85

6 Zaim Saidi. *Tidak Syar'inya Bank Syariah di Indonesia*. (Yogyakarta: Delokomotif, 2010), p. 110

7 Muhammad Uzair, "Central Banking System in an Interest-Free System", in Mohamed Ariff (Ed), *op.cit.*, p.229

8 Milton Friedman in Zangeneh and Salam, *op.cit.*, p.29

King Abdul Aziz University at 1978.<sup>9</sup> This was a very early seminar discussed many aspects of monetary and fiscal policy, including reserve requirements. After that, many books and articles were written in this theme<sup>10</sup>.

After reading these articles, at least there are two groups of muslim economists in reserve requirements, both are fractional reserve requirements and 100 percent reserve requirements.

## **Fractional Reserve Requirements: a Modern Scheme**

Many muslim economists saw that Islamic banking system should use the fractional reserve requirements as a part of the integral system in Islamic banking. The economists such as Umer Chapra, Nejatullah Siddiqi, Afzalurrahman, Monzer Kahf etc have explained about this system, what is fractional reserve requirements, why we should use fractional reserve requirements and how it imply to the Islamic banking system.

### **1. The fractional reserve ratio: more and less**

According to Chapra, the central bank only obligates the commercial banks to keep the reserves from around 10-20 percent from their total deposits.<sup>11</sup> He argued, by keeping those fractions of their total deposits, the Islamic commercial banks could ensure the safety of deposits and the adequate liquidity of banking system.<sup>12</sup> By requiring those fractions also, they can provide a withdrawal facility for *mudarabah* deposits before their maturity, as well as their conventional counterparts. According to Afzalurrahman, the fund kept as a fractional reserve could be used to meet the daily cash requirements of the depositors,

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<sup>9</sup> This seminar discussed many aspects of Islamic monetary and fiscal economics, such as monetary and fiscal policies, both tools, money, banking etc.

<sup>10</sup> The example of these books is Towards a Just Monetary System by Umer Chapra (1995), Riba, Bank Interest, and Its Rationale to Its Prohibition by Nejatullah Siddiqi (2004), etc.

<sup>11</sup> M Umer Chapra. *Towards a Just Monetary System*. (United Kingdom: The Islamic Foundation, 1995), p. 198

<sup>12</sup> *Ibid.*, p. 198

including saving deposits and demand deposits.<sup>13</sup>

In case of deciding the ratio of its, Siddiqi has a statement related to this matter. He said the introduction of demand deposits created by the banking system through reserve requirement, will introduce a potential source of instability.<sup>14</sup> Therefore, the larger the ratio of reserve requirement that can create demand deposits on the liabilities side, the more the vulnerability of the system to liquidity problems and threats of bankruptcy.<sup>15</sup>

In order to decide the ratio of reserve requirement used in a country, Siddiqi offered to first recapitulate the relative stability of the Islamic Financial system, which consists of five main grounds, which will be explained in the next chapter.

## **2. Credit creation in fractional reserve requirements: why it should be**

Chapra saw that credit creation also could be happened in Islamic banking system<sup>16</sup>, as well as Siddiqi<sup>17</sup> and Kahf<sup>18</sup>. Chapra argued that the use of fractional reserve that imply to credit creation in Islamic banking system is allowed, because by the control from the central bank, it can increase the amount of economic growth through productive financing.<sup>19</sup>

Kahf also agrees with the credit creation from fractional reserve requirements. He argued that credit creation is one tool of monetary policy to control money supply in the society. By this policy, the central bank could influence the production and stimulate recovery while the society was in unemployment and idle production.<sup>20</sup> Siddiqi added

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13 Afzalurrahman. *Banking and Insurance*. Vol.4, 1<sup>st</sup> edition, (London: The Muslim Schools Trust, 1979), p. 370

14 Mohammad NejatullahSiddiqi, *Riba, Bank Interest and The Rationale of Its Prohibition*, 1<sup>st</sup> edition (Jeddah: Islamic Research and Training Institute, 2004), p. 97

15 *Ibid.*, p. 97

16 Chapra, *op.cit.*, p. 193

17 Siddiqi, *op.cit.*, p. 97

18 Email from MonzerKahf (monzer@kahf.com) on Monday, July 2, 2012 at 4:46 pm

19 Chapra, *op.cit.*, p. 93

20 Kahf."Fiscal and Monetary Policies in Islam".*loc.cit.*, p. 136

an argument. He saw that the inflation in Islamic country may be happened. And for solving this problem, he said the supply of money needs to be curtailed by fractional reserve requirements.<sup>21</sup>

In this regard, Siddiqi saw the debts could be used as money. He argued that the debts created in Islamic banking system have principal differences with debts created in conventional banking system. Even there were many economists forbid these transaction, such they only allowed the debts for transferred at par at their face value, he hold firmly of his opinion. In Islamic banking system, debts are created based on real assets, or called also based on commodity transactions<sup>22</sup>, while the latter are created by only lending money and no-based real assets, or called in other word, created from *nothing*.<sup>23</sup> This fact suddenly brought the significant different implication, whether the first leads the debts into more stable condition compared by the latter.<sup>24</sup> But in his view, the debts only could be used at best as an inferior substitute for money is Islamic economy.<sup>25</sup>

Ariff added the reason of using fractional reserve requirements to create credit. He said that the idle fund from demand deposits should be used for investment or financing, because Islam has forbidden the hoarding, and hoarding condition should be created from savings or demand deposits that are not transformed into investment.<sup>26</sup> Although there are also investment deposits, Ariff saw that saving and investment decisions for muslim society is not completely independent, but are, to a large extent, interdependent in Islamic economy.<sup>27</sup>

However, the economic instability from fractional reserve requirements is still having such a huge attention from muslim economists. Chapra argued that multiplier effect of credit creation could

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21 Siddiqi, *op.cit.*, p. 129

22 Siddiqi, *op.cit.*, p. 99

23 FriantoPandia, S.E., EllySantiOmpusunggu, S.E., AchmadAbror, S.E., *op.cit.*, p. 11

24 Siddiqi, *op.cit.*, p.99

25 *Ibid.*, p. 99.

26 Mohamed Ariff, "Monetary Policy in an Interest-Free Islamic Economy, Nature and Scope", in Mohamed Ariff (Ed), *op.cit.*, p. 295.

27 *Ibid.*, p. 295.

happen in this system, but he insisted that the economic instability could be reduced by social welfare-oriented value system of Islam<sup>28</sup>, and then establish the welfare state<sup>29</sup>, as well as Siddiqi said.<sup>30</sup>

### **3. Monetary stability under fractional reserve system**

According to Chapra, the Islamic central bank must play a more active and positive role. He must be innovated in supervising and try to achieving social welfare state through appropriate guidance, selective credit controls, incentives, penalties and intervention.<sup>31</sup> By fractional reserve requirements, Islamic central bank may be possible to bring about a contraction of credit and vice versa by raising or decreasing it ratio.<sup>32</sup> If he could establish this function correctly, the credit creation that imposed by reserve requirement in banking system will be no danger, or in another word, could avoid such an inherent instability.

For the case of establishing welfare state<sup>33</sup>, Chapra said that every policy made by a government, or the central bank in this case, must be the social welfare-oriented value system of Islam.<sup>34</sup> They must pay attention to the poor and needy people that often forgotten by the “privileged” persons in this era that rarely use their heart and put in front their egoism, that affected by capitalism. In this case, the power to create money should be considered a social prerogative and for the sake of the poor and needy people.

According to him, at least there are two ways to make the social welfare-oriented value system of Islam from the credit creation, and also to make a good decision to set a reserve requirement ratio that

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28 Umer Chapra, *Islam and the Economic Challenge*, 1<sup>st</sup> edition, (USA: The Islamic Foundation: 1992), p. 55.

29 *Ibid*, p.54.

30 Muhammad NejatullahSiddiqi, “Islamic Approach to Money, Banking and Monetary Policy, A Review”, in Mohamed Ariff (Ed), *op.cit.*, p. 29.

31 Umer Chapra, “Monetary and Fiscal Economics of Islam”,in Mohamed Ariff (Ed), *op.cit.*, p. 172.

32 The email from Umer Chapra ([MChapra@isdb.org](mailto:MChapra@isdb.org)), at Tuesday, June 26, 2012 at 7:57 pm

33 Umer Chapra, *Islam and the Economic Challenge*, 1<sup>st</sup> edition, (USA: The Islamic Foundation: 1992), p.54.

34 *Ibid.*, p. 55.

support that aim.

Firstly, the credit created by Islamic commercial banks, should be used for broad-based economic welfare.<sup>35</sup> The meaning of this argument is, the Islamic commercial banks must try to spread the credit among the needy people of the mass of the society as wide as possible. By expanding the credit toward them, the allocation of credit, or could be said here allocation of money, can be more prevalent among the society. For this aims, the central bank must provide the reserve requirement ratio according to the society's necessitate.

Secondly, the total of derivative deposits should be considered as *mudarabah* advances to the commercial banks.<sup>36</sup> That means, the credit expansion by the Islamic commercial banks must be concentrated in *mudarabah* financing, not in *murabahah*that provide the customers to be consumer credit and loans.<sup>37</sup> The rationalization of that is the incomes from the mechanism of credit created by banking system, should be passed on to the state after allowing for *mudarabah* share of commercial banks, according to the formula in a state.<sup>38</sup> Afterward, the incomes from this mechanism should be used by the government to increase social welfare projects that benefit the poor men, as regulated in Al-Qur'an.<sup>39</sup>

Siddiqi also agreed with Chapra's opinion. In his view, the social wealth must be only aim in deciding reserve requirements policy. He said that the credit must be created to the extent that can made genuine possibilities of creating additional social wealth, and that aim only could be reached by such productive enterprise<sup>40</sup>, such as *mudharabah*, *musyarakah* etc.

So for reaching the aims of social welfare, the Islamic banking system must keep the stability of economy. And in order to keep the

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35 Chapra, *Towardsa Just Monetary System*, op.cit, p. 93.

36 *Ibid.*, p. 93.

37 Chapra, op.cit., p. 130.

38 *Ibid*,p. 93

39 QS. 59:7

40 Muhammad NejatullahSiddiqi, "Islamic Approach to Money, Banking and Monetary Policy, A Review", in Mohamed Ariff (Ed), op.cit., p. 29

stability of economy, Siddiqi offered first recapitulate the relative stability of the Islamic Financial system, which consists of five main grounds, these are:

1. Equivalence of payment obligations and revenue accruals.
2. Synchronization between revenue accruals and payment obligations.
3. Capability to absorb real shocks to the economy through appropriate changes in the cost of capital.
4. Supply of new money being directly related to the possibilities of creating new wealth.
5. Admission of foreign direct investment on profit-sharing basis.<sup>41</sup>

By completing those requirements, the economic condition will be more stable than what happened in conventional system. Even there is a fact that the introduction of debts as one of the assets as well as in liabilities side will decrease the pro-stability aspects in economic, but the possibilities of additional total production in economic system have been increased, and will be much more better than what happened in conventional system.<sup>42</sup>

The other function of central bank is to maintain the commercial banks the lender of last resort, and the central bank is deserved to be an institution with this function. As the Islamic bank is an interest-free bank that uses the profit-and-loss sharing system, the risk that happened in them probably bigger than which is faced by their conventional counterpart, because it is difficult to predict the cash flow of the customers whose lend the money from the Islamic banks. Therefore, statutory reserve is extremely important for Islamic banks, and in crisis condition, the central bank is allowed to exceed the limit of reserve requirement required before, for the sake of the commercial banks.<sup>43</sup>

Kahf has a special thought considered any other economist. He said that the credit policy made by the Islamic central bank could be

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41 Siddiqi, *Riba, Bank Interest*, op.cit., p. 100

42 *Ibid.*, p. 100

43 Chapra, op.cit., p. 199

influenced by *zakah* fund. Through the *zakah* fund, an inflow of income comes from *zakah* payers and an outflow of disbursement goes out to recipients.<sup>44</sup> From this fund, the credit expansion is could be increased and bring to the economic growth in a country.

By imposing *zakah* fund, Kahf restrains the use of demand deposit in the banking system, and by this function, the *zakah* fund may not only distribute the *zakah* receipts, but also by playing a role similar to that of the commercial banks in creating money. And by using this statement, Kahf saw that the monetary policies could be created by the authority of the central bank related to the changes of credit created by the *zakah* fund<sup>45</sup>, and therefore, this kind of policy can influence the ratio of required reserve that the Islamic commercial banks must keep in the central bank.

In case of multiplier effect of credit in fractional reserve requirements, Chapra has an explanation about it. He admitted that the multiple credit expansion that happened in conventional commercial banks may also happen in Islamic commercial banks, hence the total assets of Islamic commercial banks are several times of its capital. To reduce its impact, the interest-free system that used by Islamic banks are rarely beneficial, because the multiple effect is still bigger than what has happened in other businesses.<sup>46</sup> But, in another side, the absence of interest would be an advantage, because it will remove the destabilizing effect of fluctuating interest rate, stabilize the demand for money and reduce the economic fluctuation.<sup>47</sup>

In Siddiqi's thought, even the interest-free system is still having a huge risk, or in another word, the risk is not too far with the risk in conventional banking system. Therefore, to reduce the risk from the debts creation, Siddiqi offers a solution; it is by giving addition in ratio between money supply and production possibilities. By increasing the ratio between both side, default risk could be reduced, and by

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<sup>44</sup> MonzerKahf, "Fiscal and Monetary Policies in an Islamic Economy", in Mohamed Ariff (ed). *op.cit.*, p. 136

<sup>45</sup> *Ibid*, p. 137

<sup>46</sup> Chapra, *op.cit.*, p. 94

<sup>47</sup> *Ibid*, p. 194

keeping both side in harmony, it could avoid inflation and deflation may occurred from this system.<sup>48</sup> Although he has such a thought, he insisted there is no need to use 100% requirement in Islamic economy system, even there are some offering from some Islamic economists to avoid these risk by using it, Siddiqi insisted that, as there is no evidence yet to the effectiveness of using this policy.<sup>49</sup>

## **100 Percent Reserve Requirements**

Many muslim scholars saw that the Islamic banks must keep their reserve up to 100% from their total deposits. Some muslim scholars who has such this thought are Mabid Ali Al-Jarhi, Mohsin Khan and Abbas Mirakhor.

### **1. 100% ratio: separation between demand deposits and investment deposits**

As the opening statement, the muslim economists said that there must be a separation between demand deposits and investment deposits in 100% reserve system. Jarhi insisted the total separation between demand deposits and investment deposits, and he required for the former to 100% reserve requirements.<sup>50</sup>

Khan has some argument, with demand deposits should have a 100 percent reserve requirement placed on them, with the backing being in the form of currency, foreign exchange, or suitable government securities.<sup>51</sup> In contrast with the investment deposits, he said that there is no need to the bank to provide guarantee on their nominal value, and they would not pay a fixed rate of return. In this case, Khan, as well as Mirakhor, saw the customers as banks' shareholders, and the implication was, they will earn the profit while the banks got the profit

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48 *Ibid.*, p. 194

49 Siddiqi, *op.cit.*,p.100

50 Mabid Ali Al-Jarhi, "Remedy for Banking Crises: What Chicago and Islam Have In Common: A Comment", in *Islamic Economic Studies*,(Vol. 11, No. 2, March 2004), p. 24

51 Mohsin S Khan and Abbas Mirakhor, "The Financial System and Monetary Policy in an Islamic Economy", in *JKAU: Islamic Econ.*, (Vol. 1, 1409/1989), p.42

by profit-sharing ratio, and vice versa, if the bank's operations resulted in an overall loss, than the customers also had to bear that losses.<sup>52</sup> It is desirable to develop instruments that can provide the investors with sufficient degree of liquidity, security, and profitability.<sup>53</sup> In this case, Jarhi added the other requirements in investment deposits. He said that the banks could guarantee the losses from its operation, as if there were a negligence or unethical behavior on the part of transactions.<sup>54</sup> As the conclusion, there is no need to guarantee the investment deposits, as some western economist required<sup>55</sup>, for the profit and loss sharing ratio used for this product, and whether the bank in profit or in loss, the investment deposits holder must bear that, except there was a moral hazard in the transactions.

From above arguments, the Islamic banks could operate such a narrow banking. Jarhi said that the Islamic banking has some similarities compared with narrow banking.<sup>56</sup> He insisted the total separation between demand deposits and investment deposits, and then subjecting the former to 100 percent reserve requirement for stability reasons in one hand and to meet absolute guarantee of demand deposits. This matter is also happened in narrow banking system, as it separates both demand and investment deposits. This similarity also strengthened by some economists<sup>57</sup>, that the demand deposits, which perfectly guaranteed in Islamic financial system, and the investment deposits, which financed through the potentials investment, are similar to mutual share funds.

However, narrow banking system is not totally as same as Islamic banking system; even both systems guaranteed the demand deposits by 100 percent requirements. An Investment banks' activity is included also in Islamic bank, and the investment practiced in the Islamic bank

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52 *Ibid.*, p. 42

53 Mohsin S Khan and Abbas Mirakhor, "Monetary Management in an Islamic Economy", in *J. KAU: Islamic Econ.*, (Vol. 6, 1414/1994), p. 3

54 Jarhi, *op.cit.*, p. 38

55 The Chicago plan has required to the banks to hold 5% from their investment deposits. See Jarhi, *Ibid*, p. 32

56 *Ibid*, p. 24

57 The economists are Garcia, Marino and Cibils. See Jarhi, *Ibid*, p. 24

is totally different with the practice in conventional investment bank, as the former uses the profit and loss sharing in its application, and the latter uses the interest-based system to get the return from it. This system also occurred in the future and option markets.<sup>58</sup>

## **2. The abolition of fractional reserve: the rationale of credit creation abolition**

This section is begun with the suggestion from Jarhi. He suggested the abolition of fractional reserve requirements. According to him, the fractional reserve caused the monetary system to suffer from an “inherent instability”.<sup>59</sup> After that, Jarhi explained that the demand deposit that created by banks re considered as loans that must be paid on demand.<sup>60</sup> Khan defined it as *Amana* (safe keeping) and must be backed by 100 percent reserves, and caused of that, the demand deposits could not be used as the basis for money creation through the fractional reserves process.<sup>61</sup>

Besides that, Jarhi has other statement to strengthen his argument in abolition of fractional reserve requirements. He saw that the fractional reserve requirements provide the commercial banks to create money through derivative deposits and then get the interest from it.<sup>62</sup> This condition will leave unjustifiable redistribution from the public to banks shareholders. With those conditions, the banks shareholders will gain the huge interest from money creation caused by the fractional reserve requirement, and vice versa, the customers will get the huge loss derived from this system.<sup>63</sup> By suggesting 100 percent reserve requirement, Jarhi has abolished the banks’ ability in issuing demand deposit as money.<sup>64</sup>

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58 Jarhi, *Ibid*, p. 39

59 Mabid Ali Al-Jarhi, “A Monetary and Financial Structure for an Interest-Free Economy: Institutions Mechanism and Policy”, in Ziauddin Ahmad (eds). *Money and Banking in Islam*. (Jeddah: Institute of Policy Studies, 1983), p. 75

60 Jarhi, Remedy for Banking Crises, *op.cit.*, p. 37

61 Khan and Mirakhor, Monetary Management.*op.cit.*, p. 8

62 *Ibid.*, p. 8.

63 *Ibid.*, p. 8.

64 Jarhi, Remedy for Banking Crises,*op.cit.*, p. 37.

He argued, as said by some economists before him<sup>65</sup>, the approach presented here suggests that adding real balances to the existing stock is more costly than just operating a printing machine. The central bank, however, has to watch the price stability while in the same time it has to increase the economic growth. The customers, as well as traders, will require assurance on their relative prices of money and its future development. Therefore, this process of “asset characterization” is costly.<sup>66</sup>

By using 100 percent requirements, the more stable economic condition will be reached. Khan saw it from the eliminating any difference between the monetary base and the money supply, thus making the money multiplier equal to unity, and then make this system made the banks very liquid.

Jarhi saw the benefits from seigniorage. He argued that the direct benefits of it should be given to the public sector, not only to the few numbers of banks' shareholders. In a fractional reserve system, the seigniorage should be given to only a few numbers of banks' shareholders and there is no any return to the society. By using 100 percent reserve system, Jarhi said that the redistributes of wealth will be more evenly, because the seigniorage will be first taken by the government than redistribute it to the whole society in a country.<sup>67</sup>

### 3. Economic growth under 100% reserve system

By imposing 100% reserve requirements, some muslim economists have abolished the use of reserve requirements as a tool of monetary policy in order to control money supply. In spite of that, there were many other tools available to give the Islamic central bank its authority to make monetary policies.

According to Khan, the Islamic central bank could operate in an Islamic framework by at least two main purposes. The first is to

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65 There are some person who has an impact in his opinion about this argument, such as Mints, Tolly, Friedman P Samuelson and Tobin. For further details, see Mabid Ali Al-Jarhi, "A Monetary and Financial Structure for an Interest-Free Economy: Institutions Mechanism and Policy", *op.cit.*, p. 75.

66 *Ibid.*, p. 75.

67 Jarhi, Remedy for Banking Crises,*op.cit.*, p. 38.

allocate resources in conformity with the priorities of society, and the second is to direct monetary policy towards specific goals<sup>68</sup>, such as redistribution of wealth and economic stability.

For the tools, Khan suggested some methods. Purchasing equity shares of not only the banks but also of other financial institution, as its role as a leader in initiating and evolving primary, secondary and money market.<sup>69</sup> Besides, he also agreed with the central bank's role as a lender of last resort<sup>70</sup>. Through performance of regulatory, supervisory and control fluctuations, the Islamic central bank can continue to exert substantial influence on the financial system. There are also opportunities for the Islamic central bank to invest directly in the real sector on a profit sharing basis, as well as to take opportunities to take equity positions in joint ventures along with other banks.<sup>71</sup> The Islamic central bank also allowed buying and selling securities in the financial market<sup>72</sup>, or in another word, to perform open market operations, as long as those securities do not have par value features and a non-zero coupon rate.<sup>73</sup>

Abu Saud has already aware with the implication of 100% requirements to the monetary authorities. At first, he assumes that money-holders would prefer to hoard their money whose carrying cost is relatively low. And then, the obligation for the monetary authorities in such condition is to provide banks with quantities equivalent to demand deposit plus the would-be-created money, in order to meet the demand for current transactions and new capital goods.<sup>74</sup>

In order to manage the demand deposits, that also could be called "hoarded-money", Abu Saud suggests the use of *zakahto* manage them. He said that demand depositors, as a money-holder, must pay an amount of *zakah*. The money from *zakah*, therefore could be used for developing public wealth. The fund obtained from *zakah* could be used

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68 Khan and Mirakhor, The Financial System. *op.cit*, p. 46.

69 Khan and Mirakhor, Monetary Management. *op.cit*, p. 17-18.

70 *Ibid.*, p. 17-18.

71 Khan and Mirakhor, The Financial System. *loc.cit.*, p.46.

72 Khan and Mirakhor, Monetary Management. *loc.cit.*, p.18.

73 Khan and Mirakhor, The Financial System. *loc.cit.*, p. 46.

74 Mahmoud Abu Saud, Money, Interest and Qirad, in IIUM Journal of Economics and Management 10, (no.1. 2002), p. 20

for the entrepreneur whom should borrow the money to the banks for his business. Beside, the fund also could used by the government to if it need the liquid fund for the sake of public interest.<sup>75</sup>

Jarhi has a unique idea related to this case. He suggested the Islamic banking system to provide such a universal banking. He argued, the commercial banks could not expand their credit to the society widely because the amount of credit created by this system is very limited. For solving this problem, Jarhi offered the concept of universal banking as a main component in Islamic banking.<sup>76</sup>

Universal banking had been introduced by some Islamic economist as one of main components in Islamic banking, including Jarhi. They argued that Islamic banks provide finance to enterprises through either sharing directly their profit in their activities or financing their purchases of assets, goods and services by credit creation.<sup>77</sup>

By applying the universal banking, Islamic banks can get some benefits that cannot happen in commercial banking. They can use the information obtained from their vantage point to reduce risk from information asymmetry that could produce moral hazard and adverse selection<sup>78</sup>, and to accomplish their finance directed to the same corporation. In addition, they can operate such a financial institution provides credit, as well as they can be an insurance institution, trader goods and service and a financial markets' institution.<sup>79</sup> Another advantage, by using universal banking system, banks are sitting on the firms' board director. Therefore, banks can influence corporate governance in the whole productive sector, leading to macroeconomic growth as a whole.<sup>80</sup>

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75 *Ibid*, p. 25-28

76 Mabid Ali Al-Jarhi, The Case for Universal Banking as a Component of Islamic Banking, on *Islamic Economic Studies*,(Vol. 12, No. 2 & Vol. 13, No. 1, February & August 2005), p.1

77 *Ibid*, p.1

78 Mabid Ali Al-Jarhi and Munawar Iqbal, *Islamic Banking, Answers to Some Frequently Asked Questions*, (Occasional Paper No.4), p. 35

79 *Ibid*, p. 2

80 *Ibid*, p. 35

Besides, Jarhi also examined the possibility of Islamic finance's ability to adopt an Integrated Financial Services Provision (IFSP) or integrated banking. He suggested that IFSP has the similar rule with universal banking, with the different institution. The main function is no different with the universal banking, as both are able to access the information, control the financial institution etc.<sup>81</sup>

However, having such support from universal banking, Islamic finance will grow rapidly and better than the commercial bank system. Therefore, Jarhi recommended that Islamic banks must pay more attention to incorporating universal banking in their practice<sup>82</sup>, for reaching more stable economic and equity.

## **Towards an Economic Growth and Monetary Stability**

From above explanation, the researcher found the advantages and disadvantages from each idea, whether fractional reserve requirements or 100% reserve requirements. In this section, the researcher should offer the ideal solution in case of reserve requirements.

As known before, the main function of reserve requirements is to ensure the safety of customers fund in commercial banks. If the customer wants to withdraw his money from the bank, bank could provide it and fulfill its obligation to the customer. Besides, reserve requirements could be used also as a tool of monetary policy, especially to control money supply. It could control money supply through a process that create demand deposit, then this demand deposit given to the customer as a credit and used for medium of exchange, or could be said, used as money.

Credit creation happened in commercial banks is benefit for the sake of redistribution of wealth. By credit, the debtors could fulfill their need in their daily life. By credit creation, they can develop their business through *mudharabah* and *musyarakah* accounts. In another word, the credit creation brings the economic growth to the society.

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81 Jarhi, "The Case for Universal Banking as a Component of Islamic Banking", *loc.cit.*, p. 48

82 *Ibid.*, p. 48

Therefore, the researcher saw no danger in using fractional reserve requirements in Islamic banking system, because this policy has more benefits than disadvantages. In spite of that, the researcher admits that an over expansion in credit creation could suffer the monetary economics by such an inherent instability. To reduce the risk from that, the researcher offers to keep a larger ratio in reserve requirements.

The role of central bank in Islamic banking system is more than the role of it in the conventional system. Since the abolition of interest, Islamic commercial banks are more risky, because there is no fixed-rate return like their conventional counterparts. Therefore, the role of central bank as lender of last resort is very important. To control money supply, Islamic central bank could use open market operation policy.

For the last objection, universal banking should be added to Islamic banking system. By establishing universal banking, the banks could get the valuable information from expanding their products, and also can reduce the number of moral hazard among the customers. After those conditions, the more economic growth will be achieved, as well as the monetary stability.

## **Conclusion**

First of all, the researcher concludes that fractional reserve requirements according to muslim economists such Umer Chapra, Nejatullah Siddiqi, Monzer Kahf, Afzalurrahman and Mohamed Ariff is not so far with the fractional reserve requirements in conventional system, which means the central bank obligates the commercial banks to keep fraction of the reserves from their total deposits, not only from demand deposits. Besides, 100% reserve requirements according to some muslim economists such Mabid Ali Al-Jarhi, Mohsin S. Khan, Abbas Mirakhor and Mahmoud Abu Saud is the obligation of commercial banks to keep 100% of their total demand deposits. Therefore, they insist the separation between demand deposits and investment deposits, which required for the former 100% reserve and the latter required no reserve.

Secondly, muslim economists that saw the fractional reserve requirements argued that the fractional reserve requirements, which could create credit, can redistribute the wealth for the needy people. Besides, the fractional reserve requirements could be one of monetary policy used to control money supply in a country. For control the credit creation, the orientation of credit by the commercial banks must be social-welfare value oriented. In spite of that, muslim economists that saw the 100% reserve requirements argued that demand deposits is customers *amana*, and commercial banks must keep that *amana* in their hand. Besides, fractional reserve requirements could suffer the economic condition to such inherent instability and 100% reserve requirements could bring to more stable economic condition.

Thirdly, some muslim economists saw that fractional reserve requirements could run in Islamic banking system with more active role of the central bank as its role as the lender of last resort. Credit creation in Islamic banking system must be social-welfare value oriented for the needy people, therefore the credit must be focused to productive financing, such *mudharabah* and *musyarakah*. Besides, they impose the use of *zakah* fund to add the amount of credit. So, the other muslim economists saw that 100% reserve requirements could run in Islamic banking system by separating demand deposits and investment deposits. Therefore, to replace the fractional reserve requirements as a monetary tool, they suggest the use of open market operations based on interest-free system. For the case of credit creation, they imposed the use of *zakah* taken from hoarded-money for the sake of needy people. At last they suggest the establishing of universal banking as one of main components of Islamic banking system.

At last, here are some suggestions from the researcher:

1. The researcher suggests the use of fractional reserve requirements by a larger ratio to reduce an over expansion in credit creation.
2. The researcher also suggests the use of *zakah* fund to control the amount of demand deposits.
3. Besides, the use of open market operation in Islamic monetary system is available. That's all are for reaching such a more monetary

- stability in Islamic welfare state, as well as an economic growth.
4. Everyone who has any interest in this research, to extend it and to look for more opinions from muslim scholars in case of reserve requirements.

All muslim to learn more and study hard to find the best concept for muslim life for reaching *fiddunya hasanah wa fil akhirati hasanah*. *Wallahu a'lam bish-shawab*.

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