CREDIT CREATION BY CONVENTIONAL BANKS AND ISLAMIC BANKING SYSTEM

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ABSTRACT

All the conventional banks have been vigorously flourishing with their bedrock – interest. On the other hands, the Islamic banks have also been thriving by making their transactions without, charging or offering, interest because interest is prohibited in Islam. Conventional system of banking has been successfully using the tool of Credit Creation for making money and for controlling money market. But it is still a controversial or unresolved issue how the Islamic Banks can create credit and control the money market. Creating credit is not un-Islamic but the concern is how the Islamic Banks have been creating and utilizing it. This paper explores this aspect of Conventional Banking System with respect to Islamic Banking System.

1. INTRODUCTION

Generally it is believed that no financial institution can be functional without charging interest on lending money and offering interest on savings and other transactions. It is reckoned as the backbone of conventional banking and whole economy revolves round interest. The commercial banks create credit by providing loans and encourage their customers to save their money with them and they adopt devices by manipulating the rate of interest on savings and loans. But it is well known that the Islamic System strictly prohibits interest (Riba) as Allah (SWT) says: “O you who believe! Be mindful of God and give up what remains of al-riba (interest) if you are believers. If you do not do so, then receive a declaration of war from God and His Messenger. But if you repent, you shall have your capital sums (ru`us alamal). You do not deal unjustly and you are not dealt with unjustly” (Surah al-Baqarah, 2:278-279). The making of loans without additionality (charging interest), leads to inflate lending assets beyond what is actually available for loaning and leniency in demand for repayment are highly encouraged in Islam. Similarly the non-repayment of loans is condemned harshly by the Prophet (peace and blessings be upon him) by refusing to lead the funeral prayer of such individuals, (Islamic Thinker Society, 2011) or replying to their salutations.

The Islamic banking and finance sector has been increasing its valuable market share day by day in global finance industry. Today, over 300 Islamic banks and finance organizations have been successfully running their businesses from Dubai, Los Angeles, London, Karachi, Jakarta, Cairo, Riyadh and many other cities in the world. Total assets of all these are well in reach of the milestone of $ 400 billions. (Bakhsh, 2011) HSBC bank launched its branches as “HSBC Amanah”
in some parts of the world. It is the global Islamic financial services business of the HSBC Group. It was established in 1998 with the aim of making HSBC the leading provider of Islamic financial services worldwide. With established and successful operations in the Middle East, Asia-Pacific and Europe, HSBC Amanah represents the largest and most comprehensive Islamic proposition of any international bank. (HSBC Bank, 2011)

2. CREDIT CREATION IN CONVENTIONAL BANKING SYSTEM

Credit creation is the multiple expansion of banks demand deposits and investment skills and this manipulation is one of the strong imperative tools of the Conventional Banking System. It is an open secret now that the banks advance a major portion of their deposits to the borrowers and keep smaller part of the same to meet the customers’ demand. The customers of the banks have full confidence that their deposits are lying safe in the banks and can be withdrawn easily on demand. The banks take advantage of this trust of their clients and expand loans by much more in ratio than the amount of deposits possessed by them. This tendency on the part of the commercial banks to expand their demand deposits as a multiple of their excess cash to attract more money is called creation of credit.

Credit Creation is the main activity of conventional Banks. This enables the bank to create credit with the savings available with it. The process of 'Credit Creation' begins with banks lending money out of primary deposits. Banks cannot lend the entire primary deposits as they are required to maintain a certain proportion of primary deposits in the form of reserves with the RBI, as laid down under RBI and Banking Regulation Act. After maintaining the minimum reserves, the bank can lend the remaining portion of primary deposits. (Panwar, 2010) Banks from their experience know that all depositors would not withdraw their deposits simultaneously at a particular time. They keep a minimum amount of deposits as reserves and lend the remaining sum charging interest. Depositors feel sure of the bank promises to pay them back whenever they need money. The bank is thus able to erect a superstructure of credit on the basis of a small cash reserve. It is to be noted that the bank while lending money normally does not part with cash; it simply creates a deposit in the name of borrower from which the borrower may withdraw whenever he requires money and everything is done on paper. It is assumed that the borrower does not use full credit at a time. This leads to the creation of credit. (Bhutani, 2008) Further, a single bank or few banks cannot create credit alone. It is the whole banking system which can expand loans by many times in excess of its cash reserves. The loan advanced by a bank becomes the gain of deposit by some other bank. Loans thus make deposits and deposits make loans. (Abdullah, 2011)

2.1 PROCESS OF CREDIT CREATION IN CONVENTIONAL BANKING SYSTEM

As discussed above, the process of 'Credit Creation' begins with banks lending money out of their primary deposits. Here is an instance to illustrate the process of credit creation. Suppose there are a number of Commercial Banks in a Banking System – Bank A, Bank B, Bank C, and So on. A customer of the bank, Mr. V has deposited Rs. 1000 in the Bank A. The bank has to keep a mandatory deposit (CRR) out of its primary deposit and only remaining amount can be used for its commercial purpose. Assuming that the prevailing Cash Reserve Ratio (CRR) is 8%,
the Bank pays Rs. 80 in the Central Bank and lends Rs. 920 to Mr. X (a customer or institution). Then the balance sheet of Bank A at the end of this transaction will show:

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>Amount</th>
<th>Assets</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mr. V deposit</td>
<td>1000</td>
<td>CRR</td>
<td>80</td>
</tr>
<tr>
<td>Loan to Mr. X</td>
<td></td>
<td></td>
<td>920</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>1000</td>
<td><strong>Total</strong></td>
<td>1000</td>
</tr>
</tbody>
</table>

Mr. X then uses Rs. 920, taken as loan, to make some outstanding payments or to purchase something. The receiver of this money, say Mr. Y, will deposit this amount in Bank B. Now Bank B has Rs. 920 as its primary deposit. It will keep Rs. 73.60 with the Central Bank as CRR and lends remaining Rs. 846.40 to Mr. Z. Then the balance sheet of Bank B at the end of this transaction will be as under:

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>Amount</th>
<th>Assets</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mr. Y deposit</td>
<td>920</td>
<td>CRR</td>
<td>76.60</td>
</tr>
<tr>
<td>Loan to Mr. Z</td>
<td></td>
<td></td>
<td>846.40</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>920</td>
<td><strong>Total</strong></td>
<td>920</td>
</tr>
</tbody>
</table>

This amount of Rs. 846.40 advanced to Mr. Z will again be deposited in some other bank and this process will continue until the reserve with the banks is reduced to zero. The final position at the end of the process of depositing and advancing loan is shown below:

<table>
<thead>
<tr>
<th>Banks</th>
<th>Primary Deposit</th>
<th>CRR</th>
<th>Loan Advanced</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank A</td>
<td>1000.00</td>
<td>80.00</td>
<td>920.00</td>
</tr>
<tr>
<td>Bank B</td>
<td>920.00</td>
<td>73.60</td>
<td>846.40</td>
</tr>
<tr>
<td>Bank C</td>
<td>846.40</td>
<td>67.71</td>
<td>778.69</td>
</tr>
<tr>
<td>Bank D</td>
<td>778.69</td>
<td>62.30</td>
<td>716.39</td>
</tr>
<tr>
<td>Bank E</td>
<td>716.39</td>
<td>57.31</td>
<td>659.08</td>
</tr>
</tbody>
</table>
The above table shows that a primary deposit of Rs. 1000 in Bank A leads to the creation of the total deposit of Rs. 12485.70, having a total credit of Rs. 11486.85 plus total cash reserve of Rs. 998.86 which almost equals the primary deposits. In fact the potential credit expansion can be determined by the following formula:

\[
P_{\text{potential}} = \frac{1}{\text{Cash Reserve Ratio}} \times \text{Initial excess reserve}
\]

\[
= \frac{1}{8\%} \times 920
\]

\[
= \text{Rs. 11,500/-}
\]

2.3 CREDIT CREATION AS A TOOL OF MONETARY POLICY

Monetary policy is concerned with the circulation of money in the open market. The goals of monetary policy are to promote economic laws, steady inflation, healthy turn out in domestic production and profitable foreign trade. The effect of monetary policy is to adjust money supply, interest rate and financial regulation to cool off or boost the economy in the field of taxation, public expenditure and balance of trade.

Monitory policy decides and dictates measures to regulate the supply of money for the realization of general economic goals through the apex Bank of the country (RBI in India). It carries out some checks from time to time to regulate the squeeze and spread of money in the open money market. It is sometimes influenced by pressure of certain lobbies, vested interests and political compulsions which adversely affect national economy. Network and vicious circle of interest play a vital role in the determination of monetary policy and state’s attitude toward economy.

RBI uses credit creation as a tool of monetary policy by manipulating the CRR, a portion of total deposit of a Commercial Bank which the Bank keeps with the RBI in the form of Cash. (Bhutani, 2008) When there is inflation in the market which exhibits increase in the money supply, RBI has to take some measures to decrease this money supply and for this it increases the CRR which results in the decrement of credit creation and vice versa.
3. ISLAMIC BANKING SYSTEM

3.1 A HISTORICAL PERSPECTIVE

The present financial Islamic system has come into existence after many refinements. The earlier system which was prevailing during the period of Prophet Muhammad (peace and blessings be upon him) was based on bimetallic standard with gold and silver simultaneously calculating as Dinar and Darham with 1:10 ratio. (Chapra, 1996) Dinar was the Gold coin for Arabs like Roman (Bayzantine) coin in circulation in Syria and Hijaz during the pre-Islamic and early Islamic periods. (Nadwi, 1982) At the time of the revelation of the Quran several forms of interest transactions were in vogue and were designated as riba by the Arabs. Of these, one was that the vendor sold an article and fixed a time limit for the payment of the price, stipulating that if the buyer failed to pay within the specified period of time, he would extend the time limit but increase the price of the article. Another was that a man loaned a sum of money to another person and stipulated that the borrower should return a specified amount in excess of the amount loaned within a given time limit. A third form of interest transaction was that the borrower and the vendor agreed that the former would repay the loan within a certain limit, at a fixed rate of interest, and that if he failed to do so within the limit the lender would extend the time limit, but at the same time would increase the rate of interest. (Maududi, 2004)

In the Jahiliyyah (pre-Islamic) period lending money on interest was a well known tool of creating credit. Abbas b. Abdul Muttalib was one of the richest persons of Makkah who spent lavishly on the indigent and the needy and lent money at interest. During his farewell pilgrimage when Allah abolished usurious transactions, Prophet Muhammad (peace and blessings be upon him) declared: “The first usury I abolish today is that of ‘Abbas b. ‘Abdul Muttalib.” (Nadwi, 1982)

3.2 ABOLITION OF RIBA

In the Jahiliyyah period when Prophet Muhammad (peace and blessings be upon him) had been making changes to make the society evil free, changes in the financial atmosphere had also been made. At the same time the interest (riba) was declared as haram (forbidden). Several Quranic passages stipulate this:

That which you lay out for increase through the property of (other) people, will have no increase with Allah: but that which you give for charity, seeking the countenance of Allah (will increase): it is these who will get a recompense multiplied. (al-Rum 30:39)


In another verse Allah proclaims:

Those who devour usury will not stand except as stands one whom the evil one by his touch has driven to madness. That is because they say: "Trade is like usury, but Allah has permitted trade and forbidden usury.
Those who after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for Allah (to judge); but those who repeat (the offence) are companions of the Fire: they will abide therein (for ever). (al-Baqarah 2:275)


3.3 CREATION OF CREDIT AND THE ISLAMIC BANKING SYSTEM

Islamic banks are organized on the same structural pattern as conventional banks. But the use of interest is eliminated from their operations. (Siddiqui, 1983) In the Qur’an there are four verses in four different Surahs in which riba (loan transacted as usury and interest) has been condemned or prohibited. These verses, in chronological order, are: 30:39, 4:161, 3:130 and 2:275-280.

Financial intermediation involves bringing together those who have spare money in contact with those who are in need of money. Thus, the surplus and deficit parties in terms of possession of financial resources are required to cooperate for the efficient use and betterment of Ummah as laid down and practised by the Prophet (peace and blessings be upon him) and his successors.

Banks carry out financial intermediation. Historically, it is observed that Mudaraba or Musharaka offered a mechanism of financial intermediation in early times in Arab world. Mudaraba was said to be prevalent in Makkah and Madina in some trade activities during the Jahiliya period but was replaced by inhuman usury system. Over a period of time some more methods facilitated financial markets such as Musharaka (profit sharing), Murabaha (mark up sale) and Ijarah (leasing) got developed and received sanctity under Islamic laws. (Godbole, 2007) The underlying principles of all these methods were based on cooperation, simple and natural impulses to earn money and profit without exploitation and hurting the fabric of a just and egalitarian society laid down by Islam.

3.3.1 MUDARBAH

Mudarabah is a profit-sharing contract. This contract consists of a capital investment from the Bank and a labor investment from the person who is going (or needs money) to start a business. In this approach, the bank finances partially or fully the said business.

It is necessary for the validity of mudarabah that the parties agree, right at the beginning, on a definite proportion of the actual profit to which each of them is entitled. No particular proportion has been prescribed by Shar‘iah; rather, it has been left to their mutual consent. The contract of mudarabah can be terminated at any time by either of the two parties. The only condition is to give a notice to the other party. If all assets of mudarabah are in cash form at the time of termination, and some profit has been earned on the principal amount, it shall be distributed between the parties according to the agreed ratio. However, if the assets of mudarabah are not in the cash form, the mudarib shall be given an opportunity to sell or liquidate them, so that the actual profit may be determined. (Usmani, 1998)

Mudarabah is the one of the widely quoted operating principles in Islamic finance for joint venture business. In classical fiqh (Islamic jurisprudence) writings, mudarabah is also named as gird or muqaradah or muamalah. There are several translations and terms for mudarabah used in
English such as trust financing, profit sharing, trustee profit sharing and sleeping partnership with profit sharing. (Jalil, 2009)

Mudarabah is one of the techniques which a large number of Islamic banks have adopted for financing their customers’ business requirements. In most cases the scope of the application of Mudarabah has not been defined. Banks like the Islamic Bank of Jordan and Faisal Islamic Bank of Sudan have introduced the concept of Mudarabah Certificates as an instrument to finance fixed investment and working capital requirements. The concept of Mudarabah Certificate is also found in Pakistan for financing short-term and medium-term requirements of different sectors of the economy. Banks like Dubai Islamic Bank propose to finance commerce, industry, real estate, etc., on the basis of Mudarabah. Among all these countries Iran seems to be the only one to confine the scope of Mudarabah to trading operations excluding private sector imports. (Zaman, 1990)

3.3.2 MUSHRARAKA

Musharakah is a word of Arabic origin which literally means sharing. In the context of business and trade it means a joint enterprise in which all the partners share the profit or loss of the joint venture and take part in all activities. It is an ideal alternative for the interest-based financing with far-reaching effects on both production and distribution. In the modern system of economy (capitalist, socialist or others), where interest is the sole instrument indiscriminately used in financing of every type this practice cannot be used for providing funds of any kind. Therefore, Musharakah can play a vital role in an economy based on Islamic principles only. The proportion of profit to be distributed between the partners must be agreed upon at the time of effecting the contract. If no such proportion has been determined, the contract is not valid in Shar’iah. Is it necessary that the ratio of the profit of each partner conforms to the ratio of the capital invested by him. There is a difference of opinion among the Muslim jurists on this issue. (Usmani, 1998)

In conventional banking system, once a person take loan on a pre-determined rate of interest, the financer will receive the fixed interest, irrespective of the profit earned or loss suffered by the debtor; on the other hand Musharaka does not envisage a fixed rate of return. Rather, this system is based on the actual profit earned or loss by the joint venture. Musharaka finance covers the risk factor which makes it acceptable as an Islamic financing instrument. In conventional banking, financer is not concerned about losses but in Musharaka the financer will also bear losses, if any.

3.3.3 MURABABA

In an Islamic mortgage system of transaction, the debtor, in place of loaning the money to the buyer, purchases the item, for which the creditor needs money, and gives it to the creditor along with some markup price (in addition to the market price) and creditor can return the money in installments. But the fact is that, the market price of the item has to be disclosed to the purchaser. In order to protect itself against default, the bank asks for strict security. The goods or land is registered in the name of the buyer from the start of the transaction. This arrangement is called Murabaha.

english such as trust financing, profit sharing, truste profit sharing and sleeping partnership with profit sharing. (Jalil, 2009)
In other words, Murabahah is, a term of Islamic Fiqh and it refers to a particular kind of sale having nothing to do with financing in its original sense. If a seller agrees with a purchaser to provide him with a specific commodity on a certain profit added to his cost, it is called a murabahah transaction. (Usmani, 1998)

3.3.4 IJARAH

Ijarah is also a term of Islamic fiqh. Lexically, it means ‘to give something on rent’. In the Islamic jurisprudence, the term Ijarah is used for two different situations. In the first place, it means ‘to employ the services of a person on wages given to him as a consideration for his hired services.’ The employer is called musta’jir while the employee is called ajir. The second type of Ijarah relates to the dealings of assets and properties, and not to the services of human beings. Ijarah in this sense means ‘to transfer the usufruct of a particular property to another person in exchange for a rent claimed from him.’ In this case, the term Ijarah is analogous to the English term ‘leasing’. Here the lessee is called ‘mu’jir’, the lessee is called ‘musta’jir’ and the rent payable to the lesser is called ‘ujrah’. (Usmani, 1998)

3.3.5 HIBAH

This refers to a payment made willingly in return for a benefit received. In savings operated under Wadiah, banks will normally pay their Wadiah depositors hibah although the accountholders only intend to put their savings in the banks for safekeeping. (Bank Negara Malaysia, 2009)

As we discussed above that the conventional banks offer interest on savings and charge interest on loans. But in Islamic banking system something as a token can be given voluntarily by a debtor to a creditor in return for the money. Hibah usually arises in practice when Islamic banks voluntarily pay their customers a 'gift' on savings account balances, representing a portion of the profit made by using their savings account balances in other activities.

It is important to note that while it outwardly appears similar to interest, and may, have the same outcome, but Hibah is a voluntary payment made (or not made) at the bank's discretion, and cannot be 'guaranteed.' However, the opportunity of receiving high Hibah will draw customers' savings, providing the bank with capital necessary to create its profits; if the ventures are profitable, then some of those profits may be gifted back to its customers as Hibah. (RHB Banking Group, 2011)

BAI‘ AL-INAH (SALE AND BUY-BACK AGREEMENT)

The mechanism of Bai‘ al-inah allows for total flexibility in financing any specific amount for any maturity that would provide a definite and certain profit to the bank. The first and a very popular mechanism used by Islamic banks in South East Asian countries is based on repurchase or Bai‘ al-inah. A murabaha can change into Bai‘ al-inah if the identity of the vendor is not different from its client; when the bank purchases a commodity from its client on a spot basis and sells it back to the client at a cost-plus price and on a deferred basis. The rate of profit in this case is indistinguishable from prohibited riba on a conventional loan.
The contract of Bayʿ al-ʿinah normally involves a sale of an asset or property by the first party to a second party for immediate or spot payment followed by an immediate sale of the same asset by the second party to the first party for a higher amount on deferred payments. The asset is by no means useful to both parties either for consumption purposes or derivation of usufruct (manfah). Apparently this device is used to override the Quranic prohibition of interest as riba. (Rosly, 2001)

**BAIʿ BITHAMAN AJIL (DEFERRED PAYMENT SALE) AND BAIʿ MUAJJAL (CREDIT SALE)**

Baiʿ Bithaman Ajil or simply Baiʿ Muʿajjal is a sale where payment of price is deferred to a future date. Often it includes features of a murabaha, which implies a sale on a cost-plus basis. As a financing product, Baiʿ Muʿajjal-Murabaha is a very popular, and perhaps the most popular Islamic financing product. Baiʿ Bithaman Ajil is a Shariah approved mechanism. So is Murabaha. The mechanism may be described as follows. Individual A is in need of commodity X. He approaches Bank B. Now, B buys X from the vendor/supplier at price P. This price is also known to A. Next, B sells X to A at a marked-up price, say P+M, where M is the agreed profit or mark-up taken by B. The payment of price P+M is now deferred to a future date and is made in full or in parts.

Baiʿ Bithaman Ajil or Baiʿ Muʿajjal simply implies deferment of payment of price irrespective of whether the cost and mark-up are known to parties or not. In a Murabaha, both parties to the transaction must know the cost and the profit or mark-up. Where the seller does not disclose the cost and profit thereon, the transaction is called Musawama. Baiʿ Muʿajjal and Murabaha have been used in various debt-based banking products.

This mode of Islamic financing is used for property, vehicle, as well as financing of other consumer goods. Technically, this financing facility is based on the activities of buying and selling. (Islamic Finance in Malaysia, 2011).

Baiʿ Muajjal may also be defined as a contract between a buyer and a seller under which the seller sells certain specific goods (permissible under Islamic Shariah and the law of the country), to the buyer at an agreed fixed price payable at a certain fixed future date in lump-sum or within a fixed period through fixed instalments. The seller may also sell the goods purchased by him as per order and specification of the buyer. (Islami Bank Bangladesh, 2011)

**MUSAWAMAH**

Musawamah is a general kind of sale in which price of the commodity to be traded is stipulated between seller and the buyer, without any reference to the price paid or cost incurred by the former. Thus it is different from Murabaha in respect of pricing formula. Unlike Murabaha, the seller in Musawamah is not obliged to reveal his cost. All other conditions relevant to Murabaha are valid for Musawamah as well. Musawamah can be an ideal mode where the seller is not in a position to ascertain precisely the cost of commodities that he is offering to sell. (State Bank of Pakistan, n.d.)
BAI‘ SALAM

This is a contract in which an advance payment is to be made for the product which is to be supplied in future date. The buyer has to make full payment at the time of contract. Date of supply of product as well as the quality of the product should be made at the same time. No ambiguous contact should be signed.

A Bai‘ Salam contract (where advance payment is made for goods) is one of the (financial) contracts that is permitted under Islamic Shariah. In the Sahih Muslim collection of Hadith (sayings of the Prophet) Ibn ‘Abbas narrates: “The Prophet (peace and blessings be upon him) came to Madina and the people used to pay in advance the prices of the fruits that would be delivered within one or two years. The Prophet (peace and blessings be upon him) said (to them) "Buy fruits by paying their prices in advance (only) on condition that the fruits are to be delivered to you according to a fixed specified measure within a fixed specified period." This is why Muslims unanimously approve the permissibility of this (financial) practice. (al-Nasser, 2009)

QARD HASSAN/ QARDUL HASSAN (GOOD LOAN/BENEVOLENT LOAN)

This loan is very popular in the education sector in almost all the Muslim countries or the countries having Muslim population. One of the examples of banks who have been providing Qard Hassan is Islamic Development Bank, Jeddah, Saudi Arabia that has been offering educational scholarships for the last more than 25 years.

Qard Hassan is extended on a goodwill basis. The borrower is required to repay the amount he borrowed only on lump sum or installment basis. However, the debtor may offer some extra amount beyond the principal as an appreciation to the creditor. In the case that the debtor does not pay an extra amount to the creditor, this transaction is a truly interest-free loan.

There are many more tools like Ijarah thumma al bai‘ (hire purchase), Ijarah-wal-iqtina, Sukuk (Islamic bonds), Takaful (Islamic insurance), Wadiah (safekeeping), Wakalah (power of attorney), Islamic equity funds etc.

4. CONCLUSION

It is clear from the above discussion that Islamic Banks have also been creating credit but unlike the conventional banks, they have not been charging or offering interest. In lieu of charging interest Islamic banks have been using some other tools, like Mudaraba, Musharka, Murabaha, Ijarah etc. for credit creation or for controlling money market. Like the Central Bank of Conventional Banking System, the Central Bank of Islamic Banking System also controls the money supply in the open money market by manipulating the frequency and the amount of finance. And, of course, the money supply can also be controlled with the help of fiscal measures.

As we noted earlier, commercial banks perform two functions: money transfer services, including all current account transactions and money lending. According to Abdul Gafoor, the
former does not involve any interest. On the other side of the balance sheet, we have two types of deposits: current account (demand) deposits and savings deposits. Here too, the former generally does not involve any interest. Therefore current account operations and money transfer operations are free of riba on both sides of the balance sheet. As such all commercial banks are interest-free banks with respect to these operations. (Gafoor, 1999)

The organization of an economic system based on Islamic values entails some basic alterations in the operations of financial institutions. The interest-based system has to be converted into a profit sharing or equity participation system. The system of credit creation and control of credit has to function without charging or offering interest.

5. RECOMMENDATIONS

The supply of money has been controlling the rate of interest in the Conventional banking system. Similarly, in Islamic banking system the supply of money has also been controlling, but unlike the conventional bank, it has not been using interest, rather, the Islamic banking tools like Mudarabah, Musharakah, Murabaha, Ijarah, Hibah, Qard Hassan etc. has been using for the purpose. In case of inflation (increased money in circulation) the access in money supply may be curtailed by limiting in financing any project. And on the other hand, if there is deflation (shortage of money in circulation) the money in circulation may be increased by financing more and more projects using Mudarabah, Musharakah etc. and hence the supply of money may be controlled.

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