CHAPTER - V

MONETARY SYSTEM AND ISLAMIC BANKING

One of the complex issues faced by the Islamic bank is to work out the monetary system based on Islam. The questions discussed are: Is there any guidance from shari'ah regarding monetary and fiscal policies of Islam? What is unique in Islamic monetary policy? To what extent does it differ from the prevailing one, especially from the monetary policy followed in the capitalist world. How will the abolition of riba influence the monetary policy of a country? Will the absence of the rate of interest as an instrument of monetary policy seriously handicap an Islamic economy? Is a substitute for bank rate or other instruments of monetary policy feasible or desirable? What alternative tools of monetary policy can be developed? What will be the relationship between monetary and fiscal policies in an Islamic banking system? These questions have been raised by many Muslim writers in various seminars and conferences. But their sufficient answers are not forthcoming. They generally come to the vague conclusions that what is required is 'a fundamental reform of the entire economic system including its money and banking framework. The reform of the later would include the abolition of riba and the reform of banks to minimise their
financial power and their role in skewed income distribution. It would also include a change in the strategy and instruments of monetary policy aimed at regulating the expansion of overall credit in accordance with the non-inflationary needs of the economy as well as the value oriented allocation of credit to attain the desired socio-economic goals of Islam.¹

As regards the nature of monetary policy, it is argued that in an Islamic economy its objectives and tools must be different because of the differences in the goals and nature of two systems and because of the prohibition of interest in Islam. Moreover, the monetary policy in an Islamic economy should not only be in conformity with the ethos of Islam but should also help realise the socio-economic goals that Islam emphasises.

The proponents of Islamic banking mention the following are the chief objectives of the Islamic monetary policy:

1. Economic well-being with full employment and optimum rate of economic growth,

¹ See An outline of Research Proposal in Fiscal and Monetary Policy of Islam (Jeddah: International Centre for Research in Islamic Economics, 1982).
2. Socio-economic justice and equitable distribution of income and wealth; and

3. Stability in the value of money to enable the medium of exchange to be a reliable unit of account, a just standard of differed payments and a stable store of value.

According to them the capitalistic or socialistic economy cannot be in conformity with Islam, although there may appear some apparent similarities between these systems. In a capitalist economy the monetary policy affects the real sector only through the rate of interest. In an Islamic economy, it is claimed, the rate of interest will be replaced by the rate of profits. The rate of profits, however, depend on the business conditions. The investment decisions in an Islamic economy would not depend on the rate of interest but only on the expectations about business prospects. The proposition that an Islamic economy is inherently stable appears to be somewhat far fetched. The main issue, however, is not whether an Islamic economy is inherently stable but whether it is potentially stable in the sense of having access to various stabilisation policy instruments. But as the critics feel the only orthodox policy

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instrument still available to the central bank in an Islamic economy will be 'moral suasion' and power to change the deposit ratios for regulating the lending activities of the commercial banks. They believe that these policy instruments will not provide a really effective handle to the central bank for control of the money supply, particularly when excess liquidity exists in the banking system. In this way, as they point out, an Islamic central bank would not have too many 'degree of freedom' in exercising a decisive control on money supply through indirect means for the lack of sufficient number of policy instrument.

It is argued that the absence of the interest-rate instrument will not cripple the monetary policy in an Islamic economy, since interest rates as an instrument of monetary policy is not all that powerful even in a capitalist set up. However, the scope for monetary policy in an Islamic economy is somewhat limited, not because of the non-availability of interest rate instruments, but 'because of the neutralising changes in the velocity of money circulation'.


What is noticeable is that how in the absence of speculative free stock exchange and 'market rigidities', the Islamic economy works. How inflationary trend would be checked where profit-sharing will play an important role. Again, the danger of monopoly and oligopoly cannot be ruled out since privatisation will go hand to hand in an Islamic economy which will run on the market forces of supply and demand.

Monetary policy may be defined as any deliberate action undertaken by the monetary authority to alter the quantity availability and cost (i.e. interest rate) of money. It then becomes clear that interest rate is only a part of the story. Although interest rate changes apparently and influences the demand for and supply of money. But it is also conceivable that changes in the quantity and availability of money even without the interest rate. Be that as it may, monetary policy based on interest rate manipulation suffer serious shortcomings, which have severe implications for the efficiency of monetary policy.

Islamic economists, while criticising the Western concept of monetary policy, feel that monetary policy in modern times seems to have regained the respectability it had lost under the keynesian assault. Friedman and his disciples, in asserting the potency of monetary policy, have emphasized that the crucial
variable is the stock of money, and not the rate of interest. This message of new monetarism has far-reaching implications for the role of monetary policy in an Islamic economy where interest rate is totally prohibited.

But how the mechanism of the Islamic monetary system will work? According to its proponent:

"The volume of money can be varied for example, through the sale/purchase of government securities to/from financial institutions and through adjustments in the statutory ratio of such securities in the "advance" portfolios. In inflationary times, a rise in this ratio will siphon off a large proportion of the excess money which has been deposited with financial institutions. In addition, the central Bank may give directions to financial institutions regarding the volume and composition of their financial commitments. All such restrictive measures may effectively curtail the availability of funds for investments. But in times of depression, 'funds unlocked through the government purchase of its bonds may not necessarily stimulate investment activities if permissitetc business expectation prevails'. 5

seeking institutions can play an active role in contrast with the passive role of conventional financial institutions outside the Islamic set-up. The Islamic financial institutions can therefore lead the business community and influence the business outlook by injecting confidence and stimulating investments in time of economic recessions.  

The argument that the establishment of Islamic banks will provide a stimulus to aggregate saving, has been doubted by a number of writers. In this connection Timur Kuran points out that in countries where Islamic banks are in operation the stock market performs in inefficiently, and, because from the standpoint of individual saver and investor, mudarbah accounts serve the same function as stocks. The bulk of the individuals who have switched to Islamic banks are probably relatively less risk-averse savers who would, if the economy were more developed, be holding stocks. If this conjecture is correct, one can infer that the establishment of Islamic banks has stimulated savings by introducing a new financial service. This does not mean, however, that savings could be increased further by abolishing the traditional banking system, for, the highly risk averse

6 Ibid., p. 299
customers of traditional banks may not feel comfortable with mudaraba. In this regard, as we have earlier mentioned, theoretical analysis has not provided a clear-cut testable hypothesis, and it becomes an empirical question whether saving will increase or decrease in an Islamic system. Since consumption is always placed on a relatively low-key basis in an Islamic society, the marginal propensity to consume is somewhat low, and a low consumption propensity implies a rather weak multiplies mechanism which does not permit economic disturbances to be magnified. This considerably reduces the chances of economic fluctuations. 8

As mentioned above, the usual objectives of monetary policy are stability, balance of payments, growth of the economy and distributive justice.

As far the policy issues are concerned, one may feel that too much emphasis on distributive justice in the Islamic monetary


8 See Waqar Masood Khan's, Towards an Islamic Economic System, (Leicester: The Islamic Foundation, 1985).
policy may adversely affect its overall efficiency and effectiveness in obtaining other goals. In a seminar held in Islamabad in 1982 Muslim economists gave attention to monetary policy instruments that could be used in an Islamic economy to achieve the stated policy objectives. The general feeling was that abolition of interest, and non-availability of bank rate weapon to the central bank would not constitute any serious handicap to monetary management in an Islamic economy. It was pointed out that control over the volume of money supply is a crucial factor in monetary management. Adequate control could be exercised on money supply in an Islamic economy by regulating high powered money, defined as currency in circulation and reserve assets of banks. Besides, use could be made of various in cash reserve ratio, liquidity ratio and credit ceiling to bring about desired changes in money supply. Apart from controlling money supply, monetary policy is also capable of being used to influence the allocation of resources. In the interest-based system, variations in interest-rates and policy-induced differentials in interest rates perform an important allocative function. This role could be performed by changes in profit-sharing ratios in an Islamic system.9

9 See the report on Money and Banking in Islam, op.cit., p.7.
How will the proposed monetary policy overcome its problems? Doubts have been raised regarding the efficiency of a central bank in Islamic economy. We have mentioned that lack of financial instruments and the absence of various tools like open market operation, and deposit ratios are the main obstacles in the functioning of central bank proposed by Islamic economists. There is every possibility that monetary policy will be weakened as there is no clear cut answer to stop the inflation and unemployment. In fact, the defects of capitalist monetary system cannot be seen in the context of interest rates, only, or that mudarbah system is the ultimate answer to these problems. Many Islamic economists are still not satisfied with the profit and loss sharing. After all, an Islamic economy cannot be created in vacume. All the social behaviours and norms of human being cannot be dismissed. So far as the Islamic economic system is concerned, there are many writers who question the soundness of the arguments regarding the effectiveness of the Islamic norms. First of all, the implications of these norms are unclear in most of the context where they are expected to operate. 'A pious Muslim eager to follow them may be confused as to what wage is just and what profit rate is normal. Likewise, he may be unclear about the meaning of "moderation" in consumption and of the practical implication of the injunction against harm to others through
productive activities". This vagueness, as critics argue, would threaten the legitimacy of the Islamic economic system. One writer, for example, finds that the fundamental features of the proposed Islamic economic system raises serious doubts about the claim that this framework provides a functional alternative to existing system. He says:

"The suggested behavioural norms are not only riddled with ambiguity, but also unlikely to enjoy widespread adherence in a large society. In practice, many of them would have to be treated as state-enforced laws. There is no way of ensuring, moreover, that state officials would behave in an Islamically "correct" manner. These criticisms are borne out by the fact that throughout most of the past fourteen centuries, members and officials of Muslim communities have had a tenuous link with Islam's behavioural norms, even when they have more or less agreed as to what these norms means", 10

Credit Control and Credit Operation of Islamic Banks:

Credit control in the contemporary financial world is of great significance. It affects the consumers, business and governments. Consumers borrow to buy the goods and services they want now. Business borrows to finance investment projects. Likewise, the government borrows for meet its various needs. It

10 Timur, Kuran, op. cit., p. 134.
borrows for defence spending, socio-economic programmes, payment of the interest old debt. The government borrows funds through the central bank, and then lends to small business, farmers, low-income groups and others. Keeping this in mind economists have given much attentions to the problem of credit regulator. In capitalist economies money market occupies a central place. Change in credit policy and trends has its impact on the Gross National Product. When credit is plentiful, banks are more generous in making loans for the building of inventories, construction of new factories and residential housing. Thus a rapid growth in money and credit accompanies booms, and a reduction in money and credit is often followed by recession or worse. 11

A bank, having received some cash from customers who have brought funds to the banks is therefore in a position to make loans or investments. A bank, say bank A, starting out with deposits in currency and coins of Rs. 100,000, might feel safe to lend Rs. 80,000. In a check-using community, the bank would make its loan by giving the borrower the right to draw checks against it. In fact the procedure of credit creation comes through the

whole set of banks. These banks would create an amount of money in the form of deposits equal to several times the amount of the original deposits. Commercial bank deposits constitute a significant part of money supply. These deposits may be divided into two parts: firstly, primary deposits which provide the banking system with the base money (cash in values plus deposits with the central bank) and derivative deposits which in a proportional reserve system represent money created by commercial banks in the process of credit extensions and constitute a major source of monetary expansion in economies with well-developed banking habits. Since derivative deposits lead to an increase in money supply in the same manner as currency used by the government deficits, it has the potential of being inflationary in the absence of offsetting growth in output. 12

The relation between credit created by the commercial banks and resulting output is the major problem that Muslim economists argue in the case of inflation. Contrary to conventional systems, they say that Islamic concept of profit-sharing system is more stable. It is argued that:

12 Ibid., Ch. 3
Bank's mudaraba advances could still be a multiple of their saving deposits, but their return accrue as a percentage of profit actually realised when these advances results in creation of additional social wealth. These returns are then shared by the bank with the depositors according to an agreed percentage. Accruals of profits on deposits in this case devolves on exposers of risks involved in productive enterprise. The magnitude of these profits is determined by the conditions of market and the two ratios of profit-sharing which are the subject to the forces of demand and supply. The power of real savings to acquire additional resources with the mere passage of time is completely destroyed. Instead they have the possibility of acquiring additional resources to the extent that their utilisation in productive enterprise actually results in the creation of additional wealth.  

The present system as it is pointed out prompts the banks to patronise speculators, other financial intermediaries and the government who are ideal short-term borrower. The ultimate investors figure in their portfolios only marginally and often indirectly. The unusually lengthy chain of intermediaries between the ultimate investor is largely a product of case with which credit instruments can be created and handled, thanks to interest. They bear very little relations to the structure of production. To justify this proliferation of financial intermediaries and credit instruments with reference to the variety

of tastes, regarding liquidity, risk, size of holding and time period involved presumes a sanctity for these tastes which is highly doubtful. To a very great extent they are the product of high powered propaganda and psychological manipulation.¹⁴

The arguments against credit creation by Muslim writers, have centred around the issue of inflationary trends. They say that inflation is partly due to credit expansion by commercial banks. According to the current literature to the only effective means of curbing inflationary trends, is that commercial bank should not be empowered to create additional credit and this job would be done by the Central Bank. This issue begs numerous questions which Islamic writers have discussed in various conferences and seminars.

The question of credit control in Islamic financial system is a major issue which is still at discussion level. How the central bank will control the money supply since there is no element of rate of interest in its functioning. This question is much related to the goal of price stability and rapid real growth. As in conventional system, we see that central bank's monetary policy work through the control of monetary expansion. The mechanic of the system is that when the central Bank wants to

¹⁴ Ibid., p. 57.
control the money supply, it cut down on the reserves available to the bank. The Central Bank changes this reserve through the "open-market-operation". In this way the reduction in the bank reserves forces a multiple contraction in total bank money. The contraction in the money supply tends at first to make money 'tight' — that is more expensive and less available. The reduced quantity of money, in other words, raise the cost of money (i.e. interest rate) and reduce the amount of credit available to people. With interest rates higher, and with credit hard to get results in the reduction of wealth of the people and companies. There are also effects in private and public spending, which reduces the investment. A reduced supply of money tend to reduce aggregate demand, income, output, jobs and inflation. This long process of central bank in conventional system makes an impact on money and credit control. As for the Islamic financial system is concerned, we find that the role of central bank, is rather weak, because it would be unable to alter the reserve requirements. In this way, the stabilization targets would have to be realized through the control of the monetary base rather than credit. A recent study, regarding this issue, shows that the monetary authorities operating in an Islamic frame-work continue to have the power to regulate banking and financial operation in the economy. To achieve its policy

objective: the central bank has the control over the supply of 'high powered' money (that is, currency plus deposit liabilities of the central bank to commercial banks), the reserve ratios on the different types of liabilities, and the maximum amount of assets that bank can allocate to their profit-sharing activities. A further control is available to the central bank through its purchase of equity shares of banks and other financial intermediaries. Though performance of its regulatory, supervisory and commercial functions, as well as its lender of last resort role, the central bank can continue to make influence on the financial system. Moreover, opportunities may exist to direct investing in the real sector on a profit-sharing basis. The ability to buy and sell securities representing real asset in the financial market, that is, open market operations, would still be permitted as long as these securities do not have par value features and a non-zero coupon rate. The suggestion has been made that central bank could regulate profit-sharing ratio between the banks and borrowers on the one hand and the banks and depositors on the other. Variations in these ratios would alter the rates of return and could have the same impact as changes in interest rates on the other all and sectoral flows of financial resources.  

We may not simply over-look the western financial system as being 'inflationary' or that credit creation of commercial bank can not be controlled. The contemporary banking system which is governed by the Central Banks of the governments have their own tools to control the credit supply, and hence check the money expansion into the economy. Hansen tells us that under the fractional reserve system if the banks keep a reserve ratio of one-tenth (that is, if they keep their cash reserve at about one-tenth of their total deposit), it follows that for every additional cash dollar obtained by the bank they create ten dollars of bank money or deposit. As the banking business is concerned, the modern banks do not keep 100 per cent reserve for their deposit, on the contrary, banks are required, by law to keep a small fractional reserve for each $1 of deposits. These deposits can be held in cash on hand or in non-interest bearing deposit at the central bank. If bank kept 100 per cent cash reserve against all deposits, there would be no multiple creation of money. There would be only a 1-to-1 exchange of one kind of money for another kind of money.\(^\text{17}\)

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Islamic writers favour imposition of a 100 per cent reserve requirements on commercial banks. It is justified on three grounds: Firstly, they blame that fractional reserve causes the monetary system to suffer from an "inherent unstability" because any switch over from "high powered money to "deposit money" and vice-versa changes the supply of money. But with 100 per cent reserve, as they claim, such a switch will change only the composition of money, leaving its total supply constant. Secondly, changes in money supply arising from deposit creation or resulting from substituting deposit and cash make it more costly to maintain the existing stock of real balance. Thirdly, money creation is a social prerogative and hence the benefit of the process of money creation should accrue to the whole society which can best be achieved through 100 per cent reserve system.\footnote{See Money and Banking in Islam, op. cit., p.6.}

One writer outlines a model with 100 per cent reserve system in which the liquidity and financial requirements of the

\footnote{Fractional reserves banking means modern system of banking where only a fraction of deposits are held as reserves, the rest are used for loans and investments. Their vital function is to enable the central bank to control the amount checking deposits or bank money- that banks can create. By imposing high fixed legal reserve requirements, the central bank can limit the growth of bank money to its desired target.}
private business sector will be met by the Central bank's opening deposit and investment account in commercial banks and other financial institutions which in turn will invest these deposits in the real sector and share the profit with the central bank. Variations in the central bank's deposit accounts with the commercial banks will have the effect of bringing about the desired changes in money supply. 20 This concept however, leads to the realization that commercial bank will be reduced to safe-keeping institution like the goldsmith's establishment of the bank which was the basis of the evolution of modern banking system. 21 This also means that commercial bank cannot even invest the funds deposited with them. However, Muslim writer's argument about central bank's role makes one to think that central bank's effectiveness will diminish especially in the matter of monetary policy.

Islamic economists in this way, think that with the 100 per cent reserve requirement there would not be any major change in the vital role of the central bank. It's regulatory power over the supply of money by denying or granting loan to the

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20 Money and Banking in Islam, op. cit., p.7.

21 Commercial banking is said to have began with the goldsmith, who developed the practice of storing people's golds and valuables for safe-keeping. At first, such establishments were simply like warehouses. Depositors left gold for safe-keeping, were given a receipt, later presented the receipt, paid a small fee for the safe-keeping and got back their gold.
commercial bank is recognized. They, however, accept that in an Islamic system, central bank's loan to commercial banks are supposed to be limited, as financial assets in general are likely to be risk bearing and central bank's involvement in risk financing may reduce its status as the regulatory authority. However, loans may be sanctioned against reserves with the central bank. What they find injustice in the present system is the charging interest by commercial banks while their money is laying idle with the central bank in the form of reserve.

In this regard, another question related to this is asked as how the commercial banks in the Islamic system would utilize their current account balances. If the balance is utilized for short-term profit-bearing advances, then the depositors will have to bear risk which they may not be willing to do. If 100 per cent cash is maintained, the cost of transactions on current account may be too high for smooth commercial functioning. For this purpose it is proposed that a service charge on such transaction will compensate the cost of maintaining these transactions. The concept of service charge, however, is highly controversial. A good numbers of writers find it as similar to interest.

22 Ibid., p. 64
According to an author's view, the claims that this is different from charging interest since it is not tied to the length of time within a month or to the size of loan. This is a misleading argument. First, though the rate is not tied to the length of time within a month, its upper limited is a month, thus there is a time dimension. It is analogous to an annual rate which is not tied to the time period within a year. Second, there is an upper bound on the size of such loans since these loans ..., can not be more than the average past liquidity position of a borrower with the bank. Therefore, we safely conclude that this charge is similar to interest paid on a bank loan. 23

Inflation and Islamic Economy:

A survey of Muslim literature on money and banking indicates that question of inflation has occupied the minds of many proponents of Islamic banking as to what extent an Islamic economy could bear the evils of recession, depression and inflation? Is a long-run inflationary trend possible or desirable in an Islamic economy?

Even if it is possible to control inflation in an Islamic economy, will it be possible to overcome a recession? What if

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23 Waqar Masood Khan, Towards an Interest-free Islamic Economic System, op. cit., p.37
prospects are dim and the commercial banks and the associated private sectors are not willing to expand their mudarbah investment? However, this hypothesis may be doubted on the ground that monetary policy alone cannot solve these problems unless other government policies also work in the same direction. It is common experiences of the industrial countries that effects of monetary policy are often negated by unduly 'expansionary fiscal policy. It is said that multiple credit creation by banks also leads to inflation. It is, however, argued that some kind of indexation would be necessary at least during transitory period to protect capital from erosion. The suggestion of indexation in the time of inflation cannot be ruled out, because, in practice, the money value of a loan would be increased in line with the rising inflation so that the borrower would have to repay the loan in real term. In the absence of indexation, rapid inflation, by eroding the real value of loans, shifts resources from lenders to the borrowers and therefore disrupts the credit mechanism and capital market. Some economists, however, consider that indexation is not a cure for inflation. Because if it was so, the entire economies of western would have adopted this method. In this way, they would have ignored inflation and concentrated on reducing unemployment. This sounds like a good idea. But on closer look it turns out that more you protect the economy from inflation by indexation, the
more unstable inflation becomes.\textsuperscript{26}

A cautious summary of this discussion would be that an Islamic economy cannot overcome the misery of inflation simply by adopting the indexation method. Today's inflations come in through various ways. Economists today think that there is natural rate of unemployment which bring inflation into the economy. This phenomenon is bound to happen even in an Islamic economy.

**Demand for Money in Islamic Economy:**

It is claimed that in the Islamic economic system the concept of money is somewhat different from other prevailing system. Though Muslim writers acknowledge that basic concept of money as explained in the economic theories will not be very different from the prevailing one. Questions have been raised as what should be the characteristics of money in an Islamic economy.

\textsuperscript{26} Paul A. Samuelson, *Economics* Twelfth Edition (Mc Graw-Hill Book Company 1986); The author illustrates that indexation may be temporary device to check inflation. But assuming that whole economy is to be indexed, then problem will arise. For example, suppose that wages, rents, interest rates and prices are all 100 per cent indexed to the consumer price index (CPI). Say a bad harvest drives food prices up enough to increase the CPI by 10 per cent. The shock will rage through the economy like an epidemic. Everything indexed to the CPI goes up 10 per cent. But since all costs are indexed, the next month CPI goes up almost 10 per cent again. And the third month, price rise almost 10 per cent again. And in this way price would be up many times (p. 255).
Do the various present day forms of money fulfil these characteristics? Is there any room or scope for a rising price level? Would such a trend be in harmony with a *riba*-free Islamic economy? Keeping in view the main objective of an Islamic economy, is it necessary to have full-bodied or fully representative money in an Islamic economy? What is the scope for 'fiat money'? How does 'fiat money' with a declining real value fit into a *riba*-free Islamic economy? Would the central bank in an Islamic economy have the privilege to print money without the lacking of real resources? If this privilege is to be recognised, can some guiding principles be provided in the light of *shari'ah* to prevent government from exploiting this privilege and to save the economy from the effects of inflation resulting from rapidly expanding fiat money. What is the scope for deposit money in an Islamic economy, and in the light of *shari'ah* is it possible to say specifically whether any individual or institution has the right to lend money which he or it does not have. Is it possible for an Islamic state to make its money immune from the monetary, fiscal and foreign exchange policies of other countries.\(^{27}\)

\(^{27}\) See Ariff, *op. cit.*, p. 381
All the above issues make a complex situation for Muslim writers to reach a definite conclusion as to what would be the real position of an Islamic economy. Since there is not any real Islamic economy, it is difficult to say anything with certainty on the above issues. Some writers try to point out that in an Islamic economy the demand for money will arise basically from the transaction and precautionary needs which are determined largely by the level of money income and its distribution. The abolition of interest and the levy of zakah at the rate of two and half per cent will tend to minimise the speculative demand for money.

Muslim writers have presented their arguments in the context of capitalist economy where demand for money have always engaged the attention of economists. According to modern economic concept the demand for money arises from the need for a medium of exchange, that is, from a transaction demand. People hold currency to buy goods and pay for other services. As the incomes rise, the value of the goods goes up and therefore people need more money for transactions, and in this way, the demand for money rises. The demand for money differs from that of other commodities. It is so because money is valued for its use as indirectly and not for its direct utility. At the same time money holdings are limited because money has an opportunity cost.
Economists believe that the demand for money will be sensitive to interest rates. By this, they mean that with higher interest rates the demand for money will be low. The classical economic concept of three motives, i.e. transactions motives, precautionary motives and even speculative motives are considered to be appreciable even in an Islamic economy. Though explained by Keynes, these motives in the capitalist system are foundation of the demand for money. However, among these there motives, the speculative demand for money has raised some questions. It is felt that there is room for speculative motives in Islam. This is so because speculation often entails stockpiling and profiteering activities which have adverse economic implications for the community at large.

28 John Maynard Keynes, (1883-1946) General Theory of Employment, Interest, and Money, (New York: Harcourt, Brace, & World, 1936). Keynes called the need to hold money as a means of payment the transactions motives for holding money. In addition to holding money to make normal day-to-day purchases, people may also hold some extra money to deal with unexpected circumstances. Keynes called this the precautionary motive for holding money. In addition, however, Keynes distinguished a third motives for holding money called as speculative motives. Because people may prefer to hold much of their wealth in the form of money, hoping to exchange the money for bonds after interest rates rise and the price of bonds falls. In this way, Keynes thought that the demand for money depends both on the level of nominal income and on nominal interest rates. As nominal income arises, other things being equal, the demand for money will increase because of the transactions and precautionary motives. But given the level of nominal national income, the speculative motive will tend to make the demand for money increase as nominal interest rates decrease and to make it decrease as nominal interest rates increase. For a full treatment on the subject see; Stephen M. Goldfeld, Lester V. Chandler, The Economics of Money and Banking, 9th ed. (New York: Harper & Row, Publishers, 1986) part 4.

A closer look at demand for money concept of interest-free system reveals that it is quite different from what is now prevailing in existing financial world. As we have seen, creation of money in an interest-free system will be investment oriented, not based on lending. Here arises the questions that in the absence of interest rates what will influence the borrowing and lending. This is because interest rate influences the amount of money people want to hold and thereby the amount they lend or borrow.

Islamic monetary policy suggest that 'interest-bearing asset, in an Islamic economy, would not be available; leaving the holder of liquid funds the option of either holding them in the form of cash with no return or investing their profit-earning assets to get at least some return. Short-term as well as long-term investment opportunities with varying degree of risk will presumably be available to all investors whether they are high or low risk takers. This is perhaps the most challenging issue, so far the available studies and related conclusions force one to ask that while implementing an Islamic financial system how the risky return-bearing instrument can be devised so that sufficient degree of liquidity, security and profitability can be attained.

30 Differences in interest rates on different kinds of securities, influence how borrowers obtain their funds and lenders invest their funds. Thus changes in specific interest rates draw money from market where funds are plentiful to markets where they are scarce. See the whole process in extensive analysis by David E-Laidler, The Demand for Money: Theories and Evidence (Bombay: Allied publishers, 1972) part 2.