Money Creation and Islamic Banking: A Skeleton in the Same Closet?

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ABSTRACT

The 2008 global financial crisis has reopened the discussions on money creation by banks. The debates surrounding the matter have entered new area of discussion with the birth of Islamic banking and finance. The rise of Islamic banking which is riding on the same platform as conventional banks has brought the Islamicity of Islamic banking into the limelight. This study will revisit the discussion on money creation. Money creation process is examined both in conventional banking as well as Islamic banking by reviewing various literatures on the issue. The author establishes that Islamic banks do create money whenever financing is disbursed the same way conventional banks do every time loans are disbursed. The author strongly suggests that Islamic banking fraternity to begin scrutinising the issue of money creation and to probe on various possible viable solutions.

***Keywords**: Money Creation, Credit Creation, Islamic Bank, Conventional Bank*

ABSTRAK

Krisis kewangan global 2008 telah membuka semula perbincangan tentang penciptaan wang oleh bank. Perdebatan mengenai perkara ini telah memasuki era perbincangan baru dengan kelahiran perbankan dan kewangan Islam. Kebangkitan perbankan Islam yang menggunakan platform yang sama seperti bank konvensional telah membuka kritikan-kritikan terhadap industri tersebut. Kajian ini akan mengkaji semula perbincangan tentang penciptaan wang dengan meneliti literatur-literatur yang berkaitan dengan isu penciptaan wang. Proses penciptaan wang dalam perbankankonvensional dan perbankan Islam di teliti kembali . Penulis mendapati terdapat salah faham dalam memahami proses penciptaan wang. Penulis mencadangkan agar perbincangan mengenai isu penciptaan wang mesti dibuka semula dan pelbagai penyelesaian perlu diperiksa terutamanya dalam perbankan Islam.

1.0 INTRODUCTION

Modern banking system with its money creation apparatus via fractional reserve banking system was put into the limelight with the 2008 financial crisis that spread globally. The system was well received despite some criticism that the system will eventually result in inflationary pressures. Nadler (1979) argued that the requirement for the bank to put aside a fraction of their deposits as reserve is the mechanism in placed to control the bank's ability to create money. Werner (2014) quoted the work of John Law (1705), James Steuart (1767), Adam Smith (1776), Henry Thornton (1802), Thomas Tooke (1838), and Adam Müller (1816) to support the acceptance of the system. Rowbotham (1998), Sudeley (1999) and Leithner (2011) however blamed such money creation apparatus for the inflationary pressures in the economy.

Despite Nadler (1979)'s acceptance that bank's license to create money as one a must tool for the smooth operation of the present economic model, such move is questioned when American and European 2007 – 2008 banking crisis occurred. The renewed interest in bank's money creation was fuelled by the admission by Bank of England (2014):

"The key function of banks is money creation, not intermediation. "

Michael Kumhof, Deputy Division Chief,
International Monetary Fund

When banks extend loans to their customer, they create money by crediting their customers' accounts."

Sir Mervyn King, the Governor of the Bank of England from 2003-2013

The above Bank of England's revelation was in support of Turner (2013) statement as follows:

"Banks do not, as many textbooks still suggest, take deposits of existing money from savers and lend it out to borrowers: they create credit and money ex nihilo — extending a loan to the borrower and simultaneously crediting the borrower's money account"

Lord Adair Turner (2013)
Former head of the UK Financial Services Authority (FSA)
and one of the most referred experts in financial world

The rise of Islamic Banking and Finance which is operating on the same infrastructure (including money creation mechanism) as conventional banks has opened the debate whether or not Islamic Banking and Finance. Hence, the issue of whether or not Islamic banks create money the same way conventional banking does remain unanswered. Is it just a case of skeleton in the same closet? Is money creation mechanism a hidden practice by Islamic banks? This issue needs to be analysed as it has vital input on the future development of Islamic Banking and Finance.

2.0 LITERATURES ON MONEY CREATION

Banking sector is vital component of the smooth operation of the economy (Nadler, 1979). It provides credit that much needed to support the growth of the economy. Businesses need fund to produce more goods and services hence meeting the demand. Banking sector, as the intermediator between the surplus and deficits, is able to do this as they are licensed to do so.

Nadler (1979)'s argument is supported by Taylor (2009a) as cited by O'Connell (2010) who sees the Federal Reserve program of quantitative easing as indicating that the projected fiscal deficits will be financed by money creation. Yiming Hu, Siqi Li, Thomas W. Lin & Shilei Xie, (2011)'s study revealed the state-owned enterprises (SOEs), in particular, have long been supported financially by the government via the state banking system and money creation. Ünalmış (2015) also assumed that primary budget deficit is financed by domestic and foreign borrowing and money creation.

In addition to the above, several authors have recorded literatures on money creation by conventional banking industry. They include Laidler (1998), Werner (2005), Mouatt (2008), Oberholster (2010), Turner (2013), Werner (2014), Jakab and Kumhof (2015) and Arfah & Borges (2015).

Crick (1927), as quoted by Werner (2014), argued that banking system as a whole can create credit and money. However, in doing so, without denying the fact that banking system do create credit and money, he assured that the process is under control due to its diffusing nature hence has less direct economic impact. Hawtrey (1929), quoted by Laidler (1998), supported Crick (1927)'s analysis that the process did not lead to an adverse impact but further established that the process is a necessity as government expenditures would be insufficient to combat unemployment, unless financed by money creation.

3.0 HOW DO BANKS CREATE MONEY?

As banks act as the accountants of records (Werner, 2005) and keep records of the society's money, the process of banks' money creation is concealed and disguised. Even the banker's do not realise that they are creating money and they will not admit it (Nadler, 1979). It is very straight forward that we just feel it is not necessary to dwell into it (Galbraith, 2017).

Banks create money every time they approve applications for loan (Werner, 2014; Arfah & Borges, 2017). Contrary to the popular belief, banks do not require fund or reserve to back the money to be disbursed (Oberholster, 2010). Banks do not use depositors' money to fund the money disbursed to the borrowers (Werner, 2014; Arfah & Borges, 2017). Banks simply credit the borrower's account with the approved amount and the money created. They do not need to look for reserve or fund to back the amount required. The process is operationalised via the fractional reserve mechanism which in turn assisted by the accounting treatment (Werner, 2014; Arfah & Borges, 2017)

The certainty that banks create their own funds through lending is endorsed in the narration of the money creation process by prominent global banks' regulators and policymaking authorities from Canada, United States of America, England and Germany (Jakab and Kumhof, 2015). First is by Graham Towers (1939), the then governor of the central bank of Canada:

> *"Each and every time a bank makes a loan, new bank credit is created — new deposits — brand new money".*

Alan Holmes (1969) who was the vice president of the New York Federal Reserve stated:

> *"In the real world, banks extend credit, creating deposits in the process, and look for the reserves later."*

In England, the Bank of England employees, Berry, Harrison, Thomas and de Weymarn (2007) echoed the same by saying:

> *"When banks make loans, they create additional deposits for those that have borrowed the money."*

Two (2) years later, Keister and McAndrews (2009), economists at the Federal Reserve Bank of New York explained:

> *"Suppose that Bank A gives a new loan of $20 to Firm X ... Bank A does this by crediting Firm X's account by $20. The bank now has a new asset (the loan to Firm X) and an offsetting liability (... Firm X's deposit at the bank)."*

Bundesbank (2012) of Germany:

> *"How is deposit money created? The procedure is equivalent to the creation of central bank money: As a rule, the commercial bank extends a loan to a customer and credits the corresponding amount to his deposit account. ... The creation of deposit money is therefore an accounting transaction."*

Mervyn King (2012), former Governor of the Bank of England reiterated the above:

> *"When banks extend loans to their customers, they create money by crediting their customers' accounts."*

Lord Adair Turner (2013), former head of the UK Financial Services Authority and one of the most referred experts in financial world, also concurred with the above authors. He candidly stated:

> *"Banks do not, as many textbooks still suggest, take deposits of existing money from savers and lend it out to borrowers: they create credit and money ex nihilo — extending a loan to the borrower and simultaneously crediting the borrower's money account."*

The above proclamations by the former Governors of Central Banks and key person of regulatory bodies are undeniable facts that conventional banks do create money. Before the author proceed with examining the issue within Islamic banks, it is important to deliberate on the gravity of bank's money creation that demands immediate investigation.

4.0 THE CONSEQUENTIAL OF MONEY CREATION

Global financial crisis 2007-2008 has reopened the debate on the negativity surrounding bank's money creation that appeal for various global authorities to cease the practice of giving license to banks to create money. In June 2018 442,387 (24.3% of the turned-out voters) Swiss citizens voted on a referendum for banning Switzerland commercial banks from creating money (Financial Times, 2018). This came after a study showed that the surge of money created by banks has led to the cycle of global financial crisis (Turner, 2012; Bagus & Howden, 2013; Smirna, 2014; Weber, 2017). Positive Money (2018) explains, referring to United Kingdom property market, financial crisis occurred because of the swell of money created by banking industry whenever unfunded financing facility are awarded resulting in the debasement of the currency value hence lifting up house prices and speculate on financial markets. Generally, the soaring of money created will lead to the value of printed money in circulation is diminishing. Such modus operandi grants banking industry the authority to take away the purchasing power from those who hold physical cash to the banking industry (Meera & Larbani, 2009). In short this scenario is called inflation i.e. too much money chasing few goods (Positive Money, 2015; Leithner, 2011; El Diwany, 2007; Sudeley, 1999; Rowbotham, 1998). To make the matter worst, the people with hard earned cash money are unaware that their purchasing power is stolen every time banks disburse loan. Their ability to own an asset has been forcefully taken away. This can be construed as legalized institutional theft and it is a form of injustice (Naqvi, 2015; Meera et al., 2009).

Adair Turner (2012), Chairman of the UK's Financial Services Authority, member of the Bank of England's Financial Policy Committee, bluntly said:

> *"The financial crisis of 2007/08 occurred because we failed to constrain the private financial system's creation of private credit and money."*

Bagus et al. (2013) and Smirna (2014) link fractional reserve banking (FRB) system with the crisis and Werner (2014) establishes that FRB system results in bank's money creation. Bagus et al. (2013) asserted that the foundation of the modern banking system – the holding of fractional reserves against deposits – is also problematic from economic, legal and ethical angles. Smirna (2014), citing Mises (1980), in referring to past financial crises, convinced that fractional reserve banking which is inherently unstable tends to be revealed with the occurrence of each crisis.

As banks' ability to create money partly due the practice of FRB system, the criticisms against FRB system are valid argument to support the judgement against money creation. Rothbard (1936), as quoted by Rozeff (2010), upholds that FRB is fraudulent, coercive and unlawful. Rothbard's stance has since been espoused by Jesu´s Huerta de Soto (2006), Jo¨rg Guido Hulsmann (2009). All of them judge FRB as fraudulent, unethical, unjust, disruptive and dysfunctional, akin to embezzlement and counterfeiting. Bagus and Howden (2010) cited Rothbard (1974; 1994) characterizes FRB as fraud based (in part) on an historical review of banking practices, Huerta de Soto provides comprehensive theoretical and historical evidence to support this claim. Huerta de Soto explains how the *depositum confessatum* – a loan veiled as a deposit in order to escape the canonical ban on usury – contributed to the perversion of the clear Roman legal doctrine on monetary deposits (2006, 16fn15, 64-71). In all these historic instances, FRB emerged as embezzlement or misappropriation.

Rowbotham (1998), a British monetary reformer, consistently asserts that FRB-based money supply system is perverse and inherently monopolistic and "anti-democratic". It creates an inflationary exponential growth imperative in the economy which leads to over-centralization and environmentally damaging and unstable over-consumption. Rowbotham et. al. 1998 elaborated that the indebted are forced to induce new consumers to spend their way into debt so existing loans can be repaid with new debt-created money. Failure to achieve this goal results in businesses foreclosure and insolvency that leads to economic collapse due to the sudden contraction of the money supply. This failure is inevitable due to the fact that, eventually, debt-saturated businesses and governments will no longer be able to force individuals into further debt due to the fact that they are already debt-saturated themselves. Once this point is reached, economic collapse is inevitable without wholesale debt repudiation. The former is supported by Hulsmann (2009) who argued that FRB would eventually lead to business failures and bankruptcies in the economy. He further explained that the very existence of fractional reserves implies an additional source of bankruptcy, that is, a source of failures.

Commenters of FRB have also equated FRB with unchallenged lawful pyramid scheme (Rowbotham, 1998; Anielski, 2000 and Paul, 2013). Rowbotham (1998) stated that the indebted are compelled to induce others into debt to pay off their own. Paul (2013) commented that FRB allows more and more loans are pyramid on top of a tiny base of money to create an economic house of cards just waiting to collapse.

In short bank’s money creation has caused more harm than benefit garnered in the long term. Seemingly the mechanism has contributed to the economic growth thus far but at the expense of the reappearing financial and economic crisis and open to abuse if not properly controlled.

5.0 DO ISLAMIC BANKS CREATE MONEY?

In the previous paragraphs the author has forwarded dissertation enacting that conventional banks do create money the moment loans are disbursed to the borrowers. The author further builds up the case for the destructive impact of bank’s money creation to the economy as well as the society. Subsequently the author will deliberate on money creation by Islamic banks.

Askari, Iqbal, Krichene & Mirakhor (2010) dismisses Islamic banks creates money in the same way as conventional banks do. They arrive at this conclusion under the pretext that Islamic banks are operating under a 100 per cent reserve banking. Unfortunately, Kureshi & Hayat (2015) reject the above and argue that Islamic banks are operating in a fractional reserve banking system copy-cat of conventional banking system hence they assert that Islamic banks do create money as conventional banks do.

Islamic banks in Malaysia operate under fractional reserve banking system under the name Statutory Reserve Requirement ratio. According to Hasan (2014), fractional reserve system is the key to money (credit) creation. Smolo and Hassan (2011)’s study on the potential of *musyarakah mutanaqisah* (diminishing partnership) technique for Islamic financial institutions proposed the technique be implemented in cooperatives instead of bank (including Islamic banks) due to the existence of money creation in fractional reserve banking. In its essence money creation exists in Islamic banks as well. Hasan (2014) also discuss money (credit) creation and Islamic banks in his book titled “Islamic Banking and Finance: An Integrative Approach”. However, Hasan (2014)’s discussion on the matter centred around whether or not Islamic banks should create money. He emphasises that Islamic banks should create credit. In the process, he states that Islamic banks were not sure whether or not to follow the step of conventional banks in creating money. Ironically, he also argues that “all deferred payment contracts in Islamic finance involve credit creation.”

Meera et al. (2009)'s analysis on "Ownerships effects of fractional reserve banking from Islamic perspective" unearthed the followings:

- The present Islamic banking and finance operates under the principle of fractional reserve banking system;
- New money creation is achieved through credit creation that is purely an accounting process that does not involve any ''real'' money.

6.0 CONCLUSION

Islamic Banking and Finance in Malaysia operates under the modern banking system with the establishment of Bank Islam Malaysia Berhad as a full-fledged Islamic commercial bank in 1983 following the success of Lembaga Tabung Haji. Modern banking system is the prototyped of and originated from the Bank of England and moulded by the Enlightenment doctrine. One of the core features of modern banking system is the practice of fractional reserve banking system which enables money creation by banking industry. Money creation stratagem has inflicted greater damages than betterment to the society. As Islamic Banking and Finance is founded on the Shariah, moral compass and wellbeing of the society, the money creation mechanism is a threat to the overall development of the industry. While the birth place of modern banking system has seen escalating criticisms for the operation of money creation, the mood is opposite in the Islamic Banking and Finance fraternity.

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