Ownership Effects of Fractional Reserve Banking: An Islamic Perspective

by

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Abstract

Fractional reserve banking (FRB) is the basis of the present-day monetary systems. In most countries, Islamic Banking and Finance too operates under this principle. This article argues that the FRB has effects on the ownership structure of assets in the economy, and that this effect violates the Islamic principles of ownership. It argues that money creation through FRB is creation of purchasing power out of nothing which brings about unjust ownership transfers of assets in the economy, to the bank effectively, paid for by the whole economy through inflation. This transfer of ownership is not based on human effort by taking on legitimate risks and neither with the knowledge nor the consent of the initial owners. These violate the ownership principles in Islam and tantamount to theft. It also has the elements of riba. On the same basis, Islamic governments should not create fiat money since this is equivalent to taking assets of the people, rich and poor alike, forcefully without compensation. It is, therefore, important that Shariah scholars come up with a fatwa on both the fiat money and the fractional reserve banking system. Such a fatwa is urgent and pertinent before Islamic banking and finance, that operate under these systems, takes a course that may prove to be difficult to reverse later. The Islamic economic and finance system cannot be founded upon a money system that is fundamentally equivalent to theft and riba.

1. Introduction and Objectives of Paper

Fractional reserve banking (FRB) is the term given to the banking system practiced in almost all countries today. Indeed, it's a simple system that governs the working of the present-day monetary system[1]. In most countries, Islamic Banking and Finance too operates under this principle. This article argues that the FRB has distributive effects - i.e. effects on the ownership structure of assets in the economy, and that this effect violates the ownership principle in Islam while inflicting profound injustice on the economy and society. It shows that FRB creates ownership out of nothing, without work and taking on legitimate risks; thereby transfering ownership wrongfully. The paper also shows that FRB has elements of riba that goes against the *maqasid al-Shariah*; and therefore can be termed illegal or *haram* from Islamic perspective. If the arguments are valid, then the paper has

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[1] Nonetheless, we find that the FRB is not understood by many, or perhaps is not much of a concern to, including even those who are trained in the areas like Economics and Finance.

profound implications for the validity of FRB from Islamic perspective, including the operations of Islamic Banking and Finance under the FRB framework.

This paper is divided into six sections. The current section gives the introduction and objectives of the paper. Section 2 discusses the principles of ownership in Islam while Section 3 describes the FRB process. Section 4 then argues why FRB is unacceptable from the Islamic perspective. Section 5 discusses other justifications given by scholars in favour of the FRB. Section 6 briefly discusses if seigniorage of fiat money is riba, and finally, Section 7 concludes the paper.

2. Ownership as the Basis of Wealth in Islam

The concept of ownership is an important principle in the Islamic faith. As God created man as the Khalifa (vicegerent) on Earth, He endowed him with ownership (milikiyyah) rights over properties (mal) so that he can execute his duties and obligations to himself, family, society and God in a halal and just way. The object of ownership, i.e. mal, must be "something of value, permissible and capable of being possessed." (Qadri, 1973). It can be tangible or intangible like intellectual property.

Ownership can be private or public and it refers to a bundle of rights. Montias defines it as "the word *ownership* refers to an amalgam of rights that individuals may have over objects, or claim on objects or services" and that "these rights may affect an object's disposition or its utilization."[2] Rights include the right to own, to possess, to utilize, to exclude others, to secure income, to security, to dispose, and obtain compensation if damaged and so on[3].

Ownership is based on the following three principles (Abd Mokhtar Yunus):

i. Allah is the supreme owner of everything.

> "*Knowest Thou not that to Allah belongeth the dominion of the heavens and the earth? and besides Him ye have neither patron nor helper*."
>
> *(Al Baqarah, 2:107)*

[2] Montias, The Structure of Economic Systems, p.116
[3] Mustafa Omar Mohamed, Foundation of Islamic Economics course notes, Faculty of Economics and

A consequence of this verse is that in Islam the *human effort* is the unique basis for creation of ownership.

ii. Man as servant and Khalifa of Allah is endowed with relative and conditional ownership. Allah created the earth and universe for the human kind for the purpose of fulfilling the function of *Khalifa* (vicegerent) and to benefit from it, as revealed in the following verses.

"*It is He who hath created for you all things that are on earth; Moreover His design comprehended the heavens, for He gave order and perfection to the seven firmaments; and of all things He hath perfect knowledge."*

(Al Baqarah, 2:29)

"*Believe In Allah and His apostle, and spend (in charity) out of the (substance) whereof He has made you heirs (mustakhlafina). For, those of you who believe and spend (in charity), for them is a great reward."*

(Al Hadid, 57:7)

Conditional ownership in the sense that man cannot do whatever he likes with the property owned. For example, he cannot bequest more than one third of his property and the Qur'anic injunction that there is a share of others – the poor and needy - in one's wealth.

iii. An individual has his own importance and role in the Islamic economic framework. He is responsible for fulfilling the duty of *Khalifa* of Allah on earth and achieving the happiness for himself and for the society. For this purpose, Allah has gifted humankind with many abilities and rights; one of them is the right of ownership.

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> *“O ye who believe! give of the good things which ye have (honourably) earned”*
>
> *(Al Baqara, 2:267)*

and in another verse,

> *“ See they not that it is We who have created for them - among the things which Our hands have fashioned - cattle, which are under their dominion?”*
>
> *(Yaasin, 36:71)*

At the same time Islam has established limits for the creation, utilization and transfer of ownership in order to protect the interests of the individual and the society at the same time. From these, we can deduce that ownership has an important socio-economic role.

> *“And do not eat up your property among yourselves for vanities, nor use it as bait for the judges, with intent that ye may eat up wrongfully and knowingly a little of (other) people's property.”*
>
> *(Al Baqara, 2:188)*

The endeavor of man to satisfy his needs is a necessity that is rooted in his nature. However, the satisfaction of these needs should not be free of any limitations or regulations, for the necessities or wants of people are often conflicting and divers. The absence of any limitations or regulations on ownership would surely lead to disorder, injustice and concentration of wealth in the hands of a minority.

There are many definitions of ownership in Islam. Elkorafi states that the ownership is a legal statement, from the point of view of *Sharia*, on something or on its utility that gives right to whom it is granted to use the owned thing and to get compensation for it. According to Ibn Ashat, ownership is the ability of acquiring the legal right to use something and/or its utility by someone or his representative by proxy. Sadr Alsharia states that ownership is a legal relation between a person and a thing that gives him right to use it and prevent others from using it. Ibn Taymia states that the ownership is “the legal ability to use something”. Khafif defines ownership as the legal ability that allows someone to exclusively use and benefit from something.

We may summarize the above definitions by saying that the ownership is a legally defined relation between a person and a thing and /or it’s utility that one can use only in *halal* ways and prevent others from using it unless by proxy and the owner of the thing can get compensations for it.

As mentioned earlier, in Islam the ownership is regulated at all its stages - the creation (or sources), the utilization and the transfer of it. The next section discusses the principles that govern the creation of ownership.

2.1 Limitations on the Creation and Sources of Ownership

This section discusses the sources or causes of ownership from *Sharia* point of view. Ownership can be divided into three categories: 1) ownership of the things that had no previous owner, 2) ownership of things that are already in existence and had been previously owned by others and 3) ownership by proxy. The first one is related to the creation of new ownership, the second is related to the transfer of ownership which we discuss in the next section. In Islam the *halal* means of creating new ownership are as follows (Abadi):

i. Reviving a dead land that is not owned by anyone, by working it.
ii. Discovering a treasure.
iii. Producing something (agricultural, industrial, scientific, intellectual, and so on)
iv. If a person owns an animal that gives birth to another animal, the latter becomes the property of the owner of the former. In other words, any product of an owned thing is owned by the owner of that thing (like fruits of an owned tree, produce of a slave etc.)
v. Own something as a result of hunting or fishing.
vi. Return on investment - profit from trade, product of employees, etc.

Agriculture is regarded by many scholars as the most *halal* way that can be used to create ownership, for in agricultural the principles of *Tawakkul* and *Ikhlas* are stronger.

Labour and Effort, the Basis of Ownership 2.2

As discussed earlier, Qur'anic injunctions reveal the human effort as the basis for creation of ownership in Islam. The traditions of the Prophet (p.b.u.h.) also attest to this.

The Prophet (p.b.u.h.) is reported to have said,

> "Nobody has eaten better food than the food that resulted from his efforts; the prophet Daud a.s. used to eat from the work of his own hands."
>
> (Sahih Al Bukhari)

and in another hadith,

> "Whoever revives a dead land he has a reward (*adjr*) for it. "
>
> (Musnad Imam Ahmad)

It is clear that the underlying principle of these sources of creation of ownership is *the human effort* (physical or intellectual). Thus, human effort is the principal *halal* way for creating ownership in Islam. Allah has, in the Qur'an, exerted people to work:

> "And *when the prayer is finished, then may ye disperse through the land, and seek of the bounty of Allah. and celebrate the praises of Allah often (and without stint): that ye may prosper*."
>
> *(Al Jumu'a, 62:10)*

> "*..others traveling through the land, seeking of Allah's bounty; yet others fighting in Allah's Cause.*"
>
> *(Al Muzzammil, 73:20)*

The Prophet (p.b.u.h.) was once asked, what was the best and most preferred means of ownership. He responded by saying that it is the work of a man by his own hands and any licit trade. (Atarghib wa Atarhib).

Also, in a well-known *hadith,* the Prophet (p.b.u.h.) said:

> "A worker should be given his reward before his sweat dries."

The above traditions show clearly the importance given in Islam to human efforts and also the importance of a just distribution of wealth in society.

Prominent Muslim scholars of the past have also emphasized the importance of human effort in creating ownership. Al Ghazzali said "Allah has ordered us to fulfill our needs and the needs of our family, this is possible only by creating ownership through work; what is necessary to complete a duty (*wajib*) is also a duty (*wajib*)". This shows that work is *wajib* in order to create *halal* ownership of things that we consume. Even things that are eaten and fed to one's family must be owned first according to Shariah legal means, otherwise it can tantamount to consuming *haram* things.

Therefore, ownership for oneself and the family is one of the most important duties (*wajibat*), for it is rooted in man and it keeps oneself away from harming others by taking the wealth of others wrongfully.

2.3 Limitations on Transfer of Ownership

Transfer is the most common way of acquiring ownership and *Shariah* gives great importance to the willingness and consent of the owner in the transfer of ownership. There are two basic Shariah principles in the transfer of ownership. The first one says that it is not possible to force one to own something without one's agreement or prior acceptance, while the second says that it is not possible to take possession of something that belongs to another without his agreement or prior consent (Abadi). Among the most important *halal* ways of ownership through transfer are as follows (Abadi):

1. Trade, i.e. exchange
2. Compensation - salary, commission etc.

3. Inheritance
4. Zakat and Sadaqa
5. Hiba or gift
6. Mahr or dowry
7. Wakaf
8. Dia for death
9. Khal'a
10. Ghanima – war booty

Transfers can be classified into the following categories:

a. Transfer of something from an owner to an owner with compensation (like in trade) – that is mutual exchange of ownership.
b. Transfer of something from an owner to an owner without compensation (like heritage and *hiba*).
c. Transfer of something from an owner to a non-owner with compensation (like debt).
d. Transfer of something from an owner to a non-owner without compensation (like slave delivery, *sadaqua*).
e. Transfer of something that is not owned to a non-owner (like reviving a dead land without owner).

It is to be noted that any transfer where the ownership of one of the parties or both is not *halal*, is not valid from Shariah point of view (Abadi).

2.4 Haram Means of Ownership

The principal *haram* ways of ownership in Islam are as follows (Abadi):

1. Hoarding (storing goods until price rises)
2. Overpricing
3. *Riba*
4. Corruption
5. Theft (taking possession of assets of people secretly without their permission or agreement.)
6. Cheating on the quality of a product

7. Gambling
8. Some trade practices like *Bay Al Gharar*
9. Forced and unfair possession of the assets of people without their permission and/or agreement
10. Any means that harm the individual or society

3. Money, Seigniorage and Fractional Reserve Banking (FRB)

In most of human history, commodities played the role of money in facilitating exchange in the economy. Mankind used all kinds of things as money; from beads, shells, salt etc. as money but the dominant were gold and silver. Nevertheless, following the demise of Bretton Woods in 1971, money today is predominantly takes the form of paper notes, coins (known as state money) and accounting records (created by banks as money through fractional reserve banking). Unlike in the gold standard or Bretton Woods, 'modern' money is not backed by or redeemable for gold and hence the term fiat money. This brings the issue of seigniorage, which is the benefit one gets from the first use of fiat money, i.e. the free purchasing power which new money, not backed by gold or anything with intrinsic value, carries with[4]. Indeed, it's the seigniorage that is at the centre of the discussion of this paper relative to the Islamic concept of ownership. Seigniorage is inherent in currency notes and coins, money created through fractional reserve banking and interest charges; and this paper discusses the ownership effects embedded in these.

Let us now revert our discussion to the concept of FRB. As mentioned earlier, banking systems in almost all countries operate under the fractional reserve system. Fractional reserve banking simply means that a commercial bank needs to keep a fraction of the deposits of its customers as reserve, while the rest can be lent out. As simple as it sounds, within the fiat monetary system, it incredibly has profound implications for the economy and society. This fraction is determined by the central bank and is known as the statutory reserve requirement (SRR). In Malaysia, as of October 1, 2006 the SRR ratio as set by the Bank Negara Malaysia was 4 percent of deposits. The reserve requirement is the proportion of deposits which the banking sector must keep as reserves to fulfill withdrawal needs. Nevertheless, under this system, an original deposit of RM1,000 for example, enables the banking sector to increase deposits to a maximum amount of

[4] We have dealt extensively with the concept of seigniorage elsewhere and do not intend to discuss it further here. Please see Meera (2004), Meera and Larbani (2006a and 2006b).

RM25,000 (which is RM 1,000 divided by the reserve requirement of 0.04). This new money creation is achieved through credit creation that is purely an accounting semantic that does not involve any 'real' money[5]. Notice that for the original RM1,000 deposit, an additional RM24,000 deposit (credit money) is created by means of loans[6]. When a loan is extended, it does not reduce the deposit of any of the depositors at all, because it is new money created into the economy. As a result of this new money creation, the original RM1,000 deposit is now equivalent to 4 percent of the current total deposits of RM25,000, i.e. the required reserve ratio. Therefore, the basic money supply in a nation consists of currencies and coins, normally termed as M0, and credit money which is also called bank money. The total of these two is termed as M1. Therefore, central banks use the SRR to control the money supply in their respective economies. During the 1997 economic crisis, for example, the Bank Negara of Malaysia[7] reduced the SRR from about 13 percent to 4 percent in order to increase the money supply in accordance to its expansionary monetary policy. Nonetheless, as innocent as the system may seem, it has profound distributional effects in the economy.

4. Ownership Effects of FRB

The ownership effects of FRB can be expounded as follows. Consider a businessman approaching the bank with a business plan, seeking a business loan - to buy land, building, machinery etc. Approved, the bank creates new money through fractional reserve banking and loans it out to the businessman at interest. The Islamic bank would use the newly created money to buy the assets from the economy and resell it to the customer at profit. The implications are as follows. The businessman uses the loaned money to buy the land, building and machinery that he wanted. He now owns these assets[8]. Now the question is: Initially, neither the bank nor the businessman owned the assets. The bank did not even have the money then. But the

[5] Not even paper currency or coins. When a loan is extended, the borrower is recorded a double entry, one debit and one credit. The debit denotes him as a debtor to the bank for the loan taken, while the credit entry denotes him as a depositor, to the amount extended to him. These are simply accounting entries that do not involve the movement of any physical currency notes.

[6] This is how banks create money out of thin air. Money is created when banks extend loans. Hence money in most part is only accounting entries in the books, electronic or otherwise.

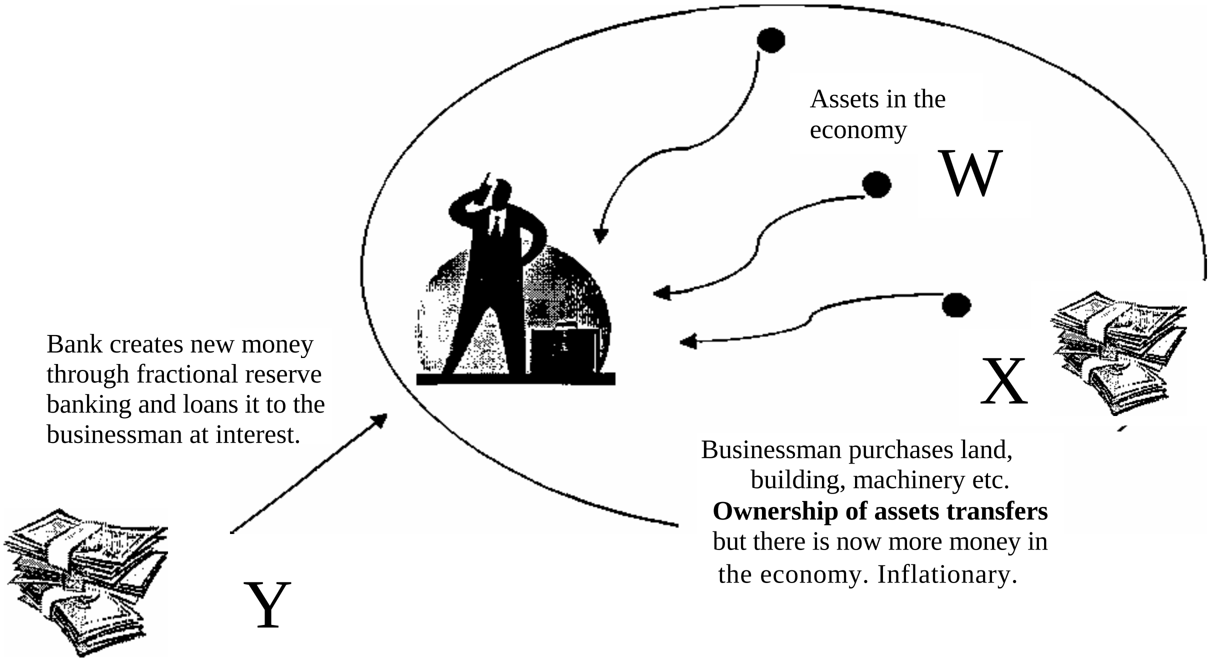
[7] Malaysia's central bank.

[8] The real owner of these assets is, indeed, the bank for if the businessman fails to pay back the loan then the bank can take possession of those assets.

businessman/bank became the owner of the assets after creating money out of nothing, through the FRB process. From the real economy perspective, every such transfer of asset, which is not a gift, inheritance or likewise, must be compensated for. If so, who then paid for the assets? Diagram 1 explains this.

Diagram 1

FRB Transfers Ownership Through Inflation



Initially, certain amount of money, X, circulate in the economy with W amount of real things. Now bank creates Y amount of new money and loans to the businessman, who uses it to acquire ownership of some of the real things. Now there is more money in the economy (X + Y) but same amount of real things, W. Therefore this causes inflation in the system. Those holding the initial X money would find their purchasing power fall. The total of the purchasing power lost equals the wealth transferred to the businessman.

Note that the introduction of new money had transferred ownership of assets. But there is now more money in the economic system than before. *Ceteris paribus,* this is inflationary[9]. Those holding money would have to forego some purchasing power of their money. They can now only claim less real things in the economy. Indeed, the total of the real purchasing power lost by the economy as a whole equals the total value of assets transferred to the businessman/bank. **In other words, all subjects in the economy paid for the transfer of wealth through inflation,** i.e. through increased price levels. Table 1 gives the growth in the monetary aggregate M1, which is the total of currency in circulation and demand deposits, for thirty two selected countries for the period 1993 to 2004. Clearly for all countries the monetary aggregate grew at a higher rate than the real economy itself, measured by the growth in real GDP. Comparing the growth in money and the real economy, the third column gives the implied inflation. Therefore, in all these countries transfers of ownership of assets have been taking place financed through inflation. The worst of these countries is Turkey and Brazil, with implied annual inflation rates of 66.66 percent and 39.73 percent respectively.

Hence when inflation is a monetary phenomenon, i.e. due to increase in money supply, it therefore is a 'tax' on the economy - a hidden tax on the rich and the poor alike - that, indeed, transfers wealth. Accordingly, when inflation is a monetary phenomenon, not all market participants are losers**. It's a zero-sum game that actually redistributes wealth and ownership of assets in the economy, where the loss to one is a gain to another.** It basically transfers ownership of assets from the economy as a whole to those who create fiat money – a one-way transfer similar to gift, inheritance, tax etc. but here with the absence of knowledge and consent. Contrarily, when inflation is due to real phenomenon, for example due to a fall in the real output, then the whole economy bears the reduction and therefore is not a zero-sum game. In effect, when a bank creates money through FRB and lends it out, in the real economy, it actually takes possession of assets of others by force, neither with their knowledge nor consent[10], and lends them out to others, for a return.

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[9] Quantity theory of money says that money supply is directly proportional to price times real output, i.e. $M \propto PY$. When money supply, M is increased, when the real output, Y stays constant, the price level, P, rises, i.e. inflationary. Price levels can also rise when real output, Y falls. For example, due to a fall in output as a result of natural disasters like flood or due to fall in the productivity levels.

[10] Since FRB is a legalized institution, even if one knows one's wealth is being taken by force and that one does not consent it, one indeed can do nothing about it, i.e. cannot demand compensation or anything like that.

Table 1

Monetary Aggregates for Selected Countries

(1993 – 2004)

		Money Growth	GDP Growth	Implied Inflation
1	ARGENTINA	10.58	1.51	8.93
2	BAHRAIN	7.72	4.17	3.40
3	BANGLADESH	13.28	4.54	8.36
4	BRAZIL	43.32	2.57	39.73
5	CHILE	9.65	4.75	4.68
6	CHINA,P.R.: MAINLAND	19.64	9.20	9.57
7	ETHIOPIA	12.92	3.84	8.74
8	GHANA	37.57	1.44	35.61
9	INDIA	16.25	5.62	10.06
10	INDONESIA	19.62	6.81	11.99
11	IRAN, I.R. OF	27.64	2.48	24.55
12	ISRAEL	13.27	3.66	9.27
13	JORDAN	7.99	3.60	4.24
14	KENYA	13.49	2.67	10.54
15	KUWAIT	5.61	2.62	2.91
16	MALAYSIA	11.80	5.41	6.06
17	MALDIVES	17.37	7.56	9.12
18	MAURITIUS	12.51	4.62	7.54
19	MEXICO	17.81	2.84	14.55
21	NIGERIA	24.77	2.83	21.33
22	PAKISTAN	14.62	3.68	10.55
23	PHILIPPINES	14.11	4.15	9.57
24	SAUDI ARABIA	7.16	2.46	4.59
25	SINGAPORE	11.77	5.63	5.82
26	SOUTH AFRICA	14.83	2.43	12.11
27	SRI LANKA	16.53	4.53	11.48
28	SYRIAN ARAB REPUBLIC	13.15	3.96	8.84
29	THAILAND	8.42	3.66	4.59
30	TUNISIA	10.43	4.70	5.48
31	TURKEY	71.82	3.10	66.66
32	VENEZUELA, REP. BOL.	36.12	0.67	35.22

Source: Computed from International Financial Statistics Yearbook 2005

From Islamic perspective, is it justified that the bank takes possession of assets of people and lend them to others for productive or consumption purposes, whenever someone shows the need for these assets? For example, when one needs a house, the bank creates new money and uses it to take possession of the house from the developer and loan it to the participant at some interest or sell it at profit as in the case of Islamic financing?

We contend that this clearly violates the ownership principles in Islam. This is indeed **equivalent to theft**, i.e. taking possession of assets belonging to others without their knowledge and permission. It can even be termed as being worse than theft because in a theft, the thief takes the risk of being caught and punished. However, under fractional reserve banking the theft takes place within the legal provisions and hence FRB may be termed as 'legalized theft". It also has elements of riba for it is purchasing power created out of nothing, neither with work nor assuming any risk. All these clearly contradicts the Qur'anic verse Al Baqarah 188 that commands Muslims not to eat up the properties of others in conceit.

5. Other for-FRB Arguments

Other arguments generally put forward in support of FRB are

a. The money multiplier brought about through FRB increases liquidity in the market.

More money may bring about more liquidity but can this be justified by transferring wealth unjustly and indiscriminatingly among the subjects in the economy - especially if the argument that FRB is similar to theft is true? The priorities of the Islamic economic system which is based on the maqasid al-Shariah must be always kept in view when solutions of any kind are sought.

In this case, therefore, liquidity cannot be justified when the means of achieving it does not protect the wealth of people.

b. Money supply increased through FRB stimulates the economy through increased demand and thereby increases the real output.

Some scholars argue that, when the money supply is increased, and if the real output were to increase too (e.g. due to a rise in productivity) then the price levels may not increase, i.e. non-inflationary. This is true, but then the moral question comes up again, i.e. On what moral or legal grounds should the bank take ownership of any productivity increase in the economy? The benefit should go to those who are responsible for the productivity increase, i.e. the firms and workers[11].

c. Some quarters propose that if that is the case, then, why not rest the money creating and lending power with the government alone, for example, by nationalizing banks[12]. In this way everyone including the poor would technically own the loans and money created in the system. Also in this way the government could use the newly created money in a 'shuratic' way in areas most beneficial to all like building infrastructure, schools, hospitals, social welfare etc.

While nationalizing banks may accrue the benefits of new money to the government that supposedly represents the people, the question remains: Can the government take ownership of assets of its subjects forcefully, without their knowledge and consent and lend/sell them to others at interest or profit . In other words, is it justified for governments to impose a 'hidden tax' on the poor and the rich alike through inflation and take possession of assets?[13] Indeed in Islam, even the government is subjected to its rules of ownership. It cannot take possession of assets of the people wrongfully. Its income from *zakat* and other levies are meticulously calculated and carefully

[11] This like someone saying, "Please give me the right to bring forth money out of nothing. With it I can have purchasing power to demand the goods and service that you produce. With that, the economy as a whole would have more goods and services. Isn't that good?"

[12] Meera (2004) suggests the nationalization of banks as an intermediary step towards a total 100 percent reserve requirement system based on real money.

[13] Some individuals and organizations, like the Christian Council for Monetary Justice, Britain, suggest that the government use this inflation 'tax' of new money and push this new purchasing power through the poorer sections of the economy - like funding orphanages, homes for the elderly, hospitals etc.

implemented. In *zakat*, for example, only those with wealth equal or beyond the *nisab* are required to pay. The poor are exempted from such levies. The system ensures that not a single soul is wronged. *Fiqh Muamalat* governs and ensures a just exchange of ownership in trade and business activities. *Faraid* go very meticulous on how transfer of wealth should take place in the case of inheritance.

Zakat and *sadaqat* are encouraged as transfers of ownership from the rich to the poor. The poor is never forced and burdened in the Islamic system but the FRB does tax the poor too. Meera (2002, 2004) contend that the seigniorage of fiat money including that created by FRB is responsible for significant global socio-economic problems.

d. Controlling the money supply by regulating the statutory reserve ratio provides monetary policy flexibility.

This may sound like a valid reason but we contend that this characteristic is necessary in the current monetary framework because of the fiat nature of all national currencies. The kind of automatic adjustment process that existed under the gold standard is absent in the current global monetary system[14]. Indeed, even in the present monetary system most developing nations' monetary policies have become subjected to the decisions by the developed nations, thereby enjoying neither flexibility nor independence of monetary policies.

e. Some quarters argue that nations issue money based on gold and foreign currencies reserves they have, like those placed with the IMF. Therefore, money is not created out of nothing but rather is backed by those reserves.

The fallacy of the above argument is that when we say money is backed by gold or anything, it is redeemable for that thing, e.g. when

[14] See Duncan (2003) for a discussion on this.

the dollar was redeemable for 1/35 ounce of gold in the Bretton Woods system. When there is no specific per unit redemption then there is no backing[15].

f. FRB allows the managing of the international competitiveness of a nation's exports. By increasing or decreasing the money supply, wages and the price levels can be affected accordingly.

Its is true that monetary policy can be used to improve competitiveness of exports. But the question is at whose expense? If competitiveness is achieved by reducing wages, then the increased exports is achieved at the expense of the workers. This again has distributional effects.

Additionally, just how much export competitiveness is enjoyed by developing nations vis-à-vis the developed nations in the current set up? The frequent failures of WTO talks and mass demonstrations during its meetings are the result of dissatisfaction among the mostly disadvantaged developing nations in international trade negotiations.

6. Ownership Effects of Interest Charges in a Fiat Monetary System

The ownership effects of interest charges are quite straight forward and easy to see. An interest charge basically imposes on the borrower a payment of additional 'free' purchasing power over and above the principal amount loaned. It's 'free' because the interest is charged without regard to and independent from the risks borne by the borrower.

In a fiat monetary system, loans are not repayable in the aggregate because the interest portion that need to be paid does not exist in the form of money. Therefore, in aggregate, the interest portion must and can only be paid in real terms, i.e. in the form of goods and

[15] This is like a government saying, "I have some gold therefore I have the right to issue fiat money and impose a

services. To illustrate this, say a central bank pushes 1 billion of its currency into the economy with an interest charge of 20 percent per annum. This 1 billion would exchange hands in the economy, creating value and wealth in the form of goods and services. This would show-up in the form of increased assets amount in the balance sheets of individuals and businesses. But the total amount of money in the system would still be 1 billion while the system is required pay back 1.2 billion. Since the 0.2 billion does not exist, at the end of the year, the system as a whole will default and the interest portion can only be paid, therefore, in the form of real assets and services (that can come from both the previously owned assets and the newly created ones). Therefore, in the current fiat money system, interest transfers ownership of assets by the mere design of the system – someone simply got to default on the loans and repayment made in the form of real things. This is the reason why collaterals and guarantors are important for banks.

When loans are repaid by means of instalments, the default is somewhat camouflaged. For instance, in the above example if the borrowers are allowed to repay the 1.2 billion in monthly instalments of 0.1 billion, the banking system could spend back monthly the 0.1 billion received thereby acquiring goods and services. This money can later be used to pay again to the bank. The system would appear as though not defaulting but in the process goods and services would have transferred to the bank, just like in the earlier example when goods and services got transferred after an obvious default.

It is therefore clear that interest transfers ownership of wealth by the mere design of the system, while refusing to take any risks involved in the process of creating value and wealth. That interest is riba is therefore quite obvious. What is not so obvious is whether the creation of fiat money itself is also riba.

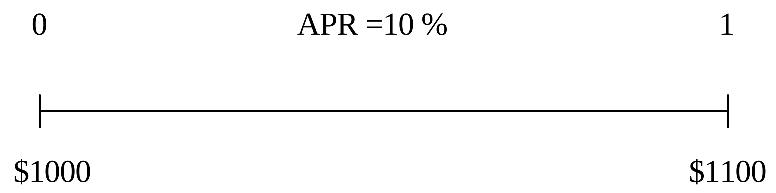
7. Is Seigniorage of Fiat Money Riba?

Having discussed the effects of FRB, can the seigniorage of fiat money be considered as riba? We assert that it is. Consider Diagram 2 below:

forced tax on the people." Is this a reasonable argument?

Diagram 2

Seigniorage of Fiat Money and Riba



If a bank lends out say $1,000 at an APR of 10 percent, the borrower must repay $1,100 at the end of the year. The additional $100 is regarded as riba because it is additional purchasing power acquired without assuming any risk. But what if the original principal amount of $1,000 is created out of nothing, as in FRB and currency notes and coins? It gives free purchasing power that is ten times the interest charge, and is assumed immediately, unlike the interest money that is received only a year later[16]. This free purchasing power that is many times more than the interest itself and acquired without assuming any legitimate risk is indeed riba. It is pertinent and urgent in current times therefore, that scholars of Shariah deliberate on this and come up with a fatwa on fiat money and fractional reserve banking. Since Islamic banking and finance operate under these systems, such fatwa is urgent and pertinent before Islamic banking and finance takes a course that could prove difficult to reverse later.

8. Conclusion

This paper looked at the fractional reserve banking system from the perspective of Islamic principles of ownership. It argued that money creation through FRB is creation of purchasing power out of nothing. In the real economy, this brings about ownership transfers of real goods and services from the economy to the bank effectively, paid for by the whole economy through inflation.

This creation of ownership or transfer of ownership does not take place with the knowledge and consent of each and every initial owner; and the transfer takes place without assuming any legitimate risk. The transfer is also not based on human effort or

[16] According to the principle of time value of money, in today's terms, the value of the $100 interest received at the year-end is less than that amount with regard to its purchasing power today.

product of labour. These violate the ownership principles in Islam and tantamount to theft. It also has the elements of riba that is even worse than interest charges. Scholars have identified this as a source of significant socio-economic problems including unjust distribution of wealth and poverty.

On the same basis, we can deduce that, not only the creation of money by FRB is not *halal* but the process of creating fiat money itself is not *halal* as well. Indeed, a bank note of USD100, for example, has a purchasing power of 100 USD but the cost of its creation might not exceed say 80 cents, so the difference, 100-0.80=99.20 USD, i.e. the seigniorage, is a purchasing power created out of noting without any human effort.

On the same basis, we can say that even the government should not create money out of nothing because it is equivalent to taking assets of people without compensation. In Islam, the ownership is protected even against the government. The government can take the assets of people in only very specified, prescribed ways like the *zakat*, and in other cases it has to give compensation.

Therefore, fiat money and FRB are anti-thesis to Islamic economics and finance. Accordingly, this paper asserts that Islamic banking and finance operating under fiat money and fractional reserve banking is unacceptable or even could be termed *haram* since it violates the principles of ownership while having the elements of theft and riba.

One may argue that the modern financial system has made the economy more efficient. But the price humanity had to pay for this efficiency in terms of loss of ownerships, unjust distribution of wealth and damage to the environment probably outweigh any efficiency gained.

It is not easy, of course, to point finger at established systems like the fractional banking system. But established systems have floundered and collapsed in the past - for example, like socialism in Russia. Now capitalism is, indeed, showing similar signs of faltering, with long established firms and banks showing sign of distress and even collapsing. Analysts normally attribute this to firm-specific factors, but from earlier arguments, we do assert here that the financial structure in the economy, in particular the fractional reserve banking system has a lot to do with it.

After a series of corporate financial distresses, particularly during the 1997 East Asian financial crisis, corporate governance has become an in-thing in this part of the world, with the determination to instill transparency and check corporate scandals and frauds. But are we bold enough to recognize fractional reserve banking as profound fraud[17]?

[17] After teaching and advising state leaders on economics for over 70 years, the late Harvard professor John Kenneth Galbraith wrote his last book titled, *The Economics of Innocent Fraud*. We recommend it for wisdoms into the workings of present-day economic and financial systems.

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