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Book Reviews

Akhand Akhtar Hossain. *Central Banking and Monetary Policy in Muslim-Majority Countries*

Cheltenham: Edward Elgar Publishing, 2015, 374 pages

Reviewer: Necdet Sensoy

The author, Akhand Akhtar Hossain, has multiple publications covering Central Banking and Monetary Policy issues in the Asia Pasific countries. The first book he published was, "***Central Banking and Monetary Policy in the Asia-Pacific***" in 2009, (Cheltenham, UK and Northampton, MA, USA: Edward Elgar). The second book was published in year 2015, titled ***"The Evolution of Central Banking and Monetary Policy in the Asia-Pacific"***, (Cheltenham, UK and Northampton, MA, USA: Edward Elgar). The second book is reviewed by Gopalan Sasidaran and the review has been published in the jounal of The Institute of Southeast Asian Studies (ISEAS) (Gopalan, 2017). Gopalan introduces the book as a contribution to the understanding of the impact of different monetary policy frameworks on macro-economic outcomes in the region. Besides an introduction chapter, the book has twelve chapters with each chapter dealing with a country case study[1]. Among the twelve country case studies, with the exception of the US, the remainder deal with countries from Asia-Pacific region. These include six advanced economies, namely

1 Contents: 1. Introduction 2. Australia 3. China 4. Hong Kong, SAR of China 5. India 6. Japan 7. South Korea, 8. New Zealand 9. The Philippines 10. Singapore 11. Sri Lanka 12. Thailand 13. The United States Appendices Index

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Australia, New Zealand, Japan, South Korea, Singapore and Hong Kong, as well as five developing economies, including China, India, the Philippines, Thailand and Sri Lanka. Gopalan refers to the first book saying, "This book is to be treated as a follow-up to the author's previous book (Hossain, 2009) which appears to have focused on case studies of monetary policy evolution in Muslim Majority Countries" and makes a comment that, "the author's previous work included an analysis of Malaysia and Indonesia, considering that they are important emerging markets in the region, excluding from the current book seems rather odd and disconnected" (Gopalan, 2017, p. 575).

The book which I am reviewing is the author's third book on this field which now claims to cover *Muslim Majority Countries*. After a comprehensive introduction chapter; Bahrain, Bangaldesh, Egypt, Indonesia, Iran, Malaysia, Pakistan, Saudi Arabia and Turkey are taken as countries subject to the case studies. Neither the definition of "Muslim Majority Country" nor how these nine countries are selected is explained. It is an unanswered question that why the author did not include the countries like; Jordan, Nigeria, Oman, Qatar, Sudan and United Arab Emirates. One criterion could be that the countries which are covered are those having dual system of banking. However Iran is included in which only Islamic banking is allowed while Sudan is not included having the same characteristics.

The author builds his proposition on the assertion that macroeconomic stability in general and price stability in particular are esssential for steady and efficient growth. As such, according to Islamic principles of equity and social justice, macroeconomic stability is critical for sustained economic growth and comprehensive stability in both social and political terms.

The author has several presumptions:

- A *fiat monetary system* can keep inflation low and stable provided that the monetary authorities conduct monetary policy by deploying a well-designed monetary rule, such as *monetary targeting under a floating exchange rate system,* requiring the use of monetary instruments to control the money supply (p. 8). While giving reference to Chapra he claims that muslim scholars now generally accept the fiat monetary system, provided that the monetary authorities commit to price stability through keeping inflation at a zero level on average (p. 8).
- Price stability is the cornerstone of an Islamic financial system and that inflation is a monetary phenomenon that can be kept low and stable through <u>*a rule-based monetary policy,*</u> such as <u>*monetary targeting*</u> (p. 7-8).

- An Islamic monetary system is most compatible with classical monetary theory and policy. At base, it links money to prices and distinguishes between money and credit. The price level is therefore an endogenous variable, showing a linkage between money and prices (p. 9).
- Money is an asset while credit represents a transfer of purchasing power in exchange for (expected) reward. The interest rate is not price of money; rather it is price of credit (loanable funds) and is determined in the credit market through the interaction of credit demand and credit supply (p. 9).
- In a properly functioning Islamic credit system, money as financial capital acts as potential real capital (physical production assets). It does not earn money (return) by itself, but only after transformation into real capital (p. 9-10).
- The opportunity cost of holding money is not interest rate but "the expected rate of profit" from the use of money as capital in a productive activity (p. 10).

The author makes his comments under the present globalized set-up with free movement of capital and concludes that Islamic banking and finance (IBF) oriented monetary financial system make open economies more resilient. He says that, "equity based banking system copes better than mainstream debt oriented systems".

He makes an observation that IBF is recognized as a complementary sub-sector of finance, within any society irrespective of that society's religious and philosophical position. His view is that they can happily operate side by side. IBF's financial intermediation is related to real sector, by definiton. This is positive side of IBF while conventional banks and financial institutions have come under criticism because of their aggresive risk taking behaviour by developing complex financial products with little or no linkage to real sector activity.

The author indicates a contradiction between what IBF as an equity based finance needs and what is available in Muslim majority countries. He says that, "the profit and loss oriented business model of Islamic banks and financial institutions is neither designed to function in an unstable economic environment nor equipped to do so efficiently". As a result of this, Islamic banks and financial institutions compromise their fundamental principles, mimicking conventional banking products and services.

He infers; "The reason of existence of IBF is thus lost before it reveals its usefulness in the modern economy and society. IFIs can operate ethically and morally only in an environment where price stability exists".

The author emphasizes that while Islamic financial institutions are gaining acceptability in western countries for the sake of low inflation and stability, many Muslim majority countries remain uncommitted to achieving the sustained low and stable inflation. His proposition is that the principles of Islam are inconsistent with policy generated inflation, on the contrary Islam is consistent with the findings of mainstream monetary economics that high and volatile inflation adversly affects economic growth.

He describes the methodolgy he followed in the book as “precise” and “matter-of-fact style” with empirical orientation and policy focus. He says that he avoids becoming strongly prescriptive in tone and substance. The emprical analysis for case studies are suggestive and exploratory not comprehensive. Those case studies are not organized following a pre-set format.

Although the author claims to avoid being prescriptive, he suggests rule based monetary policy, more flexible exchange rate systems and monetary targeting regimes (p. 8). The author does not mention the superiority of rule based policy to discretionary policies in achieving price stability in the text section of the book. However in the chapter covering Bangladesh, monetary targeting is defended as working generally better in developing countries, where interest rate channel of the transmission mechanism of monetary policy is not effective (p. 99).

Bahrain

The topics covered are : “Brief Political History / *Evolving Centre of Islamic Banking and Finance* / Central Banking and Monetary Operations / External Trade and Exchange Rate Pegging / Macroeconomic Developments, Inflation and Interest Rates / Inflation, Real interest rate, Real Output / Monetary and Exchange rate policy issues / Emprical Results of Money demand function / Summary and Conclusion”.

The author highlights the problems associated with fixed peg exchange rate systemwhich is implemented by Bahrain, by indicating the danger of boom-bust cycles and the lack of discipline in US monetary and fiscal policies. He says that “the discretionary, non rule based, opaque nature of US monetary policy, deprives it of credibility (p. 54). Therefore, he investigates that whether a monetary policy shift from its fixed peg to a flexible exchange rate system would be beneficial for macroeconomic management in Bahrain or not. He expects that the introduction of a flexible exchange rate system would enable Bahrain to conduct independent monetary policy. Here the author suggests inflation targeting for Bahrain.

Bangladesh

The topics covered are : "The Financial System *(Sub title : The Islamic banks and financial institutions)* / The Monetary Policy Framework / Monetary Policy Instruments and Transmission Mechanisms / Inflation, Inflation persistence and inflation volatility / Inflation, Real interest rate, Real exchange rate and Real Output growth / Monetary targeting for price stability / Summary and Conclusion".

The author refers to Bangladesh Bank, 2006b, p. 1; quoting : "The Bangladesh Bank abandoned the **fixed peg** exchange rate system on 31 May 2003, which had been in operation since the late 1970s, in favour of a 'managed float' exchange rate system. The managed float exchange rate system, while effectively an **adjustable peg** to the US dollar, has given the Bank some autonomy (under capital controls) in the design and conduct of monetary policy to achieve long-term policy objectives..." (p. 60).

The author determines the key policy measures important for Bangladesh as raising the flexibility of the exchange rate and improving prudential regulation and supervision of the banking system. He makes a suggestion for Bangladesh that it may have to replace the present administrative-based capital controls with market-based capital controls.

Egypt

The topics covered are : " Financial System *(Sub title : Islamic Banking Sector)* / Exchange rate arrangement and Monetary policy strategy / Monetary policy framework : Objectives, Strategies and instruments / Macroeconomic developments and inflation performance / Inflation, Real interest rate, Real exchange rate and Real Output / Monetary and Exchange rate policy issues / Summary and Conclusion".

The author reviews some monetary relations to examine the feasibility of adopting a rule-based monetary policy such as monetary targeting or inflation targeting[2] in Egypt. The money-demand relationship has been examined for the country

2 Inflation targeting combines elements of both "rules" and "discretion" in monetary policy. This "constrained discretion" framework combines two distinct elements : a precise numerical target for inflation in the medium term and a response to economic shocks int he short term. Inflation targeting provides a rule like framework within which the central bank has the discretion to react to shocks. Cited in : Jahan, Sarwat, Inflation Targeting : Holding the Line, IMF F&D Article – IV. Economics in action

and a broad money demand function has been found stable. He concludes that monetary targeting is an appropriate monetary policy strategy for Egypt (p. 138).

Indonesia

The topics covered are: "Financial system (*Subtitle: Islamic banking and finance*) / Money, Output and prices: 1950-2012 / Exchange rates, Capital flows and monetary policy / Financial reforms, money demand and inflation / Inflation targeting framework: design, policies and issues / Summary and conclusion".

Inflation targeting started in July 2005 and since mid 2010 the authorities have introduced an enhanced inflation targeting framework. Indonesia's inflation has declined since 2005 although it remains moderately high and volatile. The author observes that Indonesia's adoption of inflation targeting in 2005 was premature, given its underdeveloped money and capital markets. Inflation in Indonesia remains highly persistent. Statistical analysis has shown that inflation targeting did not raise much credibility in monetary policy for price stability. He concludes that despite some success in constant efforts to improve the design of monetary policy in Indonesia, the challenge remains to conduct credible monetary policy for price stability.

Iran

The topics covered are: "Iran's recent political and economic history / Financial system *(Sub title: Islamic banking)*/ Monetary policy framework / Macroeconomic and monetary developments / Inflation, real interest rate, real exchange rate and output / Monetary and exchange rate policy isuues / Summary and conclusion".

The author determines that Iran has maintained moderately high economic growth under successive fixed peg and then managed float exchange rate systems (p. 211). Iran's high and volatile inflation has made the real exchange rate overvalued and volatile. This has compromised Iran's economic growth potential. Iran has limited monetary policy independence under its managed float system with controls. He concludes that Iran's high and volatile inflation has been due to excess money supply. To establish control over the money supply, Iran requires a more flexible exchange rate system.

Malaysia

The topics covered are: "Financial system (*Sub title : Islamic banking and finance*) / Bank Negara Malaysia and monetary policy in Malaysia / Exchange rate arrangements, Capital controls and monetary policy / Macroeconomic developments and inflation performance / Inflation, real interest rate, real exchange rate and real output / Monetary and exchange rate policy issues / Summary and conclusion".

The author summarizes that after a long period of a mainly fixed peg exchange rate system, since 2005 the exchange rate has become somewhat flexible under the managed float.

From 1970s to 2000s Malaysia adopted a loose form of monetary targeting under varied exchange rate arrangements (p. 255). Presently, the Central Bank of Malaysia (BNM) uses policy interest rate as an instrument of monetary policy.

His observation is that Islamic banking and finance has gained prominence in Malaysia, operating in parallel with conventional banking and finance. He refers to the emprical results and indicates that money remains an important component in the inflationary process in Malaysia.

Pakistan

The topics covered are: "Financial system (*Sub title : Islamic banking and finance*) / The state bank of Pakistan (SBP): Organization and functions / Evolution and conduct of monetary policy / Macroeconomic developments and inflation performance / Inflation, real interest rate, real exchange rate and real output / Monetary and exchange rate policy issues / Summary and conclusion".

In a historical outlook the author highlights that from the 1990s through to the mid 2000s inflation was at a moderately low level of about 5% per annum. However, it has remained unstable since then. He observes that the monetary policy strategy in Pakistan is not transparent. Until the mid 1980s Pakistan pegged its rupee to US dollar. Since then it has maintained a managed float exchange rate system (p. 289).

The author is sure that the financial system in Pakistan can be regarded as adequately developed to adopt a rule based, forward looking strategy of monetary policy, such as inflation targeting. The adoption of rule based monetary policy requires the presence of some flexibility in the exchange rate system. So, to ensure monetary policy independence in Pakistan, the exchange rate should be allowed to be at least largely determined by the market forces.

Saudi Arabia

The topics covered are: "Financial system (*Sub title: Islamic banking and finance*) / The Saudi Arabian montary agency (SAMA): Organization and activities / Macroeconomic developments / Inflation, real interest rate, real exchange rate and real output / Monetary and exchange rate policy issues / Summary and conclusion".

The country's exchange rate has been pegged to the US dollar since 1980s. The author comments that price stability is apparently not the prime concern of Saudi Central Bank (SAMA) under this exchange rate arrangement. The central bank seems rather more concerned about exchange rate stability as an instrument to maintain financial stability which is important for attracting and retaining foreign investment.

He stresses that the emprical results suggest that the Saudi narrow money demand function remained stable over the study period (1958 Q1-2010 Q4), however the results do not suggest any significant short term causal relationship between money supply growth and inflation. The author observes that the financial system in Saudi Arabia is yet to be developed however there is concern that under a floating exchange rate system, the exchange rate could be highly volatile. In general, Saudi Arabia maintains disciplined monetary and fiscal policies and holds huge foreign reserves. The Saudi banking system is also well capitalized.

Turkey

The topics covered are: "Financial system (*Sub title : Islamic banking and finance*) / The Central Bank of the Republic of Turkey / Macroeconomic policies : Growth and stabilization / Macroeconomic developments and inflation performance / Inflation, real interest rate, real exchange rate and real output / Issues in monetary policy and exchange rate policy / Summary and conclusion".

The author is sceptical about appropriateness of Turkish Central Bank's monetary policy regarding inflation targeting based on his evaluation that the financial sector is not fully developed. He observes that the use of interest rate as the instrument of monetary policy has not been very effective in stabilizing inflation (p. 355). He makes a suggestion that, "The money growth rate has become more volatile. The key question for Turkey is whether it should, while retaining inflation targeting, substitute monetary aggregate for the current short term interest rate as its monetary policy instrument of choice, at least until the financial sector develops further and interest rate comes to play a greater role in the transmission mechanisms of monetary policy" (p. 355). He says that the emprical results show the presence of a link between money supply growth and inflation. He also has a risky suggestion regarding capital flows, saying "to maintain stability of the exchange rate, market based capital controls are now widely used across the globe. Such a strategy could prove useful to Turkey until it develops its financial system sufficiently absorb external shocks".

As a secondary issue with the subject matter of the book, he makes a factual error as he writes, "....Turkey's war of independence against Greece and Armania" (p.325). In fact Turkey's independence war was not against Armania.

Conclusion of the Review

The approach of the author is not an idealistic view; he rather makes a realistic analysis of the state of the macroeconomic conditions and monetary policies of so called Muslim-majority countries.

Depending on the given global economic and financial architecture, he searches for the policies which can bring stability to these economies to set the necessary environment for emergence and development of Islamic finance. Usually the propositions in the literature of Islamic economics expect financial stability to be a consequence of the implementation of ideal requirements. Here use of contemporary tools is suggested to achieve stability. The author argues that, once price stability and financial stability are achieved, Islamic finance can operate parallel to conventional finance and can also keep some comparative superiority.

References

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