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HOW WOULD NON-INTEREST BANKING AFFECT THE EFFECTIVENESS OF MONETARY POLICY IN NIGERIA

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1.0 INTRODUCTION

One of the most cardinal mandates of any government is to monitor and improve on the development of macroeconomic variables such as inflation, growth, employment, public debt, investment, and exchange rates by try to have or maintain them at manageable/optimal level using efficient policy options. The major policy options are normally the fiscal policy and monetary policy. The monetary policy option is the mandate of the Central Bank and happens to be an important tool for CBN to pursuit economic objective of price stability. Understanding monetary policy and the pertinent role it plays in achieving the tradeoff between macroeconomic objectives, like economic growth and inflation make it impossible for the government and the CBN to target all objectives at the same time and by the same instrument. This makes the economic term of opportunity cost necessary and the sophistication of positive and normative economics relevant in taking decision. To this end, economic officials have to prioritize its objectives in order of importance and then determine the suitable policy for targeting them in conventional economic framework. In this paper an attempt was made to examine how policy options can be pursuit efficiency in the case of an economy that has both the feature of non-interest banking and interest based banking with the aim of examining how the combination of the two can affect the effectiveness of monetary policy in Nigeria.

The economic thought inferred from the above is that, even in cases where some different instruments bring us to the same macroeconomic goal, government must choose its appropriate instrument among them; because each instrument has different effects/impacts on the market conditions after executing monetary policy. For example, for reducing inflation rate, central bank who is responsible to adopt monetary policy, should reduce the volume of money in circulation and execute contractionary monetary policy. On the other hand, it executes expansionary monetary policy if the aim is to increased money supply to stimulate the economy. For this purpose, Central Bank can use either credit ceiling instrument or open market operation, but either of the instrument has its own effects on the stability of goods and money markets during and after the implementation of monetary policy.

As with the conventional economics, non-interest framework economies also face macroeconomic issues like growth and inflation, so the role of monetary policy in economies that practice either non-interest or dual financing is undeniable. But since in conventional economics, interest rate is the most important instrument for executing monetary policy, prohibition of this variable, as a fundamental pillar in non-interest economics, makes the process of monetary policy in these countries with this feature more problematic than countries with conventional economic system. The dominant view among scholars is that since the interest rate is prohibited in the non-interest banking framework and cannot use interest base instruments like open market operation for monetary policy, the focus should concentrate on the monetary aggregate instruments. This paper look at Nigeria's case as it about to face the challenges of using both the profit rate instrument and the interest rate based instrument.

The paper is at contributing to the understanding of the concept non-interest banking being a new concept in Nigeria by elucidating some important principles/elements of the concept. It would aslo examine how non-interest banking would affect the effectiveness of monetary policy in Nigeria, though not econometrically, since data on the operation of non-interest banking is almost not available at the time of writing this paper.

2.0 Extant Literature

Literature on the non-interest banking and monetary policy is not quite rich especially in Africa and Nigeria in particular where the operation of non-interest banking is at a preliminary stage. However, it is imperative to mention a few especially from countries which share similar developmental characteristics with Nigeria.

**The views expressed in this paper are those of the author and do not represent the official position of the Central Bank of Nigeria or its Board of Directors.*

Empirical assessment on the merits of the interest-free banking system was initiated by Darrat (1988), the study showed that the banking system in Tunisia is more stable without interest-bearing assets than if the assets were to exist. More recent studies by Darrat (2000) and Kia (2001) provide further empirical evidences on the effectiveness of the interest-free monetary and banking system in Iran. These studies found that both short and long-run interest-free money demand functions are stable and their coefficients are invariant with respect to policy and other exogeneous shocks.

Kia and Darrat (2003) compare the demand equations for money and profit-sharing deposits and found that the demand for profit-sharing deposits has the most stable and policy invariant function. The study further suggested that the profit-sharing deposits could represent a credible instrument for monetary policy-making in Iran.

Samad (1999) and Kaleem (2000), provided empirical support for the stability of the non-interest monetary instruments in a dual banking system in Malaysia. Kaleem (2000) examines the Malaysian data spanning the period 1994 to 1999 and found that non-interest banking is less crises-ridden compared with the interest bearing conventional banking due to its asset-linked element.

Despite the supports in favour of non-interest banking framework as better tool of monetary policy, some studies disagreed on the basis that more detailed aspects of the relationships between the interest-free banking and various aspects of financial risks reveal some concerns. Baldwin (2002) showed that there is a general lack of awareness in adopting the best risk management practices in the countries that concentrate on the supply side of monetary policy due to an erroneous belief that a non-interest bank, by virtue of its interest-free nature, is not subjected to the interest rate fluctuations. Rosly (1999) found that non-interest banks in Malaysia are at disadvantage compared to the conventional banks especially during the period of increase in market interest rates. Noting that, while the conventional banks could reap higher profit from rising interest rates, non-interest banks face negative funds gap since interest-free financing is based on fixed rate, and that deposit liabilities are benchmarked against the prevailing interest rates. Kareem and Verhoeven (2005) examined whether interest-free banking institutions in Malaysia are subject to credit risk, interest-rate risk and liquidity risk. The study found that while the deposit money banks with interest-free financing have significantly lower credit and liquidity risks, they have significantly higher interest-rate risk than the banks without non-interest financing.

Another study by Kaleem and Isa (2006) reveal another weakness of the interest-free monetary system particularly in a dual banking system such as that in Malaysia they studied. They found that the financial market setup operating at the time of conducting the study was not in favour of the interest-free banking system because it enables the conventional banks to take advantage of the arbitrage opportunities provided by the dual banking system.

In trying to establish a level operating ground for both systems, it should be gotten clear that despite the different philosophical foundations governing the two systems, they are both subject to the same macroeconomic conditions. Bacha (2000) reiterates that nevertheless, the differences of which one is better than the other may lie in the profile of the customers that subscribe to both banking systems. He further suggested that there is always a possibility of switching between the two systems. Also from the customers' point of view, depositors can take advantage of the arbitrage that arises from the rate differentials between the two systems.

2.1 The concept non-interest banking in summary

A non- interest banking is the type of banking that do not take or give interest on assets and operating basically under the whim and caprices of sharia law. Each Islamic bank has a Shariah board made up of Shariah scholars as well as financial experts who are responsible for determining what activities are and are not Shariah-compliant. Non-interest banking for is majorly based on two main financial principles. Firstly, investment is to be made in the private sector through interest-free financing. Secondly, the development of financial instruments is to be done on the basis of profit and loss sharing as well as risks sharing. The law guiding the operation of non-interest banking considers interest as an unjustified increase of capital, with no effort made to earn it, and as such it is considered illegal and illicit thereby renders the earnings from false value.

It is important to know that arguments about the prohibition of interest in non-interest banking are still intense. Some of the critical ones that are against are; that interest rates have no moral foundation; that abstinence from consumption is not a justification of rewards, and that there are risks justifying the supplement of payment for capital lending if the loan is guaranteed. In addition to the prohibition of interest payments, the law guiding non-interest banking treats money strictly as a medium of exchange. Also, the creditor/debtor relationship is defined differently than in the conventional financial institutions. The provider of funds

becomes a partner in a project thereby assumes the risk activity with the entrepreneur and shares profits as well as losses.

Moreover, the concept of interest is based on the belief that the Qur'an bans all interest rates, regardless of its rate or form. In fact, what the Qur'an bans is riba, the practice of doubling the debt of a borrower unable to make restitution on schedule, including both the principal and the accumulated interest. Riba is percieved to push defaulters into enslavement and as such considered an acute source of social friction. Whatever the virtues of the notion of risk-free returns, the crux of the argument is that profit is legitimate only as a reward for risk.

2.2 Some Technical Concept of Non-Interest Banking

2.2.1 Musharakah

The literal meaning of Musharakah is sharing. It is a joint enterprise that is form for the purpose of conducting business in which all the partners share the profit/losess accrued from the business according to a ratio of contributions. This corresponds closely to equity market in which shares can be acquired by the general public. It has rules of management that includes profit determination/distribution, reviews of the contract as well as termination. The Musharakah has a certificates which is usually used as a tool of monetary policy as it makes possible for all people to invest in the great and profitable projects, and at the same time help Central Bank to control the volume of money flexible enough to bring stability in goods and money market when it wants to execute monetary policy.

2.2.2 Mudarabah. This is a kind of business partnership where one partner gives money to another for investment in profitable legal ventures. The fund supplier is called "Rabb-ul-Mal" while the fund manager is called 'Mudaraba". The major difference of mudarabah and musharakah is that mudaraba is valid for single individual/ entity as partners while the later involves several partners. The mudaraba can be of different forms ranging from a restricted mudaraba to a non-restricted. The rules of engagement and management is as enshrined in the Islamic jurisprudence.

2.2.3 Murabahah (cost-plus financing). This is a form of business transaction that involves the sale of goods at a price that includes a profit margin agreed by the parties involved.

2.2.4 Ijara. Is a form of transaction that operates as lease with an option to buy. The banks normally buy the property and lease it to a client and the client pays for both the purchase price and for the rent price.

2.2.5 Qard: This is an interest-free loan that is given for a fixed period of time on a goodwill basis and the borrower is only required to pay the principal of the loan amount only.

2.2.6 Hibah: which means gift; is a willingly payment made as appreciation in return for a benefit received. The gift can also be used by banks to absorb savings from the customers.

2.2.6 Wakalah (agency): This is a business arrangement where individuals or organizations authorize another individual/organization to act on its behalf to execute a specific business task.

2.2.7 Ghara: This is an unclear fact or condition. This is highly prohibited in non-interest banking as it renders business transaction null and void.

2.2.8 Wadiah (safekeeping): This is a business arrangement where one deposits cash or assets in a bank for safekeeping. The bank guarantees the safety of the item kept and charges a fee for looking after the item. The customer is allowed to withdraw the item at any time he/she wishes.

3.0 An Overview of Monetary Policy in Non- Interest Banking Framework

To appreciate the imperative of non-interest in the 21st century, it is important to look at general overview of the concept based on trends and performance before linking it to monetary policy. Non-interest is operational in more than 75 countries in the world. During the past decade, the assets of Islamic Banks have grown at an average rate of 1 per cent. An estimate has put global non-interest Banking assets at $ 1.1 trillion in 2012 as against $ 826 billion in 2010. The market share of non- interest banking by assets is about 14 percent in the Middle East and about 25 per cent in North African region. From 2006-2010, the Compound Annual Growth Rate of the top 20 non-interest Banks in the Gulf was 20 per cent as compared to 9 per cent for the region's conventional banks. This buttress the demand for the non-interest banks products.

As with the conventional economics, in non-interest economics policies have to be used in targeting important economic variable such as inflation, employment, national income, national debt, exchange rate and economic growth. Monetary policy should play an important role for maintaining stability and growth in non-interest economics. But prohibition of interest as one of the fundamental pillars of non-interest economics makes the instruments and mechanism of monetary policy different from conventional economics. Chapra (1983) argues that, the absence of interest rate in non-interest economics, and the existence of some institutions like Zakat, minimize the speculative

demand for money and make total demand for money more stable. In this regard, demand for money in non-interest framework consists of only transaction demand and speculative demand. He further asserted that, in economies that have significant number of non-interest banks, monetary aggregate instruments should play the main role in implementing monetary policy. In this regard, monetary policy can be executed through controlling stock of money without necessarily using the interest based instruments.

An important economic discuss that is still lingering is that there is no acceptable framework that comprehensively explains interest rate analysis in the non-interest economics as scholars are still divergent views on what is interest/non-interest bearing especially in this modern era. Some belief that the interest (riba) of economies of those days is different from today's own, and that stock of money can have different element. As mentioned earlier, quite number of scholars believe that there is no speculative demand for money in Islamic economics, and that even if this viewpoint is accepted, so long as the non-interest financial institutions attract money from depositors, they have to give profit to the depositors as required by laws guiding the practice of non-interest banking, the relationship between the profit rate and money demand would be negative.

3.1 Effectiveness of the Non-Interest Banking for Monetary Policy

- Since monetary expansion based on profit-sharing system would be hinge on investment, the possibility of excess liquidity is curtailed thereby keeping inflation in check.

- The Profit-sharing banking scheme insulates the monetary system from interest rate fluctuations and minimizes the possibility of financial instability.

- The principle of applying fixed charges on capital is recent financial literature is considered unjust on the grounds that since the results of the productive business in which capital is invested are uncertain. As such it is now considered proper and just if capital shared the actual profit/loss of the business.

- Also, a business arrangement that is based on profit sharing system is considered most stable because of the ability of cost of capital to automatically adjust itself to any shock /bounty to productivity arising from changes in business circumstances. This would help the monetary authority not to tamper with the policies unnecessarily.

- The profit sharing system has also been proved as a good stimulant for economic growth as it promotes the supply of risk capital as well as entrepreneurships.

- Major multinational banks including HSBC Amanah, Standard Chartered Saadiq, Lloyds TSB Bank and Citigroup offer products in accordance with Islamic Banking principles.

- Numerous studies conducted using Iran and Malaysia as case studies shows that non-interest banking is less crises-ridden compared with the interest bearing conventional banking due to its asset-linked element. Also, the studies showed that the non-interest financing channel is the most active transmission channel of monetary policy. E.g Yusof (2006), Said and Ismail (2007), Sayuti, (2009), Kassim et al, (2009), ETC.

- Non-interest instruments have proven to be effective in the case where an economy faces limits in credit expansion. In Iran for instance, allocating different minimum expected rates of profit to various sectors of their economy based on marginal rate of return of capitals in different sectors have proven to be an effective way of influencing the economy.

4.0 Challenges of Non-Interest Banking

- The absence of appropriate control measure of the intermediate objective by the Central banks may detract from the target of consideration monetary aggregate as an objective of monetary policy.

- The prohibition of interest payments treats money strictly as a medium of exchange. Also, the creditor/debtor relationship is defined differently than in the conventional financial institutions. This makes the concept to look abstract.

- Shortage of human capital. The requirements that the members of the Shariah Committees and the Shariah Advisory Council must be academicians and Shariah experts in Islamic banking and finance is a

challenge, and more worrisome is the fact that even the few ones are advanced in age. There is also dearth of scholars with the combined knowledge of Sharia jurisprudence and modern economic finance. This affects the efficiency with which a verdict on new non-interest products, since new products have to be cleared by shariah scholars before they can be adopted.

- There is no generally acceptable accounting and auditing reporting standard for non- interest banking. This makes it difficult to compare the performance of non-interest banks and financial condition of different banks.

- The absence of sharia complaint liquidity management instruments would make the job of the monetary authority more cumbersome.

- The challenge of image: many are still skeptical on the operation of non-interest bank as some view it as a religious affair, while others link it to terrorism.

- There is Lack of appropriate non-interest-based investments for financing budget deficits.

- There is general Lack of awareness of what a non-interest-based investment entails.

- The activity of the Non-interest banking precludes the use of discount rates and Open Market Operation to influence liquidity. These tools are considered to be one of the best monetary policy tools especially in this age of globalization and financial engineering.

- Depositors of funds are treated as if they are shareholders in non-interest banking, as such implementing it in an economy that has experience long regime of the opposite would present some challenge. Depositors under the non-interest banking framework are not guaranteed of the nominal value or a predetermined rate of return on their deposits.

- Financial market operations would not be in favour of the interest-free banking system because it enables the conventional banks to take advantage of the arbitrage opportunities provided by the dual banking system.

- Another challenge of non-interest banking is that there are no firm rules guiding the determination of profit/loss which is a cardinal element of non-interest financing. This may create conflicts of interest

5.0 How Non-Interest Banking Would Affect the Effectiveness of Monetary Policy in Nigeria

Nigeria now has both the conventional and the non-Interest banking operating Side by Side. It is important to explore this area as little is known about it. With non-interest banking operation, it implies that monetary policy direction should concentrate on the monetary aggregate control to be able to capture the dynamics of dual system. For example where a monetary aggregate is set as the intermediate objective, it is necessary that the CBN should have capacity to influence the money shock. Faced with deviations by the demand for money in respect of the target set, the CBN must assess the possible causes behind such differences and decide whether they can be accommodated or otherwise.

In another sense, the use of monetary policy instruments should allow the deviations recorded to be reduced in a relatively short period. In this respect, controllability requires that the CBN should be able to effectively influence the monetary aggregate in the short term. It does not suffice, therefore, for the CBN to have means for steering the money stock in the medium and long term; control must be exerted in a relatively immediate fashion.

The absence of appropriate control measure of the intermediate objective by the CBN may detract from the target of consideration monetary aggregate as an objective of monetary policy. Also, monetary management would become more complicated, as agents would not know whether the deviations between the actual course of the monetary aggregate and its target path were as a result of policy by the CBN or of the impossibility of controlling the aggregate in the short term. This is capable of harming the credibility of the monetary policy, because the formally announced objectives could fail to be met without the CBN being able to do anything to avoid it.

Moreover, reasonable number of writers have supported the idea that the non-interest banking visa-vi the monetary policy must be based on monetary aggregate control for the Central Bank to be able the volume of money in the economy through influencing money supply. Four main instruments of Central Bank can be valid for this purpose; determining lending ceilings for banks, changing their reserve rate,

changing profit ratio and minimum rate of return, and changing the profit margin.

Ceiling means Central Bank would put restrictions on the quality and quantity of their lending to people. The Central Bank may direct the Deposit Money Banks (DMBs) on the maximum amount of credit they can lend. The directive may be sector specific or strategic targeting of some sectors. For example the monetary authority may direct DMBs to decline their industry lending by 20 percent but remain their agricultural lending unchanged. Credit ceiling control has the advantages that its effect can be predicted, because DMBs have to act precisely as the monetary authority instructed. But this method suffers some disadvantages: notably disintermediation and reducing competition. Since this method is only concern about the supply side and is unable to control the demand side, when there is high demand for the money in the economy and Central Bank sets limit on the lending of individual banks, people will go to illegal or unauthorized institutes to borrow money and that is injurious to the economic health of the society. The other disadvantages is that when Central Bank sets lending ceilings for the DMBs, the ability of each bank would be limited in offering lower interest rate that attracts customers from another bank. Consequently, all banks will work with the limited number of customers and at the same level of interest rate. This lack of competition will decline the efficiency of the banking system.

Profit ratio is another instrument of monetary policy use to influence availability of credit in a dual banking framework. Profit ratio here is the bank's share of actual profits that is derived from a credit transactions provided by the bank. An increase or decrease of profit ratio can influence the demand for using this type of credit facility. Similar to profit ratio is the minimum expected rate of return, since the minimum expected rate of return is computed before the actual extension of credit, increasing the minimum expected rate of return has the possibility of discourage potential degree of investments.

Another method available for Central Bank to control the volume of money in an economy with dual banking is legal reserve. since the volume of lending of banks increase when their assets increase and vice versa, central bank can also control lending volume of these banks by setting limits on the assets hold by them. This implies that all DMBs have to hold some percentage of their deposits with the Central Bank. This deposit makes it possible for individual banks to clear payments between themselves and also help them to be responsible to their customers. When a large number of customers come to a bank to withdraw money from their deposits, the bank can use its money in the Central Bank to meet customer's request and provide cash to them. By increase or decrease of legal reserve rate, Central Bank is able to affect the lending ability of individual banks.

Apart from the legal reserve, granting of prizes/award in relation to interest-free deposits is another effective monetary policy instrument under the non-interest framework. The prizes given attract/absorb savings from the public but the speed of transmission of this is slower than the interest rate.

The rationale behind the title "how non-interest banking would affect the effectiveness of monetary policy" hinges on the concern that the advantage inherent in the interest based control system may be present in non-interest banking framework as well, but each system has a unique dynamism. The interest based control is one possible way for Central Bank to control money stock in the economy through the demand for bank credit by changing the interest rate. (Note non- banking affects the supply side). This method is based on the axiom that like for goods and services, demand for money depends on its price.

According to Keynes theory of money, people demand money for three reasons: transaction demand, precautionary demand and speculative demand. When interest rate increases, actually, the opportunity cost of money is increased and therefore people prefer to hold less money. In this way, there is a negative relationship between interest rate and speculative demand for money. So, the higher the interest rate, the lower the money demanded by people. Although, this relationship is only true for private sector since the public sector demand for money is determined by public spending and taxes and will not vary significantly depending on interest rate. The other thing about interest rate control of money demand is that, demand for money is not only dependent on interest rate and many other factors, such as expectation of future inflation and returns to investment, have a large effect on demand for money.

In practice, monetary officials should have precise information about the volume of money at any interest rate level and at any economic situation, to be able to execute concrete monetary policy.

Using interest based control of monetary policy, usually, Central Bank determines first the level of interest rate in the economy and then specifies its appropriate amount of securities that should be sold or bought through open market operation. For example to reduce the volume of money in the economy and executing contractionary monetary policy,

central bank increases the interest rate level. Actually, central bank by this measure has increased the interest return of securities and made them more attractive for people. Now, central bank is able to sell appropriate amount of its securities to public and so indirectly encourage them to withdraw their money from bank deposits. This process by one hand decline the volume of money in the economy and by another hand creates shortage for commercial banks and makes them borrow from central bank and among themselves at the higher rates. When commercial banks face higher rate for borrowing from central banks, they will be forced to increase their rate to meet their higher cost. Similarly, central bank can decline the interest rate level, buy securities from people and force banks to put more money in their central bank deposits. Another strategy to be considered is the inflation targeting framework.

5.1 Some Tips for CBN under dual system

The non-interest banking vis-a-viz the monetary policy must be based on monetary aggregate control for the Central Bank to able to control the volume of money in the economy through influencing the money supply. However, it is important to always consider combining both the conventional instruments of monetary policy and the non-interest rates instrument in order to effectively influence the monetary aggregates.

The central bank needs to consider most of the traditional tools in conducting its monetary policy. Tools like reserve requirements, selective credit control, changes in monetary base through currency issue and moral suasion have to be applied. The CBN should consider influencing directly the rates of return on loans and deposit by tampering with the profit sharing ratios in which the banks and the customers are expected to share profit/losses with. But this action should aim at affecting only new deposits as many scholars are of the opinion that changing an already mutually-established ratio unilaterally can be unhealthy to the financial system of the economy.

CBN should establish a standard minimum limit of participation by banks in the capitalization of long term investment projects and follow up with regular monitoring and evaluation. The supervision should not be concentrated on the non-interest banks as the conventional banks have the right to venture into the business of offering the Islamic products they find profitable.

CBN should expect a borrowing from commercial banks (including the non-interest banks) that is different from the conventional method of rediscounting at given official discount rate. Some borrowings would be based on a profit and loss arrangement, meaning banks can borrow from the Central Bank on an equity-participation basis and the rate of returns on equity share would be determine by the Central Bank.

More effort is required in training and education, Staff in the CBN needs to be trained to understand the principals of non-interest banking alongside the issues and technicalities as delineated by Islamic jurisprudence. The CBN would have be proactive as its awaits the challenges of harmonizing from different dimension. Capacity building of various stakeholders in the areas of non-interest would help the Sharia a council in passing judgment on important issues.

A lot of awareness is required as many believe that non- interest banking is only meant for Muslims, whereas in Malaysia, UK, and Pakistan, about 40 per cent of the customers are non-muslim.

6.0 Conclusion

This article espouses the effectiveness of monetary policy in a dual economic framework (interest bearing/non-interest bearing). In other words, it examines how the element of non-interest banking when combined with the interest bearing framework affects the effectiveness of implementing monetary policy. The use of interest based instruments can effectively be combined with the identified non-interest interest instruments to conduct monetary policy. This article recommends that Nigeria should start thinking towards a policy that takes into account the monetary aggregate instruments as a main tool of executing monetary policy. Also issues surrounding the application of profit ratio, grant of prizes, minimum expected rate of return and profit margin as tools of influencing the cost and amount of credit in the Nigerian economy. Staff in the CBN needs to be trained to understand the principals of non-interest banking as delineated by Islamic jurisprudence. The CBN would have be proactive as its awaits the challenges of harmonizing from different dimension.

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