

Fractional Reserve Banking System (Frb) Practices In Conventional And Sharia Banking In The View Of Economics Experts

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Abstract

The practice of Fractional reserve banking (FRB) in Indonesia is a bank activity of maintaining a portion of customer savings as deposits or deposits at the central bank, and then if there is a payment obligation to the customer, these savings can be used. Then, in other activities, namely financing, it can also be said to be creating money. The creation of excess money is what gives rise to inflation. Is this inflation mostly caused by conventional banks or Islamic banks?

The aim of this research is to find out the practices and opinions of economists regarding the implementation of the FRB. The research method used is literature study.

The research results show that Firstly, the practice of Fractional Reserve Banking is applied in both Conventional Banks and Sharia banks, this is reinforced by the statement of Central Banking Research Expert Ascarya that Sharia Banks apply fiat money as the main transaction and fractional reserve banking in money creation, because Sharia banks are still fighting interest and implementing profit sharing. Second, if the amount of money in circulation (JUB) increases, the price level in the market will increase, and this will cause inflation. This high inflation will lead to a bubble economy. Third, both Sharia and conventional banks apply FRB in money creation, but it is important to note that the biggest contribution to inflation remains conventional banks.

Keywords: FRB, JUB, Inflation, Sharia Economics

1. Introduction

A country's economic system is basically the policy of the respective country. However, in this case, the wheels of power still apply to some parties. For Karl Marx, the state is the embodiment of conflicting economic forces. Strong power resides in those who control the means of production (Bakhri: 2010,95). From this statement, is the treatment and regulation of the amount of money circulating in society, especially in Indonesia, in the hands of the authorities, or is this system in accordance with the mandate in the 1945 Constitution. And in fact, the highest power is in the hands of the bankers, no longer in the hands of the government in this case Bank Indonesia, because within Bank Indonesia there are allegedly interested parties.

The Central Bank of Indonesia (BI), is the highest national banking institution. The money supply and money creation are under its control, and the implementation of fractional reserve banking is no longer centered on BI but on other banks. These include commercial banks and sharia banks.

The practice of fractional reserve banking in Indonesia is where banks maintain a portion of customer savings as savings or deposits at the central bank, and then if there is a payment obligation to the customer, these savings can be used. The bank will use some of the savings from customers to make investments or loans to other customers. In banking, the process of lending money can be said to be credit creation (Ishaq, 2015). So when

banks lend money to debtors the bank is creating money so that the amount of money in circulation increases. If the money supply increases and continues to increase, it will trigger inflation.

As in countries with established economies, 90% of the money supply (JUB) is bank money created by banks. As a result, JUB often grows excessively and causes inflation in the prices of goods and services or inflation in asset prices (asset bubble) which often leads to a crisis following the bursting of the bubble.

Fractional Reserve Banking (FRB) is a modern banking system that is considered by economists to be a source of systemic problems and give rise to crisis events (Jarhi, 2004). This system then becomes unstable between changes in asset value and changes in liability value. Technically, with this system, banking indirectly has the ability to create its own money (creation of money), so that it can be illustrated as an inverted pyramid, that is, a smaller basic reserve actually "supports" a larger amount of deposits and credit.

In Indonesia there are two institutions, conventional banks and sharia banks with various superior product features of each. A bank is a business that collects funds from the general public in the form of savings which then distributes them in the form of credit and/or other forms in order to improve the standard of living of many people as stated in Article 1 paragraph (2) of Law no. 10 of 1998 concerning amendments to Law no. 7 of 1992 concerning banking (Siddiqi, 1992). Then the question arises whether banks, both conventional and Islamic, have the same or different abilities in creating money, so that this can have an impact on the bubble economy.

Based on the Financial Services Authority Circular (OJK, 2014), in principle, bank health is the full responsibility of the bank management concerned. Due to this, banks are obliged to maintain and improve their health by always upholding the principles of prudential banking in carrying out banking operations. So, as a form of attention, Bank Indonesia issued a banking health assessment policy based on PBI No.13/1/PBI/2011 for Commercial Banks and PBI No.9/1/PBI/2007 for assessing the health of Islamic banks.

The banking health assessment includes four aspects of assessing the level of bank health (Akbar, etc., 2022). These include assessing the profile (risk profile), good corporate governance, capital, profitability (income level). These four components are the main assessment of the level of banking health. Then, in its implementation, the practice of fractional reserve banking can be seen based on ratio levels, one of which is the Minimum Statutory Reserve (GWM).

Then, a number of studies on fractional reserve banking have also been carried out previously. Fathurachman in his research stated that fractional reserve banking is a system that contains a large composition of harm, so it is considered to be contrary to the principles and values brought by Islam (Fathurachman, 2018). Then Syamlan showed that the largest contributor to FRB in Sharia Commercial Banks was the Minimum Statutory Reserve (Syamlan, 2018). Next, Akbar examined in more depth the impact of failure and health levels on the impact of implementing FRB at BRI. The research results show that BRI implements FRB, but all the variables studied, namely Minimum Statutory Reserves, Loan to Deposit Ratio, and Return on Assets are normally distributed (Akbar, 2022).

Based on a number of previous explanations and background, this article attempts to examine in depth Fractional Reserve Banking, especially the views of experts on both conventional and Islamic banks.

2. Research Methods

This type of research is based on literature study. According to Nazir, library research is a technique for collecting data and information by reviewing various reference sources. These include a number of books, literature, notes and relevant supporting documents.

The stages in this library study research are first, collecting a number of data and information in the form of materials from books, journals, research reports, websites and relevant supporting data sources. Second, is reading library materials. In this activity, researchers must read and explore in depth the material that will enable them to obtain new ideas and ideas related to the research title. Third, make research notes. Fourth, processing research notes. All material that has been read is then processed or analyzed to obtain a conclusion which is prepared in the form of a research report. The approach used is a qualitative approach, namely research aimed at describing and analyzing phenomena, events, social activities, attitudes, beliefs, perceptions, thoughts of people individually and in groups. Several descriptions are used to discover principles and explanations that lead to conclusions.

3. Results and Discussion

Understanding Fractional Reserve Banking

Fractional Reserve Banking (FRB) is a system that determines banks to keep part of the money saved by depositors and use the rest to provide loans to other bank customers. Meanwhile, Fractional Reserves Requirement

is the amount of deposit that must be kept. There are countries that set 4% of a depositor's savings, there are those that set 10%, 20% or 50% that must be saved.

Furthermore, the remaining funds from other customers are used by the bank to make investments or loans (credit) to other customers. These other customers will deposit some of their funds to other banks, so that further loans can be made possible with continuous acceleration, this can have a multiplier effect.

According to economists, the Fractional reserve system as a modern banking system is considered to be a source of problems in generating crises. Technically, with this system, banking has the ability to create its own money (creation of money), so it can be illustrated as an inverted pyramid, that is, a smaller basic reserve actually increases the amount of deposits and credit (Valeriano, 2004).

Indication of Fractional Reserve Banking practices in Sharia Banking

Apart from conventional banks which first practiced fractional reserve banking, according to experts, Sharia Banks also implemented it. This is indeed not yet optimal in the sharia system in Indonesia. A number of experts say so. Ascarya, said that the Islamic system still has an influence on inflation because currently Islamic banks are only fighting interest and implementing profit sharing.

According to him, Islamic banks still carry out a number of the same operational activities as conventional banks, including:

- a. Sharia banks still use fiat (paper) money as a transaction tool.
- b. Application of the fractional reserve system (in creating money)

Then, Yusuf Wibisono further said that currently almost all Islamic countries cannot be separated from the conventional system. (www.republika.co.id, 2015.). For this reason, the most popular solution offered is to eliminate the evils of the fractional reserve banking system with 100% reserve banking. "One thing that is feasible is to increase the share of sharia banks and restore the sharia banking paradigm with profit sharing banking.

Money Creation Process through Fractional Reserve Banking

There are two types of money in the banking system and central banks:

- a. Central bank money: money created or adopted by a central bank in whatever form - precious metals, commodity certificates, banknotes, coins, electronic money lent to commercial banks, or whatever the central bank chooses as a form of money.
- b. Commercial Bank money: demand deposits in the commercial banking system; sometimes referred to as a "money checkbook"

There are several indications that mark the implementation of the fractional reserve banking system practice, including:

- a. Money creation is done through the loan process
- b. Then, the proceeds from bank loans are at least in the form of currency. Banks usually provide loans by accepting promissory notes in exchange for crediting them by making them to the borrower's deposit account. Deposits created in this way are sometimes called derivative deposits and are part of the money creation process by commercial banks. Issuing loan proceeds in the form of paper currency and coins is currently considered to be a weakness in internal controls.

Logical framework for bubble economics

From the indications regarding the practice of fractional reserve banking, it logically will have an impact on several aspects. Banks distribute a number of loan funds to their customers, which automatically has an impact on increasing the amount of money in circulation (JUB). Then, if we examine the quantity theory of money, money influences the prices of goods, the more money in circulation, the price of goods will increase. If this continues, it will give rise to high inflation where the prices of goods and services soar uncontrollably, and this is what is called a bubble economy, and the question is? Who is the biggest contributor to inflation? Sharia or conventional bank?

Impact on Fractional Reserve Banking practices

Financial crises can occur under various conditions in which some financial institutions or assets lose a large part of their assets. This crisis can occur in the form of financial difficulties, a systemic banking crisis, a stock market crash, a financial bubble burst, a currency crash, an imbalance in the balance of payments, and so on. This is allegedly the impact of the Fractional reserve system.

Senior Researcher at the Center for Central Banking Research and Studies at Bank Indonesia (BI), Ascarya, said that currently conventional systems such as interest rates and exchange rates make a high contribution to inflation. "At least the conventional system contributed 81.4% to inflation, while the Islamic system only contributed around 6.4%, of which 1.7% came from the influence of profit sharing returns. For this

reason, it is necessary to replace interest rates with profit sharing returns and implement a single global currency. With this profit sharing return, continued Ascaria, inflation will be able to be reduced by half. Meanwhile, cooperation between countries is also needed to be able to implement a single global currency.

Finally, quoting Prof. Henry Brutton in his book *Umer Chapra*, he stated that "we can make inflation a policy instrument rather than controlling inflation as a policy objective", (Chapra, 2000) so the real cure for inflation lies in the policies of each country.

Behind the thoughts of economists regarding the practice of Fractional Reserve Banking

One of the impacts of the operation of fractional reserve banking is allegedly to give rise to a crisis, and the climax is a bubble economy, is that true? Economists make their scientific contributions to the banking sector, which today is in line with the times and the demands of the dynamics of society's interests surrounding it. The banking industry has experienced major changes in its recorded history, becoming more competitive.

In the fractional reserve banking discourse, Muslim and non-Muslim economists, including Umer Chapra, Nejatullah Siddiqi, Monzer Kahf, Afzalurrahman and Mohamed Ariff, Mabid Ali Al Jarhi, Abbas Mirakhor, and Irving Fisher, provide opinions on the problems and solutions. They argue that according to their scientific capacity, a number of differences emerge. For this reason, the author tries to explore their thoughts on the fractional reserve banking discourse.

From this fractional reserve banking system, there are several points you need to know, apart from knowing what fractional reserve banking is, the next step is why we have to use fractional reserve banking, and how it implies an Islamic banking system.

Fractional Reserve Banking is alleged to contain usury

According to Ahamed Kameel Mydin Meera, Fractional Reserve Banking is an anti-thesis system for Islamic Economics and Finance, so that with this instrument, banks can make money above and beyond (Meera, 2004). As in her writing with Larbani, Meera further explains that the practice of fractional reserve banking contains usury, including the transfer of asset ownership without the knowledge of the owner (customer), for this reason Meera does not agree that the practice of fractional reserve banking in banking is haram in Islam (Meera and Larbani, 2004).

"And do not let some of you consume the property of others among you in a false way and (do not) bring (the affairs of) that property to the judge, so that you can consume part of the property of others by (doing) sin, even though you know." (Al Baqarah: 188)

Later, Meera also argued that Islamic banking under fiat money and fractional reserve banking will eventually merge with conventional banking because the arbitrage opportunities between the two will eventually close the differences between them. This has been proven now. Islamic banking is usually promoted as an interest-free banking system but one that operates within fractional reserve banking. Many Muslim scholars see that sharia banks must maintain their reserves up to 100% of their total deposits. Several Muslim scholars who have thoughts like this include Mabid Ali Al-Jarhi and Abbas Mirakhor, then Fisher (non-Muslim).

100% reserve banking

The repeated failures of banks have caused several economists to recommend that banks carry out reforms to the performance structures that have been established so far. In Islamic Economics, especially the Islamic monetary system, as we know, there needs to be a separation between current accounts and deposits because they are different.

According to Jarhi, giro is just a loan that is fully guaranteed by the bank and must be returned when the customer withdraws the funds. Jarhi further emphasized that funds between current accounts and deposit investments must be reserved 100% (Jarhi, 2004) and according to him this is the right action for sharia banks. The proposal for a 100% reserve ratio can also be justified on the grounds of efficiency, stability and equity.

Then, regarding the prevalence of fractional reserve banking, according to Chapra, the central bank only requires commercial banks to maintain reserves of 10-20% of all deposits. (Azizy, 1995). He argued, by maintaining reserves of their total deposits, Islamic commercial banks can guarantee the safety of deposits and adequate liquidity of the banking system. By requiring a reserve, the bank can provide a withdrawal facility for mudarabah deposits before maturity.

Kahf also agreed with the creation of credit from fractional reserve banking. He believes that credit creation is one of the monetary policy tools to control money circulating in society. With this policy, the central bank can influence production and stimulate temporary community recovery from unemployment and create unemployment (Khaft, 1982).

According to Afzalurrahman, apart from funds being kept as fractional reserves, they can also be used to meet depositors' daily cash needs, including savings and checking deposits. In the case of deciding the ratio,

Siddiqi has a statement related to this. He said the introduction of demand deposits created by the banking system through reserve requirements, would introduce a potential source of instability (Shiddiqi, 2004). Therefore, the greater the ratio of reserve requirements that the current account can create on the liability side, the more vulnerable the system is to liquidity problems and the threat of bankruptcy.

Hosseini Askari, et al also added that sharia banks can carry out *mudarabah*, *musyarakah*, *murabahah*, *ijarah*, *istisna*, and so on. In Islamic finance, the central bank has a monopoly on creating money. Interest rates cannot be used as a policy instrument. Islamic finance is therefore free from all the price distortions that are characteristic of conventional finance, as well as free from all the redistributive injustices of conventional finance that arise through lending, speculation, fraud and inflation. Therefore, Islamic finance leads to efficient resource allocation, with high and stable growth (Askari, Mirakhor, Iqbal, 2004).

According to Ariff, banks use fractional reserve banking to create credit. He said that idle money from current accounts must be used for investment or financing, because Islam has prohibited hoarding, and the condition for hoarding must be made from savings or current accounts that do not turn into investments. Although there are also investment deposits, Ariff sees that savings and investment decisions for Muslim communities are not truly independent, but, to a large extent, interdependent in an Islamic economy.

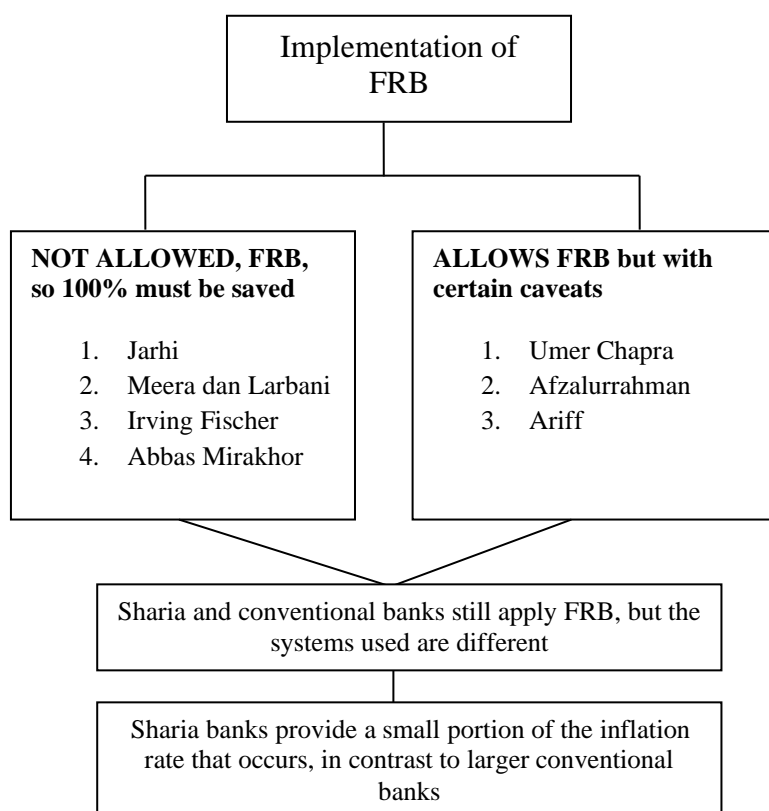
Apart from several Muslim economists, Irving Fischer was also present to provide his arguments. In his work entitled *100% Money* he suggests a method of regulation that is simpler and more effective than the use of existing monetary instruments and does not destroy job and business opportunities, namely the implementation of a 100% reserve ratio for all banks, this according to him is a means of reversing deflation major depression. An important conclusion that can be drawn from Fischer's book is that the right of private companies (commercial banks) to create money must be eliminated and that the state, based on the constitution, must take over the function as a whole. From now onwards, only the State has the authority to create money.

In line with Fisher, Hülsmann in his article entitled "Has Fractional-Reserve Banking Really Passed the Market Test?" Many have expressed harsh criticism regarding the impact of fractional reserve banking that has been implemented so far. According to him, this system will destroy the language of monetary economists and financial analysts and throw up implications and "balls of confusion" including: an imbalance between deposits and reserves will invite shocks and even continuous monetary crises (booms and busts). (Hülsmann, 2003).

Reflections on the Practice of Fractional Reserve Banking in the Thoughts of Economists

The practice of Fractional Reserve Banking to date still has its pros and cons, on the one hand assessing it from a positive side and on the other hand criticizing the system implemented because it violates Islamic principles. In practice, Sharia banks still apply it, so that both conventional and sharia banks have the potential to cause inflation due to the act of creating money. This high inflation leads to a bubble economy.

The following is a brief framework of economists' thoughts on the practice of fractional reserve banking:



4. Conclusion

From a series of descriptions of Fractional Reserve Banking, the following conclusions can be drawn:

- a. The practice of Fractional Reserve Banking is applied in both Conventional Banks and Sharia banks, this is reinforced by the statement of Central Banking Research Expert Ascarya that Sharia Banks apply fiat money as the main transaction and fractional reserve banking in money creation, because it is a Sharia bank still fighting interest and implementing profit sharing.
- b. If the amount of money in circulation (JUB) increases, the price level in the market will increase, and this will cause inflation. This high inflation will lead to a bubble economy.
- c. Both Sharia and conventional banks apply FRB in money creation, but it should be noted that the biggest contribution to inflation remains with conventional banks.

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- Ahamed Kameel Mydin Meera is an expert in gold dinar. He is currently the Head of Finance Department, International Islamic University of Malaysia. He is an author of several books, such *The Islamic Gold Dinar* and *The Theft of Nations*.
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