

Negative interest rates and Islamic finance

Introduction

Since 2014 negative interest rates have not only been episodes concerning single bonds or special deposits but a more general phenomenon supported or even driven by central banks. Being something “weird” or “abnormal”, negative (nominal) interest rates are obviously something we have to live with and be prepared for, before they spread in the economy.

There are several interesting questions concerning negative interest rates, and each of them could be a subject of a serious investigation, e.g.: what are the reasons for negative interest rates; what are and will be the consequences of such rates for the economy in general and selected classes of economic subjects in particular; how will negative interest rates influence savings, investments etc.; what will happen if after some time the interest rates return to the positive area? For preliminary considerations see Hannoun (2015).

In Islamic finance, interest, understood as earning of money on money at a predetermined rate, is forbidden. Accordingly, Islamic finance is *ex definitione* “interest rate free”. In order to achieve positive rates of return two major groups of instruments are applied: sales on profit and participation in profits. Both involve risk, so sometimes a loss, not profit, may occur. But “a systematic loss”, like a negative interest rate in conventional finance nowadays, is something unusual. This paper will thus look at the consequences of negative nominal interest rates for the Islamic finance. At least two questions arise when we consider the losses resulting from possession of money: is a systematic “negative profit rate” possible in Islamic finance and, if yes, how can it be achieved?

There are very few, if any, scientific papers dealing with these topics. This paper is an attempt to formulate first remarks and recommendations. It is organized as follows. In the first section we look at the experience with negative nominal interest rates. In the second section we try to judge whether there is a rationale for the “negative profit rates” in Islamic finance and, if yes, we look at their implementation possibilities.

1. Negative nominal interest rates – current experience, reasons and consequences

Four central banks in Europe (in Denmark, Euro zone, Sweden and Switzerland) and Japan have kept their policy rates below zero for more than one year. In the past negative interest rates were also observed but not for broad financial instruments; they rather resulted from a very high demand for special assets; their possession was valuable enough to justify a payment for it. The current situation is different: the negative interest rates are spread at least in some sectors of the economies.

Obviously, the central bank policies were the drivers of the negative interest rates, even if for different reasons.

First, Swiss National Bank (SNB) and Danmarks Nationalbank (DN) issue currencies which have an appreciation potential. In order to discourage the speculators from holding the currencies, both applied negative interest rates on the reserves of the banks. In Denmark the current account rate is zero, but the amounts above specified limit are subject to a “penalty” interest rate of -0.65% charged for certificates of deposit to which the excessive amounts are converted. “The purpose of these limits is to prevent the build-up of large deposits that may immediately be used for speculation in interest-rate and exchange-rate changes if the krone is under pressure”. The deposit rates have been negative since September 5, 2014 (www.nationalbanken.dk).

The case of SNB is slightly different, at least in technical terms. The Bank sets the target range for the three-month CHF ICE LIBOR rate, which obviously cannot be directly influenced. It has been negative since December 18, 2014 ($-0.75\% - -0.25\%$, and $-1.25\% - -0.25\%$ valid since January 15, 2015) (www.snb.ch). It should prevent the Swiss franc from strengthening, which could have negative consequences for the Swiss economy. The range is a kind of policy rate of the SNB.

To the other group of central banks belong: European Central Bank, Riksbank, and recently Bank of Japan (intentionally left out of scope of the paper¹). All of them decided to move the policy rates below zero. The main aim of such ultra-low interest rate policies is to deter saving and encourage borrowing. In addition, a weaker currency can boost net exports, and hence growth and employment, while lifting inflation through higher import prices², and avoid deflation.

The ECB moved its deposit rate into negative territory on June 11, 2014 (-0.10%), and later on September 10, 2014 (-0.20%), December 9, 2015 (-0.30%)

¹ Bank of Japan announced on January 29, 2016 that it would apply a rate of -10 bp to a part of the balances in current accounts (www.boj.or.jp); the experience with negative rates is accordingly very short.

² However, “currency wars” may occur.

and on March 16, 2016 (-0.40%) (www.ecb.int). The set of monetary policy decisions usually consisted of (a) changes (lowering) of policy rates, (b) changes to asset purchase programmes, both in terms of amounts and eligible instruments, (c) launching new targeted longer-term refinancing operations, to strengthen the transmission of monetary policy by further incentivizing bank lending to the real economy. All these measures, and the negative deposit rate in particular, were aimed at improving borrowing conditions for firms and households, as well as credit flows across the euro area (which corresponds to the positive effects for the real economy), while securing a return of inflation rates towards levels that are below but close to 2% as soon as possible (which means maintaining price stability over medium term). The ECB always stresses that the monetary measures must be supported by structural and fiscal policies (Draghi 2016).

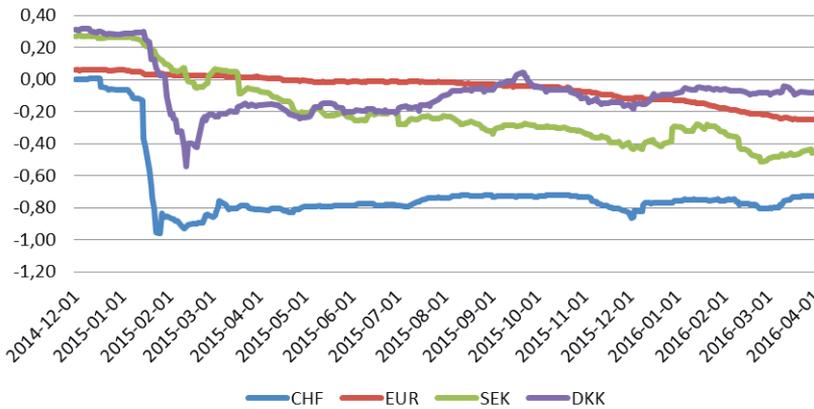
Similarly, the Riksbank implemented negative interest rates on July 8, 2009 (the deposit rate), till September 7, 2009, and later on July 9, 2014. But, the most important policy rate in Sweden is the repo rate: the interest rate that the monetary policy counterparties receive when they invest money with the Riksbank by buying Riksbank certificates or pay when they borrow money from the Riksbank through monetary policy repos. By changing the repo rate the Riksbank can control the overnight rate with intention of affecting inflation. In Sweden, the aim of monetary policy is to maintain price stability, which in the Riksbank's interpretation means that inflation should be 2%. This inflation target is regarded as nominal anchor for price setting and wage formation. Since February 9, 2015 the repo rate has been negative (-0.50% in April 2016) to safeguard the strength of the upturn in inflation³. Other monetary measures have been the massive purchases of government bonds since 2015. The Riksbank's very expansionary monetary policy has helped to strengthen the economy and reduce unemployment, and it has been contributing to an upward trend in underlying inflation since the beginning of 2014 (www.riksbank.se).

The policy rates were transmitted to the money markets, first of all to the overnight rates, which were passed through to other money market rates. Figure 1 illustrates it for 3M LIBOR (CHF and EUR), 3M STIBOR (SEK) and 3M CIBOR (DKK).

As Bech and Malkhozov (2016) observe, "In the euro area and Switzerland, money market rates track the central bank deposit rate. In Sweden, money market rates closely follow the repo rate. In Denmark, the relationship has been somewhat less tight. On some days the tomorrow-next rate is close to the current account rate of zero, whereas on other days it is closer to (or even below) the certificate of deposit rate. This volatility results from a thin market, where on some days pricing can be driven by banks whose reserve holdings do not exceed their limit and earn a higher current account rate".

³ For older readers such official statements might be weird, because in the past central banks always were aimed at reducing inflation, with more or less success.

Figure 1
 3M LIBOR for CHF and EUR, 3M SIBOR for SEK and 3M CIBOR for DKK
 (Dec. 1, 2014 – April 4, 2016)



Source: ICE Benchmark Administration Limited (delivered by St. Louis Fed <https://research.stlouisfed.org/>) for LIBOR, <http://www.nasdaqomx.com/transactions/trading/fixedincome/fixedincome/sweden/stiborswaptreasuryfixing/historicalfixing> for STIBOR and <http://www.nasdaqomxnordic.com/obligationer/danmark/cibor> for CIBOR (own presentation).

One may formulate three remarks concerning the negative nominal interest rates. All of them will be important from the Islamic finance perspective.

First, this phenomenon concerns the professional money market, especially the interbank money market, and secured transactions. Or, alternatively, it is the reserve money market, not the market for deposits and credits for non-bank customers.

Second, negative interest rates are driven by central banks. In one case a central bank wanted to force commercial banks to utilize their reserves for credit (e.g. ECB)⁴ and implemented a negative deposit rate as a disincentive for storing the reserves⁵ (and also applied targeted longer-term refinancing operations). Lower interest rates should increase aggregate demand by lowering the cost of debt, induce new spending, and thereby reduce unemployment and the threat of deflation. In fact, ECB actually addressed the wrong problem; it is not the supply side of the credit line that needs action, but the weak demand from the real economy. It seems that private companies and households have too much existing debt and do not want to borrow, while the banks have too much bad debt and do not want to lend more, at higher risk. Economic growth and high employment can be rather achieved through better education, convenient conditions for running

⁴ Please note that the granting of a new credit, and its utilization (by transfer of the new created money, e.g. to other bank) does not mean the level of reserve money changes; it is just transferred to another monetary institution, which in turn has the problem “what to do with the liquidity”...

⁵ Note that only a small fraction (about 2–3%) of banks’ assets is affected by negative interest rates (Romeo 2016, p. 24).

businesses and fully competitive, not overregulated labour markets, without too much influence from unions.

In case of currencies with appreciation potential (CHF, DKK) the negative policy rates were introduced to prevent strengthening of national currencies or to deter the speculators from opening long positions in these currencies.

The position of central banks in Islamic countries is even stronger than in developed Western countries. If monetary authorities there wished to enforce something like “negative profit rates” on money markets, they would be successful.

Third, negative interest rates may be also viewed as a result of the supply and demand for reserve money. What concerns supply: the unconventional monetary measures in the aftermath of the crisis of 2008 resulted in inflation of balance sheets of several central banks. The purchase of securities (e.g. USA) or foreign exchange (e.g. Switzerland) on the asset side was accompanied by a huge increase in monetary base. But, as mentioned examples show, not everywhere the negative interest rates for reserves were observed. On the demand side the need for reserves to fulfil the reserve requirements was weak, because the base for minimal reserves usually has not increased much while available reserves have a lot. E.g. in Switzerland for the period January 20 – February 19, 2016, the reserve requirement was 14,530 CHF million, while eligible assets, 414,237 CHF billion, of which sight deposits of the banks 407,788 and cash 6,449. Accordingly, the compliance ratio was 2 851% (!)⁶. The demand for reserves for clearing purposes is usually not high, so the remaining reason might be the liquidity, “just in case”. If so, the central bank policy could be to charge an interest for this situation, which is rather comfortable from the commercial banks’ point of view. Or, alternatively, one may treat negative interest rate as a tax on (reserve) money. Usually these were the central banks which supplied the huge reserves, and now they try to tax it by setting negative deposit rates, even if sometimes using tiered systems.

2. Negative profit rate in Islamic finance?

The Islamic financial system is derived from five legislative sources: the Quran (the Moslems’ holy book), *sunna* (the Arabic word for prophet’s preaching and practice), *ijtihad* (the opinions of Islamic jurists on specific issues), *ijma* (the consensus of the Islamic community on specific issues) and *qiyas* (the application of accepted principles by analogy to new cases (al-Sheahabi 2003, p. 5). Islam has constrained the freedom to engage in business and financial transactions on the basis of a number of prohibitions, ethics, and norms. Possibly the most far-reaching aspect of Islamic economics is the prohibition of *riba*. This Arabic word

⁶ Schweizerische Nationabank, *Important monetary policy data for the week ending 15 April 2016*, Zurich 2016, p. 2.

stands for an increase in particular item, or an excess. It has many meanings, but in finance *riba* is earning money on money at a predetermined rate (on a loan). Accordingly, *riba* used to be translated as *interest*. The Quran explicitly prohibits the payment of *riba* and the taking of the interest as in a conventional banking system, and therefore investors must be compensated by other means (in general, a profit). Islam also precludes *gharar* (uncertainty caused by lack of clarity regarding the subject or the price in a contract or exchange) and *maysir* (gambling, easy acquisition of wealth by chance). For more details see *Handbook of Islamic Banking* 2007, p. 38–47.

In this part of the paper we will judge:

- a) whether the conditions in selected Islamic countries could allow the central banks there to introduce nominal negative rates – either directly, by setting the policy rates (“indicative profit rates”) or indirectly, by increasing monetary base, and
- b) how the instruments used by Islamic banks to manage their liquidity might be used in a potential environment of negative profit rates.

Islamic countries, in general, rather face inflation than deflation, and accordingly the interest (or profit) rates are positive, if not double-digit. For example: in Iran, where the banking system is fully Islamic, the headline inflation rate was about 16% in April 2016, and the goal of the Central Bank of Iran (CBI) was, and had been for many years, to dampen the inflationary pressures, by reducing the growth rates of monetary base. In order to achieve it, the participation papers and different types of *sukuk* were issued⁷. The “implementation of Usury-free Banking Law and the introduction of contracts with fixed return and partnership contracts, the regulations pertaining to determination of profit rate or expected rate of return on banking facilities and the minimum and maximum profit rate or expected rate of return, as is stipulated in the by-law of the Usuryfree Banking Law, are determined by the Money and Credit Council. The CBI can intervene in determining these rates both for investment projects or partnership and for other facilities extended by banks” [www.cbi.ir]. In practice, the deposit (profit) rate for Iranian year 1394 (corresponding to March 2015 – March 2016) was set between 10% for short-term deposits (<3M) and 18% for one year. Setting indicative or minimum / maximum rates for commercial banks may look like dirigisme, and it is, but note that several central banks use similar measures for central bank money, e.g. the ECB sets marginal overnight lending facility rate (0.25% effective from March 16, 2016) and deposit facility rate (–0.40%). However, even more important is the interest rate on the main refinancing operations (in April 2016: 0%), which normally provide the bulk of liquidity to the Eurozone banking system.

⁷ These instruments are similar to own-debt securities of the National Bank of Poland (7-day NBP money market bills).

IMF defines the exchange rate system in Iran as “other managed arrangement”⁸; the exchange rate is fixed but changes often. It makes it easier for the central bank to conduct independent monetary policy. Similarly in Malaysia, a major Islamic financial centre with dual banking system, traditional and Islamic: since 2005 the ringgit has not been fixed against US dollar, but still “other managed”. The inflation rate in Malaysia in 2015 was 2.1%. Monetary policy operations are wholesale and interbank market transactions undertaken by the Bank Negara Malaysia (BNM) to manage liquidity in the financial system. The primary objective of such operations is to ensure the average overnight interbank rate in the ringgit interbank money market remains within the corridor of the Overnight Policy Rate (± 0.25 pp)⁹ as set out by the Monetary Policy Committee (3.25% in April 2016) while ensuring the efficient functioning of the conventional and Islamic interbank money market. Unique to Malaysia, the settlement of large-value payments within the Islamic banking sector is conducted via a separate system of Islamic current accounts maintained at Bank Negara Malaysia. This separation ensures a clear segregation of funds between conventional and Islamic banking at the settlement level to ensure compliance from the *shariah* perspective. Nonetheless, liquidity in both systems are linked, given third-party payments between banking customers in the two sectors as well as the participation of conventional banking institutions in Islamic banking products (www.bnm.gov.my).

The exchange-rate regime in Bahrain, another important Islamic financial centre, is very different from those in Iran and Malaysia. The Central Bank of Bahrain (CBB) maintains a fixed exchange rate between the Bahraini dinar and the US dollar (0.376 BHD/USD, a conventional peg according to IMF). The CBB offers a foreign exchange facility, implying that it stands ready to buy and sell US dollars, at rates very close to the official exchange rate. The CBB provides this facility to commercial banks located in the Kingdom of Bahrain. The exchange rate peg provides an anchor for monetary policy. The Central Bank of Bahrain (CBB) does not maintain any administrative controls over market interest rates. There are no interest rate caps or floors and the CBB does not seek to influence directly the cost of credit or the distribution of credit in the economy. At the moment, the inflation in Bahrain is low but definitely positive, usually below 3% (2.9% in February 2016) (www.cbb.gov.bh). However, in case of negative interest rates for USD, which are possible, the country could face the problem of transmitting them to the Bahraini economy because of the exchange-rate system, which is present in many Islamic countries and could potentially be problematic when considering instruments used for managing liquidity in Islamic finance.

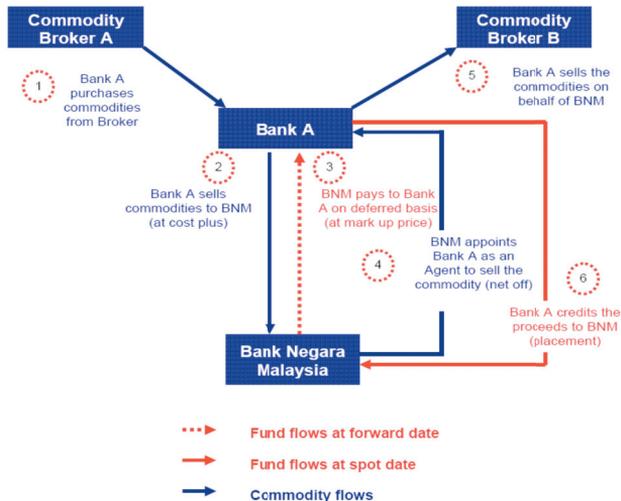
⁸ This category is a residual and is used when the exchange rate arrangement does not meet the criteria for any of the other categories. The Iranian exchange-rate system is characterized by usage of a currency basket which composition is unknown, and multiple exchange rates.

⁹ This concept is very similar to the Official Cash Rate in New Zealand.

Please note that inadequate availability of sharia-compliant financial instruments seems to have forced Islamic banks to hold a significant amount of cash reserves (Basu, Prasad, Rodriguez 2015, p. 5). Let's look at the consequences of possibly negative "profit rates" for the main categories of *riba*-free transactions used by central banks in Islamic countries in relation to commercial banks.

First category constitutes the most intensively used instruments, which are *murabaha*-based. For example, in Malaysia BNM implemented the Commodity Murabaha Programme (CMP) to manage liquidity. CMP utilises mainly crude palm oil-based contracts as the underlying commodity transactions to facilitate liquidity management via a commodity trading platform such as Bursa Suq Al Sila', or other commodity providers. Let's assume a bank would like to invest its liquidity in a sharia-compliant manner. The bank buys the commodity and is accordingly crediting the broker's account with, say, 1 million MYR. At the same time, the bank sells the commodity for higher price to the BNM, with deferred payment. The central bank sells the commodity on the market, usually not directly but by the bank, acting as an agent of BNM (Figure 2). In result, the bank spends the money and gets it back after the predetermined time with a mark-up¹⁰.

Figure 2
Commodity Murabaha Programme



Source: Bank Negara Malaysia, *Commodity Murabahah Programme*, p. 2, www.bnm.gov.my (accessed 29.08.2016).

¹⁰ When the bank needs liquidity, it buys the commodity with deferred payment and sells it immediately.

In case of negative profit rates, the price at which the commodity would be sold to the central bank would be lower than the purchase price and paid later. In fact, it does not make sense, at least for the bank involved. This transaction is not possible unless the bank is forced to do so. In addition, this behaviour might be in the contrary to the sharia rules. A commodity has to be sold above cost and not systematically with a loss. A sale with a loss is practicable only in order to avoid higher losses, and this is not the case.

The mechanism of the Islamic Sukuk Liquidity Instrument in Bahrain is based on sale and purchase transactions meant to help Islamic banks manage their liquidity. It involves three separate *sukuk* sale and purchase transactions requiring the existence of three parties, namely the *sukuk* owner (the bank in need of liquidity), the intermediary bank (the market maker), and the Central Bank of Bahrain (CBB), which offers the liquidity.

Second group of instruments used by Islamic central banks are based on profit sharing. Negative profit rate in Islamic finance is something more or less natural, because not all investments will end up with profit. Under no circumstances, however, a loss is something one should presume or accept in advance.

In Malaysia profit sharing instruments are by nature longer-term, but still relatively short (up to one year). Sukuk BNM Ijarah are based on sale and lease-back transactions. BNM sells its *ijarah* assets to SPV to obtain cash and absorb liquidity from market. SPV issues *sukuk* to finance the purchase of assets and consequently lease the properties back to BNM. Lease rental paid by BNM to SPV will be passed to investors as a return on *sukuk*. On maturity, BNM will buy the properties from SPV, which will be used to redeem the *sukuk* from investors [www.bnm.gov.my].

In Bahrain, since 2015, the Central Bank of Bahrain (CBB) uses a new sharia-compliant *wakalah* (agency) liquidity management instrument, which is aimed at absorbing excess liquidity from local Islamic retail banks and placing it with the central bank. The instrument has been developed based on a standard contract of the International Islamic Financial Market (IIFM). The *wakalah* is an investment opportunity for retail Islamic banks that wish to deposit excess liquidity with the CBB. Retail Islamic banks have to sign a *wakalah* agreement, which appoints the CBB as an agent (*wakil*) to invest cash on behalf of the bank (*muwakkil*). Accordingly, the *wakil* will invest these funds in the investment portfolio allocated in advance and contains Islamic *sukuks*. The duration of the *wakalah* is one week and is available for Islamic retail banks every week (Basu, Prasad, Rodriguez 2015, p. 17).

In Iran the central bank (and the government too) issues participation paper on a *musharaka* basis, with yields in principle linked to the central bank's profits, excluding the cost of monetary operations (or government's profit from its share in profitable state-owned enterprises or projects under construction), with a guarantee on yields and principal. The instrument is traded only at par and not suited for

more flexible monetary operations, but it is instead useful for liquidity absorption (Basu, Prasad, Rodriguez 2015, p. 19).

Third group of instruments are based on *qard* or *wadiah*.

Qard refers to a contract of lending money by a lender to a borrower where the latter is bound to return an equivalent replacement amount to the lender. A *qard* contract is established when ownership of a sum of money belonging to the lender is transferred to the borrower, which has an obligation to repay the lender in full. The *qard* contract must not result in any form of contractual benefit to the lender merely for lending money. The granting of *hibah* (gift, donation) by the borrower to the lender is only allowed when it is solely based on the borrower's discretion.

The proposed mechanism of liquidity management instruments based on *qard* is as follows:

Bank Negara Malaysia issues a tender disclosing the amount of loan to be borrowed;

- the tender is based on an uncompetitive bidding whereby bidders only bid for the nominal amount that they are willing to loan to Bank Negara Malaysia;
- the successful bidder provides the loan based on tenure until maturity; and
- upon maturity, Bank Negara Malaysia pays back the loan in total. *Hibah* (if any) may be given at the discretion of Bank Negara Malaysia (<http://ifikr.isra.my/fatwa/-/fatwa/getFatwaDetail/3905>)¹¹.

In such case a “negative profit rate” is difficult to obtain; the amount of the loan should be returned in full.

But: if for any reason “negative profit rates” should be implemented, Islamic finance will find a solution for it. Obligatory *wadiah* may be seen as a viable instrument. *Wadiah* is safekeeping of a deposit within a trust known as *amanah*. The bank client is going to accept usage over the deposit by the bank, will charge the depositor for the safekeeping, who, however, will be not entitled to participation in the profit or the loss (<https://ijaracdc.com/wadiah/>). Without *hibah* the *wadiah* corresponds to investment with a loss, equivalent to charging negative profit rate. With *hibah*, a positive profit rate may be achieved, at the discretion of the central bank, but this is not quite a systemic solution...

The reasons for negative “profit rates” may be twofold.

First, several Islamic countries apply fixed exchange-rate systems in relation to US Dollar. If Fed introduces negative interest rates, there will be a pressure for such Islamic currencies to follow. The interest (or profit) rates in Islamic countries are higher than in the USA for similar instruments, due to risk premium. But if US money market rates are significantly below zero, the Islamic countries with fixed exchange rate to US Dollar will also observe negative rates, or will be forced to implement restrictions on foreign capital flows to avoid arbitrage.

¹¹ Bank Negara Malaysia, *Qard Concept paper*, 21 January 2016.

Second, the Islamic financial institutions operate also in non-Islamic countries and compete with conventional ones. As a rule of thumb, they always bring their profit rates in line with conventional interest rates for both deposits and loans. If conventional customer deposits bring losses because of negative interest rates one day, a pressure on Islamic institutions will appear. If they offer positive rates, their profitability could be in question. For example, in July 2016 NatWest and its parent, the Royal Bank of Scotland, raised the prospect of negative interest rates in letters to 1.3m business customers in Great Britain, which already to some extent is and will be an important Islamic financial centre in the Western world (<http://www.telegraph.co.uk/business/2016/07/30/negative-interest-rates-necessary-evil-or-symbol-of-greed/>).

There are also opinions that negative “interest rates” already are and have always been a part of the Islamic economic system. The *zakat* is a kind of tax, which is calculated on zakatable wealth for one year. It is usually 2.5% of a Muslim’s total savings and wealth above a minimum amount known as *nisab*. With regard to money, *zakat* is an incentive to spend it, instead of being hoarded (Meera, Larbani 2006, p. 92).

Conclusions

To summarize: the instruments used by central banks to conduct monetary policy (managing liquidity, influencing indicative profit rates) are in general the same as Islamic instruments implemented by financial institutions in relations with their customers. The economic situation in Islamic countries (e.g. inflation), in most cases exclude the need for negative profit rates. One exception may be, in the future, currencies with a fixed exchange rate to US Dollar. Albeit Islamic financial instruments are not generally suitable for generating losses, one may imagine that some of them could achieve the same results as negative interest rates (e.g. *wadiyah*).

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Summary

Negative interest rates are a phenomenon, which attracts the attention of many economists. Several world currencies are affected, for different reasons. Currencies such as Swiss franc or Danish krone have an appreciation potential, and the central banks try to discourage the speculators from taking long positions in their currencies (CHF, DKK). Other central banks aim at restoring “normal” conditions in the economy, meaning inflation at about 2% and no deflationary slowdown in the aggregate demand and production (EUR, SEK). The goal of this paper is to identify the reasons for implementing negative interest rates in selected countries. Next, we observe that economic conditions in Islamic countries are quite different. Major groups of Islamic instruments used by central banks are discussed. We conclude that most of them are not suitable for achieving negative profit rates (or systematic losses), but if for any reason (e.g. fixed exchange rate to US Dollar) the negative rates had to be implemented, it is feasible, e.g. by *wadi'ah* (safekeeping).

Keywords: negative interest rates, Islamic finance, central bank policy