Fundamentals of Economic and Monetary Policy in Islam

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ABSTRACT

Purpose: This study aims to look at the monetary system from an Islamic perspective.

Design/Method/Approach: This research is literature research using a qualitative approach and using descriptive methods related to the discussion.

Findings: The results of the study indicate that it is necessary to abolish the interest system, increase investment, maximize zakat instruments, and others regarding cross-subsidies or bridges between the rich and the poor, and besides that, the central bank is obliged to assess the demand for money in the context of price stability and other monetary policy targets.

Originality/Values: The main contribution of this research is to fill the gap. The majority of studies mainly focus on the conceptual and theoretical aspects of the Islamic monetary economy without any empirical validation in the field. The author suggests the application of Islamic monetary instruments to carry out the ideal goals of management-based Islamic monetary.
INTRODUCTION

Monetary policy plays an important role in building the stability and growth of the Islamic economy. At the time of the Prophet Muhammad, the dinar and dirham were set as the monetary standard at that time. Where the two types of currency were adopted based on Roman and Persian. There are no businesses to print their currency. Therefore, the process of supply and demand for gold and silver money is related to trade using the two kingdoms. At that time if the demand for money was higher than dinars and dirham’s were imported. On the other hand, if the demand for money falls, then commodities are imported. The volume of imports of dinars and dirham’s as well as commodity goods depends on the volume of commodities exported to the two kingdoms and the areas under their control.¹

The interesting thing is that there were no restrictions on the import of money at that time because the internal demand for the Hijaz (which was the area of the Daulah Islamiyah at that time) for dinars and dirham’s was very small as a result, it had no effect on supply and demand in the Roman and Persian economies. Money was not fulfilled according to state finances but according to the output of foreign trade.² The non-printing of a separate currency using the special characteristics of Islam by the Islamic Khilafah took place during the time of the Prophet, Khulafaurrasyidin, and the early days of the Umayyad Caliphate. When Abdul Malik Ibn Marwan as caliph was then printed Islamic dinars and dirhams using exclusive characteristics and weights that were permanent. before that, there were no Islamic dinars and dirhams, although the dinars and dirhams were applied and used as monetary standards.³

From this fact, it can be understood that it is permissible for a country to print a specific currency. However, if the conditions require printing currency to keep the country’s economy and monetary condition under control and avoid foreign control and control, printing currency is legally mandatory. In addition, there is no requirement to produce gold and silver (dinar and dirham) as a monetary standard (full-bodied bimetallic standard).⁴ Ideally, an economic system can build general welfare, in Islamic economics to claim the welfare of the people; the state has a crucial role, namely, social security, social balance, and state intervention.⁵ Social Security means that the state is responsible for the living standards of all individuals in the Islamic people. Balance means that there

²Kholiq, 49.
⁴Kholiq, Teori Moneter Islam, 49
⁵M. Baqir Ash-Sadr, Our Economic (Jakarta: Zahra Publishing House, 2008), 455.
is no comparison in the distribution of people's income and government hegemony is carried out when the market fails to perform its main function, because the market may run unfairly as a result of direct parties seeking profit by ignoring social values (using fraudulent methods). Therefore, in Islam, business is not always left to private parties alone, there are times when the government is the main actor, but it is permanent to the principles of ownership in the interests of the wider community.\(^5\)

The monetary system seeks to create macroeconomic conditions that include economic growth, price stability, and controlled inflation rates. The fight against inflation is carried out by regulating the money supply, especially principal money. When the economy experiences high inflation, the monetary action taken is to reduce the circulation of money in the community. This measure is commonly known as a tight monetary policy. On the other hand, if the central bank has an interest in increasing the amount of money to stimulate people's economic activities, then it is an expansionary monetary policy. Both monetary policies can be operated with interest rate instruments. Interest rate instruments can be in the form of an auction of Bank Indonesia Certificates (SBI) or the form of the use of a discount facility (discount rate facility) or the form of a minimum mandatory reserve deposit in an account from the central bank (reserve requirement).

Research related to Islamic monetary policy, including research from Harun. “This research paper applies the literature review-based methodology that deliberates the money status in Islam, Islamic monetary policy, and the significant procedures and financial regulations for monetary policy in Malaysia. Developing a dedicated Islamic monetary policy has been progressing through continuous effort in embarking in-depth research on this area besides the existence of the Islamic Interbank Money Market which focuses on absorbing surplus liquidity”.\(^7\)

Research from Choudhury, which one paper to clearly distinguish between important references to \textit{tawhid} is the law of monotheism. These are the main concepts and methodologies the worldview is inconsistent with the so-called man-made oddity of \textit{sharia} compliance. Against this background, this paper promises to: A comparative study of the nature of money and monetary


policy.\textsuperscript{8}

The problem arises when we need to choose an instrument for the implementation of monetary policy. According to Islamic law, it is not permissible to use interest-based as an instrument of monetary policy in the Islamic economic framework. Chapra argues that the absence of interest rates in an Islamic economy, and the existence of several institutions such as zakat, minimizes speculative money demand and makes the total demand for money in an Islamic economy more stable.\textsuperscript{9} Metwally believes that there are only two reasons for the demand for money, such as transaction motives and precautionary motives.\textsuperscript{10} As a result of this kind of point of view, Chapra suggests that in an Islamic economic system, monetary instruments play a major role in executing monetary policy. In Islamic economics, monetary policy must be carried out to control the money supply and there is no need to use interest-based instruments. Ahmad asserts that there are two main difficulties with the adoption of open market operations in Islamic economics. The first is a conceptual problem and the second is an institutional problem.\textsuperscript{11}

The problem and research gap from this study arise when we need to choose an instrument for the implementation of monetary policy. According to Islamic law, it is not permissible to use interest-based as an instrument of monetary policy in the Islamic economic framework. The problem that arises when we need to choose an instrument for the implementation of monetary policy based on Islamic law, it is not allowed to use interest-based as an instrument of monetary policy in the Islamic economic framework. The objective from this study aims to look at the monetary system from an Islamic perspective. This is the point of the problem that will be discussed.


\textsuperscript{11}Hasan, Kiaee (2007). Monetary Policy in Islamic Economic Framework. Case of Islamic Republic of Iran, Proceeding of the 2nd iECONS2007, Faculty of Economics and Muamalat, Islamic Science University of Malaysia
METHODS

The author uses a qualitative approach and uses a descriptive method through library research. The reason the author uses the descriptive method is to describe the problem. Adopting the opinions of experts and practitioners from international books and journals and national journals who have an understanding of “Fundamentals of Economic and Monetary Policy in Islam”. The object of this scientific study. The approach is done by analyzing and interpreting things that are theoretically related. After that, a literature search will be carried out according to the research topic.

This research paper applies the literature review-based methodology that deliberates the money status in Islam, Islamic monetary policy, and the significant procedures and financial regulations for monetary policy. Research is a research effort, which is a scientific activity in the form of study, analysis, or construction that is carried out systematically, methodologically, and consistently. Systematic means the arrangement is regularly based on the system, methodological means the implementation is in a certain way, and consistent means that in the study there are no elements that contradict a certain conceptual framework. The data analysis method used is qualitative data analysis. The political economy approach is carried out by examining and interpreting matters relating Fundamentals of Economic and Monetary Policy in Islam.

SoerjonoSoekanto, Pengantar Penelitian Hukum (Jakarta: UI Press, 2012), 42.
RESULTS AND DISCUSSION

The stability of currency values is a top priority in monetary activity. Because this stability will reflect the stability of the price level in the end price stability will affect the realization of the achievement of a country's economic development goals. So that monetary management activities must have a positive contribution to the achievement of these goals. Money stability is the goal of monetary management, in addition to being interpreted as the strength of the value of money against the price of goods, the strength of the value of money against other currencies is a condition according to the strength of the economic structure. Islamic monetary is intended to be another approach to monetary management in the economic system which is of course grounded in the initial concept of money and other basic principles and Islamic values. The figures who studied this case include Muhammad Umer Chapra, Masudul Alam Choudhury, Muchsin Khan, Abbas Mirakhor, and others.20

Synchronous monetary management using this sharia basis is needed to help realize the goals of Islam. However, given the absence of interest and instruments (instruments) of bonus interest rates and open market operations in the form of interest-based securities. Of course, it will raise questions about how to equalize money supply and demand without interest rates and how monetary policy can play an active role in achieving the target.

To encourage economic growth as well as stability, Islam does not use interest instruments or money supply through printing a budget deficit. In Islam, what is done is to increase the speed of money circulation and the development of infrastructure in the real sector. The supporting factor for the acceleration of turnover is caused by excess liquidity of money that cannot be hoarded and cannot be loaned using interest. While the recommended money withdrawal factor is using the qardh (benevolent loan), alms, and business cooperation in the form of syirkah or mudharabah. The primary advantage based on this cooperative system is that the actors and funders jointly receive experience, information, methods of supervision, management, and knowledge of the risks of a business. Furthermore, there are several theories regarding monetary regulation in this sharia perspective which include money demand, money supply, monetary policy, and instruments that can be used.21 An analytical approach is adopted within the comparative perspectives of money and monetary policy for the Islamic case.22

20Kholiq, Teori Moneter Islam, 53–54.
21Kholiq, 54.
22Choudhury, ‘Comparative Islamic Perspectives in Money, Monetary Policy, and Social Wellbeing’, 143.
Money Demand

In a shari'ah-based economy, the demand for money will only arise according to the motives of transactions and precautionary measures which are influenced by the income strata of money and its distribution.\textsuperscript{23} The demand for money due to speculative motives is driven by fluctuations in interest rates in a capitalist economy. Money creation in a free or interest-free system will be oriented towards investment, not lending.\textsuperscript{24} Monetary policy can be implemented without using interest rate instruments. This was proven at the time of the Prophet Muhammad and Khulafaur Rashidin. The economy of the Arabian Peninsula at that time was a commercial or trade economy, not an economy based on natural resources. When traders export goods, it means they are importing dinars or dirham’s.\textsuperscript{25} On the other hand, it means that dinars or dirham’s are exported when goods are imported. Therefore, the balance of supply and demand in the money market is a market that comes from the balance of the market for goods and services.\textsuperscript{26}

According to Merza Gamal based on al-Ghazali’s opinion, people who hoard money mean they have committed a crime because collecting money means that money is withdrawn from circulation. In modern monetary theory, hoarding money means slowing money down. This means reducing the occurrence of transactions so that the economy slows down.\textsuperscript{27} The theory of money demand developed by al-Ghazali has many similarities with the Quantity Theory of Money which later emerged and was put forward by monetarists such as Irving Fisher and Milton Friedman. The core of the monetarist thought states that the nominal amount of state income is equal to the velocity of money circulation multiplied by the money in the economy. Because it can be seen mathematically that the faster money circulates in the economy, the higher the national income and in turn, the people will be more prosperous. On the other hand, if money is kept out of circulation, the wheels of the economy will slow

\textsuperscript{23}David Laidler, \textit{The Demand For Money; Theories and Evidence} (Bombay: Alfred Publisher, 1972), 66.
\textsuperscript{24}Moh. Nejarullah Siddiqi, \textit{Bank Islam (Terjenahab Dari Issues in Islamic Banking, Oleh Ahmad Hikmat Sabendi)} (Bandung: Penerbit Pustaka, 1984), 36.
\textsuperscript{27}Ibrahim, ‘Sistem Moneter Dalam Perspektif Ekonomi Islam’, 141–60.
down and stagnation will occur in the economy. This means that the current monetary policy is a contractionary monetary policy.  

To study the Islamic monetary instruments used to execute monetary policy, Kiaee took a case study from Iran. The Iranian government implemented Islamic rules and regulations in all aspects of society and the banking system comprehensively after the Islamic revolution in 1979. Ausaf also explained some of the regulatory controls that had been implemented in Pakistan when it started the Islamization of its banking system in 1979. Apart from that, Pakistan and Sudan have also become the focus of Ausaf’s study to determine monetary policy instruments in Islamic economics; it is known that since December 1984, all commercial banks in Sudan have been operating according to Islamic law. Islam does not find interest to be an appropriate mechanism for efficient or fair management of the demand for money. As a result, it tries to regulate the demand for money with a strategy that relies on several instruments, some of which are implemented in countries that use Islamic financial institutions.

The establishment of an economic system based on Islamic values requires fundamental changes in the operations of financial institutions. Since interest rates are not allowed, alternative mechanisms are relied on primarily. Truman said that the financial system contributed to the monetary crisis. A malfunctioning international financial system contributed to the crisis and may be the main cause, but a malfunctioning international monetary system is neither the main nor minor cause of the crisis. Truman emphasized that a malfunctioning international monetary system was the main cause of the crisis. Changes in the international monetary system are unlikely to have much effect on the functioning of the international financial system unless the system also changes. After the crisis, changes in the international financial system were needed and desired, more than just changes in the international financial system.

For the government sector. Thus, creditors will consider the feasibility of the project and the government's ability to manage a project. So the government also cannot obtain hyperbolic financing that is used for unprofitable public sectors. Applications based on this provision may create short-term difficulties, but in the long term, they can reduce regulatory and

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28 Ibrahim, ‘Sistem Moneter Dalam Perspektif Ekonomi Islam’.
30 Fauzi and Hapsari, 99–111.
macroeconomic imbalances, and can build better economic conditions. In the view of the mainstream schools, the imposition of taxes on idle assets (dues of idle funds) is one of the primary tactics and instruments of monetary policy to create a dynamic money circulation. The philosophical basis is that Islam directs the sources of power to be utilized optimally and efficiently. In this case, hoarding money or hoarding wealth is a crime.

Meanwhile, from the Iqtishaduna School, the demand for money for transactions is a function of a person's income level, with an increase in income level, the demand for money to facilitate transactions of goods and services will also increase. The function of the demand for money just in case (which also includes the demand for money for investment and savings) is influenced to a large extent by the price of tough goods for the purchase of non-cash goods. In commodity trading on credit, Zainal ibn Ali Zainal Abidin Ibn Husain Ibn Ali Ibn Abi Talib allows payment using a higher price based on cash prices.

### Money Supply

When the demand for money is stabilized and linked to the needs of achieving citizens' welfare and development, the battles that need to be considered are first, how the aggregate money supply meets money demand as a result of which there is equilibrium, then how to allocate this money supply by the needs to realize common goals. According to Metwally, the supply of money to Islam is fully controlled by the state as a legal tender monopoly holder. During the Apostle's time, the Baitul Mal forum was a prototype of a central bank whose function was to issue money and keep the exchange rate stable, as well as control its ownership. The government's policy in dealing with shocks in the money market, for example, excess demand for money, is not by printing money but by influencing the behavior of the demand for money through the imposition of fees on idle assets. This policy will avoid inflation caused by excess money.

The supporters of the Iqtishaduna School view that the amount of money spread is a complete supply using the supplement’s estimate that the government is the holder of the monetary authority and cannot influence the

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amount of money that is spread out. This was based on the economic conditions of the time of the Apostles, the free trade terms at that time according to the customs bureaucracy, the relatively small area, good trade terms, and the parallels between intrinsic value and nominal value. This causes the government cannot control the amount of money spread. In addition, at that time there was no central bank that printed its currency; it was only in Ali's Caliphate that money printing was carried out.

The supporting policies implemented are eliminating practices that interfere with the creation of a fully competitive market, for example, the practice of hoarding money and goods, the obstruction of information among all economic actors, the prohibition of talaqqirukban (buying goods according to traders who have not entered the market). 39

**Monetary System in Islam**

From an economic perspective, monetary policy is defined as one of the efforts to achieve better economic stability. With the assumption of economic stability, it is intended that the recipient through the circulation of money regulates the supply of money to realize short-term goals (optimization of production levels and price stability) and long-term goals (social welfare), monetary behavior of government regulations. This is what underlies the existence of the monetary policy, both conventional and sharia.

A policy system is needed that can overcome various macroeconomic problems faced by a country. One of the important steps that can be used to overcome these problems is to make a policy in the monetary sector. Therefore, it is important to analyze the role of monetary policy in controlling economic activity in the desired direction, namely achieving economic activity. It can be said that monetary policy is an action taken by the monetary authority (generally the central bank) to influence the amount of money and credit which in turn will affect the economic activity of the people. Monetary policy is primarily aimed at economic stability, which is measured using employment opportunities, price stability, and a balanced international balance of payments. If stability in the economy is disturbed, then economic policies can be carried out to restore it (stabilization measures). 40

The basic difference between modern monetary policy and Islamic monetary policy is seen from the main assumptions in the fundamental understanding of the motives for money demand, and monetary policy instruments, interest-based and non-interest-based. Meanwhile, in the short

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39Kholiq, 63–64.
term, conventional-Islamic policies are jointly aimed at increasing the optimization of production levels and maintaining price stability.

Chapra stressed that attempts to regulate the various components of money demand through interest rate mechanisms tend to squeeze money demand for the fulfillment of needs and productive investments rather than unproductive and speculative use, resulting in the realization of a frustrating goal. Moreover, since the demand for money associated with consumption and speculation is conspicuous tends to be relatively more volatile than that for meeting needs and productive investment, a high degree of instability will be injected throughout the economy. Not surprisingly, recent empirical studies have revealed large volatility in the aggregate money demand function as well as its principal component.  

So far, Islamic economics may be more successful in offering an alternative perspective on the economic system than in providing a substantially different way of being economical. The emphasis of his theory on social consciousness is the sharing of risk, the redistribution of wealth and opportunity. But Islamic economics has found it difficult to put theory into practice. The list of reasons ranges from history, law, politics, regulation, human behavior, and so on. But the important reason is that Islamic economics has generally been made to conform to systems designed for modern economies, and in the process of making concessions, seems to be losing what its critics see as substance.

Since banks play a central and still evolving role in the monetary and financial system, there has been strong criticism of Islamic monetary management as it is currently practiced. The essence of the criticism is that Islamic monetary management, especially Islamic monetary instruments, is nothing but a replication of the existing modern monetary management with Islamic labels. There is a lot of validity and support for this critique. Early attempts in various parts of the world to establish 'pure' Islamic finance institutions were not entirely successful, mainly because they were long in religion and short in economics and contemporary realities. They, then, bounced back by establishing institutions that are different in their operations from existing modern economic institutions. In the absence of a workable model, policymakers and economic actors feel the need to simply replicate the product in the early years, with the hope that purer, more authentic products will be developed over time. But for more than 30 years, their hopes have not been realized.

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41 Chapra, ‘Monetary Management in an Islamic Economic’, 1–35.
Current public sector lending policies in traditional economies it is the interest rate that puts countries in a very influential position. With an increase in the national debt beyond the threshold, say 100 percent, the country faces the risk of further growth which will only serve its interests on debt. The problem of paying off debt must be conveyed to the public, where tax revenues must be increased to pay off debts. Thus, the risk of economic mismanagement is passed on to present and future generations. Moreover, to the extent that the government borrows from the rich and taxes mostly middle and low-income groups, the distribution of income and wealth tends to favor the richest segment of the population. When government loans are financed from abroad, the problem is getting worse through the flow of resources to debt services, increasing pressure on the balance of payments.\textsuperscript{43}

In terms of the development of Islamic banking, within the limits of Islamic monetary instruments, Islamic banks also compare their fixed return contracts with conventional interest rates charged in the interbank market, which are usually based on Treasury-bill rates. However, the loan supply of Islamic banks is less likely to react to changes in monetary policy because, as noted earlier, they have fewer investment opportunities and are more likely to sit on a lot of reserve liquidity.\textsuperscript{44}

Therefore, the money and banking system must be reformed to avoid excesses and imbalances that encourage inequality, conspicuous consumption, and unhealthy monetary expansion to the detriment of all that should hinder large-scale business, unless necessary, and in general, protect businesses that are small, medium and large scale. The objectives of monetary policy in the presence of Islamic banks must be comprehensively aligned with the objectives of the Islamic economic system. Shortly, the function of Islamic monetary operations should be redirected and optimized back to the ideal application as stated by the scholars. The central bank must create a new Islamic monetary contract, therefore, the central bank can engage in real economic activity and work more than just managing the supply and demand for money supply. This is the true aim of Islamic monetary management.\textsuperscript{45}

In the author's view, like other policies in Islamic economics, monetary policy needs to reflect the Islamic worldview and the unique and broad nature

\textsuperscript{44}Fauzi and Hapsari, ‘Islamic Monetary Management: A Critical Overview’, 99–111.
of Islamic ideology. Monetary policy is made to complement other policies to achieve development goals. The objectives of monetary policy are not only focused on achieving stability in the real value of money, full employment energy requirements, and optimum growth rates, but also on achieving socio-economic justice and equitable distribution of income and wealth.\footnote{Aidit Ghazali, Development, an Islamic Perspective (Malaysia: Pelanduk Publications, 1990), 103.} In this case, there are several tactics in Islamic monetary policy, where the demand for money will rise naturally due to demand and precautionary motives. This need is what generically occurs at a given level of income and distribution. A more even distribution of income will increase the demand for money at the aggregate level because more people can buy goods and services. Meanwhile, to anticipate and minimize the demand for money for speculation, Islam stipulates the prohibition of usury (interest) and stipulates a permanent levy in the form of 2.5\% zakat on assets. There are at least three reasons for this:

First, with the abolition of the interest system in Islam, people who hold liquid funds must choose between holding their funds in cash without receiving a return (yield) or choosing to invest in profitable investments to receive a return. Second, good investment opportunities in the short and long term have varying levels of risk and are possible for all investors, both those who dare to take high risks and those who are also low risk-takers. The extent of the possible risk will be offset using the expected level of profit. Investors who are reluctant to use high risk will tend to enter investments using low risk to offset the effect of zakat on their financial balance. Third, as long as there is an erosive effect based on zakat on deposits, it is rational to expect holders of liquid funds not to hoard them beyond the need for precautionary and transactional purposes. It is also useful to avoid increasing speculation motives.

In addition, the authors think that the central bank must assess the demand for money in terms of full employment in the context of price stability and other monetary policy targets. This is certainly not an easy task, it can be said that people's expectations can influence the demand for money, therefore this similarity will lead to hopes to reduce one's demand for money if the demand for money is determined by the speculative motive. Because the transaction and precautionary motives may be predictable by the government but this is not the case using speculative motives. Therefore, the government must try through the central bank to regulate the money supply. the main objective must be to ensure that monetary expansion will not be excessive compared to using the capacity of supplying goods and services.
CONCLUSIONS

The conventional central bank monetary operation model provides an overview of what variables are involved in the monetary operations model and contributes to the Islamic monetary operating model modeling for Islamic economic practices, in which the banking industry plays an important role in it. However, although a lot of research is done by Islamic researchers to improve Islamic monetary theory, the majority of studies mainly focus on the conceptual and theoretical aspects of Islamic monetary economics without any empirical validation in the field. The author suggests the application of Islamic monetary instruments to carry out the ideal goals of management-based Islamic monetary.

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