

Monetary Policy: An Islamic Economic Perspective

Yousfi Karima ¹

Public Governance & Social Economy Laboratory/Professor in
Economics/ Associate Professor Grade A/ Economic Department
University of Abou Bakr Belkaid Tlemcen- Algeria-

karima.yousfi@univ-tlemcen.dz

Naveed Ahmad Lone

Professor in Economics/Associate Professor / Government Degree /
College Pulwama J & K India

lonenaveed@gmail.com

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Abstract:

In an Islamic economy, monetary policy must play the same significant role in public policy as it does in other economies. Monetary policy operating procedure serves the purpose of nuts and bolts in the overall policy set of tactics and aims to direct the macroeconomy to better and or desired conditions. However, the prevailing economic system differences will have different views on monetary policy. Islam has a unique monetary policy that differs from the traditional economic system. According to Islamic thought, the purpose of monetary management is to stabilize the demand for money in order to achieve significant and constructive objectives. Islam aims to establish a just and equitable distribution of wealth and income by suppressing the demand-supply balance in money and promoting equality with the principles of justice and brotherhood. The goal of the study is to provide some clarity on how monetary policy functions in an Islamic economic system. The study will also attempt to discuss how Islamic monetary policy, in comparison to the conventional monetary system, can stabilize prices more and control inflation because it does not rely on an interest rate system. This makes Islamic monetary policy an economic system that is more resilient to monetary crises.

Keywords: Monetary policy, Islamic economy, Shariah, Economic Stability.

Jel Classification Codes: E52, E70, P40.

Introduction:

A country's central bank controls the money supply and interest rates through a process known as monetary policy to achieve specified economic objectives, such as low inflation, stable prices, and long-term economic growth. It serves an important role in ensuring financial stability and supporting economic well-being. Central banks use monetary policy as a potent weapon to impact a country's overall economic performance. «The term monetary policy describes the steps a central bank takes to

¹ Corresponding Author.

accomplish macroeconomic objectives like low inflation, such as regulating interest rates and the money supply, high employment, and sustainable economic growth"¹. Monetary policy refers to the set of strategies and actions that a country's central bank or monetary authority undertakes to regulate the money supply, interest rates, and availability of credit within the economy. Monetary policy's primary goal is to achieve and sustain specific economic objectives, like price stability, full employment, and sustainable economic growth.

According to traditional monetary policy literature, managing expectations is a key component of monetary policy².

1-Monetary policy:

In a conventional economic framework, the central bank's primary function is usually associated with monetary policy. By modifying interest rates, the central bank controls inflation and the money supply, i. e. policy rates through the use of tools for monetary policy like reserve requirements and open market operations. Although economists do not agree about how monetary policy affects the economy, under the most basic framework, the central bank is able to change the magnitude of the money supply.

The usual method used to implement monetary policy measures is the open-market operations, wherein short-term government securities are traded with the private sector. The objective of this policy-driven alteration in the monetary base is to extend its influence beyond the immediate consequences observed on the central bank's balance sheet. Therefore, it must be impossible for other agents to balance them out by altering the amount or makeup of their own liabilities. Only when the central bank can affect the demand for money will it be able to alter the amount of money in circulation.

The central banks have recently implemented a variety of unorthodox monetary policy tools to deal with the issues brought on by the COVID-19 pandemic and the global financial crisis. The Bank for International Settlements (BIS), claims that "unconventional monetary policy tools, such as large-scale asset purchases and forward guidance, have become an integral part of the central bank toolkit"³. Moreover, the importance has been emphasized by the European Central Bank (ECB) of clear communication in monetary policy choices. In a recent address, ECB President stated that "Monetary policy cannot be effectively transmitted unless there is clear and constant communication"⁴.

The financial markets actively follow decisions made on monetary policy, businesses, and households because they can have a substantial impact on investment, lending, and consumption trends. The Organization for Economic Cooperation and Development (OECD) emphasizes that "monetary policy actions

¹ International Monetary Fund (IMF). (2023). Monetary Policy. Obtained from <https://www.imf.org/external/np/exr/glossary/showTerm.asp#104>

² Lars E. O. Svensson, <http://people.su.se/~leosven/>, January 26–27, 2004, (accessed March 28, 2024).

³ Bank for International Settlements (BIS). (2022). Unconventional monetary policy tools: a cross-country analysis. Retrieved from <https://www.bis.org/publ/cgfs64.htm>

⁴ Lagarde, C. (2023, March 23). The monetary policy strategy of the European Central Bank [Speech]. Retrieved from <https://www.ecb.europa.eu/press/key/date/2023/html/ecb.sp230323~a3d1e4f0e6.en.html>

can influence employment, economic output, and inflation through their impact on the overall level of spending in the economy"¹. As the global economy evolves, central banks must modify their monetary policy initiatives to accommodate new risks and uncertainties, while striking a delicate balance between encouraging economic growth and guaranteeing financial stability.

An understanding of the relationship between interest rates and the total money supply forms the foundation of monetary policy within an economy, which determines the cost of borrowing money. To manipulate economic growth, inflation, exchange rates with other currencies, and unemployment, monetary policy utilizes various techniques to regulate one or both of these factors. To carry out monetary policy, central banks use a variety of instruments, which can include:

1.1. Interest rates: Modifying the primary policy interest rates, like the US federal funds rate (or any other rate in any other economy) to affect how much it costs banks, companies, and consumers to borrow money. While hiking rates helps fight inflation, lowering rates can promote borrowing and spending.

1.2. Open Market Operations: To affect the money supply, the central bank buys and sells government securities on the open market. While selling securities takes money out of the economy, buying securities adds it.

1.3. Reserve Requirements: Mandating the amount of cash that banks must keep in reserve against their deposits is known as a reserve requirement. The central bank can affect how much money banks can lend by altering these rules.

1.4. Quantitative Easing (QE): Mass purchases of financial assets, typically longer-term securities issued by both the public and private sectors, in an effort to reduce long-term interest rates and increase the money supply.

1.5. Forward Guidance: Disseminating the intentions and expectations of the central bank with reference to upcoming policy moves in an effort to affect market players' behavior.

1.6. Discount Rate: The rate of interest at which banks can borrow money from the government. Changes in the discount rate may have an impact on banks' borrowing costs and, as a result, how much they are willing to lend.

1.7. Currency intervention: This is the act of directly influencing a nation's currency's value in relation to other currencies by purchasing or selling it on the foreign exchange market.

The ultimate goals of monetary policy might differ from nation to nation and may include promoting full employment, fostering economic growth, preserving financial stability, and maintaining stable prices (low inflation). On the basis of the current economic conditions and problems, central banks frequently balance these objectives and modify their policy approach. When it comes to regulating economic volatility and guiding an economy in the direction of its desired goals, effective monetary policy can be quite important.

2-Critical evaluation of monetary Policy

Central banks all around the world have adopted an inflation targeting strategy. In this view, the fundamental goal of monetary policy is inflation, which

¹ Organisation for Economic Co-operation and Development (OECD). (2022). Monetary Policy. Retrieved from <https://www.oecd.org/economy/monetary-policy/>

undermines other goals like employment and growth. However, this core objective of monetary policy is the conventional economics systems have the negative repercussions and have a systemic departure from its core objectives. The low interest rates and easy monetary policy can fuel asset price bubbles, such as in housing or stock markets, resulting in excessive risk-taking and the possibility of severe financial instability when the bubbles burst¹, as was the case in global financial crisis 2007-08. Also, the Expansionary monetary policy may disproportionately benefit wealthy households with considerable asset holdings, while harming those on fixed incomes or with fewer assets, potentially aggravating wealth disparity². One country's aggressive monetary easing and currency devaluation can trigger currency wars and trade conflicts with other countries, thereby hurting international trade and investment flows. Almost 90 countries have raised interest rates after 2021. The data is freely available on the Trading Economics website and may be verified. So yet, no single country has had considerable success in reducing inflation. Not only this but the conventional monetary policy has repercussions at macro level that contradicts with the sustainable development goals laid down by United Nations. As, many economic theories predict a trade-off between employment and inflation. As a result, reaching an agreement to limit inflation requires making sacrifices on employment and economic growth, which contradicts SDG 8: Decent Work and Economic Growth. Also, increasing the policy rate to combat inflation raises company costs, driving you away. SDG 9 addresses infrastructure, industry, and innovation. Increasing policy rates increases markup payments on domestic debt, and few banks really participate in the trade of government bonds, therefore high policy rates lead to more inequality, pushing you away from SDG 10: Reducing inequality. Not only this, but raising policy rates raises the fiscal deficit, resulting in a reduction in budget allocations (for education and health) pushing you further from SDGs 3 and 4: good health and well-being and quality education, respectively. Hence the conventional monetary policy seems more an anti-developmental.

3- Point of view of islam monetary policy:

is the means by which the monetary authority controls the amount of money in circulation.

It typically involves interest rate targeting in order to support price stability and economic growth. This function was carried out by Baytul-Mal (treasury) activities in the early Islamic regimes, and it was combined with fiscal policy. The monetary expansion mechanism did not genuinely exist at that time, Since the supply of gold has always been steady and fiat money and credit were irrelevant, as they are in the present and recent periods (Dirham and Dinar)³, then the monetary expansion mechanism did not genuinely exist as it does now⁴.

¹ Mishkin, F. S. (2011). *Monetary policy strategy: lessons from the crisis* (No. w16755). National Bureau of Economic Research.

² Coibion, Olivier, Yuriy Gorodnichenko, Lorenz Kueng, and John Silvia. "Innocent Bystanders? Monetary policy and inequality." *Journal of Monetary Economics* 88 (2017): 70-89.

³ Chapra, M. U. (1996). *Monetary Management in an Islamic Economy*, Islamic Economic Studies, vol. 4, No. Jeddah, IRTI.

⁴ B. Bidabad (1994) General Monetary Equilibrium, <http://www.bidabad.com/doc/monetary-ed8.pdf>

The primary responsibilities of an Islamic central bank are similar to those of a conventional central bank in that they include monitoring banking operations, controlling liquidity, preserving price stability, and achieving macroeconomic objectives. Islamic financial instruments should be usury-free and effective in applying monetary, fiscal, and financial policies at different levels of central bank, government and commercial banks, as well as non-banking money and financial institutions. That being said, Islamic central banks differ from conventional central banks only in that they are limited in their ability to conduct monetary policy to employ interest-free Islamic monetary instruments, and commercial banks must undertake non-usury banking operations. Conventional interest-bearing bonds are not allowed in Islamic central banking. The implementation of monetary policy is primarily what sets Islamic central banking apart from conventional central banking. Additionally, it is legally required of monetary authorities to oversee commercial banks, money market funds, and credit institutions. The use of usury-based banking operations is prohibited for both Islamic commercial banks and central banks. In addition, this adds some new and distinct supervisory responsibilities to the monetary authority and monetary policy execution.

The goals of monetary policy and central banking are comparable to those of traditional systems, with the exception of the ban on usury. The objectives such as prosperity of the whole humanity and economic stability, stabilizing domestic and external values of money, promotion of sustained and balanced economic growth, mobilizing resources for economic development, and improvement of income and wealth distribution and so on - though with different emphases- are considered in both Islamic and conventional central banking systems. Due to the suffering these systems cause for society and the destruction of economic welfare, neither system can withstand inflation, severe or protracted recessions, or unemployment. Islamic central banks perform many of the same functions as conventional ones, including controlling the money supply, directing bank financing, and supplying safeguards and ensuring prudent banking and banking supervision.

4-Monetary policy's respect for Shariah:

The ultimate goal of Islam is to make everyone feel as valuable as possible. Humans can be improved both qualitatively and quantitatively through a process called exaltation. In general, reason and Shariah are complementary to one another, and theosophically, reason and wisdom serve as the foundation for all Shariah regulations. Furthermore, Islamic decision-making is best achieved through consultation. Based on this idea, Consequently, we can say that Islam is open to consulting to address social issues.

The holy Quran orders: "**Conduct their affairs by mutual consultation**" (Surah of Shura, Verse **38**). This is a general legislative regulation that permits consultative decision-making. This method makes the general rational rule and customary limitations very evident. This directive can be used to define any new legal structures or regulations. The main reason for the theosophy of the Holy Prophet (PBUH) enacting some Shariah commands while omitting many others is that various times and locations have different obligations and prohibitions regarding numerous partial commands. Because of this, not all topics were covered by legislation; instead, decisions about them were made using good judgment and reason, which allowed for the best course of action to be chosen after taking into account various factors

and people's circumstances. The institutionalization of monetary authority and policy was introduced here, but it should be noted that laws prohibiting permissible (Mobah) activities are only permitted within the parameters of Islamic Shariah. Quran states that: **"If ye do it not, take notice of war from Allāh and his messenger: but if ye turn back, ye shall have your capital sums: deal not unjustly, and ye shall not be dealt with unjustly"** (Surah of Baqarah, Verse 279). This verse, which refers to usury (Riba), implies that policies that are implemented at all levels of money management—from individual money management to monetary policy, and even at the level of international monetary and exchange management—should not provide money above its market value, which is another way of saying "unjustly."

The goal of Islamic supervision policies is to stop transactional fraud, not to meddle in business affairs. In addition, this establishes the impartiality of the monetary authority and who is responsible for supervision.

In an Islamic economy, monetary policy must play the same significant role in determining public policy as it does in a capitalist one. However, due to the disparities in the aims and characteristics of the two systems, as well as the fact that Islam is forbidden even though it is a vital component of the capitalist system, the goals and instruments must differ. Without a doubt, monetary policy in an Islamic economy should support the achievement of the socioeconomic objectives that Islam emphasizes in addition to adhering to the Islamic ethos. The following is a summary of some of the most important goals:

Economic stability, allowing money to be a stable store of value, a just standard for deferred payments, and a reliable unit of account; Socioeconomic justice and an equitable distribution of income and wealth; and Economic well-being, characterized by full employment and an optimal rate of economic growth.

One could argue that the above-mentioned objectives of monetary policy in the Islamic economic system are identical to those of capitalism. A statement to that effect would be untrue since, despite their outward similarities, the two systems differ greatly in their emphasis on spiritual principles, social justice, and human brotherhood. This point should be evident from the discussion that follows.

4.1. Full employment and strong economic growth are indicators of well-being:

Obtaining economic prosperity as the ultimate goal is intimately linked to Maqasid Shariah. Achieving all of the fundamental human requirements, getting rid of all obstacles, and raising both the material and moral standard of living are examples of economic welfare. Welfare does not mean pursuing one's own interests at the expense of others or favoring some groups while disregarding others. As the earthly caliph of Allah, humans exist in this world. All people have access to the resources. Thus, private resource usage is acceptable as long as it is restricted so as not to endanger social happiness and goodness. The main objective of Islamic monetary policy is to maximize resource utilization while sustaining a high rate of expansion to satisfy the basic needs of all.

4.2. Distribution of income and wealth and socio-economic justice:

Islam's moral theory, which is based on a deep sense of human fraternity, places a high priority on these issues. The capitalist system's shift towards socioeconomic justice and equitable income distribution is driven by social forces, rather than a spiritual commitment to human brotherhood. The current system, including money

and banking, is not aligned with these ideals, leading to significant income and wealth discrepancies. Despite socialism and political constraints, taxation and transfer payments are helping to lessen disparities. Islam aims to address gross inequalities by addressing their root causes and using Zakat, taxation, and transfer payments to achieve equitable income distribution that aligns with human brotherhood. The money and banking system, as well as monetary policy, should be developed to align with Islamic ideals and decrease disparities..

4.3. Steady appreciation of the value of money:

The importance of honesty and justice in Islam, along with the detrimental effects of inflation on socioeconomic justice and welfare, lead the Islamic perspective to place a high priority on monetary stability. Indexation of all incomes and monetary assets, including qurū'ah-Easanah (loans given without interest or profit-sharing) loans, has been proposed as a way to satisfy the Islamic imperative of socio-economic justice in the current global inflationary environment.

Inflation is against Islamic beliefs, but so are extended recessions and unemployment, which harm specific populations and undermine the goal of economic well-being for all. Recessions can lead to uncertainty and dissuade investors from taking risks on long-term investments. To achieve Islam's overarching objectives, the Islamic State should use all available means to reduce economic swings and stabilize the value of money.

Conclusion:

The monetary policy of the Islamic economic system is markedly distinct from that of conventional monetary policy, as it is governed by the principles of Shariah (Islamic legal principles).

The primary characteristics that set apart monetary policy within the Islamic economic framework include the absolute prohibition of interest (riba) in all financial dealings, which eliminates the possibility of utilizing interest rates as a mechanism for monetary policy. The focus is on asset-backing and risk-sharing concepts, with the money supply intended to be backed by real assets and actual commodities, and financial transactions based on profit-and-loss sharing agreements. The implementation of alternative monetary policy instruments, such as modifying profit-sharing ratios, reserve requirements, and conducting open market operations using Shariah-compliant financial products. Promoting ethical practices, social welfare, and economic justice, as well as ensuring price stability and encouraging economic progress. The use of zakat (obligatory charity) as an automated stabilizer and wealth distribution mechanism. The monetary policy of the Islamic economic system seeks economic stability, promotes ethical and socially responsible actions, and aligns financial activity with Shariah principles. While implementation varies by country and jurisdiction. The fundamental principles of Islamic finance form the basis for the formulation and implementation of monetary policy within the Islamic economic framework.

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