Alternative Monetary System Mechanism to Control Inflation: Islamic Monetary Policy Perspective

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Abstract

Although as claimed in some jurisdictions, interest based monetary policies have proven to be a powerful instrument to control inflation, this is not without insurmountable number of its limitations. Accordingly, arguments were made on merits of Interest Free Monetary Policy IFMP, or interest-free banking, which derives its origin from revelations in Qur'an, the words of Allah (May He be exalted), and the traditions of Prophet Muhammad (peace be upon him). This paper seeks to present an alternative approach viewed from Islamic monetary system lenses to manage inflation through a synthetic review of an alternative interest free (Islamic) framework for tackling inflation. In the end, the paper took a position highlighting the advantage of Islamic monetary policies as the more effective route to managing inflation. The paper is however limited in its present form by lack of available empirical data covering a reasonably long period of time across different jurisdictions to indicate the outcomes of adoption of the discussed interest free monetary tools. As a contribution from this paper, it views the current scourge of global inflation presenting a demand for a radical departure from the status quo approach to its management.

Key words: Inflation, Islamic Monetary Policy, Central Bank, Monetary Systems, Covid 19

Introduction

The persistence of inflation in the global economy has been a recurring phenomenon and is of concern to central banks in any jurisdiction where it is experienced, as it potentially inhibits the bank's ability to achieve its peculiar inflation objective. Where high persistence occurs, this may suggest that economic agents (producers, raw input suppliers, labor sources, etc) have been dysfunctional to adopt a backward-looking posture on inflation expectation, as against a supposed forward-looking posture. If this happens, it thus indicates an affront to a central bank's credibility, as lagging in the efficacy of its actions.

Inflation as a number one enemy in all jurisdictions has been on an off-target mark for some time now in many economies, in both advanced and emerging climes after the Covid 19 pandemic. Although in some advanced economies, it has arguably been below target, such may not be the experience among emerging market economies which has seen a mixed phenomenon.

During the Covid 19 pandemic, the global economy was thrown into a state of uncertainty COVID-19 was declared a pandemic in March 2020 by the World Health Organization (WHO), which disrupted societies in their health systems, economies, and in governmental functions worldwide (Ali et al., 2021; Yu et al., 2021). In the midst of extraordinary challenges and uncertainty, coupled with countless personal afflictions, world leaders were put on considerable pressures to take actions and decisions in response to the immediate impact of the pandemic and its consequences. There is no doubt that the corona virus outbreak has significantly reset the state of the world economy where many countries were immersed in a multi-layered crisis that snowballed to a health crisis, a domestic economic crisis, falling external demand, capital outflows, and a collapse in commodity prices (Congressional Research Service, 2021). However, as the crises transited to ease, twilight came to many countries that are now enveloped in sharp rises in prices of commodities including surge in food prices. More so, arguments were made to suggest that the ongoing Russia-Ukraine war has resulted in food prices surge due to supply shortages from Ukraine end. In current circumstances, the International Monetary Fund IMF had presented a prediction that global inflation rates in 2023 are expected to remain higher than usual in many parts of the world. It forecasts a 6.6% rate for 2023 and 4.3% rate for 2024. In 2024, inflation rates in Africa vary significantly by region. For instance, Sub-Saharan Africa is experiencing high inflation due to economic instability and currency devaluation in countries like Nigeria, Sudan and Zimbabwe. In Asia, inflation rates are more mixed: countries like India are managing moderate inflation, while others such as Pakistan face high rates due to economic challenges. If you want a deeper delve into specific countries, let me know!This imposes an obligation on the Central banks to examine carefully, the instruments in their possession due to the limitations in the ability of the existing measures aimed to bring about effective control of inflation in the past.

Arising from the foregoing therefore, it became imperative for central banks that are statutorily charged with rescuing economies from the shackles of inflation through the instrumentality of monetary policies, to rise to this challenge if there will be a strong and sustained economic growth. While doing so however, crucial questions that central banks respond to include how they keep inflation on target? How do they eliminate the occurrence of episodes of hyper- inflation and their distasteful consequences for societal welfare? Can the CB control inflation in event an economy goes through secular stagnation, falls into liquidity trap, or a fiscal crisis?

Traditionally and in the conventional economic paradigm, where prices rise in a faster mode above the target, CBs respond by tightening monetary policy through increase in interest rates. The presumption here is that higher interest rates render borrowing more expensive, thus limiting both consumption and investment. Likewise, where inflation reduces and economic output declines, the central banks respond by lowering interest rates and make borrowing cheaper. However, it suffices to question the presumption that reduction in inflation must necessarily be accompanied by a drop in economic output as no verifiable empirical evidence is available to us. Again, we stress here that even though the famous economist Keynes did not notice any ugly side of market capitalism, an imperative abound to develop new models that challenge the status quo. This is guided by one fact among others that aggregation problem exists in economics (which disputes the premise that there is uniform utility function for all individuals and for all products at all times). As mentioned by Mabid (2023), there exists an ignored aggregation problem in economics which is the basis for the adoption of change in interest rate measure to tackle inflation.

In the context of the foregoing therefore, a noticeable flawed assumption that consumers have same time preferences and same utility functions for different commodities at different times exists. As untenable as this is, it formed the basis for rate of interest as reflective of supply and demand for money. Thus, the rate of interest does not reflect the fundamentals for its postulations to be valid. Accordingly, this paper sees a gap created in the postulation of the theory that interest rate originates from the interaction of the supply and demand for money. Again, this paper sees the unavailability of empirical evidence to support the presumption that reduction in inflation must necessarily be accompanied by a drop in economic output, which in turn creates shortages in supply, thus triggering price rises. Here, the postulation of the Philip's curve suggesting that when inflation is high, the unemployment rate will be low and viceversa is not sacrosanct in our view.

Objectives and Signigicance

This research work aims at reviewing and presenting a synthesis of existing literature on argued merits and otherwise of Interest-free/Islamic monetary policies. Specifically, the objective of this research is to showcase the merits in each instrument of Qard Hasan, Istisna'a and Musharaka based monetary policies over the conventional interest based tools of reserve variations and open market operations. The outcome from this study is of significant implication to variety of stakeholders in the economic sphere such as the central bank, manufacturers and producers, investors, the general public and others. First and foremost, central banks now have wide horizon to navigate through, as varieties of options exist while tackling inflation as provided by a new paradigm. Again, investors are presented with an alternative understanding of the mechanics of inflation control which gives them an abiding faith in the economic terrain that safeguard their investment values from erosion of inflation. To the manufacturers and producers as economic agents, an inflation controlled economy is of primary interest to them as a source of stability of their economic activities. The general public likewise, advocate for a stable prices regime that will not throw them off balance in acquiring needed goods and services.

Islamic Monetary System Overview

An important principle in Islamic monetary policy is its abhorrence of speculation as it can harm others. In the Islamic Monetary System parlance, the concept of rate of profit is a replacement of interest rate concept (Uddin, Md Akther and Halim, Asyraf, 2015).The rate of profit is a profit-sharing ratio agreed between entrepreneurs and depositors, which clearly inhibit speculation. At the macro-level, the adoption of the rate of profit concept is seen in central bank policy in countries that implement Islamic economic system whether in the dual banking system mode or in a fully Islamic economic system mode (single economic system). A clear example of the adoption is seen in Indonesia as championed by its central bank, Bank Indonesia. However, at a micro-level, currently, the application of the rate of profit concept varies due to absence of an adopted yardstick (benchmark) for determining the profit margin on Islamic credit finance contracts such as the sale-based contract (Murabahah) and lease-based contract (Ijarah) in Islamic banking practices.

Furthermore, as against time value of money concept which ascribes reward to lender of money as compensation for the opportunity cost of not utilizing it elsewhere, the time value of economic resources in the Islamic monetary parlance is about ascribing time value to economic resources known as factors of production such as land, labor, capital, and entrepreneurship. Time value here entails the value of resources deployed in the production process that accommodates time span between their deployments to when outcomes from the deployment exercise trickle in.

Monetary Policy Tools for Inflation Control

The Islamic financial system can use the following monetary policy tools in order to control inflation.

Al-Hassan

This tool is employed where Central Bank plans to implement an Expansionary Monetary Policy EMP. It announces not to only members of the money market but also to vulnerable members of the society who are financially excluded in all its ramifications, and thus do not enjoy any benefit arising from the EMP having been denied access to fair borrowing privileges.

In Qard Hasan QH -based Monetary Policy MP, money supply (MS) is not restrictively circulated to the affluent and rich class in the society but to different vulnerable groups including the poor, orphans, destitute, wayfarer, and the displaced people. The central bank as a public institution has the authority to provide loans to the poor, the needy and the displaced that may need loan for economic activities. Qard-al-hassan maximizes investment spending and optimizes its multiplier effect. Through the use of Qard-al-hassan the real sector of the economy will get a boost because money supply is channeled directly through to the poor and needy rather than through the big banks (Salim, 2019)

QH is an interest free loan to be repaid by the borrower upon the expiration of the agreed time or duration, also referred to as loan to Allah (SWA). Qard-al-hassan is mentioned in the holy Quran. Allah (SWA) promised immense reward for those who practice Godly loans (Quran 2:245). Allah (SWA) also promised believers reward for Qard-al-hassan (Quran 73:20).Qard-al-hassan is loan to Allah can be used for public good. Qard-al Hassan is a mode of financing that meets the requirements of Islamic jurists and all the schools of fiqh are in agreement to its Shariah compliant characteristics and has therefore been generally accepted as a Shariah compliant mode of financing. It was recorded as a sunnah of prophet Muhammad (SAW) who praised, practiced and encouraged Muslims to practice Qard-al hassan to earn great reward (Al-Muslim, hadith 1224/3)

Istisna'a

Istisna'a-based MP is an alternative to interest-based MP and the CB will supply funds to builders, contractors and manufacturers based on QH Istisna'a. Qard Hasan QH is used as an effective tool of monetary policy MP where the CB pursues an expansionary money supply (EMS) objective as part of expansionary Istisna'a-based MP. Here, the CB lends on QH basis for building infrastructure projects. In this arrangement, the MS will directly go to the contractors and other interested parties involved in the infrastructure projects delivery and not to the conventional channels of banks. Afterward however, the QH-based borrowed fund gets paid back to the CB in installment as an interest free repayment in a gradual mode (Selim, 2020)

The above differs from the conventional approach, where CB activates the MP tool of lowering the reserve requirement through the channels of conventional big banks for example, where it is expected that a large chunk of benefits are rather channeled to owners of such institutions. Such redirection of the channels of MP to big banks in the conventional setting disputes the dictates of Almighty Allah, may He be Exalted, who said, "What Allah has bestowed on His Messenger from the people of the townships, belongs to Allah, to His Messenger and to kindred and orphans, the needy and the wayfarer; in order that it may not (merely) make a circuit between the wealthy among you. So, take what the Messenger assigns to you, and deny yourselves that which he withholds from you. And fear Allah; for Allah is strict in punishment" (Qur'an, 59:7).

Musharakah

musharakah is an Arabic word for sharing (Adela, 2018). Basically it refers to an arrangement whereby a joint venture is formed by two or more parties who combine their resources and all parties will share the profit or loss in the joint venture. The parties to a musharakah enjoy similar rights and liabilities.

Musharakah financing is the most vital method to assert influence in the economic sphere of Muslims and even non-muslims in the Islamic economy. Compared to the conventional monetary policy where interest rate is used, the musharakah financing is preferred due to its flexibility. In a musharakah arrangement there are three rates of returns for musharakah which are the depositors' musharakah, the investors' musharakah, and the banks' musharakah. In its deployment of Musharakah based monetary policy, the CB utilizes the return rates of different Musharakah. In the case of musharakah the depositor, the bank and the investor participate simultaneously. The CB participates in one instance in a joint venture project or partnership with bank and their customers based on a mutual account without the establishment of a separate entity. The other mode can be the equity Musharakah through the establishment of a private limited joint venture with CB participation (Bello, et. al., 2024; Adela, 2018)

Effectiveness of Islamic Monetary Policy Tools

In a dual economic and banking landscape, monetary policy formulation and implementation can concurrently be pursued as seen in Asian countries including Indonesia. Thus, in its implementation, occasioned by the desire to utilize idle funds (activating the economy), each Islamic monetary instrument discussed above has the effect of an either monetary expansion or monetary contraction, which facilitates a return on investment and managing liquidity in a certain period of time. In an earlier study, Shahzad, Ahmed and Rehman (2012) opined that in an Islamic financial system, a number of ethical monetary policy tools can be used to achieve inflation free economy. Further to this, Elhananni, Gherbi, Bouteldga and Benbouziane, (2013) analysed the monetary practice and inflation trends of some Muslim countries. They found that four Muslim countries using Islamic monetary policy instruments could adequately manage their inflation for some period of time after the implementation of Islamic monetary policy.

Later studies have revealed similar results. As found by Amrial, and Tika (2019) in a study which aimed at determining the monetary policy response to the implementation of the dual monetary policy, that in Indonesia, monetary policy has responded appropriately to the problems of inflation and unemployment. However, inflation generates a bigger response than unemployment. Similarly, in a study on Interest-free monetary policy and its impact on inflation and unemployment rates, Selim and Hassan (2019) found that in a group of 12 countries where Interest Free Monetary Policy IFMP is adopted, the Misery Index MI used to measure economic performance is lower and thus performs better compared to a group of countries where Interest Based Monetary Policy IBMP is pursued. Thus, the findings from this study affirm why those countries which have been historically pursuing IFMP such as Japan, Switzerland, Sweden, the Netherlands and Denmark have been able to contain both inflation and unemployment rates when compared to their counterparts among the English-speaking countries.

Furthermore, Selim (2020) mentioned that with the adoption of Istisna'a based monetary policy; it immediately creates well-paid jobs, which have positively contributed in the expansion of the size of the manufacturing sector. It also increases capital per person employed, and enhances labor productivity. This raises output and employment that improves the pace of industrialization. It is noted here that where there is an increase in the size of manufacturing sector, this will not only enhance manufactured value-added exports but also, lower high valued manufactured imports and thus increases positive trade balance and eventually cut trade deficits. As a multiplier effect, an increase in labor productivity is expected to improve the society's standard of living, and eventually the economy.

Thus, from above findings, it is clear that real evidences abound supporting the valid assertion that implementation of an interest free monetary policies based on QH, Musharaka and Istisnaa concepts are veritable practices in managing inflation even in a dual monetary policy regime that accommodates the traditional interest based arrangements. This is so given the fact that in each of the IMP tools, interest element is absent while paying back to the financier (the Central bank) and this eases the pressure of added cost to the producer and end user of outputs

Literature Review

Even from the conventional perspective, scores of evidence exist to prove the novelty in IFMP. For instance, Shirakawa (2023) was point black in response to a well articulated speech by Jay Powell, Federal Reserve chairman, at the August 2020 Jackson Hole conference. In the speech, Powell stressed: "If inflation expectations fall below our 2 percent objective, interest rates would decline in tandem''. Shirakawa (2023) thus responded to this in this way ''Japan indeed reached the zero lower bound on interest rates long before other economies. But if this had been a serious constraint on policy, Japan's growth rate should have been lower than that of its Group of Seven (G7) peers. Yet growth of Japanese GDP per person was in line with the G7 average from 2000 (about the time the Bank of Japan's interest rates reached zero and the central bank began unconventional monetary policy) to 2012 (just before the central bank's balance sheet started to balloon). Growth of Japan's GDP per working-age person was the highest among the G7 during the same period''

In a research work by Selim (2018), it aims to investigate the macroeconomic effects of QH as a tool of MP and its effectiveness in achieving full employment and price stability in the economy. The study found that QH-based MP positively influences real sectors of the economy. It also increases output, and the economy returns to full employment. QH offers the least possible cost of borrowing within the economy thereby triggering rightward shift in aggregate supply curve. With this development increased output and lower price level is seen. In addition, increase in output eliminates excess demand or shortages and thus maintains price stability. Furthermore, QH-based MP also raises exportable surplus and exports, decreases imports as well as increases inflow of funds and foreign currency reserves with the Central Bank and thus makes MP more effective. Amrial and Arundina (2019) in a study on implementation of dual monetary policy and its relevance to inflation and unemployment in the Phillips curve context in Indonesia found that monetary policy has responded appropriately to the problems of inflation and unemployment. However, the finding indicated that inflation generates a bigger response than unemployment. Selim and Hassan (2019) further studied the economic performance of major OECD and Euro zone countries and found that the group of countries that follow interest free or Qard- Al hassan based monetary policy performed better compared to the group that pursue interest based monetary policy. Further to this, Salim, (2020) found that Islamic financial policy Qard- Al- hassan related to job creation, expansion in the size of the manufacturing sector, increase per capita per person employed, reduction of trade deficit and improved standard of living.

Along this line, in the works of Moakhar, Esavi, Khademalizadeh and Tari (2023), the authors proved mathematically that the money interest rate should be at zero level to attain productivity and Pareto optimality. In their finding, the introduction of money or credit through loan leads to inefficiency in production and households and in the general equilibrium. They further found that the inefficient condition in production stimulates the change in the price level and perpetuates it

Research Methodology

The paper adopts a content analyses approach to underscore the effectiveness of Islamic based monetary policies in tackling inflation over the conventional counterparts. In doing so, the theoretical frameworks in terms of differences in policy tools and their respective features/mechanisms were highlighted. More so, empirical evidence in terms of case studies was discussed, and challenges and criticisms of the IMP approaches are presented in content analyses form. The procedure for the research includes a review of past empirical studies made which focused on Islamic monetary systems operated in the past. This is followed with presentation of a comparative analysis of the differences between the conventional approach and the Islamic approach at conceptual levels. Thus the research focuses on global scene scenarios conceptually

Comparative Analysis

Here, an attempt is made to present a comparative discussion of the tools and features of the interest based monetary policy framework and the non Interest based one. This would enable a clear understanding of the workings of a monetary policy based on the framework it is anchored on. As summarized in Table1 below, there are a number of tools available for both the conventional and the Islamic tools which for all intents and purposes differ.

In a conventional monetary policy framework, Open market operation OMO involves the buying or selling of government securities on the open market to influence the money supply, interest rates, and ultimately, inflation. The central bank buys securities to inject liquidity, with the expectation of reducing interest rates and stimulating economic growth. It also sells securities to absorb liquidity, increasing interest rates and controlling inflation. However, under an Islamic monetary policy framework, OMO are adapted to comply with Shariah principles, which prohibit interest-based transactions. Thus, Islamic central banks use alternative instruments, such as buying or selling Shariah-compliant securities (e.g., sukuk) to manage liquidity using commodity murabahah (cost-plus financing) to inject or absorb funds thus implementing mudarabah (profit-sharing) arrangements with financial institutions. Islamic OMO aims to achieve monetary policy objectives while ensuring compliance with Islamic finance principles.

For the Islamic MP tools, the required reserve ratio is one of the tools used. This instrument is similar to the required ratio used in conventional monetary policy. It is the ratio of reserve to deposit that central banks mandate commercial banks to hold at any point in time. Here the CB can use this instrument for monetary policy by channelling the reserve deposit to finance priority projects or give them to the government as Qard- Al-hassan (benevolent loan).

Another tool is Musharakah profit- sharing Ratio. This instrument is available only in Islamic monetary policy owing to the interest factor associated with the conventional monetary policy. Here interest rate is replaced by profit sharing. The profit sharing arrangement is twofold, one is between the commercial bank and the depositor and another arrangement between the commercial bank and the borrower. In Islamic financial system, money creation is backed by investment in the real sector this way inflation is eliminated.

Another is re-financing ratio tool. Here, CB may offer extra cash to commercial banks proportionate to the percentage of the interest free loan granted by them. This policy can also be used by the central bank to encourage Qard- Al-hassan. The central bank may refinance at no charge to the extent of the percentage of this particular loan give out. Furthermore, the tool of moral suasion which is similar to the qualitative tool used by the conventional monetary policy is another tool for IMP. In this case the Central bank will be able to persuade commercial banks to implement its policies in true spirits. The central bank tries personal contact and consultations and suggest to banks ways to assist in overcoming a difficult situation when there is any (Chapra, 1996). Finally, is the use of government deposits. The CB from time to time may act on behalf of the government and remove government deposits with commercial banks. This will affect their reserve. This practice is popularly used in Saudi Arabia (Elhananni, Gherbi, Bouteldga, Benbouziane, 2013).

TABLE 1: Comparative Analysis of Differences of Conventional and Islamic Monetary Policy Tools

Monetary Policy Tool	Application in Islamic Monetary System	Application in Conventional Monetary System	Features	Remark
Open market operation Interest based approach	Not accepted	Accepted	A Pre determined upfront charge built on borrowed capital	Supply of money on interest based loan to or from government
Required reserve ratio	Accepted on the basis of Qard Al Hassan(non interest) to the government	Accepted as interest based loan to government	Upward change or downward change in reserve ratios of banks by CBN	Used as expansionary or contraction approach
Istisna'a based MP	Accepted	Not accepted	CB lends on QH basis for building infrastructure projects.	Used as expansionary or contraction approach
Musharakah based IMP	Accepted	Not accepted	Joint equity participation between CB and others	Stabilizes price levels due to agreed sharing ratios
Refinancing tool	Accepted	Not accepted	CB may offer extra cash to commercial banks proportionate to the percentage of the interest free loan granted by them	Used as expansionary approach

Source: Researchers' Summary Table 2023

Challenges and Criticisms

Notwithstanding the lofty ideals in IMP, the environment in which it will or operates presents barrage of challenges that could inhibit its optimal deployment. Some of the challenges include:

Lack of Deep and Liquid Islamic Financial Markets

A long standing hole in Islamic finance industry has been the shallowness of markets and paucity of instruments that can be used to absorb the excess liquidity that occasionally feature in the industry. This principally stems from Sharia inhibitions that cannot be circumvented. In the context of IMP tools deployment, their lack of or limited tradability in financial markets could limit realization of their potentials. This however does not negate their original value at conception and more so, not at all times the need for secondary market operations exist.

Regulatory Frameworks

Robust regulatory provisions that accommodate IMP have to be in place to address a number of issues arising from conceptualization and deployment of the IMP tools either on a contractionary or expansionary regime. Issues that need to come within the purview of the regulation should include approaches to handling default in executing transactions for example in Istisnaa based monetary policy. Where an expansionary objective is pursued here with an Istisnaa QH MP initiative and the manufacturer fails to deliver on schedule, what sanctions are recognized by Sharia to address the default with its concomitant implication for the sought monetary policy objective? In the same vein, developing the appropriate framework that specifies the nature, tenor and size of financing (expansionary) in the light of prevailing economic parameters is essential in the implementation process of the MP in consideration.

Coordination Issues and Global Monetary Interactions

For a proper and systematic implementation of the IMP tools, it is essential to institute a well organized system of interaction and synergy building among different participants in different times and climes. But this is a clearly difficult task to accomplish. The number of participants in a financial system is massive and scattered but interlinked. To put these parties into a coordinated pattern within a fragmented setting based on territories, regulators, institutions, products and indeed other participants requires skillful efforts to accomplish.

4. Conclusion and Future Research Directions

In the foregoing discussions, we have identified and analysed the instruments that CBs normally utilize in discharging their statutory functions of regulating supply of money to an economy from conventional/interest based economy perspectives More so, the underlying perspectives for the alternative Interest free/Islamic approaches have been presented.

Within the context of a dual monetary regime as adopted in some countries including Indonesia, the paper suggests the adoption of the alternative Islamic based monetary policy tools as a standalone policy where feasible, or the adoption of a dual integrated system that accommodates the 2 perspectives. This is so as central banks have an obligation to accept public opinion while conceiving and implementing monetary policies. This is predicated on the clear imperative for reconsideration of existing practices as dictated by failures seen in conventional monetary policy.

The paper suggest that future research efforts be geared towards obtaining data to enable empirical analysis on post adoption of the alternative IMP across OIC member countries.

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