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## THE DRIVEN ELEMENTS OF THE MONETARY POLICY IN THE CONTEXT OF ISLAMIC ECONOMICS

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### ABSTRACT

This paper claims that to propose an alternative way through the establishment of monetary policy. The definition of rationale human behavior in conventional system and the definition of rational human behavior in Islamic economic system are different in many ways so that the driver dynamics of the conventional economic system and Islamic economic system are differentiating. The demand of money which is the crucial point for conducting monetary policy in two systems is driven with different necessities. Due to stability of demand of money and robust financial system in the context of Islamic banking system, monetary policy can be more effective through providing price stability. Monetary policy in the context of Islamic finance do not commit just price stability but also commit more equate socio-economic justice and equitable distribution of income and wealth and optimum rate of growth.

**Keywords:** Islamic, monetary policy, money, demand.

**JEL Codes:** E41

### 1. INTRODUCTION

Generally, central banks have aimed price stability during the last few decades although they have other key aims which are growth, financial stability, unemployment and may be others. Low and steady inflation has privileges among the other aims. On the other hand central banks cannot be effective directly on the controlling inflation. In conventional system generally central banks are using three or in some cases more indirect instruments in order to effect and control price stability. These indirect instruments are interest rate, money growth and exchange rate as an intermediate target. As an indirect instrument interest rates, have uncertain effects on economy. Due to the uncertain effect of interest rates central banks have to conduct according to incomplete information (Hoggart, 1996, 5). In recent years, central banks have welcomed zero even negative interest rates in order to stimulate the economy. Even some find it successful the vast majority find lowering interest rate and monetary easing in order to stimulate the economy ineffective. "When the short-term policy rate is at or near zero, the conventional means of effecting monetary ease (lowering the target for the policy rate) is no longer feasible" (Bernanke and Reinhart, 2004, 85). We can infer that interest rates as an intermediate target to guide monetary policy decision is not perfect and unalterable policy tool for monetary policy. Monetary policy often is detected as interest rate managing phenomena. It is not meant that interest rate have no important role in the monetary policy but the biased view that the monetary policy without the interest rate cannot even be passed through the mind is not true (Ariff, 1978, 287). Thanks to fails of conventional system with crisis and other problems people started to questioning interest based monetary policy and financial environment more. It is obvious that global economy has not recovered fully after the 2008 crises. Due to continuing devastating effect of crisis people are investigating alternative financial system. Islamic finance and practices can be the alternative way through the development of stable financial environment and more robust macroeconomic environment (İncekara& Tatoğlu& Ustaoglu, 2014: 75). The Islamic banking system may find out more stable and robust because of the absence of interest rates. Interest rates fluctuations induce financial environment unstable.

The absence of interest rate which is the main characteristics of Islamic banks removes the fluctuations of interest rate. Financial system becomes more stable with the abolition of interest rate in the economy that is because of the change in money demand and may be other reasons (Ergeç& Arslan, 2011: 4). The money demand stability is crucial point for the

effectiveness of monetary policy. As a basic definition monetary policy is highly likely that the balancing money demand and supply in the economy. It can be inferred that monetary authority have to take into consideration money demand regardless the targets and tools.

## 2. LITERATURE REVIEW

There are a quite small number of studies about the stability of money demand in the context of Islamic economy although the rapid growth of Islamic finance the last few decades. Particularly there are almost 3 or more empirical studies about money demand. It is because of the lack of long-term data and the superiority of conventional banking in the country where Islamic banking exists. Darrat (1988) investigated the superiority of profit- loss sharing interest-free banking system compared with the conventional system in Tunisia. Darrat (2000) make an empirical analysis on money demand stability in short-run in Iran. This time Darrat (2002) examine the money demand stability for both Islamic banking in Pakistan and Iran. After the money demand tests Darrat (2003), examine monetary aggregates as a policy invariant for conducting monetary policy. (Yousefi& Abizadeh &McCormick, 1997) studied stability of income velocity of money and superiority of Islamic system comparing with the usefulness of monetary aggregates.

### 2.1 The Human Rationality Behind the Islamic Economy

Islamic economic system takes its own values as a base for finance and other practices. The consumption and investment behavior of homoislamicus is different compared with homoeconomicus. So that the huge differences in the definition of the human rationality, Islamic economists offer to use Islamic rationality concept. In the Islamic rational human concept, human does not try to maximize his profit and just think his interest. Human have to take an account society's interests. As a one of the difference point between homoeconomicus and homoislamicus, in the light of Islamic rational human view consumption has to be need-based. In addition, in many cases the decision making process for homoislamicus and homoeconomicus. According to Islamic rational human decision making process, human has to think his life after the death as much as his life. The way of this decision making process is tended to human think society's interest as much as himself (Hassan, 2013, 129). The rational human homoeconomicus is far away from Islamic thoughts in a way that keeping his interest a head and making everything for his profit maximization (Tabakoğlu, 2013, 84). Also, Islamic rules put obligations to think social welfare in many ways. Zakah the one of the most popular issue almost known everyone about thinking in need people pushes people social welfare on the other hand levy of zakah provides money demand stability because of minimization of holding of idle cash. Due to zakah, people tend to make productive investment against to erosion in their savings. Therefore, the need based consumption and productive investment money demand tend to be more stable compared with conventional system (Chapra, 1996, 16).

## 3. MONEY DEMAND IN THE CONTEXT OF ISLAMIC ECONOMY

According to Keynesian approach about money demand people tend to hold money for three purposes: transaction, precautionary situations and speculation. Money is demanded for transaction as a medium of exchange in order purchase and sale goods and services by governments, households and firms. All actors of the economy hold some cash money for precautionary situation in order to be prepared for unforeseen needs. Money is needed for speculation to catch the chance to get more money. The liquidity preference implies that income level effects for three purpose of money demand, transaction, precautionary situations and speculation. The liquidity preference for speculation purpose is affected by interest rates. In the Islamic view about money demand, money is demanded for transaction and precautionary purposes since the abolition of interest there is no way for speculation purposed money demand. Therefore the money demand become in this way:

$Md = kY + L(r)$  (Keynesian approach)

$Md = kY$  (Money demand in Islamic approach)

The equation in this way looks like classical and Cambridge approach's theories. Indeed, according to Islamic approach, there is a room for speculation purposed money demand but it is not the function of the interest rate. There could be place for speculation purposed money for financial assets complaint Islamic rules. Chapra (1996) argued that this purposed money demand is counted in transaction purposed money demand. The money demand in Islamic system becomes more stable with the absence of speculative purposed function of interest rate. It has to be made clear that speculation purposed money demand for equity based profit and loss sharing assets not like interest bearded assets. The profit sharing ratio is not like interest rate in comparing interest rate is extremely volatile and changing approximately every day. According to Chapra (1983) money demand is not just a function of income but also function of income distribution. When the income distribution becomes more equate, money demand increases. Islamic monetary policy is also responsible from equitable income distribution. As a monetary policy whole with its all objectives, monetary authority has to take account the increase in money demand due to more equate income distribution.

Money demand in Islamic economy can be also interpreted in the consideration of Friedman modern quantity theory. According to Friedman money demand equation looks like (Awad & Soliman, 2016: 72):

$$M_d/P = f(Y_p, R_b - R_m, R_e - R_m, \pi^e - R_m)$$

Friedman argued that real money demand is the function of permanent income, and relatively opportunity costs of holding money instead of holding bond, equity and goods. Friedman proved that demand for money is insensitive to the interest rates. Therefore, real money demand is the strongly affected the change in permanent income.

In the consideration of Friedman modern quantity theory (Awad & Soliman, 2016: 72) came up with the equation:

$$M_d/P = f(\gamma, P_c, P_c^e, RP_s, RP_e)$$

Obvious that the left side the equation is real money demand, and the right side the equation is relatively: real income, price of money, expected price of money, relative price of sukuk and relative price of equity.

(Awad & Soliman, 2016, 72) claim that the purchasing power of a monetary unit spent on goods and services  $P_c$  and real money demand have an inverse relation. When the  $P_c$  increase, real money demand decreases because of the holding money cost becomes higher. The expected purchasing power of money  $P_c^e$  and real money demand act in the same way. When the expected price of money  $P_c^e$  increases, the real money demand increases also due to future deflation expectation. Relative price of money spent on sukuk  $RP_s$  has an inverse relation with the real money demand but has a positive relation with expected return on sukuk. When the expected return on sukuk increases, relative price of sukuk increases however the real money demand decreases. Therefore the relation between real money demand and expected return on sukuk is negative.

#### 4. THE EMPIRICAL STUDIES ON THE STABILITY OF MONEY DEMAND IN THE CONTEXT OF ISLAMIC ECONOMY

Darrat as an economist quite great contribution to the empirical analyses about monetary stability in Islamic economy field examine the money demand in Pakistan, Iran and Tunisia where the economy policies were adopted according to Islamic rules. In Tunisia, after the moving to the profit and loss sharing interest-free banking system macroeconomic performance and policy making process become better (Kia ve Darrat, 2003: 1). After the finding out the money demand stable in the short run, Darrat examine the long run money demand stability in Iran due to Iran is the one country has an long-run data unique Islamic banking system. The results of the long-run money demand stability in conformity with short run money demand. As the testing money demand for two monetary aggregates: M1 and profit sharing deposits. After these stability tests (Kia ve Darrat, 2003), examine the money demand equation as a policy invariant. According to econometric analyses of (Kia ve Darrat, 2003) monetary aggregates namely M1 and profit sharing deposits can be used as a policy invariant for monetary policy.

$$\ln M_t = \beta_0 + \beta_1 + \ln Y_t + \beta_2 \ln R_t + \mu_t$$

Darrat examine the stability of money demand based on the above logarithmic demand function. (Yousefi & Abizadeh & McCormick, 1997, 869) test the income velocity of money and relative effectiveness of monetary aggregates as a policy invariant compared with in the period pre-Islamic banking and post-Islamic banking. According to tests, the income velocity of money lower after the abolition of interest rate in economy in Iran compared with the previous time of abolition of interest rates.  $M.V = P.Y$  the Fisher equation. If the velocity of money is stable or predictable, the monetary policy effectiveness increases. The increase in money supply leads output increases vice-versa. (Yousefi & Abizadeh & McCormick, 1997) claim that if the monetary base can be controlled almost completely by the monetary authority, effectiveness of monetary aggregates as a policy invariant compared with in the period pre-Islamic banking and post-Islamic banking is higher.

#### 5. CONCLUSION

People are questioning more about the economic politics a few decades because of the increased income inequalities, crises, unemployment and so on. Particularly after 2008 crisis, people focus more about the Islamic finance that is because of the commitment of Islamic finance more stable and robust financial environment. As an economic policy monetary policy has been living its golden decades last a few decades. Monetary policy in the context of Islamic finance could be the way for more robust economy and social welfare. Although the limited progress in the monetary policy area, there are useful studies and empirical analyses. Firstly the economic environments in the absence of interest rates do not become such a chaotic situation. It is just a biased view. The interest rate is a phenomena found out by human. Oppositely, according to empirical analyses the absence of interest rates makes economic environment more silent, predictable and stable. What kind of the theory is based on about conducting monetary policy money demand aggregates vital for the effectiveness of policy.

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