

ISLAMIC FINANCIAL SYSTEM: A SYSTEM TO DEFEAT INFLATION

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Abstract

Purpose: The aim of this paper is to highlights the potential of Islamic Financial System to give inflation free economy.

Design/ Approach/Methodology: The paper contended that Islamic Financial System has ability for socio economic development of financial stake holders and to put inflation at zero level.

Findings: Islamic Financial System offers various ethical monetary and fiscal instruments that can be advances and adapted for the financing. Islamic doctrine focuses on the wealth distribution (Zukah etc), which increases aggregate demand. It also encourage for participation in business activities through saving and investment. In short, IFS money creation is backed by increase in production that leads to no inflation in society.

Research Limitation / Implication: The paper is only conceptual and does not aim to empirically examine the issues or theories. However the paper will be useful to develop hypotheses for future research.

Practical Implication: Islamic Financial System will be of the interest of economist/researchers/financial institutions. The paper will also highlight the concepts of Islamic Financial System to practitioner to understand the fiscal and monetary tool of Islamic Financial System.

Originality / Value: Islamic Financial System is based on moral and ethical attributes device by the Quran and Sunnah. Fiscal & Monetary Tool of Islamic Financial System requires taqwa and honesty to implement for well being of humanity to establish an inflation free economy.

Key Words: Islam, Finance, Fiscal policy, Monetary Policy, Zukah,

Paper Type: Conceptual

1. INTRODUCTION

Inflation is one of the scourges of mankind as inflationary period increases unemployment, reduces return on investment and purchase power (Sprinkel, 1971), increases hoarding habit, slow down the business activity (Polleit, 2008) and increases social unrest (Zoellick, 2011). The decreasing purchasing power of money has been one of the most striking issues not only for the economists but also for the savers, lenders and consumers. As inflation poses a serious challenges to society, therefore policy maker try to curtail inflation as low as possible. Since the Second World Ware – II, economist fail to counter the inflation. This inflationary trend has convinced some economist for its existence along with economic development. Today most economists favor the low or steady inflation Rogger (2007). But researchers are striving to have a system which put inflation at zero level. Revival of Islamic Financial System (IFS) creates a hope for them. IFS not only grow in Islamic countries but also in developed countries e.g. America, United Kingdom. The resistance to current crisis and consistence growth of IFS during rescission has led to conclude that IFS could be a viable solution to the current financial ills.

This paper aims to assess the potential of IFS to control inflation. The paper argues that IFS has an important role for socio-economic development for investor, lender and consumers. Furthermore, IFS has moral and ethical attributes that can effectively motivate the stake holders. The first part of this paper introduces the causes of inflation. The paper then discusses the potentials of various Islamic financing concepts that can be advanced and adapted to inflation free economy.

Conventional System and Inflation

A well settled perception about inflation is “an upward trend in prices” but there is no settlement about factor behind it. Adequate literature is available which explain the inflation as a result of “money supply” result of “Paper Money”, an outcome of “demand pull” result of “government expenditure” and the result of “cost push” due to “production factor”.

Monetarist School of thought considered money supply behind the inflation. When there is increase in money supply then people have more money to spend. As supply of goods is constant therefore prices go up (Kemmerer, 1918; Grauwe and Polan, 2005). In monetary phenomena, interest rate is an effective tool to regulate money supply. Tight Monetary Policy, which did not cause disinflation in developing country as (Sheikh, 2011) argued that interest rate created market imperfection. This imperfection disturbs the supply and demand which leads to slump in economy.

To increase aggregate demand, monetary easing policy adopted which increases the consumption at individual level as well as government level. High government expenditure creates budgetary gap. In conventional economic system, deficit increases pressure on credit market and interest rate move up. Hence inflation increases (Kia, 2008).

Increase in interest rate increases the cost of capital which in turn pushes up the cost of production. Due to high production cost, import increases and export decreases. This leads to built in inflation, which reflects price/wage spiral, adaptive expectation. Oil prices also one of major factors in high inflation (Boschen and Weise, 2003)

Some other factors which trigger the inflation in conventional economic system described by a well known Islamic scholar Mufti Muhammad Taqi Usmani, in his book “An Introduction to Islamic Finance”, declared the conventional system does not base on market forces as claims. He argued that un-natured practices (e.g. gambling, speculative transaction, future contracts) tend to concentrate the wealth in few hands. The uncontrolled desire for profit also promotes monopolistic business instead of market base. As there is no role of religion in business and individual life therefore conventional financial system does not have ability to tackle these issues and aforementioned practices treated as strategy to earn and spend money. This mal function in business cycle leads to uncontrollable inflation in economy.

Ethical Solution in Islamic Financial System

Concept of wealth is quite different from conventional financial system. Islam declared wealth is a blessing of Allah and a tool to examine and punishment as well (See Khan, 2011). Therefore, one has to earn and utilize wealth in a way as described by Allah and His last Prophet Hazrat Muhammad (SAW) (for detail see Economic System of Islam: Dr Tahir ul Qadri). Islamic financial system does not for individual only but it covers all three aspects of economy e.g. private, public and government sector.

The IFS denied the interest rate. Quran and Hadith clearly states punishment for earning through interest. (For detail see Dr Tahir ul Qadri). The interest free economy reduces the cost of production. This increases the business activity base and people contribute in economy on profit

and loss sharing (Kia, 2008). There is no inflationary pressure in Japan, America despite low interest rate (Dr Ansari, 2010). Further to this Islam does not allow earning by hook & crook but create enthusiastic to earn by hardship / business and fair mean. Capital circulation in business activity reduces inflation (Khan, 2011).

Future contracts and speculative transaction are also not allowed in IFS. Such type of action creates hoarding habits and greediness which in turn increases uncertainty that leads to inflation. Islam strictly forbids such type of activities.

“And eat not up your property among yourselves in vanity”

The *Holy Qur-an*, Chapter 2, Verse 188

Monetary and Fiscal operation discussed by (Kahf, nd; Sheikh, 2008) that there is no indirect tax in IFS. Further more Islam has device the tax system to gain optimum level of investment and discourages the hoarding of cash and capital (See Jalili, 2006). Increase in investment creates more employment opportunities and enhance per capita income (Sheikh, 2008). Laliwala (1982) described that demand of goods drives the price of goods. He added demands of goods based on money which people have. People may earn money through participation directly or indirectly in business cycle. Therefore, in IFS money creation is backed by increase in production that leads to no inflation. Other way to control inflation in IFS is to impose indirect tax e.g. sale tax as proposed by Kia (2008). This suggestion deviate the IFS doctrine the welfare of poor. Kia (2008) also admits that such tax has not trace back in Islamic history. (Jalili, 2006) discussed the tax system of IFS and declared that no indirect tax imposed in early period of Islam. However he proposed new direct tax areas to increase government revenue. (Kahf, nd) indentify four sources of public fund i.e. allocation of resources by virtue of system itself, investment, Jizya and private sector. Effective use of said tools the budgetary gap may reduce to nil or surplus. Zaim (nd) noted that fiscal policy of IFS mainly base on Zukah and argued that it plays a prominent role in income distribution in society. Zero fiscal deficit, efficient equally income distribution, low tax leads to low inflation in IFS.

Conclusion

This paper aims to sort out the inflation factor in the conventional financial system. In fact, in the absences of religion role in business and personal life causes number of un-ethical transactions. Further to this unbridle desire for profit creates the anti market forces. This phenomena lead to inflation in society.

Islamic doctrine focuses on the wealth distribution which increases aggregate demand. It also encourage for participation in business activities through saving and investment. In short, IFS money creation is backed by increase in production that leads to no inflation in society. Such system can establish only and only if there is taqwa and honesty.

Implementing the true teaching of Islam there should be smooth flow for factor of production. There is no disturbance in demand and supply, unless any disaster took place. It may prevail for short period if only if every one has true spirit according to Quran and Sunnah

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