

# A Study Literature of Interest Rates and Islamic Monetary Policy

Chajar Matari Fath Mala

Department of Management & Jaya Launch Pad, Universitas Pembangunan Jaya, Banten, Indonesia

## Article Info

### Article history:

Received Oct, 2023

Revised Dec, 2023

Accepted Dec, 2023

### Keywords:

Financial Crisis

Interest Rates

Islamic Finance

Islamic Monetary Policy

## ABSTRACT

This paper provides a comprehensive analysis of the existing literature about contemporary Islamic monetary policy and its implementation through interest rates in the context of monetary policy. Upon conducting a comprehensive examination of the pertinent literature, it becomes evident that numerous conventional monetary policy instruments can be suitably modified and employed within the framework of Islamic monetary policy. Using interest rates as a monetary policy tool has been observed to directly impact injustice, including social unfairness, widespread corruption, and manipulation by global financial institutions that governments and authorities support. The current global financial crisis exemplified this. This study aims to analyze the several alternatives to interest rates utilized in Islamic monetary policy tools while also conducting a literature analysis on Islamic monetary policy.

*This is an open access article under the [CC BY-SA](#) license.*



## Corresponding Author:

Name: Chajar Matari Fath Mala

Institution: Department of Management & Jaya Launch Pad, Universitas Pembangunan Jaya, Banten, Indonesia

Email: [chajar.matari@upj.ac.id](mailto:chajar.matari@upj.ac.id)

## 1. INTRODUCTION

The current interest rate system exhibits inadequate reactivity to periods of economic expansion. Elevated interest rates adversely affect various economic indicators, including inflation, employment levels, income levels, currency valuation, and the capacity to attract fresh investment capital. The global financial crisis in recent years had far-reaching consequences on the international financial markets. The collapse of the subprime mortgage market in the United States primarily triggered this crisis. The collapse resulted from a confluence of factors, including a shock to the reserve system, a surge in low-quality financing facilitated by low interest rates, and excessive speculation that proved detrimental. The

efficacy of the interest rate mechanism in preventing a global financial crisis has been observed to be inadequate in previous instances.

Interest rates are a commonly employed monetary policy tool utilized by central banks on a global scale. Within the framework of the Islamic financial system, the prohibition of interest rates (Riba) renders traditional monetary policy ineffective in achieving objectives such as maintaining a robust currency, fostering long-term economic growth, improving living standards, promoting savings, ensuring price stability, and reducing unemployment. In contrast, the Islamic financial system necessitates an alternative approach, methodology, or instrument to govern the

supply and demand of money within the economy.

Monetary policy is considered expansionary when the money supply is increased more than usual. In comparison, monetary policy is said to be contractionary when the money supply is increased at a slower rate or even decreased. Reducing interest rates is one tactic expansionists use to fight unemployment, believing that a more favorable lending environment will encourage business expansion. Reduce inflation with a contractionary strategy to protect against asset price declines and distortions. The interest rate is the price at which money is borrowed, and the money supply is the total amount of money available in an economy. To affect outcomes like economic development, inflation, currency exchange rates, and joblessness reduction, monetary policy employs a wide range of instruments.

Except for usury, the goals of the central bank and Islamic monetary policy are the same as those of the conventional system. The objective is to maximize the well-being of all people and maintain monetary and economic stability by, among other things, fostering long-term increases in income and wealth for all and reducing volatility in the value of both domestic and foreign currencies. Nonetheless, Islamic and conventional monetary authorities place varying weight on these factors. Neither system can withstand the social and economic devastation caused by severe and persistent inflation, recession, and unemployment.

Islamic monetary policy and the alternatives to interest rates permitted by Islamic law are therefore essential to comprehend in light of the foregoing. The research was conducted to learn more about Islamic monetary policy and the alternatives to interest rates that could be used to implement it. A new approach to setting reference interest rates is proposed in this article, one that is more in line with reality and more properly reflects genuine economic growth, as indicated by high employment levels, low or stable inflation, ample

opportunities for investment and savings, and a rededication to the real sector.

## 2. METHOD

This research makes use of a literature review approach. Definitions, further exploration of theories and concepts, and identification of contextual variables were all goals of the literature review conducted for this investigation. The literature reviews were culled from archived academic journals. This literature review employed a systematic review approach, which is the process of systematically locating, evaluating, and interpreting research to provide answers to research questions [1].

## 3. ISLAMIC MONETARY SYSTEM AND INTEREST RATES

Islamic economics, grounded in the Al-Qur'an and the Hadith of the Prophet, asserts unequivocally that Islam does not accept interest rates. Thus, they are not a suitable mechanism for efficiently and equitably regulating the demand for money. As a result, the Islamic economic system employs a multi-pronged approach to controlling currency scarcity. The importance of the financial system for socially sanctioned filtering mechanisms, a motivational solid system to encourage individuals to give their best for their interests and the benefit of society, a complete economic restructuring to realize maqasid despite limited resources, and a constructive, goal-oriented role for government [2].

By estimating the money market by realizing the desired socio-economic goal of price stability, policymakers can establish a target range for expanding the money supply to help meet this demand effectively and adequately, thereby achieving monetary equilibrium. Countries that make public monetary targets experience lower inflation rates, even when they are in greater detail [2]. However, it is not good to be too mechanical about sticking to your money growth goals. This occurs because monetary targeting assumes that the rate of money

income can be predicted reasonably well over the relevant period. This assumption may be more accurate in an Islamic economy but is still susceptible to the effects of domestic and external economic shocks. That is why evaluating progress every three months and adjusting the targets accordingly are still countries with Islamic banking have dual banking systems that are still developing. Standard monetary policy instruments and provisions tend to coexist and even influence the development of Islamic banks. As Islamic finance grows, innovations within the sector could eventually dominate the traditional financial system and market conditions due to competitive pressures. Exogenous shocks, macroeconomic management, and systemic liquidity conditions affect how monetary policy is implemented and transmitted in the Islamic banking system, so Islamic banks cannot be considered in a vacuum [3].

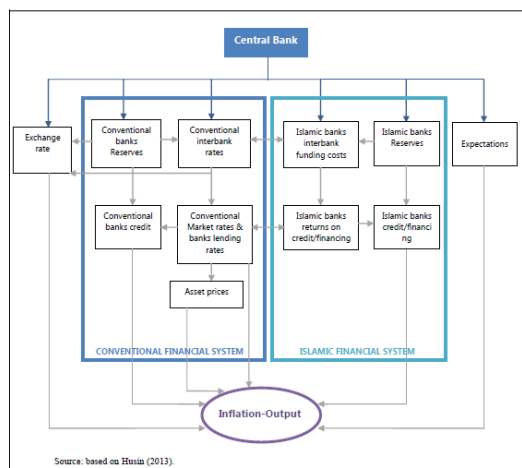


Figure 1. Conventional and Islamic Financial Systems

Source: Husin, M. (2013)

The goals of monetary policy at Islamic banks need to be modified as the Islamic financial system matures and interacts with the conventional financial system. Islamic money markets, money, Sukuk, and effective sterilization policies and liquidity management frameworks require particular focus in the early stages of development. Suppose there is to be arbitrage between the conventional and Islamic financial system segments. In that case, a balanced monetary policy is required as the two segments of the

financial system become more balanced. However, not all Islamic finance standard setters will likely approve of the monetary transmission resulting from arbitrage between conventional and Islamic banks. An integrated monetary policy stance, combining conventional and Islamic monetary policy instruments, will be necessary to meet the challenges of the future, making it imperative to study how and when this might be accomplished [4].

Conventional instruments can be adapted for use in Islamic monetary policy. Given that interest rates—a key instrument of conventional monetary policy regulation—are forbidden in the Islamic economic system, viable substitutes are urgently required. Unfortunately, Islamic banks and financial institutions use the London Interbank Offered Rate (LIBOR) as a benchmark, which has led to questions and debate about Islamic finance's special status. This expanding body of theoretical knowledge and practical experience has been tackled, as evidenced by the existing literature. However, research on alternative benchmarks for Islamic economic systems is scant, and there is little empirical work. Money market instruments and the financial and capital markets can both utilize the GDP growth rate as a reference point and as a benchmark since it shows the potential for balanced economic expansion. Comparing national income, savings, inflation, exchange rates, and investment with money market interest rates, which ignore the real sector, yields interesting results [5].

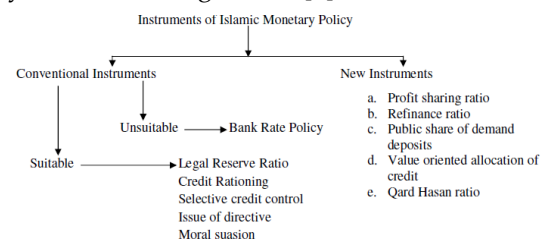


Figure 2. Islamic Monetary Policy Instruments

### Indonesian Islamic Monetary Operations

To help achieve the ultimate goals of Bank Indonesia's economic policy, Islamic monetary operations are conducted by Law No.10/36/PBI/2008. In the meantime,

operational goals may include sufficient Islamic banking liquidity or other factors set by Bank Indonesia.

Adequate liquidity can be represented either by the total amount of target base money or by its components, including public currency and Bank Indonesia's current account balance in rupiah. By affecting the liquidity of Islamic banks, monetary policy objectives can be met through either a slowing or speeding up of the economy. Monetary expansion refers to an increase in Bank liquidity through Islamic monetary operations, while economic contraction refers to a decrease in Bank liquidity. Islamic Open Market Operations and Islamic Standing Facilities are the two main mechanisms by which Islamic-compliant monetary operations are carried out.

Islamic Open Market Operations involve issuing SBIS, purchasing and selling rupiah-denominated securities that adhere to Islamic principles (such as SBIS, SBSN, and other high-quality and easily liquidatable securities), and absorbing funds without issuing securities. According to Bank Indonesia's regulations about rating agencies and ratings, "other securities of high quality and easy to disburse" refers to rupiah-denominated securities issued by various legal entities that have received a high rating from a rating agency. Approved by the Bank of Indonesia and instantly convertible to hard currency.

Meanwhile, deposit and financing services are part of Islamic Standing Facilities. The Bank Indonesia Islamic Savings Facility is one example of a savings option (FASBIS). The maximum term of a FASBIS wadi'ah (deposit) contract is 14 (fourteen) calendar days from transaction completion to maturity. The next working day after a weekend or holiday shall be used to determine the deadline date for a FASBIS transaction. In exchange for FASBIS managing Bank Indonesia money, the bank may receive compensation.

Meanwhile, rupiah-denominated security report information is one form of the financing facilities provided. The term "repo

securities" refers to a conditional sale transaction in which a bank sells securities to Bank Indonesia and must repurchase those securities later and for a predetermined price and period (collateralized borrowing).

#### 4. STUDY LITERATURE AND DISCUSSION

Since interest rates are forbidden in the Islamic economic system, they must find another way to implement monetary policy. This study finds that a GDP growth rate instrument, rather than the real interest rate, can price products in Islamic commercial banking and open the door to investment opportunities in the Islamic money and capital markets. Domestic and international debt can be compared to growth in GDP as a benchmark. The Central Bank will still have a reserve requirement relative to money creation and credit expansion, even in an interest-free economy [5]. Developing a secondary market and providing a crucial tool for Open Market Operation resulted from introducing GDP-linked instruments. The central bank can regulate the movement of funds in the banking sector by measures such as the Refinance ratio, the Qard-e-Hassan ratio, the issuance of directives, and moral suasion. Because it reflects the potential for balanced economic growth related to national income, savings, inflation, exchange rates, and investment, the GDP growth rate can serve as a benchmark for money market instruments and a reference for financial markets and capital markets. Actual interest rates are determined in the money market and do not take into account the real sector.

The interest rate system contributes to rising inflation, a hallmark of a faltering economy [6]. As is commonly known, inflation arises when the growth of the money supply outpaces actual output growth. People can buy and sell more of what they produce when the money supply grows. When the money supply grows, prices of goods and services rise unless the real economy grows at the same rate. The current price increase is not due to a decrease in supply but to increased demand for the product due to the current

economic boom. In other words, there is a hidden meaning in the current definition of inflation. This study uses a meta-analysis approach to review and synthesize relevant literature to provide qualitative and empirical evidence that interest rates are bad for the economy. Whoever controls the money supply also has no say over the inflation rate. The current interest rate-based economic system will inevitably bring about the ruination of the economy. In a nutshell, this study argues that the system as a whole is to blame for all previous and future economic crises (to serve capitalist interests).

Several factors can reduce the interest rate channel's efficacy [4]. For instance, the central bank cannot use its policy rate to influence the short-term interbank benchmark interest rate if there is no functioning interbank market. As a result, the interest rate transmission channel and the signal effect of policy rate changes were weakened. Bank loan interest rates typically refer to the yield curve or money market rates, so their absence weakens the interest rate path. The short-term interest rate shifts to the policy rate. The existence of a short-term interest rate structure—that is, expectations that operate on a short-term, long-term network in opposition to short-term interest rates—is crucial to the efficient transmission of monetary policy.

Modern monetary theory makes interest rate adjustments to balance supply and demand less critical [7]. Interest rate hikes on the money market and in credit can still be a reaction to the central bank's expansion of monetary instruments, with the latter having the potential to reduce economic liquidity and the latter to suppress inflation as a result. A drop in money market interest rates, especially credit interest rates, followed the uncertain drop in rates on monetary instruments. As the financial system becomes more interconnected, those with access to capital have more domestic and international investment opportunities. When interest rates drop, investors have other income-generating options, such as buying stocks or bonds in the domestic or international markets.

There may be obstacles to enforcing policy interest rates due to Islamic principles [8]. Qards, on the other hand, are used in obligatory reserve systems and must be treated separately from other reserves by the central bank. It is crucial in the context of *ijarah sukuk* to think about the steps that must be taken to guarantee adherence to Islamic principles. In addition, government investment certificates can function as a means of enforcing an interest-free monetary policy. *Mudaraba*-based real-world interbank investments are also feasible. It is possible to accept *wadiah* without the customary presentation of gifts. However, *tawarruq* and central bank notes are perceived as less desirable due to their divergence from Islamic standards. Therefore, the study suggests the creation of a *Tawarruq* platform based in Turkey as a viable alternative to the existing London model for various organizations. By incorporating the principles of Islamic, these findings offer valuable insights for formulating monetary policy instruments using the legal and ethical framework of Islamic in Indonesia.

Bank Indonesia plays a crucial role in implementing monetary policies [9]. A crucial aspect of these programs entails establishing the benchmark interest rate, the BI rate. The Bank Indonesia (BI) rate can be adjusted upwards to effectively control inflation by moderating the growth rate of the money supply, or it can be lowered to boost economic growth. Moreover, Bank Indonesia is responsible for effectively managing the payment system and regulating banks in Indonesia, hence enhancing economic stability. The bank is involved in many activities, including open market operations and interventions in foreign exchange markets, to maintain the stability of the Rupiah's exchange rate. Bank Indonesia has implemented mandatory reserve rules for banks to regulate the money supply. Furthermore, the institution does comprehensive analysis and research to detect elements that may impose inflationary pressure and formulate suitable monetary policies. Bank Indonesia plays a crucial role in maintaining economic stability and managing

inflation in Indonesia through a range of policies.

The study presents a comprehensive analysis of research studies examining various viewpoints regarding the significance of interest rates in monetary policy and their broader implications, specifically in Islamic economics. Each of the studies above provides distinct perspectives on the subject topic. When taken as a whole, they give a complete picture of the challenges, choices, and outcomes related to interest rates in the monetary policy, regulatory, and analytical tools at their disposal.

These works, taken as a whole, shed light on the many facets of the question of interest rates in monetary policy. From Islamic ethics to the economy's welfare, conventional wisdom is questioned, and new avenues of thought are investigated. Given the dynamic nature of the international financial system, these results emphasize the importance of continuing research and innovation in monetary policy. They stress the need to consider cultural, ethical, and economic differences while crafting sound monetary policy. Researchers and politicians must keep an open mind to new ideas and methods that may help the world's economy function more efficiently and morally.

## 5. CONCLUSION

The literature on monetary policy and the role of interest rates within that policy have been analyzed, along with their legitimacy from an Islamic perspective. Most of the world's most influential Islamic banking markets adhere to a fixed exchange rate system. The implications for monetary policy are substantial. Control over systemic liquidity is a crucial determinant of monetary policy efficacy and exchange rate sustainability in these countries, where the exchange rate is at the center of liquidity management.





However, Islamic banks in many of these nations typically have a cash surplus. Better management of excess liquidity is crucial for effective transmission of monetary policy through Islamic banking system. The conventional Islamic system segment can communicate with Islamic if the interest rate channel is efficient. Several variables, such as consumer and Islamic bank behavior in response to interest rate changes and the maturity of Islamic money markets, determine whether or not such transmission is acceptable to all scholars. If the Islamic financial sector lags behind the conventional financial sector, a dual approach to monetary policy may be considered in a dual financial system. The role of interest rates as a monetary policy instrument and their legitimacy in Islamic thought have been explored in this research. The majority of countries with a fixed exchange rate regime are those that rely heavily on Islamic banking. This has significant ramifications for monetary policymaking. Liquidity management in these countries revolves primarily around the exchange rate, making systemic liquidity control a critical factor in the success of monetary policy and the long-term stability of the exchange rate. Many of these nations, however, typically have surplus liquidity in Islamic banks. Excess liquidity must be managed for the Islamic banking system to transmit monetary policy effectively.

With an efficient interest rate channel, monetary data can flow from the Western segment of the Islamic system to the Islamic segment. Whether or not scholars approve of this form of transmission is contingent on several variables, including the degree to which consumers and Islamic banks react to interest rate changes and the maturity of Islamic money markets. If the Islamic portion of the financial sector is not growing at the same rate as the conventional portion, a dual approach to monetary policy may be considered within a dual financial system.

## REFERENCES

- [1] M. Petticrew and H. Roberts, "Systematic Reviews in the Social Sciences: A Practical Guide," *Syst. Rev. Soc. Sci. A Pract. Guid.*, pp. 1–336, Jan. 2008, doi: 10.1002/9780470754887.
- [2] U. M. Chapra, *Islam and the Economic Challenge*, vol. 9, no. 4. 1992. doi: 10.35632/ajis.v9i4.2540.
- [3] M. Husin, "Efficiency of Monetary Policy Transmission Mechanism via Profit Rate Channel for Islamic Banks in Malaysia," 2013.
- [4] M. E. H. Khatat, "Monetary Policy in the Presence of Islamic Banking," *IMF Work. Pap.*, vol. 16, no. 72, p. 1, 2016, doi: 10.5089/9781475523942.001.
- [5] M. A. Uddin and A. Halim, "Islamic Monetary Policy: Is there an Alternative of Interest Rate?," *Munich Pers. RePEc Arch.*, no. 67697, pp. 1–26, 2015, [Online]. Available: <https://mpira.ub.uni-muenchen.de/67697/>
- [6] D. Putriani and Prastowo, "A Critical Review on Interest Rate as A Tool of Monetary Policy," *Tazkia Islam. Financ. Bus. Rev.*, vol. 9, no. 2, pp. 150–165, 2014, [Online]. Available: <http://www.tifbr-tazkia.org/index.php/TIFBR/article/view/93>
- [7] I. Wisandani, S. Iswati, and R. Ismal, "The Monetary Policy in Indonesia: in the Perspective of Islamic Economics," *Int. J. Nusant. Islam*, vol. 5, no. 1, pp. 59–74, 2017, doi: 10.15575/ijni.v5i1.1443.
- [8] Z. H. Orhan, S. Zaheer, and F. Kazancı, "Evaluating the current interest-free monetary policy tools and suggesting a new one: case of Turkey via examples of Malaysia, Pakistan, and Bahrain," *Qual. Res. Financ. Mark.*, vol. ahead-of-print, no. ahead-of-print, 2023, doi: 10.1108/QRFM-11-2021-0195/FULL/XML.
- [9] A. L. . Nugraha, Y. Janwari, M. A. . Athoillah, and S. Mulyawan, "Inflation And Monetary Policy: Bank Indonesia's Role in Suppressing ...," *Islam. Econ. Bus. Rev.*, vol. 2, no. 1, pp. 96–111, 2023.

## BIOGRAPHIES OF AUTHORS

	<p><b>Chajar Matari Fath Mala</b>    was born in Cilacap on October 9, 1993, is an academic and educator. A Bachelor of Economics was the degree she endeavored to earn from Universitas Jenderal Soedirman. She continued her pursuit of excellence by graduating from Universitas Indonesia with a Master of Management. He pursued further academic qualifications by earning a doctorate in Sharia Banking from UIN Syarif Hidayatullah Jakarta. She began teaching at Universitas Esa Unggul's Faculty of Economics and Business in 2016. As she gained expertise in financial matters, she gradually increased her influence, thereby enhancing her students' educational journey and fostering the expansion of the institution. At present, she maintains her scholarly pursuits as a faculty member at the University of Pembangunan Jaya, where she teaches and imparts her finance-related knowledge and expertise. She is actively participating in a number of research initiatives concerning Islamic banking, finance, and banking. Email: <a href="mailto:chajar.matari@upj.ac.id">chajar.matari@upj.ac.id</a></p>
--	---