

# MONETARY POLICY IN AN ISLAMIC ECONOMICS

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## ABSTRACT

The primary aim of this paper is to elucidate the general concept of monetary policy under Islamic Economics. Not only does the stability of but also the growth of the economy in a country strongly depends upon monetary policy implemented. Such the phenomenon also prevails in Islamic Economics in which the term is also ruled by the Holy Quran and the Hadith of the Prophet. Moreover, the Prophet issued some regulations regarding monetary, such as to adopt Dinars and Dirhams as the Islamic currencies. It is noted that, however, the thing distinguishing between Islamic Economics and other economic systems is concerning the variable of interest or usury, where either the Holy Quran or the Hadith clearly states that it is banned. Due to using interest as the yardstick, the conventional monetary instruments such as Open Market Operation, Discount Rate and the likes are not considered as the monetary instruments under Islamic Economics. Therefore, Instead of interest, Islamic Economics adopts Profit Loss Sharing (PLS) system, regarded as the important part of monetary policy. Moreover, Islamic Economics has also its specific monetary standard and instruments, which are far from interest or riba-based variables, such as musharakah certificates and others.

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## 1. INTRODUCTION

Monetary and financial crises happening persistently throughout the world, which starts from the beginning of the twentieth century to the present time, could indicate that implemented-monetary policies cannot secure an economic stability incessantly. Since the Adam Smith's era to the current time, there are a variety of economic theories and policies that have been created and employed, but it is likely that none of them has sustainability in restoring the economic problems permanently. Moreover, sometimes when an attacked-country is provided prescriptions to overcome a crisis, another crisis occurs in the country instead, or the crisis moves to the other



countries<sup>1</sup>.

Various crises happening throughout the planet are considered, among others, to lie in monetary matters [Sari and Mirakhor \(2012\)](#). It means that the monetary adopted are regarded to have weaknesses, which at least needs to be reconsidered so as to achieve the more applicable and suitable ones. Furthermore, not only does the crisis hit developing as well as poor countries, such as Indonesia, but also it attacks other developed ones. The latest global crisis destroying the US economy in 2007/2008 and 2012 were also an obvious evidence of that the current world economy system is unable to run the inherent situations and challenges<sup>2</sup>.

As to monetary issues, Islam has its specific ways and approaches to which considered as the yardstick to arrange and run economic matters. The Holy Qur'an and the Hadith, which are regarded as the primary source of Islam, are the two core cornerstones by both which every aspect of life directed and regulated including economic matters. However, the sources do not elucidate the issues in detail; they just provide the general and root principles instead. This is a great responsibility for Muslim scholars to raise monetary policies and theories that have to be in conformity with the Qur'an or the Hadith. Furthermore, either theories or policies concerned have to not only fit into the framework of the overall Islamic economic system but also must be applicable and suitable with the current situation of the economy. Moreover, they have to be in place in the face of the persistently world economic problems, which becomes as the long-term solution accordingly<sup>3</sup>.

Monetary theories in Islam have existed since the religion was established. During the Rasulullah's era, the monetary authority at the time was only the Prophet himself. He oversaw monetary and economic activities, and then issued monetary policies incorporating to Islam. His hadith, including qauliyah, fi'liyah and taqririyah-typed, stating on monetary and finance constitutes monetary policies in Islam. One of the monetary policies undertaken by the Prophet in the early Islam was that he consented to dealing with Dinars and Dirhams as the medium of exchange for the Muslim society. Such the policy was regarded as the fundamentals for economic and financial activities during the time. As to the policy, the Prophet consented to considering them, viz. Dinars and Dirhams, as the currencies for the Moslem people, including to the weight with which the Quraysh weighed them [Zalloom \(1988\)](#).

<sup>1</sup>For instance, what has happened in Indonesia in 1997/1998 is an evidence for the above phenomenon. During the years, the country was attacked by the Asian Financial Crisis. Many ways as well as prescriptions have been provided and implemented to eliminate such the crisis, nevertheless the crisis became deeper and more dangerous instead.

<sup>2</sup>Bordo (2008) views the global crisis of 2008 and 2009 is part of a recurrent pattern. The crisis, which was triggered by events in the US Financial System, has many similarities to those of the past such as the crises of 1857, 1893, 1907 and 1929-1933. The onset of the crisis was the collapse of the subprime mortgage market in early 2007 and the end of a major housing boom. In addition, it happened following two years of rising policy interest rates, which has recently spilled over into the real economy through a virulent credit crunch and collapsing equities market which will perhaps create a significant recession.

<sup>3</sup>Because riba or interest-based is banned in the Islamic economic system and while most of traditional monetary instrument involving riba, it is very important for Islamic economists to seek for or to innovate new monetary instruments which are accordance with Shariah law ([Bidabad, et.al., 2011](#)).

According to Islamic-based financial theories, the central feature of an Islamic financial system is the absolute prohibition of the payment and receipt of interest (Khan & Mirakhor, 1989). It rejects the concept of a predetermined interest rate, but permits an uncertain rate of return based on trade and profits. Determining a certain amount of money that must be paid by borrowers for a loan in advance constitutes *riba*, which is prohibited by the Qur'an. M. S. Khan (1986) views what banned in Islam, in essence, is the fixed or pre-determined return on financial transactions and not an uncertain rate of return, such as that represented by profits. Instead of a predetermined interest rate for the amount of money lent, Islam provides a unique and specific way, which is profit loss sharing or so-called PLS system. Under the provisions of the way, either the lenders or the investors share the profit or the loss they get. Two kinds of investment fit into Islam in terms of the profit loss sharing way are *mudharabah* and *musyarakah*, which as broadly called PLS Financing Zuhaily (1985), F. Khan (2010).

## 2. HISTORICAL PERSPECTIVES OF ISLAMIC MONETARY POLICY

Matters related to monetary have been known by the people in the world long time ago or at least when the people know and use mediums of exchange for their business transactions or economic activities. The monetary matters, which consist of those such as money, medium of exchange, interest or others, were part of the human being's life in the ancient time. In the Plato's time, for instance, discussions of medium of exchange, interest rate were existed as well. In short, due to monetary things regarded as the inevitable one in the economy and daily business transactions, they had existed in the world when the history of human being started. The story of monetary policy in a country or civilization usually starts when money and exchange related-things are regulated and implemented by the people.

The starting point of great story of monetary policy in the Islamic civilization began when at the first time the Prophet Muhammad SAW consented Dinars and Dirhams as currencies for the Moslem society. With respect to the both currencies, He through a Hadith from Ibnu Umar said "the weight (Dinars and Dirhams) is the weight of the people of Makkah, and the measure is the measure of the people of Madinah". The Hadith means that what the existing currencies used by the people of Makkah and Madinah are permissible to be as the tool of economic and business transactions for the Prophet's life and for Muslim's society for good. It is important to be noted that Dinars and Dirhams have been existed before the Prophet's birth, in which the both were obtained by the Arabic people from the Empires of Roman and Persia respectively<sup>4</sup>.

<sup>4</sup> Actually, issues and policies regarding monetary particularly on currency or transaction tools had existed before Islam came to the Arabic region. At the time, there were two great empires dominated in the Arabic peninsula, viz. Roman and Persia, from which currencies came and then were used by the Arabic people for their business transactions. The empires were regarded as the central goal of the

During the life of the Prophet SAW, there were a few monetary related-statements or regulations created and issued by Him. Nevertheless, the Messenger Peace be Upon Him (pbuh) has established and issued the very basic principles related to monetary as well as financial systems. One of the most important principles underlined by Him pertaining to monetary and financial matters is that there are no riba (interest) in them [Al-Haitamy \(2003\)](#), [Nawawy and I \(2003\)](#). It means that whatever policy and system either in monetary or in finance are acceptable as long as it does not contain or relate to riba. Such the core principle of Islamic monetary and finance is declared in both the Holy Quran and the Hadith, in which the both sources of Islamic law absolutely prohibit riba-related things and those who employs and lives within riba.

With respect to the currencies, there were three kinds of metal, also known as Byzantine coins, were used for economic transactions at the time of the Prophet, viz. gold (Dinar), silver (Dirham), and copper (fulus) "[Concepts of Paper Money in Islamic Legal Thought](#)" (2001)<sup>5</sup>. Such the metals were used by the Arabic people as the foremost currency since from the starting point of Islam, viz. the Prophet's life time and the administration of the Rightly Guided Caliphs until the big time of Islam. Nonetheless, notwithstanding that the coins were still accepted as official money, the Muslim government started to make its own Dirhams. Such the monetary reform was undertaken under the Caliph Umar bin Khattab in 18H. Moreover, it is widely known the Caliph is also considered as the one who made many breakthroughs for Muslim, in an economy or other aspect of Muslim's life.

The types of Dinars and Dirhams used by the Arabic people during the life of the Prophet were the Heraclian Dinars and Chosroes Dirhams respectively. Such the currencies were used during the Khilafah of Abu Bakar As-Shiddiq and the early years of Umar bin Khattab as well. Then, the Second Khilafah created breakthrough regarding the currency, in which He made new coin of Dirhams in the Sassanid style by adding some writings in Kufic letters, such as "In the name of Allah, my Lord [Zalloom \(1988\)](#). As for Dinars, the second Khilafah did not do anything for the currency, neither did some khilafahs after him. Another monetary reformation in terms of the currencies was undertaken by Khilafah Abdul Malik bin Marwan in the 77<sup>th</sup> AH, where Dinars were made in as specific style of Islam.

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Arabic people's business activities. Currencies used by the people at the time consented by the Allah's Messenger which is finally well known in Islam, were Dinars and Dirhams. Some writers argue that there were three kinds of currencies used by the Muslim people for their economic transactions during the time of the Prophet Muhammad SAW, viz. Dinar, Dirham and Fulus (Siegfried, 2010). Dinars were made from gold, Dirhams were made from Silver and the latter Fulus were made from Copper.

<sup>5</sup>The earliest forms of metallic money before gold and silver are made from bronze and copper. Gold and silver coin were made in Lydian around 560 BC and considered as the first forms of metallic coins (Hasan, 2011).

### 3. PRINCIPLES AND INSTRUMENTS OF MONETARY IN ISLAM

It is important to note that the foremost basis of monetary policy in Islam is the Holy Quran and the Hadith of the Prophet Muhammad pbuh. Either describes general directions concerning principles and instruments of monetary in Islamic Economics. The very basic of principles of monetary policy under Islamic Economics is that there are no usury or ribawi-related variables or activities [Salus and A \(1998\)](#). Whatever available instruments as long as no ribawi are accepted in Islam albeit the currently existing ones.

It is broadly known that monetary policy is a number of instruments which are used to achieve macro-economic goals or reduction of damages of the performance of monetary system and controlling liquidity in the economy [Bidabad et al. \(2011\)](#). Monetary instruments are normally defined as the tools or the ways used by monetary authorities or governments in implementing their monetary policy, which aims to get economic stability and growth or other specific purposes of economic policies. Not only is in conventional economics, the monetary instruments is also known and regulated in the Islamic economic concept. Islamic financial institutions must be based strictly on four basic principles, they are, all transactions must be interest free, no speculation, the implementation of zakat, no (haram) prohibited-production and consumption of goods and services [Samad \(2004\)](#)

The very core distinction of monetary instruments between Islamic and conventional economics is on interest rate variabel, where the Islamic economic does not involve interest rate as its variabel in issuing monetary policies, whereas the conventional economics considers that interest rate as the core variabel in all its monetary policies. The financing system in Islamic economics relies on Profit-Loss Sharing (PLS) instead. The monetary instruments are regarded as the variables used as the means in running monetary policy by monetary officials. In theory, there are two categories of monetary instruments usually implemented, namely quantitative and qualitative one. Such the categories are also known in the monetary theory of Islamic economics, however, for the current time, there are just some Islamic countries implement the theories concerned, viz. Iran, Pakistan and Sudan.

It should be underlined that almost all countries except such the three countries mentioned above, do not have monetary policies based on the Islamic economic system. This means that the monetary policies implemented in these countries are not yet based on profit sharing. Indonesia or Malaysia, for example, although the majority of the population is Muslim and the Islamic banking industry is very advanced in that countries, the prevailing monetary policy is still interest-based. Open Market Operation or Discount Rate, which is an interest rate-based monetary policy instrument, applies to both countries.

However, Iran is one of the Muslim countries that consistently applies an Islamic economic and financial system, because monetary policy in that country is no longer entirely based on interest rates. Iran has shown that regulating the circulation of money in the economy does not have to be with an interest rate instrument. Among

the monetary instruments that have been implemented by Iran, among others, is the musharakah certificate, this is the same as the Open Market Operation monetary instrument, but the certificate use the profit sharing rate [Kiaee \(2007\)](#). Followed by controlling the profit rate at commercial banks, this is also a monetary instrument that can regulate the money supply under an Islamic Economic system.

The next monetary instruments that have been implemented in Iran without interest rates are the legal reserve, credit ceiling and special deposits to Central bank, these three instruments have proven their role as good variables in controlling the money supply in the economy. Experiences in Iran can also show that monetary policy using profit sharing instruments can play a good role, especially in achieving economic growth and stability which is the core of monetary policy objectives itself.

#### **4. ISLAMIC MONETARY STANDARD AND CONCEPTS OF MONEY**

In general, money has three functions, namely a medium of exchange, a unit of account and a store of value. Such functions distinguish money from other assets such as stocks and bond and the like. As medium of exchange, money can be used by people to buy something (goods) or to pay services in which either seller or buyer agrees in a transaction by using money concerned. With respect to its function as unit of account, money is considered as the benchmark by which people use to post prices and record debts. The third function of money, a store of value, is that money as means by which people can use to transfer purchasing power from the present to the future. This means that if a seller receives money in the current time in exchange for a good or service, the seller can hold the money and then become a buyer of another good and service at another time [Mankiw \(2010\)](#)

Nabhany (1997) views that a country is considered as the one following the gold standard if it uses gold currency in its foreign and domestic transactions, or if it uses domestically a paper money which could be exchanged for gold. Also, the country is still categorized as the follower of the standard on condition that the paper unit can be exchanged for a specific number of gold at a fixed price and vice-versa. Moreover, according to Nabhany's view, even though the paper is used for making payments abroad or solely for making payment abroad, as long as the exchange for has a fixed price, it is still classified under the gold standard term. In short, the gold standard is the standard in which gold used as the medium of exchange in economic transactions such as for paying of the price of a commodity and the wage of a worker, or the gold is used as the medium in backing a nation's currency in the case of that the nation uses a paper money as its medium of exchange.

In addition to the gold standard, there is another one which is being implemented in the world economy, viz. the fiat standard. The standard, which is also known as the inconvertible paper money, is defined that a government or a monetary authority in issuing money without backing it with gold. This type of regime have been prevailing

the economy since the collapse of the Bretton Woods regime in 1971. ed “the paper currency”, is an expression for circulated vouchers issued for the benefit of its bearer, which represent specific debt secured by the State or currency authority that issued it [Zalloom \(1988\)](#). In general, the paper is divided into three types, intrinsic, fiduciary and inconvertible paper money.

Concerning Islamic economics, there is some views among Islamic economists concerning objects considered as money in Islamic Economics. It means that what stated and concluded as money under an Islamic Economics perspective are still under discussion amid them. The differentiation of their opinions lies particularly in determining dinars and dirhams as a currency, either as the only currency or as one of the currencies in Islam. As for such the currencies, Muslim scholars are divided into two factions in terms of whether the both noble metals as the only currency in Islam or not [Hasan \(2009\)](#). The first is those who argue that the monetary standard allowed in Islam is only the gold standard, including the classical gold standard and the gold exchange standard<sup>6</sup>. The second is those who argue that monetary standard in Islam do not limit on the two mineral stones, gold and silver, they consider that either the gold standard or the fiat standard is acceptable in Islam.

Imam Al-Ghazali views that money under Islamic Economics is a medium of exchange and a standard in measuring economic value [Omar \(2011\)](#). Money is not an object that can be traded to achieve returns without real economic activities. In addition, money is a tool to obtain definite objectives, not the objective itself. Hence, it cannot be regarded as capital as well as a commodity ( $M \neq K$ , also  $M \neq C$ ).

## 5. ISLAMIC MONETARY POLICY AND ECONOMIC STABILITY

As it is known, there is a close relationship between monetary policy and economic stability in a country. Economic crises that occur in other parts of the world are often the result of inappropriate or incorrect monetary policies. If the applied monetary policy is not suitable and appropriate to the prevailing conditions, then economic instability will occur. Likewise, when a country occurs an economic crisis, if the monetary policy taken is not appropriate to overcome the crisis, the crisis is not getting better but it is getting worse. Indonesia, for instance, when the monetary crisis occurred in that country in 1997/1998, because of the inappropriate monetary policy applied, the economic situation was actually getting worse, further aggravating economic instability [McLeod \(1997\)](#).

In this chapter, the author only describes the relationship between Islamic monetary policy and economic stability in theory, not from a practical point of view. This is

<sup>6</sup> There were two kinds of standard in terms of gold used as a monetary standard; they were the classical gold standard and the gold exchange standard (Bordo, 2003). The classical gold standard prevailed from 1880 and ended with the First World War, 1914. After the war, the gold exchange standard was in lieu of the existing one. Under the new standard, member countries could hold international reserves as gold or in the currencies of the certain countries, Britain, France and the US. However it was short-lived.

because almost all Muslim countries do not implement Islamic monetary policies as they should, except for only three countries, namely Iran, Pakistan and Sudan. Countries that are predominantly Muslim and apply an Islamic banking system, however, do not implement an Islamic monetary system and policy, as implemented by the Prophet Muhammad pbuh, His companions and the Islamic caliphate.

Experiences that have occurred in various countries until now show that the economic instability that occurs is the result of speculative activity. The economic and financial crises that happened in the 20th and 21st centuries, are often caused by speculation both on the capital and money markets. For example, the economic crisis that attacked the UK in 1992, known as The Black Wednesday, was caused by speculation. Likewise with the economic and monetary crises that occurred in Asia in 1997/1998 as well as several other economic crises, almost all of which were caused by speculation.

One of the important principles in Islamic monetary policy is that speculation is not allowed, because it can harm others. One of the main principles of Islamic economics is that something that can damage others is not allowed or forbidden. With this principle, the author views that economic stability can be maintained at least as a result of speculation. The prohibition of speculation in the money and capital markets or others is a guarantee to achieve economic stability itself. So this is where the advantages of the Islamic monetary system and policy compared to other economic systems, namely that it can maintain economic stability and can avoid economic crises that will occur, because of the prohibition of speculation.

Likewise with the profit sharing system or PLS which is the core of Islamic monetary instruments. The PLS system is considered better than the interest rate system. The level of flexibility with the PLS system is seen to be better than the interest system. In theory, investment activities with the PLS system will open properly because there is no capital cost, compared to the interest rate system. In the interest rate system, the rate is the cost of capital for investment activities. This can be seen in the following formula:

$$I = f(I) \tag{1}$$

$$I_{ie} = f(PSR) \tag{2}$$

Where :  $I_{ie}$  = Investment in Islamic Economics

This means that the interest rate is an obstacle to investment activities, the higher the interest rate, the lower the investment activity, and vice versa because the interest rate is a cost of capital. Meanwhile, the PLS or PSR model as a principle for Islamic monetary policy does not recognize the cost of capital, so that investment activities will continue. The investment formula in Islam is as follows:



## 6. ISLAMIC MONETARY POLICY, ISLAMIC BANKING AND PLS SYSTEM

In an economic literature, monetary and banking are two things that are inherent and always interact one to another. The both have strong relationship each other, while the former sometimes induces the latter and vice versa. Hence, it is somewhat difficult for economists as well as policy makers to determine the suitable policy for covering economic problems or other proposes due to or related to the both things. Moreover, monetary and banking are among economic variables which usually become the most popular debatable topics among economists and policy makers.

What the Islamic economic system views towards the existence of monetary and banking in economy is the same as what the existing economic system does nowadays. Islam also considers that the both things are very essential ones in the economy, which means that Islamic economists as well as decision makers, including governments, must take into consideration on the both variables. However, the underlying foundation of either monetary or banking is not the same between Islamic economics system and its counterpart. Monetary and banking under Islamic economic system must follow and be accordance with basic principles of economic and business activities in Islam, in which one of them is no usury (ribawi) and no gharar.

Of the things differentiating principally between Islamic and conventional banking systems underlies on modes of employed-profitability system. It is known that either Islamic or conventional banking system is in line in terms of obtaining profit as their final goal of operations and transactions. However, in principle, conventional banks are enforced to achieve their profit through interest system, in which the yardstick of the profit under the conventional system is interest, which is between interest rate of deposits and loans. Nonetheless, interest rate system is prohibited in Islam including in obtaining profit as well. It means that Islamic banks are banned to employ interest rate system as the basis of their profit. Profit Loss Sharing system, which is well-known PLS system<sup>7</sup>, is considered as the benchmark of their operation instead.<sup>8</sup>

$$\text{Dep}_{cb} = f(i) \text{ and } \text{Cred}_{cb} = f(i) \quad (3)$$

$$\text{Dep}_{ib} = f(\text{PSR}) \text{ and } \text{Dep}_{ib} \text{ or } \text{Fin}_{ib} = f(\text{PSR}) \quad (4)$$

where :  $i$  = interest rate;  $\text{PSR}$  = profit sharing rate

<sup>7</sup> PLS is broadly defined a contractual arrangement between two or more parties to invest and to undertake business and economic activities, in which they have the same rights as well as duties in either profit or loss. With respect to Islamic banking products, only two modes of financing related to and categorized as PLS system, namely mudharabah and musharakah (Dar, 2000).

<sup>8</sup> Actually PLS financing is not established and ruled specifically for banking operation and system only, but it is in general for all business activities and economic transactions under Islamic perspectives. The mode of financing is one of the kinds employed by the Prophet Muhammad (pbuh) during His life. It was also followed by the Guided Caliphs after Him as well. Then, instead of interest variable which is normally used in conventional banks, Islamic banks adopt PLS system as one of their investment products due to its conformity to Islamic Economics principles.

The Profit-Loss Sharing (PLS) system, according to [Salus and A \(1998\)](#); [Siddiqi \(2004\)](#), will ensure a better allocation of resources and more equitable distribution of wealth. Zuber Hasan (1985) also views that PLS financing is more profitable to financiers in the long run than is interest financing.

However, based upon some experiences in Muslim countries, there is a relative lack of the PLS system implemented by Islamic banks. Indonesia, for instance, the Islamic banks' financing from 2007 to 2016 were only 1/3 at the PLS-based financing ([Khalidin, 2017](#)). Moreover, [Nienhaus \(1983\)](#) views that Islamic banks during the late 1970s and 1980 in several Muslim countries did not implement PLS system purely. This is because of competition with the existing banks, viz. interest-based banks, where if PLS and interest rate systems are employed simultaneously, the PSR is influenced by the variables such as rate of return on investment, rate of interest and degree of leverage [Hasan \(1985\)](#)

A number of experiences in Muslim countries that put into practice the Islamic banking system as part of their national banking industry indicates that there are some obstacles particularly in undertaking the PLS system. The most fundamental obstacle is regarding the country-adopted monetary policy in which such the policy still uses interest rates as the core instrument. For instance, Malaysia and Indonesia, although Islamic banks have operated in the both countries for some decades, monetary policy in the both are based upon interest rates. Therefore, either Indonesia, Malaysia or some other Islamic countries do not apply the PLS system purely and completely.

The most important element in the Islamic banking system, which is considered as the fundamental difference with its counterpart "conventional banking system", is a free-interest rate concept. The concept is that the funds users are not burdened to pay a determined rate of money due to using it. This is based upon that Islam disallows the "riba" as mentioned very clearly in the Holy Quran.<sup>9</sup>

## 7. CONCLUSION

Monetary policy is an economic policy related to the money supply in the economy, with the aim of achieving economic stability and growth. In Islamic Economics, monetary policy is one of the important policies in the economy, and has existed since the time of the Prophet Muhammad pbuh, or since Islam was born. Among the monetary policies that were initiated by the Prophet pbuh was to use the Dinar and Dirham as currency and medium of exchange in early Islam. In addition, the prohibition of usury

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<sup>9</sup> However, Muslim scholars are still in a debate regarding banning of interest rate in a banking system. Some argue that the interest rate is the same as riba, hence, the rate is prohibited in the banking system. Nevertheless, other group considers that the rate is not similar to riba, therefore, the prohibition of riba is not in the level of haram, but lower than it, such as makruh or mubah. In addition, Indonesia, which is known as the Muslim-majority country, does not specify the definite law regarding the interest rate. Moreover, currently three big Islamic organizations, namely, MUI, Muhammadiyah and Nahdhatul Ulama, have not categorized the interest rate as the part of riba, they give three kinds of law for the interest rate as stated above instead.

(riba) in sale and lending transactions is the most important part of monetary policy in Islam.

The main sources of monetary policy in Islam are the Holy Quran and the Hadith of the Prophet Muhammad pbuh. Both are the most fundamental sources for the Islamic economic system and monetary policy. The next sources of monetary policy in Islamic Economics after the two core sources are Ijma and Qiyas. However, monetary policy in Islam is very flexible, meaning that it can be adapted to the conditions of the times as long as it does not conflict with these two main sources, viz. the Holy Quran and the Hadith of the Prophet pbuh.

The concept of monetary policy in Islam is generally the same as current monetary policy, especially in terms of its objective, namely to achieve stability and sustainable economic growth. The difference lies in the instruments. Monetary policy in Islam does not allow monetary instruments to contain variable of interest rates, because the rates are part of usury and are prohibited in Islam. The instruments of monetary policy in Islamic Economics are based upon variable of profit sharing rates (PSR) instead. However, such the rates is still lack of implementation in the real economy including in muslim countries.

According to Islamic economics, it is not permissible to control money supply in the economy which is as part of the work of monetary policy by using interest rate instruments, such as Open Market Operations and Discount Rates, because the both contain such the interest rates. Meanwhile, instruments such as the reserve requirement are allowed because they do not contain interest rates. At short, in principle, any monetary instruments are allowed in the Islamic economic system, as long as they do not conflict with the main principles of Islam that have been outlined in the Holy Quran and the Hadith of the Prophet pbuh.

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