

The Root Causes of Economic Problems and *Maqasid Al-Shari'ah*: From The View Point of *Siyasah Shar'iyah*

Tita Nursyamsiah
Master of Economics Candidate,
Department of Economics, Kulliyah of Economics and Management Sciences,
International Islamic University Malaysia (IIUM), Kuala Lumpur, Malaysia
Email: tita.nursyamsiah@yahoo.com. Phone number : +601139989543

Abstract

The current economic system basically consists of three important instruments. These three instruments which have become the root causes of the economic destructions, called fiat money, interest rate, and fractional reserve banking. However, Islam has guidelines to obtain its objectives which is to protect its mankind, including for the economic system. The Islamic system of protection is known as maqashid al-shari'ah or the very objective of Islam that encompasses five basic elements of life. These five basic elements might be perfectly protected by implementing political strategy based on shari'ah principles, or siyasah shar'iyah.

***Objectives** of this paper are to obtain the determinant factors of economic growth and to give solutions for economic damages caused by current economic system.*

***Methodology** of this research firstly observes the determinant variables of economic growth in Indonesia by using econometrics method. After that, by applying qualitative analysis, the solutions for the economic problems are derived from the viewpoint of siyasah shar'iyah.*

***Findings** from this paper states that interest rate and fiat money system have negative relationship with economic growth in Indonesia. The solutions such as eradication of interest based system, public banking, and gold dinar should be implemented to protect the economic system.*

Keywords: economic problem, *maqasid al-shari'ah*, *siyasah shar'iyah*

Abstrak

Sistem ekonomi saat ini pada dasarnya terdiri dari tiga instrumen penting. Ketiga instrumen tersebut, yaitu uang fiat, tingkat suku bunga, dan fractional reserve telah menjadi akar penyebab kehancuran ekonomi. Namun, Islam memiliki semacam pedoman untuk memperoleh tujuannya yaitu untuk melindungi manusia, termasuk implementasinya dalam sistem ekonomi. Sistem perlindungan dalam Islam ini dikenal sebagai maqashid al-syari'ah atau objektif Islam yang mencakup lima elemen dasar kehidupan. Kelima elemen dasar akan semakin sempurna bila diimbangi oleh penerapan strategi politik yang berdasarkan pada syariat Islam biasa disebut dengan siyasah shar'iyah.

***Tujuan** dari penelitian ini adalah untuk mendapatkan variabel penentu pertumbuhan ekonomi dan memberikan solusi untuk kerusakan ekonomi yang disebabkan oleh sistem ekonomi saat ini.*

***Metodologi** penelitian ini terlebih dahulu mengamati variabel penentu pertumbuhan ekonomi di Indonesia dengan menggunakan metode ekonometrik. Setelah itu, dengan menerapkan analisis kualitatif, diharapkan dapat menemukan solusi untuk memecahkan masalah-masalah ekonomi yang berasal dari sudut pandang siyasah shar'iyah.*

***Temuan** dari penelitian ini menyatakan bahwa tingkat suku bunga dan sistem uang fiat memiliki hubungan negatif dengan pertumbuhan ekonomi di Indonesia. Solusi seperti pemberantasan sistem ekonomi berbasis bunga, perbankan publik, dan dinar emas sebaiknya diterapkan untuk melindungi sistem ekonomi.*

Kata kunci: masalah ekonomi, *maqasid al-syari'ah*, *siyasah shar'iyah*

1. Introduction

1.1. Background Study

In current global situation, there are three main instruments which have not been only the soul of economic system, but also the root causes of the economic destructions, called as fiat money, interest rate, and fractional reserve banking (Meera, 2004). All these three elements have lead the economic condition to be instability and unfair due to their basic characteristics cause an immense discrepancy or imbalance between monetary and real sector. Under fiat money system, money is created out of nothing, thus money grows exponentially. When money exponentially grows yet it could not be met with the real sector, since it rises linearly, so it would be a serious problem for economy. There is much money spread, but only small people are able to attain it, thus discrepancy between the poor and the rich will be much longer.

Furthermore, money growth or this “money creation” is transferred to the rise in price level that should be faced by all people. In other word, fiat money system causes inflation that reduces purchasing power. Besides fiat money system, interest rate roles a huge contribution to the vulnerability of the economic system as well. Interest rate insists an endless economic growth due to the rate return required by interest rate does not exist in the form of money. No matter how people put very hard effort to pay the interest, in aggregate some people should default since the system is naturally designed to be that way (Meera, 2004).

As a result, socio-economic life of most people must suffer so much because of this system. This condition is degenerated by the fractional reserve banking system that authorizes money creation through multiple credit creation. Money is easily injected by commercial banks just using the accounting system, though they do not really care on how real sector could return that money. Consequently, this system is able to create economic problem, as an imbalance between monetary and real sector and inflation in the economy. To prove this statement, Meera (2004) elucidates by employing the equation model proposed by Irving Fisher namely the equation of exchange as follows.

$$MV = PY$$

Where,

- M : the quantity of money,
- P : the price level,
- Y : output and V is velocity of money.

As money supply goes up through multiple credit creation that is not met with the growth of output in the economy, price level will unavoidably rise as it is assumed the velocity of money remain constant. Other finding that supports the existence of imbalance condition between monetary and real sector is figured by the Table 1. From the Table 1 it could be seen that the world money supply is approximately 5.5 times larger than the real economy (Howard, 2011).

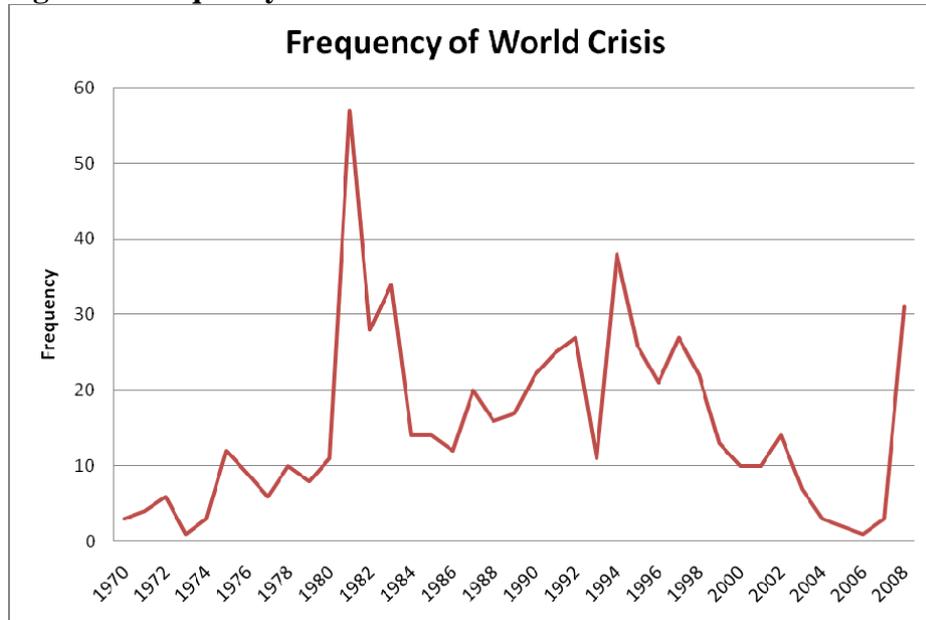
Table 1. World Money Supply and GDP

World Money Supply	USD Trillion
Narrow Money	22
Broad Money	75
Domestic Money	105
External Debt	60
Foreign Exchange Reserves	10
Total Fiat Money Base	272
World GDP	50
Ratio of Fiat Money to GDP	5.4 : 1

Source: Howard (2011)

Therefore, it is proved that under conventional system, there has been created hundred crises in the world. Leaven and Valencia as mentioned in Ascarya (2009) reported that in the period of 1970-2007, there have been 395 incidents of financial crises, i.e. banking crisis, currency crisis, and sovereign debt crisis, involving 42 twin crises and 10 triple crises (see Figure 1).

Figure 1. Frequency of World Crisis



Source : Ascarya (2009)

Nevertheless, actually Islam has provided more righteous and stable system towards economy. Islamic economic system has addressed to solve the problems that come about in the current economic system. This is due to the instruments used in the system can reduce the risk that a scourge of the problem of chaos in the monetary system and complicated signals to pass through a revolving fund monetary sector into the real sector, namely real money, full reserve banking system, and profit and loss sharing (Meera, 2004). With the signals to pass through funds from the monetary sector to the real sector, therefore this will fix price stability and increase productivity as well as employment opportunities so it could reduce the level of unemployment and poverty which in turn causes a social welfare. To attain the healthy economic condition, conventional system proved to be failed since its objectives and natural characteristics do not support this achievement.

However, Islam has guidelines to obtain its objectives which is to protect its mankind, including for the economic system. According to Jauhar (2009), the Islamic system of protection is widely known as *maqashid al-shari'ah* or the very objective of Islam which encompasses five basic elements of life (*al-kulliyat al-khams/adh-dharurat al-khams*). The *maqashid al-shari'ah* emphasizes the concept of *maslahah* (benefit) which includes the enhancement, preservation and safeguarding of five basic elements (*Usul*). The ultimate goal of *maqashid al-shari'ah* broadly embodies the lives of individual and society for a better life in this world and hereafter. It simply defines that *maqashid al-shari'ah* must be obviously understood as a comprehensive image of Islam.

Moreover Ghazali particularly divides *maqashid al-shari'ah* into five safeguardings, namely life (sovereignty), faith, intellect, posterity, and wealth (Meera and Larbani, 2009). Everything comes up with additional a utilization to five basic things called *maslahah* (benefit), and *vice versa* as everything gives bad effects to them namely *mafsadah* (harm). The most crucial matter of *maqashid al-shari'ah* is to achieve the glory (*falah*). This principle is absolutely connected to the economic system due to Islamic economic, which is represented by *maqashid al-shari'ah*, actually brings us to the social welfare and prevent to the serious economic crises.

Furthermore, government, as *ulu'amr* or leader among us, has to protect five basic elements in order to obtain the blessing of Allah and to attain the welfare of mankind. Generally, rulers should have their strategy or guidance, thus the policy implications they made would not violate *shariah* principles, called *siyasah shar'iyah*. *Siyasah shar'iyah* defines as broad doctrine of Islamic law which authorizes the ruler to determine the manner in which the principles of *shariah* must be administered¹. In the usage of the fuqaha, *siyasah shar'iyah* involves decisions and policy measures taken by the imam and the *ulu'amr* on matters for which no specific rules can be set up in the *Shariah*. As Ibn Qayyim words²:

“any measure which actually brings the people closest to beneficence (salah) and furthest away from corruption (fasad) partakes in just siyasah even if it has not been approved by the Phophet nor regulated by Divine revelation. Any one who says that there is no siyasah shar'iyah where the shariah itself is silent is wrong and has misunderstood the companions...”

From the explanation above, we can conclude that rulers have to administer *shariah's* principles in every muamalah activities, including in economic part.

In addition, Khan and Syed (2009) state that the prosperity function of the Islamic state, which is resulted from *siyasah shar'iyah*, was particularly pointed by Prophet (PBUH) when he said *“He whom Allah has made an administrator over the affairs of Muslims but remains indifferent to their needs and their poverty, Allah will also be indifferent to his needs and his poverty”*³. Finally, the Prophet of Allah said: *“Any ruler who is responsible for the affairs of Muslims but does not strive sincerely for their well being will not enter paradise with them”* *“Any ruler who is responsible for the affairs of moslem but does not attempts sincerely for their well-being will not enter paradise with them”*⁴.

¹ Mohamad Hashim Kamali, “Siyasah Shar'iyah or the Policies of Islamic Government,” (The American Journal of Islamic Social Sciences, vol.6 No. 1,1989) p. 59

² Kamali, *ibid.*, p. 61

³ Abu Dawud, Sunan, Vol. 2, p. 48

⁴ Sahih Muslim Vol. 1, p. 126

However, most of the rulers or even *muslim* scholars advocates the root causes of economic problem which as mentioned above, such as interest, fiat money system, and fractional reserve banking, that in fact bring much more *mafsadah* to *maslahah*. In addition, *riba* or interest based system is strictly prohibited in Islam. The existence of *riba* in the economy preclude the objective of *shari'ah* since its harms to the economic equity. Moreover, Khan and Syed (2009) elaborate that the welfare of individuals as well as society in an Islamic state might be obtained if there is right environment for a fuller appreciate the values of Islamic spiritual.

From the elaboration above, it could be concluded that the existence of *siyasa shar'iyah* into economic system is inevitably crucial to solve the economic problem and attain welfare for mankind. The urgency and how *siyasa shar'iyah* might be applied into modern economic system and its derived strategy will be specifically explained in this study.

1.2. Objectives of the Study

The principal objective of this paper particularly to elucidate of how *siyasa shar'iyah* is implemented, therefore social welfare could be achieved and economic problems could be solved in current economic system. In addition, some derivative objectives of the study could be seen as follows:

1. To analyze econometrically determinant factors of economic growth in real sector, which it empirically takes case study in Indonesia during 1995 to 2013,
2. To obtain the real solutions for rulers on how Islamic economic with its *siyasa shar'iyah* as the strategy that might solve the economic crises, especially which cause by conventional economic system.

1.3. Scope of Study

This study takes case study in Indonesia during 1995 to 2013. The analysis econometrically emphases more on the effect of current economic system to the real sector and the solutions based on Islamic political strategy (*siyasa shar'iyah*) to overcome the economic problems.

2. Methodology

This paper employs both of quantitative and qualitative methods for analyzing data and finding solutions for economic problems respectively. Briefly, the qualitative analysis applies econometric method to find determinant variables of economic growth while qualitative analysis is used by literature survey which finally derives proper solutions to prevent economic damages.

2.1. Source of Data

This study uses quarterly data that is retrieved from IFS, International Monetary Fund (IMF). This study uses data from January 1995(Q1) to January 2013(Q1). IPI and MS are transformed to be logarithm, while IR stands to be percentage.

2.2. Model

To get the estimation of relationship between the economic growth and its determinants, the following model is:

$$\text{LogIPI} = \{ \text{LogMS}, \text{IR} \}$$

Where,

LogIPI : Logarithm of Industrial Production Index (IPI) as proxy of economic growth
 LogMS : Logarithm of Money Supply
 IR : Interest Rate

Industrial Production Index or IPI indicates as proxy of real economic growth. Money supply (MS) represents paper money and credit creation supplied in the system or fiat money, while interest rate (IR) indicates the average number of lending rate and deposit rate of the banks.

2.3. Unit Root and Cointegration Tests

The first step in this study is to determine stationarity of variables of the models. Briefly stated, classical regression techniques may be invalid if it is applied to variables that do not meet the stationarity property (Thomas, 1997). This paper uses the most commonly test, which is Augmented Dickey Fuller (ADF) test. It is “augmenting” a random walk with drift around a stochastic trend by adding the lagged values of the dependent variable ΔY_t (Gujarati, 2003). The test will be based on following model:

$$\Delta Y_t = \beta_1 + \beta_2 t + \delta Y_{t-1} + \alpha_i + \sum Y_{t-1} + \varepsilon_t$$

Where,

β_1 and β_2 : parameters,
 t : the time or trend variable,
 δ : drift,
 ε : a pure white noise error term,
 ΔY_{t-1} : $(Y_{t-1} - Y_{t-2})$, $\Delta Y_{t-2} = (Y_{t-2} - Y_{t-3})$, etc.

If the null hypothesis exists, for instance $\delta = 0$; then there is a unit root. Hence, the time series is non-stationary. If the alternative hypothesis exists, like δ is less than zero, then the time series is stationary.

2.4. Cointegration Test

Although variables are individually not stationary, I(1), and they have stochastic trends, their linear combination is between those variables may be stationary. In this case, those variables are cointegrated. Variables are cointegrated if they have a long-term, or equilibrium, relationship between them (Gujarati, 2003). In this study, Johansen Cointegration Test will be used to identify long-term relationship between variables. The test is run under the following form:

$$Y_t = \beta_0 + \pi Y_{t-1} + \sum \Gamma_i \Delta Y_{t-1} + \varepsilon_t$$

Cointegration exists if trace statistics is greater than the critical values. After we know the number of cointegration equations, then we can proceed to the VECM analysis.

2.5. Granger Causality Test

If a time series is a stationary process, the test is conducted using the level values of two (or more) variables⁵. If the variables are non-stationary, then the test is performed by using first (or higher) differences. The number of lags to be involved is usually chosen using an information criterion, such as the Akaike information criterion or the Schwarz information criterion. Any specific lagged value of one of the variables is held in the regression if it is significant according based on t-test, and the other lagged values of the variable jointly add explanatory power to the model according to an F-test. Therefore, the null hypothesis of no Granger causality is not rejected if and only if no lagged values of an explanatory variable have been retained in the regression.

Assumed y and x are stationary time series. To test the null hypothesis that x does not Granger-cause y , one first finds the proper lagged values of y to include in a uni-variate autoregression of y :

$$y_t = \alpha_0 + \alpha_1 y_{t-1} + \alpha_2 y_{t-2} + \dots + \alpha_m y_{t-m} + \varepsilon_t$$

Next, the autoregression is augmented by including lagged values of x :

$$y_t = \alpha_0 + \alpha_1 y_{t-1} + \alpha_2 y_{t-2} + \dots + \alpha_m y_{t-m} + b_1 x_{t-1} + \dots + b_q x_{t-q} + \varepsilon_t$$

One holds in this regression all lagged values of x that are individually significant according to their t-statistics, only if collectively they add explanatory power to the regression according to an F-test (whose null hypothesis is no explanatory power jointly added by the x 's). In the notation of the above augmented regression, p is the shortest, and q is the longest, lag length for which the lagged value of x is significant. The null hypothesis that x does not Granger-cause y is not condemned if and only if no lagged values of x are held in the regression.

2.6. Vector Error Correction Model (VECM)

Vector Error Correction Model is a restricted VAR used for non stationary variables to be cointegrated. VECM specification restricts the long run behavior of endogenous variables to converge to their cointegrating relationship (Abduh, Omar and Duasa, 2011).

VECM explains the adjustment of instability relationship from short term to long term equilibrium. This method is used to anticipate a loss of long term information as long as the data are cointegrated. In short run, there may be disequilibrium. The statistical significance of the ECT (-1) coefficient decides how quickly the equilibrium is restored. In general, this method is based on the following formula:

$$\Delta Y_t = \Sigma \Gamma \Delta Y_{t-1} + \mu_0 + \mu_1 t + \alpha \beta Y_{t-1} + \varepsilon_t$$

Where,

ΔY_t : $Y_t - Y_{t-1}$

$\Sigma \Gamma$: Regression coefficient matrix (b_1, b_2, \dots, b_i),

μ_0 : Intercept vector,

μ_1 : Regression coefficient vector,

⁵ Wikipedia.2013. Granger Causality, from http://en.wikipedia.org/wiki/Granger_causality, Accessed October 19, 2013.

- α : Loading matrix
- β : Cointegration vector
- γ : Variables used in the analysis

2.7. Impulse Response Function (IRF) and Forecast Error Variance Decomposition (FEVD)

Impulse Response Function (IRF) is a method used to set the response of an endogenous variable on a certain shock, since this shock might be transmitted to the other dependent variables through a dynamic structure or lag structure in the VAR model. IRF essentially plots the dynamic response path of a variable because a one-period standard deviation shock to another variable.

In addition, Forecast Error Variance Decomposition (FEVD) is used to check how the alteration in a variable, which is pointed by error-variance changes, is influence by other variables. Through this method, strength and weakness of a variable in affecting other variables in the long run can be analyzed.

3. Findings and Analysis

3.1. Quantitative Analysis

Quantitative analysis in this study consists of stationary test, lag optimum test, cointegration test, Granger causality test, VECM model, lastly IRF and FEVD analysis. Quantitative analysis basically purposes to find the determinant variables of economic growth in Indonesia.

3.1.1. Stationary test

Test of stationary are employed to indicate unit root in the variable. The investigation using Augmented Dickey Fuller summarize in Table 2 shows that all variables have unit root. However, when the first difference condition of all variables conducted using the same method ADF by comparing the level and Mckinnon value using 1%, 5% and 10 % alpha, those variables fulfill the requirement of stationarity since the absolute number in level (ADF) are greater than Mckinnon value.

Table 2. Unit Root at Level Test

Variables	T-Statistic	Mckinnon value (1%)	Mckinnon value (5%)	Description
LogIPI	-3.34097	-4.110440	-3.482763	Not Stationary
LogMS	-2.565752	-4.090602	-3.473447	Not Stationary
IR	-2.746411	-3.525618	-2.902953	Not Stationary

Source: Author's Own

Table 3. Unit Root Test on 1st Difference

Variables	T-Statistic	Mckinnon value (1%)	Mckinnon value (5%)	Description
LogIPI	-4.258518	-4.113017	-3.483970	Stationary
LogMS	-7.797086	-4.092547	-3.474363	Stationary
IR	-4.164869	-3.525618	-2.902953	Stationary

Source: Author's Own

3.1.2. Lag Optimum Test

This test is explained if lag used too small in the unit root test, thus the residual from the regression process will not perform the white noise process as a result the model cannot predict the actual error precisely. As a consequence, standard error will not be estimated properly. However, if there is too much lag, it will reduce the ability to reject H_0 due to the more parameter is included; it will reduce the degree of freedom. This is one of the important steps since in simultaneous equation variables are affected by the lag of its variable and by lag of other variable. By referring to Table 4, number of lag suggested by AIC is five.

Table 4. Optimum Lag Test

Lag	LogL	LR	FPE	AIC	SC	HQ
0	-208.5955	NA	0.111098	6.316283	6.415001	6.355346
1	53.14263	492.2239	5.88e-05	-1.228138	-0.833268	-1.071887
2	98.13752	80.58785	2.01e-05	-2.302613	-1.611589	-2.029173
3	112.1112	23.77620	1.74e-05	-2.451082	-1.463906	-2.060454
4	136.4865	39.29145	1.11e-05	-2.910045	-1.626716	-2.402229
5	161.2357	37.67784*	7.03e-06*	-3.380169*	-1.800688*	-2.755165*
6	164.0443	4.024311	8.62e-06	-3.195352	-1.319718	-2.453159

Source: Author's Own

3.1.3. Cointegration Test

A set of variable will be cointegrated if the linear combination among the variables is stationary even though the variables are not stationary individually. If it exists cointegration, it means there is long term equilibrium among the variables. In this paper Johansen Cointegration test is used to identify this relationship. From Table 5, by using alpha 5% it can be seen that there is minimal exist one cointegration.

Table 5. Cointegration Test

Hypothesized No. of CE(s)	Eigenvalue	Max-Eigen Statistic	0.05 Critical Value	Prob.**
None *	0.388675	32.97245	21.13162	0.0007
At most 1 *	0.265433	20.66778	14.26460	0.0043
At most 2	0.008775	0.590496	3.841466	0.4422

Source: Author's Own

3.1.4. Granger Causality Test

Granger causality test aims to obtain the information whether there is a relationship among variables. The relationship between two variables could be unilateral or bilateral. Unilateral relationship means only one variable could influence other, while multilateral relationship occurs when two variables influence each other. In this study, it is found that all variables have bilateral relationship among others. So for this case, it is proved that IPI significantly is affected by both IR and MS. The results of Granger causality test could be seen in Table 6 bellow.

Table 6. Granger Causality Test

Null Hypothesis:	Obs	F-Statistic	Prob.
LOGMS does not Granger Cause LOGIPI	68	2.90001	0.0212
LOGIPI does not Granger Cause LOGMS		4.79906	0.0010
IR does not Granger Cause LOGIPI	68	5.18313	0.0005
LOGIPI does not Granger Cause IR		7.19481	3.E-05
IR does not Granger Cause LOGMS	68	1.60541	0.1734
LOGMS does not Granger Cause IR		11.3999	1.E-07

Source: Author's Own

3.1.5. Vector Error Correction Model

Vector Error Correction Model (VECM) explains the adjustment of instability relationship from short term to long term equilibrium. This method is used to anticipate a loss of long term information as long as the data are cointegrated. Due to the usage of 1st difference can eliminate long term equilibrium since the entire variables used in this study are stationary at 1st difference level.

Table 7. Vector Error Correction Model

Variables	Coefficient	T-statistic
LogMS	-1.0110022	-4.26225
IR	-0.195788	-5.98128
C	42.55670	

Source: Author's Own

By referring Table 7, it is concluded that all independent variables have significant relationship to dependent variable. It is shown that both interest rate (IR) and money supply (MS) have negative relationship to the real sector output.

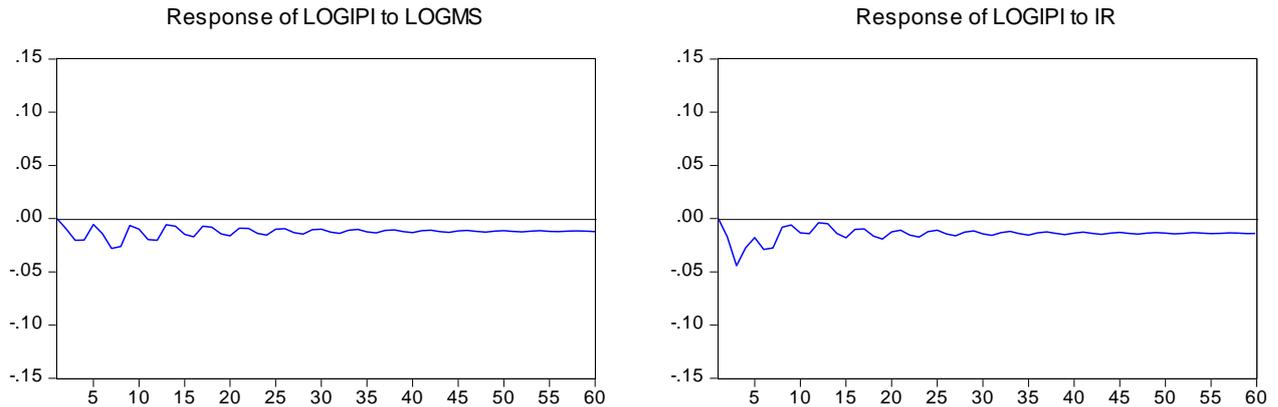
As explained in part 1, both interest rate and fiat money system create problem to the economy. Econometrically, it is proved that both variables have significantly negative relationship to the real economic growth. From the Table 7, it can be interpreted that when interest rate increases by 1 percent, the economic growth will decrease by 0.1957 percent, while if money supply increases 1 percent, the economic growth will go down by 1.011022 percent, holding the other variables constant. These findings are relevant to the theory that interest rate and fiat money system are sources of damage for the economy since it obstructs the economic growth in real sector. Interest rate basically decreases investment sector and causes liquidity trap, while fiat money system creates inflation.

3.1.6. Impulse Response Function (IRF)

The result of Impulse Response Function (IRF) on IPI to IR and MS could be seen in Figure 2. IPI has both negative response from the impulse of IR and MS. When interest rate increases, it leads to the decrease of economic growth and if money supply increases, the economic growth goes down.

Figure 2. Response IPI to MS and IR

Response to Cholesky One S.D. Innovations

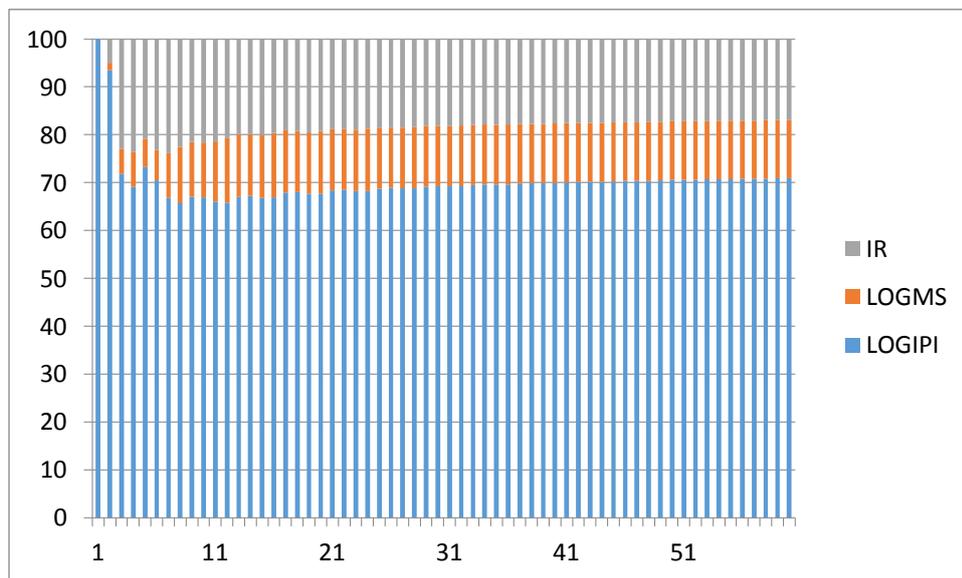


Source : Author's Own

3.1.7. Forecast Error Variance Decomposition (FEVD)

By referring to the Figure 3, it could be shown that interest rate has bigger influence to money supply. The result of variance decomposition shows that the influence of interest rate on IPI reached more than 16 percent, while money supply has about 12 percent.

Figure 3. Forecast Error Variance Decomposition (FEVD)



3.2. Qualitative Analysis

From the quantitative analysis, it can simply define main strategy to solve the economic problem due to the obstacles of economic growth. The obstacles for economic growth or root causes for economic problems in Indonesia econometrically find as interest rate and fiat money supply. The main solutions could be derived from these two variables. Firstly about eradication *riba* or public banking and other is the implementation of gold-dinar solution. The solutions taken by the rulers has to fulfill the *shari'ah* principles as the basic concept of *siyasah shar'iyah* to protect the objectives of life (*maqasid al-shari'ah*)

3.2.1. Eradication Interest: From View Point of *Siyasah Shar'iyah*

From explanation above, it is concluded that interest is one of the root cause of serious economic problem in the global situation. In reality, the application of interest mostly occurs in financial sectors such as banks or capital market. In Quran (2:275-278), Allah swt has strictly prohibited *riba* or interest. The application of interest violates *shari'ah* principle, so inevitably this is role of the government to uphold the *shari'ah* principle.

To eradicate interest system, rulers have to set up regulation, particularly for financial institution to write off the interest, thus the customers only pay for their interest. We have witnessed that so many firms, even it is big company collapsed due to their debts. The implication is the real sector will be shatter and unemployment rate will go up as many companies stop their production.

3.2.2. Islamic Banking and Public Banking

It might be difficult if government should directly regulate banks to write off all interest in short-run period. Actually there are alternatives for government to reduce the existence of interest. These alternatives have commonly taken place in some part of the world called Islamic bank system and public banking. The explanation about two these two financial institutions are explained as follows.

The most prominent objectives of Islam is to be aware greater justice in society. The existence of injustice in the society ultimately establish damage, including in economic system (Qur'an 57:25). Justice system in the economy will not be attained as long as interest based system occurs within. Conventional banks provide interest to both depositors and debtor and it creates unjust system, particularly for the debtors. They are transferred risk, from bank to debtors. Economically in long-run, interest creates liquidity trap in financial system which finally impact to the real sector. The increase of poverty and unemployment are resulted from this system. Because of interest-based, money only favor small group of people, thus the discrepancy between the rich and the poor become larger.

In fact, the financial system may be able to encourage justice, thus it would be strong and stable. In order to create an ideal financial institution, there are at least two conditions based on moral values (Adel, 2010). First, the financier must also share the risk, not to shift the entire burden of losses to the debtor. Second, an equitable share of financial resources spread by financial institutions has to be available to the poor to support poverty alleviation, expand employment and self-employment opportunities, thus it will decrease inequality of income and wealth.

Islamic finance comes up with no *riba*-based system since in Islam, interest or *riba* is strictly prohibited (2:275-278). Moreover, Islamic finance actually should require the two conditions above. Their system must be basically based on profit-loss sharing not prior to the buy and sell transaction as it occurs in the current situation. In addition, Islamic finance should consider the priority to develop small medium enterprises, thus it will slowly increase the economic growth, especially in real sector and eradicate poverty.

The government as ruler should encourage the growth of Islamic finance. Not only just to encourage, but also to control the transaction or *aqd* in Islamic banks, since nowadays sometimes it could be found contract that violates *shari'ah* principles as *bay inah*. In addition rulers may be able to encourage the microfinance institution which is free from interest and regulates the small tax for the institution or perform any cooperation of providing input variables or capital to the entrepreneur. The microfinance institution particularly points to small enterprise or agro-business system, thus real sector will grow up properly.

The other alternative for decreasing the effect of interest is to establish public bank. Compounding the interest on debt to private banks has carried us into dangerous situation. Public banks return credit as a public utility, and encourage local and regional economies since public banks invest in mankind need, not private institution.

Moreover, public banks work differently from commercial bank. Usually, the state works for the private banks, but the public banking model is that the state works for the benefit of the people. Complete transparency is crucial to avoid corruption of this essential public utility. The system has been applied in some region in U.S, though its implementation is still using interest, but with low rate. It is not recommended for using even in low rate, but actually its system to rid privatization in financial public has to be considered. If the public banking has to be applied in Indonesia or other *muslim* countries, the profit taken from *riba* should be changed by profit-loss sharing. In the other word, public bank's activities are like Islamic banking, but its profit is not only for private sector.

Its system purposes to welfare distribution, thus any profit payments charged by a state bank are return back into the state, either to reduce pressure for taxes, or as loans to fund economic development⁶. In detail, public bank is the use of the public funds of a constitutionally built government jurisdiction, such as a state, county, or municipal government, for the capital reserves of a banking institution. Subsequently, the use of those public funds by the banking institution generates affordable credit, investment, and profit for public purposes. Those public funds may incorporate tax revenues, investments, pension funds, and such hard assets as land and buildings.

Therefore, Islamic public banking might be one of the best solutions to rid the economic problems. Government as the regulator plays important role to insert this idea into the system. Moreover, financial system has an important role in economy, and if it is properly used for social interest, welfare and the five basic elements will be protected as it has already been proved, financial system will be one the crusher of economy unless it is handled by upright regulator.

3.2.3. Implementation Real Money: Is Gold Dinar Capable to Solve Economic Problems?

Gold is currently discussed about viable solution to the problems of the monetary system, including the highly destabilizing nature of flexible exchange rates. Gold played the role of money in one way or another for centuries until it lost this role in 1971 after the demise of the

⁶ Public Banking Institute. *Resurrecting Main Street: An Introduction to Public Banking*, from <http://publicbankinginstitute.org/public-banking.htm>

Bretton Woods. However, the current global scenario plagued with financial instability, crises and chaos have revived a renewed concern in gold, which is now being reconsidered as a possible shield in these troubled times.

In the gold payment system, gold is used as a medium of exchange and as a unit of account, in the place of the national or international reserve currencies, for settling international trade balances⁷. Price of exports and imports are to be cited in weights of gold. It is crucial that in this system, gold is used for pricing and not national currencies backed by gold, since otherwise it would not then be different from the gold standard of the past. As we affirmed earlier, instruments backed by gold are vulnerable for easy abuse, which brought about the failure of the gold standard.

Furthermore, in the gold dinar system, the central bank would play an crucial role of holding the national trade accounts and providing a guaranteed place to keep gold⁸. When Indonesia trades with Singapore for example, the gold accounting is held through the medium of the central banks of both countries and only the net distinction between the two is fixed periodically. Notwithstanding, every transaction, in essence, indicates gold “movement”. As bilateral and multilateral trades are ongoing process, any gold that needs to be fixed can always be brought forward and be used for future transactions and settlements. In addition, commercial banks that support gold accounts are active partners in the practice of the gold dinar system. International trade and finance participants would commit with their respective commercial banks that accommodate such gold accounts. These commercial banks would obtain gold accounts with their respective central banks. The above structure may sound a lot like the gold standard, but it is not.

For instance, let say that Indonesia exports 150 million gold dinar (GD) worth of goods and services to Malaysia while importing 120 million GD worth of goods and services. Therefore, Indonesia has a surplus trade of 30 million GD. Indonesia needs to complete only this difference of 30 million GD. Yet, this amount could be bought forward for fixing future trade imbalances between the countries, thus a physical gold movement between the countries is not important. It notices that this simple structure wipes out exchange rate risk. It means there is no need for forward, futures or options on currencies. Countries, including those without derivative markets are able to enjoy this profit.

Furthermore, with gold dinar the hedging cost is settled against gold. Actually, hedging which is conducted in any currency denomination, there will still have risk from the fluctuation of that currency. Nevertheless, gold is superior here since unlike fiat currencies, it has intrinsic value of its own. While the international gold price may fluctuate, the participants in a gold dinar system realize that gold has stable intrinsic value that can be depended upon for continuous trade into the future⁹.

⁷ Meera, Ahamed Kameel Mydin, and Moussa Larbani. 2003. The Gold Dinar: The Next Component in Islamic Economics, Banking and Finance. An initial draft of this paper was presented at the *International Conference on Banking*, organized by the Monash University, 9th and 10th September 2003, Prato, Italy, p. 11

⁸ Meera Ahamed Kameel Mydin, and Moussa Larbani. *ibid.* p.11

⁹ Meera Ahamed Kameel Mydin, and Moussa Larbani. *ibid.* p.12

Similar to a common currency, the gold dinar would also decrease speculation and arbitrage among national currencies. For instance, if three countries approve to use the gold payment system, so it is akin that the three currencies end up with a single currency. Consequently, speculation and arbitrage among those three currencies will be reduced or even eliminated, thus it contributes to greater economic efficiency. This “unification” of currency gives diversification profits as a portfolio of shares. In reality, due to people of every race, creed and nationality treasure gold, gold is appropriate global currency that benefits global diversification. It leads to be no single country’s characteristic risk may be significantly embedded in gold.

The gold dinar possibly decreases transaction costs as well, because only accounting records require to be kept. Transactions can be operated by electronic mediums with minimal cost¹⁰. Therefore, for international trades in this system, one no longer needs to involve exchange rate transaction costs or even deal with exchange rate risk. In other words, the gold dinar can be prospective to result exchange rate stability.

The gold dinar system decreases the requirement to create large amounts of national currencies through multiple credit creation in the banking sector as well¹¹. Thus, it minimizes the risk of excessive speculation and future attacks on national currencies. The current global financial system shows such signs of serious instability, which is partly but significantly because of the nature fiat money. In reality, fiat money seriously creates out of nothing and gets destroyed in certain circumstances. Nevertheless, gold has all the characteristics of ideal money, like it is desired and highly valued for its own sake, homogenous, stable, durable, divisible, and mobile. and can neither be created nor destroyed¹². Therefore, it plays the role of a stable international unit of account that is seriously missing in the current floating exchange rate system. As such, gold can be intended to significantly increase trade.

Consequently, applying gold standard is able to encourage the growth of economic and solve problems created by fiat money. Government should take this consideration in order to save its nation from the more serious damage caused by current system. This regulation inevitably brings much benefit to mankind.

5. Conclusion Remarks

Global economic crises occurred in current situation brings us to reconsider the system existed in the world. Fiat money and interest are suspected to be the most causes in economic problem. Econometrically, those variables have negatively relationship with economic growth in real sector.

To solve the problem, government role needs to be involved in term of providing regulation of its nation. Eradicating interest, establishing proper financial system like Islamic banks or public bank, and applying gold dinar system are solutions proposed to prevent the economic from the serious damage. Those solutions are expected to be implemented to protect the five basic components, which are life (sovereignty), faith, intellect, posterity, and wealth.

¹⁰ Meera Ahamed Kameel Mydin, and Moussa Larbani. *ibid.* p.13

¹¹ Meera Ahamed Kameel Mydin, and Moussa Larbani. *ibid.* p.13

¹² Meera Ahamed Kameel Mydin, and Moussa Larbani. *ibid.* p.14

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