

# Islamic State, Islamic Economy, and *Siyasah Syar'iyah*: An Islamic Political-Economy Approach

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## Abstract

*This research paper is intentionally designed to build a framework of Islamic economy into one picture of Islamic state concept. The research paper employ quantitative and historical approach. The result of geometric mean computation showing the growth of money supply in Iceland is higher than the growth of real GDP and the inflation rate reaches 18.91 percent. The regression analysis is carried-out based on natural logarithm (Ln) model. The estimated coefficient of M1 in Iceland is much higher than the estimated coefficient of GDP. This result also supports the finding of geometric computation. In other words, there is an economic problem in Iceland created by the working of compounded fiat-money interest rate. It has implicitly proven that since the power of Islamic government is absent in this world, then the Islamic state will never be established. Therefore, the need of siyasah shar'iah to build Islamic government before establish Islamic state becomes an obligatory.*  
**Keywords:** Islamic Economy; Islamic State; Islamic Welfare; Siyasah Shari'ah; Maqasid al-Shari'ah.

## 1.1. Introduction

During 2008 to 2011, European countries were in amidst of badly debt crisis. Economic crisis is viewed in Islam as a corruption (*fasad*) due to the disobedience of a man to God who thinks that there is no judgement after this life in the world

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(*duniyah*). The fall of economies in many countries into debt crisis becomes a proof how human being disregards his function as a vicegerent (*khalifah*) who carries trust (*amanah*) solely for worshipping in the sake for Allah SWT. Man, henceforth, is created to be a vicegerent of Allah along with trust bear on him in the earth. The debt crisis fundamentally come up from the creation of money through fractional reserve banking, compounded interest rate, and seigniorage. Not only it affects negatively in the economic sector, but also it significantly influences the whole life of human being. Unfortunately, these facts still unable to eliminate interest rate in the economy activities, both in individual and state level. This issue has been discussed not only in Islam, but also in Judaism and Christianity. Pro-usury (*riba*/interest rate) groups have believed that usury is a main foundation and a part of global economic system. They argue that interest rate is an obligatory due to it compensates those who sacrifice their consumption now for some potential future profit, i.e. it is designed to protect investment from the effect of inflation. Thus, interest rate becomes the price of money and still “rationale” to be existed in the economy.

Islam discourages a muslim borrow money due to irrational reason, for instance, to follow the modern life style. Unfortunately, since the rise of western world and the detriment of muslim world, the issue of debt becomes wider. In the later stage after the muslim live in backwardness, the interest rate is legally imposed on debt. Debt now is somewhat called as a “lifestyle” and it has many impact on socio economic life. *Credit card*, for instance, becomes a thing that must be had, particularly for “modern executive”. Therefore, the elimination of interest rate in the economy becomes a major agenda in the economic system. The absence of Islamic power to intervene the establishment of free-interest economic system constitutes as a main reason why does this system still remains in the level of discussion. It is impossible to implement the ideals of Islamic sociopolitical and economy, establish Islamic law, education and civilization without Islamic state (Syukri, 1999). The order to do good deeds and avoid the harms will be wholly apply if there the power and authority exist in the social activities life. In other words, the Islamic political

instrument must be built in the form of a Islamic nation (state) which will ensure the the maximization of universal common good, e.g. promotion of public welfare and enforcement of law.

Reffering to this background, hence this research paper is intentionally designed to build a framework of Islamic economy into one picture of Islamic state concept. Since politic and economic are two sides of a coin, hence this research paper is designed to combine the economic and political matters in order to build islamic state. The writing organization of this research paper will be classified into 5 parts. Part 1 explores the background of the research. Part 2 shed light on the rising issues come up in moslem countries, namely *siasah syar'iyah*, *khilafah* and Islamic Finance. Part 3 summarizes previous literatures related to the concept of Islamic State, *shari'ah* governance and *maqashid al-shari'ah*. Part 4 analyzes the rising issues from Islamic point of views and construct to build a framework of Islamic economy into one picture of Islamic state concept. Some conclusions and policy implications are presented in Part 5.

## **1.2. Paper Contributions**

Many previous research focus of research in Islamic economics is concentrated on the function of Zakah, Infaq, Sadaqah, and case study of Sharia Banking. In the other words, only few of conducted researches in Islamic economics are explored by involving Islamic political approach. Therefore, this study will especially contribute to fulfill the gap of literatures in Islamic economics and politics analysis.

## **2. Literatures Reviews**

### **2.1. Shari'ah Governance<sup>4</sup>**

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<sup>4</sup> Summarized from Putriani, Diah; Warsono, Sony; and Amalia, Fitri. 2012. "Corporate Governance and *Shari'ah* Governance: Revisited Three Basic Elements of *Shari'ah*

Allah is the creator of this universe. Only Him who knows the needs of all His creation since He has perfect insight to protect of what presence on the earth and in the heaven. Allah, thus, has an eternal attribute of divine (great) and absolute right to govern His creation. For the glory of Allah, the highest knowledge is placed in His hand. There is none same equal to Him. These perfect insight of knowledge, governance, and protection from Allah The Almighty which is called as the divine governance. Ibn ‘Arabi (1997) in his book explains that the creation of universe is a greatness (the gifts) of Allah for mankind. The divine governance, hence, focuses on how Allah directs human beings by bestowing them a guidance of light in life (Al-Qur’an), setting His unity in the hearth of man, and supervising to find Allah. The belief that Allah is the absolute ruler who perfectly manage the entire universe will direct a man to understand divine governance. *Shari’ah* governance, in this context, refers to the concept divine governance. Therefore, every individual needs to learn a basic understanding of the oneness of God.

*“Knowest thou not that Allah knows all that is in heaven and on earth? Indeed it is all in a Record, and that is easy for Allah.”*<sup>5</sup>

*“Say: He is Allah, the One and Only! Allah, the Eternal, Absolute; He begetteth not nor is He begotten. And there is none like unto Him.”*<sup>6</sup>

The relationship between the oneness of God and divine governance lies on the confession of a man against the existence of God as the sole creator and director for everything that presence in this world. In Islam, this relationship is known as an *aqeedah* (faith of monotheism doctrine). Ibn ‘Arabi (1997) elucidates that the abjuration of oneness of God is a form of ignorance. It implies that the oneness of God is basic foundation, hence, every believers must understand of oneness of God in all aspect of their worldly life.

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Corporate Governance Framework”. Paper presented in 5<sup>th</sup> International Conference on Islamic Banking and Finance. Amman, Jordan: October, 6<sup>th</sup>-8<sup>th</sup> 2012.

<sup>5</sup> QS. 22: 70

<sup>6</sup> QS.112: 1-4

*“When thy Lord drew forth from the Children of Adam - from their loins - their descendants, and made them testify concerning themselves, (saying): "Am I not your Lord (who cherishes and sustains you)?"- They said: "Yea! We do testify!" (This), lest ye should say on the Day of Judgment: "Of this we were never mindful"”<sup>7</sup>*

Praying without believe in faith (*aqeedah*) will not be admitted by Allah. Here, a one who has a strong faith will do praying, do good deeds, and do economic activities (*mu'amalah*) in line with Islamic values. It means a right *aqeedah* will direct a moslem do implement Islamic rulings in his daily activities. Historically, Rasulullah SAW even focused only on his preaching by building a hefty *aqeedah* during 13 years of his periode of life time in Mecca. Thus, in the next period of life in Madinah, Rasulullah SAW could easier deliver the true message of Islam.

*“Recite, [O Muhammad], what has been revealed to you of the Book and establish prayer. Indeed, prayer prohibits immorality and wrongdoing, and the remembrance of Allah is greater. And Allah knows that which you do.”<sup>8</sup>*

## **2.2. The Islamic Concept of State and Welfare**

Islamic state is a community based on belief. It implies that the Islamic state constitutes as an ideological state confirming the application of *shari'ah* governance in all of members' life aspects. The significance of Islamic state is pointed on the establishment of Islamic order in the moslem society. When the Qur'an reveals of rules and laws, the very fact that these rules are mentioned and meant for implementation shows that there has to be an authority to carry them out. Therefore, it is proposed that for the moslem ummah, the establishment of an Islamic political order or an Islamic state is part of the implementation of faith. The Islamic state is empowered as a political instrument for ensuring the enforcement of law, human rights, and God's will (Islamic values). In detail, the goals of Islamic state are to prevent injustice and to establish all-encompassing justice-legal, social, economic and

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<sup>7</sup> QS. 7: 172

<sup>8</sup> QS. 29:45

political, including to ensure to all non muslim citizens complete physical security as well as complete freedom of religion, culture and social development. Hence, the teaching and preaching of the message of Islam can be delivered to whole *ummah*.

It is impossible to implement the ideals of Islamic sociopolitical and economy, establish Islamic law, education and civilization without Islamic state (Syukri, 1999). The order to do good deeds and avoid the harms will not be comprehensively implement if there is no power and authority. In other words, the presence of politics based on Islam (*siyasah syar'iyah*) must be first applied. Since Islam guarantees for attaining welfare in this world and hereafter, hence, the Islamic state becomes an instrument to realize the spiritual in human organization. The state technically operates by institutionalizing *shura* as a consultation-consensus model. The principle of *shura* was revealed in the late of Mecca period which Al-Qur'an confirmed and incorporated in Islamic values. It was a concensus institution in terms of a counsultative council or assembly where tribal and political leader decided collective decisions after discussing the problems happening amongst themselves (Haq, 1991).

In fact, present system of politics the opportunity for Islamic state to be established is eliminated. Silent of Islamic politics means absence of Islamic civilization, including Islamic economy. Unfortunately, the existing economic system can not solve many human problems of economic. In this admist of fluctuation, the birth of Islamic economics as a "new paradigm" in conventional economics theory offers an alternative hope for the elimination of misery. Khan and Syed (2009) reveals that the fiasco of capitalism is obviously observed, i.e., it remains a small of minority achieving unprecedented high material standards of living, yet there is a vast majority of the people on the globe live under conditions of abject poverty. Here, capitalism recognises the absolute individual freedom. On the contrary, socialism refuses capitalism doctrine and offers the absolute role of government in individual life, including in economic aspect. In fact, the market of socialist countries have already flooded by capitalist countries product. In all probability, the outcome will be

no different since they will keen to adopt the capitalist lifestyles as well as economic strategies.

Since capitalism and socialism are established by human who unbelieve to the existence of Allah, hence only Islamic economic offering a comprehensive solution for all of human economic problems. In other words, Islamic economic is not an alternative solution, but it is the only solution for all of these chaotic. Islam, in this context, offers two dimension protections of moslem *ummah* rights and obligations, both materially and morally. The Islamic system of protection, according to Jauhar (2009), is widely known as *maqashid al-shari'ah* or the very objective of Islam which covers five basic elements of life (*al-kulliyat al-khams/adh-dharurat al-khams*). The *Maqasid al-shari'ah* underlines the concept of *maslahah* which is includes the enhancement, preservation and safeguarding of five basics ('Usul). The ultimate goal of *maqashid al-shari'ah* covers the lives of individual and society at large; in this world and hereafter. It implies that *maqashid al-shari'ah* must be understood as a comprehensive image of Islam.

Khan and Syed (2009) explain that moslem jurists have unanimously herld that catering to the welfare of people and relieving them of hardships is the basic objective of the shari'ah, hence of the Islamic state. It implies that the concept of Islamic welfare state is derived from the very objective of *shari'ah* or *maqashid al-shari'ah*. *Shari'ah* literally means the flow of water. The concept of *Shari'ah* regulate two wholly technical aspect, i.e., *ibadah* (worshiping) and *muamalat* (the rules related to worldly activities, e.g. economic, social and politics). In other words, it implies that the law of Allah is created to governs humans relationship with Him and others. Islamic teaching, hence, encompasses all of people's life at large (Warsono and Jufri, 2011; Khir, et.al, 2008).

In detail, Al-Ghazali divides a binding of *maqashid al-shari'ah* into five safeguardings, namely life (sovereignty), faith, intellect, posterity, and wealth (in Meera and Larbani, 2009). Everything that add a utilization to five basic things is a *Maslahah* (benefit), and vice versa everything that give bad effects to them is a

*Mafsadah* (harm). The urgency of *maqashid al-shari'ah* is to achieve the glory (falah). Government, as *ulu'amr*, must protect these five elements in order to pursue the blessing of Allah and to attain the welfare of moslem *ummah*. Quoted from Khan and Syed (2009), the welfare function of the Islamic state was particularly stressed by Prophet (PBUH) when he stated “Any ruler who is responsible for the affairs of moslem but does not strive sincerely for their well-being will not enter paradise with them”.

Unfortunately, there are so many ruler and *moslem* scholars advocating the evil of interest (*riba*) which has been strongly promoted by capitalism, but prohibited by Islam. The presence of interest in the economy will inhibit the objective of *shari'ah* due to its harm the economic justice. In brief, Khan and Syed (2009) elucidates that the welfare of individuals as well as society in an Islamic state may be attained if there is proper environment for a fuller realizes the values of Islamic spiritual and satisfies of all basic needs of life.

### **2.3. Rising Issues in Moslem Countries: Islamic Economic and *Siyasah Shar'iyah***

Every country usually has its own regulation related to law, politic and economic strategies. Some of moslem countries apply *shari'ah* principles to regulate their states. In this context, a broad doctrine of Islamic law which authorizes the ruler to determine the manner of which *shari'ah* must be administered is called as *siyasah shar'iyah*<sup>9</sup>. According to Ibn Qayyim, “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 (PBUH) nor regulated by Divine revelation. Any one who says that there is no *siyasah shar'iyah* where the *shari'ah* itself is silent is wrong and has misunderstood the companions....” (p.61). Related to *siyasah shar'iyah*, the belief of Islam encompasses all aspects of a

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<sup>9</sup> Ibn Qayyim in Kamali, Mohamad Hashim. 1989. “Siyasah Shar'iyah or the Policies of Islamic Government”. *The American Journal of Islamic Social Sciences*, vol.6 No. 1,1989 pp. 59



*Moslem's* life, causing the articles of their faith and the relationships between man and God, and between human beings in which Islamic law regulate in *Shari'ah* principles. Islamic law or *Shari'ah* as revealed in and derived from the Quran and Sunnah rules all politic, economic and social activities and works of *Moslems*.

For over time, Islamic economics model has been developed which is based on the rulings of *Shari'ah* on commercial and financial transactions. The Islamic financial framework as seen today, stems from the principles developed within this model, some of which are outlined as follows (Ainley, *et.al*, 2007):

- The Islamic economic model emphasises fairness. This is reflected in the requirement that everyone involved in a transaction makes informed decisions and is not misled or cheated. On a macro-economic level, the Islamic model aims at social justice and the economic prosperity of the whole community; for example, specific *Shari'ah* rulings seek to reduce concentration of wealth in a fewhands, which may be detrimental to society
- Islam encourages and promotes the right of individuals to pursue personal economic well being, but makes a clear distinction between what commercial activities are allowed and what are forbidden. For example, transactions involving alcohol, pork-related products, armaments, gambling, and other socially detrimental activities.
- One key *Shari'ah* ruling on economic activities of *Moslems* is the stricly prohibition of *riba*. *Shari'ah* scholars consider exchanging interest payments within the conventional banking system as a type of *riba*. Modern Islamic banking has developed mechanisms to allow interest income to be replaced with cash flows from productive sources, such as returns from wealth generating investment activities and operations. These include profits from trading in (real) assets and cash flows from the transfer of usufruct (the right to use an asset), for example, rental income (Bahrain Monetary Agency, 2002).

The application of Islamic economic can be seen in Islamic finance and banking. In terms of history, Islamic finance started in earnest in the 1970s with personal initiative of the concerned *Moslems* to address the problem of *riba*. Its growth has been accelerated in case of some countries that operate and also the areas of finance which has been exerted. But one of the problem is some of reliable data are not available in case of Islamic finance at the country, regional, or global levels. In current years, many Western multinational financial institutions such as Citigroup and HSBC that established offering Islamic financial products in some Arab countries (especially Bahrain and UAE) and also to a lesser extent in Western world ((including the USA and UK, where HSBC offers various Islamic financial products in New York and London, including home financing, checking accounts, etc) have been attracted by this industry. Dusuki and Abdullah (2007) find out how to distinguish between Islamic banking paradigms and model to conventional banking. Islamic banks purpose to create a fair and balanced society as prescribed by the Islamic economics. Choudhury and Hussain (2005) state that since the twentieth century Islamic banks have emerged and they rely on the resources based view to offer banking services. All financing instruments are based on the Islamic law. The prominent idea of Islamic banking is the prohibition of interest and profit loss sharing. Ghannadian and Goswami (2004) state this by conforming that the main Islamic banking principles are risk and profit loss sharing.

Furthermore, nowadays Islamic finance has spread to some areas in Asia, and it has grown fast in Eastern of Asia especially Malaysia. This country became the first to found the Islamic Inter-bank Money Market (IIMM), the full-fledged Islamic stock broking company, the corporate sukuk (Islamic bond) and the Islamic unit trust. However, there is such a pro-contra opinion in Islamic banking in Malaysia since its government allows *bay al-inah* or buy back sell transaction. The Malaysian *shari'ah* scholars validate the practice of *bay al-inah* based on two

main justifications<sup>10</sup>. Firstly, they state that the contract is not clearly prohibited either in the Quran or in the Sunnah. They do not admit the validity of the hadith which indicate the prohibition of the contract.

Secondly, the Malaysian scholars argue on the basis of *maslahah*, in which refers to the need of *Moslems* contemporary society. The scholars admit the argument that, for instance, credit card has become an important banking facility for majority of *Moslems*. In today's world, the card is important for daily business dealings and commercial transactions. Wondering this case, the scholars support the bank's idea to create a credit card that is *shari'ah* compatible. In this terms, *bay al-inah* is seen as a key contract due to it provides a *makhraj* (mode of problem solving).

In this case, *bay al-inah* implemented in Malaysia mosly is due to the rulers analyse this contract will bring *maslahah* to arouse Islamic banking in Malaysia, particularly at the first periode of Islamic banking estabilished. In perspective of *siyasah shar'iyah itself*, any measure that brings people closest to *maslahah* and furthest away from *mafsadah* partakes *shari'ah*, even if it has not been proved by Prophet (PBUH) and Divine revelation.<sup>11</sup> *Bay al-inah* as perspective of Malaysia's government has brought any *maslahah* those mentioned above. In the other country such as Bangladesh, Islamic banks have been operating in Bangladesh for about one and half decade alongside with the conventional banks.<sup>12</sup> Out of over 39 banks only five banks (including one foreign Islamic bank) and two Islamic banking branches of a conventional bank have been working on Islamic principles. Such as any other conventional banks, they do manage deposits and produce loans. But their modes of operation, based on *shari'ah* principles is different from the other conventional

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<sup>11</sup> According to Ibn Taimiyah in 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

<sup>12</sup> Sarker, Md. Abdul Awwal. "Islamic Banking In Bangladesh: Performance, Problems & Prospect". *International Journal of Islamic Financial Services Vol. 1 No.3*.

banks. However, the five Islamic banks operating in Bangladesh are Islamic Bank Bangladesh Limited (IBBL), Al Baraka Bank Bangladesh Limited (Al-Baraka), Al-Arafah Islami Bank Limited (Al-Arafah), Social Investment Bank Limited (SIBL), and Faysal Islamic Bank of Bahrain EC (FIBB) .

### 3. Data and Methodology

Given the objective of the present researches, data requirement and the availability of time and resources, this study is gathered data from secondary sources, such as Central Bank of Iceland, and International Financial Statistic International Monetary Fund (IFS IMF). This research will employ both of quantitative and qualitative methods for analyzing data and object of study. In short, the qualitative method applies historical approach and policy study analyzes in order to strengthen the analysis. Meanwhile, the quantitative methods cover financial and econometric analysis as follows.

Financial analysis is applied in order to explain the economic conditions and to proof the negative impact of the presence of interest rate in the economic system. To do so, this research will observe macroeconomic of Malaysia as a case study. The geometric mean of both money supply (M2) and the geometric mean of real GDP are computed, as follows:

$$FV = PV (1+i)^n \quad (1)$$

where,

FV : Future value

PV : Present value,

$i$  : Interest rate

$n$  : number of years.

After calculate the geometric mean, then we compute the inflation in Iceland, as follows.

$$\text{Inflation} = \frac{1 + \text{Geometric mean for M1}}{1 + \text{Geometric mean for GDP}} \quad (2)$$

The Ordinary least square (OLS) as an econometric model will be used for assessing the estimated coefficient. Both M2 and real GDP are measured in natural logarithm (Ln) in order to smoothen the results. Each of M2 and real GDP are regressed through the time aimed to capture the trends of those variables over 10 years. **The econometric model used in OLS** are built as follows:

$$\text{Ln M1} = \alpha_0 + \beta_{1t} \quad (3)$$

$$\text{Ln Real GDP} = \alpha_0 + \beta_{1t} \quad (4)$$

where,

t : time as the data collected from 2000 until 2010

Real GDP: Measuring the real economy.

M2 : Consisting M1 plus short-term investment accounts such as time deposits, money market deposits accounts, money market mutual fund shares.

Notice, if the coefficient of M2 is bigger than the coefficient of real GDP, thus the country is occurring severe economic problems, i.e., money supply grows much faster than real GDP. In other words, it indicates that the real side of economy incapable to compete with the monetary side of the economy and leave the country with several economic problems.

#### **4. Islamic State and Islamic Economic: A Preliminary Framework**

##### **4.1. Islamic Government Towards Islamic State**

Islam nowadays plays different roles in the governments of countries where moslem are in the majority. Its role in government, however, varies widely even in predominantly moslem countries. Lineback (2005) divides the role of Islam into four categories as follows. Amongst 44 moslem countries around the world, 10 are declared Islamic states meaning that Islamic law is deeply applied into the

constitutions of these countries, including the obligation for women to cover their bodies from head to toe. There are 12 countries that have declared Islam as the state religion, but whose civil laws do not specifically follow *shari'ah*. The *ulema* (clergy) is powerful in these countries, but not all powerful. These countries may have civil courts that are independent from the *ulema* and government officials who are not clergy. The harshest forms of *shari'ah* are typically avoided and governments tend to be more liberal toward personal behaviors than those in Islamic states. These first two groups are considered the core of Muslim countries across southern Asia and North Africa. Next, in the third category there are 11 states whose constitutions simply do not declare any religion, hence some Islamic laws are not applied. These 11 countries are located peripheral to the geographic core of Muslim states. Finally, the fourth group includes declared as secular states whose constitutions acknowledge the diversities of religions within their borders, so that adherents of all religions have some constitutional rights. This is a very significant issue because minorities are afforded some protection under civil law.

Referring to these categorization, it implies that Islamic state will be established since the agent deals with Islamic values, i.e. Islamic government. Although, there are 10 countries declared as Islamic state, however, the presence of interest rate in the muslim countries economy has implicitly proven that the power of Islamic government is absent in this world. Here, the need of *siyasa shar'iah* to build Islamic government before establish Islamic state becomes an obligatory. Since the politic system is under Islamic law, hence the governance of all transactions in society will invoke with *shari'ah* rulings, including economic activities. In this matter, Islam concerns on the establishment of an economic system in order to guarantee the sustainability of two broad elements, i.e. (a) accomplishment of basic needs for all individual within society including those who may be incapacitated or handicapped and (b) a fair reward of extra comfort elegance to the superior skill and enterprise through lawful means. The basic needs, specifically, are food, clothing, and shelter (Khan and Syed, 2009).

#### 4.2. Islamic Government and Islamic Economy

Historically, under the reign of caliphate Sayyidena Omar Ibn Al-Khattab, the economy of moslem *ummah* was a resource-surplus. In this case, fiscal policy effectively worked and became one of the economic engine through foreign trade expansion. Meanwhile, monetary policy was not intensively applied to stabilize the economy. The economy worked in real things and the politics system was applied under the rule of *Shari'ah*. As of Tahir (2011) explains that international trade and mobility of resources provide a natural huge opportunities for building networking with the foreigners and spreading the word of Allah SWT to the world. Government might work toward opening of the economy through developing economic protocols and agreements. In other hand, the economic system of capitalism in recent day is designed for those who greed towards the worldly things. The welfare will never be hold particularly for moslem *ummah*<sup>13</sup>. Meera and Larbani (2009) reveals that the seigniorage of fiat money, the fractional reserve banking (FRB) and interest rate constitute the root cause of uncontrollable fluctuation in the economy creating crises in many countries since this system has been implemented.

Many *ummah* in moslem countries fall under the poverty line. Since interest rate was introduced in the economy and the monetary system was changed from gold base to fiat money, the whole economy of moslem countries is then somehow controlled by the *riba*-system. A gap between real and financial sector becomes much larger and the economic growth is driven by financial sector, e.g. secondary market activities creating bubble economy. Either the economic crisis of Southeast Asia region in 1997 or the occurrence of environment disaster today are the obvious “product” of this system. In this case, referring to Hardi, et.al. (2012) the root cause of natural calamity in Indonesia deforestation is originally “created” by human

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<sup>13</sup> *Ummah* refers to society of moslem.

being's decision. Since the government, as the *ulu' amr*, agree to deal with economy-interest rate based, thus the "created" disaster will never be avoided.

The two broads elements, as stated earlier, will never be attained under the economic of capitalism as prevails today creating chaotic situation. Islam has prohibited money to be treated as commodity. Unfortunately, the fiat money refers to paper money used widely around the world since the demise of the Bretton Woods in 1971. This fiat money does not have intrinsic value since it does not backed or redeemable by gold. The printing of fiat money enthrone its creator immediately has purchasing power without bearing any risk. Seigniorage constitute the benefit derived from the first use of fiat money. Meanwhile, the FRB means a commercial bank needs to hold a fraction of the deposits of its customers as reserve, while the remaining can be lent out (Meera and Larbani, 2009). The current instability in the existing economic and monetary system is due to the presence of interest rate. Here, interest rate plays important role that become the engine of this system instrument. The work of FRB, stock or arbitrage activity in banking industries and secondary market will be nothing if there is no interest portion on it. By employing interest rate on the financial instruments, hence it will create ownership out of nothing, without effort and risks, especially for the lender and broker.

Considering these matters, government officers particularly in moslem countries should act as an *ulu'al amr* who supervise and regulate the economy and social activities in line with *shari'ah*. It implies that government might not become an economic agent i.e., it is forbidden to be involved in the economic activities. It is an unfair trade if government is allowed to be a player in the economy due to they will benefit their power for regulating market deals with the main economic purpose, i.e. earning profit. However, Islam does not neglect the role of government to interfere in the situation that might lead to injustice or disputes among the market player. Besides, the market regulation must observe the *shari'ah* rules and regulation in any of its economic transactions. The silent of *ulu'al amr* will cause instability in the society, e.g. the presence of interest rate in the economic system as explained



above. To this end, government officers as an *ulu'al amr* must know the *shari'ah* rulings in all aspect since he will also act as an agent who directing the life for moslem *ummah*. In fact, in the early era of Islamic state under Prophet PBUH until for Caliphs, the election of leader (government) became a crucial agenda. All of for caliphs basically did not want to be an *amirul mukminin* (leader of Islamic state) since they realized that the tasks of government are very serious and hard. .

Generally, Kahf (2000) elaborates the aims of Islamic government in the economy is constituted from the economic objectives of Islam itself as a way of life. Basically, the economic objective in Islam is based on 2 (two) main involved sectors directly, i.e., private sector and public sector. Meanwhile, philanthropic sector might be regarded as indirectly economic sectors which enables the government to generate revenue through *zakah*, *infaq*, *sadaqat* and *awqaf* since the taxation is not a rule. In Islamic system the economic objective for private sector i.e. individuals system are to comply with the individuals basic needs and wants by earning sufficient income, and to construct welfare and prosperity on the earth.<sup>14</sup> Meanwhile, the economic objective in Islam for public sector i.e. Islamic Government can be classified in two general tasks. The first task is to encourage the private sector to attain material joy, construction, and welfare. This attainment can be acquired by controlling and monitoring the economic activities of private sector in providing basic needs to individuals. If necessary the Islamic government shall fill the gap of production and distribution. The second task of economic objective in Islam for public sector is to safeguarde the moral value of *shari'ah* in economic activities and promoting “the boundaries of what is known as good and as bad”. To do so, the government shall establish *Al-Hisbah* (ombudmanship).

Kahf (1991) and Islahi (2008) further explain that the function of *al-hisbah* is aimed to control the activities and transactions of the market from three sides, namely (a) all of activities and transactions must under the rules of *shari'ah*, (b) all of

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<sup>14</sup> Al-Qur'an verses 11:61, 30:9, 9: 19 and 52:4

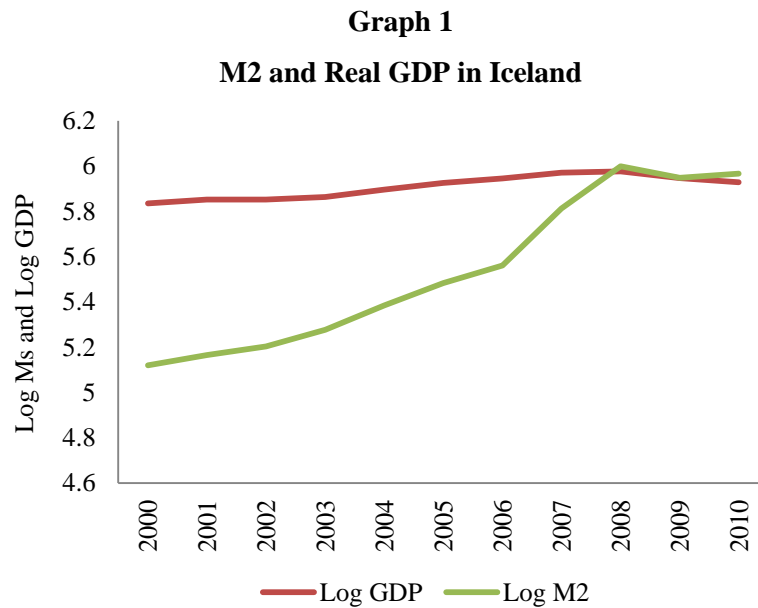
activities and transactions have to fulfill the moral value of Islam as a belief system (c) the ombudsman (Muhtasib) is also assigned with the task to ordain “what is known as good and as bad”. In detail, Al-Hisbah has some functions such as to control the quality, shari’ah, moral, environment and health. This legislation must ensure that there is no monopoly in the market. Further, the most important tool in Islamic market regulation is pricing aimed to avoid inflection of injustice giving negative effect on the market. Subsidies, licensing, registration and the use of iqta’, ihya and hima are the direct tools in Islamic market regulation.

## **4.2. Islamic Financial Architecture**

### **4.2.1. The “Evil” of Interest Rate**

The issue of the tools of market regulation in Islam is derived from the God revelation consisting of 2 parts, which are *Maqasid al-Shari’ah* and few issues in Sharia’ah rulings. Here, the few issues in sharia rulings deal with the government interventions in the market, e.g., establishing *al-hisbah* (ombudmanship). Since Islam does not admitted trading money for money, hence the fiat-money (paper money) is not admitted. Debt crisis occurred in Eurozone in the middle of 2008 is a product created by the working of compounded fiat-money interest rate as what happened in Iceland. The debt crisis in Iceland was mainly due to higher external debt in view of the failure of the banking sector. It was supported by easy access to cheap money from abroad that have primarily been driven by borrowing from the corporate, government (to finance government spending) and household sectors (domestic consumption). Net debt as percentage of GDP in 2009 was climbed to 55.79 percent compared 7.81percent in 2006 (IMF World Economic Outlook, 2006 to 2009). This condition indicates that in 2009 the confidence of investor significantly dropped in terms of Iceland ability to service its debt. The presence of interest portion on debt creates the total debt compounded. Since a country fails to follow the increasing of total debt along with interest rate by producing more output, hence the money supply

rises beyond the growth of their output (GDP). As its consequence, the rate of inflation rises faster and creates the crises.



Source: Central Bank of Iceland. Authors' calculation.

The economic condition of a country can be observed by comparing the growth of money supply and real GDP. From three graphs (1) below, we can be clearly seen that the money supply is much higher than real GDP. In this case, if the growth of money supply is higher than the growth of real GDP, it means that the inflation rate of this country is very high. In the other words, this country will be experiencing severe economic problems. To determine both of the growth money supply and real GDP, we can also employ geometric mean.

**Table 1**  
**Growth of GDP, MS and Inflation Rate in Iceland (2000-2010)**

	<b>Percentage</b>
Growth of GDP (i)*	2.18%
Growth of Ms (i)*	21.51%
Inflation rate	18.91%

Source: Central Bank of Germany, Central Bank of Iceland and IFS. Authors' calculation. (\*computed by Geometric Mean)

Table (1) summarizes the result of geometric mean computation showing the growth of money supply in Iceland is higher than the growth of real GDP and the the inflation rate reaches 18.91 percent. Following the established equation (1) and (2), the regression analysis is carried-out based on natural logarithm (Ln) model. Table (4) shows that the estimated coefficient of M1 in Iceland is much higher than the estimated coefficient of GDP. This result also supports the finding of geometric computation as stated earlier. In other words, there is an economic problem, in Iceland, i.e., worst economic crisis.

**Table 4**  
**OLS Estimation**

	<b>GDP</b>	<b>MS</b>
C	-48.18682 (11.32425)	-449.1282 (36.14156)
<b>Iceland</b>	<b>0.030818</b> (0.005648)	<b>0.230364</b> (0.018026)

Source: Central Bank of Iceland and IFS. Authors' calculation. Standard error in parentheses.

#### **4.2.2. Basic Islamic Financial Framework: Free Interest Banking**

The most crucial objectives of Islam is to be aware greater justice in human society. The absence of justice in a society will ultimately create destruction (Qur'an 57:25). Justice needs a set of rules or moral values accepted and trully agreed by every

individual in the society. The financial system may be able to promote justice if in addition to be strong and stable. It satisfies at least two conditions based on moral values (Adel, 2010). First, the financier should also share in the risk so as not to shift the entire burden of losses to the entrepreneur. Second, an equitable share of financial resources spread by financial institutions should become available to the poor to help alleviate poverty, expand employment and self-employment opportunities and, thus it will reduce inequalities of income and wealth.

To fulfill the first condition of justice, Islam requires both the financier and the entrepreneur to equitably share the profit as well as the loss. To do so, the basic principles of Islamic finance admits “no risk, no gain”. This should help introduce greater discipline into the financial system by motivating financial institutions to assess the risks more carefully and to effectively monitor the use of funds by the borrowers. Contrastingly, conventional system recognizes interest rate which is the same as *riba*. Islamic financial system strictly prohibits *riba* in its transaction since it is clearly stated both in Quran and Sunnah.

Fundamentally, the developmental role of Islamic banking and finance is almost similar with its conventional counterparts. Both financial intermediaries offer to mobilize savings from the surplus sector and conduct a credit allocation function to the deficit sector. The most important difference being in the nature of financial contracts applied in these markets. For example, in Islamic banking, the contract of *al-bay'* (selling) changes the contract of loans. The prominent issue for this replacement is the prohibition of interest as *riba*. The payments and receipt of interest must be avoided by deposit taking and financing activities due to one of the reasons always related with the distributional issue that has often been used to explain the evils of *riba*. Since profits from *riba* or interest are created without the existence of *'iwad* (an equivalent countervalue) *riba* constitutes an unlawful gain as it is created without risk-taking and value-addition activities (Haque, 1995).

Literatures on Islamic banking often state that people or institutions who benefit from *riba* conduct so without taking work and effort into the business transaction.

These return is contractual in nature that lenders hold a legal claim. Lenders are allowed to fail to make full repayments of capital and interest to do legal action against borrowers. Bankruptcies and business closure are common examples of punitive damages of the interest system. When capital owners are permitted to create wealth in this way, they become richer by virtue of the capital accumulation in which the *de facto* machine is interest. On the other hand, people who joint to risk-taking and value addition (the borrowers) are bound by the law to repay both capital and interest even if the business fails to obtain profits. It can be seen that in the long-run period the distribution of income will work in favour of the lending sector.

The European economic crisis, like in Iceland, showed message to this. May debt ridden companies gets back no protection under a regime where defaulters are punished discretely even if they can still perform a positive role in economic development. For instance, it is common work among banks to accept stocks as collaterals on loans. Banks recall loans were seen by the stock market meltdown across the emerging market countries in 1997 when the value of collaterals depreciated. It halted factory operations leading to colossal layoffs and loss of income. Under a collapsing currency system are too acutely suffered by borrowing via the bond market. Depreciation of currencies arise from panic selling of stocks and it is followed by short-selling of affected currencies impact on borrowers in a big way as they must continue to pay debt in hard currencies.

## **5. Conclusion**

Islamic state will be established since the *shari'ah* law is able to be properly implemented. People not only live for this life (*duniya*), but also they have to consider for hereafter (*akheerat*). Thus they have to allow everything in the sake for Allah by following *Shari'ah* principles. In this context, *Shari'ah* principles will be administered when the ruler or government purposes solely for worshipping to Allah. Unfortunately, not all of moslem country choose to authorize *Shari'ah* principles as base of law. Lineback (2005) divides a state where moslem becomes majorities into

four categories, namely Islamic states, Islam as the state religion, States whose constitutions simply do not declare any religion, States declared as secular states whose constitutions acknowledge the diversities of religions within their borders. These first two groups are considered the core of Muslim countries across southern Asia and North Africa.

Referring to these categorization, the Islamic state will be established since the agent deals with Islamic values, i.e. Islamic government. The existence of interest rate in the moslem countries economy has implicitly proven that the power of Islamic government is absent in this world. Here, the need of *siyasa shar'iah* to build Islamic government before establish Islamic state becomes an obligatory. Since the politic system is under Islamic law, hence the governance of all transactions in society will invoke with *shari'ah* rulings, including economic activities. In economic matters, for example, it is important to avoid *riba* or interest since its tenet is contrary with justice, one of the main principle that have to be cared of. Moreover, interest is clearly forbidden both in Quran and Sunnah, thus Islamic state is crucial issue to be paid attention by the moslem citizen. Debt crisis occurred in Eurozone in the middle of 2008 is a product created by the working of compounded fiat-money interest rate. Iceland, for instance, has been at the centre of the Eurozone debt crisis by having the highest levels of public debt and one of the biggest budget deficits. It has been proven by geometric mean and OLS that interest rate is the root cause of economic disaster. Since Islam does not admitted trading money for money, hence the fiat-money (paper money) is not admitted.

In Islamic state concept, the establishment of *Al-Hisbah* (ombudmanship) becomes an obligatory due to safeguards the moral value of *shari'ah* in economic activities and to promote “the boundaries of what is known as good and as bad”. The major function of *al-hisbah* is to control the quality, shari'ah, moral, environment and health. Technically speaking, the *muhtasib* (ombudsman) will supervise market from three sides, namely (a) all of activities and transactions must under the rules of *shari'ah*, (b) all of activities and transactions have to fulfill the moral value of Islam

as a belief system (c) the ombudsman (Muhtasib) is also assigned with the task to ordain “what is known as good and as bad”. Thus, this legislation will ensure that there is no monopoly in the market.

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