

# Money Demand Policy Model in Muslim Countries

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**Abstract:** *In the theory of demand for money for Islamic monetary, Umer Chapra uses the Keynesian model as a foothold. From here finally the profit-sharing rate in lieu of interest becomes significant in the model. The question is which one is appropriate as a foothold, classic or Keynes. Which assumptions are actually in accordance with the characteristics of the Islamic financial system which are said to be interest-free, investment to the productive, consumption that is not excessive, with the obligation of zakat, infaq and shodaqoh? The formulation of the problem in this study is how the theory of money demand in Islamic economics and how to model the demand for money in Muslim countries. The method used in this research is a qualitative method using literature studies. The results of this study are that the demand for money in an Islamic country is determined by income, in this case transactions motive and precautionary motive dominates the reason of the Muslim population. Demand for money in the narrow and broad sense is not influenced by the interest rate so the implication is that the preferences of Muslims differ from the Keynesian model, so speculation motives are not found in Islamic countries and the complete elimination of interest rates in Islamic countries will not cause serious problems in relation to the effectiveness of monetary policy in these countries.*

**Keywords:** *demand for money, monetary, Islamic economics*

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## I. INTRODUCTION

In the mainstream economy, there are two conflicting strongholds in the theory of money demand. The first stronghold was the classic and the second stronghold was Keynes. The classic stronghold, beginning with the quantity theory of money developed by Irving Fisher (1911) who has a understanding of money demand is purely a function of income, and interest has no effect on the demand for money.<sup>2</sup>

Unlike the classics, John Maynard Keynes sees that interest has a significant effect on money demand. Starting from the question if bonds produce interest and money does not, why does someone hold money? The Keynesian money demand model developed later by James Tobin and William Boumol. There are three motives that Keynes postulated behind the theory of money demand: transaction motives, preventive motives, and speculative motives.<sup>3</sup>

In the theory of money demand for Islamic monetary, Umer Chapra uses the Keynesian model as a foothold. From here finally the profit-sharing rate in lieu of interest becomes significant in the model. The question is which one is appropriate as a foothold, classic or Keynes. Which assumptions are actually in accordance with the characteristics of the Islamic financial system which are said to be interest-free, investment to the productive, consumption that is not excessive, with the obligation of zakat, infaq and shodaqoh?<sup>4</sup>

From here the author try to derive the model from the perspective of the Muslim State on the demand for money. Of course, by paying attention to models with assumptions that have been developed by economists before, both in the mainstream economic literature and the Islamic economic literature. This is expected to provide a more comprehensive model.

## II. LITERATURE REVIEW

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<sup>2</sup> Frederic S Mishkin, *The Economics of Money, Banking, and Financial Markets*, 7<sup>th</sup> ed. (Boston: Pearson Addison Wesley, 2004), h. 517-519.

<sup>3</sup> Mishkin ,2004 :p.521 .

<sup>4</sup> Khairul Umam, *Memodelkan permintaan uang individu muslim*,

### Theory of Money Demand in Islamic Economics

In Islamic economics literature, Umer Chapra developed a money demand model which can be written as follows :

$Md = f(Ys, S, \pi)$ , where:

$Ys$  = goods and services related to fulfilling needs, productive investment, and certainly not in conflict with Islamic values

$S$  = all moral, social and institutional values (including zakat) that influence the allocation and distribution of resources and can help minimize  $Md$  not only for conspicuous consumption and unproductive investments, but also for prevention and speculative purposes

$\pi$  = the level of profit or loss in a system which does not allow the use of interest rates as financial intermediaries

There are two things that can be stated about the reasons for holding money in the Islamic economy:

1. Transaction Motive
2. Precautionary Motive

Speculation in the Definition of Keynes has never existed in Islamic economics, so the function of the demand for money for speculative purposes (as a function of the interest rate) becomes zero.

The demand for money in Islamic economics is related to the level of income. The amount of cash stock held is influenced by the level of income and the frequency of expenditure. The same analysis can be used for companies that need cash to purchase raw materials and receive cash from sales of products. The cash requirements will change in the time interval and the level of business activity.

Precautionary motive arises because individuals and companies consider cash needs beyond what is used for transactions, in order to fulfill obligations and unexpected opportunities for advance purchases, with very limited amounts.

The amount of money demanded in Islamic economics consists only of the two motivations mentioned above, which are functions of the level of income, at a certain level zakat for less productive assets has been determined.

Increased income will increase demand for money by the public, for certain levels of income affected by zakat are formulated as follows:

$$MD = f(Y/\mu)$$

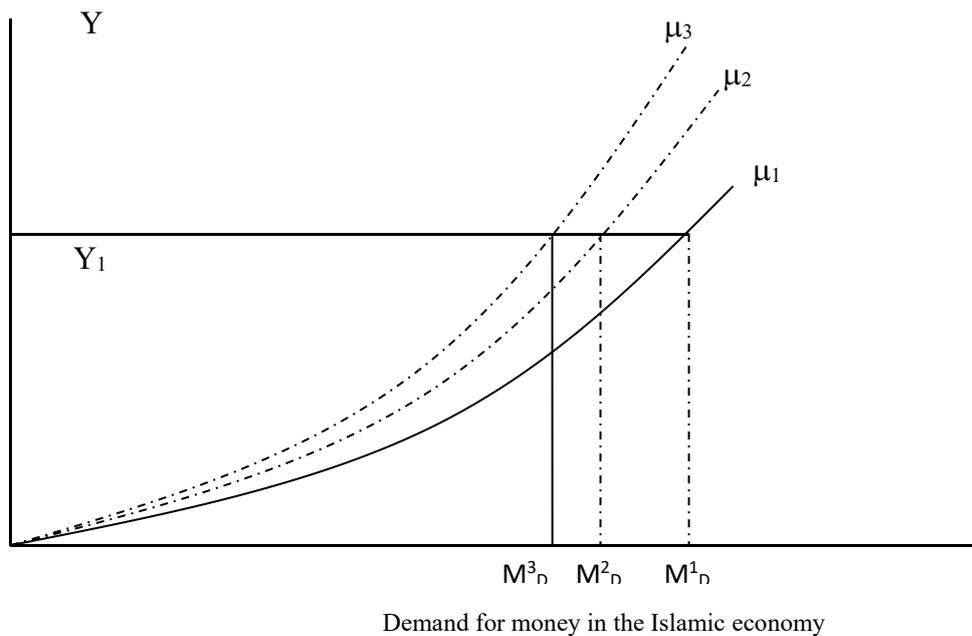
$$(\Delta_{MD}/\Delta Y)d\mu = 0 > 0$$

$MD$  = Demand for money for Islamic society

$Y$  = Income

$\mu$  = The level of costs due to saving money in cash

An increase in the cost of unemployed money, at a certain level of income tends to reduce the amount of money demand. In the following figure, if income is  $Y_1$  and the cost level is  $\mu_1$ , the amount of money demand is  $M^1D$ . An increase in the level of costs to  $\mu_2$  will result in a decrease in the number of requests to  $M^2D$ , and so on.



Monetary is one of the problems in the economic system that is quite serious. The previous Islamic scholars did not formulate a complete Islamic monetary system. This is because the economy at that time did not experience significant monetary problems. In contrast to the present, where money is no longer in the form of metal but is already in the form of paper and added to the intrinsic value of money that is much smaller than its nominal value, of course it can trigger chaos in the existing monetary system, such as inflation. On that basis in the 20th century the ideas of contemporary Muslim economists began to emerge.<sup>5</sup> They are classified in three mazhab, including the *iqtisādunā* mazhab (Baqir al-Sadr), the mainstream, and alternative mazhab.<sup>6</sup>

### III. METHOD

The method used in this research is a qualitative method using literature studies

#### Discussion

##### Money demand according to *Iqtishaduna* mazhab.

This mazhab was pioneered by Baqir al-Sadr with his phenomenal book *Iqtisādunā* (Our Economy).<sup>7</sup> This mazhab believes that economics can never be in line with Islam.<sup>8</sup> Ekonomi tetap ekonomi, dan Islam tetap Islam. Economy is still economics, and Islam is still Islam. Both of them can never be united, because both come from a contradictory philosophy. One is anti-Islam, the other is Islam.<sup>9</sup>

According to them, philosophical differences has an impact on the difference of their economic perspective. According to economics, economic problems arise because of the unlimited human desire while the available resources to satisfy human desire are limited. These mazhab reject the statement, because according to them, Islam does not recognize the existence of limited resources. The proposition used is QS. Al-Qamar (54): 49: "Indeed, all things We created with predestination." Thus,

<sup>5</sup> Abdul Azim Islahi, *Contributions of Muslim Scholars to The History of Economic Thought* (Jeddah: King Abdul Aziz University Press, 2005), 4.

<sup>6</sup> Adiwarmar Karim, *Ekonomi Mikro Islami* (Jakarta: Rajawali Pers, 2014), 30

<sup>7</sup> Muhammad Baqir al-Sadr, "*Iqtisādunā* (Our Economics) Discovery Attempt on Economic Doctrine in Islam" dalam Fadlan, "*Paradigma Mazhab-mazhab Ekonomi Islam Dalam Merespon Sistem Ekonomi Konvensional*", *Jurnal Al-Hikam*, Vol. 7 No. 1 Juni (2012): 168

<sup>8</sup> Asdar Yusup, "*Paradigma Kontemporer Ekonomi Islam*", *Jurnal Studi Islamika*, Vol. 11 No. 2 Agustus (2014): 231.

<sup>9</sup> Fadlan, "*Paradigma Mazhab-mazhab Ekonomi Islam Dalam Merespon Sistem Ekonomi Konvensional*", 169

because everything has been measured perfectly, in fact Allah has provided sufficient resources for all humans in the world. So it depends on the people who will process, utilize and optimize the perfection of the resources that exist in this world.<sup>10</sup>

This mazhab argues that economic problems arise due to uneven and unjust distribution as a result of an economic system that allows the exploitation of the strong against the weak.<sup>11</sup> Therefore, economic problems arise not because of limited resources, but because of the unlimited human greed.<sup>12</sup>

Accordingly, all theories developed by conventional economics are rejected and discarded.<sup>13</sup> Instead this mazhab seeks to develop new theories in economics that are directly explored and deducted from Qur'an and Sunnah. The figures in this mazhab include Muhammad Baqir as-Sadr, Abbas Mirakhor, Baqir al-Hasani, Kadim al-Sadr, Iraj Toutouchian, Hedayati, and others.

According to this mazhab, the demand for money is only intended for two main purposes; transactions and precautions or for investment. The demand for money for transactions is a function of income owned by someone. Where the higher the level of one's income, the demand for money for goods and services transactions will also increase. The function of the demand for money for precautionary motives (including the demand for money for investments and savings) is determined by the size of the purchase of goods or services carried out in cash.

This mazhab believes that the demand for money is a function of the level of the ratio of tough prices to cash prices ( $P_t / P_o$ ).  $P_t$  as the price to be paid for credit is greater than the cash price  $P_o$ .  $P_t / P_o$  is the price ratio between future price and the present price or the price of tough pay. If the price of a strong pay increases, it will reduce the demand for real cash, because people will prefer to hold goods that increase in price in the future rather than holding in the form of cash.<sup>14</sup>

Talking about charging a higher price than the cash price in credit transactions, Zaid ibn Ali Zainal Abidin ibn Husein ibn Ali ibn Abi Talib allowed this.<sup>15</sup>

$$M_d = M_{d_{trans}} + M_{d_{prec}}$$

#### Money demand according to mainstream madzhab

The mainstream mazhab has a rationale that contradicts the *iqtiṣādunā* mazhab. This mazhab actually agrees that economic problems arise because of limited resources that are confronted with human desire that is not limited. Limited resources encourage people to do productive, which is one of the responsibilities of humans as caliphs on earth.<sup>16</sup> But if so, where is the difference between mainstream mazhab and conventional economics.

The difference lies in how to solve the problem. The dilemma of limited resources and unlimited desire compels people to make choices about their desires. Then people make a priority scale of fulfilling desires, from the most important to the least important. In conventional economics, the choice and priority setting is done based on individual tastes. But in Islamic economics, choices and decisions must be in accordance with the guidance of the Qur'an and Sunnah.<sup>17</sup>

According to Chapra (2000), the effort to develop Islamic economics does not mean to destroy all the good and very valuable results of analysis that have been achieved by conventional economics over the last hundred years.<sup>18</sup>

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<sup>10</sup> Adiwarmar Karim, *Ekonomi Mikro Islami* (Jakarta: The International Institute of Islamic Thought Indonesia, 2003), 47.

<sup>11</sup> Amien Wahyudi, "Kebijakan Moneter Berbasis Prinsip-prinsip Islam", *Justitia Islamica*, Vol. 10 No. 1 Juni (2013): 63.

<sup>12</sup> Karim, *Ekonomi Mikro Islami*, 31.

<sup>13</sup> Ismail Nawawi, "Isu-isu Ekonomi Islam; Kompilasi Pemikiran dan Teori Menuju Praktik di Tengah Arus Ekonomi Global" dalam Zainal Abidin, "Mapping Pemikiran Akademisi dalam Mazhab Ekonomi Islam Kontemporer", *Jurnal Iqtishadia*, Vol. 1 No. 2 Desember (2014): 266

<sup>14</sup> Adiwarmar Karim, *Ekonomi Makro Islami* (Jakarta: PT Rajagrafindo Persada, 2007), 186.

<sup>15</sup> Muhammad Abu Zahra, "al-Imam Zaid", dalam Adiwarmar Karim, *Ekonomi Makro Islami*, 187

<sup>16</sup> Monzer Kahf, *Ekonomi Islam: Telaah Analitik terhadap Fungsi dan Sistem Ekonomi Islam*, diterjemahkan oleh Machrul Husein (Yogyakarta: Pustaka Pelajar, 1997), 4.

<sup>17</sup> M. A. Mannan, *Islamic Economics: Theory and Practice* (Lahore: SH Muhammad Ashraf, 1970), 3-4.

<sup>18</sup> M Umer Chapra, *The Future of Economic, An Islamic Perspective* (Leicester: The Islmaic Foundation, 2000), 49.

The prominent figures of this mazhab include M. Umer Chapra, M. A. Mannan, M. Nejatullah Siddiqi, Monzer Kahf, and others. Such is the case with the *iqtisādunā* mazhab, where the demand for money is only categorized in two ways, namely for transactions and precautions. The difference between the two mazhab is seen when discussing the problem of the behavior of the demand for money for precautions in Islam and what variables influence this precautionary motive.

The philosophical foundation of this basic theory of money demand is that Islam directs the available resources to be allocated maximally and efficiently. Prohibition of money hoarding or wealth hoarding, because it is considered as a "crime" of using money. The taxation of unemployed productive assets is the main strategy used by mainstream mazhab. Dues of idle cash or taxes on idle productive assets aims to allocate every source of available funds for productive activities.

Taxes imposition will have an impact on the pattern of money demand for precautionary motives. The higher the tax levied on productive assets which are idle, the demand for these assets will decrease, resulting in a decrease in the demand for money for precautionary motives. Decreasing the demand for money for this precautionary motive will increase the demand for money for transaction motives, thereby increasing the velocity of money. The increase in velocity of money is expected to have an impact on increasing national income in the aggregate.<sup>19</sup>

#### **Money demand according alternative madzhab**

The pioneers of this mazhab were Timur Kuran (chairman of the department of Economics at the University of Southern California), Muhammad Arif, and others. This mazhab criticizes the two previous mazhab. The Baqir Mazhab is criticized as a mazhab that seeks to discover something new that has actually been discovered by others. Destroy the old theory, then replace it with a new theory. Whereas the mainstream mazhab is criticized as a plagiarism of the neoclassical economy by eliminating the usury variable and including the zakat variable and intention.

This mazhab is a critical mazhab. They argue that critical analysis must not only be carried out on socialism and capitalism, but also on the Islamic economy itself. They believe that Islam must be true, but Islamic economics is not necessarily true because Islamic economics is the result of human interpretations of the Qur'an and Sunnah, so the truth value is not absolute. The propositions and theories put forward by Islamic economics must always be tested for their truth as they do for conventional economics.<sup>20</sup>

Demand for money according to this mazhab is very closely related to the endogenous concept of money in Islam.<sup>21</sup> Endogenous theory in Islam can be interpreted simply as follows: the existence of money is essentially a representation of the volume of transactions that exist in the real sector. This theory then bridges and does not dichotomize between the growth of money in the monetary sector and the growth of value-added money in the real sector.

Islam considers that changes in economic value added are not based on changes in time. Value added money occurs if there is economic benefit as long as the money is used. In terms of macroeconomics, the added value of money and the amount is only a representation of changes and accretions in the real sector.

The demand for money according to Choudlury (1997)<sup>22</sup> is a representation of all transactions in the real sector. The higher the capacity and volume of the real sector, the demand for money will increase. The variables that influence money demand include socio-economic variables, government policies in economic regulation and people's objective information about the real condition of the economy. The demand for money (and also the supply of money) in this mazhab is influenced by the amount of profit sharing or expected rate of profit. The high and low expected rate of profit is a representation of the prospects of actual economic growth.

Expected rate of profit is the expectation of profits that can be obtained from investing money in the real sector. If the expected rate of profit from investment activities in the real sector increases, the investment offer will also increase. An increase in investment supply will cause a decrease in real cash held by the public. This means that expected rate of profit

<sup>19</sup> Karim, *Ekonomi Makro Islami*, 190-191.

<sup>20</sup> Karim, *Ekonomi Mikro Islami*, 33.

<sup>21</sup> Karim, *Ekonomi Makro Islami*, 191.

<sup>22</sup> M. A. Choudlury, *Money In Islam: A Study in Islamic Political Economy* (London: Routledge, 1997), 41

enhancement makes people believe that holding excess cash contains losses to lose profits to get business profits. As a result, someone will adjust how much demand for money (cash) that its held to the expected rate of profit.

#### IV. CONCLUSION

Related to the Liquidity Preference function described by Keynes, from the results of statistical analysis, of all Islamic countries (whose Muslims are more than 50%), it can be concluded:

1. The demand for money in an Islamic state is determined by income, in this case : transactions motive and precautionary motive that dominates the reason of the Muslim population. Wealth is an important determinant in the demand for money in some countries.
2. Money demand in the narrow or broad sense is not influenced by the interest rate so the implications are:
  - a. Muslims' preferences differ from the Keynes model, so speculative motives are not found in Islamic countries
  - b. The complete elimination of interest rates in Islamic countries will not cause serious problems in relation to the effectiveness of monetary policy in these countries.

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