

CHAPTER I

INTRODUCTION

A. Background of Research

Since 15 of August 1971, by the decree of President Richard Nixon, the United States unilaterally terminated convertibility of the US dollar to gold, effectively bringing the Bretton Woods system to an end and rendering the dollar a fiat currency.¹ This decision, referred to as the Nixon shock, created the situation in which the U.S. dollar became a reserve currency used by many states. At the same time, many fixed currencies also became free-floating.²

Consequently, the world faced global financial crisis, this sudden change in the world monetary order had a serious and damaging impact on global economy. Even the United States' dollar significantly inflated which affected other currency that relied on the US dollar.³

Since then, the world money creation system is regulated in the way that almost all deposits in any size or currency are the reflection of someone else's credit to one bank or another. As issued and managed today, money is primarily created out of debt and only a small proportion is actual currency. This is a global phenomenon, including in most of Muslim majority countries.⁴ In practice we can give a glance at the monetary policies of Indonesian Central Bank or Bank Indonesia, BI is implementing interest

¹ International Monetary Fund, *The End of the Bretton Woods System*. About the IMF (Accessed on 24th of October 2016, 01:30 PM, from website www.imf.com)

² Virtual Resource Centre for Knowledge about Europe, *The Collapse of the Bretton Woods System*. (Accessed on 29th of October 2016, 05:21 PM, from website www.cvce.eu)

³ Isaac Igwee, History of the International Economy: The Bretton Woods System and its Impact on the Economic Development of Developing Countries, *Athens Journal of Law*, Volume 4, issue 2, p. 118.

⁴ Armen V Papazian, Islamic Money Creation, *Islamic and Finance V. 8*, Issue 3, No. 28 p. 20

rate as the basis of its policies to stimulate the interest rate of money market, commercial banks' deposits, commercial banks' credits.⁵

Considering that Indonesia is the largest Muslim population in the world with more than 85% of its citizens are Muslim or more than 200 million and yet its Central Bank is still adopting interest-based monetary system.⁶ The role of money and monetary management in an Islamic economy must be in accordance with the framework and system of Islamic economics that is comprehensively defined by Islam. In an Islamic economic system, the relations between financial and monetary sector have to be organised and conducted in a manner which diminishes the use of interest in any form. It is the restriction of interest itself that makes monetary management in an Islamic system is completely different from conventional capitalist system in very basic and important way.⁷

Islam does not recognise interest as the main mechanism for the management of money demand or supply in the manner of efficiency or equitability. The two of the most important instruments of monetary management in the capitalist economy, discount rate and open market operation in interest-bearing government securities should also be disregarded in an Islamic economy.⁸

Concerning on this situation which Muslim countries are still adopting interest-based money creation, an effort is needed to discuss the weaknesses of the system that allow money to be issued by banks at a price that equal to interest rate. Some renown Muslim economists proposed a monetary system with free-interest in exchange of interest-based system that have

⁵ Bank Indonesia, *Kerangka Kebijakan Moneter*. (Accessed on 14th of October 2016, 08:12 PM, from website www.bi.go.id)

⁶ Badan Pusat Statistik, *Penduduk Menurut Wilayah dan Agama yang Dianut*. (Accessed on 19th of October 2016, 02:38 PM, from website www.bps.go.id)

⁷ Mohsin S. Khan and Abbas Mirakhor. Monetary Management in an Islamic Economy, *J. KAU: Islamic Econ.* Vol. 6, p. 3-21

⁸ Muhammad Umer Chapra, Monetary Management in an Islamic Economy, *Islamic Economic Studies*, Vol. 4, No. 1, 1996, p. 13

been adopted by most countries in the world.⁹ Muhammad Umer Chpara on numbers of his researches proposed an interest-free money creation concept with the changes in the role and functions of central bank in light of the abolition of interest rate. Mabid Ali Al-Jarhi proposed a concept of money creation from the changes in the implementation of banking system to the instruments to replace the interest-based instruments for the financial sector.

Interestingly, Chapra and Al-Jarhi have a different approach towards the implementation of interest-free money creation system. Chapra proposed a targeting monetary framework where Al-Jahri proposed a inflation targeting framework or economic growth-based framework.

Therefore the author is convinced that it is very necessary to conduct a research in the form of undergraduate thesis on the topic of money creation, in addition the research will be conducted by comparing the thoughts and concept descriptively from two of most prominent Muslim economists in the area of monetary economics namely Muhammad Umer Chapra and Mabid Ali Al-Jarhi, because of their expertise on the area of Islamic monetary economics and policies, the research is entitled “**Money Creation in an Islamic Monetary System, A Comparative Study Between Muhammad Umer Chapra and Mabid Ali Al-Jarhi**”

B. Formulation of Problem

Based on previous background of study, the author would like to rise a couple questions below as the formulation of problem for this undergraduate thesis.

1. How is the concept and mechanism of money creation in an Islamic monetary system according to Muhammad Umer Chapra and Mabid Ali Al-Jarhi?
2. What are the similarities and differences between Muhammad Umer Chapra’s and Mabid Ali Al-Jahri’s thoughts on the concept and mechanism of money creation?

⁹ Mabid Al-Jahri, Monetary and Financial Structure for an Interest-Free Economy: Institution, Mechanism & Policy, *MPRA paper* No. 667, 2015, p. 4

C. Objectives of Research

1. To know the concept and mechanism of money creation in an Islamic monetary system according to Muhammad Umer Chapra and Mabid Ali Al-Jarhi.
2. To compare the similarities and differences between Muhammad Umer Chapra's and Mabid Ali Al-Jahri's thoughts on the concept and mechanism of money creation.

D. Benefits of Research

The benefits of study of this undergraduate thesis will be classified into theoretical and practical benefits.

1. Theoretical Benefits:
 - a. To contribute the study of Islamic Economics in the area of money creation in an Islamic monetary system.
 - b. To give a broader view to the Muslim society in the discussion topic of money creation in an Islamic monetary system.
 - c. To offer a broader idea to scholars who are concerning the Islamisation of Science and Knowledge specifically in the area of economic sciences.
2. Practical Benefits
 - a. To provide a brief guidance to practitioners in the field of monetary and banking.
 - b. To provide government a beneficial suggestion in the term of issuing the monetary policy.
 - c. To contribute more on the process of Islamisation of economic sciences in the real field.

E. Methodology

In this undergraduate thesis, the author will determine the methodology, data sources, data collecting method, and data analytical method, those methods are:

1. Type of Research

The research is a literature-based research with qualitative method.

- a. Qualitative research method is a research method which is based on positivism philosophy, used to research or study on the condition of scientific object where the author acts as the key instrument, the sample taking of data sources is conducted purposively and the collecting techniques with triangulation, the data analysis is inductive and qualitative, and the result would emphasise the meaning rather than the generalisation.¹⁰
- b. The author uses this method because this method is relevant and suitable for studying the thoughts of Muhammad Umer Chapra and Mabid Ali Al-Jarhi on Money Creation.

2. Data Sources

In the process of writing, the author will classify the data sources into primary sources and secondary sources.

- a. Primary sources are the collected data from any books, paper works, and journals authorised by Muhammad Umer Chapra and Mabid Ali Al-Jahri, or any documents that related to the topic in the area of money creation in Islamic monetary system.
- b. Secondary sources are the collected data from any books, paper works, journals, newspapers, magazines, and websites written by other Muslim economists that related to the topic of Islamic monetary system especially in the area of money creation in Islamic monetary system.

¹⁰ Sugiyono, *Metode Penelitian Kualitatif, Kuantitatif dan R&D*, (Bandung: Alfabeta 2010), p. 15

3. The Method of Data Collecting

a. Documentation Method

Documentation is notes from previous phenomenon in the form of writings, pictures, or monumental works from a person.¹¹

4. The Method of Data Analysis

In addition, to support the writing process, the author will apply three analysis methods in this undergraduate thesis, those methods are:

a. Deductive Method

Deductive is using logic or reason to form a conclusion or opinion about something.¹² The author will apply this method to explain the theories of money creation.

b. Descriptive Method

One of the objectives of data interpretation is to describe the data.¹³ The author will apply this method to reveal a comprehensive explanation of money creation concept, system, and mechanism in general and in the perspective of Muslim economists.

c. Comparative Method

A comparative research will be able to find out the similarities, differences and also critics of the discussion topic in term of ideas or procedures between two or more opinions.¹⁴ The author will apply this method to find out the similarities, differences and also critics of Muhammad Umer Chapra's and Mabid Ali Al-Jahri's ideas in the area of money creation in an Islamic monetary system

¹¹ Sugiyono, *Metode Penelitian Bisnis*, (Bandung: Alfabeta, 2007), p. 422

¹² Meriam Webster Dictionary, dedeuctive, (Accessed on 26 of October 2016 03:16 AM, from website www.merriam-webster.com)

¹³ Lexy j. Moleong, *Metode Penelitian Kualitatif*, (Bandung: Remaja Rosdakarya, 2012) p. 257

¹⁴ Suharsimi Arikunto, *Prosedur Penelitian*, (Jakarta: Renaka Cipta, 2013) p.