

# Money in Islam: Toward Re-evaluation of Islamic Financial System

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## Abstract

*This paper aims at re-evaluating the Islamic financial system based on its authenticity in the perspective of money in Islam. Imam Ghazali identifies two main functions of money: as a just unit of account and an efficient medium of exchange. These two functions are the purpose of money creation. Thus, Islam prohibits any activity diverting money from carrying out its functions. On the basis of this perspective, the current practice of Islamic banking that creates dominantly debts from sales and leasebased products and not the profit and loss sharing ones has caused money deviated from its functions. Furthermore, in Islamic capital market, this paper insists that the minimum holding period of Islamic stock market cannot abolish the practice of capital gain in the secondary market of Islamic capital market. Accordingly, Keynesian liquidity preference must exist as well as the speculative motive of money demand. As the result, money will be demanded not only for real economic activities, so the supply of money will overshoot the demand of real economic activities. Such condition distorts the ability of money to provide a true value for real economic activities. On the basis of these points of view, innovations in Islamic financial system should be designed to facilitate money providing a just value of economic activities and facilitating exchange of goods and services in efficient and equitable manner. Finally, this paper sees the need of Ulama who can control the innovation in Islamic financial system to be based on its authenticity that finally leads to the achievement of Islamic vision. In this regard, faculty should design its curriculum that provide graduates who are able to remove the western vision from Islamic finance theories and then to infuse the Islamic vision to them.*

**Keywords:** *money, Islamic financial system, authenticity, innovation.*

## 1. Introduction

In the context of a re-evaluation and a way forward of Islamic finance, everyone should read the article written by M. Umer Chapra *“Innovation and Authenticity of Islamic Finance”*. In this paper, he criticizes the current practice of Islamic financial system, *“The way the Islamic financial system has progressed so far is only partly, but not fully, in harmony with the Islamic vision. It has not been able to come out of the straitjacket of conventional finance. The use of equity and PLS modes has been scant, while that of the debt-creating sales- and lease-based modes has been predominant”*.<sup>1</sup> Besides Chapra, Haneef and Furqani bring back the idea of Ziauddin Sardar about *“to mould conventional banks into Islamic shapes”* by criticizing the current focus of Islamic banks on debt instruments such as *Murabahah* instead of equity instruments like *Mudharabah* and *Musharakah*.<sup>2</sup>

According to Chapra, the main reason why Islamic financial system cannot make significant progress in achieving its authenticity, is the lack of institutions that minimizes the risks regarding with asymmetric information and late settlement of financial obligations. Accordingly, he proposes the establishment of Centralized Shari’ah Board, Shari’ah Clearance and Audit, Credit Rating Agencies, Chamber of Commerce, and Trade Associations.<sup>3</sup> This paper, however, will not examine whether these institutions have been established or not, but will discuss the authenticity of Islamic financial system based on the framework of Money in Islam. This authenticity is very important because innovation in Islamic financial system can be proposed and designed. That is to say, failing to establish the authenticity of Islamic financial system will make any innovation useless because it will never be directed to achieve the true Islamic financial system. For this purpose, this paper will start with a discussion on what is the essence of money in Islam. This essence of money is then used as the basis of analysis to the current practice of Islamic banking from the view of money

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<sup>1</sup> M. Umer Chapra, *“Innovation and Authenticity in Islamic Finance”*, A keynote address presented at the inaugural session of the Eighth Harvard University Forum on Islamic Finance, held on 19-20 April 2008 in the Harvard Law School, No publication, 15.

<sup>2</sup> Mohamed Aslam Haneef and Hafas Furqani, *“Contemporary Islamic Economics: The Missing Dimension of Genuine Islamization”*, Thoughts on Economics, Vol. 19, No. 04, 37.

<sup>3</sup> M. Umer Chapra, *“Innovation and Authenticity in Islamic Finance”*..., 15.

in Islam. After discussing Islamic banking system, the investigation continues by analyzing the current practice of Islamic capital market. Finally, the paper is concluded by closing analysis and further suggestions.

## 2. The Purpose of Money in Islam and Its Current Problem

Imam Ghazali analyses that the main functions of money is first to be a just unit of account which reflects the true value of goods; and the second is to be a medium of exchange that makes people possible to exchange goods between them easily. Furthermore, he argues that everybody who treats money contradictory to these functions means that he has been ungrateful to the blessing of Allah and categorized of doing *dzulm*. On the basis of these main functions of money, hoarding of money is forbidden in Islam because by hoarding it, money is not available in the economy so people cannot use it for exchange their goods. Also, the rationale of ribaprohibition is because by doing so, money is then traded among them, and it is contradictory to their functions as money should facilitate exchange among goods and not to be exchanged by it. Money, according to Imam Ghazali, is not created for itself but for other goods.<sup>4</sup>

In the context of current monetary and financial system, Chapra (1996), Choudry (1997), and Toutouchian (2009) argue that interest in the financial system creates the speculative motive for money. This speculative motive to hold money, according to Choudry (1997), replaces the use money to service real transactions demand. Furthermore, Chapra (1996) addresses that the more money is demanded by speculative motive, the less money is available for the purposes of transactions. As the result, money is not only a contravention of the demand of real economic activities but also for other demand of non-real economic activities. This condition, in the perspective of money as the unit of account, money cannot reflect the true value of economic activity as the demand and supply of money are being distorted by the existence of speculative activities in the current financial system. In addition, in the perspective of money as the medium of exchange, the amount of money available for real economic activities become scarce as money is demanded for other non-real economic activities. In such

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<sup>4</sup> Imam Abi hamid Muhammad ibn Muhammad Al-Ghazali, *Ihya' 'ulum al-Din*, Vol. 4, (Beirut: Dar Al-Kotob al-Ilmiyah, 1971)

situation, the definition of money as everything functioning as a just unit of account and medium of exchange is questionable.

Interestingly, Toutouchian relates the speculative motive with the presence of the conventional function of money as a store of value. Using Keynes' analysis, he asserts that speculative money can exist because money is treated as an asset and then as a store of value and not again merely as the medium of transaction. By the existing of uncertainty in the future rates of interest and there is a market for that, so people have the opportunity to speculate in the hope of earning profit from knowing better of what will happen in the market. Related to this, Toutouchian quotes Keynes' words "*only in the event of money being used solely for transactions and never as a store of value, would a different theory become appropriate*".<sup>5</sup> In other words, he tries to argue that the functions of money in Islam are as a unit of account and medium of exchange; and not as a store of value because it is related to speculation emerged from the interest based financial system.

In addition to speculative motive, Chapra (1996) explains that the distortion in demand for money even exists in transaction and precautionary motives. He explains that someone could hold money for transaction of *Syar'i* goods and services, and the non-*Syar'i* ones. The non-*Syar'i* ones include goods and services of luxuries and status symbol, wasted goods and services, and the unproductive investments. The more money demanded for non-*Syar'i* consumptions and investments, the less money available for the *syar'i* ones. This condition finally makes money demand not efficient and effective to reach the socio-economic desired goals. Thereby, it becomes rational for Choudry to bring the epistemological question in the current money system regarding its ability to function as a standard for evaluation of socio-economic activities. He even challenges the existing theories of money by writing, "*a well definition for money after it has lost it under the indeterminacy of the monetarist-Keynesian debates and in the money-price dilemma of quantity theory*".<sup>6</sup> In other words, there is a serious problem in the current monetary and financial system that makes money cannot perform its main goal and function.

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<sup>5</sup> Iraj Toutouchian, *Islamic Money and Banking: Integrating Money in Capital Theory*, (Singapore: Wiley, 2009), 65.

<sup>6</sup> Masudul Alam Choudry, *Money in Islam: A Study in Islamic Political Economy*, (London: Routledge, 1997), 6.

In conclusion, the main functions of money are first; its ability to measure the true value for economic activities (*a just unit of account*); and the second is the availability of money to be used as medium of exchange to promote economic activities. Accordingly, any activities especially financial ones should be designed to make money able to perform its function. In other side, every activity that is contradictory to that function should be considered as a distortion. That is to say, in the context of financial system, a system could be considered Islamic or not depends on whether it makes money performing its function or deviate money from its function. Indeed, any idea developing Islamic financial system could be considered innovation when it facilitates money functioning correctly. Otherwise, it is just a distortion.

### 3. Fiat Money, Islamic Banking System and a Just Valuation for Economic Activities

In the fiat money system, the stock of money is supplied by an authority and not by the nature such in the case of commodity money. Accordingly, the supply of money is not limited by the availability of any commodity and tends to be demand driven. Based on this rationale, the challenge, according to Chapra (1996), is how to manage the demand for money in efficient and equitable manner. This efficient and equitable demand for money is a condition for money to function correctly as explained above. In this regard, has the current practice of banking system supported money demanded efficiently and equitably?

Choudry (1997) asserts that Islamic banking system is not just about changing the rate of interest by the rate of return but should be a system which makes money used as currency to monetization of economic activities. Consequently, he contends that fractional reserve banking system cannot hold as it generates promissory notes and excess reserves in commercial banks. In this framework of 100% reserve requirement, al-Jarhi (2004) proposes the model of business banks or *Banquesd Affaires* which is commonly known today as relationship or universal banks. This bank undertakes direct investment, takes the equity in the firms they finance, and provides the customary banking services. This proposal is to make sure that money is treated endogenously in the system, so the role of money is solely to monetize value of prices that emanate from market exchange between goods. In the contrary,

in fiat money financial system, money is treated exogenously. Thus, the demand can overshoot the actual capacity of spending, and then money supply rises beyond the level served by actual demand. Accordingly, the expectations of consumers in this excess of demand drive prices rising. In such system, the interest gains its legitimacy for stabilizing prices by exercising demand-pull measures and by determining real values of output at different interest rates.<sup>7</sup> That is to say, in nowadays financial system, money is not any longer endogenously coming from market, but money can be intervened by the outside of market, so its value is not more reflecting real economic values in the market. Borrowing Imam Ghazaly analysis, money is not more a correct mirror that reflects the true color. For this rationale, Choudry (1997), and Jarhi (2004) proposes 100% reserve banking system.

Nevertheless, Chapra (1996) and Siddique (1982) do not find any problem with fractional reserve banking system. Siddiqi (1982) argues that credit creation through fractional reserve banking system under an interest-free system is not harming the economy. He writes "*credit would be created only to the extent that there exist genuine possibilities of creating additional social wealth through productive enterprise*".<sup>8</sup> More precisely, fractional reserve system under Islamic system does not make money demand overshooting the actual demand in real economy. Thus, monetary authority could decide the level of money supply proportionally. In this context money supply, Chapra offers the targeted growth of money supply to be applied. Specifically, he addresses the three sources of high-powered money: government borrowings to central bank, credit central bank to commercial banks, and balance of payment surplus. In regard with the first source he insists that,

"It may hence be unrealistic for Muslim governments to talk of Islamisation of their economies without making serious effort to regulate their budgetary deficits in accordance with the demand of the maqasid, particularly price stability".<sup>9</sup>

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<sup>7</sup> *Ibid*, Masudul Alam Choudry, *Money in Islam: A Study in Islamic Political Economy*., 38.

<sup>8</sup> Muhammad Nejatullah Siddiqi, "Islamic Approach to Money, Banking and Monetary Policy: A Review", in Mohammad Ariff (ed), *Monetary and Fiscal Economics of Islam*, (Jeddah: International Centre for Research in Islamic Economics, 1982), 28.

<sup>9</sup> M. Umer Chapra, "*Monetary Management in an Islamic Economy*", *Islamic Economic Studies*, Vol. 4, No. 1, December 1996, 19.

For the second resource, Chapra believes that by the replacement of interest with profit and loss sharing, central bank can control successfully credit creation of Islamic commercial banks. For the last one, Chapra contends that central bank can sterilize it under Islamic instruments of monetary policy. From the above discussion, both 100% and fractional reserve banking system hold money to function as a just unit of account. However, the current practice of banking, according to Chapra (2008), is still lack of authenticity. This is because the debt instruments of sale and lease based finances is dominant compared to the profit and loss sharing ones. Someone may wonder why this domination of debt instruments is considered lack of authenticity, whereas in fact these sale and lease based finances are real commodity based transactions that are different from the conventional interest debt finances which are not requiring the existing of real commodities. Furthermore, the contracts used such as *murabaha*, *ijarah* etc. have been legalized to be *Syariah* compliance by authoritative board.

In spite of that, in the perspective of efficient and equitable money demand, the current condition of Islamic banking does not support real productive economic activities and opens the door for unneeded consumptions. Such condition could make Islamic banks trapped in the rational behavior of lenders. In this regard, al-Jarhi writes, *"a lender is basically a holder of monetary assets, which are claims to fixed sums of money. He is therefore interested in the solvency of the borrower, in the sense that the present value of the borrowers' net worth is at least sufficient to cover the value of his debt"*.<sup>10</sup> Accordingly, the capability of borrowers to pay is the most important while the productivity is the secondary one. Unfortunately, according to Jarhi this is the characteristic of interest based conventional banking system. In other words, Islamic banks seem to behave like the conventional banks, thus, the asymmetric information becomes the barrier for Islamic banks to enhance profit and loss sharing financial system.

If it is the situation, money, in current Islamic banking system, is demanded dominantly for the non-productive economic activities and some non-needed consumptions. These non-productive activities and non-needed consumptions take the

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<sup>10</sup> Mabid Ali Al-Jarhi, *"A monetary and financial structure for an interest-free economy: institutions mechanism and policy: Updated Version"*, (2004), <https://mpa.ub.uni-muenchen.de/66741/>.

allotments of money for productive and needed consumptive economic activities. Therefore, money is not efficiently and equitably used for medium of exchange. However, in term of unit of account, as long as Islamic banks do not participate in speculative activities in capital market, money still hold the contravention for real economic activities value. This is because every transaction in Islamic banking system must be real base activities. But, the rational behavior of lender, as explained above, could fall into not real economic activities. This presumption seems to be true because Islamic capital market, as will be argued, opens the door for speculation. On the basis of that, money through Islamic banking system could not give the true measure for real economic activities.

#### 4. Speculation and Islamic Capital Market

In the above discussion, the speculative motives of demand for money distort the function of money as a just unit of account. In line with it, muslim economists seem to agree that speculation cannot hold in the Islamic financial system. Nevertheless, speculation exists because the existence of market wherein people possible to speculate in order to gain profit. Oxford dictionary of finance and banking defines speculation as *the purchase or sale of something for the sole purpose of making a capital gain*.<sup>11</sup> For this capital gain, speculators will buy cheap and sell dear. By this meaning of speculation, Toutouchian insists that *“almost all transactions in stock markets involving the exchange of stocks whose prices are market-based are speculation..... By this reckoning, ordinary stocks that are secondary markets are, as I understand it, money markets; the primary markets, devoid of bubbles arising from speculation, are capital markets*.<sup>12</sup> By this opinion, someone may wonder whether the current Islamic capital market which recognizes stocks (after *Shariah* screening) and *sukuk* in the secondary markets contain speculation or not. Indeed, in this market people transact to attempt capital gain. According to the above speculation meaning, anyone easily concludes that speculation exists in the current Islamic capital market.

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<sup>11</sup> Oxford Dictionary of Finance and Banking, 4<sup>th</sup> ed, (New York: Oxford University Press Inc, 2008), 414.

<sup>12</sup> Iraj Toutouchian, *Islamic Money and Banking: Integrating Money in Capital Theory*, (Singapore: Wiley, 2009), 186.



However, Shariah scholars have issued rules governing this speculation practices. This rule is known as Minimum Holding Period system. By this MHP, people cannot transact by buying and selling anytime but they are required to wait certain days for transactions. Sumar'in finds empirical evidence that 7 days of minimum holding period of stocks could eliminate speculation in the Islamic capital market. If it is true, someone could say that speculation is eliminated in Islamic capital market.<sup>13</sup> Nonetheless, in the perspective of money function, money is a merely medium to facilitate exchange among goods and services, or merely measuring value of goods and services. In this context, money cannot be transacted among them because according to Imam Ghazali, money is not created for itself but for other goods and services. Thus, in the secondary market, the question is can 7 days minimum holding period make people impossible to conduct capital gain?, These 7 days MHP can reduce but cannot abolish it. If so, the Keynesian liquidity preference cannot be avoided. Thus, speculative motive must hold and people enter speculation.

Toutouchian's opinion that capital market is only primary market while the secondary one is money market might be too extreme for development of Islamic financial system. However, when someone understands that Islam only recognizes real economy and does not recognize anything not real, he could easily accept the idea of Toutouchian. Someone also can imagine if there is no such secondary market, so a huge of money must go to real economic activities then money perform its real function of a medium of exchange and measurement other goods values. When it happens, the world will experience optimal economic growth in non-inflationary economy and with fully just distribution of wealth. Thus, in this road map, Islamic financial system should be developed.

## 5. Conclusion

If Islamic capital market contains speculation and the current Islamic banks could join in this speculative demand for money, money in both Islamic banking and capital cannot hold the contravention for real economic activities. For this rationale, in his

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<sup>13</sup> Sumar'in, "Speculative Behaviour in Islamic Capital Market", South East Asia Journal of Contemporary Business, Economics and Law, Vol. 9, Issue 1 (Apr.), ISSN 2289-1560 (2016), 10.

political Islamic economy, Choudry (1997) emphasizes the important role of knowledge inducement. In this paper, this knowledge inducement is discussed as the authenticity of Islamic finance in the perspective of money in Islam. The role of inducing knowledge or governing authenticity in Islamic financial system belongs to the Ulama. The main role of *Ulama*, as mentioned in verse 122 of al-Taubah, is as the "*mundzir al-qaum*" or the warner for people. In the context of developing Islamic financial system, Ulama should warn and govern the innovation under the road map of its authenticity.

This task, nowadays, seems not easy for *Ulama'*, because the current practice of financial system is developed from the framework of western worldview. Therefore, to understand the current practice of Islamic financial system, *Ulama'* should be able to get rid of western framework induced in it. Failing to do so, it will bring to false knowledge inducement or false authenticity governing. In this case, Al-Attas proposes two steps of Islamization: de-westernization or de-secularization and the infusion of Islamic elements. In more practical, Faruqi offers 12 steps which can be simplified into 5 steps: (1) to master the modern disciplines, (2) to master the Islamic legacy, (3) to establish the specific relevance of Islam to each area of modern knowledge, (4) to seek ways for creative synthesis between the legacy and modern knowledge, (5) to launch Islamic thought on the trajectory which leads it to fulfillment of the divine pattern of Allah.<sup>14</sup> To conduct those steps of Islamization is the task of university. Failing to establish a university concerning Islamization of knowledge will lead to the failure of having true knowledge inducement on true authenticity governing into the development of Islamic financial system under the road map of Islamic civilization. As the result, no one should wish the re-arrival of Islamic civilization.

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<sup>14</sup> Mohamed Aslam Haneef, "*A Critical Survey of Islamization of Knowledge*", (Kuala Lumpur: Research Center, IIUM, 2005), 1.

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