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Monetary Stability Regulation In The Perspective Of Islam And Interest Rate Model

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Abstract

A monetary policy solely reliant on Taylor Rules may not be capable of addressing the holistic economic challenges involving social norms and Islamic principles. This research challenges the conventional reliance on Taylor Rules in monetary policy by proposing an alternative approach rooted in Islamic principles and social norms. Traditional monetary policy primarily focuses on managing inflation through interest rate adjustments, as per Taylor's rule. However, this study explores the feasibility of an Islamic framework that emphasizes discouraging excessive consumption, unproductive investment, and speculation, alongside inflation control. Employing qualitative research methods and drawing on existing literature, this study suggests that adopting such an approach could offer benefits, particularly in a country like Indonesia. By prioritizing ethical considerations and social norms, Indonesia could promote responsible economic behavior among individuals and businesses. This holistic approach moves beyond relying solely on interest rates to combat inflation and can foster a balanced and sustainable economic environment. Overall, the study highlights the advantages of integrating Islamic principles and social norms into monetary policy, enhancing its effectiveness, resilience, and potential for long-term stability and sustainable economic growth.

Keywords: *Inflation, Monetary, Stability, Taylor Rules*

Abstrak

Kebijakan moneter yang hanya bergantung pada Taylor Rules mungkin tidak mampu mengatasi tantangan ekonomi holistik yang melibatkan norma-norma sosial dan prinsip-prinsip Islam. Penelitian ini menantang ketergantungan konvensional pada Taylor Rules dalam kebijakan moneter dengan mengusulkan pendekatan alternatif yang berakar pada prinsip-prinsip Islam dan norma-norma sosial. Kebijakan moneter tradisional terutama berfokus pada pengelolaan inflasi melalui penyesuaian tingkat suku bunga, sesuai aturan Taylor. Namun, studi ini mengeksplorasi kelayakan kerangka Islam yang menekankan pada pencegahan konsumsi berlebihan, investasi tidak produktif, dan spekulasi, serta pengendalian inflasi. Dengan menggunakan metode penelitian kualitatif dan memanfaatkan literatur yang ada, penelitian ini menunjukkan bahwa penerapan pendekatan semacam ini dapat memberikan manfaat, khususnya di negara seperti Indonesia. Dengan mengedepankan pertimbangan etika dan norma sosial, Indonesia dapat mendorong perilaku ekonomi yang bertanggung jawab di kalangan individu dan dunia usaha. Pendekatan holistik ini tidak hanya mengandalkan suku bunga untuk memerangi inflasi, namun juga dapat menciptakan lingkungan ekonomi yang seimbang dan berkelanjutan. Secara keseluruhan, studi ini menyoroti keuntungan dari mengintegrasikan prinsip-prinsip Islam dan norma-norma sosial ke dalam kebijakan moneter, meningkatkan efektivitas, ketahanan, dan potensi stabilitas jangka panjang dan pertumbuhan ekonomi yang berkelanjutan.

Kata Kunci: Inflasi, Moneter, Stabilitas, Aturan Taylor

INTRODUCTION

During the economic crisis, Indonesia experienced a depreciation of its national currency, the rupiah, due to factors such as global economic uncertainties, trade imbalances, and capital outflows. Depreciation resulted in higher import costs, leading to increased prices for goods and services and consequent inflationary pressures (Ruddyanto & Panennungi, 2019; Sutrisno et al., 2022). Moreover, the weakened exchange rate negatively affected foreign investor confidence, impairing Indonesia's ability to attract vital foreign investments.

The devaluation of the rupiah during the economic crisis significantly contributed to inflationary trends. The reduced value of the currency escalated the costs of imported goods, particularly raw materials and commodities (Akpunonu & Orajaka, 2021; Rahma & Soebagio, 2023). These increased costs had a direct impact on consumers, decreasing their purchasing power and impeding their ability to make purchases. The situation also hindered businesses' long-term planning and investment decisions due to the uncertainties generated by high inflation.

The combination of a devalued currency, elevated inflation, and higher interest rates resulted in a rise in non-performing loans, which posed challenges to the stability of banks' balance sheets. As a consequence, banks experienced a decrease in their lending capacity, limiting credit availability to both businesses and consumers. This scarcity of financing options restrained investment, hampered economic growth, and exacerbated the existing economic challenges (Aji & Soebagyo, 2019).

The cumulative effects of the economic crisis created an unfavorable environment for businesses and industries in Indonesia, characterized by high inflation, increased interest rates, and restricted access to credit. These factors impeded the expansion and investment efforts of businesses, hindering innovation, job creation, and overall economic productivity. The resultant economic slowdown further intensified unemployment, leading to social problems, including rising joblessness and a loss of confidence in the government's ability to effectively address the crisis (Liotti, 2020).

To address inflation and stabilize the economy, the Central Bank of Indonesia often resorts to raising interest rates. Higher interest rates discourage borrowing and reduce consumer spending, thereby assisting in controlling inflationary pressures. However, this approach can also impede investment and economic growth. The elevated borrowing costs restrict businesses' capacity to expand, limit job opportunities, and reduce consumer spending, leading to an overall slowdown in economic activity and exacerbating the economic downturn.

The conventional approach of increasing interest rates as a policy response to economic crises does not guarantee positive outcomes for improving economic conditions. However, there is value in exploring an alternative fiscal policy framework rooted in Islamic morals, as put forward in this research. Such an approach holds potential for establishing a distinct foundation for fostering economic stability and growth, while also adhering to ethical principles. By incorporating Islamic principles, this alternative framework may offer innovative solutions to effectively address the challenges encountered during periods of economic crises (Tok & Yesuf, 2022). Moreover, Islamic finance holds significant relevance as a viable alternative for addressing one of the imminent global challenges within the upcoming five years: the economic crisis, alongside geopolitical and environmental concerns.

Despite the growing interest in exploring alternative fiscal policies, there exists a noticeable research gap in the specific context of Indonesia, particularly concerning the application of Islamic monetary policy as a means to address economic crises. While existing literature acknowledges the limitations of conventional approaches, there is a dearth of empirical studies that systematically investigate the feasibility and effectiveness of implementing an Islamic fiscal framework within the Indonesian economic landscape. Furthermore, the empirical gap in the literature becomes evident when considering the lack of concrete evidence and data-driven analyses regarding the outcomes of implementing Islamic monetary policy in response to economic crises. Existing studies often present theoretical arguments but lack substantial empirical support. This research aims to bridge this empirical gap by conducting a comprehensive analysis that incorporates both theoretical foundations and empirical evidence, providing a robust basis for evaluating the practical implications of Islamic fiscal measures.

The novelty of this research lies in its unique exploration of Islamic monetary policy as an innovative alternative to conventional approaches in the Indonesian context. By delving into the practical implications of implementing Islamic principles, this study contributes novel insights into the potential for a distinct fiscal framework that not only addresses economic challenges but also aligns with ethical considerations. Through a combination of theoretical rigor and empirical investigation, this research aims to provide a pioneering contribution to the literature on fiscal policy during economic crises, offering a fresh perspective that goes beyond the conventional wisdom in the field.

LITERATURE REVIEW

The conventional monetary policy in Indonesia, often reliant on Taylor Rules, primarily emphasizes inflation control through interest rate adjustments. This approach has been extensively studied and has demonstrated limitations in addressing holistic economic challenges (Özdemir, 2020). Numerous research highlights that during economic crises, such as the one experienced by Indonesia, depreciation of the national currency, the rupiah, often leads to higher import costs, causing inflationary pressures (Akpunonu & Orajaka, 2021; Selim & Hassan, 2019). Some articles emphasize that the devaluation of the currency escalates the costs of imported goods, reducing purchasing power and hindering businesses' long-term planning (Akpunonu & Orajaka, 2021; Apriliana & Soebagiyo, 2023). Moreover, these factors can lead to an increase in non-performing loans, impacting the stability of banks' balance sheets (Aji & Soebagyo, 2019).

To combat inflation, the Central Bank of Indonesia frequently resorts to raising interest rates, which is a standard policy response. However, research indicates that this approach may have adverse consequences. Elevated interest rates discourage borrowing and consumer spending, ultimately slowing down economic activity (Liotti, 2020; Özdemir, 2020). This can restrict business expansion, job creation, and innovation, exacerbating the economic downturn. This literature highlights the potential drawbacks of relying solely on interest rate adjustments for economic stabilization.

In response to these challenges, this research proposes an alternative fiscal policy framework rooted in Islamic principles and social norms. There is a suggestions that incorporating Islamic principles in monetary policy may offer innovative solutions for addressing economic crises while adhering to ethical principles (Ureta, 2020). This approach emphasizes discouraging excessive consumption, unproductive investment, and speculation alongside inflation control. By prioritizing ethical considerations and social norms, it is argued that Indonesia could promote responsible economic behavior among individuals and businesses.

This holistic approach seeks to move beyond the traditional reliance on interest rates and aims to foster a balanced and sustainable economic environment (Candrakusuma & Kurniasari, 2023; Prasetya & Kussudyarsana, 2020). Furthermore, it is important to note that Islamic finance holds significant relevance as a viable alternative for addressing global economic challenges, such as the imminent economic crisis, geopolitical concerns, and environmental issues.

In conclusion, the existing literature highlights the limitations of conventional monetary policy, particularly during economic crises (Jayawarsa et al., 2021; Nugraha et al., 2023). The proposed alternative fiscal policy framework rooted in Islamic principles and social norms offers a promising avenue for addressing these challenges, with potential benefits for Indonesia's economic stability and growth while adhering to ethical principles (Ponziani & Mariyanti, 2020; Rashid et al., 2020; Said & Hamid, 2018; Selim & Hassan, 2019; Syamlan & Istiana, 2018). Further research is needed to explore the practical implementation and effectiveness of this alternative approach in the Indonesian context.

METHOD

This research paper employs a literature study approach, conducting a descriptive analysis to explore and compare the principles, objectives, and stabilizing impacts of interest rate control and Islamic monetary policy. The study categorizes and analyzes published research from 2019 to 2023, utilizing both deductive and inductive coding processes. The research incorporates a comprehensive review of quantitative and qualitative methodologies, contributing valuable insights into the potential of Islamic monetary policy as an alternative to interest rate control, addressing gaps and contradictions inherent in the latter.

The content analysis of the research is structured into three main sections. Firstly, it explores the conceptual framework of each monetary policy, shedding light on the underlying principles and objectives of both interest rate control and Islamic monetary policy. Secondly, the study examines the stabilizing impact of these two approaches, analyzing how interest rate control and Islamic values contribute to economic stability. Lastly, the research investigates any contradictions inherent in interest rate policy, thereby highlighting the potential for Islamic monetary policy to fill these gaps (Rabbani et al., 2020).

The literature review underwent deductive and inductive coding processes to establish categories that are relevant to the subject of Taylor interest rate control and Islamic approaches to monetary stabilization (Soedradjad). Categorization serves as an element of content analysis that contributes to the formulation of policy conclusions. The review steps adopt the Conceptual model of the content-analysis based literature review process using both and inductive and deductive coding approaches (Elo et al., 2014).

To present the findings of the content analysis, the study offers in-depth conclusions based on the objectives, research types, approaches, and findings of the referenced studies. By considering a range of research methodologies, including quantitative and qualitative approaches, the conclusions provide a comprehensive understanding of the topic. The research findings contribute to the existing body of knowledge and offer valuable insights into the effectiveness and limitations of interest rate control compared to Islamic monetary policy (Jan et al., 2021).

Furthermore, to facilitate an easy understanding of the content analysis, an inventory of references is compiled in Excel tables. This inventory serves as a useful tool for readers, enabling them to quickly access and comprehend the relevant literature cited in the research.

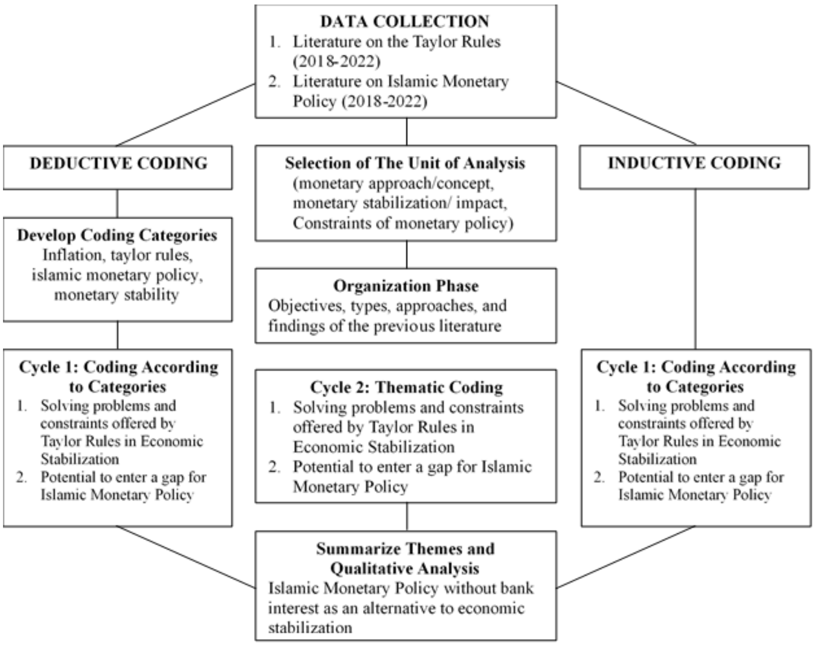

Figure 1 Conceptual model adoption of the content-analysis based literature review process using both and inductive and deductive coding approaches (Elo et al., 2014).

RESULT AND DISCUSSION

Interest Rates as the Anchors of Economic Stability

Numerous previous research endeavors have been dedicated to examining the connection between interest rates and economic policy, specifically within the context of enhancing foreign investment. One particular study, conducted between 1999 and 2021, sought to analyze the influence of the exchange rate of the Indonesian currency (rupiah) and interest rates on foreign investment in Indonesia (Apriliana & Soebagiyo, 2023). The primary goals of this study were to investigate the dynamics between these variables and comprehend their role in attracting foreign investment.

To accomplish these objectives, the study employed a quantitative analysis approach, specifically utilizing the Error Correction Model (ECM) regression technique. The researchers gathered time series data from 1999 to 2021 from reputable sources such as the Central Bank and the Indonesian Central Bureau of Statistics. By employing this robust methodology and incorporating pertinent data, the study aimed to provide a comprehensive analysis of the relationship between interest rates and foreign investment.

The findings of the study indicated a positive and lasting impact of interest rates on foreign investment in Indonesia. This outcome suggests that higher interest rates can contribute to attracting a greater influx of foreign investment to the country. Moreover, the study also corroborated the reliability of the Taylor Rules as a potential framework for implementing monetary policy. The affirmation of the Taylor Rules' effectiveness adds to the existing body of knowledge concerning the utilization of interest rates as a tool for economic policy and imparts valuable insights for policymakers in formulating effective monetary strategies.

Numerous literature pieces provide a comprehensive analysis of the interplay between inflation targeting and the regulation of monetary policy, with a specific focus on emerging countries (Benítez et al., 2020; Pérez Caldentey & Vernengo, 2020; Suranto et al., 2023; Taylor, 2019). Conducted as a meta-analysis, these studies examine various cases of inflation targeting in emerging economies, utilizing the Taylor Rules as a fundamental framework for assessing monetary policy.

The research findings, by unanimous consent, indicate that employing higher interest rates as a means to target inflation proves to be the most effective strategy in mitigating inflationary pressures, particularly in emerging countries within the Latin America region. This underscores the vital role of interest rate policy as a pivotal tool in effectively managing inflation.

Nevertheless, the studies also highlight the limitations of relying solely on interest rate policy implemented by the central bank. These studies suggest the integration of additional measures to supplement this approach, such as the combination of microprudential policies, coordination between the central bank and government through the establishment of an Inflation Control Team, and enhanced transparency. These supplementary efforts are deemed crucial components in ensuring the successful implementation of monetary policy and the attainment of inflation targets.

Overall, these studies contribute valuable insights into the intricate relationship between inflation targeting and monetary policy in emerging countries. They emphasize the significance of adjusting interest rates while underscoring the need for a comprehensive and integrated approach to monetary policy, taking into account factors beyond interest rates alone.

A literature focuses on examining the impact of interest rate monetary policy on consumer spending and the unemployment rate, specifically within the context of a pandemic in the United States (Faria-e-Castro, 2021). The primary objective of this research is to align fiscal policy with monetary stability during this challenging period.

To achieve this objective, the study utilizes a nonlinear perfect foresight transition paths approach, enabling a comprehensive analysis of the relationship between fiscal policy, the unemployment rate, and consumer spending during the 2020 pandemic.

The research findings reveal that central bank fiscal policies, in conjunction with other authorities, play a crucial role in stabilizing sectors affected by the pandemic. The study highlights the significance of the central bank's fiscal policy in ensuring the sustainability of the business sector and fostering consumer spending. Key components of the central bank's fiscal policy, such as effective inflation targeting, unemployment benefits, and liquidity assistance, are identified as essential factors contributing to the overall stability of the economy.

Overall, this research underscores the importance of aligning fiscal policy with monetary stability, particularly in times of economic turmoil like a pandemic. The findings suggest that the central bank's fiscal policy measures have a direct impact on supporting the business sector and stimulating consumer spending. These insights provide valuable guidance to policymakers in formulating effective strategies to promote economic stability, support businesses, and enhance consumer confidence during challenging times.

The utilization of the Taylor Rule as a framework for determining interest rates based on economic conditions provides valuable clarity. However, its application for achieving monetary stabilization exposes inherent contradictions. Notably, the rule's failure to account for external factors, such as changes in fiscal policy, global conditions, and political influences, limits its effectiveness (Levrero, 2023). This discrepancy between the Taylor Rule's recommendations and the real-world circumstances faced by monetary authorities can hinder the achievement of desired outcomes. Furthermore, the Taylor Rule's inadequacy in addressing extraordinary economic situations, including financial crises or pandemics, becomes evident and necessitates alternative approaches (Beckworth & Hendrickson, 2020;

Carare & Tchaidze, 2005; Ohanyan & Grigoryan, 2021). Consequently, there is a pressing need for a more adaptable and innovative monetary policy that can effectively respond to the unique challenges presented by these exceptional circumstances.

Enhancing Monetary Stability: The Prominence of Islamic Policy as a Prudent Paradigm

A research study titled "Interest Rates-Free Monetary Policy Rule" was discovered, which employs the exploratory approach to explore alternative methods of assessing monetary policy beyond the reliance on interest rates. This article delves into the application of Taylor's theory and presents a novel perspective on evaluating monetary policy attitudes (Bernanke et al., 2019; Raffinot, 2017). The findings of this study reveal two key outcomes. Firstly, the Interest Rate Free Monetary Policy Rule proposes an approach that deviates from the conventional Taylor rule, which primarily relies on short-term interest rates (Farrar, 2011). Secondly, the European Central Bank (ECB) focuses on inflation measures and sets an inflation target of maintaining consumer price index (CPI) inflation below close to 2 percent in the medium term. This research sheds light on innovative approaches to monetary policy evaluation and provides insights into the ECB's inflation targeting framework.

An islamic research explores the concept of Interest-Free Monetary Policy, offering insights into the assumptions and strategies associated with implementing such a policy (Engel et al., 2019; Maulana & Marasabessy, 2018). The findings of this study highlight two important aspects. Firstly, it emphasizes the need for money to serve its fundamental role in society as a medium of exchange for transactions and as a reflection of an item's value, rather than being treated as a commodity for trade. Secondly, the research proposes the implementation of an interest-free monetary policy through the adoption of a profit-sharing system and investment in the real sector using Islamic muamalah contracts.

To conduct this study, a Library Research methodology was employed, enabling a comprehensive analysis of existing literature and scholarly works. The research ultimately provides valuable insights into the solutions required for implementing an interest-free monetary policy. One of these solutions involves redirecting money in circulation towards the real sector, thus creating new employment opportunities and enhancing productivity. This can be achieved by facilitating real investment opportunities as a means to balance the amount of circulating money.

Overall, this research contributes to our understanding of the importance of implementing an interest-free monetary policy and offers practical suggestions for achieving this goal. By promoting investment in the real sector and ensuring a more equitable distribution of wealth, such a policy can foster economic stability and support sustainable development

CONCLUSION

The study concludes that there are no compelling arguments supporting the abolition of the Central Bank's Interest Rate Policy (also known as the Taylor Rule) in the interest of monetary stability based on the literature evaluation. The relevance and efficiency of this approach in obtaining intended economic results are supported by the body of extant literature.

This study also points out several drawbacks in the Central Bank's interest rate policy, particularly when it comes to containing inflation under unusual and difficult situations like pandemics, geopolitical unrest, and external monetary disturbances. The study highlights the insensitivity of interest rate strategies to deal with unemployment and advance equity non the medium to short term, exposing possible weaknesses in dealing with more general economic issues.

A substantial amount of literature recommends alternate strategies like Islamic Monetary Policy while not contesting the role of central bank interest rate policies in preserving monetary stability. With this strategy, the equitable distribution of wealth, the sharing of ownership advantages, and the prevention of asset speculation are given more weight. Such writings place a strong emphasis on the necessity of enacting legislation in line with Islamic values in order to promote an economic system that is more just and inclusive.

The study's findings support the central bank's interest rate policy's sustained applicability for maintaining monetary stability. It does, however, accept the need to address some policy flaws, particularly those relating to inflation control in the face of exceptional difficulties and its limited influence on unemployment and equity. The study also highlights the literature that supports Islamic

Monetary Policy, stressing its emphasis on wealth distribution, the advantages of fair ownership, and the use of non-speculative assets as viable directions for additional research and policy consideration.

SUGGESTION

The government should actively engage in collaborative endeavors with prospective researchers to advance the comprehension and enactment of alternative monetary policies. This concerted effort entails the establishment of research grants and academic affiliations aimed at facilitating exhaustive inquiries into the viability and repercussions of monetary policies grounded in ethical precepts, societal mores, and the principles of Islamic finance. Future research endeavors ought to concentrate on conducting empirical analyses across diverse economic milieus to gauge the enduring ramifications of diversified monetary policy paradigms, notably concerning economic equilibrium, income distribution dynamics, and sustainable development imperatives.

Policymakers and researchers must synergize their efforts to fashion pragmatic implementation modalities and directives for effectuating the transition from conventional interest-driven policies to pioneering frameworks. The accentuation of transparency and accountability within the precincts of monetary policy formulation processes assumes paramount significance in nurturing public trust, a feat realizable through collaborative research enterprises and the fortification of communication conduits between governmental organs and academia. This collaborative modality harbors the potential to engender conscientious economic praxes and contribute substantively to the gestation of more resilient and egalitarian economic architectures.

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