

TOWARD OPTIMUM SYNERGY OF MONETARY POLICY IN DUAL FINANCIAL/BANKING SYSTEM

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ABSTRACT

In a country adopting dual financial/banking system, where a conventional financial system coexists with an Islamic financial system, monetary authority has the responsibility to maintain financial/monetary stability and synergy of both systems. This study analyses and compares one of the main pillars of conventional monetary system and Islamic monetary system (i.e., interest system vs. profit-and-loss sharing/PLS system) and try to come up with the possible conduct of optimum monetary policy under dual financial/banking system. The results show that PLS system is superior to interest system in fairness, justice, efficiency, and stability. Therefore, the optimum synergy in the dual financial/banking system can be achieved when monetary policy in conventional system benchmarks its policy rate to the PLS market return in Islamic financial market of Islamic system, which will ensure optimum market efficiency that maximize distributive social welfare and justice. Monetary policy in managing money supply is only a response to the dynamic activity in the real sector. While, active monetary policy can be conducted, not by altering M , but by altering V , i.e. to increase the flow of money in the economy by issuing central bank SUKUK with PLS market return to finance government projects, commercially as well as socially, in the real sector.

Keywords: *Islamic Monetary System, Islamic Financial System, Dual Banking Financial System*

INTRODUCTION

Background

In the past few years, international financial system has been expanding widely. This phenomena, where capital market liberalization and free capital movement, technology advancement, and financial innovations, have contributed to the achievement of unprecedented level of financial globalization, which will not only offer significant benefits, but also create new risks. In line with the development of conventional financial institutions, Islamic financial institutions (IFIs) have also grown rapidly, especially in

Islamic banking. This development should be complemented with the development of Islamic capital market and Islamic insurance (Takaful).

Despite Islamic financial institutions and instruments promising development, there are problems remains to be resolved due to the lack of supporting infrastructures, such as Islamic legal system, the lack of commitment from the authorities, unfavorable tax policy, etc. The development of IFIs should not only focus on Islamic banking, but it should also focus on the development of other IFIs and all interrelated aspects of Islamic financial system as a whole, simultaneously.

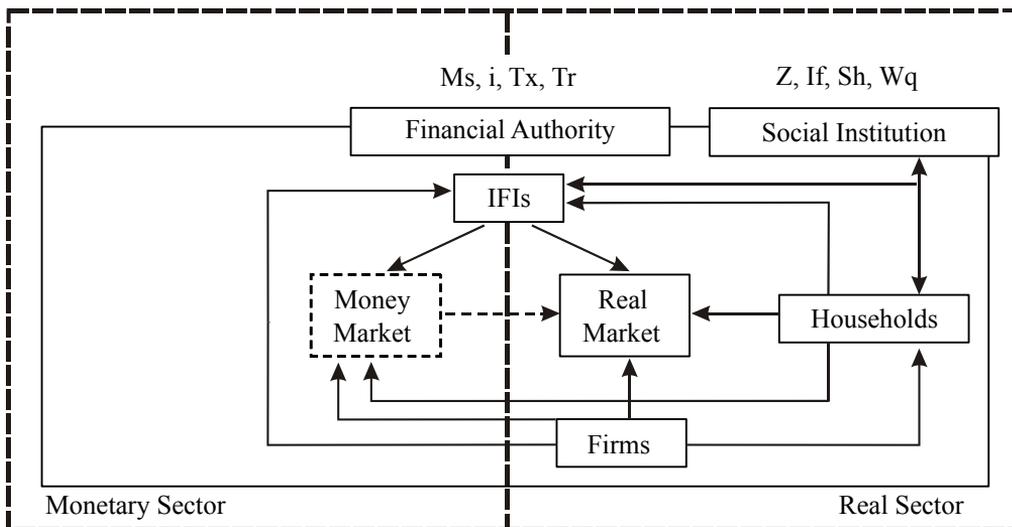
Considering the current state of Islamic finance which is still dominated by conventional finance, there should be a harmonization of both systems in order to gain maximum benefits for the economy. Furthermore, there should be a synergy of both systems in order to achieve optimum benefits and distributive prosperity to the society. The objective of this study is to formulate the optimum monetary policy that brings synergy between conventional and Islamic financial system that assure financial system stability, maximize distributive prosperity and justice as well as minimize injustice and inefficiency. The methodology applied will be literary study and descriptive analysis by comparing the existing dual financial system with the ideal dual financial system, taking existing limitations into account.

CONTEMPORARY ISLAMIC ECONOMIC AND FINANCE

Contemporary Islamic economic and financial systems have been developing under

complete domination of capitalistic conventional economic and financial systems. The domination of capitalism, like it or not, has significant impact in the development of Islamic financial system which is not always able to implement its operations purely and wholly (*kaffah*) according to *Shariah Law*. In addition, most Muslim economists are still polluted by inferiority complex with the belief that capitalist economic system is better than Islamic economic system, because of the fact that many developed countries proved to be able to achieve high level of economic wellbeing. Within this kind of environment and limitations, Islamic economic/financial system has been developing with more pragmatism and permissiveness, and mostly just has been following the capitalist economic/financial system.

Figure 1 shows that there is a different operational environment between conventional and Islamic finance. Islamic finance essentially is a real sector activity using various kinds of transactions, such as, trade,



Ms: Money supply ; i: Interest rate; Tx: Tax; Tr: subsidy; Z: zakat; If: infaq; Sh: shadaqah; Wq: Waqf (Endowment); IFIs: Islamic Financial Institutions.
Source: Sakti (2007), with adjustment

Figure 1. Contemporary Islamic Economic Structure

investment, and financial services. From this figure, it can be showed that in countries implementing dual financial/banking system, Islamic finance works as augmenting element in the real sector to balance monetary sector. In fact, social sector of Islamic economic will strengthen the structure of the real sector. However, the degree of balancing strength is dependent to the contribution or share of Islamic finance, including the social sector, to national economy.

It can also be inferred from this figure that the form of Islamic monetary instruments are policies that can speed up the velocity of money in the real sector and that can discourage hoarding of money. For example, government investment certificates offered to public to finance development projects, such as road, airport, dam, etc. however, it should be understood that in an economy adopting dual financial/banking system there might be a dilemmatic or trade off situation when the share of Islamic finance is still relatively small compare to the existing dominating conventional one. For example, when a situation arise to avoid capital outflow the monetary authority decide to set the policy rate far above the market return of profit and loss sharing (PLS) in the Islamic financial/banking system. The market return reflects the actual yield of the real sector. With high policy rate, floating customer¹ will move their investment deposits in Islamic banks to time deposits in conventional banks to seek higher return. This situation will have a contraction effect in the deposit mobilization of Islamic banks if portion of floating customer is still dominant compare to that of faithful² customer. Under the domination of capitalistic conventional

economic system, the application of Islamic finance/banking is not always able to implement purely comply with Shariah Law. Islamic finance/banking has been developing toward the mirroring of its conventional counterpart, as can be seen in Figure 2.

CONVENTIONAL MONETARY SYSTEM AND ISLAMIC MONETARY SYSTEM

Islamic economic system does not recognize the parallel dichotomy between real sector and monetary sector. Monetary sector provides support to the real sector related to the flow of money in real sector investment activities either conducted by the governmental or private institutions. The main characteristics of Islamic monetary system that can be differentiated from conventional monetary system can be read in Table 1.

The three main characteristics of conventional monetary system are fundamental in the process of money creation in the system. Interest has a number of negative effects to the economy. These three main distinct characteristics of conventional and Islamic monetary systems will be elaborated further in this section.

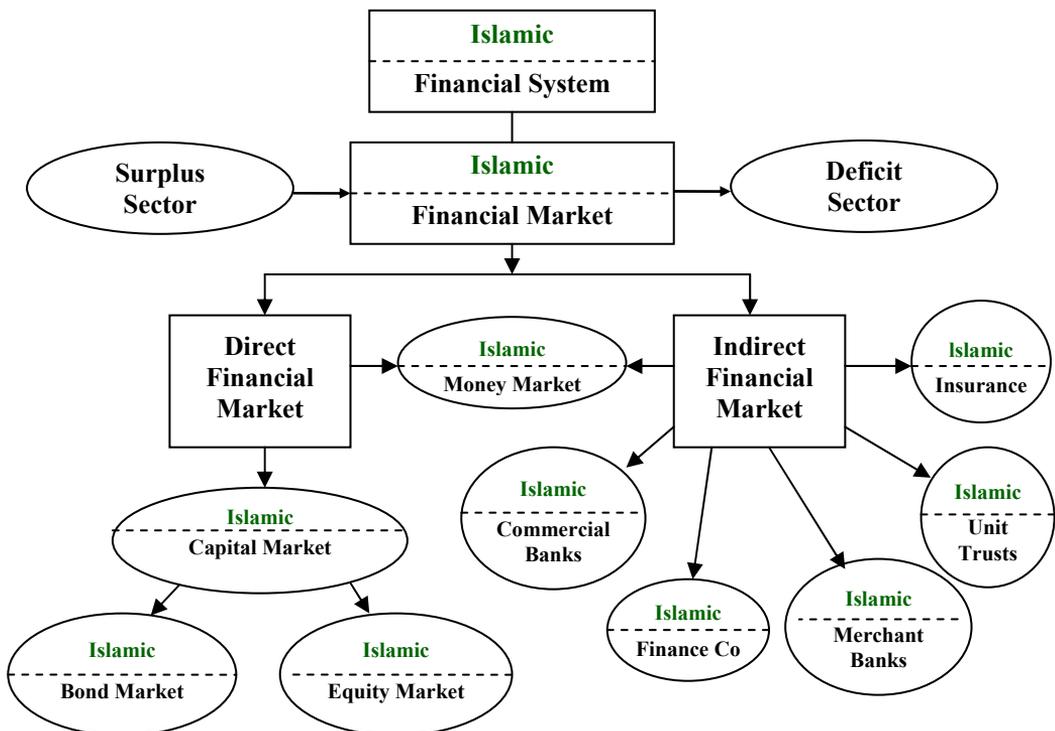
Table 1. The Characteristics of Conventional Monetary System and Islamic Monetary System

No	Conventional	Islamic
1.	Fiat Money	Full Bodied/Fully Backed Money
2.	Fractional Reserve Banking System	100 Percent Reserve Banking System
3.	Interest	Profit and Loss Sharing

Source: Author, based on Meera (2004).

¹ Floating customers are customers who based their investment decision purely on the rate of return with no consideration whether it is Islamic or conventional investment. Therefore, they are sensitive to the fluctuation of interest rates.

² Faithful customers are customers who based their investment decision mainly on the Islamic investment, while the rate of return comes second. Therefore, they are not so sensitive to the fluctuation of interest rates.



Source: Rosly (2005)

Figure 2. Contemporary Islamic Financial System

Fiat Money vs Islamic Money

Fiat money is physical money (usually in the form of bank notes or coins) that is acknowledged as a legal medium of exchange in a certain jurisdiction or state, even though it does not carry a value or back up equivalent to its nominal value. The issuance of fiat money creates a new purchasing power out of nothing. Thus, fiat money gives unfair benefit, which is commonly called *seigniorage*, to the authorized issuing authority. The creation of benefits without any *'iwad* (counter value) in the forms of ownership risk (*ghurmi*), value added (*ikhtiyar*), or liability (*daman*) are categorized as *riba* by Ibnu Arabi (Rosly, 2005).

In an economic system that uses *fiat money* as *legal tender*, the institutions authorized to issue money (usually Central

Bank, Monetary authority, finance department or other appointed institutions) gain this *seigniorage* benefits. Consequently the money purchasing power will agregately decrease (or inflation happens) corresponding to the percentage of the amount of money added in the economy. The parties that suffer from loss are all parties which hold money. For example, if the money supply is added by 10 percent (with the assumption that the printing cost is negligible) the economy in which the amount is 100 and does not increase yet, the price has already changed from 100 to 110. In the real sense, the price of a fried banana that previously IDR 100 becoming IDR 110 each. The purchasing power of the money that is held by the people decrease 10 percent, while the money printing authority obtain new purchasing power as much as the new bank

notes printed (10 percent from the amount of money supply).

Meanwhile, theoretically and historically, money in Islam is full bodied (i.e. gold and silver whose intrinsic values are equal to its nominal values) and fully-backed (i.e. bank notes or coins whose nominal values are backed up by 100 percent gold saved by the issuing authority). In issuing new money, there is no new purchasing power created (no seigniorage) so that there is no element of riba (usury). In addition, in producing new money, the printing cost becomes the responsibility of the government resulting in no single party suffering from loss.

In Islamic economic system which utilizes this type of money, the state authority that is authorised to issue money does not gain the benefits of *seigniorage*, yet it must expend the printing cost. The amount of money issued and added in the economy is in accordance with the growth of its value-added. As a result, in general, Islamic economy is not inflationary and tends to be stable. Therefore, the value of dinar (in gold) and dirham (in silver) have always been stable. For example, the price of sheep has always been around 1-2 dinar, and the price of chicken has always been around one dirham.. Having such a type of money, people will never suffer from loss due to inflation like what usually happens when issuing fiat money.

The use of fiat money in international level will be favourable for big countries like the United States of America with its US dollar and European Union with its euro where their currencies are used worldwide. With their fiat money, they can suck the wealth of other small and less developed countries that have abundance natural resources and exchange them with paper which has no intrinsic value. For example, with only US\$1 expenses to print US\$100 bill, the *seigniorage* profit earned by the US from the use of its currency by the world community would be enormous. Having

dinar or dirham as international legal tender, transactions become fairer and all countries have equal positions.

Mahmud Abu Saud in his book “*Interest Free Banking*” (1976) stated that unless we standardized our money and stabilized its value, the sound and healthy economy could not be achieved. Only with the gold (dinar) and silver (dirham) standards that money can be stabilized.

Fractional Reserve Banking System vs 100 Percent Reserve Banking System

Fractional reserve banking system refers to the system where a bank is required to hold reserve in only a certain percentage of deposits mobilized. The minimum reserve requirement of bank varies around 5 – 20 percent. With this system, bank has the ability to create another kind of fiat money, i.e. bank money (demand deposits, electronic money), through multiple deposit creation. In this case, money is created when a bank extends loan. For example, if the required minimum reserve is 10%, Rp1 million deposit, first, will be recorded as ‘Deposit’ in liability side and cash ‘Reserve’ in asset side. Second, since reserve requirement is only 10%, the bank can extend loan as much as Rp9 million, so that the total deposit becomes Rp10 million.

Balance Sheet

Reserves	1 million	Deposit	1 million
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Balance Sheet

Reserves	1 million	Deposit	1 million
Deposit	9 millions	Deposit (loan)	9 millions

The formula of multiple deposit creation can be written as follows (Meera, 2004):

$$D = 1/r \times R$$

Where:

- D = the change in the total of deposit
- r = legal deposit ratio (for example, 10 percent)
- R = in reserve (e.g., new deposit IDR1 million)

In this example, deposit of IDR1 million can create new money (deposit) nine times of its original value, IDR9 million, so that the total deposit becomes IDR10 million. Therefore, fractional reserve banking system also gives unfair *seignorage* profit to the bank which authorized to create new bank money. Remember that the creation of profit without any counter value is considered as *riba* by Ibnu Arabi. Consequently, the creation of bank money will also make the aggregate purchasing power of money to decrease (in the form of inflation) equivalent to the percentage of new bank money created by bank. The party who suffer a loss with the creation of new bank money is, again, the whole population who holds this money.

Meanwhile, the 100 percent reserve banking system does not give the opportunity for bank to create new (bank) money, since 100 percent reserve has to be deposited back to central bank. A bank can only extend loan as much as the original deposit. Therefore, there will be no new purchasing power created (and no *seignorage*), so that there is no *riba* involved, there is no inflationary effect, and there is no party suffered any loss.

For example, IDR1 million deposits, first, will be recorded as 'Deposit' in liability side and cash 'Reserve' in asset side. Since reserve requirement is 100 percent, the bank can only extend loan as much as IDR1 million, so that in the asset side, the 'Reserve' becomes 'Loan' of Rp1 million.

Balance Sheet

Reserve	1million	Deposit	1 million
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Balance Sheet

Reserve	1 million	Deposit	1 million
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Interest System vs Profit-and-Loss Sharing System

As an alternative of interest system in conventional economic, Islamic economic offers profit and loss sharing (PLS) system, where the owner of the capital (surplus spending unit) partnered with entrepreneur (deficit spending unit) to venture a business. If the business makes profit, it will be shared. If the business suffers a loss, the burden will also be shared. The PLS system guarantees fairness and no exploitation (*dzulm*) of one another. PLS system could be in the various form of *mudharabah* and *musharakah*.

Ryandono (2006) gives an illustration, the principal difference between interest system of conventional economic and PLS system of Islamic economic is from the return system applied to the customers. Conventional bank applies interest system, where certain percentage of return from fund deposited or loan extended is predetermined in front, so that the nominal amount and the due date of the return can be assured without any consideration whether the bank or the project financed will gain profit or suffer a loss. Meanwhile, Islamic bank applies PLS system, where the PLS ratio is fixed and predetermined in front, but the nominal amount of profit or loss is unknown until it is realized later.

In a conventional bank, customer will receive or pay fixed return called interest. Depositor will receive interest, which is a certain percentage of funds deposited with the bank, while borrower will pay interest, which is a certain percentage of loan borrowed from the bank. Meanwhile, in an Islamic bank, customer will receive or pay unfixed return that could be a profit or a loss. Investor (depositor of Islamic bank) will receive a portion of return from the funds invested with the bank, while entrepreneur (borrower of Islamic bank) will share the portion of return from the business financed by the bank.

The predetermined interest in conventional system has to be paid off by bank to depositor and by borrower to the bank irrespective of the outcome of their businesses. The bank could suffer a loss, but it has to pay off the interest to depositor, while the borrower could also suffer a loss, but he/she has to pay off the interest to the bank. On the contrary, the bank could gain a large profit, but the depositor will still only receive the predetermined interest, while the borrower could also gain a large profit, but the bank will still only receive the predetermined interest. Either way, there is always unfairness. This system is very much different to that of Islamic PLS system. In any case (gains profit or suffers loss) investor and the bank or the bank and entrepreneur will share the outcome. In Islamic banking, the relationship between customer and the bank is in the form of partnership with trust as the main element.

There is no exploitation in the Islamic system, since uncertain conditions (risk and opportunity) in the future are shared between/among partners. This is made possible because Islamic economic prohibits predetermination of something uncertain in the future (such as, gains profit or suffers loss). On the contrary, Islamic economic also prohibits to make certain thing becomes uncertain, so that someone can speculate or get benefit for one's

own on the loss of others and the destruction of the economy.

In the conventional banking system, exploitation, predation, and intimidation could happen. Exploitation could happen in time of high interest rates or in time of low interest rates. When the interest rate is high in a bad economic time, the debtor is the one who is exploited by the creditor. Under this circumstance, the debtor business declines and there might be a shrink in profit or even a loss, but the debtor still have to pay high interest. In this bad economic time, predation (where the strong could prey on the weak) and intimidation (where the bank force the debtor to pay the unpaid interest) could happen to the debtor. When the interest rate is low in a good economic time, the creditor is the one who is exploited by the debtor. Under this circumstance, the debtor business is booming and is earning high profit, but the creditor will only receive low interest payment.

Unfairness could happen under the interest system in a good or bad economic time in the form of exploitation, predation, and/or intimidation. These three characteristics are the basic nature of *riba* transactions. Therefore, it will be appropriate to eradicate *riba* from the economy, since it will only create inefficiency and instability in the economy.

The Impact of Monetary System in Economy

Some experts, like Bernard Lietaer and Tareq el-Diwany, have identified several bad impacts of interest rate on the economy (Meera, 2004):

1. Interest rate requires continuous economic growth, even when actual standard of living remains unchanged;
2. Interest rate encourages competitions among the economic actors;
3. Interest concentrates wealth in the hands of small minority by taxing the majority.

Comprehensively, Meera (2004) describes the impact of conventional monetary system that can cause banking crises, economic problems, and political turmoil because money gets destroyed.

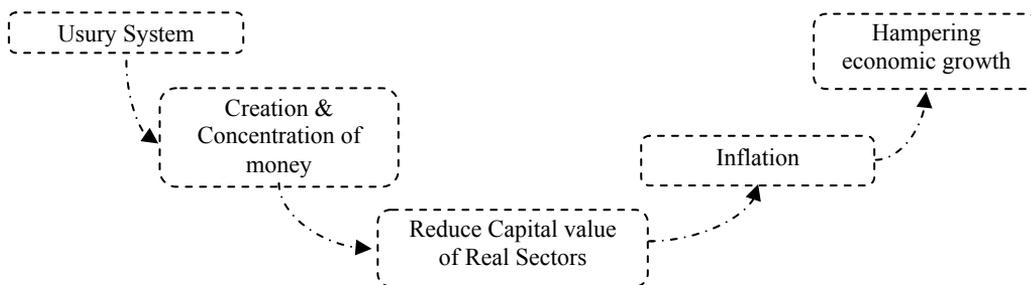
In conventional economy, interest (*riba*) system, fiat money, fractional reserve banking system, money as commodity, and the permissibility of speculation cause the creation of money (paper money and bank money) and concentration of money in monetary sector to seek higher return with less or no risk. Consequently, money or investment that should be channeled to the real sector for productive purposes mostly flows to the monetary sector and impedes growth, and even reduces the size of real sector. The creation of money without value addition will cause inflation. In the end, the goal of economic growth will be hindered (see Figure 3)

Meanwhile, in Islamic economy, the zakah system, PLS system and the prohibition of speculation will accelerate investment

activities to the real sector for productive purposes. This will ensure the distribution of wealth and income as well as the growth in the real sector. The improvement in productivity and opportunity to work and to do business finally will accelerate economic growth, and therefore, social wellbeing will be achieved (see Figure 4).

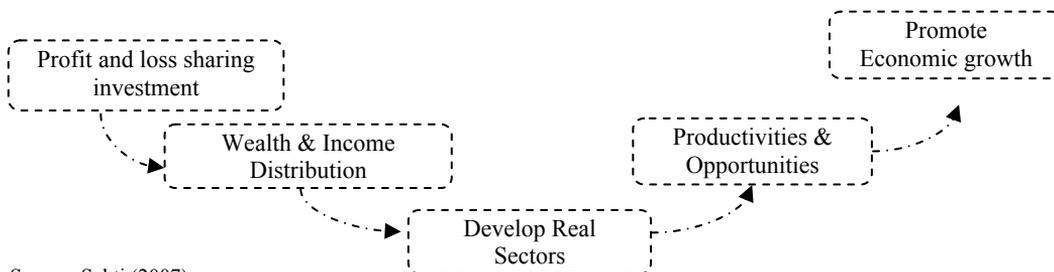
THE SYNERGY OF CONVENTIONAL FINANCIAL SYSTEM AND ISLAMIC FINANCIAL SYSTEM

In the world dominated by capitalistic system, contemporary Islamic monetary system is still heavily influenced by it. Only one of three main components of Islamic monetary system that can be applied in reality, namely, the prohibition of *riba* which is substituted by PLS system. The other two main components, the use of money and banking system, have not yet been implemented and have still adopted conventional model, namely, the use of fiat money and fractional reserve banking system (See Table 2).



Source: Sakti (2007)

Figure 3. Implication of Interest in Economy



Source: Sakti (2007)

Figure 4. Implication of Profit-and-Loss Sharing in Economy

Tabel 2. Comparison of Conventional Monetary System, the Concept of Islamic System and Its Contemporary Practices

No.	Conventional Monetary System	The Concept of Islamic System	Contemporary Practice of Islamic System
1.	Fiat Money	Islamic Money	Fiat Money
2.	Fractional Reserve Banking System	100 Percent Reserve Banking System	Fractional Reserve Banking System
3.	Interest	Profit and Loss Sharing	Profit and Loss Sharing

Source: Author, based on Meera (2004)

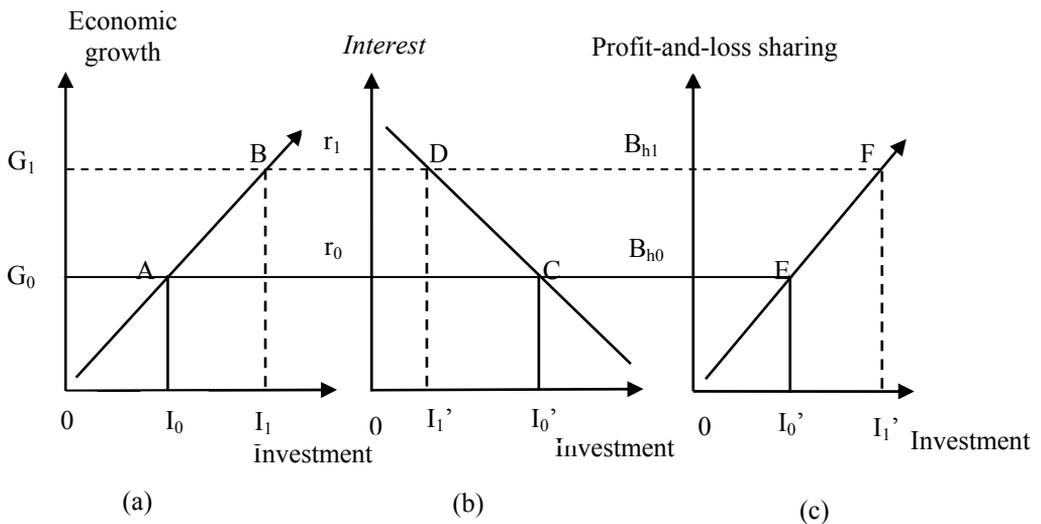
The (still) adoption of fiat money and fractional reserve banking system, inflationary money creation is still exist in contemporary Islamic monetary system. Therefore, Islamic banking operated under fractional reserve banking system is also still creating bank money (including electronic money), even though the use of this money is strictly has to be in compliance with Shariah principles.

With all of the above considerations, the optimum synergy of conventional and Islamic financial system through monetary policy

should focused on the comparison between interest system and PLS system in more detail.

The Empirical Study of Interest System and Profit-and-Loss Sharing System

Conceptually, the comparison between interest and PLS systems has been discussed in the previous chapter. To arrive at a more convincing conclusion, empirical study done by Ryandono (2006) will be discussed (see Figure 5).



Source: Ryandono (2006)

Figure 5. The Impact of Interest System and Profit-and-Loss Sharing System on Investment and the Economy

The relationship between economic growth and investment is upward-sloping or positive, implying that if we want to increase output or economic growth, then investment should be increased as well (panel a). By contrast, the relationship between interest rate and investment is negative or downward-sloping, implying that if the interest rate increases, investment decreases, since some previously feasible investment projects become not feasible. Here, interest rate could act like a dam or barrier. The higher the dam the smaller the water flows (panel b). In the meantime, the relationship between PLS return and investment is upward-sloping or positive, since when PLS return increases, investment will flourish and profitable (panel c).

In conventional economy (panel b), when economic growth is at the G_0 level, the expected output from investment (area $O.r_0.C.I_0'$) is greater than that of the total economy (area $O.G_0.A.I_0$ in panel a). To increase When economic growth to be increased to G_1 (the expected total output becomes $O.G_1.B.I_1$), interest rate would increase to r_1 that it would decrease expected output to $O.r_1.D.I_1'$. The output gap ($O.r_0.C.I_0' - O.G_0.A.I_0$ or $O.G_1.B.I_1 - O.r_1.D.I_1'$) would cause exploitation, predation, and intimidation in economic activities. Thus, interest system can hamper and distort economic development, as well as can be the source of unsynchronized monetary and fiscal systems in the economy. It is evidenced that Interest rate or *riba* can destroy the economy since it stimulates instability and inefficiency as well as ruins the human relationship.

Meanwhile, in Islamic economy (panel c) When the desired level of economic growth is G_0 , the size of expected investment (area $O.B_{h0}.E.I_0'$) is equivalent to the size of expected output of the economy (area $O.G_0.A.I_0$ on panel a). When economic growth to be increased to G_1 (expected output of the total economy becomes $O.G_1.B.I_1$), PLS return increases to B_{h1} , so that expected investment

increases to $O.B_{h1}.F.I_1'$ which is equivalent to the size of expected output of the economy as a whole $O.G_1.B.I_1$. The output gaps will not happen. As a result, exploitation, predation and intimidation will not take place in economic activities. Thus, PLS system is proved to be more just and sound; it will encourage investment and accelerate growth, as well as promote efficiency and stability in the economy at macro and micro levels. Moreover, monetary and fiscal sectors automatically will synchronize and go along with similar interests and objectives in the economy.

Towards the Synergy of Conventional and Islamic Financial Systems

In a country adopting dual financial system, monetary and fiscal authorities have the responsibility to maintain financial stability within the two financial systems (conventional and Islamic) and to synergize the two to achieve maximum benefit for the society wellbeing. Combining and synergizing conventional and Islamic financial systems require infrastructures, instruments, and system of operations which are designed precisely based on the philosophy and essence of each system, without merging or dissolving one system into the other. Mixed but not dissolved to create harmony. The concerted synergy produced by the authority will guarantee financial system stability, induce economic progress in the real sector, and accelerate growth, which is oriented towards distributive economic welfare, prosperity, and equality.

Many countries adopting dual financial system are generally implementing separate or partial monetary policy for each system with no harmonization and optimization to achieve social welfare objectives. Conventional monetary policy instruments apply interest rate as the anchor (policy rate). Meanwhile, Islamic monetary policy instruments apply several instruments based on varied schemes

with the pricing based and benchmarked to conventional policy rate. Therefore, Islamic financial institutions (IFIs) tend to behave like their conventional counterparts. For example, Malaysian Islamic banking has financing portfolio with 99% debt based (*murabahah* and *bai' bithaman ajil/BBA*) and only 1% share based (*mudharabah* and *musharakah*). In addition, Malaysian Islamic banking can only record financing to deposit ratio (FDR) of around 60%, exactly similar to loan to deposit ratio (LDR) recorded by its conventional counterpart.

With the policies that treat the two systems equally, without any consideration to each distinct characteristic, IFIs have been progressing with the behavior almost exactly the same as their conventional counterparts. This condition makes IFIs like Islamic bank almost do not have any significant differences compare to conventional bank, so that the existence of IFIs, which should be more real sector development oriented, do not give significant impact. Moreover, as previously stated, interest rate in conventional financial system possesses fundamental drawbacks which tend to be exploitative, predatory, and intimidating in economic activities, so that interest system will impede and distort economic development. Moreover, interest system causes monetary and fiscal systems difficult to be synchronized. Therefore, there should be new benchmark that is more appropriate for synergy and harmony of conventional and Islamic financial system to happen..

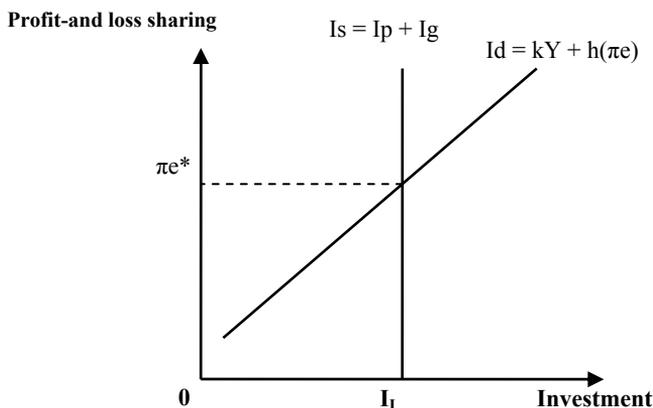
Investment Equilibrium in Islamic Economy

The demand for investment in Islamic economic empirically is illustrated in figure 4.9 which is upward sloping to PLS return. It means that when the PLS return increase, then the demand for investment will also increase. This is in line with the theory of investment demand in Islamic economics.

The supply of investment in Islamic economic can come from private, government, and social. In Islam, people who own wealth/fund are advised to invest, directly or indirectly, and not let the fund idle. Hoarding fund/money is prohibited in Islam, since money is a public goods that is intended to accelerate transaction in the economy. If fund is left idle, then (if it fulfills the conditions of *nizab/amount* and *haul/period*) *zakah maal* (Islamic taxation on extra wealth) of 2.5% will be applied. Furthermore, it has been proven by Misanam *et.al.* (2008) that the implication of law of diminishing return on investment makes Muslims will prefer to invest their fund up to the expected return of the investment equal to -2.5% (negative of *zakah* rate). Therefore, the supply of investment from private is not responsive to the expected PLS return.

In the mean time, government investment, which is mainly directed toward infrastructures development, usually does not put profit as a priority, so that the government supply of investment is also not responsive to the PLS return. Moreover, in Islamic economic, there is social investment, such as, *waqf*, *infaq*, and *shadaqah* (Islamic type of charities), which naturally is not seeking for profit, so that it is also not responsive to the PLS return. Therefore, since all sources of investment in Islamic economic are not responsive to the PLS return, the supply of investment curve will be vertical, as can be illustrated in Figure 6. Factors that can influence investment market, among others, are policies that are able to maintain the rate of PLS return attractive, the improvement of the level of collective *iman* (faithfulness) of the society, so that social funds are accumulated to be invested optimally.

Meanwhile, factors determine the rate of return in the real sector that can improve productivity and create conducive investment/business climate, among others, are efficient management, technology, bureaucracy, and legal certainty.



Source: Sakti (2007)

Figure 6. The investment balance in Islamic Economy

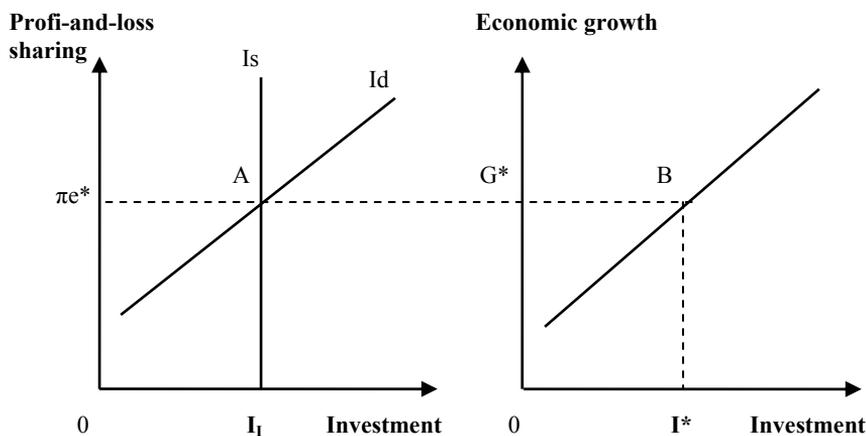
With the optimum rate of PLS return πe^* at the intersection of investment demand and supply curves, optimum economic growth of G^* can be achieved, as illustrated in Figure 7. The expected output of investment in Islamic economy, which is the area $O.\pi e^*.A.I_1$, is equivalent to the expected output of the total economy, which is the area $O.G^*.B.I^*$. Therefore, the level of investment in Islamic economy is the optimum level of investment, with no excess or gap usually occurs in conventional economy, so that there should be no exploitation, predation, or intimidation in economic activities.

Condition to Obtain Synergy

In general equilibrium, all market activities end up in the market of goods and services, with the market price (P) as a result of demand and supply interaction ($D = S$), so that it can be concluded that $\Delta Q = \Delta I = \Delta M$. It implies that the increase transaction in the real sector is reflected in the increase in investment as well as the increase in demand for money (see Figure 8, vertically). In other words, the activity of money creation (M_s) is only a **responsive policy towards the dynamic activity in the real sector**. This can be

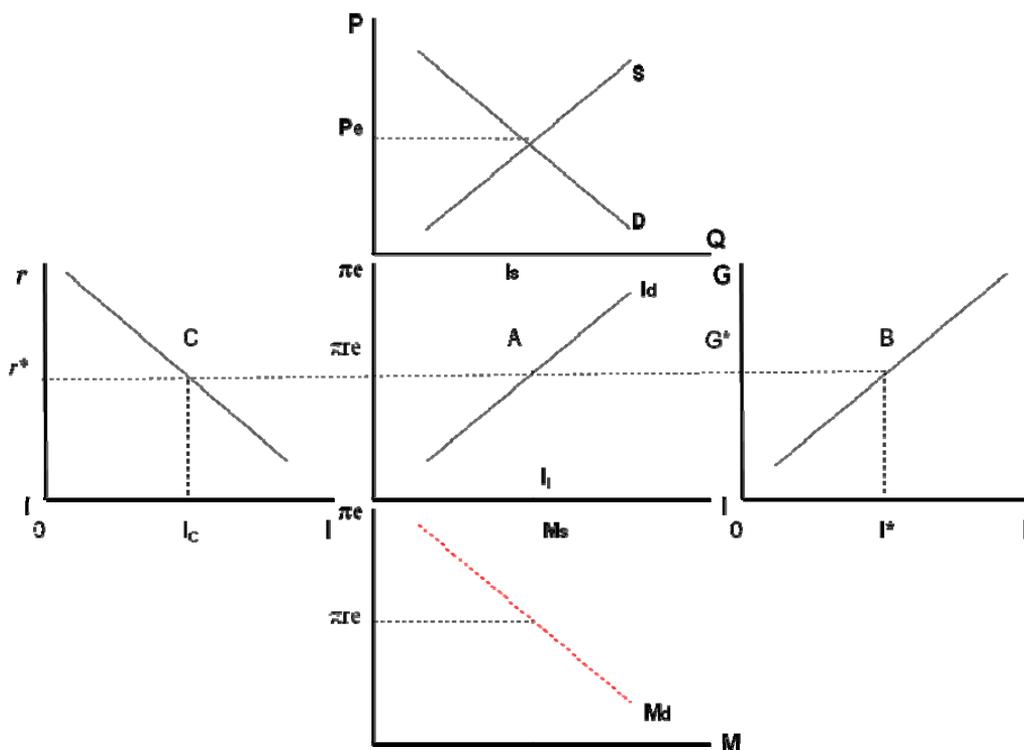
considered as passive monetary policy. Active monetary policy can be conducted by the central bank, not by adjusting M , but by increasing the velocity of money (V) flow in the economy by issuing *sukuk* to finance public and social business projects.

Based on Figure 8 (read horizontally) the optimum rate of PLS return (πe^*) in Islamic economy which is derived from the optimum level of investment will produce optimum economic growth (G^*), that will not trigger exploitation, predation, and intimidation. The rate of PLS return πe^* (which is similar to government/central bank *sukuk* return) can be used as a benchmark by the monetary authority to determine the policy rate that can maximize social welfare and minimize inefficiency, since the level of interest rate r^* which is equivalent to πe^* is the optimum interest rate that can minimize the gap or excess between demand for and supply of investments in conventional economy, so that it will produce investment level that can minimize the negative impacts of exploitation, predation, and intimidation.



Source: Author, based on Ryandono (2006) dan Sakti (2007)

Figure 7. Optimal economic growth in Islamic Economy



Source: Author, based on Ryandono (2006) and Sakti (2007), modified by author

Figure 8. Synergy of the Conventional Financial System and Islamic Financial System

Therefore, the synergy between conventional and Islamic Financial System in an economy adopting dual financial/banking system can be realized when conventional and Islamic finance are free to operate side by side according to their own paradigm, code of conduct, and characteristic. The actors/institutions of each system can be mixed and combine, but should not dissolve one into the other, and should maintain its own distinct identity. The only uniting instrument of the two systems to be able to achieve principal objectives in maximizing distributive social welfare and justice, as well as minimizing inefficiency is through the adoption of PLS market return occurred in Islamic financial system as policy rate of optimum monetary policy in the dual financial system.

CONCLUSION AND RECOMMENDATION

Conventional financial and monetary systems contain three main subsystems, namely fiat money, fractional reserve banking and interest. These three subsystems combined with the legalization of money trading and speculation give rise to new money creation (physical money, bank money as well as electronic money) and money concentration in monetary sector to seek risk free return. Consequently, most money or assets are not invested in the real sector, but invested in the monetary sector that slows economic growth down and even contracts the real sector. Money creation without any value addition leads to inflation. Ultimately, the goal of economic growth will be hindered.

Islamic financial and monetary systems, conceptually, contain three different main subsystems, namely Islamic money (full bodied/fully backed money), 100 percent reserve banking and profit-and-loss sharing (PLS). These three subsystems combined with zakah system and prohibition of speculation will encourage investment to the real sector for productive purpose. Subsequently, it will

create distributive income and wealth as well as develop the real sector. The improvement of productivity as well as employment and business opportunities eventually will accelerate economic growth, and the goal of social wellbeing will be achieved.

In the mean time, contemporary Islamic financial and monetary systems, especially in a country adopting dual financial system, such as Indonesia, do not have all the three required subsystems yet. Two conventional subsystems that are yet to be replaced are fiat money and fractional reserve banking. Therefore, the goal of Islamic economic is still far from being accomplished. To achieve the intended goal in maximizing social wellbeing and minimizing inefficiency there should be a synergy between conventional and Islamic financial systems. The synergy of conventional and Islamic financial systems in a country adopting dual financial system can be achieved when conventional and Islamic financial systems are allowed to coexist in accordance with their paradigms and characteristics. The actors of both systems could mix without sacrificing their respective identities. Meanwhile, the unifying instrument to achieve the intended goal in maximizing social well being and minimizing inefficiency is PLS return that is formed in Islamic financial markets to be adopted as policy rate in conventional financial system.

In the case of monetary policy to control money supply, the activity of money creation to increase money supply (M_s) is only a **responsive policy towards the dynamic activity in the real sector**. This can be considered as passive monetary policy. Active monetary policy can be conducted by the central bank, not by adjusting M , but by increasing the velocity of money (V) flow in the economy by issuing *sukuk* with the rate of PLS return at πe^* , to finance public and social business projects. To achieve the synergy, there should be political will, commitment and courage to implement expected PLS return as

the policy rate of monetary policy in conventional financial system. In order to purify the implementation of Islamic financial System, the government should have political will, commitment and courage to gradually adopt Islamic money and 100 percent reserve banking systems. The government should also have long-term plan to establish all necessary infrastructures, systems, laws and regulations etc. in order to enable Islamic financial institutions to operate in accordance with Shariah Law.

The monetary authority should gradually shift its mindset from conventional monetary operation to dual monetary operation to optimize dual monetary system for social wellbeing through appropriate monetary policy. Optimum dual monetary policy can be achieved by adopting PLS return as a benchmark policy rate, so that the goal of distributive social wellbeing and equity as well as minimizing inefficiency can be realized.

Islamic financial institution should not benchmark their rate of PLS return or margin to market interest rate. They should establish their own market PLS return or margin based on the actual return in the real sector. In other words, Islamic financial institutions should gradually shift from interest rate benchmarking to PLS return benchmarking. Islamic financial institutions do not follow the market interest rate when determining the level of profit-and-loss sharing to the customers, but calculate the level of the profit-and-loss sharing itself based on the financing and market profit and company operational incomes. In other words, Islamic banking must change from benchmarking the interest rate to the profit-and-loss sharing.

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