Examining the Impact of Islamic Products on Debt Expansion and Inflationary Pressure

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Abstract

Islamic debt-based contracts is a means of providing alternative solutions to the financial needs of a modern society, the debt contracts might also be perceived as contributing to economic growth particularly in emerging economies like Malaysia and the Middle East where Islamic financing such as in infrastructure contributes toward economics. Therefore, it is not strange to hear some experts claim that debt-based financing is the backbone of the Islamic financing system. Today, however, problems may arise when people have seen economic disorder and destruction that are likely to have originated from the misinterpretation of Islamic legal perspectives in that financial system. Therefore, there is considerable debate amongst Islamic scholars as to whether such a mode of financing offered by the Islamic banking system may come dangerously close to conventional banking practice in ways to stimulate socio-economic failure, in particular leading towards inflationary pressure. On the other hand, if the entire system is then based on ideal Islamic principles, debt based financing would not be a mode of financing that is believed to promote socio-economic growth. Problems may also arise from a predominantly debt financing system in the economy at large. In spite of the huge benefits of debt-based financial activities for a certain group of individuals, high levels of debt at the macroeconomic or the global level that is beyond the ability to service those debt are not sustainable and can lead to financial instability and crisis. The excessive use of debts, credits and loans are unanimously seen amongst Muslim scholars as not fulfilling the purposes of shariah; for socio-economic prosperity and sustainability.

Using Islamic principles and reasoning, the purpose of this paper is therefore to extend the examination on in particular Islamic debt products-inflation relationship and their compliancy with the philosophy of Islamic economics. The study is conducted within the ambit of two sacred sources, the Quran and Sunnah (recorded sayings and tradition of the Prophet) as well as from a number of financial tools. The finding of the research is that while the idea of Islamic device (hilah) in the modern financial system has played a vital role to provide the Muslims with a viable alternative for a riba (interest) free financial solutions, Islamic financing thus far has contributed to the "form" but hardly much to the "substance".

The dependency on debt based instruments means that the economic effects of this might be similar to their conventional counterparts, and hence its claims on the higher socio-economic objective in particular by controlling the inflationary pressure is yet to be realised. This paper is perhaps one of the first to address on the Islamic debt products-inflation relationship by referring to two methodologies; sources of shariah and economic theories.

Keywords: *Hilah*-based products, fractional reserve, personal loan, extra liability, quantity theory of money, inflation.

Paper types - Conceptual paper.

Introduction

The emergence and development of Islamic finance are globally remarkable, used by Muslims as well as non-Muslim societies. Its development does not only concentrate on Muslim countries, it is now phenomenally extending far to every single region and continent. *Shariah* resolutions and legal opinions (*fatwa*) by Muslim scholars are the essential criteria and considered the prerequisite to the growth of Islamic finance. Many controversial issues arose have been resolved as to Islamic banking and capital products, derivatives as well as Islamic insurance.

Islamic banking and finance are moving towards becoming the main stream of the financing system rather than the conventional competitor in a number of countries, in particular, countries that are dominated by Muslim residents. As the conventional system has been established ever since, followed by the Islamic system few years ago, has been well received in particular Islamic debt-based products which have provided easy availability of funds demanded by people. Banking and financing practices in Islam are subject to the guidance of Allah the Almighty in safeguarding socio-economic fields in all areas of human activity as one to fulfill the objectives of *shariah* (*maqasid al-shariah*). As it is seen there is a need for *shariah*-compliant activities, the dynamic changes have occurred in the banking system today, in the sense of the development of Islamic debt-based financing products, to provide an alternative financial mode that is based on the conventional models and which is in accordance to the comments by El-Gamal (2006): 'Islamic finance as practiced today serves a primary goal of replicating conventional financial products and services, as efficiently as possible, utilizing classical contract forms (such as sales and leases)'. Various contracts might be used by bankers and financial practitioners, but the most common contracts used in banking and financing today are then based on the concept of so-called Islamic devices. The ruling on that law of contract is mainly derived from the classical legal opinions of particular schools of law in Islamic jurisprudence.

In addition to the Islamic debt-based contracts being a means of providing alternative solutions to the financial needs of a modern society, the debt contracts might also be perceived as contributing to economic growth particularly in emerging economies like Malaysia and the Middle East where Islamic financing such as in infrastructure contributes toward economics. Therefore, it is not strange to hear some experts claim that debt-based financing is the backbone of the Islamic financing system (Homud, 1987). Haque (2006) emphasizes: 'it is expected that these (Islamic debt-based financing products) are likely to serve the varied credit needs of the rural mass, dislodge the money lenders, stabilize prices, improve production and ensure recycling of bank funds'.

The increasing use of debts, credits and loans raises various issues, both from the *shariah* ruling point of view and from that of their relation to the pursuit of economic growth and socio-economic interest. Debt expansion is not only triggered by the excessive or dominant use of its products, but also by the framework that underlies Islamic banking and financing (Hatta and Dien, 2014). They, then, constitute controversial issues, in particular with regard to the issue of interest or usury (*riba*). Interest (*riba*) literally means excess, expansion, increase, addition or growth, whereas the technical meaning is the 'unlawful gain derived from the quantitative inequality of the counter-values in any transaction purporting to affect the exchange of two or more species which belong to the same genus (category) and are governed by the same efficient cause. Deferred completion of exchange of such species may also amount to interest (*riba*) whether or not the deferment accompanied by an increase in any one of the exchanged counter-value' (ISRA, 2011). As Allah pronounces in Quran: 'while God has made buying and selling lawful and usury unlawful'[1]. Interest or usury (*riba*) is not only involved in loan or borrowing transaction due to deferment of time of payment, as it might also happen in any unjustified excess above and over the capital, either in loans (between creditor and debtor) or in trade (with similar commodities).

Today, however, problems may arise when people have seen economic disorder and destruction that are likely to have originated from the misinterpretation of Islamic legal perspectives in that financial system, as Aggarwal and Yousef (2000) observe the opinions of two eminent Muslim scholars and economists,

[1] Surah al-Baqarah, 2: 275.

Siddiqi and Khan, ostensibly, 'legally, the fear is that mark-up financing may open a 'back door' to interest. Observers (Siddiqi and Khan) worry that mark-up financing may stunt economic growth by constraining entrepreneurs from investing in new projects'.

The statement made by these influential scholars expresses the notion that there are, perhaps, defects and flaws in the current practices of Islamic banking and financing products, even if their size and scope has been greatly increasing recently. A type of contract known as a debt-based financing mode is particularly, alleged to act as a 'back-door' to un-Islamic equivalents, and a mimic of the capitalist principles which are in conflict with those laid down by the *shariah*. Therefore, there is considerable debate amongst Islamic scholars as to whether such a mode of financing offered by the Islamic banking system may come dangerously close to conventional banking practice in ways to stimulate socio-economic failure, in particular leading towards inflationary pressure. On the other hand, if the entire system is then based on ideal Islamic principles, debt based financing would not be a mode of financing that is believed to promote socio-economic growth (Usmani, 2005b). Iqbal and Mirakhor (2007) emphasize, 'an economist cannot solve all theoretical issues without understanding the principles of *shariah* or without working closely with a *shariah* scholar. Therefore it is essential that serious research efforts be made collectively to address the theoretical foundation of the system upon which a more sophisticated set of instruments can be built'.

Further by referring once again to Siddiqi and Khan's opinions, problems may also arise from a predominantly debt financing system in the economy at large. In spite of the huge benefits of debt-based financial activities for a certain group of individuals, high levels of debt at the macroeconomic or the global level that is beyond the ability to service those debt are not sustainable and can lead to financial instability and crisis. The excessive use of debts, credits and loans are unanimously seen amongst Muslim scholars as not fulfilling the purposes of *shariah*; for socio-economic prosperity and sustainability (M. Fahim Khan, 1995). Hence, there is a pressing needs to examine the critical alternatives that would fulfil the needs of markets and at the same time meeting the requirement of the *shariah*. Based on these grounds, the current study is conducted to address the following research question:

How do the Islamic products contribute to the expansion of debts and the inflationary pressure?

Discussion of debt-based financial system from the perspective of the *shariah* law would require the use of the *shariah* principles, mainly of the Quran and *sunnah* (Prophetic traditions), and an Islamic jurisprudence principles namely the concept of *riba* (interest), followed by two financial tools; fractional reserve banking system and quantity theory of money to get clearer picture of the debt-based and money supply system.

Each bank (including Islamic banks) can issue money, in the form of bank money or credit. Normally, banks issue credit against deposits. Islamic banks do issue credit via their debt-based financing products in association with the Fractional Reserve Banking System. Fractional Reserve Banking is a banking system where the banks (including Islamic banks) keep a required minimum reserve asset ratio, in order to secure sufficient liquidity to satisfy the depositors' cash demand (Pass et al., 1988). In the Malaysian banking system they actually use a different terminology, the so-called Statutory Reserve Requirement (SRR) with the same function and objective as the Fractional Reserve Banking System. Whereas, the quantity theory of money is an equation of exchange shows changes in price levels as the effect of money supply, and implies the close relationship between money supply, velocity, price level and output (Froyen, 2005). MV indicates the total sum of money in the economy, whereas PY shows the total value of the output of goods and services in the economy.

Findings and Discussion

This paper contributes to the existing body of knowledge in terms of narrowing the research gap by examining the use of legal device (*hilah*) in Islamic financial system and the system's contribution to the people's socio-economy. The novelty of this study is that it provides a holistic perspective of the critical view from *shariah* perspective and at the same time the economic discussion.

1.0 *Hilah*-based Islamic debt

Credit is expanded, *interalia*, by applying the concept of the Islamic legal device (*hilah*) in Islamic debt-based financing. *Hilah* or Islamic legal device literally means skill or *hizq* in managing something. The person thinks something over until it drives him to achieve his goal; this is mostly used in exercising evils and bad things. However, according to the technical meaning in Islamic law (*shar`i*) (Hammad, 2008), the legal device (*hilah*) is as defined by Ibn Qudamah in his great book *al-mughni*, this is defined as any act that seeks to fulfill a permissible contract (according to Islamic law), but his intention (*qasd*) is to achieve something impermissible, such as a deception or trickery (*mukhada`a,*) or to use means (*tawassul*) to carry out an act forbidden by the Almighty God, or to allow its impermissibility, or to abrogate ones' obligations, or to deny and expunge another's rights and entitlement to justice and so on (Ibn Qudamah, 1997). For instance, someone gives a donation from his savings in order that his savings do not reach the limit beyond which *zakat* (arm-giving) becomes payable. The evidence is then clearly seen from the time when his donation was made to the end of zakatable year (*haul*) (Al-Shatibi, 2001; Mohamad, 2004). Another example of something which is considered impermissible *hilah* or *mahzur* is a pre-planned marriage after the third divorce (*nikah al-tahlil*). This form of marriage, though valid in terms of the legal form, contradicts the objective of *shariah* of the establishment of the legality of Islamic marriage (Al-Duraini, 1988; Mohamad, 2004).

Accordingly the concept of (*hilah*) underlies many of the contracts of transactions which are nowadays widely used by Islamic financial institutions. Amongst the various contracts used are those referred to as 'buy-back sale' (*bay`al-`inah* or *`aqd al-`inah*) contracts. This is an underlying contract in the framing of a variety of Islamic debt-based financing products. The modus operandi of Islamic products is a little bit different from one to other, but the essence of *bay` al-`inah* contract and the concept of legal device (*hilah*) arises in every single product. Only the modus operandi of those widely used products have been selected for consideration in this study, the researcher assumes that the modus operandi of other products (not considered here) will not be so very different.

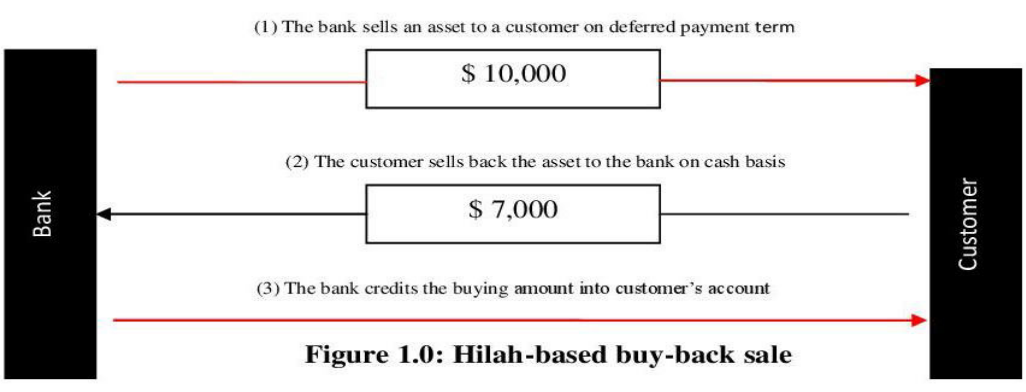

Figure 1.0: Hilah-based buy-back sale

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This modus operandi shows the flow of credit from Islamic financiers to their customers. The terms 'reselling' and 'selling back' are normally used to indicate two agreements having been made between financiers and customers. The first agreement is the sale of an asset by the financier to the customer, and the second agreement is the sale from the customer to the financier, where the asset goes back to the original or first seller. This form of transaction is called buy-back sale (*bay` al-`inah*), in which the legal device (*hilah*) forms the underlying contract.

2.0 Money supply expansion

When each Islamic debt financing instrument is underlain by an asset, it would then help to curb mountain of credit expansion and will also provide financial resources for the real economic activities (Ahmed, 2010). Perhaps, the role played by the asset in Islamic financing is vital to control money supply and arbitrary expansion might be less likely to happen in Islamic markets, unlike the conventional system where the asset is not in existence at all, thereby stimulating excessive money expansion.

However, the situation of money supply expansion by Islamic banks is not as simple as that claimed. The existence of *hilah*-based products in Islamic debt financing, as previously discussed, has huge potential to force more and more money creation. It would then end up with a mountain of money supply circulating in the markets through the principle of the fractional reserve system. This is because Islamic banks would ever consider such a *hilah*-based as generating more returns or profits; thereby they are really keen to offer such a type of financing in huge quantity. In addition to this, the Islamic system is closely comparable to their counterpart, since both conventional and Islamic banks will not offer that financing fund, unless by applying interest or *hilah*-based profit[2] as a policy tool to drive them ubiquitously cater for debt financing. By extension, the money supply will be clearly illustrated in the diagram below.

Islamic Banks	Amount Deposited	**Interest/Hilah-based Profit 10%**	Lent Out
A	**$ 10,000**	$ 960	$ 9,600
B	$ 9,600	$ 921.60	$ 9,216
C	$ 9,216	$ 8,84.74	$ 8,847.36
D	$ 8,847.36	$ 849.35	$ 8,493.47
…	…	…	…

[2] Interest is for conventional whereas *hilah* is for Islamic banking system.

…	…	…	…
	Total Amount Deposited	Total Amount at 10%	Total Amount Lent Out
	$ 250,000	**$ 24,000**	**$ 240,000**
	Bank Money + Central Bank Money Deposited	Interest/Hilah-based Profit	Bank Money Created & New Money Created
	$ 250,000	**$ 24,000**	**$ 240,000**

Table 2.0: Relationship between hilah-based profit and money supply

As the reserve ratio requirement imposed is at four percent, Islamic banks at this stage have the right to create money at the maximum of 96 percent. Further, Islamic banks are willing to provide easy availability of debt financing as it is lubricated by the charge of *hilah*-based profits at 10 percent, that is equivalent to $ 24,000 out of an overall amount credited. Imagine, if Islamic banks are not able to impose such a *hilah*-based profit they will never be willing to provide that amount of financing. Meaning to say, such a profit acts as a lubricant tool for money supply expansion, even in the Islamic asset-based financing system.

2.0.1 The *hilah*-inflation relation

Nevertheless, many thinkers, such as Calvin, Molinaeus, Camerarius, Bornitz and Eugen Von Bohm-Bawerk, have tried to explain the rationale of interest. They argue against the 'barrenness' of money. The roof and walls of a house cannot beget money, but when the use of the house is exchanged for money, legitimate money may be drawn from the house. As land is bought for money, it is quite correct to say that money produces other money in the form of yearly revenues from the land. Unemployed money is, then, certainly barren and unproductive. Thus, the borrower is not defrauded when he pays interest on the loan made (Bohm-Bawerk, 1890). By extension, the rationale of interest validity is in terms of time preference. People are happy with the present over the future, and they should be then entitled to some remuneration, i.e. interest. Some other scholars argue that nominal interest is warranted as compensation for inflationary pressure, against the depreciating value of money (Pervez, 1990).

On the other hand, some Muslim scholars and jurists from the Islamic world seem to defend the current interest-bearing system. M. Dwaleeby, for instance, took the view that interest imposed on consumption loans is certainly usury, but it is not if the loans are taken for trade or production. Much earlier A. Jewish claimed that usury is only prohibited if it is in the form of compound interest, but not if only simple interest is charged (Ahmad, 2011). Later, A. Sanhory opined that the all forms of interest and usury either compound or simple, consumption or production loans were prohibited. However, since the current interest-bearing financial system does not comply with the Islamic law of contract, he emphasized that debt financing based on interest becomes a matter of great urgency for consideration by Muslims, under the degree of necessity (*darurah*) according to *shariah*. It then creates an emergency condition that calls for relaxation of *riba* prohibition rules; and concluded by giving room for simple but not compound interest until the system becomes Islamic (Abdel-Rahman Yousri Ahmad, 2011). Again, the ex-grand mufti of Egypt Muhammad Sayyid Tantawi gave his view that conventional transactions issued by a conventional bank that were fully interest-based banking system, namely those issued by the Bank al-Ahl al-Misri, were permissible. He delivered his legal opinion (*fatwa*) claiming that the transaction is permissible (*halal*) and complies with the *shariah* law; it was publicly issued by 'The House of Islamic Legal Opinion' (*Dar al-Ifta'*) in Egypt to the public mass media on 8th September 1989 (Al-Qardawi, 2001).

Perhaps some Muslim scholars do allow the legality of interest because of the need to cope with the emergency of inflation. All these abovementioned Muslim scholars have approved interest-based products in the conventional banking system, the researcher then concludes that the contract of buy-back sale is to be considered more justifiable (*fa min bab al-awla*) to be offered to the market than conventional contracts because, according to advocates of these contracts, *`ina* is not directly involved in dealing with *riba* as *hilah* Islamizes the conventional *riba*-borne contracts.

On the contrary, interest (*riba*) in itself would be considered as 'an extra cost on borrowing', as confirmed by Brue that 'the price paid for the use of money' (Brue, 2005) directly spurs the increase of money supply in the market. It is then a core stimulus of money supply that is strongly bringing about the inflation problem. Economists agreed that the increase in money supply causes the inflation rate to increase for long-term period of time, as strongly asserted by Monetarists like Milton Friedman (Farmer, 1999). Since banks are the sources of money provider, they are directly involved in this expansion leading to inflation (Bernanke and Blinder, 1988).

With respect to the interest or usury (*riba*), perhaps it is better to introduce its objective, as it is defined in '*Dictionary: Economics*' as 'lenders require a nominal interest rate that compensates them for the effects of inflation in reducing the purchasing power of any sums that they lend' (Pass et al, 2000). Perhaps, the advocates of interest do apply this objective to justify the legality of interest as a compensation for losses in the real value of money incurred by capital providers, that is because of the inflationary emergency, as supported by a study by Bose (2002), claiming that the increase in the inflation rate must be associated with the increase in the nominal interest rate, and then agreed with by Flexner (1989).

However, the objective that 'compensates them for the effects of inflation' is inversely stimulating more inflationary pressure; and that pressure will keep going up, provided that interest is still in place, charged by creditors. Every single time a debtor makes an extra cost on his borrowing, thereby inflation is activated. Hence, despite their argument that interest is required in order to counteract inflation problem, but at the same time they are, in fact, creating and stimulating the inflation problem. Insofar as, instead of counteracting this economic disorder, they are otherwise supporting such a problem. In brief, there is then a key point of intersection between advocates of an interest-bearing and interest-free system; thereby both have agreed that there is a positive relationship between interest and inflation, as again emphasized by an economics professor, Jusoh (1990): 'In long-run, interest rate and inflation are positively related'. In addition to this, it is unjustifiable to argue that interest is required against the inflationary pressure because the price levels are not a static but are a fluctuating behaviour; either decreasing or remaining constant or increasing at a lower rate than the interest rate. Let us say, during the time of deflation; can people imagine creditors would pay interest or profit to debtors instead of debtors or borrowers to creditors? Of course not, it has never and will never happen that interest payments made by creditors to borrowers or debtors. Who will then take responsibility whose money value has deteriorated? Therefore, compensating losses might not be convincingly proven to support the legality of interest in banking system to cope with the inflation emergency.

It is perhaps similar to the current Islamic *hilah*-based products, though its physical form seems Islamic. Its substance and position might also lead to inflationary pressure as the asset created simply to legalise the current interest-based conventional products but not for the end use of the contracting parties.

Accordingly, from the Islamic source of jurisprudence, the Prophet (peace and prayer be upon him) would definitely have clarified the legality of inflation compensation during his time of revelation (*wahyu*) if interest (*riba*) or any *hilah* towards *riba*[3] were to be justifiable against inflation; because the Prophet (peace be upon him) was, during that time, aware of the problem of inflation, but said nothing about any compensation against inflationary pressure and even simply prohibited people from using pricing standard, as in his hadith (Al-Tirmidhi, 1998; Abu Dawud, 2000; No`man, 2009):

> Sayyidina Anas narrated: (Once), during the days of Messenger of Allah, dearness increased, people requested him to fix the prices (and enforce them on the merchants). The Messenger of Allah, thereupon, observed 'To raise or lower the prices is in the hands of the Lord. It is He who grants increase or decrease. He is the Sustainer and the Provider of the daily bread to all his creatures. And I wish to meet Him in the state that no one has a claim against me for doing a wrong to him or acting unjustly towards his life or property'.

In addition to that, the Prophet (peace be upon him) was against those who were intervening in markets resulting inflationary pressure at the end of the day. The Prophet

(peace be upon him) confirmed then that: 'Whosoever interferes with or intervene in market prices in order to push them up (inflationary pressure), secures for himself God's punishment of Hellfire during the day of Resurrection' (Al-Shawkani, 1998). Therefore, based on these hadiths, the researcher concludes that if interest or any *hilah* towards *riba* is to be justified as an instrument to merely counter act inflationary pressure, for sure the Prophet should have said this. But his prohibition against pricing and market intervention shows that 'interest against inflation' or '*hilah* towards *riba*' would be an obviously unjustifiable argument. By extension, the positive relationship between *hilah*-based product and inflation in economy might be perceived from the following evidence.

A) Extra liability

Although *hilah*-based mechanism might be a major form of return for Islamic financial institutions (in this case buy-back sale) but from the macroeconomic perspective, it might end up with great destruction and harm to individuals, households, firms and to the entire economic system. For instance, these negative consequences might begin from the relationship with money supply expansion in the economic market. When all banks, for example, create monies and supply them to the economy and without any doubt some money supply extension occurs. Let us say only one Islamic bank exists in a country, creates $5,000,000 and supplies them at a profit rate of 10 percent (interest benchmark) to separate time of transactions involving buyer-1. The two parties (Islamic bank and buyer-1) have made the required agreement that would lead to a successful transaction. Buyer-1 takes on debts and repayment liabilities by instalments:

[3] Majority of classical and contemporary Muslim jurists viewed that *bay' al-'inah* is a *hilah* towards *riba*.

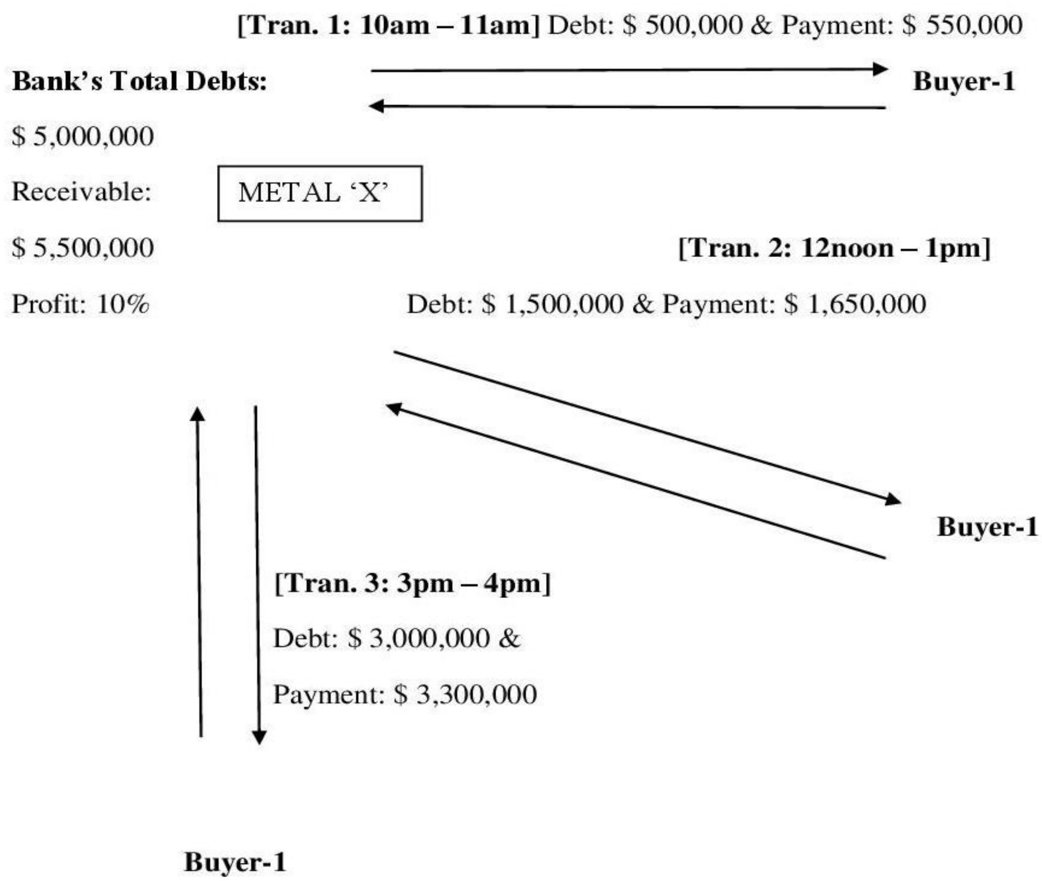

Figure 2.1: Interest, supply and liability

At the end of the day, the combined sum of currency ($) has increased to $5,500,000 from $5,000,000; due on all transactions. By using the same asset, METAL 'X' for all three transactions, the Islamic bank is able to expand money supply by $5,000,000, as confirmed by

Salman Khan: 'these parties use and reuse the same stock many times during the same day in numerous consecutive sales' (Salman H. Khan, 2010). This situation is known as 'money supply expansion' in the economy, produced by only one existing Islamic bank with only one unit of asset in the market. If we examine properly, the supply side is always in deficit, whereas the liability side is always in excess because of interest (*riba*) (Irfan, 2011). The total combined sum of all transactions cannot discharge the liability. Meaning to say, if the liability of produce (i.e. medium of exchange) is greater than the produce available on the supply side, there is a circumstance where extra liability would be artificial, because a surplus quantity of produce is unavailable. Creating an extra liability is actually creating an extra demand, without increasing supply equally. This mechanism will trigger an endless cycle of shortage of produce in the economy.

Based on 'figure 2.1', the borrower or buyer-1 is committed to make debt payment by being shown and recorded in the accounting books of the Islamic bank in receivable column.

As the 'figure 2.1' has evidenced that there is extra liability incurred by the borrower by which such a liability is increased by imposing '*hilah*-based profit' on the transaction. It is then indirectly adjusting the accounting book of the borrower for the effect of that increased liability (Irfan, 2011). Meaning to say, the asset side has to be reevaluated so as to be balanced against the liability side. The borrower finds that the most appropriate adjustment to be made is by increasing saleable commodities prices. In fact, the accounting adjustment that is caused by increased liability of '*hilah*-based profit' imposed is only possible by exercising additional prices upon goods and services. Nevertheless, suppose the profit charged does not exist, for sure there is no need to make any adjustment in the accounting books of the borrower. This means that the compelled increase in saleable commodity prices will not occur. When such a debt that contains a form of *hilah* has taken place in the economic system, commodity and service prices will keep increasing as every single debt transacted. Therefore, it shows how there is a correlation between *hilah*-based profit and price behaviour in markets.

B) Applying for a personal loan

Friedman identified then that the inflationary pressure, according to him, depends on the means of how the spending is exercised. If it exercised by creating more money it is indeed sure to produce inflationary pressure, and if it is by borrowing it will also lead to inflationary pressure. It increases the rate of inflation then, as the current interest rate on debts and loans is higher than the previous rate (Friedman, 1970). Since the buy-back sale has relied upon its conventional counterpart, hence the mechanism of Islamic debts also drives towards inflationary pressure. Thus, the claim made by Milton Friedman shows that inflationary pressure is correlated to *hilah*-based profit, as pictured below.

Suppose Mr. Firdaus wants to obtain RM 10,000 cash from an Islamic bank, and both parties agree that *bay' al-'inah* is the most appropriate contract to enter into, and inflation is absent, the fair rate of an asset sold by the Islamic bank, repayable by installment, within one year, would be 3 percent. Hence, it is equivalent to RM 10,300. Then as organized by the Islamic bank, Mr. Firdaus will simultaneously sell the asset back to the bank at the current price RM 10,000. In the absence of inflation, when received this sum (RM 10,300) will provide the Islamic bank with a 3 percent increase in the purchasing power of their funds. Based on the opinion expressed by Milton Friedman above, such an expansion would lead to an expectation of higher inflationary pressure, let us say by 7 percent.

In lieu of a zero inflation rate, prices are expected to increase by 7 percent over the course of the year. Mr. Firdaus would be delighted to still obtain cash through the *bay' al-'inah* contract payable within one year at RM 10,300. However, the Islamic bank would be rather disenchanted with such an offer. This is because the RM 10,300 that the Islamic bank would get back on the transaction actually represents a loss of purchasing power of about 4 percent (the three percent the Islamic bank received through the sale of *bay' al-'inah* contract less the seven percent loss of purchasing power due to inflation). The jargon used to describe this situation is that the nominal rate of profit is three percent whereas the real rate of profit is minus four percent. The difference between the two rates is the seven percent anticipated rate of inflation. That is, the nominal rate equals the real rate plus the anticipated rate of inflation. Hence, the Islamic bank is hardly going to be willing to make the *bay' al-'inah* contract at a nominal profit rate of 3 percent. What is likely to happen, if the market is competitive, is that the market nominal profit rate will rise to 10 percent. This argues that the nominal profit rate tends to reflect fully anticipated inflation. The behaviour resulting from the positive relationship between *hilah*-based profit and inflation would mean that both would continue to increase, since each variable (*hilah*-based profit or inflation) will stimulate the other (inflation or *hilah*-based profit).

The evidence suggests that the debt-based contract of *bay' al-'inah* is a factor contributes to the increase in the level of inflation. This also again confirms that inflation is created by built-in *hilah*, as in the case of interest-based conventional products, and it is not a solution to inflation.

C) The Quantity Theory of Money

As *hilah*-based debts multiply through fractional reserve banking, leading to money supply expansion, the relationship of money supply and inflation might then be evidenced by an equation of exchange, namely the 'quantity theory of money'. It shows changes in price levels as the effect of money supply, based on MV = PY, and implies the close relationship between money supply (M), velocity (V), price level (P) and output (Y). Velocity of money

(V) indicates the rate at which money changes hands (Froyen, 2005). MV indicates the total sum of money in the economy, whereas PY shows the total currency ($) value of the output of goods and services in the economy.

The equation implies that, by assuming velocity (V) is constant, the increase of money supply without a corresponding increase in commodities and services, will lead to a rise in prices, or inflation (Meera, 2004). In other words, when money supply is doubled, price level doubles. And this case, in fact, occurs with buy-back sale in particular, since the subject matter will be reused for the following buy-and-sale transactions. This demonstrates that the quantity of the subject matter does not correspond to the quantity of money (money supply) increment in the market. Hence, it definitely constitutes inflationary pressure. An example would be the massive amount of paper money introduced by the Japanese in Malaya, named

'banana leaf money' during their occupation; this sudden increase of money supply caused inflationary pressure (Meera, 2002). Imagine the inflationary pressure that results from that multiple money creation of the fractional reserve system. A nation cannot be then made wealthy and rich by just adding to the quantity of money, *inter alia* by exercising *hilah*-based contracts through multiple lending in the fractional reserve system and putting into the hands of its people.

For those advocates of the idea that the fractional reserve system is un-Islamic system like Meera and Larbani (2006) and among others; according to them the *hilah*-based contracts also plays an important role in expediting multiple lending processes, because the said *hilah* becomes profits for Islamic banks. It thus drives inflationary pressure to occur. Suppose the said '*hilah*-based profits' made by Islamic banks did not exist, it is certain then that Islamic banks would not be willing to provide such financing contracts.

Accordingly, Usmani (2001) admits that the interest-based credit creation through the fractional reserve system provided by conventional banks has contributed to inflation and money debasement, and he maintains that this problem is because the credit created by the conventional banks is 'artificial money, through which the amount of money supply is increased, and sometimes multiplied, without creating real assets in the same quantity' (Usmani, 2005a), hence the difference between the supply of money and unit of real assets produced creates inflationary pressure. Instead, the inflationary pressure would be coped with, according to him, Islamic financing contracts, since these are 'backed by assets (here he is referring to buy-back-sale etc.), and always matched with corresponding goods and services'

(Usmani, 2005a). This view is then supported by the advocates of the 'Real Bills Doctrine,' who assume that 'inflationary over issue is impossible, provided money is issued on loans made to finance real transactions' (Humphrey, 1982).

From this it is said that the *hilah*-based credits through fractional reserve system provided by Islamic banks, such as buy-back sale, will not bring about economic disorders, in particular, inflationary pressures. This is because these forms of contract are underlain by assets with which their total units of supply are proportionate with the supply of money. Hence, perhaps, inflationary pressure will not happen as assets are in existence, as is the case with many products provided by Islamic banks, whereas such a pressure would certainly occur within the conventional banking system.

Nevertheless, in terms of buy-back sale (*bay` al-`ina*) contracts, the underlying asset does actually return to the original seller. Which means to say, although the contracts are underlain by asset-back, the total unit of asset does not change as the total money supply expands; because the asset will never reach every single end or absolute user (as shown in the figure 2.1) and the same asset might be reused for several borrowers (Iqbal and Mirakhor, 2007). Indeed, some economists claim that the asset simply acts as a security as in the conventional system (Salman H. Khan, 2010). Hence, this evidence indicates that the said current Islamic contracts ubiquitously used by Islamic banks do stimulate that inflationary pressure as well, as it ends up by decreasing the purchasing power of the public, especially those who live in poverty, which is contradictory to the ideas expressed by Usmani.

In the researcher's opinion, the asset-based does not guarantee the elimination of inflationary pressure from the economic markets with, in particular, the built-in *hilah* still in existence. The inflationary pressure is not independent of interest and asset-based credits, though sometimes there is a response delay from one to the other; they generally track together (Brussee, 2009). That is one reason for the prohibition of any transaction that merely relies on the physical form or phrases without taking into account the meaning or substance of that transaction, as it has been described in the Islamic law of contract 'in contract, effect is given to substance and meaning not a mere words or phrases (physical form)'. Hence the *hilah*-based financing underlying a debt-oriented financial system through the fractional reserve system will never be innocent of contributing to inflationary pressure, as Siddiqi agrees: 'In a debt-based economy, the money supply is linked to debt with a tendency towards inflationary expansion' (Siddiqi, 2007).

Hence, as having been analyzed, it is true to say that there is a positive and direct relationship between *hilah*-based product and inflation, and an inverse relationship between *hilah* and the value of currency (purchasing power). The conclusion of this point is that the Islamic bank as the financial intermediary being heavily involved in providing buy-back sale (*bay` al-`inah*), underlain by elements of *hilah* through the fractional reserve system, is not a solution to financial and economic meltdown, particular inflationary pressure, as emphasized by El Diwany et al. (2010): 'Reform of the monetary system that produces inflation is the key to success in this matter (…)'. And the impact of this inflationary pressure then would not really affect well-off people or the corporate sector, instead having a much greater negative impact on workers and on small and medium businesses, as well as on those who live in poverty.

Conclusion

This study has advanced knowledge by investigating the issue of Islamic debt products. This is probably one of the first attempts to find an impact resulting from such products becoming dominant since established that perhaps would offer significant insights for people in the market as well as the academicians.

From the discussion, the research has answered the question as identified at the beginning, as the current debt products not becoming keystone pursuing the social economic growth. The prohibition of interest in Islam is because of its exploitation in the market itself, as then Islam has formulated interest-free financing system towards a real productive sector in pursuing the economic growth for all groups of people. However, the modern of Islamic debt-based products today have sabotaged this unique feature of Islamic finance by introducing *hilah*-based products in the system, although they are called asset-based products. The introduction of such a form of financing looks likely to provide a virus destroying the economic immune system that it (economic immune system) is actually a shield to protect the growth from monetary fluctuations and inflation. Islamic banks are just adapting what has been used by conventional and at the end, all debt-obligations are now saleable with *hilah*-led products.

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