

## Chapter 29

# The Role of Profit Rate in Islamic Monetary Policy

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### ABSTRACT

*Extensive research has been done regarding the Islamic pricing benchmark, both in terms of the Islamic jurisprudence (Fiqh) and Islamic economic perspectives. However, there is no in-depth study on the substitution of the interest rate concept to date in the application on the Islamic banking pricing product. This chapter will initiate the difference between the concepts of rate of profit, rate of interest, and practice in the field. Some jurists from the Middle East allow the use of a benchmark rate, such as the London Inter-bank Offered Rate (LIBOR), as a measure of Islamic financial asset prices. They equate the concept of rate of interest with the concept of rate of profit. This is the core reason (raison d'être) for the replacement of usury as instructed in the Qur'an. This study will discuss a financial asset pricing methodology in accordance with the core principles of Islam.*

### BACKGROUND: THE AIM OF THE STUDY

The abolition of interest in the Islamic financial system requires an applicative replacement concept of interest in the operational level of Islamic financial institutions in accordance with Islamic principles. The applicative replacement concept of interest according to the *Qur'an* (QS 2:275) has been mentioned as profit that derived from commercial transaction without any exploitation. In Islamic economic literature, among others, it is referred to as the (expected) rate of profit. Some conventional and classical economists, including von Neumann (1946) and Sraffa (1960), also call it the rate of profit. The neo-classical economist, Thornton (1965), calls the concept the marginal rate of profit. Wicksell (1934) mentions the concept as the natural rate of profit.

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There is disagreement among conventional and Islamic economists regarding the concept of thought. In the applicative level, the concept of rate of profit as a replacement of the concept of interest is very important at both the macro-economy and micro-economy levels, especially for setting up the Islamic financial system. This issue is important because Islamic economists do not have a clear concept on the rate of profit.

At the macro-economy level, the application of the rate of profit is practiced at central banks in countries that have implemented a dual banking system or fully Islamic economic system (single economic system). Monetary policy and product differ. Central banks have used different contracts in creating and using the instruments of monetary control. In the level of practice of the Islamic financial system, there is a difference of opinion about the use of contract agreements in the monetary instrument, namely countries with monetary instruments with a rate of profit which is determined based on profit sharing (ex-post) and countries with monetary instruments with the rate of profit using sale-based products (ex-ante).

Countries that implement monetary instruments with an ex-post rate of profit include Sudan, Iran, and Pakistan (with the contract *Musharakah* and *Mudarabah*). Countries that implement monetary instruments with the rate of profit which is determined in front (ex-ante) include Malaysia (the contract *bay' al-'inah* and *Murabahah*) and Indonesia (the contract of *Repo* or repurchase agreement). According to the author, differences in the use of monetary instruments are due to differing views on the effectiveness of monetary policy to control money supply (Rafay & Saqib, 2019). Instruments with a rate of profit which is determined in advance are considered by many experts as more effective in attracting money in circulation.

At the micro-economy level, the application of the rate of profit faces problems because there is no yardstick (or benchmark) in the determination of the profit margin/mark-up on the contract of the sale-based product (*Murabahah*) and the cost of renting the contract (*Ijarah*). Additionally, there is a difference in the calculation on the concept of rate of profit on the contract of *Murabahah* and *Ijarah*.

Some Muslim countries apply margin/mark-up on *Murabahah* and *Ijarah* in advance (ex-ante) and fixed for the long term. Others apply this in the short term. In Pakistan, *Murabahah* as a fixed margin can be used in the short term, medium term, or long term. In Bangladesh, the contract *Murabahah* is used for short-term transactions; *Bay 'muajjal* is used as installments for the purchase of long-term assets. In the United Kingdom, the contract *Murabahah* is even used in home financing transactions over an extended period of 20 to 25 years.

One topic of debate is the advanced (fixed and predetermined) definite and determined differences in the application of the rate of profit in sale-based agreements. Rosli and Sanusi (1999) argued that the imposition of an excessive rate of profit in the sale-based transaction contains elements of *ghaban fahish*. This, in fact, is prohibited by the Islam. Rahman (2010) found that the rate of profit used in the transaction of *Murabahah* cannot be long-term because it will be exposed to *Riba al fadl*. The profit does not mark to the market in accordance with market prices in the real sector in the period of the financing. According to Van Greuning and Iqbal (2008), *Murabahah* should only be used for short-term transactions. Therefore, the contract *Murabahah* is more suitable for short-term transactions from the concept of rate of profit.

Other critical issues the debate over rate of profit vs. rate of interest has emphasized is whether Islamic banks' sale-based transactions have incorporated elements of *'iwad* or the counter value from the exchange transaction or *ziyadah* (increase in the absence of activity in the real sector) in the determination of its rate of profit. The appropriate rate of profit theory based on Islamic principles determines that profit is legal when it contains three elements: (1) Value added or value addition because of the element

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