Islamic Vs Conventional Economics, The Impact of Interest Rates on the Indonesian Economy

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Abstract

This study investigates the impact of interest rates and the economy in Indonesia as a country with a Muslim population in the world but does not prohibit interest rates in the positive laws of the Republic of Indonesia. The research period for this study is from 1990 to 2020, and we use secondary data that we collect from World Bank data. We use an autoregressive vector model. We found that The lower the interest rate, the more it encourages economic growth and vice versa. Interest rates put pressure on the real sector because interest rates are the cost of capital that weighs on the economy. Low interest rates bring improvement and better economic growth. This proves that interest rates which in Islamic economics are still forbidden have a bad impact on the Indonesian economy.

Keywords: Islamic Vs Conventional Economics, The Impact of Interest Rates,Indonesian Economy, Usuary
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Introduction

World financial markets and commodity and currency prices have moved recently, based on interest rate expectations. The determination of interest rates is related to macroeconomic indicators, and this is true, but the fact is that interest rates, directly and indirectly, affect the daily life and personal finances of Humans (Wilantari, Widarni, & Bawono, 2021).

The primary instrument used by the central bank to modify the nation's monetary policy is interest rates, which are used to control the "money rate" (Varlik & Berument, 2017). Interest serves as insurance that money borrowed by a person or business won't be repaid, and the interest rate determines the cost of this insurance (Cororaton & Rosen, 2021).

Banks and other financial institutions base their interest rates for loans and savings on the base interest rate, which would be set either by central bank and represents the cost of interbank borrowing (Depren, Kartal, & Kılıç Depren, 2021). When the economy's inflation rate increases, increasing the cost of goods and services, the central bank boosts interest rates to make money more costly, which reduces lending to individuals and companies, consumer spending and demand, and inflation (Echarte Fernández, et al., 2021).

In the case of a financial crisis, the central bank lowers interest rates, lowers the cost of borrowing, boosts consumer spending as a result, and the economy picks up and leaves the crisis behind (Aguir, 2018). Of course, this is conventional economic wisdom, although there are other factors that the monetary authorities take into account when setting interest rates, the most important are indicators of inflation or stagnation (Aganbegyan, 2020).

It takes roughly a year for the effects of interest rate adjustments to become noticeable and may then start to affect the economy and people (Jarociski & Karadi, 2020). When interest rates increase, loans become more expensive, businesses reduce their investments, while consumers reduce their spending (Agarwal & Chua, 2020). Likewise, when interest rates are lowered, yet prolonged access to cheap money might result in an economic bubble, the more it increases, the more painful its collapse (Shmelev & Ayres, 2021). The price of bonds that are issued by businesses and nations to borrow money from money markets is negatively correlated with changes in interest rates (Kiseľáková, Filip, Onuferova, & Valentiny, 2020).

The exchange rate of the applicable currency rises when interest rates do as well, which is one indirect impact, which affects the direction of investors away from the stock and commodity markets to the currency market, and vice versa as well (Gu, Zhu, & Wang, 2022).

The jurists and commentators agree that usury is one of the last things prohibited by the Qur'an, and although scholars agree, then and now, about the prohibition of usury and its seriousness, they differ greatly in many respects (Abdullahi, 2021). Its branches and parts, such as the nature of usury and what is involved in it, what are the common causes of usury, and the hidden details of usury (El-Meouch, Fellner, Marosi, Szabó, & Urbán, 2020). When Islam forbids usury and strictly forbids it and fights the eater and all who deal with it, it only wants to eliminate the injustice it causes and thereby purify society from exploitation, hatred and the effects of this exchange. Sharia closes all places that lead to usury (Prabowo, Sulisnaningrum, & Harnani, 2021 ; Viphindrartin, Wilantari, & Bawono, 2022). In ancient economic thought, and since Greek times, Plato in his book The Law, forbade usury (Genc & Hassan, 2021), and Aristotle condemned usury and thought that money did not make money (Lewis & Kaleem, 2019). The early church was firm in its decision to prohibit usury and continued to do so until 1917 when the Vatican officially recognizes the legitimacy of interest (Van Boom, 2020).

The hatred of usury and moneylenders continued well after the French Revolution and the emergence of liberalism (Iyer, 2022). Where the theories that justify usury began to emerge, and they began to call it interest rates (Schefold, 2022). Some laws stipulate that it is permissible to charge a certain percentage that does not exceed 4% on a loan, which is called interest, if the interest exceeds the legal percentage, it becomes usury prohibited (Hartley & Kallis, 2021).

In 1974, the Consumer Credit Act was passed in the UK, according to which restrictions were lifted and interest rates (interest rates) were liberalized, and weak borrowers had to prove their exploitation before the courts, each according to the circumstances (Sparkes & Wood, 2021).

In America, usury laws have also been abandoned, since the 1980s, and a number of other countries have followed the same path. Thus, the distinction between usury and interest in legal and economic thought finally comes to an end. That's not exact discrimination, but maybe it's a stage on the way to legalizing usury or interest (Thiesenhusen, 2019).

From the description above, the distinction between usury and interest is not a correct distinction but is a stage in the historical development of the legalization of usury in the name of interest. The view of moneylenders in economic thought includes those dealing with interest in banks, as well as those dealing with usury from individuals, traders, or other people. This study investigates the impact of interest rates and the economy in Indonesia as a country with a Muslim population in the world but does not prohibit interest rates in the positive laws of the Republic of Indonesia.

Research Method

The research period for this study is from 1990 to 2020, and we use secondary data that we collect from World Bank data. In estimating the variables we use an autoregressive vector model with the following equation:

$\Delta C = \beta_0 + \beta_1 C_{t1} + \beta_2 GD_{t2} + \beta_3 Inv_{t3} + \beta_4 Itr_{t4} + e_t$

$\Delta GD = \beta_0 + \beta_1 C_{t1} + \beta_2 GP_{t2} + \beta_3 Inv_{t3} + \beta_4 Itr_{t4} + e_t$

$\Delta I = \beta_0 + \beta_1 C_{t1} + \beta_2 GD_{t2} + \beta_3 Inv_{t3} + \beta_4 Itr_{t4} + e_t$

$\Delta IR = \beta_0 + \beta_1 C_{t1} + \beta_2 GD_{t2} + \beta_3 Inv_{t3} + \beta_4 Itr_{t4} + e_t$

When Gross Domestic Product is represented by GD. Consumption is represented by C, investments by Inv, and interest rates by Itr.

Result And Discussion

To guarantee that our data is steady for the estimate, we perform a data stationarity test.

Table 1. Results of a stationarity test

			Stat.	Prob.**
Fisher Chi-square			10.9824	0.1927
Choi Z-stat			0.6011	0.6943
	Prob.	Lag	Max Lag	Obs
CO	0.8761	0	3	30
GDP	0.8971	0	3	30
I	0.0201	0	3	30
IR	0.3012	0	3	30

The results in Table 1 indicate that all of the data are stationary so that we can estimate the vectors presented in Table 2.

Table 2. Estimation Outcomes

	CO	GDP	I	IR
CO	0.19929	-0.89513	0.02011	-0.000000000499
	-0.70111	-1.99211	-0.42215	-0.00000000149
	[0.29112]	[-0.50112]	[0.03011]	[-0.41011]
GDP	0.050882	0.201211	0.201113	-0.00000000000391
	-0.19274	-0.80121	-0.20116	-0.000000000601
	[0.30118]	[0.19811]	[1.19662]	[-0.79222]
I	2.01	3.97	0.0197	0.0000000000171
	-0.348	-1.27	-0.291	-

				0.00000000002
	[3.80515]	[2.94359]	[0.05926]	[2.02712]
IR	-0.00000000641	-0.00000000031	-0.00000000019	-0.501
	-0.0000000017	-0.000000007	-0.0000000014	-0. 394
	[-0.40451]	[-0.39324]	[-1.39461]	[-0.93249]
C	-0.00000000491	-0.000000000297	0.000000000669	0.427
	-0.00000000107	-0.000000000029	-0.00000000007	-2.29
	[-0.50112]	[-0.89924]	[0.911121]	[0.20112]
R squared	0.76	0.71	0.759	0.71
R squared Adj.	0.72	0.69	0.73	0.63

Consumption significantly influences future consumption, according to the estimated outcomes of the autoregressive vector. Consumption is significantly impacted inversely by GDP. Consumption is significantly impacted favorably by investment. Consumption is significantly impacted inversely by interest rates. GDP is significantly impacted favorably by consumption.
GDP is significantly impacted favorably by GDP. Investment is significantly impacted favorably by consumption. Investment is significantly impacted favorably by interest rates. Investment has a positive relationship with consumption. Interest rates are significantly impacted inversely consumption. Interest rates are significantly impacted inversely by GDP. Interest rates are significantly impacted inversely by investment. Interest rates are significantly impacted inversely to the interest rate itself.

Conclusion

The lower the interest rate, the more it encourages economic growth and vice versa. Interest rates put pressure on the real sector because interest rates are the cost of capital that weighs on the economy. Low interest rates bring improvement and better economic growth. This proves that interest rates which in Islamic economics are still forbidden have a bad impact on the Indonesian economy.

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