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Macroeconomics from Islamic Worldview

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1. Introduction

Several definitions of macroeconomics have been forwarded among others:

> The study of the behavior of entire economies (see, www.crfonline.org/orc/glossary/m.html)
>
> That part of economics that is primarily concerned with the study of relationships between broad economic aggregates, such as national income, savings, investment, consumption, employment, the money supply, the average price level, exports, imports and the balance of payments. (see, customscentre.canberra.edu.au/glossary/glossary-M.html)
>
> The top-down view of the economy, focusing on aggregate characteristics (see, www.wwnorton.com/stiglitzwalsh/economics/glossary.htm)

The variety of definition is one of the reasons economists have divided views on this field. Consequently, this field is divided among schools, Keynesians, monetarists, new classical, new Keynesian and others. Their disagreements, which often appear to be as much about methodology as about results, leave public bewildered and skeptical.

Hence, we write this paper to accomplish two objectives. First, our aim is to emphasize on the unity of knowledge as a fundamental epistemological principle of scholarship. Second, we believe that the domain of economic aspects of life do not remain merely an appendage to philosophy, ethics, and jurisprudence. But, we know that to encounter the content of economic subject, we treat the economic activities as an act of worship.

The remaining discussion of this paper is as follows. Section 2 discusses on the macroeconomics field from the conventional view. Section 3 presents several macroeconomics facts that may lead to a new view. Section 4 produces the conclusions.

2. What do we think Today about Macroeconomics?

Since macroeconomics is the study of the entire economy in terms of aggregate quantities such as the total amount of goods and services produced, total income earned, the level of employment of productive resources, and the general behavior of prices. Hence, macroeconomics is used to analyze how best to influence policy goals such as economic growth, price stability, full employment and the attainment of a sustainable balance of payments. The analysis focuses on the object and analytical approaches that finally lead to produce a different school. Therefore, the discussion of this section is directed towards those issues.

a. Object of Analysis

Until the 1930s most economic analysis concentrated on individual firms and industries. With the Great Depression of the 1930s, however, and the development of the concept of national income and product statistics, the field of macroeconomics began to expand. Particularly influential were the ideas of John Maynard Keynes (1883-1946), who used the concept of aggregare demand to explain fluctuations in output and unemployment. Keynesian economics is based on his ideas.

One of the challenges of economics has been a struggle to reconcile macroeconomic and microeconomics models. Starting in the 1950s, macroeconomists developed micro-based models of macroeconomic behavior (such as the consumption function). Dutch economist Jan Tinbergen (1903-1994) developed the first comprehensive national macroeconomic model, , which he first built for the Netherlands and later applied to the United States and the United Kingdom after World War II. The first global macroecomomic model, Wharton Econometric Forecasting Associates LINK project, was initiated by Lawrence Klein (1920-??)

Theorists such as Robert Lucas Jr (1937-??) suggested (in the 1970s) that at least some traditional Keynesian macroeconomic models were questionable as they were not derived from assumptions about individual behavior. However, New Keynesian Macroeconomics has generally presented microeconomic models to shore up their macroeconomic theorizing, and some Keynesians have contested the idea that microeconomic foundations are essential, if the model is analytically useful.

b. Analytical approaches

There are two different approaches to macroeconomics: Keynesian economics, focussing on demand, and supply-side (or neo-classical) economics, focussing on supply. Neither, of course, can completely neglect the other aspect - it is a question of emphasis. Most schools are fairly clearly based on one or the other approach.

Keynesian economics, which focuses on aggregate demand to explain levels of unemployment and the business cycle. That is, business cycle fluctuations should be reduced through fiscal policy (the government spends more or less depending on the situation) and monetary policy. Early Keynesian macroeconomics was "activist," calling for regular use of policy to stabilize the capitalist economy, while some Keynesians called for the use of income policies. In economics, incomes policies are wage and price controls used to fight inflation. (The name arises because this involves control over incomes.) Many or most macroeconomists oppose the use of these controls since they interfere with the price mechanism, encouraging inefficiency: they lead to shortages and declines in the quality of goods on the market, while requiring large government bureaucracies for their enforcement. Others argue that they are less expensive (more efficient) than recessions as a way of fighting inflation, at least for mild inflation. (Few see them as helping with hyperinflation) Yet others argue that controls and mild recessions can be complementary solutions for relatively mild inflation. They work best for those sectors of the economy dominated by monopolies or oligopolies with a significant sector of workers organized in labor unions.

Supply-side economics, which delineates quite clearly the roles of monetary policy and fiscal policy. The focus for monetary policy should be purely on the price of money as determined by the supply of money and the demand for money. It advocates a monetary policy that directly targets the value of money and does not target interest rates at all. Typically the value of money is measured by reference to gold or some other reference. The focus of fiscal policy is to raise revenue for worthy government investments with a clear recognition of the impact that taxation has on domestic trade.

c. Who is Who in Macroeconomics?

It is important to understand that there are various schools of thought that are not always in direct competition with one another -- even though they sometimes reach differing conclusions. Macroeconomics is an ever evolving area of research. The goal of economic research is not to be "right," but rather to be accurate. It is likely that none of the current schools of economic thought perfectly capture the workings of the economy. They do, however, each contribute a small piece of the overall puzzle. As one learns more about each school of thought, it is possible to combine aspects of each in order to reach an informed synthesis.

Monetarism, led by Milton Friedman (1912-??), which holds that inflation is always and everywhere a monetary phenomenon. It rejects fiscal policy because it leads to “crowding out” of the private sector. Further, it does not wish to combat inflation or deflation by means of active demand management as in Keynesian economics, but by means of monetary policy rules, such as keeping the rate of growth of the money supply constant over time.

New Classical economics, which explores the implications of rational expectations. Their original theoretical impetus was the charge that Keynesian economics lacks microeconomic foundations -- i.e. its assertions are not founded in basic economic theory. Here, the macroeconomic model is built up from the actions of individual agents, whose behaviour is modelled by microeconomics. This school emerged during the 1970s. This school asserts that it does not make sense to claim that the economy at any time might be "out-of-equilibrium". Fluctuations in aggregate variables follow from the individuals in the society continuously re-optimizing as new information on the state of the world is revealed. The most famous New Classical model is that of Real Business Cycles, developed by Robert Lucas, Jr., Finn E. Kydland and Edward C. Prescott.

New Keynesian economics, which developed partly in response to new classical economics. It strives to provide microeconomic foundations to Keynesian economics by showing how imperfect markets can justify demand management.

The Austrian School is a school of economic thought that rejects opposing economists' reliance on methods used in natural science for the study of human action, and instead bases its formalism of economics on relationships through logic. Hence, we also consider Austrian macroeconomics as another laissez-faire school of macroeconomics. It focuses on the business cycle that arises from government or central-bank interference that leads to deviations from the natural rate of interest. Its most famous adherents are Friedrich von Hayek (1899-1992), Ludwig von Mises (1881-1973), Murray Rothbard (1926-1995), Israel Kirzner (1930-??), Walter Block (1941-??), Joseph Alois Schumpeter (1883-1950) and Carl Menger (1840-1921).

Post-Keynesian economics represents a dissent from mainstream Keynesian economics, emphasizing the role of uncertainty and the historical process in macroeconomics.

Then, David Romer (1990) has proposed a new basic macroeconomic framework: the IS-MP-IA model. Its proponents claim that it represents the 'modern' view of macroeconomics. We show that the new framework remains closely attached to the neoclassical synthesis and, in addition, does not take account of: (i) the empirical evidence on the output-inflation trade-off; (ii) the evidence on the interdependence of aggregate demand and supply; (iii) the institutional limits of monetary policy; and (iv) the implications for macroeconomic policy of (i), (ii) and (iii). Once these aspects have been incorporated, short-run stabilization policy is not neutral in the long run, the notion of a 'natural' rate of interest becomes untenable and aggregate demand turns into the crucial exogenous variable.

3. The Facts of Macroeconomics – Does it Guide us to another View?

The current approaches to macroeconomics focus on demand, and supply-side economics. Of course, we cannot completely neglect the other aspect - it is a question of emphasis. Our view about macroeconomics is guided by the following facts:

a. Business Cycle

The earlier version of business-cycle models started from the story of Prophet Yusuf in Chapter Yusuf, verses 42-48.[2] The Pharaoh of Egypt summoned Prophet Yusuf, then an imprisoned slave, to interpret two dreams. In the first, seven plump cattle were followed and devoured by seven lean, starving cattle. In the second, seven thin ears ate full ears of corn. After hearing these dreams, Prophet Yusuf prophesied that Egypt would enjoy seven years of prosperity, followed by seven years of famine. He recommended a consumption-smoothing strategy to provide for the years of famine, under which Pharaoh would appropriate and score a fifth of the grain produced during the years of plenty. According to the tafseer ibnu Khathir, Pharaoh embraced this plan, made Prophet Yusuf his finance minister, and thereby enabled Prophet Yusuf to save Egypt from starvation.

[2] Scholars, such as ibnu Khathir place the episode somewhere around 1800 B.C.

Why did Prophet Yusuf recommend storing the grain (a form of domestic investment yielding a rate of return of zero before depreciation) rather than lending it abroad at a positive rate of return? Thus storing the grain at home was a much safer course. More importantly, the saving decision for later consumption is considered as effective strategy.

b. Generational Transfers

In the economy, we, as individuals, apparently do not live forever, but we have a finitely lived agents (individuals and firms). It gives an interpretation that individuals live only for a finite number of periods, but by having an altruistic bequest motive,

(see, Chapter al Baqarah, verse 180: "*It is prescribed for you, when death approaches any of you, if he leave wealth, that he makes a bequest to parents and next of kin, according to reasonable manners. (This is) a duty upon al-Muttaqun*."),

individuals act so as to maximize the utility of the entire generations, which in effect makes the planning horizon of the agents infinite. Therefore, in the infinitely lived agent, every period is like the next (which makes it so useful).

Individuals do not live forever also mean that we can divide our life into two periods: working (young generation) and retirement (old generation) periods. When they work, they receive income and spend part of it,

(see, Chapter al Baqarah, verse 177, "*It is not al-Birr (piety, righteousness, and each and every act of obedience to Allah, etc.,) that you turn your faces towards east and (or) west (in prayers); but al-Birr is (the quality of) the one who believes in Allah, the Last Day, the Angels, the Book, and the Prophets and gives his wealth, in spite of love for it, to the kinsfolk, to the orphans, and to al-Masakin (the poor), and to the wayfarer, and those who ask, and to set slaves free, performs as-Salat and give the Zakat, and who fulfill their covenant when they make it, and who are patient in extreme poverty and ailment and at the time of fighting (during the battles). Such are the people of the truth and they are al-Muttaqun."*

and pay zakat (or give sadaqah). In the later, we make a transfer to the same generation (young to young) or different generation (young to old). Here, we also make a decision on how much we want to consume and save (for later consumption during retirement period).

Therefore, in an economy in which agents experience a life cycle and in which people of different ages live at the same time, we can analyze the issues like social security, the effects of taxes on retirement decisions, the distributive effects of zakat and taxes vs government deficits, and the effects of life-cycle saving on capital accumulation.

c. Money and Riba

In Islam, the payment and receipt of interest are prohibited. Islamic economist such as Al Ghazali, in his Ihya (4:91-93) stresses the important of money in solving the problem of barter and acts as a medium of exchange [see Ghazanfar and Islahi (1990)]. Therefore, money can be exchange with financial instruments and the savers become the owner of those instruments. In addition, the Islamic financial intermediaries provide a variety of services, including access to the financial markets; and evaluating, managing, and funding the entrepreneurial activity that leads to productivity growth – that become an important ingredient in endogenous growth model.

Further, Al Ghazali also argues that charging interest on the borrowing and lending of money deflects money from its key function. The creation of riba or usury is viewed as economic exploitation and of injustice to transaction (aside from sinful). Money, he argues, not created to earn money, and doing so is a transgression. If a person is permitted to sell (or exchange) money with money (for gain), then such transaction becomes her goal, and thus money will be imprisoned and horded.[3] Imprisonment in this form is also a transgression because it denies money to perform its function.

Therefore, with this role, money becomes a crucial to any financial system. The Islamic financial system will have to offer their financial services in the form of contract. Each contract possesses all its essential elements and that every essential elements meets its necessary conditions. The contracts may fall under the following categories: trading contracts, participating contracts and supporting contracts. Therefore, the role of Islamic financial market stems from the fact that Islam prohibits interest (riba) and encourages trade (bay') and profit-sharing (partnership).

d. Welfare Economics

The behavior of the agents should always reflect benevolence (*ihsan*)—meaning "doing something extra for another beyond the material benefits, though that extra is not an obligation, but merely an act of generosity" (*Ihya*, 2:79). Al-Ghazali then goes on to enumerate some guidelines concerning "benevolence" in the marketplace—such as compassion for the poor, leniency in debt transactions, foregoing repayment when selling to the poor on credit, and so on. The essential guide for business conduct must be "goodness of the Hereafter and of this life" (*maslahah al deen waal-dunya*) (*Ihya*, 2:109).

[3] Hording money or convert it to other object, dirham and dinars, gold and silver money, is against divine rules and a transgressor.

4. Conclusions

The aim of this paper is to look at the domain of economic aspects of life that do not remain merely an appendage to philosophy, ethics, and jurisprudence. We find that: first, the conventional macroeconomics focus on demand, and supply-side economics. There are several school of thought that try to explain this focus and find that none of the current schools of economic thought perfectly capture the workings of the economy. However, each contribute a small piece of the overall puzzle. Second, several macroeconomic facts lead us to believe that Islamic worldview could those facts.

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