

## The Pressure is on: Inflation

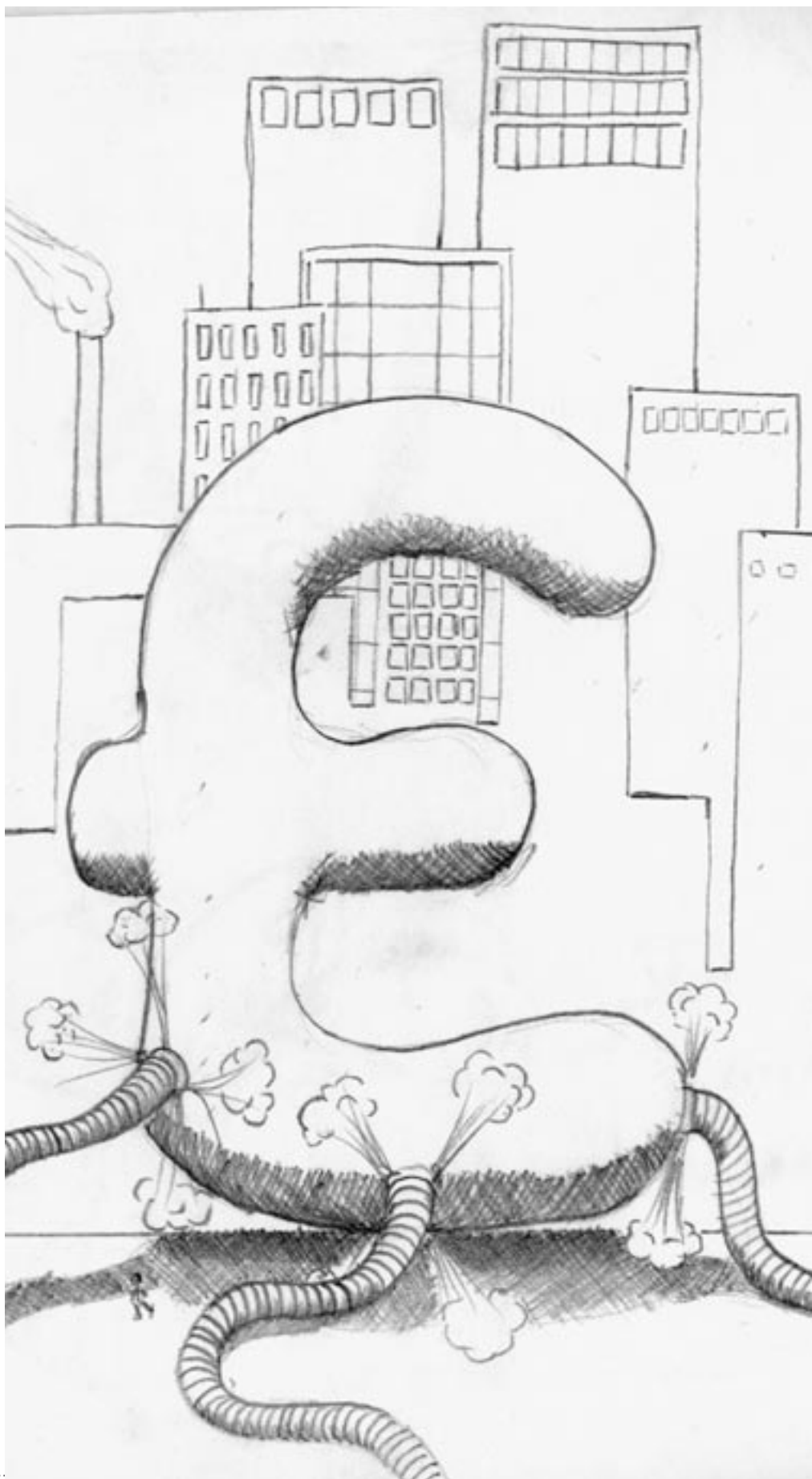
**With the financial media constantly concerned about a flailing economy and the Bank of England reluctant to lower interest rates due to inflationary pressures**

**Hamza Mian** investigates exactly what inflation is and how to overcome it as a Muslim.

**I**nflation. Most modern definitions describe this economic phenomenon as “the persistent, substantial rise in the general level of prices related to an increase in the volume of money and resulting in the loss of value of currency”.

This rather complex statement however describes what are in fact two different phenomena and also attempts to deal with not only the cause but also the effect of what is now commonly referred to as inflation in mainstream financial media.

From a consumer standpoint, the more important aspect of the definition is its effect, namely that of “the loss of value of currency”. In real terms this means that every unit of currency, every pound or ever dollar, has less purchasing power and pays for fewer goods and services. Technically, this effect is known as price inflation and is in fact not the cause of inflation but rather, its effect. Whilst this is the aspect that financial media tends to focus on and is what impacts the average consumer, choosing to analyse the effects rather than the root cause of a problem seldom leads to a good understanding of the problem at hand.





Inflation however is actually a rather simple phenomenon that may be explained using two of the most fundamental operators in economics: supply and demand. In any free market, goods and services will always find their own price level; for example, if the quantity of bananas available for sale were to increase dramatically it would be natural to expect the price to drop in order to attract a greater number of people to purchase them, or if the quantity of apples available were to fall substantially due to a bad harvest one would expect the price of apples to rise (inflation) as the supply has become limited. Whilst this type of inflation does affect some goods and services in a western economy, its effect is generally limited, and it does not result in an overall depreciation in the value of a currency. This is because the total amount of money available to consumers has not changed, and in order to purchase the apples they must purchase fewer bananas (or other goods). Looking at the supply of goods and services in this way however only illustrates one of the causes of inflation, the other is provided by looking at the supply of money itself.

Imagine the quantity of apples available for sale does not change at all, but the amount of money that is available in the economy to purchase the apples is seen to increase dramatically. The net effect would be an increase in the price of apples, as although the supply of apples has remained constant, the quantity of currency available to exchange them for has increased, resulting in the same overall effect on the ratio of apples to money. This phenomenon is what is known as Monetary Inflation, often seen in western economies of late, and is usually responsible for the overall devaluation of a currency.

## Inflation, Interest & Islam

A common question posed to Islamic economists is that in an economic system that prohibits the payment or receipt of interest, how is it possible to structure loan transactions that do not negatively impact the lender and thus discourage commerce?

Surely if the payment of interest, even to a level of simply overcoming the effects of inflation eroding the value of money over time, is not permitted, then individuals and financial institutions alike will be unwilling to engage in such transactions.

There are in fact two answers to this dilemma. The more common though less relevant response is that although loan transactions may not carry an interest component, financial transactions based on equity and the distribution of profits does overcome this problem (provided the venture is profitable).

However, more importantly, some scholars do allow for loan transactions to include an additional payment in order to overcome the effects of inflation, provided a number of criteria are met

to ensure that this payment does not resemble interest. Namely the additional component to account for inflation may not be stipulated at the outset; rather a means of calculation must be stated and applied at the end of the loan period.

Whilst this provision allows loan transactions to remain neutral in the face of inflationary pressures it does not however provide a means for the average individual to protect their savings from the erosive effect of inflation. It could be argued that under an Islamic economic system, the hoarding of wealth in such a manner that it becomes liable to erosion due to inflation (i.e. in a manner such that the capital is not being used) is discouraged in itself. Such deposits would not be affected by inflation but are also subject to taxation (zakat) and many Islamic traditions discourage amassing wealth in such a manner, preferring instead to invest it (and thus also safeguarding against inflation).

**“INFLATION IS ACTUALLY A RATHER SIMPLE PHENOMENON THAT MAY BE EXPLAINED USING TWO OF THE MOST FUNDAMENTAL OPERATORS IN ECONOMICS: SUPPLY AND DEMAND.”**

It would be reasonable to question where an increased quantity of currency originates from and the simple answer is firstly from a growing economy as peoples' incomes increase, but also and importantly it is a result of the fractional reserve banking system implemented in western economies through the issuance of credit in a fractional reserve banking system. The intricacies of this are beyond the scope of this article unfortunately,

however in simple terms the process of loaning money actually results in the creation of “new” money.

Proponents of asset backed currencies (such as the Gold Dinar and other gold standard currencies) often argue that such a means of exchange would result in an economy that does not suffer from inflationary pressures as unlike most modern currencies which are not asset backed. They argue that the requirement to back all currency with physical assets would limit the supply of money and thus naturally control inflation. However this argument is somewhat fallacious in nature, whilst the overall supply of gold may be (arguably) limited, its supply in any one country or region is not and localised (to one country or region) remains very possible through the transference of wealth.

This is a trend that has been witnessed many times through history, one only



**“IF INFLATION ESSENTIALLY HAS THE EFFECT OF ERODING WEALTH OVER TIME AND IS A FEATURE OF MODERN ECONOMIES, WHAT THEN CAN BE DONE TO MITIGATE ITS EFFECT?”**

has to look at the establishment and subsequent demise of many different empires through the ages. In fact inflation in the early Islamic era was rampant as the many battles brought in the bounty of war back into the Islamic state (and Madinah in particular).

If inflation essentially has the effect of eroding wealth over time and is a feature of modern economies, what then can be done to mitigate its effect? The standard suggestion is to invest any spare funds, often with the initial investment taking the form of an interest bearing deposit account. However this suffers from a number of potentially serious drawbacks. Inflation in the UK over the last 10 years has been in the region of two to three percent whilst deposit interest rates have been in the region of four to seven percent, thus comfortably above the CPI. Anyone saving for a deposit to purchase a property during this period of time however will be more than aware of how much buying power would have eroded on any money in a deposit account despite it earning interest.

Unfortunately whilst governments may utilise CPI as a measure of inflation, it is often not a realistic benchmark. If you

## Measures of Inflation & the CPI

Inflation may be measured in a number of different ways, however the most often referred to is one of price inflation known as the Consumer Price Index (CPI) or more formally as the Harmonised Index of Consumer Prices (HICP). It is compiled by the Office of National Statistics and is the measure used by the government to set inflation targets for the UK and the Bank of England's Monetary Policy Committee to determine interest rate levels.

The CPI figure is calculated by monitoring the change in price of a “basket” of household goods. As prices of the goods within the basket change, the total basket cost also fluctuates. It is this fluctuation that indicates changes in the headline CPI figure.

In order to ensure the CPI is representative, the selection of goods and services (approximately 650 goods and services and over 120,000 prices constitute the current basket) within the basket is updated at the start of each year and then held constant for the duration of the year. This allows for changes in consumer trends, such as shifting from VHS tapes to DVDs, while still measuring inflation on a like

for like basis throughout the year. It includes a range of household goods and services but notably excludes the price of property, though it does include rental values and interest payments on mortgages.

Critics of the CPI as a measure for inflation often refer to the lack of inclusion of inflation on capital goods such as land and property and stocks. This is especially important, as in many western economies including the UK, although the growth of money supply (another measure of inflation) has been relatively constant, the CPI does not reflect this as much of the resulting price inflation has been reflected in capital good.

This variation in itself lends doubt to the credence of price indices as indicators of inflation and raises questions of whether inflation would not be better measured by money supply figures. Unfortunately money supply figures alone do not necessarily provide an indication of an inflationary economy, merely the growth within an economy.

require funds for a particular purpose at a future date, it is therefore prudent to invest in a medium that will track the real rate of inflation for your required purchase, be this property, university fees or a motor vehicle.

The second very significant problem is the lack of Shariah compliant investment options available to Muslims in the western world. Interest bearing deposit accounts are not considered to be permissible by scholars of Islamic law even where inflation negatively impacts the wealth of a Muslim.

Fortunately there are now a small number of providers that offer alternatives that are similar in nature to interest based deposit accounts, often with returns that are at a similar level. These still however

suffer from the same problems as normal interest based accounts; any significant funds would still need to be invested in a manner that tracks the inflation of the desired end product.

Hamza Mian is an executive director at Faqat Safi, an Islamic financial services company. [hamza.mian@faqatsafi.com](mailto:hamza.mian@faqatsafi.com)