Indexation: Definition, Types and Experience in application

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In his “Using escalators to help fight inflation," (proceedings of the Economists conference on inflation, New York, 1974) Milton Friedman concluded that: “The real obstacles to ending inflation are political not economic. Ending inflation would deprive governments of revenue that it now obtain without legislation.”

Mr. Friedman’s statement was correct then and is correct today. Further more his next statement is also just as correct “indexation is not a panacea. It is impossible to escalate all contracts, and wide spread indexation is cumbersome. A great advantage of using money is precisely the ability to carry on transactions cheaply and effectively, and universal escalator clauses reduce this advantage. Far better to have no inflation and no escalator clauses” (p 412). With this dictum in mind I read Prof. Ninhause’s lucid and most illuminating article on indexation.

Prof. Ninhaus’s survey of applications is particularly absorbing.
I believe contemporary Muslims are faced with a dilemma. On the one hand we all recognize the fact that inflation produces “unfairness," that the deterioration in the purchasing power of the paper money is a fact of life, that people, in the final analysis, are concerned with how much real goods

and services money can fetch and not the mere “quantity” of money. On the other, any attempt to introduce indexation to financial obligations contradicts the basic elements of the prohibition of *riba*.

Certainly if we can “fix” the monetary system in such a way that makes it immune to inflation, the plight will be eliminated. The problem is that this is not possible, and attempting such a thing, even theoretically, is not feasible. There is no easy answer on the question of inflation. There are only difficult choices. Most promising, and certainly the most logical is “gold." We need not, at this juncture, go into the, rather well known history of the gold standard. Nor that we need to establish the importance of gold throughout human history. What we need to emphasis is something even more obvious than the above, it is the importance of the price of gold in contemporary world of money and finance. In the words of one writer. The price of gold had been “the single most reliable monetary reference point in human history." (David Gitlitz 1995).

Even the most sophisticated practitioners of monetary policy, such as the Federal Reserve system of the U.S.A, where price stability is most overriding concern, still find the price of gold extremely useful in predicting future inflation (WSJ 6-29-94). This is because the price of gold reflects inflatory expertation. Clearly this means that whenever, people are in doubt they go to gold. In a recent article in Bankers magazine, Franklin J. Chu, writing on gold and inflation concluded that “The historical reasons for owning gold as a store of value remained more or less unchanged” (p. 16).

Judy Shelton in her recent book on “restoring order to the global currency system” argued very strongly for the “re-imposition of an International gold standard." She thinks that a return to gold backed currencies would force governments, to display more fiscal responsibility or face the prospects of investors demanding gold for their paper currency”. In the long run the gold commitment by government, assures people that the financial assets they are holding can be transferred intact between generations. Prices will fluctuate in the short run (like they have always done), gold will guarantee that they are steady when measured in decades and centuries. “From 1717 when England went on the gold standard to 1934 when it went off, the general price level was essentially unchanged." (J. Wanniski).

Prices in 1933 in the U.S.A were basically the same as in 1791 when America first adopted the gold standard.

But is it really possible to go back to the gold standard? To deal with the problem at hand, we do not need to answer this question, through reply is but too obvious. This is because what we need, as Muslims, is to face the dilemma with a “micro” solution. This starts with investigating the limits of permissibility in *Shariah* for mitigating the “unfairness” problem. *Shariah* scholars and learned men of economics and finance should firstly, come to grips with the problem, not from policy point of view, but simply from “contractual” stand point. There is no denying that we need some form of indexation. Nevertheless CPI is not what we are looking for. This brings us back to Prof. Ninhause’s paper.

He showed that the empirical evidence in support of the argument of indexation as a remedy of the “mis-allocation” due to inflation is “not very strong." On the contrary, at some stage the mis-allocation it self may be attributed to indexation. Not only that indexation may lead to more flight to real assets, it may even lead to “demonetization” of the economy (p. 13). Furthermore, he showed that on the individual level, indexation may reduce the distributive distortions of inflation, but it can by no means eliminate them totally, and may even worsen them (p. 15)

As a means for a stabilization policy (prior to elimination of inflation) indexation may be an effective method. However, indexation very often is “misused” by governments (p.20). Can indexation be an effective means for restoring “full measure and weight”? The writer doubts this particularly on macro level (p. 22). In conclusion, Prof. Ninhause believes that we need to think about “adequate *institutional* frame work for monetary stability” (p.23) put differently, we are to look, for solving the problem of inflation, to the very “Villain” who is behind the whole quandary.

Our agenda should include the search for a solution that is independent of government policy. All of the short comings of price indexation emanate from the fact that monetary authorities are handling both ends of the “deal." They create inflation on the one hand, and try to eliminate it (or mitigate the side effects) on the other. Is it possible to find an index that is completely free of this weakness? The answer is in the affirmative. It is simply “gold” indexation in private and individual contract.

That this proposition is effective and practicable is beyond doubt. The problem is: Is it permissible from *Shariah* point of view?

Certainly the standard *Shariah* rules do not permit ex-post indexation. Contracts which promise monetary compensation in the future can only be paid in the very same currency on which the contract was concluded.

To satisfy this requirement we need to replace paper money with gold which is not practical. The question is can people, while they handle paper money adopt the price of gold as an underlying unit of account.?

It is permissible to conclude contracts in gold rather than paper money. Once this is done and the debtor's obligation is specified in gold he is required to pay in gold. It is possible for the two parties to settle for something else, but it is not allowed to make this a condition in the contract. If we think about it for a minute, price of gold is just as abstract as paper money itself. Certainly it would not be particularly strenuous to express gold in the form of gold certificates. (isn't this how paper money originally started.) This will not eliminate inflation. Nor that it is a panacea for its side effects in terms of fairness and efficiency.