

قُلْ إِنِّي رَسُولُ اللَّهِ نُزِّلَ إِلَيْنَا الْحَقُّ مِنَ رَبِّهِ ۚ إِنَّ اللَّهَ عَلِيمُ الْغُيُوبِ

# Towards a Just Monetary System

M Umer Chapra

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*The Word of your Lord is perfect in truth and justice. (al-An‘ām 6: 115)*

*Be just, for justice is nearest to piety. (al-Ma‘idah 5: 9)*

*Say: my Lord has enjoined justice. (al-A‘rāf 7: 29)*

*We sent our messengers with the Book and the Balance, so that mankind may establish justice. (al-Ḥadīd 57: 25)*

) :

(...

) :

(...

*From Abū Dharr al-Ghifārī: The Prophet, peace be on him, reported that his Lord said: ‘O my creatures! I have forbidden injustice (ẓulm) for Myself and have also forbidden it among you, so do not be unjust to each other. . .’*

*From Jābir ibn ‘Abdallah: The Prophet, peace be on him, said: ‘Beware of injustice, for injustice will lead to absolute darkness on the Day of Judgement.’ (Ṣaḥīḥ Muslim, Kitāb al-Birr wa al-Ṣilah wa al-Adab, Bāb Tahṛīm al-Ẓulm)*

To  
my wife  
Khairunnisa  
whose name reflects her qualities  
and who deserves *at least* half the credit for this book  
for the help and encouragement she has constantly provided



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## FOREWORD

Not long ago Islam's prohibition of interest (*Ribā*) was generally regarded as an almost impossible proposition even among most Muslim intellectual circles. The situation has changed dramatically over the last few decades. The intellectual as well as the institutional hegemony of interest has been challenged, particularly by Muslim scholars and economists. There is a greater flow of literature on the subject, showing substantial increase in quantity as well as quality. Moreover, the debate is no longer confined to theoretical argument; there is now a rich and expanding tradition of experimentation and institution-building. The monetary economics of Islam is beginning to come of age.

Looking back over the last fifty years, one can discern at least three somewhat distinct phases in the development of the discipline. It was during the mid-thirties that, among others, some of the '*ulamā*' (Islamic religious scholars) who, though they had no formal training in economics, yet had a clear grasp of the socio-economic problems of the age and Islam's approach towards them - addressed themselves to the problems of interest. They brought a fresh approach to the subject, distinct from the modernists and apologists who were trying to explain away Islam's injunctions about interest. Instead of changing the Islamic teachings to suit the current practice, these scholars boldly reaffirmed the Islamic position, without making any compromises, and invited Muslim economists and bankers to strive to change economic institutions in order to achieve conformity with Islamic norms and principles. Some Muslim economists and bankers responded to this clarion call but their efforts were of an elementary nature and their impact limited. Nevertheless, a new opening was made.

This led to the second phase in which, over the last twenty years, Muslim economists have applied themselves more rigorously to developing certain aspects of the monetary system of Islam. An economic analysis of the Islamic rationale for the prohibition of *ribā* was expounded and the major contours of an alternate system of banking and finance free from *ribā* were delineated. Significant contributions in the field were made at

the First International Conference on Islamic Economics held at Makkah in 1976, the International Conference on Islam and the New International Economic Order held in London in 1977, the two seminars on Monetary and Fiscal Economics of Islam held at Makkah (1978) and Islamabad (1981), the conference on Islamic Banking and Strategies for Economic Cooperation held in West Germany at Baden-Baden (1982) and the Second International Conference on Islamic Economics held at Islamabad (1983). Over a dozen books and monographs have been produced containing papers and discussions emerging out of these conferences and seminars. Perhaps the most significant intellectual-cum-operational contribution has been made by Pakistan's Islamic Ideology Council which, on the basis of a Report of its Panel of Economists and Bankers, has produced the first comprehensive and systematic blueprint for the elimination of *ribā* from a modern economy. In the opinion of the present writer, this report represents the high point of contemporary Muslim contributions towards developing a model of an interest-free economy. It is also a consummation of the original work done by Muslim economists during this period.

A parallel development during the last decade represents the third phase and consists of efforts to develop interest-free banking and financial institutions in the private as well as the public sector. Presently thirty-eight banks and financial and investment institutions are operating on an interest-free basis in three continents: Asia, Africa and Europe. At least two of these institutions, Islamic Development Bank, Jeddah, and Dārul Māl al-Islāmī, Bahamas and Geneva, are operating multi-nationally. Though they are very young and they still have a long way to go, these institutions are a living vindication of the Islamic theory of finance.

Islamic monetary economics is now entering its fourth phase which calls for a more integrative as well as a more critical approach to the entire theory and practice of money and banking in Islam. The pioneers have blazed the trail, but now is the time to seek for greater refinement and sophistication. The economists are faced with the challenging task of reviewing the whole situation in at least three areas.

Firstly, to bring together the work done by different economists into a comprehensive view of the monetary system of Islam in its fullness, as against concentrating on specific, sometimes even disjointed, elements of money and banking. The time has come to distinguish the wood from the trees.

Secondly, to review critically the different models of Islamic banking presented over the years in the context of the practice of Islamic banking with a view to refining the theory as well as improving the practice. Now is the time to test the theories and to examine and evaluate the emerging institutions against the touchstone of the objectives of Islamic banking and finance.

Thirdly, it is essential to put the whole theory and practice of Islamic banking in the perspective of an Islamic economy and the Islamic moral and social order. Any element of the Islamic system, however important, cannot produce the desired results, if it is allowed to operate in isolation. It must lead to other complementary changes to complete the process. Elimination of *ribā* is only one aspect of the Islamic economic programme. It must be accompanied by, and strengthened through, other motivational and structural changes. Islamic banking is only a part of the process, and not the be-all and end-all of the process.

This integrative and critical approach will lead to the development of a comprehensive theory of Islamic monetary economics. Many gaps in knowledge and practice have also to be filled and new ideas experimented with, refined and perfected. It is in this context that I welcome the present work of my brother and colleague, Dr. Muhammad Umer Chapra, *Towards a Just Monetary System*. In my humble view, if the Islamic Ideology Council's *Report on the Elimination of Interest from the Economy* is the crowning work of the second and third phases, Dr. Chapra's treatise heralds the beginning of the fourth phase. I deem it a privilege to contribute this foreword to his pioneering work and take genuine pride in presenting this book in the Islamic Economics Series of the Islamic Foundation.

Muhammad Umer Chapra is an eminent economist and a committed Islamic scholar. In him one can see the approximation to the new model of Islamic scholarship, wherein the modern and the traditional streams of knowledge embrace each

other. Educated in Karachi (M.Com.) and Minnesota (Ph.D), he has the best from the modern centres of economic learning. He has worked hard, very successfully, to acquire a command of Arabic and study Islam from the original sources. He has served in many important teaching and research positions. He taught Economics as Assistant and then Associate Professor in America, and worked as Senior Economist, Pakistan Institute of Development Economics and Reader (Associate Professor), Central Institute of Islamic Research in Pakistan. For the last nineteen years, he has been working as Economic Adviser to the Saudi Arabian Monetary Agency. His experience thus covers a broad range of teaching, research and policy-formulation. Monetary economics has been his specialisation. He has participated in a large number of international conferences, including most of the conferences and seminars on Islamic economics and finance and has contributed significantly on these occasions. *Towards a Just Monetary System* represents the sum and substance of his thinking and contributions on the subject to date.

In my view, this book is unique in many respects. First, it is the first *comprehensive* and *integrative* study of the Islamic monetary system, presenting the whole mosaic and not merely some of its pieces. It also puts the monetary economics of Islam in its proper perspective. In this respect it fulfils a great need and constitutes an antidote to some ill-placed complacency that might have shown in Islamic circles. It not only restates the Islamic position on money, banking and finance in a precise, comprehensive and authentic manner, but also identifies the gaps in some of the prevalent approaches. It is also a timely warning against piecemeal approaches. Dr. Chapra's emphasis on structural change, on the need to cleanse economic life of all forms of exploitation and inequity and on the interdependence of different elements of the Islamic scheme of life is not only a timely reminder but also constitutes a powerful agenda for future reform and reconstruction.

The second characteristic of this work is its integration of theory with practice. Dr. Chapra has very ably developed the Islamic rationale of the prohibition of *ribā* and has demonstrated

with academic rigour not only the viability but the superiority of the equity-based financing system. He has not only critically reviewed the current Islamic banking but has also come up with original suggestions to improve it and to enable it to achieve Islamic objectives more effectively.

Thirdly, the book has raised the level of debate on Islamic monetary economics by rigorous analysis of some key concepts, by a critical evaluation of some of the new ideas developed during the last decade and by presenting some new insights and policy-relevant suggestions. In this respect, I would particularly invite the reader to his discussion on joint stock company, on the reform of the stock-exchange system, on government borrowing needs and on non-bank financial institutions. His idea of a deposit insurance corporation and investment audit corporation deserve to be examined seriously. His evaluation of some of the proposals of the earlier-mentioned Islamic Ideology Council's Report has enriched the debate. His views on credit creation and indexation merit very serious consideration although this cannot be treated as the final word and some of us may continue to show sincere reservations.

Finally, I regard the two appendices as extremely valuable contributions. The first on '*Ribā* in the Qur'ān, *Hadīth* and *Fiqh*' is not only a masterpiece of scholarship but a statement that should finally settle the controversy on what constitutes *ribā*. The second on '*Mudārabah*, *Shirkah* and the Corporation' would serve as an invaluable groundwork for those economists who do not have access to the sources. The concepts have been so clarified that they can be used as building blocks for developing new business institutions in an Islamic economy in the form of new combinations and permutations.

While the book covers a vast area in monetary economics, the discussion on international monetary relations and how to cleanse them of *ribā* and other forms of exploitation requires to be developed, strengthened and expanded in many respects. I am sure Dr. Chapra and other Muslim economists will continue to face the challenge that comes from the world monetary system and develop more vividly the vision of an international monetary

system that is free from *ribā* and leads to the emergence of a just world economic order.

The Islamic Foundation, Leicester  
2 Dhū al-Hijjah, 1404  
28 August, 1984

**Khurshid Ahmad**

## PREFACE

Islam is a balanced and coherent way of life, designed to cater for human welfare (*ḥalāl*) through the establishment of harmony between the moral and the material needs of human beings and the actualisation of socio-economic justice and brotherhood in human society. The call for such a balanced and justice-oriented welfare is repeated from the minaret five times daily. The Muslims have again started responding to this call and there is a revival in the Muslim world. This revival is also reflected in the intellectual field. There is an increasing volume of literature on Islam. Since economic reform and reorganisation are important ingredients of the Islamic revival, the economic system of Islam has also received increasing attention. The abolition of interest being an indispensable feature of Islam, the design of an interest-free monetary and banking system has offered the greatest challenge to Muslim economists. Fortunately, this subject has also received the maximum attention.

A number of scholars have done pioneering work in the field of Islamic money and banking. It is not possible to give a complete list. Some of the prominent names are, Sayyid Abū A'ālā Mawdūdī, Dr. Anwar Iqbal Qurashī, Shaikh Mahmud Aḥmad, Na'im Siddiqi, Dr. Muḥammad Uzair and Dr. M. Nejatullah Siddiqi from the subcontinent, and Dr. 'Īsā Abduh, Dr. Abdallah al-'Arabī, Dr. Aḥmad al-Najjar, Muḥammad Bāqir al-Ṣadr and Dr. Sāmi Ḥamūd from the Arab countries. The establishment of Islamic banks in several Muslim countries as well as the Islamic Development Bank has also promoted the concept and discussion of Islamic banking. The charters, reports and publications of these banks have contributed greatly to an understanding of their operations and the issues involved.

The First International Islamic Economics Conference held in Makkah in February 1976 served as a great stimulant to the study of Islamic economics in general and of an interest-free, equity-based economy in particular. The pioneering role played by Professor Khurshid Aḥmad, Dr. Muḥammad Omar Zubair and Dr. Abdullah O. Nasif in this conference cannot be denied. This conference has been followed by other conferences and

seminars in Makkah, London, Indianapolis, Islamabad, Dubai, Abū Dhabi, Baden Baden, Kuwait and Dhaka. All these have no doubt served to offer a valuable forum for a fair and open discussion of the various issues involved, and helped considerably in furthering an understanding of the subject. A number of volumes have now become available giving the revised versions of papers presented at these conferences and seminars. These papers will no doubt provide food for thought for all those working in the field.

Very little work has, however, been done to put the prohibition of *ribā* in the larger perspective of the economy to indicate the strengths of a solely equity-based system and to show how such a system can be made to work. This book is a humble attempt in this direction. It has naturally drawn some of the important building blocks from the work which has already been done. It must be appreciated that the abolition of *ribā* in Islam is not an isolated injunction. It is part of a social and moral philosophy and an integral part of a set of interrelated and coherent values. Hence the problem is not merely that of removing *ribā* from the conventional system, but of introducing a new system. The objective of this book is to show what the Islamic system is and why it will not only promote justice but also contribute positively to resource allocation, capital formation, economic growth and stability.

I wish to record my gratitude to Dr. M. Anas Zarqa' and Dr. M. Nejatullah Siddiqi with whom I discussed a number of issues related to the book and benefited richly from their precious insights. The draft of the book was reviewed by a number of scholars. Dr. Anas Zarqa' , Dr. M. N. Siddiqi and Professor Volker Nienhaus made detailed and penetrating comments. Dr. Ziauddin Ahmad, Dr. Traute Wohlers-Scharf and Dr. H. Albach also made some useful observations. These helped greatly in improving the draft and strengthening the presentation even where I did not agree with their views. In the translation of the Qur'ānic passages, I have benefited from, but not reproduced, the translations of Abdullah Yūsuf 'Alī, Muḥammad Marmaduke Pickthall and A. J. Arberry. The comments made by Dr. Zafar Iṣḥāq Anṣari on the translations of the Qur'ān, *ḥadīth* and *fiqh*



passages in Appendix 11 and the glossary of Arabic terms led to a number of valuable improvements. Credit is also due to Dr. Abdul Wahhab Boase for the technical editing of the manuscript and to Mr. E. R. Fox for seeing it through the press. I am however alone accountable for the views expressed in the book and none of the scholars mentioned above nor the institution where I work bear any responsibility for them. Transliteration marks have been used only where necessary to avoid overburdening the book with such marks.

The contribution made by my wife, Khairunnisa, is undoubtedly in the nature of a foundation not visible to the normal observer. The role played by my mother and brother Ibrahim (may God have mercy on them both) and my brother Abdul Raḥmān in my initial training and upbringing, after the death of my father, deserve a special mention. May God reward them generously for what they have done. I am also grateful to Mr. Mobin Aḥmad for the research and secretarial assistance provided by him so efficiently during the preparation of the book.

Riyadh, Saudi Arabia  
Friday, 12 Rabi‘ al-Awwal, 1404  
16 December, 1983

**M. Umer Chpara**



## **Introduction: The Perspective**

Disorder has appeared everywhere  
because of what people have done.

(al-Qur'ān 30: 41)

We are betrayed by what is false within.

(Meredith, *Love's Grave*)

"The world economy has entered a phase of extraordinary instability and . . . its future course is absolutely uncertain", wrote Helmut Schmidt about a decade ago.<sup>1</sup> The instability has persisted and the uncertainty has continued. After going through the throes of painfully high levels of inflation, the world economy has experienced a deep recession and unprecedented rates of unemployment, complicated further by high levels of real interest rates and unhealthy exchange rate fluctuations. Although the recovery is now under way, the uncertainty still prevails. Real interest rates continue to be high and are expected to rise further, thus raising fears of an aborted recovery. The crisis is further aggravated by the presence of extreme poverty amidst plenty in all countries, various forms of socio-economic injustice, large balance of payments deficits, and the inability of some developing countries to service their staggering debt. Most economists would tend to agree with the view that "No previous theory seems capable of explaining the current crisis of the world economy."<sup>2</sup>

### **Roots of the Crisis**

The persistence of these problems and their gravity indicates that there is something basically wrong somewhere. What is it that is wrong? The answer would depend essentially on our basic philosophy of life as this will determine our analysis of the underlying causes of the

problems. No treatment can be effective unless it is addressed to the mainspring of the crisis. Nevertheless, the mistake which is commonly committed is that the source of the crisis is sought in symptoms: huge budgetary imbalances, excessive monetary expansion, large balance of payments deficits, rise of protectionist tendencies, insufficient foreign aid and inadequate international cooperation. The result is that the remedies adopted, like analgesics, ease the crisis only temporarily. After a short time, the crisis reappears, deeper and more serious.

The Muslim countries are not different. They are faced with the same problems as other countries. They are, however, thoughtlessly following the West in everything and committing the same mistake of looking only at the symptoms. No serious effort is being made to analyse the underlying source of their problems and to determine a proper strategy for solving them in the light of their own value system.

Within the Islamic perspective, the roots of the crisis lie deeper and no effort to solve the problems through cosmetic changes will succeed. There is need for a thorough reform. The target must be social health emerging from the inner core of human consciousness accompanied by justice and fairness at all levels of human interaction. Such health cannot be attained without a moral transformation of the individual and the society he lives in.

Human beings have both material and spiritual needs and their true happiness depends on a balanced satisfaction of both these needs. Due to a continuing moral degeneration and the dominance of consumerism, there has developed a lack of 'balance' in attitudes and aspirations. There is too much emphasis on the acquisition of material goods and the satisfaction of a maximum amount of wants, but too little on human needs, the nature and quality of the goods and services produced to satisfy these needs, or their equitable distribution among all members of society.

The satisfaction of a maximum amount of wants through a 'high' rate of economic growth has become the primary objective of life around the world. The entire machinery of production is being directly or indirectly steered toward the fulfilment of this objective, irrespective of whether the satisfaction of such wants is necessary for fulfilling human needs and realising general human well-being. A vast array of unwarranted wants, including pornography, aimless fashions and unnecessary model changes, is being systematically cultivated through persistent advertising. "All forms of consumer persuasion affirm that", asserts Galbraith, "the consumption of goods is the greatest source of pleasure, the highest measure of human achievement".<sup>3</sup> False symbols of prestige are thus being promoted and wants are being made infinite and insatiable as compared with 'real' human needs.<sup>4</sup> Consequently, as indicated very well by Tawney, a "part of goods which are annually produced, and which are called wealth, is, strictly speaking, waste, because it consists of articles which, though reckoned as part of the income of the nation, either should not have been produced until other articles had been produced in sufficient abundance, or should not have been produced at all".<sup>5</sup>

Conspicuous consumption however creates only temporary satisfaction. Without any meaning and purpose of life, fashions and models only exchange one kind of emptiness for another. Soon an otherwise perfectly satisfactory economic good becomes obsolescent. To maintain the buying orgy, everyone has to run hard for acquiring material possessions leaving little time for spiritual pursuits, for the upbringing of children, and for social solidarity. Many have even to resort to corruption and unfair methods of earning or to deprive others of their rightful share in the bounties of God.

Rising wealth has also not redeemed inequalities. The social and economic gulf between the rich and the poor has widened. Some of the essential needs of the poor - food, clothing, education, medical facilities and housing - are not

being satisfied adequately. New problems have in fact been created for the poor through inflation and spoliation of the environment, which tend to affect them more adversely. The very idea of a high rate of economic growth has hence come under attack. Moreover, growth has not been steady and continuous. It has been interrupted by recessions and unemployment which, though bad for all, are particularly severe in their impact on the poor.

The phenomenal rise in the volume of goods and services has not, however, contributed to a rise in human happiness. This is because happiness is a reflection of the peace of mind (*al-nafs al-muṭma'innah*, tranquil soul, in the words of the Qur'ān) which itself is a function not merely of material but also of spiritual well-being. While this requires the satisfaction of all the basic physiological needs of the human body and the provision of necessary comforts, it also requires moral strength, absence of tensions and satisfaction of one's obligations towards self and society. In the absence of moral strength, material possessions become the sole end of life. 'Satisfaction' then does not remain just a function of what one has but also of what others have. The unjust income distribution combined with the self-display of the pace-setters keeps a person constantly griping and unhappy. One is never satisfied and is either not able or not willing to fulfil one's obligations towards others. Social solidarity weakens and society degenerates. There is an increased manifestation of the symptoms of anomie, such as frustration, crime, alcoholism, divorce, alienation between parents and children, mental illness and suicide. "Tension," says Mishan, "is everywhere more evident than harmony, disproportion more evident than proportion".<sup>6</sup>

### **Role of the Banking System**

The syndrome of unlimited wants reduced the rate of savings. It could not have hence gained strength and momentum unless the banking system, one of the important nerve-centres of modern economies, became a fully-fledged

accomplice. Since World War II, the banking system has played the crucial role of enabling both the public and the private sectors to perpetuate their insatiable claims on the economy. It has performed the dual function of creating as well as satisfying the lust for borrowing through easy access to credit. Governments financed their excessive spending by high doses of budgetary deficits, partly or largely satisfied by borrowing from the central bank (printing money). This left an increasingly smaller proportion of savings for the private sector. However, since the private sector also increased its spending for both consumption and investment, the financial institutions satisfied the increased demand for credit through deposit creation. The central banks collaborated in this process through the expansion of high-powered money.

Since physical resources are limited, supply of goods and services has not been able to keep pace with demand. A gap has thus been created between expectations and their fulfilment. This has given rise to tensions which run deep in modern societies. The gap has also accelerated the rate of inflation which has now become one of the major problems faced by the world economy. There have been fluctuations in the rates of inflation, but the secular trend reflects a definite rise.<sup>7</sup>

In addition to accentuating business cycles, the banking system has also played an important role in promoting economic inequalities. Apart from being socially unjust, these inequalities have distorted the allocation of resources through a greater production of expensive but inessential, goods and services for the rich, and not enough of the cheaper, but essential, goods and services for the poor. This does not reflect 'efficiency' or 'fairness' in the management of the economy. "The best economic system", as Galbraith has well stated, "is the one that supplies the most of what most people want".<sup>8</sup> Within the framework of Islamic teachings, the word 'want' in the above quotation should best be replaced by 'need'.

Economic theory, both neo-classical and Keynesian, gave the impression that a combination of fiscal and monetary policies could produce comparatively stable prices at something close to full employment of the labour force. A healthy combination of monetary and fiscal policies has, however, not generally been adopted in practice. Governments are in general unable or unwilling to eliminate or reduce the budgetary deficit which, according to the 'conventional wisdom', is the main source of high growth. This provides the high-powered money to the banking system which plays its own role in the expansionary game by expanding credit. The rate of inflation accelerates and danger signals are raised. A period of fiscal and monetary restraint follows. This tends to push up interest rates and stagnate the economy besides inflicting a heavy debt service burden on the government and the private sector. Under the influence of media criticism and public pressure, expansionary policies are resumed once again. Monetary and fiscal policies have both thus become nearly paralysed.

### **The Dilemma**

With the available resources, it is just not possible to satisfy the demand for goods and services artificially propped up by consumerism and financed by large budgetary deficits and expansionary monetary policies. The obvious outcome is inflationary heat followed by recession. In the absence of a moral transformation and change in economic thinking, any effort by governments to be realistic promotes recession, unemployment and unrest. Neither democracies nor dictatorships are able to face this except for a short period.

Thus the economic dilemma confronting the modern capitalist society springs from the combination of three basic forces which are apparently coherent, but are in reality inconsistent unless simultaneously accompanied by institutional reforms and the restraining influence of spiritual values. These three forces, according to Daniel Bell, are the 'bourgeois appetites', the 'democratic polity' and the 'indi-



vidualist ethos'.<sup>9</sup> The 'bourgeois appetites' promote acquisitiveness and create a perpetually insatiable demand for goods and services which it is not possible to satisfy with the available resources in either the developed or the developing countries. It is only through the help of moral values and banking reform that demand can be restrained by the satisfaction of what might be termed 'essential' and 'functional' and the elimination, or at least minimisation, of 'inessential' or 'non-functional'.<sup>10</sup> The 'democratic polity', although by itself desirable, induces the electorate to demand, in the absence of moral restraint, more and more social services as natural entitlements and the candidates to promise more than what is possible or feasible. This syndrome is true even if there is dictatorship because the dictator also tries to please the populace to keep himself in power. The 'individualist ethos' defends the idea of personal liberty but resists and evades the necessary social responsibilities and sacrifices which social welfare and balanced growth demand.

Marxism is not capable of offering a solution because the real cause of the human problem is not class struggle but moral degeneration and Marxism has no doubt played as important a role in undermining morals as has consumerism. The 'invisible hand' of state coercive power, though necessary to a certain extent, cannot by itself play the role that only the reform of the human person can play. The collectivist system has thus failed to solve most of the problems faced by capitalism. Individual freedom has been reduced, but so has human motivation and economic efficiency. Socioeconomic justice, the *raison d'être* for totalitarianism, has also not been actualised.

### **The Human Dimension**

Human beings constitute the living and indispensable elements of an economic system. They are the main players and, unless they are reformed, nothing can work, neither the 'invisible hand' nor the 'visible hand'. Individuals in turn receive important impulses from the economic system and its

institutions and no spiritual reform can be meaningful unless it also penetrates the economic system and removes all sources of injustice, exploitation, and instability.

What is therefore needed is the moral uplift of the individual by an ideology which changes his entire outlook towards life and motivates him to act rightly in accordance with certain eternal values. The ideology should promote human brotherhood by making all individuals socially equal and removing socio-economic injustice and inequitable distribution of income and wealth. It should provide a just and humane economic system that restores dignity to the human being, provides him with employment and gives him a decent standard of living. It should create a social environment that reduces the urge for conspicuous consumption. It should also minimise corruption and waste and promote a balance between the demand for and supply of resources. It should direct all available national resources to the production of goods and services required for the 'balanced' satisfaction of all individual and national needs without promoting excesses or generating inflationary heat. It should promote a rate of economic growth which is moderate, but steady and sustainable over the long term without severe fluctuations. However, a realistic rate of economic growth may not help reduce unemployment unless there is a simultaneous move towards a technology which is conducive to full employment, or, in the words of Schumacher, "a technology with a human face".<sup>11</sup> This may require a shift of emphasis from large-scale to small- and medium-scale modes of production.

No economic system can sustain its health and vigour or contribute positively to the achievement of its socio-economic goals without the support of a sane and equitable money and banking system. The money and banking system should hence be reformed to eschew the excesses and imbalances which promote inequalities, conspicuous consumption, and unhealthy monetary expansion to the ultimate detriment of all. It should discourage large-scale business, except where it is absolutely necessary, and, in general, patronise small and

medium-sized businesses. Is it possible to design such a just and sane money and banking framework? The primary aim of this book is to show that it is possible to do so in the light of Islamic teachings.

### **The Islamic Blueprint**

Islam has certain ideological advantages which enable it to provide the blueprint for a just and workable solution to the problems faced by Muslim countries and also mankind, provided that there is the necessary political will to implement its teachings and to institute its reforms. Since the economies of most Muslim countries are still in the formative stage, it may not be too difficult for them to adopt a new design for their economies and their banking systems. However, with the passage of time it may become more and more difficult for them to implement the reforms that the Islamic system necessitates.

Islam is a universal faith based on the concept of divine unity, which is simple to understand and rationalise. This unity is reflected in its unflinching dedication to the brotherhood of mankind - not an empty slogan, but a living and throbbing concept which makes the social equality of all human beings, white or black, high or low, a cardinal element of faith. It provides values and institutions that help realise the long-cherished dream of a responsible society where everyone is answerable before the Lord for how he lives and behaves in this world. It charges the human being with the mission of a moral existence for which material well-being is only the means, not the end.

Islam provides an economic system that makes it absolutely imperative to use the God-given resources for fulfilling the essential needs of all human beings and providing them with decent living conditions. It makes wealth a trust from God and its 'proper' use a test of faith. Wealth does not actually belong to man. It belongs to God and its human owner is just a trustee, entrusted with it to realise the

objectives of God, two of the most important of which are general human well-being and socio-economic justice.

Since the satisfaction of needs is essential for general well-being, it is indispensable for an Islamic society to adopt all available means to realise this goal. Needs include not only necessities for sustaining life but also comforts for making life more pleasant and less difficult. Since Muslim countries, like other developing countries, do not have sufficient resources to satisfy even basic needs, there is no justification, within the Islamic value frame, for the use of scarce resources for the production of goods and services which do not fall within the category of 'needs'.<sup>12</sup>

Justice is such an indispensable ingredient of the Islamic faith that it is impossible to conceive of an ideal Muslim society where justice has not been established. Islam wishes to eradicate from human society all traces of *Zulm*, which is a comprehensive Islamic term referring to all forms of inequity, injustice, exploitation, oppression and wrongdoing, whereby a person either deprives others of their rights or does not fulfil his obligations towards them.

Islam has enunciated a number of moral, social, economic and institutional reforms to help realise its goals, including general welfare and socio-economic justice. All of these reforms are built into the economic system of Islam as integral parts. The abolition of *ribā* (interest) is one of these reforms. It must, however, be clearly understood that the abolition of *ribā*, though indispensable, is not sufficient, because it is not the only measure necessary for realising the goals of Islam.

A number of Muslim countries are, either sincerely or under the force of public pressure, considering the reform of their money and banking system in the light of Islamic teachings. Questions are hence being raised about the nature of *ribā*, the rationale behind its prohibition, the institutions to be established and the strategy to be adopted. The challenge faced by the Muslim countries is how to design and run a

money and banking system that is in harmony with the nature of Islamic ideology, eliminates *ribā*, and helps realise the socio-economic goals of Islam.

While there is nothing inherently wrong in borrowing institutions from other cultures, the question is whether the capitalist interest-based money and banking system, gradually adopted by Muslim countries over the last two centuries under the influence of colonialism and during their decline and degeneration, can be made to serve the goals of Islam by just abolishing *ribā* and not undertaking a fundamental reform. The answer could be positive only if it is assumed that the goals of capitalism and Islam are the same, or that the institutions constituting the capitalist money and banking system are ideologically neutral and do not help the system realise its 'inherent' objectives.<sup>13</sup> This is, however, not the case.

As apparent from the introductory review, the conventional money and banking system does not operate in an ideological vacuum. It is an integral part of its parent ideology. Its institutions have evolved gradually to enable the system to perform its functions. It has been a major instrument in the drive for unrealistic growth rates and one of the principal sources of not only unjust income distribution but also economic instability. Hence, whatever institutions are borrowed by Muslims from the capitalist money and banking system must undergo an adequate transformation to make them serve the goals of Islam.

The core of the Islamic system consists of its fundamental beliefs, its goals and values (including the abolition of *ribā*) and the moral uplift of the individual. These are indispensable and not time-bound, irrespective of whether we look back fourteen centuries ago at the Prophet's times, or look forward to the fifteenth century after the Hijrah. The institutions developed to realise and reflect these goals and values may change from time to time in the light of changing circumstances. Hence no study can propose perennial

techniques and solutions. It is only through an interaction of ideas over time that a money and banking system which is in harmony with the genius of Islam will gradually evolve and enable the Muslim *ummah* to realise its aspirations.

It is important to appreciate that the successful operation of an individual *ribā-free* bank is different from the successful management of a *ribā-free* or equity-based economy. The issues related to the latter are more complex but the benefits are equally more far-reaching and revolutionary. The movement for the establishment of individual banks has been under way for a number of years. However the rich and wholesome fruits of the Islamic system cannot be reaped fully unless a *ribā-free* economy is actually brought into reality. This is not conceivable in the true Islamic sense unless Islamic teachings are simultaneously implemented in all their ramifications.

### **Scope of the Book**

The scope of this book is limited. It does not, and cannot, go into all aspects of Islam or of the Islamic economic system. It tries to answer only those questions and to analyse only those issues which are related to the Islamic money and banking system. Chapter 1 shows some of the important goals of Islam that need to be realised in and through the money and banking system to be designed for Muslim countries and the major elements of the Islamic strategy for the realisation of these goals. Chapter 2 discusses the nature of *ribā* in the light of Qur'ānic teachings, *aḥādīth*, and *fiqh* literature. Chapters 3 and 4 show the alternative to *ribā* and the reforms that must be instituted in a Muslim country in addition to the abolition of *ribā* to help realise the objectives of Islam. Chapter 5 evaluates the major objections raised against the abolition of *ribā* and, in the process, shows the rationale behind this important injunction of Islam.

In the light of the reform measures indicated in Chapter 4, Chapter 6 provides the institutional setting which, though it may superficially appear to be similar to the conventional

framework, is in essence radically different in its scope and responsibilities. Chapter 7 discusses the management of monetary policy in the new setting and Chapter 8 evaluates the proposed programme in the light of the goals discussed in Chapter 1. Chapter 9, the concluding chapter, gives some tentative suggestions for the gradual transition of the money and banking framework in Muslim countries from its present setting to the suggested scheme for realising the goals of Islam. There are also two appendices; the first gives extracts from the Qur'ān, *aḥādīth* and *fiqh* on *ribā* to support the discussion about its nature in Chapter 2; the second is on *muḍārabah*, *skirkah* and the corporation to support the discussion in Chapter 3 on the alternative to *ribā*.

## Notes and References

1 Helmut Schmidt (ex-Chancellor of the Federal Republic of Germany), "The Structure of the World Product", *Foreign Affairs*, April 1974, p. 437.

2 Henry A. Kissinger, "Saving the World Economy", *Newsweek*, 24 January, 1983, p. 16.

3 John K. Galbraith, *The New Industrial State* (New York: New American Library, 1972), p. 153.

4 A number of expressions have been used by economists to describe this phenomenon. These include the 'bandwagon' effect, the 'snob' effect and the 'Veblen' effect. For representative definitions of these see Harvey Leibenstein, *Beyond Economic Man* (Cambridge, Mass: Harvard University Press, 1976), pp. 51-2.

5 R. H. Tawney, *The Acquisitive Society* (New York: Harcourt Brace, 1948), pp. 37-8. See also Samuel Bowles, *et al.*, *Beyond the Waste Land: A Democratic Alternative to Economic Decline* (Garden City, New York: Anchor Press/Doubleday, 1983), p. 171.

6 E. J. Mishan, *The Costs of Economic Growth* (Harmondsworth, Middlesex: Penguin Books, 1973), p. 204.

7 From the beginning of the eighteenth century until the eve of World War <sup>11</sup>, there were considerable fluctuations in prices but the overall increase was relatively small, about 33 per cent over a period of more than two centuries. During the 1940s, prices nearly doubled. Between 1950-1982, world consumer prices rose by more than seven-and-a-half times while those of industrial countries rose nearly five times (for prices since

1950, see International Monetary Fund, *International Financial Statistics*, various Yearbook issues; for earlier years see, *The Economist*, 13 July, 1974, reproduced in William Rees-Mogg, *The Reigning Terror: The Crisis of World Inflation*, London: Hamish Hamilton, 1974, p. 69).

8 John K. Galbraith, *Economics and the Public Purpose* (New York: New American Library, 1975), p. 3.

9 See Daniel Bell, *The Cultural Contradictions of Capitalism* (London: Heinemann, 1976), p. 80.

10 Functional demand has been defined by Leibenstein (*op. cit.*, pp. 51-2) as that part of the demand for a commodity which results from the commodity's inherent qualities. Non-functional demand has been defined by him as that portion of demand which results from factors other than the qualities inherent in the commodity.

11 F. Schumacher, *Small is Beautiful* (London: Blond & Briggs, 1973), p. 18.

12 For an elaboration of this subject in the light of the Islamic social welfare function as developed by al-Ghazālī and al-Shāṭibī, see Anas Zarqā, "Islamic Economics: An approach to human welfare", in K. Aḥmad, ed., *Studies in Islamic Economics* (Leicester, UK: The Islamic Foundation, 1980), pp. 13-17.

13 "All social life", as Galbraith has aptly written, "is a fabric of tightly woven threads". The economic, the political, the social, and all other aspects of life interact reciprocally upon one another and constitute an organic whole. According to Oscar Morgenstern's theory of the 'compressibility' of an economic system, there is a core, or kernel, of the economic system that, if destroyed, would necessarily lead to the end of all the rest of the system, and in organisations and systems possessing kernels there exist several kinds and degrees of interdependence (cited by Michael Harrington, *The Twilight of Capitalism*, London, Macmillan, 1971, p. 69).

The word 'inherent' has been used in the text because during the last century there has been change in the 'claimed' objectives of capitalism under the influence of socialism. However, in spite of the various adaptations to changing circumstances, the 'core' of capitalism remains unchanged and capitalism continues to cater for the same objectives which are 'inherent' in its basic philosophy and 'intrinsic' to its nature.



## CHAPTER 1

### The Goals and Strategy

The basis of the *Sharī'ah* is the wisdom and welfare of the people in this world as well as the Hereafter. This welfare lies in complete justice, mercy, well-being and wisdom. Anything that departs from justice to oppression, from mercy to harshness, from welfare to misery and from wisdom to folly, has nothing to do with the *Sharī'ah*.

Ibn al-Qayyim <sup>1</sup>

The very objective of the *Sharī'ah* is to promote the welfare of the people which lies in safeguarding their faith, their life, their intellect, their posterity and their wealth. Whatever ensures the safeguard of these five serves public interest and is desirable.

al-Ghazālī<sup>2</sup>

The money and banking system has an important role to play in the Islamic economy as in any other economy. However, to play this role in the light of Islamic teachings, it needs to be reformed and reorganised in such a way that it is in conformity with the ethos of Islam and is able to fulfil the aspirations of the *ummah*. Any programme of reform must of necessity incorporate two indispensable ingredients: the goals and the strategy.

### THE GOALS

The money and banking system should, like all other aspects of the Islamic way of life, be made to contribute richly to the achievement of the major socio-economic goals of Islam.<sup>3</sup> The system should also continue to perform the usual functions that relate to its own special field and which other banking systems perform. A comprehensive list of goals and functions is neither desirable nor intended to be given here. However, some of the most important goals and functions necessary for the discussion of the fundamental characteristics of the Islamic money and banking system are:

- (i) Broad-based economic well-being with full employment and optimum rate of economic growth;
- (ii) Socio-economic justice and equitable distribution of income and wealth;
- (iii) Stability in the value of money to enable the medium of exchange to be a reliable unit of account, a just standard of deferred payments, and a stable store of value;
- (iv) Mobilisation and investment of savings for economic development in an equitable manner such -that a just return is ensured to all parties concerned;
- (v) Effective rendering of all services normally expected from the banking system.

It may be argued that the goals and functions of the Islamic money and banking system, as stated above are the same as those under capitalism. Even though there may be an apparent similarity, there is in fact a significant difference in emphasis, arising from the divergence in the commitment of the two systems to spiritual values, socioeconomic justice and human brotherhood. The goals in Islam are an inviolable part of the ideology and the faith. They constitute an important input for a considerable part of the juristic output. They carry sanctity and, to the extent to which they are based on the Qur'ān, and the *Sunnah*, they cannot be a matter of political bargaining and expediency. However, it is the strategy, which

is crucial for the realisation of the goals and it is here that Islam has a unique contribution to make.

**(i) Economic Well-being with Full Employment and 'Optimum' Rate of Growth**

The inevitable outcome of the Islamic belief that human beings are the vicegerents of God is that they must lead a life that befits their status. The Divine Guidance embodied in Islamic teachings is intended to help them in the realisation of this objective. Muslim jurists have unanimously held the view that the welfare of the people and relief of their hardships is the basic objective of the *Shari'ah*. This view would, in the economic field, necessitate economic well-being through satisfaction of all basic human needs, removal of all major sources of hardship and discomfort, and improvement in the quality of life, *morally* as well as *materially*. It would also necessitate the creation of an economic environment where the vicegerent of God is able to utilise his time and physical and mental abilities for the enrichment of his own self, his family and his society.

Hence full and efficient employment of human resources would be an indispensable goal of the Islamic system, because it would help realise not only the objective of broad-based economic well-being but also impart to human-beings the dignity demanded by their status as God's vicegerents. Full and efficient employment of material resources would also be an essential goal because, according to Islam, all resources in the heavens and the earth are meant for human welfare and need to be exploited adequately, without excess or wastefulness, for the purpose for which they have been created. Those who are unable to work deserve, without stigma or recrimination, reasonable assistance which Islam has incorporated in its social solidarity programme.

While a reasonably high rate of economic growth should be the natural outcome of policies leading to full and efficient employment of human and material resources and to broad-based economic well-being, the high rate of growth is by itself not of prime importance. This is because the requirement to attain material prosperity within the framework of Islamic values requires that: (i) it should not be attained through the production of inessential or morally questionable goods and services, (ii) it should not widen the social gulf between the rich and the poor by promoting conspicuous consumption, and (iii) it should not harm present or future generations by degenerating their moral or physical environment.<sup>4</sup> Hence, while full employment and material well-being are essential in an Islamic context, a high rate of growth is only essential to the extent that it contributes to full employment and broad-based economic well-being; beyond this, its importance would have to be carefully weighed against all its other moral and socio-economic implications. The rate of growth considered desirable after taking into account all these implications may be termed 'optimum'.

#### **(ii) Socio-Economic Justice and Equitable Distribution of Income and Wealth**

The goals of socio-economic justice and equitable distribution of income and wealth are unanimously considered to be inviolable parts of the moral philosophy of Islam and are based on its unflinching commitment to human brotherhood. In fact there is such a great emphasis on justice and brotherhood in the Qur'ān and the *Sunnah* that it is inconceivable to think of an ideal Muslim society where these have not been actualised. Both are essentially two different profiles of the same face. Both in turn cannot be realised without equitable distribution of income and wealth. Hence these goals have been closely integrated into all Islamic teachings so that their realisation becomes a spiritual commitment of the Muslim society.

The capitalist conversion to socio-economic justice and equitable distribution of income is, on the contrary, not based on a spiritual commitment to human brotherhood; it is rather the outcome of group pressures. Accordingly, the system as a whole, particularly its money and banking arrangement, is not geared to these goals and an unjust distribution of income and wealth continues to be perpetrated. However, because of the influence of socialism and political pressures, some efforts have been made to reduce these inequalities, particularly through taxation and transfer payments. These efforts have, however, not proved to be very effective. 5

In contrast to this, Islam believes in striking at the roots of inequality rather than merely alleviating some of the symptoms. It has incorporated into the faith itself a number of measures which would not allow an unjust distribution to take place. In addition, it has a built-in programme to reduce the remaining inequalities even further through *zakāt*, and numerous other methods to bring about a distribution of income which is humane and in conformity with its concept of human brotherhood.<sup>6</sup> Hence, it is absolutely necessary that even the money and banking system and monetary policy are so designed that they are finely interwoven into the fabric of Islamic values and contribute positively to the reduction of inequalities instead of working in the opposite direction.

### **(iii) Stability in the Value of Money'**

Stability in the value of money should be an indispensable goal in the Islamic frame of reference because of the unequivocal stress of Islam on honesty and fairness in all human dealings. The Qur'ān unequivocally stresses honesty and justice in all measures of value:

And give full measure and weight with justice. (al-Qur'ān, 6: 152)

So give full measure and weight without withholding from people what is theirs, and do not corrupt the

world after its reform. This is better for you if you are believers. (al-Qur'ān, 7: 85; see also 11: 84-85, 17: 35 and 26: 181)

These measures apply not only to individuals but also to society and the state and need not be confined merely to conventional weights and measures. They should encompass all measures of value. Money also being a measure of value, any continuous and significant erosion in its real value may be interpreted in the light of the Qur'ān to be tantamount to corrupting the world because of the adverse effect this erosion has on social justice and general welfare.

Inflation implies that money is unable to serve as a just and honest unit of account. It makes money an inequitable standard of deferred payments and an untrustworthy store of value. It enables some people to be unfair to others, even though unknowingly, by stealthily eroding the purchasing power of monetary assets. It impairs the efficiency of the monetary system and imposes a welfare cost on society. It raises consumption and reduces savings. It worsens the climate of uncertainty in which economic decisions are taken, discourages capital formation and leads to a misallocation of resources. It tends to pervert values, rewarding speculation (discouraged by Islam) at the expense of productive activity (idealised by Islam) and intensifying inequalities of income (condemned by Islam).

Inflation is thus a symptom of disequilibrium and is not compatible with the Islamic emphasis on balance and equilibrium.<sup>8</sup> To accommodate inflation is to acquiesce to a disease and to yield to the loss of the economy's reflexes. Countries which have had the greatest success in curbing inflationary pressures have had the most success in attaining and maintaining higher rates of economic growth and employment.<sup>9</sup> Inflation has the same consequences in poor as in rich countries in distorting the pattern of output, undermining efficiency and productive investment and in

contributing to social inequity and tension. The only way to a lasting recovery of economic health is to put an end to inflation by attacking its root causes.

Moreover, inflation conflicts with a *ribā*-free economy because it corrodes its *raison d'être* of social justice. Although Islam urges justice to the borrower it does not approve of injustice to the lender. Inflation undoubtedly does injustice to the *ribā-free* lender by eroding the real value of *qarḍ ḥasan*, loan extended without either interest or profit-sharing.

This implies that any activity or behaviour of individuals, groups or institutions in an Islamic state which significantly erodes the real value of money should be considered to be a national issue of paramount importance and treated with a sense of concern. Nevertheless, there are other goals which are of equal, or greater, importance. If there is an unavoidable conflict between the realisation of these goals, and a compromise becomes inevitable, then the goal of stable real value for money may be somewhat relaxed provided that the damage done by such relaxing is more than offset by the realisation of other indispensable national goals and provided that such relaxing is undertaken only as long as absolutely necessary and does not become a permanent feature of the policies of the Islamic state.

It may hence be considered obligatory for the Islamic state to resort to healthy monetary, fiscal and incomes policies and appropriate direct controls when necessary, including wage-price controls, to minimise erosion in the real value of money, thus preventing one group of society from knowingly or unknowingly short-changing others and violating the Islamic norms of honesty and justice in measures.

This does not imply that Muslim countries, individually or collectively, would be able to stabilise the value of their currencies by their own effort. In a world where all countries are mutually interdependent and where the monetary and fiscal policies of some major industrial countries are respon-

sible for a substantial degree of price instability, it may not be possible for the small and open economy of an individual Muslim country to achieve the desired stability unless the major industrial countries follow saner policies. However, what it does imply is that an Islamic state should itself be clear about its role with regard to price stability and should be determined to contribute whatever it can for the attainment of this goal.

### *Indexation*

It has been suggested that, in the current world-wide inflationary climate, the Islamic imperative of socioeconomic justice could be satisfied by indexation, or monetary correction, of all incomes and monetary assets including *qurūd ḥasanah* (plural of *qard ḥasan*).<sup>10</sup> Proper monetary correction would, however, require the indexation not of income or monetary assets but of purchasing power, which is determined by the consumption and investment pattern of individuals. Hence, socio-economic justice would necessitate the indexation of income and monetary assets by the use not of one universal index, but of several indices based on different expenditure patterns. In contrast to this, widespread index-linking of incomes and monetary assets based on even one universal index has not been found to be feasible because of the complexities involved and the high administrative costs of implementation. Hence indexation of only some incomes and monetary assets has been tried. The widest use of indexation has been in the field of wages, salaries and pensions. Indexation has also been tried for some financial assets (for example, bank loans and deposits, government bonds), taxes, rents and mortgages.<sup>11</sup>

While indexation might help ameliorate partially the inequities arising from inflation, it is not a cure for inflation. It tends to reduce the pressure on governments to adopt healthy policies. It tends as a result, to perpetuate and accelerate inflation, <sup>12</sup> and to be self-defeating unless inflation is on the



decline and remedial monetary, fiscal and incomes policies are being adopted.<sup>13</sup>

Moreover, even though indexation could be perfectly justifiable in the light of the *Sharī'ah* for wages, salaries and pensions, it is difficult to see how a just case could be built for the indexation of financial assets. Since investors (who not only save but also take the risk of investment) are not assured of a stable real value of their investments, why should savers and cash holders be so assured when they don't even take the risk. Instead of introducing inequities through indexation it would be just to ask the holders of cash to seek protection through investment. Indexation would tend to induce savers to shy away from risk capital which has been emphasised in the Islamic value system and which is necessary for a growing economy. It would hence be desirable to induce savers to offset any erosion in the real value of their savings through investment.

The problem of indexation of *qurūd ḥasanah* would still remain. Is it possible to consider indexation of *qurūd ḥasanah*? The general verdict of the *fuqahā'* has so far been against indexation of all financial assets, including *qurūd ḥasanah*. This is because indexation involves an assured positive return on loans even though it is only in monetary, and not real, terms. Hence, it is considered equivalent to *ribā al-nasī'ah* (see Chapter 2).

Juristic objections have also been raised against indexation in terms of *ribā al-faḍl*.<sup>14</sup> This is because if indexation of *qurūd ḥasanah* were considered, it could be in terms of either one or all of the six commodities (gold, silver, wheat, barley, dates and salt) stated in the Prophetic *ḥadīth* about *ribā al-faḍl* (*ḥadīth* C.3 in Appendix 1) or in terms of a price index, say, the consumer price index.

The rationale for the objection is that if gold (or any other commodity) is used as a denominator, then the lender can reclaim the loan only in terms of the same denominator irrespective of whether its price rises or falls. The lender

cannot be given the right to use money or the specified commodity as a denominator at his own option if he does not wish to indulge in *ribā al-faḍl*.

Although inflation has been a continuing phenomenon, gold prices have fluctuated in a volatile manner after its demonetisation due to international speculative forces and gyrations in the rates of interest. Silver prices have suffered the same fate. Both these precious metals cannot hence serve as units of account. The prices of the other four commodities have also fluctuated substantially in response to supply and demand conditions and, in the case of wheat and barley, unhealthy speculation in the futures markets. For a commodity to serve as a hedge against inflation or as a unit of account its price must be more or less in step with inflation. Since none of these six commodities fulfils this criterion they cannot be used either individually or collectively, for purposes of indexation.

Indexation of *qurūd ḥasanah* in terms of a price index may also not be defensible on economic grounds because even though it is proposed with the innocent objective of doing justice to the lender of *qurūd ḥasanah*, it has the potential of initiating gross injustice to the borrower, particularly in years when the rate of inflation is higher than the rate of interest. Indexation essentially implies a zero real rate of interest. In the real world, however, this has rarely been the case. The real rate of interest has fluctuated. In fact, in certain years it has also been negative.<sup>15</sup> When it has been positive it has tended to drain real profits and decelerated investment growth thus exacerbating the long-run problems of economic growth. Hence when lenders have not always been assured a zero real rate of interest even in capitalist economies, would it be wise to do so in Muslim countries?

It must, however, be clearly borne in mind that *qurūd ḥasanah* would generally constitute a very small proportion of total financial transactions. They would normally be extended out of a charitable motive to mainly poor people. Instead of

just giving away the money by way of charity the lender extends *qurūd ḥasanah* to get the principal amount back. *Qurūd ḥasanah* would not constitute a general method of financing ordinary business transactions. If the *qurūd ḥasanah* is for consumption purposes, indexation would impose a burdensome extra payment on the borrower not allowed by the *Sharī'ah*. If the *qurūd ḥasanah* is for investment, the lender may participate in the profit and loss instead of being assured of a positive monetary return in the name of indexation. Hence being a special class in themselves, *qurūd ḥasanah* cannot be used as a general argument for indexation of financial assets.

It seems, therefore, that while indexation of incomes (wages, salaries, pensions and other fixed incomes of this nature) may be feasible and resorted to, to a mild extent, as a temporary sedative for the pain of inflation, it is not a permanent solution. The policy alternative which would best conform to the norm of socio-economic justice emphasised by the *Sharī'ah* is price stability and not indexation. Every effort should be made by the Islamic state to attain this objective if it wishes to fulfil truly its obligations in the light of Islamic teachings. It is not possible to find any support from the *Sharī'ah* for the indexation of financial assets. It must be ruled out. Holders of cash (including demand deposits) must seek protection against whatever inflation there is even in an Islamic economy through investment.

#### *Unemployment and Inflation Trade-off*

While inflation is in conflict with Islamic values, prolonged recession and unemployment are also unacceptable because they bring misery to certain sectors of the population and also act counter to the goal of broad-based economic well-being. A recession also tends to increase uncertainty and discourages investors from undertaking risks associated with projects that earn a return over many years. Hence, in the interest of achieving the overall objectives of Islam, the

Islamic state should adopt all available measures to minimise economic fluctuations and to stabilise the value of money.

A generally discussed concept in capitalist economies has been the trade-off between unemployment and inflation. In the context of Islamic values the concept of such a trade-off is questionable. While inflation is iniquitous and against the interest of long-term well-being, unemployment of human resources is inequitable and not only conflicts with the dignity of man's role as God's vicegerent but also vitiates the realisation of an equitable distribution of income. One may also question whether it is necessary to have inflation to achieve full employment and whether it is essential to have unemployment to avoid inflation.<sup>16</sup> In the last decade almost all industrial countries and many developing countries have seen inflation and unemployment rise together. This phenomenon has led to the realisation that the inflation! unemployment trade-off has ceased to exist. "The belief is now widely held that, under present conditions, attempts to reduce unemployment by recourse to policies of demand reflation would produce only temporary results and that in the long run such policies might increase both inflation and unemployment."<sup>17</sup>

In the Islamic system both unemployment and inflation are undesirable, and both need to be eschewed. If aggregate demand is to be contained or lowered to avoid inflation, then in the overall interest of social justice and broad-based economic welfare a value judgement needs to be made about which demand should be contained or reduced and how best this can be attained. In a value-oriented system it would be indefensible to allow demand to expand in inessential directions to attain a high rate of economic growth and, if this generates inflation, it would be equally indefensible to try to control it by reducing aggregate demand in a general, across-the-board manner by creating human unemployment. Similarly, full employment must be ensured even if this demands a restructuring of production and designing of suitable technology. Hence it would be essential to regulate

aggregate demand, restructure production, design a suitable technology and have an appropriate mix of monetary, fiscal and incomes policies to avoid both inflation and unemployment and to ensure broad-based economic well-being for satisfying the essential needs of all individuals in keeping with Islamic teachings.<sup>18</sup>

#### **(iv) Mobilisation of Savings**

The goal of mobilisation of savings is essential because Islam categorically condemns hoarding of savings and demands their productive use for the realisation of the socio-economic goals of Islam. Nevertheless, it is not possible for every saver to employ his savings productively. It would, therefore, be in the nature of fulfilling Islamic teachings if efficiently-organised financial institutions could mobilise idle savings and channel them effectively into productive uses. Such institutions should be properly equipped to be generally able to meet the genuine, non-inflationary financing needs of both the public and the private sectors for the realisation of the economy's goals. Since such institutions would not operate on the basis of *ribā* or interest but would be participating in profit or loss, they would need to be organised in such an efficient and diversified way that they are able to generate a positive net return for distribution to their depositors and shareholders.

Moreover, it is possible that even after the introduction of appropriate changes in the structure and technology of production, the economy may not be able to generate adequate demand to enable the gainful employment of the idle physical and human resources. In such a situation, the central bank should, in coordination with the government, be able to bring about a sufficient monetary expansion *within* a non-inflationary framework.

#### **(v) Rendering Other Services**

The system should not only be able to mobilise savings effectively and allocate them efficiently for their optimum productive use to meet the needs of a growing and healthy economy, but should also be able to develop a primary, and a secondary, money market, render all banking services to the public at least as efficiently as the conventional banking institutions and fulfil the non-inflationary financial needs of the government. Most of the services rendered by Islamic banks may have to evolve along somewhat different lines compared with the interest-based banks because of the difference in the nature of the customer-bank relationship.

The development of both a primary and a secondary market is essential for efficient mobilisation of financial resources. While the existence of primary markets is needed for providing financial resources to those who can employ them productively, the existence of secondary markets is essential to help savers and investors 'liquefy' their investments whenever they feel the need to do so. The existence of an efficient secondary market in an equity-based Islamic economy would be particularly important because its absence would induce savers to hold larger balances for precautionary motives, thus increasing hoardings and reducing the rate of economic growth by preventing savings from performing their natural role.

## **THE STRATEGY**

Goals cannot, however, be realised without a proper strategy. It is here that Islam has a clear advantage. Not only are the goals an integral part of the Islamic ideology, but also some major ingredients of the strategy constitute a part of the *Sharī'ah* and are inviolable.

The most important element of the Islamic strategy for realising the Islamic goals is the integration of all supposedly mundane aspects of life with the spiritual to bring about a moral uplift of the human being and the society in which he

lives. Without such a spiritual uplift, none of the goals can be realised and true human welfare would be difficult to attain.

This brings into focus the concept of welfare in Islam. Human welfare can be realised only through the satisfaction of both the material and the spiritual needs of the human personality such that neither of the two is neglected. While Islam urges Muslims to gain mastery over nature and to utilise the resources provided by God for the service and betterment of mankind, it warns them against single-minded concentration on material acquisitions as the highest measure of human achievement because this leads them to forget the indispensable spiritual content of the human self. Islam has so firmly dovetailed the spiritual and material aspects of life that they may serve as a source of mutual strength and together serve as the foundation of true human welfare and happiness. In fact there is no division between material and spiritual aspects of life in Islam. All human effort whether for 'economic', 'social', 'educational', or 'scientific' goals is spiritual in character as long as it conforms to the value system of Islam. Working hard for the material well-being of one's own self, family and society is as spiritual as the offering of prayers, provided that the material effort is guided by spiritual values. Because of the neglect of the spiritual dimension of the human self under both capitalism and socialism they cannot truly realise their claimed objectives.

Islam, however, does not remain content with the spiritual uplift of the individual and the society. While moral consciousness is important because of the support and strength it provides to the social, economic and political systems, these systems themselves need, in turn, to be organised in such a way that they are conducive to the creation of morally upright individuals. An unjust and exploitative environment would only tend to frustrate the aspirations of individuals to be honest and sincere. An unbalanced economic system can create a vast array of unwarranted wants, sharpen the acquisitive spirit of men,

cultivate in them greed and envy, make them selfish and unscrupulous and become a major source of injustice in the distribution of income and wealth. If the productive machinery is so organised and the social values are so reformed that the selfish instincts of the self are bridled through a proper moral outlook, the human being would remain humane and the 'economic man' would not be born, and if born, he would find it difficult to be unscrupulous in earning or arrogant in consumption. The acquisitiveness of most individuals may be reduced significantly when they realise that they cannot earn more prestige through 'conspicuous consumption' or through the accumulation of wealth by unfair means. If the society's value system hurts their prestige, and the banking system does not support the production or purchase of goods having a snob appeal, greater quality and meaning may be introduced into the earning and consumption pursuits of individuals.

Hence, the second important ingredient of the Islamic strategy is that it has provided a blueprint for the reorganisation of all aspects of life, whether economic, social or political, to enable them to strengthen the moral fibre of society and to actualise the goals so dear to Islam. For example, equitable distribution of income and wealth, the claimed objective of all economic systems, cannot be realised without: (a) a belief in the brotherhood of mankind, which can meaningfully spring only from a belief in the One God Who has created all human beings and before Whom everyone is equal and fully accountable;<sup>19</sup> (b) a socioeconomic system which does not create the social-Darwinist attitude of survival of the fittest, but reorganises society on moral foundations to foster socio-economic interaction based on justice and cooperation; (c) a socio-political system which prevents injustice and exploitation through various ways, including the prohibition of *ribā*, and makes the material support of the weak and the down-trodden a moral obligation of the individuals, the society and the state. With the progress of the discussion in this book, it will gradually become clearer how Islam can ensure the realisation of its goals.



A third important ingredient of the Islamic strategy is the role it assigns to the state. While Islam recognises individual freedom, it does not give any sanctity to market forces. The blind operation of market forces need not automatically reward socially-productive effort, curb exploitation or help the weak and the needy. It is the responsibility of the state to play a positive role in guiding and regulating the economy to ensure that the objectives of the *Shari'ah* are fulfilled. This positive role of the Islamic state cannot be equated with what is erroneously called 'intervention' in capitalist terminology. The term 'intervention', in addition to carrying an opprobrious connotation, smacks of commitment to *laissez faire* capitalism under which the best state is the one which plays the least role. State intervention can no doubt become despotic. This, however, happens only if the state 'intervenes' for the benefit of the powerful vested interests. But if it intervenes, when necessary, within the framework of specified values and without being arbitrary, it cannot but help promote the public interest.

It is the obligation of the Islamic state to play an active role for the fulfilment of the goals of the Islamic system without either unduly sacrificing individual freedom or compromising social welfare. An important measure would be to contain the self-interest of individuals within moral restraints so as to prevent the individual from exploiting society to gratify his self-interest, and to safeguard against society exploiting the individual by curbing his inherent rights or preventing him from enjoying the lawful fruits of his labour and skill. The goal should be to bring about a healthy balance between the interests of the individual and the society in accordance with one of the fundamental teachings of the Prophet: "Let no one harm others or reciprocate the harm done by others."<sup>20</sup> This brings all instruments of direct and indirect controls, including wage-price controls and nationalisation, to the extent considered necessary in the overall interest of the Muslim society, within the tool-kit of the Islamic state. What instruments are to be used, and to what

extent, would be determined essentially by circumstances, given the guiding principles of the *Sharī'ah* and particularly the commitment of the Islamic state to social welfare in a manner that would not destroy individual freedom.

The above discussion clearly indicates the strategy for the reform of the Muslim society and economy. While there cannot be a total reliance on market forces as in capitalism, there cannot be a total reliance on the coercive power of the state as in Marxism. The individual, being God's vicegerent on earth, has to be trusted and depended upon. He must, however, be charged morally to enable him to perform his role as a true vicegerent. The market mechanism can then play a more meaningful role. The state must, however, intervene effectively, to guide and regulate and to prevent deviations in the interest of goal realisation. The effective eradication of all forms of *ẓulm* or injustice and exploitation cannot be attained merely through moral upbringing or market forces. Even in a generally moral environment, some individuals continue to flout values and market forces cannot correct them. A strong and active role by the state cannot be dispensed with.

Since the money and banking system does not constitute an isolated part of the economy, its reorganisation has to be an important ingredient of the total change, including moral transformation, socio-economic regeneration and political reform. A positive role of the state is indispensable. It must be clearly appreciated that while the Islamic goals cannot, on the one hand, be realised without enabling the money and banking system to play its proper role in the light of Islamic teachings, they cannot, on the other hand, be realised by a reorganisation of *only* the money and banking system.

Some major elements of the strategy for the reform of the money and banking system (for example, abolition of *ribā* and profit-and-loss sharing) have been prescribed by the Qur'ān and the *Sunnah*. Other elements have to be designed by the Muslim countries depending on their circumstances and their relative position on the path of goal actualisation.

The parts of the strategy prescribed by the Qur'ān and the *Sunnah* are indispensable and beyond dispute. The crucial test for other elements of the strategy will, however, be the support they provide to the overall strategy of the *Sharī'ah* and the contribution they make to the realisation of the goals. The stronger the support provided and the greater the contribution made toward the ultimate objective, the more desirable would be the man-made elements of the strategy provided that they are not in conflict with the *Sharī'ah*. Such man-made elements of the total strategy cannot be a one-time affair. They would need to be continually improved and perfected through a process of evolution.

### Notes and References (Chapter 1)

1 Ibn Qayyim al-Jawziyyah, *A'lām al-Muwaqq'īn* (Cairo: al-Maktabah al-Tijariyyah al-Kubrā, 1955), vot. 3, p. 14.

2 Muhammad al-Ghazālī, *al-Mustasfā* (Cairo: al-Maktabah Tijariyyah al-Kubrā, 1937), vot. 1, pp. 139-40.

3 A more detailed discussion appears in the author's *The Economic System of Islam* (London: The Islamic Cultural Centre, 1970); two chapters of this were published separately under the title *Objectives of the Islamic Economic Order* (Leicester, UK: The Islamic Foundation, 1979). For a range of the views of various Muslim scholars on the subject, see M. Nejatullah Siddiqi, *Muslim Economic Thinking: A Survey of Contemporary Literature* (Leicester, UK: The Islamic Foundation, 1981), pp. 12-13.

4 It may be argued that while the production of a bewildering assortment of conspicuous consumption goods raises the rate of economic growth, it does not contribute to real welfare. In fact it generates social tensions by accentuating unhealthy competition to keep up with the pace-setting consumption of neighbours. For example, if a comfortable, frequent and efficient public transport service (bus, train or tube) is provided, it may reduce the production of cars and also reduce spending on the development and marketing of ever-changing new models of cars. This may lower the rate of economic growth to the extent to which it is not offset by (i) lower traffic congestion; (ii) less pollution of air; (iii) reduced consumption, and hence conservation, of fuel, and (iv) lower spending on continued widening of roads, enabling public authorities to economise on spending and reduce deficit financing. Similarly, if fashions and prestige symbols are discouraged, the unnecessary spending on these would decline. This might lower the growth rate but would also reduce social

tensions and conserve resources for satisfying the essential needs of the majority of the population. For an excellent discussion of the Islamic concept of economic development, see K. Ahmad, "Economic Development in an Islamic Framework" in Ahmad and Ansari, *op. cit.*, pp. 223-40.

5 See Milton Friedman, *Capitalism and Freedom* (Chicago: The University of Chicago Press, 1962), p. 172. See also, David Howell, *Freedom and Capital* (Oxford: Blackwell, 1981), p. 3.

6 Or. Anas Zarqa' has indicated a large number of measures prescribed by Islam to bring about an equitable distribution of income and wealth. See his paper "Nahwa Nazariyyah Islāmiyyah Mi'yāriyyah li al-Tawzī'" presented to the Second International Islamic Economics Conference held in Islamabad in 1983.

7 Some of the paragraphs in this section have been taken from the author's *The Islamic Welfare State and its Role in the Economy* (Leicester, UK: The Islamic Foundation, 1979), pp. 14-15.

There is a general emphasis in the *fiqh* literature on stability in the value of money. For the views of the *Fuqahā'* on the subject, particularly of al-Ghazālī and Ibn al-Taymiyyah, see Rafiq al-Misri, *Al-Islām wa al-Nuqūd* (Jeddah: International Centre for Research in Islamic Economics, King Abdulaziz University, 1981).

8 The balance created by God in the universe and desired in all aspects of life has been emphasised by the Qur'ān in many *sūrahs*. Two examples are given below:

We sent our prophets with clear signs and sent down with them the Book and the Balance so that people may establish justice (al-Qur'ān, 57: 25)

He raised the sky and set the balance so that you do not transgress it; hence weigh with justice and do not depreciate the balance. (al-Qur'ān, 55: 7-9)

9 This is the conclusion of a recent study by the International Monetary Fund based on inflation and growth records of 112 developing countries over the past decade (1972-81) (*World Economic Outlook, A Survey by the Staff of the International Monetary Fund*, Washington: International Monetary Fund, April 1982, pp. 132-5).

See George M. von Furstenberg, "Double-digit Inflation: a wasteful task for the developing world". *Development and Finance*, September 1980, pp. 28-30; see also Bijan B. Aghevli, "Inflationary Finance and Growth", *Journal of Political Economy*, December 1977, pp. 1295-1307, and Martin J. Bailey, "The Welfare Cost of Inflationary Finance", *ibid.*, April 1965, pp. 97-109.

10 This was proposed by Dr. Sultan Abū 'Alī during the discussion of the author's paper "Money and Banking in an Islamic Framework" at the Makkah Seminar organised by the King Abdulaziz University in October

1978 (published, along with the discussion, in Mohammad Ariff (ed.), *Monetary and Fiscal Economics of Islam*, Jeddah: International Centre for Research in Islamic Economics, King Abdulaziz University, 1982, pp. 145-86). This suggestion was followed by a heated discussion and it was finally concluded that the subject needed further discussion by a committee of economists and *Shari'ah* scholars.

11. S. A. B. Page and S. Trollope, "An International Survey of Indexing and its Effects", *National Institute Economic Review*, November 1974, pp. 46-59; see also, E. V. Morgan (ed.) *Indexation and Inflation* (London: Financial Times, 1975), pp. 7-10; and H. Giersch, "Index Clauses and the Fight against Inflation", pp. 1-23 in H. Giersch *et al.*, *Essays on Indexation and Inflation* (Washington, DC: American Institute for Public Policy Research, 1974).

12 William Fellner. "The Controversial Issue of Comprehensive Indexation" in *Essays on Indexation and Inflation*, *op. cit.*, pp. 63-70. See also G. D. Jud, *Inflation and the Use of Indexation in Developing Countries* (New York: Praeger, 1978), p. 144.

13 R. Jackman and K. Klappholz, "The Case for Indexing Wages and Salaries" in T. Liesner and M. King (eds.), *Indexing for Inflation* (London: Institute of Fiscal Studies, 1975), pp. 20-25. See also Fellner, *op. cit.*

14. It was indicated by Dr. Muhammad Omar Zubair and Dr. Monzer Kahf at the above seminar (footnote 10) that indexation would be tantamount to *ribā al-fadl* (q.v.) and would hence be objectionable. The Council of Islamic Ideology has taken the same position in its Report to the Government of Pakistan on *The Elimination of Interest from the Economy* (Islamabad: Council of Islamic Ideology, Government of Pakistan, June 1980), pp. 12-13.

15 See G. Santoni and C. Courtenay, "The Fed and the Real Rate of Interest", Federal Reserve Bank of St. Louis, *Review*, December 1982. Table 1 of the paper indicates that the 90-day Treasury Bill rate was negative in 7 years out of 10 in the 1970s.

16 The recent experience of stagflation, high rates of unemployment existing simultaneously with high rates of inflation, has raised serious doubts about the validity and usefulness of the celebrated Phillips Curve which postulated a stable trade-off between inflation and unemployment. See, Thomas M. Humphry, "Changing Views of the Phillips Curve", Federal Reserve Bank of Richmond, *Monthly Review*, July 1973, pp. 1-13; Charles N. Henning *et al.*, *Financial Markets and the Economy* (Englewood Cliffs, NJ: Prentice Hall, 1981), pp. 496-501; and Morgan Guaranty Trust Co. of New York, *World Financial Markets*, February 1978, p. 3). The postulate has received increasing internment over the last decade from the economics profession (see, M. Friedman, "Monetarism: a reply to the critics", *The Times*, 3 March, 1980). This internment reached its climax when the heads of state or government of seven major industrial

countries (the United States, the United Kingdom, France, the Federal Republic of Germany, Italy, Canada and Japan) concluded, at their May 1977 Summit Meeting in London, that “our most urgent task is to create more jobs while continuing to reduce inflation. *Inflation does not reduce unemployment. On the contrary it is one of its major causes*” (Bank for International Settlements: Basle, *Press Review*, 9 May, 1977, italics introduced by the author). William Poole went even to the extent of observing at a conference sponsored by the Federal Reserve Bank of Boston that “The Phillips Curve is dead - long live the Phillips Curve”. He argued that “Belief in a stable trade-off between inflation and unemployment has had much to do with the persistence of excessively expansionary policies since 1965” (William Poole, “Summary and Evaluation” in Federal Reserve Bank of Boston, *After the Phillips Curve: Persistence of High Inflation and High Unemployment*, Proceedings of a Conference held in June 1978).

17 Bank for International Settlements, *Fifty-Second Annual Report: 1 April, 1981 - 31 March, 1982* (Basle: BIS, 14 June, 1982), p. 47.

18 For an elaboration of the ideas briefly expressed here, see the author’s “Economic Problem of Man and Islam”, an address to the 20th Annual Convention of the Muslim Students’ Association of the U .S. and Canada in Bloomington, Indiana, on 30 May, 1982.

19 Arnold J. Toynbee has rightly observed that “there can be no unity of mankind without the participation of God”. (*A Study of History*, abridgement by D. C. Somervell, London: Oxford University Press, 1957, vol. 2, p. 106.)

20 From ‘Ubādah ibn al Sāmit and Ibn ‘Abbās in Ibn Mājah, Abwāb al-Ahkām, *Bāb man banā fī haqqihī mā yadurru bi jārihī*; also reported by Ahmad and Dāra Qutnī. This *hadīth* is considered by al-Qurashī to be one of the five fundamental *ahādīth* on which the derivative principles of *fiqh* are based. See Yahyā ibn Ādam al-Qurashī, *Kitāb al-Kharāj*, ed., Ahmad Muhammad Shākir (Cairo: Al-Matba‘ah al-Salafiyyah, 1384), p.93.

## CHAPTER 2

### The Nature of *Ribā*

Socio-economic justice, one of the most indispensable characteristics of an ideal Muslim society, is required to be a way of life and not an isolated phenomenon. It must penetrate all realms of human interaction, social, economic and political. Injustice in one area is bound to be diffused to other areas. One wrong institution cannot but fail to tint all other institutions. Even in the field of business and economics, all values must converge towards justice so that in their totality they reinforce, and not dilute or nullify, socio-economic justice.

Among the most important teachings of Islam for establishing justice and eliminating exploitation in business transactions is the prohibition of all sources of ‘unjustified’ enrichment (*akl amwāl al-nās bi al-bāṭil*). The Qur’ān emphatically instructs Muslims not to acquire each other’s property *bi al-bāṭil* or wrongfully (2: 188 and 4: 29; see also 4: 161 and 9: 34). What is actually implied by *bi al-bāṭil*? The Qur’ān and the *Sunnah* have given principles whereby a Muslim society can know or deduce what constitutes a ‘wrongful’ or ‘rightful’ and ‘justified’ or ‘unjustified’ source of earning or acquisition of property from others. One of the important sources of unjustified earning is receiving any monetary advantage in a business transaction without giving a just counter value. *Ribā* represents, in the Islamic value system, a prominent source of unjustified advantage.

This chapter hence discusses the nature of *ribā*. The discussion is supported and strengthened by Appendix I, section 1.1 of which gives all verses of the Qur’ān on *ribā*, while sections 1.2 and 1.3 provide a representative sample of *ahādīth* and *fiqh* related to *ribā*. Chapter 5 provides the rationale behind the prohibition of *ribā* and shows how *ribā* is not only a source of great injustice but also of misallocation of resources, erratic growth, economic instability and a number of economic problems.

#### The Prohibition of *Ribā*

The prohibition of *ribā* appears in the Qur'ān in four different revelations (Appendix 1.1). The first of these (30: 39), in Makkah, emphasised that while interest deprived wealth of God's blessings, charity raised it manifold. The second (4: 161), in the early Madinah period, severely condemned it, in line with its prohibition in the previous scriptures. It placed those who took *ribā* in juxtaposition with those who wrongfully appropriated other people's property and threatened both with severe punishment from God. The third revelation (3: 130-2), around the second or third year after *Hijrah*, enjoined Muslims to keep away from *ribā* if they desired their own welfare (in the comprehensive Islamic sense). The fourth revelation (2: 275-81), near the completion of the Prophet's mission, severely censured those who take *ribā*, established a clear distinction between trade and *ribā*, and required Muslims to annul all outstanding *ribā*, instructing them to take only the principal amount, and forego even this in case of the borrowers' hardship.

The Prophet, peace be on him, also condemned, in the most unambiguous words not only those who take *ribā*, but also those who give *ribā* and those who record the transaction or act as witnesses to it (*ḥadīth* A.1). He even equated the taking of *ribā* to committing adultery thirty-six times or being guilty of incest with one's own mother (*ahādīth* A.3 and A.5).

### **The Meaning of *Ribā***

After knowing this severe verdict of the Qur'ān and the *Sunnah* against *ribā*, it is necessary to determine what it really stands for. *Ribā* literally means increase, addition, expansion or growth.<sup>1</sup> It is, however, not every increase or growth which has been prohibited by Islam. In the *Sharī'ah*, *ribā* technically refers to the 'premium' that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or for an extension in its maturity.<sup>2</sup> In this sense, *ribā* has the same meaning and import as interest in accordance with the consensus of all the *fuqahā'*; (jurists) without any exception.<sup>3</sup> The term *ribā* is, however, used in the *Sharī'ah* in two senses. The first is *ribā al-nasī'ah* and the second is *ribā al-faḍl*.<sup>4</sup>



### ***Ribā a-Nasī'ah***

The term *nasī'ah* comes from the root *nasa'a* (نسا) which means to postpone, defer, or wait, and refers to the time that is allowed for the borrower to repay the loan in return for the 'addition' or the 'premium'. Hence *ribā al-nasī'ah* refers to the interest on loans. It is in this sense that the term *ribā* has been used in the Qur'ān in the verse "God has forbidden interest" (2: 275). This is also the *ribā* which the Prophet, peace be on him, referred to when he said: "There is no *ribā* except in *nasī'ah*" (Appendix 1.2, *aḥādīth* B.1).

The prohibition of *ribā al-naī'ah* essentially implies that the fixing in advance of a positive return on a loan as a reward for waiting is not permitted by the *Sharī'ah*. It makes no difference whether the return is a fixed or a variable per cent of the principal, or an absolute amount to be paid in advance or on maturity, or a gift or service to be received as a condition for the loan. The point in question is the *predetermined positiveness* of the return. It is important to note that, according to the *Sharī'ah*, the waiting involved in the repayment of a loan does not itself justify a positive reward. There is absolutely no difference of opinion among all schools of Muslim jurisprudence that *ribā al-nasī'ah* is *ḥarām* or prohibited (Appendix 1.3).<sup>5</sup> The nature of the prohibition is strict, absolute and unambiguous.<sup>6</sup> There is no room for arguing that *ribā* refers to usury and not interest, because the Prophet prohibited the taking of even a small gift, service or favour as a condition for the loan, in addition to the principal (see *aḥādīth* B.3-B.6). However, if the return on principal can be either *positive* or *negative* depending on the final outcome of the business, which is not known in advance, it is allowed provided that it is shared in accordance with the principles of justice laid down in the *Sharī'ah*.

### ***Ribā al-Faḍl***

Islam, however, wishes to eliminate not merely the exploitation that is intrinsic in the institution of interest, but also that which is inherent in all forms of dishonest and unjust exchanges in business transactions. These are extensively identified in the teachings of the Qur'ān and the *Sunnah*.

However, they are also encompassed by the generic term of *ribā al-faḍl*, which is the second sense in which *ribā* has been used and which is encountered in hand-to-hand purchase and sale of commodities. It covers all spot transactions involving cash payment on the one hand and immediate delivery of the commodity on the other.

The discussion of *ribā al-faḍl* has arisen from the *aḥādīth* requiring that if gold, silver, wheat, barley, dates and salt, are exchanged against themselves they should be exchanged spot and be equal (*aḥādīth* C.2-CA). There are two questions which arise from these *aḥādīth*. The first is why have *only six* commodities been specified?, and the second is why is exactly the same reciprocal payment required?

Of the six commodities specified in the *aḥādīth* about *ribā al-faḍl*, two unmistakably represent commodity money whereas the other four represent staple food items. Hence the *fuqahā'* have over the centuries debated the question of whether *ribā al-faḍl* is confined only to these six items or it can be generalised to include other commodities; and if so, what should be the reasoning (*'illat*) used for this purpose.

On the basis of the characteristic of gold and silver as commodity money, it has been generally concluded that all commodities used as money enter the sweep of *ribā al-faḍl*. With respect to the other four items, there is a difference of opinion. One opinion argues that since all four commodities are sold by weight or measure (*Ḥanafī, Ḥanbalī, Imāmī and Zaydī*) therefore, all items which are so saleable would be subject to *ribā al-faḍl*. A second opinion is that since all four items are edible, *ribā al-faḍl* would be involved in all commodities which have the characteristic of edibility (*Shāfi'ī and Ḥanbalī*). A third opinion is that since these items are necessary for subsistence and are storeable (without being spoilt), therefore all items that sustain life and are store able are subject to *ribā al-faḍl* (*Maliki*). The *Zāhirī* school, however, confines *ribā al-faḍl* to only the six commodities specifically mentioned by the Prophet. It is however, the only school, and a minority, to be so restrictive.<sup>7</sup> A fourth, but perhaps a more plausible, explanation is that all the six commodities were used as money in and around

Madinah, particularly among the bedouins, and therefore, *ribā al-faḍl* would be involved in the exchange of any goods against cash or any commodity which is used as money.<sup>8</sup>

This whole discussion, however, does not bring into focus the real significance of *ribā al-faḍl*, which may be understood only by answering the second question. On the surface it appears hard to understand why anyone would want to exchange a given quantity of gold or silver or any other commodity against its own counterpart, and that too ‘spot’. What is essentially being required is *justice* and *fair play* in spot transactions; the price and the counter value should be *just* in all transactions where cash payment (irrespective of what constitutes money) is made by one party and the commodity or service is delivered reciprocally by the other.<sup>9</sup> Anything that is received as ‘extra’ by one of the two parties to the transaction is *ribā al-faḍl*, which could be defined in the words of Ibn al- ‘Arabī as “all excess over what is justified by the countervalue” (Appendix 1.3.4). Justice can be rendered only if the two scales of the balance carry the same value of goods. This point was explained in a most befitting manner by the Prophet, peace be on him, when he referred to six important commodities and emphasised that if one scale has one of these commodities, the other scale also must have the same commodity, “like for like and equal for equal”. To ensure justice, the Prophet, peace be on him, even discouraged barter transactions and asked that a commodity for sale be exchanged against cash and the cash proceeds be used to buy the needed commodity (*aḥādīth* C.5 and C.6). This is because it is not possible in a barter transaction, except for an expert, to visualise the fair equivalent of one commodity in terms of all other goods. Hence, the equivalents may be established only approximately thus leading to some injustice to one or the other party. The use of money could therefore help reduce the possibility of an unfair exchange.

In this sense, all commodities exchanged in the market would be subject to *ribā al-faḍl*. One would then tend to agree with the *fuqahā* who have not confined *ribā al-faḍl* only to the six commodities mentioned but have tried to extend the coverage on the basis of certain inherent characteristics of these six

commodities. The more staple the food item or the greater its need for sustaining life, the greater the injustice inflicted in an unfair exchange. Similarly, the greater the capability of a good or service to be weighed or measured, the greater would be the buyer's or the seller's exposure to *ribā al-faḍl* if the just weight or measure is not given in exchange for the money or the countervalue received.

The prohibition of *ribā al-faḍl* is thus intended to ensure justice and remove all forms of exploitation through 'unfair' exchanges and to close all back-doors to *ribā* because, in the Islamic *Sharī'ah*, anything that serves as a means to the unlawful is also unlawful.<sup>10</sup> The Holy Prophet, peace be on him equated with *ribā* even the cheating of an unsophisticated entrant into the market and the rigging of prices in an auction with the help of agents (*aḥādīth* C.9 and C.10), implying thereby that the extra money earned through such exploitation and deception is nothing else but *ribā al-faḍl*. Since people may be exploited or cheated in several different ways, the Prophet warned that a Muslim could indulge in *ribā* in a number of ways (*ḥadīth* A.5). This is the reason why the Prophet, peace be on him, said: "Leave what creates doubt in your mind in favour of what does not create doubt",<sup>11</sup> and Caliph 'Umar was inspired to say: "Abstain not only from *ribā* but also from *rībāh*" (*ḥadīth* C.1). *Rībāh* is from *rayb* which literally means 'doubt' or 'suspicion' and refers to income which has the semblance of *ribā* or which raises doubts in the mind about its rightfulness. It covers all income derived from injustice to, or exploitation of, others.

Thus *ribā al-nasī'ah* and *ribā al-faḍl* are both essential counterparts of the verse "God has allowed trade and prohibited *ribā*" (2: 275). While *ribā al-nasī'ah* relates to loans and is prohibited in the second part of the verse, *ribā al-faḍl* relates to trade and is implied in the first part.<sup>12</sup> Because trade is allowed in principle, it does not mean that everything is allowed in trade. Since the injustice inflicted through *ribā* may also be perpetuated through business transactions, *ribā al-faḍl* refers to all such injustices or exploitations. It requires absence of rigging, uncertainty or speculation, and monopoly or monopony. It demands a fair knowledge of the prevailing prices on the part of

both the buyer and the seller. It necessitates the elimination of cheating in prices or quality, and in measurements or weights. All business practices which lead to the exploitation of the buyer or the seller or to a restriction of fair competition must be effectively prohibited.<sup>13</sup>

While *ribā al-nasīʾah* can be defined in a few words, *ribā al-faḍl*, interspersing a vast array of business transactions and practices, is not so easy to specify. This is what prompted ‘Umar, the second Caliph, to say: “The Prophet, peace be on him, was taken without elaborating it to us” (*ḥadīth* C.1). Therefore his natural reaction, by way of precaution, was to give up *ribā* as well as *rībāh*. It is true that the Prophet did not elaborate *ribā al-faḍl* in as much detail as one may have desired. However, this was not necessary. The whole Qur’ān and his *Sunnah* are there to help the *ummah* do so. This is the ongoing challenge to all Muslims - to examine their economic practices continually in the light of Islamic teachings and to eliminate all shades of injustice. This is a more difficult task than eliminating *ribā al-nasīʾah*. It requires a total commitment, an overall restructuring of the entire economy within the Islamic framework to ensure justice. This was, and is, the unique contribution of Islam. While *ribā al-nasīʾah* was well-known in the *Jāhiliyyah* (pre-Islam period) the concept of *ribā al-faḍl* was introduced by Islam and reflects the stamp of its own unflinching emphasis on socio-economic justice.

### **Consumption and Production Loans**

The argument that interest was prohibited because during the Prophet’s days there were only consumption loans and interest charged on such loans caused hardship is invalid because it is factually wrong.<sup>14</sup> During the Prophetic period, the Muslim society had become sufficiently inspired to adopt simple living and shun conspicuous consumption. There was hence no question of borrowing for either self display or for unnecessary consumption needs.<sup>15</sup> It had also become adequately organised to fulfil the basic needs of the poor and those in hardship due to some natural calamity. However, even if it is assumed that, in spite of simple living and the socio-political commitment of the Muslim society to fulfil the basic needs of those hard-pressed,

consumption loans were resorted to, these must have been limited and for small amounts, and fulfilled primarily through *qurūd ḥasanah*. Accordingly the eminent Muslim scholar, the late Shaykh Abū Zahrah, rightly pointed out that:

There is absolutely no evidence to support the contention that the *ribā* of *al-Jāhiliyyah* was on consumption and not on development loans. In fact the loans for which a research scholar finds support in history are production loans. The circumstances of the Arabs, the position of Makkah and the trade of Quraysh, all lend support to the assertion that the loans were for production and not consumption purposes.<sup>16</sup>

Hence, the Qur'ānic verse about remitting the principal in the event of the borrower's hardship does not refer to consumption loans. It refers essentially to interest-based business loans where the borrower had encountered losses and was unable to repay even the principal, let alone the interest.

The whole argument that interest causes hardship only for the one who borrows for consumption needs is misfounded. It is the obligation of the Muslim society to meet the dire consumption needs of the poor. Borrowing for other consumption purposes needs to be controlled and organised as indicated elsewhere in this book. Borrowing in a Muslim society would hence be largely for business purposes.

It is only in this context that one may be able to understand the argument of the *Jāhiliyyah* that trade is like interest and the distinction that the Qur'ān draws between trade and interest. While in trade an entrepreneur has the prospect of making a profit, he also faces the risk of incurring a loss. In contrast to this, interest is predetermined to be positive irrespective of the ultimate outcome of business, which may be positive or negative depending to a great extent on factors beyond the control of the entrepreneur. Imam Rāzī himself posed the question of what was wrong in charging interest when the borrower was going to employ the funds so borrowed in his business and thereby earn a profit. His well-considered reply to the question was: "While the earning of profit is uncertain, the payment of interest is predetermined and certain. The profit may or may not be realised.

Hence there can be no doubt that the payment of something definite in return for something uncertain inflicts a harm. “17

Accordingly, *ribā* is essentially in conflict with the clear and unequivocal Islamic emphasis on socio-economic justice. Financiers who do not wish to take the risk are entitled to only the principal and no more. Those who insist on charging *ribā* in spite of its prohibition are declared by the Qur’ān to be at war with God and His Prophet, peace be on him.

On the occasion of his Farewell Pilgrimage, the Prophet, while declaring the abolition of interest, announced the remission of interest accumulated in favour of his uncle ‘*Abbās* ibn ‘Abd al-Muṭṭalib (*ḥadīth* A.2). This was interest on business loans extended to the Banu Thaḳīf tribe. This tribe had not taken the loan from ‘Abbas and others for fulfilling consumption needs but for expanding their business.<sup>18</sup> This was not an isolated case but a prevalent form of business financing in those days. Several tribe members having skill in trading acted essentially like large partnerships, borrowing finance from members of their own tribe or from other friendly tribes, to carry on large-scale business, which their own resources would not permit. This is because they could not undertake too many business trips abroad from east to west. The slow means of communication, the difficult terrain and the harsh climate confined them to mainly two caravan trips during the year, one in summer and one in winter (al-Qur’ān, 106: 2). Accordingly they collected all the finance they could muster to purchase the local produce, sell it abroad and bring back what was necessary to satisfy the entire needs of their society for imports during a specific period. Most of the interest-based transactions mentioned in the classical commentaries in relation to the prohibition of *ribā* are loans taken by tribes from each other, each tribe acting like a large partnership company.<sup>19</sup> Islam abolished the interest-based nature of these relationships but reorganised them on a profit-and-loss sharing basis. The financier got a just share and the entrepreneur did not get crushed under adverse conditions, one of which was the caravan being waylaid on the journey.

### ***Concluding Remarks***

The principal reason why the Qur’ān has delivered such a harsh verdict against interest is that Islam wishes to establish an economic system where all forms of exploitation are eliminated, and particularly, the injustice perpetuated in the form of the financier being assured of a positive return without doing any work or sharing in the risk, while the entrepreneur) in spite of his management and hard work, is not assured of such a positive return. Islam wishes to establish justice between the financier and the entrepreneur.

Under these circumstances it is difficult to see how anyone could justify interest in an Islamic society. The difficulty to understand the prohibition comes from lack of appreciation of the whole complex of Islamic values and particularly its uncompromising emphasis on socio-economic justice and equitable distribution of income and wealth. Any attempt to treat the prohibition of *ribā* as an isolated religious injunction and not as an integral part of the Islamic economic order with its overall ethos, goals and values is bound to create confusion.

## Notes and References (Chapter 2)

1 See the word *ribā* in Ibn Manẓūr’s *Lisān āl-‘Arab* (Beirut: Dār Ṣādir li al-Ṭabā’ah wa al-Nashr, 1968, vol. 14, pp. 304-7), al-Zubaydī’s *Tāj al-‘Arūs* (Cairo: Al-Maṭba‘ah al-Khayriyyah, 1306, vol. 10, pp. 142-3) and Rāghib al-Isfahānī’s *al-Mufradāt fī Ḡharīb al-Qur’ān* (Cairo: Muṣṭafā al-Bābī al Ḥalabī, 1961, pp. 186-7). The same meaning is also unanimously indicated in all classical Qur’ān commentaries.

2 Ibn Manẓūr specifies that “what is prohibited is the extra amount, benefit or advantage received on any loan” (*op. cit.*, p. 304). See also the commentary on verse 2: 275 in *Tafsīr al-Kabīr* of Fakhruddīn al-Rāzī (Appendix 1.3.2), *Aḥkām al-Qur’ān* of Abū Bakr al-Jaṣṣaṣ (Appendix 1.3.3), and *Aḥkām al-Qur’ān* of Ibn al-‘Arabī (Appendix 1.3.4). See also items 4, 5, 6, 7 and 8 of Appendix 1.3.

3 ‘Abd al-Raḥmān al-Jazīrī, *Al-Fiqh ‘alā al-Madhāhib al-Arba‘ah* (Cairo: Al-Maktabah al-Tijāriyyah al-Kubrā, 5th ed., n.d.), vol. 2, p. 245. See also Appendix 1.3.1.

4 *Ribā al-Nasī‘ah* is also called *ribā al-duyūn* or *ribā al-mubāshir* or *ribā al-Jalī*, while *ribā al-faḍl* is also called *ribā al-buyū‘* or *ribā ḡhayr al-mubāshir* or *ribā al-Khaṭf*.

5 “The Muslims are agreed on the authority of their Prophet that the condition for an increase over the amount lent is *ribā*, irrespective of



whether it is a handful of fodder, as indicated by Ibn Mas‘ūd, or a particle of grain” (Muḥammad ibn Aḥmad Al-Qurṭubī, *Al-Jāmi‘li Ahkām al-Qur’ān*, popularly known as *Tafsīr al-Qurṭubī*, Cairo: Dār al-Kitāb al-‘Arabi li al-Ṭaba‘ah wa al-Nashr, 1967, vol. 3, p. 241).

6 Al-Jazīrī, *op. cit.*, vol. 2, p. 245. See Appendix 1.3.1.

7 Al-Jazīrī, *op. cit.*, pp. 249-52; Sāmī H. Ḥamūd, *Taṭwīr al-A‘māl al-Maṣrafiyyah bima Yattaḥqu wa al-Sharī‘ah al-Islāmiyyah* (Amman: Maktabah al-Aqṣā, 1976), pp. 194-5 and Rafīq al-Misri, *Maṣraf al-Tanmiyyah al-Islāmī* (Beirut: Mu‘assasah al-Risālah, 2nd ed., 1981), pp. 170-3.

8 See also Aḥmad Ṣafī al-Dīn, *Buḥūth fī al-Iqtisād al-Islāmī* (Sudan: Wizārah al-Shu‘ūn al-Dīniyyah wa al-Awqāf, 1978), pp. 4-17. Although the point made by Dr. Ṣafī al-Dīn seems to be plausible, he has not provided conclusive evidence. Dr. Ḥasan al-‘Inānī has also drawn the same conclusion as Dr. Ṣafī al-Dīn, but through a different logic. See his monograph *Illat Taḥrīm al-Ribā wa Ṣilatuhā bi Waṣīfah al-Nuqūd* (Cairo: Al-Itḥād al-Dawlī li al-Bunūk al-Islāmiyyah, n.d.) It may be stated that even Imam Shams al-Dīn al-Sarakhsī has stated that the people of Makkah used foodstuffs as a medium of exchange. See *al-Mabsūt* (Beirut: Dār al-Ma‘rifah li al-Ṭaba‘ah wa al-Nashr, 3rd ed., 1978), vol. 22, p. 21.

9 See, ‘Abd al-Karīm al-Khaṭīb, *Al-Siyāsah al-Māliyyah fī al-Islām* (Beirut: Dār al-Ma‘rifah, 1975), pp. 141-6.

10 See the commentary on verse 2: 275 in *Tafsīr Ibn Kathīr* (Abū al-Fidā’ Isma‘īl ibn Kathīr, *Tafsīr al-Qur’ān al-Karīm*, Cairo: ‘Isā al-Bābī al-Ḥalabī, n.d., vol. 1, p. 326).

11 *Ibid*

12 See the commentary on verse 2: 275 in Fakhruddīn al-Rāzī, *Tafsīr al-Kabīr* (Tehran: Dār al-Kutub al-‘Ilmiyyah, 2nd ed., n.d.), vol. 7, p. 86.

13 Several types of sales have been prohibited in the *Sharī‘ah* with the objective of safeguarding the right of both buyers and sellers. Examples are: *najsh* (rigging and collusion), *ghabn al-mustarsal* (cheating of an unsophisticated entrant into the market), *bay‘ al-hādīr li al-bādī* and *talaqqi al-rukban* (both implying monopsonistic or monopolistic collusion or exploitation to lower or raise prices beyond what is justified by market conditions), *gharar*, *muḥaḳalah*, *munabadhah*, *mulamasah* and *muzubanaḥ* (sales involving uncertainty and speculation or gambling). (See, for example, al-Jazīrī, *op. cit.*, vol. 2, pp. 273-8 and 283-91.)

14 The Pakistan Council of Islamic Ideology has also clearly expressed the view that “the term *ribā* encompasses interest in all its manifestations irrespective of whether it relates to loans for consumption purposes or for productive purposes, whether the loans are of personal

nature or of commercial type, whether the borrower is a government, a private individual or a concern, and whether the rate of interest is low or high. See *Report of the Council of Islamic Ideology on the Elimination of Interest from the Economy* (Islamabad: Government of Pakistan, 1980), p. 1.

15 See M. Abū Zahrah, *Buḥūth fī al-Ribā* (Kuwait: Dār al- Buḥūth al-Islāmiyyah, 1970), pp. 53-4.

16 *Ibid.*, p. 53. It may also be of interest to point out that Abraham Udovitch has also stated that: “Any assertion that medieval credit was for consumption only, and not for production is just untenable with reference to the medieval Near East” (*Partnership and Profit in Medieval Islam*, Princeton, NJ: Princeton University Press, 1970, p. 86).

17 Rāzī, *op. cit.*, p. 87.

18 Abū Zahrah, *op. cit.*, p. 54. Shaykh Abū Zahrah very pertinently asks: “Is it possible for any sane person to presume that if someone in need of food and clothing came to ‘Abbās ibn ‘Abd al- Muṭṭalib, he would not extend a loan except with interest?” (*ibid.*).

19 For an excellent factual presentation on the subject with numerous solid references from primary sources, see Mufti Muḥammad Shafī‘, *Mas’alah-e-Sūd* (Urdu) (Karachi: Idārah al-Ma‘ārif, 1374 AH), pp. 18-23. See also Abū Zahrah, *op. cit.*, pp. 54-5.

## CHAPTER 3

### The Alternative

The strength and vitality of any society depends on its ability to fulfil the needs of its own members and of other societies for goods and services. The production and distribution of these goods and services requires resources, not only of finance but also skills and management. Not everyone is endowed with an optimum combination of these resources. Hence it is indispensable to bring about a pooling of resources from wherever they are available for fulfilling the needs of society. Since coercion is ruled out by Islam, this pooling of resources has to be organised within a just and either altruistic or mutually profitable manner. How can such a pooling of resources be arranged if interest is abolished? The alternative must be arranged within the framework of two principles.

Firstly, Islam recognises a legitimate role for the private sector. However, since private property in Islam is only a trust from God, the owner does not have absolute rights over it. The supremacy of moral values, the imperative of socio-economic justice and the inviolable goal of general social welfare impose a number of constraints on private property. It would hence be natural and indispensable for the Islamic state to play a constructive, welfare-oriented role and even bring under state control and management whatever it considers necessary in the larger public interest. Nevertheless, this does not mean arguing in favour of totalitarianism or a 'high degree of regimentation' because there is considerable scope for individual freedom in Islam within the framework of Islamic goals and values.<sup>1</sup>

Secondly, Islam *does* recognise the role of capital as a factor of production. However, since the return on capital can be determined only after all costs have been accounted for, and may be either positive or negative, Islam prohibits a predetermined positive rate of return in the form of interest. Islam requires profit-and-loss sharing in an equitable manner, whereby the financier shares in the losses, if any, in proportion to his capital in the business, if he wishes to have a share in the profit.

## Equity Financing

Within this framework, there are only two alternatives to interest-based lending. One is *qard hasan* and the other is equity financing. *Qard hasan* is a loan which is returned at the end of the agreed period without any interest or share in the profit or loss of the business. As indicated earlier, such financing could only be on altruistic grounds. Because Islam has encouraged it, it has always been available in the Muslim world, but to a limited extent and for short periods, generally for either financing small businesses or alleviating personal hardships. Such financing may however, not constitute a significant source of business finance.

Hence, a large proportion of all business financing in an Islamic economy would of necessity have to be equity-oriented where the financier shares in the profit or loss of the business financed. Such financing would not only distribute equitably the return on total investment between the financier and the entrepreneur, but also transfer a fair share of the risks of investment to the financier instead of putting the whole burden on the entrepreneur.

Equity financing in an Islamic economy may thus have to be for either an indefinite period, as it is in the case of stocks of joint stock companies or' shares in partnerships, or a definite (short, medium or long) period as it is in the case of borrowed capital (loans, advances, bonds and debentures). Since borrowed capital would also be on the basis of profit-and-loss sharing and could not be interest-based, it would be in the nature of temporary equity financing and would mature on the expiry of the specified period. Such financing would hence not carry the same connotation as it does in the capitalist economies. It would, like equity capital but unlike *qurūd hasanah*, not enjoy any lien on the assets of the firm.

The inability to secure a lien on the assets of the business financed, possible in the case of interest-based lending, would make the financiers more careful in evaluating the prospects of the business and cautious in providing finance. Moreover, it would be difficult to find medium- or long-term financing in an Islamic economy without sharing the ownership and control of

the business. Expansion of the business would hence be closely related to the distribution of ownership and control. Similarly it would not be possible for anyone to earn an income on savings without being willing to share in the risks of business. Thus ownership, fruits and risks of business would become more widely distributed in an Islamic economy than is possible under capitalism.

There are three types of borrowers who are looking for funds to satisfy their financing needs. These are (i) private sector investors looking for funds to finance their expanding business; (ii) private sector borrowers seeking funds to finance their consumption needs; and (iii) government seeking funds to finance its budgetary deficits. Can the needs of all three categories of borrowers be satisfied within the framework of equity financing? It is only the subject of private sector equity finance which is discussed in this chapter.<sup>2</sup> Whether or not, and to what extent, equity financing can be used to meet the needs of consumers and governments are issues which are discussed elsewhere in this book.

### **Channels of Equity**

The channels that equity investment may take in an Islamic society are the same as elsewhere, namely, sole proprietorship, partnership (including both *mudārabah* and *shirkah*) and joint stock company. 'Cooperation' can also play an important role in an Islamic economy because of its harmony with the value system of Islam and the valuable contribution it can make to the realisation of its goals. Some rudiments of all these forms of organisation are indicated below to the extent necessary for the discussion of the Islamic banking system. For somewhat greater detail about *mudārabah* and *shirkah* and the role of the corporation in an Islamic economy, refer to Appendix H.

#### *(i) Sole Proprietorship*

In this case the entrepreneur depends essentially on his own finance and management. He may be able to supplement his financial resources by suppliers' credits which played an important role in Muslim society in the past and tend to be a major source of short-term capital even under capitalism. Most

suppliers make trade credits available as a matter of course to all retailers who qualify. The supplier's interest is served by the increased sales. Most *fuqahā'* Jurists) have, however, permitted a difference between cash and credit prices to cover the additional cost of servicing credit sales.<sup>3</sup> Some jurists have, however, strongly opposed this price differentiation on the ground that such a difference could lead to a built-in element of interest and become a hidden door to interest-based financing.<sup>4</sup> Even if the permissibility of price differentiation between cash and credit sales is disregarded, it should not be difficult to have profit-sharing according to an agreed formula on the goods sold and the difference between the supplier's wholesale price and the retail price.

If the sole proprietor needs substantial extra resources on a temporary basis for specific consignments or profitable opportunities, he may raise the necessary finance from other individuals or firms or financial institutions on a profit-and loss-sharing basis, in which case his sole proprietorship will merge into the *mudārabah* form of organisation. If his need for funds is of a permanent nature, he may consider the entry into his business of other partners and take advantage of the *mudārabah* or *shirkah* forms of partnership, depending on whether he needs merely finance or managerial ability as well to complement his own business talent.<sup>5</sup> He may also consider the formation of a private or public joint stock company. . .

What this implies in essence is that an enterprising businessman in an Islamic society need not be constrained in his ambitions by his own finance. Even if interest-based loan financing is not available, he can still expand his business by securing funds on a profit-and-loss-sharing basis. This should actually be better for him as well as the financier in terms of justice; the entrepreneur does not have to pay a predetermined rate of return irrespective of the outcome of his business and the financier does not get a low return even when the business is paying high dividends. Since the ultimate outcome of business is uncertain, one or other of the two parties, entrepreneur or financier, suffers from injustice in an interest-based arrangement and Islam wishes to eliminate injustice.

The sole proprietorship form of business organisation, along with *mudārabah* financing, needs to be encouraged as it will help achieve the goals of Islam. It provides self-employment, and enables the entrepreneur to stay in his own town or village, thus helping reduce concentration of population in a few large urban centres. It is amenable to small-scale business, industry and agriculture and can thus help diversify ownership and reduce concentration of wealth. It is conducive to increased efficiency because of the personal stake and interest of the entrepreneur in his own business. It also encourages competition; but to avoid the adverse effects of this on society, competition can be made to take a healthy form through the organisation of entrepreneurs in specific areas or businesses into cooperatives to help each other and solve their mutual problems in the spirit of Islam.

(ii) *Partnership*

Partnership in an Islamic society may take one of two juristic forms, *mudārabah* or *shirkah*.

(a) *Mudārabah*: This is a form of business organisation where the entrepreneur provides the management but secures financial resources from others, sharing the profit with the financiers in an agreed proportion. The *sāhib al-māl* (financier or investor) finances the *mudārib's* (entrepreneur's) business not in the capacity of a lender but as an investor. He is the owner, or part owner, of the business, and shares in the risk of the business to the extent of his share in the total financing of the business. The entrepreneur manages the investment funds placed at his disposal by the financier in accordance with the *mudārabah* agreement. If *mudārabah* is related to specific consignments or ventures or is entered into for a temporary time period, it will be dissolved as soon as the purpose has been accomplished or the specified time has expired. However, if it is for an indefinite time period, it can continue until either of the two parties gives notice of dissolution. The liability of the financier is limited to the extent of his capital and no more. (See Appendix 11 for a discussion of the nature of liability in both *mudārabah* and *shirkah* forms of business organisation.)

In accordance with the rationale behind the prohibition of *ribā*, the *fuqahā* have not allowed the entrepreneur a fixed return for his managerial and entrepreneurial services. If there is a loss, he gets no reward for his services and his loss amounts to the opportunity cost of his services. However, he shares in the loss if he has a share in equity, but only to the extent of his share in the total capital of the business because losses, according to the *ijmā* (consensus) of the *fuqahā*, constitute erosion of equity. This fits perfectly into the rationale of the Islamic model of *ribā-free* economy and implies that *mudārabah* is a form of 'investment-management', and not a 'borrowing-lending' relationship, taking into account the modern connotation of these terms.

One of the important areas where *mudārabah* financing would need to be provided is the funding needs of cottage and small-scale industries. It may be desirable to establish specialised credit institutions with special know-how in this area to supplement private sector finance on a profit-and loss-sharing basis (as also discussed elsewhere) to support such industries and to realise the Islamic objectives of broadly-based ownership of business.

(b) *Shirkah*: This is a form of business organisation where two or more persons contribute to the financing as well as the management of the business, in equal or unequal proportions. Profits may be divided in an equitable (but not necessarily equal) ratio agreed upon between the partners. The losses must, however, be borne in proportion to the capital.

(iii) *A Combination of Sole Proprietorship and Partnership*

In practice, of course, business organisations would reflect a combination of sole proprietorship and *mudārabah* or a combination of *shirkah* and *mudārabah*. Not all savers can, or are interested in, participating in the management of a business and may be just looking for opportunities to invest their surplus funds for short-, medium- or long-term periods. They could in this case make financing available to on-going businesses and share in the profits and losses in accordance with agreed ratios. If, however, they wish to spare themselves the trouble of even



directly looking for profitable opportunities of sharing as sleeping partners in other businesses, they could invest funds through financial institutions and investment trusts operating according to Islamic principles. In this case they would also have the advantage of diversifying their investments, which would be difficult for them to achieve as 'sleeping' partners.

*(iv) Joint Stock Companies*

Joint stock companies, along with financial institutions, should constitute the most convenient form of investment available to a majority of savers, who have neither their own businesses to invest in nor the ability to evaluate running businesses or becoming sleeping partners. Corporate shares would be more attractive to them because of the relative ease with which they can acquire them when they wish to invest, or to sell them when they need the liquidity. It will however be necessary to reform joint stock companies in the light of Islamic teachings to safeguard the interests of shareholders and consumers, and also to reform stock exchanges to ensure that share prices reflect more or less the underlying economic conditions and do not fluctuate erratically in response to speculative forces.

Equity-financing in place of loan-financing should help eliminate the possibility of a large superstructure of finance being raised on a narrow equity base in the style of an inverted pyramid which interest-based financing has promoted.<sup>6</sup> It should thus help bring about a wide dispersal of ownership of business and contribute substantially to the realisation of the goal of equitable distribution of income and wealth. It may, however, be noted that even when ownership is widely dispersed, the large number of small shareholders may have neither the ability nor the inclination to participate in the decision-making process. This tends to lead to the concentration of power in the hands of a few persons in large enterprises. Hence appropriate reforms would need to be introduced to minimise the malpractices of management and to safeguard the interests of shareholders. Nevertheless, since competition tends to be inadequate particularly when the enterprises are very large, and regulations can be circumvented, the general tenor of business in an Islamic

economy should preferably be small and medium-scale. 'Big' business should be allowed when it is necessary in the larger interest of society. In such cases the state should intervene more effectively to safeguard public interest and to ensure that vested interests do not exploit the 'bigness' for their private benefit.

Equity financing should also help reduce substantially the indiscriminate lending to the private sector or to governments that is often undertaken by banks when they have an assurance (sometimes false and misfounded) of the return of their principal with interest. Inadequate effort is made to critically evaluate the ultimate purpose for which the loan will be used, which would not happen if the bank has to 'participate' in the fruits (sweet or sour) of the business. Quite often short-term lending is undertaken when the need for accommodation is essentially long-term on the assumption that the credit will be rolled over. This becomes evident when a bank failure takes place and the facts come to light whether one considers the collapse of the Penn Square Bank, the affair of Drysdale Securities in the US, the scandal of Banco Ambrosiano in Italy, the problems of the Herstatt Bank in West Germany, or the difficulties of banks in other parts of the world.<sup>7</sup>

### **Cooperation**

In addition to the above forms of business organisation, which are all profit-oriented, 'cooperation', which is service-oriented, could make a rich contribution to the realisation of the goals of an Islamic economy. With the emphasis of Islam on brotherhood, 'cooperation' in its various forms to solve the mutual problems of producers, businesses, consumers, savers, and investors should receive considerable emphasis in an Islamic society. Moreover, since the general tone of business in an Islamic economy, would be small- and medium-scale, 'cooperation' could help attain some of the economies of large-scale business without the evils associated with it.

Cooperative societies could render a number of valuable services to members, including temporary financial accommodation when necessary through a mutual fund, the economies of bulk purchases and sales, maintenance facilities, advisory

services, assistance or training for solving management and technical problems, and mutual insurance. In fact it is difficult to conceive how a modern-day Islamic society could effectively realise its objectives without a proper role being assigned to 'cooperation'.

Informal cooperation between craftsmen and businesses was quite widespread in Muslim history. It took several different forms including guilds, brotherhoods or fraternities, *sūfī* orders, and *ibdā'* or *bidā'ah*. In all these forms of informal cooperation, businesses rendered services to each other without receiving any profit, commission or remuneration. These different forms reflected not only Islamic brotherhood and mutual trust but also fulfilled the common needs of businessmen on a mutually cooperative basis. With regard to the *ibdā'*, Udovitch writes that it was not "a casual or occasional favour", but "a recognized commercial practice looming large in the discussion of partnership on the same level as deposit, pledge and similar contracts".<sup>8</sup>

### **Historical Experience**

Even in the *Jāhiliyyah* (pre-Islamic) period, trade over territories stretching long distances and requiring several months of travel was carried on extensively. This trade involved the production or import of goods, on the one hand, and their sale or export, on the other. This could not be done without the pooling of financial resources and trading and manufacturing skills. During the *Jāhiliyyah* period all financial resources were mobilised on the bases of either interest or *muqāradah* and *shirkah*. Islam, however, abolished the interest basis and organised the entire production and trade on the bases of *mudārabah* and *shirkah*. With the abolition of interest, economic activity in the Muslim world did not suffer any decline. In fact there was increased prosperity.

A combination of several economic and political factors, including the ability to mobilise adequate financial resources, were responsible for this prosperity. All these factors together provided a great boost to trade which flourished from Morocco and Spain in the west, to India and China in the east, Central

Asia in the north, and Africa in the south. The extension of Islamic trade influence is indicated not only by available historical documents but also by the Muslim coins of the seventh to the eleventh centuries which have been found in several outlying parts of the then Islamic world. They have also been found in different parts of Russia, Finland, Sweden, Norway, the British Isles and Iceland.<sup>9</sup> The great wealth of material goods which the enterprising Islamic world fetched from far-distant lands were also exported to Europe. These consisted not only of Chinese, Indian, and African products but also of the goods which the Muslim countries themselves produced or manufactured.<sup>10</sup> The economic prosperity in the Muslim world “had made possible a development of industrial skill which brought the artistic value of the products to an unequalled height”<sup>11</sup>

*Mudārabah* and *shirkah* were the basic methods, by which financial resources were mobilised and combined with entrepreneurial and managerial skills for purposes of expanding long-distance trade and supporting crafts and manufacture.<sup>12</sup> They fulfilled the needs of commerce and industry and enabled them to thrive to the optimum level given the prevailing technological environment. They brought to the disposal of commerce and industry the “entire reservoir of monetary resources of the medieval Islamic world” and served as a “means of financing, and to some extent, insuring commercial ventures, as well as of providing the combination of necessary skills and services for their satisfactory execution”.<sup>13</sup>

The legal instruments necessary for the extensive use of financing through *mudārabah* and *shirkah* were already available in the earliest Islamic period.<sup>14</sup> These instruments, which constituted an important feature of both trade and industry and provided a framework for investment, are found in a developed form in some of the earliest Islamic legal works.<sup>15</sup> Accordingly Udovitch has been led to conclude that “Some of the institutions, practices and concepts already fully developed in the Islamic legal sources of the late eighth century did not emerge in Europe until several centuries later. The efficacy and vitality of these legal commercial institutions endured, I believe, for most of the Islamic Middle Ages”<sup>16</sup>

With moral decay and political and economic degeneration, the Muslim world lost its vitality in all those walks of life which had once contributed to its rise and glory. Foreign domination has played its own devastating role. Although *ribā* is still despised by Muslims, centuries of Western political, economic and financial domination has unwittingly caused the Muslim world to drift away from the pooling of financial and entrepreneurial resources through the humane institutions of *mudārabah* and *shirkah*. These institutions need to be revived if the Muslim world wishes to get rid of *ribā*. They can no doubt once again play the same invigorating role of stimulating investments, rewarding skills and entrepreneurship and accelerating growth for the benefit of the Muslim masses. Combined with cooperation, the corporate form of business organisation, and the constructive intermediary role of commercial banks and other financial institutions, even the complexities of modern-day investments can be handled without any significant problem. However, there are some prerequisites. These are discussed in the following chapter.

### Notes and References (Chapter 3)

1 For a very good discussion on the subject see Syed Qutb *al-‘Adālah al-Ijtīmā‘iyyah fī Al-Islām* (Cairo: ‘Īsā al-Bābī al-Halabī, 1964), pp.109-62; M. Baqlr al-Sadr, *Iqtisādunā* (Beirut: Dār al-Ta‘āruf li alMatbū‘āt, 14th ed., 1981), pp. 563-72; and ‘Abd al- Salām al-‘Abbādī *Al-Milkiyyah fī al-Sharī‘ah al-Islāmiyyah* (Amman: Maktabah al-Aqsā 1974), vol. 1, pp. 426-39. . ,

2 The following discussion is related essentially to the practical aspects of the subject. For a theoretical discussion of how profit can replace interest, see M. Anas Zarqa’s “An Islamic Perspective on the Economics of Discounting in Project Evaluation”, in Ziauddin Ahmed *et al.*, *Fiscal Policy and Resource Allocation in Islam* (Islamabad: Institute of Policy Studies, 1983), pp. 203-51. See also, Dr. Anas Zarqa’s penetrating discussion of S. N. H. Naqvi’s paper on “Interest Rate and Intertemporal Allocative Efficiency in an Islamic Economy” in M. Ariff (ed.), *Monetary and Fiscal Economics of Islam* (Jeddah: International Centre for Research in Islamic Economics, King Abdulaziz University, 1982), pp. 98-106.

3 See *Al-Fatāwā al-Sha‘iyyah* (Kuwait: Bayt Tamwil al-Kuwaiti, 1980-81), pp. 12-15; and *Al-Ittihād al-Dawlī al- Bunūk al-Islāmiyyah*, *Al-Mawsū‘ah al-‘Ilmiyyah wa al-‘Amaliyyah li al-Bunūk al-Islāmiyyah*, (Cairo: 1982), pp. 384-6; for juristic opinions of Shaykh Abdul ‘Azīz Bin

Bāz and Shaykh Abdul Rahmān Tāj, favouring the difference in the price between cash and credit sales, see *Al-Iqtisād al-Islāmi*, issued monthly by the Dubai Islamic Bank, August 1982, pp. 474-5.

4 Shaykh Abū Zahrah has argued strongly against the permissibility of a difference between credit and cash prices. He even quotes the opinion of Abū Bakr al-Rāzī to support his view (see his *Buhūth fī and Ribā*, Kuwait: *Dār al-Buhūth al-‘Ilmiyyah*, 1970, pp. 58-60).

5 As indicated in Appendix I, the definition of these terms by the *fuqahā’* is not watertight. The definition is, however, not crucial for the analysis.

6 See a report on Japan appearing in the *Economist* of 25 February, 1978, p. 97. It reports that Eidai, a top plywood producer in Japan, had debts close to \$1 billion and a paid-up capital of only \$32 million. This is of course an extreme case. Elsewhere the position is significantly better but even then it presents the picture of an inverted pyramid. In the U.S. of the total funds of \$178.9 billion raised by the domestic non-financial private sector, only \$10 billion or 5.6 per cent constituted equity capital (see *Federal Reserve Bulletin*, January 1978, Table A44). Data supplied by the Federal Reserve Bank, Washington, indicate that the equity to total financing (equity + debt) ratio for the private non-financial sector was .383 in 1952 but declined to .245 in 1977.

According to data published in Table A21 of vol. II of the *OECD Financial Statistics*, the ratio of equity to total finance (equity + debt) for the private non-official sector was .209 in Japan (1976), .224 in Italy (1975), .406 in France (1975), .671 in UK (1975), and .380 in Germany (1975). Total debt in the above ratios included short-term plus long-term loans from affiliates and financial institutions but did not include trade credit. If trade credit is included, the ratio of equity to total financing would be even smaller.

7 For indiscriminate commercial bank lending to Mexico, see “Banks return to earth” and “Mexico’s Crisis: a colossal mountain of debt” in *The Financial Times*, 20 August 1982. Of Mexico’s total public sector debt of \$80 billion, \$60 billion was owed to banks. Forty-nine per cent of the \$60 billion bank debt was repayable within one year. The maturity as well as the scale of Mexico’s debt were problems. Mexico’s liquidity crisis was of such an enormous proportion that it could have made major international banks insolvent had it led to default or to repudiation. Mexico’s commercial creditor banks had no choice but to agree to the country’s request to reschedule the debt and even to lend more. Some governments and international institutions also provided resources to enable Mexico to continue interest payments which it would otherwise have been unable to do. Mexico was of course not alone. A number of other countries faced the same problem.

8 Abraham L. Udovitch, *Partnership and Profit in Medieval Islam* (Princeton, NJ: Princeton University Press, 1970), p. 102.

9 J. H. Kramers, "Geography and Commerce" in T. Arnold and A. Guillaume (eds.), *The Legacy of Islam* (London: Oxford University Press, 1952), p. 100; see also pp. 101-6.

10 *Ibid.*, p. 104.

11 *Ibid.*

12 Udovitch, *op. cit.*, pp. 170, 182 and 185.

13 *Ibid.*, pp. 180 and 261. 14 *Ibid.*, p. 77.

15 *Ibid.*, pp. 77-8.

16 *Ibid.*, p. 261.





## CHAPTER 4

### SOME FUNDAMENTAL REFORMS

Just as it is not possible to construct a strong edifice without a proper foundation, it is also not possible to establish an equity-based *ribā-free* economy and to realise the whole range of Islamic objectives without a proper enabling environment. While the abolition of *ribā* is necessary, it would not be sufficient because it is not the only value which Islam stands for.<sup>1</sup> The abolition of *ribā* is only one of the several important values and institutions which together constitute the Islamic way of life. These are so well integrated and dovetailed that none can be dispensed with without weakening the system or making it less effective.

Three of the most important characteristics of an ideal Islamic environment are character, brotherhood and justice. It is not possible to conceive of a truly Islamic economy without the strength of individual and social character that Islam emphasises, the solidarity and mutual support system that Islamic brotherhood demands, and the eradication of all kinds of *zulm* or injustice that Islam condemns, that emerging from *ribā* being only one of its major forms. All Islamic values and institutions need to be revived to strengthen character. The systems of *zakāt* and *‘ushr*, along with other relevant institutions, need to be revived to reinforce Islamic solidarity. The unjust judicial system prevailing in most Muslim countries needs to be reformed to ensure justice in accordance with Islamic criteria. There is no reason why the Muslim *ummah* cannot present once again the picture that the Prophet depicted by saying: “In mutual compassion, love and kindness you will find the faithful like a body; if one part feels pain, the whole body responds with wakefulness and fever.”<sup>2</sup>

The blessings of Islam cannot be fully realised until it has been implemented in its entirety as emphasised by the Qur’ān: “O Muslims! Enter into Islam in its totality, and follow not the footsteps of the Devil for he is your obvious enemy” (2: 208). It

would also be useful to bear in mind what the Qur'ān has stated clearly in another place: "God certainly does not change the condition of a people until they change their own inner selves" (13:11). This indicates the difference between the establishment of individual Islamic banks, which does not require the transformation of the society, and the creation of a just, *ribā-free* economy which does necessitate such a transformation.

In addition to the reform of the individual and the society, indicated above, some of the other reforms indispensable for supporting a *ribā-free* economy and banking system and realising the socio-economic objectives of Islam are briefly discussed below.

### **Saving and Investing**

#### *Moderation in Spending*

Moderation is the core of the Islamic message in all human activities. Accordingly, while Islam disapproves of asceticism, it also emphatically discourages extravagance and conspicuous consumption. "Eat and drink but be not extravagant because He [God] loves not the extravagant" (al-Qur'ān, 7: 31), and "When they [the sincere Muslims] spend, they are neither extravagant nor niggardly, for the right course lies between these" (al-Qur'ān, 25:67). However, in keeping with its universal and rational approach to problems Islam has enunciated *qualitative* and not *quantitative* restrictions on consumption. The expenditure should be befitting a Muslim who is morally conscious and humble at heart.

Since Islam wishes to foster social equality and brotherhood, Muslims must refrain from any behaviour pattern that destroys or weakens these values. All expenditures undertaken with the intention of showing off or displaying pomp and grandeur and reflecting arrogance have the effect of widening, rather than narrowing, the social gulf between the rich and the poor and have been condemned by Islam. The Holy Prophet taught Muslims to be humble and exhorted them to adopt lifestyles that do not reflect arrogance.<sup>3</sup> In fact he even said: "I am

not apprehensive of your being afflicted with poverty. However, I feel concerned that the world will unfold itself for you as it did for those before you, and that you will vie with each other for its sake as did those before you, such that it will destroy you as it did those before you. “<sup>4</sup>

It should be possible for all Muslim countries to fulfil the minimum needs of the poor through the efficient use of available resources and the elimination of inessential consumption in both the public and the private sectors. The establishment of socio-economic justice and the restructuring of their economies along Islamic lines would act as catalysts. It is perhaps not yet too late to appreciate that no government can stay in power without fulfilling the basic needs of the poor and eliminating all sources of injustice. If the Muslim governments do not start giving heed to the Prophet’s warning in the *hadīth* quoted above, they will sow the seeds of their destruction through social unrest and political instability.

The ideal expenditure pattern in conformity with Islamic values would be one that reflects simplicity and modesty. This does not imply that Muslims should refrain from utilising their income or God-given resources for fulfilling all their needs or for providing themselves with necessary comforts. It does, however, demand the introduction of greater meaning and quality in consumption and the avoidance of a life-style of conceit and snobbishness adopted to ‘satisfy’ the urge to become, or keep up with, the Joneses. It is the social mood, intensified by the advertising machinery, which sets such life-styles and cultivates rivalry for the acquisition of hollow prestige symbols. Such moods cannot be transformed except by an overall reform of the society.

In a society where Islamic values effectively prevail, most individuals would shed their snobbishness when they realise that not only are they unable to attain greater prestige through self-display but that their reputation will in fact suffer a setback. Inculcation of the Islamic spirit at all levels of society will reduce the claim on resources, including foreign exchange

reserves, and promote savings and capital formation. It will also reduce the resort to credit (not only for conspicuous consumption, which is not so widespread in developing countries, but also for the import, production and distribution of such goods) and hence unnecessary monetary expansion. The violation of the Islamic norms by even some persons would tend to set the social pace for the acquisition of prestige symbols, thus sharpening the acquisitive spirit and accentuating greed and envy.

Unhealthy competition for prestige symbols accompanied by a number of un-Islamic customs, related particularly to marriage, leads to excessive spending financed by either disinvestment of past savings or mortgaging of future savings. One family does it, others try to outdo, and the whole social atmosphere becomes contaminated. It leads to increased imports or domestic production of unnecessary goods and reduces the availability of resources for productive and essential purposes. The resource endowment of Muslim countries is not capable of satisfying the demand for needs as well as conspicuous consumption. The effort to do so leads to a reduction in savings and capital formation, slows down the rate of economic growth and contributes to inflationary pressures and unending balance of payments deficits.

Muslim countries should under no circumstances commit the mistake of expanding 'inessential' consumption through credit, particularly from international sources. It is an illusion to think that faster growth can be attained by patronising, through resort to national or international debt, the production, import, distribution or consumption of 'unnecessary' goods and services. Such credit reduces the urge to make the sacrifice needed for the development of Muslim countries and the satisfaction of the needs of all. If the high and the rich are not willing to make the sacrifice of 'inessentials' /the poor have to sacrifice the 'essentials'. This cannot last long. Islamic socio-economic justice must be established as soon as possible if unrest and instability are to be nipped in the bud.

It must be clearly recognised that national or international debt does not and cannot eliminate the ultimate sacrifice. It only postpones it and makes it more and more difficult with the passage of time and the accumulation of the debt burden. Moreover, as soon as there is the slightest twilight of uncertainty on the horizon, credit is restricted internationally as well as domestically. Aggregate demand suffers a decline and there is a mild or serious recession, depending on whether the cutback in credit and spending is small or large. Hence, while living in debt may be helpful initially, living within means should be more conducive to a steady and consistent, long-run growth with substantially dampened economic fluctuations.

#### *Elimination of Hoardings*

While wasteful spending has been discouraged, hoarding of savings has also been unequivocally condemned by the Qur'ān as well as the *Sunnah*. God-given resources are meant to be used for one's own benefit (within limits prescribed by Islam) as well as for the benefit of others, thus fulfilling the very purpose of their creation. Leaving them idle and not using them for rightful consumption or for fostering the common good through welfare contributions (*zakāt*, *sadaqāt* and other such payments) or productive investments has been condemned by Islam: "And there are those who bury gold and silver and spend them not in the way of God; announce to them a most grievous penalty" (9: 34). The Prophet disapproved of leaving productive resources idle, saying: "Let him who owns land cultivate it himself, and if he does not do so let him have his brother cultivate it."<sup>5</sup> Caliph 'Umar also used to urge Muslims to use their capital productively by saying: "He who has money should develop (invest) it, and he who has land should cultivate it."<sup>6</sup> This is because the development of land and the productive investment of savings is necessary for meeting the needs of the Muslim society for essentials and comforts and doing this is certainly an act of virtue in the Islamic value system.

### *Efficient Use of Savings*

In the light of the above discussion, it would be necessary to organise and regulate the money and banking system in such a way that it not only ceases to promote wasteful spending but also mobilises savings and channels them into socially-productive uses. Under no circumstances should the system encourage or facilitate the production or consumption of goods and services that carry a lower priority in the Islamic value system. The deposits used by banks to advance loans belong to the society and socio-economic justice demands that resources thus mobilised should be so allocated that they help finance the production and distribution of all the essential needs of society before funds are made available for other purposes.

The capitalist virtue of abstaining from making value judgements can have no place in the Islamic system. There is no escape from values which have been prescribed by the Qur'ān and the *Sunnah* and which constitute the core of the Islamic system. Hence the capitalist criterion of equalising the marginal rate of return on all investments to attain 'efficiency', irrespective of the social priority of goods, tends to bring about a lower than 'optimum' production of essentials because scarce funds get diverted to the production of luxuries.<sup>7</sup> 'Efficiency' needs to be understood within the context of the overall ethos of the value system and not just of the variables of interest and profit. The 'return' should take into account not only private gains but also social benefits and the 'cost' should take into account not only private costs but also social costs, including moral degeneration, social disintegration and environmental pollution.

### *Government Spending*

The principle of avoiding wasteful expenditure and using resources efficiently in accordance with Islamic values applies not only to individuals but also to the government, and more so because governments use resources which are provided by the people as a trust to be used for the welfare of the people in

accordance with Islamic teachings. The criterion for undertaking any government expenditure should be that the total sacrifice made by the society in providing the resources is fully offset by the positive contribution to general social welfare and the realisation of the socio-economic goals of Islam. Governments should hence carefully evaluate their programmes and eliminate, or substantially reduce, all wasteful and unproductive expenditures so as to eliminate or minimise their deficits. If the deficits of Muslim countries continue to be of the magnitude they have been in the past, it will be difficult to avoid substantial borrowings from the central bank. The rate of inflation will consequently be significantly higher and an important goal of Islamic society will be unnecessarily sacrificed.

Hence it is important to adopt a number of reform measures if *ribā* is to be abolished and the goals and values of Islam are to be actualised. Firstly, the habit of simple living should be inculcated in the rich and the poor alike and all wasteful and unproductive spending by both the public and the private sectors should be minimised to eliminate or reduce substantially the demand on resources for unnecessary expenditures and expensive life-styles. Secondly, even though the first measure should automatically promote savings, they should be positively encouraged and also efficiently mobilised and invested within the Islamic framework for the production of goods and services required to meet the demand for needs and comforts of all or the maximum number of people. This is extremely important for not only attaining the desired rate of economic growth but also promoting greater political stability in Muslim countries. The state would have to play an active and positive role not only until the Islamic values have become internalised in the Muslim society, but also thereafter, to assure their continuation and to nip in the bud all vicious deviations.

### **Increased Equity Financing**

The obligation to abolish interest implies that all businesses in Muslim countries, including industry and agriculture, currently operating on the basis of a mix of equity and interest-

based loans, would have to become primarily equity-based. This equity, as indicated earlier, need not all be for an indefinite period like stocks and shares. Part of it may be for definite periods in the same manner as loans, advances and bonds. The closed-end portion of the total equity is still being referred to in the literature on Islamic economics as loan-financing even though such loans would not be interest-based. This should not lead to any confusion as long as the basic premises are well-understood. In addition to the open- and closed-end equity, there may also be *qurūd hasanah*, in relatively small amounts, and suppliers' credits in which case, as indicated earlier, the *fuqahā'* have allowed a difference between cash and credit prices to cover the additional cost of administering credit sales.

All financial needs of a permanent nature, whether for fixed or working capital, should normally be expected to come out of equity capital in an Islamic economy. This broader equity-capital base may be supported to the extent necessary by medium- and long-term *mudārabah* financing. Short-term loan financing, even though in a profit-and-loss sharing framework, may be resorted to only for bridge financing or temporary shortage of liquidity resulting from seasonal peaks in business for which purpose it may not be desirable or feasible to have a permanent increase in equity.

A number of steps would need to be taken to bring about the transformation to an equity-based financing system in the gradual Islamisation of the economy of Muslim countries. Firstly, all sole proprietorship and partnership firms should be required to increase their equity base adequately by increasing the proprietors' or partners' own capital or accepting other partners to cover all their capital needs of a relatively permanent nature. Wherever feasible, larger firms may be induced to convert to joint stock companies. All existing joint stock companies should be required to float additional shares and the funds so acquired should be used to retire their debt; commercial banks may also take up a proportion of such newly-floated shares to replace a major proportion of their medium- and long-



term debt. Here the central bank may have to play the role of monitoring the price at which new shares are acquired by banks to ensure that the price is in keeping with what is justified by the real assets and profitability of the company concerned.

Secondly, to enable firms to increase their equity it may be necessary to 'regularise' the existing stock of 'black' money (arising from tax evasion), the major outlet for which currently is mainly capital outflow or conspicuous consumption. This move should help draw a substantial volume of such funds into the fold of investment. Without this move it may be difficult to increase equity because there may not be a sufficient volume of 'white' money in the economy for this purpose.

Thirdly, the privilege enjoyed by 'interest' of being treated as a tax deductible expense should be eliminated. Tax laws should be revised to treat interest payments in the same way as dividends and profits are now being treated, and taxes should be levied on gross profits before interest payments. In fact, it would be desirable to impose a higher rate of tax on the interest portion of the gross income than that applied to profits to accelerate the transformation to an equity-based financing structure.

Fourthly, the tax structure of Muslim countries should be streamlined to ensure that it does not discourage investment and channel even legally earned profits into 'black' money. While Islam does allow the levying of taxes to a reasonable extent to meet all necessary and desirable state expenditures, it does not permit an unjust tax structure which penalises honesty and creates the un-Islamic tendency of evading taxes.<sup>8</sup> If the tax rates are reasonable, income earners would be able to satisfy not only the government but also their own conscience without necessarily reducing the total tax proceeds.

Fifthly, the formation of appropriate financial institutions and investment banks should be encouraged to make venture capital available to businesses and industries and thus enable them to undertake necessary investments. In the process they would also provide investment opportunities to savers who are

either unable to find lucrative opportunities for direct investment, or are unable to locate partners or *mudārib* for profitable investment of their savings.

### **Reducing the Power of Banks**

The privilege to mobilise vast resources through deposits provides the conventional banks, and the families that control them, “access to other people’s capital”<sup>9</sup> and thereby the ability to exercise a tremendous influence over the economy and politics of their parent and host countries. This is the main reason why banks tend to become the centres of control under capitalism and why “the wealthiest and most powerful capitalists operate through banks.”<sup>10</sup> Such is the power of banks in all countries, irrespective of whether they are developed or developing. The Muslim countries do not present a different picture.

In the United States, a study of the 200 largest non-financial corporations, which hold about 60 per cent of all manufacturing corporations and thus exercise significant political power at both state and federal level, has revealed that “Ultimate power resides with the bankers who are the major stock holders in and creditors of the modern large corporations.”<sup>11</sup> The Patman Report and the Securities and Exchange Commission Report drew similar conclusions.<sup>12</sup> Although financial institutions generally deny that they exercise significant influence over non-financial corporations in which they hold stock or to which they supply capital, one would tend to agree with Kotz’s observation that “historical experience indicates that such assurances cannot be taken at face value.”<sup>13</sup>

The inverted pyramid of power through the banking system arises from the low equity base of banks on top of which rest ‘primary’ deposits which support a substantially large volume of ‘derivative’ deposits. The equity of banks in the conventional banking system is extremely small. It tends to provide generally less than the infrastructure needs of banks except where a high equity/deposits ratio is legally prescribed. Shareholders of all US

commercial banks holding stocks worth \$23.8 billion, plus surplus, undivided profits, and reserves of \$94.8 billion in 1981 had control over total assets worth \$1,692.3 billion.<sup>14</sup> The ratio of stocks to assets was thus only 1.4 per cent while that of equity capital (stocks + surplus + undivided profits + reserves) to assets was 7.0 per cent. It is worth pointing out that people who had real control over these assets owned a substantially smaller proportion of the total stock of \$23.8 billion.

According to an analysis of over 100 largest banks in nine countries by the IBCA Banking Analysis Limited, the 1981 equity/assets ratio was 6.1 per cent for British banks, 3.2 per cent for German banks, 2.5 per cent for Japanese banks, and 2.0 per cent for French banks.<sup>15</sup> There has been a continuing decline in the capital ratio of most banks in recent years along with a notable deterioration in the quality of their assets and an erosion in their strength. Since the commercial banks are highly geared, the loss of only five to ten per cent of their loans can wipe out their capital. This has in fact contributed to the failure of some of the large banks. The Franklin National Bank is a recent example. Its capital base declined continually from 8.1 per cent of its total resources in 1964, to 5.9 per cent in 1969 and 4.0 per cent in 1973.<sup>16</sup> It had to rely more and more on short-term borrowings to fund long- and medium-term loans. This undermined its profitability and also made it vulnerable to shocks.<sup>17</sup>

The net income of banks from their operations may tend to be no more than 'normal' for the ordinary stockholder, but the 'privileged' few who control bank operations derive considerable personal benefits through various clandestine methods which are difficult to check and control. Through their immense economic power they are also able to exercise political and social influence which makes them among the most powerful members of their society.

While banks in an Islamic economy may be permitted to remain in the private sector, it would be desirable to adopt a number of measures to reduce their power. Firstly, they should be required to have a substantially larger and more widely-

owned equity base with a view not only to make them more shock-proof but also to disperse the controlling power over a larger and more broad-based sector of society. Secondly, no single family or group should be allowed to hold more than a certain maximum proportion of total shares and generally no holding companies should be encouraged in the banking business. Thirdly, members of the board of directors or management of banks should not be allowed to become directors or managers of other businesses, to avoid concentration of power in society. Fourthly, while smaller banks may be allowed to undertake business on their own, larger banks should be required to utilise the maximum feasible proportion of their resources to finance the business of other businesses and industries. These measures should help disseminate the power wielded by banks and reduce the concentration of wealth in the hands of a few families. If these precautions are not taken, the Islamic banks operating within the *mudārabah* and *shirkah* framework may tend to become more powerful than even the conventional banks.

Moreover, in the conventional system, while the power to issue currency is exercised by the central bank, the power to 'create' deposits is enjoyed by the totality of commercial banks with some indirect controls exercised by the central bank. Hence total deposits consist of 'primary' deposits which provide the banking system's reserves held in the form of cash or deposits with the central bank, and 'derivative' deposits arising from the process of commercial bank credit expansion. In the US, 'primary' deposits amounted to an estimated \$197.3 billion in 1981, and constituted a little over one-sixth of the total deposits of \$1,277.8 billion. This implies that 'derivative' deposits constituted a little less than five-sixths of total deposits. Although the ratio may not be that high in Muslim countries with less developed banking systems, it is nevertheless significant.

Derivative deposits constitute a major part of total money supply (currency + deposits) in the conventional system. The creation of these deposits gives rise to a subsidy or 'seigniorage'

(the difference between the return on, or purchasing power of, created money and the costs incurred in its creation) from society to the commercial banks.<sup>18</sup> This subsidy provides them with a certain advantage that is not enjoyed by other businesses. The question is: who should benefit from this subsidy? In the existing system, the subsidy goes directly or indirectly to three groups: (a) the banking public, through the provision of a number of banking services free of charge; (b) 'privileged' borrowers from banks, through the lower rate of interest, the loss to society being the difference between the opportunity cost of created money to society and the 'prime' rate of interest; and (c) the bank stockholders, through increased profit.<sup>19</sup> The poor and the needy people of society and the non-banking public get no direct benefit from deposit creation.

It can be argued that in the social welfare-oriented value system of Islam, the power to create money should be considered a social prerogative and, therefore, the net income from money creation should be used for general welfare and particularly, for improving the lot of the poor people.<sup>20</sup> There are two ways in which this may be arranged.

Firstly, bank credit should be used for broad-based economic welfare by being directed to an optimum number of borrowers for the production of goods and services required for satisfying the needs of the mass of the society. The criteria for its allocation, as of other God-given resources, should first be the realisation of the goals of Islamic society and then the maximisation of direct nominal profit. This would, of course, necessitate value-oriented planning in accordance with values and goals of Islam and dovetailing the commercial banking system into the plan for its efficient implementation.

Secondly, the total of derivative deposits, rather than just central bank credit to commercial banks, should be considered as *mudārabah* advances to commercial banks. If commercial banks are nationalised, the total net income will go to the public exchequer automatically. If the commercial banks continue to remain in the private sector, the net income arising from

‘derivative’ deposits should be passed on to the state after allowing for the *mudārabah* share of commercial banks, determined in accordance with an agreed formula. This entire income should be used by the state for social welfare projects, particularly those that benefit the poor so that, in the words of the Qur’ān, “wealth does not circulate among your rich” (59: 7).

Two objections could be raised here. The first is that individual banks do not create credit; it is only the totality of all banks that creates credit.<sup>21</sup> The second is that the proposed scheme could have the effect of making banking unprofitable and hence unattractive.

It is true that individual banks do not apparently create credit. However, when each of them advances loans, the funds thus made available keep on moving back and forth until the volume of credit has multiplied several times. Their total assets are hence several times their capital. Which other business in the economy has such a large leverage or gearing ratio? This provides the bank directors and their families with the ability to exercise an influence over a vast sector of the economy and to derive direct or indirect personal benefits. Although the gearing ratio would be substantially reduced in an Islamic economy, it would still be considerably higher than in other businesses. There would hence remain the need to ensure that the benefits derived from this higher gearing ratio flow to the mass of the population and do not go only to the rich or remain concentrated in a few hands.

The effect on profitability, however, needs to be examined from a different angle. Of the three beneficiaries from credit creation, the one to be affected most will be the ‘prime’ or ‘privileged’ borrowers who will have to pay a higher rate of return in the form of profit to the banks because their productivity is ‘claimed’ to be higher. Hence the net residual rate of return of such ‘privileged’ borrowers will be smaller by the difference between the rate of *mudārabah* profit they will pay to the banks in the Islamic system and the ‘prime’ rate of interest they pay to the banks in the conventional system. Of the other

two beneficiaries from credit creation, the users of bank services may continue to benefit to the extent to which the benefit derived by them is accompanied by a high rate of social return. For example, cheques may continue to be cashed freely if this benefits society generally through the spread of the banking habit and the mobilisation of savings. However, to the extent to which the benefit from bank services is confined to individuals or firms and is not widespread, the users should be made to pay the cost of these services. The normal stockholders of banks should be able to get a reasonably attractive rate of return and the *mudārabah* ratio of profit-sharing on derived deposits should be adjusted by the central bank to ensure this.

The only sufferers from the proposed scheme will thus be: (a) the 'privileged' borrowers, who will have to pay a higher rate of profit than the prime, or even lower, rate of interest they now pay to the banks, if their productivity is really higher, or else their access to financing will be substantially reduced; (b) users of bank services, to the extent to which such services yield low, or no, social return; and (c) bank shareholders, to the extent to which they earn a substantially higher than 'normal' rate of return on their equity. The general public would benefit through a more goal-oriented allocation of credit as well as through the *mudārabah* profit diverted to the state.

### **A Sane Stock Market**

A greater resort to equity financing in the Islamic economy will necessitate a more efficient organisation of both primary and secondary capital markets to enable businesses to raise funds without undue difficulty and to provide liquidity to investors who cannot, or do not wish to, hold the equity they have acquired. Development of an efficient primary market will be difficult if a secondary market is not developed simultaneously.

One of the first essentials for this purpose would be to bring about a rational behaviour in stock prices along with fair rates of dividend to inspire investors' confidence in stocks and shares. Stock markets as they exist in the capitalist world, with erratic

movements in stock values, low rates of dividend and risk of substantial capital loss, do not offer an attractive outlet for investors. They tend to make interest-bearing bonds with no risk of capital loss (if held until maturity) increasingly more attractive.<sup>22</sup>

A number of factors generate erratic and unhealthy movements in stock prices. One of the most important of these is destabilising speculation, which consists in the forward purchase or sale of stocks on margin without the intention of taking or making actual delivery.<sup>23</sup> The speculator seeks his gain from price differences and indulges only in short-term transactions. He buys and sells “something he cannot consume or use in his business, upon which he performs no work and to which he adds no value.”<sup>24</sup> He either sells short or buys long. A ‘short’ sale is a sale of securities that the seller does not possess at the time of the sale or does not intend to deliver from his own portfolio. The short seller, popularly called a bear, expects the price of the security sold short to decline and hopes to be able to ‘cover’ his short-sale through an ‘offsetting’ purchase at a lower price before maturity date to secure a profit. The long buyer, known as a bull, buys stock which he does not want in the hope of making an ‘offsetting’ sale at a higher price before the date of maturity.

Speculators stand in sharp contrast to ‘true’ investors in the stock market who make purchases by making full payment against reciprocal delivery. The objective of ‘true’ investors is to seek an outlet for their savings, to earn an income, and also to profit from any appreciation in the value of their stock-holdings if they decide to sell them in future. ‘True’ investors do not indulge in short-term transactions and their intention, at least at the time of purchase, is to hold the stocks for a long period. “The shorter the time the security is intended to be held, the less strong is the investment motive.”<sup>25</sup> Investors may change their mind later due to a number of reasons and sell the stocks they purchased. They would still be characterised as investors. There are thus three important elements characterising an ‘investment’ in the stock market: taking delivery of stocks purchased, making



full, reciprocal payment against delivery, and intention, at the time of purchase, to hold the stocks for an indeterminate period.

The ability to make margin purchases provides the speculator with a high degree of leverage and enables him to make a larger purchase with a smaller amount. In a margin purchase, the customer is required to deposit with the broker, either in cash or acceptable securities, a fraction of the purchase price to protect the stockbroking firm against loss. The balance is loaned to the customer by the brokerage house which obtains the funds usually by pledging the purchased securities with a bank for a collateral loan. The stock buyer is required to keep the margin good by depositing additional cash or acceptable securities in the event of a decline in prices below the minimum margin requirement. Conversely the customer may withdraw cash or securities from his account if a rise in price should increase his margin substantially above the requirement.

Margin purchases and sales bring about an unnecessary expansion or contraction in the volume of transactions and, hence, in stock prices, without any real change in the supply of stocks, which remains constant, or the underlying economic conditions. Variations in margin requirements and interest rates tend only to add a further dimension of uncertainty and instability to the stock markets. The lowering of margin requirements and/or interest rates generates unnecessary heat in the market. Their raising afterwards with the objective of restoring 'sanity' to the market only forces speculators to liquidate their positions. This brings down prices and ruins some of the speculators at the altar of others who are usually 'insiders' and who know what is coming. It is usually the small and less sophisticated speculators who lose because they have no insiders' knowledge, possess no basic forecasting ability, and act on the basis of rumours and impulses. The Rockwell Study conducted in the US showed that "large speculators win consistently and their profits are made at the expense of small speculators".<sup>26</sup> The overwhelming conclusion of the Blair Study

was also the same. It showed that the vast majority (75 per cent) of the speculators lost money.<sup>27</sup>

Stock market speculation has in fact tended to exaggerate price swings by excessive buying, when prices are expected to rise, or selling, when prices are expected to fall. The claim that speculation helps stabilise prices would be true only if the speculators operated in different random directions and their separate actions were mutually corrective. The claimed stabilising effect would require that there be no marked disparity in the speculators' purchases and sales. But speculation involves judgement, or anticipation of a rise or fall in prices, and gets accentuated when something happens or some information is available on which judgement can be based. The same events or rumours give rise to the same judgements.

In the real world, because of rumours, sometimes purposely spread by insiders and vested interests, there is a wave of speculative buying or selling concentrated in the same direction leading to abnormal and unhealthy speculation in prices. It is generally believed that prices in the stock markets are susceptible to manipulation and rigging. There are, in the words of Marchand Sage, "intrigues, lethal competitions, tense lunch-time deals, high-stake gambles, the subterfuges, cover-ups, and huge payoffs that make Wall Street the greatest playground in the world".<sup>28</sup> There are "safeguards against such rigging but they don't work", because "Wall Street plays its games seriously, sometimes so well that neither you nor I - nor, seemingly, the Securities Exchange. Commission - knows who is in there playing".<sup>29</sup>

It would hence be wise to maintain continuous sanity in the market through a number of reforms. The most important of these being the requirement of a 100 per cent margin, which is equivalent to cash purchases. With the abolition of margin purchases, options or privileges available in the form of 'puts', 'calls' and 'straddles', which permit the speculator to take a position with a small amount at risk, would also be eliminated. The only adverse effect of such a move would be to reduce the

short-run trading volume in the stock market with near elimination of the gyratic movements and a healthy effect on the long-run trend. As Wendell Gordon has aptly remarked, “the market machinery encourages turnover and consequently price fluctuations”, because “the greater the volume of sales, the more money made by the brokers”.<sup>30</sup>

The reduction as well as the dampening of fluctuations in the turnover through the abolition of margin purchases would help undermine speculative frenzies, maintain sanity in the stock markets and enable stock prices to reflect underlying economic conditions. Speculative activity in existing stocks on the basis of margins does not perform any useful economic function and in fact harms true investors by generating undue fluctuations in stock prices and injecting an undesirable element of uncertainty and instability into their investments. Largay has concluded, on the basis of his analysis of 71 NYSE and 38 AMEX stocks placed under special margin requirements during 1968-69, that “The empirical results support the *a priori* hypothesis that banning the use of credit for transactions in individual issues is associated with a ‘cooling off’ of speculative activity in these stocks”<sup>31</sup> Bach has also observed that “If rising stock prices have been financed by borrowed money, a downturn in the market may precipitate a major collapse in stock prices, as lenders call for cash, and may place serious financial pressure on banks and other lenders. A high market based on credit is thus far more vulnerable than a cash market and is more likely to be a cyclically destabilising force.”<sup>32</sup>

The above policy prescriptions (abolition of stock market speculation and introduction of cash purchases of shares) have been suggested because they would serve the larger public interest of maintaining sanity in the stock markets, which is extremely important for the efficient working of an equity-based economy. These same policy prescriptions could also be derived from the teachings of the *Sharī‘ah*, particularly on the basis of *maslahah* or public interest, which plays an important role in *fiqh* discussions.<sup>33</sup>

The abolition of *ribā* from the Islamic economy would itself tend to minimise stock market speculation based on margin purchases because when the lending bank is aware that it has to share in the risk of speculative business and is not assured of the return of its principal, it will tend to be extra careful in its lending for speculative purchases. Nevertheless, lending against the collateral of stocks to purchase stocks is an unhealthy practice. It breeds speculation and needs to be discouraged. The purpose of credit should be to finance productive investments and not to encourage speculative buying or hoarding.<sup>34</sup>

The abolition of *ribā* and the introduction of a system of only cash purchases in the stock market should undoubtedly help bring about an orderly behaviour of stock prices, and protect investors. Nevertheless, some other reforms would also have to be introduced in the light of Islamic teachings to eliminate all those unhealthy practices which create destabilising conditions in the stock market and hurt the public interest. These should include: requirement of full disclosure of all material facts on stocks and shares sold in the primary and secondary markets; curbing of unfair trading practices; and elimination of the manipulation of share prices by brokers and jobbers, and directors or large stock holders, on the basis of their insiders' knowledge of the stock market or company affairs.

Even though the proper organisation of stock markets for increased equity financing of businesses is a key element in the reorganisation of an economy along Islamic lines, this subject has unfortunately received scant attention from Muslim economists. Likewise the subject of reform of joint stock companies in the light of Islamic teachings, to ensure a just return to the investor, has also not received the attention it deserves. Hence proper research needs to be encouraged on both these subjects.

### ***Concluding Remarks***

It seems that only through the introduction of these fundamental changes could the banking system be made to serve

the socio-economic goals of Islam. A mere replacement of *ribā* by profit-sharing will not serve the purpose, although it could itself be welcome as a means to provide Muslim bankers with the necessary experience in *ribā-free* banking and to set the way for bringing the other major reforms later. Nevertheless, it must be borne in mind that individual *ribā-free* banks are operating on a small scale in a hostile interest-based capitalist environment without auxiliary institutions and government support. The failure of such institutions, if it does take place, should not be construed as failure of the system, because such institutions operating in an inhospitable environment do not represent the system itself but only the struggle of an embryo to survive in difficult circumstances without support systems. Nevertheless, the available evidence indicates that the Islamic banks established so far have operated successfully in spite of the difficulties they have faced.<sup>35</sup>

One serious and unforgivable failure of some Muslim governments is that, while they are allowing interest-free banks to be established, they are not taking the necessary measures to regulate and support them as was clearly emphasised by the governors of the central banks and monetary authorities of Muslim countries.<sup>36</sup> It is necessary to ensure that such institutions have sound management, adopt healthy practices and do not indulge in speculation in real estate or commodity and stock markets. Such institutions should be subjected to regular inspection by the central banks and their final accounts should be carefully examined by duly appointed auditors. However, the role of the central banks should not remain confined merely to the regulation and inspection of the Islamic banks. They should also support these institutions and conscientiously help them solve their problems and overcome their difficulties.

#### **Notes and References (Chapter 4)**

1 A number of Muslim scholars have emphasised this point. For example, Dr. Abdul Ḥamīd Abū Sulayman says: "To merely substitute interest on loans by other forms of interest or profit fails to offer a real alternative." (See his paper on "The Theory of the Economics of Islam" in

*Contemporary Aspects of the Economic Thinking in Islam*, Bloomington, Indiana: MSA, 1976, p. 10); Dr. Naqvi states: “. . . any proposition which asserts that a zero rate of interest is sufficient for the establishment of an Islamic system is false.” (S. N. H. Naqvi, *Ethics and Economics: an Islamic Synthesis*, Leicester, UK: The Islamic Foundation, 1981, p. 110.)

2 Bukhārī, *Kitāb al-Adab, Bāb Raḥmat al-Nās wa al-Bahā'im*; also Muslim.

3 Said the Holy Prophet, peace be on him: “God has revealed to me to teach you to be humble so that no one wrongs others or shows arrogance” (Abū Dāwūd, *Kitāb al-Adab, Bāb fī al-Tawaḍu'*); “God does not look at those who wear clothes reflecting arrogance” (Bukhārī, *Kitāb al-Libās, Bāb Qawluhū Ta'ālā*, “Qul man ḥarrama zīnat Allāh”; also Muslim); and that “Whoever abstains from wearing an expensive dress out of humility, in spite of being capable of doing so, will be summoned by God in the presence of all humanity on the Day of Judgement and given the option to wear any of the distinguished attires of faith that he wishes”. (Tirmidhī, *Kitāb al-Zuhd*.) Several verses of the Qur'ān as well as the above and many other pronouncements of the Prophet, peace be on him, have led the *fuqahā'* to conclude that vaingloriousness and vying with each other for worldly symbols of prestige is *ḥarām*. (See *Kitāb al-Kasb* of Muḥammad ibn al-Ḥasan al-Shaybānī reproduced in Shams al-Dīn al-Sarakhsī, *Kitāb al-Mabsūṭ*, Beirut: Dār al-Ma'rifah li al-Ṭaba'ah wa al-Nashr, 3rd ed., 1978, vol. 30, p. 268).

4 Muslim, *Kitāb al-Zuhd wa al-Raqā'iq*, from 'Amr ibn 'Awf.

5 Muslim, *Kitāb al-Buyū'*, *Bāb Kirā' al-Arḍ*.

6 Muḥammad Husayn Haykal, *Hayāt Muḥammad* (Cairo: Maktabah al-Nahdat al-'Arabiyyah, 1963), vol. 2, p. 229.

7 The definition of luxuries and essentials need not remain constant through space or time as it will necessarily be determined by the general wealth and standard of living of the Muslim society. The important point, however, that needs to be borne in mind is that Islam requires the satisfaction of all the basic needs of all human beings in society in conformity with their status as vicegerents of God. Beyond that, it allows differences in consumption levels in conformity with the status and income of the individuals but discourages the wide gaps that would have the effect of weakening the bonds of Islamic brotherhood. The criterion for distinguishing luxuries from essentials should hence be the “availability within the means of the majority”.

8 For a discussion of the Islamic requirement of justice in taxation, see the author's *Islamic Welfare State and its Role in the Economy* (Leicester, UK: The Islamic Foundation, 1979), pp. 22-3.

9 D. M. Kotz, *Bank Control of Large Corporations in the U.S.* (Berkeley: University of California Press, 1978), p. 143.

10 *Ibid.*, p. 149.

<sup>11</sup> *Ibid.*, p. 148.

12 United States Congress, House Banking and Currency Committee, Subcommittee on Domestic Finance, *Commercial Banks and their Trust Activities: Emerging Influence on the American Economy*, 90th Congress, 2nd Session, 1968, p. 5. United States, Securities and Exchange Commission, *Institutional Investor Study Report*, House Document 62-4 referred to the House Committee on Inter-State and Foreign Commerce, 1971, pt. 8, pp. 124-5.

13 Kotz, *op. cit.*, p. 119.

14 See Federal Deposit Insurance Corporation, *Statistics on Banking*, 1981, Table 109, pp. 34-6..

15 IBCA Banking Analysis Limited, *Real Banking Profitability*, October 1982, p. 4.

16 Statistics reported from Congressional Hearings by Joan E. Spero, *The Failure of the Franklin National Bank: Challenge to the International Banking System* (New York: Columbia University Press, 1980), p. 71.

17 *Ibid.*, p. 11.

18 K. E. Boulding and T. F. Wilson (eds.), *Redistribution through the Financial System: The Grants, Economics of Money and Credit* (New York: Praeger Publishers, 1978), pp. xxiii and 4. The reader may wish to read a number of papers in this book for enlightenment on the subject.

19 See T. F. Wilson, "Identification of Measurement of Grant Elements in Monetary Policy" in Boulding and Wilson, *op. cit.*, p. 48. The author also argues that "seigniorage is a grant giving the producers (or 'creators') of money or to whom the grant has been transferred, command over resources in the economy" (p. 38). According to Michael Moffitt, "The larger the loans, the greater the likelihood of borrowing below the prime. Meanwhile, small businesses are paying the prime, plus stiff markups." *The World's Money: International Banking from Bretton*

*Woods to the Brink of Insolvency* (New York: Simon & Schuster, 1983, p. 211).

20 Dr. Anas al-Zarqa', Professor of Economics at the King Abdulaziz University, argued, during the course of the Makkah Seminar, that 'created deposits' were in the nature of *Fay'* (wealth attained by Muslims without struggle) because no serious effort has been involved in their creation. Hence their benefit should be distributed in accordance with the following verse of the Qur'ān regarding *Fay'*: "Whatever Allāh restored to His Messenger from the people of the towns is for Allāh, His Messenger, the near of kin, the orphans, the needy and the wayfarer, so that it does not circulate among your rich" (59: 7). There has been a difference of opinion among the *fuqahā'* on the distribution of the total amount of *Fay'* among the five heads specified in the Qur'ān, after the death of the Prophet, peace be on him. Imam Shafi'ī felt that the total amount should be divided equally among the five heads even after the Prophet's death. The Prophet's share should, however, be used for general welfare. Imams Abū Hanifah, Mālik and Aḥmad did not consider such a strict allocation to be necessary. They felt that the entire amount of *Fay'* should be spent on the general welfare of all Muslims. (For details see the commentary on the verse in Abū A'lā Mawdūdī, *Tafhīm al-Qur'ān*, Lahore, Pakistan: Idārah Tarjumān al-Qur'ān, 1971, vol. 5, p. 392.) Whatever the interpretation, if the principle of *Fay'* is applied to the creation of deposits, it could help bring about greater general welfare with more equitable distribution of wealth.

21 This point was raised by Dr. Mahfooz Aḥmad at the Makkah Seminar. See the discussion of the author's paper on "Money and Banking in an Islamic Economy" in M. Ariff (ed.), *Monetary and Fiscal Economics of Islam* (Iddah: International Centre for Research in Islamic Economics, King Abdulaziz University, 1982), p. 186.

22 It is worth noting that the Dow Jones average of industrial stock prices was by 1981 where it had been in 1964. The consumer price index, however, rose to 293 over this period, using 1964 as a base. (See IMF, *International Financial Statistics, Yearbook*, 1982, pp. 466-7.) This implies that the Dow Jones industrial index should have risen from 874 at the end of 1964 to 2,561 at the end of 1981 just to offset the erosion in their real value due to inflation. The Index, however, rose to 1,045 at the end of 1982 in the wake of intense speculative activity brought about by the decline in interest rates induced by the Federal Reserve to overcome the recession. The oscillations in stock prices have nevertheless been severe, introducing a high degree of risk and uncertainty in common stock investments. Hence Samuelson has been led to conclude that stocks were a



poor hedge against inflation and that “the only sure thing about stock prices is that they will fluctuate” (Paul A. Samuelson, *Economics*, New York: McGraw Hill, 1980, 11th ed., p. 68). Accordingly Charles Geisst remarks”. . . shares have undergone a steady eclipse in popularity as financing instruments while bonds have grown in corporate and investment popularity”, and that”. . . stock markets are arenas to be avoided by the small investor since price movements are too volatile to be borne by those with limited capital or background understanding of how to limit risk” (*A Guide to the Financial Markets*, London: Macmillan, 1982, pp. 23-4).

23 Alan Lechner, *Street Games: Inside Stories of the Wall Street Hustle* (New York: Harper & Row, 1980), pp. 84 and 104.

24 M. S. Rix, *Stock Market Economics* (London: Sir Isaac Pitman and Sons Ltd., 1965), p. 204.

25 *Ibid.*, p. 205.

26 R. T. Teweles, C. V. Harlow and H. L. Stone, *The Commodity Futures Game* (New York: McGraw Hill, 1965), pp. 299 and 302.

27 *Ibid.*, p. 296.

28 Marchand Sage, *Street Fighting at Wall and Broad: An Insider's Tale of Stock Manipulation* (New York: Macmillan, 1980), p. i. Marchand Sage is a *nom de plume* for the writer who is a sophisticated and successful veteran on Wall Street and hence does not wish to reveal his identity.

29 Lechner, *op. cit.*, pp. 104 and 84.

30 Wendell Gordon, *Institutional Economics* (Austin: University of Texas, 1980), p. 223.

31 Reported by Irwin Friend in his paper “Economic Foundations of Stock Market” in James L. Bicksler, *Handbook of Financial Economics* (Amsterdam: Northholland Publishing Company, 1979), p. 156.

32 G. L. Bach, *Economics: An Introduction to Analysis and Policy* (Englewood Cliffs, NJ: Prentice Hall, 1977, 9th ed.) p. 182.

33 The general tendency of the *fuqahā'* so far appears to be against the permissibility of speculative transactions. The subject is, however, still under discussion. For a valuable discussion of stock and commodity market speculation from the point of view of the *Sharī'ah*, see the *Fiqhī* decision entitled “*Sūq al-Awrāq al-Māliyyah wa al-Badā'i'*” (*al-Bursah*)” issued by Idārah al-Majma' *al-Fiqhī* of the Rābiṭah al-'Ālam al-Islāmī and the article of Dr. Aḥmad Yūsuf Sulayman in *Al-Ittiḥād al-Dawlī li al-*

*Bunūk al-Islāmiyyah, Al-Mawsū‘ah al-‘Ilmiyyah wa al-‘Amāliyyah*, vol. 5, pp. 389-431, particularly the summary on pp. 429-31. See also, Bayt al-Tamwil al-Kuwaiti, *Al-Fatāwā al-Shar‘iyyah* (Kuwait, 1980), pp. 45-9. See also, Dr. Monzer Kahf, *Islamic Economy* (Plainfield, Indiana: The Muslim Students Association of the United States and Canada, 1978), p. 80; and M. Akram Khan, “Inflation and the Islamic Economy: a closed economy model”, in M. Ariff, *op. cit.*, pp. 240-2.

34 Federal Reserve Chairman Paul Volcker, in a letter to the chief executives of all member banks, warned against speculative loans, loans made to retire stocks, loans to finance takeovers, and loans involving any extraordinary financing “except as they may clearly involve the improvement in the nation’s productive capabilities” (*Fortune*, 17 December, 1979, p. 40). This warning may remain unheeded under capitalism because the system is not tuned to its acceptance (see the views of Prof. Horvitz following Volcker’s warning). In the Islamic system, however, every effort should be made to minimise the use of scarce credit resources for all unproductive purposes.

35 See M. Fahim Khan, “Islamic Banking as Practised Now in the World”, in Ziauddin Ahmed *et al.*, *Money and Banking in Islam* (Jeddah: International Centre for Research in Islamic Economics, King Abdulaziz University, 1963), pp. 259-90; Munawar Iqbal and M. Fahim Khan, *A Survey of Issues and a Programme for Research in Monetary and Fiscal Economics of Islam* (Jeddah: International Centre for Research in Islamic Economics, King Abdulaziz University, 1981), pp. 33-48; Abdel Rāhīm Hamdi, “The Operations of Faisal Islamic Bank (Sudan)”, in M. Azizul Haq *et al.*, *Readings in Islamic Banking* (Dhaka: Bangladesh Islamic

Bankers’ Association, 1982), pp. IX-20-46; Ingo Karsten, “Islam and Financial Intermediation”, *IMF Staff Papers*, March 1982, pp. 108-42; and Roger Cooper, “A Calculator in One Hand and Koran in the Other” , *Euromoney*, November 1981, pp. 44-64.

36 See “Promotion, Regulation and Supervision of Islamic Banks”, report prepared by a Committee of the governors of central banks and monetary authorities of the member states of the Organisation of the Islamic Conference, and adopted by the governors at their fourth meeting held in Khartoum on 7-8 March, 1981.



## CHAPTER 5

### Objections and Rationale

A number of objections have been raised against the *ribā-free* economy alleging that such a system will face difficulties and would not be practicable. It is therefore necessary to evaluate the nature and significance of these objections. This exercise will also help indicate the rationale behind the prohibition of *ribā*.<sup>1</sup> To the extent that there may be some weight in any of the objections, it is necessary to suggest ways of solving the problems.

#### Allocation of Resources

One of the objections raised against an interest-free economy is that it will not be able to bring about an optimum allocation of resources. The reason given for this is that interest is a price and like all prices it performs the function of allocating 'scarce' loanable funds among the 'infinite' users of such funds in an objective manner on the basis of ability to pay the price. If the demand for, or supply of, loanable funds changes, a new equilibrium is reached at a different rate of interest.

This objection is based on two assumptions. The first assumption is that in the absence of interest, loanable funds will be available 'free' to borrowers, the demand will thus be infinitely large and there will be no mechanism for equating demand with supply. This implies that interest is the only objective criterion for allocation of resources and, in its absence, scarce financial resources will be used inefficiently to the detriment of society. The second assumption is that the money rate of interest has been a successful mechanism in allocating resources optimally and that profit cannot perform the function efficiently.

The first assumption is baseless because funds will not be available 'free' in the Islamic system. They will be available at a cost, and the cost will be the 'share' in profit. The rate of profit will hence become a criterion for allocation of resources as well as the mechanism for equating demand with supply. The greater

the expected or *ex-ante* rate of profit in any business, the greater may be the supply of funds to that business. If the actual or *ex-post* profit for certain businesses is consistently lower than the *ex-ante* profit such businesses may face difficulty in raising funds in the future. Therefore, while *ex-ante* profit will be immediately important in determining the flow of investment, the *ex-post* performance will be crucial for the future success of the business in raising funds. This should help enforce a greater discipline in investments through a more careful evaluation of projects, weeding out all inefficient and unproductive projects. This is not the same in interest-based investments. The interest-oriented lender does not share in the risk of the business financed. He shifts the entire risk of business to the entrepreneur and assures himself of a predetermined rate of return irrespective of the ultimate net outcome of the borrower's business. He thus does not have to undertake as thorough an evaluation as the *sāhib al-māl* would have to undertake in a *ribā-free* economy either by himself or with the help of a bank or consulting firm. Because of a two-sided evaluation of projects, the rate of profit in the Islamic system should be a more efficient mechanism for allocation of resources than interest can ever be in the capitalist system.

The second assumption that the money rate of interest has been an efficient mechanism for allocating resources is also not valid. There is little evidence to support the contention that allocation of resources is efficient in interest-based capitalist economies. Convincing evidence to the contrary is in fact available. Enzler Conrad and Johnson have found compelling evidence to conclude that in the United States "the existing capital stock is misallocated - probably seriously - among sectors of the economy and types of capital."<sup>2</sup> Pareto optimum in the allocation of resources takes place only in the dream world of perfectly competitive equilibrium models in which market economies have been theoretically formalised. Malinvaud has accordingly pointed out that "When the inter-temporal aspect of resource allocation is put forward, one cannot but be impressed by the inadequacy of these models as describing the actual working of our economies."<sup>3</sup> Ralph Turvey contends that "the money rate of interest does not rule the roost" and feels that "the

rate of interest was irrelevant to investment decisions" and "should be replaced by the price of existing equipment (or share prices)".<sup>4</sup>

Moreover, the 'equilibrium' rate of interest is only a text-book phenomenon. In reality an efficient 'market clearing' rate does not exist. Instead there is a theoretical amalgam of a host of long-term and short-term rates with sizeable differences and variations in their levels and without any clear conception of how these numerous rates can be combined into a single measure. Moreover, all the rates which should be combined into the equilibrium rate can by no means be observed in the market. What is important for economic decisions is the expected *real* rate of interest which cannot be observed in the market and cannot be approximated reliably by econometric techniques.<sup>5</sup>

The rate of interest tends to be a 'perverted' price and reflects price discrimination in favour of the rich - the more 'credit-worthy' a borrower is supposed to be, the lower is the rate of interest he pays and vice versa. The result is that 'big' business is able to get more funds at a lower price because of its 'higher' credit rating. Thus those who are most able to bear the burden because of their bigness or claimed 'higher' productivity bear the least burden. In contrast, medium and small businesses, which may sometimes be more productive in terms of contribution to the national product per unit of financing used and at least equally 'credit-worthy' in terms of honesty and integrity, may be able to secure relatively much smaller amounts at substantially higher rates of interest. Hence many potentially high-yielding investments are never made because of lack of access to funds which flow instead into less productive but 'secure' hands.<sup>6</sup>

Therefore, the rate of interest reflects, not the 'objective' criterion of the productivity of the business, but the 'biased' criterion of 'credit rating'. This is one reason why in the capitalist system, big business has grown bigger beyond the point dictated by economies of scale, thus contributing to monopoly power, while medium and small businesses have often been throttled by being deprived of credit. This is particularly so when interest rates rise and create a liquidity crunch by reducing the internal cash flows. Small businesses are rarely given a respite by the lending banks. Loans to them are

recalled at the slightest sign of trouble, thus causing widespread bankruptcies. However, when big businesses are in trouble, there is rescheduling accompanied by additional lines of credit. Does this indicate an optimum allocation of resources or an efficient banking system?<sup>7</sup>

Instead, if credit is made available on the basis of profitability as a criterion, then not only will the banks be more careful and rational in evaluating projects but also small, medium and big business would stand on an equal footing. The higher the rate of profit, the greater will be the ability to secure funds. Big business, if it is really more profitable, should pay a higher and not smaller rate of return to the lending institutions. The Islamic system could reflect an innate ability to favour entrepreneurs with talent, drive and innovation, but who, as Ingo Karsten has put it, “have not yet established their credit worthiness”.<sup>8</sup> Thus resources would not only be more *effectively utilised* but also *equitably distributed*. It is not possible to rectify adequately the inequalities generated by capitalism through the tax system without coming to grips with the basic causes of such inequalities. The Islamic system should therefore, through the elimination of interest, the introduction of profit-sharing and a broad-based use of bank resources, be able to redistribute profits from big business to depositors and small enterprises, thus removing one of the major causes of inequalities.

Hence the charge that an interest-free economy would be unable to allocate resources optimally is baseless. In fact, the Islamic system of profit-sharing should be able not only to bring about greater efficiency in the allocation of resources but also reduce the concentration of wealth and power and foster socio-economic justice.

### **Savings and Capital Formation**

An apprehension has been expressed that because of a positive social rate of time preference, further accentuated by the erosive effect of inflation, there will be little positive private sector saving and capital formation in an Islamic economy.<sup>9</sup> This apprehension is misfounded because empirical evidence does not indicate a significant positive correlation between interest and

saving even in industrial countries.<sup>10</sup> The impact of interest rates on savings in developing countries has been found to be negligible in most studies.<sup>11</sup>

Moreover, even on theoretical grounds, the assumption of a positive time preference used by Bohm- Bawerk has been rejected by a number of prominent economists. In fact, Graaf has doubted its very existence.<sup>12</sup> Graaf may, perhaps, be an extreme case. It has however, been generally argued that a rational consumer may have a positive, zero or negative time preference.<sup>13</sup>

In spite of being myopic, individuals are obliged to save because the future is uncertain and the world of 'perfect foresight' assumed in theoretical economic models exists nowhere. Essentially saving depends not only on present income and consumption but also on expected future income and consumption needs. Since no one knows future income and needs, there is a tendency to save for 'a rainy day' in spite of the time preference. Such a natural tendency should be further strengthened by the Islamic values spurning conspicuous consumption. If the Islamic values are actualised, there should be a high degree of positive correlation between income and savings after a comfortable standard of living has been reached irrespective of the variations in the rate of return.<sup>14</sup>

If individuals save, then they are obliged to look for profitable avenues for investment of their savings to offset any positive time preference they may have, the erosive effect of inflation, and future uncertainties about income and consumption needs. There is no reason to suppose that the negative effect of positive time preference and inflation on savings, to the extent to which it exists, could not be offset effectively by income from, and appreciation in, equity Investments. Savings would flow into equity investments with this objective, particularly if all investments have by necessity to be equity-based and no other rational alternative is available except that of holding the savings idle, earning no return. Moreover, even in the capitalist system, all savings do not go into interest-based financial assets.



As already indicated, several alternative forms of equity investments would be available for ‘sleeping’ as well as ‘active’ investors in an Islamic economy. There would not only be *mudārabah* or *shirkah* forms of financial participation but also shares of joint stock companies and *mudārabah* deposits as well as equity investments in financial institutions, including commercial banks, investment trusts, venture capitalists and cooperative societies, all reformed and reconstituted to fulfil the needs of the Islamic economy. Also available would be the relatively less risky outlets of leasing and *murābahah* or *bay‘ mu‘ajjal* (see “Other Forms of Investment” in Chapter 6).

For ‘sleeping’ investors, such investments could be made available with different degrees of risk, maturity and convenience. Some may be less risky than others, with the apparent degree of risk being offset by the expected rate of return (profit + appreciation). Unlike the capitalist system where equity investments are mainly open-ended because of the availability of close-ended interest-based investments of varying maturities, the Islamic economy should develop instruments of varying maturities for equity investments to satisfy the tastes and needs of different investors with respect to risk and liquidity.

For active investors there will be their own sole proprietorship or partnership businesses to invest in, and there is no reason to assume that with the abolition of interest they will not continue to save for investment in their own businesses. In fact, with the Islamic emphasis on equity financing, there should be a greater urge to save for investment in one’s own business. If there are profitable opportunities for investment which cannot be exploited by reliance merely on internal cash flows, access could be had to premises, equipment and supplies through leasing, *murābahah* or *bay‘ mu‘ajjal*, and suppliers’ credits. Businesses desiring further expansion could also mobilise resources on the basis of profit-sharing, *murābahah* or *shirkah* (Appendix 11). They will, however, do so when they really need the funds and it may be safely assumed that they will not act in a self-defeating manner by cheating their financiers. Market forces will take care of those who act in such a self-defeating manner. Nevertheless, a state-regulated proper auditing system can be instituted to

safeguard the interest of investors (see the section on Investment Audit Corporation in the chapter on Institutional Setting). ..

Joint stock companies should also play an important role in an Islamic economy. Their shares would be available to investors who are not 'active' or do not wish to make their funds available to sole proprietors or partnerships. Corporate equities constitute a substantial proportion of total capital formation in capitalist economies. Moreover, corporate savings have also played an important role in capital formation. In the United States, over the three years from 1977-80, undistributed profits plus capital consumption allowances generated a net internal cash flow that was five times the dividends paid.<sup>15</sup> Of the total capital expenditure of \$299.1 billion by non-financial businesses and corporations in the United States in 1980, \$259.5 billion or 87 per cent, came out of internal sources (undistributed profits, capital consumption allowances and other internal sources). The balance was financed by resort to new equity (\$11.4 billion) and debt (\$28.2 billion).<sup>16</sup> There is no reason to expect that in an Islamic economy corporations will stop saving. There may be in fact a greater incentive to save because it would not be possible to raise financing through interest-based borrowings.

In addition, financial institutions, investment trusts, cooperative societies and venture capitalists will also play an important role in mobilising funds on an equity or profit-sharing basis for investment in various businesses looking for funds. It is always possible for an individual investor to diversify and reduce his risk by making financial institutions and investment trusts a vehicle for his investments because such institutions diversify their own risk by properly regulating their exposure to different sectors of the economy as well as to individuals and firms.

The assumption that savings would dry up in an Islamic economy could be supported only if one could build a solid case clearly demonstrating that all savings not invested will be stolen and all investments, whether through the channels of sole proprietorships, partnerships, joint stock companies, or financial institutions, will *definitely* suffer losses. Only such a definite expectation could accentuate the positive social rate of time

preference. However, such a possibility is not only remote but also impossible. It must be clearly understood that the return on equity in an Islamic economy will not be equal to just 'profit' but will rather be the sum of what constitutes 'interest + profits' in the capitalist economy and is called 'the return on capital' (equity + borrowing). It will include the reward for saving and risk-taking, on the one hand, and entrepreneurship, management and innovation, on the other. One can imagine that 'profit' in the capitalist sense may be negative for some enterprises but it is difficult to visualise that the sum of both interest and profit would be negative, and particularly for all enterprises. Since nominal interest is never negative, 'interest + profit' could be negative only in exceptional circumstances.

Hence the Islamic system should be able to ensure justice between the entrepreneur and the financier. No one would be assured of a predetermined rate of return. One must participate in the risk and share in the outcome of business. This may not necessarily change the total outcome. It would no doubt change the distribution of the total outcome in accordance with the Islamic norm of socio-economic justice. It would also eliminate the erratic and irrational fluctuation between the shares of the savers or financiers and the entrepreneurs. Hence situations where the savers suffer (if interest is low and profit is high) or the entrepreneurs suffer (if interest is high and profit is low or negative) would be eliminated and justice established between the two. The impact of this should be healthy on both savers and entrepreneurs.

It would therefore not be realistic to assume that the abolition of interest will reduce capital formation in the private sector of an Islamic economy. On the contrary, the injustice in the distribution of the reward between the financier and the entrepreneur, which both fluctuating and fixed interest rates introduce, tends to distort the signalling mechanism of the price system, brings about a misallocation of resources and ultimately slows down capital formation. This distortion takes place irrespective of whether interest rates are high or low.

High interest rates have served as an important deterrent to investment in the capitalist system. For the period 1970-78,

interest payments represented one-third of the return on capital before tax. This was three times the share of the 1960s and six times that of the 1950s.<sup>17</sup> Since interest costs are at the expense of profits, there has been an “erosion of corporate profitability” which according to the BIS Annual Report, “is a key factor in the weakness of the overall volume of investment”.<sup>18</sup> Hence the proportion of risk capital in total financing (equity + debt) has declined.

Shareholders’ equity in the US non-financial corporations constituted two-thirds of total financing in 1950, but declined to nearly half of total financing in 1978.<sup>19</sup> The main reason for the secular decline in the growth of capital stock has not been the lack of aggregate demand but higher interest rates.<sup>20</sup> According to Liebling the growth of corporate debt represents:

... an ominous development because it raises break-even points in profitability, makes business more vulnerable to cyclical down turns, and tends to shorten the magnitude and direction of cyclical expansions. From the stand point of individual enterprises it makes more fragile the latter’s ability to weather unexpected vicissitudes that are frequently encountered in business. It introduces a fixed cost element that is as burdensome as other fixed costs during periods of economic stagnation and contraction.<sup>21</sup>

The lower rates of capital formation in the United States have brought about the vicious circle of decline in productivity, which has in turn reduced the ability to offset the rising cost of borrowed capital. There has consequently been a decline in profitability and further decline in the rate of capital formation.<sup>22</sup> With corporate earnings in a free fall and cash flows squeezed, business dependence upon debt has grown further.<sup>23</sup> And since, because of uncertainties in the financial markets, a larger proportion of this debt has been of short maturity, acquired at high interest rates, most traditional indicators of corporate financial health have weakened.<sup>24</sup>

Low interest rates are equally the culprits. While high interest rates penalise entrepreneurs, low interest rates hurt savers who invest in interest-based instruments. By channelling only a meagre return to the investors, and particularly to small

investors, low interest rates have been a sure way of exploiting millions of small depositors and exacerbating the inequalities of income and wealth. Through most of recent history interest rates have been low as a result, not of market forces, but of administrative fiat and monetary policies. Low interest rates also stimulated borrowing for consumption by both households and governments and have thereby increased inflationary pressures. When payments became due, the savings ratio declined and created a capital shortage. Low interest rates also promoted unproductive investments and accentuated commodity and stock market speculation. Moreover, they induced “excessively labour-saving investments” which generated unemployment. Hence by distorting the price of capital, low interest rates have stimulated consumption, reduced the gross savings ratios, lowered the quality of investments and created capital shortages. The GATT Report thus rightly concludes that “Avoiding the waste of capital through all forms of misinvestment is an equally, if not more, important way of coping with the capital shortage.”<sup>25</sup>

Hence, the creation of a positive and invigorating investment climate requires the perennial maintenance of justice and balance between the savers and the entrepreneurs. It would be but realistic to assume that the abolition of *ribā*, reliance on equity financing and ensuring an equitable distribution of ‘profit + interest’ among financiers and entrepreneurs can provide such a climate and lead to a substantial and steady rise in the demand for, and supply of, risk capital. Moreover, the discipline introduced by the need to ‘participate’ in risk in the allocative decisions of financial institutions should tend to shift resources from ‘speculation-oriented’ loans to ‘productive’ loans and thus exercise a healthy influence on economic activity in general.

### **Stability**

It has also been alleged, without of course even an effort to provide logical or empirical support that a wholly equity-based system will be highly unstable.<sup>26</sup> This is also a misfounded apprehension. On the contrary, it may in fact be asserted that interest is one of the important destabilising factors in the capitalist economies. Milton Friedman posing the question of “What accounts for this unprecedentedly erratic behaviour of the

US economy?”, responds by saying, “The answer that leaps to mind is the correspondingly erratic behaviour of interest rates.”<sup>27</sup> Mr. Iacocca, Chairman of the Chrysler Corporation, observes that interest rates have been so volatile “that no one can plan for the future.”<sup>28</sup>

The erratic fluctuations of the rate of interest create gyratic shifts in financial resources between users, sectors of the economy and countries, causing erratic movements in loan-based investments, commodity and stock prices and exchange rates. They also bring about a shift in short- and long-term commitment of funds and between equity and loan financing. The high degree of interest rate volatility has injected great uncertainty into the investment market which has had the effect of driving borrowers and lenders alike from the longer end of the debt market into the shorter end, thus fundamentally altering the investment decisions of businessmen. The share of interest in the total return on invested capital also keeps on fluctuating, making it difficult to take long-term investment decisions with confidence. Moreover, with every rise in the rate of interest in a floating rate system in a short-ended market there is a rise in the rate of business failures<sup>29</sup> not because of any inefficiency or slackness on the part of the proprietor but because of the sudden decline in his share of the total return on capital. This has the same effect as would the erratic movements in the profit-sharing ratio between the financier and entrepreneur in an Islamic economy. This is however inconceivable because the ratio would be determined by custom, considerations of justice, and remain contractually stable throughout the duration of the financing agreement. Business failures mean not only personal financial losses to proprietors and stockholders, but also a decline in employment, output, investment and productive capacity - losses which take longer, and are more difficult to make up. All these factors no doubt have serious implications for economic activity and stability.

In a wholly equity-based system, with the profit dependent on the profit-sharing ratio and the ultimate outcome of the business, the share of the entrepreneur or the financier cannot fluctuate violently from week-to-week or even month-to-month.

Moreover the distribution of the total return on capital (profit + interest) between the entrepreneur and the financier would be determined more equitably by economic considerations and not by speculative financial market forces. As Hicks has rightly pointed out, interest has to be paid in good or bad times alike. Dividends can, however, be reduced in bad times and, in extreme situations, even passed. So the burden of finance by shares is less. There is no doubt that in good times an increased dividend would be expected, but it is precisely in such times that the burden of higher dividend can be borne. “The firm would be insuring itself to some extent”, to use his precise words, “against a strain which in difficult conditions can be serious, at the cost of an increased payment in conditions when it would be easy to meet it. It is in this sense that the riskiness of its position would be diminished. „<sup>30</sup> This factor should tend to have the effect of substantially reducing business failures, and in turn dampening, rather than accentuating, economic instability.

Greater stability of the equity-based system as against a credit-based system has also been recognised by a number of prominent Western economists. Henry Simons, the University of Chicago economist, writing after World War II under the strong influence of the depression of the 1930s, argued that the Great Depression was caused by changes in business confidence arising from an unstable credit system. He believed that the danger of economic instability would be minimised if no resort were made to borrowing, particularly short-term borrowing, and if all investments were held in the form of equity.<sup>31</sup> Hyman Minsky, writing more recently, argues that when each firm finances its own cash flow and plans to invest its own retained profits, there is no problem of effective demand, the financial system is robust and investment has great inertia. But when firms can raise outside finance by borrowing from rentiers or banks the system is prone to instability, particularly because “bank credit is, or at least has been, notoriously unstable”.<sup>32</sup> Joan Robinson also argues -that investment arising from a debt structure:

is not tethered by a particular ratio to the value of the stock of capital. Any rise in investment above the former ratio

increases the current flow of profits and encourages further investment and a rise in the proportion of borrowing to own finance. Soon schemes of investment are being planned that will be viable only if the overall rate of investment continues to rise. A fragile debt structure has been built-up. When the acceleration in the rate of investment tapers off, some businesses find current receipts less than current obligations, and a financial collapse occurs.<sup>33</sup>

It is not difficult to visualise why fluctuating interest rates can be destabilising. If the rate of interest is low in relation to 'profit + interest', it accentuates the demand for funds for all investments including 'secondary' investments and, as indicated earlier, reduces the quality of total investments. This is one of the reasons why, with a decline in interest rates, stock and commodity market speculation usually goes up and pushes up stock and commodity prices.<sup>34</sup> This makes it difficult to obtain funds for real long-term investment because the commitment of funds for speculative purposes is short-term while that for real investments is long-term. The rising speculative activity creates a concern in official circles and leads to the adoption of a restrictive monetary policy which raises interest rates. This reduces speculative activity but does not raise 'primary' investments because the rate of return on risk and venture capital declines as a result of the rise in interest rates. Hence venture capital tends to remain at a relative disadvantage irrespective of whether the rate of interest is high or low. However, there is a greater degree of fluctuation in speculative activity. Since the stock and commodity markets are presumed to be the 'barometers' of the economy, the interest-triggered fluctuations in these markets exert a destabilising influence on the whole economy.<sup>35</sup>

Interest rate also vitiates the operation of monetary policy. The central bank can either control the rates of interest or the stock of money. If it tries to stabilise the rates of interest it loses control over the money supply. If it tries to attain a certain targeted growth in money supply, the rates of interest, particularly the short-term rates, become volatile. Experience has indicated that it is impossible to regulate both in such a balanced



manner that inflation is checked without hurting investment. It has been suggested that short-term fluctuations in the money stock do not matter as long as the long-run growth is in line with the targeted trend. This is however not valid because volatile short-term fluctuations breed uncertainties and make long-run planning extremely difficult for investors.<sup>36</sup> It has also been argued that short-term fluctuations in interest rates do not matter as long as long-run rates are on course. This assumption has proved to be false because the fluctuations in short-term interest rates generate uncertainties, adversely affect investments, which are normally sensitive to movements in interest rates, and bring about gyrations in foreign exchange, commodity and stock markets.

Interest rate volatility has defeated all efforts to restore stability to exchange rates. In a fixed parity system it makes it impossible to keep the exchange rates pegged because of the movement of 'hot' money to take advantage of interest rate differentials. The effort to keep the exchange rate pegged leads to a significant loss of central bank reserves and impairs confidence in the strength of the currency. In a floating exchange rate system, where the rate tries to find its own equilibrium level and fluctuates excessively from day to day in response to international interest rate movements and speculative forces bearing no relationship to underlying economic conditions, it becomes difficult to predict exchange rates. This renders long-term planning almost impossible. For sectors of the economy where competition is tough and the profit margins are small, such unpredictable slides and surges in exchange rates exert an unhealthy influence. A country facing a recession is unable to keep its interest rates low because such a policy leads to an outflow of funds, depreciates the exchange rate of its currency, and raises the cost of living. To prevent an even deeper plunge in the value of its currency, the recession-ridden country is forced to maintain its interest rates at a higher level than dictated by the need for recovery. This, in turn, slows down the recovery and undermines confidence in the government. Hence there have been proposals to bring about interest rate coordination among major industrial countries. But such a coordination has so far proved to be an impossible task because all countries are rarely

in the same phase of the business cycle. Exchange rate volatility hence continues and “worsens the climate of uncertainty in which economic decisions are taken, discourages capital formation and leads to a misallocation of resources”.<sup>37</sup>

The elimination of interest and introduction of profit-and loss sharing would “not change the level of uncertainty”, as Dr. Anas Zarqa’ has rightly indicated. It would, however, redistribute the “consequences of uncertainty over all parties to a business”<sup>38</sup> It would moreover, by removing the daily destabilising influence of fluctuating interest rates, bring about a commitment of funds for a longer period and also introduce a discipline in investment decisions. In such an environment the strength or weakness of a currency would tend to depend on the underlying strength of the economy, particularly the rate of inflation, and exchange rates would reflect more nearly the strength of the real non-speculative factors. Accompanied by the Islamic emphasis on internal stability in the value of money, exchange rates should prove to be more stable because all other factors influencing exchange rates, such as cyclical developments, structural imbalances and differences in growth rates, are of a long-run nature and influence expectations about long-term trends in exchange rates.

### **Economic Growth**

It is also pointed out that the prospects for growth would be bleak in an Islamic economy after the abolition of interest.<sup>39</sup> This criticism is also invalid. The basic ingredients for sustained growth are saving, investment, hard and conscientious work, technological progress and creative management. The healthy influence of Islam on saving and capital formation has already been indicated. Islam has recognised the role of profit and has allowed the individual to pursue it, though within the bounds of moral values and constraints of general welfare. It has also been shown that allocation of resources would tend to be more efficient and equitable in an Islamic economy than in the conventional interest-based system.

The abolition of interest and its replacement by profit-sharing according to a fair ratio between the financier and the

entrepreneur should remove one of the major sources of uncertainty and injustice and be more conducive to investment and growth. It must be appreciated that the entrepreneur is the primary force behind all investment decisions and removal of one of the basic sources of uncertainty and injustice is bound to have a favourable effect on his decision making. By turning “savers into entrepreneurs”, using the words of Ingo Karsten, the risks of business can be more equitably distributed, thereby improving the investment climate. Moreover, by involving the savers and the banks in the success of the entrepreneur’s business, greater expertise should become available to the entrepreneurs, leading to an improvement in the availability of information, skills, efficiency and profitability. More productive entrepreneurship should lead to increased investment.<sup>40</sup>

Islam is absolutely positive in terms of its esteem for hard work. One of the primary obligations of a Muslim is to fulfil all his responsibilities conscientiously and diligently with the maximum possible degree of care and skill. The Prophet exhorted: “God has made beneficence obligatory towards everything”,<sup>41</sup> and that “God loves that when anyone of you does a job he does it perfectly.”<sup>42</sup> This esteem for work, along with the urge to improve one’s living conditions and those of others, should be highly conducive to growth provided that an appropriate political and economic environment is available.

There is no reason to assume that there would be less incentive for technological progress and creative management in an Islamic economy. In fact the closure of all doors to resort to unfair and dishonest practices to increase one’s income should create a greater urge for technological innovation and increased efficiency. All things being equal, this may be the only way for a businessman or an industrialist to reduce costs and raise his honestly-earned (*halāl*) income.

Uncertainty is a potent source of economic inefficiency and particularly so if it makes it difficult to make any projections. This makes investors hesitant to commit funds for long-term investments. In the case of interest-based investments, the financial risk facing entrepreneurs increases because of the interest cost of capital which has to be paid irrespective of the

ultimate outcome of the business. This uncertainty is further enhanced if interest rates move erratically and the financing agreement incorporates a floating rate, as is generally the case in the present-day world. If a fixed, rather than a floating, rate is specified, then the financier tends to wait if the rate is low compared with his future expectations and the entrepreneur tends to wait if the rate is high compared with his future expectations. Commitments are hence made for extremely short periods. It is difficult to make long-term investments on the expectation of having the credit rolled over. Hence investment suffers leading ultimately to a decline in productivity and a lower growth rate.

In an environment of equity-based investments, the entrepreneur does not have to worry about two uncertainties simultaneously; firstly, the total financial return on total invested capital which is determined by the price of his product as well as the cost of his inputs, and secondly, his share of the return, determined by the fluctuating rate of interest. With the elimination of interest he has to worry only about the total return as his share is an agreed fixed proportion of it and not fluctuating with the erratic movements in interest rates. Exposure to only one of the two uncertainties should have a favourable effect on him and should make him feel more encouraged to make investments, particularly if the uncertainty introduced by inflation is also reduced.

When interest rates were low and relatively stable, the problem was not so acute. However, when interest rates rose in the 1970s, gross domestic fixed investment declined as a per cent of gross national product in Western countries<sup>43</sup> and economic growth has everywhere been appreciably slower than in the early post-war decades. The poor investment performance has been a major cause of prolonged slow growth. It is universally recognised that better investment performance is the key to faster growth and better structural adjustments.<sup>44</sup>

The best remedy would be not just to reduce interest rates, because this would not remove the future uncertainty, given the high budgetary deficits of some major industrial countries, but to promote equity financing to allow the equitable sharing of the total return on capital between the financier and the

entrepreneur. It has already been indicated that the rise in interest rates at any time reduces profits - the entrepreneur's share of the total return - creates a liquidity squeeze by reducing the internal cash flows, forces increased short-term borrowing and rolling over of credits at higher rates (the general practice of bankers being to roll over credits at somewhat higher rates), squeezing profits further and leading to bankruptcies. This vitiates the climate for long-term investments and suppresses economic growth. The fall in interest rates does not bring about a just and constructive equilibrium. It exploits savers, boosts consumer spending, heats up speculative activity and promotes unproductive investments. It also contributes to unhealthy credit expansion and inflationary pressures and hurts long-run investment and growth in the same way as high interest rates, though through a different cumulative process. Abolition of interest and introduction of profit-and-loss sharing would be the only way to create a climate of rational expectations and a stable background for entrepreneurs, financiers, savers and consumers.

The contention that Islamic values are conducive to economic growth does not imply that the concept of growth in Islam is the same as under capitalism. As already indicated earlier, Islam stands for steady growth within the framework of its overall values such that there is harmonious development of both the spiritual and economic aspects of Muslim societies and that there is no weakening of the moral fibre of human beings. The fact that Muslim countries have in general experienced slow growth rates over the last few centuries has nothing to do with Islamic values. There are a number of historical, political, institutional, social and economic factors responsible for the poverty and slow growth and it would be beyond the scope of this book to enter into this area.

### **Losses Incurred on Deposits**

A *ribā-free* economy, it is sometimes argued, will tend to discourage savers from depositing their savings in banks because they would naturally like to have a positive rate of return and would not like to see their savings eroded by any losses that profit-and-loss-sharing banking institutions may experience. This could no doubt be a genuine problem, if the apprehension

about losses is right. There is no doubt that the banks would suffer losses on some of their *mudārabah* investments. It would however be reasonable to assume that such losses would be offset by profits on most other investments and that under normal circumstances, the banks would be making a net profit. Educating public opinion may hence be necessary to remove any irrational apprehensions. Nevertheless, a number of measures could be adopted to reassure the depositors and strengthen their confidence in the system.

With respect to demand deposits, which would give no return, the reassurance could be provided through a system of deposit insurance, guaranteeing the safety of demand deposits from any losses that the banks may suffer. Some elements of such a system of deposit insurance are discussed later. With respect to time and savings deposits, the problem would still remain because of losses suffered by businesses financed by banks on the *mudārabah* or *shirkah* basis.

Will it be possible, it is asked, for banks to have the relevant data and the technical know-how to evaluate the profitability of the thousands of businesses they would be financing? Even in the conventional system banks have to evaluate the soundness of the businesses to which they are lending, because if borrowers suffer losses the banks may lose the interest as well as a part or whole of the principal. To determine the soundness of the borrower the capitalist bank has to take into account not only the character and integrity of the borrower, his business acumen, experience and capital resources but also the purpose of the advance, the nature and prospects of the business, and the source of repayment.<sup>45</sup> This is because a sound bank loan should be collectable from the anticipated income or profit of the borrower rather than from the liquidation of any collateral that may be pledged. The proper function of collateral is to minimise the risk of loss to the bank in the event of the borrower failing to realise, for reasons which neither the bank nor the borrower can foresee, sufficient resources to repay the loan with interest.<sup>46</sup> Hence even in the conventional banking system there is no escape from estimating the expected income which determines the 'self-amortising' nature of the loan.<sup>47</sup>

The Islamic bank will no doubt have to undertake an even more careful evaluation because of the risk it would itself be taking in the project financed. The Islamic bank would hence have to develop the expertise to the extent its resources permit, but beyond that it could always seek the advice of a consulting firm specialised in the project and the area concerned. It is to be expected that with the working of the Islamic system, such specialised auxiliary institutions would become available and would be adequately equipped to submit a dependable evaluation with reasonable promptness. The aggregate costs incurred by Islamic banks for evaluation of participation proposals may no doubt be somewhat higher than those of the conventional banks. These would, however, be adequately offset by the higher return from the 'prime' and 'privileged' borrowers, the greater overall health and stability of the system, and the better rewards consequently reaped by the society in terms of improved well-being and socio-economic justice.

It may also be argued that in the conventional banking system the bank need not have an interest in the income of the borrower beyond that necessary for the self-amortisation of the loan. But in the Islamic system the determination of the exact amount of profit earned by the *mudārib* would be necessary to calculate the bank's 'share'. The Islamic bank would, therefore, face a dual risk: (i) the 'moral' risk which arises from the *mudārib* declaring a loss, or a profit lower than the actual, because of lack of honesty and integrity, and (ii) the 'business' risk which arises from the behaviour of market forces being different from that expected.

The 'moral' risk may tend to be a threat only in the beginning when the system is just established. However, when the users of bank funds realise that their ability to secure funds from banks depends on the profit that their business generates, there should be an automatic check on the tendency to cheat banks. Hence market forces would have the effect of almost eliminating such a risk. Moreover, a system of properly audited accounts accompanied by special random audit of the accounts of users of bank funds (discussed later under the sub-title of Investment Audit Corporation) could be introduced to serve as a

deterrent to entrepreneurs who contemplate cheating the banks. Nevertheless, a guarantee scheme as suggested in the chapter on Monetary Policy may be initiated to minimise losses arising from the moral risk.

The business risk is also a problem for the portfolio manager of the capitalist bank because he, too, has to be constantly aware of the quality of his entire portfolio and to guard against loss through market failure. Such a risk would of course tend to be more pronounced for Islamic banks because they would not get a predetermined rate of interest and, as partners in the business equity, would not enjoy a lien on the businessman's assets. This should tend to exert a healthy effect on the Islamic economy by eliminating most of the loose and imprudent financing undertaken by banks on the 'assurance' of repayment of the principal with interest.<sup>48</sup> Such a business risk could be minimised by the Islamic bank at two levels. First, by undertaking a proper examination of the business being financed to ensure that it is sound. Second, by implementing a system of proper 'scenario planning'<sup>49</sup> and diversification of its *mudārabah* portfolio by maturities as well as by borrowers and sectors of business. If the bank diversifies its portfolio properly there is little likelihood of a 'net' loss except in rare circumstances.

Nevertheless, to reassure even the *mudārabah* depositors, it may be desirable to require the Islamic banks to build a 'loss-offsetting' reserve from their annual profits.<sup>50</sup> Once the banks have a sufficient reserve in hand, the question of loss of confidence may be of no significance. Such a reserve could also be used, if necessary, to reduce partly, but not wholly, the amplitude of fluctuations in the dividends declared for shareholders and *mudārabah* depositors. This is because banks do tend to have higher profits in boom years and lower profits, or losses, in lean years. The adoption of this practice could also serve to exert a stabilising influence on the economy.

An objection may be raised against the above suggestion on equity grounds. The loss-offsetting reserve could, however, be defended on the principle of public interest which plays an important role in *fiqh* decisions. Such a reserve would be



necessary to strengthen the *mudārabah* banks and to boost the public's confidence in their viability. Since the successful operation of the equity-based system would be in the larger interest of Islam, the small sacrifice that the depositors would be required to make should be acceptable. It could be considered in the nature of a built-in tax on the profits of *mudārabah* deposits imposed to serve a higher goal. The partial use of this reserve for relative (not absolute) stabilisation of dividends may also be defended on the same grounds, but the case may not be as strong. However, it needs to be assured that the direct benefit of this reserve does not go to the equity holders. In the case of liquidation of the bank, any balance remaining after offsetting losses on *mudārabah* deposits should be diverted to charitable pursuits, as has been stipulated in the charter of some Islamic banks.

### **Short-Term Loans**

A sixth objection to Islamic economy is that all financing is not amenable to profit-sharing: for example, call loans, overnight loans, day loans, or loans of very short maturity for which period, it is generally felt, it is not possible to have any profit-sharing arrangement because of the difficulty of determining profit for such short periods. In this case, it is argued there will be a conflict of interest between the borrower who would be happy to borrow an interest-free amount with a small service charge, and the lender, particularly the institutional lender, who would be reluctant to lend money, though for very short periods of maturity, to a borrower who he knows will profit from this loan even though it is difficult to determine the extent of the profit. Since the risk of non-payment is associated even with such loans, it is argued, such short-term loans may not be forthcoming in an Islamic system.

This whole argument is due to the inability to get out of the capitalist frame of thinking. While considering equity financing in place of interest-based loan financing, one has to examine the overall financing needs for undertaking a given volume of a specific type of business. The business then has to manage its total cash flow within this framework. Financial institutions, if they make financing available to a given business, will be

sharing in the profit and loss within the framework of a package of financing made available to the business, including long-, medium- and short-term, and not on advances provided for a day. Temporary liquidity squeezes felt by a properly run business could be relieved by the financial institution in conformity with the package and the terms of the overall agreement. The business has to operate within the precincts of such a package. This would not be different from the interest-based system where the business firm is able to get overdraft facilities from its banker in accordance with agreed principles and not beyond. A firm which is unable to manage its cash flows efficiently and does not learn to operate in accordance with such agreed relief measures could no doubt encounter difficulties. Most financing of a very short-term nature would hence have to be made part of the overall *mudārabah* or *shirkah* agreement to the mutual satisfaction of both the borrower and the lender. However, in genuine cases, the financial institution can always consider providing additional assistance as its profit-and-loss sharing will depend on the overall financing provided on a daily average basis.

The cooperative movement could also play an important role in the solution of the very short-term financial stringencies of businesses. Cooperative societies organised by small and medium-sized businesses for mutual assistance could not only help them tide over very short-term financial difficulties, but also provide them other facilities and services as indicated earlier. If all members of the society place their surplus funds in the society, they could borrow when they need, without interest or profit-sharing, in accordance with an agreed formula such that a member's net use of resources over a given period is zero. On days when most members happen to be net users, a mutual arrangement could be made between cooperative societies or an agreement could be reached with the central bank to have access to temporary liquidity.

What about the overnight or very short-term accommodation needed by financial institutions? That needed by non-bank-financial institutions and investment trusts may be arranged with commercial banks in the same overall manner as with business

firms. That needed by commercial banks themselves may be provided in accordance with the measures suggested in the chapters dealing with commercial banks and monetary policy.

### **Instalment Credit**

A seventh problem of the Islamic economy is pointed out to be consumer credit and loans for such projects as house building and cottage industries. With respect to consumer credit it has already been indicated in the section on fundamental reforms that Islam does not encourage a high consumption economy like that of capitalism. Resorting to unnecessary purchases for demonstration purposes to keep up with the Joneses is not a value of the Islamic system. Credit for this purpose should hence be discouraged as should the purchase of such goods even on cash payment.

Therefore, a substantial part of instalment credit may not be necessary. The rest, which is considered necessary for realising Islamic objectives, could be arranged by the instalment businesses on a *mudārabah* basis from individual financiers and financial institutions with whom the dealers have a profit-and-loss-sharing arrangement. In other words, the business concerned has to plan in terms of its entire cash-flow needs for all purposes, including instalment sales. It has to raise equity finance for its entire financing needs. It is on this total financing that the firm would normally be sharing profits or losses and not on individual sales. If the firm has not raised sufficient equity finance, it will be constrained to rely on cash sales. If it expands into the area of instalment sales beyond the limit justified by its resources, it could run into trouble.

Business firms would therefore have to raise sufficient equity (permanent as well as temporary), if they wish to expand sales beyond the volume permitted by their own equity. They would also have to manage their cash flows wisely without over-extending themselves. The additional sales that they are able to accomplish because of the instalment purchase facility they offer should provide them with adequate profits to satisfy the financiers' need for dividends - if not, then the business is not worthwhile in the profit-sharing framework. A substantial part of

the short-term instalment sales takes place without any additional charge for the buyer. Hence, if the stores can afford to pay interest to the financiers, they may even be able to pay a share in the profit. For instalment sales involving payment over a long period, a higher price can be charged to cover the additional cost of such sales, as has been allowed by jurists, provided that the higher price covers only the additional cost of administering such sales and does not include the element of interest (see the related discussion in the chapter on The Alternative).

Instalment purchases of socially necessary goods, like taxis, sewing machines, cottage industry equipment, freezers and the like, which are in keeping with Islamic values and goals, could be arranged through financing from the private sector on a profit-and-loss-sharing basis and supplemented by financing from specialised credit institutions established by the government or altruistic organisations for this purpose (discussed later in the chapter on Institutional Setting).

House-building finance need also not create a problem because the lending institution could share in the rent determined on the basis of that on similar property. For example, if a sum of Rls 200,000 is provided to a home-builder for a house costing, say, Rls 300,000, the financial institution would get two-thirds of the imputed rent on such housing. The rent would be paid on the unpaid portion of the loan which would keep on declining as the loan is gradually amortised. Of course, in such an arrangement, the financier may get a share in the appreciation of property values through a rise in the rent that such appreciation may lead to. House-building finance may hence be attractive for the private sector if rents rise with the rise in property values to allow the financiers the opportunity rate of return. Since this does not usually happen because of rent controls, imposed for socio-economic considerations, the government may have to play a leading role in housing finance for the construction of modest houses for low- and medium-income households. This is already the case in a number of Muslim countries.

In short, there should be no instalment finance arrangements in an Islamic society for consumer goods purchases which are unnecessary and prestige-oriented or which do not make any

difference in the 'real' well-being of the individual or his family. Financing of other essential welfare-oriented durable consumer goods purchases would involve proper cash-flow planning and the raising of sufficient equity capital. It is difficult to see why this cannot be done in an Islamic economy. If the profit element is not attractive and the instalment sale of certain goods is still considered necessary on socio-economic grounds, it would have to be arranged through specialised credit institutions, as discussed later.

### **Government Borrowing Needs**

The major objection to an interest-free economy is that, in the absence of interest, it would not be possible for the government to finance its budgetary deficits by borrowing from the private sector. Government budgetary deficit, it is argued, is an important means of generating growth and improving living standards. How will the government budgetary deficits be financed after interest has been abolished?

Deficit by definition implies that the expenditure is higher than revenue and the government is *unable* or *unwilling* to raise revenue through additional taxes. If the deficit is of a seasonal nature resulting from the uneven flow of revenue and expenditure, and does not transcend the fiscal year, it may be satisfied by borrowing from the central bank. The implications of this for money supply are discussed under monetary policy. However, if the deficit is not seasonal and transcends the fiscal year, then it is necessary to examine the nature of the expenditure, whether it is recurring or non-recurring and whether it would lead to an increase in 'real' well-being within the framework of Islamic values. It is generally acknowledged that the entire deficit presently incurred by governments is neither necessary nor desirable. Excessive deficit financing through resort to borrowing provides, in the words of Mr. Jacques de Larosiere, the Managing Director of the International Monetary Fund, "an unwarranted sense of financial ease" which "is not sustainable over the medium term".<sup>51</sup> It cannot fail to damage the economy eventually through "inflation, balance of payments disequilibrium, high interest rates, misallocation of resources,

low growth rate, increasing unemployment and eventually social tensions”.<sup>52</sup>

It would be more appropriate for an Islamic state to finance all its *normal recurring* expenditures out of tax revenues. For this purpose, there is generally no justification for deficits under normal circumstances. Deficits essentially imply postponing the payment for services received by the present generation to future generations. Since the future generations, like the present one, do not wish to pay for past deficits and also wish to postpone even a part of their own burden to the future, the public debt burden continues to rise exponentially. The argument that ‘postponing’ is for services to be enjoyed by future generations is not valid. In the case of government consumption or wasteful expenditures and war financing, the increase in internal public debt no doubt represents the transfer of the burden to future generations. Even in the case of government capital formation, it must be borne in mind that the present generation is receiving benefits from projects financed by past generations. It would be fair to expect that the present generation, like past ones, would leave behind more capital than it has received. The financing of all consumption spending as well as a part of the capital outlays out of tax revenues would not lead to a continual and rapid expansion of the public debt as has been the case in most developed as well as developing countries.

Non-recurring public sector expenditures should be examined carefully and undertaken only if they can make a positive contribution to the realisation of desired goals. Projects which are not amenable to profit-sharing because, either it is not feasible or desirable to price their services or they have a high rate of social return, should be financed out of tax revenues. They need not create a ‘bulge’ in spending if the projects are judiciously planned and properly ‘tiered’ over a number of years, or, to the extent feasible, arranged through leasing and hire purchase. Projects which are amenable to pricing and profit-sharing should be undertaken only if it is felt, after careful benefit-cost analysis, that they are viable on a commercial basis. Such projects should be financed by the government by selling shares to the private sector to the extent the government is

unable, or does not wish, to do the financing itself. This should introduce discipline in public sector spending and weed out a number of white-elephant projects which are a financial burden on the government exchequer and the public benefit of which is doubtful or not sufficient to justify the expense. Such projects are sometimes undertaken to satisfy vested interests at the expense of the populace. Introduction of the suggested discipline should help strengthen the hands of honest government officials against such vested interests.

For financing wars as well, the government should either raise funds by taxes or, if these are not sufficient, by compulsory interest-free borrowing from individuals and businesses. These should be in accordance with income and/or wealth and should be amortised over a specified period of time from war taxes. Such taxes should continue even after the war, perhaps at a lower rate, until the debt has been fully amortised.

If a war is really necessary, then there is no reason why, with the sacrifice of life and comfort that many people are making, the rich should not make a sacrifice of financial resources. In essence the only sacrifice they would be making in the case of compulsory interest-free loans is that of foregoing the interest income on such loans. This is also offset to some extent by the higher incomes they earn during the wars and possibly also by the exemption from income and wealth taxes of income lent to the government or wealth held in the form of non-interest-bearing government debt, as suggested by Dr. Siddiqi.<sup>53</sup>

If, however, the war is not necessary, then it is not worth fighting. Present-day wars are at times the product of external or internal vested interests and the discipline of not financing them through the easy resort to the interest-based public debt method should help eliminate unnecessary wars. It would also minimise the wasteful defence build-up which is made possible in both the industrial and developing countries by the easy availability of borrowed funds. The drying up of this source of finance should force nations to explore more seriously all the possible ways of peaceful co-existence.

Government subsidies are of course defensible where they are in the general public interest. However, since this is the normal rationale used by vested interests for all subsidies, there must be a really strong case for the introduction or continuation of any general subsidy in an Islamic society. A lower price not justified by costs means a subsidy for all, and is not desirable in a system committed to socio-economic justice. In the Islamic value system there is normally no justification for subsidised services to the rich or those who can afford to pay. Only those who are unable to pay a realistic price should be helped. Administrative difficulties associated with price-discrimination may not allow a lower price for the poor. Hence different methods of helping the poor need to be considered, depending on circumstances. These may include scholarships, stipends or relief payments, paid in cash or kind out of *zakāt* funds, donations or other resources raised by the government or social service organisations for this purpose. The adoption of this strategy would also help minimise the wasteful use of goods or services brought about by a general subsidy

As Hutchinson has rightly stated, “Keynes’s name and repute have been used to support policies not justified by his writings.”<sup>54</sup> The Keynesian concept of compensatory financing has been unduly exploited and deficits incurred during recessions have not been offset by surpluses in boom periods. This is because of the unpopularity of reducing spending or increasing taxes, particularly when the easy recourse to debt financing is available. Nevertheless, while the principle of public sector deficits under recessionary conditions may be accepted even in an Islamic economy, there can be no justification for deficits under prosperous or inflationary conditions. The financing of the essential recovery-oriented budgetary deficits in an Islamic economy is discussed later under commercial banks and monetary policy.

In other words, the emphasis has to be on the careful evaluation of government expenditures and the elimination of as much fat as possible. Every effort should be made to increase efficiency in government spending and reduce wastefulness and



corruption. It would be difficult to state this idea more aptly than has been done by the World Bank in the following passage

Over the longer term the challenge for developing countries is to use their limited resources more efficiently and more equitably. Every government faces this challenge: whatever the political objectives, the goal is to find the most cost-effective means of achieving them. Evidence abounds of how much can be gained from greater efficiency. . . . And in most countries the consequences of these inefficiencies are felt most by those who have least – the poor.<sup>55</sup>

The ‘easy’ availability of credit to governments on the basis of ‘willingness’ to pay interest has led to loose financing by governments. Banks pay “little attention to how borrowing countries were managing their economies” and “how their loans were being used”.<sup>56</sup> Very often governments borrow short-term because under normal circumstances short-term loans are easier to get and can be rolled over smoothly. The tragedy is that the funds raised through debt are not used for investment in ‘real’ assets but simply to meet current expenditures, to purchase unnecessary defence hardware, or to finance projects having no economic justification.<sup>57</sup> The result is a steeply rising mountain of ‘dead-weight’ debt with a continuing rise in the debt-service burden. The resort to debt is made more and more as a means to put off painful, belt-tightening decisions. But greater borrowing now leads to even more borrowing in the future to maintain the economy on its artificial growth path and to continue the debt-service payments.

Government internal borrowing from the money market results in crowding out the private sector which receives less and costlier funds. In this case the deficit not only fails to stimulate the economy but makes it weaker because borrowing for investment is more sensitive to the rise in real interest rates than borrowing for consumption. Borrowing from the central bank has limits which should not be crossed. The crossing of these limits gives rise to inflationary expectations and makes the management of the economy along a steady, non-inflationary path extremely difficult. The resort to external borrowing also

has a negative effect on the economy ultimately when an increasingly large proportion of export earnings has to be diverted to debt servicing.

Hence the removal of domestic imbalances in both the public and the private sectors is the only remedy. But this becomes difficult if easy resort can be made to borrowing. The discipline imposed by Islam, although it may appear to be difficult in the short-run, should prove to be healthy in the long-run.

There is no room here for anyone to draw the conclusion that an Islamic state can function only on the basis of strictly balanced budgets and that there can be no scope for increase in spending unless there is a simultaneous rise in taxes. Such a conclusion would be unwarranted. The conclusion that, however, inevitable is that the Islamic state must, of necessity, tailor its expenditure policy carefully and try its utmost to make the best use of available resources. This will be possible only if wasteful and unnecessary spending is avoided. This would necessitate that defence outlays be held within reasonable bounds, wasteful expenditure be eliminated, corruption be kept under control through moral reform of the society, and welfare spending be designed, not to enrich the vested interests but, in conformity with the teachings of Islam, to help those who are really in need.

In spite of this policy of honest austerity, the Islamic state can and should have reasonable levels of deficits. These may be financed in a number of ways permissible within the Islamic value system. One way of meeting these deficits would be equity financing of projects which are so amenable. Equity financing would, however, demand maximum efficiency and discipline in the management of such projects. This, unfortunately, is not the case in most public sector projects. A second way of financing deficits would be leasing, discussed in greater detail in chapter 6. It could help finance the construction of a number of public sector projects, thus leading to greater cooperation between the public and the private sectors. Since leasing would involve some risk on the part of the private sector, it would not be available for projects of questionable merit. A third way would be to revive the Islamic institution of *awqāf* (charitable trusts) for financing a number of educational, health and other social welfare projects.

If every effort is made to reduce waste and finance government projects to the extent feasible in accordance with these methods, the excessive borrowings now being resorted to may not be necessary. Deficits which still remain may be financed, in national emergencies, by compulsory lending to the government and, in normal times, by borrowings, partly from the commercial banks and partly from the central bank, as discussed in the chapters on commercial banks and monetary policy. The borrowing from the central bank should be within the limits dictated by the goal of price stability.

It needs to be clearly borne in mind that there is no escape from sacrifice and austerity, particularly for the rich, if economic development and general well-being are to be pursued. The easy availability of interest-based borrowing tends only to weaken the urge for sacrifice. As already indicated, it only postpones the sacrifice. The procrastination continues and the debt keeps on accumulating until debt-servicing becomes unbearable. Ultimately there comes a time when spending has to be cut drastically because confidence in the government's ability to service the debt has been shaken and lenders are no longer willing to lend. The socio-economic cost of such a development is exorbitantly high, as some Latin American countries have now belatedly discovered. An international rescue operation has to be arranged, including continued lending by banks and international financial institutions if a default is to be averted. In case of default, there would be the risk of a breakdown of the whole international financial system.

### **Notes and References (Chapter 5)**

1. For a valuable presentation on the subject see Dr. Muhammad Anas Zarqa's four papers; first, his discussion paper on N. H. Naqvi's paper in M. Ariff (ed.), *Monetary and Fiscal Economics of Islam* (Jeddah: King Abdulaziz University, 1982), pp. 98-106; second, his paper "An Islamic Perspective on the Economics of Discounting in Profit Evaluation", in Z. Ahmed (1983) (2), pp. 203-51; third, his paper "Stability in an interest-free Islamic economy: A Note", *Pakistan Journal of Applied Economics*, Winter 1983, pp. 181-8; and "Capital Allocation, Efficiency and Growth in an Interest-Free Islamic Economy", *Journal of Economics and Administration* (Jeddah), November 1982, pp. 43-55. See also, Dr. Ziauddin Ahmed (State Bank of Pakistan, Karachi), "Economic Rationale

of the Prohibition of Interest in Islam”, a brief paper distributed by the author privately, Dr. M. N. Siddiqi, “Rationale of Islamic Banking” (Jeddah: International Centre for Research in Islamic Economics, 1981), Ingo Karsten, “Islam and Financial Intermediation”, *IMF Staff Papers*, March 1982, particularly section 3 of the paper on effects of the profit-and-loss-sharing financial system on economic development and stability, pp. 129-36, and M. A. Mannan, “Superiority of Islamic Conception of Banking” in his *Islamic Economics: Theory and Practice* (Lahore: Shaikh Muhammad Ashraf, 1970), pp. 228-32.

2. J. J. Enzler, W. E. Conrad and Lewis Johnson, “Public Policy and Capital Formation”, *Federal Reserve Bulletin*, October 1981, p. 759.

3. E. Malinvaud, “Interest Rates in the Allocation of Resources” in F. H. Hahn and F. D. R. Brechling, *The Theory of Interest Rates* (New York: St. Martin’s Press, 1963), p. 215.

4. Ralph Turvey, “Does the Rate of Interest Rule the Roost” in F. H. Hahn and F. D. R. Brechling, *The Theory of Interest Rates Proceedings of a Conference held by the International Economic Association* (New York: St. Martin’s Press, 1966, pp. 172 and 329). In fact he asserts that”. . . we can set out a revised General Theory where the prices of real assets rather than those of paper assets occupy the centre of the picture. The theory no longer supposes that most investment is financed by fixed investment borrowing; indeed it is so general that it even applies to economies where there is no fixed interest borrowing at all. The money rate of interest does not rule the roost.” For corporate investment he suggests “a simple short-run investment function which makes investment an increasing function of the general level of share prices in relation to the supply function of new capital goods. Share prices in their turn can be treated as rising and falling with the market values of the types of real assets owned by companies” (p. 172).

5. See Thomas Mayer, *The Structure of Monetarism* (New York: W. W. Norton, 1978), p. 10; and also G. Santoni and C. Stone, “Navigating through the Interest Rate Morass: Some Basic Principles”, Federal Reserve Bank of St. Louis, *Review*, March 1981, p. 11.

6. Dr. Anas Zarqa’ pointed out in an oral exchange of views that this should be the perfectly logical outcome of interest-based financing in an economic environment with vast inequalities of wealth. Since the lender, irrespective of whether he is an individual or a banker, does not share in the risk of business, he would naturally be inclined to lend to the rich because in this case he is assured of the payment of the principal and the interest. If, however, the lender shares in the risk, he would be more concerned about the nature and profitability of the business, in which case the poor would also stand a chance. He also indicated the opinion of Mishan, who says: “Given that differences in wealth are substantial, it

would be irrational for the lender to be willing to lend as much to the impecunious as to the richer members of the society, or to lend the same amounts on the same terms to each.” (E. S. Mishan, *Cost Benefit Analysis: An Introduction* (New York: Praeger, 1971), p. 205.

The greater flow of credit to the rich in an interest-based system is a widely acknowledged fact. Galbraith, for example, says: “The large corporation of the planning system, when it must borrow, is a favoured client of the banks, insurance companies and investment banks” (*Economics and the Public Purpose*, New York: New American Library, 1975, pp. 186-7). See also, p. 297 where he says: “Those who least need to borrow and those who are most favoured are in the planning system. Those who most rely on borrowed funds, or are least favoured, are in the market system.” See also Michael Moffitt, *The World's Money: International Banking from Bretton Woods to the Brink of Insolvency* (New York: Simon & Shuster, 1983), pp. 210-11.

7. AEG Telefunken, for example, has not paid a dividend since 1973. Nevertheless, banks have continued to lend to it. See “AEG is a Nightmare to Remember”, *Economist*, 14 August, 1982, p. 53. See also Moffitt, *op. cit?* p. 211.

8. Karsten, *op. cit.*, p. 133.

9. N. H. Naqvi, *Ethics and Economics: An Islamic Synthesis* (Leicester, UK: The Islamic Foundation, 1981), pp. 119-21.

10. “There is evidence that some people save *less* rather than more at higher interest rates; and that many people save about the *same* amount regardless of the level of the interest rate and that some people are induced to consume less by the promise of higher interest returns. . . economic principles alone cannot give us a decisive prediction. The bulk of the evidence suggests that the level of interest tends to cancel out consumption and saving decisions.” P. A. Samuelson, *Economics* (New York: McGraw Hill, 8th ed., 1970), p. 576, footnote 4.

11. See, for example, R. F. Mikesell and J. E. Zinser, “The Nature of the Savings Function in Developing Countries: A Survey of the Theoretical and Empirical Literature”, *Journal of Economic Literature*, December, 1972; J. G. Williamson, “Personal Saving in Developing Nations: An Intertemporal Cross-Section from Asia”, *Economic Record*, vol. 44, 1968; H. S. Houthakker, “On Some Determinants of Saving in Developed and Underdeveloped Countries”, in E. A. Robinson, ed., *Problems in Economic Development*, (London: Macmillan, 1965); and D. R. Khatkhate, “Analytic Basis of the Working of Monetary Policy in Less Developed Countries”, IMF, *Staff Papers*, November 1972.

12. J. Graaf, *Theoretical Welfare Economics* (Cambridge: Cambridge University Press, 1971), p. 40.

13. See Zarqa', "An Islamic Perspective. . .", *op. cit.*, pp. 2-8. Dr. Zarqa' concludes after referring to the views of a number of prominent economists that". . . positive time preference is neither a principle of rationality nor an empirically established predominant tendency among consumers. It is simply one of three patterns of intertemporal choice (the other two being zero and negative time preference), each of which is rational and observable under its own conditions" (p. 7).

14. See the papers of Monzer Kahf, M. Akram Khan and M. Ariff as well as the summary on pp. 4-5 in M. Ariff, *op. cit.*

15. *Federal Reserve Bulletin*, June 1981, Table 1.49.

16. Federal Reserve, *Flow of Funds IV-80*, February 1981, p.9.

17. Herman 1. Liebling, *U. S. Corporate Profitability and Capital Formation: Are Rates of Return Sufficient?* (New York: Pergamon Policy Studies, 1980), p. 78.

18. Bank for International Settlements, *Fifty-Second Annual Report*, 1 April 1981 - 31 March, 1982 (Basle, 14 June, 1982), p. 3.

19. Liebling, *op. cit.*, pp. 4-5 and Table 13, p. 135. The secular decline in equity ratios is not true merely in the US, it is a universal phenomenon. Even in West Germany the ratio of equity capital to total capital has declined substantially. (See Horst Albach, "Risk, Capital, Business Investment and Economic Cooperation", a paper presented at the International Symposium on "Islamic Banks and Strategies of Economic Cooperation", held in Baden-Baden in May 1981.)

20. Liebling, *op. cit.*, pp. 70 and 5.

21. *Ibid.*, p. 76.

22. *Ibid.*, p. 82; Herbert Runyon concludes: "No one can argue with the simple fact that the rate of return on capital investment has declined since 1965. This is true whether the profit rate is examined on a pre-tax basis as did Feldstein and Summers or on an after tax basis as did Nordhams", "Profit a declining share to capital?" in *Business Economics* (Cleveland, Ohio), p. 93; see also, Enzler *et al.*, *op. cit.*, p. 750. See also "America Cannot Afford its Cost of Capital", an article in *The Economist*, 30 April, 1983, pp. 115-16.

23. See Bank for International Settlements (BIS), *Fifty-First Annual Report*, 1 April, 1980 - 31 March, 1981 (Basle, 15 June, 1981), p. 62. The Report concludes: "On average corporations have been much more reliant on external financing in recent years than they were in the 1960's."

24. See the weekly *Financial Digest* issued by the Manufacturers' Hanover Trust Company, 19 July, 1982, p. 1. The *Digest* shows that the proportion of cash flow absorbed by interest payments has risen continually from 25 percent in 1977 to an estimated 49 percent in 1982.

25. For the quoted expressions and a very good presentation of the effect of low interest rates on capital formation in OECD countries, see the first chapter of the Report, "International Trade 1982/83", excerpts from which were reproduced in BIS, *Press Review*, 6 September, 1983, pp. 1-5.

26. Naqvi, *op. cit.*, p. 136.

27. Milton Friedman, "The Yo-Yo U.S. Economy", *Newsweek*, 15 February, 1982, p. 4.

28. L. A. Iacocca, "How to Cut Interest Rates", *Newsweek*, 16 August, 1982, p. 4.

29. For a chart indicating the correlation between the two, see The Manufacturers' Hanover Trust Company, *Economic Report*, June 1982, p. 1.

30. Sir John Hicks, "Limited Liability: the Pros and Cons" in Tony Orhnial (ed.), *Limited Liability and the Corporation* (London: Croom Helm, 1982), p. 14.

31. Henry Simons, *Economic Policy for a Free Society* (Chicago: University of Chicago Press, 1948), p. 320.

32. Hyman Minsky, *John Maynard Keynes* (New York: Columbia University Press, 1975). See also the summary of Minsky's argument cited by Joan Robinson in "What are the Questions?", *Journal of Economic Literature*, December 1977, p. 1331. The quotation about the instability of credit is from C. P. Kindleberger, *Manias, Panics, and Crashes* (London: Macmillan, 1978), p. 16.

33. Joan Robinson, *op. cit.*, p. 1331.

34. The conclusion of Wilfred George in his *Tight Money Timing* (New York: Praeger, 1982) is that "Tight money occurring in a given time period is a major cause of a declining stock market. Easy money occurring in a given time period is a major cause of a rising stock market" (p. 154).

35. Mr. Paul A. Volcker, Chairman of the Board of Governors of the US Federal Reserve System, while testifying before a Congressional subcommittee on 21 May, 1980, remarked that, in the recent silver speculation, the Fed had been worried that transactions financed by credit had contributed to the speculation, had diverted financing from more productive uses and had been excessive. The use of credit in this way could ultimately threaten the safety and soundness of financial institutions.

Mr. Volcker further remarked that the recent speculation in the gold and silver markets had contributed to inflation and other such speculation could do likewise. *BIS Press Review*, 23 May, 1980, p. 2.

36. The Bank for International Settlements, a highly reputed international institution, rightly observes in its 1982 *Annual Report, op. cit.*, that “The increased volatility of short-term interest rates may have added another sort of uncertainty premium to long-term rates” (p. 5). The Report further observes that “The greater volatility of both interest rates and the monetary aggregates, at the same time, have joined forces with the budget to push real long-term rates upwards” (p. 5). Later on the Report makes a stronger statement saying”. . . extreme volatility in interest rates can contribute to sharp fluctuations in economic activity and may lead to structural problems in the economy and in the financial system” (p. 89). See also the reference to the two-volume Axilord Report in footnote 21, and the related discussion in the text, in the chapter on Monetary Policy.

37. *BIS 1982 Annual Report, op. cit.*, p. 3.

38. Muḥammad Anas Zarqa’, “Stability. . .”, *op. cit.*, p. 9.

39. *Naqvi, op. cit.*, p. 127; see also the answer to this by Zarqa’ (1982), *op. cit.*, pp. 103-4.

40. Ingo Karsten, *op. cit.*, pp. 131 and 129-36.

41. *Ṣaḥiḥ Muslim, Kitāb al-Ṣayd wa al-Dhabā’ih, Bāb al-’ amr bi-lḥsān.*

42. Cited on the authority of Bayhaqī’s *Shu’ab al-Īmān* by Jalāl al-Dīn al-Suyūṭī, in his *al-Jāmi’ al-Ṣaḡhīr* under *Inna Allaha* (Cairo: ‘Abd al-Ḥamīd Aḥmad Ḥanafī, n.d.) vol. 1, p. 75.

43. For a table indicating gross fixed investment as per cent of GNP since the 1960s see *BIS Annual Report, 1982, op. cit.*, p. 29.

44. See *ibid.*, pp. 27 and 29.

45. See, L. C. Mather, *The Lending Banker* (London: Waterlow & Sons, 1966), pp. 11-23.

46. Howard Cross, *Management Policies for Commercial Banks* (Englewood Cliffs, NJ: Prentice Hall, 1962), pp. 196-8.

47. The ‘anticipated income theory’ of commercial bank loans as developed by Prochnow, in contrast to the earlier ‘self-liquidating’ and ‘shiftability’ theories of loans, emphasises the earning power of the borrower as against the liquidity or transferability qualities of bank assets. This implies that the ultimate ability to liquefy borrower obligations is embodied in the earning power of the borrower or credit taker rather than in the ability to shift assets in the market place. (See H. V. Prochnow,



*Term Loans and Theories of Bank Liquidity*, New York, 1944, pp. 401-11, and H. V. Prochnow and H. V. Prochnow Jr., eds., *The Changing World of Banking*, New York, 1974, pp. 166-7.) If even in the capitalist system, the commercial banks have to estimate the borrower's income to determine the self-amortising nature of credit, why should it be a problem in the Islamic banking system?

48. David Lasselles, while commenting on the shocks which have jarred the world banking industry, says, that "the banks which took losses appear to have brought a good part of the trouble on themselves, largely through questionable management". About the US, he adds: "American banks are particularly susceptible in this regard. With 14,000 of them beating the same well-trodden paths for business, it is easy to see how management can lose sight of the distinction between quality and quantity of earnings which is so important to sound banking" ("Poor Homework by the Banks", *Financial Times*, 29 July, 1982, p. 21). According to *Time Magazine*, Chase Manhattan's nonperforming loans amounted to 48 per cent of shareholders' equity; for Citicorp the ratio was 32 per cent, and for Continental Illinois, 121 per cent. "As bad as they are, the banks' problem-loan figures are understated because they do not include many questionable loans to foreign countries" (*Time*, 1 November, 1982, p. 49).

49. See S. P. Bradley and D. B. Crane, *Management of Bank Portfolios* (New York: John Wiley, 1975), pp. 22-7.

50. This proposal has also been made by Aḥmad A. Najjar, *Al-Mad-khallla al-Nazariyyah al-Iqtisidiyyah fī al-Manhaj al-Islāmi* (Cairo: *Al-Ittiḥād al-Bunūk al-Islāmiyyah*, 1980), p. 179; and M. N. Siddiqi, *Banking Without Interest* (Leicester, UK: The Islamic Foundation, 1983), pp. 50-1.

51. "Plea for 'responsible' bank lending", *Financial Times*, 7 September, 1982.

52. "Restoring Fiscal Discipline: A Vital Element of a Policy for Economic Recovery", an address delivered by J. de Larosiere, Managing Director of the International Monetary Fund, on 16 March, to the American Enterprise Institute in Washington, DC, *IMF Survey*, 22 March, 1982, p. 84.

53. See M. N. Siddiqi, *Banking Without Interest* (Leicester, UK: The Islamic Foundation, 1983), p. 145.

54. T. W. Hutchinson, *Keynes Versus the Keynesians* (London: The Institute of Economic Affairs, 1977), p. x.

55. International Bank for Reconstruction and Development, *World Development Report 1983* (Washington, DC, 1983), p. 126.

56. "Recyclers' Recession", *Economist*, 7 August, 1982, p. 10.

57. Mr. de Larosiere stated in the address referred to above that “Unfortunately, in recent years foreign borrowing has often been used to finance current and/or unproductive expenditures” (p. 85). For a number of examples of wasteful and unproductive spending, see “The Debt Bomb Threat”, *Time*, 10 January, 1983, pp. 4-11. The *Economist* has made a very pertinent observation with regard to excessive borrowing: “What nonsense is it to believe that money equals wealth. Mexico would be a much wealthier country today had it borrowed \$40 billion rather than \$80 billion. Its money would have been sounder, its economy would have grown stronger, its unemployment would have been less; and its politicians would have been poorer” (“Bottomless Debt”, *Economist*, 11 December, 1982, p. 12).

## CHAPTER 6

### **Institutional Setting**

The above discussion has provided the gist of the objectives, rationale and mechanics of the Islamic banking system. It is now necessary to discuss the institutional framework that would incorporate the fundamental changes suggested, help achieve the socio-economic objectives of the Islamic society and solve the major problems encountered by the conventional system. Although the proposed framework may outwardly appear to be the same as that in the capitalist system, in essence it is different because the objectives, mechanics, powers and the scope and responsibilities of these institutions would be entirely different.

The following network of institutions would be needed:

- (i) The central bank
- (ii) The commercial banks
- (iii) Non-bank financial institutions (NBFIs)
- (iv) Specialised credit institutions
- (v) Deposit insurance corporation (DIC)
- (vi) Investment audit corporation

The scope and responsibilities of these institutions are discussed below. Each of these institutions would be an integral part of the system and it may not be possible to dispense with any of them if the desired objectives are to be realised. The commercial banks, the NBFIs and the specialised credit institutions are together termed financial institutions in this book.

#### (i) THE CENTRAL BANK

The central bank should be the pivot of the Islamic banking system, because only through its conscientious and creative effort can the Islamic money and banking system

achieve its self-actualisation. It should be an autonomous government institution responsible for the realisation of the socioeconomic goals of the Islamic economy in, and through, the money and banking field.

### **Functions**

Like all central banks, the Islamic central bank should be responsible for the issue of currency and, in coordination with the government, for its internal and external stability. It should act as banker to the government and the commercial banks. It should make arrangements for clearance and settlement of cheques and for transfers and should act as lender of last resort. It should guide, supervise and regulate the commercial banks,<sup>1</sup> the non-bank and specialised financial institutions, the Deposit Insurance Corporation and the Investment Audit Corporation without significantly jeopardising the autonomy of these institutions. Unlike the conventional central banks, it should also bear the responsibility of foreclosing the possibility of concentration of wealth and power in the hands of vested interests through the financial institutions.

In keeping with the goals discussed in Chapter 1, stabilisation of the real value of money should constitute an extremely important function of the central bank to actualise the health and sustained, steady growth of the Islamic economy and to ensure socio-economic justice. For this purpose it would have to keep a close watch on money supply, to ensure that the growth in money is not out of step with that in real output. This does not imply that the money supply is the only variable influencing prices. All it implies is that money supply matters and that, without its proper regulation, one of the important instruments for realising the economic goals of Islam will have been blunted.

The central bank should be the primary institution responsible for implementing the country's monetary policy. For this purpose it should use whatever instruments and methods are necessary and not in conflict with the teachings of the *Shari'ah* (discussed later in the section on monetary

policy). Since the central bank cannot realise its goal of monetary stability without cooperation from the government, a harmonious fiscal policy would be indispensable.<sup>2</sup>

The central bank will also have to play a positive role in the promotion, regulation and supervision of all financial institutions with the objective of helping them and making them healthier and stronger. For this purpose it may have to review all existing laws related to interest-based financial institutions and amend or reconstitute them in the light of Islamic teachings. The reformed banking legislation should reflect the different needs of the Islamic system. It should be conceived with the objective of not suffocating banks but rather enabling them to play their proper role in the Islamic economy and respond successfully to the different and changing needs of the Islamic banking system. It should authorise the central bank to prescribe minimum capital and reserve requirements and liquidity ratios in accordance with the nature of deposits and the assets of the banks. It should lay down sufficient safeguards to ensure the safety of depositors' funds and the health and development of the system. It should also prevent bank directors and other vested interests from exploiting the banks and their resources for serving their selfish ends.

The central bank should not confine its regulatory role merely to the commercial banks. Its vigilance and assistance must envelope all other financial and auxiliary institutions to ensure their health and development and to safeguard the public interest. If other government agencies are responsible for promoting and regulating financial and auxiliary institutions other than the commercial banks, then there should be proper coordination between the central bank and other regulatory authorities to bring about harmony in their promotional and regulatory functions.

### **Crisis Handling**

The profit-and-loss-sharing system may not permit extensive borrowing by the commercial banks from the central bank as is the case in some countries.<sup>3</sup> Such borrowing is not

necessarily a blessing as chronic indebtedness of the commercial banks to the central bank is often regarded as a source of weakness.<sup>4</sup> Nevertheless, in the conventional banking system, it is considered necessary for the central bank to act as lender of last resort to ensure sufficient liquidity and to sustain the banks in case of both liquidity and solvency crises. The Islamic central bank would be no exception. Its ingenuity would be reflected in the way it handled crisis situations without bailing out bank management and yet safeguarding the interest of depositors and equity holders who are not a part of the management.

The liquidity crisis could arise because in a profit-and-loss-sharing framework the bank may not be able to withdraw its equity-oriented loan until the project or the venture has reached successful fruition. However, even in the conventional system, while it is theoretically possible for the banks to withdraw the principal amount on due date, very often the bank has to, or is prepared to, agree to re-rolling. Therefore, if the Islamic commercial bank faces a liquidity crisis and is unable to make an alternate arrangement for liquidity, the central bank cannot afford to remain indifferent. It should act as lender of last resort within the framework suggested later, but, of course, with appropriate penalties and warnings, accompanied by a specially-tailored corrective programme. The penalties are desirable, because as Kindleberger has rightly pointed out, "If the markets know in advance that help is forthcoming under generous dispensations, they break down more frequently and function less efficiently."<sup>5</sup>

A solvency crisis arises when the amount of bad debts to be written off exceeds the equity capital of the bank, making the bank technically insolvent. The bank lacks not merely ready cash, as in a liquidity crisis, but also sufficient real assets to back its deposits and sustain losses. Since conventional banks are highly geared, the loss of even around 5 per cent of assets can create a solvency crisis. Temporary accommodation from the central bank provides the bank with a brief respite and enables it to survive until remedial measures are enforced and become effective.

The solvency crisis may tend to be of lesser gravity in the Islamic system because of the relatively large equity base of the bank along with a substantial volume of *muḍārabah* deposits. These should be sufficient to protect demand depositors. Nevertheless, insurance of demand deposits should be instituted to prevent any run on banks and the central bank should be ready to act as lender of last resort. The purpose would be to enable the bank to survive and to reduce the losses to the *muḍārabah* depositors and equity holders. This is necessary for maintaining confidence in the banking system. .

The commercial bank concerned should be given sufficient relief and opportunity to enable it to rectify its affairs. The central bank should also require banks to build ample reserves to offset losses and to write off bad and doubtful investments. Appropriate penalties should be imposed on the management, and regulatory and remedial measures should also be taken to prevent the recurrence of such crises. Curbs should be imposed on imprudent lending and investments and effective examination should be regularly undertaken to ensure this. Ultimately, however, a great deal would depend on the honesty and professional commitment of central bank officers and the prudent and competent management of financial institutions because detailed rules and procedures need to be avoided to offer banks enough leeway for creative activity.

### **Supervision**

Bank supervision and examination should be more important in an Islamic system because of the greater risk that the banks would be shouldering in their business. However, unlike the examination of conventional banks, it may be necessary to ensure that in addition to proper documentation, the projects financed are sound. This would, of course, be a difficult task. It may, however, be possible to examine a random sample of projects financed to ensure that banks do not indulge in financing speculative or unduly risky ventures. Supervision should, however, not be concerned solely with

individual banks. It should acquire an operational importance and should aim at promoting the efficiency and stability of the whole financial system by means of action directed towards both the system itself and its individual components without interfering in normal operational decisions. Moreover, supervision presupposes adequate disclosure and accurate information and proper auditing. The central bank should play an important role in determining the requirements for this purpose. It should try to strengthen internal controls and issue policy guidelines, and monitor the quality of assets and operations. It should reform the concepts and procedures of auditing to ensure soundness and honesty.

### **Allocation of Credit**

The central bank should also have the power to guide and regulate the investment operations of financial institutions with a view to bring about an allocation of credit which is in conformity with Islamic goals. In the words of the governors of central banks and monetary authorities of Muslim countries, the central bank should have the power to “issue directives regarding the purposes for which financing may or may not be made, the maximum limits of such financing, the cash margins to be maintained and the ratio of collateral to be obtained in respect of such financing”.<sup>6</sup> A value-oriented allocation of credit is, however, a task which the central bank cannot achieve by itself. It requires a value-oriented plan along with the Islamic orientation of businessmen as well as bankers. In the absence of a proper plan prepared in the light of Islamic teachings, the central bank, like other government organisations may have no guidelines to go by and they may all operate at cross purposes. In the absence of a moral orientation all central bank directives may be directly or indirectly circumvented.

### **Pioneering Role**

Since the Islamic central bank will be at the rudder of an entirely different and challenging system, it cannot afford to be a passive onlooker or a tame follower of conventional techniques. It must play a pioneering and active role in the



whole process of Islamisation and continued evolution of the banking system, at least until the system has become viable and strong. Just like a mother, it will have to conceive, prepare for the birth, nourish, educate and help the Islamic banking system to grow. This is because the system, operating within an equity financing framework will need new techniques, proper supporting institutions, different auditing methods and a changed legal framework. The central bank will have to play the role of an innovator, adviser to the government as well as the financial institutions, and educator of the society. It will have to make arrangements for the training of officers and other employees of banks in the goals and mechanics of the new system.

The central bank should, however, guard against the danger of becoming overly restrictive in its outlook. If it imposes too many controls, it may not allow the Islamic banking system to flex its muscles. This may throttle innovation and development and prevent adaptation to changing circumstances. In the initial phase it may in fact be difficult to lay down detailed legislation because of lack of mature experience. Once a law is passed, it may be amended only through a slow and cumbersome process. In the meanwhile a great deal of harm may be caused. This fact should be carefully borne in mind before detailed legislation is introduced. Essentially there is no escape from education and the moral reform of bankers and their customers. Dr. Ziauddin Ahmed has very well emphasised that “The resurgence of Islamic spirit is the greatest assurance for the success of Islamic banks and their onward march.”<sup>7</sup>

The honest and efficient fulfilment by the central bank of its crucial and pivotal role would be difficult without a strong and competent man at the helm. It would hence be necessary that the governor of the central bank should not only be a man of great integrity and high moral calibre but should also have a deep understanding of the *Shari'ah* and the technical aspects of the money and banking fields. He should enjoy a high status in the government hierarchy and be appointed for a sufficiently long period.

To ensure the autonomy of the central bank it should be assured of an independent source of income to finance its expenditures. It should be allowed to raise income through (i) service charges levied on the government, the commercial banks and other financial institutions for various services rendered to them and (ii) investment of statutory reserves maintained by the commercial banks. To the extent necessary it may also be allowed to retain a part of the income earned from its *muḍārabah* advances to commercial banks.

#### (ii) COMMERCIAL BANKS <sup>8</sup>

##### **The Essential Differences**

While the abolition of *ribā* would be the first and essential difference between the conventional interest-based commercial banks and the Islamic banks, it would not constitute the only difference between them. The nature, outlook and operations of commercial banks would have to undergo a complete transformation.

Since the activity of commercial banks is based primarily on the use of public funds, it is essential that public interest rather than individual or group interest be served by Islamic commercial banks. This point should be the second principal difference between Islamic and conventional commercial banks. The Islamic banks should use all deposits which come from the public for serving the public interest and realising the relevant socio-economic goals of Islam. They should play a goal-oriented rather than merely a profit-maximising role and should adjust themselves to the different needs of the Islamic economy.

A third substantial difference is that the Islamic banks will be universal or multi-purpose banks and not purely commercial banks.<sup>9</sup> They would be a cross-breed of commercial and investment banks, investment trusts and investment-management institutions, and would offer a wide range of services to their customers with whom they will have to have a long-term bank-client relationship. A preponderant part of their financing would be for specific projects or ventures and most

of their very short-term financing would also be within the framework of such agreements, as indicated earlier. Their equity-oriented investments could not permit them to borrow short and lend long. This should tend to make them less crisis-prone compared to their capitalist counterparts. Since the overnight, call loan or very short-term inter-bank market may be available to them only to a limited extent within the framework discussed later, they may have to make a greater effort to match the maturities of their liabilities with the maturities of their assets.

A fourth difference is that they would have to make a more careful evaluation of applications for equity-oriented financing. Although the conventional banks also have to evaluate applications, the crutches of collateral and of non-participation in risk are nevertheless available to them and their main concern does not go beyond ensuring the security of their principal and interest receipts. Since the Islamic bank would share in the risk of the consignment, venture, business or industry, it would need to be more careful. This should introduce a healthy dimension in the whole lending business and eliminate a whole range of undesirable lending practices.

A fifth difference would be that profit-and-loss sharing would tend to foster closer relations between banks and entrepreneurs which is the hallmark of multi-purpose banks. This should help introduce financial expertise in non-financial firms and also enable the banks to assume the role of technical consultants and marketing advisers and act as catalysts in the process of industrialisation and development. The banks would take care of all the reasonable and agreed financial needs of their *muḍārabah* clients thus relieving them of the need to run around for funds to overcome their normal liquidity shortages. Like the conventional banks they may have to have an 'intensive care' unit to nurse companies in varying stages of poor health back to life. Nevertheless, the careful evaluation of projects required by profit-and-loss sharing, followed by continuing close relationship may tend to minimise cases needing such treatment.

A sixth difference would be in the framework designed to help banks overcome their liquidity shortages. In the interest-based system, it is possible for banks to resort to the money market or the central bank. Access to the money market may not be possible for extremely short periods because of the difficulty of profit-sharing in isolated loan transactions. Interest-free access to the central bank may lead to a misuse of this facility while *muḍārabah* lending by the central bank may be only within an agreed framework determined by the extent of the economy's need for high-powered money for attaining a given monetary expansion and not necessarily available whenever an individual commercial bank runs short of cash.

Three alternative arrangements may be made to solve this dilemma. First, banks could have an understanding with other banks for mutual credit facilities, as is the usual practice of conventional banks, but within the profit-and-loss-sharing - framework. Second, there could be an inter-bank cooperative arrangement to extend reciprocal accommodation to each other on condition that the net use of this facility is zero (mutual borrowings cancel out mutual lendings) over a given period. Third, the banks could create a common fund at the central bank as a part of the statutory reserve requirement to provide mutual accommodation. This is discussed under monetary policy. Of course, banks which have more frequent recourse to each other for funds would be better off having a mutual profit-and-loss-sharing arrangement. It would help banks place surplus funds and to balance their short-term assets and liabilities. In a crisis situation, when all banks face a liquidity squeeze, or individual banks are unable to get enough assistance through resort to all the three alternatives indicated above, the central bank would be the only recourse left and should act as lender of last resort within the disciplinary framework discussed earlier.

It may be argued that all the three methods would make a smaller overall contribution to the Islamic banks' funds than is the case with conventional banks. This should in fact be healthy and make banks more reliant on their own resources

and have access to other banks only when it is necessary. Excessive reliance on funding from other banks is a weakness of the conventional banking system which gains limelight whenever there is a banking crisis. “How extraordinary it is”, remarks Michael Lafferty, “that banks do not take the same precautions when they lend to other banks”, and that they do not even bother to “take the trouble to look up a set of the banks’ published accounts”.<sup>11</sup> This laxity leads to an abuse of the inter-bank facility in an interest-based environment. The limitation and discipline of the inter-bank market within the profit-and-loss-sharing arrangement should exert a healthy influence.

### **Some Issues**

In the overall scheme being discussed in this book, the various objectives of the Islamic banking system could be realised whether the commercial banks are nationalised or left in the private sector. Nationalised commercial banks may help ensure the realisation of larger public interest and also enable the entire profit to be diverted to the public exchequer.<sup>12</sup> However, since privately-owned banks, with the management having a stake in the success of the bank, may be more efficient, they should not be ruled out. Their equity base should however be substantially enlarged and broadened and they should be properly regulated and supervised to ensure that they operate within the bounds of the central bank’s monetary strategy, serve the public interest and do not lead to concentration of wealth. It is also possible to have a mix of publicly- and privately-owned commercial banks.

Whether nationalised or not, it would be desirable to have a number of commercial banks to prevent concentration of power, to avoid the risk of commercial banks becoming too cumbersome and inefficient, and to ensure efficiency in their operations and improvement in their services through competition. However, while a single monopolistic banking institution is to be avoided, the unit banking system of the US style, with a few giants or holding companies wielding enormous political and economic power and a large number

of stunted dwarfs, is also undesirable. The ideal solution would be to have a number of medium-sized banking institutions which are neither so small as to be uneconomical, nor so big as to exercise enormous power. Since the general tone of business organisation in an Islamic economy would be small- and medium-scale, medium-sized banks would fit perfectly into this framework. Nevertheless, if there is need to extend large amounts of financing, syndications could be arranged by banks with the assistance of the central bank where necessary. A greater resort to syndications would also enable the banks to spread their risk, which would be extremely desirable in a profit-and-loss-sharing banking system.

The creation of deposits by commercial banks, as discussed earlier, may be recognised in the Islamic system provided that (a) appropriate measures are taken to ensure that the creation of derivative deposits is in accordance with the non-inflationary financing needs of the economy, and (b) that the 'seigniorage' realised from derivative deposits benefits society as a whole and not a vested interest group.

Only commercial banks should however be allowed to accept demand deposits and to cash cheques. This is essential to control effectively the ability of the private sector to create money and to ensure that private institutions other than commercial banks do not exercise this privilege. The corollary of this conclusion is that financial institutions other than commercial banks should be required to hold their own liquid funds in commercial banks and to make major payments through cheques drawn on these banks.

Since mobilisation of savings would be an important value of the Islamic system, because of the rich contribution this is capable of making toward capital formation, employment creation and the welfare of the society, it would be desirable to inculcate the saving and the banking habit among the masses. A number of measures may be adopted to induce people to save more and to place their idle savings in banks, thus enabling their use for the welfare of the *ummah*. One of

these is the establishment of a large network of Islamic banks to overcome the general resistance of the masses towards 'banks' because of their association with interest which they, unlike the Western-minded elite, are convinced is *ḥarām*.

### **Resource Mobilisation**

A substantial part of commercial bank resources should come out of equity capital. There is no reason why in the essentially equity-oriented Islamic system, banks, like other businesses, should not have a substantial equity base. As discussed earlier, a low ratio of equity to total resources has not proved to be a healthy practice for banks. It would be better for Islamic banks to get away at the very beginning from this unhealthy precedent of conventional banks. Vested interests who wish to have a controlling hand in policy decisions may wish to keep the equity low. Safety of the depositors' funds however requires higher equity. Moreover, savers would also like to have a greater opportunity to invest in bank shares. What the ratio of equity to total resources should actually be cannot be specified in a vacuum. The Islamic central banks should prescribe some ratio depending on the circumstances of their own countries.

As is the case with conventional banks, the Islamic banks should also mobilise resources through demand as well as *muḍārabah* (savings, time and fixed) deposits. The greater the Islamic banks' success in this task, the greater will be the service they would be rendering the *ummah*. In practically all Muslim countries, the conventional banks have been unable to penetrate a predominant part of the rural as well as urban population because of a number of factors, an important one being the lack of faith of the Muslim masses in interest-based banking institutions. The possibility of getting a *ḥalāl*, return on savings placed in Islamic banks may draw them into the banking system and thus contribute richly to capital formation. It may also reduce wasteful spending and obviate the need for freezing savings in unproductive assets, which are at present the main outlet available for the savings of those who are not themselves active investors. As Dr. Nienhaus has

rightly pointed out, the “Islamic banks can be an instrument for the integration of the vast majority of the population into the financial system”, and “the probable impact of well-designed Islamic banks for the initiation of a self-supporting process of capital formation can hardly be overestimated”.<sup>13</sup>

Demand deposits may, like their counterpart in the conventional system, be withdrawn on demand, be fully insured, and earn no return. The rationale behind demand deposits receiving no share in profit is that they would be fully insured and, according to the *Sharī‘ah*, a share in profit is not admissible without a share in risk. Absence of return on demand deposits may help induce savers to get into equity and *muḍārabah* deposits, thus increasing the availability of venture capital to businesses, as is desirable in an Islamic economy.

*Muḍārabah* deposits will, like equity, share in the profits and losses, if any, of the bank. The depositor’s share in profit would be based on his average balance over the period of profit distribution (quarter, half year or year). To create confidence in the *muḍārabah* depositors, consideration may be given to building a loss-offsetting fund out of profits earned on *muḍārabah* deposits to be used to write off losses. Since *muḍārabah* deposits, unlike equity, would be temporary and close-ended, they would be redeemable upon maturity. Hence their value, though subject to increase or decrease as a result of profit or loss, may not appreciate or depreciate like that of stocks and shares in response to market forces. The *muḍārabah* depositor would accordingly be exposed to lesser risk than the equity holder. Moreover, *muḍārabah* depositors would not participate in the management of the bank like shareholders. Their interest must hence be represented at the meetings of shareholders and the board or directors by representatives of the depositors and/or nominees of the central bank.

### **Resource Use**

The total of all (demand plus *muḍārabah*) deposits placed with commercial banks could be utilised by them in a number



of ways. Discussed below are some possible alternatives. The ratios suggested are only illustrative and not definitive. They would need to be changed by the commercial banks or the central bank in the light of the banks' own individual circumstances or the demands of the economy and monetary policy.

(i) *Cash*: Cash may absorb about <sup>10</sup> per cent of the commercial banks' deposit liabilities and may include not only cash-in-vault but also cash items in process of collection, demand balances with other banks and excess balances with the central bank. The actual size of bank cash will essentially be determined by the development of banking habit, the use of cash in the country, and the time taken in clearing cheques in the process of collection.

(ii) *Statutory Reserves*: The commercial banks should be required to hold a certain proportion, say 10--20 per cent, of their demand deposits with the central bank as statutory reserves. This statutory reserve requirement may be varied by the central bank in accordance with the dictates of monetary policy.

There are two reasons for suggesting a statutory reserve requirement only against demand deposits. Firstly, the *muḍārabah* deposits are treated in the Islamic system like bank equity and, since there is no statutory reserve requirement against other forms of equity, there is no reason why *muḍārabah* deposits should be subject to such a requirement. Secondly, because of the equity nature of the investments of Islamic commercial banks, they may have to hold relatively larger cash-in-vault and reserves. The objectives of monetary policy may be accomplished by control of high-powered money at source as discussed under monetary policy.

The funds thus received by the central bank may be invested by it to derive income for covering its expenses, including, if considered desirable, the reimbursement of commercial banks for the cost of mobilising statutory deposits. Since interest-bearing government securities will not be available to the Islamic central bank, unlike its capitalist

counterpart, the Islamic central bank will have to find alternatives for investment. The central bank may make these funds available to the government, statutory organisations, commercial banks and other financial institutions on the basis of *muḍārabah*. However, it may withhold from investment whatever funds it considers necessary for management of monetary policy. There may be an objection to the central bank's use of commercial banks and other financial institutions as a conduit for its investments. This is of course not necessary if adequate alternative agreeable avenues of investment are available to the central bank.

(iii) The Government: A certain proportion of commercial bank demand deposits up to a maximum of, say, <sup>25</sup> per cent, should be diverted to the government to enable it to finance socially-beneficial projects in which profit-sharing is either not feasible or desirable. This will be in addition to the amount diverted to the government by the central bank for expanding the monetary base (Mo) to attain a certain desired rate of growth in money supply.

The rationale for this is that, since the funds available to banks through demand deposits belong to the public and the banks will not pay any return on these deposits, which will also be fully insured and thus involve no risk of loss, a part of the benefit should go to the public. The best way of doing this is to divert a part of the total pool of resources thus realised to the public treasury to finance socially-necessary projects without any interest burden on the public exchequer. This proposal implies that commercial banks are the agents of the public for mobilising the society's idle resources. Hence the resources thus mobilised should be used mainly for social benefit, but may be used partly by the commercial banks for private profit to the extent to which the society permits them to do so in the larger social interest.

It will thus be possible to make funds available for financing projects having large social benefits but small or no direct measurable economic return which could be used for profit-sharing. As discussed earlier, this amount should be

utilised by the government only for those projects which will be of widespread public benefit and will help achieve the Islamic goals of eradicating poverty, social and economic justice, and equitable distribution of income and wealth.

The amount so diverted should be considered as a *qard ḥasan* to the government against which it will issue non-interest-bearing securities, which, because of the absence of any return, will tend to be non-marketable. The government should pay a service charge on this amount equivalent to 25 per cent of the out-of-pocket operational cost of banks in mobilising demand deposits and rendering the services related to these deposits. This service charge would not be in the nature of *ribā* because the government would only be reimbursing the commercial banks on a pro-rata basis for costs incurred by them in acting as agents for mobilising the idle funds of the public. In addition to paying this service charge, the government should also bear, on a pro-rata basis, the costs of running the Deposit Insurance Corporation and Investment Audit Corporation and other such institutions, as these costs constitute a part of the total cost of running the banking system. Since the government shares a part of the benefit it should also bear a proportionate share of the cost. Such payments will ensure that the cost of *ribā*-free borrowing by the government from the banks does not become a burden on the banks or the public, and that the government does not get finances without sharing at least proportionately the operating cost of the banking system.

It may be argued that the existence of non-marketable securities in commercial bank portfolios will deprive the central bank of an important instrument of monetary policy. This objection is not valid because the central bank could even use these securities for monetary policy purposes. It could increase or decrease the requirement for these securities and even lend against these to commercial banks when the commercial banks are short of liquidity or a change in high-powered money is desired.

(iv) Investments: The balance of the funds left with the commercial banks - about 45-60 per cent of demand deposits and all of *muḍārabah* deposits - may be used by them in a number of ways to generate profits.

### **Forms of Investment**

The banks would be playing an important role in economic development and the general welfare of the Muslim *ummah* if they could make the resources mobilised by them available, either directly or through the non-bank financial institutions, to entrepreneurs who have the potential of putting them to productive use. There is no dearth of competent and dependable entrepreneurs in Muslim countries. But they are unable to have access to financial resources.<sup>14</sup> The conventional banks make financing available mainly to 'credit-worthy' businessmen, which essentially implies businessmen who own substantial personal wealth and have the ability to offer a collateral which has a higher value than the amount of financing sought.

. Financing by the conventional banks therefore gets directed mainly to the rich. As indicated earlier (see Chapter 5, footnote 6 and the relevant text) this is the natural consequence of interest-based lending. Since the bank does not share in the risk and its income from the loan is predetermined, its main interest lies in assuring itself of the repayment of principal with interest, which it tends to do through the collateral.

Just as intelligence is not a prerogative of the rich, so also entrepreneurship is not an inborn or exclusive characteristic of the wealthy. In fact middle class individuals who are employed by the rich and on whose skill, drive and conscientious effort the success of most businesses usually depends have greater entrepreneurial talent. However, by being rewarded only in terms of salary and not to the full extent of their contribution, the entrepreneurial talent of many withers away before blooming to the maximum level. Others who manage to start their own business are kept constantly frustrated in their aspirations by the inability to have access to

venture capital from banks or other financial institutions. The waste or ineffective use of rich entrepreneurial potential that results thereby also depresses the rate of economic growth. The *ummah*'s savings remain underutilised and improperly rewarded. This, along with the unrealistic tax structure, accentuates the incentive for flight of capital.

Since Islamic banks would be operating on a profit-and-loss-sharing framework they would tend to be attracted more by the profit than the collateral. They would thus be more disposed to hunt for talent, innovation and promise rather than just collateral. To maximise their profits within the value frame of Islam, Islamic banks may be more disposed to finance those entrepreneurs whose proposals beat the promise of being most productive in terms of profits. Their financing may be on a short-, medium- or long-term basis depending on the nature of the project. It may vary from financing a specific consignment, order, or contract to supplying medium- and long-term funds for venture capital or equity. To what extent and for how long the Islamic banks would be willing to commit funds would depend on the strength of the proposals presented by the entrepreneurs and their own perspective of the present and future market conditions and the need to diversify their portfolios in terms of businesses, areas and maturities. The moral risk arising from the non-availability of collateral may be handled in the manner suggested in the chapter on Monetary Policy.

#### *Mudārabah, Shirkah and Corporation*

The most important and unanimously agreed upon form of financing provided by Islamic banks would be on the basis of either *mudārabah*, *shirkah* or acquisition of shares of joint stock companies. In the case of *mudārabah*, the bank would not participate in the management of the business financed. It could, however, exercise adequate supervision to ensure that the funds were being used in accordance with the *mudārabah* agreement. This would make the banks *mudāribs* (entrepreneurs) with respect to their depositors and *ashāb al-māl* (financiers) with respect to their borrowers. This is what

has come to be termed as two-tier *muḍārabah* in current Islamic literature on the subject,<sup>15</sup> Of the total financing agreed between the bank and the *muḍārib*, a part could be provided for the entire period agreed, while a part could be available in the form of overdraft facilities for short periods to offset the *muḍārib*'s funds in transit or to take care of seasonal or unforeseen shortages of liquidity. In the case of *shirkah*, the bank would also participate in the management of the business. The bank and the entrepreneur may pool their talents and expertise for furthering the business. However, since banks may not be adequately equipped with the human infrastructure needed for this purpose, the *shirkah* participation may be possible in only a few businesses. A major part of commercial bank financing would of necessity have to be in the form of *muḍārabah*. This is perhaps the reason why Islamic banking is also sometimes equated with *muḍārabah* banking. Restriction of a major part of bank financing to the *muḍārabah* form is in fact desirable because it would reduce the concentration of power in the hands of banks. In addition, if their size is kept within limits, they would not be able to spread their influence beyond a reasonable limit. The reader may refer to Chapter 3 and Appendix I for details on both *muḍārabah* and *shirkah* forms of investment.

Investment in the stocks and shares of joint stock companies, whether public or private, should be an attractive avenue for the employment of bank funds. In fact, the stocks of well-established and high-dividend yielding companies may serve as an alternative for interest-bearing government securities and bonds of private companies. With the presence of a well-organised and properly regulated stock market, the banks may be able to dispose of such stocks whenever they desire - an advantage which *muḍārabah* or *shirkah* financing may not be able to offer.

### **Other Forms of Investment**

In addition to *muḍārabah* and *shirkah* financing and investments in the stocks and shares of joint stock companies,

a number of alternative financing arrangements, within the general framework of Islamic values, have been suggested by a number of scholars. However, while there is a general consensus about *muḍārabah* and *shirkah* financing and about investments in the stocks and shares of joint stock companies, there is a continuing discussion about the permissibility of some, though not all, other forms. The general principle which is beyond dispute as being the criterion for determining the permissibility or otherwise of any method of financing is that the financier cannot avert the taking of at least some risk if he wishes to derive an income. To put this in the form of an adage, one could state with respect to all financing operations: “no risk, no gain”.

Most of the alternative forms of investment have been incorporated by the Council of Islamic Ideology in its Report, The Elimination of Interest from the Economy, submitted to the Government of Pakistan. The major alternatives recommended are: leasing, investment auctioning, *bay‘ al-mu‘ajjal*, hire-purchase, ‘normal rate of return’, ‘time multiple counter loans’, and special loans facility.<sup>16</sup> The alternative arrangements have been proposed by the Committee “in view of the difficulties faced in the practical application of profit-and-loss sharing an account of the prevalent standards of morality in the society”.<sup>17</sup> This may, however, not be the only reason why these alternatives may be allowed. The banks face the perennial need to diversify their portfolios. Although this diversification may also be possible through *muḍārabah*, *shirkah* and stocks and shares, that available through the alternatives need not be ruled out. These alternatives may tend to occupy a relatively larger proportion of commercial bank portfolios in the initial phase, and reduce gradually with the passage of time and the accumulation of experience in Islamic banking.

#### *Lease Finance*

There are two types of lease arrangements: financial leases and operating leases.<sup>18</sup> Within each category there are various sub-categories. There seems to be no need to go into

their details because this would not help in clarifying the central issues related to this discussion.

A financial lease involves a non-cancellable agreement between the bank and its customer for purchase by the bank of a specific asset and its lease to the customer for a long or intermediate term. The bank would retain ownership of the asset but the customer would have the exclusive right to the use of the asset and payment of specified rentals. At the end of the agreed period the asset reverts to the bank. The rentals would be sufficient to amortise not only the capital outlay but also to yield, after taking into account the 'salvage' value of the asset, an adequate amount of profit for the bank. The lease agreement may however include a purchase option whereby the customer can purchase the asset from the bank at the termination of the lease.

Operating leases differ from financial leases in two primary respects. First, an operating lease is cancellable and is generally written for a shorter period of time than is a financial lease. Second, in an operating lease the bank would be responsible for virtually all the expenses of ownership.

Leasing is generally allowed by the *fuqahā'*. This is because even though the *Sharī'ah* does not allow a fixed charge on financial capital, it allows a fixed charge on real capital. This is because by converting financial capital into real or non-financial assets, the financier has already taken upon himself the risk. In the case of short-term cancellable operating leases, the total risk is on the lessor, and there can be no doubt about its permissibility. However, with respect to financial leases, the non-cancellable nature of the lease may create some doubt about its permissibility. Nevertheless, even in this case the bank takes the risk with respect to the salvage value of the asset, which may be negligible due to obsolescence or the asset wearing out faster than expected. Depending on the difference between the expected and realised salvage value, the bank may reap a high or low profit or a loss. Hence leasing may be considered permissible.



### *Investment Auctioning*

This involves the preparation of a detailed feasibility study for a project by one bank or a consortium of banks and the awarding of the financing required for this project to the highest bidder. This bid would probably reflect three elements: 'goodwill' for conceiving the project, the cost of preparing the feasibility study, and the scarcity value of capital given the prevailing resource endowment of the economy. The amount of the bid would be payable in agreed instalments over a specified period of time. The liability of the bidder for the stipulated amount would be independent of whether he earns a profit or incurs a loss.

It is doubtful if investment auctioning can stand the test of permissibility. The financing banks take no risk as they are assured of a predetermined profit. The argument given by the Panel that the price bid by the investor would reflect the 'potential profitability' of the project<sup>19</sup> is not different from that given to justify interest. The 'potential profitability' of a project may however change; this being so, should the entrepreneur be the only one to shoulder the risk or should the financier also have a share in this risk? It is also possible that, as Dr. Siddiqi has pointed out, "Instead of relieving them of the burden imposed by the unjust system based on interest, . . . investment auctioning might leave the entrepreneurs worse off."<sup>20</sup> In the case of leasing and hire-purchase, the bank at least takes the risk of owning or initially purchasing a physical asset whose price could change shortly after the deal, which could become obsolete or worn out sooner than expected and whose salvage value may turn out to be less than expected.

A more appropriate alternative in the light of Islamic teachings would be to form a company and invite share subscriptions after all the promotional formalities have been finalised. The banks and the entrepreneur, who would otherwise be a bidder, could retain an agreed amount of shares in the company. Even a part of the shares retained by banks initially could be sold by them later in the stock market to

release their funds. This procedure would also provide the public with an opportunity for investment and reduce the concentration of power and ownership that the 'bid' would provide to the bidder and the 'financing' would provide to the banks. The banks would also be able to diversify their risk by not providing all or a major part of financing for one project. They, along with investment banks and venture capital institutions, could thus use their resources and their expertise more effectively to play an important promotional role in Muslim societies. The major problem in many Muslim countries is not that there is a lack of finance but that proper investment opportunities are not available to the public. Evidence for this is that whenever subscriptions are invited for properly-conceived new companies, there is an over-subscription for shares.

*Bay' al-Mu'ajjal and Bay' al-Murābahah*

In the classical *fiqh* literature *bay' al-mu'ajjal* refers to a sale against deferred payment (either in lump sum or instalments).<sup>21</sup> *Bay' al-mu'ajjal* need not have any reference to the profit margin that the supplier may earn. Its essential element which distinguishes it from a normal sale is the deferred payment. *Bay' al-murābahah* in its simplest sense refers to one of three different possibilities in a sale. One of these possibilities is *murābahah* which stands for supply of goods by the seller to the buyer at a specified profit margin mutually agreed between them. Terms of payment could be either cash or deferred. The other two possibilities are sale at cost without any profit for the seller (*tawliyah*) and sale at a specified loss (*waḍī'ah*). All three possibilities are perfectly legal from the point of view of the *Sharī'ah*.<sup>22</sup>

However, in their modern usage, both the terms (*bay' al-mu'ajjal* and *al-murābahah*) are an extension over their classical sense. *Bay' al-mu'ajjal* has been used by the Council to refer to an agreement whereby the bank purchases the goods desired by its customer, who is seeking financing for their purchase, and then sells them to the customer at an agreed price which yields a specified margin of profit to the

bank, the payment being settled by the customer within an agreed time frame either in lump sum or instalments.<sup>23</sup> This arrangement is called *bay' al- murābahah li al-āmir bi al-shirā'* (sale at an agreed margin of profit to one who has ordered their purchase) by Dr. Sāmī Ḥamūd, but has become popularly known as *murābahah*.<sup>24</sup> This form of financing is being widely used by the Islamic Development Bank for its foreign trade financing operations and also by almost all Islamic banks established so far.

This is a perfectly legitimate transaction according to the *Sharī'ah*, provided that the risk for the transaction is borne by the financier until the possession has been passed to the customer. For such a transaction to be legal, the bank would have to sign two separate contracts, one with the supplier and the other with the customer. It would not be lawful for the bank to have only one contract with the purchaser, the only service rendered by it being the remittance of the amount to the supplier on behalf of the purchaser. In this case the transaction would not be different from an interest-based arrangement. In addition to the dual contract, the bank would have to continue to be responsible until the goods were actually delivered to the customer, not necessarily by the bank, in accordance with specifications and other terms of the contract. Some writers insist that the customer should enjoy the option (*khiyār*) until the goods have been actually delivered to him.<sup>25</sup> Most other scholars, including Dr. Ḥamūd, do not consider this to be necessary. However, if the option is also available to the customer, *muḍārabah* would be unanimously acceptable.

Would it be possible for the banks to provide the option? Perhaps. Exception may be where the customer is the only or the predominant user of the commodity, because in this case the bank may not be able to sell the goods in case the customer decides not to buy the goods obtained by the bank for him. In case of option, however, the bank would be carrying a much larger risk and may have to carry out, before agreeing to the financing, a more intensive market survey than may be possible for most Islamic banks in their infancy. It

would be desirable not to make the task of Islamic banks extremely difficult from the very beginning, provided that there is a clear understanding that they would move more and more in the classical direction and do not get grounded, as feared by Dr. Siddiqi, in the 'status quo'.<sup>26</sup> The danger will, however, always remain that the *mu'ajjal* and *muḍārabah* forms of sales may deteriorate into purely financing arrangements with the agreed profit margin being no more than a camouflage for interest. Accordingly the Council has rightly stressed that it would not be advisable to use it widely or indiscriminately.<sup>27</sup>

### *The Remaining Alternatives*

The Council has also suggested financing on the basis of 'hire purchase', 'normal rate of return', 'time multiple counter-loans' (where the borrower gets a loan for say, R1s 3,000, for one year if he leaves with the bank R1s 1,000 for three years), and 'special loans facility'.<sup>28</sup> In the case of hire-purchase, the price would essentially be higher than that in cash transactions. This subject has already been discussed elsewhere. It is doubtful if financing provided on the basis of 'normal rate of return' could stand the test of permissibility indicated earlier if the 'normal' rate refers to some past rate. However, if it refers to the actual rate of return in the *muḍārib's* business during the *muḍārabah* period it could serve as a basis for profit-sharing in certain standard businesses, provided that it is possible to determine the 'normal rate of return' in accordance with some agreed formula. Financing on this basis may have the advantage of reducing the likelihood of inefficiency or unfairness on the part of the *muḍārib*. The method of 'time multiple counter - loans' could be adopted for small-scale financing, particularly within the framework of cooperative institutions. For commercial banks, it would be of limited applicability.

The banks may also provide, as a special facility, limited temporary accommodation to non- *muḍārabah* customers against a service charge. This is not out of any obligation of the banks to do so. Such financing should rather be on the

same principle as other services are rendered to certain customers to attract their deposits and other business to the bank. The *Shari'ah*, however, requires that, whenever financing is provided without profit-and-loss sharing, the service charge, if it is levied, should recover no more than the bank's out-of-pocket expenses. The bank cannot realise the opportunity cost of funds.

All the alternative forms of financing indicated above have raised a great deal of controversy and doubts have been expressed about the acceptability of some of these within the framework of Islamic values even though for a brief period.<sup>29</sup> Hence, the ultimate goal of Islamic banking should be a predominant resort to *muḍārabah*, *shirkah* and stocks and shares. Of the various other alternatives, the less controversial may also be resorted to, but to a lesser extent. Nevertheless, in the initial phase, a greater resort to the alternative techniques may be inevitable in the interest of smooth transition without disruption. But there is always the danger that once the banks adopt the alternative techniques, they may get accustomed to them and may not make a serious effort to get away from them. The caution given by the Council that "the use of these methods should be kept to the minimum extent" and "that their use as general techniques of finance may never be allowed"<sup>30</sup> may not actually be heeded. Hence the challenge faced by the central bank would be how to reduce the pangs of transition and yet ensure that the movement towards the goal continues without stagnation.

The commercial banks in the Islamic system should of course render, with or without a service charge, all banking services for which conventional banks are known. In the case of all services which do not involve the extension of financing, the banks are permitted to realise the entire opportunity cost and not merely out-of-pocket expenses. As indicated earlier, there may or may not be any service charge where the bank itself stands to gain or where there are large social benefits in providing the service concerned as, for example, in the cashing and clearing of cheques drawn on demand deposits. However, a service charge should definitely

be levied where the benefit is derived mainly by the particular individual or firm.

### ***Social Welfare Dimension***

A social welfare dimension may be introduced in all bank financing. Financing should be provided to promote employment and economic well-being in accordance with Islamic values. A conscientious effort should be made to ensure that the financing provided by Islamic banks does not promote concentration of wealth or conspicuous consumption even though the Islamic system has a built-in tendency to take care of this. The financing should go to as large a number of entrepreneurs as possible in industry, agriculture and commerce to support increased self-employment and adequate production and distribution of goods and services for meeting essential domestic needs or for export. The goal should be to make *muḍārabah* and *shirkah* financing available within reasonable amounts to a large number of entrepreneurs. Islamic banking should under no circumstances lead to inequalities of income and wealth or promote socially-undesirable consumption or investment. For this purpose, *muḍārabah* and *shirkah* financing would have to be finely interwoven with the Islamic society's goals and economic plan. Certain enabling aspects of this subject are discussed under monetary policy.

The ultimate criteria for judging the effectiveness of Islamic banks would not be just the degree to which they have eliminated interest from their operations and the profit they have earned but also the extent to which they have helped achieve other desirable socio-economic objectives of the Islamic society. Some of these may be stated to be mobilisation of savings, promotion of broad-based entrepreneurship, efficiency in the use of savings for satisfying the essential needs of the Muslim society, reducing concentration of wealth and power and contributing to financial stability. It is not expected that the banks will be able to accomplish all these in a very short period. But at least they will have to try to achieve these over the long-run. Islamic banking, which is

not just *ribā*-free but also social-welfare oriented, is no doubt a challenge to Muslim bankers. Initially such banks will face problems, but with ingenuity and creativeness it should not be difficult to solve the problems with the passage of time.

### (iii) NON-BANK FINANCIAL INSTITUTIONS (NBFIs)

The term NBFIs is being used here to denote investment trusts or banks, credit unions, cooperative societies, venture capitalists, and a range of other investment-management institutions. They would mobilise savings through equity and *muḍārabah* deposits and make them available to prospective investors. They may also manage special funds placed with them by their clients and help individual entrepreneurs and partnerships secure equity or *muḍārabah* financing. These institutions would thus play the intermediary role of helping savers find profitable avenues for their savings and helping entrepreneurs find funds for expanding their businesses.

Such institutions should in general be privately-owned. Some of them may be of a general nature while others may specialise in specific economic sectors, for example, housing construction, agriculture, industry, and trade (domestic as well as foreign). The NBFIs would thus differ from each other according to their field of activity and the nature of maturity of funds placed with them for management. The common feature of all these institutions would be that they would acquire part of their funds from their stockholders, part from commercial banks and part from *muḍārabah* (but not demand) deposits and special funds placed with them for short-medium- or long-term management. They should be medium-sized institutions with sufficient and widespread equity-base to guard against concentration of wealth and power. Accordingly, an appropriate 'gearing' ratio or 'leverage' may be desirable. They should be properly regulated to ensure fairness in their dealings and the safety of the depositors' funds. They should have a representative of the central bank and/or the depositors on their board of directors. A properly organised stock market along Islamic, non-speculative lines would be an essential auxiliary to these institutions.

The NBFIs will basically act as investment trusts and use the funds they have received to acquire equity in other businesses (without having a controlling share) and to extend *muḍārabah* advances. The *muḍārabah* financing will normally provide only the temporary (short- and medium-term) capital needs of the business financed. Long-term needs should be financed by the businesses concerned through increase in equity. The NBFIs may itself acquire the increased equity or serve as an intermediary to bring together financiers and entrepreneurs, which it will be well qualified to do because of its intimate knowledge of the market. The bringing together of financiers and entrepreneurs is the crux of the *muḍārabah* scheme. It should serve to spread ownership of business and reduce concentration of wealth.

The profits earned by the NBFIs should be allocated among their equity and deposit holders in accordance with a certain agreed formula, after providing for reserves to be built to serve as a cushion for net losses which may be incurred in certain years. The NBFIs may also be allowed to build a 'profit stabilisation fund'.

The existence of a large number of medium-sized NBFIs should, through competition among them induce greater efficiency in the management of *muḍārabah* funds and also honest reporting of profits. More *muḍārabah* funds may get diverted to institutions whose performance has been better, thus ensuring the transfer of real economic resources to their most efficient uses. In the interest-oriented capitalist banking system the depositor plays a passive role in the efficiency of the banking system because banks normally pay a more or less uniform rate of interest which is considerably smaller than both the interest earned by them and the profits earned by the borrowing enterprises. This results in a tendency to provide funds at lower rates of interest to larger borrowers with a 'high' credit rating and to serve the 'vested' interests of bank-controlling families, thus contributing substantially to unhealthy concentration of income and wealth.



Since the NBFIs will be under the market compulsion to declare a competitive rate of return on their shares and *muḍārabah* deposits, there will be a natural urge on their part to demand from the users of their equity and *muḍārabah* financing a high rate of efficiency in the use of funds. Thus it is not realistic to assume that in an interest-free banking system the *muḍāribs* will cheat the NBFIs by declaring lower rates of profit. If any *muḍārib* resorts to such practice he will tend to deprive himself of *muḍārabah* financing. Since such financing may be an important source of funds for most traders and agricultural and industrial entrepreneurs, they could hardly be expected to resort to such a self-defeating policy.

To reinforce further the above-mentioned deterrent against dishonesty in declaring profits to the NBFIs, the accounts of firms financed by NBFIs could be made subject to a random audit by the Investment Audit Corporation (IAC). The IAC may also audit the accounts of customers specifically referred by the NBFIs, particularly those with whose profit reporting they are not satisfied. The IAC could also audit the accounts of firms referred to it by any of the firm's sleeping financing partners. Exposure to such audit should serve to keep the users of equity and *muḍārabah* funds on the alert.

However, there is one factor which will almost certainly act against honesty in the reporting of profits to or by the NBFIs. This is the unrealistic tax system with unduly high tax rates forcing businesses to maintain two sets of accounts. Hence it would be necessary to rationalise the tax system so that it does not have a built-in incentive to cheat the government, the banks, and the NBFIs.

The suggested scheme of NBFIs could be questioned as leading to a concentration of wealth similar to that brought about by conventional banks in capitalist societies. The danger of concentration through the inverted pyramid of loan-equity financing and the availability of large resources to privileged borrowers will have been removed. However, the danger of concentration of power attained by NBFIs would

remain, but this could be substantially reduced by a number of measures. Firstly, the number of NBFIs should be large and none should be allowed to expand beyond a certain limit determined by the central bank. Secondly, they should be required to provide financing to a large number of entrepreneurs and not to provide more than a small proportion of their resources to anyone business or family. Thirdly, they should not be allowed to acquire a controlling stock in any business. Fourthly, none of the NBFIs' directors should be allowed to become a director in any other business. Fifthly, their effort should be to bring financiers and entrepreneurs together so that they do not themselves hold the equity for a long period. And lastly, their own equity should be broadly distributed so that any specific individual, family or group does not have a controlling ownership in these institutions. Other specific measures may be adopted by means of well-conceived and properly enforced laws to ensure that the NBFIs do not lead to concentration of wealth and power.

#### (iv) SPECIALISED CREDIT INSTITUTIONS

Both the commercial banks and the non-bank financial institutions will be profit-motivated institutions even though within the social welfare framework of Islam. Hence it is likely that a number of sectors of the economy like small agriculturists, cottage industries' operators, artisans, and taxi and truck drivers, who may need to be encouraged and supported by credit availability, may not be attractive to them. The Islamic injunction of reducing inequalities of income and wealth may necessitate the extending of credit to such sectors as well. For this purpose specialised credit institutions should be established by the government to extend either *muḍārabah* advances or *qurūḍ ḥasanah*. Resources may be provided to such institutions by the central bank out of the newly created high-powered money, as indicated earlier, or by the government, out of its resources. They should finance their expenses from the *muḍārabah* share in the profit or the service charge levied on their *qurūḍ ḥasanah*. It may also be desirable to promote cooperative societies among such small-scale businesses to enable them to make mutual arrangements

for their very short-term credit needs and also to organise bulk purchases and sales of their inputs and outputs, and help them solve their other problems.

#### (v) DEPOSIT INSURANCE CORPORATION (DIC)

*Muḍārabah* banking, if allowed to take root, should prove to be as viable as the capitalist banking system. But it is possible that demand depositors, who will not be sharing in the profits of the *muḍārabah* banks, may be apprehensive of the apparent, though not real, risk of erosion of their deposits through losses suffered by the *muḍārabah* banks, and may prefer to hoard their savings. Since this is not desirable and against the long-run interest of an Islamic society, it would be helpful if demand deposits are protected against such risk. Such protection would help remove any adverse apprehensions and build confidence in the Islamic banks. A deposit insurance scheme should, therefore, be an integral part of the Islamic banking system. A Deposit Insurance Corporation should be established to insure demand deposits at the commercial banks.<sup>31</sup> The corporation should not, however, insure *muḍārabah* deposits at either the commercial banks or the NBFIs.

Would this discourage *muḍārabah* deposits in favour of demand deposits? The prospect of losses on corporate securities has not reduced investments in corporate securities in spite of the unhealthy and destabilising speculation in stock markets. Since the opportunity to hold interest-earning assets will just not be available in the Islamic economy, the alternative to *muḍārabah* deposits and equity will only be demand deposits yielding no return. Moreover, the establishment of a loss-offsetting fund, suggested earlier, would make *muḍārabah* deposits preferable to demand deposits by substantially reducing the risk on such deposits. However, even if it is assumed that demand deposits will be preferred, the volume of investment funds will not decline because these funds could be utilised productively by the government and the banks. The DIC should be an autonomous, non-profit government-sponsored organisation, operating under the

supervision of the central bank. It should be self-sustaining with no' budgetary appropriations from the government except in the initial phase when it may receive an interest-free loan from the government, to be repaid out of reserves built by the DIC over a period of years. This will be a service rendered by the government to the banking system, partially in return for the interest-free loans it will be receiving and partly due to its obligation toward the establishment and success of the Islamic banking system.

The DIC income should consist of (i) assessments on all commercial banks at the rate of a small percentage of the average total of demand deposits after allowing for certain exclusions and deductions, and (ii) income from the investment of its reserves. The government should pay the premium on the proportion of demand deposits it obtains as an interest-free loan and the central bank should pay the premium on statutory reserves. Premium rates should allow rebates for good performance to encourage healthy banking practices. The deposit insurance fund accumulated through such premiums, would be available to meet future deposit insurance claims and related losses. Its adequacy to meet these future requirements would depend upon the soundness of the insured banks and adverse factors such as unfavourable general economic conditions.

Initially, the limited means at the disposal of the DIC would compel it to set a limit on the amount of deposits it insures. This fits into the scheme because the DIC will be able to provide coverage to all small depositors. The limit may be raised later when the reserves of the DIC have risen sufficiently, provided this is considered to be in the interest of serving the socio-economic objectives of Islam. It is, however, instructive to note that "most countries have opted for less than full coverage of deposits because of considerations of equity"<sup>32</sup> even though this approach has been subjected to increasing criticism.<sup>33</sup>

Since the DIC would be a non-profit organisation financed by the commercial banks themselves, it would be a truly

mutual or cooperative insurance company. It would hence be fully acceptable even to those *fuqahā'* who find certain types of commercial insurance unacceptable by the *Sharī'ah*.<sup>34</sup>

(vi) INVESTMENT AUDIT CORPORATION (IAC)

This should also be a government-sponsored organisation constituted in the same manner as the DIC. Its main objective should be to audit the accounts of *mudārib*s who have obtained funds from others directly or through commercial banks and NBFIs, whether in the form of equity or *mudārabah* advances. The objective is to safeguard the interest of financial institutions, depositors, and equity holders. Since it is not possible to carry out the audit of all the users of *mudārabah* funds, the IAC may carry out the audit of a random sample of *mudārib*s or those specifically referred to by *ashāb al-māl* (financiers), financial institutions or investors. Such audit will keep the users of equity and *mudārabah* funds on their guard and create a deterrent to under-reporting of profits, provided of course that, as mentioned earlier, the structure of tax rates is rationalised.

The creation of IAC would save the individual financial institution the need to hire a large staff of auditors. It will thus create a substantial economy in expenses for all financial institutions. It will also provide an assurance to investors who provide their funds directly to businesses that, in case of need, they will be able to have the accounts properly examined by a qualified, impartial institution.

All the expenses of IAC should be shared by the financial institutions in accordance with some formula which may be based on a general charge on their total *mudārabah* advances and equity investments and a specific charge on the special cases audited for them. Individual investors referring any specific business for audit may be charged a service fee depending on the nature and extent of audit required.

The creation of IAC would answer the major, though invalid, criticism against the Islamic banking system that it would require each banking institution to hire a large staff of

auditors and would make bank management very expensive. In the absence of such staff, it is argued, the banks would not be able to determine the accuracy of accounts. Market forces, as argued earlier, would automatically take care of this problem, but nevertheless, the creation of IAC would further safeguard the interests of investors.

It is important to emphasise here that the whole concept of 'audit' would have to undergo a transformation in Muslim economies.<sup>35</sup> Conventional auditing is "not expressly designed to uncover management frauds".<sup>36</sup> If the auditor performs a diligent audit and evaluates the financial statements according to "the generally accepted accounting principles", the professional obligations of the auditor have been fulfilled. The auditor has no responsibility to detect management malpractices or to determine the 'real' profit. He does not have the responsibility to check and to question.<sup>37</sup> Accounting firms generally tend to accommodate their clients, particularly the big clients, who hire them. In an Islamic system, the auditor should be required to go beyond "the generally accepted accounting principles". He should be made to assume the responsibility for detection and disclosure of dishonest and questionable acts by management. The objective should be to determine the real amount of profit so as to ensure a 'fair' return to the shareholders and *muḍārabah* depositors. The state-sponsored IAC could play an important role. It could not only set new principles for auditing in the light of Islamic teachings, but also guide and help private auditing firms in doing a more effective auditing job.

## Notes and References (Chapter 6)

1. Dr. M. Uzair has suggested that the central bank should hold a part of the equity of commercial banks. This will, according to him, divert a part of the profits to the central bank, provide it additional leverage in controlling and regulating them and give it a stake in their health and development. (See p. 214 of his article "Central Banking Operations in an Interest-Free Banking System" in M. Ariff, ed., *Monetary and Fiscal Economics of Islam*, Jeddah: International Centre for Research in Islamic Economics, King Abdulaziz University, 1982.) by the commercial banks themselves, it would be a truly mutual or cooperative insurance company.

It would hence be fully acceptable even to those *fuqahā'* who find certain types of commercial insurance unacceptable by the *Sharī'ah*.<sup>34</sup>

2. No country has a completely independent central bank with exclusive control of monetary policy. However, if monetary policy is to be successful, then the central bank should have an important say in it. Monetary policy cannot, nevertheless, be meaningfully formulated without a great deal of consultation and coordination between the central bank and the treasury.

3. Among the EEC countries, commercial bank indebtedness to the central bank differs considerably from country to country. In France, Belgium and Italy, it is normal for banks to borrow a substantial part of their reserves from the central bank. In the Netherlands, and still more in the UK, borrowing is only occasional and the bank is literally lender of last resort. Germany and Ireland occupy an intermediate position between the two extremes (Economists Advisory Group, Banking Systems and Monetary Policy in the EEC, London: The Financial Times Ltd., 1974, p. 117).

4. Ibid., p. 117. The provision of credit to banks by discounting bills and granting central bank advances has, in general, steadily declined in importance as an instrument for controlling the liquidity of the economy in many countries. See a speech by Dr. Carlo Ciampi, Governor of the Bank of Italy, in BIS Press Review, 14 October, 1982, p. 3.

5. C. P. Kindleberger, *Manias, Panics, and Crashes* (London: Macmillan, 1978), p. 6.

6. Article 25, p. 12. The Report as approved by the Governors has been reproduced in the Summary Records of the Fourth Meeting of the Governors of Central Banks and Monetary Authorities of the Member States of the Organisation of the Islamic Conference held in Khartoum on 7-8 March, 1981.

7. See the comments of Ziauddin Ahmed on the paper of Volker Nienhaus on "Profitability of Islamic PLS Banks Compared with Interest Banks" in the Journal of Research in Islamic Economics, issued by the International Centre for Research in Islamic Economics, King Abdulaziz University, Jeddah, Summer 1983, p. 68.

8. A large volume of material is now available on the subject. The reader may wish to refer to the bibliography for some major works on the subject. By way of sample may be mentioned: M. N. Siddiqi, *Banking Without Interest* (Leicester, UK: The Islamic Foundation, 1983), and *Issues in Islamic Banking* (Leicester, UK: The Islamic Foundation, 1983); M. Uzair, *Interest-free Banking* (Karachi: Royal Book Company, 1978); M. Bāqir al-Ṣadr, *Al-Bank al-Laribāwi fī al-Islām* (Beirut: Dār al-Ta'āruf li al-Maṭbū'āt, 7<sup>th</sup> ed., 1981); and Arab Republic of Egypt, *The Egyptian Study on the Establishment of the Islamic Banking System* (Cairo: 1972).

9. This would not be peculiar to Islamic banks because even in continental Europe, universal banking is widely accepted. Among the major industrial countries, only the US and the UK have a more or less watertight division between the activities of commercial banks and of investment and merchant banks.

10. D. R. Khatkhate and K.W. Riechel, "Multipurpose Banking: Its Nature, Scope and Relevance for Less Developed Countries", IMF Staff Papers, September 1980, p. 480.

11. Michael Lafferty, "Why Banks' Financial Information may Contribute to their Crisis", The Financial Times, 10 September, 1982. See also "A Jolt to be Remembered", by Peter Montagnon in The Financial Times, 1 March, 1983. According to Moffitt, "A major point of vulnerability is the banks' heavy reliance on borrowed funds", which come "primarily by borrowing from each other". In 1981 these borrowings funded more than half of the major assets of American commercial banks, up from 45 per cent five years ago (Michael Moffitt, The World's Money: International Money from Bretton Woods to the Brink of Insolvency, New York: Simon & Schuster, 1983, p. 225).

12. The performance of nationalised banks has so far been extremely disappointing in Muslim countries. Not only has efficiency gone down, but corruption has increased manifold. In private discussions, some of my friends in responsible positions have expressed the feeling that nationalised banks were sometimes more oblivious to public interest and that the general interest of the ummah may be served better by properly regulated private commercial banks.

13. Volker Nienhaus, "Islamic Banks - Philosophy, Performance and Policy", an unpublished paper, pp. 5 and 6.

14. Ibid., p. 7.

15. See M. Ariff, "Introduction", and M. N. Siddiqi, "Islamic Approach to Money and Banking and Monetary Policy - A Review", in M. Ariff, op. cit., pp. 10 and 30-3.

16. Government of Pakistan, Report of the Council of Islamic Ideology on the Elimination of Interest from the Economy (Islamabad: Council of Islamic Ideology, 1980), pp. 4 and 13-17.

17. Ibid., pp. 4-5.

18. Jules I. Bogen, Financial Handbook (New York: The Ronald Press, 4th ed., 1968), p. 303.

19. The Council's Report, op. cit., p. 14.

20. M. N. Siddiqi, Issues. . . , p. 142.

21. See the Council's Report, op cit., p. 15, para 1.16 and Articles 245-51 of the Ḥanafī compendium of *fiqh* called *Majallah al-Aḥkām al-ʿAdliyyah*. The Majallah refers to *bayʿ muʿajjal* as *bayʿ bi al-nasīʾah* or *bi al-taʿjīl wa al-taqṣīt*.



22. See Abdul Raḥmān al-Jazīrī, *Kitāb al-Fiqh ‘alā al-Madhāhib al-Arba’ah* (Cairo: al-Maktabah al- Tījariyyah al-Kubrā, n.d), vol. 2, pp. 278-82. See also Mustfa Aḥmad al-Zarqa’, *AI ‘Uqūd al-Musammāt fī al-Fiqh al-Islāmi* (Damascus: Maṭba‘ah al-Jamī‘ah al-Suriyyah, 1948), pp.64-8.

23. The Council’s Report, op. cit., para 1.16, p. 15.

24. See his book *Taṭwīr al-A‘māl al-Maṣafiyyah bima Yattaḥqu wa al-Sharī‘ah al-Islāmiyyah* (Amman: Maktabah al-Aqṣā, 1976), pp. 476-83. For valuable information on *murābaḥah*, particularly with respect to the differences among the various schools of *fiqh*, see ‘Abd al-Ḥamīd M. al-Ba‘lī, *Fiqh al- Murābaḥah* (Cairo: *Al-Ittiḥād al-Dawlī li al- Bunūk al-Islāmiyyah*, n.d.).

25. Rafīq al-Misrī, “*Kashf al-Ghiṭā’ ‘an Bay’ al-Murābaḥah li al-āmir bi al-shirā’*” in *AI-Muslim al-Mu‘āṣir, Dhū al-Ḥijjah*, 1402, pp. 179-89. See also al-Ba‘lī, op. cit., pp. 58-63. Some Islamic banks, particularly the Faisal Islamic Bank of Sudan, allow their customers the option.

26. M. N. Siddiqi, Issues. . . , op. cit., p. 143.

27. The Council’s Report, op. cit., p. 15. 28. Ibid., pp. 16-19.

29. See for example, M. N. Siddiqi, ibid., pp. 133-45. Of particular significance are Dr. Siddiqi’s comments on Investment Auctioning and *Bay’ Mu’ajjal*. See also Muḥammad Ṭāsīn, “*Bilā Sūd Bank Kārī awr Islāmī Nazariyyāti Council kī Report*”; and Shaikh Mahmūd Aḥmad, “*Sūd kī Mutabadal Asāsen*”, both being privately circulated critiques of the Council’s Report.

30. The Council’s Report, op. cit., p. 5.

31. A number of countries have introduced formal deposit and/or credit insurance schemes. For an outline of some of these systems see I. S. McCarthy, “Deposit Insurance: Theory and Practice” (pp. 578-600), IMF Staff Papers, September 1980, Table 1, pp. 584-5. The suggestion for deposit insurance has already been made by some Muslim scholars. See, for example, M. N. Siddiqi, *Banking Without Interest*, op. cit., pp. 50-1; and A. Najjar, *AI-Madkhal ila al-Nazariyyah al-Iqtisadiyyah fi ai-Islam* (Beirut, 1973), pp. 125-53.

32. See, McCarthy, op. cit., p. 598.

33. D. B. Humphrey, “100% Deposit Insurance: What would it cost?”, *Journal of Bank Research*, Autumn 1976, pp. 192-8; G. Leff, “Should Federal Deposit Insurance be 100 Percent?”, *Bankers Magazine* (Boston), Summer 1976, pp. 23-30; and F. T. Furlong, “A View on Deposit Insurance Coverage”, *Federal Reserve Bank of San Francisco, Economic Review*, Spring 1984, pp. 31-8.

34. This point was indicated to the author by Or. Anas Zarqa’.

35. Mr. Abdul Jabbar Khan, President, Habib Bank of Pakistan has emphasised that the “auditing system presently in vogue suffers from a number of weaknesses. There is, therefore, an urgent need for a thorough reappraisal of the existing laws and practices governing the role of

auditors and for evolving a really independent auditing system”. See his privately circulated paper “Commercial Banking Operations in the Interest-Free Framework”, p. 39. See also Thana’ ‘Ali al- Qabbān, *Ba‘ḍ Khaṣā’iṣ Taṭawwūr al-Fikr al-Muḥāsabī al-Mu‘āṣir wa al-Muḥāsabah al-Islāmiyyah* (Cairo: Maṭabi‘ al-Ittiḥād al-Dawlī li al- Bunūk al-Islāmīyyah, n.d.), pp. 53-75; and M. Akram Khan, “Auditing in an Islamic Framework”, unpublished paper, 1981.

36. R. K. Elliot and J. J. Willingham, *Management Fraud: Detection and Deterrence* (New York: Princeton, University Press, 1980), p. viii.

37. Alan Lechner, *Street Games: Inside Stories of the Wall Street Hustle* (New York: Harper & Row, 1980), p. 143.

## CHAPTER 7

### Monetary Policy<sup>1</sup>

The above discussion should have helped make it clear that monetary policy would have to play an important role to help realise the objectives of Islam. However, given the abolition of interest and non-availability of the tools of discount rate and open-market operations in interest-bearing government securities, some questions naturally arise: What will be the mechanism for equating the supply of money with its demand in the absence of interest as a regulating mechanism; how will monetary policy be made to play an effective role in achieving the goals of an Islamic economy discussed earlier; and what will be the alternative to interest-bearing government securities for financing government budgetary deficits in a non-inflationary framework? These are the questions that need to be addressed now.

#### The Strategy

In an Islamic economy, the demand for money would arise basically from the transactions and precautionary needs which are determined largely by the level of money income and its distribution.<sup>2</sup> The speculative demand for money is essentially triggered by interest rate fluctuations in the capitalist economies. A decline in interest rates combined with expectations about their rise induces individuals and firms to increase their money holdings. Since interest rates fluctuate frequently in the capitalist economies, there is a continuous change in the public's holdings of money balances. The abolition of interest and the levy of *zakāt* at the rate of two-and-a-half per cent per annum would not only tend to minimise the speculative demand for money and reduce the 'locking-in' effect of interest rates but also impart greater stability to the total demand for money. This would be further strengthened by a number of other factors, including:

(i) Interest-bearing assets would just not be available in an Islamic economy, leaving the holder of liquid funds the option of either taking no risk and holding them in the form of cash with no return, or taking a calculated risk and investing them in profit-and-loss-sharing assets to get at least some return;

(ii) Short-term as well as long-term investment opportunities with varying degrees of risk will presumably be available to all investors whether they are high or low risk takers, the extent of foreseeable risk being offset by the expected rate of return;

(iii) It may be safely assumed that, except in an impending recession, no holder of funds would be irrational enough to 'hoard' balances in excess of transactions and precautionary needs as long as he could use the idle balances to invest in profit-earning assets to offset at least partly the erosive effect of *zakāt*, and of inflation, to the extent to which it persists even in an Islamic economy;

(iv) The rate of profit, unlike the rate of interest, will not be predetermined. The only thing which will be predetermined will be the profit-sharing ratio; and this will not fluctuate in the manner the rate of interest does because it will be based on social and economic conventions and any changes in it will be through the pressure of market forces after prolonged negotiations. If economic prospects improve, profit will automatically rise; hence nothing is to be gained by waiting. Liquidity preference is helpful in the case of interest-bearing securities and assets because waiting could mean higher earnings when interest rates rise. Some individuals could wait to choose the proper time to purchase specific investment assets, but this would be based on their personal assessment which may not be general and may be offset by the decision of others to buy the same or other investment assets.

Liquidity preference arising from the speculative motive should therefore be insignificant in an Islamic economy. The demand for funds for equity-oriented investments would constitute a part of the total transactions demand and would depend on economic conditions and the expected rate of profit which will not be predetermined.<sup>3</sup> Since expectations about rates of profit, unlike those about the rate of interest, do not fluctuate daily or weekly, the aggregate demand for transactions needs would tend to be relatively more stable. It will be determined primarily by the value of aggregate output,<sup>4</sup> with appropriate weight given to the distribution of income, which will improve gradually in an Islamic economy depending on the extent of the government's commitment to this goal and the policies it adopts for this purpose. Relatively greater stability in the transactions

demand for money would tend to impart greater stability to the income velocity of money within a given phase of the business cycle in an Islamic economy and make its expected behaviour reasonably predictable.

Hence the variable in terms of which monetary policy should be formulated in an Islamic economy is the stock of money rather than the level of interest rates.<sup>5</sup> The Islamic central bank should gear its monetary policy to the generation of a growth in money supply which is adequate to finance the potential growth in output over the medium- and long-terms within the framework of stable prices and the other socio-economic goals of Islam. The objective should be to ensure that monetary expansion is neither 'inadequate' nor 'excessive' but sufficient to exploit fully the capacity of the economy to supply goods and services for general broad-based welfare. The growth rate aimed at should be one that is steady, realistic and sustainable over the medium and long-term and not unrealistic and erratic.

While the above strategy does recognise the importance of regulating the growth of money supply in the successful management of the economy, it does not necessarily imply a simple monetarist approach or any commitment to its ideological overtones. There is no presumption that market forces left to themselves will be able to generate sustained non-inflationary growth, remove unemployment, reduce external imbalances and help realise the other desired goals if the growth in money supply is appropriately regulated. It should, in fact, be emphasised that for a full realisation of the Islamic goals, it will not only be indispensable to reform the economy and the society along Islamic lines but it will also be necessary for the state to play a positive role, and all state policies, including fiscal, monetary and incomes, would have to converge in the same direction. Monopolistic practices would need to be curbed and every effort would have to be made to remove structural rigidities and to encourage all factors capable of generating increased supplies of essential goods and services to play their natural role.

### **Sources of Monetary Expansion**

To ensure that monetary growth is 'adequate' and not 'excessive' it would be important to monitor carefully all the

three major sources of monetary expansion. Two of these are domestic and are: one, financing of government budgetary deficits by borrowing from the central bank; and two, expansion of deposits through commercial bank credit creation. The third source of monetary growth is external and is 'monetisation' of the balance of payments surplus.

(a) *Fiscal Deficits*

There is no controversy among economists about whether fiscal deficits can be, and have been, an important source of 'excessive' monetary expansion. Attempts by the government to extract real resources at a faster rate than is sustainable at a stable price level could lead to continually rising fiscal deficits and accelerated increases in money supply, thus contributing to an inflationary spiral.<sup>6</sup> Even in major industrial countries, large fiscal deficits have been a primary cause of the failure to meet money supply targets. This has tended to shift a disproportionate burden of the fight against inflation onto monetary policy. But, as has been very well stated by the Economists Advisory Group Business Research Study, "the greater the dependence of the public sector on the banking system, the harder it is for the central bank to pursue a consistent monetary policy".<sup>7</sup>

Hence, unless we wish monetary policy to become either ineffective or highly restrictive, it is imperative that there be coordination between monetary and fiscal policies for the realisation of national goals. This underscores the need for a realistic and non-inflationary fiscal policy in Muslim countries. Therefore, a conscientious Muslim government committed to the achievement of the goals of an Islamic economy should pursue a fiscal policy which is consistent with its goals. This is all the more important because the money markets in Muslim countries are relatively underdeveloped and monetary policy cannot play as effective a role in regulating money supply as fiscal policy can. This does not necessarily rule out fiscal deficits but imposes the constraint that deficits be allowed only to the extent necessary to achieve sustainable long-run growth and broad-based well-being within the framework of stable prices.

However, the removal of 'excessive' fiscal deficits could remain a pious hope in Muslim countries as long as the primary causes of deficits are not remedied. These are: firstly, the

inability or unwillingness of governments to raise adequate finance through taxation and other non-inflationary sources to meet their essential and productive expenditures; and secondly, lack of willingness on the part of governments to eliminate or reduce substantially their unproductive and wasteful spending. Therefore, an Islamic government must, if it wishes to be true to its name, eliminate both the sources of deficits. The entire tax structure of Muslim countries needs to be impartially examined. There are certain sectors of Muslim economies which are overtaxed. There are certain other sectors which are undertaxed, not because of rational socio-economic considerations, but because of the desire to please vested interests. If the tax system is rationalised, the inequities in the system are removed and the tax administration is streamlined, tax revenues can be substantially raised with a better economic impact on incentives, output and distribution. This is however an unpleasant task and the availability of the easy recourse to deficits through borrowing inhibits the governments from undertaking this necessary task.

The need to eliminate unproductive and wasteful spending is a religious imperative for all Muslims. It is, however, particularly indispensable for governments because they use resources provided by the people as a trust, and using these wastefully or unproductively is a breach of this trust. Resources available to governments for financing their expenditures are limited in all countries, including the developing Muslim countries. They need therefore to be used efficiently and effectively with the acute consciousness of answerability before God. Such a conscientious use of funds cannot be achieved by merely whittling away at frills. It requires a careful review of the entire expenditure programme in the light of Islamic teachings, concentrating not only on how much is spent but also on how it is spent. Unless this is done, an irresponsible Muslim government, finding its recourse to the market closed, may adopt the easy course of borrowing indiscriminately from the central bank, thus causing considerable damage to the economy in addition to frustrating the realisation of Islamic goals.

After all the wasteful and unnecessary spending has been eliminated the balance of government spending may be divided

into three parts: (a) normal recurring expenditures, (b) project expenditures, and (c) emergency expenditures.

All normal recurring government expenditures, including outlays on projects not amenable to profit-and-loss-sharing arrangements, must be financed by tax revenues as argued earlier. The non-availability of debt-financing for such purposes should prove to be a hidden blessing and help introduce the needed discipline in government spending, the realisation of which is frustrated by easy access to interest-based finance. In the case of projects costing vast amounts, the bulging may be avoided, as suggested earlier, through proper timing and dovetailing of all such projects in a perspective plan and the use, wherever feasible, of leasing and hire-purchase.

Projects which are amenable to equity financing may be undertaken by the government, where this is necessary in the public interest, but the financing should be obtained by selling shares to financial institutions and the public. A commercially-oriented pricing system should be adopted without a general subsidy. All subsidies needed for the poor or low middle-class families should be arranged from *zakāt* revenues, donations or *qurūd hasanah*. Equity financing and commercial pricing should help eliminate some of the unnecessary and unproductive projects that governments sometimes undertake to satisfy vested interests. This would, no doubt, also necessitate the striking of a 'social balance' between public services and private production in the light of Islamic teachings.<sup>8</sup>

All emergency expenses like war, which cannot be financed in either one of the two ways indicated above, should be financed by compulsory borrowing as discussed earlier. Wars mean sacrifice and the sacrifice involved for the rich is only the interest foregone by them on such loans. Wars for which people are not willing to make such a sacrifice are not worth fighting and should be avoided.

Nevertheless, the government may be constrained to borrow to finance some unavoidable deficits and arrangements must be made to enable the government to do so in a non-inflationary manner. This may be done partly, and to a limited extent, through borrowing from the central bank within a non-



inflationary framework as discussed later, and partly, but also to a limited extent, from commercial banks as discussed earlier.

*(b) Commercial Bank Credit Creation*

Commercial bank deposits constitute a significant part of money supply. These deposits may, for the sake of analysis, be divided into two parts: firstly, 'primary deposits' which provide the banking system with the base money (cash-in-vault + deposits with the central bank) and 'derivative deposits' which, in a proportional reserve system, represent money created by commercial banks in the process of credit extension and constitute a major source of monetary expansion in economies with well-developed banking habits. Since derivative deposits lead to an increase in money supply in the same manner as currency issued by the government or the central bank and since this expansion, just like government deficits, has the potential of being inflationary in the absence of an offsetting growth in output, the expansion in derivative deposits must be regulated if the desired monetary growth is to be achieved. This could be accomplished by regulating the availability of base money to commercial banks. For this purpose, the absence of interest as a regulating mechanism would not be a disadvantage. It will in fact be an advantage as it will remove the destabilising effect of fluctuating interest rates, stabilise the demand for money and substantially reduce the amplitude of economic fluctuations as discussed in Chapter 5.

*(c) Balance of Payments Surplus*

Only a few Muslim countries have enjoyed a balance of payments surplus while most of them have experienced deficits. In the few that did have a surplus, the surplus did not originate in the private sector and did not lead to an automatic expansion in money supply. It did so only to the extent to which the government monetised the surplus by spending it domestically and the private sector balance of payments deficit did not offset this adequately. If, in countries with a surplus, government spending is regulated in accordance with the capacity of the economy to generate real supplies, there should be no internally-generated inflation resulting from the balance of payments surplus.

In the countries that have a deficit, it is unhealthy monetary expansion along with public and private sector conspicuous consumption which generate the balance of payments disequilibrium through current account deficits and 'underground' capital outflows. These cannot be removed without socio-economic reform at a deeper level and healthy monetary and fiscal policies in the light of Islamic teachings, as has been, or will be, discussed in the appropriate section.

### **Instruments of Monetary Policy**

Within the framework of the strategy indicated above, it may be possible to suggest the mechanics for monetary policy which may not only help regulate money supply in harmony with real money demand but also help fulfil the need for financing the government's 'genuine' deficits and achieve the other socio-economic goals of the Islamic society. The mechanics should consist of six elements.

#### *(a) Target Growth in M and Mo*

The central bank should determine annually the desired growth in money supply (M) in the light of national economic goals, including the desired but sustainable rate of economic growth and the stability in the value of money.<sup>9</sup> This target growth in M should be reviewed quarterly, or as often as necessary, in the light of the performance of the economy and the trend of important variables. This is because monetary targeting presumes that the income velocity of money is reasonably predictable over relevant periods. While, as indicated earlier, this could be expected to be truer in an Islamic economy after the abolition of interest and the implementation of the suggested reforms, it would, nevertheless, be necessary to keep the targets under constant review. The targets should not however be changed frequently but only when justified to accommodate economic shocks, both domestic and external.

Since it is well recognised that the growth in M is closely related to the growth in Mo or high-powered money, defined as currency in circulation plus deposits at the central bank, the central bank should closely regulate the availability and growth of Mo. This would of course require an appropriate goal-oriented fiscal policy and proper regulation of the access of financial institutions to central bank credit. As indicated earlier,

a sane fiscal policy is essential in all countries for meeting the monetary targets. However, it is almost indispensable in Muslim countries, where the role of monetary policy would be naturally limited because of the lack of well-organised money markets.

Since the creation of Mo results from the exercise by the central bank of the power to create money, which is a purely social prerogative, the resources derived from this power should be used, in the social-welfare-oriented value system of Islam only for accomplishing the goals of the Islamic society. They should be used particularly for financing projects that would help realise the Islamic ideal of the ummah, all of whose members are brethren, not separated by a widening gulf of income and wealth inequalities.

To help bring the above goal to a reality, the central bank should make the total Mo created by it available partly to the government and partly to the commercial banks and the specialised financial institutions. The proportion of Mo diverted by the central bank to each of these sectors should, like the total size of Mo, be determined by economic conditions, the goals of the Islamic economy, and the dictates of monetary policy. The part of Mo made available to the government should be an interest-free loan to enable the government to finance its social welfare projects, including the provision of housing, medical facilities and education to the poor.

The part of Mo made available to the commercial banks, which would be mainly in the form of *mudārabah* advances and not discounting of bills, should be used by the central bank as a major quantitative as well as qualitative instrument of credit control. It should be adequate to enable the commercial banks to finance the desired growth of economic activity in the private sector without generating any inflationary heat. In the rationing of this credit among commercial banks, the central bank should keep in view the promotion of commercial bank credit for specific objectives and sectors in the light of the overall goals of the Islamic economy. The profit realised by the central bank from these advances should be partly made available to the government to finance projects designed to eliminate poverty and reduce income inequalities and partly retained by the central bank to meet its expenses.

The part of *Mo* made available to specialised credit institutions should also be a *mudārabah* advance. It should be used mainly for financing the productive activity of self-employed persons, farmers, cottage industries and other small businesses which, though viable and socially necessary, may not be able to obtain adequate funds from commercial banks and the NBFIs.

#### (b) Public Share of Demand Deposits

A certain proportion of commercial bank demand deposits, up to a maximum of, say, 25 per cent, should be diverted to the government to enable it to finance socially-beneficial projects in which profit-sharing is not feasible or desirable. This should be in addition to the amount diverted to the government by the central bank for expanding the monetary base (*Mo*). The rationale behind this proposal, as indicated earlier, is that firstly, the commercial banks act as agents of the public for mobilising the society's idle resources; secondly, the banks do not pay any return on demand deposits; and, thirdly, the public does not bear any risk on these deposits if these are fully insured. Hence it would be fair to expect that the society's idle resources thus mobilised should be used for social benefit except to the extent to which the society permits the commercial banks to use them for private benefit in the larger social interest. One of the important ways of using them for social benefit would be to divert a part of the demand deposits thus mobilised to the public treasury to finance socially-beneficial projects without imposing any interest burden on the public through taxes collected for this purpose by the treasury. As indicated earlier, the government should bear a prorated share of the total cost of mobilising demand deposits, rendering all services to the depositors related to these deposits and financing the deposit insurance scheme.

It is essential to add a note of warning here. The ratio of 25 per cent indicated above has been suggested as a maximum under normal circumstances. It may be exceeded only in exceptional circumstances when there is a national emergency or when the government has to play the role of a locomotive in an economic slowdown. In a recession banks tend to have excess liquidity and the use of a greater portion of demand deposits by the government would provide some relief to the banks themselves through the government's sharing of a greater

proportion of the costs of mobilising and servicing these deposits. In normal situations the ratio used by the government may be smaller than 25 per cent unless it is used as a mechanism to siphon off a part of the extra profits of banks in an economic boom and to reduce the liquidity of the private sector.

(c) *Statutory Reserve Requirement*

Commercial banks should be required to hold a certain proportion, say, 10-20 per cent, of their demand deposits with the central bank as statutory reserves. The central bank should pay the commercial banks the cost of mobilising these deposits just as the government would the cost of mobilising 25 per cent of demand deposits diverted to the government. This statutory reserve requirement could be varied by the central bank in accordance with the dictates of monetary policy.

The rationale behind a statutory reserve requirement only against demand deposits, as stated earlier, is the equity nature of *mudārabah* deposits in an Islamic economy. Since other forms of equity are exempt from a reserve requirement, there is no reason to subject *mudārabah* deposits to such a requirement. This should not adversely affect the control of money supply which must be accomplished through control of high-powered money at source as discussed earlier.

It may be argued that statutory reserve requirements also help ensure the safety of deposits and the adequate liquidity of the banking system. These objectives can be achieved through a higher capital requirement, well conceived and properly enforced regulations, including a suitable liquidity ratio, supplemented by an effective bank examination system. This would be preferable to immobilising a part of *mudārabah* deposits through reserve requirements which would tend to make them less profitable compared with other forms of equity. Such a reserve requirement would also induce a shift of *mudārabah* deposits from commercial banks to other financial institutions by putting the commercial banks at a relative disadvantage.

It may also be argued that in practice the distinction between demand and savings or time deposits is hazy, particularly if cheques can be written against the latter. This possibility would be substantially reduced in the Islamic system because of the equity nature of *mudārabah* deposits and the sharing in risk

which this would necessitate. Nevertheless, the Islamic banks may be willing, like their conventional counterparts, to cash cheques written against savings deposits or to allow a withdrawal of *mudārabah* deposits before their maturity, with or without notice. To face such a likelihood, the banks will have to maintain a fraction of such deposits as cash-in-vault, following the practice of conventional banks. If they are also required to maintain reserves with the central bank against these deposits, these reserves would tend to be frozen and would not be available to banks to allow such withdrawals.

The funds received by the central bank through statutory reserve requirements may be used by it for two purposes. Part of the funds should be used to enable it to serve as lender of last resort. As indicated earlier, the Islamic commercial banks, with their resources employed in a profit-and-loss-sharing framework may find the task of predicting their cash flows somewhat more difficult than is the case with conventional banks. Hence, in spite of the already suggested arrangement to provide mutual accommodation, there may be occasions when they are in need of assistance from the central bank as lender of last resort. The central bank could for this purpose create a common pool for which resources may be raised through a special reserve requirement, or diversion of a specified proportion of the total commercial bank statutory reserves. The main function of this pool would be to enable the central bank to serve as lender of last resort within agreed limits and constraints to foreclose the misuse of this facility. In a crisis situation the central bank may exceed the limit, as already suggested, with appropriate penalties and warnings and a suitable corrective programme.

The balance of the funds raised through reserve requirements could be invested by the Islamic central banks as is done by their capitalist counterparts. Since interest-bearing government securities would not be available, the Islamic central bank would have to find alternative interest-free avenues for investment. It should, however, withhold from investment whatever funds it considers necessary for the management of monetary policy.

(d) *Credit Ceilings*

While the above-mentioned tools would facilitate the central bank in bringing about the desired expansion in high-powered money, credit expansion could still exceed the desired limit. This is because: firstly, it is not possible to determine accurately the flow of funds to the banking system, other than those provided by the *mudārabah* advances of the central bank, particularly in an inadequately developed money market like that of Muslim countries; and, secondly, the relationship between commercial bank reserves and credit expansion is not very precise. The behaviour of the money supply reflects a complex interaction of the various internal as well as external sectors of the economy. Hence, it would be desirable to fix ceilings on commercial bank credit to ensure that total credit creation is consistent with monetary targets. In the allocation of this ceiling among individual commercial banks, appropriate care should be taken to ensure that it does not harm healthy competition among banks.

(e) *Value-oriented Allocation of Credit*

Since bank credit comes out of funds belonging to the public, it should be so allocated that it helps realise general social welfare. The criteria for its allocation, as for other God-given resources, should be, first, the realisation of the goals of the Islamic society and then the maximisation of private profit. This could be attained by ensuring that:

- (i) credit allocation leads to an optimum production and distribution of goods and services needed by the majority of society, and
- (ii) the benefit of credit goes to an optimum number of businesses in society.

The appropriate way to achieve the first objective would be to prepare a value-oriented plan and then to dovetail this plan with the commercial banking system for its efficient implementation. The approach should be, firstly, to make it clear to the commercial banks what sectors and areas of the economy are to be promoted through commercial bank financing and what goals are to be realised, and secondly, to adopt the institutional measures necessary for this purpose as discussed below. No effort should be made to tie the commercial banks with an

elaborate network of controls. The operation of market forces has been recognised by Islam, but within its value frame. If the Plan defines the value frame and the necessary institutional measures are adopted, it may not be necessary to have 'rigid' controls or to have 'excessive' intervention.

The reason normally given by the commercial banks for diverting a very small proportion of their funds to small- and medium-sized businesses is the greater risk and expense involved in such financing.<sup>11</sup> Hence small firms are either unable to get financing from banks or do so on highly unfavourable terms (in terms of cost and collateral) compared with their larger counterparts.<sup>12</sup> Thus the growth and survival of small firms is jeopardised even though they carry a great potential for increased employment and output and improved income distribution.

It would, therefore, be desirable to reduce the risk and expense of such financing for banks. The risk may be reduced by introducing a loan guarantee scheme<sup>13</sup> underwritten partly by the government and partly by the commercial banks. In the case of Islamic banks, the guarantee scheme cannot guarantee the repayment of loan with interest as is the case in the conventional system. The scheme should, however, relieve the bank of the need to ask for collateral in the case of small businesses whose general credentials have been registered with or certified by the guarantee scheme. The scheme would do this after a proper investigation of the firms concerned. It will also arrange to train the businesses to maintain proper accounts and be prepared even to have these accounts properly audited where necessary. A large number of small businesses would thus be able to get financing from banks without being able to offer the collateral required by the conventional banks. The bank will receive its money back in case of moral failure of the business. The scheme may also be made to include most non-commercial risks desired to be covered for increasing the availability of funds to small and medium businesses. In case of market failure and the resultant loss, the bank will of course share the consequences with the business in proportion to the financing provided by it. The additional expense incurred by the commercial banks in evaluating and financing small businesses should be partly or wholly offset by the government depending on the nature of the



case and the objectives to be served. The cost to the government exchequer arising from the above two schemes is justifiable in the larger interest of the goals of the Islamic economy. The cost could be partly or fully offset by graduated fees to be collected by the government out of profits earned from such financing by the banks and the small businesses.

The above techniques should be reinforced by a more effective and extensive use of qualitative or selective controls. Central bank *mudārabah* financing may not be made available except for specific purposes. In addition, the central bank may even accept a relatively lower profit-sharing ratio if this is considered necessary for realising the objective of distributing commercial bank financing to an optimum number of businesses for the production of the goods and services which are most needed.

(f) *Other Techniques*

The above battery of quantitative and qualitative weapons may be supplemented by others to realise the necessary goals. These should include the normally suggested tool of 'moral suasion' which should no doubt acquire an important place in Islamic central banking. The central bank through its personal contacts, consultations and meetings with banks could keep itself abreast of the strengths and problems of banks and suggest to them measures to overcome difficulties and achieve desired goals.

The Pakistan Council of Islamic Ideology as well as some scholars have suggested the instrument of varying the profit-and-loss-sharing ratio for the financing provided by the central bank to the commercial banks and for prescribing the depositors' and the entrepreneurs' share with respect to *mudārabah* deposits received and financing provided by the commercial banks.<sup>14</sup> While the indication of a reasonable range of profit-sharing ratios between depositors, banks and entrepreneurs may be helpful as a guide, it may not be desirable for the central bank to regulate these ratios, as the Council has suggested.<sup>15</sup> This is because the ratio would essentially depend on profitability, which depends on a number of factors differing from sector to sector in business and industry and even from firm to firm in the same sector. Hence prescribing a uniform ratio may not be

equitable while prescribing a band may not be meaningful, particularly if it is wide.

Even if, in accordance with the Council's suggestion, the ratio is regulated by the central bank to "reduce unhealthy competition among the financial institutions", it would not be desirable to vary this ratio frequently as a monetary policy instrument. The central bank may itself, being a non-profit institution, not mind taking a lower share in the interest of realising certain nationally-cherished goals, but why should the depositors, commercial banks or entrepreneurs be coerced to accept less than a just and reasonable share of profit? Moreover, if there is a loss, the *Sharī'ah* requires that losses be borne strictly in accordance with the ratios in which financing has been provided, irrespective of whether the financing comes from the central bank or the private sector. While the commercial banks would be happy to get a higher ratio in profit, if such a ratio is prescribed by the central banks, why would the depositors or the businesses being financed be willing to accept a correspondingly lower ratio, if it is out of proportion with their loss-sharing ratio? In addition, once the ratio has been set contractually, which is essential according to the *Sharī'ah*, the ratio cannot be changed before the end of the contract. To change it even for new contracts may also not be desirable because this would introduce inequities.

Hence it may be better to leave the determination of the ratio to the negotiating parties in conformity with their perception of market conditions and of profitability. The central bank or the government may, however, intervene when it is necessary to do so to ensure equity or eschew unhealthy competition. Tinkering with the ratio for purposes of monetary policy may not be desirable.

Three instruments which can be utilised by the central bank to create a more direct impact on commercial bank reserves than even discounting and open market operations are: government demand deposits with the commercial banks,<sup>16</sup> central bank foreign exchange swap arrangement with the commercial banks, and the 'common pool'. If it is desired to increase or decrease commercial bank reserves, the central bank can, if it is empowered to do so, shift government demand deposits to or

from the commercial banks, thus directly influencing their reserves.

The same effect may also be achieved by the use, within agreed limits, of foreign exchange swap arrangements (possible in countries with no exchange controls). The central bank may agree to swap local currency for foreign exchange when the banks feel a squeeze, with the undertaking that the banks will repurchase the foreign exchange from the central bank after a specified period at the going exchange rates, subject to a spread. The spread between the purchase and repurchase rates may be varied by the central bank to penalise, or relieve the commercial banks, as desired. This facility should not be available to banks for indulging in foreign exchange speculation.

A third instrument which can also be effectively used for monetary policy purposes by the central bank, as rediscounting is used by some conventional central banks, is the 'common pool' suggested earlier. This would be in the nature of a cooperative arrangement between banks under the patronage of the central bank to provide relief to banks in case of liquidity problems.

Some other instruments have also been suggested in the literature on Islamic banking. Three of the instruments commonly suggested are: (i) purchase and sale of stocks and of profit-and-loss-sharing certificates to replace government securities in open market operations, (ii) refinance ratio and (iii) lending ratio.<sup>17</sup> The merit and effectiveness of these for monetary policy purposes are briefly discussed below.

Equity-based instruments cannot be used for open market operations for a number of reasons. Firstly, it is not desirable for the central bank to buy and sell the stocks of private sector companies. All it can do is to purchase and sell the stocks of public sector companies. Secondly, equity-based instruments cannot have the necessary depth that government securities tend to have and open market operations in such instruments would influence their prices significantly unless used to a very limited extent, which would not be adequate for monetary policy purposes. Thirdly, variations in the prices of equity-based instruments brought about by central bank open market operations would unnecessarily benefit or penalise the

shareholders of companies whose shares are used for this purpose. This is not desirable because the primary objective of such operations is increasing or reducing private sector liquidity and not introducing inequities in the share market.

The lending ratio has been defined by Dr. Siddiqi as the percentage of demand deposits which the commercial banks may be obliged to lend as *qurūd hasanah* to their clients. The refinance ratio has been used by him to refer to the financing provided by the central bank to the commercial banks as a proportion of the *qurūd hasanah* granted by them.<sup>18</sup> It has already been proposed that the commercial banks should be required to extend a certain proportion of their demand deposits to the government as *qurūd hasanah*. The commercial banks should be able to get advances against the government *qurūd hasanah* certificates at the discretion of the central bank, depending on the extent of the need to relieve the temporary liquidity shortages of commercial banks, and to provide them with high-powered money when this is considered necessary. It is not however the responsibility of commercial banks to grant *qurūd hasanah* to their private sector clients except to a limited extent on their own volition as indicated in the previous chapter. It would therefore not be desirable for the central bank to prescribe either a lending ratio or a refinance ratio for this purpose.

The strategy proposed above for monetary policy does not claim that private demand for money can be forecast precisely by the central bank. All that the strategy implies is that given the capacity of the economy to generate a certain rate of real growth and the government's determined policy not to allow its fiscal deficit to exceed the limits dictated by the monetary targets, the central bank can (within a margin of error) estimate the high-powered money needed to generate the target rate of growth in money supply and the amount of *mudārabah* credit it can make available to the commercial banks during a given period. Since the projection may not always turn out to be correct because of errors in forecasting or changes in important economic variables, the targets should be reviewed periodically and revised whenever there is a strong justification for this. While in the long-term there is a high correlation between changes in the monetary base and those in money supply, the short-run

correlations may not always be high, particularly in Muslim countries with inadequately organised money markets. This is so because currency accounts for a large proportion of the monetary base and over short periods (weeks, months and quarters) the ratio of changes in currency to changes in money supply may not be stable.

To offset the effect of short-run instabilities in the money multiplier, the central bank should remain alert and avert liquidity squeezes as these can have a damaging effect on business. While in the capitalist system such squeezes lead to high interest rates, crash sales and bankruptcies when banks insist on not rolling over credit, in the Islamic economy they may tend to trigger crash sales and losses to both the bank and the entrepreneur. The central bank should therefore do all it can to relieve liquidity squeezes within the disciplinary framework suggested. It should be able to accomplish this through the employment of some or all of the instruments of monetary policy already suggested, including the 'common pool', central bank *mudārabah* credit to the commercial banks, lending and refinance ratios with respect to commercial bank *qurūd hasanah* to the government, statutory reserve ratios, credit ceilings, and central bank manipulation of government demand deposits with commercial banks, reinforced by other instruments like the liquidity ratio and swap arrangements.

It may also be possible to consider the simpler Friedman rule of adopting a fixed annual rate of growth in *M* in keeping with the secular growth in output and change in velocity to avoid the frequent 'tinkering' which is otherwise necessary.<sup>19</sup> However, if such a formula is adopted, it should be because of the ease it offers, and be without Friedman's excessive free-market commitment. The positive role of the state and of fiscal policy cannot be dispensed with in an Islamic economy.<sup>20</sup>

### **Conclusion**

The non-availability of some of the traditional instruments of monetary policy should therefore not pose any serious problem in managing an effective monetary policy provided that the generation of high-powered money is appropriately regulated at source. This necessarily implies that in the Islamic system, like in any other system, cooperation between the central bank and

the government is absolutely essential. Unless the government is determined to have price stability as an indispensable goal of policy and to regulate its spending accordingly, it will be impossible to have an effective monetary policy. Once high-powered money has been regulated at source, the minor adjustments that may be necessary due to changing economic conditions or errors of forecasting should be made by the central bank through the use of the instruments at its disposal.<sup>21</sup>

### ***Some Questions***

Some questions that may be asked here are: Even if it is possible to control inflation in an Islamic economy, will it be possible to overcome a recession? What if prospects for making profit are dim and the commercial banks and the associated private sector are not willing to expand their *mudārabah* investments? It is of course true that the central bank can only extend credit to commercial banks; it cannot force the private sector to invest when business prospects are not bright. Under such circumstances the government should review its expenditure programme and offset any deficiency in private sector aggregate demand by arranging a greater proportion of the increase in high-powered money through its fiscal deficit.

The external sector can no doubt create fluctuations in money supply through capital flows in and out of a country having no exchange controls. These movements may be due to a combination of economic and political factors which it is not possible to examine in this book. The most disturbing capital movements are the 'hot' speculative capital flows arising from interest rate differentials and exchange rate expectations. There is little likelihood of 'hot' capital inflows in an Islamic economy arising from interest rate differentials because demand deposits would pay no interest and *mudārabah* deposits would not only be equity-oriented and committed to relatively longer periods but also accepted by financial institutions only if they find themselves in a position to employ them gainfully in a profit-and-loss-sharing framework. Hot money inflows due to prospective currency appreciation would need to be discouraged by disincentives and controls, as has been done in some industrial countries. The monetary effect of such inflows can be neutralised by subjecting such flows to prohibitively high statutory reserve requirements.

Generally only countries having high rates of inflation and depreciating currencies combined with an unrealistic tax system experience unhealthy capital outflows in spite of their exchange control system. It is not possible to overcome such outflows significantly unless the external value of such currencies is stabilised and their tax system is reformed to minimise the extent of black money, the main outlet for which is conspicuous consumption or 'secret' accounts in other countries. The external value of a currency cannot be stabilised, as is now widely accepted, without stabilising its internal value. Any effort to stabilise the external value in isolation is bound to be frustrated. In turn, the internal value of a currency cannot be stabilised without a healthy domestic economy and sane monetary, fiscal and incomes policies. The strong stress of Islam on the reform of the human being, balanced economic development and reining of the banking system should help create healthy economies and stabilise the internal as well as the external value of the currencies of Muslim countries committed to the implementation of Islamic teachings.

### **Notes and References (Chapter 7)**

1. In the writing of this chapter the author has benefited from the valuable and thought-provoking discussion papers submitted by Dr. Muhammad Ariff, Munawwar Iqbal and Muhammad Anas Zarqa' at the Islamabad and Abū Dhabi Seminars on the author's paper on "Monetary Policy in an Islamic Economy". The reader may also wish to see the valuable papers on the subject by M. Uzair, "Central Banking Operations in an Interest-Free Banking System" and M. Ariff, "Monetary Policy in an Interest-Free Islamic Economy: Nature and Scope", in M. Ariff, *Monetary and Fiscal Economics of Islam* (Jeddah: International Centre for Research in Islamic Economics, 1982), pp. 211-35 and 287-310 respectively.

2. The more equitable the distribution of income, the greater will be the demand for money for a given level of aggregate income. See David Laidler, *The Demand for Money: Theories and Evidence* (Bombay: Allied Publishers, 1972) p. 66.

3. Keynes's original formulation of the theory of liquidity preference implies an 'all-or-nothing' choice between money and long-term bonds. See Byron Higgins, "Velocity: Money's Second Dimension" in Federal Reserve Bank of Kansas City, *Issues in Monetary Policy* (1980), p. 16. See also James Tobin, "Liquidity Preference as Behaviour Toward Risk", *Review of Economic Studies*, February 1958. Tobin assumed that investors are concerned with the expected return as well as the riskiness of

alternative assets, and most investors, instead of adopting the ‘all-or-nothing’ attitude, may be willing to accept a lower return on a low-risk investment in preference to money which has no return. It may be expected that in an Islamic economy with *zakāt*, even an otherwise risk-averter may be inclined to get into low-risk investments to offset the effect of *zakāt* on his money balances. It may also be safely assumed that on low-risk investments, ‘interest + profit’ would rarely be negative.

4. The Keynesian variant of the demand for money, which is  $M_d = kY + L(i)$ , becomes reduced to  $M_d = kY$  if it is assumed that the speculative demand for money, or  $L(i)$ , is insignificant. Thus the demand for money in an Islamic economy would be represented by the equation  $M_d = kY$ , which is the same as the ‘Cambridge equation’ with  $k$  being the reciprocal of  $V$  in the ‘quantity equation’.

Both the ‘Cambridge’ and the ‘quantity’ variants of the demand for money disregard the existence of the speculative demand for money. In contrast with the concept of constant velocity in the original quantity theory, income velocity is assumed to be predictable, though not constant, by most monetary economists (See Higgins, *op. cit.*, p. 23). Keynes originally considered both the liquidity preference function and the investment function to be erratic. Modern Keynesians, however, have de-emphasised the speculative motive for liquidity preference, which for Keynes was the source of its instability. They appear to believe that the liquidity preference function is fairly stable and predictable. Modern Keynesians, unlike Keynes, also believe that the investment and consumption functions, while unstable, are predictable (Thomas Mayer, *The Structure of Monetarism*, New York: W. W. Norton, 1978, p. 32).

In the Keynesian transmission process, changes in the money stock operate via the interest rate. A rise in the stock of money brings about a fall in the interest rate and a rise in investment in bonds and securities. Hence ( $M \rightarrow i \rightarrow I \rightarrow Y$ ). Equilibrium is restored in the monetary sector when the amount of money demanded for transactions and liquidity purposes is equal to that supplied. In the monetarist transmission process, changes in the money stock operate via changes in prices, as  $V$  is assumed

to remain constant and full employment  $Y$  has already been attained. Hence ( $M \rightarrow P$ ). The crux of the difference between the two approaches is that Keynesians regard the interest rate as the price of money held while the monetarists regard the interest rate as the price of credit and the inverse of the price level as the price of money. See, Mayer, *op. cit.*, pp. 6-14, and Brian Morgan, *Monetarists and Keynesians* (London: Macmillan, 1978), pp. 9-42. The transmission process even in the Islamic economy would tend to be through prices, the price of access to the use of liquid funds being the share in profit and the price of holding liquid balances being the loss of income in addition to the payment of *zakāt* on these balances.



5. Even in the OECD countries there has been a shift away from interest rates as intermediate targets of monetary policy towards quantitative norms for the growth of money stock (See, OECD, *Monetary Targets and Inflation Control*, Paris: OECD, 1979, p. 2). This report argues that “Manipulation of interest rates has not in all cases proved a satisfactory way of achieving monetary restraint or of stabilising monetary expansion under expansionary conditions” and that “Policies which are guided by quantitative objectives for the monetary base (or bank reserves) and under which interest rate levels are - or can be seen to be - a by-product have, therefore, come to seem increasingly attractive in some countries” (*Ibid.*, p. 1.2).

The Federal Reserve also announced in October 1979 its decision to focus attention on the reserves of the banking system rather than on the Federal Funds interest rate. This was generally acclaimed as an important policy step. This decision was taken because there was increasing dissatisfaction against the traditional view of monetary policy whereby the Federal Reserve tried to adjust interest rates up or down as necessary to smooth out swings in the business cycle. After nearly 25 years of experience there was widespread recognition that “we simply did not have the empirical information we needed to select a pattern of Federal funds rates that would produce the desired growth in the money supply consistently over time” and that “the efforts to manage interest rates are counter-productive”. Hence there was overwhelming support in favour of controlling directly “the rate of growth of money supply”. (See “Monetary Policy - The Possible and the Impossible” - address by R. P. Black, President, Federal Reserve Bank of Richmond, reproduced in *Economic Review*, September/October 1981, pp. 2-5.)

6. For the feedback process, see J. H. G. Olivera, “Money, Prices and Fiscal Lags - a note on the Dynamics of Inflation”, *Banca Nazionale del Lavoro Quarterly Review*, September 1967. For an empirical verification of the feedback hypothesis, see R. L. Jakobs, “Hyperinflation and the Supply of Money”, *Journal of Money, Credit and Banking*, May 1977; J. Dutton, “A Model of Self-Generating Inflation: The Argentine Case”, *Journal of Money, Credit and Banking*, May 1971; and B. B. Aghevli and M. S. Khan, “Inflationary Finance and the Dynamics of Inflation: Indonesia 1951-72”, *American Economic Review*, June 1977. See also B. B. Aghevli and M. S. Khan, “Government Deficits and the Inflationary Process in Developing Countries”, *IMF Staff Papers*, December 1979, pp. 775-824.

7. Economists Advisory Group, *Banking Systems and Monetary Policy in the EEC* (London: Financial Times, 1974), p. 100.

8. The ‘social balance’ has also been emphasised for the capitalist system by J. K. Galbraith in *The Affluent Society* (Boston: Houghton Miffling Company, 1958), pp. 251-69.

9. Monetary targeting has become an important instrument of monetary management over the last decade and widely accepted by a growing number of central banks, particularly among the OECD countries, because monetary management has been found to be fairly successful if this approach is adopted. See, Bank for International Settlements, *The Monetary Base Approach to Monetary Control* (Basle: BIS, September 1980) p. 7; *Banking Systems and Monetary Policy in the EEC*, *op. cit.*, p. 116; and OECD, *Monetary Targets and Inflation Control*, *op. cit.*, p. 1.2; and Paul Meek, ed., *Central Bank Views on Monetary Targeting: Papers Presented at a Conference held at the Federal Reserve Bank of New York, May 1982* (New York: Federal Reserve Bank of New York, 1983).

The BIS has strongly supported the use of monetary targeting by stating that “Published objectives of the monetary aggregates will no doubt continue to play a useful role in guiding the conduct of monetary policy and in signalling to the markets the eagerness of the authorities’ intentions. The approach was adopted in the industrial countries after other kinds of policy had proved ineffective in preventing inflation from building up and it provides a useful framework for stabilising expectations” (*Annual Report*, 1981-82, pp. 88-9). The Bundesbank first publicly announced a monetary growth target for 1975; since then such targets have been an important aid to German monetary policy. The Federal Reserve began reporting to the Congress specific numerical ‘targets’ for the growth of the monetary aggregates in 1975. The reporting of growth targets for monetary aggregates was formalised into law in 1978 with the enactment of the Humphrey-Hawkins Act which requires the Federal Reserve to present annual targets for monetary and credit aggregates to the Congress each February and to review these targets each July.

The principal conclusion of a study by Aghevli *et al.*, is that “targeting monetary policies, as opposed to policies aimed at fine-tuning the economy, are better suited to the circumstances of the Asian countries” (B. B. Aghevli, M. S. Khan, P. R. Narvekar and B. K. Short, “Monetary Policy in Selected Asian Countries”, *IMF Staff Papers*, December 1979, p. 816).

It is not of crucial importance to discuss here the question of which definition of M to adopt for monetary targeting in an Islamic economy. Different countries have selected different concepts of money supply for monetary targeting. The Federal Republic of Germany, France and the UK express their intermediate objectives in terms of the broadly-defined money supply. Elsewhere in the European Community definitions of intermediate monetary policy objectives differ more widely. Italy and Ireland express their targets in terms of total domestic credit to the private sector. (See the chapter on “Quantitative Monetary Policy” in the “Annual Economic Review 1980-81” adopted by the EEC Commission on 15 October, 1980 together with its *Annual Economic Report 1980-81*.) The 1981-82 BIS *Annual Report* states: “The quantity of money, defined in

whatever way bore the closest relationship with nominal GNP, was seen to provide a more reliable fulcrum for anti-inflationary policy” (p. 87).

With primary reliance on equity financing in an Islamic economy and with savings and term deposits also taking the form of equity participation, it is difficult to predict how the various monetary aggregates will behave in a truly Islamic economy. The specific definition of M to be adopted for targeting could hence be determined only after experience. It may be useful initially to observe carefully all variants of M until the impact of Islamic policies on different economic variables and monetary aggregates has become clear.

10. In their survey of the issues and evidence on money and monetary policy in less developed countries, Coats and Khatkhate conclude that “In LDCs, base money is a major determinant of the money stock and the deficit financing of government expenditure, which is often tantamount to the creation of central bank credit, is a principal factor affecting base money” (W. L. Coats and D. R. Khatkhate, (eds.), *Money and Monetary Policy in Less Developed Countries: A Survey of Issues and Evidence*, (Oxford: Pergamon Press, 1980, p. 32).

11. “Small companies provided 30 per cent of British jobs and 20 per cent of the GNP, yet they probably accounted for only 0.5 per cent. of the industrial investment of the financial institutions that now took a major part of the nation’s savings. The impact of only a small increase in this percentage would be very significant and would not conflict with such institutions’ fiduciary responsibilities”, *Financial Times*, 28 March, 1978. In Muslim countries, for which the relevant data are not available, the distribution of commercial bank credit is probably worse.

12. *The Wilson Committee Report on Financial Institutions*. See a review of this Report by John Elliott under the title “Not Enough for Small Companies” in the *Financial Times*, 16 March, 1979, p. 10.

13. Such a scheme was proposed for Britain by the Wilson Committee. The Chancellor of the Exchequer, Sir Geoffrey Howe, announced the introduction of a pilot loan guarantee scheme in his 1981/1982 Budget speech. See the *Financial Times*, 11 March, 1981, p.17.

14. See the Council’s *Report, op. cit.*, p. 73; see also the views of M. N. Siddiqi, M. Uzair, M. Akram Khan and M. Ariff in M. Ariff, *op. cit.*, pp. 37, 220--2, 251-2 and 302 respectively. See also the views of J. H. Laliwala, Sultan Abou ‘Ali, M. Saqr, Ziauddin Ahmad, M. N. Siddiqi and M. Al-Jarhi on this subject expressed in the discussion of Dr. Uzair’s paper in *ibid.*, pp. 231-5.

15. The Council’s *Report, op. cit.*, pp. 19-20.

16. Shifting of a part of government deposits by the central bank to and from the commercial banks for achieving monetary policy objectives has proved to be a useful instrument of monetary policy in Saudi Arabia

and has performed the same function directly that open market operations perform indirectly in influencing commercial bank reserves.

17. See M. N. Siddiqi in *Banking Without Interest* (Leicester, UK: The Islamic Foundation, 1983), pp. 110--25, M. Ariff, *op. cit.*, pp. 36-7, and M. Akram Khan, *ibid.*, pp. 251-4.

18. See M. N. Siddiqi, in Ariff, *op. cit.*, pp. 36-7.

19. Milton Friedman, *A Program of Monetary Stability* (New York: Fordham University Press, 1975), pp. 90--1.

20. The controversy over rules versus discretion in the conduct of monetary policy is over a century old but still continues unabated and unsettled. According to Sayers, "The essence of central banking is discretionary control of the monetary system. . . And working to rule is the antithesis of central banking. A central bank is necessary only when the community decides that a discretionary element is desirable" (R. S. Sayers, *Central Banking After Bagehot*, Oxford: Clarendon Press, 1957, p. 1). More recently, Sargent and Wallace have proclaimed that "There is no longer any serious doubt about whether monetary policy should be conducted according to rules or discretion. Quite appropriately, it is widely agreed that monetary policy should obey a rule" (T. Sargent and N. Wallace, "Rational Expectations and the Dynamics of Hyperinflation", in *Studies in Monetary Economics*, Federal Reserve Bank of Minneapolis, June 1975, p. 1). Coats concludes that "in the light of strong theoretical and empirical support for a simple constant growth rate rule in developed economies, *a priori* considerations make the case for a simple rule even more compelling for LDCs . . . If the lags between the need for change in monetary policy and its ultimate effect on the economy are long and troublesome in the developed economies, the difficulties arising from these are surely more serious in the LDCs where economic data are less plentiful, less accurate and less quickly available" (W. L. Coats Jr., "The Efficacy of Monetary Rules for LDCs" in W. L. Coats and D. R. Khatkhate, *Money and Monetary Policy in Less Developed Countries: A Survey of Issues and Evidence*, Oxford: Pergamon Press, 1980, pp. 166-7). See also the third paragraph of footnote 9 which reports the conclusion of Aghevli *et al.*, that targeting is better suited than fine-tuning to the circumstances of Asian countries.

It may be apparent that the position taken in this book is that it is preferable to adopt a specified monetary target in an Islamic economy, because this would be desirable for making monetary policy more effective in the absence of both interest and open market operations in government securities. However, the target should not be followed rigidly and mechanically. It should be reviewed periodically and changed whenever this is warranted.

21. See the two-volume study on the effects of monetary policy by the Board of Governors of the Federal Reserve System, *New Monetary*

*Control Procedures*, (ed.) Stephen Axilord (Washington: Board of Governors of the Federal Reserve System, 1981). The general conclusion of the Report is that if the Fed stayed within its long-range growth targets, radical week-to-week and month-to-month changes in the money supply had relatively little effect on the overall economy. This has, however, not proved to be right in the case of the US because such movements in money supply have tended to trigger erratic movements in interest rates, thus creating extreme uncertainty and adversely affecting investment decisions (see also footnote 36 and the related discussion in the chapter on “Objections and Rationale”). However, in an Islamic economy as well, with no interest rate fluctuations, the short-term fluctuations could create tight-money situations and adversely affect business conditions. The central bank should hence watch the situation carefully and use all the instruments at its disposal to try to provide relief.



## CHAPTER 8

### Evaluation

It appears from the above analysis that the Islamic money and banking system, of which the abolition of *ribā* is an indispensable ingredient, would operate to the greater overall benefit of the economy and help the Islamic state realise its short- as well as long-term socio-economic objectives. It would not only be able to remove the prevailing imbalance between the supply and use of resources but also exert a favourable influence on allocation of resources, savings and capital formation, economic growth and stability. Its richest contribution would of course be to the realisation of socio-economic justice and equitable distribution of income and wealth, which are at the core of Islamic teachings and without which the Islamic imperatives of brotherhood and social solidarity may remain only pious hopes. While the proposed equity-based monetary system could be introduced with advantage in any society, it would produce better results within the framework of an Islamic society where the moral fabric has been strengthened and the necessary institutional reforms have been introduced.

#### The Islamic Approach

The Islamic value framework concentrates not only on transforming the individual human being and changing his entire outlook towards life, but also on the reform of the society of which he is a part and of the institutions which affect his behaviour. While Islam recognises freedom, this freedom is not unbound. There is no freedom to destroy or to weaken the society's value framework or to harm others. Hence the state must play an important role - the role of educating, of creating an institutional framework conducive to the practice of Islamic values and of nipping in the bud all vicious deviations. The Islamic state is not a police state. It is not a *laissez-faire* state either.

Islam reinforces its teachings of brotherhood and the social equality of all by a socio-economic system that satisfies the needs of all in keeping with their status as vicegerents of God on earth. It requires an equitable distribution of income and wealth and stipulates values of living that are in harmony with its goals. If all individuals are socially equal, then any consumption pattern that reflects arrogance and widens the gulf between the high and the low stands disapproved. All available resources, including bank deposits, are a 'trust' from God and must be utilised for the effective satisfaction of the needs of all, rich or poor. Promotion of conspicuous consumption or satisfaction of unwarranted wants are out of the question.

The discipline that these Islamic teachings would introduce would promote living within means and substantially reduce the need for both public and private sector borrowing for prestigious and wasteful consumption. Monetary expansion could thus be kept within limits. The better balance thus achieved between resources and their use would not only keep inflationary pressures under check but also lay down firmer foundations for gradual but uninterrupted growth designed to reduce unemployment and promote 'real' general well-being.

### **Capital Formation, Growth and Stability**

The abolition of interest would remove the canker of injustice between the financier and the entrepreneur. The total return on capital (interest + profit in the capitalist framework) would be divided among the two in accordance with justice. The financier would not be assured of a predetermined rate of return even when the business has yielded a loss. This would particularly eliminate the highly unjust situation that prevails during a stagflation, when a large number of businesses suffer losses or become bankrupt because of the recession and high interest rates, but the profits of banks and financiers continue to rise irrespective of the fate of the businesses financed.



Interest rates hurt irrespective of whether they are high or low. High interest rates penalise entrepreneurs and serve as a deterrent to investment and capital formation. This ultimately contributes to decline in productivity and employment and low growth rates. Low interest rates penalise savers, particularly small savers, and contribute to inequalities of income and wealth. They stimulate borrowing for consumption expenditures by both the public and private sectors and generate inflationary pressures. They also stimulate unproductive investments and speculation, and also lead to excessively labour saving technology thus raising the rate of unemployment. Thus by distorting the price of capital, low interest rates stimulate consumption, reduce the gross savings ratio, lower the quality of investments and create capital shortages. The cherished equilibrium, whereby interest rates would be neither high or low, is just a theoretician's dream.

High or low interest rates are the result of restrictive or liberal monetary policies adopted in the larger national interest. There is no reason why the entrepreneur or the financier should be the only one to suffer or benefit from such policies. Why should not the gains or the losses be equitably distributed between them? The only way in which this can be accomplished is the abolition of interest and the introduction of profit-and-loss sharing.

Since interest would not be deducted as a cost and the total outcome would be justly shared between the entrepreneur and the saver, the entire risk for investments would not need to be carried by the entrepreneur alone. Risk and venture capital, so essential for maintaining a reasonable rate of growth and dampening economic fluctuations, would thus not be discouraged in an Islamic economy. The hope of being able to get a just reward for his savings, which may be higher than the rate of interest, would induce the saver to invest his savings within the profit-and-loss-sharing framework. Moreover, the need to offset the erosive effect of inflation and of *zakāt* on savings would force savers to look for investment

opportunities within a profit-and-loss sharing framework. The absence of a 'safe' haven in the form of interest-based fixed deposits, bonds and government securities should also help mobilise larger resources for investment and venture capital. In spite of these considerations, if a saver prefers to be a risk averter his savings need not become immobilised. They could still be available to the economy, through demand deposits, which would be guaranteed.

Since the banks and other financiers would be sharing in the risk, their stake in the ultimate outcome of business would substantially reduce loose and speculative financing. This should help infuse greater health into the economic system. The financial institutions would in this case have to resort to a greater analysis of the projects financed, but this should be worthwhile because of the contribution this could make to the health and stability of the economic system. The relatively more careful attitude in the financing of projects by financial institutions, along with the expertise made available by them to entrepreneurs, should improve the overall performance of businesses and industries and introduce greater efficiency in the allocation of resources. This should have a positive effect on economic growth.

Instability breeds uncertainty and inflicts an undesirable cost on the economy through its adverse impact on planning for investment. The instability injected into the economy by erratic movements in interest rates would be overcome in an Islamic economy. Profit-sharing ratios would not change erratically and both the financier and the entrepreneur would be assured of a fair share of the ultimate outcome of business, which would be determined by economic conditions. The entire economic environment would tend to improve with the sharing of the risk by both the entrepreneur and the financier, greater availability of risk and venture capital, substantial decline in speculative finance, non-availability of interest-based outlets and greater participation in the evaluation of business projects by financial institutions. The instability introduced in exchange rates by interest rate fluctuations

would also be reduced, thus creating a better climate for business planning and forecasting.

### **Monetary Health**

The money supply would not be influenced by the erratic and unpredictable interest rates nor by the need to stabilise them. The intractable problem of either stabilising interest rates with no control on money supply or regulating money supply with no control on interest rates will have been overcome. With no interest rates to bother about, money supply could be regulated by the central bank in accordance with the needs of the real sector of the economy and the goals of the Muslim society. The growth in M could be regulated to realise the goal of broad-based well-being and an optimum but realistic rate of growth within the context of price stability. This target growth in M could be achieved by generating the required growth in high-powered money through a combination of fiscal deficit and central bank *muḍārabah* lending to financial institutions. There could, however, still be an expansion in money supply above or below the desired level because of the effect of a number of variables which are difficult to predict or control. Such excesses or deficiencies could be evened out with the help of other instruments of monetary policy and the non-availability of discount rate and interest-based government securities should not pose any problem.

The 'seigniorage' arising from created money, along with total credit extended to the public and the private sectors, would be utilised for the social-welfare objectives of eradicating poverty, attaining a high rate of employment, and fostering socio-economic justice. It should not serve vested interests or contribute to concentration of wealth. Moreover, total commercial bank financing would be utilised for supporting the largest number of businesses for producing goods and services needed by most people in society. Thus the implementation of the Islamic system should not only help reduce concentration of wealth but also satisfy the society's

needs more effectively than is possible through the conventional banking system.

The scheme may bring about some reduction in the overall spending of both the public and the private sectors consequent to the discipline introduced in consumption as well as investment outlays. This would be offset by a number of advantages. Firstly, it would contribute to a healthier growth in money supply. Secondly, it would minimise the demand for money arising from unnecessary and wasteful expenditures and the financing of dubious and wasteful projects. Thirdly, it would lead to an increase in the flow of financing for productive purposes along with its broad-based distribution among a larger number of businesses and improved allocation among various sectors of the economy. This should help ensure an adequate production and distribution of goods and services needed by the majority of society in conformity with a value-oriented plan. Fourthly, the instability introduced into the economy by changes in interest rates and fluctuations in aggregate spending would be substantially reduced. The steady but continued growth of the economy would introduce a healthy dimension into the economy and help everyone.

### **Discipline in Government Spending**

The desirable rate of growth in money supply would, however, be difficult to realise unless the government is committed to Islamic goals and does not adopt policies which conflict with them. All government policies should converge on the achievement of these goals and monopolistic and oligopolistic practices and structural rigidities should be removed or at least substantially reduced. Government officials cannot afford to neglect their responsibilities with respect to the overall welfare of the *ummah* because, as the Prophet, peace be on him, said: “Anyone who has been given charge of people, but does not live up to it with sincerity, will not taste even the fragrance of paradise.”<sup>1</sup>

The inability to get financing on the basis of interest would introduce discipline in government spending and

project management. This would avoid the mountain of debt burden which governments accumulate because of easy access to interest-based finance. The government's financial problems may be partly reduced by transferring to it a certain proportion of all commercial bank demand deposits. This would carry a service charge which would be considerably smaller than the heavy interest burden which makes the rich richer through interest receipts and the poor poorer through additional taxes levied to service the public debt. The ability of the government to obtain funds without the high cost of interest along with the imperative that these be invested in projects of high social priority should help promote general social welfare. The major sector to suffer from the scheme would be the 'prime' borrowers who would not be able to have access to commercial bank resources at rates substantially lower than to profits they earn.

### **Justice with a Bountiful Bonus**

If the Islamic system had helped actualise only socio-economic justice by minimising unjustified enrichment and reducing inequalities of income and wealth, it would still have been commendable. However, it seems that the Islamic system would perform better on several other planes, including resource allocation, savings and capital formation, economic efficiency and growth, and stability. It would also bring about a lower monetary expansion and reduce inflationary pressures by helping attain a better balance between the supply and use of resources. The Islamic system, therefore, deserves a sincere and whole-hearted trial by Muslim countries.<sup>2</sup>

### **Notes and References (Chapter 8)**

1. Bukhārī, *Kitāb al-Aḥkām*, *Bāb man istur'iya ra'īyyatan falam yanṣaḥ*, from Ma'qil ibn Yasār.

2. Because of the injustice and the other problems created by interest, it was prohibited by most major religions.

Like Islam, Judaism and Christianity had both condemned usury and interest.

The Talmud compared the money lender to a ‘murderer’ (p. 558). The Mishnah included the usurer among those who were disqualified from giving evidence in a court of law (p. 558). No distinction was made between usury and interest. Usury was not used in its modern sense of excessive interest, it meant interest generally (p. 555). However, Judaism later allowed that interest could lawfully be taken from non-Jews as a “privilege granted by God to the faithful Israelite” (p. 556).

The Christian attitude towards usury and interest was not different. The early Fathers looked upon usury with severe disapproval. The decision of the canonist conscience was that “in itself the loan of money did not justify a charge for its use” (p. 551). Augustine placed usury “in the category of crime” and denounced the usurers as a “breed of vipers that gnaw the womb that bears them” (p. 550). A canon of the third Lateran Council (1179) ordained that “manifest usurers shall not be admitted to communion, nor, if they die in their sin, receive Christian burial” (p. 551). The Council of Vienne (1311) brought matters to a head by branding as a heretic anyone who pertinaciously held that usury was not sinful (p. 551). However, when the Church itself became one of the largest holders of property and monies, its strictures on usury gradually relaxed (p. 552). Nevertheless, it was not until 1830 that the Holy Office allowed that “interest could lawfully be taken for money lent to merchants who were in lucrative trade” (p. 552).

The page numbers given above refer to the article on ‘Usury’ in the *Encyclopaedia of Religion and Ethics*, edited by James Hastings (New York: Charles Scribner’s Sons, n.d.) vol. 12, pp. 548-58.

Hinduism also condemned interest and usury (see M. Yūsuf uddin, *Islām kāy Ma ‘āshī Naẓariyyé*, Hyderabad, India: Maṭba‘ah Ibrahīmiyyah, 1950, vol. 2, p. 402).

## CHAPTER 9

### The Transition

God does not change the condition of a people until they change their own inner selves. (al-Qur'ān: 13: 11)

The Muslim world has been in a state of degeneration for a number of centuries. The social breakdown and weakness brought about by this degeneration paved the way for foreign domination which led to further disintegration and decline. This decline is clearly reflected in all aspects of Muslim life and has been accompanied by poverty, flagrant inequalities of income and wealth, socio-economic injustice, social disharmony and loss of creativity. Nevertheless, the undeniable fact is that the Muslim masses are intensely attached to Islam all over the Muslim world and sincerely crave for its revival and supremacy.

#### The Three Characteristics

Due to the centuries of degeneration, the present-day Muslim society does not reflect the spiritual lustre of Islam. Judged on the criteria of the three previously indicated most important characteristics of an ideal Muslim society, namely, strength of character, strong bonds of brotherhood, and incorruptible justice, the Muslim countries present an unsatisfactory picture, no less distressing than that in the rest of the world.

There has been considerable erosion in the quality of the Muslim, giving rise to a wide gulf between the Muslim as depicted by the Qur'ān and the *Sunnah* and the Muslim as he actually is in the present-day world. There is ignorance, dishonesty, corruption, cheating, adulteration and degradation. Even the basic demands of faith are not being lived up to. In a vast majority of the society there is not even an adequate

awareness of the high quality of character and personality that Islam demands from a Muslim.

The uninspiring socio-economic condition of the present day Muslim world has joined hands with the moral degeneration to erode the foundations of Islamic solidarity. A number of economic institutions are legacies of the Muslim world's feudal or colonial past and are partly or wholly in conflict with Islamic teachings. Economic exploitation in all its diverse forms is as prevalent in the Muslim world as it is in any capitalist or feudal society. There is the desperation and misery of poverty existing alongside the arrogance of affluence. The minimum needs of the poor in terms of food, clothing, education, housing, transport and medical facilities are not being adequately satisfied to enable them to actualise their dignity as vicegerents of God on earth. A vast majority of the population has to do long hours of hard work to make ends meet, without any time or resources left for recreation or mental and moral upliftment, while a few get too much, without any worthwhile effort, to indulge in sloth, luxury and revelry. The socio-economic inequalities have created an ever-widening gulf between the rich and the poor, thus weakening the bonds of Islamic brotherhood. The institution of *zakāt*, although a pillar of the Islamic faith, is not being practised by a large number of well-to-do Muslims and most Muslim governments have failed to recognise the vital role it can play in lifting the economic conditions of the poor, strengthening Islamic solidarity and creating political stability.

Justice is the most conspicuous of the three characteristics in terms of either its absence or dilution, even though it has been characterised by the Qur'ān as "nearest to piety" (5: 8) and its absence equated by the Prophet, peace be on him, with "absolute darkness".<sup>1</sup> While the establishment of incorruptible justice is one of the primary functions of the Islamic state, the judiciary system in most Muslim countries, inherited from the West, has become highly time-consuming, expensive, ineffective and corrupt. It is well-nigh impossible for the poor



or the down-trodden to obtain justice against the rich, the influential and the well-placed. This is in sharp contrast to what Islam stands for and what ‘Umar, the second Caliph, required from his Governors by writing “Give equal treatment and respect to all in your councils such that the weak does not despair of fairness and the high does not crave for the unjust.”<sup>2</sup>

### **The Revival of Values**

Reform movements have always been active in the Muslim world in spite of the obstacles placed in their way by foreign and domestic power groups who find their interests threatened by the revival of Islam. The activity of these reform movements has become greatly intensified since World War II, and even though these movements have had an increasing degree of success, they have so far been unable to penetrate deep into the heart of the Muslim society. This is largely because the government machinery in most Muslim countries, dominated by a secularist minority with the support of foreign and domestic vested interests, has generally tended to play a negative role in Islamic revival, while at the same time paying lip service to Islam.

While the family as the basic human institution is still intact, it has been made ineffective in its role of bringing up children because parents are unable to fulfil their natural duties due to their own lack of proper orientation in Islamic values. Similarly the mosque, even though it continues as an institution in Muslim society, is unable to perform its natural role of character-building, because of the inadequate education of the *Imām*, his poverty, and his low, uninspiring social status. The education system has also been unable to fill the vacuum because of its colonial and un-Islamic legacy of the artificial dichotomy of knowledge into the secular and the religious. It has produced a modern educated elite ignorant of Islam and its values, and a religious class untrained in modern sciences and unable to play an effective role in society. The

two groups are unable even to communicate with each other meaningfully for the reform of the Muslim society.

The Muslim *ummah* thus requires a complete transformation. Such a transformation cannot be achieved merely by making some cosmetic changes in a few sectors of the society or the economy. It requires an improvement in the quality of the Muslim as a person and a reform of all aspects of the Muslim society, economy and polity. Such an overall transformation is difficult but indispensable. It cannot, however, be achieved in a short period through the use of either force and violence or regimentation. Wisdom and understanding have to be the pillars of the Islamisation process as the Qur'ān has unequivocally emphasised: "Call towards the way of your Lord with wisdom, courteous exhortation and befitting argumentation, for only your Lord knows who has strayed from His path and who has been guided" (16: 125). Force and regimentation cannot win hearts or lead to the change of character which is essential for the Islamic 'revolution' that the Prophet, peace be on him, preached. This transformation cannot, however, be achieved without a sincere commitment on the part of Muslim governments and an active role being played by them.

What is therefore absolutely indispensable at the very initial phase is that, while the Islamic movements and organisations continue to play their positive role in the revival of Islam, the Muslim governments rekindle the flame of their own commitment to Islam. They should take all appropriate measures to raise the moral consciousness of the society, reform all unIslamic institutions, Islamise the educational system, and use all available mass media to educate people in the teachings of Islam and to improve their business ethics in accordance with the moral code of Islam.

The family and the mosque should also be enabled to play their indispensable role as character-building institutions. This can be done only by the reorientation of the parents in Islamic teachings and the proper training, humane remuneration

ation, and social uplift of the *imām*. The systems of *zakāt* and *‘ushr* need to be revived to reinforce Islamic solidarity. The spending and saving behaviour of the rich and the poor need to be brought into conformity with Islamic teachings. A large number of other needed reforms should also be introduced in the different fields of Muslim society, economy and polity with the objective of eliminating corruption and exploitation, and enforcing justice and fair play without which realisation of all the goals of Islam would remain a pious hope.

The governments cannot succeed if they act half-heartedly with superficial measures and do not use strong deterrents against violations by anyone, high or low. They must act firmly, with persistence and determination in harmony with well-conceived, short- and long-term programmes. Even though the time taken for the revival may be long, the ultimate goal must be clear from the beginning and the direction must be firmly established towards the goal.

### **Reforms Related to the Banking System**

The establishment of the Islamic money and banking system need not, however, wait until a morally-conscious ideal Muslim society has been brought into existence. This is because the equity-based Islamic system does not necessitate a fully-Islamised environment and could even be adopted with positive results in non-Muslim countries. The prevalence of a morally-conscious and justice-oriented Islamic environment would, however, strengthen the system and enable it to bear richer fruits in greater abundance.

It would, nevertheless, be a mistake to try to achieve the transition from the conventional capitalist money and banking system now prevalent in the Muslim world to the just Islamic model in one stroke or over a very short period of time. Such an attempt could suffocate the whole system and do great damage to the economy and ultimately to Islam. The transition should be gradual and by stages running over an adequate, but not unduly long, period of time, and must be accompanied by other reforms in the society. There should be

no qualms about this gradual transition because, as already indicated, Islam has enjoined the use of understanding and wisdom in the enforcement of Islamic teachings and the Prophet, peace be on him, has, by his own example, encouraged gradual transition. This gradual strategy has also been forcefully endorsed by the Pakistan Council of Islamic Ideology in its *Report*.<sup>3</sup>

### **The Different Steps**

A number of steps need to be taken along with the socio-economic reform of the Muslim society to enable the transformation of the conventional money and banking system to the Islamic one. Some of the important steps are:

1. Interest should be declared illegal, allowing a certain grace period over which it may be tolerated as a necessary evil, but after the expiry of which it should be abolished from all *domestic* transactions. Suitable amendments should also be introduced into all relevant laws, particularly those related to financial institutions and the corporation, to take cognisance of this prohibition and the different needs of an Islamic economy. Legislation should also be passed regarding the *mudārabah* and *shirkah* forms of business organisation. Also of significance will be the reform of all legislation related to auditing to ensure minimisation of management malpractices and to do justice to investors.

2. The equity/loan ratio in the Muslim countries should be raised substantially to change the loan-based nature of the economies. All businesses - corporations, partnerships or sole proprietorships - should be required to increase gradually the equity proportion of their total finance and to reduce their dependence on loans such that all their normal, fixed and working capital needs are met out of equity. If this requires the conversion of large partnerships into corporations such a move should be encouraged and facilitated. While the long-run goal for all businesses should be equity financing they may be allowed to have some access to finance through the

alternative techniques of leasing, *murābahah* and hire-purchase.

3. The reform of the tax system will no doubt help accelerate this process. An irrational tax system drives even genuinely-earned profits into black money, which, instead of being drawn into productive uses through increase in equity and reserves, induces capital flight and wasteful consumption, deplored by Islam.

4. The economy-wide move to raise equity will help mobilise idle funds by providing investors, particularly *ribā-detesting* investors, with opportunities to employ their savings productively. This would have the effect of spreading the ownership of business in society and reducing the concentration of wealth. However, a necessary counterpart to this step is the reorganisation of the stock market along non-speculative Islamic lines such that stock and share values change rationally as dictated by economic factors and not erratically under the influence of irrational speculative forces.

5. All public sector projects which are amenable to commercial pricing, and hence to profit-and-loss sharing, should be converted to such a basis so as to reduce their burden on the public exchequer. The shares so issued should be preferably exchanged against bonds sold by the public sector companies or the government to the private sector including financial institutions. Institutional arrangements would, however, have to be made to provide meaningful relief to those who are unable to afford the realistic prices. This would necessitate the revival of the institutions of *zakāt* and *‘ushr* in a properly organised manner.

6. Interest should be eliminated from government-sponsored specialised credit institutions operating in various sectors of the economy. This of course does not imply advancing interest-free loans without profit-and-loss sharing. Such a practice would provide free funds to those so favoured and result in an over-use of this facility and greater concentration of wealth. It must be appreciated that scarce

capital resources managed by these institutions are a social trust and their efficient use in accordance with Islamic teachings is a social imperative.

7. All interest-oriented financial institutions should be converted gradually, irrespective of whether they are of domestic or foreign origin, into profit-sharing institutions. Exempting any of the banks, even though foreign, would be tantamount to sabotaging the whole system. The best way to accomplish the conversion would be to enable all financial institutions to bring about a certain percentage decrease in their interest-based assets and liabilities with a corresponding percentage increase in their profit-and-loss-sharing assets and liabilities until the total transformation has taken place over an agreed number of years. In the initial phase the financial institutions may be allowed to have a greater resort to the alternative techniques provided that there is an assurance that these methods will gradually decline in importance and be replaced increasingly by the more desirable investment forms of *mudārabah*, *shirkah* and stocks and shares. It would, however, not be sufficient just to eliminate interest from the dealings of financial institutions. It would be equally necessary to transform their entire outlook to ensure that they contribute positively to the realisation of the socio-economic goals of Islam and do not accentuate the existing social and economic imbalances.

8. The establishment of a number of auxiliary financial institutions should be initiated to facilitate the private sector placement of funds and also to support the operations of commercial banks. These would include different types of non-bank financial institutions comprising investment trusts or banks, credit unions, cooperative societies, venture capitalists and a range of other investment-management institutions. They should play, within the Islamic framework, the intermediary role of helping the savers to find profitable avenues for their savings or investments and the entrepreneurs to find funds for expanding their business. These institutions will thus, in conjunction with the commercial banks and the

reformed stock exchange, provide the major ingredients of an effective primary as well as secondary capital market for an Islamic economy. In addition it may be necessary to establish the specialised credit institutions, the Investment Audit Corporation and the Deposit Insurance Corporation.

It seems that these steps would be necessary for the establishment of the Islamic banking system. No attempt should however be made to force the accomplishment of the target instantly. The conversion process requires not only experience on the part of financial institutions as well as business firms but also the solution of many unforeseen technical and adjustment problems which are bound to arise during the process of conversion. Problems will also be faced by the Deposit Insurance Corporation because of lack of experience and know-how in the field of deposit insurance in Muslim countries. Moreover, it is better to be slow and steady than to be hasty and unsuccessful. It must be realised that success of the attempt will vindicate the strength of Islamic principles while any failure will only tend to hurt the reputation of Islam.

### **Major Obstacle**

The major obstacle to the Islamisation process will however be the burdensome interest-bearing domestic and foreign debt of most Muslim countries. The riddance from the Muslim society of the current excessive public sector debt would take the longest time and cannot be accomplished without a thorough reform of the whole government machinery and minimisation of all corruption and wasteful spending. This requires sincere commitment on the part of the government and sacrifice and cooperation from the people. The people may not be amenable to make the sacrifice until their moral consciousness has been really awakened and measures have been adopted to change their life-style in the light of Islamic teachings. The rich and the powerful must also be made to make the sacrifice needed for the revival

along with the poor and the middle-class groups who are generally more amenable.

Government domestic debt to the private sector should be converted into a profit-sharing arrangement to the extent feasible and desirable in the manner suggested in step five of the transition process. The balance of the government debt to the private sector needs to be either repaid or amortised over its period of maturity. The government debt to the poor, not converted into equity, should be repaid. The government debt to the commercial banks to the extent of 25 per cent of their demand deposits should be handled in the manner suggested elsewhere. The debt in excess of 25 per cent of their demand deposits should be repaid in accordance with a mutually-agreed programme. The debt to the rich, not converted into equity, should be considered as an interest-free loan and retired over its period of maturity. This will imply a tax on the rich to the extent of the interest they have to forego on such loans. They should accept this sacrifice willingly in the spirit of true Muslims as the Qur'ān demands: "O Muslims! fear God and give up the interest that remains outstanding, if you are believers" (2:278). The amortisation of the principal over its period of maturity would be difficult for the government unless it adopts fiscal discipline, which is a moral imperative of the Islamic state under all circumstances. Most governments, including those of Muslim countries, have become accustomed to borrow to retire their maturing debt so that the outstanding debt keeps on increasing. If, however, the Muslim government finds it impossible to repay its debt without cutting its spending drastically to the detriment of the economy, it may reschedule the debt, but only to the extent absolutely necessary.

The question of the foreign debt will still remain. Unfortunately the external debt of some Muslim countries is undesirably high and a substantial part of it has been incurred for financing unproductive expenditures. The debt-service burden (payment of interest + principal) is, therefore, high as a per cent of exports of goods and services and of gross



national product, though not as high as that of other developing countries.<sup>4</sup> Interest on such debt will need to be paid as a necessary evil. Borrowing may also have to be resorted to in future if economic growth is not to be affected adversely. The Muslim countries concerned should, however, feel themselves under an economic and moral obligation to borrow only what is absolutely indispensable as required by the Qur'ān.<sup>5</sup> This is also indispensable for preserving the independence of the Muslim countries. The greater the debt, the more vicious the debt trap and the smaller the freedom of the Muslim countries to adopt independent national and international policies in their larger, overall interest.

The Muslim countries concerned should hence gradually amortise as much of their existing foreign debt as is possible over a given period of time. If the Muslim countries' economy is run honestly and efficiently with healthy monetary, fiscal and incomes policies by governments committed to the Islamic economic system, there is no reason why they would not be able to reduce their dependence on foreign borrowing. By creating a proper investment climate conducive to the flow of foreign capital, it should be possible to attract an increasing volume of equity capital to reduce substantially the proportion of interest-based loans. For the creation of such an investment climate, it is not sufficient merely to offer tax relief and guarantees for the repatriation of capital and dividends. It is more important to create a healthy economic environment, which depends essentially on stable political conditions and sound economic policies that inspire the confidence of both domestic and foreign investors. The longer the Muslim countries take to establish such a climate, the longer it will take them to reduce their foreign indebtedness.

All normal international transactions would, however, have to remain on the basis of interest until the Muslim countries can free themselves from the interest element through an expansion in their mutual relations and some reciprocal arrangement with non-Muslim countries. This cannot be done until the economies of Muslim countries

become stronger and capable of satisfying their mutual needs. The mutual economic relations of Muslim countries, though not strong at present, have been expanding and strengthening in recent years. This process could be expedited through increased cooperation and the co-financing of projects directed towards increasing their complementarity to enable them to meet their mutual needs as much as possible.

### Notes and References (Chapter 9)

1. The Prophet, peace be on him, warned, "Beware of injustice for injustice will lead to absolute darkness on the Day of Judgement" (*Sahih Muslim, Kitāb al-Birr wa al-Silah wa al-Adab, Bāb Tahrīm al-Zulm*, from Jābir Ibn 'Abdallah). Prophet, peace be on him, has used the word *zulumāt* in the *hadīth*. *Zulumāt* is the plural of *zulmah* or darkness and signifies several layers of darkness leading ultimately to 'pitch' or 'absolute' darkness as is also evident in the Qur'ānic verse 24: 40.
2. This is a part of the letter written by 'Umar to Abū Mūsā: al-Ash'arī, one of his governors. See Abū Yūsuf, *Kitāb al-Kharāj* (Cairo: Al-Matba'ah al-Salafiyyah, 1352 AH), p. 117.
3. *Report of the Council of Islamic Ideology on the Elimination of Interest from the Economy* (Islamabad: Government of Pakistan, 1980). pp. 25-6.
4. See the relevant country tables in IBRD, *World Debt Tables: External Debt of Developing Countries*, 1982-83 edition along with the *Supplement*, and Tables 35-8 in IMF, *World Economic Outlook, 1984*.
5. The Qur'ānic verse being referred to is actually related to certain specified items which have been prohibited but the use of which has been allowed in extremely dire circumstances. "He has forbidden carrion, blood, pork and that which has been slaughtered in the name of other than God. However, if one is forced by dire necessity without wilful disobedience or transgression of the limit, no sin shall be on him. Certainly God is forgiving and kind" (2: 173). There are a number of other verses of this same implication in the Qur'ān (see, for example, 5: 4, 6: 145 and 16: 115). By analogy, this principle may be applied to interest paid to countries with whom no alternative arrangement is possible provided that it is resorted to only to the extent absolutely necessary.

## Appendix I

### ***Ribā in the Qur’ān, Ḥadīth and Fiqh***

#### **1.1 RIBĀ IN THE QUR’ĀN**

1. First Revelation (*Sūrah* al-Rūm, verse 39)

That which you give as interest to increase the peoples’ wealth increases not with God; but that which you give in charity, seeking the goodwill of God, multiplies manifold. (30: 39)

2. Second Revelation (*Sūrah* al-Nisā’, verse 161)

And for their taking interest even though it was forbidden for them, and their wrongful appropriation of other peoples’ property, We have prepared for those among them who reject faith a grievous punishment (4: 161)

3. Third Revelation (*Sūrah* Āl ‘Imrān, verses 130-2)

O believers, take not doubled and redoubled interest, and fear God so that you may prosper. Fear the fire which has been prepared for those who reject faith, and obey God and the Prophet so that you may receive mercy. (3: 130-2)

4. Fourth Revelation (*Sūrah* al-Baqarah, verses 275-81)

Those who benefit from interest shall be raised like those who have been driven to madness by the touch of the Devil; this is because they say: “Trade is like interest” while God has permitted trade and forbidden interest. Hence those who have received the admonition from their Lord and desist, may have what has already passed, their case being entrusted to God; but those who revert shall be the inhabitants of the fire and abide therein for ever. (275)

God deprives interest of all blessing but blesses charity; He loves not the ungrateful sinner. (276)

Those who believe, perform good deeds, establish prayer and pay the *zakāt*, their reward is with their Lord; neither should they have any fear, nor shall they grieve. (277) .

O believers, fear God, and give up the interest that remains outstanding if you are believers. (278)

If you do not do so, then be sure of being at war with God and His Messenger. But, if you repent, you can have your principal. Neither should you commit injustice nor should you be subjected to it. (279)

If the debtor is in difficulty, let him have respite until it is easier, but if you forego out of charity, it is better for you if you realise. (280)

And fear the Day when you shall be returned to the Lord and every soul shall be paid in full what it has earned and no one shall be wronged. (281)

(2:275-81)

## 1.2 RIBĀ IN ḤADĪTH

### A General

1. From Jābir: The Prophet, may peace be on him, cursed the receiver and the payer of interest, the one who records it and the two witnesses to the transaction and said: “They are all alike [in guilt].” (Muslim, *Kitāb al-Musāqāt*, *Bāb la ‘ni ākili al-ribā wa mu’kilihi*; also in Tirmidhī and *Musnad Aḥmad*)
2. Jābir ibn ‘Abdallāh, giving a report on the Prophet’s Farewell Pilgrimage, said: The Prophet, peace be on him, addressed the people and said “All of the *ribā* of *Jāhiliyyah* is annulled. The first *ribā* that I annul is our *ribā*, that accruing to ‘Abbās ibn ‘Abd al-Muṭṭalib [the Prophet’s uncle]; it is being cancelled completely.” (Muslim, *Kitāb al-Ḥajj*, *Bāb Ḥajjati al-Nabī*, may peace be on him; also in *Musnad Aḥmad*)
3. From ‘Abdallāh ibn Ḥanzalah: The Prophet, peace be on him, said: “A dirham of *ribā* which a man receives knowingly is worse than committing adultery thirty-six times” (*Mishkāṭ al-Maṣābīh*, *Kitāb al-Buyu’*, *Bāb al-ribā*, on the authority of Aḥmad and Daraquṭnī). Bayhaqī has also reported the above *ḥadīth* in *Shu‘ab al-īmān* with the addition that “Hell befits him whose flesh has been nourished by the unlawful” (*ibid.*)
4. From Abū Hurayrah: The Prophet, peace be on him, said: “On the night of Ascension I came upon people whose stomachs were like houses with snakes visible from the outside. I asked Gabriel who they were. He replied that they were people who

had received interest.” (Ibn Mājah, *Kitāb al-Tijārāt, Bāb al-taghlīz fī al-ribā*; also in *Musnad Aḥmad*)

5. From Abū Hurayrah: The Prophet, peace be on him, said: “*Ribā* has seventy segments, the least serious being equivalent to a man committing adultery with his own mother.” (Ibn Mājah, *ibid.*)
6. From Abū Hurayrah: The Prophet, peace be on him, said: “There will certainly come a time for mankind when everyone will take *ribā* and if he does not do so, its dust will reach him.” (Abū Dāwūd, *Kitāb al-Buyūʿ, Bāb fī ijtinābi al-shubuhāt*; also in Ibn Mājah)
7. From Abū Hurayrah: The Prophet, peace be on him, said: “God would be justified in not allowing four persons to enter paradise or to taste its blessings: he who drinks habitually, he who takes *ribā*, he who usurps an orphan’s property without right, and he who is undutiful to his parents.” (*Mustadrak al-Ḥakīm, Kitāb al-Buyūʿ*)

#### B. *Ribā an-Nasīʾah*

1. From Usāmah ibn Zayd: The Prophet, peace be on him, said: “There is no *ribā* except in *nasīʾah* [waiting].” (Bukhārī, *Kitāb al-Buyūʿ, Bāb Bayʿ al-dīnāri bi al-dīnār nasaʾan*; also Muslim and *Musnad Aḥmad*) “There is no *ribā* in hand-to-hand [spot] transactions.” (Muslim, *Kitāb al-Musāqāt, Bāb bayʿi al-ṭaʾām mithlan bi mithlin*; also in *Nasāʾī*)
2. From Ibn Masʿūd: The Prophet, peace be on him, said: “Even when interest is much, it is bound to end up into paltriness.” (Ibn Mājah, *Kitāb al-Tijārāt, Bāb al-taghlīz fī al-ribā*; also in *Musnad Aḥmad*)
3. From Anas ibn Mālīk: The Prophet, peace be on him, said: “When one of you grants a loan and the borrower offers him a dish, he should not accept it; and if the borrower offers a ride on an animal, he should not ride, unless the two of them have been previously accustomed to exchanging such favours mutually.” (*Sunan al-Bayhaqī, Kitāb al-Buyūʿ, Bāb kulli qardin jarra manfaʿatan fa huwa ribān*)
4. From Anas ibn Mālīk: The Prophet, peace be on him, said: “If a man extends a loan to someone he should not accept a gift.”

(*Mishkāt, op. cit.*, on the authority of Bukhārī's *Tārikh* and Ibn Taymiyyah's *al-Muntaqā*)

5. From Abū Burdah ibn Abī Mūsā: I came to Madinah and met 'Abdallah ibn Salām who said, "You live in a country where *ribā* is rampant; hence if anyone owes you something and presents you with a load of hay, or a load of barley, or a rope of straw, do not accept it for it is *ribā*." (*Mishkāt, op. cit.*, reported on the authority of Bukhārī)
6. Faḍālah ibn 'Ubayd said that "The benefit derived from any loan is one of the different aspects of *ribā*." (*Sunan al-Bayhaqī, op. cit.*) This *ḥadīth* is *mawqūf* implying that it is not necessarily from the Prophet; it could be an explanation provided by Faḍālah himself, a companion of the Prophet, peace be on him.

#### C. *Ribā al-Faḍl*

1. From 'Umar ibn al-Khaṭṭāb: The last verse to be revealed was on *ribā* and the Prophet, peace be on him, was taken without explaining it to us; so give up not only *ribā* but also *rībah* [whatever raises doubts in the mind about its rightfulness]. (Ibn Mājah, *op. cit.*)
2. From Abū Sa'īd al-Khudrī: The Prophet, peace be on him, said: "Do not sell gold for gold except when it is like for like, and do not increase one over the other; do not sell silver for silver except when it is like for like, and do not increase one over the other; and do not sell what is away [from among these] for what is ready." (Bukhārī, *Kitāb al-Buyū'*, *Bāb bay' al-fidḍati bi al-fidḍah*; also Muslim, Tirmidhī, Nasā'ī and *Musnad Aḥmad*)
3. From 'Ubādah ibn al-Ṣāmit: The Prophet, peace be on him, said: "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt - like for like, equal for equal, and hand-to-hand; if the commodities differ, then you may sell as you wish, provided that the exchange is hand-to-hand." (Muslim, *Kitāb al-Musāqāt*, *Bāb al-ṣarfī wa bay' al-dhahabi bi al-waraqī naqdan*; also in Tirmidhī)
4. From Abū Sa'īd al-Khudrī: The Prophet, peace be on him, said: "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt - like for like, and hand-to-hand. Whoever pays more or takes more has indulged

in *ribā*. The taker and the giver are alike [in guilt].” (Muslim, *ibid*; and Musnad Aḥmad)

5. From Abū Sa‘īd and Abū Hurayrah: A man employed by the Prophet, peace be on him, in Khaybar brought for him *janībs* [dates of very fine quality]. Upon the Prophet’s asking him whether all the dates of Khaybar were such, the man replied that this was not the case and added that “they exchanged a *ṣā’* [a measure] of this kind for two or three [of the other kind]”. The Prophet, peace be on him, replied, “Do not do so. Sell [the lower quality dates] for dirhams and then use the dirhams to buy *janībs*. [When dates are exchanged against dates] they should be equal in weight.” (Bukhārī, *Kitāb al-Buyū’*, *Bāb idhā arāda bay’a tamrīn bi tamrīn khayrun minhu*; also Muslim and Nasā’ī)
6. From Abū Sa‘īd: Bilāl brought to the Prophet, peace be on him, some *barnī* [good quality] dates whereupon the Prophet asked him where these were from. Bilāl replied, “I had some inferior dates which I exchanged for these - two *ṣā’*s for a *ṣā’*.” The Prophet said, “Oh no, this is exactly *ribā*. Do not do so, but when you wish to buy, sell the inferior dates against something [cash] and then buy the better dates with the price you receive.” (Muslim, *Kitāb al-Musāqāt*, *Bāb bay’ al-ṭa‘ami mithlan bi mithlin*; also Musnad Aḥmad)
7. From Faḍālāh ibn ‘Ubayd al-Anṣari: On the day of Khaybar he bought a necklace of gold and pearls for twelve dīnārs. On separating the two, he found that the gold itself was equal to more than twelve dīnārs. So he mentioned this to the Prophet, peace be on him, who replied, “It [jewellery] must not be sold until the contents have been valued separately.” (Muslim, *Kitāb al-Musāqāt*, *Bāb bay’i al-qiladah fihā kharazun wa dhahab*; also in Tirmidhī and Nasā’ī)
8. From Abū Umamah: The Prophet, peace be on him, said: “Whoever makes a recommendation for his brother and accepts a gift offered by him has entered *ribā* through one of its large gates.” (*Bulūgh al-Marām*, *Kitāb al-Buyū’*, *Bāb al-ribā*, reported on the authority of Aḥmad and Abū Dāwūd)
9. From Anas ibn Mālīk: The Prophet, peace be on him, said: “Deceiving a *mustarsal* [an unknowing entrant into the market] is *ribā*. (*Suyūṭī*, *al-Jāmi’ al-Ṣaghīr*, under the word *ghabn*;

Kanz al-‘Ummāl, *Kitāb al-Buyū‘*, *al-Bāb al-thānī, al-faṣl al-thānī*, on the authority of *Sunan al-Bayhaqī*)

10. From ‘Abdallah ibn Abī Awfā: The Prophet, peace be on him, said: “A *nājish* [one who serves as an agent to bid up the price in an auction] is a cursed taker of *ribā*.” (Cited by Ibn Ḥajar al-‘Asqalānī in his commentary on al-Bukhārī called *Fath al-Bārī, Kitāb al-Buyū‘, Bāb al-najsh*; also in *Suyūṭī, al-Jāmi‘ al-Ṣaḡhīr*, under the word *al-nājish* and Kanz al-‘Ummāl, *op. cit.*, both on the authority of Ṭabarānī’s *al-Kabīr*)

### 1.3 RIBĀ IN FIQH

#### 1. The Four Schools

‘Abd al-Raḥmān al-Jazīrī’s *al-Fiqh ‘alā al-Madhāhib l-Arba’ah*, is a compendium on the juristic opinions of the four predominant schools of Muslim jurisprudence. It is held in high esteem and considered to be an authority on the subject. Given below are some relevant excerpts from this book on the subject of *ribā*.

#### Definition and Classification

*Ribā* is one of those unsound (*fāsid*) transactions which have been severely prohibited (*nahyan mughallaḏan*). It literally means increase. ..

However, in *fiqh* terminology, *ribā* means an increase in one of two homogeneous equivalents being exchanged without this increase being accompanied by a return. It is classified into two categories.<sup>1</sup> First, *ribā Al-nasī’ah* where the specified increase is in return for postponement of, or waiting for, the payment; for example, buying an *irdab* (a specific measure) of wheat in winter against an *irdab* and a half of wheat to be paid in

<sup>1</sup> The Shafi‘iyyah divide *ribā* into three categories. First, *ribā al-faḍl* which includes *ribā* on loans, as the lender extending a loan of twenty guineas on condition that he will receive in return an advantage, like the borrower purchasing a commodity from the lender, or marrying the lender’s daughter, or receiving a monetary benefit as discussed under. void transactions, (*al-bay‘ al-fāsid*); second, *ribā al-nasī’ah* as mentioned; and third, hand-to-hand *ribā* which means selling two homogeneous commodities like wheat, without reciprocal possession on spot. (This footnote is also a part of the quotation.)



summer. As the half *irdab* which has been added to the price was not accompanied by an equivalent value in the commodity sold and was merely in return for the waiting, it is called *ribā al-nasī'ah*. The second category is *ribā al-faḍl*, which means that the increase mentioned is irrespective of the postponement and is not offset by something in return. This happens when an *irdab* of wheat is exchanged hand to hand for an *irdab* and a *kilah* (another measure) of its own counterpart, the buyer and the seller both taking reciprocal possession; or when ten carats of gold produce are exchanged for twelve carats of similar gold produce.

#### *Ribā al-Nasī'ah*

There is no difference among Muslim jurists about the prohibition of *ribā al-nasī'ah*. It is indisputably one of the major sins. This is established by the Book of God, the *Sunnah* of His Prophet, and the consensus of the *ummah*. The Qur'ān says: . . (Verses 2: 275-9).

This is the Book of God which has prohibited *ribā* vehemently and has reprimanded the taker so severely that it makes those who believe in their Lord and dread His punishment tremble with fear. Can any reprimand be harsher than God equating the takers of *ribā* with those who have risen in revolt against Him and are at war with Him and His Prophet? What will be the state of that feeble human being who fights with the Almighty and Overpowering God, Whom nothing on earth or in the Heaven can frustrate. There is no doubt that by resorting to *ribā* such a person has adopted the course of self-destruction and deprivation.

The obvious meaning of *ribā* to be understood from this noble verse of the Qur'ān is the *ribā* known by the Arabs in the *Jāhiliyyah* period as explained by the commentators of the Qur'ān. More than one of them has mentioned that when a loan extended by an Arab matured, he would ask the borrower for the return of the principal or for an 'increase' in return for the postponement. This is also the 'increase' that is known to us. This increase was either in quantity, like postponing the return of a camel now for two in the future, or in age, like postponing the return of a camel aged one year against a camel aged two or three years in the future. Similarly, the Arabs were familiar

with situations where a lender would advance money for a period and take a specified amount of *ribā* every month. If the borrower was unable to repay the principal when the loan matured, he would be allowed an extension in the time of repayment [rescheduling] with the continuation of the *ribā* he has been receiving from the borrower. This is the *ribā* which is prevalent now and charged by banks and other institutions in our countries. God has prohibited it for Muslims. . .

The noble verses have decisively prohibited *ribā al-nasī'ah* which involves, what is generally understood in our times, as the giving of a principal amount on loan for a given period against the payment of interest in percentage terms on a monthly or annual basis. Some people try to justify this kind of *ribā* in spite of its conflict with Islam. It is far removed from Islam and is in discord with its basic philosophy in form as well as meaning. Some of them claim that what is prohibited is the charging of *ribā* many times the principal amount as stated by the Qur'ān: "O believers! charge not doubled and redoubled interest, and fear God so that you may prosper" (3: 130). This claim is however absolutely wrong because the objective of the verse is to express a repulsion against interest. . .

#### *Ribā al-Faḍl*: Its Legal Position

*Ribā al-Faḍl* . . . is prohibited according to the four schools of jurisprudence. But some of the Prophet's companions, among them Sayyid 'Abdallāh ibn 'Abbās (may God be pleased with him), allowed it. Nevertheless, it is reported that he recanted his opinion afterwards and talked about its prohibition. *Ribā al-Faḍl* does not have substantial effect on transactions because of the rarity of its occurrence; it is not the objective of people to buy or sell one thing in exchange for the same thing unless there is something extra from which each of the parties may benefit. Notwithstanding this, it has been prohibited because it might lead to the defrauding or deception of less sophisticated persons. For example, a shrewd trader may claim that the *irdab* of a specific brand of wheat is equivalent to three *irdabs* of the other kind because of the excellence of its quality, or this unique piece of gold ornament is equivalent in value to twice its weight in gold; in such transactions there undoubtedly is defrauding of people and harm to them.

The authority for the prohibition of *ribā al-faḍl* lies in what the Prophet, peace be on him, said:

Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt - like for like, equal for equal, and hand-to-hand; if the commodities differ, then you may sell as you wish, provided that the exchange is hand-to-hand.

This *ḥadīth* indicates that it is neither proper to sell these homogeneous commodities against themselves with addition nor is it proper to delay the reciprocal taking of possession. Hence it is not proper to sell a gold guinea against a gold guinea and ten *qurūsh*, neither on a hand-to-hand, nor on a deferred basis, just as it is not right to sell a gold bar weighing ten carats against a gold bar weighing twelve carats. Similar is the case with wheat and barley and other items mentioned in the *ḥadīth*.

And if such is the case, then does *ribā* enter into every commodity or is it confined to just the commodities mentioned in the *ḥadīth*, namely, gold, silver, wheat, barley, dates and salt? There is no difference of opinion among the four schools of jurisprudence that analogically *ribā* enters into other commodities not mentioned in the *ḥadīth*. If there is any difference it is in the analogy (*‘illat*) used to arrive at the conclusion that the ‘addition’ [*ribā al-faḍl*] is prohibited for all commodities wherever the analogy holds. Only the *Ẓahiriyyah* (a juristic school which was opposed to analogical reasoning) confined *ribā al-faḍl* to only the commodities specified in the *ḥadīth*. (‘Abd al-Raḥmān al- Jazīrī, *Al-Fiqh ‘Alā al-Madhāhib al-Arba‘ah*, Cairo: Al-Maktabah al-Tijāriyyah al-Kubrā, 5<sup>th</sup> ed., n.d., Vol. 2, pp. 245-8).

Even though the above excerpt is sufficient to convey the views of the four schools of jurisprudence, the reader may wish to go through the following sample of opinions from prominent Qur’ān commentators and/or jurists of the various schools, particularly the Ja‘farī school, which is not covered in the above-quoted book. It may be seen that there is hardly any difference of opinion on the subject except in presentation and in certain minor details.

2. Fakhr al-Dīn al- Rāzī (Qur’ān commentator and philosopher)

*Ribā* is of two kinds: *Ribā al-nasī'ah* and *ribā al-faḍl*.

*Ribā al-nasī'ah* is what was well known and conventional among the Arabs in *Jāhiliyyah*. They used to give loans on the condition that every month they will receive a stipulated amount with the whole principal remaining outstanding. Then, when the loan matured and the borrower was unable to clear his obligation, the amount was raised and the period was extended. This is the *ribā* that was practised in the *Jāhiliyyah*.

*Ribā al-naqd (faḍl)* is, however, the selling of one maund [a unit of weight] of wheat, or anything similar to it, against two maunds. (*Al-Tafsīr al-Kabīr*, Tehran: Dār al-Kutub al-‘Ilmiyyah, 2nd ed., n.d., vol. 7, p. 85)

3. Abū Bakr al-Jaṣṣāṣ (Qur’ān commentator and Ḥanafī jurist)

The literal meaning of *ribā* is increase. . but in the *Sharī‘ah* it has acquired a connotation that its literal meaning does not convey. The Prophet, peace be on him, termed the increase, [which is a condition] for waiting, as *ribā* as is evident from the *ḥadīth* narrated by Usāmah ibn Zayd in which the Prophet said: “*Ribā* is in waiting. . .” Hence God abolished the *ribā* which was being practised at that time. He also invalidated some other trade transactions and called them *ribā*. Accordingly, the Qur’ānic verse “God has prohibited *ribā*” covers all transactions to which the connotation applies in the *Sharī‘ah* even though the indulgence of the Arabs in *ribā*, as mentioned above, related to loans in *dirhams* and *dīnārs* for a specified period with the increase as a condition.. The term *ribā* hence signifies different meanings. One is the *ribā* prevalent in *Jāhiliyyah*; the second is the disparity or differential (*tafāḍul*) in the volume or weight of a commodity [in spot transactions] . . .; and the third is postponing (*al-nasā*); this implies that it is not permitted to sell a commodity against future delivery of the same volume, weight or other measure of the given commodity. (*Aḥkām al-Qur’ān*, Cairo: Al-Maṭba‘ah al-Bahiyyah al-Miṣriyyah, 1347 AH, vol. 1, pp. 551-2)

4. Muḥammad ibn ‘Abdallāh ibn al-‘Arabī (Qur’ān commentator and Mālikī jurist)

*Ribā* literally means increase, and in the Qur’ānic verse (2: 275) it stands for every increase not justified by the return (*Aḥkām al-Qur’ān*, Cairo: ‘Isā al-Bābī al-Ḥalabī, 1957, p. 242)

It may be clarified here that the ‘waiting’ involved in a loan is not considered by the jurists to be a return justifying the increase (interest) on the principal amount.

5. Ibn Qayyim al-Jawziyyah

*Ribā* is of two kinds: *Jalī* and *Khafī*. The *Jalī* has been prohibited because of the great harm it carries and the *Khafī* has been prohibited because it is an instrument for the *Jalī*. Hence prohibition of the former is deliberate while that of the latter is precautionary.

The *Jalī* is *ribā al-nasī’ah* and this is what was engaged in during the *Jāhiliyyah*, like allowing the postponement of repayment of principal against an increase, and every time there was a postponement, there was an increase. .

However, *ribā al-faḍl* has been prohibited to close the access to *ribā al-nasī’ah*. (*A’lām al-Muwaqqi’īn*, Cairo: Maktabah al-Kulliyāt al-Azhariyyah, 1968, vol. 2, pp. 154-5)

6. Shāh Walī-Allāh Dihlawī

Remember that *ribā* is of two kinds: One is primary (*ḥaqīqī*),<sup>2</sup> the other is subject to it. Primary *ribā* is only on loans. The other *ribā* is called *ribā al-faḍl* and is akin to primary *ribā*. (*Ḥujjat Allāh al-Bālighah*, Lahore: Qawmī Kutub Khānā, 1953, tr. Mawlāna Abdul Rāhīm, vol. 2, pp. 474-5).

7. ‘Abdallāh ibn Aḥmad ibn Qudāmāh al-Miqdasī (a Ḥanbalī jurist)

*Ribā* is of two kinds: *ribā al-faḍl* and *ribā al-nasī’ah*. The prohibition of *ribā al-faḍl* involves the exchange of one commodity against itself and covers all commodities which are exchanged by volume or by weight regardless of whether the quantity exchanged is small, like one date for two dates or one grain for two grains. . . (p. 64)

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<sup>2</sup> The actual translation of *ḥaqīqī* should be ‘real’. This has, however, been avoided because of the possible confusion with real interest which technically means nominal interest adjusted for price inflation.

*Ribā al-nasī'ah* is involved in the exchange of two commodities one of which is not the price. (p. 73) (*Al-Muqni'*, Qatar: Maṭābi' Qatar al-Waṭaniyyah, 1973, vol. 2, pp. 64-77)

8. Ḥasan ibn al-Muṭahhar (Ja'farī jurist)

*Ribā* literally means increase and, technically, it refers to the increase in the exchange of two commodities, one against its own kind. . . . *Ribā* is of two kinds: *Ribā al-faḍl* and *Ribā al-nasī'ah* and the jurists are agreed on their prohibition. (*Tadhkirah al-Fuqahā'*, Najaf: Maṭba'ah al-Najaf, 1955, vol. 7, p. 84)

## Appendix II<sup>1</sup>

### ***Muḍārabah, Shirkah and the Corporation***

All forms of business organisation where two or more persons pool together their financial resources, entrepreneurship, skills and goodwill to do business have been discussed by the *fuqahā'* under the general terms of *muḍārabah* and *shirkah*. Most of the principles indicated below have been derived by the *fuqahā'* directly or indirectly from the Qur'ān, the *ḥadīth* and the practice of the *ṣaḥābah* (the Prophet's companions). It is generally agreed that the essential difference between *muḍārabah* and *shirkah* lies in whether or not all the partners make a contribution towards management as well as finance or only one of these. The legal discussion of *muḍārabah* is nearly uniform among the different schools of Muslim jurisprudence, with differences mainly on minor details. However, in the case of *shirkah*, there are some fundamental differences. Hence only the broad principles of *shirkah* have been outlined in this Appendix. The major differences have been indicated in footnotes.

*Muḍārabah* and *shirkah* are both treated as fiduciary contracts (*'uqūd al-amānah*) in the *fiqh* literature and unblemished honesty and fairness are considered absolutely imperative. The partners must act in good faith for the benefit of the partnership and any effort by partners (or directors of joint stock companies) to cheat and derive an unfair share of income would be in utter violation of Islamic teachings. The Qur'ān requires the honest fulfilment of all contracts (5: 1) irrespective of whether these are written or oral, and explicit or implied. It prohibits all betrayal of trusts (8: 27) and considers it immoral to derive any income by cheating, dishonesty or fraud.<sup>2</sup>

#### **MUḌĀRABAH**

*Muḍārabah* is a form of partnership where one of the contracting parties, called the *ṣāhib al-māl* or the *rabb al-māl* (the financier), provides a specified amount of capital and acts like a sleeping or dormant partner, while the other party, called

the *muḍārib* (entrepreneur), provides the entrepreneurship and management for carrying on any venture, trade, industry or service with the objective of earning profits. The *muḍārib* is in the nature of a trustee as well as an agent of the business. As a trustee he is required to act with prudence and in good faith and is responsible for losses incurred due to his wilful negligence. As an agent he is expected to employ and manage the capital in such a manner as to generate optimum profits for the *muḍārabah* business without violating the values of Islam. The *muḍārabah* agreement could also be consummated between several financiers and entrepreneurs.

*Muḍārabah* is also synonymously termed *qirād* in which case the financier is called *muqārid*. In general, the *Ḥanafīyyah*, *Ḥanbaliyyah* and *Zaydiyyah* schools of Muslim jurisprudence have used the term *muḍārabah* while the *Mālikiyyah* and *Shāfi'iyyah* have preferred the term *qirād*.

The *muḍārabah* agreement could be formal or informal, and, written or oral. However, in view of the Qur'ānic emphasis on the writing and formalising of loan agreements (al-Qur'ān, 2: 282-3), it would be preferable for all *muḍārabah* agreements to be in writing, with proper witnesses, to avoid any misunderstanding.

*Muḍārabah* contracts could also be unrestricted or restricted. In the unrestricted case, the *muḍārabah* agreement does not specify the period, the place of business, the specific line of trade, industry or service, and the suppliers or customers to be dealt with. A restriction in terms of any one of these renders the *muḍārabah* into a restricted one. In the case of restricted *muḍārabah*, the *muḍārib* must respect the restrictions imposed by the *ṣāhib al-māl*. If the *muḍārib* acts contrary to these restrictions, he is alone responsible for the consequences. In the case of *muḍārabah* restricted by time, the *muḍārabah* is dissolved with the expiry of the specified time period. In the case of unrestricted *muḍārabah*, the *muḍārib* has an open mandate and is authorised to do everything necessitated by the *muḍārabah* in the ordinary course of business. If he is guilty of wilful negligence, fraud or misrepresentation, he is himself



responsible for the consequences, and the resulting loss, if any, cannot be charged to the *muḍārabah* account.

All normal expenses related to the *muḍārabah* business, but not the personal expenses of the *muḍārib*, can be charged to the *muḍārabah* account. The *muḍārib* is not entitled to a fixed remuneration or to an absolute amount of profit specified in advance. His only entitlement beyond the normal expenses of business is to a proportionate share in the profit as a reward for his management services.

The net profit is to be divided between the *ṣāhib al-māl* and the *muḍārib* in accordance with a just proportion agreed in advance and explicitly specified in the *muḍārabah* agreement. There cannot be a distribution of profits until the losses have been written off and the equity of the *ṣāhib al-māl* has been fully restored. Any distribution of profits before the conclusion of the *muḍārabah* agreement will be considered as an advance. In the case of a continuing *muḍārabah*, it may be permissible to specify a mutually agreed accounting period for the distribution of profits, treating each period independently. However, it seems that even in such an arrangement, the net loss in any given accounting period would need to be written off by charges against profits in future periods unless the *muḍārabah* agreement has come to a final conclusion. Hence in the case of a continuing *muḍārabah*, it may be advisable to build reserves from profits to offset losses.

All losses incurred in the ordinary course of business must be charged against profits before they can be charged against the equity of the *ṣāhib al-māl*. The net loss must however be borne by the *ṣāhib al-māl* and any stipulation that it will also be shared by the *muḍārib* would be void and unenforceable. The general principle is that the *ṣāhib al-māl* risks only his capital while the *muḍārib* risks only his time and effort. This is probably the reason why *muḍārabah* is sometimes referred to as 'partnership in profit'.<sup>3</sup>

If it has been agreed that the entire profit will be taken by the *muḍārib*, then the *ṣāhib al-māl* would be considered a lender

and the *muḍārib* would be required to bear all losses and be responsible for returning the principal (which is, in this case, *qard ḥasan*) to the lender (*ṣāhib al-māl*) in accordance with the agreement. If it has been agreed that the entire profit will be taken by the *ṣāhib al-māl*, the *muḍārib* will be entitled to the customary remuneration (*ajr al-mithl*) for his services. If he decides to forego even the remuneration, the transaction becomes an *ibḍāʿ* or *biḍāʿah*. This has often been the case in history, particularly when the capital of widows, orphans and charitable institutions was involved or when services were rendered by businessmen to each other by way of mutual cooperation.

The liability of the *ṣāhib al-māl* in a *muḍārabah* contract is limited to the extent of his contribution to the capital and no more. This is an important point because it would not be appropriate for the *ṣāhib al-māl* to be a sleeping partner if his liability is unlimited. The *muḍārib* is not allowed to commit the *muḍārabah* business for any sum greater than the capital contributed by the *ṣāhib al-māl*. If he does so he is on his own, himself eligible for the profits from his extra commitments and responsible for the losses, if any. Goods purchased on credit in the course of normal business operations within the framework of the general consent of the *ṣāhib al-māl* in the *muḍārabah* agreement would be on the responsibility of both the *ṣāhib al-māl* and the *muḍārib* in accordance with the principles of *shirkah al-wujūh* (discussed under *shirkah*).

In case the *muḍārib* also contributes a specified amount to the capital of the *muḍārabah*, he takes the entire profit related to his portion of the total capital, the balance of the profit being divided as agreed. The loss, if any, would be divided among them in proportion to their share in the total capital, for losses, according to the *fuqahāʾ*, are erosion in equity and must be charged to the capital.

The *muḍārabah* would become dissolved with the completion of the venture for which it was undertaken, or the expiry of the specified time period, or the death of either the *ṣāhib al-māl*

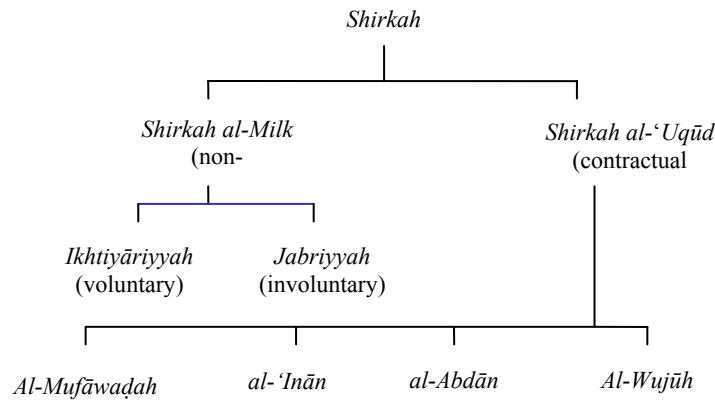
or the *muḍārib*, or the serving of notice by either of the two partners of his intention to dissolve the *muḍārabah*.

The *muḍārib* is required to work with honesty and sincerity and to exercise the maximum possible care and precaution in the exercise of his functions. In the words of al-Jazīrī, the *muḍārib* should discharge his duties like” A Muslim who does not commit a breach of trust, does not lie and does not act insincerely; such is the man with whom the *ṣāhib al-māl* will be at ease and in whom he will have confidence for the safety of his investments. . . . The *ṣāhib al-māl* should not give his funds to someone who is unwary, spendthrift or untrustworthy, because the care and safety of wealth are imperatives and its waste and dissipation are prohibited.”<sup>4</sup>

### **SHIRKAH**

*Shirkah* (or *sharikah*) refers to partnership between two or more persons.<sup>5</sup> It may be of two kinds: *shirkah al-milk* (non-contractual) and *shirkah al-‘uqūd* (contractual).

*Shirkah al-milk* (non-contractual partnership) implies co-ownership and comes into existence when two or more persons happen to get joint-ownership of some asset without having entered into a formal partnership agreement; for example, two persons receiving an inheritance or gift of land or property which may or may not be divisible. The partners have to share the gift, or inherited property or its income, in accordance with their share in it until they decide to divide it (if it is divisible, e.g., land) or sell it (if it is indivisible, e.g., a house or a ship). If the property is divisible and the partners still decide to stick together, the *shirkah al-milk* is termed *ikhtiyāriyyah* (voluntary). However, if it is indivisible and they are constrained to stay together, the *shirkah al-milk* is characterised as *jabriyyah* (involuntary). *Shirkah al-milk*, the essence of which is common ownership of property, cannot be considered a partnership in a strict sense because it has not come into existence by mutual agreement to share profits and risks. Accordingly, it appears in *fiqh* discussions as a peripheral notion.



*Shirkah al-'uqūd* (contractual partnership) can, however, be considered a proper partnership because the parties concerned have willingly entered into a contractual agreement for joint investment and sharing of profits and risks. the agreement need not necessarily be formal and written. It could also be informal and oral. However, as indicated under *murdarabah*, it would be preferable if the *shirkah al-'uqūd* is also formalised by a written agreement with proper witnesses, specifically stating the agreed terms and conditions in conformity with the Qur'ānic teachings about loans and important business transactions (2: 282-3). Just as in *muḍārabah*, the profits can be shared in any equitably agreed proportion. Losses must, however, be shared in proportion to capital contributions.<sup>6</sup>

*Shirkah al-'uqūd* has been divided in the *fiqh* books into four kinds: *al-Mufāwāḍah* (full authority and obligation); *al-'Inān* (restricted authority and obligation); *al-'Abdān* (labour, skill and management); and *al-Wujūh* (goodwill, credit-worthiness and contacts).

In the case of *mufāwāḍah* the partners are adults, equal in their capital contribution, their ability to undertake responsibility and their share of profits and losses, have full authority to act on behalf of the others and are jointly and severally responsible for

the liabilities of their partnership business, provided that such liabilities have been incurred in the ordinary course of business. Thus each partner can act as an agent (*wakīl*) for the partnership business and stand as surety or guarantor (*kafīl*) for the other partners.<sup>7</sup>

*‘Inān* on the other hand implies that all partners need not be adults or have an equal share in the capital. They are not equally responsible for the management of the business. Accordingly their share in profits may be unequal, but this must be clearly specified in the partnership contract. Their share in losses would of course be in accordance with their capital contributions. Thus in *shirkah al-‘inān* the partners act as agents but not as sureties for their colleagues.<sup>8</sup> Hence their liability towards third parties is several but not joint.

*Shirkah al-abdān*<sup>9</sup> is where the partners contribute their skills and effort to the management of the business without contributing to the capital. In *shirkah al-wujūh* the partners use their goodwill, their credit-worthiness and their contacts for promoting their business without contributing to the capital.<sup>10</sup> Both these forms of partnership, where the partners do not contribute any capital, would remain confined essentially to small-scale businesses only.

These are of course models. In practice, however, the partners may contribute not only finance but also labour, management and skills, and credit and goodwill, although not necessarily equally. The *‘inān* partnership, which implies unequal shares and is recognised by all schools, may tend to be the most popular. In this case, the profits would be divided in accordance with a contractually agreed proportion, since the *Sharī‘ah* admits an entitlement to profit arising from a partner’s contribution to anyone of these three business assets.<sup>11</sup> However, the *Sharī‘ah* makes it absolutely imperative that losses be shared in proportion to the contribution made to capital. This is because losses; as already indicated, constitute an erosion in equity according to the *ijmā‘* of the jurists and must be charged to the capital. If a loss has been incurred in one period, it must be offset against profits in the subsequent periods until the entire

loss has been written off and the capital sum has been restored to its original level. This may be done in one stroke or in instalments depending upon circumstances and the understanding of the partners. However, until the total loss has been written off, any distribution of 'profits' will be considered as an advance to the partners. Accordingly, it would be desirable to build reserves from profits to offset automatically any losses that may be incurred in future.

Just as *shirkah* or partnership may not fall into anyone of the specific models indicated above and may be a combination of all three forms, *mudārabah* may also not fall into the classical category. The real world situation may be a combination of *mudārabah* and *shirkah* where all partners contribute to the capital but not to the entrepreneurship and management. In this case profits need not be shared in accordance with capital contributions. They may be shared in any proportion agreed to by the partners, depending on their contribution to the success and profitability of the business. The only requirement of the *Shari'ah* would be justice, which would imply that the proportional shares in profit must reflect the contribution made to the business by their capital, skill, time, management ability, goodwill and contacts. Anything otherwise would not only shatter one of the most important pillars of the Islamic value system, but also lead to dissatisfaction and conflict among the partners and destabilise the partnership. The losses *must*, however, be shared in proportion to capital contribution and the stipulation of any other proportion would be *ultra vires* and unenforceable.

It is important to indicate here that there is no specific direct discussion in the *fiqh* literature on the nature of the partners' liability, limited or unlimited, with respect to third parties. This is however, understandable because the nature of liability gains prominence under interest-based loan financing which makes it possible to raise a large superstructure on a small equity base. In such a situation it is important to know the extent of the equity-holder's liability. Limited liability helps confine the degree of the equity-holder's risk to the extent of his share in total equity. However, in an Islamic economy, since all financial participation

in business would be essentially in the form of equity, the only exceptions being suppliers' credits and *qurūd ḥasanah*, the liability of the partners would in reality be limited to their capital contributions. Prudence would induce the 'suppliers' to keep an eye on total equity, movement of sales and cash flows of the business concerned, while *qurūd ḥasanah*, as already pointed out, would tend to be limited. All other participants in the business (whether by way of loan or equity) would be treated as equity holders and would share in the risks of business. Since interest-bearing loans are not allowed, the total obligations of the business could not be out-of-step with the total assets, and any erosion in their value may not exceed the total equity. Hence, in the ultimate analysis liability would essentially be limited to the extent of the total capital (including ploughed-back profits) invested in the partnership business. However, it may be desirable to make this point clear in the legal reform being undertaken in Muslim countries in conformity with their Islamisation programme.

### **THE CORPORATION**

The corporate form of business organisation, with a separate legal entity, does not appear directly in the classical *fiqh* discussions. The closest approximation to the corporate legal entity have been the *bayt al-māl* (public treasury), mosque property, *awqāf* (trusts), and *mufāwadah* partnership.<sup>12</sup> However the *fuqahā'* have now in general approved the corporate form on the basis of the *fiqh* principles of *qiyās* (analogy) and *istiḥsān* or *maṣālih mursalah* (public interest). There are of course differences on details, but these need not concern us here.<sup>13</sup>

The corporation should be an important form of business organisation in the Islamic system. It provides certain conveniences and advantages not available in other forms of business organisation. Some of these are: (i) limited liability of the stockholders, (ii) divisibility and easy transferability of ownership, (iii) the absence of *delectus personae* among stockholders (the personal right of partners to choose other partners) such that stock certificates can change hands without the prior approval of other stockholders, (iv) separate legal entity

of the corporation apart from its stockholders, enabling the corporation to sign contracts in its own name, to sue and be sued, and to continue its separate existence perpetually irrespective of the turnover of its stockholders.

The concepts of limited liability of stockholders, easy transferability of shares and separate legal entity of the corporation should be perfectly acceptable in an Islamic economy as these do not appear to violate any principles of the *Sharī'ah*.<sup>14</sup> These advantages of the corporation would not only provide easily available, and yet 'liquid', assets to savers but also make substantially large sums of equity financing accessible to entrepreneurs, which may not be possible if reliance was placed only on *muḍārabah* and *shirkah*.

The corporate form of business organisation could be made to play a significant role in an Islamic economy after the abolition of interest. However, unlike its counterpart in the capitalist economy, the Muslim corporation should be required to raise most of its financing needs through capital subscription. Nevertheless, the scope for raising short- and medium-term financing through *muḍārabah*, *muḍārabah*, hire-purchase and leasing cannot be ruled out to avoid the over-capitalisation of the corporation, to tide over periods of liquidity shortages, and to provide respite until undercapitalisation has been removed by the issue of new shares.

The modern corporation constitutes essentially a combination of *muḍārabah* and *shirkah al-‘inān*. All shareholders are partners, not necessarily equal, by virtue of their having contributed in varying amounts to the capital of the corporation. In this sense the shareholders wear the hat of the *ṣāhib al-māl*. However, shareholders who act also as directors are like *muḍārib*s by virtue of their responsibility for the management of the company. They are agents through whom the company acts. They also occupy a fiduciary position, and must act with loyalty and good faith and exercise maximum possible care and skill in the discharge of their responsibilities in the same way as a *muḍārib*s is expected to do in his capacity as a trustee. The



directors, therefore, wear the hats of both the *ṣāhib al-māl* and the *muḍārib*.

It would, however, be necessary to regulate the corporations in the light of Islamic teachings to ensure that justice is done to shareholders as well as consumers and to remove the malpractices of corporations. The divorce of ownership from control, particularly in large corporations, leads to malpractices and it would be important to introduce reforms, especially in proxy rules, to safeguard the interests of shareholders. The directors in their capacity as *muḍāribs*, should not, according to the *Sharī'ah*, be entitled to a fixed management fee or remuneration as they are in modern corporations. In addition to their normal share in the profit like other shareholders, on the basis of their shareholdings, they may also get an agreed extra percentage share in the profit for their management services, if the corporation makes a profit. This extra percentage share must be clearly specified in the Articles of Agreement so that it is well known by the shareholders. If the corporation makes a loss, they should get no 'fee' for their management services, and should share in the losses in proportion to their stock-holdings. The adoption of this principle should prove to be healthy because the 'management' (directors and not employees) should get a reward only if it has contributed to profits.

The directors should also be prevented from making 'secret' profits for themselves. They should not be allowed to manipulate share prices or to get an advantage from their insiders' knowledge of company affairs. The 'expense account' of directors should also be controlled in the light of *muḍārabah* principles, allowing them only genuine business expenses and nothing more. These and other necessary reforms should help do away with some of the malpractices that have crept into the corporate form of business. It would also be desirable to prevent the formation of holding companies to avoid the centralisation of business and industry in a few corporations leading to concentration of wealth and power.

The reform of stock exchanges as briefly discussed in the text, would be an indispensable element of the Islamisation

programme to fit the corporate form of business organisation in the Islamic setting. The objective should be to ensure that share prices reflect underlying business conditions and do not fluctuate as erratically as they do in conventional stock markets. A well-organised and properly regulated stock market would help provide the ‘sane’ secondary market that is necessary to raise the confidence of savers and investors and to enable them to buy or sell shares in response to their circumstances or their perceptions of future market developments. Such ease and convenience in investing and disinvesting should constitute one of the important pillars for supporting the edifice of an interest-free and equity-based economy.

### Notes and References (Appendix 11)

1. In addition to some of the original sources, the author found the following secondary sources to be considerably useful in the writing of this Appendix:

(i) ‘Abd al-Rahmān Al- Jazīrī, *Kitāb al-Fiqh ‘alā al-Madhāhib al-Arba‘ah* (Cairo: AL-Maktabah al-Tijāriyyah al-Kubrā, 1938), vol. 3, pp. 34-93.

(ii) *Majallah al-Ahkām al-‘Adliyyah*, Chapters 1-7 of Book 10 on kinds of *Shirkāt*. The *Majallah* incorporates the Ḥanafī *fiqh* related to *buyū‘* (commercial transactions) codified during the Ottoman period. The English translation of this by C. R. Tyser *et al.* and entitled *The Mejelle* was published in 1967 by the All Pakistan Legal Decisions, Nabha Road, Lahore.

(iii) Aḥmad ‘Abdullah al-Qārī, *Kitāb Majallah al-Akhām al-Shar‘iyyah ‘alā Madhhab al-Imām Aḥmad ibn Ḥanbal al-Shaybānī* (Jeddah: Tihāmah, 1981), pp. 535-74. This is the Ḥanbalī counterpart of the Ḥanafī *Majallah* mentioned under (ii) above.

(iv) ‘Alī al-Khafīf, *Al-Shirkāt fī al-Fiqh al-Islāmī* (Cairo: Ma‘had al-Dirāsāt al-‘Arabiyyah al-‘Āliyah, 1962).

(v) ‘Abd al-‘Azīz al- Khayyāt, *Al-Shirkāt fī al- Sharī‘ah al-Islāmiyyah wa al-Qānūn al-Wad‘ī* (Amman, Jordan: Wizārah al- Awqāf, 1971).

(vi) M. N. Siddiqi, *Shirkat awr Muḍārabat kay Shar‘ī ‘Uṣūl* (Urdu) (Lahore: Islamic Publications Ltd., 1969).

(vii) ‘Alī Ḥasan ‘Abd al-Qādir, *Fiqh al-Muḍārabah* (Cairo: *Al-Ittiḥād al-Dawlī li-al- Bunūk al-Islāmiyyah*, 1980).

(viii) Sāmī H. Ḥamūd, *Taṭwīr al-A'māl al-Maṣrafiyyah bimā Yattaḥiqqu wa al-Sharī'ah al-Islāmiyyah* (Cairo: Dār al-Turāth, 1976), pp. 389-499.

(ix) *Raḥīq al-Misrī, Al-Jāmi' fī 'Uṣūl al-Ribā* (forthcoming book), the chapter on *Qirāḍ* (*Muḍārabah*)

(x) Abraham L. Udovitch, *Partnership and Profit in Medieval Islam* (Princeton, NJ: Princeton University Press, 1970).

2. There are innumerable Qur'ānic verses and Prophetic *aḥādīth* which emphasise the characteristics of a Muslim. It is not possible to provide a complete coverage. The interested reader may wish to refer to Chapter 3 of the author's book, *The Economic System of Islam* (London: The Islamic Cultural Centre, 1970), pp. 25-37.

3. Dr. M. N. Siddiqi suggests that it would be "advisable to describe the Islamic proposition as merely profit-sharing" (see his comments on the Report of the Pakistan Council of Islamic Ideology on the Elimination of Interest from the Economy, in Ziauddin Ahmed *et al.*, *Money and Banking in Islam*, p. 225).

4. Al- Jazīrī, *op. cit.*, vol. 3, pp. 48-9.

5. According to al-Jazīrī, *shirkah* is classical and preferable, *Ibid.*, p.63.

6. According to the Shāfi'i school, even profits should be divided in proportion to capital contributions. This is because the contribution of labour (or skill and management) is difficult to measure and it is assumed that labour will be contributed equally. Profits, like losses, should also be in proportion to the risk shared. However, if two partners contribute to the capital and only one of them works, then even according to the Shāfi'i school, the working partner's share in the profit should be higher (Muhammad ibn Rushd al-Qurṭubī, *Bidāyah al-Mujtahid*, Cairo: Mustafā al- Bābī al-Ḥalabī, 1960, vol. 2, pp. 253-4; and Abū al-Ḥasan 'Alī al-Marghīnānī, *al-Hidāyah*, Cairo: Mustafā al-Bābī al- Ḥalabī, n.d., vol. 3, p. 7).

7. The Ḥanafī, the Mālikī and the Ḥanbalī schools, all recognise *mufāwadah* partnership, with some differences. The Ḥanafīs require that there be equality of the partners in net wealth and that the entire net wealth should enter the partnership business. The Malikīs do not consider this to be necessary. They require only the equality of capital contributions (see Ibn Rushd, *op. cit.*, vol. 2, pp. 254-5; and Shams al- Dīn al-Sarakhsī, *Al-Mabsūṭ* (Beirut: Dār al-Ma'rifah li al-Ṭabā'ah wa al-Nashr, 3rd. ed., 1978), vol. 11, p. 177).

8. *Al-Hidāyah*, *op. cit.*, vol. 3, p. 4; see also, *Majallah*, *op. cit.*, Article 1335. See also Udovitch, *op. cit.*, pp. 134-5.

‘*Inān* is the only partnership recognised by the Shāfi‘is and the partners must share the profits and losses in accordance with their capital contributions (see Ibn Rushd, *op. cit.*, vol. 2, p. 251; and al- Jazīrī, *op. cit.*, vol. 3, p. 76).

9. This is also called *Shirkah al-a‘māl* (partnership in labour or management), *shirkah al-ṣanā‘ī* (partnership in crafts or art) and *shirkah al-taqabbul* (partnership in contracting).

*Shirkah al-abdān* is not recognised by Shāfi‘ī, according to whom *shirkah* arises from the pooling of only financial resources because, as indicated above, the contribution of work cannot be measured precisely and it is assumed that all partners will contribute to the work equally (see Ibn Rushd, *op. cit.*, vol. 2, p. 255).

10. *Shirkah al-wujūh* or credit partnership is not recognised by the Māliki and Shāfi‘ī schools. Ibn Rushd, *op. cit.*, p. 255.

The Ḥanafī school permits *mufāwāḍah* as well as ‘*inān* even in *abdān* and *wujūh* partnerships. See Sarakhsī, *op. cit.*, vol. 11, pp. 154-5 and 179.

11. See Sarakhsī, *op. cit.*, vol. 11, p. 157, and *Majallah*, Articles 1347 and 1348, and also Article 1371. See also footnotes 6 and 9.

12. See al- Khafīf, *op. cit.*, pp. 22-7; also Udovitch, *op. cit.*, p. 99.

13. For a valuable discussion on the subject, see al- Khafīf, *op. cit.*, pp. 22-7 and 96-7. and al-Khayyāt, *op. cit.*, vol. 2, pp. 127-256.

14. See al- Khayyāt, pp. 206-11 and al- Khafīf, *op. cit.*, p. 97

## Glossary of Arabic Terms

### (frequently used in the text)

(The meanings given below are those in which the terms have been used in the text.)

**Āḥādīth** Plural of *ḥadīth*, q. v.

**Ashāb al-Māl:** Plural of *ṣāhib al-māl*, q. v.

**Āyah:** A verse of the Qur'ān. See also *sūrah*

**Bay':** Stands for sale and has been used as a prefix in referring to different types of sales: *Mu' ajjal*, *Murābaḥah*, *Tawliyah* and *Wadī'ah*, q.v.

**Bay' al-Mu'ajjal:** Sale against deferred payment, either in lump sum or instalments. The Council of Islamic Ideology (Pakistan) has, however, used it in the same sense as *murābaḥah*, q. v .

**Faqīh:** Jurist; plural, *fuqahā'*, q. v.

**Fiqh:** Muslim jurisprudence; it covers all aspects of life, religious, political, social or economic. In addition to religious observances (prayer, fasting, *zakāt* and pilgrimage) covers family law, inheritance, social obligations, commerce, criminal law, constitutional law and international relations, including war. The whole corpus of *fiqh* is based primarily on the Qur'ān and the *Sunnah* and secondarily on *ma'* and *ijtihād*.

**Fuqahā'** (singular, *faqīh*): Jurists who give opinion on various issues in the light of the Qur'ān and the *Sunnah* and 'ho have thereby led to the development of *fiqh*.

**Ḥadīth** (plural, *ahādīth*): A report on the saying, deed or tacit approval of the Prophet, peace be on him.

**Ḥalāl:** Anything permitted by the *Sharī'ah*

**Ḥarām:** Anything prohibited by the *Sharī'ah*.

***Ijmā'***: Consensus of the jurists on any issue *of fiqh* after the death of the Prophet, peace be on him. See also *fiqh*.

***Imām***: The word is used in this book in its most popular meaning of leader of the congregational prayer; the word is, however, also used for the founders of different schools of Muslim jurisprudence or other eminent jurists and also for the prominent descendents of 'Alī ibn Abī Ṭālib and distinguished *Shī'ah* theologians. In *aḥādīth* it has also been used to refer to the ruler.

***Jāhiliyyah***: The period in Arabia before the advent of Muḥammad, peace be on him.

***Muḍārabah***: An agreement between two or more persons whereby one or more of them provide finance, while the others provide entrepreneurship and management to carry on any business venture whether trade, industry or service, with the objective of earning profits. The profit is shared by them in an agreed proportion. The loss is borne only by the financiers in proportion to their share in total capital. See also *ṣāhib al-māl* and *muḍārib*. See Appendix II for details.

***Mu'ajjal***: See *bay' al-mu' ajjal*.

***Murābahah***: Sale at a specified profit margin. The term is, however, now used to refer to a sale agreement whereby the seller purchases the goods desired by the buyer and sells them at an agreed marked-up price, the payment being settled within an agreed time frame, either in instalments or lump sum. The seller undertakes all the management needed for the purchase and also bears the risk for the goods until they have been delivered to the buyer. See also *bay' al-mu' ajjal*.

***Muḍārib***: The partner who provides entrepreneurship and management in a *muḍārabah* agreement as distinct from the *ṣāhib al-māl* who provides the finance. See also *muḍārabah*, *ṣāhib al-māl* and Appendix 11.

***Qarḍ ḥasan***: A loan extended without interest or profit-sharing (plural, *Qurūd ḥasanah*).

**Qur'ān:** The Holy Book of the Muslims consisting of the revelations made by God to the Prophet Muḥammad, peace be on him, during his Prophethood of about 23 years. The Qur'ān lays down the fundamentals of the Islamic faith, including beliefs and all aspects of the Muslim way of life. These are supplemented or further elaborated by the *Sunnah* (q.v.). The Qur'ān consists of 30 parts (*ajzā'*), 114 chapters (*sūrahs*), and 6,666 verses (*āyahs*). There are a number of translations of the Qur'ān by both Muslims and non-Muslims. The translations by 'Abdullah Yūsuf 'Alī and Muḥammad Marmaduke Pickthall, both Muslims, and by A. J. Arberry, are the most popular. In all references to the Qur'ān in the text (e.g., 30: 41), the first number refers to the *sūrah* and the second to the *āyah* or verse.

**Rabb al-Māl:** See *ṣāhib al-māl*.

**Ribā:** Literally means increase or addition and refers to the 'premium' that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or an extension in its maturity. It is thus equivalent to interest. It is used in the *Sharī'ah* in two senses: *ribā al-nasī' ah* and *ribā al-faḍl*.

**Ribā al-Faḍl:** An extension of *ribā* to trade, because while trade is allowed, not everything is permitted in trade. The prohibition of *ribā al-faḍl* closes all back-doors to *ribā* through trade. It covers all income realised in trade through dishonesty, fraud or 'unfair' exchanges. See also Chapter 2 and Appendix I.

**Ribā al-Nasī'ah:** Refers to the 'addition' of the 'premium' which is paid to the lender in return for his 'waiting' as a condition for the loan and is technically the same as interest. See also Chapter 2 and Appendix I.

**Rībāh:** Is from *rayb* which literally means 'doubt' or 'suspicion' and refers to the income which has the semblance of *ribā* or which raises doubts in the mind about its

rightfulness. It covers all income derived from injustice to, or exploitation of, others.

**Şāhib al-Māl:** (plural, Aṣhāb al-māl): The financier; in the *muḍārabah* form of partnership agreement, the *şāhib al-māl* (also, *rabb al-māl*) provides the finance while the *muḍārib* provides the entrepreneurship and management. There can be many *şāhib al-māl* and *muḍārib* in a given *muḍārabah* agreement. See also *muḍārabah*, *muḍārib* and Appendix 11.



**Sharī'ah** : Refers to the divine guidance as given by the Qur'ān and the *Sunnah* and embodies all aspects of the Islamic faith, including beliefs and practices.

**Shirkah**: Partnership between two or more persons whereby, unlike *muḍārabah*, all of them have a share in finance as well as entrepreneurship and management, though not necessarily equally. See Appendix II for details.

**Sunnah**: After the Qur'ān, the *Sunnah* is the most important source of the Islamic faith and refers essentially to the Prophet's example as indicated by his practise of the faith. The only way to know the *Sunnah* is through the collection of *aḥādīth* q. v .

**Sūrah**: A chapter of the Qur'ān. There are 114 *sūrahs* of varying lengths in the Qur'ān. In all references to the Qur'ān in the text (e.g. 30: 41), the first number refers to the *sūrah* and the second to the *āyah* or verse.

**Tawliyah**: Sale at cost without any profit for the seller.

**Ummah**: Refers to the whole Muslim community, irrespective of colour, race, language or nationality, which carry no weight in Islam.

**‘Ushr:** Ten per cent (in some cases five per cent) of agricultural produce payable by a Muslim as a part of his religious obligation, like *zakāt*, mainly for the benefit of the poor and the needy.

**Wadī‘ah:** Sale at a loss.

**Zakāt:** The amount payable by a Muslim on his net worth as a part of his religious obligations, mainly for the benefit of the poor and the needy. See also *‘ushr*.

**Zulm:** A comprehensive term used to refer to all forms of inequity, injustice, exploitation, oppression and wrongdoing, whereby a person either deprives others of their rights or does not fulfil his obligations towards them

## Selected Bibliography

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Three comprehensive bibliographies by M. Nejatullah Siddiqi, Volker Nienhaus and M. Akram Khan are now available,<sup>3</sup> providing a complete list of writings in Arabic, English, German and Urdu on Islamic Economics, including money, banking and monetary policy in an Islamic framework, the principal subject of this book. These should prove to be useful for those looking for a more extensive coverage of the subject.

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<sup>3</sup> M. Nejatullah Siddiqi, *Contemporary Literature on Islamic Economics* (Jeddah: International Centre for Research in Islamic Economics, King Abdulaziz University, 1981).

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*TOWARDS A JUST MONETARY SYSTEM* is the first comprehensive study of the goals, nature and operations of the monetary system of Islam, which has justice as one of its most indispensable objectives.

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