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# Issues in Islamic Banking

Selected Papers

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The Islamic Council of Europe, London, for 'Banking in an Islamic Framework' presented at a conference in London in 1977 and included in the book *The Muslim World and the Future Economic Order* published by the Council in 1979. The paper was first published in the journal *Islam and the Modern Age*, New Delhi (Vol. VIII, No.4, November, 1977).

## Foreword

Islamic banking is no longer a mere theoretical proposition. In excess of twelve national and international banks are now successfully operating on an interest-free basis in different parts of the world including the West. This development is bound to have far-reaching consequences for the future mode of banking in the entire Muslim world. It is, therefore, important that professional economists should engage in more rigorous examination of the principles and practices of Islamic banking and participate creatively in the process of this historic development.

Dr. M. N. Siddiqi, Faisal Laureate for 1982/1402 H. is amongst the leading pioneers of Islamic economics. He has already authored some twelve books on different aspects of Islamic economics and his book *Banking Without Interest*, first published in 1969, was the first full and professionally thorough treatment of the subject. Over the last decade Dr. Siddiqi has written extensively on certain aspects of Islamic banking, mainly in the form of papers contributed to international conferences and seminars on Islamic economics. He has done a valuable service to the academic community in general and the students of Islamic economics in particular by compiling these papers and lectures in the form of *Issues in Islamic Banking*. I have been involved with most of the conferences and seminars to which these papers were contributed and I have no hesitation in saying that Dr. Siddiqi's contribution in clarifying many issues in the monetary and fiscal economics of Islam is original as well as sizeable. I am sure the present collection is a significant contribution to the dialogue on Islamic banking and anyone who goes through this work with openness will find that he presents a formidable case in favour of interest-free banking. It should also convince our friends and foes alike that Islamic economics is not an exercise in Muslim theology or *fiqh* but a new and lively approach to the economic problems of man.

We may be condemned as 'utopians' and 'romanticists' but we believe that the best form of realism lies in challenging all those systems which are based on the exploitation of man in one form or

another and in seeking to establish a just socio-economic order, whatever the effort needed to realise it. Dr. Siddiqi demonstrates with cogent arguments that an Islamic economy is capable of freeing modern man from the debt-ridden economy in which he lives and of guiding him towards a society based on justice and equity. He also demonstrates that such an economy would also ensure growth and stability. I am sure *Issues in Islamic Banking* is going to be a valuable contribution to the debate on the future of banking in our own time.

Institute of Policy Studies,  
Islamabad  
Sept., 1982

**Khurshid Ahmad**

## Preface

The idea that Islam is a unique way of life distinct from all other isms and ideologies naturally extends to the economic life of the *Umma*. A determination to reshape the economy on distinctive Islamic lines has been an important dimension of the Islamic resurgence visible all over the world of Islam. The areas of money, banking and investment are regarded as crucial to the process of Islamisation of the economy. Modern banking, based on interest and biased in favour of the capitalists and the rich and well-to-do, is rejected as un-Islamic because of the unequivocal prohibition of *ribā* by the Qur'ān, which the consensus of Muslim jurists has interpreted as covering all kinds of interest, usurious or otherwise, irrespective of the nature and function of the loan. The Islamic emphasis on cooperation as the key concept in economic life has led to reliance on profit-sharing and participation as the alternative bases for banking and investment in the Islamic framework.

Muslim society never legitimised interest: throughout the thirteen centuries of its history prior to domination by imperialist powers, it managed its economy and carried on domestic and international trade without the institution of interest. Profit-sharing and various kinds of participation arrangements served as adequate bases for savings and investment and considerable capital was mobilised for mining, ship-building, textiles and other industries, as well as for maritime trade. Introduction of interest-based banking by colonial régimes in the Muslim countries during the nineteenth century failed to involve the bulk of the community until the legal framework made it almost impossible for any business to thrive without such involvement. Efforts of some pseudo-jurists to distinguish between *ribā* and bank interest and to legitimise the latter met with almost universal rejection and contempt. Despite the fact that circumstances force many people to deal with interest-based financial institutions, the notion of its

essential illegitimacy has always remained. A sizeable section of the community still refuses to have any dealings with these institutions despite the inconveniences involved.

Rejection of interest is seen as a necessary part of the rejection of the exploitative capitalist system which is to be replaced by the just and equitable Islamic system. The recent literature on interest-free Islamic banking in fact grew as a part of the literature on the economic system of Islam in contradistinction to the capitalist and the socialist systems of various hues. Now we have a number of books and articles in Arabic, English, Urdu, Turkish, Persian and Bengali, etc. Early writers mostly attempted a critique of modern banking, exposing the rôle of interest in the exploitation of individuals and nations. Then they proceeded to suggest that partnership and profit-sharing could form a viable basis for banking. Some economists with adequate training in the *Shari'a* sciences worked out a detailed model of interest-free banking on these bases. My earlier work *Banking Without Interest* (1973, first published in Urdu in 1969) belongs to this category. Since then the subject of Islamic banking has undergone considerable development. Discussion is now conducted in the broader context of economic analysis inspired by Islamic values and ends. Subjects such as the nature and functions of money, determinants of the demand for money and the alternative ways of managing its supply are also receiving attention. Fresh impetus has been provided by the establishment of a number of banking institutions operating without interest, and some initial steps taken by the governments of Pakistan and Iran to phase out interest from the economy. The subject is now attracting the attention of the entire body of economists and bankers in the Muslim world. The conference of the Governors of the Central Banks of 36 Muslim countries held at Riyadh in September, 1980 was merely acknowledging the wind of change when it said that:

'The Governors appreciated the desire to apply Islamic *Shari'a* in the field of banking and noted with interest the establishment of Islamic banks in a number of member states.'

For those with a sense of history, it should not be difficult to see that the move towards an interest-free Islamic banking and financial system could be a process with revolutionary consequences. What guarantees this in the first place is the will of the Muslim masses to whom freedom from colonial powers and disillusionment with westernised secular leaders has now given the chance to re-assert their identity and intentions in the wake of Islamic resurgence. Islamic banking provides them with a legitimate means of directing their savings into profitable avenues of investment. The same applies to businessmen who are eager to get on without at the same time being involved in interest which is prohibited by Allah. One of the major reasons why the banking habit never put down deep roots in Muslim societies has been interest. Once interest is eliminated from banking operations and the social priorities of Islamic banks impress the masses they are likely to get involved in a big way. This could revolutionise the economies of the Muslim countries. Luckily, the inception of Islamic banking coincides with a great spurt in economic activities in several Muslim countries, especially those with oil. The resilience brought in by oil wealth and its spill-over effects reinforces their ability to stand up and challenge an alien system created to serve vested interests.

What lends added credibility to the whole exercise is the perilous condition of the monetary and financial system the world over. With two-figure inflation raging alongside high levels of unemployment, with interest rates soaring at times beyond twenty percent, and the system of international payments under heavy strain due to piling up of debts, the situation is becoming increasingly untenable. The system has lost credibility, leading to a universal recognition of the need for basic changes.

The basic change advocated by Islamic economists is a changeover from interest to profit-sharing. This simple change, some implications of which are elaborated and examined in this volume, has far-reaching consequences for the entire system. It amounts to a change from a lending-based system to one based on real investment and participation. It affects the supply of money, linking it directly with the transactions needs of the community, as

well as the allocation of financial resources in direct response to production possibilities. Both affects strike at the very roots of inflation. In international relations the change would force nations with a surplus to invest to enter into participatory arrangements with developing nations, expecting a return only to the extent real development takes place. While it cannot be claimed that these and other implications of the change have been fully worked out, discussion has largely centred around these issues in recent years. The present writer had the opportunity of participating in this discussion through a number of papers and notes some of which are presented here. Their availability in one volume will be useful for those who do not have access to the journals or seminar proceedings where most of these papers were first published or read. The volume also contains some hitherto unpublished material.

The first essay on the Islamic Approaches to Money, Banking and Monetary Policy is in the nature of a review of the literature up to 1977. It sets the perspective in which later contributions can be meaningfully studied. It covers what Islamic economists have written about the nature of money and its functions, and the demand for money in an Islamic economy. The nature of bank money or credit, its desirability or otherwise, and the possible ways of its management also come up for discussion. The idea of hundred percent reserves is also examined in this context as are the suggestions to confine creation of credit to the Central Bank. The essay surveys the major contributions to the subject of interest-free banking, reporting the various viewpoints on such issues as supply of short-term interest-free loans, bills of exchange, financing the consumer and financing the government. The paper reviews the various writings on Central banking and monetary policy in an Islamic framework, examining the various policy instruments discussed by our writers. This includes the suggestion to use profit-sharing ratios as an instrument of policy, besides the reserve ratio, selective credit control and open market operation through sale and purchase of shares, etc. Originally written for a seminar held in 1978, a postscript has been added to cover the contributions up to 1981, covering issues not discussed earlier

such as indexation and seigniorage.

The next paper, Banking in an Islamic Framework, gives an exposition of the model of interest-free banking based on two-tier *muḍāraba* that now forms the operational basis of Islamic banking. It examines such evil consequences of interest-based banking as distribution of income and wealth and inflation and demonstrates the advantages of Islamic banking which is free from these evils, examining the creation of credit at some length. Some of the other issues briefly dealt with in the first essay also come up for detailed consideration.

The third article, Rationale of Islamic Banking, answers the question why Islamic economists advocate a change from interest to profit-sharing. It is argued that the interest-based system is inefficient as well as unjust. It has an inherent tendency towards inflation and it fails to provide a just and viable basis for international monetary relations. The change to a system based on profit-sharing will contribute to allocative efficiency, justice and stability. It can also serve as a viable basis for international flow of funds.

The fourth paper, Economics of Profit-Sharing, covers entirely new ground by discussing how the ratios of profit-sharing between the depositors and banks, and between the banks and businessmen will be determined. It studies the effects of changes in the expected rate of profits on these ratios and the alternative possibilities as regards the responsiveness of supply of and demand for deposits to changes in the expected rates of profits. It examines and refutes the contention that a system based on profit-sharing must be unstable and subject to wide fluctuations. The paper demonstrates that the system gains in efficiency by assigning the allocative rôle to the rate of profit without the disturbing interference from rate of interest.

The brief paper on Monetary Theory of Islamic Economics that follows restates the main points made in the three preceding papers in a summary form with a view to providing a synoptic view of the subject. It also takes notice of some fresh doubts on the viability of interest-free banking, being the report of a discussion in which non-Muslim professional economists were also participating.

The sixth paper, on Issues in Islamisation of Banking, is a comment on the Report of the Council of Islamic Ideology on elimination of interest from the economy, submitted to the Government of Pakistan in 1980. I have tried to make this note meaningful to readers, to whom the Report itself may not be available, by adding explanatory footnotes. The comment discusses such practices as *Murābaha* and investment-auctioning proposed in the context of interest-free banking.

These six papers along with this introduction will, I hope, inform the reader of the current state of debate on Islamic banking. This will facilitate understanding of much that is being reported in some journals and a section of the Press. To students of Islamic economics in general, and of Islamic banking in particular, it provides a comprehensive up-dated report on the subject and identifies possible subjects for further research. It is hoped that the publication of this volume will provoke further deliberations on this vital subject.

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Jeddah

Muhammad Nejatullah Siddiqi

## CHAPTER 1

# Islamic Approaches to Money, Banking and Monetary Policy

Muslim society had been using money since its inception and some form of banking was also in existence. But issues relating to money, banking and monetary policy posed themselves in an entirely new perspective in the twentieth century. Emergence of modern banks and other financial institutions in Muslim countries, introduction of paper currency, increase in public debt and commercial dealings in securities presented the jurists with new questions to answer. A review of newly introduced western institutions was followed by attempts to devise alternatives free from interest and other features repugnant to *Shari'a*. As Muslim countries regained political independence, their élite were called upon to manage their own affairs. Interest in Islamic injunctions relevant to the management of money and finance increased, and the desire to spell out the distinctively Islamic approach, in contrast to those of capitalism and socialism, led to a number of fresh formulations.

The main juristic issues discussed in the early stages were *Ribā* and interest, gambling and speculation, transactions involving *gharar* (chance and uncertainty), forward sales, foreign exchange transactions and transaction in debt. While the problem posed by the introduction of paper currency was soon settled by accepting it as a substitute for the familiar gold and silver coins, the remaining issues continue to be debated.

We shall not be able to review the whole of this debate in this paper as it involves detailed juridical discussions. Our focus is on the very recent writings, mostly by economists, on the nature and rôle of money, banking free of interest and monetary policy in an Islamic framework.



### On the Nature of Money and its Rôle in the Economy

Islamic writers concede the advantages of money as a medium of exchange and favour the transition from barter to a money economy. They interpret the injunction of the Prophet against *ribā al-faḍl* as a step, in the early days of Islam,<sup>1</sup> towards such a transition, as well as being a measure directed at making barter rational and eliminating in it the possibilities of injustice and exploitation. Similarly, the prohibition of interest is vital for ridding the money economy of injustice and exploitation and making it rational.

This is borne out by examining the function of money as a store of value. Making a reference to Keynes's *General Theory* (chapter 17: Properties of Interest and Money) Mahmud Ahmad emphasises the distinction conferred on money as compared to other assets by the institution of interest: it has a liquidity premium but no carrying costs. On the other hand its elasticity of substitution is zero, so that a rise in its demand must raise the rate of interest.<sup>2</sup> Should interest be abolished the liquidity premium would go and the speculative motive for holding cash would disappear. Liquidity premium is not the cause but the effect of interest. Speculative hoarding of money is at the root of fluctuations in the demand for money which is the cause of trade cycles. To discourage hoarding and bring money on a par with other assets (commodities) it should be subjected to a carrying cost, besides being divested of liquidity premium by abolition of interest. The 2½% per annum *Zakāt* levy is regarded as a measure ensuring such a carrying cost. Abolition of interest coupled with *Zakāt* is expected to ensure that money serves its primary function of a medium of exchange.

The above point, made by several other writers beside Mahmud Ahmad, is further elaborated by Mahmud Abu Saud. When barter

<sup>1</sup>Nūr al-Dīn al-Itr: 'Illat ribā' l-Faḍl', *al-Ḥaḍarāt al-Islāmīyah* (Kuwait) (116) Aug. 1974, pp.51-53; and Ahmad Safiuddin, 'Iwāḍ: Taṣawwur Jadīd li-ribā' l-faḍl', *al-Ḥaḍarāt al-Islāmīyah* (Kuwait) (111) Mar. 1974, pp.57-69

<sup>2</sup>Sheikh Mahmud Ahmad: 'Man and Money', *Islamic Studies* (Islamabad) IX (3) Sept. 1970, pp.217-244.

is replaced by the use of money as a medium of exchange, it becomes possible to leave the process of exchange incomplete by withholding the money obtained from sale of a commodity '... because money obtained represents half an exchange transaction, the value of money related to itself in terms of present time as against a future time becomes different. This is the basis of the "time preference" theory.'<sup>1</sup> The deficiency of money as a measure of value also derives from this phenomenon as the value of money is unstable because its supply cannot be controlled in view of the money holders' power to withhold it from circulation. 'Unless we standardise our money and stabilise its value, letting the values of the measured objects fluctuate, no economy can be held in a sound wholesome state, and nobody can rightly claim that money is the "standard of value" or the real unit of account.'<sup>2</sup> As Abu Saud sees it, 'Interest is gained because somebody *does not purchase* immediately on receiving the proceeds of his sales, because this somebody knows that if he abstains from spending he would gain ...'<sup>3</sup>

The key to a solution lies in subjecting money to the natural law of depreciation over time to which all other commodities are subjected. This is the purpose of the Islamic principle of *Zakāt* which makes all forms of private wealth 'depreciate' from the viewpoint of the private owner, by about 2.5% per annum. This will discourage hoarding and make all money circulate. Money will serve as a medium of exchange and remain stable in value, thus serving as a standard measure of value.

Najjar has also discussed the nature and rôle of money in detail, concluding that hoarding, interest rates, and reckless spending by governments, are the main obstacles in the way of money playing its proper rôle in the economy.<sup>4</sup>

<sup>1</sup>Mahmud Abu Saud: 'Interest Free Banking', p.20. Paper presented at the First International Conference on Islamic Economics held at Makka, 1976.

<sup>2</sup>*ibid.* p.20.

<sup>3</sup>*ibid.* p.91.

<sup>4</sup>Najjar, Ahmed: *al-Madkhal ilā' l-naẓariyat al-iqtisādiyyah fi'l-minhaj al-Islāmī*. Beirut, Dār al-Fikr, 1973, pp.125-153.

Economic literature abounds in evidence to the effect that hoarding and speculative holding of money is a source of much trouble in the economy causing instability in the value of money, fluctuations in output and employment, and resulting in maldistribution of wealth. Islamic economists have scored a valid point by demonstrating that *Zakāt* will discourage hoarding. The view that the institution of interest has something to do with speculative holding of money is also substantially correct. Abolition of interest and the consequent disappearance of the bonds market will leave little room for the type of speculation prevalent today. Savings will have to be invested in common stock (ordinary shares) or deposited in the 'profit-sharing' accounts of the 'interest-free banks' (i.e. advanced to entrepreneurs), through banks, on a profit-sharing basis). This will still leave some room for holding cash in expectation of a rise in the expected rate of profit, or in anticipation of better opportunities for investment.

This does not, however, decrease the weight of the Islamic economists' argument noted above, nor does it seek substantially to modify it. It is only meant to put on record something which they have failed to note in the context of the above discussion. In so far as the 'speculative motive' would still be operative in an Islamic economy, it will no longer be capable of generating the wide fluctuations experienced at present. With expected profits the saver would have to weigh the possibility of loss which in a profit-sharing banking system would devolve entirely on him. Shackle's focus gain-focus loss hypotheses can be invoked to demonstrate that fluctuations in profit-expectations may be counter-balanced by accompanying loss-expectations and the net result may be movement within not too wide a range. In an economy where speculative demand for money is a function of the rate of interest the story is entirely different.

Money in a money economy must not cease to perform the function of a store of value. Although the carrying costs involved in *Zakāt* would certainly make an impact, they cannot obliterate the precautionary and 'speculative' motive (as function of the changing profit-loss expectations). Abolition of interest and the *Zakāt* levy would eliminate wide fluctuation, but there would still

be need for a monetary policy to ensure stability.

The institution of credit and bank money has been another object of scrutiny by the Islamic economists. Early writers saw something morally wrong in it. Some doubted its need and ascribed its proliferation to the vested interests of the banks. More recently it has been realised that interest is the villain of the piece. Abolition of interest will, to a large extent, curtail the harmful features of the creation of credit by banks. However, strong arguments have been advanced against allowing private commercial banks to create credit in an interest-free banking system.

'Banks gain a lot out of thin air or of no air at all. They create an artificial purchasing power and take advantage of the demand for it. This demand is also illicitly created by those who have managed to liquidate their assets and preferred to enjoy a guaranteed income against their withheld money.'<sup>1</sup> Having so pronounced, Mahmud Abu Saud sees no need for bank created money as real money can take care of all transactions. As to the extra money needed for financing innovations, the Central Bank can issue additional currency for this purpose which will have a temporary inflationary effect and no further harm will be done.<sup>2</sup> S.M. Yusuf, while suggesting a 100% reserve system seems to take a similar position.<sup>3</sup>

The anti-credit verdict based on the alleged undeserved profits of the bank is further strengthened by the more valid argument that a credit economy is inevitably an inflationary economy. Over-expansion in credit caused by the lure of easy banking profits leads to an untenable situation with the inevitable downturn and depression.<sup>4</sup> The crucial question is related, however, to the role of interest in such a credit system. As Mahmud Ahmad sees it, the institution of interest and not credit creation as such is the cause of

<sup>1</sup> Mahmud Abu Saud, *op. cit.*, p.91.

<sup>2</sup> *ibid.*, pp.91-93.

<sup>3</sup> S.M. Yusuf: *Economic Justice in Islam*, Lahore, Sheikh Muhammad Ashraf, 1971, p.51.

<sup>4</sup> Muhammad Uzair: *An Outline of Interestless Banking*, Dacca, Raihan Publications, 1965. Reprinted in the author's *Interest Free Banking*, Royal Book Co., Karachi, 1978, pp.195-217.

trade cycles. The entrepreneur has to aim at a rate of profit which is three times as high as the rate of interest or even higher: '... high pitching of profits is a compulsive phenomenon emerging from the institution of interest. The essential high profits can only be made by either raising the price of the product or lowering the wages. Whatever proportion is assigned to either of the alternatives, effective demand is slashed.'<sup>1</sup> The remedy suggested by him is 'to reshape the credit structure so that loans cease to command any interest and profits get reduced to the level where they will pay only for the labour of the enterprise. Pure profits will tend to reach zero at zero rate of interest.'<sup>2</sup> It is difficult to agree with the last part of Mahmud Ahmad's statement, but that does not concern us here. But he is right in his vision that with the abolition of interest the structure of credit will be directly governed by profits from enterprise.

It takes only one further step to conclude that possibilities of over-expansion in that case will be severely limited, especially as the liability to losses will attach to the banks — the creators of credit. As Siddiqi has argued, in the Islamic system of banking without interest, 'credit would be created only to the extent there exist genuine possibilities of creating additional social wealth through productive enterprise. Demand for profit-sharing advances will be limited by the extent of the available resources and banks' ability to create credit will be called into action only to the extent of this demand, subject to the constraint imposed by profit expectations that satisfy the banks'<sup>3</sup> and their depositors. Earlier, Uzair must have had the same point in mind while arguing that the possibilities of over-expansion of credit can be eliminated by making capital and enterprise move together through abolition of interest.<sup>4</sup>

<sup>1</sup> Sheikh Mahmud Ahmad: 'Monetary Theory of the Trade Cycle', p.176. *Islamic Studies* (Islamabad) XII (2) Sept. 1973, pp.159-178.

<sup>2</sup> *ibid.*

<sup>3</sup> Muhammad Nejatullah Siddiqi: 'Banking in an Islamic Framework', p.10. *Islam and the Modern Age* (New Delhi) 8(4) Nov. 1977. Reproduced below as the next paper in this volume. See p.55.

<sup>4</sup> Muhammad Uzair: *Interest Free Banking*, p.20, Royal Book Co., Karachi, 1978.

This important clarification justifies Hasan Homud's acclamation of credit in an interest-free system<sup>1</sup> and leaves no case for scepticism regarding credit *per se* as harboured by Kahf<sup>2</sup> and some early writers on the subject. Some of these misgivings were rooted in the vague notion that credit was in some way the child of interest. This is far from being true. As Siddiqi demonstrated a decade ago,<sup>3</sup> banks' ability to create credit is independent of the terms on which it is created, depending as it does on the public's habit of keeping only a part of its income in cash and depositing the rest with the banks. Credit will therefore continue to be created even after the switch from interest to *mudāraba* (profit-sharing) as the basis of bank advances to businessmen.

While ruling that commercial banks are not permitted to create money which should be a monopoly of the state in an Islamic economy, Kahf fails to examine whether such permission to interest-free commercial banks, operating on the basis of *mudāraba* (profit-sharing) will still be against public interest, and whether the Monetary Authority will or will not be able to regulate their activities in the public interest. It is not clear how his suggestion can be put into practice without nationalising commercial banks. He envisages private commercial banks operating with 100% reserves as 'service institutions'. If the commercial banks operate with 100% reserves, their only earnings will be service charges on checking deposits and fees charged for transfers, safekeeping and other services. They will be obliged to raise their charges to meet their administrative costs and earn competitive returns on bank's capital. In order to justify this additional burden on the public, one must argue that the main objective of the 100% reserve banking, i.e. control of the total supply of money, cannot be secured in any other way. This Kahf fails to do. The Chicago plan for banking reform, which advocated 100% reserves

<sup>1</sup> Sami Hasan Ahmad Homud: *Taḥwīr al-a'māl al maṣrafiyah bimā yattaḥiqū wa'l-sharī'at al-Islāmiyah*. Dār al itihād al-'Araby li'l ṭibā'ah. Cairo 1976, p.361.

<sup>2</sup> Monzer Kahf: *The Islamic Economy*, pp.74-75. The MSA, Plainfields, Indiana, 1978.

<sup>3</sup> Muhammad Nejatullah Siddiqi: *ghair sūdī bank kāri*, Lahore and Delhi, 1969, Chapter 5. English translation: *Banking Without Interest*, Lahore, Islamic Publications, 1973, Chapter 5. New revised edition published by The Islamic Foundation, Leicester, 1982.

during the thirties, has been thoroughly debated. A reconsideration of the idea in the context of Islamic banking requires a more detailed discussion than is available to date in our literature. More on this point in the postscript below.

Kahf suggests establishment of Finance Houses for handling *muḍāraba* funds for investment on a profit-sharing basis. But he does not insist on it since, according to him, 'both can be thought of as one body providing two separate services.'<sup>1</sup> It may be desirable to combine the two institutions in view of the fact that a separation will leave the commercial banks in a very weak position as profit making institutions.

### Banking

As reported earlier,<sup>2</sup> the idea of interest-free banks based on the Islamic legal concepts of *shirka* (partnership) and *muḍāraba* (profit-sharing) gradually evolved during the last thirty years, leading to a fairly comprehensive model of banking by the early seventies.

A bank is conceived, in the first instance, as a financial intermediary mobilising savings from the public on the basis of *muḍāraba* and advancing capital to entrepreneurs on the same basis. Profits accruing to entrepreneurs on the capital advanced by the bank are shared by the bank according to a mutually agreed percentage. The bank also performs a number of familiar banking services against a fee or a commission. The bank's own share capital also goes into its business of offering banking services and advancing capital on a profit-sharing basis. Making allowance for administrative costs, the net revenue on all these counts constitutes the profits of business. This is distributed over the entire capital involved — public deposits on the basis of *muḍāraba* and the bank's share capital. The percentage profits so worked out are then shared with the depositors according to a proportion

<sup>1</sup> Monzer Kahf: *The Islamic Economy*, op. cit., p.76.

<sup>2</sup> Muhammad Nejatullah Siddiqi: *Muslim Economic Thinking: A Survey of Contemporary Literature*, The Islamic Foundation, U.K. 1981, pp.28-37.

announced in advance. Profits received by depositors in *muḍāraba* accounts are, therefore, a percentage part of banking profits which mainly accrue to the bank as a percentage of the profits of enterprises financed by it.

Deposits are also accepted in the current accounts with promise to pay on demand. No profits are distributed to these depositors from whom a service charge may or may not be realised. The bank is obliged to grant very short term interest-free loans to the extent of a part of total deposits in its current accounts.

The above model is based on a two-tier *muḍāraba* contract. A large number of depositors enter into individual *muḍāraba* contracts with a banking company, organised on the basis of share capital, the contracts stipulating the sharing of the profits of the 'business of banking'. The bank undertakes two kinds of 'business'. Firstly, it offers banking services earning fees and commissions. Secondly, it assumes the rôle of a financier-entrepreneur making judicious selection of businessmen who seek capital from it, stipulating that they share with it the profits of their productive enterprise. Liability to loss in a *muḍāraba* contract attaches to the financier only, the working party bears no part of the loss accruing to capital extended by the financier. As shown by Siddiqi, all schools of Islamic Law are unanimous on this point.<sup>1</sup> It follows that the loss incurred by an individual entrepreneur working with capital advanced by the bank will be borne by the bank. The bank has, however, advanced capital to a large number of entrepreneurs, diversifying its investments as far as possible. Losses incurred on individual advances are likely to get absorbed by some of the profits accruing to the bank from the successful entrepreneurs. As long as the totality of profits accruing on bank advances plus the fees and commissions earned by the bank remain a positive quantity, i.e. as long as the banking business as a whole does not end up in loss, the depositors' interests are safe. But what if the net revenue of the bank is a negative quantity? This will mean a loss, to be distributed equally on share capital and *muḍāraba* deposits.

<sup>1</sup> Muhammad Nejatullah Siddiqi: *Shirkat aur muḍārabat kē shar'ī usūl*. Delhi, Lahore, 1969, pp.25-30.

The possibility is merely theoretical, both on economic and empirical grounds. But according to the nature of a *muḍāraba* contract, the depositors in *muḍāraba* accounts do stand liable to loss should such a possibility materialise.

Islamic economists in search of a viable alternative to interest-based banking have, quite understandably, felt uneasy about this conclusion. They have sought to absolve the depositors of this liability in different ways.

The bank may build loss compensating reserves, out of its earning in good times, to meet any net loss in bad times, so that depositors can always be sure of getting their deposits back in full, if not with any profit. A deposit insurance scheme may be launched with the backing of the Central Bank and participation of all banks and their depositors. This is the approach of Siddiqi<sup>1</sup>, Irshad Ahmad<sup>2</sup> and Najjar<sup>3</sup> among others.

Baqir al-Sadr seeks to absolve the depositors of even the theoretical liability to loss by denying the status of the bank as the middle link in a two-tier *muḍāraba* outlined above — a status they enjoy according to Abdullah al Araby,<sup>4</sup> Siddiqi<sup>5</sup> and the majority of writers on the subject. According to Baqir, the bank is an agent working for the depositor for a special kind of reward, akin to a prize, called *ju'āla* in Islamic law.<sup>6</sup> *Muḍāraba* contract takes place only between the bank and the entrepreneurs. Having absolved the depositors of the liability to loss, Baqir seeks to ensure that banks too do not incur any losses by stipulating some kind of a wage contract between the bank and the entrepreneurs.<sup>7</sup>

In his recent work, Sami Hasan Homud<sup>8</sup> concludes that

<sup>1</sup> Muhammad Nejatullah Siddiqi: *Banking Without Interest*, Lahore, 1973, pp.45–47.

<sup>2</sup> Shaikh Irshad Ahmad: *Interest Free Banking*, Orient Press of Pakistan, n.d.

<sup>3</sup> Najjar, Ahmad: *al-Madkhal*, op. cit., p.179.

<sup>4</sup> Muhammad Abdullah al Araby: 'Contemporary Bank Transactions and Islam's Views Thereon' *Islamic Thought* (Aligarh) II (3,4) July 1967, pp.10–43.

<sup>5</sup> op. cit.

<sup>6</sup> Muhammad Baqir al-Sadr: *Islāmī Bank*, pp.83–87 and pp.187–189. Jamali Publications, Bombay 1974 (Urdu Translation of *al bank al-Lārabī fi l-Islām*).

<sup>7</sup> For a critical review of Baqir's model see Siddiqi, M.N.: 'Islāmī Bank', *Islām aur 'Asr-e-Jadīd* (New Delhi) 7(2) April 1975, pp.106–126.

<sup>8</sup> Sami Hasan Ahmad Homud: op. cit., pp.341–448.

individual contracts of *muḍāraba* discussed by early jurists cannot be expanded to provide for collective type of investments involved in interest-free banking. He too seeks to modify the two-tier *muḍāraba* model described above in such a manner that liability to loss in the depositor-bank relationship attaches to the bank only. The bank's share in the profits actually accruing to entrepreneurs can be justified only on the basis of assuming this liability, he thinks. The only other basis of a right to profits could be supply of capital or work (enterprise). The bank provides neither of these two as capital comes from depositors and work is done by entrepreneurs.<sup>1</sup> The bank's share in profits, in the model outlined above, could therefore be justified on the basis of its liability to losses in respect of the depositors' money which it advances to the entrepreneurs.

The question that Homud fails to raise and answer is: how could the depositors be entitled to a share in profits when the return of their 'capital' is guaranteed to them? They have ceased to be suppliers of 'capital', having become suppliers of 'loan' instead. A lender with guarantee of repayment is not entitled to any profits. Secondly, Homud is mistaken in hypothesising that the bank does not supply work or enterprise. The entrepreneurial activity of the bank lies in scrutinising the projects the businessmen present to it, making a choice of whom to advance its capital, and keeping an eye on the progress of their productive enterprises. Siddiqi refers to F.H. Knight's classic work on *Risk, Uncertainty and Profit* in support of the view that the essence of entrepreneurship lies in the choice of men who would conduct the actual business.<sup>2</sup>

As regards the loss incurred by an individual entrepreneur on capital obtained from the bank, it has already been noted above that this attaches to the bank. Some scholars seem to question this principle on 'practical grounds', but we have not come across any reasoned statement of their case.

The two-tier *muḍāraba* model has been further extended by

<sup>1</sup> *ibid.*, p.448.

<sup>2</sup> Muhammad Nejatullah Siddiqi: *Islām kā Nazariyah-e-Milkiyat*, Vol. I, Lahore, 1967, p.163.

providing for partnership contracts between the bank and an entrepreneur. The bank would participate, through its employees or commissioned agents, in the actual conduct of business, along with the entrepreneur, who invests his own capital also. Losses, if any, would be shared by both parties in proportion to capital supplied. Profits of the joint venture would be shared according to an agreed percentage. Some writers, especially Najjar<sup>1</sup>, would like this to be the dominant form of banking operations. Najjar's banks seek a marriage between development banks and commercial banks. They would promote savings and effect their useful employment, mainly in the rural sector. He has reported in detail the successful operation of such banks in Egypt.<sup>2</sup>

Some of the recently established interest-free banks have gone into productive enterprise directly too. The Dubai Islamic Bank is a case in point. The model of banking outlined above admits of such an extension, but the economic advisability of mixing this function with the other functions remains to be thoroughly examined by our economists.

As regards the numerous banking services, such as safe keeping, transfers, letters of credit, etc., performed for a fee or commission, these would continue to be performed as interest is not involved. Several writers have examined them in detail. Homud, finding some commissions similar to interest, has suggested certain modifications.<sup>3</sup>

A number of questions relating to the accounting aspect of profit-sharing arising out of the variety in size and duration of *muḍāraba* deposits have been discussed by several writers but they need not detain us here. Of special interest, however, is Homud's suggestion relating to the term structure of the rates of profit-sharing between the banks and the depositors. The bank may give a larger percentage share from profits accruing to it to those depositors who commit their deposits for a longer period of

<sup>1</sup> Ahmad 'Abdul 'Azīz al-Najjār. *Bunūk bilā fawā'id*, Jeddah, 1972 and *Manhaj al-Ṣaḥwah al-Islāmiyah*; also *al-Madkhal*, *op. cit.*, pp.157-184.

<sup>2</sup> Najjar, A.A.A.: *Manhaj al-Ṣaḥwah al-Islāmiyah*. Jeddah, 1977.

<sup>3</sup> Sami Hasan Ahmad Homud. *op. cit.*, pp.350-387.

time.<sup>1</sup>

We do not endorse Homud's view, based on some legal texts pertaining to individual *muḍāraba* contracts, that costs of bank administration should be met out of the revenue from commission and fees only, so that profits earned through advancing depositors' money are not affected.<sup>2</sup> It is not necessary to do so if we take the entire business of banking as the activity in which both *muḍāraba* deposits and share capital are invested. Moreover it is not a practical suggestion.

Since this model began to be seriously discussed a number of practical problems have attracted special attention. The supply of short term interest-free loans, discounting of bills of exchange, supply of credit to consumers and the related problem of instalment credit (in hire-purchase), and lastly, the financing of the public sector are the main issues which merit mention.

### Short-Term Loans

It is agreed that, as far as possible, all advances to business parties should be on the basis of profit-sharing. Insofar as it is not possible to do this, as in the case of call money and loans for a few weeks' duration, provision for interest-free loans to business becomes inevitable. Many writers on the subject have suggested that banks should be obliged to earmark part of the total deposits in their current accounts for interest-free loans. This supply would, however, be limited, though there is some scope for augmenting this supply by the Central Bank in a manner explained later on. The crucial problem is how to control the demand for interest-free loans from business so as to ensure an equilibrium between supply and demand.

'Much of the demand for call money and very short term credit emanates from within the financial sector itself and is likely to disappear when that sector shrinks in consequence of abolition of interest. In the production sector, the total demand for short term

<sup>1</sup> *ibid.*, pp.485-487.

<sup>2</sup> *ibid.*, pp.492-497.

credit depends on the volume of long term investment and the extent of trade credit (credit extended by one firm to another) prevalent. Credit needs for the week or the month can be estimated at the macro level. This could be done by the Central Bank which would then ensure a supply commensurate with the demand by manipulating the 're-finance ratio' and the 'lending ratio'.<sup>1</sup> The task of allocating the loanable funds at the micro level would then be performed by the individual banks on the following criteria:

1. Specific credit needs of a firm.
2. Social priority attaching to the enterprise.
3. Nature of the security offered against loan.
4. Whether the credit seeker has also obtained long term advances from the bank for the same enterprise.
5. Annual, monthly or weekly average of the applicant's balance in current account with the same bank.<sup>2</sup>

### Bills of Exchange

Bills of exchange pose a special problem for interest-free banking. Two solutions (proposed long ago) are: to advance an interest-free loan against the bill; or to advance cash to the buyer (who would have written the bill) on the basis of *muḍāraba*, claiming a share in the profits from sale of the merchandise involved. No discounts are involved in either case. Recently, however, Ali Abdur Rasul has justified discounting bills of exchange, citing some Maliki jurists on the validity of 'leaving part of a loan to (be appropriated by) the one who secures repayment of the loan (from the borrower) as a reward of this service of securing repayment'.<sup>3</sup> It follows that if the loan is not actually repaid no

<sup>1</sup>Both these instruments of Central Bank policy are explained in the next section.

<sup>2</sup>Muhammad Nejatullah Siddiqi: 'Banking in an Islamic Framework', pp.16-17. *Islam and the Modern Age* (New Delhi) 8(4), November, 1977.

<sup>3</sup>Ali Abdur Rasul: 'Bunūk bilā fawā'id', p.2. Paper presented at the First International Conference on Islamic Economics, Makka 1976.

reward can be given. This view failed to find any support in the literature. It has been criticised on practical as well as juristic grounds. It has rightly been characterised as allowing a payment similar to interest.<sup>1</sup> There is hardly any need to adopt this advice as a *muḍāraba* advance; stipulating a comparatively smaller proportion of profits, would suit most buyers who are presently meeting their obligation to the seller by writing a bill of exchange duly underwritten by a bank.

### Credit for the Consumer

Interest-free banks can play only a marginal rôle in supplying loans to needy consumers. This is a service which should be organised as part of a comprehensive social security programme. Proposals to allow banks to collect *Zakāt* and disburse them by way of grants and interest-free loans have not found favour with most writers and can at best be looked upon as a transitory arrangement in response to state failure to discharge this function. Banks could grant interest-free loans to their depositors as overdrafts, for short periods of time.

A more active rôle has been envisaged for interest-free banks in relation to facilitating the purchase of durable goods by consumers who can pay for them only in easy instalments. Uzair has suggested that commercial banks should finance the supply side and share profits with sellers.<sup>2</sup> Recently Sami Hasan Homud has suggested financing the demand side in a manner that would bring some profits to the bank. Consumer A approaches the bank requesting it to purchase a durable item which A is willing to buy from the bank, stipulating payment in instalments. The bank buys it for him and sells it to A at a two or three per cent profit on its own purchase price. Homud cites a precedent from Shāfi'ī in his support.<sup>3</sup> Though it is not mentioned by Homud, the consumer

<sup>1</sup>Sami Hasan Ahmad Homud, *op. cit.*, p.378 and Siddiqi, M.N.: *Muslim Economic Thinking*, *op. cit.*, p.36.

<sup>2</sup>Muhammad Uzair: *op. cit.*, p.34

<sup>3</sup>*op. cit.*, pp.479-480.

may have to pledge a security to the bank till all instalments are paid up. The operational difference between it and the prevalent practice is that the seller will get the full price of the item and the consumer will be under obligation to pay the instalments to the bank. Economic consequences of the change will be substantial as the banks will have to operate within the constraints of liquidity imposed by the system. Instalment credit will be part of the credit system operated through the banks under supervision of the Monetary Authority. It will not have an uncontrolled growth outside the system and, in all probability, will be much more restricted than at present.

### Finance for the Government and the Public Sector

One of the major evils of the interest-based system, according to Islamic economists, has been the phenomenal growth in public debt. A switch to an interest-free system will curtail this growth to a very great extent. Costs of administration, defence and other 'non-productive' services of the state will have to be met through fiscal measures including compulsory borrowing from owners of large surpluses. Public sector projects may be financed through issue of 'shares' promising part of the profits to shareholders. Funds could flow into the public sector projects on the basis of *muḍāraba* or *shirka* directly from the public or indirectly through the commercial banks.<sup>1</sup> Our writers envisage a sizeable flow of interest-free loans to the government, especially in the event of a war or national calamity. Exemption of money lent to the state from *Zakāt* could be an added incentive to the lenders. Some other tax concessions have also been suggested.<sup>2</sup>

The above model of interest-free banking has not evoked any serious criticism from professional circles. Doubts have been expressed, however, mainly on one point: the possibility of cheating by businessmen who would, it is alleged, find it to their advantage to understate their profits, or even show losses, with a

<sup>1</sup> Siddiqi, M.N.: *Banking Without Interest*, Chapter 7.

<sup>2</sup> *ibid.*, pp.156-166.

view to surrendering a smaller part of their profits to the banks, or even avoid surrendering any profit at all. This they may do in view of the condition that banks can claim only a *share* of actual profits of business and, in case of a loss, have to bear the entire loss. It has rightly been pointed out, however, that such practices will be contrary to the interests of the businessmen themselves. It will destroy their creditworthiness and ruin their chances of getting any further advances from the banks. The banks, in selecting their business partners, will naturally be guided by their past record. Those with a record of involving the bank in a loss will be poor candidates for a fresh advance. Those with a record of ploughing back positive returns to the banks on the advances made by it will have a better chance of fresh arrangements. Those who have returned higher percentage profits to the bank, as bank's share of business profits, will have the brightest chances of obtaining additional capital. It will be, therefore, in the interest of businessmen to strive to make high profits and yield attractive returns to their financier banks.

Furthermore, the modern techniques of audits and accounts will be used, preferably under the patronage of the Central Bank, to eliminate the possibility of cheating from the system. It is also hoped that moral standards in an Islamic economy will be sufficiently high as to counteract such tendencies towards cheating.

A total rejection of the *muḍāraba*-based model has come from Muslehuddin.<sup>1</sup> He thinks that *muḍāraba* as envisaged by Islamic jurists cannot provide a basis for the depositor-bank and bank-businessmen relations envisaged in the above model. This view is based on a narrow interpretation of the legal texts involved, which makes him conclude that the *muḍāraba* contract can be only between two *persons*, the working party (*muḍārib*) cannot invest any capital of his own in the business financed by the bank; and the Islamic bank will not be able to make advances to firms which have already invested their own capital in their business. Lastly,

<sup>1</sup> Muhammad Muslehuddin: 'Interest Free Banking and the feasibility of *muḍārabah*'. Paper presented at the First International Conference on Islamic Economics, Makka 1976; and *Banking and Islamic Law*, Islamic Research Academy, Karachi, 1974, especially Chap. XIV.



he finds that the condition that the risk of loss in case of *muḍāraba* would attach to the bank alone rules out the possibility of success for these banks.

Unfortunately, Muslehuddin fails to suggest a viable alternative to the *muḍāraba*-based model. His Islamic banks<sup>1</sup> will be confined to services performed against a fee or a commission. They would lend depositors' money for short periods recovering only service charges just sufficient to cover administrative costs. This would hardly make his banks a profitable business, allowing them to pass back some of the profits to the depositors.

The juridical issues involved in the above model, and questioned by Muslehuddin, have already been thoroughly examined.<sup>2</sup> Our writers have established the validity of the two-tier *muḍāraba* involved in the model outlined above. It is also valid for a working party in *muḍāraba* to invest its own capital in the same enterprise, and for the financier to advance capital to a businessman who has already invested his own capital. Some of the other issues relating to the feasibility of the above model, the supply of short term loans and the possibility of cheating, etc., raised by Muslehuddin, have already been discussed above.

### Monetary Policy

Monetary policy is directed at regulating the quantity of money, its availability and its cost. The usual objectives of monetary policy are price stability, balance of payments, growth of the economy and distributive justice — objectives in whose realisation fiscal policy also partakes. The Central Bank, functioning under supervision of the Government (the Ministry of Finance), pursues these ends using a number of instruments at its disposal.

Policy goals have been discussed by Islamic economists under the general study of the economic functions of the Islamic state. It

<sup>1</sup> *ibid.*, Chapters XVII, XVIII.

<sup>2</sup> Several writers have discussed these issues (See the Bibliography entitled: *Contemporary Literature on Islamic Economics*, Leicester, 1978). Reference may be made here to Siddiqi, M.N.: *Shirkat aur muḍārabat kē shar'ī uṣūl*, Delhi, Lahore, 1969, especially pp.84–100.

is presumed that the goals listed in the preceding paragraph are desirable with comparatively more emphasis on stability and distributive justice.

Not many writers have paid special attention to Central banking, the immediate interest being focused on evolving a viable model of commercial banking. Some tended to assign the relevant functions to the *Bait al-Māl*, a view that could hardly stand further scrutiny. As a result, Siddiqi's preliminary discussion of Central banking<sup>1</sup> has yet to be followed up by a more detailed treatment.<sup>2</sup> He notes the absence of Bank Rate as an instrument of policy. But changing the reserve ratio and direct controls on supply of credit are two of the conventional weapons still available. In the absence of interest-bearing securities, sale and purchase of certain kind of shares and 'loan certificates' could provide the means of 'open market operations'.<sup>3</sup> As an alternative to the Bank Rate a number of other policy instruments are suggested. The 'Re-finance Ratio'<sup>4</sup> refers to the offer of the Central Bank to provide additional cash to the commercial banks to the extent of a certain percentage of the interest-free loans granted by them. Raising or lowering this ratio will have the effect of expanding or contracting the supply by the commercial banks of short term credit. Prescribing different ratios in respect of credit extended to different sectors of the economy can be a means of channelling credit into desired directions. Another instrument is the Lending Ratio<sup>5</sup> which refers to the percentage of demand deposits which the commercial banks will be obliged to lend out as interest-free loans. This instrument too can be manipulated to affect the supply of short term credit. The Central Bank may also consider the advisability of controlling the 'ratios of profit sharing' — the percentage of profits accruing to the entrepreneur (working with capital advanced by the commercial banks) which

<sup>1</sup> Muhammad Nejatullah Siddiqi: *Banking Without Interest*, Chapter VI.

<sup>2</sup> More on this issue in the postscript below.

<sup>3</sup> *ibid.*, pp.123–129 and 158–169.

<sup>4</sup> Siddiqi, M.N.: *Some Aspects of the Islamic Economy*, p.105. Delhi, Lahore, 1970. This ratio has been earlier named the 'Borrowing Ratio', see *Banking Without Interest*, op. cit., pp.116–122.

<sup>5</sup> *ibid.*

would flow back to the bank. This issue is also taken up again in the postscript below.

Moral persuasion in policy decisions arrived at through mutual consultation has played a significant rôle in recent times. It is hoped it will have a still greater rôle to play in the Islamic banking system.

Thus the Central Bank in an interest-free system will have a number of instruments which it could use to regulate the supply of credit and the terms on which it is available to the entrepreneur. Abolition of interest, absence of interest-bearing securities and, hence, of the speculation in the bonds market, will greatly reduce its problems. The marriage of capital and enterprise effected by the replacement of interest by profit-sharing will contribute towards growth and development. The ends of distributive justice will be served by the abolition of interest coupled with the principle of *Zakāt* applied to most forms of wealth.

These considerations provide a sound enough basis for concluding that interest-free banking is viable in both commercial and Central banking. As the practice grows, the Monetary Authority as well as the banking community are sure to discover and devise newer means of realising the desired objectives.

At present, the chief practical concern of Monetary Authorities in the Muslim countries is controlling inflation — a subject being covered separately in this Seminar. With the creation of high powered money entirely vested in the Central banks, and the automatic curtailment of credit with the abolition of interest and curbs on speculation, inflation can be more easily controlled in the framework of Islamic policies and interest-free institutions.

### International Banking

Most of the discussion on interest-free banking assumed a closed system, in the first instance. In an interest-free international economy the same model can be extended without difficulty. A special problem is, however, posed by the realistic assumption

that interest-free national banking systems will have to interact with the interest-based system dominating the world. This issue was taken up by early writers on the subject and a simple solution based on 'permission due to necessity' was suggested. While transactions with interest-based institutions would involve payment as well as receipt of interest, these transactions can be channelled through the Central Bank which could, as far as possible, insulate the indigenous economy from the effect of these transactions. If and when a number of countries are willing to operate on an interest-free basis they can form a group of their own. Interest can be abolished from all international transactions within this group. The group can negotiate alternatives to interest with the outside world wherever feasible.

The establishment of the Islamic Development Bank at Jeddah followed by the formation of Islamic banks at Dubai, Cairo, Khartoum and Jordan\* have prepared the ground for international monetary cooperation free of interest. The recently founded International Association of Islamic Banks is a step in that direction. One of its declared aims is to advise its members on investment and to attend to their liquidity problems, besides effecting coordination in their working and standardisation in their practice. One of the prime concerns of International Islamic Banking should be the mounting foreign exchange reserves of the oil-rich countries which are exercising inflationary pressures at home and have, surprisingly enough, increased their vulnerability to the manoeuvrings of international high finance. Speedy utilisation of these surpluses for human capital formation in, and transfer of technology to, the Islamic peoples in particular and the Third World in general, is hardly possible in the framework of interest-bearing loans and investments. Interest-free loans on a liberal scale and long term profit-sharing arrangements, possibly with an initial period of grace, could usher in an era of rapid all-round development to the advantage of the entire regions of North

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\*More recent additions are the Islamic Banks in Bahrain, Kuwait and Luxembourg. Similar institutions are appearing in Bangladesh, Malaysia, Guinea and some other countries. The recently established Dār al-Māl al-Islāmī is promoting these institutions and creating interest-free investment facilities in western countries also.

Africa and South and South East Asia of which the creditor countries would be the major beneficiaries.

### Conclusion

Abolition of interest has become the hallmark of Islamic economics in modern times. Here lies the greatest challenge for the Islamic economists: to justify it by a fresh analysis of money and its rôle in the economy and present an operational model of interest-free banking which may convince the modern man that Islam's economic system based largely on the twin principles of *Zakāt* and abolition of *Ribā* is more just and more efficient than any other alternative. They have been quite aware of this challenge and their response has been vigorous. The idea of interest-free banking has already entered the stage of experimentation after a quarter century devoted to model building. It is now receiving attention not only from trained economists but also from professional bankers and governments. It is advisable that the existing interest-free institutions provide relevant data and report their problems for analysis and careful consideration by economists. More than in any other area in economics, practice leads theory in money and banking.

Meanwhile the entire area of non-bank financial intermediaries, of near money, of transactions in foreign currencies and the vital subject of international monetary organisation awaits the attention of Islamic economists. It is hoped expert attention will be focused on these areas in individual researches as well as in seminar discussions.

### Postscript:

#### Review of Contributions during 1977 – 1981

The two seminars on the Monetary and Fiscal Economics of Islam in 1978 and 1981, held at Makka and Islamabad respectively, have contributed to further progress in the subject under review. Many of the points made earlier and noted above received further elaboration and clarity. Of great interest, however, are the new issues that received attention. These are noted below:

### Demand for Money

Demand for money and its determinants have always engaged the attention of economists. Writers on an interest-free economy owed the subject a fresh look. This is the more necessary as they have successfully demonstrated that the mode of supply of money in an interest-free economy based on profit-sharing will be entirely different from what it is at present. Creation of money in an interest-free system will be investment oriented, not based on lending. Seen in this perspective the transactions and precautionary demand for money remain intact, with perhaps some variation in their magnitude depending on the redistributive effects of *Zakāt*, its impact on marginal propensity to consume, and the extent to which the social security arrangements in Islamic society lessen the need for precautionary holding of money. The factor requiring a closer scrutiny is the 'speculative' demand for money.

Hardly anyone agrees with Metawally's assertion<sup>1</sup> that in an Islamic economy 'No money would be demanded for speculative purposes since . . . no speculation is allowed in Islam.' As Sultan Abou Ali pointed out<sup>2</sup> all three motives for the demand for money will exist in an Islamic economy. There has been a general feeling, however, that the speculative motive for holding money will be much weaker in an Islamic economy as compared to the interest-based economy. This viewpoint, already reported above, has been recently reaffirmed by Chapra<sup>3</sup> who thinks that the demand for money will be 'basically' determined by transactions and precautionary motives which are largely a function of the level of income.

A closer look at the demand for money has been attempted by Ma'bid Ali al-Jarhi in his comprehensive discussion on 'A Monetary and Financial Structure for an Interest-Free Economy:

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<sup>1</sup>M.M. Metawally: 'Fiscal Policy in Islamic Economy'. Paper presented at the Follow-up Seminar on Monetary and Fiscal Economics of Islam, Islamabad, 1981.

<sup>2</sup>*ibid.*, Comments.

<sup>3</sup>M.U. Chapra: 'Monetary Policy in an Islamic Economy'. Paper presented at the Follow-up Seminar on Monetary and Fiscal Economics of Islam, Islamabad, 1981.

Institutions, Mechanism and Policy'.<sup>1</sup> An average rate of profit on investment replaces the rate of interest as the opportunity cost of money, in the context of investment behaviour in an interest-free system. In Jarhi's model the closest approximation to this rate will be the rate of return on Central Deposit Certificates of the shortest maturity. 'The Central bank can open investment accounts in its member banks, in which it deposits whatever money it creates and from which it withdraws whatever money it requires. Member banks . . . will invest these deposits in the real sector in accordance with the investment policy of each . . . Such deposits will be termed Central Deposits or CD's . . . The Central bank can create an instrument which could be termed Central Deposit Certificate. CDC's can be sold to the public and their proceeds be invested in CD's through the banking system. Obviously the CDC's provide a lower degree of financial risk since each carries with it a title to a more diversified investment portfolio than any member bank can itself provide. The rate of return on CDC's will approach the average rate of profit on investment for the whole economy.'<sup>2</sup>

Once Jarhi is able to replace the rate of interest with a clearly defined rate of return he can call the conventional analysis of demand for money to his service. 'Whenever this rate of return rises people will find it preferable to economise in holding money for transactions and to divert some of it to investment. Whenever this rate of return falls, it becomes less costly to hold cash, encouraging people to increase their current deposits or add to their holdings of loan deposits in the Central bank. Briefly, we can say that the

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<sup>1</sup> Paper presented at the Follow-up Seminar on Monetary and Fiscal Economics of Islam, held at Islamabad, January 6-11, 1981. We have before us the revised version of this paper submitted in February, 1980 for inclusion in the seminar volume under publication. But the author has made substantial changes in this paper since then and an Arabic version dated June 1981 is being published by the International Centre for Research in Islamic Economics, King Abdulaziz University, Jeddah. We have quoted the English version where no changes were involved, reference being made to the Arabic version only when it does involve changes. It is interesting to note that section VI-C, of the English version entitled 'Speculative Demand for Money' is completely rewritten for the Arabic version, appearing as chapter five section IV under the title 'Demand for Money in the Interest-Free System'.

<sup>2</sup> al-Jarhi, *op. cit.*, English version, section III, A, 4.

demand for money is an inverse function of this rate of return.'<sup>1</sup> Jarhi then proceeds, with a demand for money curve sloping downward from left to right, with the Y axis showing the rate of return on CDC's, to study the equilibrium in the financial market. No fresh insights are offered as far as the demand for money is concerned. Attention is focused instead on how the supply of money can be managed in an interest-free system. The only point he makes about changes in the rate of return on CDC's is that they would reflect real factors relating to production. Then he hastens to conclude that his 'demand for money function relies on real factors which are stable in the long run. It is not an unstable function like the speculative demand for money function.'<sup>2</sup>

Jarhi fails to discuss the relationship between changes in the price of CDC's and other marketable investment instruments and the demand for money. Thus he leaves out the whole subject of expectations so crucial to any analysis of demand for money. He fails to distinguish explicitly between the ex post rate of return and the expected rate of return on investments. He makes the demand for investment instruments a direct function of the rate of return, people buying more CDC's and other investment instruments as the rate of return rises. What happens to the price of CDC's and other investment instruments in such a situation? Presumably they would rise with every rise in the rate of return, implying larger quantities being demanded at higher prices, and vice versa! People who want to use their money for making profits through buying and selling 'investment instruments' generally 'speculate' about the direction in which the prices of these instruments are expected to change. Once Jarhi introduces marketable instruments like CDC's in the system he is obliged to deal with this type of speculation at some length, which, unfortunately, he fails to do. A greater attention to the market for CDC's and other investment instruments and the extent to which 'speculation' may interact with 'real factors' in determining their prices, and hence their rate

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<sup>1</sup> al-Jarhi, *op. cit.*, Arabic version, chapter five, section IV.

<sup>2</sup> *ibid.* It may also be noted that an earlier attempt in section IV.C of the English version to relate demand for money to changes in the market price of CDC's and other investment instruments is abandoned in the Arabic version.

of return, is called for before one can get a clear idea of determination of demand for money in an interest-free economy.

Jarhi rightly started by stressing the point that abolition of interest would forge a direct link between demand for money and real investment via the average rate of profit on investment. The higher the profit you expect the more investment you make, and the less money you hold. But this simple world is shattered to pieces by two facts to which closer attention has to be paid in order to salvage that world. One is the availability of marketable investment instruments which can be regarded as the next best alternatives to money. The other fact is that the price of these investment instruments will be subject to forces of demand and supply. Hence, one has to reckon with the self-justifying nature of speculation on future trend of prices and rates of return, despite the real factors to which Jarhi refers. We need greater details regarding the nature of his CDC's and other marketable investment instruments, and the terms and conditions attached to them, in order to examine his contention that they would be immune to such speculation.

What Jarhi does instead is to rely on diagrammatic analysis to argue how the Monetary Authority *should* manage the supply of money to keep the rate of return on investments at the equilibrium level. Changes in the rate of return arise in his analysis in the investment sector, leading to changes in the demand for money. The Monetary Authority moves in to make compensatory changes in the supply of money which can eventually bring the rate of return back to its former level (figures 1-3 to 1-5 and 2-3 to 2-5 in the Arabic version). Alternatively, the propensity to consume may increase leading to a decline in saving. This too will raise the rate of return, increasing the demand for money. Compensatory changes in the supply of money may fail, however, to bring the rate of return to its former level, in this case (figures 1-6 and 2-6 in the Arabic version).

The diagrammatic analysis remains unconvincing in the absence of an analysis of expectations and prices of investment instruments, as noted above. Profit expectations in an investment-centred, rather than lending-centred, system call for a much closer analysis

than Jarhi could afford. His model leans too heavily on the supply side for the obvious reason that it can be managed. The fact that we do not know how to manage the demand for money to hold makes an insight into the determinants of this demand still more important. The economics of an interest-free economy must await greater efforts in that direction.

### Discounting Future Values

Another contribution of some significance has been the affirmation that there is nothing un-Islamic about discounting future values e.g. future yields of capital goods, to their present values, and that the expected rate of return on equity and not the rate of interest is the proper factor to discount with. This has been done recently by Anas Zarqa.<sup>1</sup> It is not a positive time preference that necessitates discounting of future values but the fact that investment often has a positive net marginal product. Hence, discounting is required in order to ensure efficiency. Furthermore, it is desirable to do this 'to achieve the Islamic objective of avoiding *isrāf*'. Zarqa finds the alleged dependence of discounting on interest to be rather illusory. Zarqa's paper should put a stop to the tendency of some of our writers to turn to a 'shadow' rate of interest because of the need for discounting future values.

### Indexation

Another issue that attracted great attention during the period under review is that of indexation. Price stability is an accepted goal of monetary policy in an Islamic economy, but inflation is rampant all over the world and it cannot be claimed with certainty that abolition of interest alone will eradicate this evil. Since loans do not carry interest in an Islamic economy, the lender will be deprived of whatever compensation interest could offer against the depreciation of the sum lent due to inflation. This led

<sup>1</sup> Muhammad Anas Zarqa: 'An Islamic Perspective on the Economics of Discounting in Project Evaluation'. Revised paper for inclusion in the volume on Islamabad Seminar (January, 1981).

Rafiq al-Misri to observe that 'indexation of loans solves a big economic, legal and financial problem and is also useful in the context of Islamic banking. It will encourage savings and deposits (loans) without interest. It will only protect the real value of loans, which is a great advantage for the people of our time who often find the rate of inflation to be higher than the rate of interest. Lastly, indexation of loans realises the objective of stability in the value of money which has always been so dear to the Muslims as stated above'.<sup>1</sup> Al-Misri cites some juristic opinions to buttress his case, but he does not discuss the economic implications of indexation. Indexation has, however, been recommended on economic grounds by Naqvi.<sup>2</sup> According to him, 'a positive rate of interest performs, though imperfectly, the functions of safeguarding the real value of private saving'; when interest is abolished, 'a system of linking private saving with an appropriate cost of living index may provide an answer — perhaps the only answer — to this problem'. But Naqvi conveniently forgets the fact that abolition of interest would not deprive savings of a positive return, only that the return would be uncertain. Chapra<sup>3</sup> has rightly argued that indexation is no cure for inflation. It may even accelerate it. Besides that: 'even though it is proposed with the innocent objective of doing justice to the *Ribā*-free lender, it has the potential of doing gross injustice to the borrower'.<sup>4</sup> As Kahf observes, 'the attempt to compensate one party for erosion in the value of money is unfair and unjust, and it will be redundant if everybody were to be compensated for the sake of justice'.<sup>5</sup> According to him indexation would also violate the Islamic prohibition of *ribā'l-faql*. Zubair also finds indexation

<sup>1</sup> Rafiq al-Misri: *al-Islām wa'l-Nuqūd* (Islam and Money) p 92, International Centre for Research in Islamic Economics, King Abdulaziz University, Jeddah, 1981.

<sup>2</sup> S.N.H. Naqvi: *Ethics and Economics: An Islamic Synthesis*, The Islamic Foundation, Leicester, 1981, p.121.

<sup>3</sup> M.U. Chapra: 'Money and Banking in an Islamic Economy'. Proceedings of the Makka Seminar, 1978.

<sup>4</sup> *Ibid.* The argument is repeated with added force in a later paper 'Monetary Policy in an Islamic Economy' presented at the Islamabad Seminar in 1981.

<sup>5</sup> Monzer Kahf in discussion on Chapra's paper. Proceedings of the Makka Seminar, 1978.

to be against Islamic principles and without any basis in *Sharī'a*.<sup>1</sup> As a practicing banker, Abdul Jabbar regards indexation to be impractical.<sup>2</sup>

As a matter of fact, any scheme of indexation can hardly cover all categories of people affected by inflation. Insofar as it does not, it will be discriminatory. Assuming that it does, it will accelerate inflation, defeating its purpose. There is only one remedy to inflation and that is price stability. This objective may be realised only imperfectly, but it is not advisable to single out lenders for compensation as all contractual incomes are affected by inflation.

The eagerness to protect depositors in 'loan accounts' of Islamic banks (i.e. depositors who are not interested in investing their savings but only in safe keeping) which makes al-Misri suggest indexation is quite understandable. Sultan Abou Ali has also joined him by suggesting that 'the amount of loan could be related to a physical unit according to the lender's preference. The borrower will borrow on the same terms. The principal of this loan will be redeemed indexed, either more or less, to the unit chosen with no interest'.<sup>3</sup> Notwithstanding the juristic objections of Zubair and Kahf noted above, the idea seems to be impractical in the context of Islamic banking. This is evident when we consider the disposal of these deposits by interest-free banks. They are utilised partly in giving interest-free loans and partly in profitable investment by the bank itself. The interest-free loans are earmarked for priority consumer needs, very short term business needs and the government. In most cases these loans are for non-productive purposes. It is hard to find justification *from the borrower's viewpoint* for the compensation against inflation he would be called upon to make at the time of repayment. Regarding the part banks are allowed to invest on a profit-sharing basis, we run into difficulties if the rate of inflation is higher than the rate of profit

<sup>1</sup> Muhammad Umer Zubair in discussion on Chapra's paper. Proceedings of the Makka Seminar, 1978.

<sup>2</sup> Abdul Jabbar Khan: 'Commercial Banking Operations in the Interest-Free Framework', Islamabad Seminar, 1981.

<sup>3</sup> Sultan Abou Ali as contributor to the discussion on Chapra's paper 'Money and Banking in an Islamic Economy'. Proceedings of the Makka Seminar, 1978.

accruing to the bank as its share of the profits of the enterprise to which the funds are supplied. In such a situation the banks may totally refuse to accept deposits into their loan accounts. Once banks are deprived of the possibility of making profits by utilising part of these deposits, they may legitimately demand 'service charges' from the depositors as well as from those who secure interest from loan. This would be doubly justified in view of the additional cost of calculating the inflation coefficient. This will open a door which has undesirable implications, as noted by Sultan Abou Ali himself in a subsequent paragraph of the note quoted above.

There is a significant volume of voluntary private lending without interest in an Islamic society. Once the principle of indexation is introduced at the bank's level this practice will be put under heavy strain. If a similar practice is allowed in private dealings, it will open the floodgates to interest. If it is not allowed, the prohibition will carry no moral weight and is likely to be violated on a large scale. To the extent that such a prohibition is enforced it may lead to a cessation of private lending so causing hardship.

Lastly, indexation of loans gives a privilege to the lender which the one who decides to hold his money does not enjoy. In the inflationary world in which we are considering this proposition (which is never known to have been made in a deflationary situation) this amounts to a 'gain without risk' which runs counter to the basic Islamic principle in the realm of finance.

### Creation of Credit and Seigniorage

In their search for effective cures for inflation some Islamic economists have turned once again to creation of credit and the fractional reserve system — issues which have been under discussion for quite some time, as reported above. Credit has, of course, to be created to meet the society's growing need for means of exchange but Kahf<sup>1</sup> and Jarhi<sup>2</sup> insist that it must not be left to the

<sup>1</sup>Monzer Kahf: *Islamic Economy*, op. cit. p.73.

<sup>2</sup>Mabid Ali al-Jarhi: Islamabad paper, op. cit.

commercial banks as it enables them to reap unjustified profits. Creation of money by commercial banks is bound to be inflationary as these banks are motivated by profits and not public interest. The power to create credit should, therefore, belong to the Central Bank which is moved by public interest.

Serious doubts have been expressed, however, regarding the efficiency of a system in which only the Central Bank is empowered to create credit. Arriff<sup>1</sup> notes that the advocates of this change have failed to argue that it will be a more efficient way of creating credit, and Saqr<sup>2</sup> goes one step further to suggest that the proposed system will be more inflationary as the Central Bank will be under constant pressure to create credit for non-productive purposes. Chapra<sup>3</sup> seeing no advantage in such a change focuses attention on the 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. '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 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 stockholder, through increased profits. The poor and the needy people of the 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 should be used for general welfare and, particularly, for improving the lot of the poor people'.

Chapra then proceeds to suggest ways and means through

<sup>1</sup>Mohammad Arriff in discussion on Chapra's paper 'Money and Banking in an Islamic Economy'. Proceedings of the Seminar on Monetary and Fiscal Economics of Islam, Makka, 1978.

<sup>2</sup>Mohammad Saqr in Proceedings of the Makka Seminar, discussion on Chapra's paper.

<sup>3</sup>M.U. Chapra 'Money and Banking in an Islamic Economy'. Proceedings of the Makka Seminar, 1978. Section 3-B.

which this can be arranged. One of these ways is to consider the total of derivative deposits as *mudāraba* advances by the Central Bank (representing the society) to the commercial banks. Part of the net income arising from derivative deposits will thus pass on to the state to be used for social welfare.

The basic idea propounded by Chapra is sound but it requires more detailed consideration than Islamic economists have been able to give it so far. While the suggestion to siphon off part of the seigniorage is acceptable, every care has to be taken not to kill the goose that lays the golden eggs. Unfortunately, the discussion on seigniorage in economics literature is also of recent origin and does not offer many policy options. It does show, however, that the benefits flowing to the 'banking public' are much larger than would appear at first sight. It can also be argued that these benefits would tend to be distributed more widely in a profit-sharing system free of interest. The banking public, especially the entrepreneurs securing investible funds from the commercial banks have a very crucial rôle to play in a developing country. Any benefits which are *directly* transferred at their cost to the non-banking 'needy people of the society' must be carefully compared with the indirect harm such a transfer may do in terms of efficiency and growth.

### 100% Reserves

Jarhi<sup>1</sup> has joined Kahf in proposing to do away with the fractional reserve system in favour of 100% reserves. The fractional reserve system is inherently unstable as it leads to changes in the total supply of money whenever people wish to convert their deposits into legal tender money and vice versa. This would not happen under the 100% reserve system. Secondly, the fractional reserve system is unjust as it gives the commercial bank the power to create money which should belong to the society as a whole. Lastly, Jarhi argues that cost of creating real balances (as distinguished from nominal money balances) is higher under a

<sup>1</sup>Jarhi, *op. cit.*, Arabic version, chapter two, section, 2, 1.

fractional reserve system as compared to what it would be under 100% reserve system, as the Central Bank would, in the latter situation, be in full control of the situation. However, the majority of those participating in the debate remain unconvinced. Uzair<sup>1</sup> thinks that it will introduce unnecessary rigidities into the system, and Arrif<sup>2</sup> thinks that it will reduce banks to safe-deposit vaults.

### Profit-Sharing Ratio as an Instrument of Policy

While the issues of indexation, credit creation and 100% reserves continue to be debated, more attention is being paid to the larger issue of monetary policy in an interest-free economy. Chapra, Jarhi and Uzair have broadened an approach initiated earlier, as reported above. The use of the ratios of profit-sharing as an instrument of monetary policy, suggested by Siddiqi<sup>3</sup> and Uzair<sup>4</sup> has also received greater attention in this context. Ziauddin<sup>5</sup> finds it to be acceptable in principle but Saqr<sup>6</sup> thinks it would be un-Islamic for the Central Bank unilaterally to change a contractually determined ratio which should be altered only by mutual consent. But this objection holds only if changes are applied with retrospective effect. There should be no objection to the Central Bank subjecting fresh deposits and advances and renewal of old ones to a change in the ratio of profit-sharing. However, Sultan Abou Ali<sup>7</sup> prefers leaving the determination of these ratios to market forces, presumably on grounds of efficiency. Chapra<sup>8</sup> also

<sup>1</sup>Mohammad Uzair: 'Central Banking Operations in an Interest-Free Banking System'. Proceedings of the Makka Seminar, 1978.

<sup>2</sup>Mohammad Arrif in discussion on Chapra's paper. Proceedings of the Makka Seminar, 1978.

<sup>3</sup>M.N. Siddiqi: *Banking Without Interest*, *op. cit.* Chapter six.

<sup>4</sup>Mohammad Uzair: 'Central Banking Operations in an Interest Free System'. Proceedings of the Makka Seminar, 1978. Also included in the author's book *Interest Free Banking*, *op. cit.*

<sup>5</sup>Ziauddin Ahmad in discussion on Uzair's paper. Proceedings of the Makka Seminar, 1978.

<sup>6</sup>Mohammad Saqr in discussion on Uzair's paper. Proceedings of the Makka Seminar, 1978.

<sup>7</sup>Sultan Abou Ali in discussion on Uzair's paper. Proceedings of the Makka Seminar, 1978.

<sup>8</sup>M. U. Chapra in discussion on Uzair's paper. Proceedings of the Makka Seminar, 1978.



advises against interference in this regard as the Central Bank can control credit in other ways. Jarhi<sup>1</sup> thinks it would be better to influence this ratio indirectly by affecting the supply of funds.

### Islamic Banking in Operation

Whereas the discussion on monetary policy in an interest-free economy remains purely academic — no Central Bank has given up dealing with interest — suggestions to broaden the interests of interest-free banks have a relevance for more than half a dozen institutions already in operation. To these has been added the declared intention of the government of Pakistan to effect a gradual transition in its banking system towards one free from interest. A Pakistani banker, Abdul Jabbar Khan<sup>2</sup> examines leasing, hire purchase, *bai' salam* and *bai' mu'ajjal* in this context; and Mohsin<sup>3</sup> has argued in favour of a unit investment plan under which 'the depositor will be required either to deposit a lump sum or to make a regular contribution': these deposits will be treated as part of the capital of the bank, but will be refundable at the option of the depositor after the expiry of the stipulated time. The *pro rata* profit will be paid to the depositor either in cash or credited to the 'Unit Investment Plan'. Mohsin links this plan to a housing scheme. 'The RFB (Ribā Free Bank) may also construct houses as per specification of the members. The member will be refunding the principal amount in monthly instalments without any rate of interest. But he will be required throughout his membership under the scheme to pay a monthly sum into the Unit Investment Plan...' It is difficult, however, to make any sense out of this scheme unless further details are provided. It is not clear, for example, at what stage of one's membership one can get a house. If it is possible to get a house long before one's subscriptions to the scheme are sufficient to meet the cost how does the bank manage

<sup>1</sup> Mabid al Jarhi in discussion on Uzair's paper. Proceedings of the Makka Seminar, 1978.

<sup>2</sup> Abdul Jabbar Khan: 'Commercial Banking Operations in The Interest Free Framework', *op. cit.*

<sup>3</sup> Mohammad Mohsin: 'A Profile of Ribā Free Banking'. Proceedings of the Makka Seminar, 1978.

to advance the required capital 'free of interest'?

Most of the operations suggested by Abdul Jabbar are already being practiced by some Islamic banks. These forms have also been examined and approved by the Council of Islamic Ideology in Pakistan, whose report is taken up for consideration separately below. The difficulty with operations like *bai' mu'ajjal* and *murābaḥa* is, however, that instead of expediting the transition from interest-based banking to interest-free banking, they tend to retard it by legitimising the *status quo*. The Council of Islamic Ideology<sup>1</sup>, basing its observations on the report of the Panel of Economists and Bankers on the elimination of interest from the economy,<sup>2</sup> has done well to affirm that profit-sharing should emerge as the chief alternative to interest in the reformed system. But this purpose would be defeated by making recourse to *bai' mu'ajjal* or *murābaḥa* in situations where profit-sharing is also feasible. The essence of both operations is to enable a buyer to finance his purchase on deferred payment by accepting a mark-up on the market price of the commodity. The financier, in this case the Islamic bank, earns a predetermined profit without bearing any risk.

It is good, however, that these issues have been brought into the open as a result of the deliberations of the Council of Islamic Ideology. Fahim Khan's report<sup>3</sup> on the functioning of the existing interest-free institutions also serves the same purpose. It is hoped similar surveys of what is going on and deliberations on how to effect a change in the entire banking system will provide the academics with more food for thought.

Islamic banking has started attracting the attention of bankers and economists in the western world also. One interesting angle from which the subject is being examined is its potentiality for opening up new avenues of cooperation between the oil-rich Muslim countries and the western economies. Professor Horst

<sup>1</sup> & <sup>2</sup> See paper 7 below.

<sup>3</sup> M. Fahim Khan: 'A Report on the Islamic Banking as Practiced Now in the World'. Follow-up Seminar on Monetary and Fiscal Economics of Islam, Islamabad, 1981.

Albach<sup>1</sup> has pointed out that the West German economy is suffering from a continuous decline in the supply of equity capital relative to loan capital, with bad consequences for the economy. Islamic banking which replaces loan capital by risk capital as the chief form of supply could channel some of the surplus petro-dollars to western economies as risk capital, to the mutual advantage of both.

Unfortunately, the Islamic economists have yet to examine their position in the context of the international financial situation to discover the potentialities of their approach and identify the questions in money and banking which they must answer. The contemporary financial system, in which both the creation of money and its supply to producers is based on lending, and lending involves interest, is collapsing under the strains of a new international situation. This new situation in which the West has the technology, oil-rich countries have the capital and the Third World has vast possibilities of production and large potential markets, calls for a new approach based on participation rather than lending. Those who seize this opportunity to evolve a convincing and beneficial arrangement bringing the three parties together as partners in progress will have served humanity well, and interest can hardly find a place in their arrangement.

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<sup>1</sup>Horst Albach: 'Risk, Capital, Business Investment and Economic Cooperation'. 5300 Bonn I, Adenauerallee 24-42, 1981, mimeograph.

## CHAPTER 2

# Banking in an Islamic Framework

Banking has done for man's modern economy what the advent of money did for his primitive economy when barter was the rule. It has greatly facilitated exchange and helped capital formation and production on a vast scale unprecedented in human history. But the way it has done so has been largely responsible for some of the greatest evils of modern economy: inequities in the distribution of income and wealth, concentration of economic power, an endemic tendency towards inflation and fast accumulation of debt in several sectors of the economy with serious political, economic and social consequences. The system, therefore, calls for a close scrutiny in a study which advocates a basic reform in banking that would eliminate these ills and gear the system to the universally acclaimed ends of justice, equity and progress.

The main rôle of banks is that of financial intermediaries between the ultimate savers — the households — and the ultimate investors — the firms. Savings accrue with millions of households while business enterprise is confined only to tens of thousands of firms. Every society needs some mechanism through which savings are channelled from savers to investors, on the basis of some understanding relating to repayment and returns. Inadequate knowledge and communication and diversity of tastes regarding liquidity, risk, and time involved, etc., make a direct deal between savers and ultimate investors inefficient and limited in scope. Banks stepped in offering the savers various types of deposits and withdrawal facilities, and guaranteed returns by way of interest. Non-bank financial intermediaries also have a rôle in this respect which we shall leave aside for the moment. With so much public money in their vaults banks are in a position to offer advances to business enterprise for investment. Thus they play a decisive rôle

in the allocation of financial resources available within the society. The fact that bank advances are based on fixed interest payment, and that liquidity is one of their major concerns besides profit making, is crucial in this respect. The banks' allocative policies are not guided by the society's needs for productive enterprises, nor by its priorities therein, as they perforce favour quick-maturing, high-yielding projects.

Modern society's vast needs for a medium of exchange could not possibly have been met by metallic money alone. It would have been in any case a wasteful method of meeting these needs. Introduction of paper currency and later of cheque deposits and their acceptance as money by society is largely owed to the banking system. Bank credit, or money created by banks through entries in their ledgers, is a convenient way of augmenting the supply of money *pari passu* with the society's demand for it. It developed as a concomitant of the above-mentioned rôle of the banks and soon became their predominant function, almost overshadowing the first. It is interesting to note, however, that the terms on which the banks performed their first function were to a very great extent responsible for creating vast demands for credit. Demand for very short-term credit has grown out of proportion with the structure of production process mainly because banks would not go in for long term financing nor participate in risk-taking. Recourse to a series of short-term arrangements and reliance on other financial intermediaries became inevitable for firms.

Banks perform a number of other functions such as keeping demand deposits, safe custody of valuables, agency functions in respect of payments and receipts etc. and money transfers over time and distance. These, however, do not concern us here as they are not relevant to the desired reform. We shall therefore turn to the main function and trace some of the consequences that follow from the fact that they are rooted in the institution of interest.

All that is ethically and aesthetically good and beautiful in society is born of creative action rather than action impersonally determined by forces of nature. In trying to convince us that entrepreneurial behaviour was determined by impersonal forces leaving no room for creative action, economists of yore were

deceived as well as deceiving. This deception was reinforced by the institution of interest. The society would gain by removing this constraint and widening the possibilities of ethically oriented voluntary action on the part of the entrepreneurs.

The third and the most serious consequence of bank advances being based on interest relates to the enterprise which incurs losses. It is nevertheless constrained to repay the principal as well as the interest stipulated, making up the deficiency out of its own assets. This raises the question of justice. If the results of enterprise are uncertain due to the nature of the world, why should the supplier of capital be guaranteed a fixed positive return, leaving the burden of uncertainty, falling in the form of loss, entirely on the entrepreneur. The uncertain world in which capital and enterprise cooperate in production does not guarantee a positive value productivity to either of them. Having dealt with the related issues of productivity of capital, distinction between capital goods and money capital, and that between risk capital and loan capital elsewhere,<sup>1</sup> we focus our attention on the central issue involved. The penalty imposed on the unsuccessful entrepreneur is entirely unwarranted in view of the uncertainties involved. The ability of the entrepreneur has presumably been tested earlier and scrutinised by the banker who agrees to make an advance. Accrual of losses is as much due to macro-economic factors beyond his control as, probably, to inefficient management. Failure of an enterprise to make a profit deprives the entrepreneur of any reward for his entrepreneurial services, and rightly so, because the enterprise failed to create additional wealth out of which he could be rewarded. To oblige him to make up the deficiency in capital caused by the loss and pay up the interest due, presumes an inherent property in capital not only to remain undiminished but also to grow with the mere passage of time, despite uncertainty. This is a false presumption without any basis in logic or history. In perpetrating this injustice the banking system penalises entre-

<sup>1</sup>Teaching of Economics at the University level in Muslim Countries. The Challenge of alien concepts and the formulation of Islamic concepts.' Paper presented at the first World Conference on Muslim Education, Makka, April 1977. published in *Islam and the Modern Age*, (New Delhi) Vol. IX, No.1, February, 1978.

preneurship in general and tends to exclude individual entrepreneurs from further activity by depriving them of assets built earlier. A constant stream of wealth must flow from the entrepreneurial class to the banks against no actual contributions made to social wealth. In a world where growth of wealth as a result of productive enterprise is uncertain due to changing tastes, weather and imponderables such as political developments and innovations etc., capital participating in enterprise is assured of constant growth and entrepreneurship, enabling this participation, is made to bear the entire burden of uncertainty as well as serve up certainty to capital. The system of interest-based advances must, therefore, be judged unjust, discriminatory and prejudicial to social interests.

Replacement of interest by profit-sharing as the basis of banks' advances to business, which is the basic reform advocated by us, takes care of the evil consequences of the system noted above. One further advantage is to ensure active involvement of the banks in the productive ventures financed by them. Banks' income being derived directly from the actual profits realised in the ventures they finance, their expertise will also be focused on efficient decision-making and proper management in these ventures.

### Consequences of Interest

The ultimate investor faces an uncertain world in which the results of his enterprise cannot be foreseen with certainty. He is nevertheless obliged to commit himself to the bank for payment of a fixed percentage return over and above the principal. In doing so his only guide are his expectations regarding the profits of his enterprise. Should the expected rate of profit be lower than the market rate of interest or, to be more realistic, not sufficiently higher than it to leave some profits for himself, he is constrained to drop the project. These often include projects rated high in the social order of priorities but the individual is entirely helpless in this regard. The society is, therefore, obliged to adopt other methods to take care of such projects. Historically, it had to admit them into the public sector or finance them through special

agencies relying on public funds raised through borrowing or taxation. The institution of fixed interest charges on advances is, therefore, inimical to the growth of a free society and it introduces a tendency towards socialisation.

Secondly, interest due on bank advances has to be treated as an item of cost raising the cost curves and influencing the firm's policy regarding pricing of its products and the wages offered to labour, assuming that the imperfectly competitive world affords some manoeuvrability to many firms in these respects. Higher cost curves imply higher equilibrium prices and smaller scales of production. Furthermore, the profit-sharing entrepreneur is free from the constraint of realising interest costs as his sole commitment to the supplier of capital is that of sharing the ex post profit with him. Though still a profit-seeker, he can nevertheless take care of social objectives in his price policy and wages policy, should he so desire. He can serve other ends at the cost of some short term profits. No such freedom is available to an interest paying entrepreneur.

### Interest and Bank Credit

We shall now trace the impact of interest on creation of credit by the banks. Banks' ability to create credit is independent of the terms on which it is extended, depending as it does on the habits of the public which keeps only part of its income in cash and deposits and the rest with the banks. The institution of interest is neither a necessary nor a sufficient condition for the bank's ability to create credit.<sup>1</sup>

Interest is crucial, however, for the purposes for which credit is extended and for the extent of its supply and demand. In the absence of interest, and assuming that the supply of interest-free loans cannot be a major rôle of the banks as profit seeking firms, bank advances would be made only for the purpose of productive enterprise. Credit would be created only to the extent there exist

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<sup>1</sup>Siddiqi, M.N.: *Banking Without Interest*, Chapter Five, Islamic Publications, Lahore, 1973.

genuine possibilities of creating additional social wealth through productive enterprise. The financial resources that banks provide by way of credit will have to be more than fully matched by real resources awaiting mobilisation by entrepreneurs. Credit created on the basis of profit-sharing would not be inflationary in the long run. Demand for profit-sharing advances will be limited by the extent of the available resources and banks' ability to create credit will be called into action only to the extent of this demand, subject to the constraint imposed by profit expectations that satisfy the banks. Supply in this case would not be able to create its own demand as it does at present.

Some further consideration of the nature of bank credit would enable a better appreciation of the rationale of the suggested reform. In the pre-capitalist days loans represented real savings. Command over social produce acquired by making some contribution to it was temporarily transferred to the borrower. With the advent of banking a loan became so much purchasing power created and passed on to the borrower. Payment of interest on loans involved a simple transfer of command over real resources from the debtor to the creditor. Payment of interest on money created *ad hoc* for lending greatly magnifies this effect, raising new questions regarding its justification. Assuming reserve ratio of 10% and no leakages, saving deposits worth 100 enable the banks to advance 1000 as loans, involving a transfer of 100 per year from the debtors to the bank, assuming the rate of interest to be 10% per annum. Previously 100 saved and lent would have involved a transfer of 10 per year only. While the repayment of loans extinguishes the money created by banks, the interest paid to them remains. The power of savings to acquire additional resources with the mere passage of time has increased manifold, thanks to the social convention that allows the banks to create credit. What part of the additional resources so acquired goes to the ultimate savers and what accrues to the banks is a different story.

Consider the situation consequent upon a changeover from interest to profit-sharing. Banks' *muḍāraba* advances could still be a multiple of their saving deposits, but their returns accrue as a percentage of profits actually realised when these advances result

in creation of additional social wealth. These returns are then shared by the banks with the depositors according to an agreed percentage. Accrual of profits on deposits in this case devolves on exposure to risks involved in productive enterprise. The magnitude of these profits is determined by the conditions of market and the two ratios of profit-sharing which are subject to the forces of demand and supply. The power of real savings to acquire additional resources with the mere passage of time is completely destroyed. Instead they have the possibility of acquiring additional resources to the extent their utilisation in productive enterprise actually results in the creation of additional wealth. Creation of credit by the banks has, no doubt, broadened these possibilities, but their actual realisation depends on the extent of production possibilities available. The social convention that allows the creation of credit is harnessed into use to the extent that the production possibilities available in the society call for it, and its benefits are then passed to parties participating in the fulfilment of this social need at the risk of loss: of their real savings (depositors); or of the reward of services rendered as agents and intermediaries (banks); or of the reward for entrepreneurial services (firms).

The present system prompts the banks to patronise speculators, other financial intermediaries and the government who are ideal short term borrowers. The ultimate investors figure in their portfolios only marginally and often indirectly. The unusually lengthy chain of intermediaries between the ultimate savers and the ultimate investors is largely a product of the ease with which credit instruments can be created and handled, thanks to interest. They bear very little relation to the structure of production. To justify this proliferation of financial intermediaries and credit instruments with reference to the variety of tastes regarding liquidity, risk, size of holding and time period involved presumes a sanctity for these tastes which is highly doubtful. To a very great extent they are the product of high-powered propaganda and psychological manipulation. One is reminded of the sex industry justifying pornography, and all that goes with it, by reference to the variety of human taste. As in sex and family so in finance and economy, the society must have some norms more stable than shifting tastes

exposed to manipulation by interested parties. With a change-over from interest to profit-sharing, creation of credit instruments will be sharply curtailed.

Public debt has now assumed such proportions that its repayment is no longer considered a feasible proposition. Society must go on servicing these debts by raising more debts, in most cases. Alongside this, there has been a phenomenal growth in consumer credit in the more advanced economies. Abolition of interest will make the provision of consumer credit mostly a welfare service organised by the State. There would also be a limited possibility of using pension funds and the like for providing such credit. Thus, curtailed to reasonable dimensions, it will cease to threaten the peace of homes and composure of individual personalities as it does today by creating worries and tensions. The State may be able to raise some interest-free loans from the public, relying for the rest of its capital needs on profit-sharing with the public as well as the banks. Foreign capital would also flow in on the same basis. In all these cases repayment and servicing<sup>1</sup> (by way of paying the due share of ex post profits) will be fully within the competence of the public authority. Cooperative societies may be encouraged to organise instalment purchase for the consumers. While there is every argument in favour of increasing the individual's efficiency and improving his standard of living through acquisition of consumer durables early in life, in lieu of payment out of future income, this has to be done in a manner that does not involve transfer of a sizeable proportion of his income to lenders by way of interest on credit extended to him.

Reduction in the volume of credit instruments and public debt, coupled with curtailment in the size of bank credit, will go a long way towards halting the tendency towards inflation which has become the bane of modern economy. It will also severely limit the scope of speculation. Arbitration over time and space, which provides the economic justification for speculation, will have to be rationally organised and guided in an Islamic framework which cannot admit most of the unhealthy forms of speculation prevalent

<sup>1</sup>*op. cit.*, chapter VII.

at present. This will have important implications for business cycles. It has been argued elsewhere that abolition of interest and speculation will tend to eliminate business cycles. Investments based on production possibilities directly assessed by businessmen and bankers are not likely to overreach themselves to an extent that makes a crash in share prices inevitable at a later stage.

Lastly, a changeover from interest to profit-sharing will counter the tendency towards concentration of economic power in the hands of bankers and financiers. Much of this power depends on the permanent state of indebtedness in which important sectors of the economy find themselves. With the abolition of interest the state of indebtedness will be transformed into a position of participation over a large area of the economy. Indebtedness, free of the obligation to pay interest, insofar as it does survive, would not provide the lenders with any instrument for exercising this power. Different rates of interest and discriminatory terms at which credit could be extended will no longer be available to the bank. Economic power of the bankers and financiers will also decline as the financial sector shrinks in size and its share in national income goes down, as a necessary consequence of the changeover from interest to profit-sharing.

It is time to turn to the question of feasibility of banking without interest.

### Profit-Sharing Banks

Banks can serve as financial intermediaries mobilising savings from the public on the basis of profit-sharing and making advances to firms on the same basis. Banking companies could be established with share capital, the shareholders sharing the profits as well as losses of the banking business. Entrepreneurs obtaining capital from banks would have to share their profits with the banks according to a mutually agreed percentage. The banks would share the profits so accruing to them with the depositors in the 'investment' accounts according to a predetermined percentage. This would leave part of the profits with the banks which would, along with the net revenue from fees and commissions charged for

other banking services, and profits accruing on the investment of banks' own capital, constitute the gross profits of banking.

Liability to losses in the bank-entrepreneur relationship attaches to the bank. Banks could also go in for actual participation in the management of an enterprise, part of the capital coming from the bank and part of it coming from the entrepreneur. In that case both the parties would share the profits as well as losses in proportion to the capital supplied by each. Unlike this arrangement, called *Shirka* in Islamic Law, in the first-mentioned arrangement called *mudārabā*, liability to losses attaches to the supplier of capital alone, that is the bank, assuming that the entrepreneur does not invest any capital of his own. The banks are not likely, however, to incur losses on their advances taken as a whole. This could be ensured by diversification of investment and supervision of entrepreneurial management. By building loss-compensating reserves by retaining part of the profits realised on earlier advances, banks could absolve the deposits into 'investment' account of the risk of loss which in principle attaches to them. Banks will also be able to accept deposits in current accounts payable on demand. These depositors will not be entitled to any share in profits. They may or may not be subjected to any service charges. But the banks will be obliged to earmark part of their demand deposits for extending short term interest-free loans. Other banking services presently performed against fees charged will continue as they are. There is a strong case in favour of combining investment banking and development banking with commercial banking, so that the banks are involved in production and capital formation in a number of ways.

The Central Bank would continue to perform its conventional functions even though it would lack the 'Bank Rate' as an instrument of policy. Advice, moral persuasion and regulatory directives, which are playing an increasingly prominent rôle, would be reinforced by the fact that the Central Bank would be working under the patronage of an Islamic state dedicated to the people. The reserve ratio will remain unaffected as an instrument of policy by the change from interest to profit-sharing. The proportion of their demand deposits which the banks would be

allowed to utilise in making profit-sharing advances, designated as 'lending ratio' could become a new instrument of policy for adjusting the supply of interest-free loans with their demand. A 're-finance ratio', promising Central Bank credit to commercial banks, to the extent of a certain proportion of interest-free loans given by them, can become yet another instrument of policy for regulating the volume of credit and ensuring bank liquidity. Bonds and securities will be replaced by shares in public enterprises which could provide the Central Bank with a means for open market operations.

Savings will continue to flow into the investment accounts as the depositors will be assured of a positive return whose rate would fluctuate within reasonable limits, thanks to the pooling of large volumes of savings and diversification of investment by the banks. Given the propensity to save and the *ex ante* rate of profit in productive enterprise, the volume of investment deposits will be a function of the two ratios of profit-sharing — between the banks and firms and between banks and depositors. The supply of profit-sharing advances will be a function of the volume of total deposits, given the reserve ratio and the lending ratio. Demand for banks' profit-sharing advances will be determined by the expected rate of profits, the ratio of profit-sharing between bank and firm, and the rate of profits regarded as the minimum satisfactory rate by the firms.

### Short-Term Credit

Supply of short-term loans to business and the related problem of bills of exchange deserve special attention in an interest-free system. It is hardly possible to assess the profitability of very short-term credit intended to meet the liquidity needs of business, hence profit-sharing cannot be the basis of such advances. They have to be provided as loans with guaranteed repayment but free of interest. Service charges can, however, be recovered from the borrowers. Banks can use part of their demand deposits for providing such credit as they are not obliged to pay any profits to these depositors. Some writers have argued in favour of charging

some 'profits' on advances made for a month or more, calculated on the basis of the firm's annual rate of profit. In case of bills of exchange involving a period of about three months it could well be possible to calculate the specific rate of profit relevant to the capital advanced.

More crucial, however, is the allocation of short-term interest-free loans. How can the demand be adjusted to the limited supply available?

Much of the demand for call money and very short-term credit arises from within the financial sector itself and is likely to be eliminated as that sector shrinks in consequence of the abolition of interest. In the production sector, the total demand for short-term credit depends on the volume of long-term investment and the extent of trade credit (credit extended by one firm to another) prevalent. Credit needs for the week or the month can be estimated at the macro-level. This could be done by the Central Bank which would then ensure a supply commensurate with the demand by manipulating the 're-finance ratio' and the 'lending ratio'. The task of allocating these loanable funds at the micro-level would then be performed by individual banks on the following criteria:

1. Specific credit needs of a firm.
2. Social priority attaching to the enterprise.
3. Nature of the security offered against loan.
4. Whether the credit-seeker has also obtained long-term advances from the bank for the same period.
5. Annual, monthly or weekly average of the applicants' balance in current accounts with the bank.

It is within the competence of the Central Bank to exercise direct and indirect influence on banks' decisions on the second ground. Discriminatory use of the 're-finance ratio' is a case in point.<sup>1</sup> Banks are expected to prefer good securities over the not so good and patronise client firms over enterprises in which they have

<sup>1</sup>*op. cit.*, pp.121-123.

no stakes. A credit seeker's average balance in the current account may provide a basis for overdraft facilities — one form in which short term credit is granted.

As regards interest-free loans to consumers, they have, in general, to be arranged through agencies other than banks which are profit seeking firms. In an Islamic society consumer loans could be provided out of a *Zakāt*-based fund specially set up for this purpose. Some writers have suggested that banks may be entrusted with the operation of such funds. Besides that, banks could offer some overdraft facilities to their depositors, as an incentive.

In all cases of interest-free loans, repayment has to be guaranteed, ultimately by the State. In genuine cases of inability to pay, repayment could be made out of *Zakāt* funds too. A comprehensive insurance scheme could also take care of them.

Lastly, notice must be taken of the view that replacement of fixed interest charges by a percentage share in profits actually realised by the enterprise makes the return on bank advances devolve on honest book-keeping by the entrepreneur. Similarly, depositors in investment accounts will get their due share of profits only if the bank reports its own profits correctly. It is, therefore, asserted that the whole system hinges on the moral standards of the parties concerned.

There is no denying the need for raising the moral standards of the people in view of complementarity between morality and Islamic institutions. It is hoped that such an improvement will accompany an Islamic transformation of society. No less crucial, however, are the economic forces working against cheating and fraudulent account-keeping. Banks as profit-seekers would be guided by the past records of the firms with respect to the profits they made and paid to the banks on earlier advances. Those with a record of giving a higher percentage return on bank advances will have a better chance of obtaining fresh advances. Those who gave a poor return or declared losses would stand little chance of getting fresh advances. It is largely irrelevant for the banks whether the cause was fraudulent book-keeping or bad management. A poor record with respect to profits would deprive a firm of bank



advances in future, threatening its continuation in business. In their own long-term interests, firms would try to maintain a good record of profit making and desist from practices which reflect ill on their efficiency as profit-makers. The same applies to profits on deposits. Competition amongst banks will ensure that a tendency to understate banks' profits with a view to distributing smaller profits on deposits is curbed. Should the banks in general indulge in such practices, the volume of bank deposits will go down forcing them to change their practice with a view to attracting more deposits.

Yet another dimension of this problem is the competence of modern techniques of critical audit and management audit to prevent cheating and fraud. It is also possible for the bank in most cases to stipulate that all financial transactions of a client firm be routed through it.

A changeover from interest to profit-sharing in banking will be greatly facilitated if it is accompanied by other changes involved in an Islamic transformation of society. A total ban on interest will plug the loopholes which could frustrate the suggested reform if it is confined to the banking sector. A ban on all unhealthy forms of speculation and forward transactions will eliminate many intermediaries and reduce the financial sector to reasonable dimensions. Imposition of *Zakāt* on all cash balances will discourage liquidity preference and encourage investment. A comprehensive social security scheme in the broader framework of a welfare state will reduce the demand for consumer credit and counter the tendency towards concentration of wealth and economic power. Lastly a change of attitude from self-centred individualism to the cooperative and humane attitude of 'live and help others live' will change the nature and quality of economic relations in human society.

### Prospects

The idea of profit-sharing banks has already caught on and a number of reformed banking institutions have recently appeared. The Dubai Islami Bank is making good progress mainly through direct participation in trade and industry. The two Islamic banks

operating in Cairo and Khartoum are too recent to show any progress. The first year of the Islamic Development Bank at Jeddah has provided some practical examples of how expected profits can guide investment on a large scale. The idea of equity banks is attracting attention in banking circles of the West. Insofar as modern financial organisations have failed to better the world, hindered by their complexities, their concentration of economic power and stagnation, the case for reform becomes stronger and the one suggested by us increasingly merits serious consideration.

## CHAPTER 3

# Rationale of Islamic Banking

Banks function as financial intermediaries between savers and the ultimate users, the households and firms. Besides this, they offer a number of other services such as safe deposits, cheque facilities, easy transfers, overdrafts, guarantees and agency functions in respect of purchase and sale, payment and receipt, management and promotion etc. These facilities attract, besides savings, much of current income into bank deposits as the income receivers do not spend all income immediately upon receipt. They need and withdraw only a fraction of it at any time enabling banks to advance the rest, along with time deposits, of which a smaller fraction needs to be kept in reserve, to other people desirous of using money capital for various periods of time. As borrowers use this money new incomes are generated and bank deposits increase, and the same process starts again. This means 'creation of money' and increase in money supply. An increase in the supply of money may affect the value of money and influence the level of economic activity in the society. As entrepreneurs obtain money capital from banks, banks are in a position to influence the allocation of resources in the society. Thus the most vital interests of society related to the level of economic activity, allocation of resources and the value of money are liable to be handled by banks for the good of the society or to its detriment. Everything largely depends on the way they perform their main function, that of being financial intermediaries and keepers of people's incomes in demand deposits — the latter service being conveniently associated with the former.

Historically, banks have performed this function on the basis of fixed interest payment<sup>1</sup>. Interest forms the basis of the bank's dealings with the savers as well as with the entrepreneurs to whom it advances money capital, mobilised from depositors as well as created *ad hoc*. The purpose of this brief study is (a) to demonstrate that this basis works to the detriment of social interests affecting as it does, the level of economic activity, allocation of resources and value of money in undesirable ways, as well as causing other evils; (b) to argue that an alternative to the institution of interest in the form of profit-sharing is available and feasible; and lastly (c) to analyse how the banks' functioning, on the basis of profit-sharing instead of fixed interest payment, will result in desirable effects on the level of economic activity, allocation of resources and value of money. The changeover to a profit-sharing banking system will not only save the society from the evil consequences of interest-based banking, it will serve the good of society by securing justice, effecting a better distribution of income, and contributing towards greater stability and peace.

We do not propose, however, to discuss in detail how the profit-sharing system will work. We have the limited purpose of presenting the rationale of Islamic banking which is based on profit-sharing instead of interest. We want to answer the question 'why' Islamic banking, rather than the question 'how' Islamic banking.<sup>2</sup>

<sup>1</sup>It may be noted that application of moving interest rates to some loans and use of floating rates in case of some deposits does not alter the nature of the contract which still guarantees an assured return on money capital per period of time. It continues to assign losses and profits to the entrepreneurs only, which is inequitable. These adjustments in the rate of interest are tied to the average trend in the market and not to the actual profits realised in the enterprise concerned, as required by equity. In fact the market average and the realised return in a particular enterprise may sometime move in opposite directions in which case a variable rate of interest becomes more inequitable than a fixed one. It will be appreciated, therefore, that the above-mentioned practices do not affect our case against interest, based as it is on considerations of equity and efficiency, as elaborated in what follows.

<sup>2</sup>A number of good works are available on the subject, including the recent paper by M. U. Chapra: 'Money and Banking in an Islamic Framework' included in the forthcoming volume on the Proceedings of the Seminar on Monetary and Fiscal Economics of Islam held at Makka in 1978. Also Mabid Ali al-Jarhi: 'A Monetary and Fiscal Structure For an Interest Free Economy: Institutions, Mechanism and Policy.' Paper presented at the Follow-up Seminar on Monetary and Fiscal Economics of Islam, Islamabad, 1981 and M.N. Siddiqi: *Banking Without Interest*, Islamic Publications, Lahore, 1973.

## The Critique

The most pernicious consequence of basing banks' intermediary function on interest is the creation of a debt-ridden economy wherein the entire entrepreneur class, the government and the bulk of consumers, find themselves heavily in debt to the financiers. This has important economic, social, psychological and political consequences which we will trace below. It will then be possible to realise how the replacement of interest by profit-sharing eliminates this state of indebtedness in most cases, transforming the debtor-creditor relationship into a kind of partnership with its salutary economic, social, psychological and political effects.

The economic implications of the debtor-creditor relationship have two distinct dimensions relating to efficiency and justice respectively. We shall concentrate on the efficiency aspect first and discuss the justice aspect second.

## The Investment Sector

### Inefficiency of Debt Finance

Let us first consider the creditor-debtor relationship from the perspective of the creditor. He is naturally most concerned about the safe return of the principal lent along with the interest stipulated. The best way to ensure this is to advance money only to creditworthy borrowers who have enough assets to fulfil their commitments. The creditor's interests are best served when the borrower has the ability to meet his obligations irrespective of the fate of the actual project in which the loan is to be invested. This is not to imply that the financier does not examine the project or satisfy himself about its soundness. He certainly does so, but it takes second place in his consideration. Even if the project seems to be sound he will hesitate to make a loan if the borrower does not have sufficient assets independent of the projected enterprise. On the other hand he may ignore the dubious prospects of the projected enterprise if the borrower is in a position to offer him a sound collateral and is fully creditworthy. Debt finance generally goes to the most creditworthy parties not to those with the most

promising projects. Since the financiers get only the market rate of interest as stipulated in their contract with the borrower, the prospects of the entrepreneur making a higher than average rate of profit are not of immediate relevance to them. What matters more for them is safety, which may at best require a reasonable expectation of making enough profits to pay the contractually fixed interest. Prospects of higher profits, the economic criterion<sup>1</sup> which should channel investible funds to a project in preference to others expected to yield a lower rate of profit, fail to exercise a decisive influence on the financiers as their own returns do not improve due to such prospects.

In order to appreciate the economic implications of the above more clearly, let us imagine the existence, at a particular time, of a large number of entrepreneurial projects all of which carry an expected rate of profit higher than the market rate of interest, both in the assessment of the entrepreneur as well as the financier. Assume for the sake of simplicity that the degree of uncertainty associated with each expectation is the same. These projects can then be arranged according to the expected rate of profit they promise, in a descending order. Secondly the same projects can be arranged in a descending order according to the creditworthiness of the entrepreneurs presenting them. It is plain to see that a project may not occupy the same position in the two orderings, society's interests are best served when projects are financed according to the first ordering, the one based on profitability. But the flow of finance on the basis of contractually fixed interest payments largely follows the second ordering based on the creditworthiness of the borrowers. This involves a departure from optimum allocation of resources. In an interest-based system expected profitability ceases to be effective in ensuring an efficient allocation of investible funds because of the terms on which these

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<sup>1</sup>We make this assumption, other things being equal, for the purpose of this study. There may be social priorities and other criteria e.g. creation of jobs, production of essential goods, etc., which do or should guide the financier and/or the entrepreneur. This study does not take them into consideration in comparing the efficiency of the profit-sharing system with the one based on interest.

funds are supplied — loans carrying interest.<sup>1</sup>

Let us now consider the creditor-debtor relationship from the perspective of the debtor. The user of investible funds is naturally keen to employ them as profitably as he can. This may sometimes require innovation and experimentation with new methods of production. But the contractual obligation to repay the principal and pay interest irrespective of the results of enterprise acts as a severe constraint. This is especially true of small-scale enterprises and small farmers who do not have any reserves of their own to fall back upon in case the adoption of new practices does not yield good dividends. Investible funds may, therefore, fail to flow into avenues which carry a higher expected rate of profit but involve a large degree of uncertainty as the enterprise is under obligation to repay the capital with a return that is contractually fixed. The refusal of the supplier of capital to share the uncertainties involved deprives the society of possible gains in the productivity of capital through innovation and adoption of new techniques.

Again we arrive at the same conclusion as above: in an interest-based system of financing productive enterprise, expected profitability ceases to be effective in ensuring an efficient allocation of investible funds because of the terms on which these funds are supplied.

### Injustice of Debt Finance

We have argued that financing enterprise through interest-bearing debts fails to channel investible funds in the most productive directions. We shall now proceed to argue that this method of financing is unjust and results in maldistribution of income and wealth in society.

The money capital that the entrepreneur obtains from the financier is used for buying such goods and services as are necessary to carry on the productive enterprise. He buys raw materials and machinery, hires wage labour and salaried staff and

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<sup>1</sup>It is therefore difficult to accept the claim that 'the market rate of interest traditionally has two functions: It rations out, into uses with highest net productivity, society's existing supply of capital goods...' Paul A. Samuelson: *Economics* (10th ed.) p.602.

rents buildings and land, all involving contractually fixed costs. His revenue comes after the process of production is completed and the product is marketed. The price at which the product sells is, however, uncertain. It is not known to him at the beginning of the process. His venture is based on estimates that the selling price would be such as to meet all costs of production and leave a surplus (profits). But this estimate may or may not prove accurate. The contractual commitment to repay the loan with interest is not in harmony with this reality. There is no justification for obliging the entrepreneur to pay interest if there is no positive return on the money capital invested. To claim the contrary, as prevalent in the interest-based system, requires that money capital be regarded as essentially productive of value; but this is not so. Value is a market phenomenon and not an intrinsic property of money capital. Given the uncertainty of the prices of the products the total value resulting from the employment of money capital in production may be more than, equal to, or less than its own value. This is true irrespective of who employs the money capital, its owner or someone else to whom it is advanced. It is also true irrespective of the terms at which the advance is made, at a fixed rate of interest or on any other basis.

The only reasonable assumption regarding the entrepreneur is that he tries his best to make profits since his own rewards always rest on his making a profit. The possibility of loss in business enterprise arises not only from the quality of entrepreneurship but from the nature of the world in which the enterprise is carried. Insofar as an enterprise can be characterised as bad, it can be done so only *post facto*, on the evidence of the actual losses incurred. It is unfair to ignore this reality when money capital is advanced with the specific purpose of employment in productive enterprise with a view to earning profits. There is no justification for prescribing a certain return when in the nature of things it is uncertain. Money capital seeking a positive return through enterprise ought to and must bear this uncertainty.

When the enterprise incurs a loss the entrepreneur is made to bear the loss and pay the interest out of his own assets. This may result in his permanent or temporary disability insofar as future

entrepreneurial activities are concerned. From the individual as well as the social viewpoint this is very unfortunate. As noted above, the incidence of loss does not necessarily imply bad entrepreneurship. It is the nature of the world around us that some enterprises sometimes fail. It is sufficient to caution the entrepreneurs that in the eventuality of failure they go unrewarded for their entrepreneurial services, earning no profits. This would make them more vigilant in future. But to disable them by depriving them of part of the assets accumulated in the past is hardly justified. It encourages the wealth owners to act as lenders and rentiers rather than expose their wealth to entrepreneurial risks, either directly by investing them in owner-enterprises or indirectly by offering them as collateral against loans obtained for enterprise. A system in which debt financing of productive enterprise is the dominant form puts a premium on passive waiting and puts active enterprise at a disadvantage. Wealth owners who choose to lend and wait steadily grow richer over time whereas wealth owners who choose to expose their wealth and abilities to the risks of productive enterprise have no such guarantee.

At the macro-level, the present arrangement causes a flow of wealth from the loss-incurring entrepreneurs, for there are always some who incur a loss, to their creditors. Wealth is made to always bring more wealth whereas enterprise must endure the rough weather by making losses good from profits previously earned. This additional wealth flowing to the creditors from loss-incurring enterprises does not come out of additional wealth created by the employment of the money capital they advanced, as losses imply that the relevant productive process failed to create additional wealth. This redistribution of existing wealth in favour of owners of money capital is inequitable. Given this built-in inequity, the distribution of income and wealth becomes more and more inequitable as time passes. This inevitably weakens the entrepreneur class and strengthens the rentier class.

Sometimes the productive employment of capital borrowed from banks may result in very large profits accruing to businessmen, of which only a meagre share comes to the banks in the form of interest. A change in the terms on which capital is supplied so

that the return to capital is proportionate to the profits actually realised would promote justice. It would also contribute towards greater allocative efficiency by making the banks look for and finance projects carrying higher expected profits. The demands of justice would be fully met, however, when a similar change is effected in the terms on which banks obtain deposits from the public, the returns on deposits being made proportionate to the profits actually realised by the banks. Higher banking profits will, in that case, be immediately reflected in higher dividends being paid to depositors. This may not be true of the rate of interest paid on deposits which the competitive process would raise only if the rise in banking profits is universal and is sustained over a period of time.

The injustice of the interest-based system to the savers and creditors becomes much more pronounced in an inflationary situation when the rise in the rate of interest may lag far behind the rise in prices and profits. Depositors may actually get a negative return if the rate of interest is lower than the percentage rise in prices. The lending rates of the banks also fail to keep pace with rising prices, leaving businessmen to collect the swelling profits. A changeover from interest to proportionate sharing of profits will be free of this inequity.

### **Consumer Debt**

Loans appear in the consumption sector for two different reasons. There is the case of the needy consumer who cannot pay his grocery bill or hospital bill. Secondly, there is the case of the consumer who would like to own a car or a house for which he cannot make full payment now, though he hopes to be able to do so over a period of time.

Let us first consider the case of the needy consumer. There is no similarity between this case and that of the entrepreneur seeking investible funds. There does not exist any possibility of a positive money return on any sum of money advanced to this consumer. No net productivity is involved. Human society has long recognised this to be a case of social responsibility and the modern welfare

state has adopted the same approach. The real issue is how best to provide relief without encouraging voluntary unemployment, inefficiency or any other kind of abuse. Interest-bearing loans do not qualify for this purpose as they are more likely to aggravate the situation, creating more needs in the future and increasing social liability.

It can easily be seen, however, that once a price is set on loanable funds in the production sector, it is bound to carry a price in the consumption sector too, regardless of the fact that the alleged rationale of net productivity of capital in the production sector does not obtain in the consumption sector. As it is, it provides an ideal ground for the traditional moneylender and the bloodsucker. It is a source of much suffering for the poor of the society. It is also a source of much litigation, generally leading to transfer of the meagre assets of the debtors to the wealthy creditors.

The second case, that of the consumer desirous of debt financing for the purchase of consumer durables, can be regarded as an investment which may eventually lead to greater efficiency and increase the income-earning capacity of the consumer. But this does not apply to all cases of hire purchase or instalment credit presently in vogue. They cover many luxury items and gadgets which might give satisfaction but can hardly increase the capacity to earn.

Insofar as some consumer durables are to be regarded as investment leading to increase in income-earning capacity of the consumer, the idea of a return on this investment may, in principle, be admitted. But the returns remain uncertain and unmeasurable, to a far greater extent than in the case of investment in production. There is no tangible marketable 'product' involved. The eventual increase in income may or may not come about, and when it actually does, a number of imponderables are involved making any imputation of value to the consumer durable very difficult. Uncertainty of value returns on investment in consumer durables knocks out the case for a fixed rate of interest on the loan concerned.

Recently there has been a phenomenal increase in the volume

of consumer credit in some of the most advanced countries. Fifty percent of families in the U.S.A. are involved<sup>1</sup> and the consumer debt payments amounted to nearly one fourth of their disposable income in 1979.<sup>2</sup>

For understandable reasons, the cost of servicing instalment sales are notoriously high, necessitating a very high rate of interest on instalment credit. The price the consumer actually pays for these articles is much higher than its market price. It is not surprising, therefore, that recourse to consumer credit may eventually result in a lower standard of living.<sup>3</sup>

Easy availability coupled with high-pressure advertising and aggressive sales promotion lead many families into indebtedness to an extent hardly justified by their present assets or future income prospects. It is one thing to plan the purchase of a car, save for that purpose and then buy it. It is an entirely different story when it is available for the asking and a few signatures are all that is required.<sup>4</sup>

Easy availability of consumer credit leads to an initial increase in demand which can be sustained only by further exponential growth in credit. There is a constant effort to involve more and more people by reducing payment and liberalising other terms. It is, however, obvious that the process cannot go on for long. Presently it is being sustained, even expanded, by inflation. Expectation of price rise induces the consumers to go in for more credit purchases. But this in turn accentuates the inflationary trend in prices further aggravating the situation and worsening the crisis when it comes.

The institution of easy consumer credit is responsible for many ills for those directly involved, besides its baneful effects at the macro-economic level. It puts the debtor families under great

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<sup>1</sup>David Caplovitz: *Consumers in Trouble*, The Free Press, New York, 1974, p.ix.

<sup>2</sup>*Time Magazine*, Feb. 18, 1980, p.46.

<sup>3</sup>David Caplovitz: *op. cit.*, p.286.

<sup>4</sup>Adds Stan Benson, a Los Angeles Consumer Credit Counsellor: 'It is not uncommon to see a 26 year old come in here already \$10,000 to \$12,000 in debt, with an average take home pay of \$1000 a month, and owing that amount to ten or 15 creditors', *Time Magazine*, Feb. 18, 1980, p.46.

psychological strain. It leads to break-up of homes, ill health and even loss of jobs. Eventually the debtor may end up in complete ruin, economically as well as otherwise.<sup>1</sup>

Social intervention to prevent these evils can hardly succeed without striking at the root of this institution. We have already noted that no rationale exists for fixed interest charges on consumer credit. If it is desirable to facilitate the acquisition of consumer durables the society has to find some alternative ways of doing so. The evils of the present system cannot be eliminated through 'reforms' which leave the root cause of the evil untouched.

### Public Debt

A modern government's need for debt finance mainly arises for three different reasons. It needs short-term finance to bridge the time gap between expenditures made and revenues collected or received. This need is presently met by sale of treasury bills. Secondly, it needs medium and long-term finance for industries in the public sector as well as public utilities like electrification, transport etc. Lastly, it needs huge financial resources to meet natural calamities or to mobilise defence expenditure during a war.

No net productivity or actual returns are involved in the first case out of which a share could be ascribed to the money capital borrowed.

Since a price is already set on the loanable funds in the investment market, the government has to pay interest for these short-term loans usually obtained by selling treasury bills of short maturity. The interest paid eventually comes out of the tax revenue. Since the lenders are monied people and it is they who pay most of the taxes in a welfare state, it amounts to taxing the same class of people to pay them interest. The cost of administering the tax to the extent that it is related to interest payment must, therefore, be regarded as a social waste as well as an extra burden on this class necessitated by this irrational arrangement.

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<sup>1</sup>David Caplovitz: *op. cit.*, ch. 14.

Financing public sector industries and utilities through interest-bearing loans suffers from the same irrationality which attends investment in the private sector. The value productivity of investment in the public sector is as uncertain as it is in the private sector, hence guaranteeing a positive return to the supplier of money capital is unfair. It amounts to transferring the entire burden of possible losses to the society as a whole, while assuring the suppliers of money capital of a guaranteed increment to their wealth.

Most of the huge public debts that the modern states are carrying originated during wars that were financed by raising interest-bearing loans. Most of these debts are carried in perpetuity, old bonds being replaced by new ones as they mature, and interest being paid out of tax revenue. Once again they are necessitated by the fact that a price is already set on loans in the investment market. The nature of the need itself, and the actual use of the resources mobilised defy any increment of value or profits. As in the first case above, the same people are taxed in order to pay them interest on the bonds they own. The taxes have in fact to be more than interest due so that the cost of administering the tax can also be met.

As the volume of outstanding debts is very large, their final repayment is never seriously considered. Historically, the only means of lightening this burden has been provided by inflation. This has, however, created a vested interest in inflation, dissuading heavily indebted governments from pursuing effective stabilisation policies.

The notion of the state as a welfare institution, representing the people and working to ensure their good through their cooperative efforts, is contradicted by the practice of paying interest on funds obtained for meeting such contingencies as war, famine or flood. It is an anachronism inherited from *laissez faire* capitalism and the era of extreme individualism. To seek a remedy through inflation is to ignore its devastating social and economic effects on society.

### International Debt

International debt has registered a phenomenal increase in the

past three decades. Most of these debts have accumulated during the process of 'development' through which all but a score of countries in the world are passing. Debt finance whether government or private or coming through international 'aid' agencies, is supposed to help increase production in the debtor countries which should eventually be in a position to pay them back, with interest. The practice is justified on the basis of the alleged net productivity of capital. In the nature of things, however, uncertainty of the value-productivity of capital is most pronounced in this sector for a host of new reasons.

Not all the debts obtained by poor countries go to finance development. Part of it may go to finance needed consumption. In some cases it may go to finance defence mobilisation or an armament race with a neighbour. Part of aid may go to finance cost of government, in most cases serving the purpose of keeping an unpopular régime in power so that it can serve the interests of the creditors. These non-productive uses could not possibly provide for repayment of the principal much less for creation of additional value to justify payment of interest.

Insofar as external loans were utilised for productive purposes they were usually attended by circumstances which greatly reduced their efficiency in serving the real long-term interests of the debtor countries. Creditors imposed strategies designed to serve their own interests rather than those of the aid recipients. Strings were usually attached to aid, restricting the freedom of the recipients regarding sources of supply and choice of techniques.

Other negative effects of 'aided' development have been worsening distribution of income, increasing social unrest and ever more wasteful use of resources, besides the baneful cultural impacts of westernisation.

For the creditor countries and their multinationals, it was an exercise in creating new markets for their exports and making the debtor economies more and more dependent on their own economies. Aid giving, a euphemism for interest-bearing loans, has been their own need more than that of the recipients as their own growth could hardly continue without an expanding foreign market. The arms industry of the advanced countries provides a



typical example.

Something similar to what has happened in the consumer sector happened also in the debtor economies. Poor countries have been goaded into debts far beyond their means and induced to use the resources so obtained in an extravagant way. They have learnt to live beyond their means and not to tighten their belts, save and economise and work hard to build a better future. The easy availability of loans and the possibility of continuing to borrow with no chances of repayment in sight have further aggravated the situation. For this, the main blame must lie on the basis on which these transactions were effected — commitment to repay with interest irrespective of the actual outcome of the utilisation of these resources.

This particular way of international monetary transaction creates a strong motive to lend. It makes it easy for short-sighted politicians and vested interests to borrow. It is the only mechanism which makes it possible for a nation heavily in debt to continue borrowing — borrowing in order to service the old debts and postpone the day of final reckoning. One cannot imagine any other mechanism through which such an absurdity could have been perpetuated. If we rule out interest-bearing debts, the only viable alternative would be to base the flow of resources from the rich to the poor on direct transfer payment and some kind of participation: aid funds to be utilised for increasing production and to be repaid out of the produce, the actual 'returns' on the investment being shared with the supplier of funds. While we postpone a consideration of alternatives to a later section, it can easily be appreciated that they could not have led to the present situation.

The present system of interest-bearing loans has led the developing countries into an outstanding debt totalling U.S. \$400 billion<sup>1</sup> with interest and amortisation alone exceeding U.S. \$40 billion per year.<sup>2</sup> Three decades of debt financing have not been able to make the debtor countries self-sufficient or even

<sup>1</sup> *Newsweek*, 31st March 1980, p.41.

<sup>2</sup> *Economic and Social Indicators, Documents of the World Bank*, Report No.700/79/04, Oct. 1979 gives the figure of 37.6 billion dollars for 1978.

less dependent, not to speak of their being able to generate a surplus to pay back. This has put the world economic order under heavy strain. Developing countries have come to look upon aid as a means of exploitation rather than of help. The rationale of interest-bearing debt in the context of international economic cooperation is being seriously questioned, and it can hardly bear the scrutiny. The institution of interest-bearing loans owes itself to a self-centred individualistic view of ownership which the realities of the present world can hardly sustain. It is completely blind to the nature of resource endowment on the globe, the contingent nature of nation states, the accidents of past history and the demands of peaceful and amicable coexistence of the peoples of the world. The entire world community is convinced of the need for a new economic order radically different from the present one. It has, however, yet to realise the priority of abolishing interest as the basis of rich-poor financial transactions as the first step towards such a change.

### Worsening Distribution of Income and Wealth

Having traced the consequences of interest in some important sectors of the economy, let us now turn briefly to its impact on the distribution of income and wealth in society. The institution of fixed-interest payment ensures a continuous flow of resources from the debtors, who are many, to the creditors, who are few. In many cases the loan does not result in creation of additional wealth out of which interest could be paid to the lender. This is true of consumption loans<sup>1</sup> and most of the loans to the government. This is also true of some loans to business insofar as the business enterprise concerned incurs losses or ends up with a profit smaller than the rate of interest. In all these cases, the institution of interest is responsible for a net transfer of the existing resources from the debtors to the creditors. It is only in case of the entrepreneurs making a profit higher than the rate of interest that no net transfer

<sup>1</sup> Credit for consumer durables may, however, lead to increase in efficiency, increasing production in the future.

of existing resources is involved, interest being paid out of the additional wealth created by the use of the borrowed funds.

Add to this the fact that the bulk of the credit advanced by the banks is created *ad hoc* for the purpose — it is new money appearing simultaneously with, and because of, the act of lending. This new money, to which no real resources correspond in the first instance, acts as an instrument of ploughing back part of the wealth of society to the lenders. As we have noted above only part of the wealth so transferred may come out of the additional wealth created by the productive employment of bank credit. The institution of interest, coupled with the fact that creation of credit is contingent upon the act of lending by the banks, enables the financiers to commandeer a continuous flow out of both the existing and the newly created wealth of society.

This is also true of lending operations at the international level. The I.M.F., for example, is presently charging 10.25% from its debtors and paying 9.225% interest to its creditors<sup>1</sup> — rich nations whose 'hard currency' is required by the poor nations to bridge the gap in their balance of payments. Loans channelled through the World Bank and the various 'aid' agencies are also serving the same purpose. We have noted above how and why these loans sometimes fail to create additional wealth in the recipient countries. Insofar as they fail to do so, interest payment involves a transfer of existing resources from the poor to the rich countries. This would be inconceivable under a system where the returns are tied to actual additions to wealth and not predetermined as in the case of interest.

The régime of interest has been a major factor responsible for the worsening distribution of income and wealth within and between nations. Fiscal measures directed at alleviating the situation, in some countries, fail to counter this trend and can, at best, be regarded as wasteful cures for an ill of the system's own creation.

The increasing concentration of wealth and its continuous flow

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<sup>1</sup>The daily *Saudi Gazette*, Jeddah, March 30, 1980.

from the many to the few, both within and between nations, has been generating social and political tensions whose accumulation results in minor and major eruptions in the form of peasant revolts, labour strikes, civil strife and world wars. The widening gap between the few very rich countries (of the North) and the many poor countries (of the South) poses a menacing threat to world peace and stability.

### Concentration of Power

Power has always been, to some extent, a function of wealth, but it is much more so in the modern materialistic society. With the concentration of wealth goes concentration of power, both economic and political. In a society like that of the United States 'the basis of economic power is not expertise but ownership and control over abstract capital — that is, ultimate power resides with the bankers who are the major stockholders in and creditors of the modern large corporations.'<sup>1</sup> Examining the significance of bank control over large corporations in a more recent paper, Kotz concludes that 'it has also implications for the prevailing degree of effective aggregate concentration of economic and political power.'<sup>2</sup> 'The large commercial banks have become the major holders of equity capital as well as the major suppliers of debt capital'<sup>3</sup> he notes.

Wealth is concentrated amongst the few and it brings them more wealth, not because the wealthy have greater expertise, enterprise and ingenuity than others but thanks to the institution of interest. With wealth goes power. Power, in fact, has a greater tendency to concentrate. As the many become poorer they become exceedingly powerless. This makes a sham of 'democracy' as the press, the platform and the party, like all other institutions of

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<sup>1</sup>Kotz, David M. *Bank Control of Large Corporations in the United States*. University of California Press, Berkeley, 1978. p 148.

<sup>2</sup>Kotz, David M: 'The Significance of Bank Control Over Large Corporations', *Journal of Economic Issues*, Vol. XIII No.2, June 1979, p.42.

<sup>3</sup>*ibid.*

an interest-based society, succumb to the organised efforts of wealth and power to exploit these to their own advantage.

### Tendency Towards Inflation

One of the most serious consequences of interest is the endemic tendency of the banks to over-expand credit. The cause lies in the manner new money is created in an interest-based system: it is contingent upon the lending operations of the commercial banks.<sup>1</sup> Lending is a process concerned essentially with the solvency or creditworthiness of the borrower to ensure repayment with interest, of which the best index is his net worth — the assets he holds at the time of borrowing. The prospects of the enterprise in which the borrowed funds are employed figure in the lender's calculations only as a secondary line of defence. Productivity of the projected enterprise is not the main concern of the lender. There is no sure linkage, therefore, between the creation of new money and the creation of new wealth through its productive employment. Increase in money supply through commercial banks' creation of credit does not necessarily lead to increase in the supply of goods and services. It is not done for that purpose, in the first instance. Secondly a number of non-productive activities may otherwise eminently qualify for bank loans because of the creditworthiness of those who are seeking the loans. Speculation is a case in point.

Since banks' own profits out of lending and credit creation do not rest on productive employment of these funds, and creation of additional wealth thereby, they continue to do so even though the prospects are not favourable. Their profits, in such a situation, can come only through a rise in prices. This creates a vested interest in inflation. Nothing ensures rising bank profits better than a rising price level. Why should the banks care if it is an indicator of the supply of money overstepping supply of goods and services?

A sure linkage between creation of money and creation of

<sup>1</sup>The creation of high powered money by the Central Bank is also partly contingent upon its lending to the government. But, as the Central Bank is not motivated by profits, the initiative rests entirely with the government whose decisions are politically determined.

wealth can come about by making credit creation contingent upon productive investment whose returns are tied to the actual results of the productive enterprise, as explained in a subsequent section.

### The Alternative

Islamic banking is based on two cardinal principles laid down in the *Shari'a*: prohibition of interest<sup>1</sup> and its replacement by profit-sharing wherever feasible and desirable.<sup>2</sup> Though its consequences are revolutionary, the change involved is simple. Instead of being promised a fixed return in the form of interest, depositors in savings or time deposits will be promised a definite share in the profits accruing on these deposits as a result of their investment by the banks. The entrepreneurs seeking advances from the banks will promise the banks a share of the profits accruing to them. In case there are no profits the banks get back only what they gave. In case the enterprise ends up in a loss, the loss is regarded as an erosion of equity and the banks get back what remains. The banks, in fact, cease to be lenders and become partners in enterprise. There are several ways of investing bank funds on the basis of profit-sharing but we choose the simplest form to make our point. The diversification of investment by banks is likely to ensure positive returns on the totality of their investments, so that the depositors are, in practice, assured of a positive return.

### Allocative Efficiency

With the replacement of interest by profit-sharing the returns on capital advanced by the banks, as well as its repayment, will depend entirely on the productivity of the projected enterprise. The bank would, of necessity, take every care to examine the project and assess its productivity, selecting those projects which promise the highest rate of profit. Allocation of investible funds

<sup>1</sup>Allah has permitted trade and forbidden interest. The Qur'an, II 275.

<sup>2</sup>See Siddiqi, M.N. *Shirkat aur mudarabat ke shar'i usul*, Islamic Publications, Lahore, 1969.

will no longer be guided by the ability of the borrower to repay and meet interest obligations, as indicated by his net worth, but solely by the soundness of the project and the entrepreneurial abilities of the business partner. Investible funds will flow in the directions indicated by the expected rates of profit and the distortion in allocation of resources caused by the institution of interest, noted above, will be removed.

The entrepreneurs working with capital acquired from banks can maximise their own rewards by maximising the profits of the enterprise. The expertise of the banks will now join hands with the expertise of the business in ensuring efficient management directed at maximising productivity, since the profit-sharing arrangement, unlike the lending arrangement, envisages continued interest of the financier in the performance of the enterprise. The relationship between finance and business is henceforth transformed. The interests of the two harmonise, both have to work jointly to create more wealth, as the more they produce the larger is the share of each. This spirit will permeate the whole system of production, irrespective of the form profit-sharing may take in the various sectors.

### Stability in the Value of Money

Assuming fractional reserves, commercial banks would still be capable of expanding credit and creating new money,<sup>1</sup> but the new money will no longer appear in the form of interest-bearing loans. New money will mostly appear in the form of bank advances stipulating a share in the actual profits of the enterprise. An advance will be made, and hence new money created, when both the bank and the entrepreneur are convinced that genuine prospects of creating additional wealth exist. New money will be created only when there is a strong likelihood of a corresponding increase in the supply of goods and services.

What if the expectation does not come true and the enterprise

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<sup>1</sup>See Siddiqi, M.N. *Banking Without Interest*, op. cit., pp.77-94.

ends in loss? Unlike lending, repayment of capital to the bank is diminished by the amount of loss, being equal to the value actually realised by the enterprise. Thus, in the new system of banking based on profit-sharing, the supply of money is not allowed to overstep the supply of goods and services.

Part of the credit expansion would take place in the form of very short-term interest-free loans. New money supplied as consumption loans is inflationary as it increases the demand for goods and services without a corresponding increase in their supply. Consumption loans may not be inflationary when they come directly out of savings or tax revenue. In a system based on profit-sharing banks can play only a minimal rôle in the supply of interest-free loans to consumers. Such a policy is still more desirable in view of the inflationary effect of bank money given as consumption loans. Interest-free loans to consumers should be arranged on the basis of tax revenue (including *Zakāt*)<sup>1</sup> and savings made available to the government and other public agencies especially for this purpose.

It may not be possible to meet all the financial needs of the production sector on the basis of profit-sharing. Bridge finance and other very short-term needs for funds may have to be met through interest-free loans, in cases where the contribution of these funds to the profits of enterprise cannot be assessed. Since banks would not be getting any direct returns through such lendings, this activity cannot assume large proportions. In fact they may have to be persuaded to do so through special regulations and incentives.<sup>2</sup> These loans may have to be rationed according to such needs of the business community as cannot be met through profit-sharing advances. Though their profitability cannot be calculated they will, nevertheless, contribute towards creation of additional wealth by facilitating the process of production and, therefore, may not be inflationary. In any case, the supply of

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<sup>1</sup>A number of scholars have suggested use of *Zakāt* funds for giving interest-free loans to needy consumers. These include Hameedullah, Abu Zuhra and Khallaf. For details see Yūsuf Qarḍāwī: *Fiqh al-Zakāt*, vol. II, p.643, Beirut, 1980.

<sup>2</sup>See Siddiqi, M.N. *Banking Without Interest*, op. cit., pp.53-65.

interest-free loans to business may not assume proportions that the Monetary Authority cannot control effectively and swiftly.

As regards the supply of interest-free loans to the government, its effect on the value of money depends on the use to which borrowed funds are put, as well as on whether the loans come out of savings or out of bank money. Public borrowing for non-productive purposes from the commercial banks would be inflationary and must be kept to the minimum.

### **Increase in the Volume of Investment**

The entrepreneur's obligation to repay the borrowed capital as well as to pay a predetermined rate of interest to the bank severely constrains his willingness to take risk. No project can be taken up unless the expected profits are sufficiently high to cover the risk of loss, assure a return equal to the rate of interest, plus yield a surplus to the entrepreneur himself at least equal to his alternative earnings on the labour market. A changeover to profit-sharing removes the obligation to pay a fixed rate of return as interest. The entrepreneur would be still keen to earn profits as his own reward accrues as a share in actual profits. In trying to ensure a profit for himself, at least equal to his alternative earnings as quoted above, the entrepreneur is also ensuring repayment of capital as well as a positive return on that capital. Depending on the rate of profit-sharing between the bank and the entrepreneur,<sup>1</sup> the expected rate of profits of enterprise satisfying the latter condition — ensuring the minimum acceptable to the entrepreneur — is likely to be lower than the one satisfying the former condition (i.e. covering the risk premium, the rate of interest and the entrepreneur's reward). Other things being equal, the profit-sharing arrangement may allow many such projects to be taken up by the entrepreneurs which would be ruled out under the interest-based arrangement. The demand for investment is, therefore, likely to be higher under the profit-sharing arrangement, other things being equal.

As noted below, there is no reason to believe that the supply of

<sup>1</sup>For a brief discussion on the determination of this rate, see the paper 'Economics of Profit-sharing' below.

savings should be adversely affected by a changeover from interest to profit-sharing. Given the supply of savings to bank deposits, the supply of investible funds to the entrepreneurs would be a positive function of the rate of return the banks expect to realise. Assuming, in the absence of any strong reason to believe otherwise, the shape and position of the supply curve to remain unchanged, a right-ward shift in the demand for investment curve is likely to ensure a larger volume of investment in the economy, as interest is replaced by profit-sharing. An increase in the volume of investment implies an increase in the volume of employment and a rise in the level of income.

### **Justice and Equity in Distribution**

The maximum loss an entrepreneur working with profit-sharing capital can suffer is to go unrewarded for his entrepreneurial services. An unsuccessful act of enterprise will not entail transfer of his own assets to the supplier of capital, as in the case of interest-bearing loans. Every successful enterprise will, on the other hand, yield to the entrepreneur a proportionate share of profits realised, whatever the rate of profit. This too is in sharp contrast with the present arrangement under which the entrepreneur gets only the residue, the supplier of capital having a prior claim to the stipulated rate of interest.

The new arrangement rules out any net transfer of existing wealth from the entrepreneurs to the wealth owners. The addition to capitalists' wealth comes out of the additional wealth created as a result of the productive employment of their capital. Part of this goes to compensate for the losses which are regarded as erosion of equity and are borne by the owners of capital. The remainder is a net addition to the wealth of the capitalists. The relative shares of the owners of capital and the entrepreneurs out of the net addition to social wealth will depend on the average rate of profit-sharing in the economy.

Regarding the consumers and the government, replacement of interest by profit-sharing will imply that wherever the use of funds is productive of value, the supplier of funds is made a sharer in the

value added, excepting the cases where it is not possible to assess the value added. As regards the cases where no net productivity is involved, yet a supply of funds is socially necessary, it will have to be arranged on a non-commercial basis, as interest-free loans with guaranteed repayment. While we briefly discuss below the forms of doing so, its implications for the distribution of income and wealth may be noted at this stage. It would stop any transfer of existing wealth to owners of capital in return for use of capital. Wealth would bring more wealth to its owners *only* when its use has actually resulted in the creation of additional wealth. There would be no worsening of the distribution of income and wealth on that count, over the whole of the society, as has been the case in the régime of interest throughout history.

The relative shares of the capitalists and the entrepreneurs in the net additions to social wealth resulting from the productive employment of capital by entrepreneurs will depend on the average rate of profit-sharing between the two parties. As this rate will be determined by demand and supply,<sup>1</sup> the possibility of wealth owners receiving a larger share of the additional social wealth cannot be ruled out. Insofar as this may be regarded as undesirable, the society will need other measures to remedy the situation.

### Finance for the Government

The possibility of financing the government with profit-sharing funds has already been explored elsewhere.<sup>2</sup> Different kinds of shares and certificates can be marketed to mobilise resources for public enterprises, the suppliers of funds being entitled to dividends and able to liquidate their equity in an orderly shares market.<sup>3</sup> This may, however, leave the government in need of short-term funds for bridge-financing non-productive government expenditure. This need may be fulfilled by issuing tax-exempt loan certificates<sup>4</sup>

<sup>1</sup> Siddiqi, M.N. 'Economics of Profit-sharing', *op. cit.*

<sup>2</sup> Siddiqi, M.N. *Banking Without Interest, op. cit.*, pp.138-153.

<sup>3</sup> Chapra, M.U. *op. cit.*, p.16.

<sup>4</sup> Siddiqi, M.N. *Banking Without Interest, op. cit.*, pp.153-163.

or by obliging the commercial banks to earmark part of their demand deposits for lending to the government, free of interest.<sup>1</sup>

In case of natural calamities like floods and famines, or during emergencies such as a war, the state would appeal for donations and interest-free loans and fill the gap by special levies on, and compulsory borrowing from, those who have a surplus to spare,<sup>2</sup> the recourse to interest-bearing loans being completely out of the question.

### Finance for the Consumer

The case of consumer durables can be handled in a number of ways, within the framework of profit-sharing. The sellers can be funded<sup>3</sup> on a profit-sharing basis to encourage them to sell consumer durables on instalment payment, involving no interest, but allowing for cost of collecting the instalments and maintaining the accounts. Sale on instalments will increase demand so making this arrangement attractive to the sellers. The buyer can be funded on a 'profit-sharing' basis, the rental assessed at the market rate net of depreciation being regarded as 'profits' of the investment. The buyer may be obliged to pay instalments, part of which is construed as the share of rental going to the supplier of capital and the remainder as the repayment of capital, the rental component declining as the capital is gradually paid up. This method has recently been used for financing house building<sup>4</sup> and may be applied to automobiles and other costly consumer durables as well. It raises, however, questions relating to the nature of rents and rentals which have yet to be examined in the light of *Shari'a*.

This leaves out purely consumption loans needed to alleviate suffering and privation. The supply of such loans should preferably be treated as a social service and made part of the *Zakāt*-

<sup>1</sup> Chapra, M.U. *op. cit.*, pp.30-31.

<sup>2</sup> Siddiqi, M.N. *Islām kā Nazariya-e Milkiyat*, Vol. II, pp.209-238. Islamic Publications, Lahore, 3rd edition, 1977.

<sup>3</sup> Chapra, M.U. *op. cit.*, p.20, also Mohammad Uzair: *Interest-Free Banking*. Royal Book Company, Karachi, 1978, p.34.

<sup>4</sup> See the *Gazette of Pakistan, Extra ordinary*, Aug. 30, 1979, Part II, Clauses 2(b), 14, 15 and 21.

based comprehensive social security arrangements of an Islamic state. This may be supplemented by obliging the commercial banks to earmark part of their demand deposits for granting overdrafts and short-term interest-free loans to their needy customers.

### International Flow of Funds

There is a strong moral and economic case for the rich nations of the world providing outright grants or, at least, interest-free loans to the poor nations to finance development — but that is not our main concern in this study. A sane and efficient alternative to interest is provided by profit-sharing as the basis of international flow of funds. The government of a developing country may obtain funds for a particular project, or for developmental projects in general, on the condition that the actual returns on their productive employment will be shared with the supplier of the funds — foreign governments or international agencies. Since repayment of capital as well as 'profits' will depend on successful completion of the projects involved, the supplier of funds will be keen to promote the interests of the recipient countries. They will, in fact, become partners in progress. Every care will have to be taken, however, to prevent foreign investors dictating priorities or strategies to the users of their capital. Repayment may start as soon as production is under way, final accounts being settled after the completion of the project. The flow of private capital may also take place within the same framework.

New ways will have to be devised for handling of payments deficits in an international economic order from which interest has been banished. Trade deficits can be financed with profit-sharing funds obtained from an international 'bank' or some agency especially set up for this purpose. Much more than abolition of interest is involved, however, in the reconstruction of a world economic order based on justice and cooperation.

### Curbing Speculation

Arbitrage through space and time is a useful function performed

by traders, but experience has shown that it is vulnerable to abuse by speculators who can create artificial scarcities, so engineering price rises to benefit therefrom and play havoc with the economy.<sup>1</sup> Several provisions of the *Shari'a* are directed at elimination of such practices so that arbitrage activities are kept within socially useful bounds. Hoarding with a view to raising prices is prohibited<sup>2</sup> and forward transactions are allowed only in a restricted way.<sup>3</sup>

The absence of bonds and securities will itself seriously curtail the possibilities of the speculative game. This, coupled with the constraints on dealing in futures and other forms of speculative trade will ensure a degree of sanity in the market conducive to diversion of resources to productive activities. The existence of common stock and certificates bearing the promise to a share in the actual returns on investment will provide sufficient means for organising an orderly secondary capital market enabling business to raise funds and ensuring liquidity to equity holders.

### Mobilisation of Savings and Profitability of Investments

The issue of savings in an interest-free economy and their mobilisation for productive uses has been discussed elsewhere<sup>4</sup> to conclude that the absence of interest will cause no problems whatsoever. The urge to make a profit through savings is not the only, nor even the major, motive for savings, savings being largely a function of income and consumption patterns. Nevertheless, the investment accounts of the commercial banks will provide savers

<sup>1</sup> A classic example is provided by the recent rise in the price of silver. The price of silver on the New York Commodity Exchange rose from \$6 per oz in early 1979 to \$50 per oz in January 1980. It fell again reaching \$10.20 per oz in March 1980. (*Time Magazine*, April 7, 1980, pp.25-27).

<sup>2</sup> 'One who hoards with a view to making things dearer for Muslims is a wrongdoer and Allah would not give him any protection.' So said the Prophet as reported by Abū Huraira in Hākim's *Mustadrak*, Vol. II, p.12, Hyderabad (India) 1324 A.H.

<sup>3</sup> Details can be had from the chapter on *salam* in any standard work on *fiqh*. For a good summary see Mustafa Ahmad al-Zarqa: '*Aqd'l-Bai'*' pp.117-122. Matba'a al-Jāmi'ah al-Sūriyah, 1948. In a footnote on page 121 the author argues that the speculative transactions on the stock exchange are entirely different in nature from, and violate the essential conditions of, the *salam* contract permitted by the *shari'a*.

<sup>4</sup> Siddiqi, M.N. *Banking Without Interest*, op. cit., pp.182-186.

with a convenient means of earning profits through their savings. Pooling of resources, diversification of investment and building loss-compensating reserves will ensure a positive return on these deposits, in practice. Common stock and investment certificates<sup>1</sup> will provide another means of investing one's savings.

The channelling of the banks' share of entrepreneurial profits and the distribution among depositors of their share in these profits requires honest book-keeping by all concerned, especially the entrepreneurs. There is reason to believe that they will do so. The ability of the entrepreneurs to continue getting bank advances will depend on the profits they actually pay on the capital advanced. Poor performance in this regard, whether it is due to cheating or bad management, will seriously jeopardise their chances of getting more advances and hence, of continuing in business. Furthermore, special arrangements should be made to audit the accounts and ascertain the actual profits. Last but not least, it is presumed that a changeover to Islamic banking will be accompanied by a multi-pronged drive to educate people, inculcate Islamic values in them and orient them towards honest Islamic behaviour. Likewise, the banks' ability to attract savings into their investment accounts will also be a function of the profits paid on these deposits, as they will be competing with the stock market for attracting savings. Competition among businessmen for capital will work against cheating and withholding the profits due.

### Conclusion

As noted in the beginning, this paper does not attempt a detailed description of 'how' banking can be organised without interest, its focus being *why* it is necessary to banish interest from the system and build a new one based on profit-sharing. The above discussion has shown how the present system of money and banking built around interest-based lending results in injustice and inefficiency and a change to one based on profit-sharing will ensure justice and improve efficiency. We may nevertheless, conclude with a very brief outline of Islamic banking.

<sup>1</sup>al-Jarhi, M. Ali *op. cit.*, Section B 'The Financial Instruments'.

There will be a Central Bank as the only source of cash and with sufficient powers to control the supply of money and regulate and guide the activities of the commercial banks and other financial institutions.<sup>1</sup> Commercial banks will be organised with share capital and will accept demand deposits and investment accounts from the public. They will offer all the conventional banking services like safe keeping, transfers etc. for a fee. Demand deposits may or may not involve any service charges and they will not bring any return to the depositors. In return for the privilege of using demand deposits in their normal operations, as is the case in the fractional reserve system, the banks will be obliged to earmark part of these deposits for making short term interest-free loans. Repayment of these loans and safety of the demand deposits will have to be ensured by the Central Bank through special arrangements. Deposits in investment accounts may be for specific projects, or left to the discretion of the bank for suitable investment. Investment of bank funds may take the form of partnership, the banks actually participating in the management of the enterprise, or of profit-sharing advances leaving management to the entrepreneur. Banks may also buy stocks or investment certificates to diversify their portfolios. They may also resort to leasing arrangements covering such items as buildings, ships, planes, industrial equipment etc. Actual practice may bring in other innovations in the field of profit-sharing investments. Bank profits will be shared by the depositors, on a *pro rata* basis, according to agreed percentages.

As noted above there would be some provision for short-term interest-free loans to business, government and consumers. But the dominant form of transaction in the system will be investment and not lending. Additions to the supply of money will be largely contingent upon investments directed at creating additional wealth. Though the system has a built-in tendency to prevent concentration of wealth and power, the Central Bank as well as the state will guard against such a possibility and take suitable steps to maintain a balance. A transition from the interest-based debt-

<sup>1</sup>For details refer to the works listed in the footnote on p.68 above.



ridden society to an investment-oriented one based on profit-sharing will raise some special problems not discussed in this paper, one of them being the question of outstanding public and private debt.<sup>1</sup> Once the crucial steps towards the demise of the debt economy are taken, however, it will not be difficult to solve these problems in due course.

<sup>1</sup>For a brief discussion on this and other problems relating to transition, see M. U. Chapra *op. cit.*, pp.45-47.

## CHAPTER 4

# Economics of Profit-Sharing

One of the basic changes envisaged in the wake of the Islamic transformation of a modern economy is replacement of the institution of interest by profit-sharing, in pursuance of the Qur'anic precept: 'Allah has permitted trade and forbidden interest . . .'<sup>1</sup>

Consensus has it that the permission to trade implies the permission to profit thereby. The legitimacy of sharing profits under a variety of arrangements, including the one in which money capital is supplied by one party and enterprise by another, follows, being also established by *Sunna*.<sup>2</sup>

To appreciate the rationale of this change, one has to grasp the Islamic view of the relations between man and man and the nature of the world in which men engage in productive enterprise. It is an uncertain world in which the value product of enterprise cannot be predetermined. To claim a predetermined positive return on money capital when capital and enterprise jointly engage in production runs counter to this reality. It amounts to *Zulm*, especially exploitation of the entrepreneur by the capitalist, as the entrepreneur is left alone to bear the uncertainty which in reality devolves on both. It is an unjust arrangement. Islam abhors injustice and exploitation and seeks to forge human relationships on the bases of justice and cooperation. A replacement of the unjust and exploitative institution of interest by the just and cooperative arrangement of profit-sharing is therefore a socio-economic as well as a moral and spiritual imperative. All men being equal brethren in the community of Allah, let them face the

<sup>1</sup>The Qur'an, II:275.

<sup>2</sup>Siddiqi, M.N. *Shirkat aur mudarabat ke shar'i usul*. Islamic Publications, Lahore, 1969.

uncertainties of life equitably and share the consequences, good or bad.

This brief study seeks to demonstrate that the replacement of interest by profit-sharing will cause no problems as regards the smooth functioning and stability of the system. We will do this by studying the behaviour of the ratios of profit-sharing between suppliers of capital and its users in productive enterprise. We examine and reject the hypothesis that a profit-sharing system will be exposed to wide fluctuations as the changes in the entrepreneurial profits will be communicated back all along the line. The paper does not deal with all aspects of a profit-sharing system but it does indicate that the changeover will ensure a better allocation of resources and a more equitable distribution of income and wealth.

Certain methodological issues must be cleared before we proceed further. We recognise multiplicity of objectives both at the entrepreneurial and the financier's levels, profit seeking being only one of these objectives. In an Islamic society behaviour of all economic agents is expected to be socially oriented, ready to sacrifice profits for the social good if and when the social priorities so require. It is not possible, however, to introduce multiplicity of objectives in this brief study at this stage of analysis. We assume profit motive at the private level, conscious of the fact that our conclusion will need modification when specific non-profit objectives are introduced.

We have assumed competitive behaviour through the Islamic spirit would call for cooperation among economic agents for the achievement of common goals. Profit-sharing is, indeed, one form of cooperation, but other forms of cooperation may also emerge. It will require a separate study to identify these forms and analyse their consequences. Meanwhile, retention of the competitive market as well as the profit motive has the advantage of enabling us to focus exclusively on the consequences of the replacement of interest by profit-sharing.

It may be noted that the possibility of losses is admitted only at the micro-economic level, aggregate profits at the macro-economic level are assumed always to be positive. This seems to be a reasonable assumption in the light of history as well as the

literature on the subject.

We assume a closed economy and do not take growth explicitly into account. The temporal dimension is considered only in the context of allocation of income to present consumption and future consumption (savings) or allocation of resources to current production and future production (i.e. consumer goods industries and capital goods industries).

### The Rate of Profit

Profits of trade or industry are the difference between revenue (sales proceeds) and costs. Should this difference be negative it is called losses. More precisely, it is the difference between the money value of the product and the money value of the goods and services used up in the process of production from its initiation to its culmination in the sale of the product. It is a magnitude determined by the market through the price of the products and factors. Functionally it is related both to entrepreneurial decision-making in face of uncertainty and to the subjecting of money capital to this decision making, thereby exposing it to risk. Profit belongs, therefore, to both enterprise and capital. Should both entrepreneurship and money capital come from one person, all profits go to him; should several parties jointly undertake entrepreneurial decision making as well as supply money capital, they may share profits in proportions agreed upon; should enterprise and capital come from separate parties, they share profits according to agreed proportions. Losses are regarded by *Shari'a* as diminution in money capital and are to be borne by the supplier or suppliers of money capital in proportion to the capital supplied.<sup>1</sup> As the *Shari'a* sees it, the entrepreneur who prefers, in expectation of profits, to face uncertainty rather than sell his services for a salary, runs the risk of going unrewarded. The capital which prefers exposing itself to uncertainties of productive enterprise over lying idle or being lent with guaranteed repayment, in expectation of profit, runs the risk of being returned diminished to

<sup>1</sup> *ibid.*, pp 25-30.

the extent of the loss. The Islamic principle of 'no gain without risk of loss' is applied both to enterprise as well as capital.

The nature of entrepreneurial profit and its determination is a subject long discussed by the most eminent economists of every age, from Smith and Ricardo to Knight, Keirstead and Shackle. As a result of these contributions we have a clear idea of how the uncertainty surrounding entrepreneurial decisions in a dynamic economy causes unimputed value residues to occur after contractual claims are met. But the uncertainty theory does not fully explain the magnitude of profits. One of the contractual claims taken into account is interest on capital — a product of the institutions of capitalism. Since it is stipulated that profits and interest are synonymous in the perfectly competitive equilibrium characterised by absence of uncertainty,<sup>2</sup> we are left with an elusive concept of pure profits with no clues to its magnitude. In more recent times attention turned to the macro-economic concept of profit defined as non-wages, whose determination is easily possible at the aggregate level, but it has little operative value for behavioural studies.

For the operational needs of this study we find the accounting concept of profits as defined above more relevant. It would include the reward for capital, as also some kinds of rent, as defined by the economists, besides the reward of enterprise. The divergence of the value product of productive enterprise from the value of inputs (costs) is regarded as one integral phenomenon, caused by the forces of the market reflecting changing social valuations, and incapable of being objectively subdivided into pure profits and 'productivity of capital' (or interest).

<sup>1</sup> Traditions to this effect appear in Abū Dā'ūd: *Sunan, Kitāb al-Buyū'*, and also in the *Sunans* of Tirmidhī, Nasā'ī and Ibn Māja, as well as in the *Musnad* of Imām Aḥmad Ibn Ḥanbal. A good juridical exposition of the principle is found in Kāsānī: *Badā'ī' al-Ṣanā'ī'*, Jamālī Press, Cairo, 1910, Vol. VI, pp.62-63.

For detailed references and a brief discussion refer to Siddiqi, M.N.: *Islām kā Nuḡariya-e-Milkiyat*, Islamic Publications, Lahore, 1973, Vol. 1, pp.175-176.

<sup>2</sup> Samuelson, Paul A. in: *Essays in Modern Capital Theory*, edited by Murray Brown, Kazuo Sato and Paul Zarembka. North Holland Publishing Company, 1976, p.14.

## Profit-Sharing

Rather than discuss in detail how entrepreneurial profits are determined, we analyse how they are shared between the entrepreneurs and the suppliers of capital. In what follows we shall first proceed on the assumption of a given expected rate of entrepreneurial profits,  $p$ , relaxing this assumption later to trace the consequences of fluctuations in this rate. Before we proceed to do so, it is advisable briefly to state the model of interest-free banking underlying the subsequent discussion.

Banks are established on the basis of share capital. They accept demand deposits on usual terms. They also accept deposits into 'investment accounts' entitled to an agreed percentage share of the profits accruing to the banks on the profitable employment of these deposits in a pooled manner. These are *muḍāraba* deposits and the percentage of bank profits given to these depositors is described as the Depositor's Ratio of Profit-Sharing, abbreviated as *drp*. These depositors are liable to losses, their liability being limited to the extent of their deposits. Banks invest their funds (share capital and *muḍāraba* deposits less reserves, and part of the demand deposits) in a variety of ways, chief among them being supply of *muḍāraba* funds to business. The banks are entitled to an agreed percentage share in the profits accruing to these funds in the business enterprise in which they are invested. This percentage is called the Banker's Ratio of Profit-Sharing, abbreviated as *brp*. *Muḍāraba* funds invested in business enterprise are also liable to losses, liability being limited to the extent of the funds supplied.

Banks operate on the basis of fractional reserves subject to regulation by a Central Bank. The Central Bank is the only source of high-powered money. It has sufficient powers to control the volume of credit and regulate' the ratios of profit-sharing, besides guiding the activities of the banks in the public interest.

Besides the banking sector and other financial intermediaries operating on the basis of profit-sharing, there is also a shares

<sup>1</sup> Since these ratios are contractual, Central Bank regulations may not affect the past contracts. They may, sometimes, take the form of fixing ceilings and floors for the two ratios in order to ensure equitable sharing of profit. The Central Bank may also fix the ratios themselves as a means to control the volume of credit.

market on which one can buy and sell. More about this market later.

### The Ratios of Profit-Sharing

It will be noted that  $drp$  and  $brp$  are not the rates of profit earned by the depositors and bankers respectively.  $drp$  is the ratio in which depositors share the profits accruing to deposits as they are employed profitably by the banks. Similarly,  $brp$  is the ratio in which banks share the profits accruing to *muḍāraba* funds supplied by them to the entrepreneurs. For the sake of convenience both ratios are expressed as percentages. The rate of profits percent of capital invested in enterprise,  $p'$ , accrues to the entrepreneurs in the first instance. Since entrepreneurs are operating with *muḍāraba* funds supplied by banks, they surrender  $brp \times p'$  to the banks. The banks, in their own turn, pass on  $drp$  times the profits accruing to them to the depositors. Thus the actual rate of return on deposits equals  $drp \times brp \times p'$ . The rate of profit earned by the banks as intermediaries, on the deposits they supply to entrepreneurs as *muḍāraba* funds equals  $(1 - drp) \times brp \times p'$ , and the rate of profit earned by the entrepreneurs on funds obtained from the banks equals  $(1 - brp) \times p'$ .

But  $p'$ , the rate of profit realised in business, is an *expost* category, and so are the other rates derived from it. These are not known when the decisions to make deposits, supply *muḍāraba* funds or embark on business enterprise, are made. Behaviour is determined by what the respective parties expect the relevant rates to be. These expectations are built around  $p'_t$ , business profits realised in the previous period or periods, taking into consideration changes in cost conditions, state of demand, new entries, etc. We can, therefore, treat  $p_t$ , the expected rate of business profits in period  $t$  to be a function of  $p'_{t-i}$ , profits realised in period  $t-i$  (or an average of the profits realised in period  $t-1, t-2, t-3, \dots$ ).

$$p_t = f(p'_{t-i}), \quad i = 1, 2, \dots, n$$

In the above equation  $f$  denotes the expectations of the entrepreneurs. Bankers and depositors may have different expect-

tions about what business profits are going to be, though these expectations are also built around  $p'_{t-i}$ . But we make the simplifying assumption that depositors as well as bankers share the expectations of the entrepreneurs so that all concerned expect the current rate of profits to be  $p_t$  as in the above equation. This will enable us to focus our attention on  $drp$  and  $brp$ , the variables whose determination we want to study. At a later stage, this assumption is relaxed and variety of expectations regarding current business profits is introduced and its consequences are traced.

### Determination of the Banker's Ratio of Profit-Sharing, $brp$

Given  $p$ , the rate of profit entrepreneurs expect to earn in the first instance, their demand for *muḍāraba* funds from the banks is an inverse function of  $brp$ . Banks' willingness to supply *muḍāraba* funds is a direct function of  $brp$ , given  $p$ . But their ability to supply these funds depends on the volume of deposits. As shown below the chief determinant of the volume of *muḍāraba* deposits in the short run is  $drp$ , the percentage share of bank profits going to depositors. In the long run changes in national income, variations in the monetary base of the banking system, and the credit multiplier, exercise a more decisive influence on the supply of *muḍāraba* funds, either through changes in the volume of deposits or directly. Assuming these to be given in the short run, the supply of *muḍāraba* funds can be treated as a direct function of  $brp$ . Given  $p$  and  $drp$ , the equilibrium level of  $brp$  is determined by the supply of and demand for *muḍāraba* funds. This has been shown in figure 1 below.

### Determination of the Depositor's Ratio of Profit-Sharing, $drp$

The volume of savings in an economy is largely a function of the level of income. The channelling of these savings into banks' investment accounts in preference to hoarding and placement of funds in the shares market will, however, be determined by the rate of profits the depositors expect to earn. As we have seen above,

given  $p$  and  $brp$ , this rate depends on  $drp$ . Other things remaining the same, the supply of *muḍāraba* deposits can, therefore, be treated as a direct function of  $drp$ . Banks' demand for *muḍāraba* deposits is an inverse function of  $drp$ , the lower this ratio the more the banks stand to gain out of the investment of these deposits, given  $p$  and  $brp$ . The equilibrium level of  $drp$  is determined by the supply of and demand for *muḍāraba* deposits, given  $p$  and  $brp$ . This has been shown in figure 2 below:

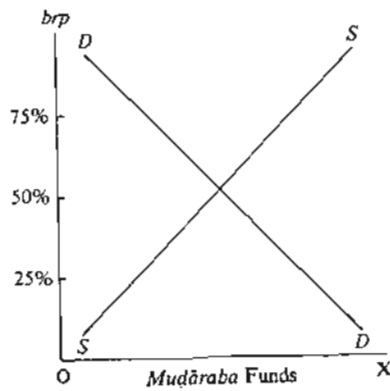


Fig. 1  
Determination of  $drp$ , given  $p$  and  $brp$ . No effort has been made to depict the probable shapes of the demand and supply curves.

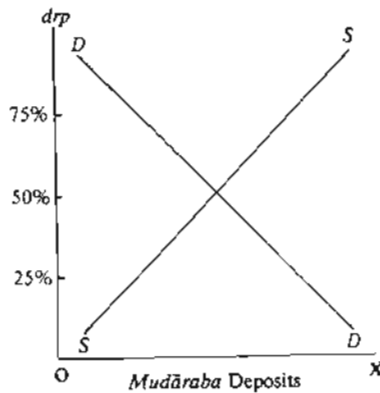


Fig. 2  
Determination of  $drp$ , given  $p$  and  $brp$ . No effort has been made to depict the probable shapes of the demand and supply curve.

### From Interest to Profit-Sharing

As the interest-based system switches over to profit-sharing, the banks will, in the first instance, offer a  $drp$  which would ensure an expected rate of return on deposits equal to or larger than the rate of interest on time deposits on the eve of the switchover, so that the supply of deposits is not affected. This implies that:

$$drp \times brp \times p \geq r_1$$

where  $r_1$  is the rate of interest on time deposits on the eve of the switchover. In a similar manner, they will make a start by fixing  $brp$  at a level such that

$$brp \times p \geq r_2$$

where  $r_2$  is the lending rate for the relevant term on the eve of the switchover.

Entrepreneurs and savers will also strive for a bargain that leaves them no worse off than on the eve of the old system. They may also try to improve their position; in particular, the entrepreneurs may claim a better deal in the framework of the new ideology. The ratios mentioned above may not, therefore, be the equilibrium ones equating demand and supply. A process of adjustments will ensue resulting in a pair of  $drp$  and  $brp$  that clears the market and satisfies all the three parties concerned: depositors, bankers and entrepreneurs. In the context of a given  $p$ , it implies that the two ratios,  $drp$  and  $brp$  are such that the corresponding volume of deposits can sustain a supply of *muḍāraba* funds sufficient to satisfy entrepreneurial demand for these funds.

### Effects of Changes in the Expected Rate of Entrepreneurial Profits, $p$

It may be noted, as we relax the assumption of a given  $p$ , that no empirical evidence relating to the operations of the above model is available so far. The only course open to us for further analysis is to make an intelligent guess on the behaviour of the various variables in response to any particular changes, stating our

reasons as far as possible.

A rise in  $p$  will shift both the demand for and supply of *muḍāraba* funds curves to the right, more being demanded and supplied at the same ratios of profit-sharing,  $brp$ , as a rise in  $p$  raises the expected returns for both banks and the entrepreneurs. But the shift in demand curve is likely to be larger than the shift in supply curve, so that  $brp$  will tend to rise. This has been shown in figure 3 below. This disparity in response is caused by the constraint exercised by the volume of deposits as determined in figure 2 above. Even in a fractional reserve system, the supply of *muḍāraba* funds has a ceiling.

The supply of and demand for deposits curves in figure 2 are drawn on the assumption of a given  $p$ . As  $p$  rises, these curves also shift to the right, since a rise in  $p$ , given  $brp$ , raises the expected profits of depositors and banks in the same proportion. These shifts may, therefore, leave the equilibrium level of  $drp$  unchanged. But the new equilibrium being to the right of the old one, the volume of deposits is now larger, enabling banks to increase the supply of funds. This tendency for the volume of deposits to increase, increasing the supply of funds to entrepreneurs is reinforced by a possible rise of  $brp$  as noted above, since the  $DD$  and  $SS$  curves in figure 2 are also drawn on the assumption of a given  $brp$ . A rise in  $brp$  raises the expected profits of depositors and banks in the same proportion, shifting both the supply of and demand for deposits curve to the right. The combined effects of a rise in  $p$  with a possible rise in  $brp$  on the determination of  $drp$  are shown in figure 4 below. The expansion in the supply of funds consequential to expansion in bank deposits may result in the new equilibrium level of  $brp$  being to the right of but equal to its old level. It is not likely that the two shifts in the supply of funds curves, one caused by the rise in  $p$  and the other caused by increase in the volume of deposits, would add to an amount larger than the shift in demand for funds curve with the result of bringing the  $brp$  lower than its old level. The banks can prevent this by manipulating the supply of funds. They will have no incentive to let this happen as a fall in  $brp$  will cut into their profits as well as into the rate of return on deposits, affecting the supply of deposits. The prospects

of a smaller percentage share in business profits in the face of a rising demand for *muḍāraba* funds is not very plausible for the banks.

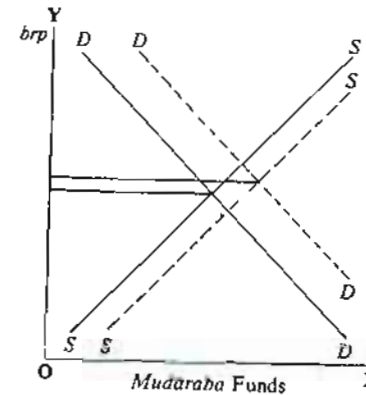


Fig 3  
Effects of a change in  $p$  on the determination of  $brp$ .

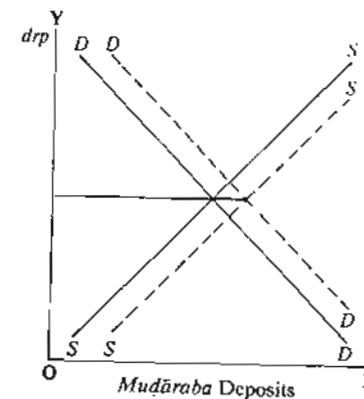


Fig 4  
Effects of a change in  $p$  on the determination of  $drp$ .

A rise in  $p$ , the expected rate of entrepreneurial profits, would either leave  $brp$  unchanged or raise it to a level not far above its old equilibrium level. It is likely to leave  $drp$ , the percentage of bank profits accruing to depositors, unchanged.

A fall in  $p$  will shift the demand for *muḍāraba* funds curve to the left, less being demanded at each level of  $brp$ . But it may not cause a left-ward shift in the supply of funds curve, in the first instance, since, given the volume of deposits, a contraction in the supply of funds will decrease the net income of the banks. A contraction in demand with supply unchanged will, however, tend to depress the  $brp$ , as shown in figure 5 below. On the other hand a lower  $p$  will cause both the supply of and demand for deposits curve to shift to the left as shown in figure 6. This may leave the equilibrium level of  $drp$  unchanged, but it would decrease the volume of deposits. As the supply of *muḍāraba* deposits contracts the supply of *muḍāraba* funds curve shifts to the left, arresting the tendency of  $brp$  to fall. A fall in  $brp$  in consequence of a fall in  $p$  may suit the banks since it will arrest the contraction in demand by yielding the entrepreneurs a larger share-out of a smaller profit.

A fall in  $p$  is, therefore, likely to lower  $brp$  to a level not far below its old equilibrium level, but it is likely to leave  $drp$  unchanged.

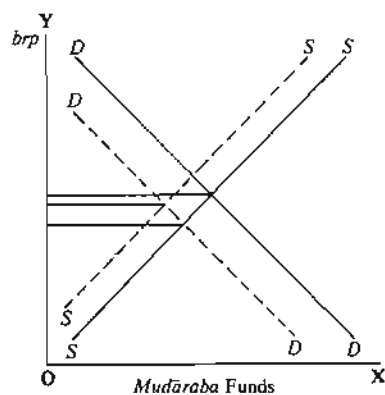


Fig. 5  
Effect of a fall in  $p$  on the determination of  $brp$ .

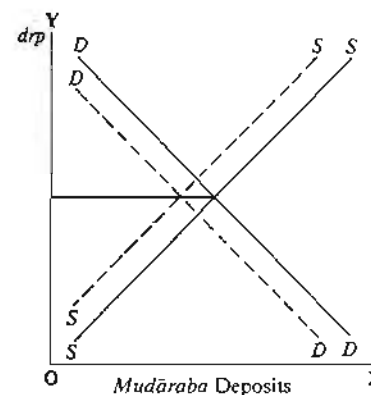


Fig. 6  
Effect of a fall in  $p$  on the determination of  $drp$ .

### Responsiveness to Changes in $p$ in Supply and Demand of Deposits

So far we have concluded that changes in the expected rate of entrepreneurial profits  $p$  are likely to change  $brp$  in the same direction in which  $p$  changes, but they would leave  $drp$  unchanged. It is time to scrutinise the stability of  $drp$  more closely. In the above analysis, that stability is partly based on the assumption that the shift in supply of deposits curve in response to a change in  $p$  is equal to the shift in the demand for deposits curve in response to the same change. Other things remaining the same, this assumption seems to be quite reasonable as the expected return on deposits, as well as the profits expected by banks as they employ these deposits profitably (i.e.  $drp \times brp \times p$  and  $(1 - drp) \times brp \times p$  respectively), are both simple fractions of  $p$ . But it may be hypothesised that the shifts are not equal, in which case the  $drp$  will change when  $p$  changes.

In case of a rise in  $p$ , if the rightward shift in the supply of deposits curve is larger than the rightward shift in the demand for deposits curve, the  $drp$  will fall, increasing the banker's share of profits and, therefore, tending to expand the supply of *muḍāraba*

funds. This merely reinforces the tendency caused by a rise in  $p$  as noted above, arresting the upward trend in  $brp$ .

On the contrary, if a rise in  $p$  causes the rightward shift in the demand for deposits curve to be larger than the rightward shift in the supply of deposits curve, the  $drp$  will rise. A higher  $drp$  will reduce the bank's share of profits counteracting the expansion in the supply of *mudāraba* funds and reinforcing the tendency of  $brp$  to rise.

Thus the above conclusion regarding the effect of a rise in  $p$  on  $brp$  remains substantially valid despite the possible variety in the responsiveness to changes in  $p$  of supply of and demand for deposits. A rise in  $p$  will either raise  $brp$  or leave it unchanged. The  $drp$  may fall or rise depending on the relative responsiveness of the supply of and demand for deposits curves to changes in  $p$ .

By a similar reasoning, a fall in  $p$  will either leave the  $brp$  unchanged or cause it to fall, whatever the relative magnitude of the leftward shifts in the supply of and demand for deposits curve caused by the fall in  $p$ . The  $drp$  will fall or rise depending on the relative magnitudes of the two shifts.

In the absence of empirical evidence, it is difficult to decide whether the demand for or the supply of deposits will be more responsive to changes in the expected rate of profit, but the odds seem to favour the demand. Supply of savings into the banks' investment accounts is likely to be sluggish in its response to changes in  $p$ , as compared to the response of the bankers' demand for deposits to changes in  $p$ , because the latter are better informed and keener to take advantage of the expected changes. Should this be true, changes in  $p$  will cause  $drp$  to change in the direction in which  $p$  changes. A rise in  $p$  will cause  $drp$  to rise and a fall in  $p$  will cause  $drp$  to fall. This will not affect our conclusion relating to  $brp$ , which will also change in the direction in which  $p$  changes.

#### Effect of Variety in Profit Expectations

Let us now relax another assumption made above, that the depositors as well as the bankers share the entrepreneurs'

expectations regarding  $p$ , the expected rate of profit in business enterprise.

Deviation of the banker's expectations regarding  $p$  from those of the entrepreneur's will not affect the conclusions of the above analysis as long as both expect  $p$  to move in the same direction and differ only regarding the magnitude of the change. If they expect  $p$  to move in different directions, it would only reinforce the tendency of  $brp$  to fall when the entrepreneurs expect  $p$  to fall, and to rise when the entrepreneurs expect  $p$  to rise. This follows from the more decisive rôle of the demand side in the determination of  $brp$  in the above analysis. The conclusion relating to  $drp$  is not affected.

As regards the depositors, they would generally be guided by the dominant opinions of the bankers to whom they entrust their savings for investment. They are too large and diffused a body strongly to hold independent opinions of their own regarding  $p$ . Insofar as they do hold expectations contrary to the expectations of the bankers, it will contribute towards instability in  $drp$  by causing the supply of and demand for deposits curves to shift in opposite directions. The  $drp$  would still rise when the entrepreneurs expect  $p$  to rise, and fall when the entrepreneurs expect  $p$  to fall. Variety of expectations will only cause the magnitude of rise or fall in  $drp$  to be larger in comparison to what it would have been in case of similarity of expectations.

#### Stability of the System

We can safely conclude that changes in  $brp$  are related to the direction in which entrepreneurs expect the rate of profit to change. Minor changes may leave  $brp$  unchanged, but when it does change it will change in the same direction in which  $p$  changes, rising when  $p$  rises and falling when  $p$  falls.  $drp$  is likely to remain unaffected by changes in  $p$ . If it does change, however, it will also change in the same direction in which  $p$  changes, but the change would be relatively smaller than the change in  $brp$ .

The behaviour of  $brp$  has significant implications for the stability of a profit-sharing system in face of expansionary and



contractionary trends in the economy as happens during a boom or a slump. As  $p$  rises continuously in successive periods during a boom, the consequential rise in  $brp$  will arrest the expansion by dampening the increase in entrepreneurs' demand for *muḍāraba* funds, as a rise in  $brp$  decreases the relative share of the entrepreneurs in business profits. The opposite will happen during a slump. The relative stability of  $drp$  will ensure a decisive rôle for  $brp$  in contributing towards the system's stability.

Thus the ratios of profit-sharing,  $brp$  and  $drp$ , seem to have a tendency to gravitate towards their historical equilibrium level never moving very far above or below them. While this can be confirmed only in the light of empirical data (when these become available), whatever we know about the ratio of profit-sharing in the past supports this conclusion. It may be noted however, that the past evidence relates mostly to simple *muḍāraba*: the owner of capital contracting directly with the entrepreneur without there being an intermediary. The share of capital has been within the range of one-third to one-half of the profits realised in business enterprise in which it is employed by the working partner. A systematic research on the reports relating to profit-sharing in the past is, however, still awaited.

Among the factors held constant in the above analysis has been the level of income, but we have already considered the behaviour of the ratios of profit-sharing during a boom or a slump. A gradual rise in the level of income over time need not call for changes in these ratios as it would affect both the supply of savings and the demand for *muḍāraba* funds in the same direction.

Changes in the propensity to save, the banking habits of the community and Central Bank regulations affecting the credit multiplier will affect the supply of deposits and of *muḍāraba* funds calling for readjustments in the two ratios which can be easily traced.

This leaves us with the changes in the state of knowledge, level of technology and the psychological factors influencing the supply of enterprise which operate on the demand side and will exercise their influence through changes in the expected rate of entrepreneurial profits, analysed above. The ultimate determinants of  $p$

and the two ratios of profit-sharing are the productive resources of the society, the level of technology, the availability of entrepreneurial abilities and the will to develop. The supply of enterprise is likely to be larger in a profit-sharing system as compared to an interest-based system (assuming the same society) as the obligation of fixed interest payment discourages the marginal entrepreneur.

It may also be noted that the above analysis is not affected if we allow for various ratios of profit-sharing between depositors and the banks,  $drp$  varying with the length of time for which a deposit is made, being higher for longer periods. In a similar manner the  $brp$  may also vary with the length of time for which funds are tied in a particular enterprise, rising with the length of the period involved. Banks will be in competition with the shares market, as well as with other financial intermediaries, to attract savings and to serve as sources of funds for entrepreneurs in the various sectors of the economy. In the economy as a whole, a spectrum of ratios of profit-sharing will obtain, with careful attention to the differences in liquidity and security of alternative avenues of investment.

### Profit-Sharing in the Shares Market

The main avenue for profitable investment of savings outside the banking system will be the shares market. As explained elsewhere,<sup>1</sup> shares in limited liability concerns, being titles of ownership, will be transferable. Fluctuation in their market value will correspond to fluctuation in the expected rate of entrepreneurial profits,  $p$ . Elimination of unhealthy speculation on the shares market will see to it that fluctuations in share prices reflect genuine changes in the rate of profit expected on various shares. These changes will ensure a levelling of the rates of profits in various sectors by ensuring a flow of savings in those directions where the expected rate of profit is higher.

<sup>1</sup>Siddiqi, M.N.: *Banking Without Interest*, Lahore, Islamic Publications, 1973, pp.139-152.

It may be hypothesised that since shares may turn out to be more liquid than bank deposits (in *muḍāraba* accounts), an average profitability lower than that expected on bank deposits may satisfy the shareholder. But the possibility of capital gain or loss will also influence their demand and supply, determining the market price. Thus the choice of allocating savings to bank deposits or to the shares market may be influenced more by the savers' aversion to risk or (conversely), their adventurousness, and by their ability to gather information, than by the respective rates of expected profits. The expected rate of profit in the shares market will, on the other hand, normally have to be higher than that on bank accounts to compensate for the greater possibility of capital losses.

#### Other Avenues of Investment

Investment in real estate, machines, means of transport like cargo ships etc., and consumer durables like cars, refrigerators etc., supplied on lease can be, in the light of the limited experience of the few existing Islamic banks, another avenue of profitable employment of bank funds. The expected rate of profit (net after costs of operation) would generally have to be higher than that obtaining in the shares market in view of lack of liquidity. The possibility of default and the resulting cost of litigation may be another reason pushing the (gross) expected rate of profit higher. Theoretically speaking, the margin between the rate of profit in the shares market and the real goods market has to be just sufficient to compensate for the two factors noted above — lack of liquidity and extra costs of operation including litigation. If it is any higher, flow of funds into this avenue will bring down the rates, thanks to competition. But the real goods market is likely to have greater imperfections, relegating the competitive deal into the background and necessitating intervention by the social authority to ensure 'fair' rates.

#### Allocation of Resources

The basic cause of divergence between the value product of the enterprise and the value of inputs (costs) involved, can be found in the way society values goods and services. Social valuation of objects, old and new, is bound neither by its own earlier valuation of some of these, nor by its present valuation of the inputs involved. It is, on the contrary, an empirical fact that generally its valuation of products of enterprise exceeds its valuation of the inputs, in which case productive enterprise ends up with a profit. The situation could well be, and sometimes is, otherwise, and results in losses. The society itself is the final arbiter in this regard and no objective criteria exist; changing tastes and incomes and a number of other factors account for this valuation, a phenomenon described briefly by the term 'uncertainty' of market values. But the fact that a positive average rate of profit is socially necessary to secure a continuous supply of productive enterprise ensures the empirical reality noted above.

Each successful act of productive enterprise takes the society forward as its resources are transformed into objects of greater value. As the increment in value produced (profits) accrues to the entrepreneur in the first instance, entrepreneurial activities are directed to where it is expected to be maximum. This is why and how it is the expected rate of profit that determines the allocation of resources. Competition ensures that enterprise pushes forward in all possible directions till the rate of profit is equal on the margin — an ideal situation being always approached but never reached.

The sectoral allocation of resources in a competitive economy is fully explained by the expected rate of profit. In doing so resources are also allocated between the consumption goods sector and the production (capital) goods sector. Guided by the expected rates of profits in various industries, say textile, textile machines, steel, and iron ore mining, allocations are made to these industries as they are made for various consumer goods industries like cloth, sugar and transport. The demand and supply mechanism, and the technological needs of one industry for the

products of another industry, gear industries in the capital goods sector to those in the consumer goods sector in such a manner as to sustain supplies commensurate with social requirements, reflected in market valuation of the products — final goods as well as intermediate goods involved. In allocating resources for the capital goods industries, the society is allocating resources for the future, but this is done in the present according to current valuations as reflected in the currently expected rate of profits. All valuation takes place in the present which is the only real time. Valuation of things past has no relevance, and valuation of things to come in the future is possible only through their significance being realised in the present. Seen in this perspective, inter-temporal allocation of resources is a by-product of intersectoral allocation of resources done according to the expected rates of profit.

No sanctity attaches to the allocation of resources effected in this manner. Social authority can always sit in judgement over it, modifying it in accordance with the social priorities at a given time and place. Furthermore, competition is always imperfect in the real world. It is not our intention in this brief study, however, to discuss in detail the rationale of social intervention, its modalities, and its guiding principles. It is sufficient to recognise its need, having made our main point that the market does effect allocation of resources without there being a rate of interest.

Allocation of individual incomes between current consumption and savings is done largely on criteria other than profitability of savings, a fact universally recognised after Keynes, and supported by a number of empirical studies on the responsiveness of the volume of savings to changes in the rate of interest.<sup>1</sup> In planning the disposal of his income the individual takes future needs, provision for posterity and a number of other factors into consideration. The same is done by corporate savers and the government, which has means to manipulate the volume of savings through a series of fiscal and monetary measures as well as

<sup>1</sup> Commission on Money and Credit (CMC): *Impact of Monetary Policy*, Prentice Hall, Inc., 1964, pp. 13–21; p. 41; *Redcliffe Committee Report*, Her Majesty's Stationery Office, 1959.

through its incomes policy. Allocation of current income between consumption and savings is mostly a planned affair, both at the social and the individual levels. The expected rate of profit plays only a minor rôle in this process. For the social authority it indicates, through rising rates of profits, the need to mobilise savings in order to sustain current investment demands in the private sector. Mobilisation of savings for the public sector is guided by social priorities with expected rates of returns playing a subsidiary rôle. Falling rates of profit depress investment demands indicating a reduced social need for additional savings.<sup>1</sup> For the individual, increasing or decreasing monetary advantages of savings, indicated by a rise or fall in the expected rate of profits, may necessitate revision of current allocation of incomes between consumption and savings. But it is generally agreed that the overall direction of this revision cannot be predicted with certainty.<sup>2</sup>

The above is not meant to deny imperfections in the competitive market mechanism, rôle of power in allocation of resources or of other institutional factors. Our sole purpose is to emphasise that, insofar as there is scope for a rational indicator, the expected rate of profit serves the purpose. The absence from the scene of the rate of interest does not pose any problem whatsoever. Its rôle in the savings/consumption decisions is already recognised to be insignificant and uncertain, its rôle in investment decisions depends on the fact of its existence — an institutional reality rather than an economic necessity. It puts a valuation where none was warranted to suit the interest of capitalists. Its disappearance restores valuation to where it belongs; to the consumers as far as it is feasible and desirable and to social authority as far as needed and found advisable.

A proportionate sharing of entrepreneurial profits by the supplier of money capital has no effect on the economic rôle of the expected rate of profit. The entrepreneur's urge to maximise profits, and the tendency of competition to ensure equality in the

<sup>1</sup> This may not be true for the less mature economies of the Third World where the social need for savings is recognised largely by criteria other than the rate of profit on investment.

<sup>2</sup> Samuelson, Paul A.: *Economics*, 10th ed., p. 602.

rate of profit in various sectors, are not affected by the institutional arrangement that the entrepreneur has to surrender an agreed percentage share of these profits to the financier. This remains true if one or more intermediaries are found between the entrepreneur and the ultimate saver. In contrast, the situation is fundamentally altered if the entrepreneur is obliged to pay a positive rate of interest to the financier, irrespective of the results of the enterprise. The risk of loss, which is confined in the profit-sharing arrangement to the entrepreneurial services going unrewarded, now threatens the entire assets of the entrepreneur. The entrepreneurs' willingness to assume risk is thereby severely constrained.

#### Fluctuations in the Rate of Profit

Fluctuations in the rate of profit earned by the entrepreneur should occur mainly because of the changing valuation of products by society and the inability of the entrepreneur to foresee these correctly. Society has no foolproof defence against limited foresight or against the vicissitudes of its own valuation. The indicator of profit helps society redirect productive efforts after losses in some quarters and extraordinary gains in others. Meanwhile, the losses are to be borne, the extraordinary high profits reaped, by those immediately involved in the process. These are the entrepreneurs, the financial intermediaries and the savers. In case of a loss the entrepreneur (working with *muḍāraba* capital) goes unrewarded for his enterprise, his other assets are not affected. He is still capable of a fresh effort, though with a diminished chance of securing *muḍāraba* capital, which facts urge him to revise his plans and be more convincing to the suppliers of capital.

The financial intermediary (say, the bank) receives back a capital diminished by the extent of the loss. It is able to absorb this shock by virtue of the pooling of investments. The diminution in capital in one venture is made up by profits from other ventures, but the potential average of profits is slightly pulled down. For the future, a revision of investment policy *vis à vis* the party, industry, or the sector concerned becomes necessary. Losses serve as

guides in the restructuring of investment policy, just as they do in the case of redirection of productive enterprise. For the saver who deposited his savings in a large pool from out of which banks make investment on a diversified basis, the above mentioned losses would imply a rate of return on their savings slightly lower than it would have been without these losses. The price the society has to pay for changing valuations and limitations of human foresight is, in a profit-sharing system, shared by the public, the financial intermediaries and the entrepreneurs in a manner which does not disable or destroy any of them. It is a far more efficient way of responding to loss than placing the whole burden on the entrepreneur. Needless to repeat that it is highly unjust to spare the capitalists and single out the entrepreneurs to pay the price of failure.

In case of an enterprise making extraordinary profits, the entrepreneur is placed in a relatively more advantageous position as his actual rewards move up more quickly than those of the intermediary or the ultimate saver, both of whom, due to the pooling arrangement, receive a slightly lower rate of profit than they would have received otherwise. This has the effect of urging the entrepreneurs to push further in the same direction, supported by the encouragement coming from suppliers of *muḍāraba* capital. Meanwhile, the extraordinary profits are shared with the savers and the intermediaries to an extent which the system of contractually fixed rates of interest is incapable of ensuring.

It is quite obvious from the above discussion that the impact of losses or extraordinary profits felt by the ultimate saver is greatly reduced, first because of the sharing and second because of the pooling at the bank's level. As a matter of fact, the saver will ordinarily be insulated from all effects of fluctuations that are confined to a few industries or any one sector of the economy. It is only in case of a general rise or fall in the rate of profit that the effect will be communicated to the ultimate saver.

Stability of the rate of return on savings may seem to be a less plausible assumption when the shares market is also taken into consideration. Two observations seem to be in order here. Firstly, competition with banks will oblige the corporations to work for the

stability of dividend rates, and consequently of share prices, by building loss-compensating reserves and other possible means. Secondly, investment in shares may largely take place through banks and other financial intermediaries which would be able to reduce the impact of these fluctuations upon the ultimate savers. Those savers who still prefer to deal directly on the shares market will do so because of their higher propensity to take risk in expectation of rates of return higher than the banks and other financial intermediaries could offer them.

Thus, the hypothesis that the profit-sharing arrangement will expose the whole system to wide fluctuations by communicating back the effects of fluctuations in entrepreneurial profits all along the line, has no basis in reality. On the other hand profit-sharing will be a safeguard against bankruptcies and bank failures which, in an interest-based system, distribute these fluctuations in an irrational manner distorting both the distribution of income and the pattern of productive enterprise.

There are reasons for believing that, even at the entrepreneurial level, the profit-sharing system will be less prone to 'crises' and wild fluctuations than the interest-based system. The main reason lies in the terms on which capital is supplied to the entrepreneur. Since returns on bank's *muḍārabā* funds, and even the security of its capital, are fully tied up with the performance of the productive enterprise, the prospects of productive enterprise will be thoroughly examined before funds are supplied. Once this is done, the interest of the entire financial sector will continue to lie in the success of the production sector,<sup>1</sup> to which it would still be able to contribute in several ways. No such identity of interest and harmonisation of policies occurs in the present system, where creditworthiness of the borrower is the major (if not the sole) consideration before the lender. As long as the borrower has assets to guarantee repayment with interest, the banker is not obliged to care about the prospects or the progress of the enterprise. This basic change in relationship is bound to have far-reaching implications for the policy of the

<sup>1</sup> Kahf, Monzer. *The Islamic Economy*, MSA of US & Canada, 1978, pp.71-72.

financial sector *vis à vis* the production sector during periods of rising or falling rates of profit.

At present, the bank's supply of credit is guided by expected changes in the rate of interest, liberal when these rates are expected to fall and tight when they are expected to rise, whereas the real interest of the production sector may require it to do just the opposite, thus aggravating the possibility of a fall or rise in the rate of entrepreneurial profits. Since the return on *muḍārabā* funds supplied by the banks will now be in the form of a proportionate share, the banks are expected to be more liberal when the rate of profit is expected to rise and cautious when it is expected to fall, making credit supply in harmony with the real interests of productive enterprise.

The creation of credit in a profit-sharing system, whether done by the Central Bank or the commercial banks, would be fully geared to the genuine needs of the production sector. Elimination of unhealthy speculation on the shares market, and of general speculation, hoarding and some forms of forward transactions on the commodity market, is also likely to make both the money market and the commodity market more orderly and less prone to fluctuations.

A severe crisis in the production sector involving sharp universal fall or rise in the expected rate of profit could not be caused by sudden changes in human foresight or social valuation, both being relatively slow moving. Its cause may be exogenous to the system and/or it may lie in revolutionary change in technology or state of knowledge. These call for action by the social authority by way of planning and regulation. The market is incapable of effecting a smooth painless transition in such cases.

### Monetary Policy in a Profit-Sharing System

What are the possibilities of manoeuvrability of the crucial variables in the profit-sharing system by the Monetary Authority, with a view to regulating the supply of money? Elsewhere we have explored the potentialities of the reserve ratio, the re-finance ratio and the lending ratio as instruments of Central Bank policy for

controlling the supply of money, besides direct control and moral persuasion. We have also seen how sale and purchase of certain kinds of shares can help open market operations.<sup>1</sup> We would now examine the possibility of the Central Bank changing the bankers' ratio of profit-sharing (*brp*) or the depositors' ratio of profit-sharing (*drp*) to effect a change in the supply of money.

Insofar as the supply of savings into banks' investment accounts is responsive to the expected rate of return on bank deposits, raising the *drp* may increase the volume of bank deposits, and *vice versa*, increasing the banks' ability to supply *muḍārabā* funds which may eventually result in expansion of money supply. Lowering *drp* will be effective as a means of contraction to the extent that the volume of deposit declines, and the bank has no surplus reserves.

The *brp* can be lowered with a view to inducing demand for *muḍārabā* funds or raised with a view to curbing it. Anti-inflationary policy may require curbing demand as well as reducing the volume of bank deposits, a raising of *brp* accompanied by a lowering of *drp*. An expansionary monetary policy requires lowering *brp* accompanied by a raising of *drp*. Both steps will have consequences for the banks' profit margins which will have to be taken care of, to the extent desirable, by other measures.

### Conclusion

This study has tried to demonstrate that an Islamic economy possesses a rational principle for organising productive enterprise which capital and enterprise jointly undertake. The principle of profit-sharing will ensure mobilisation of savings, its channelling to productive enterprise, and its allocation in accordance with social preferences as indicated by the rate of profit. The inter-temporal allocation of resources will also be partly guided by the indicator of profits, but it may be largely effected by deliberate choice and planning according to social priorities. The system is likely to result in fairly stable ratios of profit-sharing between the

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<sup>1</sup>Siddiqi, M.N.: *Banking Without Interest*, op. cit., pp.106-131.

savers, the financial intermediaries and the entrepreneurs. These ratios may change in response to changes in the rate of profit expected by the entrepreneurs but they have a tendency to move back towards their original level. The entrepreneurial rate of profit itself will be less prone to fluctuations because of the changed behaviour of the financial sector which is, at present, the major source of fluctuations. The Central Bank will be in a position to mitigate the effects of these fluctuations by regulating the supply of money through a number of policy instruments available to it. The impact of such fluctuations as still remain will be communicated back to the ultimate savers in a much reduced degree.

CHAPTER 5

## Monetary Theory of Islamic Economics\*

The fourth group discussion in the 'International Symposium on Islamic Banks and Strategies of Economic Cooperation' focused on the Monetary Theory of Islamic economics. Islamic economists presented a formulation centred round profit-sharing which would replace interest in the depositor-bank and bank-business transactions. Investible funds would be supplied to entrepreneurs promising to share their profits with the banks in an agreed ratio. Banks would be able to mobilise savings promising depositors an agreed percentage share of the profits accruing to banks as a result of the supply of investible funds to the entrepreneurs. The two ratios of profit-sharing, the one between banks and depositors and the other between banks and entrepreneurs will be determined by supply and demand. The equilibrium ratios of profit-sharing will be such as to ensure a supply of savings to bank deposits sufficient to sustain a supply of investible funds to business, commensurate with the business demand, and for investible funds which will be largely a function of the expected rate of profit in productive enterprise. The expected rate of profit in the economy will play the allocative rôle which is supposedly played by the rate of interest in modern economies. Capital, as a scarce factor of production, will have a price, not in the form of a

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\*This is a report of a discussion on 'Monetary Theory of Islamic Economics' during the First International Symposium on Islamic Banks and Strategies of Economic Cooperation held at Baden-Baden, Federal Republic of Germany on May 6-8, 1981. The group was chaired by the author who made most of the points noted in the report. The group comprised a number of Islamic economists as well as some German economists.

Though more than half of this report is essentially a summary of the three papers preceding this note in this volume, the latter part takes note of some doubts expressed by some German economists regarding the Islamic position which have not come up for discussion in the above papers.

predetermined rate of interest, but in the form of a probable rate of return thrown up by the profit-sharing system. Savers will have the expected rate of returns to bank deposits as the incentive to save and deposit their savings in banks' investment accounts. Savings are largely a function of the level of income, however, and the rate of return on savings has little influence on its volume.

It was pointed out by the Islamic economists that the profit-sharing system was not only feasible, it was also more efficient than the system based on interest. The interest-based system is inefficient insofar as productive enterprise is financed by interest-bearing credit where the suppliers of investible funds (the banks) are mainly concerned with the creditworthiness of the borrower. The prospective productivity of the venture for which the funds are intended is not their major concern. By contrast, in the projected interest-free system, the banks as suppliers of investible funds would be guided solely by the prospective profitability of the ventures since their returns, as well as repayment of capital, would depend on the productivity of the venture, the creditworthiness of the entrepreneur concerned not being at all directly relevant for this purpose. Since there is no reason why the ventures which carry the largest prospective profitability should be the ones sponsored by those with highest creditworthiness, the interest-based system of financing production fails to allocate resources to the most productive uses (in the *ex ante* sense) which the profit-sharing system always does.

It was also pointed out that the profit-sharing arrangement would result in a just and equitable sharing of the social surplus, whereas the system based on interest is unjust for it guarantees a definite positive return to the financier whereas the value productivity of investment is uncertain. It transfers additional wealth to owners of capital even when no additional wealth has been created through the employment of capital in productive enterprise. The system results in a constant transfer of existing wealth from loss-incurring entrepreneurs to wealth owners, which makes the distribution of wealth more inequitable with the passage of time. By contrast, profit-sharing ensures justice both at the micro and macro level. When the returns to productive employment of

capital are high, the entrepreneurs, the banks as intermediaries, and the savers, all get good returns as agreed shares out of the new wealth created. When the returns are low each one still receives a share. In the case of a loss the entrepreneur goes unrewarded but does not lose his own assets, as happens in the interest-based system. The banks get back what remains of the capital supplied. A policy of pooling of deposits and diversification of investment can ensure that the banks do not sustain a loss on the totality of their investments and, hence, the depositors do not get a negative return, except in the case of a deep recession. In the profit-sharing system, wealth will bring more wealth to its owners only to the extent the employment of their wealth results in the creation of more wealth, in which case the entrepreneurs will also have received a share. Thus the profit-sharing arrangement results in a sharing of social surplus which is just and equitable. The arrangement harmonises the interest of the financiers with that of the entrepreneurs which contributes to the efficiency of the system.

Besides being superior to the interest-based system when judged on the criteria of justice and efficiency, the profit-sharing system has the unique advantage of not being prone to inflation. This characteristic follows from the way money capital is supplied for business. The banks as suppliers of investible funds examine the projects presented to them and supply investible funds only when they are fully satisfied that the project will result in the production of a value larger than that invested, since the banks' own returns depend on it. In a fractional reserve system supply of investible funds by banks involves creation of new money. This applies to the profit-sharing system also. But the creation of new money in the profit-sharing system is effectively linked with genuine possibilities of creating additional value. It may not be so in the interest-based system where creditworthiness of the borrower is more important than the prospective productivity of the project. Furthermore, the profit-sharing system automatically curtails the money supply to the extent that investment of funds fails to be productive of value. This happens when, in the eventuality of a loss of productive enterprise, the banks receive



back an amount less than they had supplied. This reduced amount of money capital corresponds to the value of the goods and services produced. The part of money capital that failed to result in production of goods and services is simply annihilated. There is no counterpart to this peculiar mechanism in the interest-based system which makes that system prone to inflation.

It was pointed out that once interest is allowed it permeates all sectors of the economy including those where no 'productivity' is involved. Two obvious examples are consumer loans and public debt for non-productive purposes, especially for national emergencies like famine or war. Interest in these sectors leads to suffering (in case of consumer loans) and inequity (in case of public expenditure). In a profit-sharing system the society can arrange supply of needed consumer loans on a service basis out of welfare funds. Non-productive public expenditure can be financed through taxation as well as, partly at least, through interest-free loans some of which can be obtained from the banks which handle the public's demand deposits.

International financial transactions, especially aid for development is better organised on the basis of participation and partnership in progress. The aid givers will receive a share-out of the actual fruits of the productive employment of their funds, which they will be keen to ensure. The experiment with interest as the basis of economic aid in the last few decades has been quite frustrating, resulting in inefficient use of funds, increasing burden of debt, and increasing dependency of the aid recipients on the aid givers.

Lastly, it was pointed out that a switchover from interest to profit-sharing will encourage enterprise leading to an increase in the volume of investment and the level of employment. The entrepreneur's willingness to take risk will increase as the obligation to repay the borrowed capital as well as to pay a predetermined rate of interest to the banks is replaced by an obligation to *share* the profits and/or return the capital (or whatever remains out of it in the eventuality of a loss). Depending on the availability of funds, projects with expected yields not high enough to cover the risk premium, and the rate of interest, and

entrepreneurial reward equal to possible alternative earnings, but sufficient to cover the entrepreneurs' possible alternative earnings in view of the expected rate of profit and the ratio of these profits to be retained by the entrepreneurs, will now fully qualify for entrepreneurial efforts.

The German economists participating in the group discussion appreciated the above points but expressed reservations on several counts. One of the important points made by them related to the higher cost of information in the Islamic system in which the banks must examine the final accounts of every enterprise financed by them (in order to ensure their due share in profits), besides evaluating each project before funds are committed to them. The Islamic scholars responded by admitting that the cost of information in the Islamic system would indeed be higher than in the interest-based system where banks have no reason to look into the relevant accounts as their own returns are predetermined. They pointed out, however, that the costs involved may not be as high as visualised by their German colleagues since the scrutiny of accounts can be done through some specialised agency for a fee. The higher costs have to be considered in the context of the corresponding benefits to the society in terms of more efficient allocation and more equitable distribution of the social surplus accruing as profits. Both sides agreed that the issue required analytical as well as empirical research. The German scholars were referred to some recent papers by Islamic economists which may further enlighten them on some issues which they regarded to be unclear, e.g. the opportunity cost of capital, mobilisation of savings and profitability of the Islamic banks.

Some German economists pointed out the significance of the rate of interest as the price of capital acting as a clear market signal as any other price does. Islamic economists responded by asking what it was a price of, money capital or capital in the sense of capital goods? Economic literature was confused on this issue, and it also stressed that the rate of interest in a competitive equilibrium with perfect knowledge was identical with the rate of profit. The expected rate of profit was a sufficient market signal for allocative purposes and the system hardly needed anything

beyond that. Both sides agreed that the subject needed research and the distinct rôles of money capital and physical capital in production need to be clearly ascertained. The German scholars requested the Islamic economists and bankers to arrange easy availability of literature on Islamic economics and data relating to the Islamic banks which was at present very difficult to acquire. They complained of the high 'cost of information' in this regard. It was agreed to make a joint recommendation in this connection.

One German economist expressed serious doubts on the advisability of shifting the liability to losses from the entrepreneur (as it is in the interest-based system) to the supplier of capital (as it is in the profit-sharing arrangement). He pointed out the economic rôle of the penalty losses imposed on the inefficient entrepreneur. One more reason for making the entrepreneur liable to losses of enterprise is to deter him from dabbling with objectives other than profit maximisation, especially those relating to the public good, which is better taken care of by the public authority. Islamic economists pointed out that the penalty is unjustified as losses are not always caused by the inefficiency of the entrepreneur. Insofar as entrepreneur's inefficiency is involved, the Islamic system does penalise the entrepreneur as he has to go unrewarded for his entrepreneurial services. He is also penalised by having a poor chance of getting funds from banks in future. The idea of preventing the entrepreneur from serving the public good at the cost of some profit cannot be acceptable, unless one believes in the 'invisible hand' and the myth that the public good is best served when every individual is serving his own interests. Dissemination of all available information relating to social objectives, and the attempt on the part of every individual to serve these objectives, decreased the burden on social authority and reduced the need for social intervention.

It was agreed that the issues of creation of money and inflation, as well as that of cost of information required in-depth research. It was also necessary to work out the functioning of the Islamic monetary system in greater detail. This should be done both under the assumption of a wholly Islamic world, where every economic agent behaves according to Islamic teachings, and the assumption

of a mixed world where non-Islamic behaviour coexisted with weak Islamic motives as at present. These studies may be done for a closed system as well as for an open system in which the Islamic world interacts with the non-Islamic world.

It was agreed that research relating to the Islamic monetary system, free of interest and based on profit-sharing, was of great contemporary relevance in view of the severe crisis facing the present economic and monetary order. The German scholars expressed the hope that the Islamic approach might lead to an alternative worthy of utilisation by the western economies as well as the developing countries.

## CHAPTER 6

# Issues in Islamisation of Banking\*

Issues likely to be faced in the process of changeover from interest to profit-sharing in the banking system as a whole were recently taken up at the official level for the first time in modern history in Pakistan. The result was the report of the Council of Islamic Ideology on elimination of interest from the economy which is a comprehensive document covering all aspects of the matter. The Council, to which a similar report of a panel of economists and bankers appointed by it was available, has discussed in detail the operations of the commercial banks, specialised financial institutions, and the Central Bank in the light of the desired change. It has also suggested how the government transactions can be freed from interest. This document running into 127 pages is a valuable contribution to the literature on interest-free banking. The Government of Pakistan had invited comments from some foreign scholars also, and the note that follows was in response to this invitation. A number of footnotes have been added for the benefit of those readers to whom the Council report may not be available.

I offer my compliments to the Government of Pakistan for initiating a process which has led to the writing of these reports on the elimination of interest from the economy by the Council of

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\*Comments on:

Report of the Council of Islamic Ideology on the Elimination of Interest from the Economy, June, 1980.

Report of the Panel of Economists and Bankers submitted to the Council of Islamic Ideology January, 1980.

Report on Interest-Free Banking (by a Committee headed by the Finance Minister, Government of Pakistan).

Islamic Ideology, the Panel of Economists and Bankers and the Committee headed by the Finance Minister. It is the first time in modern history that the Qur'anic injunction against interest has been taken seriously at the highest level, and a government has shown its determination to manage the economy without interest. I also wish to pay my respects to all the ulema, economists and bankers involved in formulating these proposals which are likely to help not only the Government of Pakistan but also other Muslim peoples in reconstructing their economies in accordance with Islamic injunctions.

The very fact that these reports are likely to form the basis of crucial decisions of far-reaching consequences, and that the decisions eventually taken in Pakistan may serve as a model for other governments and peoples, necessitates very careful scrutiny of these proposals by all concerned so that the final outcome is in consonance with Islamic principles and viable enough to stand the test of time.

The following comments are offered in all humility to assist this process.

#### **Profit-Sharing as the Chief Alternative to Interest**

The chief alternative to interest, on the commercial level, can only be profit-sharing in accordance with the relevant Islamic rules. This has been noted in the Preface to the Council Report (p. xiii) and emphasised repeatedly in later chapters. *Qard Hasan* is a service proposition and has to be organised as such through the banking system and other financial institutions and also through other agencies. It is gratifying to note that the Council has duly modified the 'new system' of sharing profits and losses proposed by the Panel in paragraph 1.27 of its report (as also contained in the Committee Report on Interest Free Banking). It has stated categorically that 'the loss would, however, be shared strictly proportionately to the respective capital contributions' (Council Report 1.23). The system proposed in the other two reports violated the *Shari'a* and went against the Islamic approach to the respective rôles of capital and enterprise in the productive process.

Any departure from this approach, which regards losses as an erosion of equity (i.e. decrease in capital) and profits as a joint result of and reward for capital and enterprise, will lead us astray from the justice ordained by the *Shari'a*. It is advisable, therefore, to be on our guard against any dilution of this approach.

It is in this context that I fail to understand why the Council has agreed to describe the proposed system as profit/loss sharing instead of profit-sharing. Such a description is understandable as far as the reports of the Panel and the Committee are concerned, as they explicitly provide for a sharing of the losses, accruing to the capital supplied by the banks, by industry. The Council has rightly rejected this as being *ultra vires* of *Shari'a*. It has strictly adhered to the Islamic position that whenever capital participates in enterprise every capital owner bears the entire loss accruing to his capital. It is quite clear that neither the entrepreneur nor the other suppliers of capital actually 'share' the loss accruing to any particular supplier of capital. This is true of *shirka*, in which all partners are suppliers of capital as well as of *muḍāraba* in which a particular partner may be supplying no capital at all. The justice of this Islamic rule is quite evident, especially in case of simple *muḍāraba*, as the working partner, in case of loss in enterprise, gets no reward for his labour and enterprise. He, too, bears a loss to that extent, though he is not obliged to compensate part or whole of the loss in capital supplied by the other partners. This being the case, and losses in the reports under consideration meaning accounting losses (as they do always unless otherwise specified), it is advisable to describe the Islamic proposition as merely 'profit-sharing'. In fact the recent writers on interest-free banking based on *shirka* and *muḍāraba* use this description and avoid calling it a system of profit/loss sharing which is, to say the least, confusing. In view of the fact that some economists and bankers still find it advisable to propose sharing of losses in violation of the relevant rules of the *Shari'a* and against the Islamic approach to capital and enterprise, it is all the more necessary to avoid such a description.

In the light of the difficulties in the practical application of the profit-sharing system in certain spheres, explained in these reports, the Council has rightly endorsed the need of using some

other methods. The Council has, however, made it clear that it wants these other methods to be used very sparingly and that the rôle of profit-sharing and *Qard Hasan* should expand (Preface to Council Report p. xiv).

One is, however, disturbed by the fact that the other methods suggested by the Panel are allowed to cover a very wide range of operations, which include some of those operations which could have been easily handled by the profit-sharing arrangement. An obvious example is the case for which the 'Investment Auctioning' device has been accepted, about which we have more to say later. Once we agree on the profit-sharing arrangement to be the chief alternative, it is advisable to provide categorically that any other method should be used only where the profit-sharing arrangement is not workable. Other methods should not be allowed as alternatives to profit-sharing, as they have been at present.

This is all the more necessary when the other method under consideration, though found permissible by the Council, is nearer to interest and far removed from profit-sharing on two important counts:

1. The banks get back a definite sum of money in the future.
2. The rate of return on the capital invested by the bank is known in advance.

The very proximity of these 'alternative' arrangements to the present interest-based arrangements may see to it that they gradually replace profit-sharing even where it is introduced in the first instance, besides refusing to yield ground to it where it is installed from the very beginning. Permission to use these methods as 'alternatives' to profit-sharing is, therefore, likely to frustrate the Council's intention to expand the rôle of profit-sharing and reduce the rôle of other methods with the passage of time.

I would, therefore, recommend a categorical policy statement on this issue. It should be clearly laid down that any other methods endorsed by the Council can be adopted only in cases where profit-sharing is found to be unworkable.

## Supplementary Methods of Eliminating Interest

We have to examine the other methods suggested in the reports under consideration not as alternatives to profit-sharing, where a profit-sharing arrangement is also feasible, but as second best substitutes for it in cases where profit-sharing does not seem workable at present. In doing so we have to keep away, as far as possible, from devices which bear close proximity to the present interest-based arrangements in effect, though they may be different in formal legal details. Seen in this light, the methods of Leasing, Hire-purchase, Financing on the basis of normal rate of return, Time multiple counter loans, and Special Loan Facility as modified by the Council (Council Report, paragraphs 1.13, 1.18, 1.19, 1.20, 1.21) seem to be acceptable. They can be applied within the limits and along with the safeguards proposed by the Council.

It is difficult, however, to say the same about *Murābaḥa* as suggested by the Panel<sup>1</sup> (1.16 Panel Report) or *Bai' Mu'ajjal*, as approved by the Council<sup>2</sup> (1.16 Council Report). The Council has

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<sup>1</sup>*Murābaḥa* may be defined as a sale in which the margin of profit is mutually agreed upon between the buyer and the seller. The payment of sale price, inclusive of the agreed profit margin, may be immediate or deferred and either in lump sum or in instalments. This system could be of considerable use in financing current input requirements of industry and agriculture as well as in the financing of domestic and import trade. For instance, if the current cost of a bag of fertilizer to the bank is Rs.50, the bank will sell it through its agent to farmer needing bank finance at Rs.55 subject to actual payment of this price after an agreed period. The bank would, however, pay Rs.50 to its agent prior to or immediately after the supply of the fertilizer by the agent under its instructions. The possible mechanism in the case of domestic and import trade may be on the following pattern: A business firm needs finance from a bank to purchase/import an item from a domestic seller/manufacturer or foreign exporter. Instead of discounting a bill or making an advance, the bank under an agreement with the firm concerned may purchase/import the commodity on its own account and sell it to the firm at a price, to be settled in advance, which includes a mark-up over the cost price for a reasonable profit margin for the bank. Payment for the firm would be receivable by the bank after the agreed period', pp.8-9, *The Elimination of Interest from the Economy: Report of the Panel of Economists and Bankers submitted to the Council of Islamic Ideology*.

<sup>2</sup>*Bai' Mu'ajjal* may be defined as a sale under which the price of the item involved is payable on a deferred basis either in lump sum or in instalments. This system could be of considerable use in financing current input requirements of industry and agriculture as well as in the financing of domestic and import trade. For instance, if the current cost of a bag of fertilizer to the bank is Rs.50, the bank may sell it through its agent to farmers needing bank finance at Rs.55, subject to actual payment of this price after an agreed period. The bank

done well in modifying *Murābaḥa*, which is based on a particular juristic opinion not shared by many eminent jurists, to *Bai' Mu'ajjal* which has relatively more secure foundations, despite the fact that it remains controversial. I do not propose to question the formal legal status of *Bai' Mu'ajjal* as defined by the Council: 'a sale under which the price of the item involved is payable on a deferred basis either in lump sum or in instalments' (1.16 Council Report). I am afraid, however, that in practice it will become a cover for continuing the present interest-based transactions. Those needing finance for purchase or import of inputs would approach the banks to buy the item for them, with the commitment to buy it from the bank at a higher but deferred price. The mark-up will naturally tend to be higher the longer the period of time involved. The banks will have a guarantee of receiving back the price they actually pay plus a predetermined return as the result of

(Footnote 2 cont.)

would, however, pay Rs. 50 to its agent prior to or immediately after the supply of the fertilizer by the agent under its instructions. The possible mechanism in the case of domestic and import trade may be on the following pattern: a business firm needs finance from a bank to purchase/import an item from a domestic seller/manufacturer or foreign exporter. Instead of discounting a bill or making an advance, the bank under an agreement with the firm concerned may purchase/import the commodity on its own account and sell it to the firm at a price, to be settled in advance, which includes a mark-up over the cost price for a reasonable profit margin for the bank. Payment from the firm would be receivable by the bank after the agreed period.

Although to be in conformity with the *Shari'a*, it is necessary that the sale item should come into the possession of the bank before being handed over to the other party, it would be sufficient for this purpose if the supplier, from whom the bank has purchased the item, sets it aside for the bank and hands it over to any person authorised by the bank in this behalf, including the person who has purchased the item in question. For reference see *Fatāwā 'Alamgīrī*, Matb' a Rahūmīa, Deoband, 'Kitāb al bai', vol. III, Ch. 4, Section 3, p.12. *Report of the Council of Islamic Ideology on the Elimination of Interest from the Economy*, pp.15-16.

This system commends itself for its relative simplicity as well as the possibility of some profit for the bank, without the risk of having to share in the possible losses, except in the case of bankruptcy or default on the part of the buyer. However, although this mode of financing is understood to be permissible under the *Shari'a*, it would not be advisable to use it widely or indiscriminately in view of the danger attached to it of opening a back-door for dealing on the basis of interest. Safeguards would, therefore, need to be devised so as to restrict its use only to unavoidable cases. In addition, the range of mark-up on purchase prices would also need to be regulated strictly so as to avoid arbitrariness and the possibility of recrudescence of interest in a different garb. The State Bank may, therefore, specify and, from time to time, review and vary, the sub-sectors/items, for which banks may provide the needed finance under '*Bai' Mu'ajjal*' arrangements. It may also lay down the range of the profit margin in general or separately for each sub-sector or item and may impose such other restrictions as may be deemed necessary with a view to avoiding the emergence of unhealthy practices.

the mark-up. For all practical purposes this will be as good for the bank as lending on a fixed rate of interest. This will create a tendency of preferring this method over profit-sharing or any of the other methods approved by the Council, since it helps maintain the *status quo*. I am disturbed by the fact that, instead of confining the use of this method to situations where profit-sharing may not be feasible, the Panel and the Committee headed by the Finance Minister have already envisaged a very wide range of operations to be covered by this method (which they called *Murābaḥa*), including the supply of working capital requirements 'which may be financed by banks by way of sale of inputs on deferred payment basis by putting a mark-up price of goods purchased by the financed industry' (paragraph 75, Report on Interest Free Banking by the Committee. See also 2.11 of the Panel Report).

Both the Council and the Panel are apparently aware of 'the danger attached to it of opening a back-door for dealing on the basis of interest' (1.17 Council Report; 1.17 Panel Report). The fact that they have nevertheless approved of this method must be construed, therefore, as an expression of their feelings that there are some 'inescapable cases' (Paragraph 1.17 in Council as well as the Panel Report) where other methods, especially profit-sharing, are not workable. One such case seems to be the supply of fertilisers to farmers, which has been cited in their reports as an example.

I would prefer that *Bai' Mu'ajjal* is removed from the list of permissible methods altogether. Even if we concede its permissibility in legal form we have the overriding legal maxim that anything leading to something prohibited stands prohibited. It will be advisable to apply this maxim to *Bai' Mu'ajjal* in order to save interest-free banking from being sabotaged from within.

Should some pressing situations defy any other solution we can, at least, confine the use of *Bai' Mu'ajjal* specifically to them as a temporary measure, while prohibiting its use in other situations. There is no justification for using this method in financing working capital requirements of industry, as suggested in paragraph 75 of the Committee Report quoted above, as this can easily be done on

a profit-sharing basis. One can, however, understand its application in the agricultural sector on a limited scale, to cover cases which cannot be handled by *Bai' Salam* as proposed by the Council<sup>1</sup> (2.17 Council Report). Even in that case, it will be advisable to specify the mark-up as well as the time period involved. Any other possible case of application of this method should first be thoroughly examined to see if it really defies profit-sharing, leasing, hire-purchase and financing on the basis of normal rate of return.

It is gratifying to note that the Council did not endorse the method of 'Investment Auctioning' as formulated by the Panel<sup>2</sup> (Panel Report 1.14). According to this formulation 'the offer of the needed long term/medium term finance' is part of the package being 'sold' on deferred payment. But an offer to finance is not a valid object of sale in *Shari'a*. It would be an exchange of a smaller sum of money for a larger sum of money to be paid later — a clear case of the prohibited *ribā*. Inclusion of another item in the package being sold, i.e. 'industrial project with complete details' cannot legitimise this transaction. The Panel's argument that the transaction 'would be in the nature of a sale on deferred payment

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<sup>1</sup> Under the *Bai' Salam* arrangement, banks may enter into an agreement with the farmer for advance purchase of agricultural produce, specifying complete details of the commodity, its quality, price and the place and time of delivery, and make the payment of the agreed amount at the time of entering into the agreement. When the commodity is produced and supplied to the bank, on the appointed date, the bank is free to sell the commodity as it wishes. It must be emphasised, however, that *Bai' Salam* is a special type of trading arrangement which is subject to strict stipulations and conditions as laid down in the Holy Qur'an and *Ahādith*. It will, therefore, be necessary to enact a law that may ensure the fulfilment of these conditions in all respects. It may also be pointed out that since there can be a danger of misuse of price fixation in advance as an exploitation device, an independent agency may have to be set up which should be responsible for exercising proper control on the price fixation in respect of *Bai' Salam*, p.4, *Report of The Council of Islamic Ideology on the Elimination of Interest from the Economy*.

<sup>2</sup> Another method for replacement of interest in the case of long and medium term financing in the industrial sector is the system of investment auctioning. Under this system, commercial banks may form a consortium with long-term financing institutions and formulate industrial projects with complete details. Therefore, the consortium may announce the project with the offer of the needed long/medium term finance in specific terms and call for bids from prospective investors for the purchase of the project. The consortium may fix a reserve price which may include a reasonable profit margin. It may also reserve the right to accept or reject any bid. The project may then be awarded to the highest bidder if the party is

basis' is not convincing as the seller retains the ownership of the plant and machinery until full payment is made by the buyer. A genuine sale on deferred payment transfers the ownership to the buyer who becomes liable to payment on the agreed future date or dates.

The Council has modified the Panel's proposal to make it a genuine sale of plant and machinery, to be delivered on agreed dates, on deferred payment. The modified proposition is correct in formal law. What is questionable is the need to apply this method to a case to which profit-sharing can be applied without any difficulty. This violates the basic policy we have recommended above, a policy which also seems to have guided the Council as it has recommended gradual reduction in the rôle of other methods and expansion in the rôle of profit-sharing and *Qard Hasan*.

Apparently a justification in favour of this departure has been provided by the Council in paragraph 1.15 of its report which reads: 'The most significant advantage of this system from the economic point of view would be that the price paid by the investor for industrial machinery would adequately reflect the potential profitability of the project which is essential for efficient allocation of resources.' But the heart of the matter is that potential profitability is uncertain, it cannot be known in advance. This is why the just Islamic system is based on the sharing of *expost* profits. What the buyer's bid would reflect is his estimate of the profit, not the actual profit. This estimate may or may not come true. Profit-seeking capital is exposed to this uncertainty and it is not fair to transfer it entirely to the buyer as the Panel proposal

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(Footnote 2 cont.)

considered to be a sound one. Otherwise, the project may be awarded to the next highest bidder considered capable of efficient implementation and running of the project, provided the bid is higher than or at least equal to the reserve price. The agreement may provide for necessary safeguards to the consortium against undue delay in implementing the project or possible malpractices on the part of the investor. The amount of the bid accepted would be repayable in instalments over the agreed period. The liability of the investor whose bid is accepted by the consortium would be independent of whether he earns profit or incurs a loss. However, this may not constitute a violation of *Shari'a* in view of the fact that the transaction would be in the nature of a sale on deferred payment basis as the ownership of the entire plant and machinery would be transferred to the investor after full redemption of his liability to the consortium', pp.7-8, *Report of the Panel, op. cit.*

seeks to do. The Panel's argument in paragraph 1.15 of its report (which the Council has repeated with the replacement of 'scarcity value of capital' by 'potential profit of the project') seeks to do exactly what interest is presently doing: ensuring a guaranteed return to investment by the banks and transferring the risk entirely to the entrepreneur. How far the formally correct proposal of the Council changes this materially, deserves attention.

An efficient allocation of resources is ensured by the profit-sharing arrangement as argued in my paper 'Economics of Profit-sharing'.<sup>1</sup> The argument of paragraph 1.15 quoted above does not, therefore, provide a special justification for 'Investment Auctioning' in place of profit-sharing. But those who think that investment auctioning does something which profit-sharing fails to do must advocate the replacement of profit-sharing by investment auctioning all along the line. The Council is apparently not aware of this implication otherwise it would not have repeated the argument of paragraph 1.14 of the Panel report. In endorsing this proposal it has not found it necessary to urge that this method should be used sparingly. This might result in an expanding rôle for the use of this method at the cost of the profit-sharing arrangement. This, in my view, will do serious damage to the system and frustrate the whole exercise, at least with respect to the industrial sector. Nothing will prevent the 'Consortium' from adding the current rate of interest in similar economies to the market price of plant and machinery to arrive at their 'reserve price', leaving the 'auction' to bring them additional gains. Entrepreneurs with nowhere else to go will be constrained to 'buy' the project at whatever price they can. Instead of relieving them of the burden imposed by the unjust system based on interest the 'Islamic' system with investment auctioning might leave the entrepreneurs worse off.

I am sure once these dangers are realised there will be no hesitation in dropping this proposal altogether. The profit-sharing arrangement supplemented by the methods of Leasing, Hire-purchase, Financing on the basis of Normal Rate of Return and

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<sup>1</sup>See Chapter 4 above.

Time Multiple Counter loans within the limits proposed by the Council as well as the methods of *Bai' Mu'ajjal* and *Bai' Salam* applied in the agricultural sector with utmost caution would be sufficient to replace interest in all sectors of the economy. It should be our endeavour, at the same time, to reduce the rôle of the supplementary methods to the minimum necessary so that profit-sharing becomes the dominant form of financing in the whole of the economy. Any other methods like investment auctioning or use of *Bai' Mu'ajjal* on an extended scale will pull the system back to the *status quo* and retard its progress.

#### Action Plan for the Elimination of Interest

The Panel as well as the Committee have suggested that savings and fixed deposits may continue to be interest-bearing during a transitional period of two years. The Council has agreed to this as is evident from the timetable set in paragraph 1.35 (especially page 30) of its report. This proposal has the disadvantages of keeping away savers who wish to gain through deposits but do not want it in the form of interest which is prohibited. NIT units or ICP mutual funds may not attract all as they lack the easy accessibility of bank deposits. The disadvantage can be removed by introducing profit-sharing (i.e. *muḍārabā*) accounts from the very beginning, side by side with the (transitional) interest-bearing accounts. This may have some other advantages also, as noted below.

The proposal to continue with interest-bearing deposits even after a changeover to profit-sharing on the asset side is obviously based on the assumption that banks will earn sufficient profits to pay interest to their depositors and still retain some for the shareholders. By the same assumption, there will be enough profits left after interest is paid on interest-bearing deposits to pay a dividend on profit-sharing deposits which is, at the least, equal to that rate, without jeopardising the shareholders' prospects. There is an even chance that the rate of dividend accruing to the profit-sharing deposits might be higher than the rate of interest on deposits. In either case introduction of profit-sharing accounts in the transitional phase will facilitate the eventual closure of the



interest-based accounts by way of familiarising the people with the new method and allaying their doubts regarding it, if any. Should the operation of these accounts create any problems, they can be taken care of before the complete changeover. A case in point is the suitable ratios of profit-sharing relating to the bank-businessmen and bank-depositor transactions. Whatever ratios are fixed in the first instance can be adjusted in the light of experience of the transitional phase, with a view to making the rate of dividends on profit-sharing deposits at least equal to the rate of interest on deposits on the eve of the changeover.

If this suggestion is accepted the introduction of profit-sharing accounts in the transitional phase should be accompanied by a media drive to persuade the public to opt for these accounts in preference to the interest-bearing accounts. The success or failure of this drive would serve as an index of the popular enthusiasm for the new system, which may help.

#### **Towards the Goals of the Islamic Economy**

Elimination of interest from the economy is obviously a means for the realisation of some higher ends, not an end in itself. The ways and means of eliminating interest should, therefore, be ultimately examined in the context of the goals of the Islamic system. In other words our job is not only to devise a system of banking and finance free of interest. The system should also be geared to the maximum realisation of the goals of an economic system in Islam. The reports under discussion have undoubtedly made a great contribution towards devising a system free of interest but they could not attend properly to the larger question of how effectively to direct the financial system towards the achievement of the Islamic goals of eradication of poverty, justice, stability and growth. I suggest that a review of the interest-free system from this point of view might result in significant improvements. One possible area of improvement is to provide for a larger rôle for banks and other financial institutions, under the guidance of the Central Bank, in exploring the possibilities of increasing production and inviting labour and enterprise to avail themselves

of these opportunities through participation. Projects designed to contribute directly to the incomes of the poorest sections of the population should receive greater attention and possibly direct patronage from special agencies set up for this purpose. A crucial factor for the success of the new system in terms of goal achievement is its projection as a system that cares for the majority of our masses who are weak and poor. The masses can be involved in the developmental process, which the banking and financial system is supposed to promote, only when they have the assurance that a fair share out of the fruits of development will flow to them. Their Islamic consciousness can be aroused and their energies mobilised to making this pioneering effort at Islamic reconstruction of economy a success, provided they feel that the decision-makers are sincerely orienting the system towards the achievement of the Islamic objectives, especially those related to eradication of poverty and reduction of inequalities in the distribution of income and wealth.

Another possible area of improvement upon the system of interest-free banking presented in these reports is the dovetailing of this system with other crucial aspects of the economic system of Islam: a market free of unhealthy speculation and monopoly, a welfare-oriented fiscal policy, a social security system based on *Zakât*, a just system of land tenure and a programme of removing the inequities of the initial distribution of wealth inherited from the past. This admittedly requires that elaborate schemes for these other changes are also available. It will be advisable to assign this task to special working groups so that the various blueprints relating to these different aspects of the Islamic economy could be integrated into a whole that is clearly and effectively directed towards the ultimate goals of the system. The Islamic reorganisation of banking and finance can reach its maturity only when it is put in that perspective and revised accordingly.

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