King Abdulaziz University

International Centre for Research in Islamic Economics

RATIONALE OF ISLAMIC BANKING

Dr. Muhammad Nejatullah Siddiqi

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Foreword

Some literature is now available on interest-free banking elaborating the possible ways of reorganising banking without the institution of interest and discussing the various practical issues that arise in this connection. Though this literature touches the obvious question: Why such a change is needed at all, a detailed rationale of the change is yet to be offered, especially from the economic point of view. I have tried to do so in this paper on a modest scale.

I was fortunate in getting valuable comments from Prof. M. Ishaq Nadiri, Dr. M.U. Chapra, Dr. M.A. Zarqa and Dr. F.R. Faridi on a preliminary draft of this paper. Prof. K.A. Naqvi of the Delhi School of Economics also drew my attention to some weak points in the analysis. Dr. Zarqa was also kind enough to supply me with a copy of an unpublished note on "*Economic Rationale of the Prohibition of Interest in Islam*" by Dr. Ziauddin Ahmad, Deputy Governor, State Bank of Pakistan, which already contained some of the points made by me, besides throwing more light on the subject. The paper now presented to the readers owes a lot to the contributions of these scholars. I also owe a debt of gratitude to the two anonymous referees selected by the centre. Their comments were helpful in the final revision of the paper. Needless to remind that I remain responsible for the deficiencies that might still be there. Further comments by the learned readers are keenly awaited.

M.N. Siddiqi 3/6/1401A.H. 7/4/1981A.D .

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Dr. Muhammad Nejatullah Siddiqi*

Introduction

Every society needs some mechanism through which savings are channeled from savers to investors, on the basis of some understanding regarding repayment and returns. Savings accrue with millions of households but business imperfections of knowledge and communication, as well as variety of tastes relating to risk, liquidity and time horizon make direct deals between savers and investors inefficient and limited in scope. Banks function as financial intermediaries between savers and the ultimate users, the firms and households. Besides this, they offer a number of other services such as safe deposits, checking 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 the current income into bank deposits as the income receivers do not spend all of it immediately upon receipt. They need and withdraw only a fraction of it

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at any time enabling banks to advance the rest, along with time deposits of which a smaller fraction needs being 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 for the good of the society or to the detriment of its interest by banks. 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(1). Interest forms the basis of bank's dealings with

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(1) 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 inequitious. 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 some time move in opposite directions in which case a variable rate of interest becomes more inequitious than a fixed one. It will be appreciated, therefore, that the above mentioned practices do not affect our case against interest based on considerations of equity and efficiency, as elaborated in what follows.

savers as well as 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; (c) and lastly to analyse how 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 change over to 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(2).

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(2) 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 Mecca 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.

1. The Critique

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

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 credit-worthy borrowers who have enough assets to fulfill their commitments. This is not to imply that the financier does not examine the project in which the loan is to be invested in order to satisfy himself about its soundness. He certainly does so, but it has a 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 credit-worthy. Debt finance generally goes to the most credit-worthy 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(3) 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

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(3) 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 or/and 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.

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 credit-worthiness 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 credit-worthiness 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 funds are supplied-1oans carrying interest[(4)].

Let us now consider the creditor-debtor relationship from the perspective of the debtor. The user of investible funds is naturally keen to employ it 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

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(4) 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 Edition) page 602.

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.

THE INVESTMENT SECTOR; Injustice of Debt Finance

Above we have argued that financing productive enterprise through interest bearing debts fails to channel investible funds into 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 enterepreneur obtains from the financier is used for buying such goods and services as are necessary to carryon the productive enterprise. He buys raw materials and machinery. hires wage labour and salaried staff and 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, unceratin. 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 mayor may not come true. 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 to 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 himself or some one 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 devolve 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. In so far as an entrepreneurship can be characterised as bad, it can be done so only post facto, on the evidence of the actual losses having been 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 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 in so far as future entrepreneurial activities are concerned. From the individual as well as the social view point this is very unfortunate. As noted above the occurence of loss does not necessarily imply bad entrepreneurship. It is the nature of the world around us that some enterprises some times 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 punish 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 of external finance 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 always to bring more wealth whereas entrepreneurship must face the rough weather by making losses good by 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 inequitious. Given this b1lilt-in inequity, the distribution of income and wealth becomes more and more inquitable 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 to 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 deopositors.

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 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 business men to collect the swelling profits. A change over 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 to any sum of money advanced to this consumer. No net productivity is involved. Human society since long has recognised it 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 reduce the net benefit of this relief or wipe it out altogether.

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 retionale 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 money lender. 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 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 installment credit presently in vogue. They cover many luxury items and gadgets which might give satisfaction but can hardly increase the capacity to earn.

In so far 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 to this investment may, in principle, be admitted. But the returns remain uncertain and unmeasurable, to a greater extent than in case of investment in production. There is no tangible marketable' 'product" involved. The eventual increase in income mayor may not come about, and when it actually does, a number of impondrables are involved making any imputation of value to the consumer durable very difficult. Uncertainty of value returns to 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(5) and the consumer debt payments amounted to nearly one fourth of their disposable income in 1979(6).

Due to understandable reasons the cost of servicing installment sales are notoriously high necessitating a very high rate of interest on installment credit. The price the consumer actually pays for these articles is higher than its market price. It is not surprising, therefore, that recourse to consumer credit may eventually result in a lower standard of living(7).

Easy availability coupled with high pressure advertising and agressive 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(8).

Easy availability of consumer credit leads to an initial increase in demand which can be sustained only by further exponential growth in

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(5) **David Caplovitz** (1974) Consumers in Trouble; The Free Press, New York, page ix.
(6) **Time Magazine**, Feb. 18, 1980, page 46.
(7) **David Caplovitz**, *op. cit.*, p. 286.
(8) Adds Stan Benson, a Loss Angles 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.

credit. There is a constant effort to involve more and more people by reducing down 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 inf1ation. Expectation of price rise induces the consumers to go in for more credit purchases. But this in turn accentuates the inf1ationary 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 macroeconomic level. It puts the debtor families under great psychological strains. It leads to break up of homes, ill health and even loss of jobs. Eventually the debtor may end up in complete ruins economically as well as otherwise(9).

Social intervention to prevent these evils can hardly succeed without striking at the root of this institution. We have already noted that no reationale exists for fixed interest charges on consumer credit. If it is desirable to facilitate the acquisition 01 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

Modern government's need for debt finance mainly arises due to three different reasons. It needs short term finance to bridge the gap

(9) **David Caplovitz**, *op. cit.*, Chapter 14.

between the time expenditures are made and revenues occur. 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 moblise defense 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. More often than not it amounts to taxing the same class of people to pay them interest. The cost of administering the tax, to the extent it is related to interest payment. is a social waste as well as an extra burden on this class necessitated by this irrational arrangement.

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 of their wealth.

Most of the huge public debts that the modern states are carrying along 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 mautre, 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 interests on the bonds they own. The taxes have in fact to be more than interest due so that 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 stabilization policies.

The notion of the state as a welfare institution, representing the people and working to ensure their good through their cooperative efforts abhors 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 the 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 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 defense moblisation 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 regime in power so that it could 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.

In so far 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 increasingly wasteful use of resources, besides the baneful cultural impacts of westernization.

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 the consumer sector happened in this sector too. 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 unlearnt 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 in order to service the old debts and postpone the day of final reckoning. One cannot imagine of 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" to 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 totaling U.S. $400 billion(10) with interest and amortisation alone exceeding U.S. $40 billion per year.(11) Three decades of debt financing have not been able to make the debtor countries self sufficient or even 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 strains. Developing countries have come to look upon aid as means of exploitiation rather than 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

(10) **Newsweek**, 31st March 1980, p. 41.

(11) 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.

individualistic view of ownership which the relaities 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 coexistence and amicable living of 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 on Income and Wealth

Having traced the consequences of interest in some important sectors of the economy let us now briefly turn to its impact on the distribution of income and wealth in the 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(12) and most of the loans to the government. This is also true of some loans to business in so far 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 of existing

(12) Credit for consumer durables may, however, lead to increase in efficiency increasing production in the future .

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 bulk of the credit advanced by the banks in created **ad hoc** for the purpose it is new money appearing simultaneous to 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 the 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 enable the financiers to commandeer a continuous flow out of both the existing and the newly created wealth of the 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(13) rich nations whose 'hard currency' is required by the poor nations to bridge the gap in their balance of payments. Loans channeled 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. In so far as they fail to do so, interest payment involves a transfer of existing resources from the poor to the rich countries. This would be inconceiveable under a system where the

(13) **The daily Saudi Gazette**, Jeddah. March 30, 1980.

returns are tied to actual additions to wealth and not predetermined as in case of interest.

The regime 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 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 erruptions 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 stock holders in and creditors of the modern large corporations."[14] 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,"[15] "The large commercial banks have become the major holders of equity capital as well as the major suppliers of debt capital"[16] 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, because they have wealth. 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 'domocracy' as the press, the platform and the party, like all other institutions of an interest - based society, succumb to the organized 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

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(14) **Kotz, David M.** (1978) Bank Control of Large Corporations in the United States, Berkeley, University of California Press, p.148.

(15) **Kotz. David M.** (1979) The Significance of Bank Control Over Large Corporations, *Journal of Economic Issues*, Vol. XIII No. 2, June, p. 42.

(16) Ibid, p. 423.

the lending operations of the commercial banks.[17] Lending is a process concerned essentially with the solvency or credit worthiness 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 as a secondary line of defense. 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 bank's own profits out of lending and credit creation do not devolve on productive employment of these funds, and creation of additional wealth thereby, they continue doing 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 banks care if it is an indicator of the supply of money overstepping the supply of goods and 'services ?

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(17) 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.

A sure linkage between creation of money and creation of 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.

II. THE ALTERNATIVE

Islamic banking is based on two cardinal principles laid down in the shariah**;** prohibition of interest(18) and its replacement by profit-sharing wherever feasible and desirable(19). 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 banks. The enterpreneurs seeking advances from banks will promise the banks a share of the profits accruing to them. In case there are no profits 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 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.

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(18) " Allah has permitted trade and forbidden", **The Quran** 11:275
(19) **Siddiqi, M.N.** (1969) *Shirkat aur mudarabat ke shar'I usul*, Islamic Publications, Lahore.

Allocative Efficiency

With the replacement of interest by profit - sharing the returns to 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 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 as 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 interest 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 one of them. 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,[20] 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, hence the new money will be 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 ends up in loss ? Unlike lending, repayment of capital to 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 role in the supply of interest free loans to consumers. Such a policy is still the more

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(20) **Siddiqi, M.N.,** Banking Without Interest. *op. cit.*, pp. 77-94.

desirable in view of the int1ationary effect of bank money given as consumption loans. Interest free loans to consumers should be arranged on the basis of tax revenue (including *Zakat*)[(21)] 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 can not be assessed. Since banks would not be getting any direct returns through such lendings, this activity can not assume large proportions. In fact they may have to be persuaded to do so through special regulations and incentive.[(22)] These loans may have to be rationed according to such needs of the business community as can not be met through profit - sharing advances. Though their profitability can not 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 interest free loans to business may not assume proportions that the Monetary Authority can not 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

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(21) A numbers of scholars have suggested use of *Zakat* funds for giving interest-free loans to needy Consumers. These include **Hameedullah, Abu Zuhra** and **Khallaf**. For details please see **Yousuf Qardawi**; *Fiqh al Zakah* vol II, p. 643. Beirut 1980.

(22) **Siddiqi, M.N.,** Banking Without Interest, *op. cit*.

funds are put, as well as on whether the loans come out of savings or out of bank money. Public borrowing for nonproductive purposes from the commercial banks would be inflationary and must be kept at 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 switch over 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 accures as a share in actual profits. In trying to ensure a profit for himself, at least equal to his alternative earnings as noted above, the entrepreneur is also ensuring repayment of capital as well as a positive return to that capital. Depending on the ratio of profit sharing between the bank and the entrepreneur,(23) 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

(23) For a brief discussion on the determination of this ratio, see the author's paper Economics of Profit-sharing, *op. cit.*

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 the same.

As noted below, there is no reason to believe why the supply of savings should be adversely affected by a change over from interest to profit - sharing. Given the supply of savings into 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 it in case of interest bearing loans. Every successful enterprise will, on the other hai1d yield to entrepreneur a proportionate share of the 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 entrepreneurs to 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 owner of capital. The remaining 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 ratio 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 asses 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 briet1y 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 to 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 will be no worsening of the distribution of income and wealth on that count, in the whole of the society, as has been the case in the regime 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 ratio of profit - sharing between the two parties. As this ratio will be determined by demand and supply,[24] the possibility of wealth owners receiving a larger share of the additional social wealth cannot be ruled out. In so jar as this may be regarded as undesirable the society will need other measures to remedy the situation.

Finance for The Government

The possibilities of financing the government with profit-sharing funds has already been explored elsewhere.[25] 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.[26] 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 Joan certificates[27] or by obliging the commercial banks to earmark part of their demand deposits for lending to the government, free of interest.[28]

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(24) **Siddiqi, M.N.** "Economics of Profit-sharing" *op. cit*.
(25) **Siddiqi, M.N.** Banking Without Interest. *op. cit*., pp. 138-153.
(26) **Chapra, M.U.** *op. cit*., p. 16.
(27) **Siddiqi, M.N.** Banking Without Interest. *op. cit*., pp. 153--163.
(28) **Chapra, M.U.** *op. cit*. pp. 30-31.

In case of national calamities like floods and famines, or during emergencies such as a war, the state should 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,[29] the recourse to interest bearing loans being completely out of question.

Finance for The Consumer

The case of consumer durables can be handled in a number of ways, within the frame work of profit - sharing. The sellers can be funded[30] on a profit - sharing basis to encourage them to sell consumer durables on installment payment, involving no interest, but allowing for cost of collecting the installments and maintaining the accounts. Sale on installments will increase demand 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 installments, part of which is construed as the share of rental going to the supplier of capital and the remaining 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[31] and may be applied to automobiles and other costly consumer durables as well. It raises, however, questions relating to the nature of rents and retails which have yet to be examined in the light of **shariah**.

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(29) **Siddiqi, M.N. (**1977**)** *Islam Ka Nazariya-e Milkiyat*, vol. II pp: 209-238. Islamic Publications, Lahore. 3rd edition.

(30) **Chapra, M.U.** (1978) *op. cit*., p. 20. also **Mohammad Uzair**; *Interest-Free Banking*, p. 34, Royal Book Company, Karachi, Pakistan.

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

This leaves out purely consumption loans needed to alleviate suffering and privation. The supply of such loans cannot be a business proposition. It must be treated as a social service and made part of the **zakat** 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 the 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, ort the condition that the actual returns to 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 underway, 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 devsied 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 engineering price rises to benefit there from and play havocs with the economy.(32) Several provisions of the **shariah** 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(33) and forward transactions are allowed only in a restricted way.(34)

(32) 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.)

(33) "One who hoards with a view to making things dearer for Muslims is a wrong doer and Allah would not give him any protection". So said the Prophet as reported by Abu Huraira in Hakim's *Mustadrak*, Vol. II, Page 12, Hyderabad (India) 1324A.H.

(34) 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-Jami. ah al-Suriah, 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 **shariah**.

The absence of bonds and securities will itself seriously curtail the possibilities of the specultative 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 to 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 mobilization for productive uses has been discussed elsewhere(35) 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 saving, savings being largely a function of income and consumption patterns. Nevertheless, the investment accounts of the commercial banks will provide savers 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 to these deposits, in practice. Common stock and investment certificates(36) will provide another means of investing ones savings.

The channeling of the banks' share of entrepreneurial profits and the distribution among depositors of their share in these profits requires honest

(35) **Siddiqi, M.N.** *Banking Without Interest*, *op. cit.*, pp. 182-186.
(36) **al-Jarhi. M. Ali**, *op. cit.*, Section B "*The Financial Instruments*".

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 funds will depend on the profits they actually pay on the capital supplied. Poor performance in this regard, whether it is due to cheating or bad management, will seriously jeopardise their chances of getting more funds and hence, of continuing in business. Furthermore, special arrangements should be made to audit the accounts and ascertain the actual profits. Last but not the least, it is presumed that a switch over to Islamic banking will be accompanied by a multypronged 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 financial intermediaries for savings, and competition among businessmen for capital will work against cheating and witholding 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 switch - over to one based on profit - sharing will ensure justice and improve efficiency. We may nevertheless, conclude with a very brief online of Islamic banking.

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.(37) 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 mayor may not involve any service charges and they will not bring any return to depositors. In return to the privilege of using demand deposits in their normal operations, as is the case in the fractional reserve system, 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

(37) For details please refer to the works listed in the footnote 2 above.

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, and industrial equipments 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 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 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.[(38)] 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.

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(38) for a brief discussion on this and other problems relating to transition, see **M.D. Chapra** *op. cit*., pp. 45-47.