

M. Umer Chapra

Towards a Just Monetary System

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The development of Islamic economics has been profound over the last twenty years. The excellent survey of Muslim Economic Thinking by Mohammad Nejatullah Siddiqi (Ahmad 1980) demonstrates the progress that has been made in every avenue of economic thought; the recent work by M. Khan and A. Mirakhor on Islamic Banking in Pakistan and Iran represents the first major study to quantify the effectiveness of an Islamic monetary system. The book by Dr. Umer Chapra, *Towards a Just Monetary System*, which is the subject matter of this review article, is an attempt, or so we are told by Khurshid Ahmad in the preface, to provide a "*comprehensive and interpretative study of the Islamic monetary system*" (P. 12), to "integrate theory and practice" and to "give a vigorous analysis of some key concepts" (P.13) in Islamic monetary economics. The reader is therefore given very high expectations of the book as the beginning of the fourth phase of Islamic economies - "a more integrative as well as more critical approach to the entire theory and practice of money and banking in Islam" (P.11). If these expectations are fulfilled Chapra has claim to pioneering work in Islamic macroeconomics but is this the case?

Certainly the literature in Islamic macroeconomics has not yet offered, at least in the English language, more than a piecemeal approach to a complete macroeconomic system.⁽¹⁾ There are already some notable contributors on specific areas, particularly on

public finance, the role of the state, growth and development, consumption and investment (see Siddiqi, PP. 194-235); but no one has yet created an Islamic framework in which different markets can be seen working together; there is not yet a 'general equilibrium' analysis appropriate to Islam although there have been some bold efforts to achieve this; neither is there a clear understanding of the dynamic processes present in the ideal Islamic system.

Towards a General Theory?

As reviewers we have to proclaim a certain bias; our approach to Islamic economics is through the English language and against a background of Western economic thought. It is difficult, if not impossible, to shake off the shackles that this background creates. But in some ways it may be a helpful perspective in assessing Chapra's contribution. Chapra's book appeared one year before the fiftieth anniversary of Keynes' great work *The General Theory of Employment, Interest and Money* and it is productive to draw some interesting parallels. Keynes' book was the beginning of modern macroeconomics; it too was labeled as an integrative work; it also had a critical approach to what had gone before in the 'classical' school.

Towards a Just Monetary System does not have the weight or authority of Keynes' *General Theory*; Chapra would be the first to admit this. But it does have the capacity to do for Islamic macroeconomics what Keynes did for Western macroeconomic theory and economic policy. Chapra's starting point is fundamentally different to that of Keynes. Neither offers any empirical support for the arguments each puts forward, but Chapra is excused this limitation in that he is attempting to describe the works of an ideal or perfect Islamic monetary system which naturally would be difficult to test empirically. Keynes, in contrast, focused upon an explanation of how the *real* world, at the least the real, capitalist economy, functions. Chapra defines what should happen, Keynes thought he was describing what does happen-the real economy with all its imperfections.

Now this creates a problem for Islamic macroeconomics in terms of its usefulness. If the perfect, Islamic macroeconomic system can be clearly defined-and this is Chapra's objective - how can it be implemented? As economists we all know the virtues of perfect competition, but are aware of the difficulties of achieving it in practice. Will Islamic macroeconomic theory simply describe our ideal macroeconomic system, or will it also possess the means of getting us there?; the transformation process becomes crucial; Chapra does not convincingly identify this transformation process; it is not just a question of institutional and regulatory changes, it is a fundamental change, over perhaps many years, in the ways in which Muslim producers, consumers, entrepreneurs, suppliers of labour, amongst others, behave. As admirable as Keynes' book was, over the past fifty years economists have developed its general themes and added to its sophistication as an explanation of the real and monetary economy. This will also be true of Chapra's book. Keynes did not really present a clear view of the integrated working of the macro system; it was left to J. R. Hicks with the IS/LM framework and later efforts at general equilibrium analysis to do this. Neither does Chapra really give an integrated approach. There is little guidance as to how markets should work together, merely some clues as to the operation of individual markets - the markets for consumer and productive goods and the market for finance. Equally many of the confusions of

Western macroeconomics over the past fifty years are present in Chapra's book and need also to be clarified in future work. The major elements in this list would be the differentiation between stock and flow concepts and their consistent integration into theory, the related development of both static and dynamic analysis, particularly the development of disequilibrium analysis, the impact of uncertainty and expectations in an Islamic macroeconomic model (can we forever assume a real world of perfect knowledge and mobility), and the detailed analysis of the juxtaposition of Islamic and Western economic systems and the role of the Islamic economic order in the world economy. The realisation within Western macroeconomic theory is that there are no definitive answers to both theoretical and practical macroeconomic problems and the achievement of macroeconomic goals. All that economists can hope to achieve is a positive debate which has some beneficial impact upon the policy makers. This is as true for the Islamic macroeconomist as it is for the classical, Keynesian, monetarist or neoclassical economist. We are all in an endless search for truth.

Testable Hypotheses, Derived Set of Policy Rules?

Chapra unfortunately fails to provide a testable set of hypotheses and consistently derived set of policy rules. For example, he calls for the reform of tax systems (P. 228) but gives no indication of the form or structure that these reforms should consider. This is no different to the situation in Western economies which are currently searching for optimal tax structures, recognizing dissatisfaction with inequity between taxpayers and showing concern about disincentives and irrationality in fiscal structures that have been adopted over the centuries.

If Chapra has failed to provide an integrated model of an Islamic economy and precise guidelines about policy, then the all important question to which we should turn our attention is the extent to which Chapra has identified the distinguishing characteristics of an Islamic monetary system and hence the goals, instruments and policies that are compatible with it. If this has been achieved then we can consider that he has truly laid the foundations upon which the building blocks of an Islamic macroeconomic model can be laid.

The major economic goals of an Islamic system are indistinguishable from that of any other system although the rationale that underlies these goals may have perceptible differences. It is the desire to achieve social and economic justice within the teachings of Islam that lead to the stated economic goals. This underlying rationale gains importance when considering, as one inevitably must, priorities when these goals cannot be simultaneously achieved. In addition, the achievement of these economic goals is of secondary importance if the policies adopted to achieve them undermine Islamic values and the well-being of society as a whole.

In line with alternative economic systems, the major economic goals can be proclaimed as the achievement of full employment and an optimum rate of growth to together with a stable value of money. To these are added socio-economic justice and equitable distribution of income and wealth, including a just return to all members of society from economic development (Chapra 1985, pp. 33-45). The main emphasis of an Islamic system is highlighted by these latter considerations which give a dominant role to the maximization of the welfare of the *Ummah*.

The maximization of social welfare and relief of hardship provide the criteria on which the economic goals and policies of an Islamic economy should be based. All economic policies should aim towards the reduction of human suffering and in equalities in the distribution of income and wealth. For example, full employment not only allows individuals the opportunity to satisfy their basic needs but also imparts to them dignity within society. Islamic belief allows individuals the opportunity to exploit all natural resources to improve their material well-being provided it does not involve excess of waste. Thus economic growth is only of importance if it allows a broadly based development of economic well-being. Economic growth would conflict with Islamic principles if it is attained through the production of inessential or morally questionable goods and services, or the widening of inequalities or the harming of present or future generations by degenerating their moral or physical environment (Chapra, pp. 35-6).

Inflation undermines the functions of money and leads to inefficiency within a monetary system. It redistributes income in an arbitrary and often unjust manner and by inducing uncertainty discourages capital formation and leads to a misallocation of resources. Their relative importance for an Islamic economy is demonstrated:

"It (inflation) tends to pervert values, rewarding speculation (discouraged by Islam) at the expense of productive activity (encouraged by Islam) and intensifying inequalities of income distribution (condemned by Islam)". (Chapra 1985, P.38).

However, we must question whether these concerns are unique to an Islamic economy.

There is no reason to believe that Islamic economies will be protected from the conflicts that prevent the simultaneous achievement of these goals in all other economies in the world; as with Capitalist economies, there has to be some trade-off between them no matter how painful the thought of this trade-off may be. Chapra seems to imply that this trade-off will not exist in an ideal Islamic economy, but only the most ideological economist would fail to recognize that world economies are all characterized by instability and continuous change with the corresponding need for adjustment. The choice between alternative policy solutions inevitably leads to value judgments and this will be no different in an Islamic economy to any other. However, there may be rejection of broad economic policies, such as the general reduction of demand to cure inflation. Rather the policy should be geared towards the reduction of demand for inessential products or towards those products that least harm the general well-being of the community as a whole, thereby considering the needs of all individuals.

Islamic Monetary Policy

When considering monetary policy, the main theme of the book, there are two well documented, distinguishing aspects of the Islamic system that require special mention. First, Islam condemns the hoarding of savings. Any idle resource, including financial resource, should be used productively. Financial institutions have a role to play in this respect by mobilizing these resources for the benefit of the community as a whole. This allows a central bank, through a non-inflationary framework, to expand the money supply in order to stimulate sufficient aggregate demand in order to encourage

the employment of idle physical and human resources. Second, no financial institution should operate on the basis of *Riba* or interest and this is an essential part of any Islamic economic program.

The essential departure between finance in Islamic and non-Islamic economies is therefore the attitude towards interest. The essence of Islamic teaching is to forbid exploitation and injustice. One such form of injustice occurs when a lender is assured a positive return even though the financier does not share the risk or do any work. On the other hand the borrower, despite hard work and entrepreneurial skill, is not assured any positive return. Islam therefore prohibits predetermined positive rates of return on lending.

The suggested replacement is profit and loss sharing whereby the financier shares the profits and losses of a business in proportion to the share of his capital in the business. However, it is questionable whether it is just for financiers to receive such a high share of profit if all that they are supplying is capital. The entrepreneur risks not only capital but also his human endeavor and surely should be allowed more than the share of profit granted according to the proportion of his capital invested in the business. In addition, if financial institutions have a prior claim over other creditors on the assets of a debtor business in the event of bankruptcy, this would presumably be considered socially unjust in an Islamic economy. The solution to protecting the bank deposits of relatively poor members of the community in the event of these in situations supporting businesses that make losses is via an insurance scheme. One may be forced to ask why it should be only depositors who have insurance protection against loss, is it not just that this should also extend to the entrepreneur who has risked more than just his capital?

One may also question how this would work in times of unforeseen recession or financial crisis, for there is no *a priori* reason to assume that Islamic economies would be prevented from suffering from such economic problems at some time in the future. Investment will depend crucially on the ability of lenders and borrowers predicting future economic events a type of perfect foresight view of the world. Unfortunately it is the way of the world that it is not characterized by predictable events and thus under profit and loss sharing agreements people with better information than others have the opportunity to exploit those less well endowed. Any uncertainty will deter risk averse financiers or suppliers of funds from venturing into risky projects.

However, capitalist economics based on the free market principle would also argue that resource misallocation and inefficiency could occur in the finance of risky business enterprise thereby failing to fulfill the criterion for a successful market economy. For example, this form of market failure occurs in situations of risk and uncertainty when the economic agents, such as the lender and borrower, have asymmetric information (Maisel 1981). As with Islamic economies equity finance can be used as a fair means of sharing the risk between financier and entrepreneur.

Islam allows equity finance for either indefinite periods, as in the case of partner ships and joint stock companies, or definite periods as in the case of borrowed capital (e.g., loans, advances) (Chapra, P.68). A second form of finance, *Qard hasan*, is also

allowed. In this case the loan is repaid without interest or without profit and loss sharing. These loans are made on altruistic grounds. However, during periods of inflation the lender would suffer at the expense of the borrower as the real value of the *Qard hasan* declines. Inflation thus causes injustice to the lender.

This approach to finance can, argues Chapra, be extended to all forms of lending whether for private consumption or government expenditure. Finance should not be made available for non-essential or prestigious consumer goods. Other essential welfare-oriented consumer goods, such as housing,⁽²⁾ etc. which increase a person's well-being should be financed on a profit and loss sharing basis which could be calculated by estimating the imputed rent obtained from the ownership of these goods. In the case of government finance, there is strong argument for governments balancing their budgets. Goods that are amenable to commercial pricing should be provided on a profit and loss sharing basis through bonds sold to the private sector, including financial institutions. Only a small proportion of goods cannot be provided in this way, i.e., where imputed rents cannot be calculated or where there is a high social return and these should be financed via taxation. Whilst this may be effective in a developed economy one must question whether sufficient finance can be mobilized using this approach in a developing economy with a relatively underdeveloped financial sector.

Concern over high public sector debt and its finance is a feature that can be observed in many economies throughout the world. In the absence of balanced budgets the problems of financing a growing domestic and foreign debt will still be present and will not be resolved by a switch to a system of profit and loss sharing finance. It is difficult to see how the large public sector debt of many Islamic countries can be switched from the current interest bearing debt to that based on a profit and loss basis. As Chapra correctly asserts:

"The major obstacle to the Islamisation process will however be the burdensome interest-bearing domestic and foreign debt of most Muslim countries". (Chapra, P.231).

However, it is also difficult to see how the large sums needed to finance the necessary development programs can be raised on a profit and loss finance basis when any profit from the scheme is unlikely to accrue for several decades. In the case where imputed rents can be calculated but these are less than actual rents received, the question of how the difference is to be financed must be answered; Chapra rightly recognizes dependence on non-Muslim finance will only be removed when Muslim countries become stronger. Even then as international trade flows become even more interwoven and complex the Muslim countries will need to convince the rest of the world of the benefits of interest-free finance if they are to eventually free themselves from all traces of interest.

Thus it is our contention that there are many similarities between the goals and concerns of Islamic and non-Islamic countries. At first glance the economic system suggested by Chapra seems close to the perfect foresight, free market model suggested by liberal economists. The main themes apparent in the Islamic approach are the importance of social welfare, the reduction of inequality, the mobilization of savings,

the abolishment of interest, the need for governments to balance their budgets and the restriction of the public sector to the provision of a limited range of goods and services. In time all businesses should be equity financed. Clearly the transition will be slow and will require careful planning if it is to be achieved.

That Chapra has contributed significantly in *Towards a Just Monetary System* is beyond dispute. As one would expect from such an eminent, well respected scholar, he has given us much food for thought. It is open to all of us who are serious students of Islamic macroeconomics to respond to the challenges created by Chapra's important work in this field.

Footnotes

- 1 - As an exception see *Income Determination in an Islamic Economy*, Ausaf Ahmad, Centre for Research in Islamic Economics, Research Series No. 25, 1987.
- 2 - Thus if an individual pays half the cost of the purchase of a house and borrows the remainder from a financial institution, the financial institution would receive half the imputed rent. The amount paid to the financial institution would decline and the loan is repaid. If rents rise in line with any increase in property values then the financial institution would share this gain with the house purchaser. However, in a situation of rent control this would not happen and the government may need to provide additional finance to the housing market in order to achieve the socio-economic objective of low cost housing available to all.

References

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