

***Mohammad Uzair***

## **Interest Free Banking**

*Karachi, Royal Book Company, 1978. 222 p.*

Dr. Uzair's thinking on Islamic economics dates back to his student life at the Allahabad University in India where the present reviewer had the privilege of being associated with him, in a group of young men inspired by Maudoodi's writings advocating reconstruction of knowledge on Islamic bases. *Interest Free Banking* is a compilation of writings between 1954-1978. But for an unfortunate suspension of the author's thinking and writing on the subject during 1954-1975, the volume could be instructive in tracing the development of his own thoughts and, incidentally, that of Islamic economics in general. Although his recent writings (chapter 1 to 4) have been included to fill in, as it were, this very gap, part I and part II of the book are based on almost the same intellectual hinterland and do not diverge much in style and content.

1. Dr. Uzair's analysis has followed in the footpath of modern secular analysis of banking and financial operations. It has adopted, as it were, the existing economic and financial system except for the difference of the substitution of interest by profit sharing. This might have been a rewarding endeavour in certain contexts, but to assume that the functions and objectives of monetary and credit operations, and the economic needs of the society will remain intact and to attune the Islamic system to an equally efficient fulfillment of these very functions and needs is fraught with dangers. An Islamic economic system will have, as Dr. Uzair himself agrees, its own ideals and values which may effect a profound change in financial and credit needs and objectives. Hence, a more fruitful course of action would be to build an entirely new model of Islamic financial system, derive its functions and objective there from, and then proceed to examine if it can meet its needs efficiently. However, Dr. Uzair is not an exception. Most of the Islamic economists have adopted the same course of action.

2. The first two articles, of Part I, set out the conceptual landscape of Islamic economics. Dr. Uzair points out that Islamic economics is the study of on particular segment of an Islamic society, and is based, like other aspects of life, on Islamic ideology, and proceeds to examine the main parts of that ideology. He believes that Islamic economics has its own philosophy and precepts derived from "*Nusoos*" (texts). In Qur'an and Sunnah with partial help from "*Tafsirs*" (commentaries), explanation of "*Ahadith*" (traditions from the Prophet) and Islamic jurists. Those principles have to be

translated into the language of economics, to constitute principles of Islamic economics. But economic principles alone do not make Islamic economic analysis; appropriate tools of analysis would have to be adopted from modern economics subject to their compatibility with 'basic approach' of Islamic ideology. "With the help of the principles and economic analysis, the framework of economic system can be developed". However such an effort will produce only a broad and sketchy framework of an Islamic economic system. "A clear picture will emerge", Dr. Uzair asserts, "only after sustained research efforts of two kinds:

- (a) basic principles of Islamic economics; and
- (b) partial aspects of the system or sub-systems (such as interest free banking, system of *Zakat* and so on)".

After outlining the steps leading to the development of Islamic economics, the learned writer asserts that all systems followed similar path of development and hence "those interested in developing Islamic economic system will have to proceed in the same way". However, in his reference to the basic 'facets or parts of Islamic ideology like any other ideology he has perhaps, inadvertently, wrongly defined "*Nusoos*" and "*Ahadith*" which are in his view the basic sources of Islamic ideology, and "*Tafsirs*", commentaries on "*Ahadith*" and juridicial opinions of "*Aimma*" and "*Fuqaha*" as "secondary sources". We believe, he is fully aware of the sources of Islamic law, namely Qur'an, Sunnah, *Qiyas* and *Ijma'* but his presentation is extremely misleading. His definition of *Nusoos* as tenets and precepts is also erroneous, while his treatment of the *Tafsir*, and commentaries on *Ahadith* are mistaken.

3. Adhering to his own scheme, he proceeds to develop a conceptual framework appropriate to Islamic economics. It is one of the brilliant parts of Dr. Uzair's analysis wherein he makes a very ingenious distinction between capital and enterprise and suggests that financial capital is only an instrument in the hand of enterprise, and hence cannot be legitimately recognised as an independent factor of production to get independent reward. He argues his case quite forcefully and believes that this redefinition of capital will effectively answer the charge that Islamic approach toward interest is "illogical". The second article is a further elaboration of this argument, together with an analysis of the modern theories of interest. Some details of Islamic banking have been spelt out on the basis of *Mudaraba*, which Dr. Uzair defines as partnership between the supplier and user of capital who "share the profit or loss, as the case may be" (page 23). But banking will have three parties to the whole transaction, namely the entrepreneur, the banker, serving as intermediary and the suppliers of savings i.e., depositors (p.23). Thus Dr. Uzair envisages two tiers of *Mudaraba* partnership, one between depositors and bankers and the other between bankers and investors. These parties may share the profit according to a pre-arranged ratio. These ratios may be regulated by the market or the central bank and may be used by the latter as an alternative instrument of credit control (p.25).

In a further elaboration of the theme, the writer applies the Keynesian approach to liquidity preference and classifies deposits in accordance with the motives of depositors and believes that current deposit-funds may be used by the Islamic banks "to make very short term loans to the parties which run short of the liquidity", (p.28) and in case of

suppliers of funds "they can make use of the funds in this category for holding near cash items like government treasury bills, of course. without interest" (p.28), and further, "interbank lending on a short term can also be made out of the excess liquidity in this category of deposits", (p.28). Thus he solves the problem of very short term loans through the surplus funds available in the current account deposits.

Dr. Uzair realises that short term loans may also be used by the borrowers to earn profit and hence the problem of the application of *Mudaraba* principle between the banker and the depositor arises. To solve this problem he has adopted a simplistic approach by classifying the short term loans on the basis of their maturity and suggests that the calculation of profitability of loans for a year or a quarter is possible, while for loans for one to three months he devises a method of assessment of their profitability, but loans for a period of less than one month are treated as those whose specific object is to improve liquidity of the borrower and can be provided on a fixed service charge. This reviewer finds it difficult to agree with such classification that equates the maturity of short term loans with their use. Another issue tackled by the author is that of consumer credit, which he suggests Islamic commercial banks can provide by financing the sellers of durable goods on "hire purchase", and sharing the profit with the sellers (p.34). However, since consumer credit for the employees may be supplied by the employers and by special institutions sponsored by the Government, consumer credit demand from commercial banks will be comparatively small (p.34).

4. In the chapter on central banking the author lists the main functions of a conventional central bank and proceeds to examine their relevance in a changed Islamic framework. Most of the traditional functions of the central bank will be retained but credit control, regulation and lending as the last resort will be substantially modified both conceptually and operationally. 'The central bank will act as the catalyst in growth and development of interest free banking' (p.40). The Islamic central bank will also act as the lender of last resort but in order to ensure the business viability of this operation, Dr. Uzair suggests to legislate "that the central bank would hold 25% of the credit stock of all commercial banks operating in the country" (p.41). This provision will help the central bank to regulate investment financing of the commercial banks and also put a curb on very risky investments. But he does not point out how the central banks' function of lending of last resort and this provision are linked together. For its specific purpose is to provide credit in a tight market to prevent nervous withdrawal of loans and investments that may dampen the money market. Moreover, the central bank's ownership of profit yielding capital stock may not enable it to exercise a salubrious impact on earning banks.

5. However, the most important part of this discussion is the one where the author analyses the relevance of tools of credit control. At the outset, he points out that selective credit controls are more appropriate in an Islamic scheme of things, "if the central banks follow a more realistic policy" (p.46). But why? Of quantitative credit control methods, Dr. Uzair thinks, open market operation will require fundamental changes (p.46). "In an interest free banking system the entire public debt management philosophy and mechanism will have to be changed" (p.27). Government treasury bills, on which open market operations depend, will continue to exist with "perhaps normal service charges of administrative expenses" substituting interest rate (p.47). Although

quantitatively much less significant in an interest free market, treasury bills will provide some scope of open market operations. However, it is not clear why he does not refer to the possible use of capital stock of the commercial banks, which are to be held by the central bank in his scheme of things. He also avoids analysing the likely impact of these operations on the investment portfolio of the commercial banks, on investment climate and profitability. Perhaps he deferred this analysis to his ingenious substitution of bank rate by the use of profit sharing ratio (p.48). "By revising this ratio from time to time the central bank will be able to exercise a control over the "profit sharing investment" by the commercial banks" (p.49). Through this device the central banks will be able to regulate the quantum of profit sharing investment of the commercial banks (p.49). Dr. Uzair thinks that the substitution of 'Bank Rate' by the regulation of profit sharing ratio will solve the problem of reckless expansion of credit in an interest based economy.

However, one fails to find any profound analysis of profit sharing ratio as a credit control device. First of all, the fact that bank rate is a short term rate and exercises its impact on real investment only indirectly, whereas his device will have a direct impact on long term investment. Since the central bank is to hold 25% of the capital stock of the commercial banks, the central bank will not act impartially: it will consider the profits on its own stock. Secondly, profit sharing ratio will be a ratio and not a rate. Will this make no difference in its effective use as a credit control tool? Thirdly, there is the problem of time lags. It is a common experience that bank rate's impact on investment is a delayed one. Will the profit sharing ratio have an immediate impact? Will the change of profit rates bring about the desired adjustment in the supply of investible funds? And further, will it be a selective weapon? Such questions do not worry him.

6. The remaining part of chapter III is only a brief excursion into complementary policy measures. A detailed discussion of these issues is, perhaps, beyond the scope of his analysis, yet certain issues of the fiscal policy of an Islamic state will impinge upon its monetary and financial organisations so deeply, that no discussion of the latter will be adequate without their treatment. For instance, debt management is the common ground of both monetary and fiscal policy. In the absence of interest, what factors will determine the rate and structure of public debt, the form of public loans and its scope?

Dr. Uzair thinks that only some sort of interest free treasury bills may continue to be issued and hence used as a technique of credit control. However, it is not clear, if the long term profit based securities of the government will also be available for such a use? If so, what likely impact they may exercise on the credit position of the market? And how will *Zakah*, react on demand and supply of public securities in the market? For instance, if investment in government stock is free of *Zakah*, how will it influence its price and demand? And, so on and so forth.

7. The last chapter in Part I of the book outlines the mechanics of the introduction of interest free banking in the special context of Pakistan. Although brief, the strategy has been clearly outlined and thorny issues involved have been duly recognised. Alternative strategies suggested by other experts share the concern of the author that only a gradual programme can be effective with minimum dislocation.

Uzair, unlike some other experts, would not like to begin Islamization with banking proper, that is with commercial banks borrowing and lending operations, which would present, in his view, the most difficult and intricate aspects of the strategy. Instead, he would begin with the central bank, for whom it is an obligation to lead the movement and also, curiously enough, much easier and simpler to alter its base of operation and switch over to Islamically permissible methods of credit regulation. 'The main change that the central bank will have to introduce is with respect to the bank rate and its dealings with the commercial banks' (p.61). He conveniently forgets that the complex nature of central banking operations are a concomitant of the complexities of the money market, where the commercial banks constitute an important segment. So long as money market transactions take on a confusing variety of interest bearing forms, how could the central bank deal with them disarmed from its most frequently used weapon: the price and volume of credit. For both the bank rate and open market operations work on the same base, although differently, and exercise a controlling impact on money market primarily through the price of credit.

Yet Uzair's overall strategy is not adhoc, but is a firm and integrated approach based on the belief that productive uses of funds through specialized banks and real investment, if any, by commercial banks, could be most fruitfully tackled first. A switchover from interest bearing investment transactions to profit based ones may also cause minimum dislocation and lead to gradual changes in short term credit operations. This is why he classifies sources of funds (deposits) with reference to their intended use and advocates the substitution of interest by profit sharing in the case of time and savings deposits first. Although he does not spell it out clearly, the underlying belief seems to be that when all or most investment financing will be free of interest, an environment conducive to a switchover to interest free dealings in trade and commerce will be created. The strategy is, perhaps, superior to the one officially adopted in Pakistan which appended interest free counters to the commercial banks as a first step.

8. The second part of the work comprises mostly his early writings and it is these which do credit to the author's creative genius and his firm belief that interest based banking system of modern economies can be substituted by Islamic principles with the minimum possible dislocation in the supply or demand of investible funds. Beginning with a brief evaluation of the role and significance of a modern bank, Dr. Uzair argues effectively and forcefully that these functions can be discharged, if not more, at least equally efficiently, by a banking system organised in deference to Islamic values and precepts. Although, professionally, far more effective expositions of the rationale of interest free banking and sharing have subsequently been made, Dr. Uzair's analysis (first published in 1955) is the earliest presentation in an unreceptive environment. It has been a daring exercise, and a rare economic exposition of the principle of *Mudaraba* in the banking area. Essays 8 and 9 discuss the principle of *Mudaraba/Qirad* and their application to the banking operations, in a very lucid and intelligible style for the uninitiated. Except for some confusion in the economic interpretation of *Mudaraba*, which might be excused because of its being an early attempt, the whole exercise is extremely valuable. But a confusion arises from Dr. Uzair's frequent statement that *Mudaraba* envisages a share in both profit and loss [pp.23, 114 (iii); 129; 130 (iii) and 133]. Although true, if loss is interpreted as equivalent to loss of the prospective reward to the worker, such an unqualified statement is likely to be misinterpreted. It would be

better if the general definition of *Mudaraba* principle stipulates that in the event of a loss, the whole is borne by the supplier of capital. In the reviewer's knowledge no such detailed exposition similar to Uzair's of the *Mudaraba* as applied to banking is available in the English language even today.

Essays 10 and 11 outline the structure of interest free banking and offer very valuable guidelines to the reorganisation of modern banking. It is unfortunate that latter expositions by other writers have failed to benefit from it. Parts of this analysis, particularly those dealing with the nature of deposits, are still very instructive.

In such attempts, errors are quite easy to detect, and differences of opinion very natural, but the book constitutes a landmark in the development of Islamic economics. Had the author made a little more effort to bring it up-to-date, the work would have risen far above its historical value, to contribute substantially to the ongoing concern with Islamic banking.

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