MONEY AND BANKING IN AN ISLAMIC ECONOMY

by

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INTRODUCTION

The present-day world is experiencing a number of economic ills including poverty of a large proportion of mankind, social and economic injustice, gross inequalities of income and wealth, high rates of unemployment, economic instability, inflation and erosion of the real value of monetary assets. All these maladies, in spite of being in conflict with the value system of Islam, are as prevalent in the Muslim world as elsewhere. No doubt they have a number of root causes. However, the failure to provide a stable and just money and banking framework has been one of the major contributing factors. No economic system can sustain its health and vigour or contribute positively to the achievement of its socio-economic goals without the support of same and equitable money and banking system. Is it possible to design such a money and banking framework in the light of Islamic teachings?

This paper represents an effort to answer this and other pertinent questions. Section 2 provides the philosophical underpinning, arguing that the capitalist money and banking system has its own ideological setting and cannot serve the cause of Islamic socio-economic goals even if *Ribā* is abolished, unless some fundamental changes are introduced to set it in the ideological mould of Islam. In the light of these radical changes Section 3 provides the institutional setting which, though it may appear to be similar to the existing framework, is radically different in its scope and responsibilities. Section 4 discusses the management of monetary policy in the new setting, while Section 5 tests theoretically the proposed programme against the goals discussed in Section 2. Finally, Section 6 gives some tentative suggestions for the gradual transition of the money and banking framework in Muslim countries from its present setting to the suggested scheme for realizing the objectives of Islam.

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THE PHILOSOPHICAL UNDERPINNING

The money and banking sector of any economic system does not operate in an ideological vacuum. It has its own philosophical background and objectives. Its institutions evolve gradually to perform the functions necessary for enabling the system to realize its basic goals and to perpetuate itself by surviving the recurring shocks of history. The capitalist money and banking system is also essentially an integral part of its parent ideology. It serves the objectives of capitalism.

There is nothing inherently wrong in borrowing institutions from other cultures, provided that they are modified appropriately to serve the goals of the guest culture. The question is whether the capitalist money and banking system, gradually adopted by Muslim countries over the last two centuries, can be made to serve the goals of Islam instead of those of capitalism without any fundamental reform. The answer could be positive only if it is assumed that the goals of capitalism and Islam are the same or that the capitalist financial institutions are ideologically neutral and do not help the system realize its 'inherent' objectives.[1]

2A. The Goals

The money and banking system should, like other aspects of the Islamic way of life, not only contribute to the achievement of the major socio-economic goals of Islam [2] but also perform the functions that relate to its own special field. The principal goals and functions are as follows:

(i) Broad-based economic well-being with full employment and optimum rate of economic growth.
(ii) Socio-economic justice and equitable distribution of income and wealth.
(iii) Stability in the value of money to enable the medium of exchange to Be a reliable unit of account, a just standard of deferred payments, and a stable store of value.
(iv) Generation of adequate savings and their productive mobilization within a framework which is consistent with the above goals.
(v) Effective rendering of all services normally expected from the banking system.

It may be asked at this point whether the goals of Islam, as stated above, are not the same as those of capitalism. On the surface they may appear to be the same, but in essence there is a fundamental difference arising from the differences in the roots of the two systems - the Islamic economic system is morally-based while capitalism is secularist and morally-neutral. The ensuing discussion should help to make this point clearer.

(i) Economic well-being with full *employment and optimum rate of growth.* Islam is not an ascetic religion. It takes a positive view of life, based on the belief that human beings are the vicegerents of God. Man must therefore lead a life that befits his status, and the Divine Guidance embodied in Islamic teachings is intended to help him in the realization of this objective. It is designed to make life richer and worth the living, and not poorer, full of hardships. Hence, Muslim jurists have unanimously held the view that welfare of the people and relief of their hardships are the basic objectives of the *Sharī'ah.* This view, when applied to the economic aspect of life, implies economic well-being through satisfaction of all basic human needs, removal of all sources of hardship and discomfort, and improvement in the quality of life. In fact, any struggle intended to fulfil basic human needs, to remove misery and to make life a blessing has been equated by Islam with an act of virtue. Thus full and efficient employment of human resources is an indispensable goal of the Islamic system, as it helps realize the objective of broadbased economic well-being and also imparts to human beings the dignity demanded by their status as God's vicegerents. Full and efficient employment of material resources is also essential, because according to Islam all resources in the heavens and the earth are meant for human welfare and need to be exploited adequately, without excess or wastefulness, for the purpose for which they have been created.

While a high rate of economic growth should be the natural result of policies leading to full and efficient employment of human and material resources and broad-based economic well-being, it is not of prime importance if it entails the production of inessential or morally undesirable goods and services, excessive and overly rapid use of God-given resources at the expense of future generations who are equal owners of these resources, and degeneration of the moral or physical environment. A high rate of growth is only essential to the extent to which it contributes to full employment and broad-based economic well-being, but beyond this its importance would have to be carefully weighed against all its other implications.[3]

(ii) Socio-economic justice and equitable distribution of income and wealth: The goals of socio-economic justice and equitable distribution of income and wealth are an integral part of the moral philosophy of Islam and are based on its unflinching commitment to human brotherhood. The capitalist conversion to socio-economic justice and equitable distribution of income, on the contrary, is based not on a spiritual commitment to human brotherhood but on expedience arising from group pressures. Accordingly, the system as a whole, particularly its money and banking arrangement, is not geared to these goals, and glaring disparities of income and wealth continue to be generated. Nevertheless, because of the influence of socialism and political pressures, some of these inequalities are being partly reduced by taxation and transfers. In contrast, Islam tries to uproot the causes of gross inequalities at their source, also using *Zakah,* taxation, and transfers as additional measures to reduce inequalities even further to bring about a distribution of income which is in conformity with its concept of human brotherhood. Hence it is essential that the money and banking system and monetary policy are so designed that they are finely interwoven into the fabric of Islamic values and contribute positively to the reduction of inequalities.

(iii) Stability in the value of money: Stability in the value of money should be an important goal in the Islamic frame of reference, because of the unequivocal stress of Islam on honesty and fairness in all human dealings and the adverse effect that inflation tends to have on social justice and general welfare. Inflation implies that money is unable to serve as a just and honest unit of account. It makes money an inequitable standard of deferred payments and an untrustworthy store of value, and enables some people to be unfair to others, even if unknowingly, by stealthily eroding the purchasing power of monetary assets. It thus imposes welfare cost on society by reducing the efficiency of the monetary system. It tends to pervert values, rewarding speculation (discouraged by Islam) at the expense of productive activity (idealized by Islam) and intensifying inequalities of income (condemned by Islam). Moreover, inflation conflicts with a *Ribā*-free economy, because it corrodes its raison d'être of social justice. Although Islam urges justice to the borrower, it does not approve of injustice to the lender. Inflation undoubtedly does injustice to the *Ribā-free lender* by eroding the real value of *Qard Hasan.*

It may be suggested that in the current world-wide inflationary climate the Islamic imperative of socio-economic justice could be satisfied by indexation, or monetary correction, of all incomes and monetary assets including *Qard Hasan.* Proper monetary correction would, however, require the indexation not of income or monetary assets but of purchasing power, which is determined by the consumption and investment pattern of' individuals. Socio-economic justice would hence require the indexation of income and monetary assets by the use not of one universal index but of several indices based on different expenditure patterns. In contrast with this, widespread index-linking of incomes and monetary assets based on even one universal index has not been found to be feasible, because of the complexities involved and the high administrative costs of implementation. Hence indexation of only some incomes and monetary assets has been tried. The widest use of indexation has been in the field of wages, salaries and pensions. Indexation has also been tried for some financial assets (e.g.,. bank loans and deposits, and Government bonds), taxes, rents and mortgages.[4]

While indexation might help ameliorate partially the inequities arising from inflation, it is not a cure for inflation. It may, in fact, tend to accelerate inflation.[5] It may well he self-defeating, unless inflation is on the decline and remedial monetary, fiscal and incomes policies are being adopted.[6] It seems, therefore, that while indexation may he feasible to a limited scale and may be resorted to as a temporary sedative for the pain of inflation, the policy alternative, which would best conform to the norm of socio-economic justice emphasized by the *Sharī'ah, is* price stability and not indexation.

Indexation of *Qard Hasan* has so far been rejected by the *Fuqahā'* because they generally consider it similar to *Ribā* in its essence. Their opposition to indexation of *Ribā*-free loans is also defensible on economic grounds because, even though it is proposed with the innocent objective of doing justice to the *Ribā*-free lender, it has the potential of initiating gross injustice to the borrower.[7]

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

A generally accepted principle in capitalist economies is a trade-off between unemployment and inflation. In the context of Islamic values, such a trade-off is questionable, for Islam rejects both unemployment and inflation. Moreover, it is doubtful whether it is essential to have inflation to achieve full employment or to have unemployment to avoid inflation.[8]

In the Islamic system both unemployment and inflation are undesirable, and both need to be eschewed even though this may require a fundamental change in economic relationships. If aggregate demand is to he contained or lowered to avoid inflation, then in the overall interest of social justice and broad-based economic welfare a value judgement needs to be made about which demand should be contained or reduced and how. In a value-oriented system it would be indefensible to allow demand to expand in inessential directions to attain a high rate of economic growth and, if this generates inflation, it would he equally indefensible to try to control it by reducing aggregate demand in a general, across-the-board manner by creating human unemployment.

Similarly, full employment must be ensured even if this demands a restructuring of production and designing of suitable technology. Hence it would be essential to regulate aggregate demand, restructure production, design a suitable technology and have an appropriate mix of monetary, fiscal and incomes policies in order to avoid both inflation and unemployment and to ensure broad-based economic wellbeing with a realistic rate of economic growth.

(iv) Mobilization of savings: The goal of mobilization of savings is essential because Islam categorically condemns hoarding of savings and demands their productive use for the realization of the socio-economic goals of Islam. Nevertheless, it is not possible for every saver to employ his savings productively. It would therefore be in the nature of fulfilling Islamic teachings if efficiently-organized financial institutions mobilize idle savings and channel them efficiently into productive uses. Such institutions should be properly equipped to be generally able to meet the genuine, non-inflationary needs of both the public and the private sectors.

However, *Ribā* or interest has been prohibited by Islam and neither the saver nor the user of savings is allowed to receive or pay *Ribā,* defined by the *Fuqahā'* as a predetermined positive rate of return on savings or loans. Profit, which may be positive or negative and which is not predetermined,[9] is recognized by the *Fuqahā'*. Hence in the interest of implementing Islamic teachings, it is necessary to organize a banking system which mobilizes savings and yet operates on the basis not of *Riba* as in the capitalist system, but by sharing the net outcome, be it profit or loss.

Moreover, if the economy is unable to generate adequate demand that would ensure gainful employment of idle physical and human resources, then the system should be able to bring about a sufficient monetary expansion within a non-inflationary framework.

(v) Rendering other services: The system should not only be able to mobilize savings effectively and allocate them efficiently for their optimum productive use to meet the needs of a growing and healthy economy, but also be able to develop primary and secondary money markets, render all banking services to the public at least as efficiently as the existing banking institutions and fulfil the non -inflationary financial needs of the government.

The development of both primary and secondary markets is essential for efficient mobilization of financial resources. While the existence of primary markets is needed for providing financial resources to those who can employ them productively, the existence of secondary markets is essential to help savers and investors 'liquidity' their investments whenever they feel the need to do so. The absence of a secondary market would compel savers to hold larger balances for precautionary motives thus increasing hoarding and reducing the rate of economic growth by preventing savings from performing their natural role.

2B. Some Fundamental Reforms

The range of objectives mentioned above would call for a fundamental reform of the economic system in general and the money and banking framework in particular. While this reform would include the abolition of *Ribā* as an indispensable element, it would also include the introduction of some essential changes in the economy and the banking system. Some of the essential reforms, without which it would be difficult to achieve the socio-economic objectives of Islam, are briefly indicated below.

(i) Avoidance of wasteful spending and conspicuous consumption: Moderation is the core of the Islamic message which emphatically discourages extravagance and conspicuous consumption. However, in keeping with its universal and rational approach to problems, Islam has. enunciated *qualitative* and not *quantitative* restrictions on consumption. The

expenditure should be befitting a Muslim who is morally conscious and humble at heart.

Since Islam wishes to foster social equality and brotherhood, any behaviour pattern that destroys or weakens these values must be avoided. All expenditures undertaken with the intention of showing off or displaying pomp and grandeur and reflecting arrogance have the effect of widening, rather than narrowing, the social gulf between the rich and the poor, and have been condemned by Islam. Said the Prophet (peace be upon him): "God does not look at those who wear clothes reflecting arrogance".[10] "God has revealed unto me to teach you to be humble so that no one wrongs others or shows arrogance"[11].

While wasteful spending has been discouraged, boarding of savings has also been unequivocally condemned by the Qur'an as well as by the *Sunnah.* God-given resources are meant to be used for one's own benefit (within limits prescribed by Islam) as well as for the benefit of others, thus fulfilling the very purpose of their creation. Leaving them idle without using them for rightful consumption or for fostering the common good through welfare contributions (e.g., *Zakah, Sadaqāt,* etc.) or for productive investments has been condemned by Islam. "And there are those who bury gold and silver and spend it not in the way of God; announce to them a most grievous penalty", (the *Qur'an, 9:34).* The Prophet (peace be upon him) disapproved of leaving productive resources idle, saying: "Let him who owns land cultivate it himself; if he does not cultivate it himself let him have his brother do so."[12] Khalifa Umar also used to exhort Muslims, saying: "He who has money let him invest it, and he who has land let him develop it."[13]

The money and banking system should be so organized and regulated that wasteful spending is not promoted, and savings are mobilised and channelled into socially productive uses. Under no circumstances should it encourage or facilitate the production or consumption of goods and services that carry a lower priority in the Islamic value system. The deposits used by banks to advance loans belong to society and should be so allocated that they help finance the production and distribution of all essential needs of society before funds are made available for other purposes. The capitalist virtue of abstaining from making value judgements should have no place in the Islamic system. There is no escape from values which have been prescribed by the Qur'an and the Sunnah. Hence the capitalist criterion of equalizing the marginal rate of return on all investments to attain 'efficiency', irrespective of the social priority of goods, tends to bring about a lower than 'optimum' production of essentials, because scarce funds get diverted to the production of luxuries.[14] 'Efficiency' needs to be understood within the context of the overall ethos of the value system and not just of the variable of interest and profit.

The values of avoiding wasteful expenditure and using resources efficiently in accordance with Islamic values apply not only to individuals but also to the government, and more so because governments use resources which are provided to them by the people as a trust to be used for the welfare of the people in accordance with Islamic teachings. The criterion for undertaking any government expenditure should be that the total sacrifice made by society in providing the resources is at least offset by the positive contribution to general social welfare and the realization of the socio-economic goals of Islam.

(ii) Increased equity financing: The obligation to abolish interest would make it indispensable that there be primary reliance on equity capital and little dependence on borrowed money in an Islamic economy. The Islamic economy would thus have to be essentially equity-based, compared with capitalism which is predominantly loan-based and in which a vast superstructure of finance is usually raised on a small foundation of equity capital in the style of an inverted pyramid.[15] Business in an Islamic economy would have to rely on equity for mustering additional financial resources. All financial needs of a permanent nature, whether for fixed or working capital, would have to come out of equity and not from borrowings from banks; it is not of material significance whether this increase in equity is by way of joint-stock companies or partnerships. Resort to borrowing should be allowed only to the extent of bridge-financing and temporary shortages of funds resulting from seasonal peaks in business. Under normal circumstances, there would be no justification for medium or long-term borrowing in an Islamic economy. Dependence on borrowing implies that either the owner of the business is not willing to share the ownership and the fruits of his expanding business with others or that the lenders are not willing to share in the risks of business and wish to have a predetermined positive rate of return, both of which constitute undesirable traits in a Muslim society.

There is no doubt that the jurists have recognized *Muddrabah*.[16] However, a deeper analysis of the concept of Muddrabah reveals that it is essentially an investment-management agreement. The *Sahib al-Mal* (capital contributor or investor) is basically not the lender but the owner of the business to the extent of his share in the total financing of the business. The *Mudarib* (manager or entrepreneur) manages the investment funds placed at his disposal by the *Sahib al-Mal* in accordance with the *Mu¼ārabah* agreement. *Muddrabah* is a form of equity which is temporary in nature and is liquidated as soon as the objectives are realized. The liability of the *Sahib al-Mal* is limited to the extent of his capital and no more.[17] In accordance with the rationale behind the prohibition of *Ribā,* the manager of *Muddrabah* funds is not entitled to a fixed return for his management services irrespective of what happens to the business. If there is a profit, he shares the profit in an agreed proportion as a reward for his managerial and entrepreneurial services. If there is a loss, he gets no reward, and his loss amounts to the opportunity cost of his services. However, he shares the loss if he has a share in the equity of the business, but only to the extent of his share because losses according to the *Fuqahā'* constitute erosion of equity. This fits perfectly into the rationale of the Islamic model of *Ribā*-free economy and implies that the spirit of business relationship preferred by the *Sharī'ah* is "investment-management" and not "borrowing-lending", taking into account the modern connotation of these terms.

Equity-financing in place of loan-financing will help eliminate the possibility of a large superstructure of finance being raised on a narrow equity base. It would help bring about a wide dispersal of ownership of business and contribute substantially to the realization of the goal of equitable distribution of income and wealth. It may, however, be remarked that even when ownership is widely dispersed, the large number of small shareholders may have neither the ability nor the inclination to participate in the decision-making process. This tends to lead to concentration of power in the hands of a few persons in large enterprises. Since competition tends to be inadequate, particularly when the enterprises are very large, and regulations can be circumvented, the general tenor of business in an Islamic economy should preferably be small and medium-scale. "Big" business should be allowed only when necessary in the larger interest of society. In such cases, the state should intervene more effectively, to safeguard public interest and to ensure that vested interests do not exploit the "bigness" for their private benefit.

(iii) Reducing the power of banks: In the capitalist framework, society's resources mobilized by banks are utilized by them for enriching a few families. One of the primary reasons why banks tend to become the centers of control under capitalism is that capitalists who operate through a bank "obtain access to other people's capital."[18] The Rockefellers and Mellons can thus control corporate empires of far greater worth than their own personal fortunes and, "it is not surprising that the wealthiest and most powerful capitalists operate through banks."[19]

The inverted pyramid of power in the banking system arises from the low equity base, on top of which rest 'primary' deposits that support a substantially large volume of "derivative" deposits. The equity of banks in the capitalist banking system is usually very small. Shareholders of all U.S. commercial banks holding equity worth $73.1 billion (stocks worth $16.4 billion plus surplus, undivided profits, and reserves against contingencies worth $56.7 billion) in 1976 had control of total assets worth over $1,040 billion or fourteen times as much.[20]. People who had real control over these assets owned a substantially smaller proportion of the total stock of $16.4 billion.