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Issues in Islamic Banking

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The book contains six papers both published and unpublished and begins with a survey article on money, banking and monetary policy in which the author has claimed that he examined critically issues such as demand for money, credit creation, 100% reserves, discounting, indexation and so on. Then the author provides an "exposition" of the "*mudaraba*" and answers the question "*why*" Islamic economists advocate a change from interest to profit-sharing which will contribute to allocative efficiency, justice and stability. On the economics of profit-sharing, the author argues that forces of demand and supply should determine the ratio of profit-sharing between users and suppliers of capital. The last chapter offers brief comments on the Report of the Pakistan Council of Islamic Ideology, 1980. (p. 133).

This collection is an interesting addition to the growing literature on the subject. The first paper on "Islamic Approaches to Money, Banking and Monetary Policy" surveys the recent contribution in the field. Its main strength lies in the fact that it is informative. In most cases, the paper has described, *not* analyzed the implications of various viewpoints on some major issues such as creation of credit, discounting future values, indexation, etc. Thus, contrary to the author's claim, most of the issues have *not*, in my view, been critically examined or unfolded. In many cases, it is not at all clear as to what is the viewpoint of the author who appears to have taken simplistic views on the highly complex monetary process.

Let me give a few examples. The author appears to assume that value of money will remain stable once interest rate is abolished and *zakah* is imposed. Money will then perform its primary and derivative functions smoothly. (p. 16, para 2, p. 17, para 2).

Although abolition of interest and imposition of *zakah* is expected to contribute to stability, yet sound economic analysis calls for an examination of the economists' distinction between two concepts of money (i.e., defined narrowly as either M_1 or widely as M_2 or M_3). This is needed to understand the changing views on what is money. The fact is that what is an acceptable medium of exchange has changed and will continue to change over time. It is to be clearly recognized that stability of money depends *not* merely on interest but also on endogenous factors such as level of business activity, level of expected profit, commercial banks' ability to respond to economic incentives, as well as exogenous factors such as the control of the central bank.

Despite this inadequate treatment, the author appears to accept the role of money as a medium of exchange in an Islamic economy. But surprisingly in his treatment of indexation (p. 44, para 3), the author has relegated the role of money as a medium of exchange and wants to place currency transaction and commodity transaction on the same footing. This confusing and contradictory position becomes further complicated when he tells us that in an inflationary situation indexation of loans gives "a privilege to the lender" and "this amounts to a gain without risk which runs counter to the basic Islamic principle in the realm of finance" (p. 44, para 3). Here also the author could not identify the difference between real value of money and its monetary value. This will remain a standing puzzle to me. At this stage, it is to be clearly understood that the outcome of indexation of loans is inherently uncertain; while the indexation of loan can be positive, negative or equal to principal in money term, *not* in real term, a pre-determined rate of interest on loan tends to be *always* positive in money term.[1] Thus interest on loan is a "gain without risk". This is what is prohibited in Islam.

Again, on the question of discounting future values, the author appears to have taken a simplistic view by leaning *solely* on Dr. Zarqa's paper (p. 41, para 3). Though Dr. Zarqa's paper helps to understand the role that the rate of return can play in Islamic economics, a number of questions are still unresolved. The author did not provide an objective analysis. It is to be noted, however, that while discounting future values to present value (PV) involves a clear choice between present and future consumption involving the welfare of the future generation, it is not only an economic choice, but also a moral and ethical choice rooted in the *Shari'ah*. Thus expected rate of financial return may not *always* be the true guide to appropriate use of discount rate. Even the secular economists advocate the use of zero interest rate for discounting the future flows of costs and benefits in respect of government projects. Besides, at an operational level, the proper discount rate (i.e., (i) in the equation of PV method) is *not* some form of interest but the marginal rate of return. Using the market rate of interest as discount rate is indeed a very special case, as it is based on the assumption of perfect capital market. Seen in this light the author's exposition of this issue is considered to be inadequate. So is the case with his treatment of other issues such as 100% reserves (p. 46, para 3), *Murabaha* (p. 137, para 2), *Bai Mu'ajjal* (p. 139) and investment Auctioning (p. 149, para 2).

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(1) See reviewer's article: "Indexation in an Islamic Economy: Problems and Prospects" in the *Journal of Development Studies*, vol. **iv**, 1981, Institute of Development Studies, NWFP Agricultural University, Peshawar, Pakistan.

On the rationale of Islamic banking the author's arguments against interest, based on justice, efficiency, stability and growth are refreshing. Although it helps to understand the role of profit-sharing, this chapter has *not* really presented any insights or grounds that are *new* to us. They are well-covered by various writers on the subject and includes the writings of the present reviewer in the ‘60’s and the early ‘70’s.[2] Had there been a need for further conceptual breakthrough, its key lies in the area of empirical research to establish the burden of interest via debt servicing problem or redistribution of income through loan beneficiaries (loan/aid is said to be poor man's money of the rich country transferred to the rich of the poor country). Despite difficulties, we have now reasonable data base to conduct this enquiry in the case of selected Muslim or Third World countries.

Though the author wants to answer the question ‘why’, *not* ‘how’ Islamic banking, the question ‘how’ Islamic banking is, in my view, more important and relevant to-day than ever before.

On the economics of profit-sharing the author observes that “the two ratios of profit-sharing the one between banks and depositors and the other between banks and entrepreneurs will be determined by demand and supply. The equilibrium ratios of profit-sharing will be such as to ensure a supply of savings to bank deposits sufficient to sustain a supply of investible funds to business, commensurate with the business demand, and for investible funds which will be largely a function of the expected rate of profit in productive enterprise. The expected rate of profit in the economy will play the allocative role which is supposedly played by the rate of interest in modern economies” (p. 125). This theoretical formulation supposed to be based on the notion of partial equilibrium analysis and "perfect competition" is too simple to explain the complex reality particularly in the case of Islamic enterprises having multiplicity of objectives to achieve. Perhaps neither perfect competition nor perfect co-operation models meet the goals of an Islamic economy. Other models such as an optimal mix of "supervised" competition, induced or voluntary co-operation may perhaps provide a better basis for an Islamic economy. The economics of profit-sharing is no exception.

To conclude, despite my strong reservations about the analytical contents of the book, I am inclined to say this volume provides an interesting reading material as to what is happening in the area of Islamic banking, the language is good, the style lucid and get-up excellent. I may agree to differ with the author's interpretation of ideas or his inadequate formulation of the problem, the in-depth analysis of which requires separate treatment, yet the author should be commended for producing this volume which may initiate the debate on Islamic banking.

(2) See reviewer's book: *“Islamic Economics: Theory and Practice”* (1 970), (pp. 157-170, pp. 228-230) and his other 12 to 15 papers as listed in a recent bibliography on *Literature on Islamic Economics* in English and German, compiled by a German scholar Dr. Volker Nienhaus, published by Al-Kitab Verlag, Koln, West Germany, 1980.