ISLAMIC FOREX TRADING

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1. The Basic Exchange Contracts

There is a general consensus among Islamic jurists on the view that currencies of different countries can be exchanged on a spot basis at a rate different from unity, since currencies of different countries are distinct entities with different values or intrinsic worth, and purchasing power. There also seems to be a general agreement among a majority of scholars on the view that currency exchange on a forward basis is not permissible, that is, when the rights and obligations of both parties relate to a future date. However, there is considerable difference of opinion among jurists when the rights of either one of the parties, which is same as obligation of the counterparty, is deferred to a future date.

To elaborate, let us consider the example of two individuals A and B who belong to two different countries, India and US respectively. A intends to sell Indian rupees and buy U.S dollars. The converse is true for B. The rupee-dollar exchange rate agreed upon is 1:20 and the transaction involves buying and selling of $50. The first situation is that A makes a spot payment of Rs1000 to B and accepts payment of $50 from B. The transaction is settled on a spot basis from both ends. Such transactions are valid and Islamically permissible. There are no two opinions about the same. The second possibility is that settlement of the transaction from both ends is deferred to a future date, say after six months from now. This implies that both A and B would make and accept payment of Rs1000 or $50, as the case may be, after six months. The predominant view is that such a contract is not Islamically permissible. A minority view considers it permissible. The third scenario is that the transaction is partly settled from one end only. For example, A makes a payment of Rs1000 now to B in lieu of a promise by B to pay $50 to him after six months. Alternatively, A accepts $50 now from B and promises to pay Rs1000 to him after six months. There are diametrically opposite views on the permissibility of such contracts which amount to bai-salam in currencies. The purpose of this paper is to present a comprehensive analysis of various arguments in support and against the permissibility of these basic contracts involving currencies. The first form of contracting involving exchange of countervalues on a spot basis is beyond any kind of controversy. Permissibility or otherwise of the second type of contract in which delivery of one of the countervalues is deferred to a future date, is generally discussed in the framework of riba prohibition. Accordingly we discuss this contract in detail in section 2 dealing with the issue of prohibition of riba. Permissibility of the third form of contract in which delivery of both the countervalues is deferred, is generally discussed within the framework of reducing risk and uncertainty or gharar involved in such contracts. This, therefore, is the central theme of section 3 which deals with the issue of gharar. Section 4 attempts a holistic view of the Sharia relates issues as also the economic significance of the basic forms of contracting in the currency market.

2. The Issue of Riba Prohibition

The divergence of views1 on the permissibility or otherwise of exchange contracts in currencies can be traced primarily to the issue of riba prohibition.

The need to eliminate riba in all forms of exchange contracts is of utmost importance. Riba in its Sharia context is generally defined2 as an unlawful gain derived from the quantitative inequality of the countervalues in any transaction purporting to effect the exchange of two or more species (anwa), which belong to the same genus (jins) and are governed by the same efficient cause (illa). Riba is generally classified into riba al-fadl (excess) and riba al-nasia (deferment) which denote an unlawful advantage by way of excess or deferment respectively. Prohibition of the former is achieved by a stipulation that the rate of exchange between the objects is unity and no gain is permissible to either party. The latter kind of riba is prohibited by disallowing deferred settlement and ensuring that the transaction is settled on the spot by both the parties. Another form of riba is called riba al-jahiliyya or pre-Islamic riba which surfaces when the lender asks the borrower on the maturity date if the latter would settle the debt or increase the same. Increase is accompanied by charging interest on the amount initially borrowed.

The prohibition of riba in the exchange of currencies belonging to different countries requires a process of analogy (qiyas). And in any such exercise involving analogy (qiyas), efficient cause (illa) plays an extremely important role. It is a common efficient cause (illa), which connects the object of the analogy with its subject, in the exercise of analogical reasoning. The appropriate efficient cause (illa) in case of exchange contracts has been variously defined by the major schools of Fiqh. This difference is reflected in the analogous reasoning for paper currencies belonging to different countries.

A question of considerable significance in the process of analogous reasoning relates to the comparison between paper currencies with gold and silver. In the early days of Islam, gold and silver performed all the functions of money (thaman). Currencies were made of gold and silver with a known intrinsic value (quantum of gold or silver contained in them). Such currencies are described as thaman haqiqi, or naqdain in Fiqh literature. These were universally acceptable as principal means of exchange, accounting for a large chunk of transactions. Many other commodities, such as, various inferior metals also served as means of exchange, but with limited acceptability. These are described as fals in Fiqh literature. These are also known as thaman istalahi because of the fact that their acceptability stems not from their intrinsic worth, but due to the status accorded by the society during a particular period of time. The above two forms of currencies have been treated very differently by early Islamic jurists from the standpoint of permissibility of contracts involving them. The issue that needs to be resolved is whether the present age paper currencies fall under the former category or the latter. One view is that these should be treated at par with thaman haqiqi or gold and silver, since these serve as the principal means of exchange and unit of account like the latter. Hence, by analogous reasoning, all the Sharia-related norms and injunctions applicable to thaman haqiqi should also be applicable to paper currency. Exchange of thaman haqiqi is known as bai-sarf, and hence, the transactions in paper currencies should be governed by the Sharia rules relevant for bai-sarf. The contrary view asserts that paper currencies should be treated in a manner similar to fals or thaman istalahi because of the fact that their face value is different from

their intrinsic worth. Their acceptability stems from their legal status within the domestic country or global economic importance (as in case of US dollars, for instance).

2.1. A Synthesis of Alternative Views

2.1.1. Analogical Reasoning (Qiyas) for Riba Prohibition

The prohibition of riba is based on the tradition that the holy prophet (peace be upon him) said, "Sell gold for gold, silver for silver, wheat for wheat, barley for barley, date for date, salt for salt, in same quantities on the spot; and when the commodities are different, sell as it suits you, but on the spot." Thus, the prohibition of riba applies primarily to the two precious metals (gold and silver) and four other commodities (wheat, barley, dates and salt). It also applies, by analogy (qiyas) to all species which are governed by the same efficient cause (illa) or which belong to any one of the genera of the six objects cited in the tradition. However, there is no general agreement among the various schools of Fiqh and even scholars belonging to the same school on the definition and identification of efficient cause (illa) of riba.

For the Hanafis, efficient cause (illa) of riba has two dimensions: the exchanged articles belong to the same genus (jins); these possess weight (wazan) or measurability (kiliyya). If in a given exchange, both the elements of efficient cause (illa) are present, that is, the exchanged countervalues belong to the same genus (jins) and are all weighable or all measurable, then no gain is permissible (the exchange rate must be equal to unity) and the exchange must be on a spot basis. In case of gold and silver, the two elements of efficient cause (illa) are: unity of genus (jins) and weighability. This is also the Hanbali view according to one version3. (A different version is similar to the Shafii and Maliki view, as discussed below.) Thus, when gold is exchanged for gold, or silver is exchanged for silver, only spot transactions without any gain are permissible. It is also possible that in a given exchange, one of the two elements of efficient cause (illa) is present and the other is absent. For example, if the exchanged articles are all weighable or measurable but belong to different genus (jins) or, if the exchanged articles belong to same genus (jins) but neither is weighable nor measurable, then exchange with gain (at a rate different from unity) is permissible, but the exchange must be on a spot basis. Thus, when gold is exchanged for silver, the rate can be different from unity but no deferred settlement is permissible. If none of the two elements of efficient cause (illa) of riba are present in a given exchange, then none of the injunctions for riba prohibition apply. Exchange can take place with or without gain and both on a spot or deferred basis.

Considering the case of exchange involving paper currencies belonging to different countries, riba prohibition would require a search for efficient cause (illa). Currencies belonging to different countries are clearly distinct entities; these are legal tender within specific geographical boundaries with different intrinsic worth or purchasing power. Hence, a large majority of scholars perhaps rightly assert that there is no unity of genus (jins). Additionally, these are neither weighable nor measurable. This leads to a direct conclusion that none of the two elements of efficient cause (illa) of riba exist in such exchange. Hence, the exchange can take place free from any injunction regarding the rate

of exchange and the manner of settlement. The logic underlying this position is not difficult to comprehend. The intrinsic worth of paper currencies belonging to different countries differ as these have different purchasing power. Additionally, the intrinsic value or worth of paper currencies cannot be identified or assessed unlike gold and silver which can be weighed. Hence, neither the presence of riba al-fadl (by excess), nor riba al-nasia (by deferment) can be established.

The Shafii school of Fiqh considers the efficient cause (illa) in case of gold and silver to be their property of being currency (thamaniyya) or the medium of exchange, unit of account and store of value . This is also the Maliki view. According to one version of this view, even if paper or leather is made the medium of exchange and is given the status of currency, then all the rules pertaining to naqdain, or gold and silver apply to them. Thus, according to this version, exchange involving currencies of different countries at a rate different from unity is permissible, but must be settled on a spot basis. Another version of the above two schools of thought is that the above cited efficient cause (illa) of being currency (thamaniyya) is specific to gold and silver, and cannot be generalized. That is, any other object, if used as a medium of exchange, cannot be included in their category. Hence, according to this version, the Sharia injunctions for riba prohibition are not applicable to paper currencies. Currencies belonging to different countries can be exchanged with or without gain and both on a spot or deferred basis.

Proponents of the earlier version cite the case of exchange of paper currencies belonging to the same country in defense of their version. The consensus opinion of jurists in this case is that such exchange must be without any gain or at a rate equal to unity and must be settled on a spot basis. What is the rationale underlying the above decision? If one considers the Hanafi and the first version of Hanbali position then, in this case, only one dimension of the efficient cause (illa) is present, that is, they belong to the same genus (jins). But paper currencies are neither weighable nor measurable. Hence, Hanafi law would apparently permit exchange of different quantities of the same currency on a spot basis. Similarly if the efficient cause of being currency (thamaniyya) is specific only to gold and silver, then Shafii and Maliki law would also permit the same. Needless to say, this amounts to permitting riba-based borrowing and lending. This shows that, it is the first version of the Shafii and Maliki thought which underlies the consensus decision of prohibition of gain and deferred settlement in case of exchange of currencies belonging to the same country. According to the proponents, extending this logic to exchange of currencies of different countries would imply that exchange with gain or at a rate different from unity is permissible (since there no unity of jins), but settlement must be on a spot basis.

2.1.2 Comparison between Currency Exchange and Bai-Sarf

Bai-sarf is defined in Fiqh literature as an exchange involving thaman haqiqi, defined as gold and silver, which served as the principal medium of exchange for almost all major transactions.

Proponents of the view that any exchange of currencies of different countries is same as bai-sarf argue that in the present age paper currencies have effectively and completely replaced gold and silver as the medium of exchange. Hence, by analogy, exchange involving such currencies should be governed by the same Sharia rules and injunctions as bai-sarf. It is also argued that if deferred settlement by either parties to the contract is permitted, this would open the possibilities of riba-al nasia.

Opponents of categorization of currency exchange with bai-sarf however point out that the exchange of all forms of currency (thaman) cannot be termed as bai-sarf. According to this view bai-sarf implies exchange of currencies made of gold and silver (thaman haqiqi or naqdain) alone and not of money pronounced as such by the state authorities (thaman istalahi). The present age currencies are examples of the latter kind. These scholars find support in those writings which assert that if the commodities of exchange are not gold or silver, (even if one of these is gold or silver) then, the exchange cannot be termed as bai-sarf. Nor would the stipulations regarding bai-sarf be applicable to such exchanges. According to Imam Sarakhsi4 "when an individual purchases fals or coins made out of inferior metals, such as, copper (thaman istalahi) for dirhams (thaman haqiqi) and makes a spot payment of the latter, but the seller does not have fals at that moment, then such exchange is permissible..... taking possession of commodities exchanged by both parties is not a precondition" (while in case of bai-sarf, it is.) A number of similar references exist which indicate that jurists do not classify an exchange of fals (thaman istalahi) for another fals (thaman istalahi) or gold or silver (thaman haqiqi), as bai-sarf.

Hence, the exchanges of currencies of two different countries which can only qualify as thaman istalahi can not be categorized as bai-sarf. Nor can the constraint regarding spot settlement be imposed on such transactions. It should be noted here that the definition of bai-sarf is provided Fiqh literature and there is no mention of the same in the holy traditions. The traditions mention about riba, and the sale and purchase of gold and silver (naqdain) which may be a major source of riba, is described as bai-sarf by the Islamic jurists. It should also be noted that in Fiqh literature, bai-sarf implies exchange of gold or silver only; whether these are currently being used as medium of exchange or not. Exchange involving dinars and gold ornaments, both quality as bai-sarf. Various jurists have sought to clarify this point and have defined sarf as that exchange in which both the commodities exchanged are in the nature of thaman, not necessarily thaman themselves. Hence, even when one of the commodities is processed gold (say, ornaments), such exchange is called bai-sarf.

Proponents of the view that currency exchange should be treated in a manner similar to bai-sarf also derive support from writings of eminent Islamic jurists. According to Imam Ibn Taimiya "anything that performs the functions of medium of exchange, unit of account, and store of value is called thaman, (not necessarily limited to gold & silver). Similar references are available in the writings of Imam Ghazzali5 As far as the views of Imam Sarakhshi is concerned regarding exchange involving fals, according to them, some additional points need to be taken note of. In the early days of Islam, dinars and dirhams made of gold and silver were mostly used as medium of exchange in all major

transactions. Only the minor ones were settled with fals. In other words, fals did not possess the characteristics of money or thamaniyya in full and was hardly used as store of value or unit of account and was more in the nature of commodity. Hence there was no restriction on purchase of the same for gold and silver on a deferred basis. The present day currencies have all the features of thaman and are meant to be thaman only. The exchange involving currencies of different countries is same as bai-sarf with difference of jins and hence, deferred settlement would lead to riba al-nasia.

Dr Mohamed Nejatullah Siddiqui illustrates this possibility with an example6. He writes "In a given moment in time when the market rate of exchange between dollar and rupee is 1:20, if an individual purchases $50 at the rate of 1:22 (settlement of his obligation in rupees deferred to a future date), then it is highly probable that he is , in fact, borrowing Rs. 1000 now in lieu of a promise to repay Rs. 1100 on a specified later date. (Since, he can obtain Rs 1000 now, exchanging the $50 purchased on credit at spot rate)" Thus, sarf can be converted into interest-based borrowing & lending.

2.1.3 Defining Thamaniyya is the Key ?

It appears from the above synthesis of alternative views that the key issue seems to be a correct definition of thamaniyya. For instance, a fundamental question that leads to divergent positions on permissibility relates to whether thamaniyya is specific to gold and silver, or can be associated with anything that performs the functions of money. We raise some issues below which may be taken into account in any exercise in reconsideration of alternative positions.

It should be appreciated that thamaniyya may not be absolute and may vary in degrees. It is true that paper currencies have completely replaced gold and silver as medium of exchange, unit of account and store of value. In this sense, paper currencies can be said to possess thamaniyya. However, this is true for domestic currencies only and may not be true for foreign currencies. In other words, Indian rupees possess thamaniyya within the geographical boundaries of India only, and do not have any acceptability in US. These cannot be said to possess thamaniyya in US unless a US citizen can use Indian rupees as a medium of exchange, or unit of account, or store of value. In most cases such a possibility is remote. This possibility is also a function of the exchange rate mechanism in place, such as, convertibility of Indian rupees into US dollars, and whether a fixed or floating exchange rate system is in place. For example, assuming free convertibility of Indian rupees into US dollars and vice versa, and a fixed exchange rate system in which the rupee-dollar exchange rate is not expected to increase or decrease in the foreseeable future, thamaniyya of rupee in US is considerably improved. The example cited by Dr Nejatullah Siddiqui also appears quite robust under the circumstances. Permission to exchange rupees for dollars on a deferred basis (from one end, of course) at a rate different from the spot rate (official rate which is likely to remain fixed till the date of settlement) would be a clear case of interest-based borrowing and lending. However, if the assumption of fixed exchange rate is relaxed and the present system of fluctuating and volatile exchange rates is assumed to be the case, then it can be shown that the case of riba al-nasia breaks down. We rewrite his example: "In a given moment in time when the

market rate of exchange between dollar and rupee is 1:20, if an individual purchases $50 at the rate of 1:22 (settlement of his obligation in rupees deferred to a future date), then it is highly probable that he is , in fact, borrowing Rs. 1000 now in lieu of a promise to repay Rs. 1100 on a specified later date. (Since, he can obtain Rs 1000 now, exchanging the $50 purchased on credit at spot rate)" This would be so, only if the currency risk is non-existent (exchange rate remains at 1:20), or is borne by the seller of dollars (buyer repays in rupees and not in dollars). If the former is true, then the seller of the dollars (lender) receives a predetermined return of ten percent when he converts Rs1100 received on the maturity date into $55 (at an exchange rate of 1:20). However, if the latter is true, then the return to the seller (or the lender) is not predetermined. It need not even be positive. For example, if the rupee-dollar exchange rate increases to 1:25, then the seller of dollar would receive only $44 (Rs 1100 converted into dollars) for his investment of $50.

Here two points are worth noting. First, when one assumes a fixed exchange rate regime, the distinction between currencies of different countries gets diluted. The situation becomes similar to exchanging pounds with sterlings (currencies belonging to the same country) at a fixed rate. Second, when one assumes a volatile exchange rate system, then just as one can visualize lending through the foreign currency market (mechanism suggested in the above example), one can also visualize lending through any other organized market (such as, for commodities or stocks.) If one replaces dollars for stocks in the above example, it would read as: "In a given moment in time when the market price of stock X is Rs 20, if an individual purchases 50 stocks at the rate of Rs 22 (settlement of his obligation in rupees deferred to a future date), then it is highly probable that he is , in fact, borrowing Rs. 1000 now in lieu of a promise to repay Rs. 1100 on a specified later date. (Since, he can obtain Rs 1000 now, exchanging the 50 stocks purchased on credit at current price)" In this case too as in the earlier example, returns to the seller of stocks may be negative if stock price rises to Rs 25 on the settlement date. Hence, just as returns in the stock market or commodity market are Islamically acceptable because of the price risk, so are returns in the currency market because of fluctuations in the prices of currencies.

A unique feature of thaman haqiqi or gold and silver is that the intrinsic worth of the currency is equal to its face value. Thus, the question of different geographical boundaries within which a given currency, such as, dinar or dirham circulates, is completely irrelevant. Gold is gold whether in country A or country B. Thus, when currency of country A made of gold is exchanged for currency of country B, also made of gold, then any deviation of the exchange rate from unity or deferment of settlement by either party cannot be permitted as it would clearly involve riba al-fadl and also riba al-nasia. However, when paper currencies of country A is exchanged for paper currency of country B, the case may be entirely different. The price risk (exchange rate risk), if positive, would eliminate any possibility of riba al-nasia in the exchange with deferred settlement. However, if price risk (exchange rate risk) is zero, then such exchange could be a source of riba al-nasia if deferred settlement is permitted7.

Another point that merits serious consideration is the possibility that certain currencies may possess thamaniyya, that is, used as a medium of exchange, unit of account, or store of value globally, within the domestic as well as foreign countries. For instance, US dollar is legal tender within US; it is also acceptable as a medium of exchange or unit of account for a large volume of transactions across the globe. Thus, this specific currency may be said to possesses thamaniyya globally, in which case, jurists may impose the relevant injunctions on exchanges involving this specific currency to prevent riba al-nasia. The fact is that when a currency possesses thamaniyya globally, then economic units using this global currency as the medium of exchange, unit of account or store of value may not be concerned about risk arising from volatility of inter-country exchange rates. At the same time, it should be recognized that a large majority of currencies do not perform the functions of money except within their national boundaries where these are legal tender.

Riba and risk cannot coexist in the same contract. The former connotes a possibility of returns with zero risk and cannot be earned through a market with positive price risk. As has been discussed above, the possibility of riba al-fadl or riba al-nasia may arise in exchange when gold or silver function as thaman; or when the exchange involves paper currencies belonging to the same country; or when the exchange involves currencies of different countries following a fixed exchange rate system. The last possibility is perhaps unIslamic8 since price or exchange rate of currencies should be allowed to fluctuate freely in line with changes in demand and supply and also because prices should reflect the intrinsic worth or purchasing power of currencies. The foreign currency markets of today are characterised by volatile exchange rates. The gains or losses made on any transaction in currencies of different countries, are justified by the risk borne by the parties to the contract.

2.1.4. Possibility of Riba with Futures and Forwards

So far, we have discussed views on the permissibility of bai salam in currencies, that is, when the obligation of only one of the parties to the exchange is deferred. What are the views of scholars on deferment of obligations of both parties ? Typical example of such contracts are forwards and futures9. According to a large majority of scholars, this is not permissible on various grounds, the most important being the element of risk and uncertainty (gharar) and the possibility of speculation of a kind which is not permissible. This is discussed in section 3. However, another ground for rejecting such contracts may be riba prohibition. In the preceding paragraph we have discussed that bai salam in currencies with fluctuating exchange rates can not be used to earn riba because of the presence of currency risk. It is possible to demonstrate that currency risk can be hedged or reduced to zero with another forward contract transacted simultaneously. And once risk is eliminated, the gain clearly would be riba.

We modify and rewrite the same example: "In a given moment in time when the market rate of exchange between dollar and rupee is 1:20, an individual purchases $50 at the rate of 1:22 (settlement of his obligation in rupees deferred to a future date), and the seller of dollars also hedges his position by entering into a forward contract to sell Rs1100 to be

received on the future date at a rate of 1:20, then it is highly probable that he is , in fact, borrowing Rs. 1000 now in lieu of a promise to repay Rs. 1100 on a specified later date. (Since, he can obtain Rs 1000 now, exchanging the 50 dollars purchased on credit at spot rate)" The seller of the dollars (lender) receives a predetermined return of ten percent when he converts Rs1100 received on the maturity date into 55 dollars (at an exchange rate of 1:20) for his investment of 50 dollars irrespective of the market rate of exchange prevailing on the date of maturity.

Another simple possible way to earn riba may even involve a spot transaction and a simultaneous forward transaction. For example, the individual in the above example purchases $50 on a spot basis at the rate of 1:20 and simultaneously enters into a forward contract with the same party to sell $50 at the rate of 1:21 after one month. In effect this implies that he is lending Rs1000 now to the seller of dollars for one month and earns an interest of Rs50 (he receives Rs1050 after one month. This is a typical buy-back or repo (repurchase) transaction so common in conventional banking.10

3. The Issue of Freedom from Gharar

3.1 Defining Gharar

Gharar, unlike riba, does not have a consensus definition. In broad terms, it connotes risk and uncertainty. It is useful to view gharar as a continuum of risk and uncertainty wherein the extreme point of zero risk is the only point that is well-defined. Beyond this point, gharar becomes a variable and the gharar involved in a real life contract would lie somewhere on this continuum. Beyond a point on this continuum, risk and uncertainty or gharar becomes unacceptable11. Jurists have attempted to identify such situations involving forbidden gharar. A major factor that contributes to gharar is inadequate information (jahl) which increases uncertainty. This is when the terms of exchange, such as, price, objects of exchange, time of settlement etc. are not well-defined. Gharar is also defined in terms of settlement risk or the uncertainty surrounding delivery of the exchanged articles.

Islamic scholars have identified the conditions which make a contract uncertain to the extent that it is forbidden. Each party to the contract must be clear as to the quantity, specification, price, time, and place of delivery of the contract. A contract, say, to sell fish in the river involves uncertainty about the subject of exchange, about its delivery, and hence, not Islamically permissible. The need to eliminate any element of uncertainty inherent in a contract is underscored by a number of traditions.12

An outcome of excessive gharar or uncertainty is that it leads to the possibility of speculation of a variety which is forbidden. Speculation in its worst form, is gambling. The holy Quran and the traditions of the holy prophet explicitly prohibit gains made from games of chance which involve unearned income. The term used for gambling is maisir which literally means getting something too easily, getting a profit without working for it. Apart from pure games of chance, the holy prophet also forbade actions which generated unearned incomes without much productive efforts.13

Here it may be noted that the term speculation has different connotations. It always involves an attempt to predict the future outcome of an event. But the process may or may not be backed by collection, analysis and interpretation of relevant information. The former case is very much in conformity with Islamic rationality. An Islamic economic unit is required to assume risk after making a proper assessment of risk with the help of information. All business decisions involve speculation in this sense. It is only in the absence of information or under conditions of excessive gharar or uncertainty that speculation is akin to a game of chance and is reprehensible.

3.2 Gharar & Speculation with of Futures & Forwards

Considering the case of the basic exchange contracts highlighted in section 1, it may be noted that the third type of contract where settlement by both the parties is deferred to a future date is forbidden, according to a large majority of jurists on grounds of excessive gharar. Futures and forwards in currencies are examples of such contracts under which two parties become obliged to exchange currencies of two different countries at a known rate at the end of a known time period. For example, individuals A and B commit to exchange US dollars and Indian rupees at the rate of 1: 22 after one month. If the amount involved is $50 and A is the buyer of dollars then, the obligations of A and B are to make a payments of Rs1100 and $50 respectively at the end of one month. The contract is settled when both the parties honour their obligations on the future date.

Traditionally, an overwhelming majority of Sharia scholars have disapproved such contracts on several grounds. The prohibition applies to all such contracts where the obligations of both parties are deferred to a future date, including contracts involving exchange of currencies. An important objection is that such a contract involves sale of a non-existent object or of an object not in the possession of the seller. This objection is based on several traditions of the holy prophet.14 There is difference of opinion on whether the prohibition in the said traditions apply to foodstuffs, or perishable commodities or to all objects of sale. There is, however, a general agreement on the view that the efficient cause (illa) of the prohibition of sale of an object which the seller does not own or of sale prior to taking possession is gharar, or the possible failure to deliver the goods purchased.

Is this efficient cause (illa) present in an exchange involving future contracts in currencies of different countries ? In a market with full and free convertibility or no constraints on the supply of currencies, the probability of failure to deliver the same on the maturity date should be no cause for concern. Further, the standardized nature of futures contracts and transparent operating procedures on the organized futures markets15 is believed to minimize this probability. Some recent scholars have opined in the light of the above that futures, in general, should be permissible. According to them, the efficient cause (illa), that is, the probability of failure to deliver was quite relevant in a simple, primitive and unorganized market. It is no longer relevant in the organized futures markets of today16. Such contention, however, continues to be rejected by the majority of scholars. They underscore the fact that futures contracts almost never involve delivery by both parties. On the contrary, parties to the contract reverse the transaction

and the contract is settled in price difference only. For example, in the above example, if the currency exchange rate changes to 1: 23 on the maturity date, the reverse transaction for individual A would mean selling $50 at the rate of 1:23 to individual B. This would imply A making a gain of Rs50 (the difference between Rs1150 and Rs1100). This is exactly what B would lose. It may so happen that the exchange rate would change to 1:21 in which case A would lose Rs50 which is what B would gain. This obviously is a zero-sum game in which the gain of one party is exactly equal to the loss of the other. This possibility of gains or losses (which theoretically can touch infinity) encourages economic units to speculate on the future direction of exchange rates. Since exchange rates fluctuate randomly, gains and losses are random too and the game is reduced to a game of chance. There is a vast body of literature on the forecastability of exchange rates and a large majority of empirical studies have provided supporting evidence on the futility of any attempt to make short-run predictions. Exchange rates are volatile and remain unpredictable at least for the large majority of market participants. Needless to say, any attempt to speculate in the hope of the theoretically infinite gains is, in all likelihood, a game of chance for such participants. While the gains, if they materialize, are in the nature of maisir or unearned gains, the possibility of equally massive losses do indicate a possibility of default by the loser and hence, gharar.

3.3. Risk Management in Volatile Markets

Hedging or risk reduction adds to planning and managerial efficiency. The economic justification of futures and forwards is in term of their role as a device for hedging. In the context of currency markets which are characterized by volatile rates, such contracts are believed to enable the parties to transfer and eliminate risk arising out of such fluctuations. For example, modifying the earlier example, assume that individual A is an exporter from India to US who has already sold some commodities to B, the US importer and anticipates a cashflow of $50 (which at the current market rate of 1:22 mean Rs 1100 to him) after one month. There is a possibility that US dollar may depreciate against Indian rupee during these one month, in which case A would realize less amount of rupees for his $50 (if the new rate is 1:21, A would realize only Rs1050). Hence, A may enter into a forward or future contract to sell $50 at the rate of 1:21.5 at the end of one month (and thereby, realize Rs1075) with any counterparty which, in all probability, would have diametrically opposite expectations regarding future direction of exchange rates. In this case, A is able to hedge his position and at the same time, forgoes the opportunity of making a gain if his expectations do not materialize and US dollar appreciates against Indian rupee (say, to 1:23 which implies that he would have realized Rs1150, and not Rs1075 which he would realize now.) While hedging tools always improve planning and hence, performance, it should be noted that the intention of the contracting party - whether to hedge or to speculate, can never be ascertained.

It may be noted that hedging can also be accomplished with bai salam in currencies. As in the above example, exporter A anticipating a cash inflow of $50 after one month and expecting a depreciation of dollar may go for a salam sale of $50 (with his obligation to pay $50 deferred by one month.) Since he is expecting a dollar depreciation, he may agree to sell $50 at the rate of 1: 21.5. There would be an immediate cash inflow in Rs

1075 for him. The question may be, why should the counterparty pay him rupees now in lieu of a promise to be repaid in dollars after one month. As in the case of futures, the counterparty would do so for profit, if its expectations are diametrically opposite, that is, it expects dollar to appreciate. For example, if dollar appreciates to 1: 23 during the one month period, then it would receive Rs1150 for Rs 1075 it invested in the purchase of $50. Thus, while A is able to hedge its position, the counterparty is able to earn a profit on trading of currencies. The difference from the earlier scenario is that the counterparty would be more restrained in trading because of the investment required, and such trading is unlikely to take the shape of rampant speculation.

4. Summary & Conclusion

Currency markets of today are characterized by volatile exchange rates. This fact should be taken note of in any analysis of the three basic types of contracts in which the basis of distinction is the possibility of deferment of obligations to future. We have attempted an assessment of these forms of contracting in terms of the overwhelming need to eliminate any possibility of riba, minimize gharar, jahl and the possibility of speculation of a kind akin to games of chance. In a volatile market, the participants are exposed to currency risk and Islamic rationality requires that such risk should be minimized in the interest of efficiency if not reduced to zero.

It is obvious that spot settlement of the obligations of both parties would completely prohibit riba, and gharar, and minimize the possibility of speculation. However, this would also imply the absence of any technique of risk management and may involve some practical problems for the participants.

At the other extreme, if the obligations of both the parties are deferred to a future date, then such contracting, in all likelihood, would open up the possibility of infinite unearned gains and losses from what may be rightly termed for the majority of participants as games of chance. Of course, these would also enable the participants to manage risk through complete risk transfer to others and reduce risk to zero. It is this possibility of risk reduction to zero which may enable a participant to earn riba. Future is not a new form of contract. Rather the justification for proscribing it is new. If in a simple primitive economy, it was prevention of gharar relating to delivery of the exchanged article, in todays' complex financial system and organized exchanges, it is prevention of speculation of kind which is unIslamic and which is possible under excessive gharar involved in forecasting highly volatile exchange rates. Such speculation is not just a possibility, but a reality. The precise motive of an economic unit entering into a future contract - speculation or hedging may not ascertainable (regulators may monitor end use, but such regulation may not be very practical, nor effective in a free market). Empirical evidence at a macro level, however, indicates the former to be the dominant motive.

The second type of contracting with deferment of obligations of one of the parties to a future date falls between the two extremes. While Sharia scholars have divergent views about its permissibility, our analysis reveals that there is no possibility of earning riba with this kind of contracting. The requirement of spot settlement of obligations of atleast

one party imposes a natural curb on speculation, though the room for speculation is greater than under the first form of contracting. The requirement amounts to imposition of a hundred percent margin which, in all probability, would drive away the uninformed speculator from the market. This should force the speculator to be a little more sure of his expectations by being more informed. When speculation is based on information it is not only permissible, but desirable too. Bai salam would also enable the participants to manage risk. At the same time, the requirement of settlement from one end would dampen the tendency of many participants to seek a complete transfer of perceived risk and encourage them to make a realistic assessment of the actual risk. .

Notes & References

1. These diverse views are reflected in the papers presented at the Fourth Fiqh Seminar organized by the Islamic Fiqh Academy, India in 1991 which were subsequently published in Majalla Fiqh Islami, part 4 by the Academy. The discussion on riba prohibition draws on these views.

2. Nabil Saleh, Unlawful gain and Legitimate Profit in Islamic Law, Graham and Trotman, London, 1992, p.16

3. Ibn Qudama, al-Mughni, vol.4, pp.5-9

4. Shams al Din al Sarakhsi, al-Mabsut, vol 14, pp 24-25

5. Paper presented by Abdul Azim Islahi at the Fourth Fiqh Seminar organized by Islamic Fiqh Academy, India in 1991.

6. Paper by Dr M N Siddiqui highlighting the issue was circulated among all leading Fiqh scholars by the Islamic Fiqh Academy, India for their views and was the main theme of deliberations during the session on Currency Exchange at the Fourth Fiqh Seminar held in 1991.

7. It is contended by some that the above example may be modified to show the possibility of riba with spot settlement too. "In a given moment in time when the market rate of exchange between dollar and rupee is 1:20, if an individual purchases $50 at the rate of 1:22 (settlement of his obligation also on a spot basis), then it amounts to the seller of dollars exchanging $50 with $55 on a spot basis (Since, he can obtain Rs 1100 now, exchange them for $55 at spot rate of 1:20)" Thus, spot settlement can also be a clear source of riba. Does this imply that spot settlement should be proscribed too ? The fallacy in the above and earlier examples is that there is no single contract but multiple contracts of exchange occurring at different points in time (true even in the above case). Riba can be earned only when the spot rate of 1:20 is fixed during the time interval between the transactions. This assumption is, needless to say, unrealistic and if imposed artificially, perhaps unIslamic.

8. Islam envisages a free market where prices are determined by forces of demand and supply. There should be no interference in the price formation process even by the regulators. While price control and fixation is generally accepted as unIslamic, some scholars, such as, Ibn Taimiya do admit of its permissibility. However, such permissibility is subject to the condition that price fixation is intended to combat cases of market anomalies caused by impairing the conditions of free competition. If market conditions are normal, forces of demand and supply should be allowed a free play in determination of prices.

9. Some Islamic scholars use the term forward to connote a salam sale. However, we use this term in the conventional sense where the obligations of both parties are deferred to a future date and hence, are similar to futures in this sense. The latter however, are standardized contracts and are traded on an organized Futures Exchange while the former are specific to the requirements of the buyer and seller.

10. This is known as bai al inah which is considered forbidden by almost all scholars with the exception of Imam Shafii. Followers of the same school, such as Al Nawawi do not consider it Islamically permissible.

11. It should be noted that modern finance theories also distinguish between conditions of risk and uncertainty and assert that rational decision making is possible only under conditions of risk and not under conditions of uncertainty. Conditions of risk refer to a situation where it is possible with the help of available data to estimate all possible outcomes and their corresponding probabilities, or develop the ex-ante probability distribution. Under conditions of uncertainty, no such exercise is possible. The definition of gharar, Real-life situations, of course, fall somewhere in the continuum of risk and uncertainty.

12. The following traditions underscore the need to avoid contracts involving uncertainty.

Ibn Abbas reported that when Allah's prophet (pbuh) came to Medina, they were paying one and two years advance for fruits, so he said: "Those who pay in advance for any thing must do so for a specified weight and for a definite time".

It is reported on the authority of Ibn Umar that the Messenger of Allah (pbuh) forbade the transaction called habal al-habala whereby a man bought a she-camel which was to be the off-spring of a she-camel and which was still in its mother's womb.

13. According to a tradition reported by Abu Huraira, Allah's Messenger (pbuh) forbade a transaction determined by throwing stones, and the type which involves some uncertainty.

The form of gambling most popular to Arabs was gambling by casting lots by means of arrows, on the principle of lottery, for division of carcass of slaughtered animals. The carcass was divided into unequal parts and marked arrows were drawn from a bag. One

received a large or small share depending on the mark on the arrow drawn. Obviously it was a pure game of chance.

14. The holy prophet is reported to have said " Do not sell what is not with you"

Ibn Abbas reported that the prophet said: "He who buys foodstuff should not sell it until he has taken possession of it." Ibn Abbas said: "I think it applies to all other things as well".

15. The Futures Exchange performs an important function of providing a guarantee for delivery by all parties to the contract. It serves as the counterparty in the exchange for both, that is, as the buyer for the sale and as the seller for the purchase.

16. M Hashim Kamali "Islamic Commercial Law: An Analysis of Futures", The American Journal of Islamic Social Sciences, vol.13, no.2, 1996