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Ziauddin Ahmad, Munawar Iqbal and **Fahim Khan**

Money and Banking in Islam

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Reviewed by
Medhat Hassanein
The American University, Cairo

This study is the product of a seminar entitled: "Monetary and Fiscal Economics of Islam" held in Islamabad in 1981 One may classify the deliberations of the seminar under five main headings, clearly stated by Ahmad in his insightful introduction to the volume: 1) the characteristics of Islamic economics, 2) the objectives and instruments of monetary policy in an Islamic economy, 3) the developments in the theory and practice of interest-free banking, 4) the issues of fiscal policy and 5) project evaluation in an interest-free framework and the impact on growth stability and resource allocation. The volume on *Money and Banking in Islam*, the object of this review, incorporates the first three headings.

One feature common to all the participants in the seminar is their postulation that the Islamic economy is a free enterprise economy. Accordingly, instruments of this economy can survive in the Islamic economy but they should be subjected to serious modifications whether in objectives or policies. Hence, the characteristics of Islamic economics can best be distinguished by "the absence of interest-based transactions and the presence of a properly functioning *Zakah* system." However, other ingredients of the free enterprise economy, such as production, distribution, market structure, aggregate supply, aggregate demand. employment, growth, etc. together with the prevailing institutional structure may continue to function in a similar manner in an Islamic economy.

The *zakah* system is regarded by participants in the seminar as a fundamental component of the Islamic economic order and the most important element of the social security system. This proposition invites further examination by Muslim thinkers. Islamic economic literature comprises two schools of thought when it deals with *Zakah*; one treats *Zakah* as an essential constituent of *`Ibadat*, the other school con forms with the views presented in the seminar, namely *Zakah* is a principal integrant of *Mu'amalat*. A third feature of Islamic economics commented upon by the participants is the minimum of state intervention to achieve *`Adl and Ihsan*. In modern societies, even in traditional capitalist economies, state intervention is unavoidable and is demanded and encouraged by different factions in the society. The continuous failure of market mechanisms to bring capitalist economies to desired equilibrium necessitates state intervention. A fourth characteristic of an Islamic economy is the existence of a "voluntary sector". This sector encompasses all individual and social activities motivated not by material considerations but by the hope of a reward in the Hereafter. This voluntary sector is a blend of ethics and economics. One may question however, how this sector can be integrated into the other well-known sectors i.e. the private and the public sectors.

M. Umer Chapra presented the first paper to the seminar: "Monetary Policy in an Islamic Economy". In it Chapra stated that the goals of monetary policy in an Islamic economy should be:

"1. Economic well-being with full employment and optimum rate of economic growth;

2. Socio-economic justice and equitable distribution of income and wealth; and

3. 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." (p.22)

To achieve these objectives Chapra suggested the following set of monetary policy instruments for the Islamic economy: a) target growth in M and Mo, b) public share of 25 percent of demand deposits, c) a statutory reserve requirement of 10-20 percent, d) credit ceilings on commercial bank credit, and e) value-oriented allocation of credit. The first three instruments aim at enhancing the central bank's authority to control the expansion in high-powered money. The last two instruments determine the appropriate amount of credit and its allocation to lead to optimum production and distribution of goods and services and to allocate the benefit of credit among an optimum number of businesses. The discount rate instrument is excluded entirely from the set of monetary policy instruments since interest is abolished from the Islamic economy.

The instruments Chapra suggested are not alien to a free enterprise system, with the exception of the public share of 25 percent of demand deposits. This instrument seems theoretically attractive, but one tends to doubt its effectiveness for achieving the objectives stated in Chapra's paper. Demand deposits are short term money, thus the 25 percent that would be shared by the monetary authority could only be used to finance current deficit in the national budget not socially beneficial projects.

The objectives of monetary policy stated by Chapra fall short of what monetary policy can realize even in a capitalist society. No one can claim that monetary policy alone would bring economic well-being with full employment and optimum growth to the Islamic economy. Chapra himself realized this in his paper when he mentioned that the achievement of full employment and price stability would require fundamental reforms of the entire economic system as well as the regulation of aggregate demand, the restructuring of production, the design of suitable technology and the development of an appropriate mix of monetary, fiscal and income policies.

The second paper of part one of the first volume was presented by Ma'bid A. Al Jarhi: - "A Monetary and Financial Structure for an Interest-Free Economy: Institutions, Mechanism and Policy". In a free enterprise economy the financial institutions include the central bank, commercial banks, investment banks, specialized banks and other financial intermediaries. Al-Jarhi argued for a change of roles in the financial institutional structure of an Islamic economy. The central bank in an Islamic system would continue to set the money supply at the level which provides the maximum amount of transactions services while maintaining price stability. In free enterprise economies the central bank controls the supply of money by issuing fiat money and by operating in the open market through interest-bearing securities. Al-Jarhi proposes that the central bank open investment accounts in member banks (Central deposits or CD's) to which the central bank deposits whatever money it retires. Commercial banks would invest these deposits in the productive sector of the economy and the central bank would share the profits accrued from the central deposits. The central bank could issue certificates against the central deposits which would be sold to the public and the proceeds invested throughout the banking system.

In the interest-free system the limited role of traditional banking expands to include new roles such as direct investment, profit sharing and leasing. Al-Jarhi suggested calling these banks business banks rather than commercial banks. He also advocated a one-hundred percent reserves to change the composition of money and to leave its total supply constant. He referred to Friedman's 1959 argument to support his view. The Islamic economy according to Al-Jarhi's, paper requires new financial instruments to cope with the interest-free banking structure. In that respect, a number of these instruments appeared in his paper: Specific Investment Certificates (SICs), General Investment Certificates (GICs), Profit-Sharing Certificates (PSCs), and Leasing Certificates (LCs). All these certificates centre around the principle of profit/loss sharing rather than interest-bearing.

Part Two of the volume addresses the recent developments in the theory and practice of interest-free banking in today's world. This part comprises the Council of Islamic Ideology Report on the Elimination of Interest from the Pakistani economy, to which was appended the Interim Report of the Panel of Economists and Bankers on the Elimination of Interest. Part Two also includes M.F. Khan's paper on Islamic Banking as practiced now in the world.

On 29 September 1977, the President of Pakistan asked the Council of Islamic ideology to prepare a blue-print of an interest-free economic system. He set a time limit of three years for the elimination of interest from the Pakistani economy. Concrete actions had already been taken by the government of Pakistan on the introduction of *Zakah* and the elimination of interest from the operations of the National Investment Trust, the Investment Corporation of Pakistan and the House Building Finance Corporation. The Report is a product of the efforts of a group of dedicated persons specialized in economics, banking and *Shari'ah*.

The Report consists of an introduction, a conclusion and five sections. The introduction discusses the nature and rationale of the prohibition of *riba* in Islam. Section One deals exhaustively with practical considerations in applying the profit/loss sharing system. Section Two discusses the mechanisms for the elimination of interest from the operations of commercial banks. Section Three deals with ways and means of eliminating interest from the operations of specialized financial institutions. Section Four addresses the roles of central banking and monetary policy in an interest- free economy. The last section of the Report presents ways and means to eliminate interest from government transactions.

The Council correctly realized that the elimination of interest is not in itself an end, but a part of the overall value system in Islam. This measure alone cannot be expected to transform the entire economic system in accordance with the Islamic vision. This observation is truly phenomenal. Many Muslim scholars tend to agree that an interest-free economy is the Islamic economy. I will debate this contention and elaborate on this point in my concluding remarks. The Report emphasized another related point: remodelling the banking system on Islamic lines requires changes in the existing laws dealing with the sale of goods, mortgage, hire, lease, agency, loans, trust, partnership, etc. This indicates that the elimination of interest is only one step towards the Islamization of the economy and that other actions must follow.

The first section of the Council's Report highlighted the issues and problems and suggested a strategy for eliminating interest and implementing the profit/loss sharing system. Potential problems and issues include the maintenance of proper accounts by business enterprises, improper business practices and collusion between bank staff and clients. The Council considered a number of possible devices to replace the fixed interest system. These are: service charges, indexing bank deposits and advances, leasing, investment auctioning, *Bai Muajjal*, hire-purchase financing on the basis of a normal rate of return, time multiple counter-loans, and specical loans. The Council also agreed that under a profit/loss sharing system, *Shirakah* and *Mudarabah*, the profit sharing ratios should be regulated by the central bank. "This will reduce un healthy competition among the financial institutions and also enable the central bank to influence the allocation of resources among competing uses (p. 122)". To operate the profit/loss sharing system properly certain institutional as well as organizational reforms have to be made. Among these reforms suggested by the Council were reforming and upgrading the present auditing system in Pakistan, giving financial institutions the powers of inspection over projects and records, allowing banks to have free and unfettered discretion on acceptance or rejection of financing proposals on the basis of sound banking principles and criteria, and remodelling commercial banks' operations on the pattern of merchant banks.

The Council considered three different alternatives for eliminating interest. These were: a) set up a model bank which operates on an interest-free basis, b) prepare a comprehensive scheme and select a time for a complete switch-over to the interest free economic system, c) eliminate interest from the economy in phases. The Council considered the third alternative to be the most practical and reasonable. The Council suggested a few optional mechanisms for replacing interest in domestic banking transactions and in specialized financial institutions. The mechanism they suggested centre around the above mentioned instruments i.e. profit/loss sharing, normal rate of return, hire-purchase, leasing, and for financing fixed investment they proposed issuing a new corporate security to be called the Participation Term Certificate (PTC). PTC would allow its holders to share in the profits of the concern issuing it instead of receiving a fixed interest. The Council was with the view that the responsibilities and functions of the central bank would remain the same and that most of the monetary policy instruments would not be affected with the exception of the bank discount rate which becomes redundant under the interest-free system. The discount rate will be replaced by the central bank's power to fix profit-sharing ratios in relation to its own financial assistance to banks and other financial institutions and also the power to determine maximum and minimum profit-sharing ratios for banks according to the finances provided by them.

Concerning government transactions, the Council proposed that the borrowing requirements of the government would have to be met by the central bank on an interest-free basis. Government loans from commercial banks for financing commodity operations would be free of interest. In addition counter-financing by the central bank to commercial banks could be provided in the form of interest-free loans. I do not have any objections to the second alternative of government borrowing, but I have certain reservations concerning the first borrowing alternative. If the central bank lends directly to the government on interest-free basis, these resources will be provided by fiat money and not from institutional or household savings. As a result this type of finance would bring inflationary pressures on the Islamic economy.

Khurshid Abmad, in his comments on the Council Report, emphasized a crucial point that the "abolition of interest is not the be-all and end-all of Islamization of economy and a number of supplementary and very fundamental changes would have to be needed (p. 233)". Ahmad invited Seminar's participants to reflect and suggest whatever additional modifications are required in the functions of the monetary authorities and the financial institutions. This invitation should also be extended to all Muslim scholars to help Pakistan in her truly admirable endeavor.

The last contribution to the Seminar was a paper presented by M. Fahim Khan: "Islamic Banking as Practiced Now in the World." This paper explained the objectives of Islamic banks based on documentation and actual operation. Khan wrote: "The objective of these Islamic Banks, in general, is to promote, foster and develop the application of Islamic principles, law and tradition to the transaction of financial, banking and related business affairs and to promote investment companies (p. 260)". He explained that Islamic banks accept deposits which they can either commit to investment or general deposits. They also have investment accounts with or without authorization. Banks engage in investment activities based on *Musharakah* (equity participation) *Mudarabah* or *Qirad* (agencies), *Murabaha, Bai' Salam* (post delivery sale) and/or leasing arrangements especially for equipment. On the lending side, Islamic banks issued a number of new lending instruments such as *Al-Muqarada* profit bonds to finance large projects and *Al-Mudarabah* certificates which were not issued for specified projects. Islamic banks practice conventional short term financing on a profit/loss basis.

Khan devoted part B of his paper to what he believes are the issues facing Islamic banks such as the lack of sufficient devices to attract deposits. Khan may have not been exposed to the experience of some Islamic banking institutions such as the Kuwait Finance House (KFH), for if he had he would have known that the KFH two years ago stopped accepting deposits of less than KD 5000 ($:2000). The lack of investment opportunities and the over liquidity problem may have been some of the causes of the KFH's decision. This suggests that more research is needed on the in vestment channels than on devising tools for deposits attraction. Khan also found that Islamic banks are at a disadvantaged position vis-a-vis the interest-based banks because the former have to supervise, and in some cases manage, the projects and the enterprises they finance. These responsibilities mean an extra management burden for Islamic banks due to either the lack of proper accounts or the existence of different accounts for different purposes.

The third issue Khan identified was the reluctance of Islamic banks to finance long-term investment projects because of the long gestation period and the desire of these banks to generate profit in a shorter period of time to compete with interest-based banks. This tendency Khan believes reduces the long-run efficiency of Islamic banks. However, this practice is no longer followed by most existing Islamic banks. Many have taken equity stake and/or provided long-term finance to a number of industrial, agricultural and real estate projects.

In conclusion, the effort incorporated in the volume of "Money and Banking in Islam" deserves commendation. The distinguishing feature of this effort is the contribution of Muslim economists to the literature of Islamic economics. Previously, the principal contributors to this body of literature were non-economists mainly Muslim jurists (*Ulama*). In their writings one sees more of *Shariah* than economics. In contrast, Muslim economists in this volume present their subject in the language of specialists which without any doubt attracts the attention of other Muslim economists and opens more avenues to enrich and enhance the understanding of Islamic economics.

However, no one can deny that the theme of the argument in this invaluable volume is the Islamization of free enterprise economics, and not the Islamic system. I do not object to this approach as long as Muslim economists and social scientists realize that this is required in the transitory stage. The ultimate end would be to have an Islamic system based entirely on the principle of the unity of God (*Tawhid*). Free enterprise systems are based on the principle of the freedom of the individual. This principle is manifested in the political, social and economic systems of these societies. Democracy, right of ownership, social security, and capitalist economy are all manifestations of the basic concept of freedom of the individual or individualism.

Therefore, we will not achieve an Islamic system if we only Islamize a free enterprise economy. The Islamic system will exist if and only if we have an economic system, a social system and a political system i.e. a way of life based entirely on the fundamental principle of (*Tawhid*). Thus, as the Islamization effort continues, more attention from Muslim social scientists should be devoted to the development of the Islamic system. These efforts cannot be made individually, they must be made collectively and multidisciplinarily.