

ISLAMIC FINANCE: A WESTERN PERSPECTIVE – REVISITED

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This paper provides a critical response to the arguments presented by H. Darr and J Presley in their article respecting their understanding of the Islamico-Western approach to economics and financial issues. This paper expounds an authentically Islamic approach to the same issues raised by the mentioned authors.

1. Introduction

The paper by H. Dar and J. Presley on the above theme published in IJIFS (1:1, 2003) makes a brief detour of the area of Islamic finance and slightly of Islamic economics while attempting to invoke the need for Islamic economic and financial experts to resort to certain Western methods of study and reference in this area. The authors alert the reader to Western trends on economic theories relating to interest rate, business cycle and long and short-term volatility caused by the relationship between interest rate and monetary policy. The paper while undertaking a brief but succinct introduction to classical, neoclassical, Keynesian and neo-institutionalism views on the theme of interest rate and economic activity wants that Islamic economists and financial experts should emulate the quantitative methods being used in the Western economic tradition.

It is our arguments here that this kind of comparison and advice on equating the two approaches, and thereby, the call for adopting Western methods of analysis constitutes a flawed reasoning. Equally flawed is the authors' argument that the Qur'anic emphasis on economic matters by Islamic economists warrants an idealistic construction of a perfectly imitated world-system of the Qur'an. Farther away from this claim is the distance of prevailing Islamic socio-scientists from any substantive reference to the Qur'anic worldview. Consequently, there remains an utter vacuum regarding the construction of the Islamic phenomena vis-à-vis epistemology, the world, positivism and the ontological reconstruction of a socio-scientific normative thought, which then converts itself into positivism (Choudhury 1998). Within this broad arena dwell massive questions that span methodology, methods and both normative and positive construction in the light of the Qur'an and the Sunnah. Without this fundamental epistemological understanding there cannot be an authentic building bloc of the Islamic revolutionary paradigm of the socio-scientific worldview. Within this worldview is the embedded field of Islamic economics and finance as a subset. In the following sections, we will explain the difficulties that are encountered from the Islamic side.

2. The Epistemological *Problematique*

Problems arise both with the authors' arguments and with the general body of literature presently existing in the Islamic socio-scientific field. Such problems manifest themselves in their failure to comprehend the essentially epistemological origins of an ontological construction of theory and application. The Islamic inquiry has thus remained ambivalent to such profound questions that underlie the construction of any revolutionary theory and the worldview. Without such a fundamental invocation there cannot be a substantive theory and premise for Islamic economics and finance.

The mentioned authors have remained ambivalent to these essential and fundamental blocs of ideas and have used axiomatic inferences that do not comply with the otherwise non-optimal but simulative and learning world-system that the Qur'an presents. It is therefore incorrect to exhort that Islamic experts are to emulate the models and quantitative applications of the Western genre of empiricism. Even the field of empiricism is differently presented, interpreted and applied in the Qur'anic worldview and then too not in cognizance of a perfectly comprehended world by the human understanding but rather within a learning world-system.

The epistemological origins of the learning world-system *a la* unity of divine knowledge in the Qur'an is the central point of departure that delineates the great divide between Occidentalism and Islam and within the existing structure of thought in the Islamic scientific community. Imitation and prolonged ambivalence to the 'originary' foundations has been the main cause of the temporary life of the discipline of Islamic economics and finance.

3. Western Methodological Enigma vis-à-vis the Islamic Worldview

While we will return to this epistemological *problematique* briefly later on, it needs to be alerted here that some of the grounds of comparison of theory and application (empiricism) within the Western tradition as presented by the authors are questionable. We will selectively take up the problem of the relationship between short-term and long-term interest rate, capital formation vis-à-vis real output and money. We will examine this from the viewpoint of Western neo-institutionalism of the Austrian School *a la* Hayek and then of Keynes.

3.1. The Austrian School of Economics and Professor Fredrick Hayek on Interest, Resource Mobilization and Entrepreneurship

Hayek's *Good Money* Part I and Part II (1999) presents two kinds of economic dynamics. With respect to the allocation of money as resource over time he modifies the neoclassical idea of marginal rate of commodity substitution. Hayek (*Good Money* Part I) writes (p. 195)

.... in a state of pure barter, the exchange between goods of the same kind available at different points in time will not as a rule take place at the ratio 1:1, but according to the circumstances can take place at any other ratio, and that what happens in this case follows precisely the same rules as does the formation of the prices of two different goods.

On the side of his process-oriented institutionalism theory Hayek's idea impinges upon an entrepreneurial model of economic innovation characteristic of Schumpeter and the Austrian legacy (Schumpeter 1961). By combining these two aspects of Hayek's thought we note that the entrepreneurial model is not altogether safe of the interest rate presence that comes from the resource allocation side.

There is nothing in Hayek's thought to differentiate between the short and long run rates of interest. But from the entrepreneurial legacy of economic transformation and the full role to be played out by the market process, which Hayek champions, it is logical to deduce that the focus was on long-run interest rates. Now if money were mobilized through savings as a long-run process then the neoclassical roots of Hayek's thought would permit the prevalence of long-run rates to tie up with the process of entrepreneurial change. A contradiction occurs between Hayek's market catalysis for economic progress and the presence of a long-run rate of interest coming from the side of long-term savings.

The authors have mistakenly interpreted entrepreneurial activity in mainstream economic thinking with the condition of lower interest rate in these systems, especially as vouched by the Austrian school.

The fact of the matter is that in all of mainstream economics entrepreneurship is seen as the cause and effect of capital accumulation. This in turn is shown to take place through the route of interest rate either of the short or long run types.

Such a theory of resource mobilization is contrary to the Islamic view on the relationship between money and the real economy. It is precisely on such a well-defined causal relationship that the theory of abolition of interest rate and its productive effect on capital formation centers. Thereby, the relationship of entrepreneurship to money and real economy in the presence of interest rate is established.

3.2. John Maynard Keynes and Capital Accumulation

In Keynes too it is found how the interest question is deeply embedded in the socially unwanted element of human wellbeing. Keynes (1963, p. 369) wrote:

The love of money as a possession – as distinguished from the love of money as a means to the enjoyments and realities of life – will be recognized for what it is, a somewhat criminal, semi-pathological propensities which one hands over with a shudder to the specialists in mental disease.

Yet in Keynesian economic methodology there is no final liberation from the rate of interest. Keynes called the low-level interest rate as the low-level liquidity trap. At this level a maximum effect of the income multiplier is realized.

Although the authors tend to promote such perceptions regarding the rate of interest in mainstream economics, a substantial difference remains from the Islamic thinking on the issues. That is, no macroeconomics can be developed along lines of the Keynesian type with a liquidity trap and a consequential dynamics of the Islamic general equilibrium analysis.

4. Islamic Approach to the Resource Mobilization Theory

On the contrary, the resource mobilization problem of Islamic economics and finance depends upon a microeconomic understanding of the relationship between money and project-specific financial mobilization using co-operative instruments as pronounced by the Shari'ah in order to establish systemic unification between money and the real economy (Choudhury 1997). In this kind of formalism it is impossible to construct a negative relationship between the rate of return and output, as must otherwise be the case if we adopted the IS-curve of the Keynesian type general equilibrium analysis *a la* Hicks for Islamic general equilibrium analysis. Equally so, the relationship between the rate of return and output also remains positive.

Thereby, no Islamic equilibrium consequences in the sense of the Keynesian system can be explained when both the IS and the LM curves remain positively sloped. Likewise, no Islamic meaning can be attached to the relationship between saving and investment over the business cycle fluctuations in the light of the Keynesian general equilibrium analysis. Only in the instantaneous case of saving = investment can a resource mobilization be understood, but that too for the static case. Over the business cycle forced saving and inflationary pressure cause inequality between anticipated investment and actual saving. Now the rate of interest remains endemic in such phases of business-cycle fluctuations.

5. A Diagrammatic Explanation of the Islamic Money, Interest and Output Relation

Thus there can be no emulation of the mainstream macroeconomic ideas on money, interest rate and output for a straight transference to Islamic ideas on economics and finance. In Figure 1 we provide a schematic presentation on the Islamic relationship between money, output and interest rate as opposed to such relationships in mainstream economics. The important perspective here relates to the nature of the dynamics shown by the directions of change along the arrows. Subsequently, we configure the relationships between money, output and interest rate relative to rates of return.

To explain this difference in the light of the Shari'ah we proceed in a cursory fashion. No serious analytical explanation is invoked. The difference between mainstream economic and financial thinking is this. The presence of a knowledge dynamics that generates productivity and ethical values through unity of knowledge, as in the case of the Shari'ah, is unknown in mainstream economics. In fact, mainstream economics is not a study of a process-oriented world-system (Georgescu-Roegen 1971). The role of r/i (where r denotes the rate of return and i denotes the rate of interest) as an endogenous variable in relation to the evolving effect of M (money domain) and Q (output domain) (shown by outward evolving arrows, $\leftarrow A \text{ B} \rightarrow$) under the impact of knowledge, as in the case of the Shari'ah, is unknown in mainstream economic and social studies. The latter case is shown in Figure 1 by collapsing arrows (i.e. $C \text{ D} \phi$). More details can be found in the boxes given along with the Figure 1.

6. Conclusion

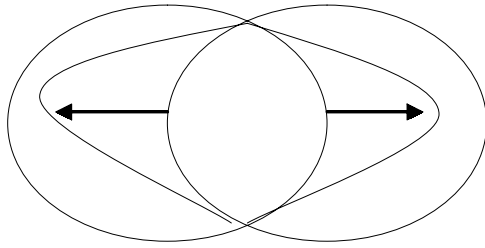
Without the fundamental theoretical premises of Islamic economic, financial and social investigations, and thereby the delineation and analysis of the emergent problems, it is incorrect to claim any kind that similar Islamic kinds of thinking regarding interest rate, real economy and social relations in mainstream economic and financial studies. The two processes and their study and consequences are fundamentally different.

We need to point out as well an inference from this brief rejoinder as Choudhury (1994, pp. 475-503) has done in earlier occasions, noting that the copying by Islamic economists and finance researchers from and of the premises of Western paradigms is not merely a fiasco; it is a non-starter for a truly Islamic economic, social and scientific thinking. Yet this is how the bulk of Islamic economics and finance has continued on to develop over long many years in utter disregard and ambivalence of the roots of the Islamic worldview. Others in this group have continued on to force deductions from the works of the scholastic Islamic scholars to fit the Western model and thought, when truly the scholastics thought about socioeconomic problems in altogether different ways (Hoque 2002) in the light of the Islamic worldview. In this regard see Oslington (2003) for a criticism of Ghazzanfar and Islahi (1990).

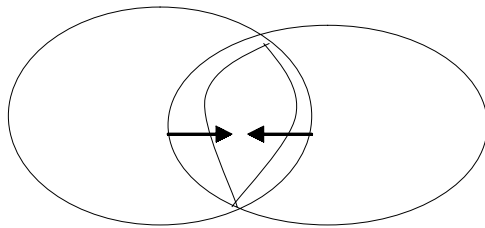
The Islamic worldview is a distinctive and unique praxis of life and thought. It emanates from the Qur'anic principle of Tawhid, meaning the Oneness of Allah and thus the Unity of Divine Knowledge (Choudhury, 2002). The Islamic world-system is established and its analytics constructed on the basis of the worldview of Tawhid and none else. There is no similitude to this worldview and as such the authors' premise regarding Islamic economics and finance is flawed.

7. References

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A denotes money domain (M); B denotes output domain (Q); C denotes interest rate domain (i); D denotes rate of return domain (r). $A \cap B$ is the interrelationship between money and output in the sense of the Shari'ah. Hence the Shari'ah effect as the effect on unity of knowledge is shown by the outward enlargement induction of this knowledge of unity between A and B.



Contrarily, the collapsing inward of the C and D sets as shown by the arrows indicate the knowledge induction on the increasing separation between the C and D domains through the causal effect generated by $A \cap B$. The limiting value is given by $C \cap D = \emptyset$ with the advancement of Shari'ah. \emptyset is the null set. The knowledge of Shari'ah is denoted by θ values.

$$M(\theta) = M(r/i, Q) \cap Q(\theta) = Q(r/i, M) \cap \theta$$

$$r/i = f(M, Q) \cap \theta$$

$$dr/di < 0; dM/dQ > 0. dr/d\theta < 0; di/d\theta < 0;$$

$$dM/d\theta < 0; dQ/d\theta < 0.$$