

Why Prevailing Framework of Islamic Banks is incoherent with philosophy of Islamic Finance and Economics?

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ABSTRACT

Purpose: To analyze and suggest solutions to overcome the limitation of current framework of Islamic Banks in providing socially constructive alternatives.

Approach: This paper is descriptive and conceptual in nature. It provides a comprehensive view of the macro-economic implications of the process adopted by prevailing Islamic Banking framework and how it has the propensity to violate some of the objective of Shariah including establishing socio-economic justice in society.

Findings: The findings of the paper suggest that by adhering to neoclassical concept of banking intuitions and limiting the scope of Shariah to only Islamize the financial products; will make it difficult to develop a healthy socio-economic environment - close to the respective ideals of Islam. The paper takes a longitudinal view on the credit-money creation aspect of the banking system and incompatibility of resulting socio-economic scenario with the objectives of Islamic Shariah (Law). It is inferred therefore that it is imperative to holistically analyze the foundations of conventional financial and economic system, in the light of Shariah, before erecting workable alternatives over the same. In order to bring about the required changes new regulatory framework for Islamic banking has to be devised, which is Shariah compliant from all aspects. Before this occurs, the paper suggests some workable ideas which may help Islamic banks to move closer to bring socio-economic justice in the society while operating within the prevailing regulatory framework.

Keywords: Islamic Banking and Finance, Islamic Economics, Business Cycle, Inflation, Unemployment, Money Multiplier, Neo classical and Post-Keynesian Economics, Financial Intermediary, Social Responsibility, Capitalism.

JEL Classification: I3, E24, E31, E32, E42, E51, E58, D63, L10, L20, P10, M14

INTRODUCTION

This paper doesn't intend to challenge the theory of Islamic Finance, but the neoclassical axioms which drive its practical implementation, and attempts to argue that neoclassical axioms keep the Islamic Banking model in contradiction with *Maqasid-al-Shariah* (Shariah Objectives), particularly with the establishment of socio-economic justice in the society.

This paper would investigate the impact of neoclassical axioms on the socio-economic impact an Islamic Bank (IB) would create. If the result is injustice in society contrary to *Maqasid-al-Shariah*, then it would be assumed that neoclassical axioms, despite existence of *Illah* (anything which renders a particular ruling applicable), are making Islamic Banking Framework (aspects beyond modes of finance) to violate some rulings of Shairah as defined in Qur'an and Sunnah¹.

This inductive reasoning is based on the claim of Al-Qur'an that if the entire socio-economic and political fabric is in compliance with the Shariah rulings then subsequently all forms of justice would prevail in that particular society (Qur'an 57:25), and vice versa. This claim is considered as a universal truth in the premise of the discussion.

Islamic Banking was founded with an objective to help Muslim population to get rid of Riba (Usmani, 2009), which is prohibited not just by Islamic Shariah (Usmani, 2001), but also by Old (Exodus 22:25; Leviticus 25:36; Leviticus 25:37; Deuteronomy 23:19; Deuteronomy 23:20) and New Testaments (Luke 19:23, Matthew 25:27, Luke 19:22-23). A part from Riba, IBF theory claims to protect its customers from speculative transaction², gambling (Ghazi, 1998), short selling or excessively risky transactions³ which may result in "dispute among parties" (Mansoori, 2008, p. 5). This is so because *Illah* of these prohibitions are specifically mentioned in Qur'an and Hadith, *Hikmah* (wisdom) being fairness and justice to all participating members (Mansoori, 2008, p. 11).

Theory of Islamic Banking and Finance exclusively focuses on eliminating the prohibited practices from transactions and replacing them with 'Shariah Compliant' alternatives. These alternatives are *Murabaha*, *Ijarah*, *Salam*, *Istisna*, *Musharakah*, *Mudarabah*, *Bai' Muajjal*, *Diminishing-Musharakah*. *Musharakah* and *Mudarabah* being the most preferred modes among these (Usmani, 2005, p. 19). However despite this, their share in the over all portfolio of Islamic Financial Industry has fallen below negligible proportions (Iqbal & Molyneux, 2005; Kuran T. , 2004; Lewis & Algaud, 2001; Yousef, 2004).

This is so because Islamic Banks are today operating in competition with interest based banks. The competition is based on same criterions which are popular in any capitalistic market. Such as profitability, stock value, market share, brand equity, geographical reach, financial stability, risk versus profit on investments (Hasan & Dridi, 2010), etc. In this scenario, modes other than *Musharakah* and *Mudarabah* can only facilitate. This is so because *Musharakah* and *Mudarabah* are more risky investments from capitalist perspective, because the bank has to share the loss (along with the profit) with the investee, in contrast with other modes such as *Murabaha* and *Ijarah* etc which yields a smooth and less risky inflow of profits (Al-Diwani, 2000). Usmani (2008, p. 3) has also noted that:

¹ It should be noted that in case any form of injustice is not easily visible then it doesn't suggest that some of Shariah rulings are still not being violated. The signs might not be visible temporarily, and may surface at a later time. So to as a precaution it is better to keep things in check against the benchmarks defined in Qur'an and Sunnah even if there isn't any visible disturbance. The same doctrine applies in preventive and breakdown maintenance of machineries, plants and equipments.

² Muslim ibn al-Hajjaj Muslim, *Sahih, Kitab al-Buyu'*, *Bab butlan Bay al-Hasat ...*, Beirut: Dar Ihya al-Turath al-Islami, Kitab al-Tijarat, no. 1513.

³ Sulayman ibn al-Ash'ath al-Sijistani Abu Dawud, Sunan, kitab al-Buyu, Bal fi bay al-Madtar, Cairo: Ihya al-Sunnah al-Nabawiyyah, 1975, no 3382, vol. 3, p.676

“This has prompted Islamic Financial Institutions to compete with their conventional counterparts in all respects, and restrict themselves to the debt-based products. In their zeal to compete conventional banks, they are trying to invent ‘Shariah compliant’ counterparts for each and every financial product available in conventional capitalist market, regardless of whether or not they are in consonance with the ethos of Islamic economy. Instead of gradual progress towards equity, the tendency is to make maximum compromises to accommodate debt- related products matching with practices of the conventional market.”

Guod (2010) also noted that “Islamic banks have generally tried to structure themselves as closely to conventional banks (for a number of reasons). The primary reasons are that the people running the bank have backgrounds in conventional banking and therefore adapt their experience in conventional banking and want to move away from conventional-type products only incrementally. The secondary reason is that almost all Islamic banks globally are regulated the same way as conventional banks and it would be difficult (if not impossible) for them to diverge significantly from the activities associated with ‘banks’ in the conventional sense.”

Khan (1997) had also point out that if the purpose of an Islamic bank is to just providing Shariah compliant service to its clients, then conventional banks can do so in better way, by opening windows for Islamic banking, why create standalone Islamic banks for just this purpose?

As a consequence of imitating their conventional counterparts and only focusing on Shariah compliance of transactional matters it should be asked the implications of this deviation from the path which could have led it to fulfill the Maqasid-al-Shariah? The result of this deviation, Asutay (2007) noted “... therefore, has been the divergence between the assumptions, normative principles and aspirations of Islamic economics as a system and Islamic finance as an instrument of that system. ... Islamic finance has been developing its own course away from the systematic understanding by finding a surrogate financial framework in neo-classical economics. This trend has disturbed the founding fathers of modern Islamic economics too, as they asked the question: ‘where Islamic finance has gone wrong?’” He further (2008) noted, “IBF [Islamic Banking & Finance], in responding to the realities of the international financial system has converged towards conventional notion of managing wealth, resulting in tensions with the foundational axioms upon which an Islamo-ethical financial system was intended to be built.”

Before it is explained the Shariah noncompliance of neoclassical axioms it is important to explain the same for Islamic-ethical financial and economic system, and the concept of resulting socio-economic justice.

AXIOMS OF ISLAMIC-ETHICAL ECONOMY

According to Qur'an one of Islam's core objectives is to establish justice in the society (Qur'an 57:25) and to develop mankind to his highest level (Iqbal M. , 1930). The term Justice hasn't also been left arbitrary in Islam, rather through out Qur'an we see numerous verses which explain what is justice and what is not (Khadduri, 1984, p. 8). Perhaps those actions which are unjust are more vividly explained (Ali M. S., 2006, pp. 355-360). Simply justice from Qur'anic perspective is when mankind obeys the laws or principles explained in Quran and Sunnah, and mankind becomes unjust on himself and others when the same is violated (Qur'an 5:44-45; 5:47-49). The concept of justice is categorized as personal, social and economic, all achieved when man submit his will to Divine commandments, at individual and collective levels (Khadduri, 1984).

When every man in a particular society would do so, an environment is developed, which in fact further allows its inhabitants to submit to divine will or fulfill their purpose of existence (Auda, 2008, p. 3); “And I did not create the jinn and mankind except to worship Me.”(Qur'an 51:56). It's is assumed to be a cyclic process. The physical manifestation of this justice isn't very

different from the general perception. The society which is developed is socially, economically and politically stable.

Once Divine guidance is obeyed the society progress toward prosperity (Qur'an 3:200; 5:35; 22:77), poverty is no where to be seen and those who qualify to receive Zakat are no where to be found (Al-Qaradawi, 1999, p. 46), cooperation is considered more sacred than single minded pursuit of self interest (Qur'an 59:9). The society would be a perfect welfare state that all lonely elderly, widows and all those incapable to earn their living would be assigned caretakers by the government (Nomani, 2004, pp. 283-285). Indeed history has seen a society which sounds utopian today. During the era of Khulfa-e-Rashideen (RAA) the epitome of Islamic Justice did exist (Ali S. A., 1924, pp. 62-63, 125-26; Aabadi, 2004, pp. 499-503).

MARKETS IN ISLAMIC ECONOMY

A market place is often considered a necessary component of every society. Each individual, institution or government have to earn and spend to fulfill their basic needs, at least. In other terms buyer and seller, debtor and creditor interact with each other in a market. The two (in most cases) parties involved, seller and buyer, have their unique interests which are often conflicting in nature. A buyer would want to spend less, and the seller would want to earn greater profit, however both bargain and mutually agree at a particular price in exchange of a particular subject matter. Conflicting rights in such a setup would bring in the question of justice, as different players in the market may pose lesser or higher bargaining power; and stronger players in this regards would assume to subdue the right of weaker players. Therefore keeping in view the criticality, Islam has indeed provided guidelines to its followers, discussed below, on how to operate a market at a micro and macro scenario.

MAN AND HIS ROLE IN MARKET

Islam views Man (or woman) having a natural tendency to become unjust (Qur'an 33:32; 14:34). However, he also has been given an ability to identify right from wrong and choose between the two (Qur'an 91:7-10). There is an incentive in this for him as well in terms of internal satisfaction (Qur'an, Surah 13:13), which is amplified with the promise of bounties in the hereafter (Ali M. S., 2006, pp. 661-686). Islam however also discourages monasticism (Qur'an 5:87-88), and requires its followers to fulfill the needs of their physical and psychological self as well; emphasis on marriage (Qur'an 24:32) and earning legitimate income (Shu'ab-ul-Emaan, Hadith: 8482), for example, is a proof.

A Muslim ought to consider his life in this world as a journey of a traveler (Bukhari Vol:8, Book:76, Hadith:425) whose destination is *Akhirah* (Bukhari Vol:8, Book:76, Hadith:427). Therefore the believers have been cautioned about things which have a tendency of shifting this balance toward the material life (Qur'an, 63:9; 3:14). Man is subservient to Al-Mighty's wish (Qur'an, 3:20; 4:65; 6:71; 22:54) therefore he may fulfill his desires only as permitted by the Al-Mighty and doesn't transgress (Qur'an 40:28; 40:34; 83:12). A Muslim trader may also perform his role in the market with the same worldview (Ahmad M. , 1999, pp. 29-39).

His worldview would oblige him to follow the commandments of the Holy Qur'an and Hadith in all his roles, including the one in the market. Therefore a Muslim trader would fulfill his contracts, agreements, promises (Qur'an 2:177; 17:34), he would not hide defects of the products he is selling (Ahmad M. , 1999, p. 116), he would not charge or pay Riba on loan or debt, he would not do speculation, or gambling, or avoid contracts with high risk which might result in dispute, he may not deceive his customers, or act fraudulently (Mansoori, 2008, pp. 5-10), he would not hoard commodities to create shortage to increase prices (Al-Qaradawi, 2001, p. 254), or he would give full quantity and would not steal (Qur'an 83:1-6), he would not charge more or less than the market value of his commodity (Ahmad M. , 1999, pp. 123-124), he would not give bribery for winning contracts (Tirmizi, Hadith:1256; Musnad Ahmad, Hadith:6490; Al-

Mu'jam Al Kabeer, Hadith: 1400), he would respect meritocracy (Ahmad M. , 1999, p. 86), he would not exploit the vulnerabilities of his seller or buyer if he enjoys a strong bargaining power (Khan M. A., 1994, p. 10), he would not sell or purchase any of those items whose consumption is prohibited or declared *haram* by Qur'an and Hadith, such as wine or alcoholic products, swine, narcotics, material which promotes vulgarity, statues or pictures of living things, or any other thing whose consumption or usage is prohibited in Islam (Mansoori, 2008, pp. 35-36). A Muslim trader would also consider cooperation superior to competition in a market place as well, if the former is more likely to bring bounties for him in hereafter (Ahmad M. , 1999, p. 38). The list of don'ts mentioned above rather define the boundaries which if crossed would make the business man guilty of injustice to others from Islamic Perspective (Qur'an 5:45).

This is a list of don'ts as prescribed by Islam and every trader who claims to be a Muslim should abide to them when operating in the market place. A part from that a Muslim trader or business man might have a habit to eliminate wastages (Qur'an 17:26-27), by making his processes or material handling techniques more and more efficient. Or he might want to continuously improve the quality of his product and services, to achieve higher and higher level of excellence; "... one should try to achieve perfection and excellence in all of our acts! It should be a constant attempt in all aspects of life: with rituals, working, relationships, etc. We need to try to implement *ihsan* [doing good with excellence] in everything we do" (Khaled, 2006). He may also prefer for his employees what he prefers for himself. He would do so because these traits are not specifically business centric in Islam, rather a Muslim should acquire them for all his roles in life. The traits may reflect personal excellence of a Muslim business man.

Majority in a particular society, whenever resort to these practices, then economic justice prevail, as was the case during the rule of Khulfa-e-Rashdeen, as mentioned above. The government may also play its role in making the 'don'ts' constitutionally illegal as well and punish those who are found guilty of transgressing the boundaries (Ali S. A., 1924, pp. 62-63). The significant symptom of prevailing justice is continuous circulation of wealth in all corners of society. If circulation is unidirectional, i.e. from the poor to the rich and economic disparity is seen increasing then it is sign that society lacks economic justice (Ahmad M. , 1999, p. 53), and actions of majority of market players are not in compliance with Shariah or enforcement of law by the government is insufficient to reduce or eradicate the unjust practices.

CONTRADICTORY REALITY

Today economic injustice, in Muslim countries and the rest of the world, is not hard to find. It is generally observed that governments are even more none serious then the general population about restoration of economic justice among most of the Muslim countries, eventually causing great suffrages to poor pockets of the society. Ahmed (2004) reports that more than half the population in 26 Muslim countries (51.5 per cent) lives on less than \$2 a day, and close to a quarter (24.6 per cent) lives on less than \$1 a day in these countries. An estimated 20 per cent of the people in the world (1.2 billion) live on \$1 a day and 46.7 per cent (2.8 billion) of them live on \$2 a day (World Bank, 2001, p. 3). The corresponding percentages of poverty for Muslim countries indicate that a relatively large percentage of the population of these countries is poor compared to world averages. Poverty in Pakistan particularly is on the rise as well and it is estimated that around 60% of the population is living below or around poverty line⁴.

⁴ The official count of poverty in 2008, which says around 22.3% of population is living under poverty (ADB, 2008), is too old to represent the present ground realities. World Bank (2007, p. 15) reported that around 67% of Pakistan population is considered vulnerable, which includes people who are already poor and those who have a more than 50% chance of falling below the poverty line in coming three years. Three years have passed since WB published its analysis; in this period Pakistan have faced sever economic recession due to various endogenous and exogenous factors, let alone the impact of recent floods on the rural economy of Pakistan, all of which having the potential to push a large number of people below the poverty line. If we assume the assessment of World Bank to be correct then it wouldn't be wrong to assume that at least 60% of Pakistani Population would be surviving below and around

All of this implies that at social, economic and political levels, Shariah rulings are being violated eventually resulting in extreme socio-economic injustice to the masses. It is beyond the scope of this paper to discuss the social and political issues responsible for contributing to a wide range of problems being faced by the masses; however the focus would remain on economic causes of poverty which is assumed to be most visible form of economic injustice.

POVERTY AND ITS ROOT CAUSE

It is difficult to estimate the horrors of poverty, unless one has faced them himself. A Hadith indicates that poverty leads to apostasy as well, henceforth Prophet Muhammad SAW himself has prayed to Allah SWT for protection from poverty⁵. Furthermore Islam has also advocated the welfare of, the poor class, to a great extent; emphasis in Quran on charitable spending is a proof (Qur'an 90:1-7). Poverty can be termed as an extreme form of social and economic injustice, presence of which in a particular society contradicts the core objectives of Islam to establish justice, as described before.

In western academic circles, there is a lot written on the subject of poverty and its causes. These causes are considered to be accidental⁶, sociological (Hunt, 1996; Wilson, 1996), economic (Feldstein, 1998; Powers, 1995; Saunders, 1992; Tobin, 1994) and even political (Pandey, Sinha, Parkash, & Tripathi, 1982; Acemoglu, 2003; Brady, 2003). Complete eradication of poverty would demand corrections in all these dimensions, however it is assumed that most significant improvements would be brought when economic and sociological solutions are coupled when implemented (Marshall & Keough, 2004, p. 8). Though for their sustainability the idea of their political support is considered debatable (Brooks & Manza, 2006), and beyond the scope of this paper.

A look will be taken on economic causes of poverty, namely unemployment and inflation. It is important to review western literature in this regards. This is because of nature of the problem within the liberal or neoclassical economic framework, whose explicit or direct critique cannot be found in sacred or historical literature of Islam, as per see. However, principle disagreement of neoclassical assumptions with Islamic philosophy would be noted in the forth coming discussion.

UNEMPLOYMENT

One of the major economic root causes of poverty is considered to lack of employment opportunities (Tobin, 1994). Rather poverty and unemployment can be assumed to be interrelated problems. It is generally observed that vicious circle of poverty in turn disables a person in various ways; a poor person is unable to purchase medical treatment for his sickness (considering medicines are not free), education for his children (considering books aren't free as well), or a place to sleep at night so as to wake up fresh in the morning. All these conditions would knock him disqualified or unfit for most jobs, which demands consistency of performance or productivity in a unforgiving marketing place. On the other hand tough competition-due to lack of employment opportunities-in the market even makes things worse for him. Too many chasing for a single job opportunity ... the relatively fittest survives (Tammone, 1995; Claeys, 2000). In rural areas the feudal lords enjoy the high profits due to dropping wage rates because of increasing surplus in supply verses demand of labors (Bardhan, 1979) where as in urban

the poverty line.

⁵ Sunan Abu Dawood, Tr. by Ahmad Hasan, Kitab Bhavan, New Delhi, India, 1990, Vol. 3, # 5071.

⁶ Here it is referred to accidental loss of property or source of sustenance, like in case of a natural disaster such as an earthquake, tsunami or flood. Technological advancement has allowed man to take preventive measures to save lives and property. However foolproof protection from natural disasters is an idea too far fetched for mankind today.

areas the poor class is an opportunity for the capitalist. Ricardo (1931) has also explained the effects of competition in the labor market on wages and its subsequent influence on poverty:

“When the market price of labor is below its natural price, the condition of the laborers is most wretched: then poverty deprives them of those comforts which custom renders absolute necessities. It is only after their privations have reduced their number, or the demand for labor has increased, that the market price of labor will rise to its natural price, and that the laborer will have the moderate comforts which the natural rate of wages will afford ... Labor is dear when it is scarce and cheap when it is plentiful.”

Unemployment on the other hand is a macro economic problem, caused by lack of investment and growth in any type of industry (Young & Pedregal, 1999; Alexiou & Pitelis, 2003; Bean, 1989). Economic recession, there takes away jobs when business couldn't think any other way to cut costs then to layoff employees which from management's point of view are unnecessary for the survival of business (Levine, 2005; Gordon R. J., 1976). This way employed gets unemployed and new jobs are difficult to find. The worst-hit are the lowest quintiles of the society (Saunders, 1992; Monea & Sawhill, 2009). Interestingly this is all done via monetary and fiscal policies to curb inflation which was hurting the low quintiles in the first place; Rowbothom (1998, pp. 27-28) observes:

" ... This method of controlling banks, inflation and money supply certainly works; it works in the way that a sledge-hammer works at carving up a roast chicken. An economy dependent upon borrowing to supply money, strapped to a financial system in which both debt and the money supply are logically bound to escalate, is punished for the borrowing it has been forced to undertake. Many past borrowers are rendered bankrupt; homes are repossessed, businesses are ruined and millions are thrown out of work as the economy sinks into recession. Until inflation and overheating are no longer deemed to be a danger, borrowing is discouraged and the economy becomes a stagnating sea of human misery. Of course, no sooner has this been done, than the problem is lack of demand, so we must reduce interest rates and wait for the consumer confidence and the positive investment climate to return. The business cycle begins all over again”.

INFLATION

Inflation is therefore another contributor to poverty (Powers, 1995). The segment of population in any quintile which is unable to grow their income and savings faster than inflation rate, it is often observed, is pushed back in real terms. In most cases this segment would be among lower quintiles of society.

The causes of inflation are many, “the complex and dynamic interactions of four groups of factors i.e., demand shocks, supply shocks, inertial factors and the political process, come together to explain inflation in any economy” (Kibritcioglu, 2002). The focus in this paper would remain on demand-pull or demand-shock inflation. This is due to alleged contribution of banks in this type.

The Milton Friedman's version of Quantity Theory of Money agrees that Demand pull Inflation is generally caused when the rate of expansion of monetary base is faster than an increase in supply of goods and services (Kibritcioglu, 2002). Gordon (1975) explains that most economists are also willing to agree that the long-run inflation is a result of monetary expansion. It is also agreed that the banks are directly involved in this expansion leading to inflation (Niggle, 1991; Bernanke & Blinder, 1988) and the phenomenon is known as money multiplier effect.

Furthermore when monetary base expands through money multiplier effect in a fractional reserve system, domestic debt is also multiplied in similar proportion rather this debt leads to

monetary expansion in the first place (Rowbothom, 1998; Lavoie, 1984). Therefore monetary-debasement is in fact a result of how money is produced in a particular society.

Before any society or its government decide to opt for monetary expansion, it is important that there be a motivation to do so. Study of monetary history tells us that irrespective of the form of money, governments or authorities had debased the currency to meet their requirements. During old times when coins were used, governments use to debase the currency by either reducing its size or adding impurity in them so that the total size of monetary base is increased and government may have additional sum of money to cover its expenses. This would also expand the monetary base leading to inflation, for example, during late 14th century in Ottoman Empire, as according to Pamuk (2003, p. 7) "... those ... held onto state power and benefited from debasements and those that stood to suffer from a sliding currency and spiraling prices". Furthermore the debasement which occurred during the Mughal rule in Indian subcontinent was also referred to as "defrauding of poor and the ignorant" by Amberkar (1947, p. 5). Al-Maqrizi (1405) has also termed an easily producible thus debase-able currency *fulus*⁷ (pp. 55-72) to be one of the root-causes of inflation, poverty, economic decline and collapse of the second Mamluk period in Egypt starting from 1382 to 1517 AD.

It is also argued that a little inflation is beneficial for the economy (Danziger, 1988; Grunwald, 2010). However if this is occurring due to monetary expansion, then it is assumed to be equivalent to debasement of currency during old times (Sussman & Zeira, 2003) whose benefit is reaped by a spenders of newly created money-belonging to the upper class or the government. This is at the cost of loss of purchasing power for those who will get this money after it is debased, as explained earlier, or the savings they already have. The ones at the losing end are the lower income groups of the society. Meera and Larbani (2009) have even declared this unwarranted transfer of purchasing power of money, in a fractional reserve banking system, as 'theft' from Islamic standpoint.

CREDIT-MONEY EXPANSION AND BUSINESS CYCLES

The idea that business cycles are a result of credit expansion is generally advocated by Austrian school of economics (Polleit, Manipulating the Interest Rate: a Recipe for Disaster, 2007), hence the name 'Austrian Business Cycle Theory' (ABCT). There are however a lot's of criticism against this theory as well. Many economists suggests that this theory is insufficient to define the phenomenon of business cycle completely, and that there are other reasons which leads to boom and bust in any given economy (Friedman, The 'Plucking Model' of Business Fluctuations Revisited, 1993; Tullock, 1988; Caplan, 2008; Krugman, 1998). That's said however despite inherent imperfection of this theory the empirical evidence which significantly correlates the 'Credit Money' expansion by banks and 'Inflation' is too obvious to be ignored (King, 2001; Polleit, 2005; Roffia & Zaghini, 2007; Hasan M. S., 1999; Benati, 2005). This is the point of concern of this discussion due the implication it holds for Islamic Banks.

Therefore in contemporary scenario banks, if not entirely but to significant extent are allowed by the central banks to contribute to the problem of inflation during economic boom. This occurs when they are on a spree to increase their profits, market share (Cetorelli & Gambera, 2001) via expanding their total credit base. This is said because of the marketing activities done by the banks⁸ to sell their financial products during economic boom (Kim J. , 2010; Lee, 2010;

⁷ Coins of copper used as a loose change of silver or gold coins

⁸ It is assumed that that demand of any product become a reason for its supply. This assumption implies that Cigarettes are sold because there is a market demand for it, wine is sold because there is market demand for it, similarly, junk food, drugs, pornography are sold because of the same reason. It is however ignored that a business firm today has a potential to create its demand through manipulative advertising, marketing or Public Relation campaigns to sell products or services which they might not need. Edward Burney, nephew of Sigmund Freud mastered the use of emotionally manipulative ways to transform social behavior, hence showed how business firm and governments can manipulate masses as per their interests. During 1920 Burney's experiment to convince the

Atkinson, 1992) and retain their customer base during recession (Elliott, 2008; Monks, 2009). In a capitalistic market if profit motive derives every business to expand and grow, then banks shouldn't be an exception.

After credit expansion, when inflationary trends become disturbing, the monetary and fiscal policies are tightened which eventually leads to unemployment as already discussed. *Zulm* (injustice) thus never ends; only changes its form, during the entire business cycle.

In this scenario it should be asked, what social responsibility banks hold's during the entire business cycle? Should the Banks blindly strive to expand their credit base without considering its inflationary effects? Is it just the sole responsibility of the Central Bank to pull the strings on banks or loose it during different phases of a business cycle? Would Islamic Banks also perform blindly, focusing solely on their commercial objectives, assuming themselves to be only answerable to central banks? It can be said that any form of corporation cannot have limited liability from Islamic perspective because if Muslims are running the show of any corporation including banks, they would know that Allah SWT will eventually hold them accountable for their deeds, if not in this world, then in hereafter (Al-Qur'an 99:8).

ISLAMIC BANKS AND MONEY MULTIPLICATION

Islamic Banking is operating in compliance with neo-classical school of economics (Asutay, 2007; Siddiqi, Islamic Finance and Beyond - Premises and Promises of Islamic Economics, 1999; Kuran T. , 1995). Subsequently theory of Islamic Banking assumes that a bank is simply an organization which takes investments from one side and invests on the other. The investors are called depositors, and the creditors are their clients or customers. In conventional banks the creditor gets a loan with an interest or markup against collateral, which the creditor may use for personal or commercial purpose. IBF further assumes that if the relationship between the bank and the customer is established on the basis of Shariah complaint means such as *Murabaha*, *Ijarah*, *Bai' Muajjal*, *Istisna*, *Salam*, Diminishing *Musharakah*, *Musharakah* or *Mudarabah*, instead on the basis of an interest based contract then Banks will eventually perform a socially beneficial function such as providing large sums of money for giant projects (Kaleem, 2008; Usmani, 2009).

Banks in reality are more than that, due to their Fractional Reserve System, as they create credit-money as already discussed. Islamic Banks are also no different in this regards (Meera & Larbani, 2004; Zubair & Abbas, 1987, p. 4). The Central Banks require them to operate on this system, i.e. by maintaining Statutory Liquidity and Cash Reserve Requirements (SBP, 2008). Furthermore the balance sheets of Islamic Banks clearly show that the total cash they carry is only a fraction of their total liabilities and deposits. In a report to State Bank of Pakistan a consolidated balance sheet showed that the total cash was Rs. 15.2 billion verses total deposits of Rs. 83.7 billion and total liabilities of Rs. 102.3 billion (Ahmad & Baloch, 2007).

Usmani (2001) also have acknowledged the unwarranted expansion of credit-money by conventional banks through their Fractional reserve system hence have accepted the contribution of banks to monetary debasement and inflation, but he later argued (2005, pp. 21-22) that the problem of "artificial ... money supply ... multiplied without creating real asset in the same quantity" can be solved via Islamic Banking because it is "... backed by asset, [therefore] it [money supply] is always matched with corresponding goods and services".

The claim stated above asserts that credit-money creation done by Islamic banks is productive or non-inflationary or will no cause debasement of currency and this would be so despite

women to smoke by symbolizing cigarettes as 'torches of freedom' is just one example. His experiments of were based on Freud's theory that humans are governed by irrational forces, contrary to the widely held assumption that humans are rational beings by all economic schools (Curtis, 2002). These techniques are still commonly used today.

Islamic Banks operating on Fractional Reserve System. It is assumed to be so because for these modes presence of an asset is a necessary requirement. In other words, the claim asserts, domestic debt of an economy would be expended by Islamic Banks only when an asset is in existence which a bank would acquire before selling on Installments (*Murabaha* or *Bai' Muajjal*) or renting (*Ijarah*) to its client, or use any other modes of Islamic Finance. *Salam* or *Istisna* are exceptions with strict conditions, however in these two modes, an asset does come into existence at a future time (Usmani, 2005, pp. 189-190). Therefore money multiplication via Islamic Banks would be backed by actual asset and if all banks in an economy would resort to this then the problem of Inflation would be eliminated in totality.

IS BEING ASSET BACKED ENOUGH?

Does argument stated above imply that the impact of operations of Islamic banks on macro economic scenario will not debase the currency? It is important to ask in this perspective about the preference among Shariah compliant contracts and the type of assets which Islamic banks would deal in.

It should be noted that Shariah doesn't allow trading of *Haram* commodities (Usmani, 2005, pp. 20-21; Mansoori, 2008, pp. 35-36). However any type of property, land or building, machinery, automobiles, raw materials, office supplies, agricultural products etc may be included in Shariah approved list of assets.

During economic boom, Islamic Banks in a capitalistic market would want to compete with other banks and will eventually try to expand their customer base and as a result will create credit-money by trading in various forms of assets, subsequently increasing the amount of broad money even if the hard cash in the economy remains the same. As a result this will lead to monetary expansion, negatively affecting the purchasing power of the hard cash, or contribute a rise in CPI index, or contribute to the debasement. Since the speed of credit-money creation is always greater than its destruction in a fractional reserve system, because financing is done in lump-sum, but returned to the bank in installments; therefore Islamic Banks will also want to create credit-money continuously, due to the profit motive attached.

Another argument may be given to counter the assumption 'IBF being asset backed would not add to the inflation', is that any asset exchanges multiple hands before reaching the end users. Such as a farmer may sell his yield to the distributor, who would sell it to the wholesale market, who would then sell it to the retailer, who then finally sells it to the end user. If Shariah compliant commodity markets exist in economy, then eventually the commodities which are traded in these markets will exchange more hands than they do in a regular supply chain. Many of these exchanges may involve an Islamic financial intermediary, creating credit-money at each step, by the exchange of same unit of asset. In simpler words a single unit of asset may have a potential to create debt or broad money many times more than its original value. This may add to expansion of monetary base and push CPI upward.

ASSET-BACKED ASSUMPTION AND THE 'REAL BILLS DOCTRINE'

The assumption that if bank financing is backed by real asset is also advocated by 'Real Bills Doctrine', it assumes that "inflationary over issue is impossible provided money is issued on loans made to finance real transactions" (Humphrey, 1982, p. 4). However the various flaws in this doctrine have been explained by Humphrey (1982) while referring to Henry Thornton (1760-1815), the British banker, monetary theorist, and long-time Member of Parliament. The first of these arguments was, any unit of asset may exchange many hands and during each transaction any financial intermediary would create credit-money; "Goods ... may be sold a number of times, each sale giving rise to a real bill. Also, the period for which a given bill is customarily drawn may exceed the turnover period of goods ... In general, the volume of bills

outstanding will be ' $B = mGt$ '. Where B is the volume of bills, m their maturity, G the nominal stock of goods, and t its annual turnover rate." (p. 9).

The second argument was that the debt incurred on the manufacturer of the goods would add to the cost thus adding to the selling price, thus inflation would subsequently become an excuse for a further credit-money creation for the purchases of the respective goods. This would yet become another reason for making inflation a "vicious circle", as Thornton (1802, p. 342) described "forgot that there might be no bounds to the demand for paper; that the increasing quantity would contribute to the rise of commodities: and the rise of commodities require, and seem to justify, a still further increase."

Thirdly, Humphrey explained (p. 10), while referring to Thornton, that "... the interest [profit in case of IBs] differential, if maintained indefinitely, produces a *continuous* and not merely a *one-time* rise in money and prices. This is so, he said, because as long as the differential persists, borrowing will continue to be profitable even at successively higher price levels. The result will be more borrowing, more lending, more monetary expansion, still higher prices and so on ad infinitum in a cumulative inflationary spiral."

This suggests that just by claiming to be asset backed Islamic Banks would expand the credit-money and generate a money multiplier effect, and would subsequently contribute in debasing the currency. In other words inflationary effects of fractional reserve banking may not be curtailed by simply bringing assets based transactions. In other words by just by Islamizing the transaction may not make the banking industry compliant with Shariah standards in totality. It would be imperative for the policy makers to think beyond the transactional matter and device alternatives to fractional reserve banking due to its propensity to cause economic injustice in the society.

REASONS FOR NOT PREFERRING MUSHARAKAH AND MUDARABAH OVER OTHER MODES

Capitalistic viewpoint links risk with profitability i.e. riskier investments should yield higher profitability. *Musharakah* and *Mudarabah* are often assumed to be riskier investments then the remaining because the investor also has to share the loss along with the profit, over and above the ratio of loss is determined by the "ration of ... investment" (Usmani, 2005, p. 37). Furthermore due to their fractional reserve nature, banks cannot redeem all their deposit claims, making them more sensitive to risky investments (Al-Diwani, 2000). Additionally, Islamic banks have recently being acclaimed to be more shock resistant then conventional banks due to their asset backed financing (Hasan & Dridi, 2010), going for more riskier investments such as *Musharakah* and *Mudarabah* would therefore be against the preferences of profit seeking investors.

It can be said that even if Islamic Banks do offer *Musharakah* or *Mudarabah* option to their clients, then IBs operating with a capitalistic mindset would demand a higher percentage of profit from their clients as compare to what they would demand over other modes of finance like *Murabaha* and *Ijarah*⁹. As a result *Musharakah* and *Mudarabah* would stand less attractive for customers, making it difficult for them to decide. Instead this would make it more likely for customers to opt debt incurring modes of Islamic Finance, which would add to the cost of products and services adding to inflation. This might not be the case when financing is done via

⁹ It is assumed at this point that Islamic banks have no apprehensions to offer this mode, however in reality Islamic banks prefer to stay away from these because of the difficulties involved in knowing the correct profitability of investees, for details see Usmani, M. M. (2005). *An Introduction to Islamic Finance*. Karachi: Maktaba Ma'ariful Qur'an, p. 77. It can be assumed that during recession *Musharakah* and *Mudarabah* would remain help maintain economic justice as compare to other Islamic modes of finance, However recessionary environment is expected to subsequently make Islamic banks reluctant, due to their risk evasiveness, in using these modes because of the greater anticipation of loss over investments.

Musharakah or *Mudarabah* where there are no Installment payments, instead investor share a percentage of profit, preferably gross (Usmani, 2005, p. 77), along with any loss incurred in the business venture.

IS SPIRIT THE PROBLEM?

One of the reasons for dominance of commercialized approach in Islamic Banking industry is perhaps due to nature of the market where they have preferred to operate, a red ocean (Kim & Mauborgne, 2005) i.e. highly competitive environment of conventional banking industry. In this market higher profitability, market share, shareholders value, etc are assumed to be the determinants of success of any player, and social responsibility is seen as a public relation strategy (Friedman, 1970). In order to be identified as Islamic, Islamic Financial institutions adhere to Shariah compliant modes of finance to the extent allowed by the Central Banks. The credit creation and money multiplication function via Fractional Reserve system remains part of the Islamic banks despite its ability to produce injustice on the society, as explained above. Some scholars even claim this system, due to its ill-effects on society, is in contradiction with *Maqasid-al-Shariah* (Meera & Larbani, 2006; Siddiqi, 2009, pp. 231-237). Perhaps in order to qualify as a bank and remain competitively in the market, Islamic banks, like their conventional counterparts, have to operate on fractional reserve system, as otherwise in legal terms they would be reduced to an investment company or a standalone depository organization.

Hypothetically if in a Fractional Reserve based banking system, only the nature of transactions is Islamized, then inflationary trends would eventually materialize, as explained. During the period of economic growth, the wild pursuit of profits and market share driven by capitalistic spirit would make it possible for the inflation to rise beyond its comfortable limit. Subsequently this would steal away the purchasing power of money from the pockets of everyone in the society (Meera & Larbani, 2009), including the lower income segments who haven't even availed financial services from any bank, particularly. To curtail the inflation the central bank would eventually pull the strings by increasing markup rates or CRR etc values, eventually leading to slower economic growth, low inflation but high unemployment rates.

Some IBF experts highlight the ability of Islamic Financial Institutions to bear the shocks of global recession, when many conventional banks collapsed Islamic Banks either remained stable and even some cases retained their profitability even (Hasan & Dridi, 2010). Chaudary (2009) quoted from the speech of Muhammad Kamran Shehzad, Deputy Governor State Bank of Pakistan that "World financial crisis that resulted into taking big banks of the world in deep waters, have impacted Pakistani banking system to the extent of 2 percent to 3 percent only and Islamic Banking has remained totally safe from the impact of this crisis". That's said, however this doesn't prove that Islamic Banking at present comply with *Maqasid-al-Shariah*, fully. On the contrary "the result, therefore, has been the divergence between the assumptions, normative principles and aspirations of Islamic economics as a system and Islamic finance as an instrument of that system. ... Islamic finance has been developing its own course away from the systematic understanding by finding a surrogate financial framework in neo-classical economics. This trend has disturbed the founding fathers of modern Islamic economics too, as they asked the question: 'where Islamic finance has gone wrong?' (Asutay, 2007, p. 2).

This suggests that Islamic Finance is standing somewhere in between its western counterparts and Islamic Ideals. However in order to fulfill its responsibility of promoting and contributing to the establishment of economic justice in the society, and qualify as Islamic in true sense, Islamic Finance needs to forgo the framework which is compliant with neoclassical axioms.

Neoclassical axioms on the other hand are believed to justify greed, lust, selfishness and materialism, eventually making them the driving force of the economy. Concluding remarks of Boldemen (2007), in his book "The Cult of the Market: Economic Fundamentalism and its Discontent", explicitly declares that neo-classical paradigm is taking mankind away from where Divine instructions want him to be, he says:

"... It is greed that also represents one of the prime threats to our civilization; economic fundamentalism is an ideology that attempts to justify that greed. In particular, it promotes selfishness and materialism. ... Consequently, economic fundamentalism is a significant threat to our civilization. Its application to public decisions cannot be reconciled with the ethical import of our cultural heritage, with its Christian [...even Islamic] underpinnings, its command to love God and to love one's neighbor as oneself. Nor can it be reconciled with other religious traditions, including Buddhism, with its calls for compassion and detachment. Taking something that is good—such as rational thought, or economic analysis, or markets, or human rights, or liberty, or law, or money, or consumption—and turning it into an absolute is the essence of a new idolatry."

If this is so then how come Islamic finance may seek to fulfill its objectives or *Maqasid-al-Shariah*, by driving its operations with a banking framework subservient to neoclassical axioms?

IF SPIRIT IS CORRECTED, THEN WHAT?

In order for a matter, related with public dealing, to be Shariah compliant, its form has to in compliance with Shariah instead of its spirit. If its form is in compliance with Shariah, then it is assumed, that matter will subsequently produce socio economic justice for all stakeholders, and at collective level. Further it is assumed that if Spirit or *Niy'at* (Intention) is also in compliance with Shariah then participants will get its benefit in hereafter or judgment day as well, furthermore such a spirit will bring in excellence in Shariah compliance of the respective activity.

As described earlier the author is not in disagreement in Shariah compliance of the form of the modes of finance used by the IBs to fulfill the requirement of its customers. It is the bank's influence on monetary expansion through its Fractional Reserve System, which is being questioned by the author. The Fractional Reserve System, which all IBs are obliged to follow due to Central Banks policies, even if unwilling, makes the remaining part of the framework or the form of the system non-compliance with Shariah due to its propensity to contribute in economic injustice in society as explained earlier, eventually going against *Maqasid-al-Shariah*.

To clarify again, socio-economic justice could be the wisdom behind the Shariah rulings, not it's *Illah*. However contribution of IBs operation on Inflation and unemployment implies that some of *Illah* of Shariah rulings are not being respected and subsequent rulings are not being followed. To make it clearly, it is not being said that Banks are solely responsible for the forms of economic injustice as explained, rather being criticized on their propensity to contribute to the problem.

IMPLICATION OF DISCUSSION ON ISLAMIC BANKS

It is suggested that if Islamic Banks would operate with capitalistic interest then their focus would steer them away from contributing in the society as per Islamic Ideals. However even if we assume that the Islamic Banks change their priorities and began promoting Ideals of Islam's socio-economic system, keeping capitalistic objectives as secondary, then the existing framework of Islamic Banking based on Fractional Reserve Banking would hinder in its way as explained earlier.

This is just like driving a conventional automobile, even in perfect condition, running on petrol or diesel, would add to pollution irrespective of how environmentally conscious its driver may be. The only option for such a driver is to abandon his vehicle and switch to the one driven by electricity rather, if he doesn't want to contribute to the problem of pollution. However if electric cars are not available or not permitted by government for any reason, then the only way is to keep the emission level as minimum as possible, by all means.

In this context if Islamic Banks are bound to follow the monetary policies of maintaining a 'Cash Reserve Requirement' (CRR) and other regulators as directed by Central Bank, or continue their Fractional Reserve Practices, then what should be the strategy of Islamic Banks to promote socio-economic justice? Following are a few suggestions, briefly explained, however detailed discussion is imperative on how these ideas would be implemented and practiced effectively.

Promote Socially Responsible and Shariah Compliant Businesses: Islamic Banks already are in practice of doing business with organizations which offer *Halal* products. However additional focus should be given on supporting firms which are involve in socially constructive or philanthropic activities, for example, by given them discounts on financial services or better return on their investments. In Pakistan such organizations are not hard to find. Almost all such firm get a tax benefit for their social spending. Islamic Banks can get records of such benefits to evaluate to the extent a firm is conscious of its social responsibility. Furthermore Islamic banks should also focus on facilitating local businesses instead of multinational ones. This is said so because of the ability of local business (which add real value to economy unlike capital markets) to contribute significantly greater to local economy as compare to multinational businesses (Civic Economics, 2002; 2008). This is only a suggestion; Islamic Banks may device other ways as well.

Along with socially conscious businesses, Islamic Banks should also encourage those firms who emphasis on promoting Islamic values among all their stake holders including employees. A Shariah compliance standard should be devised by Islamic Banks like ISO-9001 etc, in order to evaluate the degree of Shariah compliance of a particular firm. AAOIFI should play its role in devising such standards. Independent auditing firms may be established in this regards comprising of Shariah Scholars who would perform auditing of concerned business firms. This auditing firm would evaluate each activity of the firm being audited, let it be related with Human Resource Management, Marketing, Accounts, Finance, Operations, Manufacturing, Quality Control and Assurance, or Logistics etc. All firms complying with these standards may get extra leverage, relaxed terms and discounts from Islamic Banks.

Promote and Support Non-profit Islamic Microfinance Organizations: Islamic Banks are bound to give away the entire amount collected as penalties from defaulters into charity. It is believed that they do so as well. In addition to that IBs need to offer a helping hand to various non-profit or welfare organizations, offering Islamic microfinance for employment generation, operating in different capacities in different geographical regions in Pakistan and rest of the world (Allenn & Overly, 2009, pp. 13-22). Islamic Banks may offer them Interest free loans so that they may extend it to poor pockets of society. This collaboration should be made Shariah complaint though the guidance of experienced Shariah scholars. IBs may also start service to provide *Qard-e-Hasana* (Interest free loan) to the needy from their existing infrastructure as well. There are a number of organizations who may be contacted by IBs to learn about their best practices, as and when required¹⁰.

Develop Inflation Proof Investments: Gold, silver and other commodities are proven to be the best hedge against inflation (Jastram, 2009). Means should be developed for all segments, especially the lower of society to convert and secure their savings in form of gold, silver and other commodities.

Promote *Musharakah* and *Mudarabah*: Enough has already been written to express the importance of *Musharakah* and *Mudarabah* from the perspective of Islamic economics. It is a matter of intention and will for IBs to start increasing the share of investments under these modes in their portfolio of investments. IBs need to redefine their priorities and how they measure their success, Shariah scholars will have to play their due part in this change.

Change the basis of competition among Islamic Banking Industry: In conjunction to the previous point, Shariah scholars may emphasis on altering the basis of competition among

¹⁰ See Islamic Microfinance Network website: <http://imfn.org/index.php>

Islamic Banks. The best way would be to change the priorities and perceptions of customers, and positively increasing the demand of those modes such as *Musharakah* and *Mudarabah*, which are closer to Islamic ideals. Marketing and public relations department of Islamic banks may play its role in this regards. Broadly speaking instead of competing on profitability, market share etc, Islamic Banks should race each other on parameters reflective of socio-economic justice established in the society via their efforts. Such parameters could be direct and indirect employment generation¹¹, contribution to monetary expansion¹², number of Shariah complaint corporate customers etc.

CONCLUSION

As explained earlier, this paper isn't written to challenge the theory of Islamic Finance, rather the neoclassical axioms which are driving its practical implementation today. It was argued that if neoclassical axioms are not in compliance with Shariah then they will eventually contribute in socio-economic injustice in society. This paper has taken a brief look in this context and has analyzed the extent to which neo-classical economic platform disables the Islamic Finance to contribute toward its intended *Maqasid-al-Shariah*.

The result of this analysis and discussion shows that neoclassical axioms would rather create hindrance instead of facilitating Islamic Finance toward its intended objective. The reason perhaps is the impartial approach neoclassical economic ideology has taken to explain the role of banks in an economy and its influence on monetary phenomenon, or in creation and destruction of money, and its debasement. This partiality nevertheless makes neoclassical economics misfit to derive the implementation of Islamic Finance in a way that it brings about its intended objectives. Instead, the loop holes or reservation on the neoclassical thought, highlighted by various post-Keynesian and heterodox economists, should provoke the Islamic Financial experts to think twice before following the crowd of financial industry.

The propensity of neoclassical paradigms to insignificantly handle the problem of inflation and unemployment subsequently allows these problems to surface. This implies that even Islamic banking system when operated under neoclassical axioms would allow its fractional reserve nature to violate some rulings of Shariah. Which ones? To find out, a more detailed analysis in supervision of Shariah scholars would be required.

Furthermore, a holistic approach should rather be taken to device alternatives for the entire conventional financial system, not just products or modes of finance. It is the core responsibility of the Central Banks facilitate research to device such alternatives, and a moral responsibility of Bankers and Shariah Scholars to intimate the Central Banks of the respective economies in this regards.

In the existing scenario existing approach of Shariah Scholars and all concerned could only be understandable when they are clear in their understanding of the economic paradigms in question, and use the Fractional Reserve aspect of banking system either abhorrently under the doctrine of necessity due the absence of an alternative; or if it is significantly in compliance with Shariah. However, the analysis suggests that such compliance rather doesn't exist.

¹¹ Direct employment generation could be done through Qard-e-Hasana, Indirect employment generation could the result of investment in any commercial venture.

¹² Lesser the monetary expansion, the higher the banks rating in this regards.

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