# *Ribā* Versus Profit in An Exchange Economy: Conceptual Foundations for Stable Financial System in Islamic Perspectives

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*Despite the fact that an enormous research work has been conducted on this emerging field of Islamic Finance in juristic as well as economic perspectives, however, the gap between theory and practise is increasingly persisting. The crux of the problem goes to the conceptual ambiguities associated with the identifications of profit and interest in economic literature on one hand and to the diverse juristic interpretations of ribā on the other. Consequently the predominant view of equating ribā to conventional term–interest is apparently inconsistent with the axiomatic principle of trade vis-à-vis ribā, which constitutes the hardcore and raison d'être of Islamic financial system. In an attempt to amend this incoherence the present study revisits this principle and explores the essence and origin of ribā and profit in the context of exchange economy. It tries to demonstrate the inherent connection between eligibility and natural relations of exchange items. It outlines the essential features constituting conceptual borderline between profitable exchange and ribā transaction in the perspectives of relative price, resource allocation and financial stability. In the light of this conception, it envisages that the theoretical foundation and operational efficiency of Islamic finance could be significantly improved.*

## 1. Introduction

Although, the illustrative mathematical models and sophisticated form of contemporary journal articles are the preferred way of scientific communications, the nature of the present study is a desk of an audit tool of research work, based on conceptual reconstruction of the subject, with the belief that unless the fundamental conceptual problems are resolved, any well articulated model and empirical studies are most likely liable to miss the mark. It is not deniable that the existing literature on the subject is facing a highly unsettled theoretical state in both juristic deliberations and conventional economic explanations. The main source of the confusion is probably the methodological approach followed by the contemporary Muslim writers that heavily overloaded with presumed theoretical dichotomy of concentrating on *ribā* - interest equivalence with the isolation of profit concept.

The nature and originating causes of profit and interest in their separate entity have been the confusing matter commonly confronted by the economists

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throughout the history. According to classical economists these two terms are looked to be one and the same, (Sraffa, 1951). Most economists were, of the view, that the term interest is equivalent to the term of profit and explicitly used the two concepts interchangeably (Obrinsky, 1983). In more explicit terms Schumpeter (1934) documented the position of classical economists arguing that there was no separate problem of interest at all "these economists had used them; interest and profit as synonyms". On the basis of this common apprehension Schumpeter has accepted to use these terms alternatively for the same meaning.

Even in the presence of uncertainty, it is argued that the rate of interest is equivalent to the rate of profit anticipated to be certainly realized, (Fisher, 1977), The well-known Fisherian model in its simplest version predicts that there is a triple equality in every time period, where the rate of interest will be equal to the rate of time preference and the rate of profit (Dougherty, 1980). Hausman (1981) concluded in his exhaustive study on the subject that there is no reason (understandable) to distinguish between profits and interest or distinguish between the rate of profits and that of interest in the existing economic literature.

In this jungle of ambiguities and interchangeable usage of basic terms, to assert that the prohibited *ribā* in Islam is equivalent to the conventional term of interest is conceptually questionable. They may have apparently similar features, as the case of profit and *ribā*, but that does not make them to be absolutely compatibles. Thus, without going into their technical interpretations, a shallow equation of Qur'ānic concept of *ribā* to conventional interest leads only into recurring conceptual controversies and innovative stratagems in the applications of Islamic finance.

For this background, it is imperative to study the Qur'ānic approach of prohibited *ribā* in contrast to trade, in other words, *ribā* versus profit which with modest examination one can discover the underlying wisdom and economic rationale of Sharīʿah principles. To this end, this work concentrates on separation approach between *ribā* and profit, demonstrating their underpinning natural differences and economic implications, based on Sharīʿah principle of prohibition of *ribā* and permission of profit.

## 2. The Scope and Role of Exchange Economy

Exchange is considered as the central problem of economics which coordinates and adjusts consumption and production. It is the core concept of the discipline of business activity and fundamental characteristics of market economy. The widespread use of economic definition as a study of choice and scarcity focuses the central issue of the subject that justifies the recognition of economics as a science of exchange.

The term exchange in Islamic literature is usually translated as a trade or sale; however, it has a comprehensive meaning and broader applications than might be commonly thought of. It covers any economic activity that captures the connotations; replacement, substitute *bay*ʿ' (sale), trade, preference or choice. In *fiqh* context, exchange of any two kinds of benefits/utilities is known as trade. In its tangible form it is the transfer of a good/service in return for another or a commodity in exchange for money. In general comprehension of exchange we find that the holy Qur'ān used it in the sense of choice or preference "these are they who have purchased error in exchange for guidance their trade has brought them no profit" ( Qur'ān, 2:16). This broad notion of exchange is recognized as a part of human interactions rather than its traditional confinement to economic context where most of relationships between people can be interpreted as forms of exchange. It is observed that exchange is the purest and most developed kind of interaction, which shapes human life when it seeks to acquire substance and content (Simmel, 1889).

Islam places a great importance on exchange and encourages it, for exchange as we mentioned earlier is the major vehicle of generating real income. Sharīʿah wants people to be prosperous and to avail themselves of the bounties of Allah (swt), (Zarqa, 1992). Moreover, Sharīʿah considers the permissibility of this profit generating exchange or trade and the freedom to exchange as the fundamental rights of individual's choice. It is invariable rule which should not be violated except for very clear and justifiable reasons. Sharīʿah has laid down governing principles of exchange for two important purposes (i) for increasing the gains from exchange and (ii) for minimizing the costs and unnecessary possible difficulties that exchange may encounter, (Zarqa, Ibid).

## 2.1 Conceptual Foundations of Exchange

In purely objective and impersonal perspectives, exchange gives specified value to objects. The object acquires its practical value not only by being in demand for itself but through the demand for another object. Value is determined not by the relation to the demanding subject, but by the fact that this relation depends on the cost of a sacrifice which, for the other party, appears as a value to be enjoyed while the object itself appears as a sacrifice, (Simmel, 1889). However, in subjective perspective, exchange is considered as a purely human activity directed by satisfying needs and wants through substitution processes. It is a natural and a part of human nature, one to long for and desire relatively more what he does not have compared with what he possesses. What then gives the traded commodities both the common quality of exchangeability in general and specific values are nothing but the freedom and mutual acts by which their owners render them equivalently exchangeable. The socially specific wants of owners and reciprocity or coincidence of their desires is regarded as the governing factor of exchange, (Windfield, 1988).

Thus, freedom of economic activities is the essence of market economy which enables the economic agents to advance their economic goods or money in order to acquire more goods or money. Advancing an object for receiving more of it, is generally the underlying driving force of commercial activities. They can be actually exchanged only when their respective owners freely choose to trade, without any external regulations. Action is an attempt to substitute a more satisfactory state of affairs for a less satisfactory one. We call such a wilfully induced alteration, an exchange. What gratifies less is abandoned in order to attain something that pleases more. The one which is abandoned is called the price paid for the attainment of the end sought. The value of the price paid is called costs. Costs are equal to the value attached to the satisfaction which one must forego in order to attain the end aimed at. The difference between the value of the price paid (the costs incurred) and that of the goal attained is called gain or profit or net yield, (Hayek, 1939). In this context the relationship between Islamic *fiqh* and economics of exchange goes to the heart of economic theory in Islam. It is this issue which is the very central point of the economic theory of markets and prices. The idea is to allow exchange to take place on the basis of mutual willingness and just standards; Islam places a great deal of emphasis on the market and its moral principles and efficient operations.

## 2.2. Exchange Patterns and Incremental Value

Generally Islamic scholars consider profit as the result of commercial activities or increase by trading. According to their literal definition, exchange is the transfer of one commodity in return for another. It may be exchange of one commodity for another as the case of barter system or one commodity in exchange for money or even money for money, i.e., currency transaction. In this economy there may be various patterns of transactions for exchange depending on the nature of the commodity, available contractual arrangements and perhaps the relative needs of concerned parties such as; (i) exchange of one good for a particular one, (ii) exchange of a commodity/services for money, (iii) exchange of money for more money. The contemporary studies of Islamic finance classify transactions on the basis of time element associated with transactions.

Accordingly trade is divided into two main categories spot/current and deferred transactions. The former category is immediate exchange of give and take without any delay in either consideration, which is generally, in Qur'ānic terminology, referred to *tijārah ḥāḍirah*. Unlike deferred contracts, spot transactions may not require for reducing them in writing "…but if it is a transaction which ye carry on the spot among yourselves, there is no blame if ye reduce it not to writing." (Qur'ān, 2:282).

The later category is vast area of deferred transaction; three important forms of deferred transactions are (i) price deferred sale, (ii) object deferred sale and (iii) object and price deferred sale. The first two sales involve delaying in delivery of either consideration and they mostly referred to *bayʿ al-salam* and *bayʿ al-mu'ajjal* respectively. However, the third case is exceptional form of selling absent object for delayed payment. The deferred exchange as it falls under the term *al-bayʿ'* pertains to deferment in the delivery of either consideration, such as: *bayʿ al-mu'ajjal*, al-*murābaḥah*, *bayʿsalam*, *bayʿ al-istiṣnāʿ*, or both, like the case of *ijārah*, to a specified point in the future. Deferred transaction is an inseparable component of exchange activities which Sharīʿah has permitted in its general ruling principles "O you who believe when you deal with each other in transactions involving future obligations in a fixed period of time reduce them to writing. Let a scribe write down faithfully as between the parties ... If you are on a journey, and cannot find a scribe, a pledge possession may serve the purpose" (Qur'ān, 2:282). It is generally accepted the price difference between spot and deferred sale. Usually the deferred price is higher than the spot price enabling to possess and benefit from the commodity, in certain period of time. This broad spectrum of deferred transactions seems to be the predominant practical operations of Islamic financial institutions in the present time.

These patterns of exchange transactions share common basic features which determine their essential characteristics of being part of sale or *bay*ʿ. They comply with our above definition of *bay*ʿ, or exchange in general, as long as there is a mutual consent of the two parties where the seller has something to sell and purchaser is giving its price according to the market value of that thing. In other words, there is a sale, as long as, there are two things to be reciprocally transferred either immediately on a spot or with delay, over time period. For instance, in the case of renting, price is the payment value and the utility or the benefits that the consumer is to derive from it, is the intended object. Whereas one party is selling services and the other is purchasing it by giving its due price, in terms of money, commodity, or other utilities and services. This is commercial activity that can generate profit as long as the accumulated paid price is greater than costs of service provision. Nevertheless, one of the important aspects of transaction division which the contemporary studies have overlooked is dividing transactions on the basis of economic relations of exchange objects. This classifies economic dealings into two ample categories; exchange in homogeneous and heterogeneous kinds of objects. The significant of this division could be judged from the fact that the resulting physical incremental value will be essentially characterized by the natural differences of exchange objects or common instincts based on economic relations of exchangeable items.

## 3. Manifestations of *Ribā* and Profit

We have seen that exchange emerges from a desire of an individual to acquire other specified commodity belongs to another individual. The fundamental concept of earning additional income or incremental value in general is based on exchange. Profit and *ribā* possess common features in nomenclature, which may pose certain difficulties on the face of drawing conclusive economic distinctions. This is noted by Ibn Haytham stating that both *bay*ʿ (profit) and *ribā* share common attributes and individual operations of each are the same. Each one comprises a *'mu*ʿ*āwadah* (mutual exchange) of goods for goods but one of them is just permissible and perfect while the other is unlawful perverse and harmful that falls in the category of gravest sins, (Ibn Hazmi, in al-muhalla, 1982).

According to *fiqh* scholars profit is a justified increase which is usually generated through exchange of two goods while, *ribā* occurs either in the same thing or commodity to be returned with an increase. It is important to note that the most profound explanations were presented by the great jurist, al-Imam Al-Sarakhsi in clear and comprehensive manner. According to his interpretation, *ribā* is an incremental magnitude or additional value over its original principal stipulated in *bay*ʿ, (Sarakhsi, in al-Mabsut, 1324 H.). As far as, the literal interpretations of both terms are concerned, we find closely related connotations; excess, growth, increase or surplus etc. *Ribā* is regarded as an increase or excess over principal or, more precisely, a stipulated surplus on debt. In modern economic theory, profit is also seen as a surplus or residual value over contractual payments or simply the difference between revenue and costs. Even in the domain of risk and uncertainty profit is regarded as a residual value that arises from the difference between actual and expected incomes.

There is a general agreement among *fiqh* scholars that *ribā* is based on exchange or sale regardless of its nature in deferred or spot transaction. This reduces *ribā* squarely in the domain of exchange. Similarly, the available juristic teachings explain profit in its literal context as a growth or increase to a thing by trading. More technically profit is defined as the increase in the value of assets actually realized in exchange. Therefore, both *ribā* and profit are excess claims through exchange. Nevertheless, despite these closely similar features of these most confused elements we have a given revealed fact that "And Allah has permitted sale (profit) and prohibited *ribā*"(Qur'ān, 2:276). On the basis of these teachings, profit and *ribā* must be two inherently separate concepts in economic point of view with necessarily distinctive sources of origin.

## 3.1 Homogeneity versus Heterogeneity in Exchange

Examining the concept of exchange from the perspectives of economic relations of exchangeable objects, it is important to classify it into two significant categories relevant to this study namely; (i) transaction of heterogeneous objects and (ii) the transaction of homogeneous ones. While the heterogeneity in kind can be easily grasped, what the term of homogeneity means in this context may require further explanations. Due to the scarcity of studies on this division we have not come across any standard definition, however, in this connection homogeneity in kind implies (i) a similarity in species and use (ii) a similarity in qualities and price, (Nur, 1999). The relations of similarity and dissimilarity of exchange objects as it goes to the differences in the nature of their utilities derived from and market situations, it could be then attributed to purely subjective and economic matter.

The concept of exchange is applicable to both cases for what the term of exchange implies is that two things are given one for another and nothing more in both linguistic usage of the term and its technical interpretations. General meaning of exchange is applicable to reciprocal transaction of similar as well as dissimilar items irrespective of their physical nature and time of delivery, i.e., goods or services, spot or deferred. Both terms of *tijārah* (trade) and *bay*ʿ(sale) in Islam as we have mentioned above convey the meaning of exchange or trade. While the exchange of different things is normal commercial activity in which the term exchange automatically applies to, but, a mutual transference of the same object may seem to be an innovative and strange to some readers. However, closely looking into the matter, we find that this kind of transaction occupies important aspects in modern economic transactions and it is the subject matter of contemporary debates on Islamic finance. Both kinds of this particular exchange involve a reciprocal offer of identical goods, because loan transactions mean merely exchanging the present benefit for its similarity in the future.

Although this division of exchange on the basis of the economic relations of traded items is overlooked in conventional literature as well as the contemporary writings of Muslim economists, it contains extremely fascinating conceptual implications and demonstrates the essence of fundamental economic parameters, i.e., price and profit. The *aḥādīth* of the Prophet (saw) have clearly expressed that the excess or incremental value is strongly linked to the relations of the exchange items: The heterogeneity or homogeneity which is the natural characteristics of exchangeable objects is the essential yardstick differentiating between *ribā* and profit. The most popular *ḥadīth* of the Prophet (saw) in this connection is the one narrated from Ubada Ibn al-Samit stating that;

> "The messenger of Allah "said gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, like for like, equal for equal and hand to hand, if these species differ, then sell as you like, as long as it is hand to hand", (Reported by Muslim, 262 H.).

This *ḥadīth* emphasized the terms of trade in the exchange of homogenous kinds, which its conduct necessitates the transaction to take place in absolutely equal balance in terms of quality and quantity. In other words the value of the two items should be at par, so as to avoid any discrepancy that may accrue to either party. However, if the exchangeable items are different no equality required but still the condition of hand to hand is intact for preventing any uncertainty or asymmetric information. The Porphet's (pbuh) directives in the case of trading inferior date for superior one, also consolidates this view. Cautioning against that the direct exchange of homogenous kinds to contain *ribā* to the extent of quantitative or qualitative discrepancy in exchangeable items, the prophet (pbuh) directed intermediation according to the market prices to be the safe way of doing away with *ribā*.

From Abu Sa'id: Bilal brought to the Prophet, some *Barni* [good quality] dates whereupon the Prophet asked about where these dates from. Bilal replied, "I had some inferior dates which I exchanged for these - two *ṣʿā's* for a *ṣʿā*." The Prophet said, "Oh no, this is exactly *ribā*. Do not do so, but when you wish to buy, sell the inferior dates against something [cash] and then buy the better dates with the price you receive." (Reported by Muslim).

The *ḥadīth* is clear that the disproportions of the dates are prohibited through direct exchange, while the transformation of dates through intermediate object i.e., money or another commodity is not only permitted but strongly encouraged. The negation of disproportions in an exchange ratio of the same items in both quantitative and qualitative aspects is peculiar to the direct transaction of the same object. It is this issue which is the very central point of the economic theory of markets and prices. It is the fair play of market interactions that yields just prices for products.

As far as the exchange in similar objects is concerned, we find its most popular form in modern economy is loan transaction. It is the modern inter-temporal concept that reduces pure loan transaction into the domain of exchange, in line with the Bohn-Bawerk's long ago arguments. According to him;

> "The loan is nothing more nor less than a true and genuine exchange of present goods for future goods. Indeed, it represents the purest conceivable form….. I really know of nothing which is a purer and clearer embodiment of the concept of exchange in general and exchange of present for future good in particular" [Bohm-Bawerk, 1888]

The sale in identical goods seems to be a spot transaction while the case of loan transaction it represents a kind of deferred one. But in essence both cases are the same.

## 3.2 *Ribā* and Profit in Price Perspectives

In connection to price definition in this exchange context, it is to recall the raison d'être of exchange—the fact that each individual values goods and services differently by attaching relatively higher value to the good he/she gets than to the good he/she gives up. (Windfield, 1988). Hence, exchange shows the existence of double inequalities a fact which is enough to eliminate the fallacious notion - equality of value of exchange objects. Moreover, it is important to keep in mind that price serves only as a signal or symptom of exchange, but the fundamental feature of exchange is increase in satisfaction (utility) realized, (Gani, 2004).

This view immediately reveals why the prevailing theory of price is in trouble in explaining certain aspects of economic activities. For instance, if good y pays for good x then the price of x, in physical terms, is given by the ratio (y/x) not the quantity demanded of y. More interestingly, it does not sound meaningfully to express or argue that price of x is x as usually assumed in inter-temporal exchange theory. There is an obvious but unnoticed lapse of rigor in mathematical reasoning in traditional neoclassical price theory. As the price, in this regard, seem to be devoid of meaning. This definitional error of price has adverse implications on conceptual identifications of most rudimentary economic terms; rent, interest and profit.

The most simplest definition of price is manifested by the concept of relative price as one thing (usually a good) in terms of another; i.e., the ratio of two prices, which is true only in the form of interactions of exchange objects of different kinds, where the exchangeable items exhibit their values against others. The most observable fact is that objects express their exchange values reciprocally against each other, not against themselves. For an object however valuable it might be, is mute in indicating its own price, in other words the price of an article in respect to itself is equivalent to the same only and nothing more. One aspect of this transaction is attributed to qualitative difference of exchange items, for instance, if the counterparts have different characteristics, presumably due to the existence of visible qualitative disparity; neither consideration will directly indicate the exact price of the other. The concept of price loses its true sense if an object is exchanged for another of the same kind and intuitively, in this context there would not be conceivable profit. The price notion, therefore, in real or relative terms, is ineffective and irrelevant to this reciprocal exchange of the same identity and thus trading through intermediary object seems to be the necessary alternative.

Another aspect of this issue is selling the same thing in two times either through extension of its maturity or through two bargains in one contract. The popular form of this double bargaining in the same deal is *bayʿal-ʿīnah*. *Bayʿ al-ʿīnah* is generally known as sale based on the transaction of *nasi'ah* (delay). The (prospective) debtor sells to the (prospective) creditor some object for cash which is payable immediately; the debtor immediately buys simultaneously the same object for a greater amount for a future date. In this sense the seller supplies an object without intending to sell it and the buyer accepts without intention of buying it. It is simply a juristic stratagem (to achieve illegal ends through legal means) in making an impermissible transaction permissible through separating between means and ends. It is obvious that *bayʿ* al-*ʿīnah* is an obvious legal dodging devised to avert from the prohibition of *ribā* through a surrogate trade not deemed to be an act of sale, as there is a clear evidence that such an act amounts, in effect, to a contract of loan. For illustration, we may compare the following loan transaction and its extended forms in the name of sales;

- A lends B $10,000 today, B to repay $11000 in one year. All *fiqh* scholars are unanimous that this practise is a form of the forbidden *ribā* simply because it is an ordinary loan with unjustified increase.
- In two-steps-form, suppose B sells a car to A, for the cash price of $10,000. A turns around and sells the car to B for a credit price of $11,000 payable in one year. This practise is called "*bayʿal-ʿīnah*" (selling and reselling the same item in one deal).
- In further extended form, C sells a car to A, for the cash price of $10,000. A sells the car to B for the credit price of $11,000 payable in one year. B sells car to C for the cash price of $10,000. This practise is called *tawarruq* (monetization) through intermediary object.

Although, the last two hypothetical transactions contain terms of sale in essence they are loan transactions but with unnecessary costs. The primary motive of both cases is not to sell the object, as such, but to acquire a credit covered in the name of sale. What is weirder is to purchase a good in credit, so as, to sell it, in cash at lower price. The extension of intermediary goods or involved individuals may not change the nature of this transaction where the seller (buyer) remains to be the debtor (creditor) in de facto. The logical problem of this contract is that the same individual is selling and purchasing the same item with different prices in the same deal. There is an economic interest for both the borrower and the lender in entering such contract by combining two sales or more in one transaction for intention to circumvent the prohibited *ribā*. Paradoxically this innovative stratagem may lead to *ribā* with higher cost and inefficiency. The difference between the two prices cannot be profit for there is no real transformation (as we shall see later) that can generate justifiable real income. The Prophet (saw') has prohibited this transaction as narrated from Abu Hurayra that "the Prophet (saw) has prohibited two sales in one transaction, (San'ani, ibid). In another version the Prophet (saw) has said: "whoever makes two sales in one transaction should receive the principal only, otherwise, he commits *ribā*". In this connection as it may appear from its basic definition, *ribā* based transaction is clearly contradictory to basic principle of price, where value of an object in terms of itself must essentially remain the same, for it is simply two equal parts of the same object. Thus, any discrepancy to either party will be excess value which amounts to purely *ribā*, as it is based on unjustified enrichment without giving a counter value.

The classical Islamic jurists were aware of this conceptual problem as they held general consensus that *ribā* falls in the context of increase without corresponding price. More precisely it is interpreted as an increase or excess value (*faḍl*) in exchange or sale of a commodity that accrues to the owner (lender) without equivalent counter value (*ʿiwaḍ*). This is the fundamental principle that differentiates *ribā* from sale (profit), [Ibn Arabi, 1967]. Accordingly it is an exchange of one item for itself, where the selling and purchasing is taking place on the same specie of an exchangeable object. In the case of *bayʿ*', as we have mentioned earlier, where the exchangeable goods are different the concept of excess is irrelevant. Jurists, thus firmly hold this position that while *ribā* transaction has no counter value, *bayʿ* (sale) activity entails a corresponding value accordingly; this is the basic principle which separates between *ribā* and profitable trade in price perspectives.

## 4. Economic Aspects and Implications

In contrary to the concept of counter value corresponding to *ribā*, there are fewer disputes on that trade of goods and services are gainful activities. People conduct exchange due to various reasons and motives however, the most important features attribute to their natural difference such as (i) differences in endowments and abilities of producing goods and services (ii) differences in preferences or taste. These differences are considered as the fundamental vehicle of exchange and consequently the source of gain from trade. It is plausible to assert that to benefit from trade it pays to be different from the others for trading difference gives an opportunity to gain. The essential features that constitute conceptual borderline between *ribā* and profit can be consolidated in examining it in their economic implications such as; transformation, resource allocation and stability.

## 4.1 Productive Transformation versus Transference

Unlike neoclassical view of optimization, entrepreneurship is devoted to creating new wealth through transmitting resources or services and consequently bridging these differences. And by doing so it turns something of lower value into something of higher value which possible only by the action of exchange. When the same good is valued at a lower level by the current owner than by the perspective buyer as compared to a given payment, exchange allows pure gains. Exchange in its indirect form is essentially an entrepreneurial action. The mainstream body of microeconomics eventually denies the existence of gainful trade. Its core principle rests upon the view of zero profit equilibrium. Resolving this apparent contradiction between the trade model and the core idea of zero equilibrium profit, a clear distinction is to be made between allocation by an optimizer and an exchange by an entrepreneur. An optimization model totally neglects how pure profit can exist in equilibrium. Instead in exchange perspective what is very important is the relationship between a good and its payment that resulting gains to both parties. The gains from exchange comes precisely from the fact that relative prices differ across household, based on the underlying factors; endowments, tastes, technologies as well as probably geographical locations.

However, in commercial activity, although the essence of the goods does not change, the transference of the ownership over individuals gives brought to additional value which is nothing else except profit. This simplest case of profitable transformation in commercial circuit may consist of two items, two transactions, three agents (supplier, customer and trade arbitrager) and existence of an opportunity for realizing gain or profit. Profit in this sense appears to be purely subjective; it is an increase in the acting man's happiness and a psychical phenomenon that cannot be cardinally measured except through arbitraging activities of transforming part of these surplus values into original terms.

More interestingly, it is through systematic transformation of existing resources into more desirable state that more demand or use can be created. This value creating process conforms with the natural physical laws, that we are unable to create either matter or force; but we can convert those that are given (in terms of goods and services) into different form, in such a way that as many as possible rise from the realm of reality into the realm of values through exchange. Thus, both exchange and production have almost the same economic implications. Individuals feel that they have produced the objects they acquired by means of exchange. In other words, normally individuals feel that they have produced the goods they accepted in return for their services (Silver, 1989). Therefore, equating productive activity with exchange has a wide recognition in historical experience, legal treatment and linguistic usage of the terms in various human civilizations. It is predictable that producers would experience the manufacture of objects, i.e., X and its exchange as the continuation of the operational process that is a creation (acquisition) of a new object, i.e., Y. There is no conceptual inconsistency between process of exchange and productive mechanism. Our great *fiqh* scholars have recognized this fact and considered both kinds as transformation process which is necessary for generating profit. Therefore, the production process is not desired for itself, but simply is a necessary intermediate activity and complex multistage process of exchange. While, the trade is a simple direct form of exchanging produced goods, endowments or services, the production process is regarded as indirect exchange of goods and services, (Traut Rader, 1989).

Transformation is regarded as the fundamental features of trade activity and consequently profit generating mechanism. The Islamic injunctions have clearly shown that the transformation process of objects and trading of goods one for another is itself the objective matter and considered as a necessary condition for profit. Majority of the classical *fiqh* scholars are of the view that profit is from trade only and it is not called profit except what is grown through sale and purchase, (Ibn Hazm, Muhalla). However, they discussed that profit may arise either through the repetition of commercial activities by keeping the good in its original form or through transformation of the good into more valuable state. They argued that the basic motive of the *muḍārabah* contract is to generate profit and profit cannot be created except through commercial activities. In line with this view, Ibn Hazm has logically concluded that "*muḍārabah* is permissible only in trade, (Muhalla, vol.15).

In the case of production, transformation takes place in total conversion of goods from one state to another which is acknowledged as the main profit generating vehicle. Nevertheless this process does not, in general, go in conflict with the essence of the commercial activity, for trade is the culmination of transformation process intended to create more value. It is through "these processes that the commodity may fetch a higher price than its origin and consequently produce more income known as profit (Hamoud, 1985). Needless to mention that transformation requires human effort, and perhaps, that is why profit is always linked with work. In this sense, production confirms the basic features of exchange. There may no be difference, whether the transformation takes place in trading where initially a monetary asset is transformed into merchandise goods and these goods are transformed into a larger sum of money or in production process where organized efforts/services and goods (raw material) are channelled into producing (in the future) a new object. This kind of operation is virtually commercial activity, (Saleh, 1992). However, it may take in the form of transformation through production process. This would suggest that that exchange is just as productive and value creating as in the case of production itself. In both kinds of transformation process, each one is concerned with receiving goods for the price of other goods in such a way the final situation shows surplus in the form of satisfaction as compared with the situation before the action.

In contrast to the aforementioned concept of transformation, loan transaction seems to be merely transfer of resources from one point of time to another due to the inter-temporal discrepancy between demand and availability of resources. Thus, loan in essence is a reciprocal conveyance of property in two quantities of goods one of which is given as the equivalent of the other and both of which are absolutely identical except that one belongs to the present and the other to the future. As such, this transfer is inherently unable to generate additional satisfaction, for simply there is no real transformation. Thus, pure loan or *qarḍ ḥasan* as referred in *fiqh* terminology is considered as an altruistic action which is inherently not expected to create additional income. This could be grasped from the very Qur'ānic message in this connection declaring that *ribā* transaction can never be a means of growing wealth "That which you give as *ribā*, to increase the peoples' wealth, increases not with Allah…"(Qura'an 30:39). Accordingly the *fiqh* principle that "Any loan that draws benefit (utility) is one of the forms of *ribā*" is further consolidating this meaning.

This confirms the general juristic view on the sale of debts (*bayʿ al-dayn*) which does not allow such transaction unless the debt is sold on its par value. In fact, the prohibition of *bayʿ-al-dayn* is a logical consequence of the prohibition of "*ribā*" on the basis of Prophet's (saw) directives "Any loan that draws interest (additional income) is *ribā*" (San'ani, in al-Subul al- *salam*)

In principle a "debt" receivable in monetary terms corresponds to money, and every transaction where money is exchanged from the same denomination of money, the price must be at par value. Any increase or decrease in one side is tantamount to "*ribā*" which prohibited in sharīʿah. The rationale for this ruling is that financial transactions involving debt should never allow for a payment against the length of the period of the loan. For any physical discrepancy accrued to either party is possible only at the cost of the other which amounts to strictly prohibited *ribā*. This is the underlying rationale for permissibility of trade and prohibition of *ribā*. Transferences of debts created through sale of goods or through pure loan transactions are fundamentally different from real economic activities through transformation of resources from one state to another

## 4.2 *Ribā* and Profit in Consumption Perspectives

In ordinary trade transaction, two goods pay for each other. It is not possible to visualize the arbitrage process as optimization, because it is by its very character non-optimizing. The arbiter does not consume and yet he buys. He does not produce, and yet he sells. We must recognize the presence of a bargain which leads to an agreement between the buyer and the seller on price. The essence of the agreement is to find the ratio at which two goods that pay for each other are of equal value. Even in barter, one of the agents must take up the role of the arbitrageur to finalize the price. The idea that trade is gainful is the starting point for the standard presentation of the theory of trade. It is worth repeating that the gain made by the either party from the trade can be measured in two ways; firstly in terms of increase in utility by substitution and secondly in terms of increase in units of output available for consumption. However, it is not necessary for the gain to come from increased material output, but it is necessary that the utility be increased.

It is a natural fact that goods are demanded for their utilities, the satisfaction or the pleasure a consumer derives out of consumption or usage of a good or services is termed utility. Utility is the subject matter and underlying motive of all exchange activities. In Islamic teachings it is used usufruct (*manfaʿah*) long ago the word utility had appeared in the western economic literature. In modern understanding, utility is simply catch-all-term for whatever it is that makes us consume goods or services, (McKenna, 1992).

Constructing this discussion on microeconomic platform, it demonstrates an important economic insight and illustrates strong linkage between the consumption and exchange. Economists assert that individuals need to exchange because they face diminishing marginal utility in keeping single kind of stock or because of the disproportionate of their endowments, and the multi dimensional nature of their wants. Naturally individuals demand not for a bulk of the same good but for the desired proportions of basket to provide the desired level of satisfaction, (Zarqa, 1992). This principle asserts that marginal utility of a commodity diminishes with every increase in stock that one already has. It is generally accepted that as the same enjoyment continues over time, the magnitude (intensity) of pleasure continues decreasing at a specific point of time. It is human ego to have a choice or demand for variety in consumption and substitute what in his possession with others regardless of their relative costs of production and quality.

It is relevant to refer this discussion to historical example of companions of Prophet Moses (as) as the Qur'ān has preserved it (2:57,61). Reportedly after long period of using heavenly food of *manna* and *salwa* Israelis got tired of and said that they could not be content with only one kind of food. They requested for cultivated produce: such as green herbs, cucumbers, wheat, lentils and onions. They sacrificed the ready heaven meals in exchange for inferior earth products which they could achieve only through hard work of tilling the soil with toil, (Al-Razi ibid). In the light of Qur'ānic verses (2:61), Al-Imam al-Razi scholarly explained economic insights of this event. He asserted that 'in general the repetition of the same kind of food causes lose of appetite, it weakens digestion and reduces the desire or taste. On the other hand the diversity in food consumption stimulates the appetite and increases the satisfaction or utility. Hence, the substitution of one kind of a thing for another is the objective pursue of rational people' (Al-Razi Ibid,). Based on these rationalizations he concluded that as long as the demand of

Israelites is falling in this context they did not commit sin and there was no blame on them for their demand for variation of meals in particular. And this could be grasped from the given answer to their request, instead, they were directed to dwell a city/town where they could get their demand.

This reveals the wisdom of variety in Allah's bounties, the diversity of human taste and importance of exchange for human life. The cost and taste differences are underlying motivating forces of trade and business operations and both of which are naturally given factors. Where the difference in costs arises mostly from scarcity of supply or the difference of natural endowments and similarly taste is inherited character of human nature. However, the above example could be empirically tested that human preference /taste is stronger than the cost considerations. Hence, trade (transformation of utilities) is always preferable to its opposite state, as it leads to variety in consumption and consequently to increasing in welfare to concerned parties.

## 4.3 *Ribā* versus Profit in Resource Allocations

In contrast to trade which leads to prosperity and development as it is based on exchange of heterogamous basket of benefits, the exchange in homogenous kinds of goods takes us to absurd and irrational kind of economic activities. *Ribā*-based transaction, as mentioned earlier is simply selling a good in exchange of itself at higher price. Though each commodity may have different relative price with any other good, it can have only single price in respect to itself in given period of time, provided that its value content or quality remains the same in the same period. This suggests that any thing that is produced should be either consumed by the producer or sold in terms of itself with increase. For instance, if a wheat producer sells it with additional amount (*ribā*) of wheat; his stock of wheat will be increasing at the cost of the other party. Similar is the case of gold supplier who sells gold for more of it. Each one is producing to sell his production or resources in order receive more of the same. Consequently, this absurd economic dealings lead to unimaginable situation characterized by extreme scarcity and crave.

For instance, in the case of gold, if those who acquire first or posses biggest shares start to sell it in exchange for gold at a higher rate, they will continue to accumulate gold. The more gold they acquire the more they will lend on *ribā* and on the other hand less sources of gold will be available to the borrowers. Taking the weakened repayment position of borrowers into account lenders may further exploit the situation by increasing the price or the rate of *ribā* in order to acquire more and more gold. This process if continue indefinitely, ultimately it will end up with putting the existing resources of gold under the command of certain individuals, assuming the total gold endowment is fixed. Extending this scenario to all goods and taking it as a general phenomenon of the economy, where each producer or owner sells what he possess for more of itself without accepting any substitution for another, it would result ultimately that each commodity to be concentrated in the hands of certain individuals. Given this phenomenon, it is very reasonable to expect that resources particularly most dear and durable ones sooner or later will accumulate into the hands of small opportunists of *ribā* users.

This kind of egoist behaviour would lead to abnormal economic situations: On the side of lenders there would be building up and extreme accumulation of economic resources while on the part of borrowers there would be acute shortage and deficiency in possibly most essential resources. Furthermore, as the law of diminishing marginal utility dictates the former group will experience with disutility, intense demand for variety, for the endowment of each would be concentration consisting of a single good. According to this principle with every increase in the stock of a commodity its marginal utility diminishes, and with every increase in stock that someone already has the less welfare he may drive from it. While *ribā* users would suffer from deficiency in variety as a result of their lust for collection of wealth, which holds in single good, the other part of the society (borrowers) would suffer from scarcity and destitute. The above extreme scenarios of *ribā* based economy demonstrate that *ribā* element is the root cause of problems that leads to excessive scarcity and acute wants for variety as the teachings of the Prophet (saw) cautioned before fourteen centuries. Ibn Masud reported in Musnad Ahmad that the messenger of Allah (swt) said: "However, plentiful (flourished) the *ribā* (*ribā*-based economy) may be, its end is want and scarcity." (No'mani, 1983).

In this context, it is plausible to expect that trade or profit based economy in general, fosters resources to flow from where they are in plenty to where they are in scarce, from where they are relatively idle or less productive to where they are productive and usefully utilized, while, in the case of *ribā* resources flow, in the reverse order, from where they are in scarce and dear, to where they are already concentrated. In this way the economic resources although they seem to be very much when they are concentrated in few hands without utilizing properly, the scarcity in general and want for variation in both haves and have nots would create inevitable adversities.

## 4.4 *Ribā* versus Profit in Stability Perspectives

The question of stability of Islamic financial system has been the focal point of contemporary writings of Muslim economists. Most of them emphasized the smooth functioning and long-lasting economic equilibrium to be the main characteristics and peculiar built-in forces of Islamic economic system. Islamic economists have theoretically articulated that the profit-sharing system assures a relative degree of stability and more equitable compared to *ribā*-based economy, (Zarqa, 1983) and (Muhsin Khan, 1986), (Chapra, 1985). It is asserted that financial system based on profit sharing techniques enables the economy efficiently absorb any possible shocks to its asset position (Mirakhor & Zaidi, 1991). On the other hand, owing to its essential factors like; debt financing, speculation, money creation etc, instability as acknowledged by the renowned economist is considered inbuilt features of conventional economic system. Post-Keynesian economists hold that the institution of interest as one of the main causes of financial instability which leads to recession or stagflation, (Maclachlan, 1993). Keynes has demonstrated that systematic instability and financial crises is inherent characteristics of modern capitalist economy, which results securing the means of production through debt creation. Minsky (1977) maintains that a modern capitalist economy is based on a pervasive system of short-term financing of long term capital assets. Under such a system of financing, debt is repaid when it is due, by issuance of new debt, i.e., refinancing would be continuous process, if the expectation of future cash-flows and interest rates remain optimistic. But as it might happen if the expectations turn out wrong or expected in pessimistic perspective, then refinancing would be very difficult and attempts to acquire cash would bring the asset values below their original prices or even below their current cost of reproduction. This according to Minsky would make the whole investment activities to cease and bring down income and employment.

The basic idea of the Minsky(1986), is that the relationship between cash receipts and payment commitments determines the course of investment and thus, employment, output and profits. Chishti (1985) interpreted the problem that the fixity of financing terms, vis-à-vis the uncertainty of profits to be mainly responsible for the gap between cash flows and payment commitments. In addition to this scholastic view, as the main practise of interest based system, contractual commitment is not linked to feasible profit. In other words the required cash repayments seem to be totally isolated from the actual return. Consequently the gap between cash flows and payment commitments may become beyond controllable measures that produces a chaos in the asset market when many units try to sell their assets to generate cash in order to meet their commitments.

In nutshell, the above discussion asserts that, it is the existing dichotomy in fixed dated payments and actual profitability that generates economic instability and financial crises of modern capitalist economy. While many economists seem to agree that debt financing is the major destabilizing factor of investment in capitalist economy, Muslim economists have yet to present a coherent alternative model understandable to general readers having inbuilt factors that would maintain the stability of Islamic economy. There is ongoing debate on to what extend that the abolishing *ribā* in Islamic finance would essentially lead the economy towards sustainable stability.

The strict and absolute prohibition of *ribā* and promotion of profit based financial system constitutes one of the cardinal features of an Islamic economy. This prohibition naturally eliminates pure debt market as a means of conducting business and income generating mechanisms. In the light of transformation view of exchange, the main source of instability appears to be a composite of two main factors:

The first important source is the scale of pure *ribā* element associated with economic transactions, in other words, the magnitude of excess value claimed through non-income generating mechanism (i.e. pure credit business or exchange of similar items). This magnitude of *ribā* depends on; (i) the terms of transaction; the rate of physical excess, value or any stipulated benefit in favour of either party, (ii) the volume of *ribā* based transaction in the economy. Interestingly, this appears to be the evil element of modern economy but yet to be diagnosed. It is most transparent root cause of financial crises or investment instability, household overindebtedness and distributional injustice of resources. It is the most important instrument of speculation based on pure time exchanges and credit creations with unjustified predictable returns

The second equally important source of instability is the degree of disparity between the anticipated profitability and dated payments, in other words, to the extent, that the fixed profit returns are not linked to the productivity of investment activities. This falls in the armpit of income generating sphere – justified by existence of real transformation mechanism through production or commercial activity, but associated with uncertainty or *gharar* in juristic terminology. The effect of this element will be determined by (i) the degree of *gharar* or uncertainty associated with the intended transaction. In other words, the extent the predetermined rate of return/profit differs from realized outcome. While the profit is practically variable and a discretionary outcome, in the case of predetermined returns, the payment commitment is continuous flow essentially linked to the principal capital regardless of the actual results of the investment. (ii) The size of economic activities involved with uncertainty and avoidable risk element. So, the increase of the degree of *gharar* element creates instability for it causes that the gap between the cost of capital and the real return/profit of the economic productivity to be amplified.

However, these two major sources of instability are different in nature in the following aspects; (i) In terms of their sources as, they belong to two different categories of exchange forms as the differences of profit and *ribā*. (ii) In terms of clarity and assessment. Unlike *gharar* and risk, *ribā* is known measurable and predictable discrepancy (iii) In terms of being the object matter of the contract where *ribā* is always the intended economic objective (iv) In terms of permissibility and legal considerations, While *ribā* is prohibited in absolute terms, there is a significant flexibility and tolerance in the case of *gharar* in Sharīʿah (Dhareer, 1997).

Thus, if *ribā* is abolished and the terms of financing are linked to the anticipated profit rate, which varies with its movements, the chaotic condition which makes the investment as the most unstable factor in macroeconomic components could be brought under control. The alternative method of Islamic financial system suggests the capital resources to be channelled into productive investments which are expected to generate a stream of returns that at least sufficiently repay the cost of the investment capital. It proclaims elimination of asymmetry between the fixity of returns on one hand and the uncertainty of actual profit rates on the other as the essential characteristics of Islamic financial system which distinguishes it from the traditional financing system. In this case, the payment commitments will be function of income flows, in view that financing terms adjust according to the changing economic conditions such that the ratio of cash flows to cash commitments remains relatively stable. This provides built-in stabilizing elements to absorb the volatility of investment in Islamic financial system. Thus the justifications of the profit and the rationale of abolishing *ribā* become the yardsticks not for Islamic financial peculiarities but imperative for the stability of modern economic relations.

Therefore, profit being an increase resulting from real economic activities through transformation and productive mechanism which though may not be constant in the long run remain relatively stable for it is expected to vary only with real change of economic activities. Accordingly, when a capital owner gets into partnership on the basis of profit sharing, there is a slim chance of requirement for reopening the contract even if the expected average gross rate of return changes. According to the Islamic financial system the elimination of *ribā* and *gharar* will take care of checking speculation behaviour of arbitragers.

The underlying profit and loss sharing financial modes, i.e. *muḍārabah* and *mushārakah* are accordingly related to distributional aspect, depending on the level and nature of the participation. Criteria for equitably sharing expected return appears to depend on the degree of uncertainty and risk, as well as, on the role of participants in investment activities. However the agreed proportions may vary or remain fixed depending on the effective variation of actual return in respect to the anticipated level. Usually the rate of sharing outcome associates with terms of contract and nature of the business activity and entrepreneur's characteristics; integrity and ability or with the organizational structure of the enterprise.

In this context, the profit-sharing system could be extended to all forms of organizational structure and participation options based on profit generating activities. The diversity in business needs may coincide with the diverse circumstances of supplier of capital. Some may seek permanent partnership and are willing to and capable of assuming risk, others may desire to part from liquidity only for a short period. Thus, the issue of a variety of financial instruments i.e., shares to cater to every sort of taste ultimately helps the business in attracting funds for its own needs. Therefore, the financial institutions based on Islamic principles must offer diversified forms of profitable options with different business returns, maturity, rights and responsibilities. For instance, some contract may be permanent, others may be temporary, and some may carry voting rights others may not (Muhsin, M. 1992).

Therefore, reshaping Islamic firm's operations in the light of these observations, there is possibility of improving the theoretical rationalization of profit sharing system and enhancing the efficiency of its operational conditions than its envisaged state. Under this circumstance Islamic investment enterprises may able to introduce attractive financial instruments in which the Sharīʿah rulings are not violated. The value of these instruments should be determined by real economic activities and market value of these instruments may fluctuate under given economic circumstances such as variation in company's performance and expected profits.

Some of emerging good examples of such instrument are *muḍārabah* bonds, as the term denotes, it is based on a genuine *muḍārabah* with capital on one hand and labour on the other, and the shares of profit are determined before hand by a definite proportion of the total. In line with the above arguments this may not necessarily confine itself to traditional bilateral *muqāradah* modes. The proposed *muqāradah* bonds therefore need to be further examined and seriously considered as a dynamic alternative to Islamic securities. *Ijārah sukūks* seem to be the most popular certificates, probably in part to their Sharīʿah conformity and familiar leasing operations. (Rosly and Sanusi, 1999). In analogous to *ijārah* there is a dire need for developing other avenues of *ṣukūk* issuances, like *iṣtisnaʿ*, *mushārakah* and corporate certificates. *Ṣukūk* markets are growing fast as they created the first genuinely global convergence between conventional and Islamic finance. However, proving the Islamicity of these instruments in their current operational state appears to be challenging question, (El-Gamal, 2004). Islamic financial system should accommodate the investors' preference diversity and business needs in real economic transformation methods of value creating techniques according to sharīʿah principles. If we seriously look into basic principles that govern financial issue in the light of the universality of Islamic message, we must believe that Islamic finance will be better finance acceptable to humanity at large for its own merit.

## 5. Concluding Remarks

In conclusion, the followed approach exposes the fascinating features of exchange economy and its important role on creating additional economic value to the extent that one can redefine economics as a science of exchange. In exchange context, the complex concept of *ribā* could be easily identified in its unified form which consequently enables us to draw a natural borderline between *ribā* and profit. With these findings we can better grasp the underlying economic rationale of the revealed wisdom regarding the difference between prohibited *ribā* and profitable trade. In this perspectives the theoretical contribution of this core principle can be appreciated to the extend it integrates Islamic finance to the logical analysis of mainstream economics. Finally the enormous implications of this principle on most economic and financial issues cannot be overemphasized. However, there is a dire need for further scientific research on its juristic consistency and economic applications.

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# COMMENTS

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