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Islamic Finance and Banking: The Challenge and Prospects*

*Khurshid Ahmad***

Abstract: Throughout history, Muslims have opposed riba (interest). However, as an offspring of the marriage between capitalism and imperialism, a global economic system based on riba has overwhelmed the world, including Muslim countries. In forty years, nonetheless, a band of Muslim scholars and jurisprudents have devised an alternative riba-free economic order. Today, there are more than 176 Islamic banks and other financial institutions with deposits exceeding $112.5 billion and operating in 40 countries. Apart from the private sector, three Muslim countries have been working for the elimination of riba from the banking system from the banking system. Islamic banking is characterized by its unique terms of reference for money, financial cooperation and investment. It stands for equity-sharing and stake-taking, while doing away with a debt-based relationship, is rooted firmly in an ethical framework, is entrepreneur-friendly and non-inflationary, as opposed to the exploitative, unjust and crisis-generating Western economic system. The havoc wreaked by the interest-debt system has been taking its heavy toll. Based on religious and moral premises, the Islamic finance and banking model has to address many challenges and tasks ahead, ranging from providing an efficient and equitable system to restructuring the economy completely. The Islamic - Banking movement is a positive development which bears great promise for the future.

Let me at the very outset submit that in my view, Islamic Finance and Banking is no longer just a theory or a dream. In fact it is now a reality, albeit an emerging, evolving and fast growing reality. In view of their religious and ethical commitment, Muslims have never compromised on the concept of *ribā*. For 1,200 years they developed and successfully managed a thriving economy on a *ribā*-free basis. They were a major actor in the arena of the world economy.

Muslims constituted the bulk of what now goes as the Third World. The position of this Third World in the 18th century *vis-à-vis* the West was in no way inferior. They lost the game in the following centuries of industrialization and Western imperialism. But the relative share of the Third World in world

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** Professor Khurshid Ahmad, a former Federal Minister for Planning and Economic Development, Government of Pakistan (1978–79) and Senator (1985–97), is presently Chairman, Institute of Policy Studies, Islamabad, Pakistan, and Chairman, The Islamic Foundation, Leicester, UK. He has authored or edited over three dozen books and was the recipient of the King Faisal International Prize for Services to Islam (1989), the Islamic Development Bank Award on Islamic Economics (1988) and the American Finance House Award for services to Islamic Economics and Finance (1997).

manufacturing output at the advent of the 19th century was three times higher than that of Europe and the *per capita* level of industrialization was comparable till 1800. The economies of the Muslim countries were, by and large, supported by a financial system that was not tainted with *ribā*. Paul Kennedy gives a snapshot view of the world from 1750 to 1900.

Table 1. Relative Shares of World Manufacturing Output[1]

Region/Country	Years				
	1750	**1800**	**1830**	**1860**	**1900**
Europe	23.2	28.1	34.2	53.2	62.0
(Russia)	(5.0)	(5.6)	(5.6)	(7.0)	(8.8)
(UK)	(1.9)	(4.3)	(9.5)	(19.9)	(18.5)
USA	0.1	0.8	2.4	7.2	23.6
Third World	73.0	67.7	60.5	36.6	11.0
(India/Pakistan)	(24.5)	(19.7)	(17.6)	(8.6)	(1.7)

Table 2. Per Capita Levels of Industrialization (1750–1900)

(Relative to UK in 1900 = 100)

Region/Country	Years				
	1750	**1800**	**1830**	**1860**	**1900**
Europe	8	8	11	16	35
(Russia)	(6)	(6)	(7)	(8)	(15)
(UK)	(10)	(16)	(25)	(64)	(100)
USA	4	9	14	21	69
Third World	7	6	6	4	2
(India/Pakistan)	(7)	(6)	(6)	(3)	(1)

The scenario materially changed in the following two centuries of Western domination. In 1800, Europe occupied or controlled 35 per cent of the land surface of the world. In 1878, its control extended to 67 per cent of the world, and in 1914 it reached the high water mark of 84 per cent. A new economic system was imposed on the world, an offspring of the marriage between capitalism and imperialism.

The last two hundred years are also characterized by a global economic system based on *ribā*. The kingpin of the post-industrial revolution financial system had been interest. Muslim countries were also overwhelmed and overtaken by this new economic order. Some Muslim intellectuals, *ʿulamāʾ*, *fuqahāʾ*, and intellectuals did try to develop, at an academic level, a critique of interest as also of capitalism and imperialism as economic and political systems. They also came up with suggestions and proposals as to how an alternative system could be established. Maulānā Abul Aʿlā Mawdūdī, Imām Muḥammad Bāqir al-Ṣadr, Dr. Anwar Iqbal Qureshi, Dr. Nejatullah Siddiqi, Dr. Muhammed Uzair and Dr. Ahmad al-Najjar were amongst the pioneers of this movement.[2] Yet their efforts remained theoretical exercises. It was only in the last 40 years that material change has taken place and major developments have occurred in four directions.

First, at the academic level, professional economists and bankers have overtaken the field and tried to build on the foundations laid down by the *ʿulamāʾ*, *fuqahāʾ* and intellectuals. Second, serious efforts at the institutional level have been made to establish *ribā*-free financial, investment and banking institutions. Third, universities, research institutions, international professional organizations (including some Western universities and professional associations) have begun and developed academic training and research programmes in different areas of Islamic Economics, Banking and Finance. As such, they initiated a process of widening the academic horizon and are making research inputs towards the problems that are bound to arise with the introduction of *ribā*-free systems and instruments. Finally, at the state level initiatives began to be taken to switch over the national financial system from *ribā* to a *ribā*-free basis. At least in Pakistan, Iran, Sudan and Malaysia such efforts began to take off. At the global level also the establishment of the Islamic Development Bank and its research institution, the Islamic Research and Training Institute, represent major developments in establishing a network of financial arrangements and institutions within the Muslim World. That is why I regard the last 40 years as a period of major breakthrough, moving towards not only greater sophistication and professionalism in the discipline but also a transition from theoretical formulations towards practical experimentation.

Elementary efforts were made in Pakistan in the 1950s, both in the cooperative as well as commercial sectors.[3] In Egypt, two pioneering experiments were also made. First, in the form of the Mit-Ghamr Bank (1963–67) combining the idea of a German savings bank with principles of rural financing but within the framework of Islamic values. This was followed by the establishment of the Nasr Social Bank in 1971, to help in particular the weaker sections of society. In Malaysia, a major breakthrough was achieved with the establishment of Tabung Haji (1963), a specialized financial institution to mobilize savings and enable Muslims to participate in investments, industry, commerce and plantation in accordance with Islamic principles and also to provide for the protection, control and welfare of Muslims while on pilgrimage (Ḥajj) through the various facilities and services of Tabung Haji. With a modest start of 1,281 depositors in 1963 and a total of M$ 46,600 in deposits by mid 1985 this has risen to a million depositors with total deposits exceeding one billion Malaysian ringgits.[4]

1975 stands out as a landmark in the emergence of contemporary Islamic banking. The Islamic Development Bank was established at Ummah level, with the full backing of the Islamic Foreign Ministers' Conference. Dubai Islamic Bank was also established in the same year. This was followed by an emerging stream of Islamic banks: 3 in 1977, 2 in 1978, 2 in 1979, 1 in 1980, 4 in 1981, 3 in 1982, 10 in 1983, 5 in 1984 and 1 in 1985. By 1985 there were 35.[5] The number of Islamic banks, financial and investment institutions, according to a survey by the International Association for Islamic Banks (1997), now totals over 176. Their deposits exceed $112.5 billion, their assets are estimated at around $147.6 billion and they are operating in some 40 countries, including a number of non-Muslim countries

A new development in the field is represented by the emergence of what can be described as trans-national groups like the Dār al-Māl al-Islāmī and al-Barakah-Dallah Group. We also find that traditional, Western *ribā* based banks are now beginning to take an interest in interest-free banking. Around a dozen leading European and American banks and finance houses now operate interest-free savings and investment programmes. Even Dow Jones are developing an Islamic Index to attract Muslim capital. We also find that the *ribā*-free principle is being extended to the fields of insurance (*takāful*), leasing (*ijārah*) and real estate finance. In this way, new Islamic financial instruments are being developed and used successfully. Prof. Rodney Wilson of Durham University, UK, has recently prepared a study for the *Financial Times*, London, which gives a fair review of the landscape of contemporary Islamic Banking as an emerging and expanding field.[6]

This being the situation, it is fair to claim that Islamic Banking is no longer a mere dream or just a theory; it is a *reality*. Yet I must add that it is at a nascent stage. Hence, I call it an emerging, evolving, and fast growing reality.

Three Major Models

Analyzing this Islamic financial global landscape, one finds that these experiments can be grouped under three scenarios, each representing a distinct model:

First, in the private sector, there are banks, financial institutions, investment companies, leasing companies, mutual funds trying to operate without interest. They are primarily owned by private investors and entrepreneurs, although in respect of some there is a degree of financial participation by some governments or international financial institutions. In some countries, special laws have been enacted to enable interest-free banks to operate effectively with the necessary depositor security. The two major financial groups of Dār al-Māl al-Islāmī and al-Barakah-Dallah belong to this category.

Second, at least three countries have tried to make a beginning in the direction of developing a state-sponsored process for the elimination of *ribā* from among the entire banking system. Instead of establishing interest-free banks in the private sector, the strategy was to first establish 'interest-free counters' within the system, and then extend the interest-free system to the whole banking sector, so as to operate

on new principles under the protection of state policy and central bank guidelines. The objective remains to finally cleanse the whole economy of interest. Pakistan initiated the process partially in 1980 and moved towards total change in 1985, but I am sorry to say that the process was frustrated somewhere in the middle. Primarily because of lack of political will, the new system could not be established and the process became somewhat aborted. Iran and Sudan are still moving in that direction, with much mileage yet to cover. They have not followed exactly the same routes yet the strategy of total and state-sponsored change is common. The aim is not just one or some Islamic banks at the micro level, but the transformation of the entire financial and banking system and, ultimately, the whole economy so as to conform to Islamic norms.

Third, the model which Malaysia has introduced is a mix of the two. On the one hand they have established under the country's legal framework a totally *ribā*-free Islamic bank with a distinct law and identity. On the other, they have created a mechanism through which any conventional bank can also have a *ribā*-free window within the system. Some 52 conventional banks have opened such *ribā*-free counters. In this system the two streams of *ribā*-free and *ribā*-based banking can somehow co-exist and compete with each other.

Presently the Islamic *Ummah* is trying to experiment with these three models.[7]

What is Islamic Banking?

Now is the time to pause for a moment whilst we try to clearly identify what constitutes Islamic Banking.

First, let us start with a foundational concept. The concept and role of money is crucial to any financial system. In an Islamic system money is primarily and exclusively a measure of value, a means of exchange and a standard for deferred payment. As distinct from the ethos of Western economics and conventional banking, however, money is not regarded as a commodity in itself, to be bought, sold and used to beget money. As a logical consequence of this, in an Islamic framework, money has to operate through some real economic activity or service. It is a facilitator and an intermediary, not an active self-contained agent in itself. Capital is productive, not money *per se*. It is a means towards production, through creative entrepreneurial efforts. It is to be an instrument towards the value-added through the physical expansion of the economy. In other words, real economic progress and development consist in the expansion of the physical and human aggregates of the economy via the creation of assets, products and services, and not merely in the form of fiduciary financial expansion. It is through such generation of wealth that well-being takes place and the relationship between money-economy and physical-economy remains in real equilibrium. Wealth does not create islands of affluence in an ocean of poverty and deprivation. Money never becomes the objective, the hero of the cast. It remains an intermediary and an instrument for real productive effort, for asset creation, for value-added and for the expansion of physical economic activity in a manner that benefits all sectors and which participates in the economy as a whole.

The next basic point is that there are two methods or processes through which financial cooperation takes place. The first is direct investment. That is people who have money in excess of their needs and people who have productive ideas and expertise – entrepreneurs, innovators, producers, workers, traders – join hands to pool their resources for further production and exchange. Those with excess funds through direct investment provide others with these resources to move the wheels of productive machinery and trade processes. This is the oldest and one of the most common forms of productive cooperation between money and entrepreneurship.

However, there is also a second process and this is through financial intermediation. Instead of direct investment there emerges a series of banks, financial institutions, mutual funds, etc. which act as intermediaries between savers and producers. They are the intermediary institutions through which savings can be mobilized and canalized for investment. The emergence of such institutions has transformed the economic landscape. They have been able to mobilize savings on a vast scale and in an institutionalized manner and make them available for production and other uses. The economic explosion of our times has been financed by this process. That is a very genuine role of banking and financial institutions. In principle, direct investment as well as financial intermediation are accepted as part of the Islamic framework.

The crucial point though is that whether it is direct investment or financial intermediation, there cannot be a fixed predetermined return on capital, loanable funds or credits. This does not mean that Islam stands for a zero rate of interest. And this is where some confusion persists. Islam does not deny a return on capital. It holds that capital is productive, as it leads to greater value added, and as such is entitled to a share from what it is instrumental in producing. There has to be a reward for capital. That is just and reasonable. What Islam challenges, however, is the right of money or loanable funds, in normal circumstances, to a predetermined, fixed and *assured reward* without a share in the risks of the enterprise or project. It has to be a *variable return* based on the actual performance of the project, enterprise, or the economy as a whole. Islam prohibits a reward without a share in the risks or a stake in the economic venture. That is the basic premise. So Islam says that if you want to give money to someone by way of a loan, to help him in need, you go for *qarḍ ḥasan*, where you are assured of your principal amount, but no increase on that. But if you are interested in a return, it has to go with risk-sharing. Reward and risk must go together. Interest is prohibited in all its forms, whether it is simple or compound, low rate or high rate, personal or institutional, private or public, on a consumption loan or on a productive investment. Whatever the category be, any predetermined, fixed increase without sharing the risks of the project or enterprise is *ribā* and this is prohibited. It is only the principal amount that is justified in loan transactions. If you want to share the fruits and the rewards, that has to be on the basis of sharing the risk as well as sharing the reward. Otherwise it is exploitation and *ẓulm*, for one or the other, the lender or the creditor.

Let me sum up by submitting that in an Islamic framework there is room for *qarḍ ḥasan* where the principal is guaranteed, but there is no increase on that; as also for investment where return is justified but not in a pre-determined form for one party, an *ex-ante* assured return, but return for both based on the real performance of the project, i.e. *ex-postfacto*. That is just for both parties.

Major Characteristics of Islamic Banking

Now we are in a position to spell out some of the major characteristics of the Islamic system of Banking and Finance. In my view, five such elements deserve special mention:

First, Islamic Finance stands for a system of equity-sharing and stake-taking. It operates on the principle of a variable return based on actual productivity and the performance of the projects, specific or general, individual or institutional, private or public. Economic cooperation may assume as many forms as may be desired, both at micro and/or macro levels, but the principle remains one of the equity and reward sharing and not of a simple loan-interest relationship as in capitalism.

Second, a very crucial point relates to the whole vision of an Islamic economy. Islamic Banking, as part of that vision represents a revolutionary departure from the conventional system. Islam wants the economy, its major monetary and business dealings, to move from a debt-based relationship to an equity-based and stake-taking economy. While there is scope for some debt-based transactions on the principle of *qarḍ ḥasan*, the overall thrust of the economy would be towards equity-based and risk-sharing arrangements. This is a revolutionary change as it calls for a new psychology and a new approach to the economy. It demands that all the major actors within the economy participate in the productive system and does not allow some to become a rentier class. This is distinct from the capitalist approach where the whole economy is geared to making money by manipulating, managing and creating money and serving the interests of the rentier class. This is the root cause of exploitation in society and leads to the grossly inequitable distribution of income and wealth in the economy.

Third, the Islamic approach is rooted in an ethical framework. As such, it represents not only a shift from a debt-based economy to an equity-based economy, but also a movement from purely pecuniary and hedonistic profit-taking to a gainful economy that is also characterized by ethical norms and social commitments. The ethical and social dimensions are crucial to all economic activities. There is a framework of *ḥalāl* (permissible and desirable) and *ḥarām* (prohibited and undesirable) within which all economic activity, private and public, has to take place. The moral filter plays a crucial role in this system. Furthermore, this filter operates at different levels, the conscience of the entrepreneur and the firm, the social climate of society, the legal framework, and the supervisory and guiding role of the state and government. An activity which would be treated in the capitalist system as productive because it is supposed to be satisfying *some* demand (e.g. pornography, gambling, prostitution, the promotion of alcohol, etc.) in the Islamic framework would be unacceptable. So ethical and social dimensions are integral to the Islamic Economic approach. It asks questions, such as: what are the objectives for which money is being acquired? Will it benefit individuals, society and humanity? Will it lead to the establishment of a just, honourable, sustainable society, or result in exploitation, moral degeneration, social tensions and inequities? These questions are as relevant to decision-making as the financial profitability and economic viability of an activity or project. This is integral to the system, and not peripheral, or outside its pale, under the garb of value-neutrality.

Fourth, Islamic Finance and Banking is entrepreneur-friendly. It is directed not towards mere financial expansion, but towards the physical expansion of economic production and services. Money does not beget money. It is expected to finance talent, innovative spirit, new ideas, skills and opportunities. It is expected to result in greater decentralized economic activity and more equitable distribution of resources and wealth in society. Conventional banking operates predominantly on the principle of financial collateral, with the result that the concentration of wealth, income and power takes place on a vast scale. The more money you have, the more you can get. The emphasis shifts from the viability of a project to the financial worth of the borrower. If you lack collateral, you stand a very poor chance of acquiring loans irrespective of the viability or feasibility of the project and intrinsic trustworthiness of the person. The focus shifts altogether in an Islamic system. Collateral is not irrelevant, but it is cut to size. Instead, the trustworthiness of the person and the viability and usefulness of the project become more important. A more human approach is adopted which results in greater distributive justice, equity, along with ensuring the diffusion of resources in society by going to the grass-roots, to community development and the individuals that go to make it. As such, the small saver, investor, trader and producer become more important. It is community oriented and talent and entrepreneur-friendly.

Fifth, the Islamic system is non-inflationary. This is a very important and fundamental characteristic of Islamic banking. Banker's almost uncontrolled powers to create credit is, among others, at the root of inflationary pressures. The de-linkage between financial expansion, money supply and the physical expansion of the economy is a result of the financial and banking dynamics of our time. Islamic Finance and Banking restores equilibrium between these three variables. Stability in the value of money is a primary goal of an Islamic economy.[8] The measure of value must have a degree of stability, otherwise the economic fundamentals become disturbed. The poor suffer the worst, and this must be rectified. Islamic Banking operates within limits that ensure stability in the value of money and an almost inflation-free economy.

In my view, these five major characteristics make the Islamic system of Banking and Finance distinct and unique. While it is very clear that the system's distinctive feature is its interest-free character, it does not begin and end with this. There are other very crucial dimensions, like its positive vision of an equity-sharing and stake-taking economy, its non-inflationary character and its ethical and social welfare dimensions in respect of savings and investment policies. Of course, the Islamic economic system has other dimensions that further strengthen and develop the egalitarian character and people-orientation of the system. Islamic Banking and Finance is a part of this ethical, humanitarian and justice-targeted socio-economic system.

Why Islamic Banking?

In order to understand the real challenges of the 21st century, it is important to reflect for a while on some of the major changes that have taken place during the last two centuries and in the context of those transformations spell out the rationale and role for Islamic Banking.

The central issue is that the contemporary financial system is exploitative, unjust, discriminatory, unstable and crisis-generating. There is no denying some positive contributions that have been made by the banking and financial system towards the promotion of economic development and global capitalism. But when a balance sheet of achievements and failures is made, its failures outweigh and out-number. To claim that the modern banking system has been an unmixed blessing is to do violence to the facts and gruesome realities of the world economy. As such, it is worthwhile to reflect on the ethical as well as the economic and social imperatives that call for a change from interest-based banking and financial systems to an equity-based, stake-taking system whereby money is primarily a means and a measure, a servant and not the master; a system in which money does not beget money but money is rather used as a facilitator for the greater production of goods and services resulting not merely in increasing the number of billionaires but producing real well-being for the people in the context of a developing, conserving and sustaining economy.

First and foremost as Muslims, for us the prohibition of *ribā* is a religious and moral imperative. Islam forbids interest in all its forms. The Qur'ān uses the strongest terms for its prohibition. It challenges those who are not prepared to leave dealing in interest to prepare for war with Allah and His Messenger.[9] A Muslim society cannot exist, what to say of prosper, while it is at war with Allah and His Messenger. There must be a cease-fire, before we can hope for Allah's Blessings and Bounty. But it is not Islam alone that has prohibited interest. All major religious and ethical systems have prohibited interest. So whether you look at Judaism, Christianity, Buddhism or Hinduism, interest was originally forbidden. Similarly, all ethical and religious systems throughout history have forbidden it. Confucius, Socrates, Plato, Aristotle and all major medieval thinkers and theologians stood against interest and regarded it as a form of exploitation and tyranny (*ẓulm*). It is only during the last 200 years that the legitimization of interest has taken place. For that matter one of the greatest intellectual frauds perpetuated was to change the nomenclature whereby usury was replaced by 'interest'; as if usury was forbidden and not interest. Usury was exhorbitant/high interest, interest was supposed to be reasonable and low rate. Yet that is a myth.

If we look into the history of interest rates we will find that rates vary from 0.01 per cent to 10,000 per cent. The same applies today, where in Japan the going rate is 1 per cent, whilst in the UK it is 8–10 per cent, in Pakistan 20–24 per cent, and in Turkey over 80 per cent. The plastic money that is increasingly being used the world over carries a rate anywhere between 18 to 30 per cent. Sidney Homer, in *A History of Interest Rates* sums up, as follows, his conclusion based on a survey of interest rates from Hammurabi's times to our own:

> A bird's eye view of the history of interest rates will unsettle most preconceived ideas of what is a high rate or an average rate. Each generation tends to consider normal the range of interest rates with which it grew up; rates much higher suggest a crisis or seem extortionate, while rates much lower seem artificial or inadequate. Almost every generation is eventually shocked by the behaviour of interest rates because, in fact, market rates of interest in modern times have rarely been stable for long. Usually they are rising or falling to unexpected extremes. A student of the history of interest rates will not be surprised by volatility. His backward-looking knowledge will not tell him where interest rates will be in the future, but it will permit him to distinguish a truly unusual level of rates from a mere change.
>
> It is easy enough to cite seemingly fanciful interest rates. In fact, we do not have to look beyond our own century to find the highest and lowest rates in the entire span of this history: 10,000 per cent high in Berlin; .01 per cent low in New York. Both rates were quoted on standard money-market credits under very unusual circumstances. This is a range of one million to one.

Hammurabi's legal limit of 20 per cent per annum on loans in silver cannot be usefully compared with today's money-market interest rates. It was well above twentieth-century rates on prime business loans, savings bonds, savings deposits and the like, but was below 30–42 per cent per annum legal limits and actual charges in many states of the United States for small personal loans. It will be very difficult, throughout this history, to compare like rates with like rates. There are more types and varieties of credit contracts in ancient and modern history than are dreamed of in the philosophy of the modern bond salesman.[10]

Whether the rate is high or low is both relative and irrelevant. To us as Muslims, and to all men of religion, it is illegitimate because it has been forbidden by God, the Sovereign and Law-Giver. It is against religion, against ethical values and against the interests of humanity.

Having said so, the role of interest in economy and history also deserves to be examined on economic and social criteria. On deeper reflection, we are forced to conclude that interest has been one of the greatest menaces to humanity and economy. The glamour and glitter of the *ribā*-based system is deceptive, not real. When we reflect on economic theory and practice, particularly during the 19th and 20th centuries, we find some very disturbing trends. Some of the more important ones that deserve to be noted are as follows:

1. A systematic effort was made to drive a wedge between economics and ethics. Economics, which had always been a part of the overall ethical system of a society and civilization was turned into an autonomous, self-contained discipline. In a craze for making it a 'positive science', it was delinked from the values and socio-ethical norms on which human society and civilization are based. A fact much ignored was that even Adam Smith's *An Inquiry into the Wealth of Nations* (1776) was preceded by and rooted in the values he emphasized as cardinal to the human situation in his *Theory of Moral Sentiments* (1759). 'Self-interest' in *An Inquiry* was to go hand-in-hand with the concept of 'prudence' spelled out in the *Theory of Moral Sentiments*. The ethical and moral roots of economics were severed. Its normative character sacrificed at the altar of so-called positivism. Consequently, over the years, economics became neutral towards values, amoral and a dismal science unconcerned with the ethical, social, humanitarian and environmental consequences of its concepts and policies. It was in this climate that the god Mamon replaced God the Creator and Source of Guidance.

2. All religious and moral systems were man-centered in the sense that their ultimate objective was human well-being and the establishment of justice among human beings in all walks of life, legal, political, social and economic. During these centuries of capitalist development the concepts of justice and equity were relegated to oblivion. Initially, economic effort and all wealth-generating activities were geared towards human well-being and equity. In fact 'wealth' and 'well-being' were almost synonymous. But in the modern phase 'wealth' and 'well-being' no longer meant the same thing. Gradually the concept of desirable and undesirable, even of productive and non-productive effort began to become irrelevant. 'Needs' were replaced by 'wants', tied to the purchasing power and the length of the purse. Efficiency became the new catchword. People-centredness was replaced by wealth-centredness. 'Growth' became the rallying cry. 'Consumption must grow', 'production must grow', 'money must grow' became the new targets, irrespective of their consequences for ecology, conservation, distributive justice, grass-root well-being, and the needs of society and posterity. The delinking of economics, investments and markets from justice and well-being lies at the root of the crisis of contemporary economies, local, national and global.

3. Monetization of the economy and the new role of interest and interest-based financial and banking institutions led to the establishment of a debt-based economy at national and global levels. A debt-based economy is bound to primarily and predominantly serve the interests of only certain sections of society, particularly the rentier classes. This system, over the years, leads to the transfer of money, wealth and resources from the many towards the few, from the poorer people, regions and countries, towards the richer people, regions and countries. It is the weak and the under-privileged who suffer; it is the powerful and the rich that prosper.

4. Finally a delinking takes place between the physical economy, the process of real asset-creation and value-addition in terms of greater production of useful grounds and services on the one hand, and monetary and financial expansion in the economy on the other. Money no longer acts simply as a medium and a measure. It becomes a commodity and an object in its own right. The historical role of money as an intermediary for exchange (commodity-money-commodity – C-M-C) gets transformed into money-commodity-money (M-C-M) as Marx rightly identified. But that is not the end. In the contemporary phase of capitalist development, the relationship between monetary and physical aggregate has totally changed. Now with the advent of future options, claims, derivatives and swaps, we have entered a world where even M-C-M is being rendered into M-M-M. According to the *World*

Economic Outlook (IMF, October 1996, p. 167) between 1986 and the end of 1994 the total notional principal of outstanding exchange-traded derivatives contracts, including interest rate futures and options, grew at an average rate of 40 per cent from $0.6 trillion to $8.9 trillion. In the same period, annual turnover rose from $315 million contracts to $1,142 million contracts. The balloon of the financial economy is expanding at an alarming pace, via speculation, while the real economy is only crawling at an uneasy pace. According to a recent study in foreign exchange markets, financial derivatives are being exchanged at a rate of $1.2 trillion per day, which is almost 50 times more than the daily physical international trade in goods and services. Similar is the situation in the domestic economies of developed countries. Emphasis has shifted from asset-creation to making money by speculation in respect of claims over claims on assets. It is a make-believe world of financial players who are creaming off billions without contributing to real value-added in society and its spillover for human well-being.

Let me substantiate this situation by bringing you a few quotations from some of the perceptive writers of our times:

John Gray, in his recent work, *False Dawn: The Delusions of Capitalism*, says:

> Most significantly, perhaps transactions in foreign exchange markets have now reached the astonishing sum of around $1.2 trillion a day – over fifty times the level of world trade. Around 95 per cent of these transactions are speculative in nature, many using complex new derivative financial instruments based on futures and options. According to Michael Albert, 'the daily volume of transactions on the foreign exchange markets of the world holds some $900 billion – equal to France's *annual* GDP and some $200 million more than the total foreign currency reserves of the world's central banks'.
>
> This *virtual* financial economy has a terrible potential for disrupting the underlying *real* economy as seen in the collapse in 1995 of Barings, Britain's oldest bank. Together with the accelerating development of global capital markets on which it stands, the virtual economy is a phenomenon unknown in the worlds economic history.[11]

Joe Roglay, a regular columnist of *The Financial Times*, London, laments:[12]

> Liberal economists, promote the marketization of everything in sight adding to the sense of isolation that lurks within so many of us. Wealth creation is an amoral pursuit. It is what is done with wealth that matters. The population of billionaires is growing; NOT all of them are generous to the poverty stricken.
>
> Only a belief in the spiritual self can soften the effects of this counter-human revolution. Alas, the defenders of the spirit are divided, sulking in their tents all over the place. Lacking cohesion, their strength once irresistible is draining away.

James Robertson, in a very perceptive study, *Future Wealth: A New Economics for the 21st Century*, writes:

> Unlike both the capitalist and socialist versions of conventional economics, then, the 21st century economy must be based on recognition that people are moral beings whose freedom as such should not be narrowly bound by impersonal parameters laid down by market and state. The 21st century economy must accept, as an aspect of self-reliance, that people need space in which to exercise moral responsibility and choice in their economic lives. Measures designed to allow this free space to people as individuals, and also to groupings of people in local economies and national economies (especially in Third World), must be part of the new economic order...
>
> The new economics must thus transcend the materialist assumptions of a conventional economics: that economic life is reducible to production and consumption; that wealth is a kind of product that has to be created before it can be consumed; and that wealth production and wealth consumption are successive stages in a linear process which converts resources into waste. It must reinterpret the manipulative concern of conventional economics with the production and distribution of wealth and the allocation of resources, into a developmental concern with how to enable people to meet their needs, develop themselves, and enhance the resources and qualities of the natural world. It must recognize that because human beings are moral beings the basic questions about economic life are moral questions...[13]

James Robertson's observations on the role of interest and need for an interest-free economy also deserve noting:

> The pervasive role of interest in the economic system results in the systematic transfer of money from those who have less to those who have more. Again, this transfer of resources from poor to rich has been made shockingly clear by the Third World debt crisis. But it applies universally. It is partly because those who have more money to lend, get more in interest than those who have less; it is partly because those who have less, often have to borrow more; and it is partly because the cost of interest repayments now forms a substantial element in the cost of all goods and services, and the necessary goods and services looms much larger in the finances of the poor than of the rich.
>
> When we look at the money system that way and when we begin to think about how it should be redesigned to carry out its functions fairly and efficiently as part of an enabling and conserving economy, the arguments for an interest-free, inflation-free money system for the twenty-first century seem to be very strong.[14]

In a recent book, *One World Ready or Not: The Many Faces of Global Capitalism*, William Greider observes that the rich nations of the world are acting like ancient usurers, lending money to the desperate poor on terms that cannot possibly be met and, thus, acquiring more and more control over the lives and assets of the poor. This is done mainly by commercial banks and private capital, but amplified and policed by public lending institutions. The real profit on owning US bonds was 8.2 per cent in the 1990s as compared to 6.7 per cent in the 1980s and 8.8 per cent during the 1920s after which there was the Great Crash (1929). This exhorbitant return to rentier classes is to be seen in context of the fact that across the 20th century the average real return on holdings of long term bonds has been only 1.6 per cent.[15] In other words, creditors are at present receiving returns on their wealth 5 times the average level that real economies are functioning at.

As a result of the interest-debt system, societies are being drowned in debt. In 1901, the total domestic debt of the USA was only $1 billion; today it is over $4 trillion, with some $1.3 trillion in external debt. This is a four thousand-fold increase over the century. So the richest country of the world is also the most indebted country, both domestically and internationally. According to recent studies in the USA, every household's debt has reached an astonishing 91 per cent of its disposable income as compared with 65 per cent in 1980. Debts contracted via plastic cards invite 18–30 per cent rates of interest, punishing terms by all standards. Yet interest remains an innocent helper in the economy. The fact, however, is that a debt based economy is thc most exploitative of them all – ultimately the system works against the common man, against the poor, and against the small entrepreneur, who go to make up the back-bone of the economy. It is only the rentier class that gains. *The Economist* (London, 30 May, 1998) comments editorially that in America there were only 13 billionaires in 1952, but in 1996/7 they have increased to 170. This is accompanied by the impoverishment of the poor and the generation of ever-increasing inequalities in society.

Contemporary capitalist economies that have been reared on the foundations of interest and debt are very deceptive. Their apparent affluence conceals the miseries and deprivations they have generated. They are exploitative as well as unstable. The system is unjust and violative of all human values. Let me conclude this part by one more quote from James Robertson's latest work *Transforming Economic Life: A Millennial Challenge*:

> Today's money and finance system is unfair, ecologically destructive and economically inefficient. The money-must-grow imperative drives production (and thus consumption) to higher than necessary levels. It skews economic effort towards money out of money, and against providing real services and goods.

The transfer of revenue from poor people to rich people, from poor places to rich places, and from poor countries to rich countries by the money and finance system is systematic... One cause of the transfer of wealth from poor to rich is the way interest payments and receipts work through the economy. Dividing people into ten sections of equal size, a German study (Kennedy, M., *Interest and Inflation Free Money: Creating an Exchange Medium that Works for Everybody and Protects the Earth*, New Society, Philadelphia, 1995) suggested that the effect of interest is that the richest section receive far more than it pays, the second richest receives a little more, and the other eight receive less. The result is a substantial transfer of money from the poorest majority to the rich minority.

The transfer of money from poorer to richer localities takes place through the automatic working of the national and international banking and financial networks... Third World debt in the 1980s and 1990s illustrate some of the causes and effects of [the] systematic transfer of wealth from poorer to richer countries. International interest rates rose and so did the cost of imported know-how and technologies, while international commodity prices fell. Through no fault of their own, indebted Third World countries found themselves with escalating debts, resulting from higher interest rates and composite prices to be paid and reduced foreign exchange. (Out of $1,200 billion owed by the Third World to the First World in 1990, only $400 billion constituted original borrowing. The rest consisted of accrued interest and capital liabilities.) The response of the International Monetary Fund and the World Bank was to prescribe development that placed even greater emphasis on the export of commodities at low world prices . . .

The money-must-grow imperative is ecologically destructive. . . . (It) also results in a massive world-wide diversion of effort away from providing useful goods and services, into making money out of money. At least 95 per cent of the billions of dollars transferred daily around the world are for purely financial transactions, unlinked to transactions in the real economy.

People are increasingly experiencing the workings of the money, banking and finance system as unreal, incomprehensible, unaccountable, irresponsible, exploitative and out of control. Why should they lose their houses and their jobs as a result of financial decisions taken in distant parts of the world? Why should the national and international money and finance system involve the systematic transfer of wealth from poor people to rich people, and from poor countries to rich countries? Why should someone in Singapore be able to gamble on the Tokyo stock exchange and bring about the collapse of a bank in London? Why, when taking out pensions, should people have to rely on advice corrupted by the self-interest of the advisers? Why do young people trading in derivatives in the City of London get annual bonuses larger than the whole annual budgets of primary schools? Do we have to have a money and financial system that works like this? Even the financier George Soros has said ('Capital Crimes', *Atlantic Monthly*, January, 1997) that 'the untrammelled intensification of *laissez-faire* capitalism and the extension of market values into all areas of life is endangering our open and democratic society. The main enemy of the open society, I believe, is no longer the Communist but the Capitalist threat'.[16]

The same author raises some other very pertinent questions in the context of the havoc wreaked by the interest-debt system and the possibilities that the next century may offer to restructure the financial and banking system of the world on alternate foundations – something Islamic Banking is aiming to do and offering as an alternative, not only to the Muslim Ummah, but to the whole of humanity. After re-affirming that 'the effects of interest include transferring money from poor to rich, accelerating resource extraction and environmental damage, and diverting effort to making money out of money', Robertson raises the following succinct questions:

> Why has the process of issuing new money into the economy (i.e. credit creation) been delegated by governments to the banks, allowing them to profit from issuing it in the form of interest-bearing loans to their customers? Should governments not issue it directly themselves, as a component of a citizen's income?
>
> Would it be desirable and possible to limit the role of interest more drastically than that, for example by converting debt into equity throughout the economy? This would be in line with Islamic teaching, and with earlier Christian teaching, that usury is sin. Although the practical complications would make this a goal for the longer term, there are strong arguments for exploring it – the extent to which economic life world-wide now depends on ever-rising debt, the danger of economic collapse this entails, and the economic power now enjoyed by those who make money out of money rather than out of risk-bearing participation in useful enterprises.
>
> May there be a role for negative interest rates? These were proposed early this century by Silvio Gessel (from whom Keynes said the future would learn more than from Marx). The Austrian local currency experiments of 1930s required each currency note to be revalidated every month by attaching a special stamp costing 2 per cent of its value. This stimulated the local economy by encouraging people to spend, not hoard, the local currency. Could other liquid financial assets, like current bank balances, be subject to negative interest rates? And would that be a good idea?...
>
> The shift to a people-centred, ecologically sustainable economic system will require a corresponding shift in the services offered by conventional financial institutions and the further developments of new financial institutions. The latter include ethical, green and social banks, micro-credit banks, credit unions and other grass-roots people's banks which provide credit for people and localities, unable to get it from conventional financial institutions.[17]

The Challenge of the 21st Century

In light of the above submissions let us clearly try to identify the real challenge humanity is facing at the close of the 20th and the advent of the 21st century. The challenge comes from the lop-sided financial and economic system into which humanity finds itself entrapped. The divorce between ethics and economics, between religion and society, between well being and wealth is at the root of this crisis. Another major challenge comes from the unguarded and extended role of money, from a means and a measure, to a commodity and a mysterious tool to beget more money without adding real value to the economy and without increasing the flow of useful goods and services. The disastrous consequences of this process entails driving whole societies and humanity at large into the hands of rentier classes, rendering the vast majority into a suffering mass. The result is increase in inequalities of income and wealth, huge transfers of resources from the many and the poor to the few and the rich, both peoples and regions. This is the predicament of mankind, and it poses the greatest threat to all our futures. The interest-debt regime, with banks' powers to create credit and the financial system's fiduciary expansion via futures and derivatives have increased manifold the exploitative character of the system as also made it extremely unstable and vulnerable.

Because of the role of interest, coupled with the two distinct roles of banking and financial institutions, i.e. credit creation and derivatives, the world economy has reached a point where reform and restructuring have become unavoidable if total disaster is to be avoided. It is now a question of survival for all. With over $150 trillion worth of derivatives circulating in the world and where the combined GDP of all the 188 countries of the world is only around $30 trillion, where are we heading? And who are the major players in this world of financial speculation? Almost 80 per cent of this trade is in the hands of some two dozen big banks and hedge funds! The threat is not only to the world economy, but to the very nature of human society and civilization. The world economy is turning into a bubble and into this bubble, we are blowing more and more air only to stay afloat. Yet how long can such bubble economies last? Ten years ago, the Japanese economy was thriving and beginning to challenge the strongest economy of the world – the USA. Five years ago, the Japanese economy was being described as a bubble. Now the bubble has burst and we are seeing the consequences. What has happened to the East Asian Tigers? Even the USA's economy has its stakes. In the last six months, *The Economist* has twice expressed its apprehension about how the American economy is in danger of also becoming a bubble. It is worthwhile, then, for us to open our eyes before a real crash takes place.[18]

Our critique of interest and interest based banking is rooted in religious and moral premises, but it is also based on sound economic grounds. It is based on the demands of justice and the vision of an economy and society that caters for the well-being of all human beings and does not serve the interests of only a few sharks who live by preying on others. It is this vision of tomorrow that prompts us to move towards a new paradigm in economics and finance. It should be the concern of all human beings, in all parts of the world.

With globalization, I am sure, no country is safe. While the 20th century will also be remembered for its great achievements in the fields of technology, science and informatics, which I don't deny, the other side of the picture is also important. The forces of globalization riding on the back of an exploitable system are becoming a threat to human society and values. The way out lies in a new approach. May I submit that the 21st century needs to address itself, from an economic viewpoint, to at least five basic issues:

1. The need to bring about spiritual and moral re-awakening. The key lies in rediscovering the relationship between ethics and economics. This is the core issue. Ethics must not be confined to private conduct. It must be the pace-setter for

individual character as well as group behaviour and socio-economic policies, at local, national and global levels.

2. A move towards the establishment of a new world order, which is non-hegemonistic. What a shame that we talk of democracy and human rights, but the whole world system is based on the hegemony of the powerful. Human rights and democracy are on all our lips. But what is the reality? Even one of the five veto-holding countries, can nullify a united resolution of the entire world. Look into any international organization, the UN, the IMF and the World Bank, the WTO – everywhere we find hegemonistic trends shattering the dreams of democracy, power-sharing, participatory development, and co-operative relationships. Authentic pluralism is the answer. Coexistence and not a clash of civilization is the need of the hour. Political, cultural and religious pluralism alone can lead us towards a world enjoying peace, affluence and justice.

3. A re-discovering of the importance of physical and human capital formation and the production of real goods and services. The physical and human dimensions of development deserve to be re-emphasized. The role of money has to be redefined and the creation of physical aggregates, products and services that are useful for mankind should be made the objective of all developmental effort. Untrammelled financial expansion has distorted the balance between monetary and real economic aggregates. The balance has to be restored by cutting the financial economy to its real size; control credit creation and re-emphasize the development of local economies, public utilities, basic and consumption industries and effective distributive mechanisms.

4. The need for an equitable distribution of wealth and income at all three levels, that is: globally between countries, within each country and region, and at the level of individuals and households in every society, constitutes another basic challenge.

5. The need for a market economy with social responsibility, moral commitment and the positive role of the state to ensure the fulfilment of social ideals and respect for the rules of the game. *Laissez-faire* and command economies both have failed. To swing from one to the other is not the answer. It is the golden mean between market economy and social responsibility that can set the house of economy in order. Both go hand in hand to ensure freedom, prosperity and justice for all. As such a three sector economy – private, voluntary-altruistic and public sector – with complete harmony amongst them may provide the organizational model for the 21st century.

Islamic Banks and the Future

Now if we reflect on these challenges, we find that Islamic banks and Islamic Economics are destined to play a very important role in the making of the future. This calls for a move from a debt-based economy – an unjust, exploitative and inequitable economy – towards a risk-sharing, stake-holding, participatory, community-oriented and people-friendly economy. Therein lies the key role that

Islamic Economics, Islamic financial institutions and the Muslim states can play in order to make the next century closer to our vision of a just and balanced society. This also means that the centrality of the productive criteria will have to be rediscovered. The financier should become a real investor, prepared to play a participatory role as investor along with the entrepreneur. In the Western banking system, because of collateral, the banker moves in only when he smells prospects of bankruptcy. In an Islamic system, as the bank is also an investor it remains an active participant throughout. As such, the bank is concerned with and responds to early warning signals if things start going wrong. In this way, mistakes can be set right before the rot goes too far. Furthermore, the system is more stable and transparent. In such a system there is an automatic adjustment of real assets and their financial counterparts. In the conventional banking system there is no such mechanism for adjustment. It is, therefore, hoped that banking that operates on Islamic principles will ensure growth with financial stability, equity and distributive justice. It can be sustainable both horizontally, that is at a particular time, and vertically, deep into the future. The ecological dimensions and the needs of future generations would equally be taken care of.

The Task Ahead

The challenge is grave and multi-dimensional. The dangers and threats are too serious and alarming to be ignored. But the task is also gigantic. Islamic Banking has offered a new approach. But the experience and contributions made so far are far short of what is required. As such it is important that a realistic assessment of what is to be done be made. Man lives by hope. But man cannot live merely by hope! Effort, planning, training, management and creativity are all required to face the challenges ahead. What Islamic Banking should do to initiate a global process deserves to be explored. Some tentative ideas are expressed below:

To recap, the Islamic approach is rooted in a different vision of the economy: one that is equity-based as against credit-based. Not that there would not be a possibility for loan transactions – *qarḍ ḥasan* exists at a certain level to meet genuine individual or business needs. But the structure of the economy would be on a very different footing – capital and entrepreneurship would be co-participants, sharing the risks as well as the rewards of the enterprise.

Islam encourages trade and commerce. Profit is not only permissible, it is encouraged as a positive value. Instead of *a fixed* rate of return geared to an *assumed* rate of profit, Islam provides for a *variable* rate of return based on *actual* profits. This is the basis on which Islam wants capital and entrepreneurship to cooperate and co-participate in the production process. Islamic societies were able to develop a number of financial instruments and institutions during the first millennium of Islamic history. Although the economic system is much more complex today, the Islamic Banking movement is an effort to develop an alternate system in the context of the contemporary economy.

However, it deserves to be noted that the abolition of interest is only one aspect of Islamic Economics. Islam aims at establishing a just economic order, based on clearly spelled out economic rights and concepts of property, contracts, work and the distribution of income and wealth. It stipulates a framework of values and disvalues, desirables and undesirables and hedges the market mechanism with a moral filter so as to ensure efficiency and equity in the processes of the allocation of resources.

The role of the state has also been clearly defined. The Islamic state is neither a neutral police state of the *laissez-faire* type nor a totalitarian state of the socialist order. There is a limited scope for intervention in order to achieve specific objectives. Islam also emphasizes the need for the stabilization of prices and the protection of the value of money. In such an economy, banks are not mere financial intermediaries but also play an active role in developing and maintaining a certain pattern of economy, serving certain socio-moral objectives as well. Of course, banks are not expected to act as charities, philanthropic organizations or mere 'welfare institutions', but the welfare, equity and stability dimensions are as relevant to the banking ethos in an Islamic scheme as are considerations of security efficiency, optimality and profitability. Definitely there would be trade-offs. As such the objective is to achieve a balance between efficiency and equity, between profitability and welfare, and between expansion and stability. Traditional banking is also trying to discover the moral dimension in a limited sense. The whole movement towards ethical banking is an instance in point.[19] But that is something on the periphery – and not even the whole periphery. Ethics and social objectives are central to Islamic Banking – and that is why Islamic Banking is not mere interest-free banking. It is much more than that. It represents a new and vastly different vision of the whole economy.

The basic idea of Islamic Banking is to devise an efficient and equitable system of profit-sharing (PLS). *Efficiency property* derives from its insistence on *the linkage between the financial and the real sectors of the economy*, while *equity property* is based on *maximizing the rate of return on deposits*, depending on the length of the period for which they are held.

But to make Islamic Banking efficient and equitable, its profitability – that is, the difference between the rate of return on advances and the rate of return on the deposits (which is also referred to in the literature, as the 'spread') – should be maximized, without in any way becoming exploitative. Yet another requirement is that the risk element inherent in the bank's operation is minimized, and scrupulously managed.

The connection between efficiency and profitability properties is provided by the fact that, as established by many empirical studies, the level of economic activity is the most significant determinant of the growth of deposits and advances, and of the 'spread'. In other words, to maximize the profitability of the banking system, economic policy must aim at enhancing the growth rate of output and the creation of effective demand. From which it follows that Islamic Banking, by strengthening the link between the financial and real sectors of the economy, also raises the potential level of social profitability as against that of traditional banks.

The link between the superior equity and efficiency of Islamic Banking derives from the requirement that the profits (and the losses) made by such banks are shared

in accord with moral (and binding) principles of justice and beneficence (*al-ʿadl wa al-iḥsān*). Thus, given the normal operating expenses incurred by Islamic banks and the rate of return on their advances, the potential rate of return on deposits would be generally higher than that offered by the traditional banks.

The linkage between the riskiness, the efficiency, the equity, and the profitability of Islamic Banking rests on its ability to devise an investment portfolio which, on the one hand, satisfies the preferences of the risk-averse investors and those of the risk-takers (i.e. those who take no risk and those who can afford a lot of risk); while, on the other hand, it should reflect the state of economic activity in society.

Apart from any considerations for efficiency, equity and profitability, there is the case for the PLS instruments because they seem to reflect most faithfully the principles of the *Sharīʿah.* Such instruments also set Islamic Banking (based on equity-finance) apart from traditional banking (based on debt finance). In other words, the PLS instruments make the Islamic nature of banking more visible. The revolutionary potential this type of banking bears for the future is beginning to be realized by an increasing number of Western economists and bankers.

A study by the Development Centre of the OECD on *Arab and Islamic Banks* touches upon this aspect. The author, Traute Wohler-Scharf, says:

> If the South proposes now, with Islamic banking principles, a new concept of socio-economic interaction (profit-sharing systems, focus on small and medium-sized innovative entrepreneurs, with the major objective of economic asset creation, etc.), it would be a contribution to co-operation concepts so far mainly propounded by the countries of the industrialized world.
>
> Islamic banking is trying to change the relationship between finance on one hand and industry and commerce on the other. This new relationship is the basis of the Islamic economic system being set up. Though Islamic principles have yet to be put to the test in the competitive environment of international finance, the two systems are similar in that they both strive for closer ties between financial intermediation and economic asset creation.
>
> Islamic banks could make a useful contribution to economic growth and development, particularly in a situation of recession, stagflation and low growth levels, because the core of their operations is oriented towards productive investments. All countries, both in the North and in the South, need more venture capital. Loan capital is available, particularly in industrialized economies, but at high interest rates. However, even medium-scale entrepreneurs there find it difficult to raise sufficient risk capital for expansion and innovation. This has acted as a brake on productivity and economic growth in the North.
>
> Thus, practical and intermediate co-operation possibilities exist between Islamic banks and enterprises all over the world. The intermediate process remains to be fully developed.[20]

Professor John R. Presley and J.G. Sessions of Loughborough University (UK) have in the May 1994 issue of the Journal of the Royal Economic Society of Britain, *The Economic Journal*, tried to examine this central contribution of the Islamic principles of finance. The authors, after regretfully noting that:

> Western economists have been somewhat remiss in the last decade in failing to recognize what has the appearance of a new paradigm in economics – that of Islamic economics,

conclude that:

> A *ribā* contract creates an explicit mapping between the compensation and the input of capital . . . The prevalent method of *Muḍārabah-financing* ties compensation on the outcome of the project. *Muḍārabah* therefore allows the contract to control the managers incentive to exert effort directly, since this effort affects the relationship between capital investment and the outcome of the project. Under a *Muḍārabah* contract the manager is let free to choose the individually optimal level of investment in each state contingent on his contractually specified level of effort. Such a contract permits a mean-variance improvement in capital investment – average investment is increased whilst inefficiently large fluctuation around this level is reduced. . . We have shown that the use of the prevalent alternative method of financier remuneration (i.e. *Muḍārabah*) will, under certain conditions, lead to an enhanced level of capital investment on account of the ability of *Muḍārabah* to act as an efficient revelation device.[21]

Islamic Banking, if properly developed on the fundamental principles expounded by Islam, is destined to play a crucial role in reconstructing the economy in the 21st century on very sound foundations. But let me say in all honesty that Islamic Banking, despite a promising beginning, is only in its larval stage. The real concept in its all comprehensiveness is yet to be fully translated into reality. The movement has a long way to go to become truly representative of the original concept. The efforts that are being made with seriousness and dexterity to eliminate *ribā* from financial dealings, however welcome, have much mileage to go to be achieved. It is a fact that these experiments are being made in a climate – both domestic and external – which is anything but congenial. The moral fibre of society is weak. The legal framework is antagonistic. The tax system is partial towards the interest system and almost inimical to a profit-sharing system. The state of competition between the Islamic and traditional banking systems is such that most of the odds are against the Islamic system. In this context, whatever progress has been made is groundbreaking. Yet it deserves to be acknowledged that these efforts represent only the first steps in the direction of Islamic Banking. Present day interest free banks have relied rather too heavily on those permissible instruments of financing which are closest to the traditional system like *Murābaḥah* (mark-up) and *Ijārah* (leasing). Almost 80 to 90 per cent of lending has been done through these instruments. The real alternate instruments

of *Muḍārabah* (trustee-financing) and *Mushārakah* (profit-sharing) have been resorted to only to a very limited extent. Other ethico-social objectives have also not received the importance they deserve. Greater success has been achieved in the field of deposit-mobilization, where many untapped resources have been drawn upon. But the socially beneficial and development and welfare oriented utilization of these resources has left much to be desired. Employment generation and the flow of resources towards the lower and middle classes of society, particularly in the rural sector, where great potential as well as the greatest needs exist, has not taken place. This raises the question of the efficient utilization of funds. However, it would be unfair to judge the success or otherwise of the Islamic Banking scheme mainly on the basis of the limited and partial experiment that is presently being made. The experiment is not even halfway through. The mileage yet to be covered is crucial. The distinctive character of the system is yet to unfold and take shape. Then and only then can the scope and extent of the experiment be fully and realistically appreciated.

However, looking at the actual experience, at least in some countries, the rate of return offered by the Islamic banks has been generally lower than that offered by the traditional banks before Islamic Banking was introduced.

The investment portfolio held by the Islamic banks has generally favoured trade-related over production-related activities, short-term profitability over long-term profitability, and private profitability over social profitability. The heavy concentration in a few assets of short-term duration has typically lowered the stability of the Islamic bank's portfolios and has increased the degree of their risk.

In practice, there has been an overwhelming preference by the users of loanable funds for the mark-up instruments over the PLS instruments, which have been overshadowed in the bank's portfolios. The real rate of return (adjusted for the inflation rate) has been generally lower, if not negative, while that on the bank loan is strictly positive.

In view of these challenges from within and the major difficulties and bottlenecks from without, the Islamic banks have to make a Herculean effort towards implementing Islamic financial norms in such a manner that efficiency, profitability and equity are achieved simultaneously.

It is also submitted that the system of auditing of bank accounts must be upgraded to determine their legitimate operating expenses and the monitoring of the cases of bank default or other deviations from the norm. This should be an integral part of the Islamic Banking review (indeed, of any responsible banking). In other words, the information basis of Islamic banks must be widened and made readily available with the help of modern computer-based technologies – which allow the storage, processing and dissemination of relevant information in a very short time and at least cost. This is basic; because the information cost typically rises when Islamic Banking is introduced. For instance, depositors will have to evaluate the relative performance of competing banks to reach a decision about where to invest their funds. On the other hand, the bank will have to seek greater and timely information about the use of the funds it makes available to entrepreneurs.

Cases of loan default must be dealt with severely in Islamic banks as they amount to *khiyānah* (deception and fraud), which is a great sin in Islam. In general, any misappropriation of bank funds should be declared a social crime.

Islamic banks should evolve innovative portfolios to suit the risk preferences of different classes of savers. It would be morally indefensible to make all classes of savers bear the same degree of risk – irrespective of their capacity to take risk (which depends on the size of their respective incomes, savings, etc.). Islamic banks should also show enterprizing spirit by funding projects of a longer-term nature and where the social profitability of investment is higher than their private profitability – which typically covers all areas where external economies are large (health, education, infra-structure investment, etc.).

During the period of transition or in cases where the law of the land so demands (as in some Western countries) some form of deposit insurance may be developed, in light of the Islamic permission of third party guarantees. On the side of bank advances, the legal structure governing private property rights should be clarified and strengthened. The evolution of effective supervisory mechanisms at different levels, horizontal and vertical, also pose a critical challenge that must be met unequivocally.

While the present writer firmly believes that Islamic Banking can come of age only in an economy and society that is committed to total Islamization and where real transformation is produced as a result of a comprehensive movement, consisting of the Islamically oriented behaviour of the individual and socio-economic reforms based on Islamic values, he belongs to that group of economists who regard the contemporary Islamic-Banking movement, despite all its weaknesses, as a positive development which bears great promise for the future.

It should also be mentioned that despite fundamental differences with traditional banking there is a vast area of co-operation between the two streams. After all, venture capital has played a very important role in the development of the world economy. Investment banking has also been an integral part of banking though more prominently in the German and French traditions of banking. Unit trusts and investment houses are operating as major financial institutions in the world today. The IFC as against the IMF and World Bank has gone into equity financing as part of the international developmental effort. I do not think Western bankers would be averse to the idea of developing new modes of co-operation with the Islamic banks and financial institutions if they are presented with economically viable projects. If Bosphorus Bridge – a billion dollar project – could be financed through venture capital, why not hundreds of other projects? Once this new commonality of interest, based not on traditional 'interest' but on some form of equity sharing – is built, I am sure new avenues of co-operation can be explored. Huge untapped resources exist in the Muslim world and one of the reasons why they remain untapped is Muslims' reluctance to go for interest-based financial instruments and institutions. Recent surveys have shown that even in Saudi Arabia, between 40-60 per cent of households that have a relatively high *per capita* income do not have a bank account. A large number of those who keep deposits have refused to take interest.[22]

The situation is no different in other Muslim countries and even with the Muslim communities in many Western countries. This potential is yet to be tapped fully. Moreover, Islamic Banking principles and instruments are not relevant to the Muslims only. They have universal applicability. Some recent trends in world capital movements show a clear shift towards equity investment and venture capital. Net private capital flows (direct investment, net portfolio investment and other longer and short-term net investment flows) to developing countries represented $10.1 billion on average during 1973–77, increased to $27.4 billion during 1978–82, and to $117.8 billion during 1989–95. The actual figure for 1998 is $155 billion. As against this, net official flows, mainly debts, represented $11.1 billion during 1973–77, $23.4 billion during 1978–82, and declined to an average $16.4 billion during 1989–95.[23] If these trends provide some clue to the future, they suggest greater scope for equity-investment in the coming decades.

Notes

1. Source: *The Rise and Fall of Great Powers*, Paul Kennedy, Random House, New York, 1987, p. 149.
2. See Abul Aʿlā Mawdūdī, *Sūd* (Interest), Islamic Publications, Lahore, 1951; Mawdūdī, *Maʿāshiyāt-e-Islām* (Economics of Islam), Islamic Publications, Lahore, 1969, p. 436; Muḥammad Bāqir al-Ṣadr, *Iqtisāduna* (Our Economics), Dār al-Fikr, Beirut, 1968 (2 Volumes) p. 694; Bāqir al-Ṣadr, *al-Bank al-Lāribawī fi'l-Islām* (Interest-free Bank in Islam), Jami al-Naqi, Kuwait, 1974, p. 208; Anwar Iqbal Qureshi, *Islam and the Theory of Interest*, Ashraf Publications, Lahore, 1950; Mohammad Nejatullah Siddiqi, *Ghair Sūdī Bank-Kārī* (Banking Without Interest), Islamic Publications, Lahore, 1969, p. 224; Dr. Muhammad Uzair, *An Outline of Interestless Banking*, Karachi, Dacca, Rehan Publications, 1955; Dr. Ahmad al-Najiar, *Bank bilā Fawā'id Ka-Istrātijīyah liʿ al-tanmiyah al-iqtisādīyah* (Bank without Interest as a Strategy for Economic Development), Jāmiʿah al-Malik ʿAbdul ʿAzīz, Jeddah, 1972.
3. See Sheikh Irshad Ahmad, *Interest Free Banking*, Karachi, Orient Press of Pakistan, 1951.
4. Ausaf Ahmad, 'Evolution of Islamic Banking', in Khurshid Ahmad (ed.), *Elimination of Riba from the Economy*, Institute of Policy Studies, Islamabad, 1995, pp. 350–4.
5. Ausaf Ahmad, *Development and Problems of Islamic Banks*, Jeddah, IRTI, IDB, 1987, Table 1, p. 9.
6. Rodney Wilson, *Islamic Finance*, Finance House, Financial Publishing, London, 1997.
7. For details see Ausaf Ahmad, op. cit.; Rodney Wilson, *Islamic Finance*, op. cit.
8. al-Qur'ān, 6: 152; 7: 85; 11: 84–5; 17: 35; 26: 181.
9. al-Qur'ān, 2: 279. It is worth noting that the Qur'ān condemns and prohibits *ribā* (interest/usury) in the most powerful of terms and makes it very clear that one is entitled to the principal amount only, and nothing more. 'Those who gorge themselves on *ribā* behave but as he might behave whom Satan (the Devil) has confounded with his touch; for they say "Buying and selling is but a kind of *ribā*" – while God has made buying and selling lawful and *ribā* unlawful. Hence, whoever becomes aware of his Sustainer's admonition, thereupon desists (from *ribā*), may keep his past gains, and it will be for God to judge him; but as for those who return to it – they are destined for the Fire, therein to abide.

'God deprives usurious gains of all blessings, whereas He blesses charitable deeds with manifold increase. And God does not love anyone who is stubbornly ingrate and persists in sinful ways . . .

'O you who have attained to Faith! Remain conscious of God, and give up all outstanding gains from usury, if you are Believers; for if you do not then know that you are at war with God and His Apostle. But if you repent, then you shall be entitled to the return of your principal (amount only); you will do no wrong and neither will you be wronged. If however (the debtor) is in difficult circumstances, (grant him) a delay until a time of ease: and it would be for your own good – if you but knew it – to remit (the debt entirely) by way of charity' (Qur'ān, 2: 275–81).

10. Sidney Homer, *A History of Interest Rates*, Rutgers University Press, New Brunswick, 2nd ed., 1977, p. 6.

11. John Gray, *False Dawn: The Delusions of Capitalism*, Grunte Books, London, 1998, p. 62.

12. 'Time for Religions to Merge or Bust', *The Financial Times*, London, 20–21 December, 1997.

13. James Robertson, *Future Wealth: A New Economics for the 21st Century*, Cassell Publications, London, 1990, pp. 21–8.

14. Ibid., pp. 130–1.

15. William Greider, *One World, Ready or Not*, Simon & Schuster, New York, 1997.

16. James Robertson, *Transforming Economic Life: A Millennial Challenge*, Green Books, Devon, 1998, pp. 51–4; George Soros has also developed this theme in his latest book, *The Crisis of Global Capitalism*, Little, Brown & Co., London, 1998. He has come out with a frontal attack on 'Market Fundamentalism' and pleaded for the control and management of global financial flows.

17. James Robertson, ibid., pp. 57–8.

18. See a recent study by Peter Warburton, *Debt and Delusion*, Allen Lane, Penguin Press, London, 1999. The author comes to the eye-opening conclusion that: 'The promise of economic freedom held out by the dismantling of state ownership and control has been subverted by a personal and collective enslavement to debt. The parallel accumulation of financial wealth since the early 1980s has obscured this painful reality, but history warns that this situation is unsustainable. When stripped of their capital gains in equities and bonds, today's rising generations will appear overburdened by interest payments and debt repayment schedules. Far from commencing a golden era of economic liberty and individual choice, millions are teetering on the edge of debt default and misery.' He further says: 'Apart from financial mismanagement, the only other essential ingredient of the West's predicament is the personal and collective addiction to debt. Indeed, the most significant aspect of financial mismanagement is the failure to confront debt addiction and warn of its consequences.' He ends his Preface on a personal note worth reflecting upon: 'When the opportunity arose to become free of debt in 1995, I took it and have not regretted it for one moment. I urge the readers of this book to take or make the opportunity to do likewise' (pp. xi-xlii).

19. See James J. Lynch, *Ethical Banking: Surviving in an Age of Default*, Macmillan, London, 1991.

20. Traute Wohlers-Scharf, *Arab and Islamic Banks*, new business partners for developing countries, OECD, Paris, 1983, p .95.

21. J.R. Presley and J.G. Sessions, 'Islamic Economics: The Emergence of a New Paradigm', *The Economic Journal*, Vol. 104, No. 424, May 1994, p. 595.

22. See R. Wilson, *Banking and Finance in the Arab Middle East*, Macmillan, London, 1983; N.A. Sherbiny, *Oil and the Internationalization of Arab Banks*, Oxford, Institute of Energy Studies, 1985.

23. *International Capital Markets: Developments, Prospects and Key Policy Issues*, by Takatoshi Itu and David Folkerts-Landau, IMF, Washington, September 1996, pp. 5–6. The figure for 1998 is from an article by Joseph Steglitz, Chief Economist and Senior Vice President of World Bank, originally published in *International Herald Tribune* ('Dawn', 1 May, 1999).