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Issues in Islamic Banking

Selected Papers

Muhammad Nejatullah Siddiqi



The Islamic Foundation

Islamic Economics Series – 4

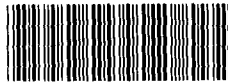
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Preface

The idea that Islam is a unique way of life distinct from all other isms and ideologies naturally extends to the economic life of the *Umma*. A determination to reshape the economy on distinctive Islamic lines has been an important dimension of the Islamic resurgence visible all over the world of Islam. The areas of money, banking and investment are regarded as crucial to the process of Islamisation of the economy. Modern banking, based on interest and biased in favour of the capitalists and the rich and well-to-do, is rejected as un-Islamic because of the unequivocal prohibition of *ribā* by the Qur'ān, which the consensus of Muslim jurists has interpreted as covering all kinds of interest, usurious or otherwise, irrespective of the nature and function of the loan. The Islamic emphasis on cooperation as the key concept in economic life has led to reliance on profit-sharing and participation as the alternative bases for banking and investment in the Islamic framework.

Muslim society never legitimised interest: throughout the thirteen centuries of its history prior to domination by imperialist powers, it managed its economy and carried on domestic and international trade without the institution of interest. Profit-sharing and various kinds of participation arrangements served as adequate bases for savings and investment and considerable capital was mobilised for mining, ship-building, textiles and other industries, as well as for maritime trade. Introduction of interest-based banking by colonial régimes in the Muslim countries during the nineteenth century failed to involve the bulk of the community until the legal framework made it almost impossible for any business to thrive without such involvement. Efforts of some pseudo-jurists to distinguish between *ribā* and bank interest and to legitimise the latter met with almost universal rejection and contempt. Despite the fact that circumstances force many people to deal with interest-based financial institutions, the notion of its

essential illegitimacy has always remained. A sizeable section of the community still refuses to have any dealings with these institutions despite the inconveniences involved.

Rejection of interest is seen as a necessary part of the rejection of the exploitative capitalist system which is to be replaced by the just and equitable Islamic system. The recent literature on interest-free Islamic banking in fact grew as a part of the literature on the economic system of Islam in contradistinction to the capitalist and the socialist systems of various hues. Now we have a number of books and articles in Arabic, English, Urdu, Turkish, Persian and Bengali, etc. Early writers mostly attempted a critique of modern banking, exposing the rôle of interest in the exploitation of individuals and nations. Then they proceeded to suggest that partnership and profit-sharing could form a viable basis for banking. Some economists with adequate training in the *Shari'a* sciences worked out a detailed model of interest-free banking on these bases. My earlier work *Banking Without Interest* (1973, first published in Urdu in 1969) belongs to this category. Since then the subject of Islamic banking has undergone considerable development. Discussion is now conducted in the broader context of economic analysis inspired by Islamic values and ends. Subjects such as the nature and functions of money, determinants of the demand for money and the alternative ways of managing its supply are also receiving attention. Fresh impetus has been provided by the establishment of a number of banking institutions operating without interest, and some initial steps taken by the governments of Pakistan and Iran to phase out interest from the economy. The subject is now attracting the attention of the entire body of economists and bankers in the Muslim world. The conference of the Governors of the Central Banks of 36 Muslim countries held at Riyadh in September, 1980 was merely acknowledging the wind of change when it said that:

'The Governors appreciated the desire to apply Islamic *Shari'a* in the field of banking and noted with interest the establishment of Islamic banks in a number of member states.'

For those with a sense of history, it should not be difficult to see that the move towards an interest-free Islamic banking and financial system could be a process with revolutionary consequences. What guarantees this in the first place is the will of the Muslim masses to whom freedom from colonial powers and disillusionment with westernised secular leaders has now given the chance to re-assert their identity and intentions in the wake of Islamic resurgence. Islamic banking provides them with a legitimate means of directing their savings into profitable avenues of investment. The same applies to businessmen who are eager to get on without at the same time being involved in interest which is prohibited by Allah. One of the major reasons why the banking habit never put down deep roots in Muslim societies has been interest. Once interest is eliminated from banking operations and the social priorities of Islamic banks impress the masses they are likely to get involved in a big way. This could revolutionise the economies of the Muslim countries. Luckily, the inception of Islamic banking coincides with a great spurt in economic activities in several Muslim countries, especially those with oil. The resilience brought in by oil wealth and its spill-over effects reinforces their ability to stand up and challenge an alien system created to serve vested interests.

What lends added credibility to the whole exercise is the perilous condition of the monetary and financial system the world over. With two-figure inflation raging alongside high levels of unemployment, with interest rates soaring at times beyond twenty percent, and the system of international payments under heavy strain due to piling up of debts, the situation is becoming increasingly untenable. The system has lost credibility, leading to a universal recognition of the need for basic changes.

The basic change advocated by Islamic economists is a changeover from interest to profit-sharing. This simple change, some implications of which are elaborated and examined in this volume, has far-reaching consequences for the entire system. It amounts to a change from a lending-based system to one based on real investment and participation. It affects the supply of money, linking it directly with the transactions needs of the community, as

well as the allocation of financial resources in direct response to production possibilities. Both affects strike at the very roots of inflation. In international relations the change would force nations with a surplus to invest to enter into participatory arrangements with developing nations, expecting a return only to the extent real development takes place. While it cannot be claimed that these and other implications of the change have been fully worked out, discussion has largely centred around these issues in recent years. The present writer had the opportunity of participating in this discussion through a number of papers and notes some of which are presented here. Their availability in one volume will be useful for those who do not have access to the journals or seminar proceedings where most of these papers were first published or read. The volume also contains some hitherto unpublished material.

The first essay on the Islamic Approaches to Money, Banking and Monetary Policy is in the nature of a review of the literature up to 1977. It sets the perspective in which later contributions can be meaningfully studied. It covers what Islamic economists have written about the nature of money and its functions, and the demand for money in an Islamic economy. The nature of bank money or credit, its desirability or otherwise, and the possible ways of its management also come up for discussion. The idea of hundred percent reserves is also examined in this context as are the suggestions to confine creation of credit to the Central Bank. The essay surveys the major contributions to the subject of interest-free banking, reporting the various viewpoints on such issues as supply of short-term interest-free loans, bills of exchange, financing the consumer and financing the government. The paper reviews the various writings on Central banking and monetary policy in an Islamic framework, examining the various policy instruments discussed by our writers. This includes the suggestion to use profit-sharing ratios as an instrument of policy, besides the reserve ratio, selective credit control and open market operation through sale and purchase of shares, etc. Originally written for a seminar held in 1978, a postscript has been added to cover the contributions up to 1981, covering issues not discussed earlier

such as indexation and seigniorage.

The next paper, *Banking in an Islamic Framework*, gives an exposition of the model of interest-free banking based on two-tier *muḍāraba* that now forms the operational basis of Islamic banking. It examines such evil consequences of interest-based banking as distribution of income and wealth and inflation and demonstrates the advantages of Islamic banking which is free from these evils, examining the creation of credit at some length. Some of the other issues briefly dealt with in the first essay also come up for detailed consideration.

The third article, *Rationale of Islamic Banking*, answers the question why Islamic economists advocate a change from interest to profit-sharing. It is argued that the interest-based system is inefficient as well as unjust. It has an inherent tendency towards inflation and it fails to provide a just and viable basis for international monetary relations. The change to a system based on profit-sharing will contribute to allocative efficiency, justice and stability. It can also serve as a viable basis for international flow of funds.

The fourth paper, *Economics of Profit-Sharing*, covers entirely new ground by discussing how the ratios of profit-sharing between the depositors and banks, and between the banks and businessmen will be determined. It studies the effects of changes in the expected rate of profits on these ratios and the alternative possibilities as regards the responsiveness of supply of and demand for deposits to changes in the expected rates of profits. It examines and refutes the contention that a system based on profit-sharing must be unstable and subject to wide fluctuations. The paper demonstrates that the system gains in efficiency by assigning the allocative rôle to the rate of profit without the disturbing interference from rate of interest.

The brief paper on *Monetary Theory of Islamic Economics* that follows restates the main points made in the three preceding papers in a summary form with a view to providing a synoptic view of the subject. It also takes notice of some fresh doubts on the viability of interest-free banking, being the report of a discussion in which non-Muslim professional economists were also participating.

The sixth paper, on Issues in Islamisation of Banking, is a comment on the Report of the Council of Islamic Ideology on elimination of interest from the economy, submitted to the Government of Pakistan in 1980. I have tried to make this note meaningful to readers, to whom the Report itself may not be available, by adding explanatory footnotes. The comment discusses such practices as *Murābaḥa* and investment-auctioning proposed in the context of interest-free banking.

These six papers along with this introduction will, I hope, inform the reader of the current state of debate on Islamic banking. This will facilitate understanding of much that is being reported in some journals and a section of the Press. To students of Islamic economics in general, and of Islamic banking in particular, it provides a comprehensive up-dated report on the subject and identifies possible subjects for further research. It is hoped that the publication of this volume will provoke further deliberations on this vital subject.

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