Index **Friday Nov. 9, 2012**

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(1) The Money Market in Islamic Finance

July 18, 2012 at 9:32 PM · Filed under legal ; By Camille Paldi

Thoughts from Iraj Toutounchian's Islamic Money & Banking: Integrating Money in Capital Theory

"The money market, which plays such a major role in the capitalist system, is the result of speculation with money. It is only logical, then, that the abolition of interest would lead to the total disappearance of this market. Therefore, any changes in the level of investment in an Islamic economy should be directly attributed to the marginal efficiency of capital (or, equivalently, the rate of profit).

To summarize then:

Money has just two functions to perform: as a medium of exchange and a unit of account. It can no longer be a store of value.

Money can be viewed as a public good.

Money is potential capital and as soon as it is legally combined with one factor of production its legal character changes to capital and hence is eligible for a reward in the form of profit, whose magnitude is neither fixed nor predetermined.

The volume of money is dependent upon the economic capacity of the economy. Therefore, its supply can, in theory, increase indefinitely provided that the capacity allows.

Banks act as shareholders and are therefore not capable or allowed to create either money or credit. They can only supply capital. Hence, the conventional required reserve ratio is irrelevant and its rate can go down to zero. Naturally, there would be no markets for money or loans in the system. If these conclusions are correct, then what is the use of talking about the money market (as do Khan and Mirakhor 1987:177 and Khan 1985:12) or demand for money in an Islamic economy (see Chapra 1985: 209, for example?) Therefore, the appropriate policy followed by banks can no longer be called 'monetary' policy, but rather 'financial' policy.

Based upon the assumption that all capital expenditures are financed through banks, the opportunity costs of capital is zero.

The ultimate result is that there can only be three markets in an Islamic system: labor, capital and commodity, in which their respective unit values are wage rate, profit rate, and price level." (308-309)

"It has been made clear throughout this book that Western financial markets are essentially money markets built on speculation. They produce instability via artificial risk and, by creating virtual, rather than real, wealth, distort the allocation of resources. It is a zero-sum game that leads to an inequitable distribution of income and wealth and prevents the economy from moving towards equilibrium…

Past experience has shown that the constant manipulation of interest rates in the money market by the central banks of industrialized countries has both greatly damaged their credibility and produced uncertainty in the real sector. As long as the central banks adhere to such damaging policies, the situation will only get worse." (325) – Iraj Toutounchian

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2- Qard-ul-Hassan

August 11, 2012 at 11:46 PM · Filed under legal ; By Camille Paldi

Thoughts from Iraj Toutounchian's Islamic Money & Banking, Integrating Money in Capital Theory

From the legal point of view, the main ingredient of a *Qard-ul Hassan* contract is a loan that is not contaminated in any way by Riba. There is a lender and a borrower, with no reference to a market, which might give one the impression that there should be a 'price' for it. The relationship between lender and borrower is one of creditor and debtor, and the principal of the money loaned out remains the responsibility of the borrower. The lender cannot demand his dues before the end of the contract period.

Funds in this form are advanced to both real and legal entities with the aim of providing humanitarian assistance and creating financial strength for members of society who lack the wherewithal to meet their general and essential needs. When *Qard-ul-Hassan* is given to a real person (that is, a household), it may be just for humanitarian and individual welfare purposes. Many Muslim countries have had long experience of this type of finance and such funds have been set up as private institutions among many believers. They are quite often short-term, humanitarian arrangements (based on Qu'ranic teachings) to help people meet an immediate need. The borrowed money can be used for a variety of purposes, including the purchase of household durable goods. Such behavior, using interdependent utility functions, produces and develops a brotherly feeling among people within and between the households involved. These interest-free loans are in line with Qu'ranic injunctions to honor society as vice-regents of Allah (SWT).

A legitimate question may arise here as to how such loans would deal with inflation. The simple answer is that it is hard to imagine inflation arising within the grand cooperative system in the first place, except perhaps during the transition period from the old capitalist system. In such circumstances, to prevent injustice to the lender in the face of inflation, it is recommended that the principal amount of the loan be pegged to the price of a specified commodity such as rice or wheat, provided that the commodity is free of any speculative activities. At the end of the loan period, the borrower then pays an amount of money equivalent to the amount of the chosen commodity that could have been bought when the contract was initiated. In such circumstances, it is probably best to leave such funds in the hands of the private sector, which, for reasons outlined earlier, is normally more efficient than the public sector.

The more important aspect of *Qard-ul-Hassan* funds is that part, which involves both the state-owned Islamic banks and the legal entities. All persons, real or legal, depositing their so-called extra funds (over and above their immediate needs, and for the sake of pleasing Allah (SWT) into an Islamic bank in the form of *Qard-ul-Hassan* savings accounts will clearly see that the bank utilizes them for the immediate needs of the firms to which the bank has initially provided loans. Such properly justified needs might include cash flow, either to buy raw materials or to pay wages. These loans are of a short-term nature and are designed to alleviate temporary financial problems being experienced by enterprises, large or small. They undoubtedly have a beneficial effect, particularly in small regional towns and villages.

In cases where the problems are of a longer-term nature, the short-term humanitarian solution provided by *Qard-ul-Hassan* contracts would not suffice. The answer has to be found elsewhere. (Iraj Toutounchian)

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3- Mosa'qaat Contract in Islamic Finance

August 12, 2012 at 3:34 AM · Filed under legal; By Camille Paldi

Thoughts from Iraj Toutounchian's Islamic Money & Banking, Integrating Money in Capital Theory

This is a contract between the owner of a 'tree and the like' and an *Amel*, against a clear-cut share of the yield, which includes fruit, flower petals, and so on. Again, the constituent parts of *Mosa'qaat* can be separated into tree, labor, yield, and time period. The 'tree and the like,' which form the subject of an agreement must possess the following characteristics:

1. The trees and plants should be such as have gone into the ground and be capable of staying in the ground for more than one year. It then follows that vegetation and plants of a seasonal nature, which naturally last less than one year, cannot be the subject of such a contract.
2. Non-yielding trees, which do not give fruit, cannot be the subject of a *Mosa'qaat* agreement unless their leaves or flowers have market value.
3. The garden (or orchard) owner should really own the trees or interests therein, and/or should be entitled to use them.

The specification and boundaries of the orchard or garden should be stated in relation to the yield, as well as the type and number of trees. If the share of the parties is fixed as a definite quantity of the yield, and/or the yield of certain trees is reserved for one of the parties, and the rest for the other party, the transaction is void. In the same way, it is not permissible for the entire yield to go to one of the parties. (Iraj Toutounchian)

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4-Direct Investment and Islamic Syndication

August 12, 2012 at 1:57 AM · Filed under legal; By Camille Paldi

Thoughts from Iraj Toutounchian's Islamic Money & Banking, Integrating Money in Capital Theory

This is another of the activities of Islamic banks subject to joint-venture regulations. The establishment and start-up of new production and development units through this type of investment is permitted where equity participation is either impossible or where the private sector is reluctant to become involved. Where possibilities for direct investment exist in line with the country's economic expansion and development programs, such a contract is the most viable for Islamic banks. They are subject to the usual technical, economic, and financial studies and evaluation, which should show the project to be viable from all angles.

The syndication transaction is a special financing instrument devised for the purpose of financing large-scale investment projects. Such projects are jointly financed by a consortium of Islamic banks, which pool their resources and thus spread the risk between them.

Khan recommends that this consortium be operated using a lead-manager in the shape of a bank of international repute and standing: "It is usual for the Lead-Manager to form a consortium of underwriters and co-managers to execute [the project] effectively. The relationship between the Lead-Manager and other participants in the financing is clearly defined." (Khan 2000: 29) The sale of all or part of the investment (that is, all or part of the shares of the Islamic bank) to the general public in an Islamic stock exchange is possible after the project becomes operative. (Iraj Toutounchian)

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5-Mudharabah

August 12, 2012 at 1:36 AM · Filed under legal;By Camille Paldi

Thoughts from Iraj Toutounchian's Islamic Money & Banking, Integrating Money in Capital Theory

Mudarabah, the most-widely known Islamic contract, is a profit sharing contract in which one party (the *Rab al Maal*) provides funds and the other (the managing trustee, the *Mudarib* or *Ameel*) management expertise. This contract is believed to come from the Arabic word *darb*, which means walking and traveling on the earth. (The *Mudhrabah* is sometimes known as *Qirad*).

While the literature extends this contract to include investment and launching a project, we confine ourselves here to trade activities. Profits are shared between the *Rab al-Maal* and the *Mudarib* in a proportion agreed in advance. Losses, if any, are the liability of the former, and the latter loses his share in the expected profits. If, however, the *Mudarib* is proven to be guilty of willful negligence, fraud, or a breach of trust in handling the funds, he/she is totally responsible for the losses. Funds are to be used for Islamically permitted activities and, according to Khan:

The *Rab-al-Maal* has the option to restrict the *Mudarib* to a specific purpose, period, level of risk, and so on … The *Mudarib* is not allowed to buy or sell *Mudarabah* assets against or for his own possessions. The profit can be used again in another trade, but only after paying the share of the *Mudarib* in the profit. (Khan 2000:27)

Other characteristics of the *Mudarabah* contract are set out below:

1. *Mudarabah* is an optional contract, giving either of the parties the right to revoke the agreement unless a condition to the contrary has been included in the agreement;
2. It is a short-term contract of up to a maximum of one year and solely for the expansion of commercial activities. The *Mudarib* is either a real person or a legal entity;
3. Unlike the Principal-Agent theory, the roles of the *Rab al Maal* and the *Mudarib* are completely separate; and in this respect, the owner should only supply the capital and under no circumstances accept the responsibilities of the managing trustee, thus ruling out the possibility of Islamic banks acting as the *Mudarib*. Even if, at the signing of the contract, the *Mudarib* accepts responsibility for

some of the costs, this does not constitute playing the role of the owner of the funds.

4. The capital must definitely be in ready cash supplied in a lump sum or in parts, which means that a *Mudarabah* in profits and dues is not correct;
5. Except for those stipulated in the agreement, no other costs can be defrayed from the capital, and any such incidental costs are to borne by the *Mudarib;*
6. The responsibility of the *Mudarib* in safeguarding the *Mudarabah* capital is that of the trustee agent. Otherwise, the *Mudarib* cannot be held responsible for the safety of the capital or for damages suffered in the course of trading, except if it has been clearly stipulated in the agreement that the *Mudarib* will pass the ownership of his own property to the owner up to the extent of the damage or loss.

The *Mudarabah* contract has another characteristic that is peculiar to real persons. It is composed of three different contracts; namely: safe-depositary (*Amanah*); Trustee agency (*Wakalah*); and Partnership (*Musharakah*). The importance of each becomes evident if the *Mudarib* happens to die in the course of trading. If (s)he dies before the purchase is made, then the total capital is owned by the *Rab al Maal*. If s(he) dies after purchase of the goods, but before selling, the *Mudarib* is treated as the trustee agent and all costs incurred in the course of buying are the responsibility of the owner of the funds. Finally, if the *Mudarib* dies before selling the goods, but before reporting to the *Rab al Maal*, then (s)he has all the rights as if (s)he were alive and is considered to be a partner and his/her share is to be paid according to the conditions agreed at the outset.

The capital of the *Mudarabah* contract should include one or more of the following: purchase price; packing; transportation, and forwarding costs; insurance and registration of orders; warehousing; bank costs; customs levies and commercial tax; and any other foreseeable costs. The payment of other costs not provided for in the contract is the responsibility of the *Mudarib* who, by signing a letter of understanding, accepts this responsibility against receipt of a compensation fee. (Iraj Toutounchian)

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6-Properties of Money in Islamic and Conventional Settings and the Effect on Society

August 9, 2012 at 10:03 PM · Filed under legal ; By Camille Paldi

Thoughts from Iraj Toutounchian's Islamic Money & Banking, Integrating Money in Capital Theory

…if benevolence were to lead each person to regard her fellow's concerns as her own, there would be no free riders or parasites to be restrained by the visible hand of

cooperation. All would seek naturally to coordinate their actions for the common good, without putting forward opposed claims to the fruits of their endeavours, which justice must resolve. (Brosio and Hochman 1999, Volume 1: 114).

'In my view, the most important properties of money in an Islamic Setting are the following:

(1) Centrally produced and managed (by central bank);

(2) Indivisibility (further elaboration needed);

(3) Velocity of circulation (greater than one);

(4) Externality (of becoming actual capital);

(5) Non-excludability.'

In the case of fiat paper money in capitalism, its being considered durable, with no depreciation, but interest bearing seems to have raised its rights well above those of commodities it represents.

If money itself were a commodity, like gold, the picture would look different, as we saw above. The commodity value of gold contained in money would appears as one of the asset items on the Central Bank's balance sheet, with the other part, which comprises the exchange value of the money, as a liability. Therefore, there are two extreme cases. First, total money consists of say gold in which its exchange value equals its value; that is, its metallic value. Second, total money consists of fiat paper money, in which its commodity value is nil. In the first case, the metallic value of money appears as an asset item in the Central Bank's balance sheet and nothing, in this regard, on the liability side. In the second case, all exchange values of the money appear on the liability side of the balance sheet and nothing, in this regard, on the asset side.

In capitalism, the functions of money are traditionally discussed and analyzed with the underlying implicit assumption of interest.

'Only in the event of money being used solely for transaction and never as a store- of-value, would a different theory become appropriate.' J.M. Keynes

'The transition from the conception of money as a medium of exchange to money as a store- of -value has raised new problems.' (H. Johnson)

Mill was not unaware of the function of money as a store- of- value:

...the effect of the employment of money, and even the utility of it, is that it enables this one act of interchange to be divided into two separate acts or operations; one of which may be performed now, and the other a year hence, or whenever it shall be most convenient. Although he who sells, really sells only to buy, he need not buy at the same moment when he sells; and he does not therefore necessarily add to the immediate demand for one commodity when he adds to the supply of another. (Mill 1848:70)

This statement clearly demonstrated that Mill had quite well understood the analogy between store- of- value and speculation.

Many economists, myself included, believe that the capitalist economic system is incapable of settling such annoying issues in a satisfactory manner. Its inability to do so probably stems from its denial that speculative motives could be behind the motive demand for money; which is obvious and clearly undeniable. *Any attempt to save capitalism from its malfunctions is futile unless the robust destructive role of the store-of-value function of money as a means of speculation is admitted and the system amended accordingly.*

It was long believed that money had just one important function to play; that is, as a medium of exchange. To this was added the unit- of- account function. This belief, beginning with the pre-classical monetary theory and extending to the classical and neoclassical monetary theories, was maintained during the period from 1650 through to 1936.

In the economics of John Maynard Keynes, as Professor Dillard so aptly put it,

...'money holds the key to explaining unemployment but not to its remedy.' In the economics of Jacob Vanderlint ... money holds not only the key to explaining unemployment, but also the effective remedy for unemployment. The explanation of this phenomenon lies in the fact that none of these writers paid any attention to the role of expectations in the economic decision-making process. Hence, the theory of liquidity preference is conspicuously absent in their writings. Without the speculative (asset)-demand-for-money function, the elasticity of aggregate demand with respect to an increase in the quantity of money will be equal to unity. (Ascheim and Hsieh 1969: 141: my italics).

1. Social Justice is the ultimate goal of Islamic economics, the importance of which cannot be exaggerated. Any deviation from such teachings brings about Zulm (injustice). Embedding justice into the heart of an economic system is not as hard as most mainstream economic theories imagine.

2. There must be cooperation among all individuals and legal entities, from which positive synergy emerges. This will naturally bring about externality, both in consumption and production. Externality in consumption takes the form of

interdependent utility functions; in production it gives rise to 'the share economy' or a 'grand cooperative system,' which make it possible for individuals to enjoy part of the profits of the firms for which they work.

3. In any conflict between social and personal interests, the social interest must prevail. To most Western economists, the concept of efficiency is based on Paretian value judgments, which assume that: a) there is no society above and beyond individuals. Thus, we should be interested only in the welfare of individuals and nothing else; (b) individuals are the best judges of their own welfare and choose what is best for themselves; (c) social welfare can be said to have increased if at least one person's welfare has increased and no one else's has fallen. Pareto optimality has little to say about the 'correct' allocation of resources and says nothing about equity (justice).

When it comes to the debate over the level of redistributive taxation of public expenditure, such comparison cannot usually be made using the Pareto criteria. Similarly, saying which of two options is the better when both are Pareto improvements is impossible. (Connolly and Munro 1999: 32-3) In brief, the capitalist system exhibits all the hallmarks of a zero-sum game. Muslim scholars have different interpretation of 'individual' and 'society,' however. Briefly, in Islam we believe that (a) society exists independent of real entities (individuals); (b) society has the prerogative in policy issues; (c) only with cooperation among individuals will social welfare increase; (d) with cooperation and the resulting externality, both individual and society benefit without incurring any loss to either side; and (e) the Islamic economic system can be visualized as an increasing-sum game. Keeping all of this in mind, we are really talking about a very different economic system.

4. There must be no money market. This is a simple outcome of the abolition of Riba in Islam, which in turn prevents the development of speculation in any market. *Money then becomes an endogenous variable and integrated in capital theory.*

Capitalism is mainly characterized and analyzed in an environment with no cooperation and externality – the two fundamental characteristics of human societies, whose neglect has a profound and adverse impact on the welfare of a state. Specifically, Pareto optimality, which has been proved not to be necessarily superior to any non-optimum, ignores these two elements (see Nath 1976: 21-2). Underlying the concept of Pareto efficiency (known as the first and second fundamental theorems of welfare economics) are the Paretian value judgments outlined above.

Pareto optimality has been extensively criticized as being overly utilitarian, with Professor Sen leading the attack:

The traditional propositions of welfare economics depend on combining self-seeking behaviour, on the one hand, and judging social achievement by some utlity-based criterion, on the other. In fact, the traditional welfare economic criterion used to be (and still seems to be) the simple utilitarian one, judging success by size of the sum total of utility created – nothing else being taken to be of intrinsic value. A social state can be said [said to be] Pareto Optimal if and only if no one's utility can be raised without reducing the utility of someone else. This is a very little kind of success and in itself may or may not guarantee much. A state can be Pareto Optimal with some people in extreme misery and others rolling in luxury but can be made better off without cutting into the luxury of the rich. (Sen 1987:30-1)

Sen believes that the basic issue is whether there is a plurality of motivations or whether self-interest alone drives human beings.

Quite contrary to the Paretian Value judgments outlined above, I like Murtada Mutahhari believe that:

Society is a real compound like the natural compound. But the synthesis here is of minds and thoughts and of wills and wishes; the synthesis is cultural and not physical … Individuals … who enter into social life with their gifts acquired from nature and their inborn abilities, spiritually merge into one another to attain a new spiritual identity which is termed 'social spirit.' In this case, the whole or the compound does not exist as a single entity. It is different from other compounds … In the synthesis of society and individual, though an actual synthesis takes place .. the plurality of individuals is not converted into a unity … Society conceived as a single physical unity is only a hypothesized abstraction. (Mutahhari 1985: 12)

Viewed in this way, the welfare of society takes place over one or a group of individuals. This overrules the Paretian values and means that society is the best judge when conflict arises between the welfare of the society and that of an individual. (Iraj Toutounchian)

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7-Interest (Riba) in Islam

July 16, 2012 at 7:11 PM · Filed under legal; By Camille Paldi

Thoughts from Iraj Toutounchian's Islamic Money & Banking: Integrating Money in Capital Theory

In examining the scope of interest on money, we adhere to the valuable Judgment on Interest produced by the Pakistan Federal *Shari'ah* Court in 1995. Unless otherwise specified, all the following assertions are adopted directly from this valuable work.

These include:

The definition of *Riba* as:

The excess amount chargeable over and above principal in lieu of time and by way of a condition. The definition is applicable both to contemporary simple and compound interest. Excess, whether a penny worth or compounded to many fold, is *Riba* if the same is stipulated at the time of contract.

To resolve the misunderstanding about simple and compound interest, the assertion is:

Some scholars have misunderstood the verse "Devour not *Riba*, doubling and quadrupling," interpreting thereby that the *Qu'ran* bans only compounded Interest but not simple interest…The verse was revealed to discard the anti-social pre-Islamic custom. That is why they are warned of their selfishness by adding the word doubled and quadrupled. This does not mean that if interest is not thus multiplied, it would become acceptable. Absolute prohibition of interest appears in the other two verses … An examination of the contemporary practices of interest would suggest that it multiplies itself firstly by becoming a part of capital for re-lending and secondly by debt servicing retaining the principal intact.

With respect to savings accounts:

Interest [that is, any nominal excess over and above the principal amount deposited and being the obligation of the bank] accruing on the Provident Fund or Saving [bank] Account comes under *Riba* … The Account as in vogue consists of *Riba* (383).

With respect to the opinion of the *Fuqaha* (Shari'ah Scholars in Islamic Jurisprudence):

…an excess over and above the sum lent would become interest and is treated to be strictly prohibited. This fact is born out of the *Qu'ran*, the Holy Prophet's (peace of Allah be upon him) tradition and the detailed discussion by the *Fuqaha* of all the schools of thought without any exception.

Islamic *Fiqh* Academy, Jeddah, which is representative body of the Muslim world, has declared bank interest in all forms and on all accounts as *Riba,* prohibited in Islam.

At this point, it should be clear that a sharp distinction exists between a 'loan' and all other Islamic modes of contract. A loan, by definition, is a temporary abstinence from using a sum of money and is generally paid by the lender, the abstainer, to the borrower, the user of the money, for whatever purpose the borrower has borrowed and for an excess over and above the principal amount, varied on the basis of the time period of the loan. It is, further, the obligation of the borrower to pay back the principal amount of loan plus the agreed excess. The lender does not have any claim over the outcome of the use to which the borrower puts the money as long as the lender receives the principal plus the excess. The lender can obtain a warranty from the borrower to ensure both parts of this obligation are met. The excess is obviously independent of the outcome of the purpose for which the loan has been borrowed. This independence makes it realistic to consider the excess as 'the cost' to the borrower. Finally, in a loan contract, the legal aspect of money remains intact in that it does not have to be involved in 'investment' in its strict sense. It could be used in any activity – consumption, speculation, or investment. Unlike an equity fund, a loan, or debt fund, is the liability of the borrower. In the case of a *Musharakah* contract, for instance, the equity fund composed of each partner's money is pooled and no one is responsible for another partner's share. They all have inseparable responsibility to the extent of their individual share of the whole.

Riba occurs when the borrower is obliged, by whatever means, to pay back an excess, over and above the nominal principal. Such excesses are strictly forbidden in Islam. Even in *Qard-ul-Hassan* loans (which are generally short-term and for small amounts), the only obligation on the borrower is to repay the principal. All Islamic contracts are strictly purpose-oriented and each party to the contract must know the exact purpose and, in some cases, the period of time for which they have agreed to sign the contract. The signed contracts, with all the pre-specified conditions, make them very different and distinct from loans. The central issue in Islamic contracts lies in the fact that it is a legal device which transforms the legal nature of money to that of 'capital.' For reasons that will be made clear later, I prefer to use 'asset' rather than 'capital' in order to avoid any confusion and misunderstanding, and to bridge the gap that exists between the different connotations employed by economists and accountants about these two concepts. As I see it, 'loan' stands in the same relation to Islamic contracts as bonds do to stocks. The interest paid to bond-holders is considered as a cost to the issuer of the bond but not the dividend paid to the stock-holder by the stock-issuer. The obligation of the bond-issuer has to be clearly distinguished from that of the stock-issuer. This distinction plays a crucial role in distinguishing Islamic banking practices from those of conventional banking.

Ironically, this important point has slipped the mind of many Muslim scholars.

Conventional Banking is based on loans received from depositors and loans granted to customers. An Islamic Bank behaves, on the one hand, as the advocate of depositors and, on the other, as the partner of potential investors. When it comes to signing contracts with investors, the Islamic bank behaves as one of the partners to the contract, both on behalf of depositors and of itself. In essence, this makes Muslim depositors shareholders in the investment projects the Islamic bank signs with potential investors…

Surprisingly, for whatever reason, some Muslim scholars attempt to find 'resemblances' between Islamic and conventional banking (especially with US banking) despite the fundamental differences that exist between them in many aspects; philosophical foundations (world view), type of analysis, factors included or left out, and outcomes. For example, Mohsin S. Khan writes:

"It will be noted that the model here is a dynamic variant of the standard IS-LM model, and no special factors have had to be introduced up to now … In many ways … lack of understanding and confusion … exists about Islamic economics … As was shown in the paper, this model does provide a reasonable portrayal of the types of Islamic banking systems that have been put into practice in certain countries…The model that has been developed in this paper also turns out to have many similarities with standard models used to analyze the behavior of banks at an aggregate level … Indeed, it is readily apparent that the Islamic model of banking, being based on principles of equity participation, bears a striking resemblance to proposals made in the literature on the reform of the banking systems in many countries, particularly in the United States."; (Khan and Mirakhor 1987: 15-35).

One of the main objectives of this book is to strive against biases, confusion, misunderstanding and finally misdirecting the authorities of Islamic banks. Another objective is to show, to the best of the author's knowledge, how Islamic banking is supposed to operate given that justice will be obtained and maintained in conjunction with efficiency.

Let us return now to the judgments about *Riba* made by the Pakistan Federal *Shari'ah* Court, which points out that 'interest' and Islam cannot remain together in a Muslim society. Having made clear what the nature of a loan is, the Court says, 'It may, therefore, be stated that what *Riba* has forbidden in the *Qu'ran* and *Sunnah* includes interest due on the loans taken or given for commercial and productive purposes by banks or other financial institutions. With reference to Dinar and Dirham it says: 'Guided by the *Hadith*, the *Fuqaha* have pointed that in case Dirham or Dinars are lent out by counting, they will be paid back by counting not by weight. Similarly, in case these are lent out by weight, they will be returned by weight, not by counting.

On the verdict made on commodity loans, it is interesting to note the following: 'In respect of the loan of a commodity, it is further provided by the *Fuqaha* that it should be returned in the same kind and quantity irrespective of any change in its price at the time of return of the loan." It notes also, however, that 'there is a considerable juristic opinion available to the fact that an increase to offset the inflation would have legal justification and would not be counted as *Riba.*

However, we need to elaborate on these last two verdicts, on several grounds:

a. The opinions expressed are not necessarily the verdict of one jurist. However, if it happened to be the one person's verdict, they would necessarily be contradictory unless the jurist has correctly made the distinction between money and commodity.

b. It is not clear in the second of these as to whether it is applicable to a ‘loan’ or potential capital (that is, deposits) made by Muslims in an Islamic society. If it happened to be restricted to loans (that is, *Qard-ul-Hassan*) it would seem to be justified; but if it is not, and it refers to a truly Islamic banking system in which deposits are share-holdings in investment project undertaken through Islamic banks on behalf of depositors, it runs into a problem in that the verdict has failed to make a distinction between loan and Islamic contract. At this point, I would like to make a strong assertion that is subject to verification in theory as well as practice as follows: If Islamic banking is properly launched using Islamic contracts, then inflation, if any, is automatically taken care of. This assertion can easily be derived from the mere fact that money and Islamic banking will no longer be exogenous to the system, but endogenous. The evidence of economic history throughout the world has shown that dealing with the monetary sector independently from the real sector will necessarily make the system unstable. An important symptom of instability is inflation, or unemployment, or both simultaneously.

Let us briefly go over the part of the assertion that seems to have been ignored by jurists.

Islamic banks take part of the profits earned based on preconditions set out in the signed contract. Profits are, by definition, the difference between total revenue and total costs. Total revenue is, in return, the product of the price of the commodity sold multiplied by the quantity sold. Any probable inflation is reflected in total revenue terms. In other words, in Islamic contracts the depositors are automatically hedged against inflation as opposed to a loan, where the lender is always worried about the probable decline in the purchasing power of the principal lent out.

If the verdict refers to the decline of the purchasing power of the deposits made in an Islamic bank, it is worth the reader’s while to note the results obtained by the author’s experiments on the data of 12 highly advanced industrial countries. The results show that inflation is deeply rooted in interest-based loans and speculation (on money or any other durables), these being the principal sources of money creation. Given that the statistical results are correct and reliable, the verdict has failed to recognize the real cause of inflation; hence a different verdict is called for and soon.

To end this section, let us see what the most celebrated economist of the century, Lord Keynes, has to say about interest:
It should be obvious that the rate of interest cannot be a return to saving or waiting as such. For if a man hoards his savings in cash, he earns no interest, though he saves just as much as before. On the contrary, the mere definition of interest is the reward for parting with liquidity for a specified period. (Keynes 1936: 166-7)

Though he doesn’t say so explicitly, it is clear from the fact that he includes time as one of the essential components of interest that Keynes is referring to a loan contract here. His definition substantiates ours in such a way as to prevent any misunderstanding. He further observes that ‘the rate of interest is, in itself, nothing more than the inverse proportion between a sum of money and what can be obtained for parting with control over the money in exchange for a debt for a stated period of time.’ (Keynes 1936: 167)

This last statement seems to remove any possible confusion about our definition in that it contains all the elements for interest to prevail. Additionally, it substantiates our formulation for the interest rate emerging from speculation. Finally, he is quite clear on the equilibrating force behind the rate of interest: “The rate of interest is not the ‘price’ which brings into equilibrium the demand for resources to invest with the readiness to abstain from present consumption.’ (Keynes 1936: 167)

Again, this statement clearly demonstrates that the rate of interest is the outcome of the money market and not that of the real sector.

Yet, strikingly, there are many writers who still believe that interest (rate) cannot be avoided as long as economic forces are in play, even in an interest-free Islamic system!

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8-Democracy in Capitalist Societies is Questionable

July 28, 2012 at 2:56 AM · Filed under legal; By Camille Paldi

“The most important feature of capitalism is interest. It essentially manifests in (interest-based) loans. Loans of this sort are founded on self-interest, which excludes the lender from the outcome of the way they are used. This means that the borrowers – mainly firms – take responsibility for the outcome of their business. In most cases, they have the power to pass the interest burden on to consumers in the form of higher prices. In fact, the interest cost is part of the costs of production. The individualistic nature of such contracts is itself the underlying assumption of capitalism. The share stock is not a loan but a ‘cut’ in the ownership of a firm, in the form of a fraction of the ownership of means of production. (Wilken 192:36) Unlike loans, the financial essence of shares is that it need not be paid back. Thus, the majority share (equity) capital controls the firm. In some circumstances, less than half of the shareholders may, in practice, be sufficient to control the firm. This has far-reaching consequences and provides the basis for the concentration of capital into a few hands. Economic power, in turn, reaches a point where it exerts significant impact in political matters. Under such conditions, democracy and the democratic society become questionable.” – Iraj Toutounchian

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9-The Evils of Interest

August 7, 2012 at 5:40 PM · Filed under legal; By Camille Paldi

Thoughts from Iraj Toutounchian's Islamic Money & Banking: Integrating Money in Capital Theory

"*The most powerful force in the universe is compound interest*." — Albert Einstein

"*Zero nominal interest rates are necessary for efficient resource allocation*." — Friedman Rule

No country could experience severe economic problems if there were a deep understanding of money, interest, and speculation. This is neither an exaggeration nor a naïve assertion. If interest were necessary and useful, or even simply harmless, it would not have attracted so much debate and controversy. History provides abundant evidence of the harm that it has inflicted over the centuries.

No country has ever implemented a full-fledged interest-free financing system to supply a plumb-line through which almost all deviations would be directly associated with economic justice and is, in my view, nothing more than the abolition of interest. If properly implemented, it would relieve millions of households that currently lie under its fatal heaviness. In short, we need a theory of money free from the anomaly of interest.

It has been asserted again and again that we need speculative demand for and supply of money in order for the rate of interest to develop. The rate of interest developed in the money market may or may not have an impact on saving and investment.

An interest-based loan involves the transfer of ownership of a sum of money from the lender to the borrower, for a pre-specified agreed period and the addition to the principal. It is based fundamentally on the individualistic behavior upon which capitalism has been constructed. Since it is based on the mutual consent of the lender and borrower, a naïve person may view it as a contract, which benefits both parties. While this may be true in some cases for the individuals involved, it is not true for society as a whole. In most cases, the borrowers are experiencing some degree of hardship, to relieve which they accept all the consequences, which may result in compounding that hardship in a way that has an adverse effect on their whole lives. This quite often happens in the case of consumption loans. The production loan is quite different in both its analysis and consequences. Unlike the consumption loan, in which borrowers have no choice other than to put their family life in hardship, the production loan quite often provides an opportunity for the borrower to pass the interest costs on to consumers since, in the capitalist system, these are accepted as part of the costs of production and, hence, tax deductible.

Heinrich Haussmann produced an interesting and amusing attempt to show the evils of interest in Germany, using statistics from Bundesbank. To show how interest income accumulates exponentially, he quotes the example of a calculation of the increase in value of one pfennig (one-hundredth of a Deutschmark) at 5 percent compound interest from the birth of Christ to 1990. The number was huge, amounting to 135 billion balls of gold, each the size of the earth!

To obtain a better understanding of the accumulated figure at different times, the time span was divided into different periods. In the first period, consisting of 296 years, only one kilogram of gold was obtained. In year 1499, the first gold ball was formed; in 1749, there were one million gold balls; in 1890, one billion gold balls were obtained. Interestingly enough in the final 100 years to 1990, 134 billion gold balls the size of the earth had been obtained. (Creutz 1999: 25-6).

The simple rule of the compound interest shows that the principal amount would double every 14 years, which would produce 268 billion balls by 2004 and 536 billion in 2018. (Iraj Toutounchian)

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10-Classification of Islamic Modes of Contract

August 10, 2012 at 7:45 PM · Filed under legal; By Camille Paldi

Thoughts from Iraj Toutounchian's Islamic Money & Banking, Integrating Money in Capital Theory

Islamic contracts can be classified into two broad categories: (1) those with variable returns (such as *Musharakah* and *Mudarabah* contracts) and (2) those with fixed returns (Installment Sales, Hire Purchase, *Jo'aalah*, and the like). The second category may be defined as auxiliary contracts, which can be used in conjunction with the first category or after such has been utilized. While the first category involves risk, the second type is riskless, which might be more appealing to Islamic banks. However, there is an urgent need for a government institution to shoulder the burden of risk produced by the public sector and beyond the control of the private sector. Reducing or eliminating risk for investors requires that the banks pay compensation from their own share of profit by changing the value of Alpha (The ratio of a bank's share of profit to its capital share relative to that of the potential investor). This process has to be closely monitored by the central bank and provides uniformity across all banks under its control, wherever they may be located.

Whichever contract an Islamic bank uses, the accountants responsible for submitting balance sheets and P&L statements to the tax authorities do not accept anything under the heading of cost. Neither accountants nor economists can deny that the Islamic banks' share of profit paid by investors is a sort of dividend, which is essentially determined after all costs have been subtracted from revenue.

To fulfill all of these functions effectively, an Islamic central bank must have personnel highly qualified in portfolio and risk management and project appraisal. This is also a must for each individual Islamic bank.

After they have followed the central bank's instructions to the letter, the banks can safely be allowed to gradually reduce RRR (Required Reserve Ratio) to zero, which will make capital abundant (in perfect line with Keynes' assertion that there is no reason for capital to be scarce).

Admittedly, the monitoring costs involved in Islamic banking are higher than those of conventional banking but these are outweighed by the potential benefits to be had from reducing unemployment and keeping prices constant. More importantly, the distribution of income and wealth will be more equitable and guarantees sustained economic development. The role of an Islamic central bank in this regard cannot be overstated.

The Islamic banking system and Keynesian theory coincide in their aim of 'getting rid of many of the objectionable features of capitalism.' Keynes acknowledged that 'it is our best advantage to reduce the rate of interest to that point relative to the schedule of the marginal efficiency of the capital at which there is full employment.' (Keynes 1936: 375)

In working toward this goal, the Islamic central bank need not act as an independent institution (as it is in the conventional system). In order to make money an endogenous variable through its integration in the real sector, it makes sense that the institution responsible for financial policy is also part of the institution responsible for fiscal policy. In other words, we suggest that the governor of the Islamic central bank be a vice-minister under the control and supervision of either the Ministry of Economics or Ministry of Finance. This will have the effect of making financial policy complementary to fiscal policy. It has been shown that this financial – fiscal mix will prevent the emergence of the 'crowding-out effect,' which concerns many economists. — (Iraj Toutounchian)

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11-Capitalist v Islamic Economic System

August 9, 2012 at 9:11 PM · Filed under legal; By Camille Paldi

Thoughts from Iraj Toutounchian's Islamic Money & Banking, Integrating Money in Capital Theory

Negatives of the Capitalist Economic System

1. Non-satiation: the primary assumption in utility theory;

2. Denial of society: assumed Pareto efficiency;

3. No cooperation: due to both impossibility of comparison of utilities and fixed-wage payment to labor;

4. Emphasis on self-interest to the neglect of other aspects of the complexities of human nature;

5. Self-interest overwhelming social interest;

6. Denial of externality, based on self-interest and impossibility of comparison of utilities;

7. Equity, a second-hand argument with no guarantee of success;

8. Conflict between efficiency and equity;

9. Equilibrium guaranteed by efficiency but not optimality;

10. Unchecked greed due to non-satiation and to denial of society;

11. Zero-sum game as a result of no cooperation;

12. Virtual wealth, resulting from non-satiation and to denial of society;

13. Endorsement of all kinds of risks, artificial or resulting from non-satiation;

14. Positive interest rates in all markets: basically characterized by individualism;

15. Scarcity of capital arising from positive nominal interest rates on money and the resulting speculative activities;

16. Unemployment as a result of scarcity of capital;

17. Inflation and business cycles arising from speculative activities;

18. Failure of 'invisible hand' to direct each person to promote the benefit of all;

19. Free market, resulting from mutual unconcern;

20. Profit maximization, which means least remuneration possible given to the factors of production;

21. Fixed-wage rate for labor determines the productivity of labor, rather than vice versa;

22. Endorsement of speculative activities in all markets;

23. Money treated as a private good, despite being an almost perfect expression of a large externality, and put in the hands of the private sector;

24. Denial of public sector to a large extent;

25. Wealth-based voting system;

26. Given constant technology unethical actions such as aggression serve to increase social welfare;

27. Either Aggregate Demand or Aggregate Supply can be increased, but not both at the same time;

28. Interest (Riba) forces the monetary sector to be separated and treated independently from the real sector;

29. Interest (Riba) and money market make money an exogenous variable with all the problems attached to it.

Positives of the Islamic Economic System

1. Satiation checked via social considerations;

2. Existence of society as a top priority;

3. Cooperation guarantees equity, to a large extent, via labor's share in profits;

4. Social interest overwhelming private interest;

5. Emphasis on human nature in all its complexity;

6. Presence of all kinds of externalities on a large scale;

7. Equity as the ultimate goal;

8. Coexistence of equity and efficiency;

9. Cooperation guarantees both efficiency and optimality;

10. Greed held in check through cooperation;

11. Increasing sum-game arising from cooperation;

12. Denial of virtual wealth;

13. Denial of any artificial risk; endorsement of all natural risks;

14. Zero nominal interest rates in any market;

15. Adequate capital arising from abolition of interest and from speculative activities;

16. Full employment resulting from removal of restrictions on the supply of capital;

17. Stable prices and sustained growth resulting from equitable distribution of income and wealth through cooperative enterprises and through abolition of interest (RIBA) and of its derivatives;

18. Cooperation provides a visible hand to promote the benefit of all;

19. Managed market;

20. Maximazation of social welfare function as if labor force and the whole population matter;

21. Labor's share in profits of cooperative firms leads to increased production and to an increasing-sum game;

22. Denial of speculative activities in any market;

23. Money endorsed as an 'impure public good' and thus in the hands of the public sector;

24. Emphasis on private-public partnerships;

25. Knowledge-based voting system;

26. Given constant technology, social welfare increases through cooperation between and among individuals and institutions;

27. Aggregate Demand and Aggregate Supply can simultaneously be increased; the importance of which cannot be exaggerated. This unique feature is absent in the proposed stimuli plans to combat the present global financial crisis;

28. Monetary sector is not allowed to be treated independently and separated from the real sector;

29. In the absence of interest (Riba) and of the money market money becomes an endogenous variable being determined from within the system.

'It has to be noted that greed being 'shrewd' in nature has several origins that have to be tamed and checked in order to prevent further economic unrest. Fiat money is inherently a virtual phenomenon and one of the strongest factors in encouraging the kind of unchecked greed which played such a pivotal role in the recent global financial crisis in the form of virtual financial derivatives. It is imperative that this is revised so that it cannot happen again.

If all the positives of the Islamic economic system outlined above are correctly launched, they will provide the world with a new challenge and bring it to the zenith of prosperity. They will expand man's utility frontiers beyond those in effect and substantially increase social welfare.

The Islamic economic system might provide a slower rate of growth than that of capitalism, but it will be steady. The capitalist system has had a bad record in producing economic turbulence that causes suffering for millions before it returns to its normal trend. It is a matter of choice whether rapid economic growth accompanied by severe cyclical movements and injustice is preferable to a slower but steady growth rate accompanied by equitable distribution of income and wealth. (Iraj Toutounchian)

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12-Islamic Banking Can Save Capitalism (Part 1)

July 18, 2012 at 10:58 PM · Filed under legal; By Camille Paldi

Excerpt from Iraj Toutounchian's Islamic Money & Banking: Integrating Money in Capital Theory

"It was once believed that the capitalist economy would be self-regulating and self-correcting, but the intensity and frequency of economic fluctuations have made even the most ardent of economists withdraw from such claims. The greed and selfish consumption that underlies the system has disturbed the ecological balance in a way that poses a massive threat to all mankind, a threat whose magnitude could have never been imagined by the great architects of the Scientific Revolution. Despite the scientific community's repeated warning about the vast potential for catastrophe, the irresponsible exploitation of natural and human resources is perpetuated by a system which secures the benefit of a few at the expense of the overwhelming majority of the planet's population. There is a rising tide of public dissatisfaction and disgust with such behaviour. The “Greed is good” mentality, which has predominated in the capitalist world, particularly since the 1980’s, is under challenge.

The United States represents the prototype of a purely capitalist country. While the sheer size, power, and complexity of its economy put it in a category of its own, this does not mean that its manifold problems are confined within its shores. Quite the opposite, in fact – to which the worldwide ramifications of the recent U.S. sub-prime crisis will attest. Nevertheless, the uniqueness of the American economy requires that a few specific comments be made about it.

There is endless discussion among economic theorists and experts of America’s federal budget deficit, its negative current account balance, its lack of investment, and the bursting of the financial bubble. But for all the talk, these theorists fail to acknowledge that the capitalist economy intrinsically tends toward recession. They may admit that the economic growth rate has been falling since the 1960’s, but they attribute this to bad policy, rather than seeing it as a reflection of a general process of modern capital accumulation.

The rapid growth of the 1950’s and 60’s was the result of people saving during World War II and the second wave of industrialization in such things as steel, glass, and rubber for the automobile industry, in the construction industries and in the interstate freeway network.

Added to these were the economic stimuli created by two regional wars in Asia, and the extraordinary increase in sales related to modern marketing techniques. Most of these factors have either completely vanished (along with people’s savings) or have reached the point where they can no longer be considered as major stimulants for economic growth.

During the 1980’s, the main economic stimulant was the expansion of the financial superstructure of theU.S.economy through huge advances in the electronics and computer technologies that gave birth to the Internet. These factors, too, have weakened following the bursting of the stock market bubble and a decrease in investment in these industries.

Unemployment, too, is a continuing source of concern in the U.S. During the economic downturn in the early years of this century, the New York Times reported in February 2003 that employment was at its lowest for 20 years and, since the beginning of the crisis two years earlier, had lost more than 20 million job opportunities. Given that the official statistics – which for January 2003 showed 6.5 percent unemployment – do not include those who, confronted with the prospect of prolonged unemployment, stop looking actively for jobs, or those who work part-time yet want full-time work- the real level of unemployment was probably closer to 11 percent. By October 2007, the corresponding figure provided by the Bureau of Labor Statistics was around 5 percent, which again emphasizes the cyclical volatility that characterizes the system.

In spite of lowering interest rates to historically low levels on several occasions in recent years, the Federal Reserve has failed to stimulate investment. This is not surprising since, as we saw earlier, what determines investment volume in the new output capacity is the prospect of gaining investment profit in the future. Recent events should help persuade Western Economists (both Keynesians and Monetarists) that investment is not a function of interest rate and should stimulate them to search for another factor, a factor that is responsive in normal as well as in risk conditions.

This search should direct them toward interest-free (Islamic) Banking, where interest rates are replaced by profit rates and attention is given to both the supply side and the demand side simultaneously. We should bear in mind that business cycles are rooted in money and are related to interest, which is the result of speculation.

As we saw in earlier chapters, the two main issues that should concern all economists are those of equity (Justice) and efficiency. Between the two lies a trade-off area. Under capitalism, the emphasis on efficiency and equity is a spill over that will somehow emerge in the process of economic growth. But consider the position in the United States, where 'the richest 1 percent of households owns 36 percent of all the wealth ...[and] wealth inequality has a Gini coefficient of 0.82, which is pretty close to inequality.' (Wolff 2003: 1-2) Where is the equity in that, and why is it that after the passage of more than 200 years justice has not yet emerged?

The socialist system claims to have justice as its goal and regards efficiency as a by-product. Yet, it has a mistaken image of justice. The socialists' error is that they do not respect private property. Proudhon's famous assertion that 'property is theft' is used to justify the belief that ownership is always obtained through theft. However, he did not attack private property as such. 'On the contrary,' argues Eric Roll '...he regarded property as an essential condition of liberty' and saw justice – 'the supreme principle of human life' – as an equilibrium of opposing forces. (see roll 1961: 242).

The issue of equity is the issue of rights, including the right of the owner of capital (not money) to possess and enjoy the results gained through the utilization of that capital. Neither is the issue of a given society. Even when economists talk about efficiency they implicitly consider equity. Specifically, the welfare cost of inflation, which has occupied a considerable volume of economic literature, is mainly targeted toward ensuring the least damage to society. This is nothing other than justice (equity).

In Islamic economics, the rights of people and those of 'things have been defined prior to and after the distribution of wealth and justice as an uncompromising goal for all members of the community. Where there is justice as people like Rawls and Gauthier interpret it, all things are in their proper places and it is not difficult to demonstrate that this produces optimality. The resulting corollary is that simultaneous access to both stable prices and full employment is attainable. Meanwhile, the natural course of affairs, which results from the application of justice, will create a state of equilibrium between human psychological needs and the surrounding environment (something the capitalist economy has been unable to attain).

History shows that ever since mankind achieved this understanding of justice, he has struggled against interest – a struggle that pre-dates Christ by hundreds of years. (In this regard, note that usury was repugnant to Aristotle.) The economic literature throws up many examples of serious thinkers who rejected interest. Rolls tells that Proudhon believed that 'interest being abolished, exploitation through property is abolished, too" (Roll 1961: 244). In the serious scientific discussions of zero interest in the 1930's, Gesell came up with the idea of 'stamped money' as a means of omitting interest from the economy (Gesell 1934: 129-41). In 1947, Maurice Allais reached the conclusion that the optimum real interest rate is zero.

Professors Pesek and Saving (1967) argued that if money were to bear interest, it would cease to be used as money. Professor Friedman (1969), too, reached the conclusion that zero nominal interest rate is a necessary condition for efficient resource allocation. Later, economists working for the U.S. Federal Reserve showed that zero interest is both a necessary and sufficient condition for efficient resource allocation (Cole and Kocherlakota 1998:2-10).

These results come as no surprise to Muslim economists. Yet, the question remains as to how banks would operate under these circumstances. If Friedman's proposal (Friedman 1966:339) of a legal reserve ratio of 100 percent for the purposes of economic stability is adopted, what form will banking assume? Despite their efforts, none of these economists has yet found an answer to this vital question and mankind has paid a heavy price for this failure.

This book has argued that the Islamic model of economics, which shows the way to those who believe in the unity of Almighty God, is the safest and least costly of all, a view that is perhaps reinforced by the fact that an increasing number of capitalist economies are now turning their attention to Islamic economics and, in particular, to Islamic banking." (325 – 329) – Iraj Toutounchian

13-Islamic Banking Can Save Capitalism (Part 2)

July 18, 2012 at 11:49 PM · Filed under legal; By Camille Paldi

Thoughts from Iraj Toutounchian's Islamic Money & Banking: Integrating Money in Capital Theory

Challenges:

"We must gain the courage to implement the Divine Rules in the form of logical models that can be presented coherently to the world's scientific community. Though these rules have remained, unchanged, for centuries, serious analytical research on Islamic banking goes back 50 years at most. The world expects us to do more. We should expect more of ourselves...

The reaction of Western economists to Islamic banking theory has been somewhat muted. This may be partly attributable to differences of perspective and approach among Muslim economists. However, many economists, Muslim and Non-Muslim, have used the Islamic lexicon and contracts, to conceal capitalist economics. For example, given that interest is overtly banned in Islam, how can a noted economist discuss the LM curve, money market, and their derivatives? It is the same when many articles discuss loans (not *Qard-ul-Hassan*). In the legal definition of a loan, the obligatory payment of surplus on the part of the borrower is interest per se, which is *haram*. As we have seen, a loan in itself does not involve profit; rather, it is capital that produces the profit. Or, similarly, when discussing the opportunity cost of capital in Islamic banking, Muslim economists, imitating their Western colleagues, consider a positive figure, rather than zero.

Distinguishing the money market from the capital market is not an easy task, and we would do well to head Joan Robinson's warning 'not to acquire a set of ready-made answers to economic questions, but to learn how to avoid being deceived by economists.' Our goal must be to convert an M-C-M relation into a C-M-C, because it is the capital market that fosters economic growth. Keynes demonstrated that interest is the necessary and sufficient condition for speculation. But there are still those who make a distinction between interest and *Riba*, arguing that what is prohibited in Islam is prohibitive interest, *Riba*, and that small interest is not *haram*...

The flawed reasoning of some Muslim economists has led Western scientists to suppose that, in banning interest, our position is similar to that of socialists in that we would maintain there must be no return attached to capital. They have failed to note our true position – that interest is the return attached to money, while profit is the return to capital. Under an Islamic framework, there can be no money market and thus no derivatives thereof. This sets limits on the transactions in a securities exchange market (bonds, for example, would be absent because of the interest they acquire). A securities exchange market in which stocks are exchanged on a speculative basis is a money market, not a capital market. A money market, by definition, has short-term loans as the basis of transaction. Thus, even if stocks are transacted in such a market, the intent of the buyer and the seller is to receive income, which is obtained – sometimes on a daily basis – through the difference on the price of stocks transacted. This being the case, the same M-C-M relation persists, in which the stocks function as 'C.' Under

Islamic rules, the buyer is entitled to know exactly what he is buying. In current securities exchange markets, this is not the case.

While the capitalist economy is beset with many problems, the social capital in the capitalist nations is stronger than in the developing Islamic countries, the significance of which should not be underestimated. We should be able to prove that not only will these problems be solved in the light of Islamic banking but also that new fields will be opened in the process. One of the conditions to attain sustained growth (development) is the equitable distribution of income and wealth. Capitalism is faced with a conflict between efficiency and equity. In Islamic economics, there is no higher goal than establishing justice and fairness. We should be able to demonstrate that through implementing the Divine Rules of Islam, by which efficiency is attained, we can also reach equity. Islamic banking will accelerate this goal…

Keynes showed that interest will lead to speculative activities. In other words, he showed that interest was necessary for speculation to take place. I have done the opposite. I have shown that speculation is a necessary condition for the rate of interest to emerge. Put these together and we reach the conclusion that the rate of interest is both a necessary and sufficient condition for speculation to develop…

We should also remember that the Islamic community is a cooperative entity, in the wider sense of the word. Western economists have recognized the fact that the capitalist economy is unable to increase aggregate demand (AD) and aggregate supply (AS) simultaneously. That is why their monetary and fiscal policies cannot escape from stagnation and unemployment. Cooperative Islamic economics, particularly where Islamic banking is concerned, is capable of such a task, and again we should demonstrate this capability.

<u>Prospects:</u>

Profit-and-loss sharing (PLS), as a principle, constitutes the backbone of Islamic banking. The expansion of this principle throughout a community transforms that community into a Grand Cooperative System within which each individual exerts the utmost effort and thereby, through benefiting others, gains benefit. If the interaction of individual efforts were utilized in a proper way, then the community's welfare would be high enough not to let these interactions be mutually exclusive. This is also true of a worker's remuneration scheme through which workers can share the profit gained by the Islamic banks' contracts with productive firms. In addition, the depositors will enjoy the profit gained through the banks' participation with investors, bearing in mind that the rate of profit is frequently higher than that of interest. These factors will help the equitable distribution of income and wealth; the necessary condition for sustained growth. The price of manufactured goods would fall as a result of price decreases arising from the abolition of interest and as a function of a decrease in wage expenditure brought about by workers' participation in profit. Such a policy will enable a simultaneous increase in AD and AS. In addition, the investment multiplier has been shown to be substantially higher than that in the conventional system.

We noted earlier Professor Weitzman's erroneous belief that workers' participation in production would 'conquer' the stagflation inherent in capitalist societies – this despite the fact that workers' participation is incompatible with the elementary principles of capitalism. Quite apart from this elementary confusion, Weitzman neglected the fact that interest constitutes the prime fallacy of the capitalist societies and leads only to more complex and larger fallacies. It is difficult to envisage that Islamic economics, having eliminated such a fallacy, would encounter similar problems…

Having banned interest and all its attendant baggage, Islam attempts to emancipate all men from the exploitation of wealthy individuals. Through the establishment of Islamic Banking, the necessary condition for full employment (that is, the equality of saving with investment) will be created…

The world has come to realize that capitalism is not a self-regulating or self-adjusting system, and that capitalist economic models are based upon disequilibrium. The time is right for Muslims to use this historic opportunity to devise and present a logical Islamic banking system…

The only sure, long-term remedy, I believe, is offered by Islamic economics. Islam and its Divine Rules are not nation-specific. Mankind has paid a heavy price for neglecting these rules and it is the responsibility of Muslim scientists to present mankind with an alternative route. With closer cooperation between scientific figures in Islamic and non-Islamic nations, this goal is attainable." (333) – Iraj Toutounchian

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14-The Role of the Central Bank in Islamic Banking

August 10, 2012 at 7:06 PM · Filed under legal; By Camille Paldi

Thoughts from Iraj Toutounchian's Islamic Money & Banking, Integrating Money in Capital Theory

1. In economics, we are basically dealing with two interrelated concepts – one legal (or conventional), the other real. All contractual agreements such as marriage, ownership, organizational hierarchy, money, interest and the like fall into the first category; while human-beings, commodities, buildings, amenity and the like are included in the second. Each of these concepts is able to produce the other or be transformed into itself. Let us call these two properties "Completeness" and "Reflexivity," respectively. Hence, money, being a legal concept, is capable of

producing another legal concept (actually its derivative) called "interest" or a real concept such as capital equipment.

2. Money as potential capital is a legal concept capable of being transformed into actual capital. A simple example given earlier is that of a *Mudarabah* contract, in which as soon as one person's money is legally combined with another person's labor, the nature and the function of money is changed into capital. The higher the speed at which the stock of money is transformed into the flow of capital, the higher will be the rate of economic growth. This is the most important task of the Islamic Central Bank.
3. The various modes of contract available to Islamic banks are the major means of transforming the money deposits of individuals and firms into capital (or assets). Any financing under any mode of contract will essentially increase the value of the economy's assets. However, some modes of contract (*Musharakah* and Installment Sales (originated by firms), for example, increase the productive capacity of the economy. Again, any positive change in a firm's asset values (rather than their capital values, which is a vague concept responsible for considerable confusion) can be called "investment." Following this practice, it is easy to calculate with a high degree of precision the amount of investment which has taken place in an economy during any specific year. This can be done by reading the asset values off the current balance sheets, which firms submit to tax authorities. Putting asset values, rather than capital, into the production function makes it more precise and meaningful. A firm's rate of profit is, hence, logically defined as the ratio of profit to their assets. Since the value of the assets is normally greater than the value of capital, defining the rate of profit as the ratio of profit to the value of capital underestimates the true ratio of profit.
4. Speculation, which necessarily entails artificial risk in any market, is not permissible in an Islamic setting. A corollary to this is that with the disappearance of the bond market stocks are expected to be exchanged in an Islamic stock market based upon their book values. In a stable price system, the market to book value becomes unity, because in an efficient Islamic stock market, the book value of shares reflects all relevant facts about a firm based on its assets. Tobin's Q becomes irrelevant in that it uses "debt," which is non-existent in an Islamic context. One implication of this is that in a world with perfect markets valuing the firm would be easy; that is, we could read the economic value of the firm off the current balance sheet. Risk is essentially interwoven with investment. It can be considered "natural" and can be accounted for, and thus is permissible in Islam. However, the impermissibility of artificial risk is grounded upon the fact that any income received by a speculator will eventually bring about excess demand for goods and services (without the speculator having any share in productive activities). This excess demand can, in turn, be proved to become the main source of inflation. As Professor Ackley has pointed out, speculation – if mistaken – tends ultimately to be self-correcting in any commodity market; and the real cause of unemployment is speculative demand for money (Ackley 1969).

5. The unique and powerful tool of financial policy in Islamic central banking is to determine the share of profit relative to that of capital for all investment projects submitted to Islamic banks. This is probably the most important role a central bank can play because, if effectively used, this would channel the bank's financial resources into asset-building processes without having to worry about the emergence of a money whirlpool. The ratio thus determined by the Islamic central bank is especially useful in cases where different risks are involved and it is another of the central bank's tasks to prepare a list of the different risks involved in various investment projects.
6. Western economists have always and justifiably been worried about unnecessary expansion of money supply, the volume of which is hard to control. This is probably why Friedman advocated an RRR (Required Reserve Ratio) of 100 Percent. Nevertheless, if Islamic banks are prohibited from lending on interest, the different modes of contract available to them enable them to finance the specific needs of both firms and individuals. With constant and effective supervision by the central bank, the chances of a money market developing are very slim. By preparing accurate information and making it available to the general public, the central bank would be able to provide symmetrical information and, to a great extent, prevent moral hazard.
7. The fact that money will not be a tradable entity and that its production and volume will be closely monitored by the central bank make it appropriate for classification as an impure public good in an Islamic state. Other properties of such goods which also apply to money include: (a) demand can be constructed by vertical summation of individual demands; (b) externality can be derived from its capability to become actual capital; hence, government (that is, central bank) intervention. Furthermore, it benefits each person simultaneously and is thus equally available to each person. Additional individuals looking for money may be added at zero marginal cost; (c) the indivisibility of money refers to its purchasing power and not its physical character; and (d) its velocity is greater than unity, implying that it is not supposed to be withheld, contrary to the case with a private good. Money has two distinct attributes. At the micro level, it is part of the assets of the individual possessing it. But at the macro level, it cannot be added to the assets of the economy. To count money as the wealth (or asset) of a nation will lead both to the fallacy of composition and to the double-counting problem. This property is the only thing that makes it distinct from other public goods and may well be the consequence of it being the medium of exchange.
8. *The removal of interest and all its derivatives will lead Islamic banks to finance investment projects through PLS based on the profitability and feasibility of the projects. Hence, projects compete with each other on the basis of their IRR (Internal Rate of Return).* However, the criterion used by a potential investor is the IRR of a specific project. The role of the central bank in determining an array of IRRs for various activities in different sectors is extremely valuable for channeling resources into proper projects. After their feasibility and profitability have been confirmed, projects become eligible to obtain finance; furthermore, the projects themselves

become collateral for finance. As long as there are appropriate factors of production available for investment, projects have to be financed by Islamic banks, irrespective of how much money is required. In Islam, it is the right of labor not to be kept unemployed. In the final analysis, everything coming out of an Islamic bank in response to financing an investment project can be called a Certificate of Asset Building (CAB). These CABs are appropriate to both the production and household sectors.

9. The appropriateness of projects is to be determined by the central bank with a close eye on social welfare. However, to determine which projects are more profitable to finance is the task of each individual bank. The central bank's task is to instruct the banks to give priority to projects, which are more compatible with the country's overall economic plan. – (Iraj Toutounchian)

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15-Sukuk and Tawarruq Contracts in Islamic Finance

August 12, 2012 at 7:38 PM · Filed under legal; By Camille Paldi

Thoughts from Iraj Toutounchian's Islamic Money & Banking, Integrating Money in Capital Theory

The Institute of Islamic Banking and Insurance (IIBI) defines *Sukuk* contracts as having 'similar characteristics to that of a conventional bond with the key difference being that they are asset backed; *Sukuk* represent proportionate beneficial ownership in the underlying asset. The asset will be leased to the client to yield the return on the *Sukuk.*

The *Sukuk* has attracted considerable attention in recent years from Muslims and non-Muslims alike. It is categorized as the 'Islamic equivalent of a bond' in Wikipedia (as up-to-date and reliable a source as any in the fast-growing area), which also provides the following information on the workings of Sukuk:

The essence of *Sukuk*, in the modern Islamic perspective, lies in the concept of asset monetization – the so-called securitization – that is achieved through the process of issuance of *Sukuk* (*taskeek*). Its great potential is in transforming an asset's future cash flow into present cash flow. *Sukuk* may be issued on existing as well as specific assets that may become available at a future date.

The fact that this new product has been introduced would seem to imply that all other Islamic products have been exhausted or inadequate to the task required. I do not believe this to be the case and feel that some Muslim scholars have rushed into this position without exploring the full potential of existing contracts.

The artificial demand for new products was originally promoted under the cover of 'Islamic banking' by Western institutions in an attempt to attract funds from Muslims. If there is any elements of truth in the Friedman Rule – which I, for one, believe to be in conformity with the word of Allah (SWT) – this means that both host and guest economies must have benefited from the fruits of zero nominal rates of interest. But then, we have to ask: Which one of these countries, Islamic or non-Islamic, has full employment, stable prices, equitable distribution of income and wealth, counter-cyclical movements, in relative terms? These are sound and reliable measures to test such claims, because these are the fruits of the absolute negation of interest. For many years, Muslim scholars have concentrated on what constitutes *Riba,* but in doing so, have completely neglected the fruits of its abolition. We have yet to see even a small city – let alone an entire country – practice the full economic consequences of the abolition of *Riba*.

To some respected economists, it appears that Islamic banking has been 'hijacked by the West' and that all the major developments of the last decade or so seem to have been directed toward the same end: to collect as much money as is possible, particularly from the oil-producing, Muslim countries. It is no coincidence that "From its tentative beginnings, Islamic banking has mushroomed to the point that huge multi-national banks are rushing to offer *Shari'ah* compliant versions of their products.' (Hammoudi: 2007)

Hammoudi puts the problem this way:

The central issue is that although these products allow banking to take place without offending *Shari'ah* compliance – *haram* conventional banking products sanitized to become *halal* ... there is a certain level of expectation within the contemporary Muslim community that social justice, mutuality, and fairness are supposed to be centre-pieces' of Islamic banking institutions, but 'that expectation is not being met by the current means of approaching Islamic finance' ... some of the products have been created through 'artifice'; Constructing products that follow the letter of the law so that they are not illegal per se ... The larger conventional banks and smaller Islamic banks operate in much the same way ... both types of institutions attempt, more or less, to figure out ways to mimic interest rates without explicitly doing so ... (Ibid.: 34-5)

My assessment of *Sukuk* is that it is indeed one of the products, which appear to be *Shari'ah*- compliant and in accordance with the letter of the law, but which are not within the spirit of the law. Specifically, it has been manipulated to change it from a genuinely M(1) – M(2); M(2)>M(1) transaction by making it 'asset-backed' to become a M-C transaction and making it resemble equity-financing. As I understand it, since *Shari'ah* considers money to be a medium of exchange and not an asset in itself, it requires that one should not be able to receive money from money. The M(1) – M(2) transaction reflects the time value of money; which, as we have seen in earlier chapters, is not permissible.

In this regard, Wikipedia has the following to say:

Sukuk are widely known as controversial due to their perceived purpose of evading the restriction of *Riba*. Conservative scholars do not believe that this is effective, citing the fact that a *Sukuk* effectively requires payment for the time-value of money. This can be regarded as the fundamental test of interest. *Sukuk* offers investors fixed return on their investments which is also similar in appearance to interest in that the investor's return is not necessarily dependent on risks of that particular venture. However, the reality is that banks invest in assets and the return from these such as rent is evenly spread over the rental period and it is this stream of income, which forms the basis of the 'fixed' income stream and return to investors. Furthermore, given that there is an asset in the background, there is more security for the investor, which makes *Sukuk* increasingly appealing to global investors including both Muslims and non-Muslims.

Another seemingly *Shari'ah* compliant instrument is *Tawarruq*, defined as the sale of a commodity to the customer by a bank on deferred payment at cost plus profit. The customer then sells the commodities to a third party on a spot basis and gets instant cash.

Again, the transaction here is of the M-M form, but by artificial use of C, made to look like C-M in two different transactions; one a deferred payment and the other a spot price. This is totally non-compliant with *Shari'ah*, as it is in reverse order; that is, selling a commodity at a spot price and buying the same commodity at deferred payment, with the spot price being lower than the deferred price. It is, once more, a transaction of the form M-M, but disguised. The true intention behind such instruments is neither to buy nor to sell the same item: rather, it is to obtain money via a commodity. All transactions involving buying and selling by a buyer or seller who is not the final demander is speculative.

It is high time to abandon these deceptive devices and take to the regular waters of peace of mind and become part of the regulatory motion of the universe. Despite all their efforts, the capitalist economies have failed to meet the demands of nations. As Joan Robinson put it:

It is ironic that after the great technical achievements brought by the age of growth, all we are offered is a return to large-scale unemployment and poverty in the midst of plenty, in an age of frustration…The modern economies have failed to develop the political and social institutions, at either domestic or international level, that are needed to make permanent full-employment compatible with capitalism. (Robinson 1979:265).

A strong caveat is in order here. We have to be extremely careful to avoid producing the circumstances in which Islamic economics and banking experience the same fate as capitalism through modifying *Shari'ah* principles in order to accommodate perverse notions of compliance.

Regardless of the contract(s) used, after it has been proved that the firm is able to run on its own, the bank has to sell its share, either to the firm or on an Islamic stock exchange. The price of the share has to be based on the asset value of the firm, not on a manipulated market value. The logic behind this can be made quite simple using an analogy between the stock price and manpower remuneration. The capitalist system puts great emphasis on 'money' and commodity and their continuous growth by whatever means possible, rather than on human beings, for whose benefit everything else is supposed to be managed and organized. On the one hand, this allows the price of stock to be determined in a speculative stock market on the grounds that the future profits of the issuing firm will, in all likelihood, go up and be exchanged at whatever price the market determines. On the other hand, it restricts the wage rates of motivated, intelligent, young people who might otherwise go on to become great scientists who might be able to change the course of world events. Before such young people are able to become an authority in their chosen field, they are remunerated, at best, according to their value as a marginal product in the category to which they belong. In this, the system follows a double standard and acts unjustly. I believe that what is recorded under 'assets' in a firm's balance sheet should be the basis for stock pricing; nothing more and nothing less. Anything below or above is unrealistic and virtual. As we have seen, virtual wealth leads to the misallocation of resources and to the inequitable distribution of income and wealth. If we are to understand the origin of capitalism's problems, there is an urgent need to separate virtual wealth from real wealth. (Iraj Toutounchian)

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16-Mudharabah

August 12, 2012 at 1:36 AM · Filed under legal; By Camille Paldi

Thoughts from Iraj Toutounchian's Islamic Money & Banking, Integrating Money in Capital Theory

Mudarabah, the most-widely known Islamic contract, is a profit sharing contract in which one party (the *Rab al Maal*) provides funds and the other (the managing trustee, the *Mudarib* or *Ameel*) management expertise. This contract is believed to come from the Arabic word *darb*, which means walking and traveling on the earth. (The *Mudhrabah* is sometimes known as *Qirad*).

While the literature extends this contract to include investment and launching a project, we confine ourselves here to trade activities. Profits are shared between the *Rab al-Maal* and the *Mudarib* in a proportion agreed in advance. Losses, if any, are the liability of the former, and the latter loses his share in the expected profits. If, however, the *Mudarib* is proven to be guilty of willful negligence, fraud, or a breach of trust in handling the funds, he/she is totally responsible for the losses. Funds are to be used for Islamically permitted activities and, according to Khan:

The *Rab-al-Maal* has the option to restrict the *Mudarib* to a specific purpose, period, level of risk, and so on … The *Mudarib* is not allowed to buy or sell *Mudarabah* assets against or for his own possessions. The profit can be used again in another trade, but only after paying the share of the *Mudarib* in the profit. (Khan 2000:27)

Other characteristics of the *Mudarabah* contract are set out below:

1. *Mudarabah* is an optional contract, giving either of the parties the right to revoke the agreement unless a condition to the contrary has been included in the agreement;
2. It is a short-term contract of up to a maximum of one year and solely for the expansion of commercial activities. The *Mudarib* is either a real person or a legal entity;
3. Unlike the Principal-Agent theory, the roles of the *Rab al Maal* and the *Mudarib* are completely separate; and in this respect, the owner should only supply the capital and under no circumstances accept the responsibilities of the managing trustee, thus ruling out the possibility of Islamic banks acting as the *Mudarib*. Even if, at the signing of the contract, the *Mudarib* accepts responsibility for some of the costs, this does not constitute playing the role of the owner of the funds.
4. The capital must definitely be in ready cash supplied in a lump sum or in parts, which means that a *Mudarabah* in profits and dues is not correct;
5. Except for those stipulated in the agreement, no other costs can be defrayed from the capital, and any such incidental costs are to borne by the *Mudarib;*
6. The responsibility of the *Mudarib* in safeguarding the *Mudarabah* capital is that of the trustee agent. Otherwise, the *Mudarib* cannot be held responsible for the safety of the capital or for damages suffered in the course of trading, except if it has been clearly stipulated in the agreement that the *Mudarib* will pass the ownership of his own property to the owner up to the extent of the damage or loss.

The *Mudarabah* contract has another characteristic that is peculiar to real persons. It is composed of three different contracts; namely: safe-depositary (*Amanah*); Trustee agency (*Wakalah*); and Partnership (*Musharakah*). The importance of each becomes evident if the *Mudarib* happens to die in the course of trading. If (s)he dies before the purchase is made, then the total capital is owned by the *Rab al Maal*. If s(he) dies after purchase of the goods, but before selling, the *Mudarib* is treated as the trustee agent and all costs incurred in the course of buying are the responsibility of the owner of the funds. Finally, if the *Mudarib* dies before selling the goods, but before reporting to the *Rab al Maal*, then (s)he has all the rights as if (s)he were alive and is considered to be a partner and his/her share is to be paid according to the conditions agreed at the outset.

The capital of the *Mudarabah* contract should include one or more of the following: purchase price; packing; transportation, and forwarding costs; insurance and registration of orders; warehousing; bank costs; customs levies and commercial tax; and any other foreseeable costs. The payment of other costs not provided for in the contract is the responsibility of the *Mudarib* who, by signing a letter of understanding, accepts this responsibility against receipt of a compensation fee. (Iraj Toutounchian)

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17-Direct Investment and Islamic Syndication

August 12, 2012 at 1:57 AM · Filed under legal; By Camille Paldi

Thoughts from Iraj Toutounchian's Islamic Money & Banking, Integrating Money in Capital Theory

This is another of the activities of Islamic banks subject to joint-venture regulations. The establishment and start-up of new production and development units through this type of investment is permitted where equity participation is either impossible or where the private sector is reluctant to become involved. Where possibilities for direct investment exist in line with the country's economic expansion and development programs, such a contract is the most viable for Islamic banks. They are subject to the usual technical, economic, and financial studies and evaluation, which should show the project to be viable from all angles.

The syndication transaction is a special financing instrument devised for the purpose of financing large-scale investment projects. Such projects are jointly financed by a consortium of Islamic banks, which pool their resources and thus spread the risk between them.

Khan recommends that this consortium be operated using a lead-manager in the shape of a bank of international repute and standing: "It is usual for the Lead-Manager to form a consortium of underwriters and co-managers to execute [the project] effectively. The relationship between the Lead-Manager and other participants in the financing is clearly defined." (Khan 2000: 29) The sale of all or part of the investment (that is, all or part of the shares of the Islamic bank) to the general public in an Islamic stock exchange is possible after the project becomes operative. (Iraj Toutounchian)

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18-Salam Contract in Islamic Finance

August 12, 2012 at 4:57 PM · Filed under legal; By Camille Paldi

Thoughts from Iraj Toutounchian's Islamic Money & Banking, Integrating Money in Capital Theory

This contract (also known as 'advance payment sale') is an advance payment for deferred delivery. In this case, the bank pays the agreed amount of the financing to the client in advance, and the goods are delivered to the bank at a specified future date and place.' (Khan 2000: 25) To avoid any misunderstanding, it should also be added that the goods in question have to be based on a client's demand. Of such contracts, Shirazi says the following:

When, during the process of production, the producer feels a financial constraint on part of his or her working capital needs … forward deals are signed only to help the producer by supplying part of the working capital needs. Banks [can be] authorized to sign such deals only at the request of a producer. (Shirazi 1988: 201)

It must be added, though, that the produced goods could have been used either in another process for further value-adding or, if they are needed in society, the request could have been made by a third party. The Islamic bank does not receive the goods, rather, it acts as a facilitating agent. A producer's need for working capital does not alone justify payment from the bank. One of the uses of the *Qard-ul Hassan* contract mentioned earlier is to pay the working capital of those producers, which have already been financed by the Islamic bank and thus enjoy a good reputation. Such an instrument can be used as a trilateral contract involving the bank, the client, and the client's supplier or producer.

As to the price of the commodity in question, a *Salam* purchase is usually cheaper than a spot purchase (Khan 2000:25). There is no need for an Islamic bank to enter into any conceivably profitable transaction, and to ensure that it is entirely *Shari'ah* compliant, the price of the forward purchase should never exceed the cash price of similar products at the time the goods are delivered.

Khan sees *Salam* as 'an exception to the general rule that the seller must possess the goods he is selling.'

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19-The Jo'aalah Contract in Islamic Finance

August 12, 2012 at 5:34 PM · Filed under legal; By Camille Paldi

Thoughts from Iraj Toutounchian's Islamic Money & Banking, Integrating Money in Capital Theory

This is a contract under which one party, the *Jaa'el* or bank, undertakes to pay a specified amount of money, the *Jo'ol*, to the other party, the *Amel* or contractor, for rendering a service specified in the terms of the contract. Either party may opt to rescind the contract so long as the stipulated action under it has not been taken. A bank may enter a *Jo'aalah* agreement either as an *Amel* or as *a Jaa'el,* as necessary. In general, the right of the *Amel* to transfer part of the known activity to a third party under a secondary *Jo'aalah*, with the agreement of the other party, is reserved.

Responsibility for the preparations and purchase of materials, tools, equipment, performing a service and other essentials for carrying out the *Jo'aalah* may fall to either party, depending on the terms of the agreement. If the *Amel* accepts this responsibility, he should, at the outset, submit an estimate of all the operational costs for the *Jo'ol* to the *Jaa'el.*

The *Jo'ol* may be repaid either in lump sum or at intervals, in equal or unequal installments, at fixed maturity or maturities. Whenever the bank acts as an *Amel*, it is essential to obtain sufficient security from the *Jaa'el* to be assured of the fulfillment of commitments made; if necessary, arrangements should also be made to insure the property involved. (This is sooo interesting, isn't it? Let's thank Dr. Iraj Toutounchian for allowing me to share all of this information with you).

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20-Divine Rules

July 14, 2012 at 1:49 AM · Filed under legal; By Camille Paldi

Excerpt from Iraj Toutounchian's Islamic Money & Banking: Integrating Money in Capital Theory

"The only reliable and absolute sources on all matters – past, present and future – are Allah's (SWT) sayings in the Qu'ran, which stands first, and then the Sunnah, as a natural complement. History has taught us that no matter how well-designed and sophisticated man-made experiments are, they have defects. The more man searches, the more he is faced with unknowns and reminders of the depth of his ignorance. It is the absolute knowledge and the power of Allah (SWT) over all His creatures that governs the Universe. Man's limited knowledge and mental abilities make it absolutely impossible for him to discover all the secrets of the universe, no matter how great his endeavors. Allah (SWT), the Eternal, the Absolute (Quran 112:2) has graciously provided through the Qu'ran vivid guidelines (Mobeen) and principles which are faultless and valid forever and in all circumstances.

His knowledge and power encompass past, present, and future. This is the natural outcome of His being 'the' creator of the universe and thus 'the' reason for His guidelines and instructions having ‘the’ veto power over all man-made systems and institutions.

Allah (SWT) has made it possible for human beings to explore why such rules, guidelines and instructions have been given. In the realm of economics, this can only be done in the light of justice, the ultimate goal of the Islamic state. Far from being an impediment to exploration, the Divine Rules set out in the Qu’ran provide a strong incentive to discover the reason for their existence.” – Iraj Toutounchian

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21-Hire-Purchase (Leasing) in Islamic Finance

August 12, 2012 at 4:17 AM · Filed under legal; By Camille Paldi

Thoughts from Iraj Toutounchian’s Islamic Money & Banking, Integrating Money in Capital Theory

A hire-purchase agreement provides the hirer with the option to become the owner of the item at the end of the tenure of the hire provided that the hirer has fulfilled all the conditions in the agreement. Under its terms, a business entity or individual may request the bank to purchase capital goods such as equipment, tools or machinery and rent them to him or her. The rent is charged from the date the lessee takes delivery of the goods and the duration of the lease is determined. In cases of non-payment of installments, the bank (lessor) has recourse to the leased asset. Under the contract, the lessee is obliged to pay a periodical rental charge, which normally exceeds the depreciation value of the asset. This can be a fixed amount for the whole period of the lease or a variable amount, depending on the specific terms of the agreement. Provisions for such things as insurance, repair costs and protection of the leased item can also be tailored to the respective needs of the parties. The duration of the hire-purchase period must not exceed the useful life of the item in question and the lessee has no right to transfer the property to any other party without the bank’s written permission.

For the lessee, hire-purchase (leasing) has many advantages over direct purchase in that it is the use of the asset that is most important, not who has the title to it. There are many reasons, good and bad, for leasing. In general, though, it has gained momentum in the banking system largely as a result of the tax advantage it has to offer. (Iraj Toutounchian)

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22-Salam Contract in Islamic Finance

August 12, 2012 at 4:57 PM · Filed under legal; By Camille Paldi

Thoughts from Iraj Toutounchian's Islamic Money & Banking, Integrating Money in Capital Theory

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It must be added, though, that the produced goods could have been used either in another process for further value-adding or, if they are needed in society, the request could have been made by a third party. The Islamic bank does not receive the goods, rather, it acts as a facilitating agent. A producer's need for working capital does not alone justify payment from the bank. One of the uses of the *Qard-ul Hassan* contract mentioned earlier is to pay the working capital of those producers, which have already been financed by the Islamic bank and thus enjoy a good reputation. Such an instrument can be used as a trilateral contract involving the bank, the client, and the client's supplier or producer.

As to the price of the commodity in question, a *Salam* purchase is usually cheaper than a spot purchase (Khan 2000:25). There is no need for an Islamic bank to enter into any conceivably profitable transaction, and to ensure that it is entirely *Shari'ah* compliant, the price of the forward purchase should never exceed the cash price of similar products at the time the goods are delivered.

Khan sees *Salam* as 'an exception to the general rule that the seller must possess the goods he is selling.'

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23-Civil Partnership in Islamic Finance

August 12, 2012 at 12:56 AM · Filed under legal; By Camille Paldi

This contract involves mixing the capital of one or more partners with the capital of the Islamic bank on a joint-venture basis for the performance of a specific job in the fields of production, trade, and services for a limited period. This is an optional partnership in that, unless a specific duration is stated at the signing of the contract, any one of the partners may withdraw from it at anytime.
Again, this is a very flexible contract that can be used and applied to a wide variety of activities. One good example is in constructing a house, an apartment, or business premises, for that matter. The duration of any of these is when construction has been completed. The mode of settlement of accounts should be known and may adopt one of the following arrangements:

1. A non-bank partner may purchase the finished 'product' at the end of the agreement, at the current sale price;
2. A non-bank partner may purchase the finished 'product' at the end of the agreement, at a price to be fixed with the concurrence of partners.

In either case, the share of each partner may be paid at different times and on the basis of the progress reports. The buyer can purchase on an installment basis, the period of which must have been stated in the contract. In the first option, the Islamic bank, which is not the final buyer, protects its depositors by enjoying the likely increase in the general price level. The bank might choose the second option in order to encourage the real or legal person in need of the 'product.' Finally, the banks are prevented from buying the finished product and thus from becoming big owners of the property. They must adhere to their ultimate goal of maintaining social welfare by meeting the demands of as many clients as they can. The following notes are important to take into account:

1. Unlike a commercial partnership, which is formed and works within the framework of the laws and regulations of the commercial code, the civil partnership works with the laws and regulations of the civil procedure code and is forbidden for commercial activities;
2. Unlike a commercial partnership, a civil partnership does not possess an identity independent from the identity of the partnership;
3. In some commercial partnerships, a partner cannot transfer his share to anyone without the concurrence of the other partners. In a civil partnership, any partner can transfer all or part of his share to a third party without the concurrence of the other parties.
4. In a civil partnership, if the partners are unable to pay their debts, insolvency regulations are applied. But in a commercial partnership, bankruptcy regulations apply.

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24-Example of the Harmful Effect of an Interest-Based Economy (United States)

June 19, 2012 at 3:20 AM · Filed under legal; By Camille Paldi

"In order to better understand the harms done to an economy from having an interest-based system, a few observations are worthwhile here. A U.S. economist and then coordinator of the Center for Economic and Policy Research, Dean Baker, in 2001, had this to say:

"(1) Nobel Laureate Milton Friedman and U.. Federal Reserve Board Chairman Alan Greenspan have been the economies preaching the gospel of monetary policies to run our economies for the benefits of the 'few and privileged.' In particular, they have been hailing the institution of the stock market as representative of our well-being and as a consequence, they have been selling the gospel of changing the central banks to prop up the stock market. They further observe that: We need to change our financial institutions for the better and we must break down this obsession with the stock market performance as a proxy of our own well-being. (2) At its peak in the first quarter of 2001, the ratio of the price of all corporate equities to after tax corporate profits was over 31 to 1. This is more than twice the historic average of less than 15 to 1. This bubble implied more than $9 trillion in illusory wealth compared to a situation in which price-to-earnings ratios were near their historic levels. (3) It is not possible for the stock market to consistently rise more rapidly than the growth rate of corporate profits… (4) Stock holdings are heavily concentrated among the nation's richest families. The richest one percent own nearly 50 percent of stock shares and the richest 10 percent own more than 80 percent of individually held shares. In brief, 1 percent of population own 50 percent of everything. When the Federal Reserve Board makes a decision to prop up the market, it is making a decision to transfer wealth from the rest of the nation to a minority of rich people. (5) The value of individual stock holdings constitutes, in effect, claims against the nation's wealth. The greater the value of these holdings, the larger the portion of the nation's wealth is controlled by those who have stock holdings…Tens of millions of families are paying more for homes or rent because the stock market has given a small segment of the population more money to bid up home prices…"

Over the past decade alone, there have been countless self-explanatory examples to support the validity of my view in relation to the evils of an interest-based economic system; most notably perhaps, the cost of unemployment in developed economies such as Germany and Japan. At the time of writing, the sub-prime crisis in the U.S. housing market is spreading to other sectors and threatening the very foundations of the capitalist system. On September 20, 2008, the Associated Press reported the following:

"The Bush administration asked Congress on Saturday for the power to buy $700 billion in toxic assets clogging the financial system and threatening the economy as negotiations began on the largest bailout since the Great Depression. The rescue plan would give Washington broad authority to purchase bad mortgage-related assets from U.S. financial institutions for the next two years. It does not specify which institutions qualify or what, if anything, the government would get in return for the unprecedented infusion ... We're going to work with Congress to get a bill done quickly,' President Bush said at the White House. Without discussing specifics he said, "There is a big package because it was a big problem."

The Wall Street Journal (online) reported the crisis this way:

"The latest trouble spot is an area called credit-default swaps, which are private contracts that let firms trade bets on whether a borrower is going to default. When a default occurs, one party pays off the other. The value of the swaps rises and falls as the market reassesses the risk that a company won't be able to honor its obligations. Firms use these instruments both as insurance – to hedge their exposures to risk – and to wager on the health of other companies. There are now credit-default swaps on more than $62 trillion in debt, up from about $144 billion a decade ago."

With stock markets plunging and banks across the globe having to rely on government guarantees for their continued existence, there is increasing evidence that the bubble of virtual wealth has finally burst and many people are pointing to these as symptoms of the collapse of capitalism." (Iraj Toutounchian)

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25-Mozara'ah Contract in Islamic Finance

August 12, 2012 at 2:44 AM · Filed under legal; By Camille Paldi

Thoughts from Iraj Toutounchian's Islamic Money & Banking, Integrating Money in Capital Theory

In Islamic jurisprudence, *Mozara'ah* is an agreement between the owner of land and the farmer, according to which the farmer (*Amel*) cultivates the land and the produce is divided between the parties in an agreed fixed-ratio. A more elaborate definition describes it as a contract in accordance with which one of the parties gives a plot of land for a fixed period to the other party to cultivate and divide the yield.' (Shirazi 1988: 229).

The person giving the arable land as *Mozara'ah* should either be the landlord or the owner of the benefits thereof. The specifications, boundaries and area of the land should be clearly fixed and known. It has to be capable of cultivation and of yielding the produce expected. Shirazi says:

The framework of duties and responsibilities of the *Amel* must be specified in the *Mozara'ah* agreement. The responsibility of the *Amel* with regard to the *Mozara'ah* property is like that of a trustee, and he may be held responsible to make good the difference or loss caused, only if he is not careful in farming. (Ibid.: 231)

If farming is done in a location where only one kind of farm produce is obtained, even if the agreement does not stipulate it, the kind of farming is considered as having been determined.

This is an obligatory contract and is therefore binding on both parties and cannot be annulled by one of the parties unilaterally. The death of one or both parties does not nullify the agreement, unless supervision by the *Amel* has been stipulated in the agreement, and/or the landlord is a life-owner of the interests in the land.

The contract is applicable both in cases where the Islamic bank owns the land and when the land is privately owned. It differs slightly from PLS contracts in that it is about output sharing, rather than profit sharing, or what is known as sharecropping, with all the advantages attached to it. Nevertheless, there seems to be a misunderstanding in this regard on the part of a few Western economists. Professor Silberberg, for example, asserts that: Sharecropping is a form of rent payment in agriculture in which the landlord takes some share of the output, specified in advance, instead of a fixed amount, as payment for the use of land (Rent)" (Silberg 1990: 607; my italics). He goes on to add:

Sharecropping as a contractual form of rent payment came under attack by various economists on the grounds that it misallocated resources relative to the fixed-rent contract. In its neoclassical formulation, the rental share paid to the landlord was regarded as equivalent to an excise tax on the sharecropper's efforts, inducing sharecroppers to reduce output below the level where the marginal value product of the sharecropper equaled their alternative wage.

Silberbergs's analysis and remarks require further examination:

1. Why should sharecropping be treated as a 'form of rent payment' in the first place? Rent, by definition, is always considered as a cost, whereas sharing, like dividends paid on stocks, is never treated as such in accounting procedures.
2. In saying that the rental share paid to the landlord induces sharecroppers to reduce output, he is, in fact, talking about irrational behavior. It is certainly irrational, if not ridiculous, to postulate that they would, in effect, harm themselves in order to harm others. If the sharecropper is induced to reduce output, his share will definitely also be reduced. Would it not be more

meaningful to say the reverse; that is: to put more effort in order to share more in the output?

3. Silberberg has used his analysis as an application of the Coase Theorem, which was originally used in a situation where the production of one good is a negative output in where the production of one good is a negative output in the production of some other good; that is, in a situation of negative externality. He clearly had difficulty in recognizing situations where positive externalities might exist for both situations where positive externalities might exist for both sides. However, his framework of analysis is within a zero-sum game, within which 'my gain is your loss.' His analysis assumes the aims of the landlord and the tenant to be in conflict with each other and, under such conditions, it is hardly surprising that he arrived at his misleading conclusion. There are many examples where both sides benefit. A trivial and old example is trade. This should guide us to take the case of sharecropping in a cooperative system, where the end result is an increasing sum-game, with a totally different outcome. The proposal here is that such cases have to be analyzed in a cooperative framework, with common goals on both sides. In this example, the common goals would be to maximize output with a view to increasing the tenant's share. In mathematical terms, the problems could be analyzed as one of unconstrained maxima. (Iraj Toutounchian)

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26-Musharakah

August 12, 2012 at 12:32 AM · Filed under legal; By Camille Paldi

Thoughts from Iraj Toutounchian's Islamic Money & Banking, Integrating Money in Capital Theory

This contract in its general form is the pillar of Islamic finance in that it is primarily based on profit-and-loss sharing (PLS). It has the flexibility that enables it to be used for a wide variety of economic activities, from industry (as equity participation), to construction (as civil partnerships and installment sales), to farming (as *Mozara'ah*), to plantation (as *Mosa'qaat*), and finally to trade (as *Mudarabah*).

Equity Participation

In this contract, the Islamic bank supplies part of the capital required to establish a new joint-stock company or to purchase shares in an existing company…

The project has to be both economically and socially justified and in accordance with the country's general economic priorities. The bank's participation will be contingent on its receiving satisfactory results from its initial studies of the proposed project. Such investigations will include the following

(1)Economic considerations:

The effects of the project have to be directed toward increased employment, a reduction in general price levels, a more equitable distribution of income and wealth, an increase in general social welfare, and the creation of secondary and downstream industries. The bank will also consider such things as total outlay and the proportion of that taken up by fixed and variable costs. Average and marginal costs at different capacity levels are important aspects. An efficiency – equity trade-off has to be made and compared with other countries, without losing sight of social considerations.

(2) Technical considerations:

There will include the best mode of operation in light of the available infrastructure, skills, machinery, and equipment; the location of the project and any special incentives for investing in the region; the rules and regulations governing its operations; and a host of other considerations that directly and/or indirectly affect the feasibility of the project. A timetable for both physical progress and expenses at different stages of the implementation process is vitally important.

(3) Financial Study and Forecasts:

These are often being undertaken in parallel with economic considerations and are mostly concerned with whether the project is useful and viable from the standpoint of the rate of return on capital and profitability. Data needed here include all production costs, domestic and foreign demand, foreign exchange rates, and the tariffs imposed by the importing countries…

Risk has to be taken into consideration in any investment decision-making process. The client would definitely be happier when risk is low but the proportionate rate of return is high. High risk is considered to be a deterrent as far as investors are concerned. But what happens when the project is both viable and badly needed, but the risks involved are high? The state-owned Islamic bank has the central role to play here. The potential investor's expected rate of return has to take into account the risk factor by compensating the risk-premium of the investor. Our recommendation in such cases would be to increase the relative profit share of the investor to that of the bank. Once these matters have been agreed, a timetable has to be drawn up for the operation of the project at various stages and arrangements put in place for close and regular supervision to ensure that the project is on schedule, both physically and financially.
(Iraj Toutounchian)

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27-Going Back to the Basics with Islamic Finance

July 18, 2012 at 7:35 PM · Filed under legal; By Camille Paldi

Thoughts from Iraj Toutounchian's Islamic Money & Banking: Integrating Money in Capital Theory

"In conventional economics, the place of man in society is ambiguous in that it (society) works as an instrument whose ultimate goal is consumption. Islamic economics is designed to give man the dignity and status he deserves. He is given the potential to enhance his spiritual life in parallel with his physical life. Islam provides rules and regulations giving him the option to choose between vice and virtue. Without this option, there is no way for spiritual elevation. Unlike in the capitalist system, comfort and happiness come from both material and spiritual elevation.

Islam teaches us that life is a test: 'Blessed be He … who created death and life, that He might try you which of you is fairest in work.' (Quran 67:2) Allah (SWT) endowed people differently and in many ways: in mental or physical ability, in material and social environment, in power, knowledge, wealth, and so on. Some of these things an individual is born with; some are acquired by effort, and still others come from circumstance; but each individual is accountable to Allah (SWT) for all the ways in which he has been preferred over others. "It is He who has appointed you vice-regents in the earth, and raised some of you in rank above others, that He may try you in what He has given you …" (Qu'ran 6:165). On the Day of Judgment, each individual will be held accountable for the way he lived his life, how he used his knowledge, how he spent his wealth." (257)

"Only the Creator knows in absolute terms who we are and why He has created us. For Muslims, the ultimate goal of man is to please Allah (SWT) by following His orders as well as His guidelines and recommendations. Man, as vice-regent of Allah (SWT) on earth, is responsible to society as well as to himself. He should understand the reciprocity of actions between individuals and society and, at every stage of life, he has an obligation to all societies and people who have made contributions to the present state of knowledge and technology.

The doctrine of vice-regency indicates that wealth is not an end in itself. Material and spiritual comfort work as the wings of a bird to take him to the destined place. The doctrine further implies that wealth exists to serve others and it is this balance between material and spiritual comfort that is one of the most valuable lessons to be learnt from Islam.

I am in complete agreement with the sentiments expressed by Professor El-Ghazali that:

‘At the same time, the responsibility of Vice-regency demands that people work and toil unceasingly to invest this wealth so that it will continue to increase until the Day of Judgment. The work expected of Man is ‘the good work,’ the work which purifies the soul, upholds morality, increases charity, depends piety, and protects faith, body, mind, property, and progeny.’” (El-Ghazali 1994: 46-7) (258)

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28-Istisna’a Contract in Islamic Finance

August 12, 2012 at 5:57 PM · Filed under legal; By Camille Paldi

Thoughts from Iraj Toutounchian’s Islamic Money & Banking, Integrating Money in Capital Theory

Istisna ‘a appears in the literature as follows:

At the request of the client, the bank places an order for the manufacture of some equipment or the construction of some major item as road or water pipeline… When the item is ready, the bank buys it from the manufacturer and sells it to the client at whose behest the order was placed, at a profit, on a deferred payment basis. (Khan 2000: 26-7)

While this is clearly a useful contract and one designed to promote production, it seems to me that it would be more practical and manageable for the bank if it were amended to read that the bank may sign, on the basis of a written request from a client, a civil partnership contract with a contractor for the manufacture of some equipment or the construction of some major items needed by the country.

The item(s) requested by the client should be specified precisely, and the place, delivery, price, and so on have to be predetermined. Immediately after the completion of the manufacture, the item has to be sold to the client on an installment basis. This contract is typically a combination of two contracts: a Civil Partnership between the bank and manufacturer (or contractor), and another between the bank and, most likely, a government entity, for security reasons. The bank is the financier, the client is the final user, and the firm or the contractor is the manufacturer. There are many instances, especially in developing countries, in which there is a need, the financier is available and the contractor has the qualifications to meet the client’s demand. The amended version of the contract can help bring three parties together and enable otherwise- impossible projects to come to fruition. The trilateral agreement paves the way for major projects in which the client lacks the necessary funds.

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29-The Money Value of Time

June 14, 2012 at 3:49 AM · Filed under legal; By Camille Paldi

"It has been argued by some Muslims that the rate at which installment sales are based is the same as the rate of interest. This has become another source of confusion in some Islamic countries. In order to make this clear, it has to be emphasized that the rate of interest is the 'time value of money,' which is forbidden. The mark-up used in installment sales is the 'money value of time,' which is permitted. In the former, the commodity (C) is not involved except as a deceptive device to circumvent the rule. In the latter, the (C) is necessarily involved. While the former is not channeled into investment expenditure unless the expected rate of return is higher than the going rate of interest, the latter is part of the effective demand, which works as a stimulant to production and further employment.

In installment sales, the seller has the right to add a percentage to the cash price of the commodity equivalent to that he could have had from selling in cash. This amount is the product of two numbers: a percentage the seller adds each time to the cash price of the commodity, and the number of transactions that could have taken place otherwise (Toutounchian 1379 = 2000-2001: 368-371). While it may be that the rate of interest is the same as the mark-up rate, their equivalence does not make them of equal nature and consequence.

Obviously, although the total installment payments exceed the cash price this is Shari'ah compliant on the grounds that the commodity (C) is exchanged with money (M) in the future, but the transaction is of the C – M type, rather than the M – M type which involves interest." (Iraj Toutounchian)

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30-Shall We be Pareto Optimal or Socially Spirited?

July 16, 2012 at 6:39 AM · Filed under legal; By Camille Paldi

Thoughts from Iraj Toutounchian's Islamic Money & Banking: Integrating Money in Capital Theory

1. Social Justice is the ultimate goal of Islamic economics, the importance of which cannot be exaggerated. Any deviation from such teachings brings about Zulm (injustice). Embedding justice into the heart of an economic system is not as hard as most mainstream economic theories imagine.
2. There must be cooperation among all individuals and legal entities, from which positive synergy emerges. This will naturally bring about externality, both in

consumption and production. Externality in consumption takes the form of interdependent utility functions; in production it gives rise to 'the share economy' or a 'grand cooperative system,' which makes it possible for individuals to enjoy part of the profits of the firms for which they work.

3. In any conflict between social and personal interests, the social interest must prevail. To most Western economists, the concept of efficiency is based on Paretian value judgments, which assume that: a) there is no society above and beyond individuals. Thus, we should be interested only in the welfare of individuals and nothing else; (b) individuals are the best judges of their own welfare and choose what is best for themselves; (c) social welfare can be said to have increased if at least one person's welfare has increased and no one else's has fallen. Pareto optimality has little to say about the 'correct' allocation of resources and says nothing about equity (justice). When it comes to the debate over the level of redistributive taxation of public expenditure, such comparison cannot usually be made using the Pareto criteria. Similarly, saying which of two options is the better when both are Pareto improvements is impossible. (Connolly and Munro 1999: 32-3) In brief, the capitalist system exhibits all the hallmarks of a zero-sum game. Muslim scholars have a different interpretation of 'individual' and 'society,' however. Briefly in Islam we believe that (a) society exists independent of real entities (individuals); (b) society has the prerogative in policy issues; (c) only with cooperation among individuals will social welfare increase; (d) with cooperation and the resulting externality, both individual and society benefit without incurring any loss to either side; and (e) the Islamic economic system can be visualized as an increasing-sum game. Keeping all of this in mind, we are really talking about a very different economic system.
4. There must be no money market. This is a simple outcome of the abolition of Riba in Islam, which in turn prevents the development of speculation in any market. Money then becomes an endogenous variable and integrated in capital theory.

Capitalism is mainly characterized and analyzed in an environment with no cooperation and externality – the two fundamental characteristics of human societies, whose neglect has a profound and adverse impact on the welfare of a state. Specifically, Pareto optimality, which has been proved not to be necessarily superior to any non-optimum, ignores these two elements (see Nath 1976: 21-2). Underlying the concept of Pareto efficiency (known as the first and second fundamental theorems of welfare economics) are the Paretian value judgments outlined above.

Pareto optimality has been extensively criticized as being overly utilitarian, with Professor Sen leading the attack:

The traditional propositions of welfare economics depend on combining self-seeking behaviour, on the one hand, and judging social achievement by some utility-based criterion, on the other. In fact, the traditional welfare economic criterion used to be (and still seems to be) the simple utilitarian one, judging success by size of the sum total of utility created – nothing else being taken to be of intrinsic value. A social state can be said [said to be] Pareto Optimal if and only if no one's utility can be raised without reducing the utility of someone else. This is a very little kind of success and in itself may or may not guarantee much. A state can be Pareto Optimal with some people in extreme misery and others rolling in luxury, but can be made better off without cutting into the luxury of the rich. (Sen 1987:30-1)

Sen believes that the basic issue is whether there is a plurality of motivations or whether self-interest alone drives human beings.

Quite contrary to the Paretian Value judgments outlined above, I like Murtada Mutahhari believe that:

Society is a real compound like the natural compound. But the synthesis here is of minds and thoughts and of wills and wishes; the synthesis is cultural and not physical … Individuals … who enter into social life with their gifts acquired from nature and their inborn abilities, spiritually merge into one another to attain a new spiritual identity, which is termed 'social spirit.' In this case, the whole or the compound does not exist as a single entity. It is different from other compounds … In the synthesis of society and individual, though an actual synthesis takes place … the plurality of individuals is not converted into a unity … Society conceived, as a single physical unity is only a hypothesized abstraction. (Mutahhari 1985: 12)

Viewed in this way, the welfare of society takes place over one or a group of individuals. This overrules the Paretian value (b) and means that society is the best judge when conflict arises between the welfare of the society and that of an individual.

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31-Society and Cooperation in Islam: Incentives and Consequenes

August 12, 2012 at 11:58 PM · Filed under legal; By Camille Paldi

By Iraj Toutounchian

The classical economists did not treat society as a co-operative…"Joan Robinson"

The purpose of studying economics is not to acquire a set of ready-made answers to economic questions, but to learn how to avoid being deceived by economists. "Joan Robinson"

Economics is haunted by more fallacies than any other study known to man. "H. Hazlitt"

Society is a real compound like the natural compounds. But the synthesis here is of minds and thoughts and of wills and wishes. [The] new compound comes into existence and the elements continue their existence with a new identity, individuals also, who enter social life with their gifts acquired from nature and their inborn abilities, spiritually merge into one another to attain a new spiritual identity, which is termed the 'social spirit'...in the synthesis of society and individuals, though an actual synthesis takes place—because, the constituents, the individuals, as a result of their interaction, attain a new form and identity—the plurality of individuals is not converted into a unity...Society conceived as a single physical entity is only a hypothesized abstraction. "M. Mutaahhari'

Society, then, as is conceived has its own identity albeit this identity is derived from each individual member of the society; such that no one individual member of the society loses his/her identity. The mutual interaction between individual and society best exemplifies the paradigm: unity in diversity and diversity in unity.

Mankind's well being has to be based on global responsibility and cooperation. It should provide benefit to all cooperating nations. If no action is taken to address the manifold deficiencies of the existing global zero-sum game, the universal gap between south and north will simply widen. It will take a global will to make the world a better place. The will has to be directed towards instituting an increasing-sum game in which underdeveloped and developed countries alike have an equitable share of life's rewards. Without this, the global financial crisis will become a global humanitarian crisis.

Many misunderstandings can be found in the Islamic banking literature, but that is not to say that nothing valuable has been done on the subject. On the contrary, there are many more outstanding works, which deserve special attention and admiration. In this assessment of some of the mistakes, I have endeavored to follow four complementary criteria, but three of them, which we call the Trinity Criteria as three pillars of Islamic economics, deserve special attention:

1- Social justice is the ultimate goal of Islamic economics, in general, and Islamic Banking, in particular, the importance of which cannot be exaggerated. Any deviation from such teachings brings about Zulm (injustice). Embedding justice into the heart of an economic system is not as hard as most mainstream economic theorists imagine.

2- There must be cooperation among all individuals and legal entities, from which positive synergy emerges. This will naturally bring about externality, both in consumption and production. Externality in consumption takes the form of interdependent utility functions; in production, it gives rise to "the share economy" or a "Grand Cooperative System," which makes it possible for individuals to enjoy part of the profits of the firms for which they work.

3- In any conflict between social and personal interests, the social interest must prevail. To most Western economists, the concept assumes that: a) there is no "society" above and beyond individuals. Thus, we should be interested in the welfare of individuals and nothing else; b) individuals are the best judges of their own welfare and choose what is best for themselves; and c:) social welfare can be said to have increased if at least one person's welfare has increased and no-one else's has fallen. Pareto optimality has little to say about the "correct" allocation of resources and says nothing about equity (justice)...In brief, the capitalist system exhibits all the hallmarks of a zero-sum game...only with cooperation among individuals will social welfare be increased. With cooperation and the resulting externality, both individual and society benefit without incurring any loss to either side; thus, the Islamic economic system can be visualized as an increasing-sum game. The degree of certainty of receiving just remuneration in cooperatives for each individual member should be of such a magnitude that it precludes staying out of the sphere of cooperation. An effective incentive scheme restrains misbehavior while rewarding active and cooperative behavior. An institution's continued viability is dependent on just and cooperative behavior. Its success requires collective action towards a common goal. "A collective is a set of entities with mutual trust and unconditional cooperation. The incentive for cooperation in a collective stems from being a member of the same collective". Mutual trust and unconditional cooperation induces each member to put its utmost effort in the cooperative in which he/she is a member. Effort takes on a value of unity in the conventional wage system and greater than unity in the case of a cooperative enterprise.

An incentive pattern should not assume remote future cooperation in order to stimulate cooperation. Cooperation between labor and management can be thought of as a two-person game in which both share the same goal and form a coalition. As long as incentive patterns for cooperation are well organized and effectively implemented, selfish players will do well for a while, but will tend to change their behavior as they see that the more cooperative players have higher payoffs.

Contrary to common belief, cooperation and justice are not separate issues. It has been shown that they go hand in hand. Furthermore, justice is not unattainable in this world. It has to be sought in the causalities of Islamic verdicts, so to speak. Also cooperation is not hard to achieve between and among individuals. The problem lies in the fact that most, if not all, laws and regulations protect self-interested institutions and much less have been devoted to strengthen the ties between individuals in one institution. There is nothing wrong with cooperation; we should blame scarcity or lack of legal-legislative protection of cooperation.

"Where the invisible hand fails to direct each person, mindful only of her own gain, to promote the benefit of all, cooperation provides a visible hand...cooperation is the domain of justice. Justice is the disposition not to take advantage of one's fellow, not to seek free goods, or to impose uncompensated costs, provided that one supposes, others similarly disposed…", says D. Gauthier. Thus, we find ourselves in agreement with the most beneficial contemporary theorist of justice, John Rawls, when he says, 'The circumstances of justice may be described as the normal conditions under which human cooperation is both possible and necessary'.

It does not look hard to well define the principles of cooperation. A set of well-defined principles of cooperation can produce a larger pie from the synergy that results and can distribute that pie on an equitable basis.

A simple non- economic example about the fruit of cooperation (interaction) is as follows:

The product of any two numbers each of which is greater than 2 is always greater than the sum of them; that is:

$A \times B > A + B$ given that: $A, B > 2$

Like: $3 \times 3 > 3 + 3$.

A x B shows the interaction between person A with person B and A + B demonstrates mutual unconcern between them. The former demonstrates cooperation, say, in Islam, and the latter shows self-interest in capitalism.

We might call the difference between A x B and A +B as Barakah resulting from cooperation (interaction between and among individuals) whose origin might be interpreted to be the following:

يدالله مع الجما عه

This emphasizes the benefit derived from cooperation. Another evidence is that in our daily prayers the Surahs we use all are in plural verbs not singular.

Why should citizens within a community be treated differently if they all strive to achieve common goals? If the goals are the same, each individual member of a society has to contribute towards those goals. Logically, inconsistencies and fallacies emerge from a segmented society. But how is it possible to achieve a common mission in which: (1) consumers are assumed to maximize their utilities when they prefer to pay less for the commodities they purchase with given quality; (2) producers have the ultimate goal of maximizing their own profits, which is possible only if prices of the commodities they produce exceed the average cost of production by the maximum amount possible; and (3) money lenders (conventional banks) enjoy the highest possible interest rate spread, which is ultimately passed on to consumers? There is clearly a conflict of interests here, which does not lead to increasing the size of the pie. This is a perfect example of a zero-sum game, which best characterizes capitalistic economic system. "It is through the drive for maximization and for minimization that modern big business has obtained its dominating position in the economy. This continually disrupts the organic balance of the economy; obviously, the organs and cells in an organism must be in balanced relationships with one another if they are to function correctly", F. Wilken.

Unlike Adam Smith, who mistakenly thought individual self-interest was a minimum unifying social force in all economic activities, I firmly believe that cooperation among all agents of economic activity is the answer to the failure of capitalism (and socialism). The cooperative environment that produces maximum efficiency provides love and envy, the powerful dynamism for self-improvement and promotion, and these replace hatred, greed, jealousy, and oppression. Unity in diversity and diversity in unity becomes a fact of economic life.

Mutual human interactions produce externality, whether positive or negative. The Islamic economic system provides an environment full of externalities, which take different forms in production, exchange, and consumption but are all rooted in the same logic; cooperation. Without mutual interaction, justice becomes irrelevant. Mutual cooperation and interaction between individuals, between individuals and firms, and between firms and firms guarantee justice and pave the way for preventing the evils of conflict. "…the greed that knows no limit…is the very opposite of justice" says T. Gorringe aptly.

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32-Collateral in Islamic Finance

July 18, 2012 at 6:48 PM · Filed under legal; By Camille Paldi

Thought String from Iraj Toutounchian's Islamic Money & Banking: Integrating Money in Capital Theory

The Place of Interest in Capitalist Economics

"Western economists treat interest as if it were a necessary and unavoidable aspect of every economic system, as a common string to tie all economic activities together and without which the system collapses.

This belief might be true for capitalism, bearing in mind Sir Dennis Robertson's comment about Keynes' work raising the rate of interest 'to a position of commanding theoretical importance.' Obviously, there are many elements of truth in Keynes' analysis of capitalism; yet this should not prevent us from reconsidering the place of interest in that system. Let us begin by returning to basic economic principles. We assume a country with one huge firm whose factors of production are labor, capital, land, and entrepreneurship…The monetary value of the output produced is to be allocated among the factors of production on the basis of their respective contributions.

In a primitive society where the owners of the firms are also the managers, this kind of income distribution makes sense. But what about in modern societies, where stockholders (the real owners) may not even know the managers of the corporations? In such cases, critical issues develop that require correcting:

1. The managers are not the owners of the profits earned, although they may be highly skilled and earn high incomes. They may enjoy profit-sharing privileges, or be given a proportion of the increased sales income, or of the decreased cost arising as a result of their competence and qualifications. Whichever the case may be, the managers are part of the labor force, however skilled. Therefore, they have to be included under the heading 'labor.' This modification leaves 'profit' an unassigned income for which the proper owner has to be found. The issue is a serious one because if profits are a reward to entrepreneurs, what is left to be paid to the stock-holders? Interest, perhaps? Definitely not. Interest is paid to bond-holders, not to stockholders. Bond-holders are not the owners of firms, but stockholders are. This means that the profit is also theirs. They are the ones who run the risk of incurring loss but, as long as debts are based on collateral, bond-holders assume no risk whatsoever. These problems lead us to the second issue.

2. It has often been stated by Western economists that 'interest' is the 'price of capital.' However, interest is the price of a sum of money borrowed to put into the firm or used for speculative purposes. We cannot be sure that all borrowed money will be converted into actual 'capital.' As long as it is not entered into a firm and put into the production function, it cannot be considered as 'capital.' The legalities, as distinct from the technicalities, of the production function are important issues that are often neglected. A common and perhaps deliberate failure to distinguish the legal difference(s) between money and capital, and their respective returns, has become the source of considerable confusion and misconception. Interest is basically determined in the money market because of its being speculated upon. There seem to be no doubt that explaining the forces which determine the interest rate has been one of the major problems facing economists." (94)

<u>Speculation:</u> "The term 'speculation' is used here to mean any action which, for the benefit of the few and to the detriment of the general public, alters the normal course of events in a money economy to make it an unsound and unhealthy economy. Unhealthy events are those which, sooner or later, bring about instability and the crises of confidence, which afflict the economy. Speculation harms public confidence because of the nature of the speculators' expectations about the future course of the rate of interest. Speculators normally earn money income by attempting to 'buy cheap and sell dear.' 'Speculation' as it is used here follows the way Keynes used it in his General Theory. To be specific, almost all transactions in stock markets involving the exchange

of stocks whose prices are market-based are speculation. The exception to this is the exchange of stocks issued by firms and sold when stock prices closely match the real value of the firm and not the market value of the stocks. The prices at which stocks are normally exchanged far exceed their real value as a result of bubbles. The real value of stocks is the real value of the assets of the stock-issuing firm. By this reckoning, ordinary stock markets that are secondary markets are, as I understand it, money markets; the primary markets, devoid of bubbles arising from speculation, are capital markets. Capital markets are essential and necessary for any economic system, Islamic or otherwise." (186)

Underlying Conditions for Success in Islamic Finance

"In the Islamic financial system, money does not earn any return without being legally converted into actual capital in collaboration with effort. The proportionate returns for the investor, who provides part of the actual capital to undertake an investment project, and the bank which, on behalf of the depositors, provides the remainder, depends upon several factors such as the priority of the project in terms of value added or increase in employment, the degree of risk involved, social interests, and the like. We will say more about these issues later.

In the interest-based conventional system, collateral is often required to guarantee the return of the principal and interest.

This seems to be unproblematic as long as the value of the collateral exceeds that of the principal amount of the loan plus interest to cover any legal expenses in cases of default. In theory, though not necessarily in practice, neither the lender nor the borrower cares about where the money is spent. Trust and/or trustworthiness play no significant role as long as the above considerations are taken care of. In the extreme case of the bankruptcy of the borrower, liquidation of the collateral is used as a source of 'trust' that the borrower's debt will be collected. The borrower strives to make more money than the amount borrowed. The lender does not care about the outcome of the borrower's activities, being concerned solely with the return of his money plus the interest charges. Each side is independent of the other. Yet this seeming positive is also negative in that their economic activities have social consequences for the communities in which they live. These often manifest themselves in the form of an adverse impact on employment, higher prices, and the inequitable distribution of income and wealth.

Western welfare theorists such as Pareto have yet to provide evidence that society – that is interactions among individuals in a community – does not exist. It is this failure to take account of such interactions that gives rise to conflicting interests. Until the well-being of all individuals is tied together, a humane economic system cannot exist. Separating individuals within a society requires a strong public sector to deal with the problems arising from inevitable conflicts." (241)

Collateral:

"In the conventional banking system, 'collateral' is usually taken to mean the pledge of an acceptable (generally solid and redeemable) asset as security for a loan or credit. But in the different philosophical setting of Islam, where people matter and man plays the central role, a different value system is practiced. Here, 'collateral' is understood to stand for attainment of certainty and security based on the solid foundation of the transaction and good performance of the undertakings to minimize the risk to return on the capital. In this context, the word 'collateral' is generally replaced by the phrase 'sufficient security.' The security needed here has much to do with proper utilization of the code of ethics combined with the intellectual property of the applicant – which has rarely, if ever, been used before. As we saw in Chapter 1, the shareholders in a Musharakah contract never ask for collateral from the issuing firm since each of the shareholders has a proportionate claim on all assets of the firm. Instalment sales provide another example, where the subject property itself is used as collateral until the bank's resources have been fully redeemed. As we also saw earlier, a *Qard-ul-Hassan* contract is basically a loan, but payment is made without taking any collateral. In brief, any action taken by an Islamic bank is taken because it is considered to be the trustee agent or advocate for its depositors.

In any economic downturn, every participant in our Grand Cooperative System (GCS) has to bear a share of any losses; that is to say, everybody is made responsible for the rest of the community. Similarly, in years of prosperity, everyone enjoys the benefits of cooperation in proportion to their respective contributions to the social product. It is worth reiterating the fact that an Islamic bank exerts itself to the full to maximize the social welfare and maintain equity through cooperation. The GCS is composed of numerous atomistic cooperatives whose goals are the same. This, then, leads inevitably to a position outlined by Professor Gauthier as follows:

As we have seen, the best and most reliable 'collateral' is for intellectual property of the applicant who makes a proposal for a PLS contract. Sufficient inbuilt security in the form of trust, combined with intellectual property and technical ability, renders the policy of the conventional system irrelevant.

Unlike conventional banks, an Islamic bank performs functions that are integrated into the whole economic system and thus is inseparable from the real sector. In essence, it works as the development engine of the economy. It also performs an investment-development bank whose functions vary, as we have seen, from the simple to the most complicated. Profit maximization is not the goal. Profit comes after an economy enters into a healthy stage. We demonstrated earlier how full employment in this system is guaranteed through the abolition of interest and the absolute absence of speculation of any sort. The transmission mechanism for this is the institution of the Islamic bank. Its function makes efficiency and equity complementary, rather than conflicting, objectives." (263)

33-Speculation, Uncertainty, Interest, and Unemployment

July 16, 2012 at 7:33 AM · Filed under legal; By Camille Paldi

Thoughts from Iraj Toutounchian's Islamic Money & Banking: Integrating Money in Capital Theory

ASSERTION: Speculation, in any market, produces a rate of interest in terms of itself. Keynes proved the opposite; therefore, interest is both a necessary and sufficient condition for speculation to take place.

ASSERTION: Store-of-value makes of itself a triangular trap whose equal sides are hoarding, liquidity preference, and speculative demand for money – none of which can be studied independently from the rate of interest.

ASSERTION: Speculative activities with any durable commodity produce the rate of interest in terms of themselves. This is done on the basis of the M-C-M relationship. This is nothing but indirect demand for money; that is, an Islamic interest-free economic system is not only futile and misleading but it is also the result of confusion and misunderstanding.

A corollary to the above assertions is that in the absence of interest (and hence speculation) in any market, stability, full employment and a self-correcting mechanism are brought about in an Islamic economic system.

ASSERTION: In an interest-free Islamic economic system, money can no longer perform the conventional store-of-value function. No speculation in any market is allowable because of the interest (Rate) that it naturally bears. All in all, there is a one-to-one correspondence between the store-of-value function of money and speculative demand for money.

Unlike a grand cooperative Islamic System, capitalism can be visualized as a zero-sum game in which for every gain there has to be found a loss of equal amount. Speculation in any market brings about income for the major speculators behind the scenes. The gains are enjoyed by a few and the losses borne by the rest of society. The money whirlpool, which emerges from every speculative activity does not allow the equality between saving (S) and investment (I) to hold.

This means that speculation and the interest bearing on it produces a savings gap; that is S>I. Hence, the necessary condition for full employment is never satisfied. The loss to society is the cost of unemployment.

The social cost of speculation goes far beyond its private benefits. By allowing interest (rate) to operate, the capitalist system gives speculators the opportunity to hunt the most profitable monetary opportunities and inflict the most harmful consequences on society. The proper expected rate of interest emerging from speculation, particularly in the money market, is necessarily higher than the going rate in any other money markets. This gives another reason for the saving gap to deepen even further, other things being equal. The unavoidable consequence of allowing interest and speculation is unemployment.

ASSERTION: the money whirlpool resulting from speculation in the money market does not allow the equality between saving and investment to hold. The natural consequence of this is unemployment.

ASSERTION: By allowing interest (Rate) to prevail in a society, speculators are given the opportunity to hunt the most profitable chances inflicting an equivalent loss to society in a zero-sum game.

There are two reasons to believe that in an interest- free Islamic economic system, money cannot be speculated upon: firstly, it is an impure public good; and secondly, speculation on any commodity in any market which brings forth with it a rate of interest is totally prohibited. These factors bring about equality between saving and investment, the consequence of which is full employment.

ASSERTION: the abolition of interest and speculation in an interest-free Islamic economic system eliminates the store-of-value function of money. This reduces the demand for money to irrelevance.

Unlike capitalism, the Islamic economic system provides the necessary conditions for money to perform its logical and universally accepted functions…

Pierce and Shaw's Assertion:

People want to hold money, Keynes said, not only for transacting current business but also as a store of value or wealth…The reason … is the existence of uncertainty: uncertainty as to the future of the rate of interest…Once the future of the rate of interest is uncertain people have the opportunity to speculate in the hope of securing profit from knowing better than the market what the future will bring forth. In his analysis of the speculative motive, Keynes considered only one alternative to money as a store of value, namely bonds.

Interest is an obvious attribute of both money and bonds. Less obvious is speculation, which, as Keynes pointed out, is one of the most profound characteristics of capitalism and the root cause of the Great Depression. The clear intention of speculators in both buying and selling commodities is not to hold and consume them but to make profit through the exchange of money for money.

From the point of view of Islamic teachings, the importance of intention in transactions cannot be exaggerated. The intention of traders is not hard to trace back in some cases. Uncertainty – artificial risk – is an essential element in all speculative activities, the sole purpose of which is to make the environment suitable for a few speculators to make a profit. Such a risk manifests itself directly in the rate of interest. If my understanding of this point is correct, it makes interest rates even more volatile. What a sound and stable economic system needs is as much certainty as possible for all economic agents. Artificial risk might explain frequent variations in the investment function, via its mutual relationship with interest rates in capitalist economies. This has to be added to the money whirlpool produced as a result of speculation; combined these factors do not allow full employment to be maintained.

Any kind of artificial risk attached to the expectation and put into the future course of interest rates will transform itself into the actions of speculators. Speculators – and the word here is used in a morally neutral sense to mean anyone who buys a financial asset at the lowest expected price in the hope of selling it at a higher expected price in the near or distant future – typically operate on borrowed money. Obviously, the return on such activities must be higher than the interest rate on borrowed funds. Furthermore, sane speculators never bet against central banks, which are the center of the entire financial universe in that they create money, regulate credit, and often decide whether troubled private banks will live or die. The central banks are in fact playing in the market with other people's money.

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34-Conventional Bank as Loan House v Islamic Bank as Finance House

August 7, 2012 at 1:05 AM · Filed under legal; By Camille Paldi

Thoughts from Iraj Toutounchian's Islamic Money & Banking: Integrating Money in Capital Theory

Conventional Bank as Loan House

It is a loan house;

It has deposits as its inputs and loans made to customers as outputs;

It has bank depositors and customers on the basis of loans given to or received from the bank;

Accumulation of deposits makes it a powerful 'monetary' institution with monies available for lending, leaving the legal aspect of loans intact;

It will only be concerned with gathering more deposits and lending out more money, part of which will go for speculative activities (for which the bank has no responsibility) and the rest for debt-capital. The 'money whirlpool' this produces brings about inequality between saving and investment, whose immediate result is unemployment;

It does not play an active role in the economy in that, as long as the borrower has sufficient collateral, the purpose to which the loan is put does not matter. In other words, money goes where the 'return' is highest, not where it is needed most;

Interest charges from both sides are considered as a cost. Interest paid to depositors is part of the cost of the bank; similarly, interest paid on borrowed money is part of the cost of the borrower;

The rate of interest is basically determined as the result of speculation of money;

Any changes in the rate of interest come from the money market. Quite often, these changes are dictated by the monetary authority, the Central Bank, and are due to interference in the market mechanism, despite the misleading idea that the market mechanism brings about efficient allocation of resources. Even if this assertion happens to be true, it should be noticed that it does not guarantee justice (equity).

Risk is inherently interwoven with investment. Our bank does not involve itself in any investment project; rather, by lending money, it keeps itself away and safe from any risk. Thus, the conventional bank plays a completely passive and neutral role in the economy from which it flourishes.

As we have seen, the individualism implicit in capitalism makes it a zero-sum game. Given that people necessarily interact with others with different and quite often opposing goals, such a game produces conflicts of interest. In addition, as long as there are other ways to earn 'income,' the borrower need not engage in any 'productive' activity. Speculation, the first immediate derivative of interest, is often an attractive alternative in that the speculator need not engage in the difficulties associated with such things as labor – management relations, pricing policy, the most effective use of existing technology, and so on. The huge amounts of money circulating in speculative activities offering a rate of return far above those offered in 'productive' activities can only have adverse effects on the economy.

The balance sheet of our bank is such that the value of either side of it varies inversely with general economic activity. Although this might be thought to keep our bank on a safe margin, it also emphasizes the point that it is not integrated into one whole system, all elements of which tend to go up or down simultaneously. Such a bank is alien to the general economic activity. An economy is based on such paradigms is quite vulnerable, as the recent history of capitalism has shown.

Profit here is the difference between interest-income received from money loaned out and interest expenses paid to depositors. This difference might be called 'net interest (RIBA) income,' to distinguish it from profits earned by economic activities in producing goods (and when we reach the discussion of operational costs of such banking, especially when those costs are passed on to the consumers as if they were independent economic agents. The carelessness of the conventional banks about the economic performance of the system means that it has become separately and independently studied from the real sector as a result of the conflicting interests of the two sectors.)

As long as money remains potential capital and is pumped into an economy in the hope of stimulating the system, not only will it fail to become an incentive for increased production, but it will also have adverse effects on the economy by raising general price levels. Furthermore, it is almost impossible to anticipate with any certainty the extent to which the GDP will go up in line with change in the money supply.

<u>Islamic Bank as Finance House</u>

What we expect from Islamic banking is not only to remove 'the evil' of interest, but also to provide an environment where there are stable prices, full employment, equitable distribution of income and wealth, sustained growth and no business cycle – something the capitalist system has not been able to achieve in the last two centuries.

There are special features of an Islamic bank which make it fundamentally different from a conventional bank:

Depositors are no longer lenders to the bank… they are shareholders in any activity in which the bank becomes involved;

The Islamic bank is an advocate for depositors in that it takes their interests and those of society in general into consideration in all of its decision-making;

The customers are potential investors through having a Profit-Loss Sharing (PLS) contract. They are no longer borrowers. They have to have an investment project proposal whose justification – economic, technical, and financial – will have already been approved by the bank. This means that every dollar going out of the bank has to be project- specific. This is the way projects are financed.

Through its engagement in PLS contracts, the bank becomes the partner of investors and unlike its conventional counterpart, provides equity capital rather than debt capital. The Islamic banking institution as the financier channels funds to specific projects proposed by the firm applying for partnership, the financee. The bank then becomes a shareholder on behalf of its depositors and thus, unlike the conventional bank, has the right to monitor the way the finance is being used. This makes the money supply for conversion into actual capital an endogenous variable and the supply of money is thus synchronized with production in a way that is not reliant on the required reserve ration for purposes of alignment. In fact, this could be safely lowered down to zero. Further, as long as there are justifiable investment projects, the supply of money could be increased, without a limit, with no fear of inflationary pressure. [During the gestation period of certain projects, however, there might be occasions where the prices of some commodities in short supply go up. However, as soon as investors and consumers satisfy themselves that such shortages are merely temporary, there is no reason for consumers to panic.]

All in all, our Islamic bank is neither a loan house nor an intermediary funding institution, rather, it is a finance house directly involved and integrated into the economic system.

There is no guarantee of a predetermined rate of return to the depositors. However, the expected rate of return (profit) is what makes the Islamic bank a strong financial institution in that its general and active performance in the economy attracts depositors. This means that the cost of capital is zero (a more detailed explanation will follow in coming chapters). In this sense, the tasks and commitments of the bank management rate are similar to those of any Islamic firm, which pursues not only the interests of its shareholders, but also those of society in general. This clearly differentiates it from privately-owned firms in the capitalist system. To better understand and distinguish the differences between the activities of an Islamic bank and their impact on the economy from those of the conventional bank, one need only compare the nominal value of stocks in the absence of speculation with the par value of bonds resulting from speculation. Where the former exactly exhibits the performance of the economy, the latter often reflects something quite different. More importantly, the dividend paid to stock-holders will not represent part of the cost of the issuing firm but the interest on bonds, unquestionably, is part of the cost of the issuing firm. Again, stock-holders are not promised a predetermined return and thus the cost of obtaining equity-capital is zero. Bond-holders definitely accept a return from the outset, which counts as a cost of debt-capital. Further elaboration and the logic underlying this argument might seem a challenging issue for some scholars.

There is no need for banking authorities to intervene in the market, as the Islamic bank is expected to play an active role in a capital market free of any speculation. Determining the ratio of profit shares to capital is not undertaken through intervention in the market. Surprisingly enough, investment projects, which are long-run in nature cannot and ought not to respond to very short-term changes of interest rates. Moreover, there is always an urgent need for potential investors to make decisions in a stable environment; something which everyday changes in the rate of interest and expectations on its future changes do not allow. Such changes are the products of speculative activities, which benefit a few at the expense of the majority. These activities can be avoided by allowing the system to take its natural course while monitoring the outcome. The conventional system has proven over the past several decades that it is unable to stand up on its own. My criticism of the capitalist system and its inevitable collapse is more fundamental than that of Marx. Where his main concern was with the exploitation of labor, ours here is much broader in that it incorporates every individual exploited by Riba. Exploitation, here, does not refer to underpayment to individuals to the benefit of capitalists, but being exploited with the invisible hand of interest in unemployment, inflation, inequitable distribution of income and wealth, business cycles, and irregular growth in the zero-sum game called capitalism.

The nature of PLS requires the Islamic bank to get directly involved with risky capital investment, which requires that it take an ownership state in any joint-venture it enters into. The bank becomes fully involved to ensure that the capital – not money – is used wisely.

Following the Friedman Rule, it seems that the necessary condition for achieving full employment is through elimination of interest – that is, a zero nominal interest rate, to be specific. If speculation as the first and immediate derivative of interest is completely abolished then full employment can be guaranteed. This important target can be maintained in an Islamic setting and Islamic banks would bring about the necessary savings and investment conditions through providing equity-capital and monitoring measures, but the rest of the system would take responsibility for maintaining those sufficient conditions.

Under such a system, the bank's balance sheets on the asset side would show the various equity positions they hold in different firms under PLS contracts, the values of which would vary with the general economic conditions. On the liabilities side, deposits would work more like shares in a mutual fund. The returns to depositors would vary with those of the firms whose projects have been financed by the banks. There the hundreds of different projects financed by the Islamic banks which encompass the whole economy. If the economy does well, the profits would be distributed proportionately to the shareholders. Similarly, if the economy does not do well, losses would be shared proportionately. This has the advantage of bringing the aligning the interests of all concerned and strengthening the sense of cooperation among laborers, consumers, and the firms. The stronger the ties, the higher the social welfare of the system and the fewer the potential conflicts. With such an arrangement, there would be no need, as Professor Akacem puts it, for:

Deposit insurance and no likelihood of financial panics, since both sides of the balance sheet would move in tandem ... It is tempting to conclude that an Islamic financial structure would not be conducive to risk-taking, and might stifle the entrepreneurial spirit for which America is prized. Perhaps. But it could also be argued that such a system would eliminate the financing of the marginal projects from the start, and thus remove the likelihood of a major bailout. (Akacem, 1991)

Among the advantages offered by PLS Contracts are the following:

a. Interest results in inefficient resource allocation since loans not only go for speculative purposes but also to more credit worthy borrowers rather than to more productive products.

b. Despite the general conviction that interest has the important role of making efficient allocation of scarce resources, the logic becomes useless as the number of projects increases. Investment projects compete with each other on the basis of IRR before they reach the cut-off rate externally imposed by the rate of interest. You will recall how the G-7 group, individually and collectively, demonstrated that rates of profit did not get close to the long- run rate of interest in these countries and were also far apart from each other. The profit rate would be greater if the internal rate of return were used instead of the rate of interest.

c. The problem of whether interest rate is inversely related to investment remains unresolved. Empirical results do not provide conclusive evidence as to the relationship between these two variables. In an excellent and valuable survey, W.H. White had the following to say:

From the late 1930's, economists have been growing increasingly skeptical of the value of monetary policy for moderating the swings of the business cycle or for controlling inflation. The main source of this skepticism lies, with regard to conditions other than deep depression, in the evidence provided by a number of empirical investigations showing that the interest elasticity of demand for investment is extremely small.

In conclusion, he remarks: In view of all their defects, no definite conclusion can be drawn from the surveys of business attitudes toward capital costs. The surveys do indicate that investment is to some degree less interest-elastic than thought by the proponents of interest-rate policy. (Ibid: 113) Given the continuing doubt about the impact of interest rates on investment, it remains to be seen what role interest plays other than to inflict irreparable harm on the majority of households to the benefit of the very few.

Money creation in the conventional system is based on lending, which makes it prone to an oversupply of money (that is, inflation), as there is no direct linkage between additional production and additional money supply. Debt- financing based on fixed and predetermined rates of return (namely, interest) on money produces ways for money to go astray, mostly, for speculative purposes, from the production process in which it was once supposed to make saving (S) identical with investment (I). In the Islamic system, on the other hand, the abolition of interest and the prohibition of speculation on any durable commodity would necessarily bring these two into equality (following the Friedman Rule).

Public sector borrowing based on virtual wealth rather than backed by tangible assets adds to the burden for future generations. Islamic asset-backed financing does not carry a debt-burden; and in the rare and unlikely event of inflation, its value goes up and assets are available which can be liquidated to repay the shareholders.

Except for current accounts (the liabilities of the Islamic bank) all other deposits are accepted on a fiduciary basis and are invested on behalf of depositors who enjoy the major portion of the profits and bear any losses, unlikely though they are. While profit is important for Islamic banks, it is not their main objective. The emphasis is on achieving the community's socioeconomic objectives in line with the injunctions of Shari'ah. Giving depositors a share in the profits of firms financed by the banks, in which the rate has been shown to be much higher than the rate of interest, brings about a more equitable distribution of income. It also creates a greater incentive for others to save more, which, in the absence of Riba and speculation, brings the system into full-employment equilibrium. The role of the Islamic bank is that of an advocate who manages to legally transform the money deposits (potential capital) into actual capital on behalf of depositors. This system ensures that the assets and liabilities of the Islamic Bank are always in balance. The stability of the system is increased by the close linkages between financier and financee. It is not hard to demonstrate that a sharing system is more conducive to growth, as it affords greater initiative and drive to the entrepreneurs.

The proposed system follows Lord Keynes in his belief that:

It is much preferable to speak of capital as having a yield over the course of its life in excess of its original cost, than as being productive. For the only reason an asset offers a prospect of yielding during its life services having an aggregate value greater than its initial supply price is because it is scarce; and it is kept scarce because of the competition of interest on money. (Keynes 1936: 213; original italics)

I am convinced that the scarcity of capital in the capitalist system arises from the misconception that money is a private good in which price is interest. As demonstrated in previous chapters, money is an impure public good and if it is given into the hands of the private sector, it will produce a less-than-optimum performance which results in unemployment. This assertion goes one step further than Keynes, for whom the only remedy for unemployment was to bring the central bank under public control (Ibid: 235). With the rate of interest changing every day, many projects become justified while others are rejected. This is not incompatible with interest inelasticity of investment expenditure, as cited earlier. Expectations of future changes in the rate of interest create uncertainty for investors as far as the price elasticities of the commodities they produce are concerned. This, in turn, has a negative effect on investment decision-making, which makes this variable the most volatile components of GNP. In a reversal of the Friedman Rule, Keynes asserted that 'the rates of interest will only reach equilibrium when there is full employment.' (Ibid). The abolition of interest rates and the consequent removal of speculation in any commodity market will guarantee full employment in an Islamic setting. Keynes had more to say on this:

The only alternative position of equilibrium would be given by a situation in which a stock of capital sufficiently great to have a marginal efficiency of zero also represents an amount of wealth sufficiently great to satiate to the full the aggregate desire on part of the public to make provision for the future, even with full employment, in circumstances where no bonus is obtainable in the form of interest. (Ibid: 218)

The Islamic financial institution system honors the rights of ownership by individuals and institutions. It favors just rewards for hard work, skill and initiative, and makes the relationship between the individual and the community one of cooperation, integration, and duty.' (IIBI 2000: 5)

In an efficient and well-organized cooperative system, inflation arising from the mismanagement and mistakes of the economic agents will be minimal, if not zero, as the supply of money is fully synchronized and directly linked with economic activity.

Before we conclude this section, it is worth noting that while the Islamic bank is value-oriented and the conventional bank is value-neutral; and that: Islamic banks are multi-purpose banks, as they play the role of commercial banks and investment banks, as well as development banks. They operate in the short- term like conventional banks [such as handling current accounts, opening of letters of credit based on Qard ul Hassan, collection, remittances, safe deposits, and so on, on which the bank earns fees, commission and exchange and in the medium and long term investment development banks like non-bank financial institutions ... depending upon the structure of their resources.]

All of the above-mentioned advantages of an Islamic finance system have to be put at the forefront of the research agenda. While much has been undertaken in this regard, much remains to be done.

But the central question has yet to be answered. Why, despite their strong social capital, their hi-tech developments, increased efficiency and other advantages, do developed countries still experience inflation and high unemployment. As should be clear by now, I firmly believe that interest has proved to be the Achilles heel of the capitalist system.

If a community has committed itself to Islamic Banking Practice and yet has failed to realize the full advantages it holds out over the conventional banking system, then it is clear that the Islamic banking system has not yet been properly launched. There are increasing numbers of countries, Islamic and non-Islamic, which have started to operate on Islamic principles, yet almost all continue to suffer from the same problems encountered by the capitalist system. In my observation, this arises from the fact that they are mostly organized along political rather than banking principles and are designed to absorb billions of dollars from Muslim countries, irrespective of the consequences. The mere surface of Shari'ah principles has been used as a cover for conventional-system practice, especially among Islamic banks located in non-Muslim countries. There is no logical reason why the real advantages cannot be realized to the benefit of all. As has been demonstrated in earlier chapters, the conflicts of interest that are the hallmark of the capitalist system make it very unlikely that the system will ever reach equilibrium and students of the system have to be taught economics on the basis of disequilibrium. The Islamic economic system, on the other hand, starts from equilibrium and moves along the upward trend of inter-temporal equilibrium. Where labor, money, and capital are given due respect, conflicts between economic agents are removed. This can only be achieved via Justice within the regulatory framework of an Islamic Grand Cooperative System. Justice (equity) has dual characteristics. Equity puts everything in its proper place and guarantees equilibrium. Justice, however hard to launch, removes hatred, jealousy, conflict and brings about love, cooperation, and prosperity.