

# Islamic Banking:

## A last Ditch to Save Capitalism

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Iraj Toutounchian

Professor of Economics

The prevalence of stagnation in today's capitalistic world is unprecedented; a capitalistic world confronted with complex economic issues, which were not so acute in the past. Business cycles, which were played down in the past, no longer can be treated as such. The intensity of business cycles has reached such degrees, within the last couple of decades that advanced capitalistic regimes have to encounter their overriding existence. This is especially true in a world in which communications have expanded enormously as a result of which countries, willingly or not, have come closer to one another for purposes of economic relations.

Once it was offered, as a claim, to envisage capitalistic economy as being self-regulating and self-correcting. The intensity and frequency of economic fluctuations have made even the most ardent of economists to withdraw such a claim. The catastrophe has reached points that if one would fail to see the impact of collapse of the capitalistic system as greater than that exerted by war, he would succeed in comparing its unpleasant consequences to those created by warfare. War destroys people and facilities.

But the great collapse, which is likely to occur in near future, will swamp living human beings. Unemployment, poverty, disease, and hunger are not predetermined events; man is not doomed to accept them as inevitable.

Mankind, through the hands of colonialists and strongmen of the capitalistic world has brought about the perilous present situation. The greedy and selfish consumption in major advanced industrial nations, which had been severely and ever-increasingly disturbing the ecological balance, has culminated catastrophically in new heights now imposing a massive threat to all mankind, a threat whose magnitude could have never been imagined by great architects of the Scientific Revolution. The real danger lies in the fact that potentiality of this catastrophe is being played down by some highly influential executive offices, despite the scientific community's repeated warnings, in order to perpetuate irresponsible exploitation of natural and human resources in a capitalistic mode, which secures the benefit of a few over the planet's population. The unjustified and unresponsive acts, disregarding good purposes of humanity, committed by the world capitalism, particularly since World War II, has disgusted the public, creating critical reactions of many kinds, each expressing deep dissatisfaction concerning the status quo, and the world governance. A casual glance through the history of contemporary social thought would reveal a mass of evidence supporting the point just put forward. We resist the temptation to offer a view on

the social dimension of such dissatisfaction here, in order to make room for economics.

United States of America represents the prototype of a pure capitalistic country, and no foreign force as yet has been able to alter its sheer capitalistic course. The immensity of size, power, and the economic complexity of the USA, is unique. It follows, naturally, that its problems do not conform to those of other nations. Thus US economy has to be analyzed as a separate category. This “separate” treatment does not mean that the other advanced industrial nations are immune to perils that America is doomed to face. Here, while withholding approval of points expressed by the socialists or the Marxists, we quote a sentence from Joseph A. Schumpeter:

**Marx was wrong in his diagnosis of the manner in which capitalist society would break down; he was not wrong in the prediction that it would break down eventually.**

The advanced industrial nations have many characteristics in common, and all of them will face, sooner or later, the looming threat America is destined to experience. Nevertheless, the uniqueness of the American economy requires us to point to dire realities concerning this nation. Obviously the act of pointing to the USA comprises a general warning of interest to all advanced capitalist industrial nations. What follows is partially taken from the recent report of the Monthly Review.

The economic theorists and experts discuss endlessly America's federal budget deficit, its negative current account balance, lack of investment, and the breaking of financial bubble. These theorists fail to realize the possibility that these are merely symptoms of recession. The prevailing view regards capitalist economy as naturally tending toward abundant investment, striking economic growth and wealth, thus the authenticity of the view that the capitalist economy intrinsically tends toward recession, is disregarded. The theorists may admit that growth rate of the US economy has been falling since 1960's, yet they attribute this decreasing process to state's bad policies not as a reflection of a general process of modern capital accumulation.

A more rational treatment of the present situation depends on admitting the view regarding capitalist economy as tending towards recession as a natural event. What created the rapid growth of the 1950's-60's, were historical events like people's saving during the World War II, the second wave of automobilization of the US economy (which included steel, glass, tire, construction industries, and the inter-state freeway network). Added to these were the economic stimuli created by two regional wars in Asia, and the extraordinary increase of sales organization related to modern techniques of marketing. Most of these factors have either completely vanished ( as people's saving during World War II) or have reached the point of stability where they can no longer be considered as major stimulants for economic growth.

During the 1980's the main economic stimulant came from the expansion of financial superstructure of the US economy. This expansion took place particularly in recent years as regards electronics and computer industries and that of the internet. These factors, too, have weakened following the breaking of the stock market's bubble, and decrease of investment in the electronics and computer industries.

The unemployment statistics is indicative of the seriousness of the danger poised by it. The number of employment has reached its lowest since twenty years ago. According to a report by the New York Times of February 6, 2003, since the crisis commenced in March 2001, the US economy has lost more than twenty million job opportunities. Most individuals, confronted with the prospect of prolonged unemployment and the glimmer chance of reemployment, are disappointed and thus have stopped looking actively for jobs. Hence, the official statistics does not include these people, and therefore the unemployment statistics is an underestimation of the real jobless. To obtain the official figure of the unemployed their number is divided by sum of both employed and unemployed individuals, and the result is stated in percentage. According to such a calculation, the official unemployment statistics, for January of 2003 was over 6.5% (disregarding seasonal factors). But if we consider the number of individuals who have recently left--per official definition of--the labor force, and add the number of individuals working part-time yet seeking full-time work, the real dimension of plight of

unemployment will surface. Considering these individuals, the unemployment figure for January of 2003 (disregarding seasonal factors) has been 11%.

It is crucial to note that according to the New York Times, the Federal Reserve Board has lowered the interest rate twelve times within last two years, decreasing interest on the inter-bank loans to its lowest; to 1.25%, inside of last forty years. In spite of these efforts, the Federal Reserve has not been able to motivate investment volume. What determines investment volume in the new output capacity is the prospect of gaining investment profit in the future, viz., when the new output capacity would reach exploitation point. If due to limits of the market, or any other reasons, little were expected of the future profit to be gained from investment, then new investments are simply not made.

The recent events must have persuaded the western economists (both, Keynesians and monetarists) that despite their views, investment is not a function of interest rate, but there should be an effort made to search for another factor, a factor that is responsive in normal, as well as, in risk conditions. This point directs us towards interest-free, Islamic banking, to substitute profit rate with rate of interest. In addition, in such a system, attention is paid simultaneously to both; the supply side, and demand side economy. These two points, taken together, constitute a special feature of Islamic banking, a feature lacking in capitalist economy. We should bear in mind that all business

cycles are rooted in money and are somehow related to interest, which is the result of speculation.

Two main subjects are discussed here. First is that economic system should deal with two principle categories, viz., on the one hand, the issue of justice (equity), and on the other, the issue of efficiency. Between these two issues lies their “trade-off” area. Capitalist economy puts emphasis on efficiency and regards equity as its “spillover”, that is, it holds that in the process of economic growth, equity will emerge. In discussing justice (equity) the main issue is the equitable distribution of income and wealth. What justice is this, as M. Friedman puts it: “That **1% of population owns 50% of everything?**” And, how is it that after the passage of two hundred years, this justice has not yet emerged?

The socialist system claims to have justice as its goal, yet it has a mistaken image of justice. In the meanwhile, the socialist position takes efficiency as a byproduct of the issue of equity. The socialist’s error is that they do not respect private property. Is it true that ownership is always obtained through theft? Proudhon initiated sanction against private property by stating that “**property is theft**”. Nevertheless Proudhon not only does not deny workers’ ownership but also considers equity important enough to rightly assert that: **Justice is equilibrium of opposing forces.** And that: **Justice is the supreme principle of human life.**

Proudhon, thus, bestows on justice a certain scientific-analytic aspect. While avoiding the assertion of attributing the demise of the former Soviet Union to the supposed fall of

philosophy of socialism, it seems necessary to bear in mind that the issue of equity is the issue of “rights”, and that within rights of the owner of capital (not money) to possess and enjoy the results gained through utilization of “his” capital.

Moreover, justice is not meant to be an issue applicable only to workers, it must encompass all members of a given society. Even when economists talk about efficiency they implicitly consider equity. Specifically, welfare cost of inflation, which has occupied a considerable volume of economic literature, is mainly targeted toward least damage to the society. This is nothing but justice (equity).

In Islamic economics, rights of people and those of “things” have been defined prior and after the distribution of wealth. Then, justice is defined for all members of the community as an uncompromising goal. It must not be difficult to demonstrate that the implementation of justice as such will conduct all affairs in their natural course. The resulting corollary is that simultaneous access to both stable prices and full employment (unlike capitalist economy) is attainable. Meanwhile, natural course of affairs which results from application of such a justice will create a state of equilibrium between human psychological needs and his surrounding environment (something the capitalist economy has been unable to attain).

The second subject is that mankind has comprehended justice concept and the joy which is derived from applying justice, in some periods of human history. Then, ever since mankind

achieved this understanding of justice, using his intellect, which is intrinsically moral, he has struggled against interest (Riba). This struggle goes back to hundred of years before Christ. So that: usury (Riba or interest) had been repugnant to Aristotle.

Economists, later, embarked upon more detailed inquiries on interest. Proudhon is one of those who rose against interest in such a manner that he believed: **interest being abolished, exploitation through property is abolished, too.** Nevertheless, serious scientific discussions on zero interest began in 1930's. Silvio Gesell suggested "stamped money" in order to omit interest from economy. Maurice Allais, while publishing a book in 1947, had reached the conclusion that: **the optimum real interest rate is zero.**

We will suffice mentioning three other thinkers who rose against interest in economic literature. After Allais, another economist, namely, M.Sidrauski in 1967, using a dynamic utility function in which money was inserted reached the conclusion that in order zero down welfare cost, interest rate must be equal to that of social marginal cost. Applying it to money it amounts to zero interest. B.P.Pesek, and T.R. Sving (1967) have argued that the essential characteristic of money is its non-interest bearingness, and that if money were to bear interest it would cease to be used as money. Professor M. Friedman, too, in 1969 reached the conclusion that zero nominal interest rate is the necessary condition for optimal allocation of output factors. In 1998, two economists working for the US Federal Reserve, of

Minneapolis District, showed that for optimal allocation of output factors, not only is zero interest necessary condition, but it is sufficient , too.

The result emerging from these studies do not strike Muslim economists as surprises. Yet, the question remains that under these circumstances how banks would operate? If banks, for example, grant interest-free loans, (considering that M.Friedman designates legal reserve rate banks to be 100% for purposes of economic stability), what form, then, banking will assume? Despite valuable efforts made, none of these economists has yet addressed this vital question. **We have taken up the task to deal with this question in a book coming out soon.** Having discussed briefly the issue of zero interest in economic literature, we realize that mankind has paid a heavy price, within prolonged years, as a result of paying little or no attention to instructions that Islam issued. Yet, one has to admit that man has learned much through these processes of trail and error. What Western economists have reached on this issue is that through designating a certain goal as welfare state, they have attained the necessary condition for realization of justice. In short, this is nothing but zero interest rate. This is what has been carried out in Islam, which begins with sanction against interest (Riba), and ends with the welfare state; the one envisaged in Islam.

Then, we argue for the Islamic model of economics, which shows the way to those who believe in the unity of Almighty God, so that they would not be misguided. We would reach the desired

destination, if the way is taken and traveled through. Thus, Islamic way is the safest and the least costly of all and it is on this score that all humanity, especially the capitalistic society, has focused attention on Islamic economics in general, and on Islamic banking in particular.

At this juncture, we would like to present a review of the main challenges and prospects that Muslim economists are facing as listed succinctly below:

### **Challenges:**

1-We must gain the courage to implement the divine rules in the form of logical models, coherent enough to be presented to the world's scientific community. We have to admit that the world expects us to do more. The history of serious and analytical research on Islamic banking goes back at the most to fifty years ago, while the same divine rules had existed before and have not changed ever since. Having endured many hardships, the western nations catered the tree of modern science. That is why we see that the tree of science has grown to such a bulk over there, and with the passage of every single day the bulk of scientific literature expands even further. It can be argued that if the divine rules were available to the westerners they might have elevated the status of science even higher.

2-It is regrettable that only articles and seminars refer to the benefits of Islamic banking, and that little of Islamic banking

has been practiced in few Islamic nations so that people could enjoy its benefits.

3-The Western economists' reaction to the theory of Islamic banking has been somewhat deficient in character and vigor. I attribute such a benign reaction to the existing differences of perspective and approach among Muslim economists, which is partially normal and acceptable. Yet the remaining part of reason for such a reaction is due to the fact that many Muslim economists have concealed capitalistic economics under the guise of Islamic lexicon and contracts. Interest rate, for instance, has been covered by profit rate and it is not clear while interest has been overtly banned in Islam, how can people discuss LM curves money market and their derivatives? It is the same when many articles discuss loan (not Qard ul-Hasan). In legal definition of loan, the obligatory payment of surplus on the part of the borrower is interest per se, which is Haram (banned). It is obvious that loan 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 the Western colleagues and without much scientific thinking, consider a positive figure, other than zero, that is debatable.

4-Distinguishing money market from capital market is not an easy task, and this is exactly what professor Joan Robinson has warned us about, so that we do not be misled. Our goal must be to convert M-C-M relation to proper C-M-C, because it is not money market which accomplishes the task of economic growth, rather it

is capital market which must be reinforced in order to foster economic growth. Once J.M. Keynes showed that interest creates speculation (a subject to which the classical economists paid no attention). It is not hard to show, on the basis of his rigorous analysis, that speculation, too, causes interest. In other words, interest is the necessary and sufficient condition for speculation. In the meantime, there are still those who make a distinction between interest and Riba, and what has been sanctioned against in Islam is, considered by them as prohibitive, Riba. At the same time they surprisingly enough do not consider small interest as Haram!

5-The Western monetary theorists, too, have not shown a considerable reaction to the above shortcoming. It seems that having glanced through articles on Islamic banking models, written by Muslim economists, the Western monetary theorists have found those models to be very close to capitalistic banking. On this score, they are apologetically happy to have discussed a model not different from the traditional one! That is perhaps why the Western economists have not been cognizant of articles on Islamic banking written by Muslim economists.

6-The Westerners have declared that the science of economics was established in 1776 by Adam Smith. Objecting to this notion, some have considered the French as having devised economics, indicating France as its homeland. Upon supposing a fictitious and unfair stance to the effect of exclusion of the early Islamic period, we would be still faced with Ibne-Khaldoun in

more than 600 years ago who in his book, *The Introduction*, as acknowledged by the Westerners, is the first Muslim thinker to discuss ways of administering a nation. Today, we find on the web sites more than 4000 entries on Ibne-Khaldoun's material.

7-The indulgence and weakness of Muslim economists (myself included) have made the Western scientists suppose that by banning interest our position is similar to that of socialists in that we would maintain there must be no return attached to capital, while interest is the return attached to money, and profit is the return attached to capital. Having accepted capital market we admit a return to capital. Yet, rejecting money market, we are not prepared to pay anything as return for money. Under an Islamic framework money market has no function to play, that is, it has to be obliterated. It follows that all of money market derivatives, too, would be considered as non-Islamic. This would set limits to transactions in securities exchange market (limitation would be on stocks exchange not on bonds, which would be absent because of interest they acquire). Securities exchange market, contrary to some misconceptions, is money market, not capital market. Money market, by definition, is where loan is the center of transaction, which is administered within a year or less. Thus, even if stocks are transacted in such a market, since the intent of the buyer and the seller is indeed to gain income, which is obtained even daily through the difference on the price of stocks transacted, then, the same M-C-M relation persists in which stocks function as "C". In this retained relation, the loan is

received and paid on a daily basis, while “C” functions as collateral for the loan, and the differential rate of interest gained thereby is the source of income thus made. Moreover, the pricing of stocks, too, in securities exchange market must conform to the Islamic rules, that is, the prerequisite conditions for realization of a proper transaction must be met. This means that the buyer is entitled to know exactly what he is buying. In current securities exchange markets, the buyer does not exactly know what he owns in the community.

8-The capitalistic economy is fraught with many problems, some of which have been pointed out above. Nonetheless, we must bear in mind that social capital is stronger in the capitalist nations as compared with developing Islamic countries, the significance of which should not be under-estimated in Islamic countries. We should be able to prove that not only will these problems be solved in the light of Islamic banking but also new fields be opened to Muslim economists:

A: One of the conditions to attain sustained growth (development) is the equitable distribution of income and wealth. It has been demonstrated (by Westerners) that capitalistic economy will not reach such equity.

B: The capitalistic economy is faced with a conflict between efficiency and equity. This, among others, makes one of the fallacies of capitalism. Whereas, in Islamic economics there is no goal higher than establishing justice and fairness. We should be able to demonstrate that through implementation

of the Diving Rules of Islam, by which efficiency is attained, we can also reach equity. Islamic banking will accelerate this goal. We should also remember that Islamic community is a cooperative entity in the wider sense of the word “cooperative”.

C: The Western economists have recognized as genuine the fact that capitalistic economy is unable to increase aggregate demand (AD) and aggregate supply (AS) simultaneously. That is why their monetary and fiscal policies cannot depart from stagnation and unemployment. The cooperative Islamic economics, particularly where Islamic banking is concerned, is capable of such a task, and again, we should demonstrate this capability.

### **Prospects:**

1-Profit & 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 large cooperative within which every Muslim individual would try his/her utmost efforts and thereby through benefiting others, he/she would gain 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 workers remuneration through which workers can share the profit gained by Islamic bank's contracts with productive firms. In addition, the depositors will enjoy the profit

gained through banks' participation with investors. This point becomes clearer if we remember that the profit rate is frequently higher than that of the interest. These two factors will help the equitable distribution of income and wealth; the necessary condition for sustained growth. The price of manufactured goods would fall due to two reasons. On the one hand, price decrease is due to the omission of interest (Riba), on the other, it is a function of decrease of wage expenditure (brought about by workers participation in profit). Pursuing a policy accompanied by participation of Islamic bank with productive firms and by dividing the proportionate profit among the depositors, simultaneous increase of AD and AS will be made possible.

2-It is interesting to notice that professor M.Weitzman, imitating Japanese workers participation in production has amateurishly considered it quite fit to overcome stagnation (as he admits to be inherent) in capitalistic societies. Whereas participation of workers is not compatible with the elementary principles of capitalism. Professor Weitzman, aside from mixing subjects, has neglected the point that interest constitutes the prime fallacy of the capitalistic societies, a fallacy which will be followed by yet more complex and larger fallacies. It is difficult to envisage that Islamic economics, having eliminated such a fallacy, would encounter similar problems.

3-Based on existing literature, it seems that for the sake of modeling in Islamic economics, in general, and Islamic banking, in

particular, we possess more than enough criteria and procedures to act upon.

4-Marx once, lacking relevant expertise, omitted capital's share in the Industrial Revolution era and thereafter, and worried solely about the proletariat. Whereas Islam worries about all individuals; workers and investors both. Could Marx have ever imagined that interest would penetrate the economic life of the Western societies that, for instance, in contemporary Germany, for every 100 Marks spent in a family as expenditure, 1/3 goes for interest? The elimination of interest, supposing it were inert in other areas of Muslims social life, will have the least effect of raising their purchasing power to up to 1/3.

5-Having banned interest (Riba), and having logically eliminated money market, speculation and all related affairs in secondary market, which involve artificial risks, Islam attempts to emancipate all men (Muslim and non-Muslim) from being dominated by wealthy individuals who have always lived a life exploiting others. This emancipation comes by through establishment of Islamic banking. By the omission of interest from the whole system, money whirlpool will disappear and thus the necessary condition for full employment (that is, the equality of saving with investment) will be created. We should not be misled by Japan's experience. Although interest rate in Japan is nearly zero, yet unemployment rate has been declared as 5.4%, which is expected to reach 7% within five years. Two reasons can be offered for not reaching full employment in Japan (despite

workers participation in profit or income gained by productive firms). First, Japanese bank do not operate on the basis of participation, rather they lend and borrow loans, (that is, they function as fund intermediary) like any other capitalist system. Second, stock exchange (of bond, stock, and commodity) is active as ever. Speculation in these markets creates interest in terms of same goods. In other words, interest (Riba) has not been eliminated in its wider sense in Japan. The mere existence of these interest rate create money whirlpool, which has prevented the equality of saving and investment. In short, as an economic system is farther removed from capital market, getting closer to money market and its derivatives, the more unstable it becomes.

6-A general equilibrium model can be constructed in which there would be three markets of labor, capital, and of goods, on whose coordinate diagram profit rate and national income are made possible to be demonstrated.

7-The world today has reached the point that realizes that capitalistic system, despite claims put forward by its early founders, is not a self-regulating or self-adjusting system, and that capitalistic economic models must be devised based upon disequilibrium (this is being done for some time by certain Western economists). This is the time for Muslims to be alert and vigil to use this historic opportunity for devising and presenting a logical Islamic banking system without having any reservations whatsoever.

8-In the final analysis, we reach the conclusion that the research on Islamic economics, in general, and in Islamic banking , in particular, has grown within the past several years, and that in some instances this growth has been much beyond the expectations of researchers of the field. This growth rate is the result of the work done by Muslim as well non-Muslim economists. We should be proud of it.

Economic problems and difficulties of many nations have become so complicated that capitalistic economics, as admitted by Western economists, cannot possibly respond accordingly. The Western economists thought has been so contaminated by concepts such as individualism, profit seeking , and interest (Riba) , that it is hard, if not impossible, for them to imagine any other workable system. In order to find answers to ever growing problems of the capitalistic world, their theorists once in a while find a subject here and there, and try to patch it up to or inject it into the ailing capitalistic system.

Among these injections we can point to labor unions, syndicalism, creation of cooperatives, and The Share Economy. A scientific approach to Islamic banking has been added in recent years to the list just offered.

Evidently, these are not ways to completely cure the institutionalized problems faced by capitalism. These short-term solutions may act to pacify the wounds inflicted on the system. To describe a definite resolution as to the issues and a way for freeing from the capitalistic ailment a quote is in order: “It takes a theory

to kill a theory”. The remedy cannot be anything but that offered by Islamic economics. Islam and its Divine Rules are not nation-specific; they contain the message of hope for all men in all nations. It is only through Divine Rules that mankind can overcome his terrestrial problems. Men’s own solutions seem not getting through in this complex sphere.

Mankind has paid a heavy price for neglecting the Divine Rules, which are for his own welfare and salvation. In this setting, the modern man should prepare an alternative approach to administer his economic affairs.

Muslim scientists should use their thinking capacity, and the capacity of their interacting with one another, and through avoiding mixing the content of capitalism with that of Islam, they can present mankind an alternative route. This is not a far-fetched goal because Muslims enjoy absolute advantage in this area. For this reason, we can hope to restore the glory of our past in near future. This goal is attainable given closer, further, and continued cooperation among scientific figures of Islamic, as well as non-Islamic, nations.







