

**Islamic Money and Banking: Integrating Money in Capital Theory**

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**The following fundamental sample questions are posed and answered in this book: What does it take for all economies to be conflict-free? How can the present global financial crisis be solved? How can we have no severe business cycle in the future? Is a peaceful world possible?**

Repeated cycles, with prolonged damaging impacts, have been occurring in the financial sphere of capitalist economies. This fact has imposed an inevitable question to the effect that there must be an alternative to the current financial system, the one which carries the least, if not any, significant harmful impacts. This momentous question that seeks an alternative was taken and posited by Islamic financial system, or what that has come to be meant by designation 'the Islamic banking.' This alternative banking system has emerged especially after the frequent and short intervals in economic imbalances witnessed in capitalist economic systems. Thus it is the dissatisfaction with the state of the existing literature on the subject that prompted the author to embark on writing this book.

In some cases the Islamic banking system, as outlined by some scholars, appears to be a blend of capitalist features that is a mix with some Islamic cover which results in bearing close resemblances to the conventional system. Considering the Islamic banking system as being in its embryonic stage, such blending developments have not been unanticipated. Notwithstanding, there is an urgent need to sterilize Islamic banking by removing the alien factors. With regards to the existing literature on Islamic economics, one must admit all the merits that can be attributed to it. But it appeared that each and every one of the writings contained some, but not all, of features of the Islamic economics. There is no single book that contains these features in their entirety. It is on this crucial score that this book claims to have been succeeded in incorporating all the features within a single volume. But, no use in making a mere claim.

My book is an attempt at realizing the above goal. I believe to have been able to provide readers with a pure Islamic banking void of imbalances. It contains built-in shock-proven elements within the system.

The Islamic banking is an integral part of the larger Islamic economic system. In making such a comprehensive banking system that is one which embraces all peculiarities of a system we incorporated the "trinity criteria" which includes: (1) justice, as the ultimate goal of Islamic economic system, (2) society, as the platform justice has to be implemented upon. This has long been overlooked in capitalist system especially handling public policies using Pareto efficiency which denies society, (3) cooperation, as necessary condition to achieve justice. Co-operation precludes free-ridership and fraud, transforms the zero-sum game of capitalism into

increasing-sum game, and the new voting system in co-operatives proposed here not only has the advantage of moderating greed but also works as a powerful impetus for each player to enjoy its fair share.

Islamic banking as the most important part of Islamic economics cannot be treated in isolation. In other words, it has to include some of the less important characteristics of Islamic economics. Of particular significance among these characteristics is labor's share in profits of the firms. Labor's share has been borrowed and accommodated in the Islamic banking. However, all the general results which this book arrives at rely heavily on the features discussed in it. That is to say much less reliance is put on features not discussed in the book. The inclusion of such features is to render the model complete and comprehensive.

No claim is made to the effect that the entire analyses and the conclusions reached in this book are ultimate or flawless. The author has long strived to incorporate the most fundamental and important elements of Islamic economics conduct in a coherent manner in a single book. Hence, what he claims is that it is more compatible with both those Quranic verses and Hadiths that are directly related to Islamic economic activities. This allows him to safely assert that the book more closely resembles the genuine Islamic model than any other major book on the subject.

Special features of this book which make it differ radically from similar books and are to be regarded as a solution to the present global financial crisis are:

(1) The main body of the existing literature on the subject has neglected to address the importance of "money", as potential capital being capable of converting into actual capital. Such neglect has been redressed, for the first time, in a legal framework as one step taken forward. Money has long been one of the most important controversial issues in the orthodox theory of capital and, even more so, in Islamic finance. This has forced the author to devote almost half of the book on this issue and on its first derivative; interest. It was further demonstrated that in this system: (a) money can be treated as an "impure public good" due to its large externalities; thanks to Prof. Gordon Tullock for his reference to this point in a separate paper that inspired the author indirectly. (b) Its first derivative, interest, is an issue in normative economics, not positive. It would be illusionary to prove 'interest' via analytical tools often used in positive economics. All attempts made in this direction appear futile.

(2) The book is, in all modesty, to be considered a cornerstone for further research and application on Islamic banking. This is so because its original treatment is based on grounded arguments aimed at enhancing the global humanity. The book can also be used, in conjunction with other issues outlined here, to reconcile the conflicts among the goals of labor, management, and the consumer that arise from the zero-sum game inherent in the capitalist system.

Based on bad track records of interest-based financial system, it is argued here that with the use of Friedman Rule a country is to be provided with a model capable to guarantee: stable prices, full employment, equitable distribution of income and wealth, self-regulating-adjusting factors built-in within the system, and more importantly, counter cyclical movements; the premises that capitalist system has long been unable to maintain. This has been successfully accomplished by making money

an endogenously determined variable and integrated markets; quite contrary to the conventional system where they have made money exogenous variable and applaud segmented markets. The alarm for danger of separating the monetary sector from the real sector had been voiced by some Western master economists in whose response no serious attempt was made. This book is privileged to capture the danger and produce integrated markets void of such separation.

(3) The author is of the conviction that if specifications and functions of money were fully understood then an appropriate banking system emerging from them could easily be modeled. Neglecting this important argument has led many scholars to keep on producing a so-called "Islamic Banking" which can be described as a mixture of conventional banking, as their bases, covered with some jargons qualified, discretely understood, and presented as Islamic terminology. The resulting product can be described as pork, a forbidden food in Islam, packaged as a Halal one. The severe objection to such treatments can be summed in a phrase: given that interest is strictly forbidden in Islamic economic doctrine, yet being the backbone of capitalist system is it still going to have negligible impact both on the analysis and conclusion? Surprisingly, such a large error has led some writers to reach the conclusion that there are many similarities between the Islamic and the capitalist system. Such conclusion is quite contrary to the findings of this book.

(4) Special attention has been paid, in this book, to several determining factors such as: (a) artificial risk, denounced in Islam, and prevalent in money market as well as in stock market. This does not imply by any means that Islamic stock market is denounced but that its operations have to be strictly adhered to by the book value of stocks in the balance sheets of the issuing firms with no bubbles, (b) intrinsic inter-relationship between speculation and interest which leads to better understanding of both, (c) co-operation as the most important determinant of justice which, in turn, is directly associated with society. This turns the zero-sum game of capitalism into a "Grand Co-operative Islamic Economic System (GCS)" with the natural outcome of an increasing-sum game. Pareto optimality ignores society as an identity which makes justice irrelevant and thus the conflict between justice and efficiency has logically remained an unresolved issue, (d) justice is seen as the ultimate goal of Islamic economic system.

Factors mentioned above are either absent in similar books or have not been properly accommodated in their models obscured by scanty references. Incorporating and putting these factors together in a logical and comprehensive manner has generated conclusions and implications that are very different from many books written on this subject.

(5) The conventional procedure of incorporating interest, money market in a system, and making allowance to perform speculative activities in markets naturally produces money whirlpool which in turn generates unemployment resulting from investment falling short of saving. With the abolition of interest, and of money market and speculative activities, in any market, the end result would be full employment due to equality of saving and investment. All these imply that stock of money is directly linked with the availability of resources which in turn signifies stable prices. This in addition to co-operation and Profit & Loss Sharing (PLS) contracts will lead to equitable distribution of income and wealth. Stock of money is then constantly

converted into the flow of capital ensuring economic growth. The higher the speed of transformation of stock of money into flow of capital the higher would be the rate of economic growth.

The model presented here by removing the harms of ever-deepening money whirlpool prevents these harms from neutralizing the all-benefits of the flow of capital. The harms of the interest inflicted in the economy in the form of money market and speculative activities in stock markets go far beyond additional cost of production called "cost of capital". It works as cancer cell which will paralyze the entire body of the economic system.

(6) Zero cost of capital is deduced from elimination of Riba in Islamic economic system. It is rather easy to show that in the absence of interest, money market and speculative activities, all investment projects financed through Islamic modes of contract become, in one way or another, interrelated making cost of capital equal to zero. Its implications go far beyond the reduction of the cost of production. It implies that those who take natural risk become eligible for return void of any speculation. The elimination of money market and of interest-based loans through abolition of Riba persuades and solidifies co-operation among all economic agents. Such elimination plays a signal role in Islamic economics which when added to the Profit & Loss Sharing and the interdependencies of the Internal Rates of Return (IRRs) of all capital investment projects, will allow the players to earn fair share in profits. The positive synergy derived from co-operation with a different voting system proposed here proves to be an essential element to maintain justice.

Although changes in the relative share of profit might indirectly affect, if any, the user (rental) cost of some kinds of capital, the cost is known only in retrospect. Besides, it is, as aptly put by Prof. M. Ariff, a ratio and not a rate.

(7) Interest (Riba) is return to money, not to capital. Furthermore, it is a normative concept contrary to the well-established belief in the West that artificial attempts have been made to use analytical tools to prove its existence and necessity. We have been able to demonstrate here that the proponents have ultimately adhered to moral factor which resides in the realm of normative, not positive, economics. Western type of argument is fundamentally baseless and futile in that in proving the necessity of interest they concentrate on the return to capital not on money. Additionally, it cannot be proved that money is one of the factors of production. Unquestionably, it is capital that plays the most important role in the production function in a legally-confirmed identity called "firm". Money, potential capital, has to undergo legal transformation, via firm, in order to become actual capital and counted as one of the factors of production.

(8) The trinity criteria: Justice, co-operation and society are pillars of Islamic economics that are intrinsically interwoven and go hand in hand. Justice is the ultimate goal of an Islamic system whose standing cannot be challenged by other pillars. Its emergence and maintenance is guaranteed by co-operation which in turn precludes free-ridership and fraud. Additionally, without society justice becomes irrelevant. Justice is taken to be a state of affairs which in order to be meaningful has to include others. The impact of justice goes beyond the individual's behavior. This is quite contrary to the principle of Pareto efficiency which denounces society and is

almost always used to treat issues of welfare and public economics in a zero-sum game framework, characteristic of capitalism.

The orthodox capitalism is mainly aimed at seeking efficiency equilibrium to the cost of ignoring justice. Obviously, in the absence of society, as envisaged in orthodox capitalism, justice becomes irrelevant given the ever-lasting conflict between efficiency and equity. In the increasing-sum model outlined in this book justice has the ultimate power to reconcile the conflict and it finally guarantees optimality. We find ourselves in full agreement with the Friedman Rule when he says zero nominal rates of interests are necessary condition for efficient allocation of resources. It is further demonstrated that zero nominal rates of interests not only is necessary but sufficient condition for efficient allocation of resources. Added to this, co-operation, in our analysis, is responsible for optimality.

Co-operation works also as a powerful moderating factor to check greed which has mostly been seen as the principal cause of present economic meltdown. Global crisis has proven to cost the taxpayers billions of dollars whose burdens would stretch out to future generations as well. With a new proposal for voting system made here, in a co-operative Islamic economic system, the extreme values of greed boils down to its mean value leaving the society in the hands of mediocre with the passion to serve "society" as an integral part of decision making processes.

Moreover, co-operation in our GCS will resolve the conflict of goals between and among the three economic agents; namely (a) for firms the goal is highest possible output, sales, prices, and lowest possible wages, (b) for the labor the goal is highest wages (income) and time off possible and as little work as possible, and (c) for consumers the goal is highest incomes and consumption possible but lowest prices. This has not only been the consequences of capitalist zero-sum game but also segmented markets designed for firms, labors and consumers. In our GCS model all three markets are integrated via co-operation among them with an eye to social welfare. Any viable economic theory has to include elements of welfare throughout its echelons. Segmented markets in capitalism do not allow this to happen which amounts to the assertion that it lacks such elements.

(9) It has also been demonstrated that the principal cause of inflation is speculative activities whose origins are traced back to interest and money market. Speculative activities, in turn, are responsible for both unemployment and business cycles even when nominal interest rates are zero. Equitable distribution of income and wealth is guaranteed by sharing profits in Shariah-compliant contracts used in Islamic banks. Such contracts whose values are directly reflected in the balance sheets of Islamic banks work as shock-absorbers against external forces as opposed to the effect of inflation on the balance sheets of conventional banking. In case of inflation, the nominal values of interest-based loans granted in interest-based banking remain intact whereas their real values decline which makes the conventional banking vulnerable to shocks. The devices used in Islamic banking to counteract such imbalances would be PLS contracts. They not only change the values of such contract in the same direction, in a less likely event of inflation, but also work as anti-inflationary devices.

(10) We have proposed newly developed banks here. They will act as financial institutions as opposed to monetary institutions in capitalism. In the 'newly

developed banks' regular banking activities are seen to be performed but when it comes to financing a project, usage of Shariah-compliant contracts becomes necessary. The only kind of loan used here would be Qard-ul Hassan with no element of Riba (interest) in it. This kind of loan is also Shariah-complaint. Having defined money creation by conventional banks as a function of Required Reserve Ratio and as a multiple of initial interest-based loans, such concept of money becomes obsolete and inapplicable here. With direct linkage between potential capital and availabilities of economic resources there is no need for RRR; that is, contrary to the findings of some scholars it can be safely reduced down to zero.

(11) Integrating money in capital theory as the result of abolition of interest in all financial activities has another advantage and an important implication other than those outlined above. It reduces the Islamic central bank to an authority other than that in capitalism. Its function changes from the passive role of intervention in the market, by changing stock of money and/or changing the rate of interest, to an active and more basic role of determining the profit ratios of different capital investment projects for different activities and for different regions. This role has to be coordinated with another independent institution responsible for national economic planning. As a consequence, different economic growth rates of different regions will constantly be adjusted which allows the economy to enjoy balanced regional economic growth which in turn will, to a great deal, reduce, if not eliminate, migration.

As a policy issue, Islamic central bank need not be a separate institution as opposed to an independent institution in capitalism. It can safely and effectively serve under the prevalent institutions known in different countries as: Ministry of Economics, Ministry of Finance, Treasury Department, and the like. This outcome is derived naturally from our model which has been able to integrate money in capital theory. This important conclusion reduces the autonomy of the Central Banks to its minimum level. Policies differing from what described above have put economies on the verge of collapse. Our model of an Islamic central bank would bring economic activities under check with most efficient tool of analysis which is the determination of the ratio of profit rates in different activity domains. The supply of money, in this system becomes "demand determined" variable and an "endogenous variable" in its purest sense of the term. It shall not be confused with the existing literature using similar terminology.

In brief, this book not only overcomes the negatives of the capitalist system but also by introducing new elements such as justice, co-operation, and society into their proper places and integrating them in a coherent manner converts it into a different system with positives. These have to be added to the use of other humane factors responsible of changing the negatives to positives through which each and every economic agent will have fair share of the total product produced. It shall come as a solution to the present global financial crisis. It is noteworthy that all the positives lean back to the abolition of Riba (interest) and its derivatives in addition to using Shariah-compliant contracts seen as necessary to finance investment projects with efficient governance and supervision methods. There seems to be no resemblance between Islamic banking and conventional banking. Neither are there any similarities between Islamic central bank and the conventional central bank. Hence, we have a

very different model for Islamic banking and Islamic central banking with no resemblances compared to those of the conventional system. Our findings are quite contrary to those which appear in the mainstream capitalist literature which helps to propagate the conventional system.

It was made somewhat clear earlier, the kind of treatment conducted in this book is, in brief, unique and new in three aspects: (a) in approach, (b) in analysis, and (c) in conclusions. Our approach includes society as one of the principal components of the system. This allows us to speak of justice and to locate it. In addition, money with large externalities has been looked at as an impure public good; thanks to Professor Gordon Tullock. Friedman Rule has been incorporated throughout our analysis which lends itself to very different conclusions. The elimination of both Riba and money market leads firms to use contracts different from interest-based loan contracts in order to finance their investment projects. This kind of analysis, although precedent in the existing literature, generates co-operation, in an unprecedented way, in all aspects of the economic system among economic agents. The importance of co-operation cannot be overstated. It follows that the zero-sum game of the conventional system is transformed into an increasing sum-game in an Islamic economic system. This book, both in its approaches and the types of analyses, leads us to original results absent in the literature. These results are: (1) zero cost of capital, (2) zero Required Reserve Ratio, (3) full employment, (4) stable prices, (5) self-regulating and self-adjusting factors built-in within the system, (6) counter cyclical movements, (7) reconciliation between efficiency and equity which leads to optimality, (8) equitable distribution of income and wealth, and finally (9) stable economic growth.

Finally, as to the role of ideology, let me close by citing two pieces of quotation for readers with ideological concerns.

...ideologies ...affect the topics discussed, the manner of discussion, the factors included or left out or inadequately stressed in arguments, comments and models, and attitudes shown, sympathetic or hostile, to past and contemporary economists' works and views.

Professor G.C. Harcourt

...economics itself...has always been partly a vehicle for the ruling ideology of each period as well as partly a method of scientific investigation. ...without ideology we would have never thought of ...question.

Professor Joan Robinson