

The Prohibition of *Ribā* in Islam: An Evaluation of Some Objections

M. Umer Chapra*

A number of objections have been raised against the prohibition of *ribā* (interest) in Islam and it has been alleged that a *ribā*-free economy will face so many problems that it may not be able to survive. This paper evaluates the nature and significance of some of the major objections and, in the process, also indicates the rationale behind the prohibition of *ribā*.¹

I. ALLOCATION OF RESOURCES

One of the objections raised against an interest-free economy is that it will not be able to bring about an optimum allocation of resources. The reason given for this is that interest is a price and like all prices it performs the function of allocating 'scarce' loanable funds among the 'infinite' users of such funds in an objective manner on the basis of ability to pay the price. If the demand for, or supply of, loanable funds changes,

*M. Umer Chapra, Ph.D., is Economic Adviser to the Saudi Arabian Monetary Agency, Riyadh. He wishes to record his thanks to Dr. Anas Zarqa and Dr. Najatullah Siddiqi for their valuable comments on an earlier draft. He also wishes to thank Mr. Mobin Ahmad for the efficient secretarial assistance rendered by him during the preparation of this paper. This paper is part of Chapter 5 of his forthcoming book, *Towards a Just Monetary System*, to be published shortly by the Islamic Foundation, Leicester.

¹For a valuable presentation on the subject, see Dr. Muhammad Anas Zarqa's three papers, first, his discussion paper on H.H. Naqvi's paper in Muhammad Ariff (ed.), *Monetary and Fiscal Economics of Islam* (Jiddah: King Abdulaziz University, 1982); second, his paper "An Islamic Perspective on the Economics of Discounting in Profit Evaluation" presented to the Islamabad Seminar in January 1981; and third, his unpublished paper "Stability in an Interest-free Islamic Economy." See also, Dr. Ziauddin Ahmad (State Bank of Pakistan, Karachi), "Economic Rationale of the Prohibition of Interest in Islam," a brief paper distributed by the author privately; Dr. M.N. Siddiqi, "Rationale of Islamic Banking" (Jiddah: International Centre for Research in Islamic Economics, 1981); Ingo Karsten, "Islam and Financial Intermediation", *IMF Staff Papers*, March 1982, particularly section 3 of the paper on effects of the profit-and-loss-sharing financial system on economic development and stability, pp. 129-36; and M.A. Mannan, "Superiority of Islamic Conception of Banking" in his *Islamic Economics: Theory and Practice* (Lahore: Shaikh Muhammad Ashraf, 1970), pp. 228-32.

a new equilibrium is reached at a different rate of interest.

This objection is based on two assumptions. The first assumption is that in the absence of interest loanable funds will be available 'free' to borrowers, the demand will thus be infinitely large and there will be no mechanism for equating demand with supply. This implies that interest is the only objective criterion for allocation of resources and, in its absence, scarce financial resources will be used inefficiently to the detriment of society. The second assumption is that the money rate of interest has been a successful mechanism in allocating resources optimally and that profit cannot perform the function efficiently.

The first assumption is baseless because funds will not be available 'free' in the Islamic system. They will be available at a cost, and the cost will be the 'share' in profit. The rate of profit will hence become a criterion for allocation of resources as well as the mechanism for equating demand with supply. The greater the expected or *ex-ante* rate of profit in any business, the greater may be the supply of funds to that business. If the actual or *ex-post* profit for certain businesses is consistently lower than the *ex-ante* profit such businesses may face difficulty in raising funds in the future. Therefore, while *ex-ante* profit will be immediately important in determining the flow of investment, the *ex-post* performance will be crucial for the future success of the business in raising funds. This should help enforce a greater discipline in investments through a more careful evaluation of projects, weeding out all inefficient and unproductive projects. This is not the same in interest-based investment. The interest-oriented lender does not share in the risk of the business financed. He shifts the entire risk of business to the entrepreneur and assures himself of a predetermined rate of return irrespective of the ultimate net outcome of the borrower's business. He thus does not have to undertake as thorough an evaluation as the *sāhib al-māl* (financier) would have to undertake in a *ribā*-free economy, either by himself or with the help of a bank or consulting firm. Because of a two-sided evaluation of projects, the rate of profit in the Islamic system should be a more efficient mechanism for allocation of resources than interest can ever be in the capitalist system.

The second assumption that the money rate of interest has been an efficient mechanism for allocating resources is also not valid. There is little evidence to support the contention that allocation of resources is efficient in interest-based capitalist economies. Convincing evidence to the contrary is in fact available. Enzler Conrad and Johnson have found compelling evidence to conclude that in the United States "the existing capital stock is misallocated—probably seriously—among sectors of the economy and types of capital."² Pareto optimum in the allocation of

²J.J. Enzler, W.E. Conrad and Lewis Johnson, "Public Policy and Capital Formation," *Federal Reserve Bulletin*, October, 1981, p. 759.

resources takes place only in the dream world of perfectly competitive equilibrium models in which market economies have been theoretically formalised. Malinvaud has accordingly pointed out that "When the intertemporal aspect of resource allocation is put forward, one cannot but be impressed by the inadequacy of these models as describing the actual working of our economies."³ Ralph Turvey contends that "the money rate of interest does not rule the roost" and feels that "the rate of interest was irrelevant to investment decisions" and "should be replaced by the price of existing equipment (or share prices)."⁴

Moreover, the 'equilibrium' rate of interest is only a text-book phenomenon. In reality an efficient 'market clearing' rate does not exist. Instead there is a theoretical amalgam of a host of long-term and short-term rates with sizeable differences and variations in their levels and without any clear conception of how these numerous rates can be combined into a single measure. Moreover, all the rates which should be combined into the equilibrium rate can by no means be observed in the market. What is important for economic decisions is the expected *real* rate of interest which cannot be observed in the market and cannot be approximated reliably by econometric techniques.⁵ The rate of interest tends to be a 'perverted' price and reflects price discrimination in favour of the rich—the more 'credit-worthy' a borrower is supposed to be, the lower rate of interest he pays and vice versa. The result is that 'big' business is able to get more funds at a lower price because of its 'higher' credit rating. Thus those who are most able to bear the burden because of their bigness or claimed 'higher' productivity bear the least burden. In contrast, medium and small businesses, which may sometimes be more productive in terms of contribution to the national product per unit of financing used and at least equally 'credit-worthy' in terms of honesty and integrity, may be able to secure relatively much smaller amounts at

³E. Malinvaud, "Interest Rates in the Allocation of Resources" in F.H. Hahn and F.D.R. Brechling, *The Theory of Interest Rates* (New York: St. Martin's Press, 1963), p. 215.

⁴Ralph Turvey, "Does the Rate of Interest Rule the Roost" in F.H. Hahn and F.D.R. Brechling, *The Theory of Interest Rates - Proceedings of a Conference held by the International Economic Association* (New York: St. Martin's Press, 1966, pp. 172 and 329) In fact he asserts that "...we can set out a revised General Theory where the prices of real assets rather than those of paper assets occupy the centre of the picture. The theory no longer supposes that most investment is financed by fixed investment borrowing; indeed it is so general that it even applies to economies where there is no fixed interest borrowing at all. The money rate of interest does not rule the roost." For corporate investment he suggests "a simple short-run investment function which makes investment an increasing function of the general level of share prices in relation to the supply function of new capital goods. Share prices in their turn can be treated as rising and falling with the market values of the types of real assets owned by companies" (p. 172).

⁵See Thomas Mayer, *The Structure of Monetarism* (New York: W.W. Norton, 1978), p. 10; and also G. Santoni and C. Stone, "Navigating Through the Interest Rate Morass: Some Basic Principles," Federal Reserve Bank of St. Louis, *Review*, March, 1981, p. 11.

substantially higher rates of interest. Hence many potentially high-yielding investments are never made because of lack of access to funds which flow instead into less productive but 'secure' hands.⁶ Therefore, the rate of interest reflects, not the 'objective' criterion of the productivity of the business, but the 'biased' criterion of 'credit rating'. This is one reason why in the capitalist system, big business has grown bigger beyond the point dictated by economies of scale, thus contributing to monopoly power, while medium and small businesses have often been throttled by being deprived of credit. This is particularly so when interest rates rise and create a liquidity crunch by reducing the internal cash flows. Small businesses are rarely given a respite by the lending banks. Loans to them are recalled with the slightest sign of trouble, thus causing widespread bankruptcies. However, when big businesses are in trouble, there is rescheduling accompanied by additional lines of credit. Does this indicate an optimum allocation of resources or an efficient banking system?⁷

Instead, if credit is made available on the basis of profitability as a criterion, then not only the banks will be more careful and rational in evaluating projects but also small, medium and big business would stand on an equal footing. The higher the rate of profit, the greater will be the ability to secure funds. Big business, if it is really more profitable, should pay a higher and not smaller rate of return to the lending institutions. The Islamic system could reflect an innate ability to favour entrepreneurs with talent, drive and innovation, but who, as Ingo

⁶Dr. Anas Zarqa pointed out in an oral exchange of views that this should be the perfectly logical outcome of interest-based financing in an economic environment with vast inequalities of wealth. Since the lender, irrespective of whether he is an individual or a banker, does not share in the risk of business, he should naturally be inclined to lend to the rich because in this case he is assured of the payment of the principal and the interest. If, however, the lender shares in the risk, he would be more concerned about the nature and profitability of the business, in which case the poor would also stand a chance. He also indicated the opinion of Mishan, who says: "Given that differences in wealth are substantial, it would be irrational for the lender to be willing to lend as much to the impecunious as to the richer members of the society, or to lend the same amounts on the same terms to each." (E.S. Mishan, *Cost Benefit Analysis: An Introduction* (New York: Praeger, 1971), p. 205.

The greater flow of credit to the rich in an interest-based system is a widely acknowledged fact. Galbraith, for example, says: "The large corporation of the planning system, when it must borrow, is a favoured client of the banks, insurance companies and investment banks" (*Economics and the Public Purpose*, New York: New American Library, 1975, pp. 186-7). See also, p. 297 where he says: "Those who least need to borrow and those who are most favoured are in the planning system. Those who most rely on borrowed funds, or are least favoured, are in the market system."

⁷AEG Telefunken, for example, has not paid a dividend since 1973. Nevertheless, banks have continued to lend to it. See "AEG is a Nightmare to Remember," *Economist*, August 14, 1982, p. 53.

Karsten has put it, "have not yet established their credit worthiness."⁸ Thus resources would not be only more *effectively utilised* but also *equitably distributed*. It is not possible to rectify adequately the inequalities generated by capitalism through the tax system without coming to grips with the basic causes of such inequalities. The Islamic system should, therefore, through the elimination of interest, the introduction of profit-sharing and a broad-based use of bank resources, be able to redistribute profits from big business to depositors and small enterprises, thus removing one of the major causes of inequalities.

Hence the charge that an interest-free economy would be unable to allocate resources optimally is baseless. In fact, the Islamic system of profit-sharing should be able not only to bring about greater efficiency in the allocation of resources but also reduce the concentration of wealth and power and foster socio-economic justice.

II. SAVINGS AND CAPITAL FORMATION

An apprehension has been expressed that because of a positive social rate of time preference, further accentuated by the erosive effect of inflation, there will be little positive private sector saving and capital formation in an Islamic economy.⁹ This apprehension is misfounded because empirical evidence does not indicate a significant positive correlation between interest and saving even in industrial countries.¹⁰ The impact of interest rates on savings in developing countries has been found to be negligible in most studies.¹¹

Moreover, even on theoretical grounds, the assumption of a positive time preference used by Bohm-Bawerk has been rejected by a number of

⁸Karsten, *op. cit.*, p. 133.

⁹N.H. Naqvi, *Ethics and Economics: An Islamic Synthesis* (Leicester, U.K.: The Islamic Foundation, 1981), pp. 119-21.

¹⁰"There is evidence that some people save *less* rather than more at higher interest rates; and that many people save about the *same* amount regardless of the level of the interest rate and that some people are induced to consume less by the promise of higher interest returns... economic principles alone cannot give us a decisive prediction. The bulk of the evidence suggests that the level of interest tends to cancel out of consumption and saving decisions." P.A. Samuelson, *Economics* (New York: McGraw Hill, 8th ed., 1970), p. 576, footnote 4.

¹¹See, for example, R.F. Miksell and J.E. Zinser, "The Nature of the Savings Function in Developing Countries: A Survey of the Theoretical and Empirical Literature," *Journal of Economic Literature*, December, 1972; J.G. Williamson, "Personal Saving in Developing Nations: An Intertemporal Cross-Section from Asia," *Economic Record*, vol. 44, 1968; H.S. Houthaker, "On Some Determinants of Saving in Developed and Underdeveloped Countries," in *Problems in Economic Development*, E.A. Robinson, ed., (London: MacMillan, 1965); and D.R. Khatkhate, "Analytic Basis of the Working of Monetary Policy in Less Developed Countries," IMF, *Staff Papers*, November, 1972.

prominent economists. In fact, Graaf has doubted its very existence.¹² Graaf may, perhaps, be an extreme case. It has, however, been generally argued that a rational consumer may have a positive, zero or negative time preference.¹³

In spite of being myopic, individuals are obliged to save because the future is uncertain and the world of 'perfect foresight' assumed in theoretical economic models exists nowhere. Essentially saving depends not only on present income and consumption but also expected future income and consumption needs. Since no one knows future income and needs, there is a tendency to save for 'the rainy day' in spite of the time preference. Such a natural tendency should be further strengthened by the Islamic values spurning conspicuous consumption. If the Islamic values are actualised, there should be a high degree of positive correlation between income and savings after a comfortable standard of living has been reached irrespective of the variations in the rate of return.¹⁴

If individuals save, then they are obliged to look for profitable avenues for investment of their savings to offset any positive time preference they may have, the erosive effect of inflation, and future uncertainties about income and consumption needs. There is no reason to suppose that the negative effect of positive time preference and inflation on savings, to the extent to which it exists, could not be offset effectively by income from, and appreciation in, equity investment. Savings would flow into equity investments with this objective, particularly if all investments have by necessity to be equity-based and no other rational alternative is available except that of holding the savings idle, earning no return. Moreover, even in the capitalist system, all savings do not go into interest-based financial assets.

Several alternative forms of equity investments would be available for 'sleeping' as well as 'active' investors in an Islamic economy. There would

¹²J. Graaf, *Theoretical Welfare Economics* (Cambridge: Cambridge University Press, 1971), p. 40.

¹³See Zarqa', "An Islamic Perspective...., *op. cit.*, pp. 2-8. Dr. Anas concludes after referring to the views of a number of prominent economists that "... positive time preference is neither a principle of rationality nor an empirically established predominant tendency among consumers. It is simply one of three patterns of intertemporal choice (the other two being zero and negative time preference), each of which is rational and observable under its own conditions" (p. 7).

¹⁴See the papers of Monzer Kahf, M. Akram Khan and M. Ariff as well as the summary on pp. 4-5 in M. Ariff, *Monetary and Fiscal Economics of Islam* (Jiddah: International Centre for Research in Islamic Economics, King Abdulaziz University, 1982).

not only be *mudārabah* or *shirkah** forms of financial participation but also shares of joint-stock companies and *madārabah* deposits as well as equity investments in financial institutions, including commercial banks, investment trusts, venture capitalists and cooperative societies, all reformed and reconstituted to fulfill the needs of the Islamic economy.

For 'sleeping' investors, such investments could be made available with different degrees of risk, maturity and convenience. Some may be less risky than others, with the apparent degree of risk being offset by the expected rate of return (profit + appreciation). Unlike the capitalist system where equity investments are mainly open-ended because of the availability of close-ended interest-based investments of varying maturities, the Islamic economy should develop instruments of varying maturities for equity investments to satisfy the tastes and needs of different investors with respect to risk and liquidity.

For active investors there will be their own sole proprietorship or partnership businesses to invest in, and there is no reason to assume that with the abolition of interest they will not continue to save for investment in their own businesses. In fact, with the Islamic emphasis on equity financing, there should be a greater urge to save for investment in one's own business. If there are profitable opportunities for investment which cannot be exploited by reliance merely on internal cash flows, sole proprietors and partnerships would tend to mobilise resources on the basis of profit-sharing, *mudārabah* or *shirkah*. They will, however, do so when they really need the funds and it may be safely assumed that they will not act in a self-defeating manner by cheating their financiers. Market forces will take care of those who act in such a self-defeating manner. Nevertheless, a state-regulated proper auditing system can be instituted to safeguard the interest of investors.

Joint-stock companies should also play an important role in an Islamic economy. Their shares would be available to investors who are not 'active' or do not wish to make funds available to sole proprietors or partnerships. Corporate equities constitute a substantial proportion of total capital formation in capitalist economies. Moreover, corporate savings have also played an important role in capital formation. In the United States, over the three years from 1977-80, undistributed profits

*In the Islamic juristic terminology, *mudārabah* represents an agreement between two or more persons whereby one or more of them provide finance, while the others provide entrepreneurship and management to carry on any business venture whether trade, industry or service, with the objectives of earning profits. The profit is shared by them in an agreed proportion. The loss is borne by the financiers in proportion to their share in total capital. The financier is referred to as the *sāhib al-māl* or *rabb al-māl* while the entrepreneur is called the *madārib*. *Shirkah* represents a partnership between two or more persons whereby, unlike *madārabah*, all of the partners have a share in finance as well as entrepreneurship and management, though not necessarily equally.

plus capital consumption allowances generated a net internal cash flow that was five times the dividends paid.¹⁴ Of the total capital expenditure of \$299.1 billion by non-financial businesses and corporations in the United States in 1980, \$259.5 billion or 87 percent, came out of internal sources (undistributed profits, capital consumption allowances and other internal sources). The balance was financed by resort to new equity (\$11.4 billion) and debt (\$28.2 billion).¹⁶ There is no reason to expect that in an Islamic economy corporations will stop saving. There may in fact be a greater incentive to save because it would not be possible to raise financing through interest-based borrowings.

In addition financial institutions, investment trusts, cooperative societies and venture capitalists will also play an important role in mobilising funds on an equity or profit-sharing basis for investment in various businesses looking for funds. It is always possible for an individual investor to diversify and reduce his risk by making financial institutions and investment trusts a vehicle for his investments because such institutions diversify their own risk by properly regulating their exposure to different sectors of the economy as well as to individuals and firms.

The assumption that savings would dry up in an Islamic economy could be supported only if one could build a solid case clearly demonstrating that all savings not invested will be stolen and all investments, whether through the channels of sole proprietorships, partnerships, joint stock companies, or financial institutions, will *definitely* suffer losses. Only such a definite expectation could accentuate the positive social rate of time preference. However, such a possibility is not only remote but also impossible. It must be clearly understood that the return on equity in an Islamic economy will not be equal to just 'profit' but will rather be the sum of what constitutes 'interest + profits' in the capitalist economy and is called 'the return on capital' (equity + borrowing). It will include the reward for saving and risk-taking, on the one hand, and entrepreneurship, management and innovation, on the other. One can imagine that 'profit' in the capitalist sense may be negative for some enterprises but it is difficult to visualise that the sum of both interest and profit would be negative, and particularly for all enterprises. Since nominal interest is never negative, 'interest + profit' could be negative only in exceptional circumstances.

Hence the Islamic system should be able to ensure justice between the entrepreneur and the financier. No one would be assured of a predetermined rate of return. One must participate in the risk and share in the outcome of business. This may not necessarily change the total outcome. It would no doubt change the distribution of the total outcome

¹⁵Federal Reserve Bulletin, June 1981, Table 1.49.

¹⁶Federal Reserve, *Flow of Funds IV-80*, February 1981, p. 9.

in accordance with the Islamic norm of socio-economic justice. It would also eliminate the erratic and irrational fluctuation between the shares of the savers or financiers and the entrepreneurs. Hence situations where the savers suffer (if interest is low and profit is high) or the entrepreneurs suffer (if interest is high and profit is low or negative) would be eliminated and justice established between the two. The impact of this should be healthy on both savers and entrepreneurs.

It would, therefore, not be realistic to assume that the abolition of interest will reduce capital formation in the private sector of an Islamic economy. On the contrary, the injustice in the distribution of the reward between the financier and the entrepreneur which both fluctuating and fixed interest rates introduce tends to distort the signalling mechanism of the price system, brings about a misallocation of resources and ultimately slows down capital formation. This distortion takes place irrespective of whether interest rates are high or low.

High interest rates have served as an important deterrent to investment in the capitalist system. For the period 1970-78, interest payments represented one-third of the return on capital before tax. This was three times the share of the 1960's and six times that of the 1950's.¹⁷ Since interest costs are at the expense of profits, there has been an "erosion of corporate profitability" which according to the BIS Annual Report, "is a key factor in the weakness of the overall volume of investment."¹⁸ Hence the proportion of risk capital in total financing (equity + debt) has declined. Shareholders' equity in the U.S. non-financial corporations constituted two-thirds of total financing in 1950, but declined to nearly half of the total financing in 1978.¹⁹ The main reason for the secular decline in the growth of capital stock has not been the lack of aggregate demand but higher interest rates.²⁰ According to Liebling the growth of corporate debt represents:

. . . an ominous development because it raises break-even points in profitability, makes business more vulnerable to cyclical down-turns, and tends to shorten the magnitude and direction of cyclical expansions. From the risk within a standpoint of individual enterprises it makes more fragile the

¹⁷Herman I. Liebling, *U.S. Corporate Profitability and Capital Formation: Are Rates of Return Sufficient?* (New York: Pergamon Policy Studies, 1980), p. 78.

¹⁸Bank for International Settlements, *Fifty-Second Annual Report - 1st April 1981 - 31st March, 1982* (Basle, 14th June, 1982), p. 3.

¹⁹Liebling, *op. cit.*, pp. 4-5 and Table 13, p. 135. The secular decline in equity ratios is not true merely in the U.S., it is a universal phenomenon. Even in West Germany the ratio of equity capital to total capital has declined substantially (See Horst Albach, "Risk, Capital, Business Investment and Economic Cooperation" a paper presented at the International Symposium on "Islamic Banks and Strategies of Economic Cooperation" held in Baden-Baden in May, 1981.

²⁰*Ibid.*, pp. 70 and 5.

latter's ability to weather unexpected vicissitudes that are frequently encountered in business. It introduces a fixed cost element that is as burdensome as other fixed costs during periods of economic stagnation and contraction.²¹

The lower rates of capital formation in the United States have brought about the vicious circle of decline in productivity, which has in turn reduced the ability to offset the rising costs of borrowed capital. There has consequently been a decline in profitability and further decline in the rate of capital formation.²² With corporate earnings in a free fall and cash flows squeezed, business dependence upon debt has grown further.²³ And since, because of uncertainties in the financial markets, a larger proportion of this debt has been of short maturity, acquired at high interest rates, most traditional indicators of corporate financial health have weakened.²⁴

Low interest rates are equally bad culprits. While high interest rates penalise entrepreneurs, low interest rates hurt savers who invest in interest-based instruments. By channelling only a meagre return to the investors, and particularly to small investors, low interest rates have been a sure way of exploiting millions of small depositors and exacerbating the inequalities of income and wealth. Through most of recent history interest rates have been low as a result, not of market forces, but of administrative fiat and monetary policies. Low interest rates also stimulated borrowing for consumption by both households and governments and have thereby increased inflationary pressures. When payments became due, the savings ratio declined and created a capital shortage. Low interest rates also promoted unproductive investments and accentuated commodity and stock market speculation. Moreover, they induced "excessively labour-saving investments" which generated unemployment. Hence by distorting the price of capital, low interest rates have stimulated consumption, reduced the gross savings ratios, lowered the quality of investments and created capital shortages. The

²¹*Ibid.*, p. 76.

²²*Ibid.*, p. 82; Herbert Runyon concludes "No one can argue with the simple fact that the rate of return on capital investment has declined since 1965. This is true whether the profit rate is examined on a pre-tax basis as did Feldstein and Summers or on an after tax basis as did Nordhams", "Profit a Declining Share to Capital?" in *Business Economics* (Cleveland, Ohio), p. 93; see also, Enzler *et al.*, *op. cit.*, p. 750. See also "America Cannot Afford Its Cost of Capital", an article in *The Economist*, April 30, 1983, pp. 115-6.

²³See Bank for International Settlements (BIS) *Fifty-First Annual Report*, 1 April 1980 - 31 March 1981 (Basle, 15 June, 1981), p. 62. The Report concludes: "On average corporations have been much more reliant on external financing in recent years than they were in the 1960's."

²⁴See the weekly *Financial Digest* issued by the Manufacturers' Hanover Trust Company, July 19, 1982, p. 1. The digest shows that the proportion of cash flow absorbed by interest payments has risen continually from 25.0 per cent in 1977 to an estimated 49 per cent in 1982.

GATT Report thus rightly concludes that "Avoiding the waste of capital through all forms of misinvestment is an equally, if not more, important way of coping with the capital shortage."²⁵

Hence, the creation of a positive and invigorating investment climate requires the perennial maintenance of justice and balance between the savers and the entrepreneurs. It would be but realistic to assume that the abolition of *ribā*, reliance on equity financing and ensuring an equitable distribution of 'profit + interest' among financiers and entrepreneurs can provide such a climate and lead to a substantial and steady rise in the demand for and supply of risk capital. Moreover, the discipline introduced by the need to 'participate' in risk in the allocative decisions of financial institutions should tend to shift resources from 'speculation-oriented' loans to 'productive' loans and thus exercise a healthy influence on economic activity in general.

III. STABILITY

It has also been alleged, without of course even an effort to provide logical or empirical support, that a wholly equity-based system will be highly unstable.²⁶ This is also a misfounded apprehension. On the contrary, it may in fact be asserted that interest is one of the important destabilising factors in the capitalist economies. Milton Friedman posing the question of "What accounts for this unprecedentedly erratic behavior of the U.S. economy?", responds by saying, "The answer that leaps to mind is the correspondingly erratic behavior of interest rates."²⁷ Mr. Iacocca, Chairman of the Chrysler Corporation, observes that interest rates have been so volatile "that no one can plan for the future."²⁸

The erratic fluctuations of the rate of interest create gyratic shifts in financial resources between users, sectors of the economy and countries, causing erratic movements in loan-based investments, commodity and stock prices and exchange rates. They also bring about a shift in short- and long-term commitment of funds and between equity and loan financing. The high degree of interest rate volatility has injected great uncertainty into the investment market which has had the effect of driving borrowers and lenders alike from the longer end of the debt market into the shorter end, thus fundamentally altering the investment decisions of businessmen. The share of interest in the total return on

²⁵For the quoted expressions and a very good presentation of the effect of low interest rates on capital formation in OECD countries, see the first chapter of the Report, "International Trade 1982/83", excerpts from which were reproduced in BIS, *Press Review*, September 6, 1983, pp. 1-5.

²⁶Naqvi, *op. cit.*, p. 136.

²⁷Milton Friedman, "The Yo-Yo U.S. Economy", *Newsweek*, February 15, 1982, p. 4.

²⁸L.A. Iacocca, "How to Cut Interest Rates", *Newsweek*, August 16, 1982, p. 4.

invested capital also keeps on fluctuating, making it difficult to take long-term investment decisions with confidence. Moreover, with every rise in the rate of interest in a floating rate system in a short-ended market, there is a rise in the rate of business failures²⁹ not because of any inefficiency or slackness on the part of the proprietor but because of the sudden decline in his share of the total return on capital. This has the same effect as would the erratic movements in the profit-sharing ratio between the financier and entrepreneur in an Islamic economy. This is however not thinkable because the ratio would be determined by custom, considerations of justice, and remain contractually stable throughout the duration of the financing agreement. Business failures mean not only personal financial losses to proprietors and stockholders, but also a decline in employment, output, investment and productive capacity—losses which take longer, and are more difficult to make up. All these factors no doubt have serious implications for economic activity and stability.

In a wholly equity-based system, with the profit dependent on the profit-sharing ratio and the ultimate outcome of the business, the share of the entrepreneur or the financier cannot fluctuate violently from week-to-week or even month-to-month. Moreover the distribution of the total return on capital (profit + interest) between the entrepreneur and the financier would be determined more equitably by economic considerations and not by speculative financial market forces. As Hicks has rightly pointed out, interest has to be paid in good or bad times alike. Dividends can, however, be reduced in bad times and, in extreme situations, even passed. So the burden of finance by shares is less. There is no doubt that in good times an increased dividend would be expected, but it is precisely in such times that the burden of higher dividend can be borne. "The firm would be insuring itself to some extent," to use his precise words, "against a strain which in difficult conditions could be serious, at the cost of an increased payment in conditions when it would be easy to meet it. It is in this sense that the riskiness of its position would be diminished."³⁰ This factor should tend to have the effect of substantially reducing business failures, and in turn dampening, rather than accentuating, economic stability.

Greater stability of the equity-based system as against a credit-based system has also been recognised by a number of prominent western economists. Henry Simons, the University of Chicago economist, writing after World War II under the strong influence of the depression of the 1930's, argued that the Great Depression was caused by changes in

²⁹For a chart indicating the correlation between the two, see The Manufacturer Hanover Trust, *Economic Report*, June 1982, p. 1.

³⁰Sir John Hicks, "Limited Liability: the Pros and Cons" in Tony Orhial (ed.), *Limited Liability and the Corporation* (London: Croom Helm, 1982), p. 14.

business confidence arising from an unstable credit system. He believed that the danger of economic instability would be minimised if no resort were made to borrowing, particularly short-term borrowing, and if all investments were held in the form of equity.³¹ Hyman Minsky, writing more recently, argues that when each firm finances its own cash flow and plans to invest its own retained profits, there is no problem of effective demand, the financial system is robust and investment has great inertia. But when firms can raise outside finance by borrowing from rentiers or banks the system is liable to instability, particularly because "bank credit is, or at least has been, notoriously unstable."³² Joan Robinson also argues that investment arising from a debt structure:

is not tethered by a particular ratio to the value of the stock of capital. Any rise in investment above the former ratio increases the current flow of profits and encourages further investment and a rise in the proportion of borrowing to own finance. Soon schemes of investment are being planned that will be variable only if the overall rate of investment continues to rise. When the acceleration in the rate of investment tapers off, some businesses find current receipts less than current obligations and a financial collapse occurs.³³

It is not difficult to visualise why fluctuating interest rates can be destabilising. If the rate of interest is low in relation to 'profit + interest', it accentuates the demand for funds for all investments including 'secondary' investments and, as indicated earlier, reduces the quality of total investments. This is one of the reasons why, with a decline in interest rates, stock and commodity market speculation usually goes up and pushes up stock and commodity prices.³⁴ This makes it difficult to obtain funds for real long-term investments because the commitment of funds for speculative purposes is short-term while that for real investments is long-term. The rising speculative activity creates a concern in official circles and leads to the adoption of a restrictive monetary policy which raises interest rates. This reduces speculative

³¹Henry Simons, *Economic Policy for a Free Society* (Chicago: University of Chicago Press, 1948), p. 320.

³²Hyman Minsky, *John Maynard Keynes* (New York: Columbia University Press, 1975). See also the summary of Minsky's argument cited by Joan Robinson in "What are the Questions?", *Journal of Economic Literature*, December, 1977, p. 1331. The quotation about the instability of credit is from C.P. Kindleberger, *Manias, Panics, and Crashes* (London: MacMillan, 1978), p. 16.

³³*Ibid.*

³⁴The conclusion of Wilfred George in his *Tight Money Timing* (New York: Praeger, 1982) is that "Tight money occurring in a given time period is a major cause of a declining stock market. Easy money occurring in a given time period is a major cause of a rising stock market" (p. 154).

activity but does not raise 'primary' investments because the rate of return on risk and venture capital declines as a result of the rise in interest rates. Hence venture capital tends to remain at a relative disadvantage irrespective of whether the rate of interest is high or low. However, there is a greater degree of fluctuation in speculative activity. Since the stock and commodity markets are presumed to be the 'barometers' of the economy, the interest-triggered fluctuations in these markets exert a destabilising influence on the whole economy.³⁵

Interest rate also vitiates the operation of monetary policy. The central bank can either control the rates of interest or the stock of money. If it tries to stabilise the rates of interest it loses control over the money supply. If it tries to attain a certain targeted growth in money supply, the rates of interest, particularly the short-term rates, become volatile. Experience has indicated that it is impossible to regulate both in such a balanced manner that inflation is checked without hurting investment. It has been suggested that short-term fluctuations in the money stock do not matter as long as the long-run growth is in line with the targeted trend. This is however not valid because volatile short-term fluctuations breed uncertainties and make long-run planning extremely difficult for investors.³⁶ It has also been argued that short-term fluctuations in interest rates do not matter as long as long-run rates are on course. This assumption has proved to be false because the fluctuations in short-term interest rates generate uncertainties and adversely affect investments, which are normally sensitive to movements in interest rates, and the gyrations they bring about in commodity and stock markets.

Interest rate volatility has defeated all efforts to restore stability to exchange rates. In a fixed parity system it makes it impossible to keep the exchange rates pegged because of the movement of 'hot' money to take advantage of interest rate differentials. The effort to keep the rate

³⁵Mr. Paul A. Volcker, the chairman of the Board of Governors of the US Federal Reserve System, while testifying before a Congressional sub-committee on May 21, 1980, remarked that in the recent silver speculation, the Fed had been worried that transactions financed by credit had contributed to the speculation, had diverted financing from more productive uses, and had been excessive. The use of credit in this way could ultimately threaten the safety and soundness of financial institutions. Mr. Volcker further remarked that the recent speculation in the gold and silver markets had contributed to inflation and other such speculation could do likewise. *BIS Press Review*, May 23, 1980, p. 2.

³⁶The Bank for International Settlements, a highly reputed international institution, rightly observes in its 1982 *Annual Report, op. cit.*, that "The increased volatility of short-term interest rates may have added another sort of uncertainty premium to long-term rates" (p. 5). The Report further observes that "The greater volatility of both interest rates and the monetary aggregates, at the same time, have joined forces with the budget to push real long-term rates upwards," (p. 5). Later on the Report makes a stronger statement saying "...extreme volatility in interest rates can contribute to sharp fluctuations in economic activity and may lead to structural problems in the economy and in the financial system" (p. 89). See also the reference to the two-volume Axilord Report in footnote 20, and the related discussion in the text, in the Chapter on Monetary Policy.

pegged leads to a significant loss of central bank reserves and impairs confidence in the strength of the currency. In a floating exchange rate system, where the rate tries to find its own equilibrium level and fluctuates excessively from day to day in response to international interest rate movements and speculative forces bearing no relationship with underlying economic conditions, it becomes difficult to predict exchange rates. This renders long-term planning almost impossible. For sectors of the economy where competition is tough and the profit margins are small, such unpredictable slides and surges in exchange rates exert an unhealthy influence. A country facing a recession is unable to keep its interest rates low because such a policy leads to an outflow of funds, depreciates the exchange rate of its currency, and raises the cost of living. To prevent an even deeper plunge in the value of its currency, the recession-ridden country is forced to maintain its interest rates at a higher level than dictated by the need for recovery. This, in turn, slows down the recovery and undermines confidence in the government. Hence there have been proposals to bring about interest rate coordination among major industrial countries. But such a coordination has so far proved to be an impossible task because all countries are rarely in the same phase of the business cycle. Exchange rate volatility hence continues and "worsens the climate of uncertainty in which economic decisions are taken, discourages capital formation and leads to a misallocation of resources."³⁷

The elimination of interest and introduction of profit-and-loss-sharing would "not change the level of uncertainty," as Dr. Anas Zarqa has rightly indicated. It would, however, redistribute the "consequences of uncertainty over all parties to a business."³⁸ It would moreover, by removing the daily destabilising influence of fluctuating interest rates, bring about a commitment of funds for a longer period and also introduce a discipline in investment decisions. In such an environment the strength or weakness of a currency would tend to depend on the underlying strength of the economy, particularly the rate of inflation, and exchange rates would reflect more nearly the strength of the real non-speculative factors. Accompanied by the Islamic emphasis on internal stability in the value of money, exchange rates should prove to be more stable because all other factors influencing exchange rates, such as cyclical developments, structural imbalances and differences in growth rates, are of a long-run nature and influence expectations about long-term trends in exchange rates.

³⁷BIS 1982 *Annual Report, op. cit.*, p. 3.

³⁸Muhammad Anas Zarqa, "Stability...", *op bit.*, p. 9.

IV. ECONOMIC GROWTH

It is also pointed out that the prospects for growth would be bleak in an Islamic economy after the abolition of interest.³⁹ This criticism is also invalid. The basic ingredients for sustained growth are saving, investment, hard and conscientious work, technological progress and creative management. The healthy influence of Islam on saving and capital formation has already been indicated. Islam has recognised the role of profit and has allowed the individual to pursue it, though within the bounds of moral values and constraints of general welfare. It has also been shown that allocation of resources would tend to be more efficient and equitable in an Islamic economy than in the conventional interest-based system.

The abolition of interest and its replacement by profit-sharing according to a fair ratio between the financier and the entrepreneur should remove one of the major sources of uncertainty and injustice and be more conducive to growth. It must be appreciated that the entrepreneur is the primary force behind all investment decisions and removal of one of the basic sources of uncertainty and injustice is bound to have a favourable effect on his decision making. By turning "savers into entrepreneurs," using the words of Ingo Karsten, the risks of business can be more equitably distributed, thereby improving the investment climate. Moreover, by making the savers and the banks involved in the success of the entrepreneur's business, greater expertise should become available to the entrepreneurs, leading to an improvement in the availability of information, skills, efficiency and profitability. More productive entrepreneurship should lead to increased investment.⁴⁰

Islam is absolutely positive in terms of its esteem for hard work. One of the primary obligations of a Muslim is to fulfill all his responsibilities conscientiously and diligently with the maximum possible degree of care and skill. The Prophet exhorted: "God has made excellence obligatory upon you"⁴¹ and that "God loves that when anyone of you does a job he does it perfectly."⁴² This esteem for work, along with the urge to improve one's living conditions and those of others, should be highly conducive to growth provided that an appropriate political and economic environment is available.

There is no reason to assume that there would be lesser incentive for

³⁹Naqvi, *op. cit.*, p. 127; see also the answer to this by Zarqa (1982), *op. cit.*, pp. 103-4.

⁴⁰Ingo Karsten, *op. cit.*, p. 131 as well as pp. 129-36.

⁴¹*Sahih Muslim* (Cairo: 'Isa al-Babi al-Halabi, 1955), vol. 3, p. 1548:57.

⁴²Cited on the authority of Bayhaqi's *Shu'ab al-Iman* by Jalal al-Din al-Suyuti, in his *al-Jami' al-Saghir* (Cairo: 'Abd al-Hamid Ahmad Hanafi, n.d.) vol. 1, p. 15.

technological progress and creative management in an Islamic economy. In fact the closure of all doors to resort to unfair and dishonest practices to increase one's income should create a greater urge for technological innovation and increased efficiency. All things being equal, this may be the only way for a businessman or an industrialist to reduce costs and raise his honestly earned (*halāl*) income.

Uncertainty is a potent source of economic inefficiency and particularly so if it makes it difficult to make any projections. This makes investors hesitant to commit funds for long-term investments. In the case of interest-based investments, the financial risk facing entrepreneurs increases because of the interest cost of capital which has to be paid irrespective of the ultimate outcome of the business. This uncertainty is further enhanced if interest rates move erratically and the financing agreement incorporates a floating rate, as is generally the case in the present-day world. If a fixed, rather than a floating, rate is specified, then the financier tends to wait if the rate is low compared with his future expectations and the entrepreneur tends to wait if the rate is high compared with his future expectations. Commitments are hence made for extremely short periods. It is difficult to make long-term investments on the expectation of having the credit rolled over. Hence investment suffers leading ultimately to a decline in productivity and lower growth rate.

In an environment of equity-based investments, the entrepreneur does not have to worry about two uncertainties simultaneously, firstly, the total financial return on total invested capital which is determined by the price of his product as well as the cost of his inputs, and secondly, his share of the return, determined by the fluctuating rate of interest. With the elimination of interest he has to worry only about the total return as his share is an agreed fixed proportion of it and not fluctuating with the erratic movements in interest rates. The exposure to only one of the two uncertainties should have a favourable effect on him and should make him feel more encouraged to make investments, particularly if the uncertainty introduced by inflation is also reduced.

When interest rates were low and relatively stable, the problem was not so acute. However, in the 1970's when interest rates rose, gross domestic fixed investment declined as a per cent of gross national product in western countries⁴³ and international growth has everywhere been appreciably slower than in the early post-war decades. The poor investment performance has been a major cause of prolonged slow growth. It is universally recognised that better investment performance is the key to faster growth and better structural adjustments.⁴⁴

⁴³For a table indicating gross fixed investment as per cent of GNP since the 1960's see BIS *Annual Report*, 1982, *op. cit.*, p. 29.

⁴⁴See *ibid.*, pp. 27 and 29.

The best remedy would be not just to reduce interest rates, because this would not remove the future uncertainty, given the high budgetary deficits of some major industrial countries, but to promote equity financing to allow the equitable sharing of the total return on capital between the financier and the entrepreneur. The rise in interest rates at any time reduces profits—the entrepreneur's share of the total return—creates a liquidity squeeze by reducing the internal cash flows, forces increased short-term borrowing and rolling over of credits at higher rates (the general practice of bankers being to roll over credits at somewhat higher rates), squeezing profits further and leading to bankruptcies. Abolition of interest would be the only way to create a climate of rational expectations and a stable background for entrepreneurs, financiers and consumers.

The contention that Islamic values are conducive to economic growth does not imply that the concept of growth in Islam is the same as under capitalism. As already indicated earlier, Islam stands for steady growth within the framework of its overall values such that there is harmonious development of both the spiritual and economic aspects of Muslim societies and that there is no weakening of the moral fibre of human beings. The fact that Muslim countries have in general experienced slow growth rates over the last few centuries has nothing to do with Islamic values. There are a number of historical, political, insitutional, social and economic factors responsible for the poverty and slow growth and it would be beyond the scope of this paper to enter into this area.