Welfare Implications of Interest-free Bank Asset Management

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This paper introduces some theoretical aspects of Islamic banking asset management strategies for reducing economic instability. Since public welfare deteriorates during periods of inflation and unemployment, the procyclical behavior of modern interest-based commercial banks is known to aggravate these fluctuations and *ipso facto* produce an even more severe impact on welfare. The paper will show that equity-based Islamic banks contain some structural features that reduce these procyclical tendencies and therefore shield public welfare from further deterioration.

BANK ASSET MANAGEMENT AND ECONOMIC STABILITY

Procyclical Nature of Interest-based Commercial Banking

It is well-known that an interest-based commercial banking system contains inherent procyclical tendencies, i.e., it tends to aggravate economic instabilities.[1] This is largely attributed to its dual role as profit-maximizer and money creator. Modern interest-based commercial banks, like any other business entities, are profit-seeking. Their contribution to economic growth and stability depends on how sources of funds are utilized. For example, to increase deposits or reserves, liability management would mobilize the funds required by introducing attractive yields on their liabilities. These reserves increase a bank's ability to make loans, and the return (interest) on these loans represents the bank's earning. Liability management however is not the focus of our study.[2] A more relevant approach for comparative exercise is to look at bank asset management, i.e., strategies to increase a bank's earnings by increasing the profitability of its portfolio.

Bank Earnings and Asset Management

Like any other business, a commercial bank's reaction to economic instabilities is drawn along profit-maximization. During an economic upturn, for instance, the bank will expand loans since the demand for funds by business increases as higher future production and earnings are expected. Hence, the proportion of assets diverted into loans is higher than that diverted into investments. During an economic slowdown, however, output normally falls due to poor sales. The accumulation of inventories will force firms to reduce output and employment. Such a contraction in production reduces business spending and hence weakens the demand for loans. The situation is made worse when banks cut down lending in favor of safer assets, thus placing a lower proportion of assets in loans and higher proportions in investments.[3] In both situations, banks' lending policies will further intensify economic fluctuations. In other words, as commercial banks expand loans during inflationary periods, prices increase since the economy is already at full capacity. On the other hand, loan contraction during recession may further

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reduce business spending, resulting in an acceleration of the economic downswing.

Bank Earnings and Public Welfare

As a business entity, commercial banks may not find it rational to pursue a liberal lending policy to reduce instability during economic slowdown.[4] In fact, the role of controlling inflation and unemployment is irrelevant to commercial bank philosophy on asset or liability management. Such responsibility falls under the authority of the central bank. The pursuance of liberal lending policies by commercial banks during bad business conditions is perceived as financially unsound when it is known that weak consumer demand will produce less business sales. In the end, it has the potential to fuel the creation of bad debts. Similarly, a conservative lending policy during economic prosperity may reduce potential bank profits since qualified borrowers are eager to pay the price of credit from which the capital obtained is expected to produce even higher returns. It is then clear that the pursuance of such lending policies during various patterns of economic fluctuations may indeed jeopardize national interest. If the banking system were to react in favor of welfare, by combatting instabilities, it might pave the way to business failure. Paradoxical as it may seem, commercial banks' dual role as business entities and as money creators will frustrate to a certain extent attempts by the monetary authority to counteract instability. The central bank is empowered to control money supply in the banking industry since such control reduces the procyclical tendencies in the system. But the inherent destabilizing structure of interest-based commercial banking remains a threat to which the central bank can find little remedy. Thus, regulation is imminent, and the use of discount rates and changing reserve requirements to control money supply is still the state of the art.

Commercial Banks and Safety

In order to earn higher profits, banks must grant more loans, but such profit-maximizing behavior must be consistent with bank safety.[5] Loan expansion requires more reserves, which could be released either by central bank monetary instruments or by liability management. To encourage loan expansion during recessions, the central bank often resorts to reducing reserve requirements. However, this policy becomes effective only if banks convert the excess reserves into loans. But profit-maximization during economic recession requires a contraction in loans, for any liberal lending strategy may result in bad debts. Bank safety is thus paramount. In the final analysis, countercyclical monetary control by central banks to reduce instabilities may not be effective.

On the other hand, to put a stop to inflation, central bank policy requires an increase in, say, reserve requirements. Although excess reserves intended for lending purposes may fall, banks can easily convert investments into loans, since the returns from loans under these prevailing conditions are much higher than from investments. In other words, the role of loan as an asset during economic boom is less risky than during a depression. Again, central bank contractionary policies may be thwarted by commercial bank lending policies.

In the above, we have briefly outlined the profit-seeking, risk-averting, and procyclical behavior of modern interest-based commercial banks. One may wonder whether Islamic banks would behave in a different fashion and provide instant remedies for the above problem. Empirical investigation can give us more insights, but since the operation of Islamic banks is only a recent phenomena, it is hard to obtain data that include well-represented periods of economic fluctuations. Therefore, for the moment we will only attempt to hypothesize Islamic bank behavior during economic instability and suggest some possible designs of asset portfolios to achieve the two-pronged goals of profit-maximization and economic stability.

CHARACTERISTICS OF ISLAMIC BANKING

Islamic Banking System

The following discussion is based on three hypothetical Islamic banks which can be categorized as (1) trading-based Islamic (TBI) banks, (2) equity-based Islamic (EBI) banks, and (3) combinations of TBI and EBI banks. The first type refers to banks in which trading activities constitute the bulk of operations. By trading, we mean buying and selling of commodities, such as activities related to the retailing and wholesaling business. Business profit is the difference between cost price and selling price, commonly known as the mark-up. Since Islamic banks do not make loans the way interest-based banks do, an alternative approach designed to meet customer demand for loans is sought in a manner similar to general trading, in which banks supply items desired by a buyer on credit at a mark-up price.[6] The customer will not receive a bank cheque but the item he intended to buy. A long-term trading deal is made on the basis of *bay' bi thaman ajil* contract. For short-run transactions, a *murabahah* contract is most popular. Most Islamic banks have gone into these lines of business for various reasons.

First, it ensures easy cash flows. Profit may be realized as customers make their monthly credit payments. Thus profits can easily be remitted to investors at any prescribed time.

Second, risk is relatively low in trading as compared to production. This is important because private savings constitute the bulk of a bank's sources of funds and must be guarded against risky investment, which may jeopardize the bank's performance. Failure either to show commendable profits or to maintain the safety of deposits may cause depositors to look for other options.

A TBI bank is basically a commercial type of bank. Unlike a development bank, which receives funds primarily from public and international agencies, TBI banks cannot afford to confront high risk alternatives found in production activities, for the sole reason that welfare of depositors must be ensured. The tight competition for funds in the banking industry may further require TBI banks to pursue risk-free investments for fear of losing potential depositors.

Trading-based Islamic Banks and Economic Stability

Recession

Having discussed some important traits of the TBI bank, its reactions to stabilizing economic fluctuations may now be explored. Although this discussion is somewhat hypothetical, it is justified since the activity of trading is soundly embedded in economic theory.

During economic slowdowns, low demand for goods will push sales downward. Poor sales mean low profits. To reduce inventories, firms may reduce manpower utilization, thus causing unemployment, resulting in less income for household spending. To maintain or even reduce current production, business will stop adding new capital toward production. Hence investment falls. Such poor demand for investment and household goods from TBI banks is quite similar to the low demand for loans from interest-based commercial banks. Similarly, even if demand exists, TBI banks may refuse to extend trading facilities for the simple reason that businesses are highly risky during recession. Failure to update monthly installment payments by poorly performing firms will pose potential hazards to bank cash flow. Hence, TBI banks may settle with relatively risk-free assets to ensure company safety. They may increase holdings of low-yield securities or may even prefer to hold idle cash balances. Such a trading policy may only slow down the pace of recovery, which otherwise requires higher spending to stimulate the economy.

As a remedy, the exercise of certain liberal trading techniques to stimulate aggregate demand is much desired. This is what welfare is all about in the banking industry, which implies the

pursuit of a countercyclical trading policy, or at least of a less procyclical one. Welfare in the banking scenario must not be misinterpreted as a benevolent approach in lending policy, such as making loans without collateral or extending interest-free loans without qualifications. Welfare in this sense falls within the public domain and has little to do with private undertakings. But to pursue welfare by introducing a countercyclical trading policy during economic fluctuations may also be unrealistic because business self-interest does not allow such altruistic policy to interfere with profit-seeking. Thus, there seems to be no apparent reconciliation between profit-maximization and welfare with TBI banks.

Inflation

Businesses are generally active during economic expansion. But as the economy reaches full capacity, input prices will rise as firms compete among themselves to acquire existing resources. Since at full employment real output remains constant, general price level will increase. Under such circumstances, the central bank would normally pursue a restrictive monetary policy. As inflation is always attributed to "too much money chasing few goods," contraction of money supply is often sought by increasing reserve requirements and raising discount rates. Such regulatory measures to control a nation's money supply via control of money creation in interest-based commercial banks may work against inflation, but commercial banks' liberal lending policies may prove procyclical as indicated earlier. In the case of TBI banks, there is no reason for bank management to refuse to extend trading facility finance by murabahah or bay' *bi thaman ajil* sales and purchase since attractive business climate would ensure easy credit installment payments and hence faster profit. In other words, good business will increase the demand for both capital and consumer goods. Banks will channel their reserves into trading activities, selling goods to firms and households. The risk of business failure is relatively low, and as TBI banks pursue liberal trading policies in line with company profit-motives, their procyclical resemblance to interest-based banks becomes more apparent. The rationale for putting assets into trading activities due to high returns potential will pave the way toward more deposit creation and thus expanding money supply. Inflationary spiral continues, and public welfare is not invulnerable. Since inflation eats up the purchasing power of fixed income earners, especially the aged pensioners, and of consumers at large, persistent liberal credit/trading policies during periods of inflation remain detrimental to economic prosperity.

Equity-based Islamic Banks

An excursion into early literature on Islamic banking can either lead us into issues on partnership (*mudharabah*) or equity-based (*musharakah*) techniques in the banking business. These techniques are proposed as alternatives to interest-based banking, with a hope to explore the viability of profit-loss sharing (PLS) in banking business.[7]

Previously we raised some important issues about the manner in which a TBI bank pursues its profit-motive policies during periods of economic fluctuation. We have also shown that, as far as welfare is concerned, there is not much difference between TBI banks and interest-based banks: both tend to aggravate economic fluctuations. Of course, more empirical research is required to confirm this view, but this may not be possible for some time. With a relatively small working capital, Islamic banks stand alone to compete against well-established conventional banks. The problem tends to be aggravated by the fact that in most Muslim countries, Islamic banks constitute a marginal segment of the banking industry.

The author's view about the manner in which EBI banks respond to economic fluctuations remains a hypothetical one, especially since EBI banks are rarely to be found. The dominance of trading operations in most Islamic banks today (for reasons we have mentioned earlier) has

made EBI banking a lesser alternative to interest-based banking. There are many reasons for these developments, including problems concerning cash flow, project monitoring, business trustworthiness, and occasionally even Shari'ah restrictions. However, these are not our concern at the moment. Our main task is to analyze the response of EBI banks to economic instability.

In general, EBI banks are those in which mudhar*abah* and *musharakah* constitute the main instruments of operation. Although the former may not fit into the equity framework, its inclusion is made for the sake of expediency although we express some reservation over the viability of *mudharabah* in modern commercial banking for the simple reason that safety factors require the bank as fund-provider (*rabb al-mal*) to demand more than a mere manpower commitment from the *mudharib*.[8] This author feels that the second partner must contribute certain minimal funds apart from his expertise to ensure proper commitment to the project concerned. Unless this be the case, the extent to which equity represents the main bloodline of Islamic banking will put *mudharabah* to minimal use.

For example, a firm that runs short of cash may invite an EBI bank to enter into equity in so far as it is able to provide the firm with cash for a specific purpose, the return of which will be obtained when profit is realized (e.g., at the end of the year). Such equity-based partnership seems more relevant to today's business needs than the capitalist-labor contractual relationship typical of any *mudharabah* activity. Not only will Islamic banks be relieved of the high financial burden required in *mudharabah* investment, they will also find stronger commitment from the business partner who has put his money at risk as well. Thus risk-sharing will be made more equitable among partners to the extent that bank's monitoring and supervisory cost could be minimized.

However, this will be different in a *mudharabah* framework, as total funding remains the bank's sole contractual responsibility. This is indeed difficult to uphold in commercially-oriented banking practise. Perhaps *mudharabah* should be put back to its original place, in which the fund-provider is not a financial intermediary but a production unit whose knowledge about the PLS system is well defined and who is thus willing to put mobilized savings into direct investment. Since *mudharabah* activity is open to abuse, a practical approach to Islamic banking should assume larger *musharakah* operations in which both partners take active part in the project. This may be more relevant in development or merchant banking scenarios than in the commercially - oriented banking industry. However, our attempt to hypothesize EBI bank response to economic fluctuation will not be hampered by the fact that in the Islamic banking industry today such EBI banks are not widely found.

As mentioned earlier, welfare implies a conscious attempt by bank to help reduce economic fluctuation, which in the modern sense is a task undertaken by the central bank. Such attempt would also imply the ability of the banking system to neutralize economic fluctuations by virtue of its PLS mechanism. We will now explain how EBI banks, as profit-making entities, react to such economic instabilities.

Recession

During economic recession, relatively high business risks cause demand for funds to fall. This does not imply, however, a definite reduction in investment, because a firm's decision to reduce investment may be caused either by its reluctance to undertake higher risk projects or by the mechanism from which borrowed funds are obtained. The two are nevertheless interrelated. The latter refers to commercial bank lending policy, which assumes zero risk-sharing in production. In such cases, risk in production is a matter of borrower responsibility. However, if bank financing facilities were extended to accommodate risk in production, the demand for loans would be higher than normally observed during economic slowdown, because equity relation

in production would boost business confidence. Such technique has the potential to benefit both parties in several ways.

First, such an approach would perhaps make it possible for banks to find better ways to utilize their idle reserves, which otherwise produce marginal or no returns at all under maximum risk-free asset portfolio management.

Second, it might help reduce the rate of decrease in business spending and hence reduce the rate of contraction of aggregate demand. Thus the expansion of money supply sought by the central bank to stimulate the economy might not be thwarted, as normally happens under present interest-based systems. Such moderating procyclical behavior of EBI bank would pave the way for stronger economic recovery, which can be explained as follows.

During recession, investment spending may fall due to the fact that expected return becomes smaller. This leaves a lower profit margin for entrepreneurs who have to settle rental on capital in addition to bearing risk and potential loses in production. As a consequence, the number of economic projects undertaken will fall, implying a fall in demand for loans as well.

The ability of the EBI banking system to prevent a severe fall in aggregate demand is now explained. Focus is given only to investment spending. There is no doubt that aggregate demand will indeed fall during a recession under any system, even an Islamic one. But our contention is that an EBI banking system is able to reduce the rate of contraction in aggregate demand and thus sustain a mild if not a severe recession.

The amount of idle balances in EBI banks are kept low during an economic slowdown. This is quite the contrary of interest-based banks, which normally maintain high excess reserves in the form of cash balances to ensure safety. EBI banks are not able to do this because of *zakah* levied on idle cash. The *zakah* is in effect a penalty on banks for not mobilizing investable funds for productive use.[9] Since money is the legal tender, less money in circulation results in less production, employment, and income. The *zakah* of 2.5 percent on idle cash thus discourages high levels of liquidity in bank asset portfolios. To avoid such unnecessary burden, equity-based banks must look for projects that generate a return of at least 2.5 percent.[10] Banks are not avoiding *zakah* obligations, simply paying *zakah* out of profits rather than cash balances. EBI banks obtain funds from depositors-cum-investors, and are legally obligated to invest those funds in search of profits, though not necessarily a guaranteed sum, since depositors know that the banks operate on a PLS basis. Therefore EBI banks are more fluid in the use of excess reserves during recession, as *zakah* is put into use as a deterrent against hoarding.

Since *zakah* ensures low levels of idle bank balances, one may ask how bank could find profitable yet safe investment projects when, in fact, businesses are slow and risky. Under these circumstances, risks in production may be high enough to trigger losses. Being a dominant supplier of capital, this could mean a business deal in favor of entrepreneurs but against the banks themselves which could lead to a point where banks could neither hoard their money (due to *zakah*) nor invest it. Such a deadlock could never happen in an EBI banking system, however because banks are not under pressure to guarantee a fixed return to depositors, and, more importantly because EBI banks can be more innovative and enterprising. About the latter, the slow economy does not imply a business standstill. Although income and profit remain relatively low, people still need food and clothing. For a small, trade-dependent economy, for example, banks can go into labor-intensive, import-substituting ventures that could help lessen imports and balance-of-payment problems. To earn foreign exchange banks can also look into those export industries in which the economy has a comparative advantage. Since an EBI bank is not merely a financial intermediary but an enterprise involved in real production as well, a recession should never be an impediment to some reasonable level of capital mobilization.

From the demand side, entrepreneurs are supposed to provide not only some degree of managerial and technical expertise but also some amount of capital into projects in which an EBI bank is the partner, providing the bulk of capital required for investment. To begin with, recession would mean a different scenario for entrepreneurs. Since there is no rental on capital, the reduction in expected returns would not discourage entrepreneurs from initiating or extending equity contracts with equity-based banks. This does not mean, however, that firms would pay no heed to business risks and losses. It simply means that the system provides a greater sense of confidence since risks and losses would be the burden of both investing parties.

Inflation

The same reasoning applies in cases of inflationary pressure. While TBI banks and interest-based banks grant trading facilities and loans during times in which demand for capital is rising, the same may not apply to EBI banks. Since equity business relations require cautious investment because production risks are accommodated into banks' asset management, the approval of project equity investment in EBI banks during economic booms would exercise some moderating tendencies on the increase in money supply via deposit creation. In other words, the rate of increase of deposit creation is made smaller because equity-type investment requires substantial caution, resulting in reduced rate of increase in money supply and consequent dampening of the degree of aggravation of economic fluctuation

During a boom period, the economy observes a relatively high level of trading and production activities. With higher expected returns from potential investment projects, high levels of investment spending eventually follow. Money supply increases as loans expand to meet business demands. Boom periods are normally accompanied by higher prices and eventually inflation. However, the extent to which EBI banks react against inflation is not so much a matter of policy preference of the banking industry as an implication of equity principles structured within the system, which can produce a moderate increase in capital expansion to enable the banking system to behave countercyclically during inflation, though such impact is expected to be mild and less effective than that produced by the monetary authority.

Inflation is basically a phenomenon in which society experiences a fall in purchasing power. A relevant issue about how EBI banks reduce the increase in money creation during boom periods is related to demand-pull inflation. As mentioned earlier, interest-based banks are known to be more liberal in making loans during economic upturns. The same applies to the EBI banking system except for the types of loan given. In general, two types of loan make up the bulk of funds supplied by the banking industry: loans for production purposes and loans for consumption purposes. Production loans are normally injected into the production sectors. Since risk-bearing in production under the equity framework involves both investing parties, we can say that the cautious approach to investment still plays a major role in equity management, although the impact may be marginal relative to that of conventional asset management. However, the increase in price level due to demand-pull is not dominant in the supply-side industries, as they are directly involved in long-term real production. Growth in these industries may only be affected by some cost-push elements caused by external shocks and to some extent by higher prices of imported intermediate inputs for import substitution and export industries.

Too much money creation during an economic boom is often said to be cause of demand-pull inflation, during which one may observe a rather active, buoyant property and stock market. However, the demand for these assets tends to be more speculative, as buyers are more concerned about short-term gains. A control on speculative investment activities is therefore needed to help reduce inflation due to excessive money creation. The *murabahah* scheme is a potential remedy but now only suited for the purchase of real property, such as land and residential assets. It should

not be applied to the production sectors where *musharakah* or transactions prevail.[11] Once purchases of assets are tied to the *murabahah* scheme, speculative buying can be reduced since the price of assets bought under the *murabahah* contracts does not reflect present market price or cash price but the expected future market price of the asset, and it thus named credit price.[12] Once such a framework is set up, demand for money tends to be smaller due to a slowdown in speculative purchases. Hence, the impact of equity-based banking system in reducing the rate of expansion of money supply during economic boom can be observed by replacing consumption loans with *murabahah/bay' bi thaman ajil* credit sales, which can ensure genuine purchases of assets and durable goods. An equity-based bank can establish equity relations with traders and retailers in which the credit sales of commodities are made through *murabahah* schemes.[13] Facilities extended to individuals for the purchase of ordinary shares or new issues should only be made on equity from which less demand for speculative shares purchases is expected due to the cautious approach to investment by EBI banks. The scheme will help pave the way for the public to put savings into real, long-term production activities. Interest-free consumption loans are made only on humanitarian grounds or *qard al-hassan*.

From the above discussion, some observations are in order. First, a higher degree of equity in banks' asset management would tend to stabilize national output. The equity-based banking system thus contains some structural features that tend to prevent inflation from overheating or to stimulate production when the economy slows down. In fact, equity-based banks would play a role of built-in stabilizer commonly observed in changes in tax revenues, welfare payments, and family savings. Although fiscal and monetary policy would still play a dominant role in maintaining economic stability, the equity-based banking system would make the job much easier.

Second, a TBI bank is procyclical and thus unable to make positive contributions to economic stability. Although a TBI bank can be instrumental in Islamizing banking transactions, it fails to protect the common man from inflation and unemployment.

Finally, since most Islamic banks today have incorporated both *murabahah* and *musharakah* instruments in their asset portfolio management, the extent to which these selections of portfolio can help stabilize national output depends on the *musharakah/murabahah* (Ms/Mb) ratio. The larger the proportion of assets put into *musharakah* activities relative to *murabahah* activities, the less procyclical the banking system. (For example, $Ms/Mb = 0.8$ indicates that 80 percent of bank assets are put into equity and the remaining 20 percent into trading.) At the other extreme, an Islamic bank operating purely on the basis of murabahah (i.e., $Ms/Mb = 0$) has procyclical tendencies similar to those observed in interest-based banking systems. It is difficult, however, to envisage an EBI bank with $Ms/Mb = \infty$. EBI banks may have to put some of their assets into *murabahah* activities as explained earlier. Though no optimal ratios could be determined at present to suit varying trends of economic activities, a high Ms/Mb ratio is considered a desirable policy parameter. It follows that neither an economic upturn nor a slowdown would suggest a substantial diversion of assets into *murabahah* or otherwise.

CONCLUDING REMARKS

Although it is assumed that Islamic banks are profit-seeking and thus do not act as welfare institutions, they can in fact assume these two noble roles by putting welfare in a proper context: protection of public interest via reduction of economic instability. Since most present-day Islamic banks are based on a combination of *mudharabah*, *bay' bi thaman ajil*, and *musharakah*, the protection of public welfare can be pursued by mobilizing a higher percentage of assets into equity. However, it does not mean that *murabahah* instruments are inferior to *musharakah*. Indeed,

some *murabahah* transactions are most relevant to fulfillment of certain private needs that *musharakah* instruments cannot accommodate, such as short-term financing of automobiles and household goods. Both instruments are indispensable and therefore must remain in bank portfolios, but to maximize bank earnings, the bulk of bank assets should be mobilized into production. Production involves resource mobilization, i.e., it increases employment of inputs. It could also generate skills among workers, encourage innovation, and produce various forward and backward linkages much needed for economic growth. Islamic banks therefore should not devote much attention to the trading aspect of business. This should be left to its traditional agents: wholesalers, distributors, and retailers. In addition to the above, imputing risk of production into bank portfolios will in the long-run produce a new structure in the financial system, which in itself will prove to be potent against instability that arises to some extent from private speculative portfolio investment. In addition, the public will acquire practical experience in direct production, where risk is in fact a natural law. Thus, the rule of no gain without loss (*al-gharam bi al-ghunum*) can be put into practise. In fact the recent interest in venture capital expresses the state of remorse in the financial sector in confronting the recession during which a substantial reduction in loans and a dramatic increase in idle reserves were observed. Under the equity-based system, not only will profit be equitably distributed among different income classes, banks' function as built-in stabilizer will also allow the role of welfare institution to be played without jeopardizing earnings. Hence, in an Islamic equity banking system, no inherent conflict between profit and welfare-seeking is expected.

NOTES

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1. This point is discussed in many textbooks on money and banking; for a good coverage see John J. Klein, *Money and the Economy* (New York: Harcourt Brace Jovanovich, 1982), 84–93.
2. Mohsin Khan's discussion of liability management in the PLS banking system is interesting in relation to its shock-absorbing ability. The PLS banking system is said to contain certain structural features that enable the system to sustain the impact of such shocks as panic deposit withdrawals.
3. Investments are low-risk assets such as bonds and securities. This is not to be confused with the term 'investment', which is an addition to capital stock.
4. Interest-based banks indeed play an important role in national development and are also welfare-oriented in terms of making financial contributions via charities to various welfare and non-profit organization. In fact, the manner in which the Qur'an depicts *riba* makers does not correspond exactly to Western banks, because these banks are development-oriented, unlike the parasitic oppression of the poor by the rich through *riba* in the mercantile Makkan community.
5. One must not confuse profit-maximizing behavior with profiteering. For example, in an Islamic framework of modelling economic behavior, profit-maximization is generally subjected to two constraints: the Shari'ah and the law of nature. As long as these constraints are not violated by producers, there is no limit to profit. Profiteering takes place only when these two constraints are violated. For further discussion see the author's *Market Structure in Islam* (Shah Alam: Institut Teknologi MARA, 1989).
6. In general trading, cash price when payments are made on credit; *murabahah* instruments operate in similar fashion.
7. A classic discussion of *mudharabah* banking is given in M. Nejatullah Siddiqui, *Banking without Interest* (Lahore: Islamic Publications Ltd., 1973), 7–47. Due to high risks and uncertainties in the banking business when *mudharabah* system is proposed, the model is seemingly abandoned in favor of the *murabahah* instrument. PLS remains the basis of Islamic banking, however.

8. At present, the nature of the *mudharib* seems uncertain, since most entrepreneurs who wish to enjoy banking facilities do own some kind of assets with which to begin their businesses. It may be a bit naive to assume the growing presence of inexperienced *mudharib* devoid of even minimal assets or capital to whom the Islamic bank (in this case, the *mudharabah* bank) will relentlessly provide capital. This may prove highly risky to the *rabb al-mal*. These types of potential entrepreneurs should first acquire the necessary business experience through *ijarah* schemes or simple employment at fixed wages. Even an Islamic bank that assumes the role of a *mudharib* is somewhat misleading, since the bank itself owns some paid-up capital.
9. Cash or idle balances are part of net wealth and therefore zakatable. The same applies to a bank's excess reserves in the cash vault. Since cash balances are unproductive asset, the *zakah* levied on them can be considered a penalty.
10. This may imply that the number of viable projects is high from the bank's viewpoint. If *MEC* is 6 percent and the number of corresponding viable projects is 100, then a minimum return of 2.5 percent would open up more potential projects. However the minimum *MEC* of 2.5 percent serves only as a guideline, not as a target for mobilizing investable funds. It also does not imply that EBI banks would submit themselves to such a low rate of return, except as the only alternative to the *zakah* penalty.
11. As mentioned earlier in the article, trading-based Islamic banks utilize *murabahah/bay' bi thaman ajil* contracts for all consumption and production sales and purchases. An equity-based Islamic bank will instead establish an equity relationship with a company that handles the *murabahah* business directly, which justifies its procyclical behavior.
12. For example a residential property costing $100,000 can be bought on credit at $180,000 payable in 20 years. Under such terms, it is unlikely that the owner would find it easy to dispose of the property for capital gain unless there were a desperate buyer willing to buy the property at $180,000. Therefore, the *murabahah* contract, which involves money–commodity transactions, is quite different from conventional lending, in which money–money transactions remain the main ingredient of trade.
13. For convenience, the term *murabahah* may also be used to imply *bay' bi thaman ajil* (BBA) when long-term purchase of assets is involved. Thus the *Ms/Mb* ratio can be renamed the *Ms/BBA* ratio if the bulk of a bank's assets are diverted into long-term trading investments.

the loan was extended to arrive at the "loan value" of the debt. The bank and the borrower should exchange equivalent loan values so that the "measure of deprecation suffered by the lender... is also the measure of gain received by the borrower" (p. 57). Under this model, a person wishing to "borrow" Rs. 1,000 from the bank for one year should "lend" Rs. 125 to the bank for eight years plus provide collateral worth 110 percent of the value of the loan when he takes out the loan from the bank. In essence, the "borrower" would actually receive a net loan of Rs. 875.

Furthermore, "loans cannot be advanced to people [without adequate means] who possess neither the requisite collateral nor the requisite counter loan, though some manipulation in the latter condition is possible ... by deducting counter-loan from the loan advanced, [but] no such relief is possible in the matter of collateral" (p. 124). Thus while a loan advanced by the bank would be protected by collateral, no such protection would be given to the loan of the individual to the bank. Moreover, the original amount would be returned to the bank after one year while to the "borrower" only after eight years. This means that fluctuations in purchasing power due to inflation and deflation are ignored altogether.

More interesting, the author himself concedes in an earlier work that equivalent exchange of loan value is impractical.

> Supposing a man needs Rs. 100,000 from a bank for one year to start a business. It is not unlikely that such a man may have Rs. 10,000/- of his own. Can he give Rs. 10,000/- to the bank for ten years? A loan of Rs. 100,000/- for one year has the same value as a loan of Rs. 10,000/- for ten years. We have struck the equilibrium we sought for. But have we? This is not equilibrium, because a financial institution has overhead costs to bear to run the establishment, and those who run it do so just to make money. Our equilibrium has not taken this into consideration. Let us meet the problem by an increase in the multiples of time.
>
> If a counter loan of Rs. 10,000/- for ten years is not an enough recompense for a loan of Rs. 100,000/- for one year, it becomes a question of accountancy and experience to discover the right recompense in time. Rs. 10,000/- for 15 years may be the correct answer, which not only compensates a loan of Rs. 100,000/- for one year but also helps meet overhead expenses and leave some reasonable margin as profit.[2]

Thus the equivalent exchange is impractical because the value sacrificed by the borrower outweighs the value sacrificed by the lender.

Ahmad argues that Keynes was in "doubt whether institutional and psychological factors will allow interest to fall to a level at which full employment can be attained. He therefore feels forced to regard a technical minimum of around two percent as necessary" (p. 27). He further maintains that "forcible squashing or even reducing interest generates a black market for money loans at exorbitant interest rates" (p. 14). Yet he commends his TMCL concept, even though it is based on zero rate of interest.

The question of why banks should extend loans at zero rate of interest was raised and answered earlier by the author in his "Interest in Islam." "Here someone may object: the bank has not earned anything except some time. The bank cannot pay his employees BITS of time that it has earned. This of course is not a problem. Time can be converted into money.... Investments in trade, in industry, in stock exchange, in real property are all various ways of turning time into money. We can depend upon bankers to discover what will be the best manner of investment."[3] If so, is it not more practical to let banks levy service charges instead of recovering overhead costs through investments? Moreover, why should banks not then employ all their funds in remunerative investments instead of issuing interest-free loans without remuneration? Of course, profitable investment would require participation of banks in productive projects on profit-sharing arrangements such as *shirkah*, *mudharabah*, *bay' muajjal*,

and *bay' al-ina*. But to Ahmad, *shirkah* and *mudharabah* are not viable bases for interest-free banking. If adopted, he says, they would prove "obsolete" because most of the loanable funds are borrowed by governments to cover fiscal deficits. Besides, *shirkah* and *mudharabah* fail to satisfy demand for consumption loans, require supervision, and severely curtail the number of borrowers while drastically increasing unemployment, leading to explosive political consequences (p. 45). Interestingly, though, the author himself advocated *shirkah* in his *Economics of Islam*.[4] By now, however, he sees his earlier advocacy as a "dereliction" and a "stupendous error" (p. 44).

Bay' muajjal is seen as a "stratagem" to avoid the name of interest while keeping it intact in spirit. According to Ahmad, the practice of *bay' muajjal* is prohibited by the Prophet (*s.a.w.*). However, in view of the *hadith* that prohibits "sale of a debt for another debt," the TMCL is granted legitimacy on the pretence that "no rise in the quantum of counter loan compared with the loan advanced is stipulated" (p. 132).

Ahmad's arguments in respect of savings, deposits, demand for loans, and inflation are simply naive, to say the least. For example, he quotes Kyenes' dictum "that highest level of savings can only be obtained at the lowest level of interest" to claim that the "highest possible savings must occur at zero rate of interest" (p. 60-61). Extinction of statutory reserves is suggested first to meet increased demand for loans, but later such reserves are reintroduced, as is apparent in the statement, "it is true that this does not work upto 35% bank reserve at present obtaining in Pakistan. By raising the percentage of counter loan, it is entirely possible to reach that level as well" (p. 68). Inflation is to be controlled by denying "all non-productive loans whether related to consumptional or speculative or even government deficit covering purposes" (p. 71). Success of the TMCL concept depends on the unwarranted assumption that there is a direct relationship between the 'absence of interest' and 'growth rate' in an economy. Even if this assumption were true, however, it would not mean that the elimination—or substitution—of interest necessarily leads to higher growth rate. Rather, higher economic growth would reduce demand and increase the supply of loanable funds, resulting in a lower interest rate.

It is also interesting that the Quranic support claimed for both *qard al-hassan* and TMCL results from a plain misinterpretation of the relevant verses. The Qur'an uses *qard al-hassan* to imply spending in the way of Allah only and not to imply a loan at zero rate of interest.[5] Stretching the idea of *qard al-hassan* to justify exchange of debts under TMCL on the basis of "good begets good" (*hal jazaul ihsan illal ihsan*) is, to put it mildly, manipulative interpretation of the Qur'an to justify 'debt against debt' which is prohibited by the *hadith*.

All said and done, the author's proposals for the elimination of interest without appropriate returns to financial capital, the TMCL concept, 110 percent collateral, and elimination of consumption loans and government loans to cover deficits are unsound, impractical, and, of course, of doubtful Islamic validity.

NOTES

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1. An article under the same title "Man and Money" appeared in *Islamic Studies* 9 (1970): 217-44.
2. Shaikh Mahmud Ahmad, "Interest in Islam," in *Readings in Islamic Banking*, ed. Ataul Hoque (Dacca: Islamic Foundation Bangladesh, 1987), 19-20.
3. Ibid., 20.
4. Shaikh Mahmud Ahmad, *Economics of Islam*, reprint ed. (Lahore: Sh. Muhammad Ashraf, 1977), ch. 7.
5. See Surah al-Baqarah (2): 245; Surah al-Ma'idah (5): 12; Surah al-Hadid (57): 11, 18; Surah al-Taghabun (64): 17; and Surah al-Muzzammil (73): 20.