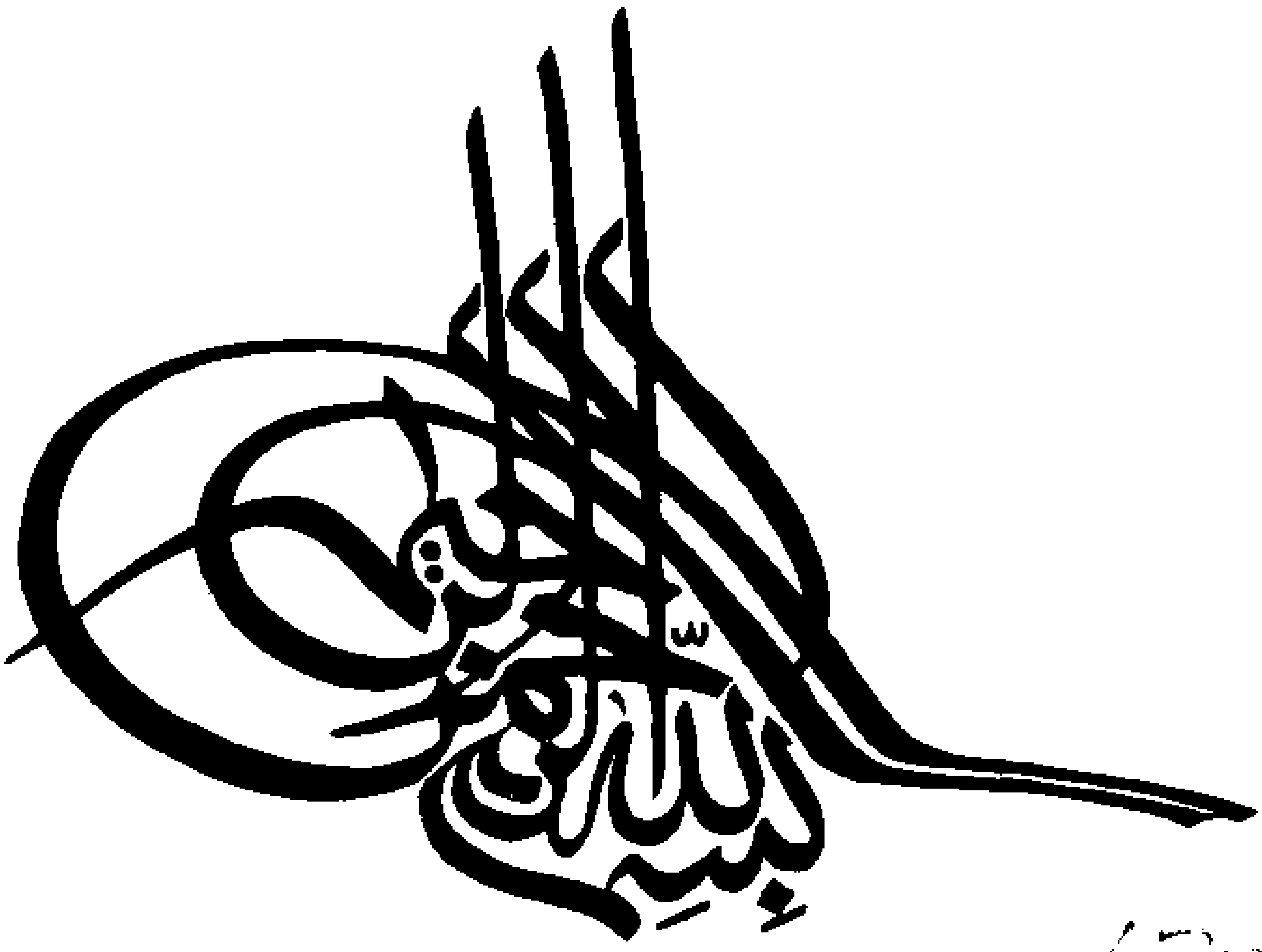
MONEY AND BANKING IN ISLAM

ZIAUDDIN AHMED
MUNAWAR IQBAL
M. FAHIM KHAN

INTERNATIONAL CENTRE FOR RESEARCH IN ISLAMIC ECONOMICS
KING ABDUL AZIZ UNIVERSITY, JEDDAH

INSTITUTE OF POLICY STUDIES,
ISLAMABAD



IN THE NAME OF ALLAH,
THE MERCIFUL,
THE MERCY-GIVING

MONEY AND BANKING IN ISLAM

Edited by

ZIAUDDIN AHMED
MUNAWAR IQBAL
M. FAHIM KHAN

International Centre for Research in Islamic Economics
King Abdul Aziz University, Jeddah
and
Institute of Policy Studies, Islamabad

Produced for the

**International Centre for Research in Islamic Economics,
King Abdul Aziz University, Jeddah.**

by

**Institute of Policy Studies,
3, St. 56, Shalimar–6/4,
Islamabad (Pakistan).
Tel: 24930**

Printed by

**Pap-Board Printers Ltd.,
277, Peshawar Road,
Rawalpindi Cantt.
Tel: 64108 – 66907**

Price:	**Paperback**	**Hardbound**
	Rs. 125.00	**Rs. 225.00**
	US $ 12.00	**US $ 20.00**

بسم الله الرحمن الرحيم

Contents

PART – II

ISLAMIC BANKING IN PRACTICE

Foreword

Perhaps it would not be an exaggeration to suggest that the field of money and banking represents an area in which most original and pioneering work has been done by Muslim economists and bankers during the last decade. At the intellectual level a number of conferences, seminars and colloquia were organised, amongst which the two seminars on the "Monetary and Fiscal Economics of Islam" held at Makkah (Oct. 1978) and Islamabad (Jan. 1981) were outstanding. The Makkah Seminar addressed itself to some of the major theoretical problems, while the Islamabad Seminar, along with further strengthening the theoretical research, undertook a thorough examination of the experiment in Islamic banking in different parts of the world in general, and the Report of the Islamic Ideology Council on the Elimination of Interest from the Economy in particular.

The Institute of Policy Studies, in cooperation with the International Centre for Research in Islamic Economics, King Abdul Aziz University, Jeddah, has already published a research report on the major contributions of the Islamabad Seminar. Now we are extremely happy to present the complete proceedings of the Seminar in two volumes. The first volume is devoted to the theme of money and banking in Islam, while the second volume shall have as its theme the problems of fiscal policy and resource allocation in an Islamic framework. Both these volumes are being offered in cooperation with the International Centre for Research in Islamic Economics, King Abdul Aziz University, Jeddah and have been edited by Dr. Ziauddin Ahmed, Dr. Munawar Iqbal and Dr. M. Fahim Khan. Dr. Ziauddin Ahmed has kindly acted as the chief editor for the two volumes, and has contributed a highly perceptive introduction to this volume, which in itself is an original contribution to the themes of the Seminar. Dr. Munawar Iqbal and Dr. M. Fahim Khan have worked hard to prepare these volumes for publication and I feel personally indebted to all three of them for their painstaking efforts. For a number of reasons work on the project started very late and the editors did not have more than a few months to complete this monumental task. It is nothing short of a miracle that the editing and publication of these volumes has been done in less than six months. May Allah bless these efforts and give the best of the rewards to the editors and the team of young workers who have seen it through the press. Our special thanks are due to brothers Khalid Rahman, Rao Muhammad Akhtar, Muhammad Ramazan Akhtar and Tariqullah for the almost round-the-clock efforts they have made to bring the first volume of the proceedings of this Seminar on the occasion of the Second International Conference on Islamic Economics (Islamabad: 19–23 March, 1983).

I would fail in my duty if I do not record our gratitude to Dr. Mohammad Omar Zubair, Dr. Omar Hafiz, Dr. Anas Zarqa, and Dr. M. Nejatullah Siddiqi for their cooperation, support and guidance. It is hoped that these two volumes will be of immense assistance to all those scholars, researchers, students and economic practitioners who want to have a better understanding of the monetary and fiscal economics of Islam. These volumes should be treated as companion volumes to the two books already produced by the International Centre for Research in Islamic Economics viz. *Studies in Islamic Economics* (Leicester: The Islamic Foundation, 1980), and *Monetary and Fiscal Economics of Islam* (ed. by Mohamed Ariff, Jeddah, International Centre for Research in Islamic Economics, 1982).

KHURSHID AHMAD

Institute of Policy Studies,
4, Jamadi al-Akhir 1403
20th March, 1983.

Introduction

These two volumes* comprise of ten papers presented at the International Seminar on Monetary and Fiscal Economics of Islam held in Islamabad, Pakistan in January 1981 along with the written comments of the main discussants on each of these papers and a gist of the general discussion following the presentation of the papers. The authors of the papers were provided an opportunity to revise their papers in the light of the comments made by the main discussants and others in the Seminar, and the present volumes contains the revised versions of these papers. The agenda of the Seminar also included a discussion on the Report on the Elimination of Interest from the Economy submitted by the Council of Islamic Ideology to the Government of Pakistan in June 1980. This Report is reproduced in this volume with the kind permission of the Council of Islamic Ideology.

The Seminar presented an excellent opportunity for an exchange of views on various aspects of monetary and fiscal economics of Islam. A unique feature of the Seminar was that, for the first time, it brought together a galaxy of prominent academic economists, policy makers and practising bankers of the Muslim World to dilate exclusively on this subject. The ground work for this Seminar was already laid by the contributions made by the Muslim economists at the Seminar on Monetary and Fiscal Economics of Islam held in Makkah in 1978. On that very occasion it was decided that a follow-up seminar should be held as early as possible to explore further the themes discussed there as also to appraise the progress of interest-free financial institutions that had started functioning in the Muslim World and to study the operational aspects of Islamic banking and finance. The Islamabad Seminar provided a valuable opportunity for the cross fertilisation of ideas among theoreticians, policy makers and practical bankers which resulted in greater understanding at the complex issues involved in remodelling the monetary and fiscal systems of Muslim countries in line

**Money and Banking in Islam*, and *Fiscal Policy and Resource Allocation in Islam*.

with Islamic injunctions. The results achieved by these two Seminars have been truly remarkable and have contributed immensely towards enlarging the frontiers of knowledge in this specialised branch of Islamic economics.

This introduction offers some general reflections on the work of the Seminar. It is not intended to be a summary of the discussions as a complete record of the proceedings is available in this volume after each paper. We have merely attempted to highlight the main points of the discussion and while doing so we have tried to synthesise the ideas expressed, wherever possible, and to indicate the divergence in views, wherever it appeared to be pronounced. Every care has been taken to faithfully reflect the views expressed by various participants both in the record of the proceedings and in this introduction but if there have been some lapses on our part, we wish to assure that these are entirely unintentional.

The papers presented at the Seminar dealt with almost all the major issues in the field of monetary and fiscal economics of Islam. For purposes of this introduction, it has been found convenient to cover the whole gamut of the discussions under certain broad heads. The first section deals with the distinguishing characteristics of an Islamic economy which have a bearing on monetary and fiscal policies and to which frequent references were made in the Seminar. The second section deals with the objectives and instruments of monetary policy in an Islamic economy. The third section reviews developments in the theory and practice of interest-free banking. The fourth section deals with issues related to fiscal policy. The fifth section deals with matters related to project evaluation in an interest-free framework and the likely impact of the abolition of interest on growth, stability and allocation of resources. The final section identifies certain areas for further research and study.

I

DISTINGUISHING CHARACTERISTICS OF AN ISLAMIC ECONOMY

The deliberations of the Seminar resulted in a reaffirmation of the view, already well crystallised in the literature on Islamic economics, that absence of interest-based transactions and presence of a well-functioning *Zakah* system are to be regarded as the two most distinguishing features of an Islamic economy. An Islamic economy has to conform to the dictates of Islamic *Shari'ah*. In view of the clear prohibition of interest in Islam, the financial system of an Islamic economy has to be organised on a basis which steers clear of interest. The Seminar provided an excellent opportunity for discussing ways and means of re-modelling the monetary and banking systems of Muslim countries in accordance with the tenets of Islam. The main points of the discussion are reviewed briefly in a separate section of this introduction. As for the *Zakah* system, participants in the Seminar regarded it as a basic ingredient of the Islamic economic order and one of the most important components of the Islamic system of social security.

It was also emphasised at the Seminar that social justice is the hallmark of the Islamic economic system, and abolition of interest and establishment of the *Zakah* system are to be seen as two major institutional devices to establish a just social order. Islam seeks to promote the virtues of *'Adl* and *Ihsan* among its followers and any society which is permeated by these qualities would need a minimum of state intervention to establish a just social and economic order. It is the responsibility of the state, however, to ensure social justice and, in the context of prevalent conditions, it is empowered to take all necessary actions within the framework of Islamic *Shari'ah* to achieve this objective.

Papers presented at the Seminar pointed to what the authors of these papers regarded as certain specific distinguishing characteristics of an Islamic economy having a special bearing on monetary and fiscal policies. Faridi concentrates on the expenditure pattern of Muslims guided by Islamic precepts in developing his idea of a "third sector" which he regards as a distinguishing feature of an Islamic economy. The argument runs somewhat along the following lines. Islam lays great stress on spending in the way of Allah to attain the welfare of *Al-Akhirah* (hereafter). There should be a great urge, therefore, on the part of Muslims to spend a good part of their income and wealth for bettering the lot of the poorer sections of the community through cash disbursements and improvement of community services. Payment of *Zakah* is of course obligatory on Muslims but they are exhorted to spend as much as possible, beyond this compulsory levy, on the general welfare of the community for their own spiritual uplift and to attain beneficient reward in the hereafter. Faridi states that empirical and historical evidence suggests substantial spending of this nature in Muslim countries. He attaches so much importance to such welfare oriented resource transfers in a Muslim community that he envisions an Islamic economy to be composed of three sectors, namely, public sector, private sector and a third "voluntary sector". The private sector is characterised by the forces of demand and supply and is actuated by the profit motive. In the public sector, profit motive is substituted by considerations of social welfare. The "third" or "voluntary sector" encompasses all such individual and social activities as are not motivated by material considerations but are undertaken for securing reward in the hereafter.

The concept of the "third sector" introduced by Faridi has a bearing on resource allocation in an Islamic economy. It reduces the role of the market forces in the allocation of resources, and since the activities of this sector are intended to directly raise the general economic and social welfare of the community, it leads to a more socially optimum allocation of resources. The composition of the national output is more need-oriented and less luxury-dominated. The government budget is relieved of a lot of social welfare expenditures which means that resort to taxation can be kept low in an Islamic economy.

The participants in the Seminar recognised the theoretical validity of the "third sector" in Faridi's scheme but questions were raised as to its quantitative significance in the context of the present state of Muslim societies. In fact, Faridi himself acknowledges in his paper that the volume of resources flowing through the "third sector" will be a function of the state of *taqwa* of an Islamic society. The general feeling as that fiscal policy will have to play a major role in present day Muslim societies in alleviating mass poverty and modifying the pattern of income distribution in line with the egalitarian objectives of an Islamic polity.

There was interesting debate on the question whether, as compared to other economies, an Islamic economy would be characterised by a higher average and marginal propensity to consume. Metwally is of the view that because of the "tax of *Zakah*", both the average and marginal propensities to consume would be higher in an Islamic economy. The proceeds of *Zakah*, he states, go mainly and directly to the poor and the needy and hence act immediately to raise the propensity to consume. It was pointed out by some participants that Metwally's proposition could not be treated as axiomatic because the consumption pattern of a society is determined by a host of factors. There is no doubt that the institution of *Zakah* serves to transfer purchasing power to poorer sections of society and reduces inequalities of income and wealth but it does not necessarily follow from this that the overall propensity to consume would be higher in an Islamic economy. Abu Ali refers to the work of Duesenberry who shows, with the use of Veblen's demonstration effect, that consumption as a proportion of a given level of income could be higher in a society characterised by larger inequalities of income and wealth. He believes that in an Islamic economy consumption would be less compared to other economies with the same level of income. Other participants also referred to Islam's emphasis on simple living and avoidance of ostentatious consumption which should serve to keep the overall propensity to consume lower in an Islamic economy. It appears that this is a field which admits of considerable pragmatism for the actual situation can differ from country to country, depending on the stage of a country's development, its historical background and the attachment of its people to the moral values of Islam.

II

OBJECTIVES AND INSTRUMENTS OF MONETARY POLICY IN AN ISLAMIC ECONOMY

The papers presented at the Seminar identified three major objectives of monetary policy in an Islamic economy, namely, stability in the value of money, economic well-being with full employment and optimum rate of economic growth, and promotion of distributive justice. Al-Jarhi emphasises that it is almost mandatory on the central bank of an Islamic economy to preserve the value of money and suggest, in this context, that the central bank should allow expansion of money supply only to the extent it is justified by a possible contribution to growth in real balances. Chapra is also of the view that stability in the value of money should be accorded high priority in the Islamic frame of reference because of the unequivocal stress of Islam on honesty and fairness in all human dealings and because of the negative impact of inflation on socio-economic justice and general welfare.

While inflation is incompatible with the goals of an Islamic economy, prolonged recession and unemployment are also unacceptable. Monetary policy has therefore to aim at a high rate of economic growth with full employment. Chapra, however, clarifies that maximisation of economic growth *per se* is not the objective of monetary policy in an Islamic economy. He emphasises that the requirement to attain material prosperity within the framework of Islamic values necessitates that it should not be attained through the production of inessential and morally questionable goods and services, should not lead to an excessive and overly rapid use of God-given resources at the expense of future generations and should not harm present or future generations by degenerating the moral or physical environment.

Most participants were of the view that monetary policy should be used actively to promote the goal of distributive justice in an Islamic economy. Ariff, however, was of the view that too much concern with distributive justice in formulating and implementing monetary policy may adversely affect its overall efficiency and effectiveness in attaining other goals of monetary policy. Ariff too, like other participants, subscribed to the view that reduction in income inequalities should be an important policy objective of an Islamic state but felt that instead of over-burdening monetary policy by assigning to it too many objectives, the goal of distributive justice should be achieved by activating other policy tools. In making this suggestion Ariff referred to the well known Meade-Tinbergen principle that the number of policy instruments should be equal the number of policy objectives; otherwise, there may be conflict of policy goals. The general feeling in the Seminar, however, was that it is difficult to follow the Meade-Tinbergen principle too faithfully in actual practice, and that an attempt has to be made to so chisel the monetary policy that, along with other policy tools, it makes an important contribution to the attainment of the goal of distributive justice.

The Seminar gave careful attention to monetary policy instruments that could be used in an Islamic economy to achieve the stated policy objectives. The general feeling was that abolition of interest, and the non-availability of the Bank Rate weapon to the central bank, would not constitute any serious handicap to monetary management in an Islamic economy. It was pointed out that control over the volume of money supply is a crucial factor in monetary management. Adequate control could be exercised on money supply in an Islamic economy by regulating high powered money, defined as currency in circulation and reserve assets of banks. Besides, use could be made of variations in cash reserve ratio, liquidity ratio and credit ceilings to bring about desired changes in money supply. Apart from controlling money supply, monetary policy is also capable of being used to influence the allocation of resources. In the interest-based system, variations in interest rates and policy-induced differentials in interest rates perform an important allocative function. This role could be performed by changes in profit-sharing ratios in an Islamic system. The actual manner in which the various monetary policy instruments may be used in an Islamic economy is discussed in the next section.

It was emphasised that the allocation of bank resources in an Islamic economy should be value-oriented to help realise the goal of general social welfare. Both Al-Jarhi and Chapra express dissatisfaction with the manner in which bank resources are utilised in the capitalistic system. Al-Jarhi points out that in the interest-based banking systems operating in capitalistic countries, solvency of the borrowers is a paramount consideration while the productivity of the investment undertaken is considered secondary. Chapra expounds the view that the monetary and banking arrangements in capitalistic countries tend to generate income inequalities because "society's resources mobilised by banks are utilised by them for enriching a few families." He, therefore, pleads for reduction in the financial power of banks. This, he feels, could not be achieved by the apparently simple expedient of nationalising the banks because "the place of businessmen and industrialists could easily be taken over by bureaucrats". He feels that the solution lies in: (a) having a larger number of banks and ensuring that none of them expands beyond a certain limit determined by the central bank of the country; (b) requiring the banks to provide financing to a larger number of entrepreneurs and limiting the provision of finance to any one business or family to a small proportion of banks resources; and (c) disallowing the inter-locking of directorates of banks and big business firms. Besides, special measures as deemed necessary may be taken by the central bank to bring about a more equitable distribution of bank finance. These could include inducement mechanisms, such as central bank introducing loan guarantee schemes to reduce the risk of financing in certain sectors, and compulsive measures such as setting of mandatory targets to ensure sufficient supply of bank resources for specified sectors or purposes.

Al-Jarhi goes a step further. He favours imposition of a 100 per cent reserve requirement on commercial banks. He justifies this on three grounds. Firstly, fractional reserves cause the monetary system to suffer from an "inherent instability" because any switch from "high powered money" to "deposit money" and vice versa changes the supply of money. With 100 per cent reserves such a switch will change only the composition of money, leaving its total supply constant. Secondly, changes in the money supply arising from deposit creation or resulting from substituting deposits and cash make it more costly to maintain the existing stock of real balances or to add to it. Thirdly, money creation is a social prerogative and hence the benefits of the process of money creation should accrue to the whole society which can best be achieved through 100 per cent reserve system.

Al-Jarhi outlines a model with 100 per cent reserve system in which the liquidity and financial requirements of the private business sector will be met by the central bank opening deposit and investment accounts in commercial banks and other financial institutions which in turn will invest these deposits in the real sector and share the profit with the central bank. Variations in the central bank's deposit accounts with the commercial banks will have the effect of bringing about the desired changes in money supply.

While there was general agreement with regard to the objectives of monetary policy in an Islamic economy as outlined by Chapra and Al-Jarhi, doubts were expressed by some participants whether replacement of the present monetary institutional framework by an entirely different model was absolutely necessary. Ziauddin Ahmed was of the view that problems of instability and inequity could be solved within the framework of the fractional reserve system. If there are suitable checks and balances, the process of money creation need not be unstable. Further, even in the fractional reserve system measures can be adopted to ensure that the allocation of derivative deposits is such that the benefits are equitably distributed. It seems that this is an area in which there are genuine differences of opinion among Muslim economists and further exchange of views would be fruitful.

III

THEORY AND PRACTICE OF INTEREST-FREE BANKING

Prohibition of interest in Islam necessitates that in countries seeking to introduce Islamic economic system, banking and financial practices be organised on a basis other than interest. Research work on the subject has proceeded to suggest that the principle of profit-sharing offers the best alternative to interest in an Islamic system. The participants in the Seminar were familiar with the work of Muslim economists in this field. Apart from this background they had the opportunity of going through the Report of the Council of Islamic Ideology on the Elimination of Interest (hereinafter referred to as CII Report) which was submitted to the Government of Pakistan in June 1980. Among the papers presented at the Seminar, those by Al-Jarhi and Chapra contained material on the subject. Besides, the paper presented by Fahim Khan reviewed the working of Islamic banks which had already started functioning in some countries.

There was overwhelming support in the Seminar for the view expressed in the CII Report that the ideal alternatives to interest in an Islamic economic system are profit/loss-sharing and *qard-hasanah*. The view is rooted in the Islamic philosophy of justice between man and man. To charge interest from someone who is constrained to borrow to meet his essential consumption requirements is considered an exploitative practice in Islam. Charging of interest on loans taken for productive purposes is also prohibited because it is not an equitable form of transaction. When money is invested in a productive undertaking the quantum of profits that may accrue is not known before hand and there is also possibility of a loss. Charging of a fixed and pre-determined rate of interest on loans for productive purposes cannot therefore be morally justified. Justice demands that provider of money capital should share the risk with the entreprenèur if he wishes to earn profit. Thus, there is a basic difference between Islam and capitalism in regard to the treatment of money capital as a factor of production. Whereas in the capitalistic system, money capital is treated at par with labour and land, each being entitled to a return irrespective of profit or loss, this is not so in Islam which treats money capital at par with enterprise.

The CII Report contains a detailed blueprint for reorganisation of banking practices and procedures on the basis of the principles of profit/loss-sharing in consonance with the Islamic legal concepts of *sharakah* and *mudarabah*. Under this system, the amount of return on the funds invested is neither fixed nor pre-determined. The quantum of profits depends on the operational results of the economic undertaking. When capital is provided entirely by one party and enterprise and/or labour entirely by another party the profit is to be divided in proportions agreed at the time of the contract while loss is to be borne by the provider of capital, unless it is due to the negligence of the entrepreneur/worker. If there are more than one providers of capital, profit is to be distributed among them in agreed proportions, while loss is to be shared by them strictly in proportion to their capital contributions.

The CII Report does not suggest any change in the institutional structure of the monetary and banking system. The central bank, the commercial banks and the specialised financial institutions would continue to perform the same functions as previously but their operating procedures would be modified to replace interest-based transactions by a system of variable return. Commercial banks would provide funds to business enterprises and would be entitled to receive a part of the profits earned by the enterprise in accordance with the agreed proportions stipulated in the *mudarabah* contract. For the purpose of profit distribution, the respective capital contributions of parties, utilised for varying periods, would be brought to a common denominator by multiplying the amounts with the number of days during which each particular item such as equity capital of the firm, its current cash surpluses, suppliers' credit as well as the finance provided by the bank were actually deployed in the business. In other words, the calculation of the respective capital contributions of the parties would be made on a daily product basis. As for deposits, the commitment on the part of the bank to pay a fixed return on savings and time deposits would be replaced by an agreement with the depositors to pay to them a part of the profits earned by the bank. Distributable profits would be computed by setting off the administrative expenses, payments due to the central bank and other banks in respect of finance provided by them, provision for taxes and appropriation for reserves from the total earnings. The amount of profit so arrived at would be divided between the shareholders of the banks and the holders of savings and time deposits, the basis of the calculation for apportionment of profits being the daily products of the amount of capital and reserves and the total amount of savings and time deposits. Commercial banks would also accept demand deposits but they would not share in the profit of the bank.

The methodology suggested in the CII Report for the elimination of interest from the transactions of the non-bank financial intermediaries and specialised financial institutions is modelled more or less on the same lines as in the case of commercial banks. A somewhat different procedure has been suggested for providing housing finance which is based on the sharing of the actual or imputed rent.

No change is contemplated in the functions and responsibilities of the central bank. However, its operating procedures and the contents and substance of some of its monetary policy instruments would undergo significant changes consequent to elimination of interest. These are discussed in detail in CII Report. The Bank Rate weapon is proposed to be replaced by an alternative instrument of control to influence the total availability of bank finance as well as the allocation of bank finance among competing uses. This consists of empowering the central bank to vary the profit-sharing ratio on the basis of which it would provide financial assistance to banks. It can also be empowered to prescribe profit-sharing ratios for banks in respect of finance provided by them to business firms and, as observed in the CII Report as well as by Nejatullah Siddiqi, variations in such profit-sharing ratios can powerfully influence investment decisions in the desired direction. The central bank's power to require the commercial banks to maintain minimum cash reserves with it against their demand and time liabilities and to vary this ratio from time to time will remain unaffected by the elimination of interest. It will be possible to retain liquidity ratio requirement as an instrument of monetary policy with the only change that the interest-bearing securities held in the portfolio of the banks will have to be replaced by such financial instruments as are permissible under the *Shari'ah.* The central bank's role as "lender of the last resort" as well as the provision of refinance by it to commercial banks and other financial institutions would not be affected by the abolition of interest. However, under the new system such assistance would in general be provided under profit-sharing arrangements or other alternative methods permissible under the *Shari'ah.*

The CII Report recognizes that there are certain spheres where it will not be possible to use the system of profit/loss-sharing so that use will have to be made of alternative devices to replace interest. The most prominent case of this type relates to government borrowings from the banking system as well as the non-banking sector. The CII Report suggests that the banking system should provide loans to government on interest-free basis within the safe limits of monetary and credit expansion. Some participants in the Seminar pointed to the possibility of indexation of government loans and small savings schemes and felt that by preserving the real value of *qard-hasanah,* indexation fulfilled the Islamic imperative of socio-economic justice and should therefore be permissible. Others pointed out that under the *Shari'ah* currency transactions are not treated differently from commodity transactions in as far as lending and borrowing are concerned. The basic principle in this respect, they pointed out, is that the same quantity should be returned as was borrowed even though the price of the commodity may have changed in the meantime. The possibility of the use of indexation in the dealings of the banks with private clients, particularly in respect of mobilisation of deposits, was also discussed in the Seminar but, in view of the lack of unanimity of views on this issue, it was considered a suitable subject for further research and study.

Another area where interest cannot be replaced by profit-sharing relates to government borrowing from external sources. The Council of Islamic Ideology recognised the difficulties in the elimination of interest from transactions relating to international loans and aid and has therefore acquiesced in government borrowing from abroad on the basis of interest for the time being. The CII Report, however, expresses the hope that if Muslim countries work jointly, reduce reliance on outside assistance and promote movement of capital among themselves on the basis of profit/loss-sharing or some other non-interest basis, it is not unlikely that, with the passage of time, non-Muslim aid-giving countries and international financial institutions may also begin to deal with Muslim countries on a basis compatible with *Shari'ah*.

The CII Report gives due recognition to difficulties that may arise in changing the whole system to profit/loss-sharing in one step. It has therefore given qualified approval to certain other methods being used in conjunction with profit/loss-sharing like leasing, hire-purchase, *Bai Muajjal*, investment auctioning and financing on the basis of normal rate of return*. However, cautioning against the danger that such methods could open a back-door for interest, it emphasises that their use should be kept to the minimum extent that may be unavoidably necessary under given conditions and that their use as general techniques of financing must never be allowed. The participants in the Seminar were even more emphatic in sounding such a note of caution. They were strongly of the view that, keeping in view the rationale for the condemnation and prohibition of interest in Islam, no mechanism other than profit/loss-sharing really conformed to the spirit of Islam.

It was recognised, however, that the concept of profit-sharing cannot be applied in the case of personal loans taken for meeting consumption requirements. It was felt that in a truly Islamic society, the need for such loans should be minimal as Islam emphasises austerity and exhorts people to live within their means. Moreover, the *Zakah* system is expected to assist persons who find it difficult to meet their essential consumption requirements from their own earnings. Still some arrangements would need to be made to meet loan requirements of an emergent nature arising from temporary causes. Some participants in the Seminar were of the view that such requirements should be met by stipulating that each bank should devote a small percentage of its resources for interest-free lending. Others were of the view that banks should not be burdened with this responsibility and separate consumer loan institutions should be organised for the purpose with resources contributed by the Government or derived from *Zakah* proceeds.

The Seminar also devoted attention to the evolution of new financial instruments to suit an interest-free system. In this context, the recommendation made in the CII Report to replace debentures with

*The concepts and operating procedures of these methods have been explained in Section I of the CII Report.

a new type of corporate security to be called the Participation Term Certificate based on the principle of profit-sharing was noted with interest. Al-Jarhi in his paper has mooted the idea of banks offering various types of certificates to mobilise investible resources which he has named as Specific Investment Certificates, General Investment Certificates, Profit-sharing Certificates and Leasing Certificates. Al-Jarhi also suggests the issuance of Central Deposit Certificates by the central bank of the country to attract the savings of the people on a profit-sharing basis. The idea is that savings thus mobilised should be placed by the central bank in the investment accounts of different commercial banks and profits realised from such investment should be distributed among the holders of Central Deposit Certificates. This seems to be a promising idea because, as Al-Jarhi states, such Certificates would give a more stable yield on account of diversified investment and would therefore make a useful addition to the variety of financial instruments that would be available for investment in an interest-free economy.

The Islamabad Seminar did not confine itself only to theoretical aspects of interest-free banking. It had an occasion to review the actual field experience in the conduct of interest-free banking operations in the Muslim World. The paper presented by Fahim Khan gives a good deal of information about the actual operating procedures of a number of Islamic banks some of which were personally visited by him. The participants in the Seminar also had the opportunity to hear the executives of some of the Islamic banks who expounded the methods of their working.

It was apparent from the paper presented by Fahim Khan that interest-free banking, which still recently existed only in the realm of theory, has now a lot of practical experience to offer. At the time the paper was written, interest-free banks were already functioning in Sudan, United Arab Emirates, Kuwait, Bahrain, Jordan and Egypt. Two other interest-free institutions were located in European countries. Besides, the Islamic Development Bank, which is a multilateral financing institution of the Muslim World, had been in the field for some years. In Pakistan, interest had been eliminated from the operations of a number of specialised financial institutions and more than 6500 branches of Pakistani banks had just embarked on interest-free banking by opening separate counters where people could deposit their savings which banks undertook to invest in profitable but interest-free avenues.

The review of the working of the interest-free banks in Fahim

Khan's paper shows that these banks have successfully devised banking practices which are in conformity with *Shari'ah.* They accept both current deposits and deposits committed for investment which are called Investment Accounts. The Investment Accounts are usually of two types, namely, accounts with authorisation and accounts without authorisation. In the accounts with authorisation, the account holder authorises the banks to invest the money in any project. In the other type, the account holder may choose any particular project for investment of his deposited money. On the assets side, these banks were found to be operating on the basis of *musharikah* and *mudarabah* which are essentially profit-sharing arrangements. Besides, business is conducted on the basis of *murabaha* under which the bank buys a specified item for the client who agrees to pay the bank later, in lump sum or instalments, a price including an agreed percentage of profit.

The performance of the banks in respect of profits earned appeared to have been quite encouraging. The profit rate on capital in the case of Islamic banks included in Fahim Khan's study is reported to have been in the range of 9 to 20 per cent. This was not much different from the profitability of interest-based banks in the same areas. Persons holding investment accounts in these interest-free banks are reported to have received a return ranging from 8 to 15 per cent which is again comparable to rates of return available in interest-based banks.

It appears that the banks included in Fahim Khan's study showed a preference for financing trade and investment in real estate. They generally seemed to have looked for projects with quick returns. This is not difficult to understand because most of these banks had been only recently established, and to face competition from well established interest-based banks they must have been anxious to show good profitability even in the initial years of their operation. Moreover, appraisal of long gestation investment projects requires technical expertise of a high order which it takes time to assemble. One ought to remember also that these banks are operating in a scenario which is dominated by interest-based banks which have close inter-bank relationship and can also get financial support from the central bank of the country in time of need. The interest-free banks, on the other hand, have no support of this type as they cannot borrow from interest-based institutions. Viewed in the context of the handicaps they face their performance appears to be commendable. The real value of their contribution lies in the fact that they have blazed the trail for others and prepared the ground for further advancement in this field.

IV

ROLE OF FISCAL POLICY

There was a wide-ranging discussion on the role of fiscal policy in an Islamic economy which touched on almost all aspects of public finance. The starting point of the discussion was whether the objectives of fiscal policy in an Islamic economy were in any way different from those in other countries. The papers presented by Faridi, Salama, Kahf and Metwally strongly emphasise that fiscal policy in an Islamic state should have an ideological orientation. Specifically this means that fiscal policy in an Islamic economy has to be evolved in the ideological framework of Islam and cannot be value-neutral. It is the responsibility of an Islamic state to promote Islamic values and, since Islam gives equal attention to both material and spiritual welfare, the state policies including fiscal policy have to reflect this basic philosophy. This then is the distinguishing feature of fiscal policy in an Islamic economy.

An Islamic state has to defend both its geographical and ideological frontiers. It should have enough resources to maintain a strong defence capability. It has also to guard the faith of the people and to keep them Islamically motivated. Further, it has to ensure that basic economic needs of the entire population are adequately met. Like other states, an Islamic state has also the responsibility for maintaining law and order and for providing the necessary infrastructure to promote economic growth. There was no difference of opinion among the participants in the Seminar in regard to these basic functions of an Islamic state. There was a shade of difference, however, in regard to the responsibility of an Islamic state to raise the living standards of the poor beyond subsistence level by direct state action. Kahf is of the view that the responsibility of the state ends after ensuring the fulfilment of a "socially determined subsistence standard of living" for the poor which includes indispensable food, clothing and shelter. Most others feel that the Islamic state should also be active in reducing inequalities of income and wealth and in promoting an egalitarian economic and social order.

The view one holds about the responsibilities of an Islamic state has an important bearing on his views about the taxation policies that should be followed. Thus Kahf stands for a low level of taxation and quotes the views of early Islamic thinkers like Imam Malik, Ibn Hazm and Kattani that imposition of taxes over and above *Zakah* is justified only to meet defence needs, assurance of a subsistence living for the poor and the indispensable expenses that safeguard the collective interests of Muslims. Kahf is also against the use of taxation for purposes of income redistribution. He is in favour of giving maximum scope to private effort and enterprise so that economic activity proceeds without being inhibited by high levels of taxation. Other participants took a more pragmatic view about the scope and justification for additional taxation in an Islamic economy. They felt that the state has a wide discretion in determining the limits of taxation. They favoured active use of tax policy for achieving the goals of an Islamic society which, they believed, include promotion of an egalitarian socio-economic order, acceleration of economic growth and maintenance of monetary stability. However, all were agreed that to keep taxation within reasonable limits, all wasteful expenditure should be avoided and administrative expenditures should be kept to the minimum.

A good deal of attention was focussed in the Seminar on the potentialities of *Zakah* as an instrument for eradicating poverty, as an income redistributive measure and as a stabilisation device. *Zakah*, it was recognised, was the most important component of the social security system of Islam. However, ability of *Zakah* alone to eradicate poverty depended on the number of people who needed *Zakah* assistance in a particular country. If the teachings of Islam are faithfully followed in a society, glaring income inequalities would not exist nor would there be many people subject to abject poverty. In such a situation proceeds from *Zakah* should suffice to eradicate poverty. However, if for historical reasons and neglect of Islamic teachings, the number of poor people in a country is very large, it is the duty of an Islamic state to supplement the resources obtained through *Zakah* by other means to meet the minimum basic needs of the poor.

The importance of *Zakah* as an essential income redistributive mechanism in an Islamic economy was emphasised by several participants. The payment of *Zakah* is obligatory on Muslims possessing *nisab* while those who do not possess *nisab* are eligible to receive assistance from *Zakah* funds. Faridi is of the view that *nisab* allows for a dynamic interpretation in terms of cost of living index and reasonably defined current standards of living. He brings in the concept of the "poverty line" in this context and suggests that government may designate a poverty line based on current living standards. Persons having income above the poverty line would be required to pay *Zakah* and those having income below the poverty line would be eligible to receive the transfer payment. This view of *nisab* differs from the traditional view according to which *nisab* is fixed not in terms of income but in terms of possession of a certain quantity of gold or silver or assets equivalent in value to that quantity of gold or silver. There was not enough discussion on this point in the Seminar and it would perhaps be useful to take it up again on some other occasion. Another point made in connection with the redistributive aspects of *Zakah* was that if glaring inequalities of income and wealth exist in a society, *Zakah* alone may not suffice to achieve the desired reduction in such inequalities, especially because the *Zakah* rates are fixed and cannot be changed. It follows from this that an Islamic state would have to use other fiscal policy instruments, including progressive taxation, for redistributive purposes.

The use of *Zakah* as a stabilisation device also figured in the discussions. Some participants pointed out that *Zakah* could be used as a counter-cyclical device as it is not obligatory on the state to disburse all the *Zakah* proceeds within a particular time period. Thus, some part of *Zakah* proceeds could be withheld in an inflationary situation and these funds could be released to increase purchasing power in a period of depressed economic activity. However the general feeling was that as *Zakah* rates are fixed and the purposes for which *Zakah* proceeds can be used are also prescribed in *Shari'ah*, there is not much scope for using *Zakah* as a stabilisation device. Moreover, the primary aim of the *Zakah* system is to help the poor and it would not be appropriate to withhold disbursements from the *Zakah* collections to serve as an anti-inflationary purpose in the face of persistence of poverty.

The theme recurred again and again in the Seminar that though *Zakah* is a basic pillar of Islam and serves a highly important purpose, it should not be expected to achieve all the objectives of an Islamic state. Faridi puts it explicitly when he says that "Islamic tax system should be so structured as to fill the 'objectives gap' indicated by or incidental to *Zakah*". He goes further and states that there is nothing wrong in using other instruments of fiscal policy even to modify the economic effects of *Zakah* if this is considered necessary from the viewpoint of the general welfare of the *Ummah*. On the other hand, if certain developments in the economy tend to frustrate the objectives of *Zakah*, other fiscal policy instruments should be used to arrest or control them.

Metwally assigns highest importance to fiscal policy in an Islamic economy to achieve the economic objectives of an Islamic state. He is of the view that major reliance will have to be placed on fiscal policy to achieve stabilisation and equilibrium in the money market in an Islamic economy because monetary policy without the availability of the interest rate weapon will not be able to achieve this objective. In this connection he puts forward the idea of "economic dues" on "both incomes and idle assets" whose rates may be varied from time to time for stabilisation purposes. An increase in the rate of dues on idle cash, he claims, can be used to bring about a reduction in the quantity of money demanded at a given level of income. By making the alternative to investment more costly, the enhancement of economic dues can stimulate private investment. Metwally's proposal is theoretically attractive but its practical implementation will not be easy. Moreover, the main problem with his idea of variable economic dues on idle cash is that it may in effect amount to varying the rate of *Zakah* which is not permissible in *Shari'ah*. His fear about the inability of monetary policy to achieve an equilibrium in the money market in the absence of interest rate weapon also appears to be unfounded as models have been developed by Muslim economists which show that alternative mechanisms are available in an Islamic economy to bring about the necessary equilibrium in the money market.

Attention was also given in the Seminar to ways and means of meeting the budgetary deficits of the governments in Islamic countries. It was recognised that taxation has its own limitations as a means of raising resources, and government may need to borrow to meet inescapable needs. One way of meeting the situation is suggested by Chapra in his paper. This consists of making a provision for interest-free borrowing by the government from the commercial banks in some proportion to the interest-free demand deposits held by them. The other option consists of central bank making the needed resources available to the government on interest-free basis. Borrowing from the central bank has of course to be kept within reasonable limits to safeguard monetary stability but there appears to be nothing wrong in government borrowing from the central bank from the viewpoint of *Shari'ah*.

V

GROWTH, STABILITY AND RESOURCE ALLOCATION IN AN ISLAMIC ECONOMY

Apart from monetary and fiscal issues, the participants in the Islamabad Seminar had an occasion to discuss the macro-dynamics of growth, stability, equilibrium and resource allocation in an Islamic economy. While reviewing contributions in this field, one has to bear in mind that a full-fledged Islamic economy does not exist anywhere in the world at present. Many of the propositions advanced in these contributions are therefore in the nature of hypotheses rather than definitive conclusions derived from observed behaviour of an Islamic economy. This, however, does not detract from the value of these contributions. In fact, theoretical constructs of this nature are essential building blocks for the science of Islamic economics. Moreover, they help in envisioning the inner working of an Islamic economy consequent to its taking practical shape in any country.

The theme that an Islamic economy would be a dynamic, growth-oriented economy recurs frequently in the literature on Islamic economics. As mentioned in the first section of this introductory note, an Islamic economy has two main distinguishing features. Firstly, it does not allow transactions based on interest. Secondly, it has a well-functioning *Zakah* system. Both these features can be expected to provide a powerful stimulus to growth. That the interaction between the incentive and disincentive effects arising from these two basic features of an Islamic economy serves to promote growth is demonstrated once again by Metwally in his paper. He first states the familiar proposition that by penalising idle resources, the *Zakah* system discourages hoarding and stimulates investment. He then proceeds to demonstrate formally that the demand for investment at a given expected rate of profit will always be higher in an Islamic economy compared to other economies. Since investment is one of the most important determinants of the rate of growth, it follows that an Islamic economy would have a pronounced growth orientation.

An apprehension is sometimes expressed that savings which are essential for capital formation and growth, would be discouraged in an Islamic economy because of the prohibition of interest. In fact, some writers go to the extent of suggesting that all savings will cease at a zero rate of interest. The argument employed is that people have a positive time preference, and unless the interest rate is positive, the positive time preference cannot be transformed into negative time preference which is necessary for savings to take place. Anas Zarqa questions the tendency to take positive time preference for granted. In his paper he conclusively demonstrates 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 inter-temporal choice (the other two being zero and negative time preference) each of which is rational and observable under its own conditions. Intuitively also one finds it difficult to believe that people will stop saving if the interest rate is zero because motivations for savings are many and varied and most of them would continue to operate to bring forth positive savings even if the return on savings is zero.

However, even if it is assumed that everyone has a positive time preference, it does not follow that a society cannot do without the institution of interest. What is needed to transform a positive time preference into a negative time preference is the existence of some return on saving. This can be either a fixed return or a variable return. As the CII Report points out, abolition of interest does not mean that the saver will not get any return on his savings. In a system based on Islamic principles, the saver will continue to get a return on his savings; the only difference would be that instead of being fixed in money terms the return would be variable.

It is necessary to probe into this matter further for it can well be argued that the fact of variability of return on saving, including the possibility of making a loss, may discourage saving. However, this argument also does not bear close scrutiny. We know that savers in the interest-based system too are faced with uncertainty of return because while the nominal rate of interest is fixed, the real rate of return on saving is uncertain on account of the unpredictivity of the actual extent of the change in the price level in a future time period. In fact, savers in an interest-based system get a negative return, which means they suffer a loss in real terms, whenever the rate of inflation exceeds the rate of interest. It is true that savers in an Islamic economy face a double uncertainty, that is, uncertainty about the nominal yield and the uncertainty about the inflation rate. However, it is by no means axiomatic that the saver in an Islamic economy will be worse off because of this double uncertainty because, under a porfit-sharing system, increases in the nominal price level are likely to be associated with increases in the nominal return on investment and this could even reduce the variability of the real yield on saving.

Nejatullah Siddiqi has sought to demonstrate in his paper that change-over to interest-free system will not only foster growth but would also lead to greater equity. In the interest-based system, the entrepreneur has to bear all the risks and all the losses. Losses often arise from unexpected developments and changing valuation of products by society which, due to imperfect foresight, cannot be accurately foreseen by the entrepreneurs. Losses are a natural concomitant of the changing economic scene and serve as guides in the restructuring of investment and redirection of productive enterprise. The entrepreneur performs a socially useful function in the society. He is often an agent of change and his productive activities create employment opportunities for others. In line with its humanistic approach, the Islamic system gives a fair deal to everyone. It does not give a privileged position to providers of capital by insulating them from all risk. The price the society has to pay for changing valuations and imperfections of human foresight is, in a profit-sharing system, shared by the providers of capital and entrepreneurs in a manner which does not disable or destroy any one and serves the ends of equity.

Consideration was also given in the Seminar to the implications of a change over to an interest-free system for the stability of the system and for allocative efficiency. In his paper, Nejatullah Siddiqi seeks to demonstrate that replacement of interest by a system of profit-sharing will cause no problems as regards its smooth functioning and stability. In this context it seeks to dispel the apprehension expressed in certain quarters that a profit-sharing system will be exposed to wide fluctuations as the changes in the entrepreneurial profit will be communicated back all along the line. The two profit-sharing ratios on which attention is concentrated in the paper and which have relevance for the stability of the system are the ratios in which business profits are shared between the bank and the entrepreneur, and the ratio in which bank profits are shared between the bank and the depositors. The paper employs a partial equilibrium approach to analyse the likely behaviour of these two profit-sharing ratios in a changing business situation. The original version of the paper presented at the Seminar gave the impression as if the author believed that his main thesis has been proved by demonstrating the long run stability of these ratios. Some of the deficiencies of the analytical apparatus employed by the author and the arguments used by him in reaching this conclusion were pointed out by Ziauddin Ahmed and other participants in the Seminar. In the revised version of the paper, included in this volume, the analysis has been considerably refined but it is doubtful whether the point that the author is trying to make is even now fully established. However, this does not detract from the value of his contribution. In fact, the paper by Nejatullah Siddiqi has served a very useful purpose by stimulating further thought in a difficult area of macro-dynamics of an Islamic economy.

It might be in order to mention at this stage that fluctuations in the money rate of return on deposits under a profit-sharing system should not be a cause for concern. Neither should this be regarded as a factor necessarily militating against the stability characteristics of an Islamic economic system. In fact, if the rate of return to depositors rises in money terms in an inflationary situation, it would help preserve the real rate of return on deposits and will serve an economically useful purpose. In recent years even the interest-based economies have witnessed considerable fluctuations in money rates of return. In fact, gyrating interest rates and continuously fluctuating exchange rates are now a familiar part of the economic scenario in Western economies.

Allocative efficiency of an interest-free economy has been an area of major concern for the Muslim economists. The paper presented by Anas Zarqa at the Islamabad Seminar, the revised version of which is published in the second volume (Fiscal Policy and Resource Allocation in Islam), represents a great step forward in this field. The main contribution of the paper lies in an effective refutation of the thesis that interest is indispensable for an efficient allocation of resources. Anas Zarqa does not deny that investment efficiency requires the use of discounting to take proper care of the time dimension of costs and benefits. He, however, emphasises that use of an interest rate is not inescapable for discounting purposes. In fact, he forcefully argues that interest rate is not the proper discount factor under conditions of uncertainty even in interest-based economies. Under conditions of uncertainty, the rate of return on equity is the proper discount rate. Since the real world is a world of uncertainty and since no real investment in any economy can be undertaken without facing risks, cash flows of such investment should be discounted not by a riskless interest rate but by the true opportunity cost of venture capital.

Participants in the Seminar were unanimously of the view that discounting as a technique of computing the present value of future cash flows does not violate any Islamic injunction. Work is necessary, however, to determine an appropriate discount rate for an Islamic economy. Anas Zarqa suggests rate of return on equity as the appropriate discount rate but does not suggest any specific procedure for choosing a representative rate for the purpose. Masudul Alam Choudhry, in his paper, outlines a methodology for calculating an appropriate discount rate for an Islamic economy. This turns out to be a sum of the marginal efficiency of investment determined through a process of inter-temporal allocation of income to real investment and of the price for risk bearing in a *mudarabah*. This is one possible approach to project evaluation in an Islamic economy and opens the way for further work in this field.

VI

AREAS FOR FURTHER RESEARCH AND STUDY

A survey of the available literature on Monetary and Fiscal Economics of Islam, including papers presented at the Makkah and Islamabad Seminars, shows that there is vast scope as well as need for further research and study in this specialised field of Islamic Economics. The following areas appear to deserve special attention.

1. Reform of the Monetary-Institutional Framework in the Islamic Perspective

The present monetary-institutional framework in Muslim countries is the product of an era in which Muslim societies had lost their dynamism and ideological orientation. It is necessary to examine what changes are needed in the existing framework to achieve the goals of an Islamic society. Such an examination may reveal the need for the setting up of some new institutions and the reform of some of the existing institutions. The Islamic financial system is pivoted on equity financing but this has remained a neglected field in many Muslim countries. Stock exchanges, which specialise in dealing in equity issues, are not well developed. Some of the existing practices in stock exchanges may also not be in conformity with *Shari'ah*. Very few countries have Investment Trusts. Cooperative financing institutions are also not well developed. It would be useful to study the present monetary-institutional framework in Muslim countries and to suggest measures for reform in the perspective of Islamic teachings.

2. Mechanics of Credit Creation and its Equitable Distribution in an Islamic Society

The debate whether commercial banks should be subject to 100 per cent reserve requirement or allowed to create credit has gone on among Muslim economists for quite some time. However, the differing views on this issue are not irreconcilable. There is need to carry out an in-depth study to help reach a consensus in the matter. Since the controversy in regard to the legitimacy of credit creation by commercial banks centres mainly on its bearing on distributive justice, this aspect has to be given special attention in further studies on the subject.

3. Techniques of Islamic Banking

Basic material on the subject is already available. There is need, however, for further work in regard to the operational details of Islamic banking techniques. The financing needs of various sectors differ in content and character. The Islamic banking techniques have, therefore, to be evolved keeping in view the distinguishing characteristics of different forms of productive activities. The principle of profit-sharing, for example, cannot be applied in a uniform, standardised fashion in all sectors. It has to assume different forms in the context of objective conditions in each sector. In evolving different operating procedures, however, care has to be exercised that they conform to the basic philosophy underlying the principle of profit-sharing. Special attention needs to be given to determine as to how the principle of profit-sharing may be applied in practice in financing the needs of small scale agriculture, small scale business and other fields of activities where the accounts are not maintained in accordance with recognised accounting principles.

4. Indexation of Deposits and Loans

Some Muslim economists feel that indexation of deposits and loans can be used as one of the methods for replacing interest. However, *Ulema* have generally been opposed to it and have expressed the view that it is not in accordance with the principles of *Shari'ah.* Indexation could of course if permissible, be used with advantage in a selective way in situations where there are some practical difficulties in applying the principle of profit-sharing. For example, there is no possibility for the government to borrow from the general public to meet its budgetary deficit on the basis of profit-sharing. However, this could be done on the basis of indexation of government loans. It would be useful to give the question of indexation further thought. This is a field where joint research by Muslim economists and religious scholars is indicated.

5. Financing the Needs of the Government Sector

Governments do stand in need for borrowing to finance a part of budgetary deficit as taxation beyond a point causes undesirable economic repercussions. It is worth-studying as to how best the borrowing needs of government be met. One possibility is indexation of government loans which has already been mentioned. The other possibility is that the borrowing needs of the government be met through borrowing from the commercial banks or the central bank on interest-free basis. However, different modes of borrowing will have different economic effects. The economic effects of borrowing from the commercial banks will be different in several respects from those of borrowing from the central bank. It would be useful to study this matter and to determine whether any criteria can be evolved to serve as guidelines in this field.

6. Economics of Profit-Sharing

A good deal of literature is already available on this subject. However, there is considerable scope for refining and extending the analysis. It is necessary to give particular attention to the principal determinants of supply and demand for investible resources in an Islamic economy. The consequences of introduction of profit-sharing on the demand for and supply of money have also to be rigorously studied. The interaction between the monetary and real sectors in an interest-free economy has to be traced in all its ramifications. It is also necessary to develop an alternative analytical framework which may suitably replace the familiar IS-LM framework applicable to interest-based economies.

7. How the Discount Rate for the Purpose of Project Evaluation Should be Calculated in Practice

In theory, it may be convincing that the rate of return on projects of equivalent risk may serve as a discount rate in project evaluation. But how the rate of return is to be calculated, how the risk is to be defined and calculated, how the divergence in the rates of return and risks should be reconciled, are the issues that need to be solved before the concept can be made practicable. The definition of a discount rate for public sector projects is another issue that still needs to be resolved. In theory, social rate of return on capital can be said to be the appropriate discount rate but how this is to be calculated in practice is a subject open for the researchers. The preparation of a Manual of Project Evaluation in Islamic Perspective should also be considered so that it is available for the planners of the Muslim countries for practical use.

8. Non-interest Pricing of Capital and General Equilibrium in an Islamic Economy

In an Islamic economic framework a positive rate of interest will no longer be available for the pricing of capital goods. The interest rate plays a crucial role in the general equilibrium inter-relations in interest-based economies. It is necessary to develop a general equilibrium framework for an Islamic economy in which interest is non-existent.

Editors

PART-I

MONETARY STRUCTURE AND POLICY

Monetary Policy in an Islamic Economy

*Dr. M. Umer Chapra**

Monetary policy has to be as important an instrument of public policy in an Islamic economy as it is in its capitalist counterpart. The objectives and tools must, however, be different because of the differences in the goals and the nature of the two systems and because of the prohibition of interest in Islam while it is a key ingredient in the capitalist system. This paper represents an attempt to highlight the role that monetary policy should be designed to play in an Islamic economy and to show how it can be made to play its role effectively if interest is abolished and two important instruments of monetary policy in the capitalist economy, discount rate and open market operations in interest-bearing government securities, are not available. The paper also discusses the mechanism for equating the supply of money with its demand in the absence of interest as a regulating mechanism and the feasible alternative to interest-bearing government securities for financing government budgetary deficits in a non-inflationary framework.

*Dr. Umer Chapra is Economic Advisor, Saudi Arabian Monetary Agency, Riyadh, Saudi Arabia. The author wishes to record his indebtedness to Mr. Mobin Ahmad for the secretarial assistance rendered by him during the preparation of this paper. In writing this paper the author has drawn heavily on the revised version of his paper 'Money and Banking in an Islamic Framework' presented to the Seminar on Monetary and Fiscal Economics of Islam held at Makkah in October 1978 under the auspices of the International Centre for Research in Islamic Economics, King Abdul Aziz University and to be published in the forthcoming second volume of Studies in Islamic Economics. The author is grateful to Dr. Anas Zarqa for his valuable comments on an earlier draft which have helped improve the presentation.

I

THE ROLE

There can be no question that monetary policy in an Islamic economy should not only be in conformity with the ethos of Islam but should also help realise the socio-economic goals that Islam emphasises. Some of the most important goals may be briefly stated as:

1. Economic well-being with full employment and optimum rate of economic growth;
2. Socio-economic justice and equitable distribution of income and wealth; and
3. Stability in the value of money to enable the medium of exchange to be a reliable unit of account, a just standard of deferred payments and a stable store of value.

It may be argued that the goals of monetary policy in the Islamic economic system, as stated above, are the same as those of capitalism. Such a statement would not be correct because even though there may be an apparent similarity; there is in fact a significant difference in emphasis arising from the divergence in the commitment of the two systems to spiritual values, socio-economic justice and human brotherhood. The ensuing discussion should make this point clear.

1. Economic Well-being with Full Employment and High Rate of Growth

The inevitable outcome of the Islamic belief that human beings are the vicegerents of God, is that they must lead a life that befits their status. The Divine Guidance embodied in Islamic teachings is intended to help them in the realisation of this objective. Muslim jurists have unanimously held the view that welfare of the people and relief of their hardships is the basic objective of the *Shari'ah*. This view would, in the economic field, necessitate economic well-being through satisfaction of all basic human needs, removal of all major sources of hardship and discomfort, and improvement in the quality of life, morally as well as materially. Hence full and efficient employment of human resources would be an indispensable goal of the Islamic system, because it would help realise not only the objective of broad-based economic well-being but also impart to human beings the dignity demanded by their status as God's vicegerents. Full and efficient employment of material resources would also be an essential goal because, according to Islam, all resources in the heavens and the earth are meant for human welfare and need to be exploited adequately, without excess or wastefulness, for the purpose for which they have been created.

While a reasonably high rate of economic growth should be the natural outcome of policies leading to full and efficient employment of human and material resources and to broad-based economic well-being, the high rate of growth is by itself not of prime importance. This is because the requirement to attain material prosperity within the framework of Islamic values requires that it should not be attained through the production of inessential or morally questionable goods and services, should not lead to an excessive and overly rapid use of God-given resources at the expense of future generations who are equal owners of these resources, and should not harm present or future generations by degenerating their moral or physical environment.[1] Hence, while full employment and material well-being are essential in an Islamic context, a high rate of growth is only essential to the extent to which it contributes to full employment and broad-based economic well-being. Beyond this, its importance would have to be carefully weighed against all its other implications.

2. Socio-economic Justice and Equitable Distribution of Income and Wealth

The goals of socio-economic justice and equitable distribution of income and wealth are an integral part of the moral philosophy of Islam and are based on its unflinching commitment to human brotherhood. The capitalist system's conversion to socio-economic justice and equitable distribution of income is, on the contrary, not based on a spiritual commitment to human brotherhood; it is rather the outcome of group pressures. Accordingly, the system as a whole, particularly its money

[1] It may be argued that while the production of a bewildering assortment of conspicuous consumption goods raises the rate of economic growth, it does not contribute to real welfare. In fact it generates social tensions by accentuating unhealthy competition to keep up with the pace-setting consumption of neighbours. For example, if a comfortable, frequent and efficient public transport service (bus, train, or tube) is provided, it may reduce the production of cars and also reduce spending on the development and marketing of new models of cars. This may lower the rate of economic growth to the extent to which it is not offset by the increased production of public transport vehicles. However, there will be: (i) lower traffic congestion; (ii) less pollution of air; (iii) reduced consumption and, hence, conservation of fuel, and (iv) lower spending on continued widening of roads, enabling public authorities to economise on spending and reduce deficit financing. Similarly, if women's ever-changing fashions are discouraged, the unnecessary spending on keeping in fashion would decline. This might lower the growth rate but would also reduce social tensions, and conserve resources for satisfying the essential needs of the majority of the population.

and banking arrangement, is not geared to these goals and glaring disparities of income and wealth continue to be generated. Nevertheless, because of the influence of socialism and political pressures, some of these inequalities are being partly reduced by taxation and transfer payments. In contrast to this, Islam tries to uproot the causes of gross inequalities at their source and also uses *Zakah*, taxation, and transfer payments as additional measures to reduce inequalities even further to bring about a distribution of income which is in conformity with its concept of human brotherhood. Hence it is essential that even the money and banking system and monetary policy are so designed that they are finely interwoven into the fabric of Islamic values and contribute positively to the reduction of inequalities.

3. Stability in the Value of Money

Stability in the value of money should be accorded high priority in the Islamic frame of reference because of the unequivocal stress of Islam on honesty and fairness in all human dealings and because of the negative impact of inflation on socio-economic justice and general welfare.[2] It has been suggested that in the current world-wide inflationary climate, the Islamic imperative of socio-economic justice could be satisfied by indexation, of all incomes and monetary assets including *qard-hasanah* – loans extended without interest or profit-sharing.[3]

While indexation might help ameliorate partially the inequities arising from inflation, it is not a cure for inflation. It may, in fact, tend to accelerate inflation[4] and be self-defeating unless inflation is on the decline and remedial monetary, fiscal and incomes policies are being adopted.[5] It seems, therefore, that while indexation could be examined as a temporary sedative for the pain of inflation, the policy alter-

[2]For a more elaborate discussion of this point, see the author's papers: (1) 'The Islamic Welfare State and its Role in the Economy' in K. Ahmad and Z. I. Ansari, *Islamic Perspectives* (Leicester, UK: The Islamic Foundation, 1979), pp. 204-5; and (2) 'Money and Banking in an Islamic Framework', *op. cit.*, pp. 5-7.

[3]In the discussion following Chapra's paper "Money and Banking in an Islamic Framework", *op. cit.*, Sultan Abu Ali suggested indexation. This became the subject of a heated discussion. See Chapra, *op. cit.*

[4]William Fellner, "The Controversial Issue of Comprehensive Indexation" in Essays on Indexation and Inflation, *op. cit.*, pp. 63–70. See also G. D. Jud, *Inflation and the Use of Indexing in Developing Countries* (New York: Praeger, 1978) p. 144.

[5]R. Jackman and K. Klappholz, "The Case for Indexing Wages and Salaries" in T. Liesner and M. King (eds.) *Indexing for Inflation* (London: Institute of Fiscal Studies, 1975), pp. 20–25. See also Fellner, *op. cit.*

native which would best conform to the norm of socio-economic justice in Islam is price stability and not indexation. However, it is important to note that indexation has so far not received the blessing of any school of Muslim jurisprudence.

While inflation is in conflict with Islamic values, prolonged recession and unemployment are also unacceptable because they bring misery to certain sectors of the population and also act counter to the goal of broad-based economic well-being. Recession also tends to increase uncertainty and discourages investors from undertaking risk associated with projects that earn a return over many years. Hence, in the interest of achieving overall objectives of Islam, it would be necessary for the Islamic state to adopt all available measures to minimise economic fluctuations and to stabilise the value of money.

A generally accepted principle in capitalist economies is a trade-off between unemployment and inflation. In the context of Islamic values the concept of such a trade-off is questionable. While inflation is iniquitous and against the interest of long-term well-being, unemployment of human resources is inequitable and not only conflicts with dignity of God's vicegerent but also vitiates the realisation of equitable distribution of income. One may also question whether it is necessary to have inflation to achieve full employment and whether it is essential to have unemployment to avoid inflation.[6]

[6]The recent experience of stagflation, high rates of unemployment existing simultaneously with high rates of inflation, has raised serious doubts about the validity and usefulness of the celebrated Phillips curve which postulated a stable trade-off between inflation and unemployment. See, Thomas M. Humphry, 'Changing Views of the Phillips Curve' Federal Reserve Bank of Richmond, *Monthly Review*, July 1973, pp. 1–13; Charles N. Henning, *et. al. Financial Markets and the Economy* (Englewood Cliffs, NJ, 1975), pp. 350–55; and Morgan Guaranty Trust Co. of New York, *World Financial Markets*, February, 1978, p. 3. The postulate has received increasing internment over the last decade from the Economics profession (See, M. Friedman, 'Monetarism' a reply to the critics *The Times*, March 3, 1980). This internment reached its climax when the Heads of State or Government of seven major industrial countries (the United States, the United Kingdom, France, the Federal Republic of Germany, Italy, Canada and Japan) concluded, at their May 1977 Summit meeting in London that 'Our most urgent task is to create more jobs while continuing to reduce inflation. *Inflation does not reduce unemployment. On the contrary it is one of its major causes'* (Bank for International Settlements: Basle, *Press Review*, 9th May 1977 (italics introduced by the author). William Poole went even to the extent of observing at a conference sponsored by the Federal Reserve Bank of Boston that "The Phillips Curve is dead – long live the Phillips curve". He argues that "Belief in a stable trade-off between inflation and unemployment has had much to do with the persistence of excessively expansionary policies since 1965" (William Poole "Summary and Evaluation" in Federal Reserve Bank of Boston, *After the Phillips Curve: Persistence of High Inflation and High Unemployment*, proceedings of a conference held in June 1978.)

In the Islamic system both unemployment and inflation are undesirable, and both need to be eschewed. If aggregate demand is to be contained or lowered to avoid inflation then in the overall interest of social justice and broad-based economic welfare a value judgement needs to be made about what kind of demand should be contained or reduced and how best this can be attained. In a value-oriented system it would be indefensible to allow demand to expand in inessential directions to attain a high rate of economic growth and, if this generates inflation, it would be equally indefensible to try to control it by reducing aggregate demand in a general, across-the-board manner by creating human unemployment. Similarly, full employment must be ensured even if this demands a restructuring of production and designing of suitable technology. It would be essential to regulate aggregate demand, restructure production, design a suitable technology, and develop an appropriate mix of monetary, fiscal and incomes policies to avoid both inflation and unemployment, and to ensure broad-based economic well-being for adequately satisfying the essential needs of all individuals in keeping with Islamic teachings.

Achievement of the whole range of objectives mentioned above would require a fundamental reform of the entire economic system including its money and banking framework. The reform of the latter would include the abolition of *riba* and the reform of banks to minimise their financial power and their role in skewed income distribution.[7] It would also include a change in the strategy and instruments of monetary policy aimed at regulating the expansion of overall credit in accordance with the non-inflationary needs of the economy as well as the value-oriented allocation of credit to attain the desired socio-economic goals of Islam. It is with the strategy and instruments of monetary policy that the following discussion will be concerned.

II

THE STRATEGY*

In an Islamic economy, the demand for money will arise basically from the transactions and precautionary needs which are determined

[7]This reform has been discussed by the author in his paper 'Money and Banking in an Islamic Framework', *op. cit.*

*The analysis in this section has been revised in the light of the discussion in the Seminar (Editors).

largely by the level of money income and its distribution[8]. The abolition of interest and the levy of *Zakah* at the rate of two-and-a-half per cent will tend to minimise the speculative demand for money because of a number of reasons including:

(1) Interest-bearing assets would just not be available; leaving the holder of liquid funds the option of either holding them in the form of cash with no return or investing them in profit-earning assets to get at least some return.

(2) Short-term as well as long-term investment opportunities with varying degrees of risk will presumably be available to all investors whether they are high or low risk takers, the extent of foreseeable risk being offset by the expected rate of return.[9]

(3) It may be safely assumed that no holder of funds would be so irrational as to 'hoard' balances in excess of transactions and precautionary needs as long as he could use the idle balances to invest in profit-earning assets to offset at least partly the erosive effect of *Zakah*, and of inflation, to the extent to which it persists even in an Islamic economy. Liquidity preference arising from the speculative motive, may hence tend to be insignificant. The demand for funds for equity-oriented investments would constitute a part of the total transactions demand and would depend on the expected rate of profit which will not be predetermined.[10] Since expectations about rates of profit, unlike the rate of interest, do not fluctuate daily or weekly, the aggregate

[8]The more equitable the distribution of income, the greater will be the demand for money for a given level of aggregate income. See David Laidler, *The Demand for Money: Theories and Evidence*, (Bombay: Allied Publishers, 1972) p. 66.

[9]Keynes original formulation of the theory of liquidity preference implies an "all-or-nothing" choice between money and long-term bonds. See Byron Higgins, "Velocity: Money's Second Dimension" in Federal Reserve Bank of Kansas City, *Issues in Monetary Policy* (1980), p. 16. See also James Tobin, "Liquidity Preference as Behaviour Toward Risk", *Review of Economic Studies*, February 1958. Tobin assumed that investors are concerned with the expected return as well as the riskiness of alternative assets, and most investors, instead of adopting the "all-or-nothing" attitude, may be willing to accept a lower return on a low-risk investment in preference to money which has no return. It may be expected that in an Islamic economy with *Zakah*, even an otherwise risk-averter may be inclined to get into low-risk investments to offset the effect of *Zakah* on his money balances. It may also be safely assumed that on low-risk investments, interest + profit would rarely be negative (See Footnote 10).

[10]It needs to be clearly appreciated here that profit in an Islamic framework will not be the residual after all operational costs (including interest) have been paid. It will rather be the sum of what constitutes interest and profit in the capitalist system. Hence the rate of profit will not fluctuate with the erratic and

– *Continued*

> demand for transactions needs would tend to be more stable and will be determined by the value of aggregate output[11] with an appropriate weight given to the distribution of income, which will materialise gradually in an Islamic economy depending on the extent of the government's commitment to this goal and the policies it adopts for this purpose.

The Islamic central bank should estimate the demand for money at full employment within the framework of stable prices and other socio-economic goals of Islam and try to regulate the supply of money accordingly. Hence the variable in terms of which monetary policy should be formulated should be the desired stock of money and not the rate of interest.[12] The objective should be to ensure that monetary expansion is neither "inadequate" nor "excessive" as compared to the capacity of the economy to supply goods and services.

frequent movements of the rate of interest. In addition, the capitalist will not be assured of a predetermined rate of return in the form of interest. He will have to share with the entrepreneur the risks of business. The total profit (interest and profit) will be divided among the capitalists and the principles of socio-economic jutice in the Islamic value framework.

[11] The Keynesian variant of the demand for money, which is $Md = kY + L(i)$, becomes reduced to $Md = kY$ if it is assumed that the speculative demand for money, or $L(i)$, is insignificant. Thus the demand for money in an Islamic economy would be represented by the equation $Md = kY$, which is the same as the 'Cambridge equation with k being the reciprocal V in the 'quantity equation'. Both the 'Cambridge' and the 'quantity' variants of the demand for money disregard the existence of the speculative demand for money. In contrast with the concept of constant velocity in the original quantity theory, income velocity may be assumed to be predictable, though not constant, as is being done now by most monetary economists (See Higgins, *op. cit.*, p. 23). In the Keynesian transmission process, changes in the money stock operate via the interest rate. A rise in the stock of money brings about a fall in the interest rate and a rise in investment in bonds and securities. Hence $(M - i - I - Y)$. Equilibrium is restored in the monetary sector when the amount of money demanded for transactions and liquidity purposes is equal to that supplied. In the monetarist transmission process, changes in the money stock operate via changes in prices, as V is assumed to remain constant and full employment Y has already been attained. Hence $(M - P)$. The crux of the difference between the two approaches is that Keynesians regard the interest rate as the price of money held while the monetarists regard the interest rate as the price of credit and the inverse of the price level as the price of money. See, Thomas Mayer, *The Structure of Monetarism* (New York: W. W. Norton, 1978) pp. 6–14, and Brian Morgan, *Monetarists and Keynesians* (London: MacMillan, 1978) p. 9–42. The transmission process even in the Islamic economy would tend to be through prices, the price of access to the use of liquid funds being the share in profit and the price of holding liquid balances being the *Zakah* payable on these.

[12] Even in the OECD countries there has been a shift away from interest rates as intermediate targets of monetary policy towards quantitative norms for the

– Continued

While the above strategy does recognise the importance of regulating the stock of money in the successful management of the economy, it does not necessarily imply a simple monetarist approach or any commitment to its ideological overtones. There is no presumption that market forces left to themselves will be able to generate sustained non-inflationary growth, remove unemployment, reduce external imbalances and help realise the other desired goals if the growth in money supply is appropriately regulated. It should, in fact, be emphasised that for a full realisation of the Islamic goals, it will not only be indispensable to reform the economy and the society along Islamic lines but it will also be necessary for the state to play a positive role. All state policies, including fiscal, monetary and incomes policies, would have to converge in the same direction. Structural rigidities and monopolistic practices should also be removed and all factors capable of generating increased supplies of essential commodities and services should be allowed to play their natural role.

1. Sources of Monetary Expansion

To ensure that monetary growth is 'adequate' and not 'excessive', it would be important to monitor carefully all the three major sources of monetary expansion. Two of these are domestic and are: one, financing of government budgetary deficits by borrowing from the central bank; and two, expansion of deposits through commercial bank credit creation. The third source of monetary growth is external and is 'monetisation' of the balance of payments surplus.

(a) Fiscal Deficits

There is no controversy among economists that fiscal deficits can be, and have been, an important source of 'excessive' monetary expansion. Attempts by the government to extract real resources at a faster rate than is sustainable at a stable price level could lead to continually rising fiscal deficits and accelerated increases in money supply thus contri-

growth of money stock (See, OECD, *Monetary Targets and Inflation Control*, Paris: OECD, 1979, p. 2). This Report argues that "Manipulation of Interest rates has not in all cases proved a satisfactory way of achieving monetary restraint or of stabilising monetary expansion under expansionary conditions" and that 'Policies which are guided by quantitative objectives for the monetary base (or bank reserves) and under which interest rate levels are – or can be seen to be – a by-product have, therefore, come to seem increasingly attractive in some countries.' (*Ibid.*, p. 1.2). Even the Federal Reserve Bank announced in October 1979 its decision to focus attention on the reserves of the banking system rather than on the Federal Funds interest rate. This was generally acclaimed as an important policy step.

buting to an inflationary spiral.[13] This destabilising tendency of fiscal deficits underscores the need for a realistic and non-inflationary fiscal policy in Muslim countries. Therefore, a conscientious Muslim government committed to the achievement of the goals of an Islamic economy should pursue a fiscal policy which is consistent with its goals. This does not necessarily rule out fiscal deficits but imposes the constraint that deficits be allowed only to the extent necessary to achieve broad-based well-being within the framework of stable prices.

However, the removal of 'excessive' fiscal deficits could remain a pious hope in Muslim countries as long as the primary causes of deficits are not remedied. These are: firstly, lack of willingness on the part of governments to eliminate or reduce substantially their unproductive and wasteful spending, and secondly, the inability of governments to raise adequate finance through taxation and other non-inflationary sources to meet their essential and productive expenditures. Therefore, an Islamic government must, if it wishes to be true to its name, eliminate unproductive and wasteful spending. It is something required by Islam from all Muslims, but particularly from the government because it uses resources provided by the people as a trust and using these wastefully or unproductively would be a breach of this trust. The government may, nevertheless, be constrained to borrow to finance its unavoidable deficits. Arrangements must be made to enable the government to do so in a non-inflationary manner.

How will the genuine borrowing needs of the government be satisfied? In the absence of interest it may not be possible for the government to borrow from the private sector unless it uses coercion which may not be practical or desirable except in national emergencies, like war. Not all public sector projects are amenable to equity financing and even if equity financing is possible in some public works projects it may not be either possible to determine the economic return or desirable (as in certain educational and health projects) to price the services rendered because of the Islamic emphasis on social welfare and equit-

[13] For the feedback process, see Olivera J. H. G., 'Money, Prices and Fiscal Lags – a note on the Dynamics of Inflation', *Banca Nationale del Lavoro Quarterly Review*, September, 1967. For an empirical verification of the feedback hypothesis, see, Jakobs, R. L. 'Hyperinflation and the Supply of Money' *Journal of Money, Credit and Banking*, May, 1977; and Dutton, J. 'A Model of Self-Generating Inflation: The Argentine Case', *Journal of Money, Credit and Banking*, May 1971, and Aghevli, B. B. and M. S. Khan 'Inflationary Finance and the Dynamics of Inflation: Indonesia 1951–72' *American Economic Review*, June 1977. See also, Aghevli, B. B. and M. S. Khan, 'Government Deficits and the Inflationary Process in Developing Countries', *IMF Staff Papers*, December 1979, pp. 775–824.

able distribution of income and wealth. The importance attached to price stability will also prevent the state from resorting to inflationary financing. How then will the deficits be financed? The answer lies in: firstly, minimising all wasteful spending both in the public and the private sectors to reduce the demand for credit, and secondly, restructuring the entire financial system to enable it to meet the genuine funding needs of the public sector within a non-inflationary framework without depriving the private sector of adequate liquidity. This would, no doubt, also necessitate the striking of a 'social balance' between public services and private production in the light of Islamic teachings.[14]

(b) Commercial Bank Credit Creation

Commercial bank deposits constitute a significant part of money supply. These deposits may, for the sake of analysis, be divided into two parts: firstly, 'primary deposits' which provide the banking system with the base money (cash in vault plus deposits with the central bank) and 'derivative deposits' which in a proportional reserve system represent money created by commercial banks in the process of credit extension and constitute a major source of monetary expansion in economies with well-developed banking habits. Since derivative deposits lead to an increase in money supply in the same manner as currency issued by the government or the central bank and since this expansion, just like government deficits, has the potential of being inflationary in the absence of an offsetting growth in output, the expansion in derivative deposits must be regulated if the desired monetary growth is to be achieved. This could be accomplished by regulating the availability of base money to commercial banks. For this purpose the absence of interest as a regulating mechanism would not be a disadvantage as will be discussed later.

(c) Balance of Payments Surplus

This source of monetary expansion will be discussed only briefly in this paper, because most Muslim countries are experiencing balance of payments deficits and in the few that do have a surplus, the surplus does not originate in the private sector. Hence it does not lead to an automatic expansion in money supply. It does so only if the government spends its surplus domestically and the private sector balance of

[14] The 'social balance' has also been emphasised for the capitalist system by J. K. Galbraith in *The Affluent Society* (Boston: Houghton Mifflin Company, 1958), pp. 251–69.

payments deficit does not offset this adequately. If in countries with a surplus, government spending is regulated in accordance with the capacity of the economy to generate real supplies, there should be no inflation resulting from the balance of payments surplus.

2. Instruments of Monetary Policy

Within the framework of the rationale provided above, it may be possible to suggest the mechanics for monetary policy which may not only help regulate money supply in accordance with real money demand but also help fulfil the need for financing the government's "genuine" deficits and achieve the other socio-economic goals of the Islamic society. The mechanics should consist of five elements.

(a) Target Growth in M and M_o

The central bank should determine annually the desired growth in money supply (M) in the light of national economic goals including stability in the value of money.[15] This target growth in M should be reviewed quarterly, or as often as necessary, in the light of the performance of the economy and the trend of important variables. It is well recognised that the growth in M is closely related to the growth in M_o or high-powered money, defined as currency in circulation plus deposits at the central bank, and hence the central bank should closely regulate

[15]Monetary targetting has become an important instrument of monetary management over the last decade and widely accepted by a growing number of central banks, particularly among the OECD countries, because monetary management has been found to be fairly successful if this approach is adopted. See, Bank for International Settlements, *The Monetary Base Approach to Monetary Control* (Basle: IS, September, 1980) p. 7; *Banking Systems and Monetary Policy in the EEC* (London: *Financial Times,* 1974) p. 116; and OECD, *Monetary Targets and Inflation Control, op. cit.*, pp. 1-2.

It is not of crucial importance to discuss here the question of which definition of M to adopt for monetary targetting in an Islamic economy. Different countries have selected different concepts of money supply for monetary targetting. The Federal Republic of Germany, France and the UK, express their intermediate objectives in terms of the broadly-defined money supply. Elsewhere in the European Community definitions of intermediate monetary policy objectives differ more widely. Italy and Ireland express their targets in terms of total domestic credit to the private sector. (See the Chapter on 'Quantitative Monetary Policy' in the *Annual Economic Review, 1980-81,* adopted by the EEC Commission on 15th October 1980 together with its *Annual Economic Report, 1980-81*). With primary reliance on equity financing in an Islamic economy and with savings and term deposits also taking the form of equity participation, it is difficult to predict how the various monetary aggregates will behave in a truly Islamic economy. The specific definition of M to be adopted for targetting could hence be determined only after experience. It may be useful initially to observe carefully all variants of M until the impact of Islamic policies on different economic variables and monetary aggregates has become clear.

the availability and growth of M_0.[16]

Since the creation of M_0 by the central bank results from the exercise, by the central bank of the power to create money, which is a purely social prerogative, the resources derived from this power should be used, in the social-welfare-oriented value system of Islam only for accomplishing the goals of the Islamic society. They should be used particularly for financing projects that would help realise the Islamic ideal of an *Ummah*, all of whose members are brethren, not separated by a widening gulf of income and wealth inequalities.

To bring the above goal to a reality, the central bank should make the total M_0 created by it available partly to the government and partly to the commercial banks and the specialised financial institutions. The proportion of M_0 diverted by the central bank to each of these three sectors should, like the total size of M_0, be determined by economic conditions, goals of the Islamic economy, and the dictates of monetary policy. The part of M_0 made available to the government should be an interest-free loan to enable the government to finance its social welfare projects. The part of M_0 made available to the commercial banks should be treated as *mudarabah* advances and the profits realised from these should be made available to the government to finance projects designed to eliminate poverty and reduce income inequalities. The part of M_0 made available to specialised credit institutions should also be a *mudarabah* advance and be used mainly for financing productive activities of self-employed persons, farmers, cottage industries and other small businesses which, though viable and socially necessary, are unable to obtain funds from commercial banks.

(b) *Public Share of Demand Deposits*

A certain proportion of commercial bank demand deposits up to a maximum of, say, 25 per cent, should be diverted to the government to enable it to finance socially beneficial projects in which profit-sharing is not feasible or desirable. This should be in addition to the amount diverted to the government by the central bank for expanding the monetary base (M_0). The rationale behind this proposal is that firstly, the commercial banks act as agents of the public for mobilizing the

[16]In their survey of the issues and evidence on money and monetary policy in less-developed countries, Coats and Khatkhate conclude that "In LDC's, base money is a major determinant of the money stock and the deficit financing of government expenditure which is often tantamount to the creation of central bank credit, is a principal factor affecting base money". (W. L. Coats and Dr. Khatkhate (eds.), *Money and Monetary Policy in Less Developed Countries: A Survey of Issues and Evidence* (Oxford: Pergamon Press, 1980, p. 32.

society's idle resources; secondly, the banks do not pay any return on demand deposits; and, thirdly, the public does not bear any risk on these deposits if these are fully insured. Hence it would be fair to expect that the society's idle resources thus mobilized should be used for social benefit except to the extent to which the society permits the commercial banks to use them for private benefit in the larger social interest. One of the important ways of using them for social benefit would be to divert a part of the demand deposits thus mobilized to the public treasury to finance socially beneficial projects without imposing any interest burden on the public exchequer.

It would, however, be fair to demand that the government should pay a service charge on the resources thus made available to it. The charge should be equal to at least 25 per cent of the total cost of mobilising demand deposits, including the cost of rendering all services to the depositors related to these deposits. This service charge would not be in conflict with the abolition of *riba* because the government would only be reimbursing the commercial banks on a *pro-rata* basis for actual costs incurred by them in acting as agents for the government in mobilising the idle funds of the public. In addition to pay this service charge, the government should also bear, on a *pro-rata* basis, the cost of insuring demand deposits.

(c) Statutory Reserve Requirement

Commercial banks should be required to hold a certain proportion, say, 10–20 per cent, of their deposit liabilities with the central bank as statutory reserves. The central bank should pay the commercial banks the cost of mobilising these deposits just as the government would pay the cost of mobilising 25 per cent of demand deposits diverted to the government. This statutory reserve requirement could be varied by the central bank in accordance with the dictates of monetary policy. The rationale behind a statutory reserve requirement only against demand deposits is that the *mudarabah* deposits would constitute a part of bank equity in an Islamic economy and since there is no statutory reserve requirement against other forms of equity, there is no reason why *mudarabah* deposits should be subject to such a requirement. This should not adversely affect the control of money supply which must be accomplished through control of high-powered money at source as indicated earlier.

The funds thus received by the central bank could be partly used by it to enable it to serve as lender of last resort and partly invested to derive income for covering its expenses.

The Islamic commercial banks, with their resources employed in a profit-and-loss-sharing framework, may not be able to predict their liquidity needs with precision and would stand in need of assistance from a lender of last resort if, for some unforeseen reason, they run short of liquidity. In the conventional interest-based commercial banking system it is possible for banks to borrow from the central bank or from the inter-bank money market to offset such liquidity shortages. The Islamic banks should also have some mechanism whereby they can have temporary access to funds if their liquidity position becomes tight. A built-in arrangement for such eventualities could be made by diverting a certain part of the commercial bank statutory reserves to a common pool, the main function of which would be to enable the central bank to serve as lender of last resort within certain agreed limits and constraints to avoid the misuse of this facility.

The balance of the funds raised through reserve requirements could be invested by the Islamic central banks as is done by their capitalist counterparts. Since interest-bearing government securities would not be available, the Islamic central bank would have to find alternative avenues for investment. It should, however, withhold from investment funds it considers necessary for management of monetary policy.

(d) Credit Ceilings

While the above-mentioned tools would facilitate the central bank in bringing about the desired expansion in high-powered money, credit expansion could still exceed the desired limit because, firstly, it is not possible to determine accurately the flow of reserves to the banking system, other than those provided by the *mudarabah* advances of the central bank, and, secondly, the relationship between commercial bank reserves and credit expansion is not very precise. The behaviour of the money supply reflects a complex interaction of the various sectors of the economy. Hence, it would be desirable to fix ceilings on commercial bank credit to ensure that total credit creation is consistent with monetary targets. In the allocation of this ceiling among individual commercial banks appropriate care should be taken to ensure that it does not harm healthy competition among banks.

(e) Value-oriented Allocation of Credit

Since bank credit comes out of funds belonging to the public, it should be so allocated that it helps realise general social welfare. The criteria for its allocation, as for other God-given resources, should be first, the realisation of the goals of the Islamic society and then the maximisation of private profit. This could be attained by ensuring that:

(i) credit allocation leads to an optimum production and distribution of goods and services needed by the majority of society, and

(ii) the benefit of credit goes to an optimum number of businesses in society.

The appropriate way to achieve the first objective would be to prepare a value-oriented plan and then to dovetail this plan with the commercial banking system for its efficient implementation. The approach should be, firstly, to make it clear to the commercial banks what sectors and areas of the economy are to be promoted through commercial bank financing and what goals are to be realised and, secondly, to adopt the institutional measures necessary for this purpose, as discussed below. No effort should be made to tie the commercial banks with an elaborate network of controls.

The reason normally given by the commercial banks for diverting a very small proportion of their funds to small- and medium-sized businesses is the greater risk and expense involved in such financing.[17] Hence small firms are either unable to get finances from banks or do so at highly unfavourable terms (in terms of cost and security) compared with their larger counterparts.[18] Thus the growth and survival of small firms is jeopardised even though they carry a great potential for increased employment and improved income distribution. It would, therefore, be desirable to reduce the risk and expense of such financing for banks. The risk may be reduced by introducing a loan guarantee scheme[19] underwritten partly by the government and partly by the commercial banks. The additional expense incurred by the commercial banks in financing small businesses should be partly or wholly offset by the government depending on the nature of the case and objectives to be served. The cost to the government exchequer arising from the

[17]'Small companies provided 30 per cent of British jobs and 20 per cent of the GNP, yet they probably accounted for only 0.5 per cent of the industrial investment of the financial institutions that now took a major part of the nation's savings. The impact of only a small increase in this percentage would be very significant and would not conflict with such institutions fiduciary responsibilities' *Financial Times*, March 28, 1978.

[18]The Wilson Committee Report on Financial Institutions. See a review of this Report by John Elliott under the title 'Not Enough for Small Companies' in the *Financial Times*, March 16, 1979, p. 10.

[19]Such a scheme has been proposed for Britain by the Wilson Committee Report, *ibid.* Chancellor of the Exchequer, Sir Geoffrey Hower announced the introduction of a pilot loan guarantee scheme in his 1981-82 budget speech. See the *Financial Times* March 11, 1981, p. 17.

above two schemes is justifiable in the larger interest of the goals of the Islamic economy.

It is not being claimed here that private demand for money can be forecast precisely by the central bank. All that the proposal implies is that given the capacity of the economy to generate real growth and the government's determined policy not to allow its fiscal deficit to exceed the limits dictated by price stability, the central bank can (within a margin of error) estimate the high-powered money needed to generate the target rate of growth in money supply and the amount of *mudarabah* credit it can make available to the commercial banks during a given period. Since the projection may not always turn out to be correct because of errors in forecasting or changes in important economic variables, the targets should be reviewed and revised periodically. Central bank credit availability to commercial banks, statutory reserve ratios and credit ceilings should be changed and reinforced by other instruments of monetary policy like the liquidity ratio, specific directives, moral suasion and selective controls. It may also be possible to consider the simpler Friedman rule of adopting a fixed annual rate of growth in M in keeping with the secular growth in output and decline in velocity to avoid the frequent 'tinkering' which is otherwise necessary.[20] However, if such a formula is adopted it should be without Friedman's excessive free-market commitment. The positive role of the state and of fiscal policy cannot be dispensed with.

The non-availability of some of the traditional instruments of monetary policy should hence not pose any serious problem in managing an effective monetary policy provided that the generation of high-powered money is appropriately regulated at source. This necessarily implies that in the Islamic system, like in any other system, cooperation between the central bank and the government is absolutely essential. Unless the government is determined to have price stability as an indispensable goal of policy and to regulate its spending accordingly, it would be impossible to have an effective monetary policy. Once high-powered money has been regulated at source, the minor adjustments that may be necessary due to changing economic conditions or errors of forecasting may be made as indicated above.[21]

[20]Milton Friedman, *A Programme of Monetary Stability* (New York: Fordham University Press, 1975), pp. 90–91.

[21]See the two-volume study on the effects of monetary policy by the Board of Governors of the Federal Reserve System, *New Monetary Control Procedures* (Washington, 1981). The general conclusion of the Report is that if the Fed stayed within its long-range growth targets, radical week-to-week and month-to-month changes in the money supply had relatively little effect on the overall economy.

Some questions that may be asked here are: Even if it is possible to control inflation in an Islamic economy, will it be possible to overcome a recession? What if prospects for making profit are dim and the commercial banks and the associated private sector are not willing to expand their *mudarabah* investments? It is of course true that the central bank can only extend credit it cannot force the private sector to invest when business prospects are not bright. Under such circumstances the government can always review its expenditure programme and try to offset any deficiency in private sector aggregate demand by arranging a greater proportion of the increase in high-powered money through its fiscal deficit.

The external sector can no doubt create movements in money supply through capital flows. These movements may be due to a number of reasons which it is not possible to examine in this paper. The most disturbing capital movements are the 'hot' speculative capital flows arising from interest rate differentials and exchange rate expectations. These need not be a problem for an Islamic economy. For countries having a strong balance of payments position there is little likelihood of hot capital inflows arising from interest rate differentials because demand deposits would pay no interest and time deposits would not only be equity-oriented and committed for relatively longer periods but would also be accepted by financial institutions only if they could be gainfully absorbed in a profit-sharing framework. Hot money inflows due to prospective currency appreciation could be discouraged by disincentives and controls and their monetary effect may be neutralised by subjecting such flows to prohibitively high statutory reserve requirements. The stress on price stability in an Islamic economy should also help minimise current account deficits and the resulting currency depreciation and capital outflows.

III

AN APPRAISAL

The question now is: How will the proposed monetary policy help the Islamic economy to achieve its goals?

The money supply would be regulated by the central authority in accordance with the needs and goals of the Muslim society. The growth in M would be regulated to achieve the goal of attaining broad-based well-being and an optimum but realistic rate of growth within the context of price stability. This target growth in M could be achieved by generating the required growth in high-powered money through a combination of fiscal deficit and central bank lending to financial institutions. However, there could still be excessive or deficient expansion in money supply because of the effect of a number of variables which are difficult to predict or control. Such excesses or deficiencies could be evened out with the help of changes in central bank *mudarabah* advances to commercial banks, statutory reserve requirements and ceilings on credit expansion. It is assumed that the government would be committed to Islamic goals and would not adopt policies which conflict with them. It is also assumed that all government policies would converge on the achievement of these goals and that monopolistic and oligopolistic practices and structural rigidities would also be removed.

The created money or the profit arising from it would go mainly to the public exchequer to be utilised for social welfare objectives of eradicating poverty, attaining a high rate of economic growth and low rate of unemployment, and fostering socio-economic justice. It would not serve vested interests or contribute to concentration of wealth. Thus the implementation of this scheme would help to reduce concentration of wealth to the extent to which it is brought about by the commercial banking system in the capitalist society.

The government financial problems would also be solved partly because, firstly, additional interest-free resources would be made available to the government in the form of created money, and secondly, a certain proportion of all commercial bank demand deposits would also be made available to the government. This would carry a service charge which would be considerably smaller than the heavy interest burden which makes the rich richer through interest receipts and the poor poorer through additional taxes levied to service the public debt.

The scheme need not reduce the overall volume of funds available to the private sector. It would, however, lead to a redistribution of these funds through a reduction in inequalities of income and concentration of wealth and a dispersal of total credit among a larger number of people along with its reallocation among various sectors of the economy to ensure an adequate production and distribution of goods and services needed by the majority of the society in conformity with a value-oriented plan. Since a preponderant part of the financial needs of business would come out of equity there would be no fixed interest cost to be added by firms to the cost of goods.

The ability of the government to obtain funds without the high cost of interest along with the imperative that these funds be invested in projects of high social priority should help eradicate poverty, increase employment, provide essential social and economic services and raise the rate of economic growth to an appropriate level thus contributing to general social welfare.

Hence it appears that the proposed scheme would operate to the greater overall benefit of the economy and help the Islamic state to realise its short-term as well as long-term social and economic objectives.

Comments

Dr. Mohamed Ariff*

Dr. Chapra's excellent paper entitled "Monetary Policy in an Islamic Economy" represents a valuable contribution to the growing Islamic economics literature. The significance of this paper lies in that it attempts not only to design a monetary policy that is truly Islamic in character but also to assign to it a rôle that is quite novel and unique. To appreciate the paper and to do justice to it, one must also read Dr. Chapra's earlier seminal work on "Money and Banking in an Islamic Framework" which was presented to the Seminar on "Monetary and Fiscal Economics of Islam" in Mecca in October 1978. However, my comments here will be confined to policy matters discussed in his present paper.

The ingenuity of the author is clearly manifested in the manner in which he has approached the whole subject, by injecting an Islamic flavour into the objectives which he sets out to achieve with the help of 'unconventional' monetary instruments in an interestless environment.

I am as strongly convinced, as the author himself indeed is, that all these socio-economic goals can be achieved efficiently and effectively in an interest-free system. However, I am inclined to think that the author has quite unnecessarily overburdened the monetary policy by assigning to it too many objectives. I do not suggest that monetary policy instruments are not capable of achieving a number of objectives simultaneously in certain circumstances either independently or with the assistance of other policy tools. Nor do I suggest that all these objectives are unnecessary or unimportant. As a Muslim economist, I whole-heartedly subscribe to each and every objective that Dr. Chapra has listed out. But, I do question the wisdom and the practicality of expecting the monetary policy to achieve all of these objectives at the same time. It is only in this sense as I feel that Dr. Chapra has been rather unfair or unkind to the monetary policy in an Islamic framework.

It is of relevance to note that according to the famous Meade-Tinbergen principle, the number of policy instruments should equal the number of policy objectives, if multiple objectives are to be simultaneously achieved. Otherwise, there may be conflicts of policy goals. In this regard, it is also pertinent to bear in mind the Mundellian principle of "effective market classification" which stresses the importance of

*Dr. Mohamed Ariff is Professor of Analytical Economics, Faculty of Economics and Administration, University of Malaya, Kuala Lumpur, Malaysia.

appropriate pairing of policy objectives with policy instruments. It is, therefore, imperative that we assign to monetary policy what it can best achieve and leave the rest for other policy instruments. Thus, too much concern for redistributive justice in formulating and implementing the monetary policy may impose constraints which may adversely affect its overall efficiency and effectiveness. I am not at all implying that this concern for redistributive justice is wrong or misplaced. Rather, the point I wish to drive home is that it may be best achieved by activating other policy tools.

Having made my preliminary remarks on the scheme outlined by Dr. Chapra, let me come to the monetary policy itself. My general impression is that the monetary policy in Dr. Chapra's model plays a somewhat passive role, especially with regards to the regulating of money supply, i.e. the role of avoiding liquidity shortage and liquidity glut so as to ensure stability in the value of money. Dr. Chapra's prescription that the central bank adjusts the money stock in such a way as to keep pace with the secular growth of output implies a passive role, not one of actively influencing the level of national output and employment. Perhaps Dr. Chapra has been strongly influenced by Friedman in this regard.

Dr. Chapra also seems to believe that the control of money supply can be accomplished by merely regulating the high-powered money (M_0) at the source. He recommends a statutory reserve requirement against demand deposits only. But M_0 in a modern economy accounts for only a small proportion of the total money supply, and as such the central bank's control of M_0 alone may not be sufficient. It is, therefore, necessary for the central bank to exercise similar controls on the deposit money component of the aggregate money supply as well.

The author has suggested two alternatives both of which have been motivated by his genuine concern for Islamic redistributive justice. The first alternative is to impose a 100 per cent reserve requirement on the commercial banks. This really means that the commercial banks will be reduced to safe-keeping institutions. For, then, the commercial banks cannot even invest the funds deposited with them, let alone 'create' deposits. This alternative, however, permits the central bank to create "credit" which will be channelled through the commercial banks on a *mudarabah* basis.

The second alternative is to allow the commercial banks to 'create' deposits. The redistributive justice will be taken care of either by nationalising the commercial banks or by forcing the banks to pass on to the state the net income arising from 'derivative' deposits after allowing for the *mudarabah* share of the commercial banks. It is not clear to me how this 'net' income is to be divided among the shareholders, the depositors and the government. Since the sum of the *mudarabah* shares must add up to 100 per cent, it begs the question what should be the share of the state which has not injected funds of its own into the commercial banking operation? Does this mean that the share of the state can be fixed arbitrarily and varied at will? Does not this amount to taxing the incomes of commercial banks? If so, are we not really speaking of fiscal measures rather than monetary economics proper?

Dr. Chapra carefully mentions the various pros and cons of these alternatives, without committing himself to any one of these. It will be of interest to know which of the two he really opts for and why.

Of the various monetary instruments discussed in Dr. Chapra's stimulating paper, the suggestion that a maximum of 25 per cent of the demand deposits of the commercial banks be earmarked for providing interest-free loans to the government, deserves a special mention. The novelty of this proposal lies in that this source of financing, which is interest-free, is not costless, as the government, will have to bear at least 25 per cent of the total cost of mobilizing the demand deposits and rendering services related to these deposits *and* the cost of deposit insurance. This is certainly a non-inflationary way of financing government expenditures, unlike his other suggestion that a part of the M_0 created by the central bank is made available to the government.

As mentioned earlier, Dr. Chapra restricts the statutory reserve requirement of 10–20 per cent to the demand deposits only without extending it to cover other deposits as well. His argument is that the *mudarabah* deposits, which constitute a part of the equity in an Islamic economy, should not be subject to any reserve requirement, unless similar requirements are imposed also on other forms of equity. I think that it is important here to make a distinction between *mudarabah* deposits and other forms of equity. *Mudarabah* deposits in a banking system play a more crucial role than direct equity participation elsewhere in the economy. Hence, there is no basis for equating the two in considering the merit of the statutory reserve requirement. I also think that the statutory reserve requirement against *mudarabah* deposits is far more important than that against the demand deposits. The commercial banks normally hold a large proportion of the demand deposits in liquid form, as these deposits can be withdrawn at any moment. Since the twin purposes of the statutory reserve requirement are to ensure that the financial institutions remain reasonably liquid and that they do not over-expand credit, such a statutory requirement becomes all the more important and necessary for the *mudarabah* deposits. Since the *mudarabah* deposit cannot be withdrawn immediately, the banks will tend to commit these funds on long-term projects which are profitable at the expense of liquidity considerations. In such circumstances, the statutory reserve requirement against the *mudarabah* deposits will force the banks to keep a part of these deposits in liquid form and limit their scope of credit expansion.

With regards to the 10–20 per cent statutory reserve requirement against the demand deposits, Dr. Chapra's suggestion is that the central bank should invest these funds to derive income for covering its expenses. In the present-day set-up, the central bank invests such funds in interest-bearing government securities which can be easily converted into cash. But, in an Islamic economy where such interest-bearing securities are out of question, what alternatives are really available to the central bank for investing these funds, without jeopardising the liquidity of the reserves? I am thus inclined to think that investing these funds is not as simple as Dr. Chapra seems to suggest.

The other suggestion of Dr. Chapra that "the central bank does not invest these funds directly but makes them available to commercial banks and other financial institutions on the basis of profit-sharing" is even more objectionable on a number of grounds.* First, it will imply that the central bank relinquishes its control on how these funds should be invested, thereby totally disregarding liquidity aspect, which in my opinion is of over-riding importance in the case of such reserve funds. Second, to make these funds available again to the banks will defeat the very purpose of the statutory reserve requirement and will amount to a dilution and even a negation of the monetary control implicit in the instrument of statutory reserve requirement. Third, it is morally wrong for the central bank to enter into profit-sharing arrangement with the commercial banks using funds that really belong to the latter.

The statutory reserve requirement can be a powerful instrument of monetary control, and its importance to the Islamic monetary system, where the instrument of interest rate is not permissible, is readily obvious. Extreme care should, therefore, be exercised so as not to blunt the statutory reserve ratio instrument in any way.

There are a number of other monetary instruments which have not been mentioned in Dr. Chapra's paper. These instruments were discussed in the Mecca Seminar in October 1978. These include: (a)

*The relevant part of the paper has been revised in the light of this discussion (Editors).

"refinance ratio" which refers to the central bank's refinancing of a part of the interest-free loans provided by commercial banks, (b) "*qard-hasnah*" ratio by which is meant the percentage of demand deposits that commercial banks are obliged to lend at an interest-free loan, (c) "profit-sharing ratio", which forms the basis on which *mudarabah* investments are to take place between the banks and the clients in the economy, and (d) the ratio of interst-less government securities in the advances portfolio of financial institutions. All these ratios, which can be varied or adjusted by the central bank in such a way as to regulate the money supply, represent potent instruments of monetary control in an Islamic economy.

Finally, Dr. Chapra does conclude that monetary policy will be asymmetrical in its impact, since it will not be as effective in a recession as in an inflation. This leads him to suggest that the government should offset deficiency in aggregate demand by undertaking fiscal deficits financed by an increase in the supply of M_O. That fiscal measures are more effective than the monetary ones in overcoming recessions has been acknowledged not only by the Keynesians but also by the Monetarists themselves. Nonetheless, it may be in order for us to question whether the monetary policy in an interest-free Islamic economy will be as weak as that in an interest-ridden capitalist economy in times of recession. The current weakness of the monetary policy as an anti-recessionary device may be attributed to: (a) interest inelasticity of investments, and (b) passive role played by the financial institutions. But, in an Islamic economy, interest is no longer a cost to the entrepreneur and the risk borne by the entrepreneur in times of recession is much less under the *mudarabah* system than in the capitalistic order. Thus, entrepreneurs in an Islamic economy will be less cautious and more adventurous even in times of recession than their counterparts in the capitalist system. Moreover, the financial institutions in an Islamic framework play a more active role than do their counterparts elsewhere. As we all know, the financial institutions in an Islamic economy are envisaged to take on an entrepreneurial role by being a partner in *mudarabah* investments, quite unlike the present-day financial institutions which merely provide funds for investment. It is in this sense that the Islamic financial institutions can be expected to lead the business community and actively influence the business outlook by injecting confidence and stimulating investments in times of economic downturn.

My final comment relates to the speculative demand for money. The author seems to completely dismiss the speculative motive out of consideration in an Islamic system. I think that speculation of all kinds is not un-Islamic. I do not think that there is anything wrong or un-Islamic for me if I want to have my assets in a liquid form if I think that it is not the best time to buy property. If I could buy it next month may be I stand a better chance of profit. This is really speculative motive for holding money and I do not think there is anything un-Islamic about it. So in my view the speculative motive should be taken into account in formulating the demand function for money.

I believe that my comments do not in any way undermine the value of Dr. Chapra's paper which undoubtedly is an excellent piece of work. I do hope that the criticisms offered here will provide further impetus for the author in his relentless efforts to formulate a workable and meaningful monetary policy framework for an Islamic economy.

Dr. Munawar Iqbal*

Dr. Umer Chapra's paper, "Monetary Policy in An Islamic Economy" is a useful contribution to the literature on Islamic Economics. It addresses some very important theoretical issues and policy problems. It also contains concrete policy proposals to solve the problems discussed. However, this is not to suggest, that the paper is the last word on the question of monetary policy in an Islamic Economy, nor is it to say that every word of it is correct. In my view the contribution of the paper is to identify the real issues and to set the state for further debate and research by providing policy recommendations which in his view will resolve the problems. One may disagree with any of his proposals or add new dimension to it but the fact remains that Dr. Umer Chapra has provided enlightening ideas and exciting proposals.

In the section on the goals of monetary policy in an Islamic eonomy he enumerates three goals namely: full employment and high rate of growth; socio-economic justice and equitable distribution of income; and stability in the value of money. As the author notes these objectives appear on the face to be the same as those of capitalism but there are fundamental differences in their interpretations. The author adequately explains those differences. What the paper lacks is, in my view, a discussion of the relative importance of various objectives.

There is one supreme objective of all economic activity – rather all human activity – that is to maximize human welfare. The various objectives enumerated are simply the "means" or "semi-objectives" and

*Dr. Munawar Iqbal is Director, School of Economics, Islamic University, Islamabad.

not the ultimate "goals". The concept of welfare is different in different systems and hence the importance or "weight" of the different tributories to the ocean of welfare will also be different. This difference in emphasis is one of the things that distinguish one system from the other. It is well known that these "objectives" are not always compatible with one another. There are many trade-offs involved and the "rate of substitution" of one objective for the other depends on the social and ethical values of the society.

In the same section the author raises a very interesting question i.e. the position of inflation in an Islamic economy. The author states* that "any continuous and significant erosion in its (money's) value should be interpreted in the light of Islamic teachings to be tantamount to "corrupting" the world because of the adverse effect this erosion has on social justice and general welfare". The quotation is undoubtedly true but this does not give inflation position which is much different from its position in other systems. What makes inflation really repugnant to the Islamic economy is the fact noted later, that is inflation conflicts with *riba*-free economy because inflation involves injustice to the *riba*-free lender by reducing the real value of the amount he has lent. The question is how to avoid any injustice to a person advancing a goodly loan (*qard-hasanah*). The author suggests that price stability is the best answer. Sounds great: However, when it comes to practice it possesses many problems. In this regard I would request the learned author to elaborate a few points. Firstly, what is his interpretation of price stability? Usually a mild rate of inflation (2–3 per cent) is not considered to be incompatible with price stability. Should the author accept this definition, then the question of injustice to the *riba*-free lender rises again. Islam prohibits injustice irrespective of its degree. On the other hand if he implies zero rate of inflation, then, is he recommending absolutely rigid prices? If so, would not it be harmful for the investment activity? More importantly, how would the government achieve a zero rate of inflation? In today's work most of the inflation in less-developed countries is of foreign origin which is not easy to control by domestic policies. Thus, if the objective is to avoid injustice to any party, would it be permissible to "index" loans to the extent that inflation persists.

Now I come to what I consider to be the most important contribution of the paper. This is the section dealing with the public share of demand deposits. Because of the immense practical importance, the

*The relevant passage of the paper has been revised (Editors).

issue may become a subject of considerable debate. I will, therefore, deal with it at some length.

Let me start by recording my broad agreement with the proposal. I have some differences with regard to its implementation which are noted later. I fully endorse the view, that since the funds available through demand deposits belong to public, a part of the benefit should go to the public.

Under multiple credit creation the banks receive a regular flow of resources which may be called "seigniorage", by analogy to the resources which used to accrue to sovereign rulers of the past who had the right to mint coin with a face value larger than the intrinsic metal value in the coin and the cost of manufacturing etc. The present value of the social seigniorage (SS) arising from the issue of D units of credit money is equal to:

$$SS = \left[\frac{R-C}{1+d} + \frac{R-C}{(1+d)^2} + \frac{R-C}{(1+d)^3} + \ldots\ldots\ldots + \frac{R-C}{(1+d)^n} \right] \times D$$

Where n is the period at which the paper money has to be "retired" or is replaced by a commodity substitute; R is the marginal social productivity of the resources; C is the social unit cost of servicing the fiat money, (if interest is paid on deposits then that will be included in C) and d is the social discount rate.

In reference to the capitalist economies, it is maintained that this seigniorage gets distributed to the depositors through the payment of interest on deposits and through other banking services. Specifically, assuming n to be infinite.

$$SS = \frac{(R - r - C)\, D}{d}$$

Where r is the rate of interest on deposits and if $r = R - C$ then $SS = 0$. It is claimed that competition among the banks will assure that r approaches (R–C). There are two problems with this solution. First, historically banks have been earning extra-ordinarily high profits. This is because it is very difficult to achieve competitive conditions in the banking industry. Secondly the payment of interest is out of question in an Islamic economy. Now it is possible to pay out ***mudarabah*** share instead of the rate of interest but the nature of demand deposits is such that the holders either need immediate liquidity or they are risk-avert.

In both cases it is not possible to invest them on profit-sharing basis. The alternative is to divert these resources to the government which can spend it in accordance with social priorities. Thus the author's proposal makes a lot of sense.

Another advantage of the scheme is that making the public share of demand deposits a variable provides the authorities with another policy tool which may be valuable in the absence of some other policy tools available to the monetary authorities in a *riba*-free economy. In this regard I do not quite understand the author's recommendation* that in a period of recession, the government may use a higher proportion than that in conditions of full employment. In my view it should be exactly the opposit. A higher percentage will have a contractional effect since the money multiplier will be reduced. In its effect on money market, the public share of demand deposits is similar to statutory reserves and in recession we reduce the statutory reserve requirement, not raise it.

A related point is that apart from any counter-cyclical manipulation the rate of the public share of demand deposits should not be very high because the higher the share of government in demand deposits, the lower will be the money multiplier. This is critical because the profit-sharing system which will replace the present *riba*-ridden system, already involves under-expansion of credit for many reasons. These include: (i) The ratio of demand deposits to total deposits will increase, since the perfect risk averters will put their savings in demand deposits; (ii) The demand by banks for "excess reserves" may increase because of the greater uncertainty under the profit-sharing system, since deposit variations arising from cyclical change will increase; and (iii) Loaning operations of the commercial banks will also be limited since considerable loaning is at present done on a riskless basis, which allows the commercial banks to maximize profits and to decrease their demand for liquidity.

In the framework of the paper under discussion, the provision of enough money will necessitate printing more money which will have an inflationary effect. Elsewhere in the paper the author has very effectively made a case against inflation in an Islamic economy.

Another point on which I would beg to differ with the learned author is his assertion that the proposed model would not seriously affect the profits of banks.† I feel that it would. This is nothing to be regretted, however. Rather I consider it to be another attractive feature

*The relevant passages of the paper have been dropped from the revised draft (Editors).

†The author has dropped his assertion while revising the paper (Editors).

of the model. In view of the extraordinarily high profits of the banking industry it is very much desirable to siphon off excess profits of the bank and distribute them to the poorer sections of the society. The scheme is thus in line with the equity objective of the Islamic economy.

To sum the discussion on public share of demand deposits, I feel that the proposal is very useful. It provides the monetary authorities with a much needed tool and the government with much needed funds. The rationale for the scheme is well justified. However, the implications of the proposed scheme for money multiplier call for a cautious approach in determining both the level and the counter-cyclical variation of the public share.

In the end I would like to suggest a few extensions of the present analysis which should be considered by the author and other researchers in the field.

Firstly, it should be investigated how the suggested policy proposals will affect the "real" sector of the economy. In a capitalist economy the monetary policy affects the real sector only through the rate of interest. In an Islamic economy the rate of interest will be replaced by the rate of profit. The rate of profit, however, depends on the business conditions. Thus the saving, investment decisions in an Islamic economy would not depend on the rate of interest but only on the expectations about business prospects. How, then the monetary policy will have any bearing on the real sector? (Incidently the achievement of a desirable rate of growth would depend on this.)

Secondly, the nature of the *mudarabah* advances of the central bank and their role in the management of the monetary policy should be explored in greater detail. Suppose there is an excess demand for liquidity for whatever reasons, e.g. crisis of confidence, change in expectations etc. The discount window is not available to the banks. They approach the central bank for additional funds. On what terms will the central bank make funds available to them? Since the commercial banks would not be investing these funds, the question of profit-sharing does not arise. For another example suppose there is recessionary trend in the economy. The central bank wants to follow an expansionary policy. In the framework of the present paper, it offers more funds to the commercial banks. Would it solve the problem? Obviously not. The problem in a recession is not that commercial bank do not have funds to lend. The problem is that people are not willing to borrow due to slack business expectations. What role, then the *mudarabah* advances can play and how?

Thirdly, some analysis is required to determine the implications for monetary policy of the replacement of interest-bearing assets by non-interest-bearing assets. In an Islamic economy securities, treasury bills, bonds debentures will all have to go. The predominant asset will take the form of equities. Now equities have different characteristics than the securities. The change will, therefore, have important implications for the conduct and effectiveness of monetary policy as well as the working of the other monetary institutions.

Discussion

Chairman (Dr. Ziauddin Ahmed)

Before I ask for comments, I would like to highlight some of the areas in which it will be useful to have comments, rather than repetition of the arguments already made. As you may have noted, there are a few areas of disagreement between the author and the discussants. One is that monetary policy should not be over-burdened with too many objectives. The second is on the question of indexation. The third point is whether or not in Islamic economic system there are valid reasons for having speculative demand for money. Another important point for further discussion is whether the methods suggested for financing government deficits, particularly by earmarking 25 per cent of the commercial bank demand deposits, is really the right way to go about it and whether it makes any substantial difference or not. Finally, the assertion that the Islamic monetary policy plays a more active role in a period of recession. I would suggest that these points should be given a greater weight in the ensuing discussion.

M. Akram Khan

About the goals stated by Dr. Chapra, I would like to know what is the authority from the *Shari'ah* in support of these objectives, because some of the Western writers have said that recently Muslim thinkers have started saying good things about social justice, full employment and distribution of income. They say that these ideas have been borrowed from the West. I want to know the reference from the *Shari'ah*.

Agha M. Ghouse

In an Islamic economic system, the function of money is essentially as a medium of exchange rather than a store of value because Islamic economic system is essentially an expenditure-oriented system. The moment we consider money as a medium of exchange rather than the store of value, we can easily see that indexation may not be necessary to compensate for inflation.

Dr. Monzer Kahf

I have two short comments. First is on Indexation. In this regard I want to bring your attention to two points: First, the alternative use of the money lent. If the alternative is to keep it in demand deposits or in the money form, then we are not doing any injustice to the lender. The second point on indexation is the saying of the Holy Prophet (Peace Be Upon Him) on the matter which is called by the *Fuqaha, Riba-al-Fadal,* wherein the difference in value of the same quantity caused by time is not recognised. Even with a time lag no additional quantity should be given. The second point that I have, is concerning the speculative demand. The author recognises the possibility of the Islamic central bank using open market operations. He should then, recognise with it, the speculative demand, because open market operations imply the speculative demand of the other party in that transaction.

Dr. Nevzat Yalcintas

I would like to draw the attention of Dr. Umer Chapra to three problems. One is how to define the area for inessential investment. This will be decided by investors, whether they are private or public. If there is emphasize upon solving the problem of unemployment, there can be some field of investment where the main aim could be creation of more employment. This is why the definition of inessential investment poses problems.

Another problem is that there are many people who do not have any deposits in the bank. How to compensate those people for inflation? This is why I think that instead of indexation it is better to use other tools of social policy like raising of wages and salaries or raising the pension when the inflation rate is high. Finally, I am doubtful whether it will be useful to give the government the right to have 25 per cent of the demand deposits of commercial banks. It is better to keep the government out of the banking system as far as possible. Another related question is that when will the government return that 25 per cent? In abstraction the model may sound very well. But in practice what will happen is that after one year or two, the government will say that we are not paying back the 25 per cent borrowed.

Dr. Sultan Abu Ali

I do not think that Dr. Chapra is over-burdening the monetary policy by having multiple objectives. We should look at these objectives as the objectives of government policy and what he is trying to show is what role monetary policy should play in achieving those and he is correct in that. My second point relates to the matter of finding resources to finance government activity. I think if *Zakah* is properly collected, it would not be necessary for the government to resort to deficit financing. His suggestion of diverting 25 per cent demand deposits to the government, means that he is accepting the government deficit as a means for achieving economic objectives. But I think deficit financing is the main source of the rate of inflation that we are experiencing. If we make more resources available to the government, this will aggravate the situation of inflation further.

Thirdly, about speculative motive, I would like to agree with Dr. Ariff. I think in Islamic economy, the speculative motive will still exist. What might be the reason for some of us not accepting the speculative motive, is that when Keynes was talking about the liquidity preference he compared money as a store of value with bonds and bonds are not permissible in Islam. But this does not mean that this is the only form of assets which should be considered. You may very well hold money till you have a more appropriate asset to invest in and this is speculative motive. As for *Zakah* and its effect on speculative demand, I do not agree that the *Zakah* would reduce the speculative demand. *Zakah* will be imposed on assets which are lying idle for one full year. It will not be imposed on deposits which are lying idle for less than one year. On the question of indexation, I disagree with Monzer Kahf. Actually, indexation makes more justice because we are trying to return the same purchasing power and this is also implied by so many *Ahadith* and by the principle of Islamic justice.

Dr. Syed Aftab Ali

In case of indexation, shall I assume that you would be just talking about indexation in terms of the value of money and ignoring the indexation of income and prices which also play a rather integral role in any economic system including the Islamic economic system. Secondly, I have an observation with respect to the speculative demand for money. Is it because we do not know enough about the nature of risks and uncertainties involved in the speculative demand that this aspect has completely been ignored by Dr. Chapra?

My third, observation relates to the role of investment which the central bank will probably assume. (i) What will happen to the decisions that would have to be taken in terms of various types of portfolio investment if any? (ii) What will be the role of the central bank in terms of getting involved into some very sophisticated industrial investment decisions? I assume that if that happens to be the case then a certain amount of technological expertise would be required either in the central bank, or in the commercial banks where the investment decision have to be ultimately taken.

Dr. Anas Zarqa

The paper by Dr. Chapra is an excellent one. I would like to mention three important points which were well argued in the paper, before I take exception to another point. First, the multiplicity of the objectives is crucial and should be kept in the forefront all the time.

The second important point is the idea that the central bank can provide finances to commercial banks *through mudarabah advances.* This answers the question of how can we affect the supply of money without interest-bearing instruments. Another significant point is the question of financing part of the government deficit. Here, I think what Dr. Chapra should have said is that we can make use of a certain proportion of the *growth* in deposits to finance government deficit. Deficit is a flow, whereas deposits are stocks. So only the growth in the stock of deposits can finance part of the government deficit on a permanent basis.

The exception I want to take is about the question of indexation where a satisfactory treatment requires a separate paper. An Islamic position on indexation can be reached only after careful assessment of its economic implications in the light of both *Shari'ah* principles and the alternatives to indexation. Regarding alternatives, it is worth remembering that *Shari'ah* permits interest-free loans *in kind* where repayment is also made in kind (an equal quantity of the same commodity). Another alternative to indexation of loans is to facilitate real investments in *small* units through suitable kinds of mutual funds. The assets of such funds are well diversified in real investments or in shares of productive enterprises. Such assets usually appreciate during inflation. This is entirely acceptable in *Shari'ah* (whereas outright general indexation of loans is not – as far as I know) and should be seriously considered by those who claim that permitting interest is the only way to protect the small saver. More research is required in this area, and I hope Dr. Chapra and other competent Muslim economists and jurists would scrutinise the issue.

Dr. Omar Zubair

I have a couple of points to make. First of all, the question of indexation, the *Fuqaha* do not accept it generally. However, as Dr. Anas Zarqa has pointed out loan in kind is acceptable. So that may be one possibility. As for the definition of inflation, I think a mild rate of inflation may be acceptable in an Islamic economy but we must try to minimize it since a high rate of inflation involves injustice to the lender in an interest-free system. Multiple credit creation by banks also leads to inflation. As a matter of fact less than 100 per cent reserve requirement is not permissible in the Islamic economic system.

Dr. M. M. Metwally

I have three points. First, the rate of interest in a capitalist economy performs the function of achieving equilibrium in the money market. In Islamic economy there would not be interest. How would we achieve equilibrium in the money market? The rate of profit would not do it. We have to find some other alternative. My second point is that in Islamic economy there would not be any short-term bonds. Some substitute is required. Finally, I agree with the view that speculative demand for money can exist in an Islamic economy.

Dr. M. A. Mannan

My first point is that indexation is justified in Islamic economy. It will protect the value of money and bring more justice to the lender in an interest-free system. Secondly, a view was expressed here that in Islamic economy, money has only a medium of exchange function. I do not agree with that. I think there is also a store of value function for money in an Islamic economy. Also, there is a role of speculative demand for money.

Dr. Anas Zarqa

Both Dr. Munawar Iqbal and Dr. Ariff have raised very thought-provoking comments. A big question that was raised by Dr. Iqbal is that we need to spell out the effect of money on the real sector of the economy in Islamic framework. This is a very important theoretical question. I will offer a very very small answer, though partial, building on the paper of Dr. Nejatullah Siddiqi. When the central bank decides to expand the money supply to provide more funds to commercial banks as *mudarabah* funds, the commercial banks will be willing to accept a smaller share to profit when they provide these funds to investors and that is how you can affect the real sector. The businessmen will realise more net profits even if the profit expectations are low. There is a financing partner who is willing to accept a lower profit share so the net profit accruing to the businessmen will be affected. Thus, we have a sort of uni-directional effect of monetary expansion on the profits of business.

Professor Syed Nawab Haider Naqvi

I want to draw the attention of the author to a fundamental fallacy in his paper where he talked of a trade-off between inflation and unemployment that he thinks is a characteristic of the capitalist economy, and which he does not like. I do not like it either, but it does not mean that it will automatically go away. In an Islamic economy the trade-off between inflation and unemployment will not vanish. What the author implies is a vertical Phillips curve, which will obtain in case of price rigidity, because price rigidity means perfect foresight. In practice, however, neither complete price rigidity nor perfect foresight is possible. So Phillips curve will have a negative slope and the trade-off between inflation and unemployment will exist.

Dr. Sharafat Ali Hashmi

The experience of last 50 years shows that inflation is going to persist for quite a long time. In this condition of persistent inflation what would be the motivation for interest-free saver? My personal view is that the capital should be protected from inflationary erosion. Some kind of indexation would be necessary at least during transitory period.

Dr. A. R. Kemal

There has been a discussion on multiple policy objectives. Hoping to do every thing with one policy is all right but the question is whether we are going to achieve the target or not? I agree with Dr. Ariff that we should use one policy instrument for one policy objective. I also agree with Dr. Munawar Iqbal that we should rank the objectives. My second point is concerning indexation. I think it is permissible in an Islamic framework. If we have a basket of goods and we use it as a means to index the loans then we will be able to protect the value of the loans over time.

Dr. Mahfooz Ali

There is a built-in element of indexation in an interest-free economy in case of fixed investment under *muzarabah* as well as under *sharakah* enterprises. This can be clearly seen in case of liquidation of the enterprise. For settlement of accounts in the event of dissolution of *sharakah*, the issue will be settled by the valuation of assets, and liabilities so as to determine the net realisable worth. This will have a built-in element of indexation. The problem of indexation in interest-free economy, therefore, mainly relates to working capital financing. If there is indexation in case of fixed investment how can we weed out indexation from working capital financing? To do so will be inequitable to the providers of working capital. Also in interest-free banking the general mode of *muzarabah* as well as *sharakah* will be that of transitive *muzarabah* and transitive *sharakah* between deposit holders and users of bank credit via financial mediation by banks. It is simple to see that banks will be protected by built-in indexation. This benefit must be passed on by the banks to the deposit holders. To do so will sustain the confidence of the depositers and encourage savings rate and also achieve justice by protecting the real value of savings.

Dr. Masudul Alam Choudhry

I would like to make a point about the effect of monetary policy on unemployment. There is a kind of unemployment known as structural unemployment and this kind of unemployment is a very large segment of the unemployment picture. But neither monetary nor fiscal policy has an effect on this kind of unemployment. I would like the author to explain how will monetary policy in an Islamic framework improve the situation of structural unemployment. I think, what we need in that case is a manpower policy.

Dr. A. A. Rushdi

I congratulate Dr. Chapra for his very illuminating and scholarly paper without repeating what has already been said. One point I would like to know from the learned author is whether in his opinion the present *credit* creating power of the commercial banking system will continue in the Islamic system? As we know, the commercial banks in the process of multiple credit creation, create money for which neither the banks nor their depositors make any *sacrifice*. By doing so the commercial banks exercise a power which should be a prerogative only of the state or its agent, the *central bank*. I think the suggestion for handing over to the government a percentage of the demand deposits is very much innovative. Now, if this is against the *created deposits*, government may *not* be liable to pay any service charge as prescribed by the learned speaker. Moreover, exact apportioning of the cost of mobilizing demand deposits may not be practicable either. As regards created deposits or the 'derivative deposits', the learned speaker has suggested to regulate this through controlling *base money*. As a matter of fact the main source of base money for the commercial banks is not the central bank, it is rather public deposits. The central bank's regulatory power over the supply of base money by variation of reserve requirement and by denying or granting a loan to the commercial banks is recognised. In an Islamic system, central bank's loans to commercial banks are supposed to be limited, as financial assets in general are likely to be risk-bearing and central bank's involvement in risk-bearing financing may reduce its status as the regulatory authority. However, loans may be sanctioned against reserves with the central bank. In the present system it is an injustice to the borrowing commercial banks to charge interest while their money is lying idle with the central bank in the form of reserves. However, the reserve requirement is a strong instrument to control the size of money multiplier (m) provided the proportion of M held by public as cash remains constant. In the Islamic system if the *multiple* is taken away by the government, the reserves with the central bank may be used for granting loans in emergency and for facilitating inter-bank transactions only.

Another point related to this is how the commercial banks in the Islamic system would utilize their current account balances. If the balance is utilized for short-term profit-bearing advances, then the depositors will have to bear risk which they may not be willing to do. If 100 per cent cash is maintained, the cost of transactions on current account may be too high for smooth commercial functioning. In the present system the real interest given to current account holders is sometimes more than the nominal interest given to saving depositors – this is what has been revealed by a survey made by the *Guardian* of London in 1971. Under these circumstances it may be worth considering that a certain portion of current account balances be utilized to meet the emergency withdrawal of PLS accounts and margin of benefit may be provided to even C/A holders. This will provide incentives to many to keep their balances with banks rather than keeping idle with themselves. As such this would provide a more favourable condition for central bank to control the overall monetary situation. My fourth point is related to maintaining the external value of currency, which is one of the very important objectives of present-day system. Monetary policy in Islamic framework cannot overlook this either. Moreover, in UDCs, internal value is also closely related to the external value of the currency. Today throughout the Muslim World we use dollar and sterling as our reserve currencies. It is a pity that the Muslim countries use U.S. dollar even for transactions among themselves. Thus the total demand for U.S. dollars appears more than what it is in fact. This puts them in an advantageous position to have their currency recognised as reserve currency and thus they can meet their international commitments simply by running deficit and thus exporting inflation to others. Muslim countries together have a very substantial balance of payments surplus. If all the Muslim countries could form an institution like Islamic Monetary Fund in line with IMF, I think most of our problems in international transactions would be solved even without resorting to very high interest-bearing SDR. I am sure, this would help us a lot towards stability in the value of money both home and abroad.

Dr. N. Vagar

Previously we used to manipulate rate of interest to control the monetary sector and to control the money supply. Now it is exactly opposite, i.e. we control the money supply and that will take care of the rate of interest.

Dr. Mohamed Ariff

I want to emphasize the point whether or not we can assign more than one policy objectives to monetary policy. In some cases that may be possible. But sometimes there are policy crisis when you assign a number of policy objectives to one instrument. So it is imperative for us to identify the situations when such policy crisis can occur and what to do about these crisis. I want to emphasize the relationship between the right kind of policy objectives to the right kind of instruments. But that does not mean that you assign only one policy objective to one instrument. Monetary policy instrument can tackle more than one objectives at certain times. But the point I want to make is that some policy instruments are better suited to achieve certain objectives. Mundell has demonstrated that fiscal policy instruments are better suited to achieve internal equilibrium and monetary policy is better for achieving external equilibrium and if you pair them wrongly, you have an explosive situation where you move away from general equilibrium. Let us see what are the objectives which can be better tackled by monetary policy and what are the objectives which should be left for other policy instruments.

Dr. Umer Chapra (Winding up)

I am grateful for a number of comments which are extremely valuable and which I will certainly take into account. However, I must point out that some of the comments were not relevant because may be the speakers did not have the time to go through the paper before they made their comments and they relied only on the presentation that I made which was very brief. For instance, this point which Dr. Vagar raised about the shift in the monetary policy these days to the regulation of the quantity and the shift away from the rate of interest;

this has been quite elaborately given in the paper and I did not bring it in the presentation because I assume everybody has studied this point. Now, of course, some of the points are certainly going to remain as points of dispute between us now and may be in future and this is something really healthy. We cannot create a unanimity on a number of points which have come up in the discussion.

I must point out the reason for the multiplicity of objectives and particularly my stress on the distributional aspect of monetary policy. This is because I believe that the banking system has been one of the major sources of inequalities of income and concentration of wealth and unless monetary policy addresses itself to this subject, we will be just beating about the bush. We have to use the banking system for reducing inequalities and concentration of wealth. In the other two objectives there was no major disagreement. But I would insist that if we want to bring about equitable distribution of income in the Islamic economy, we have to tackle the major sources of these inequalities and we cannot do so without proper handling of the banking system. As to the stability of the value of money, I have stated prices stability as our ideal. How far can we achieve it, is of course a different thing. But we must try to check it. There are questions raised as to whether the mild inflation is good or bad and what are the safe limits. These are of course points which need to be given necessary attention. The fact is that it can mean different things at different times. There was a time when 1 – 1½ per cent was considered to be mild but now in some countries even ten per cent may be accepted. Regarding the external value of money, it is generally realised that if you do not have inflation in the domestic economy, then the external stability in the value of money may not be a problem. Coming to Dr. Naqvi's point about Phillips curves; it is now generally realised that the emphasis, that he placed, is not right and in fact it has been empirically proved to be wrong. There has been a lot of discussion on this question and there have been periods in the past when there has been inflation or a rising rate of prices accompanied by rising rate of unemployment. So the validity of the Phillips curves has not been as secure as he tried to point out.

A question has been raised about the use of money for speculative purposes. I think if this concept is applied to the Islamic economy we are bound to get into a number of problems. One of the reasons for large volume of speculative funds available, is the unrealistic tax structure in a number of developing countries. The tax structure is such that it generates black money and this black money cannot be used for productive purposes. So the only use you are left for it is either to indulge in luxury consumption or speculation of various types, because it can only go in the areas where it is difficult for the government to detect. So if we want to talk in terms of these elements, we shall have to talk about removing these problems which our economies have created for themselves. Whether there is Islam or no Islam we have to solve these problems and then comes the question of applying the Islamic ideals to our economies which would take us even a step further towards our goals.

A Monetary and Financial Structure for an Interest-Free Economy: Institutions Mechanism and Policy

*Dr. Ma'bid Ali Al-Jarhi**

I

THE BANKING STRUCTURE

The banking structure usually comprises a central bank representing the monetary authority and the commercial banks which work under its supervision as well as the specialized banks and financial intermediaries. However, the role of these institutions is bound to change under the system of interest-free banking. This section will review this structure in the light of their operations without an interest rate.

The Central Bank

A central bank is an institution entrusted with the management of the supply of money. This involves the issue of fiat money as well as the control of commercial banks.

a. Fiat Money Creation

Ordinarily, the central bank stands ready to issue money against interest-bearing claims on the government. The central bank creates money in two cases: firstly, when the government borrows directly from it, and secondly, when it (the central bank) decides to carry out an expansionary "open-market operation."

In the first case, government borrows to finance a deficit in the budget, which is politically determined. In the second case the central

*The author is in Arab Monetary Fund, Dubai.

bank attempts to stabilize the economy through open-market operations. The decision to borrow from the central bank is politically easier than raising taxes and less costly than borrowing from the public. This would make it relatively more attractive for governments to extend their hands to the central bank which is always there to oblige. Financing politically unpopular undertakings as well as an important fraction of the activities of politically weak governments, or governments with inefficient tax structure is always done through this method. While both bring forth to the government the resources it desires, borrowing from the public and borrowing from the central bank are not similar in economic effects.

Borrowing from the public keeps the current (nominal) money supply at the same level. However, to the extent it raises future tax liabilities, it redistributes wealth from future to present generations.[1] Borrowing from the central bank, however, changes the nominal supply of money. This has ramifications on price and, consequently, on the distribution of wealth. It could, therefore, influence both efficiency and equity. Further effects of changes in the money supply on the real sector cannot be ruled out *prima facie*, and can, under certain conditions, be significant.

To be a lender of last resort to the government is not critical to the central bank. Besides, there is an alternative which is economically, if not politically, superior, i.e. to borrow from the public. However, if the central bank does not issue fiat money against interest-bearing assets, it may be thought of as not exercising its authority to control the money supply and, consequently, the price level. We will show below that there are alternative means for doing so.

b. The Determination of the Money Supply

The function of the management of the money supply involves providing for the transaction needs of the community, especially in a growing economy. While the central bank must, therefore, set the money supply at the level which provides the "maximum" amount of transactions services, it must keep the level of prices stable.

It is important to note that it is the real and not the nominal unit of money that produces transactions services. This implies that an increase in the supply of (nominal) money will afford greater transactions services for the community only to the extent that the price level stays stable; or increases less proportionately than the money supply.

[1]The wealth of the holders of new government debt will not change except through future tax liabilities.

c. Money, Growth and Prices

An increase in the rate of growth of money creates excess demand for goods (excess supply of money) at faster rates. Assuming markets to be stable, equilibria will be regained. However, the new rates of growth of prices will differ from the old ones depending on the *price* speed of adjustment as compared to the *quantity* speed of adjustments in all markets.

Speeds of adjustment can be related to three factors: the institutional framework of the economy, the degree of complementarity and substitution between goods, and the rate of growth of the economy.

To illustrate the first point, the rate of growth of prices can be written as:

$$\dot{P} = \dot{P}\,(P_i; i = 1, \ldots, n) \qquad (1)$$

where P_i is the rate of growth of the price of the i^{th} good, which is equal to:

$$\dot{P}_i = \frac{dP_i/dt}{P_i} \qquad (2)$$

$$= \left[\frac{\delta P_i}{\delta S_i} \cdot \frac{dS_i}{dt}\right] / P_i \qquad (3)$$

where S_i is the excess demand for the i^{th} good.

Equation (3) shows that the rate of growth of the i^{th} price can be decomposed into two factors. The first is the responsiveness of the price of the good in question to changes in its excess demand. The second is the extent to which that excess demand is increasing or decreasing over time. While the first term refers to the price speed of adjustment, the second refers to the quantity speed of adjustment.

Speeds of adjustment can be hindered by non-competitive elements on the institutional side of the market, e.g. government regulations, monopolies, etc. They also depend on substitutability and complementarity between goods.

Given the institutional arrangements as well as the degree of substitutability between goods, speeds of adjustment depend on the rate of economic growth. This is so because the quantity speed of adjustment is faster with higher rates of growth, as it becomes easier to satisfy excess demands in this case. Therefore, we can say that, *ceteris* *paribus,* the higher the rate of growth, the lower the rate of inflation[2] resulting from a certain increase in ($\dot{M}$).

The optimal supply of money is the rate of monetary growth which maximizes the transactions services for the community; and the optimal monetary policy is that which equates monetary growth to this rate. Since we are concerned with the services of real money units, a comparison between monetary growth and rate of inflation is necessary.

The comparison between the rate of growth of the money supply ($\dot{M}$) and the rate of growth of prices ($\dot{P}$) could be based on a postulated relationship between the two variables like the one depicted in Figure I. The faster the growth of money, the stronger is its effect on the real sector in terms of rising demand schedules and, consequently, the faster rise in prices.

We can, therefore, perceive rates of monetary expansion low enough not to produce any inflation, given the real growth of the economy and the state of expectations. As $\dot{M}$ rises, $\dot{P}$ will increase in response, but less proportionately in the beginning. Sooner or later, increase in $\dot{M}$ produces equiproportional changes in $\dot{P}$. This is depicted by the portion of the curve in Figure I beyond 0a.

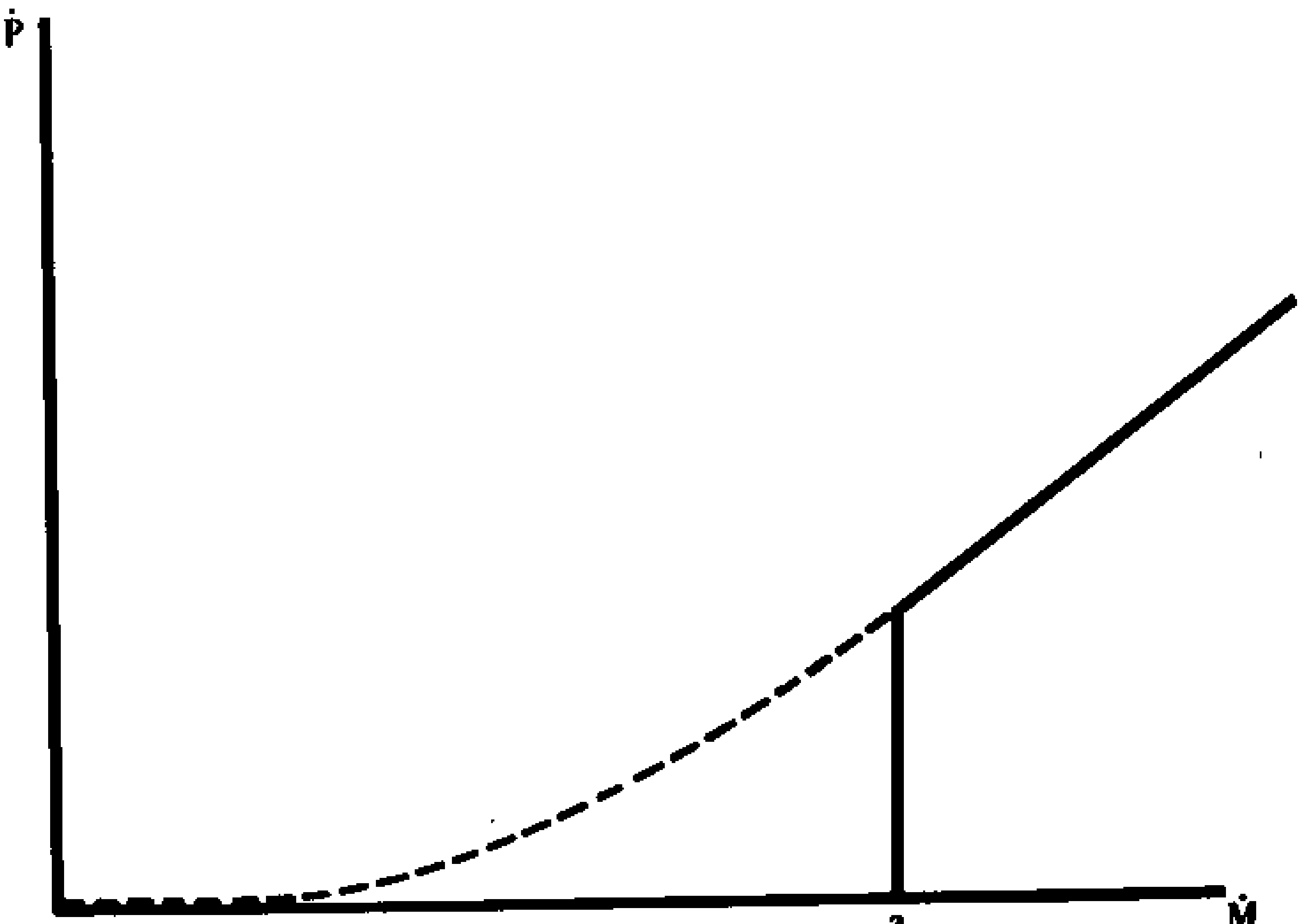


Figure I

[2]Notice that higher rate of growth means decreasing excess demands over time, i.e. negative $\frac{(ds_i)^2}{d^2t}$ in equation (3).

It is possible that increase in $\dot{M}$ produces more than a proportional change in $\dot{P}$, when higher monetary growth gives reason to expect more of the same in the future. However we rule this case out for simplicity.

We can consider the proposition that economic growth attenuates the effects of monetary expansion on prices. Figure II shows the monetary expansion lines L_1, through L_4 which are associated with the rates of growth g_1 through g_4, respectively; where $g_1 > g_2 > g_3 > g_4$. The proportion of the expansion curve within which prices respond less proportionately to monetary expansion is larger with higher rates of economic growth. Along L_4 (g_4) the rate of growth is so low that any monetary expansion produces equiproportional change in prices.[3]

The portions of the expansion lines which coincide with the horizontal axis show that monetary expansion is being fully reflected in growing real balances. As indicated by Figure II, such a non-inflationary monetary expansion would be equal to $0e_1$ when the economy grows at g_1, and $0e_2$ when it grows at g_2. Higher rates of monetary expansion would lead to positive rates of inflation.

An economy which prefers strict price stability, *viz,* $\dot{P} = 0$, should choose $\dot{M} = 0e_1$, or $0e_2$ when real growth is equal to g_1 or g_2, respectively. Otherwise, $\dot{M}$ should equal zero. Rates of monetary expansion higher than $0a_1$, $0a_2$, or $0a_3$, with g_1, g_2, or g_3, respectively would cause correspondingly equal rates of inflation. However, if the central bank cannot issue money against interest-bearing securities, the mechanism for monetary expansion, or contraction must be outlined.

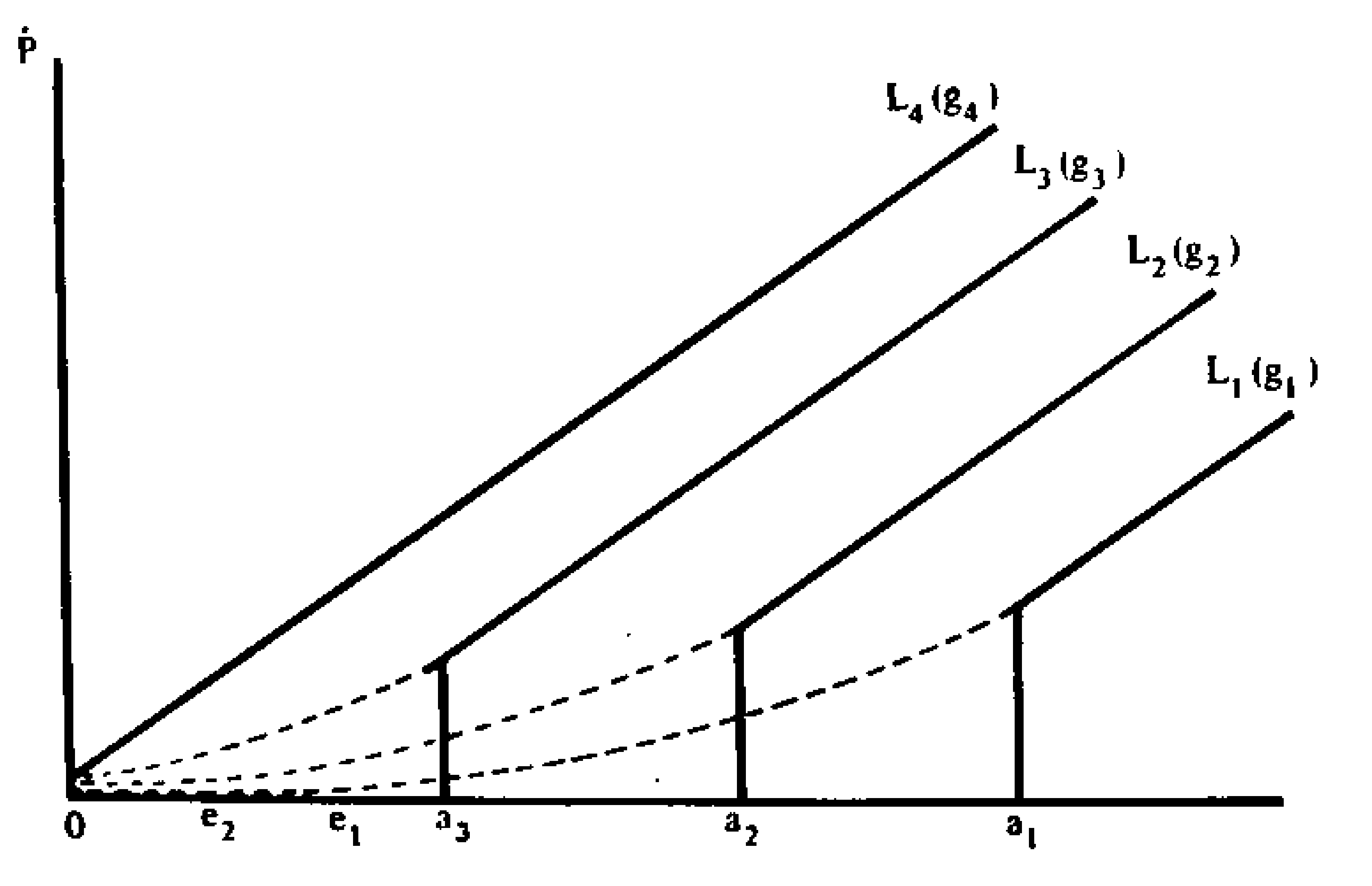


Figure II

[3]This is where the quantity theory of money strictly applies.

d. Variation in the Supply of Money

Variations in the supply of money can be effected through opening investment accounts by the central bank in the member banks to which the central bank deposits whatever money it creates and from which it withdraws whatever money it retires. Member banks, as will be seen below, will invest those deposits in the real sector in accordance with their investment policies. Profits earned on such deposits could be used to cover the cost of central bank operations. Such deposits will be termed central deposits, or CDs.

While CDs can be used as a tool of monetary policy, they can also be used as a means of financial intermediation, which would amount to additional monetary services. The central bank can create an instrument which could be termed as "central deposit certificate". These certificates can be sold to the public and their proceeds be invested in CDs throughout the banking system. Obviously, the central deposit certificates provide a lower degree of financial risk, since each carries with it a title to a more diversified investment portfolio than any member bank by itself can provide. The rate of return on the CDCs will approach the average rate of profit on investment for the whole economy.

Member Banks

Member banks in this system are not the traditional commercial banks, since they would undertake direct investment in addition to providing the regular banking services as well as lending. A rather proper term for such an institution could be a "business bank", or *Banque d'Affaires*.

a. Banking Services

(1) Demand Deposits. These are similar to the checking accounts usually held in commercial banks. They carry no rate of return, but give their holders the right to write checks against them. They could be insured against bank insolvency. The existence of demand deposits raises the question of whether the central bank should enforce a 100 per cent or a fractional reserve rate. It is obvious that with fractional reserves, when traders switch from "high powered money" to "deposit money" and *vice versa*, the total supply of money will change. However, with one hundred per cent reserves, such a switch will change the composition of money, leaving its total supply constant.

Friedman uses the above reason to suggest the abolition of fractional reserves.[4] He argues that fractional reserves cause the monetary system to suffer from an "inherent instability". While Friedman's argument is correct, it is not the only basis for abolishing fractional reserves.

In contrast to many writers who believe that the "Production" of money is costless[5], the approach presented here suggests that adding *real balances* to the existing stock is more costly than just operating a printing machine. The central bank has to watch for the changes in prices while keeping an eye on economic growth. Traders would require assurances of the relative price of money and its future developments, so that their expectations are not misread, whatever is the monetary policy. Such a process of "asset characterisation" is costly.[6]

The process of creating derivative deposits and the change in the money supply resulting from substituting deposits and cash for each other both change the cost of producing real balances. Specifically, such changes in the money supply resulting from banking as well as depositors' behaviour under fractional reserves make it more costly to maintain either the existing stock of real balances or make any addition to the same.

We consider that both these factors – the inherent instability and the cost of producing real balances – warrant the adoption of 100 per cent reserves.

(2) Other Services. The bank can provide the same services as those of the commercial banks, like selling foreign exchange, issuing letters of credit, etc. Such services can be provided for a fee.

The bank may have to establish correspondence relationships with foreign banks to facilitate the provision of these services. It may keep interest-free deposits with its correspondents on a reciprocal basis, or may pay its correspondent for whatever services it requires.

[4]M. Friedman, *A Programme for Monetary Stability,* (New York: Fordham University Press, 1959).

[5]L. W. Mints, *Monetary Policy for a Competitive Society,* (New York: McGraw-Hill Book Co., 1950), p. 186; G. S. Tolly, "Providing for Growth of the Money Supply", *Journal of Political Economy,* 65 (December 1957), p. 465–485, especially pp. 477–484; M. Friedman, *A Program for Monetary Stability,* (New York: Fordham University Press, 1959), pp. 71–73; M. Friedman, "The Optimum Quantity of Money", in *The Optimum Quantity of Money and other Essays,* (Chicago Aldine Publishing Co, 1969), 1–50; P. Samuelson, "What Classical and Neoclassical Monetary Theory Really was", *Canadian Journal of Economics,* 1 (February 1968), pp. 7–10; P. Samuelson, "Nonoptimality of Money Holdings Under Laissez Faire", *Canadian Journal of Economics,* 2 (May 1969), pp. 303–308; J. Tobin, "Notes on Optimal Monetary Growth", *Journal of Political Economy* (July/August 1968), pp. 833–873.

[6]M. A. Al-Jarhi, p. 373 f(f).

b. Investment Activities

Member banks can engage themselves in three kinds of investment activities.

(1) Direct Investment. This allows the bank to hold shares in enterprises and participate in their administration. The bank can use its expertise to give technical assistance to those companies, in order to enable them to be more profitable. Geographic proximity to the projects involved, possession of first hand information about their activities, and relative familiarity with people operating them, all afford banks excellent opportunities for profit. Considering their expertise, banks can increase the degree of business success in their communities.

(2) Profit-Sharing Ventures. This category of investment provides for short-term placement of funds to finance business needs for liquid capital for the duration of a production cycle. It is also a good outlet for funds to be employed in commercial activities. When a businessman requires funds for transitory use during the production cycle and until the output is sold, the bank can provide such funds on a profit-sharing basis. The earnings of the business after allowing for the cost, will be divided between the business and the bank according to an agreed formula. The same goes for commercial ventures.

The time length of such operations could vary from six to twelve months for industrial and agricultural projects. Yet it could be as short as 60 or 90 days for commercial ventures.

(3) Leasing Activities. A member bank in this scheme can purchase means of transport (ships, planes, etc.), industrial equipment, buildings, and the like and lease them to users against periodical instalments. The lease agreement may terminate with a transfer of title to the user.

While leasing contracts can provide a means to serve customers in a way that is flexible enough to cater for varying needs, they provide the bank a way to invest in an equity which transfers itself into liquid cash gradually over a certain period of time.

c. Lending Activities

Since banks do provide long- and short-term capital to enterprises on equity or profit-sharing basis, borrowing by business would become unnecessary. Yet some borrowing would still be needed to balance one's income stream with his consumption stream. This is the case when an individual expects higher levels of income in future periods and hence aspires for a correspondingly higher level of present consumption. This cannot be done without borrowing.

The central bank can frame a regulation that each bank would devote a small percentage of its resources to interest-free lending. The central bank can supplement such resources from its CD earnings. Naturally, since loans would be interest-free, funds have to be rationed according to some social criteria.

Some members of the community would be interested in making a part of their financial resources available for interest-free lending. While this would be motivated by altruistic reasons, it could be encouraged by stable prices. Some individuals may hesitate to lend due to their inability to assess the borrowers' future earnings. In addition, since they are non-specialists, it would be relatively more costly for individuals to do so. The central bank can overcome this problem by issuing central lending certificates (CLCs), which carry no return, but are *guaranteed* to be paid on maturity. Proceeds of CLCs can be made available to member banks which would lend them to borrowers after proper assessment of their future income, and application of social criteria, if rationing is required.

II

THE TREASURY

The functions of the public sector have been traditionally divided into what is known to be the distributive branch and the allocative branch.[7] While this would bear similarity to the Islamic structure, there are some differences.

The distributive branch in the Islamic system is responsible for the collection as well as the distribution of *Zakah*. The allocative branch takes responsibility of the mineral resources which are generally considered to be a social property. This adds another feature to the allocative branch which is traditionally known to be in charge of the financing and production of public goods.

Handling monopolies, ensuring orderly markets, correcting for externalities, and the like can be placed in another branch which will be termed as the "market correction branch".

The Distributive Branch

A distributive tax is levied on the following:

1. Monetary assets held for one year, including cash, demand deposits and debt.

[7] R. A. Musgrave, *The Theory of Public Finance*, New York, McGraw-Hill, 1959.

2. Titles to real assets held for a year, e.g. shares, profit-sharing funds, etc.
3. Gold, precious metals, and diamonds, on the basis of their current market value, when held for a year.
4. Net earnings of assets not included in the above categories.

The tax rates, which differ from one category of assets to another, are applied to holdings over and above a certain level.[8] Persons having an income below a certain "minimum" level, called *nisab*, are entitled to a share of *Zakah* proceeds, until they reach that *nisab*. The government is allowed to increase *Zakah* collection if incomes below *nisab* persist, despite the collection (and distribution) of ordinary rates and as long as the current distribution of wealth allows further redistribution.[9]

The Allocative Branch

a. Division of Mineral Resources

The state ownership of mineral resources does not necessarily imply state production. The state could enfranchise private producers for this purpose. However, the state can involve itself in the production of minerals through state-owned enterprises.

The Mineral Resource Division assumes, directly or indirectly, the responsibility for mineral production, and its proceeds are added to the Treasury to be used for financing government operations.

b. Division of Public Goods

Public goods are the goods whose consumption is carried out *collectively*, e.g. defence, education, certain categories of health services, and so forth. While the details of their provision is determined through the political process, the state stands responsible for putting those provisions into effect.

Public goods may be produced directly by government-owned enterprises or by private-sector enterprises. They are financed by the net proceeds from the Mineral Resource Division and from other taxes. Some of the public goods, like defence, can be financed from *Zakah* proceeds given enough funds from that source.

c. Division of Market Order

The working of free markets can always be disturbed by the rise of

[8]Those who desire further details can refer to Yussuf Al-Qaradhawy, *Fiqh Al-Zakah*, 3rd ed. Muassassat Al-Rissalah, Beirut, 1977.

[9]There are other uses of *Zakah* proceeds, but the poor hold first and utmost priority to them.

monopolies, the existence of externalities, and other market "disorders". Dealing with such problems could involve a certain tax-subsidy network or direct regulations by the government. Most of the time, what is required is a tax-subsidy scheme. In extreme cases, direct control may be called for. These operations could be financed through balancing tax collections with subsidy payments. It may also call for special taxes to finance the maintenance of "orderly markets".

III

THE FINANCIAL MARKET: INSTRUMENTS

A review of the balance sheet of the central bank as well as member banks will show the different financial instruments which comprise the "demand side" in the financial market. In order to obtain a complete picture of the financial market, the "supply side" will also be considered.

Bank Balance Sheet[10]

a. The Central Bank

Assets	Liabilities
1. Central Deposits	1. Central Deposit Certificates
2. Loan Accounts with Member Banks	2. Central Lending Certificates
3. Cash in Vault	

The central bank holds central deposits and loan accounts with member banks which, in addition to cash in vault, constitute the central bank assets. On the Liability side, the public holds the central deposit and the central lending certificates.

Unlike the traditional process of money creation, issuing money by the central bank is not a liability that is offset by holding assets (government securities). In our case, this process increases the central bank deposits with member banks. Retiring money has the opposite effect of decreasing the central bank assets, with no offsetting liabilities.

[10]Other items, not directly related to our discussion are ignored.

b. Member Banks

Assets	Liabilities
1. Cash	1. Demand Deposits
2. Equity in Enterprises	2. Specific Investment Deposits
3. Profit-Sharing Accounts	3. Specific Investment Certificates, SICs.
4. Leasing Accounts	4. Profit-Sharing Deposits
	5. Profit-Sharing Certificates, PSCs
	6. Leasing Deposits
	7. Leasing Certificates, LCs
	8. General Investment Certificates, GICs

Member banks place their resources in equity (direct investment), in profit-sharing accounts, and in leasing accounts. That constitutes the Assets side.

On the Liability side, member banks open deposits for specific or general investment, for profit-sharing, and for leasing. The deposits are to be used for the purposes designated by their names. In addition, demand deposits are offered to those interested in checking accounts. Depositors can move their funds from one kind of deposits to another, within the time limits which could be specified for their deposits. Moreover, except for demand deposits, withdrawal requires a prior notice within a time limit. In addition, member banks issue specific and general investment certificates (SICs & GICs), profit-sharing certificates (PSCs), and leasing certificates (LCs). Each kind of certificate is issued for a variety of maturities that cover the spectrum of tastes of the savers. Each certificate pays out dividends whose amounts are not specified in advance.

The Financial Instruments

Savers in the present model have the following three investment alternatives:—

a. Corporate Stocks

A saver can directly buy stocks and become a stockholder. This affords him direct participation in the management of the company to the extent of his capital. If his savings are substantial, he can divide them into holdings in different companies. A proper diversification scheme can be applied in this respect.

In an economy where private enterprise has a significant degree of freedom, stocks would be easy to trade. To the extent this is true, stock prices should reflect a "market consensus" on the expectations of the future earnings of each respective enterprise.

b. Member Bank Certificates

Member banks can offer four kinds of certificates:

(1) Specific Investment Certificates (SICs). These certificates would carry the name of an enterprise in which the value of the certificate would be invested. They would be exactly like stocks held by a member bank for a particular customer.

The advantages of holding stocks through a bank include the use of the bank's expertise as well as its block-vote, as a representative of more than one stockholder. Small stockholders in particular would benefit from these advantages.

(2) General Investment Certificates (GICs). A GIC value would enter the general pool of member bank investment. Its holder would be entitled to an average rate of profit on all operations undertaken by the bank. It is the closest thing to holding a stock in the bank itself. In addition to the expertise and the blockvote power, the GIC provides a greater degree of diversification. This could mean lower risk for savers. GICs can be issued for different maturities ranging from 60 days to 5 or even 10 years, depending on the range of bank operations. They can be marketable, which would make them relatively liquid.

(3) Profit-Sharing Certificates (PSCs). A profit-sharing certificate involves investment in short-term operations. Its maturity varies from 60 days to one year. It offers diversification among short-term placements. All these characteristics could make it specially marketable and relatively attractive for savers who desire to stay closer to the higher edge of the liquidity spectrum.

(4) Leasing Certificates (LCs). A leasing certificate is similar to an SIC, except that it is a form of declining equity. Lease payments include profit plus capital depreciation. If both parts are refunded to the holder, net of bank costs, he recoups part of his capital as the term of the lease gets closer to maturity. It is possible to design LCs which entitle holders to dividends only during lease time. Meanwhile, capital repayments would be reinvested in other lease contracts.

c. Central Deposit Certificates (CDCs)

As mentioned above, a CDC gives its holder a share in the central bank deposits which are being invested with all member banks. This makes it the most diversified investment in the economy. In addition, since it involves two layers of financial intermediation, namely banks and the central bank, it should be the safest instrument available.

The central bank allocates its CDs among banks according to profitability, liquidity, and risk. By using these traditional investment criteria, the central bank encourages investment efficiency in the economy, since only bank operating efficiently will obtain central deposits. This ultimately leads to high rates of economic activity in the economy, especially if the aggregate amount of CDs is significant.

Being relatively more familiar with member banks than individuals, the central bank can make a more reliable judgement on the performance of each. This further reduces the financial risk to the CDC holder. CDCs are easily tradable and would have a wide market. Moreover, since there are titles to CDs, they can be redeamed for their face value plus dividend through the central bank. This, however, could not be done instantly. Since CDs are investment rather than demand deposits, prior notice must be given to banks for withdrawal.

d. Central Lending Certificates (CLCs)

As mentioned before, CLCs are titles to a fixed sum of money. The proceeds from their sale will be used by the central bank for loans to borrowers whose future income expectations warrant their solvency. Besides, the CLCs do not give any rate of return to their holder.

It may be suspected as to why people would want to hold "barren" assets, when a wide spectrum of financial assets are available. Altruistic reasons explain that. In addition, the central bank could guarantee the instant encashment of CLCs[11]. This makes them both safe and liquid. They are good substitutes for cash considering the cost of demand deposits and of safe deposit boxes. However considering the fact, that a holder would have to pay *Zakah* (2.5%) on CLCs it would apear that people will hold them for very short periods. Only philanthropic motives could make the amount of CLCs significant.

IV

THE FINANCIAL MARKET: EQUILIBRIUM

Alternative Uses of Money in an Interest-free Economy

In contrast to the interest-based system, an interest-free economy gives a minute role to the process of lending. Considering safety, CLCs

[11] Islamic teachings do not allow the same for other certificates.

are quite good. They are also liquid, due to their encashability; but so is money. Yet, the rate of return on CLCs is *negative.*

To hold a barren asset, for a full period of one year, implies getting no yield while having to pay *Zakah* at a rate of 2.5 per cent. This means that the net rate of return on these assets is negative. This applies to money hoardings as well as CLCs. In general, it applies to all *monetary assets,* i.e. claims to fixed sums of money. Therefore, lending is not the "next best" alternative to investment.

In an interest-free economy, the investor considers placing his money into a CDC as the "next best alternative". Diversification exercised in the management of CDs gives a high degree of safety. Specifically, it gives the lowest degree of risk for income-earning assets. CDCs with short-term maturities should be encashable with a notice that is shorter than on other income-earning assets. This places them next to CLCs in terms of liquidity.

Since central deposits are allocated to banks according to the efficiency criterion, their rate of return approximates the average rate of return on investment for the whole economy. It is, therefore, possible to say that this rate of return becomes in itself the opportunity cost of money.

This is an investment-centred economy. Investors consider the safest possible investment opportunity as their next best alternative. They do not consider the safest possible lending opportunity as such. In this way money and investment markets are effectively interconnected, for money holding is considered in relation to investment undertaking directly and not through a scheme of financial intermediation based on lending.

Speculative Demand for Money

People hold money for speculative purposes either when they expect prices to decline or they expect the rate of interest to increase. Both reasons, in an interest-based economy are inter-related. Expectations of lower future prices or higher interest rates will both lead to a shift from real and financial assets into money thereby causing a decrease in real asset prices and in bond prices which is equivalent to an increase in the rate of interest.

It is true that investment behaviour in an interest-free economy replaces the rate of interest with the rate of return on CDCs. Yet, speculative demand for money should not increase with expectations of higher rate of return on CDCs. Such expectations would automatically be translated by the market into higher prices of investment instruments.

The rate of return on CDCs is used to discount the stream of future earnings of other instruments into their present values. When it is higher, the expected returns of such instruments must be higher, since the latter is some kind of an average of the former. Moreover, and for the same reason, the rise in the expected returns from investment instruments will always be higher than the rise in the CDC rate. The final result is not a decline but a rise in the prices of investment instruments. For similar reasons an expected decline in the CDC rate must be associated with a decline in the prices of investment instruments. However, expectations of such decline will not lead to a rise in speculative demand for money unless it reduces their rates of return to zero.

In an interest-free economy, prices should be stable, since monetary growth is tied to the rate of change in prices. Nevertheless if prices are expected to decline, because of say, some policy error, people would revert to money. They would sell some of their investment instruments and would hold cash or buy CLCs.

While the economy can adjust itself back to equilibrium through changes in the prices of investment instruments, the effects of a rise in speculative demand for money can be easily reversed through monetary policy. This is more effective since all monetary growth is automatically translated in CDs which flow through member banks to investors.

Market Equilibrium

From the above discussion, we can define the following functions:

$$S = S(\rho, Y) \quad \ldots\ldots (1)$$

$$I = I^p(\rho) + I^g(\dot{P}) \quad \ldots\ldots (2)$$

where S is savings, ρ is the rate of return on CDC of shortest maturity, Y is real national income, and I is investment. Superscripts p and g refer to private and government, respectively. Moreover,

$$I^g(\dot{P}) \left.\begin{array}{l} = 0 \ \text{ if } \dot{P}^e_{t+1} \geqslant \dot{M}_t \\ \geqq 0 \ \text{ if } \dot{P}^e_{t+1} < \dot{M}_t \end{array}\right] \quad \ldots\ldots (3)$$

The above functions imply that savings depend on the average rate of return on investment as well as on the level of real national income. Meanwhile, private investment depends on the average rate of return[12]

[12] For simplicity, we assume it includes investment of the Mineral Resource Division.

and public investment depends on the rate of inflation. It should be noted that I^g is that part of government investment through money creation, which takes place only if the rate of inflation is expected to be lower than the rate of monetary growth as in (3). Equilibrium in the investment market would require:

$$S(\rho, Y) = I^p(\rho) + I^g(\dot{P}) \quad \ldots\ldots(4)$$

Similarly, the money market can be described in the following manner:

$$M^s = M^s(\rho, \dot{P}) \quad \left|\begin{array}{ll} \Delta M^s = 0 & \text{if } \dot{P}^e_{t+1} \geqslant \dot{M}_t \\ \quad > 0 & \text{if } \dot{P}^e_{t+1} < \dot{M}_t \end{array}\right. \quad \ldots\ldots(5)$$

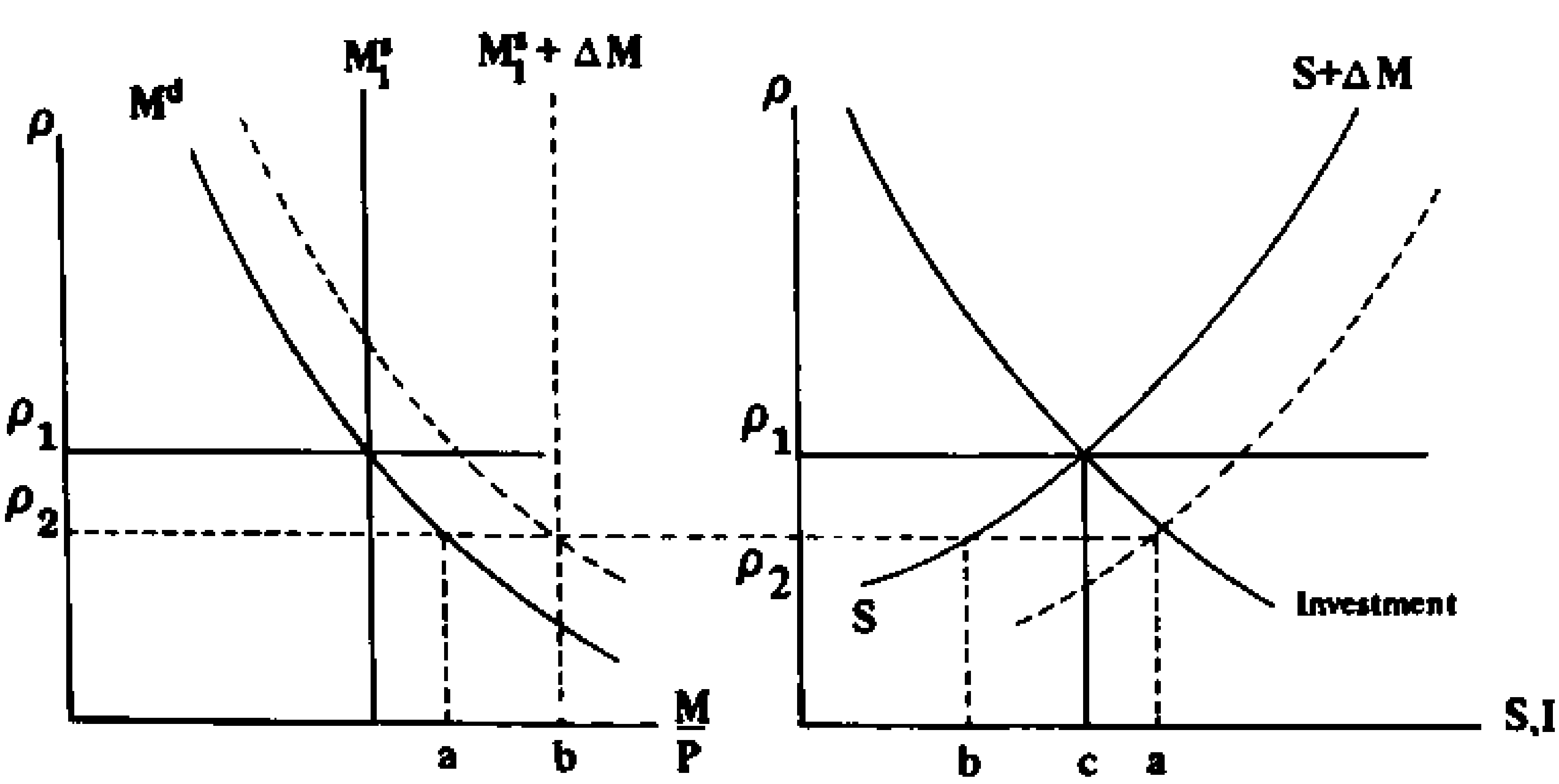
$$M^d = M^t(\rho, Y) + M^c(\rho, P) \quad \ldots\ldots(6)$$

$$M^s(\rho, \dot{P}) = M^t(\rho, Y) + M^c(\rho, P) \quad \ldots\ldots(7)$$

where M^d and M^s refer to the demand and supply of money, M^t and M^c refer to transactions and speculative demand for money, respectively.

The supply of money equation reflects the mechanism of money creation outlined in Section I-d.

Transactions demand for money is made to depend on the opportunity cost of holding money, ρ, as well as the level of real income. Speculative demand for money depends, in addition to ρ, on the price level. Figure 3-b represents, equilibrium in the investment market,



(a) Money Market

(b) Investment Market

Figure III

which started initially at $\rho 1$. Given the demand for money and the price level, ρ_1 determines the supply of money at M_1^s in Figure 3-a which equilibrates the money market.

Now suppose the central bank increases the supply of money by ΔM. As the extra money is added to the flow of investment, and given the investment schedule, the rate of return declines to ρ_2. This causes a decline of private investment by ab, which will be offset by government investment ΔM = bc.

In the money market, the larger money supply will have caused, through extra investment, income to rise, shifting M^d to the right. Meanwhile, the new money supply $M^s + \Delta M$ will equilibrate the money market at ρ_2.

V

MONETARY POLICY IN AN INTEREST-FREE ECONOMY

The monetary authority in the economy described above can change money supply through two means. The first is the addition of new cash to central deposits, or the destruction of cash by withdrawal from those deposits. The second is the sale and purchase of central deposit certificates, in a manner similar to open market operations.

It is obvious that neither the required reserve ratio nor the discount rate exist in such an economy as policy tools. Yet, the smaller number of tools should not, in our case, be taken as a disadvantage.

The expansion in money supply must always be justified by a possible contribution to real balances. Therefore, the matter is not left totally to the discretion of the monetary authority.

The central bank will have to monitor the real growth of the economy, through the investment performance of its member banks. Growth as well as past peformance of the general price level will provide the central bank with necessary information on whether a faster expansion of the money supply can contribute to real balances.

An interesting consequence of the above is that monetary policy becomes closely intertwined with development policy. Through the central bank, the country can encourage investment in certain regions or sectors, as may be needed. This is hardly possible in the existing financial system, where monetary authorities' main concern is stabilization rather than development.

However, despite the developmental aspects of monetary policy in an interest-free economy, it must be compared with the existing system with respect to stabilization.

It is clear from the above discussion that monetary expansion in an interest-free economy is effectively constrained by the rate of inflation. The reason is that the monetary authorities in this economy visualize themselves as creators of *real* and not *nominal* balances. It can, therefore, be said that stability is not just an objective to be sought by policy tools. Rather it becomes *also* a mandatory precondition for the use of monetary policy tools.

The role of the Treasury reinforces the importance of stability. Since the monetary authorities leave no opportunity to create real balances foresaken, there is no need for government deficits financed by monetary expansion. Such an inflationary impulse is neither necessary nor useful. Nonetheless, the government has sufficient flexibility to expand its economic activities through taxation and *Zakah.*

An important aspect of the strength of the interest-free economy is that its policy rules cause question of stabilization to deserve much less attention than in the current system. This gives more weight to questions of development. Such turn-around of priorities may have been much over-due.

Comments

Dr. M. Ishaq Nadri

Dr. Ma'bid Ali Al-Jarhi has addressed a question of considerable policy and theoretical importance. What would (or should) be the institutional structure of monetary and financial system in an interest-free economy? The answer to this question is essential if a modern economic system can be erected based on fundamental Islamic doctrine. I shall briefly state the essential arguments of the author and then raise some questions about them.

The author correctly proceeds to identify the main features of the present Western-type financial and monetary structure and compares it with the alternative structure that might exist in an interest-free Islamic economy. An essential feature sets the modern financial and monetary structure apart from that the author argues will prevail in an interest-free economy. The present system allocates investible resources and creates monetary assets from lenders' vantage point. Resources are handed down by their owners to the investors through lending organizations which use nominal interest rates as an allocative device to ration resources to different investors. The modern banking system also creates money which is lent to government, consumers, business, etc. The basic feature common to both these activities is that money balances are lent on the basis of being repaid in fixed monetary sums with an agreed interest return. Solvency of the borrowers becomes paramount while the "productivity" of investment undertaken by them is considered secondary.

What Dr. Al-Jarhi proposes is to replace this system with what he calls as productivity based financial-monetary structure. The organizational structure of his alternative system is essentially the same as the existing systems in the U.S. and other Western developed countries: there exist a central bank, a number of commercial banks and the public sector that uses the facilities of the monetary system. However, what is different is how the central and commercial banks and the treasury operate in an interest-free economy. Central bank creates fiat money but not against government interest-bearing securities. It anchors the growth of money supply to the growth rate of the economy and if full employment prevails the rate of inflation will be zero. In this system there is no fractional reserve and the central bank issues certificates as liabilities and holds loan accounts and deposits in member banks and some of its assets are held in form of cash. The member banks hold assets in form of cash, equity shares, profit-sharing and leasing accounts while their liabilities consist of non-interest-bearing demand deposits and deposits and certificates issued to their customers. The treasury is assigned the role of collecting and distributing the proceeds from *Zakah* and management of society's social resources. Finally, in this system there is a multiplicity of financial instruments such as Central Deposit or Lending Certificates, Profit-sharing Certificates, Leasing Certificates, etc.

What is important in this structure is that none of the financial instruments commands any interest; instead what propels the system is that member banks are basically investment banks which participate in different investment projects and make their profits or losses by taking equity position in real investment projects. Thus the present indirect link between the financial market and the goods market established by the intermediation of the financial institutions is replaced by direct participation of banks in productive investment projects.

The following questions can be raised about the proposed financial and monetary structure:

1. It is not clear as to how the proposed system would work when there are unanticipated shocks in the real sector of the economy which may require expansion of credit; what motivates member banks to hold central bank certificates is also not quite clear.
2. The author suggests that the banking system should provide interest-free loans for the purpose of smoothing out the consumption expenditure. But what should be the size of these loans and how should they be distributed? What would be the criteria for allocation?
3. In an international environment where money balances could be shifted from one banking system to the other, what would prevent firms and individuals from shifting resources out of the interest-free economy?
4. Though there is a tax on all idle balances, would it be enforceable and the tax rate be high enough to compel holders of idle cash balances to relinquish them?
5. The process of how different financial instruments are traded in the financial market where there is no interest bearing securities is not obvious enough; can there exist an implicit interest rate structure in such a market and how is this determined?
6. If the government is completely barred from the financial markets and if its activities can only be financed through direct borrowing

from the public or through taxation, would this not hinder the economic role of public sector? It is true that politically motivated deficits are less likely to occur in Dr. Al-Jarhi's system, but how can the government meet external economic shocks which require immediate fiscal action? Also what will the treasury offer to the public to persuade them to hold government certificates?

7. Finally, it is not clear that inflation is always a monetary phenomenon and that an economy can be on its steady state where the rate of growth of money supply is equated to the real rate of growth. If these two conditions do not exist then it may be difficult to visualize how the monetary system will operate.

These questions are raised to stimulate discussion and hopefully be of use to Dr. Al-Jarhi. He has addressed a very important and relevant issue and has made considerable progress. However, it would be useful to see further development of his system since a great deal depends on whether it is possible to convince people to abandon an entrenched financial and monetary structure for a new, perhaps better, but nonetheless, untried system.

Discussion

Dr. Zia-ud-Din Ahmed

I would first like to add two questions to the list of questions that have been posed by Dr. Ishaq Nadri. In his paper, the author has argued that in Islamic banking we should have 100 per cent reserve requirement on demand deposits. The case does not seem to have been really made out. I find this idea recurring in the literature on Islamic banking. It is not clear to me at all as to why the writers on Islamic banking bring it up so often that there should be 100 per cent reserve requirement or credit-creating capacity of the banks should be curbed as if there is something unethical about credit-creation by the commercial banks. I think that any innovation which takes place anywhere which has some use for the society and which cannot be described as patently un-Islamic should not be frowned upon. I think credit-creation by banks falls in the same category. In theory it is always possible to visualise situations when in the absence of credit creation, the productive resources of an economy will remain unutilized. Depending on the structure of deposits of the banking system there might be a shift from time deposits to demand deposits. This may be particularly so in the transitory phase when you introduce profit-sharing. Therefore, in that transitory phase if you have 100 per cent reserve requirement on demand deposits you are completely toppling the credit-creation capacity of the banking system. Thus, if the growth rate is good, the only option that is left by which you can bring productive resources into use is that of deficit financing. But some people have also maintained that deficit financing *per se* is bad. I think there is enough literature on these issues showing that none of these is necessarily good or bad. Depending on the economic situation and the type of price situation that you have, a good use can be made of credit-creation in the private sector as well as of the deficit financing. So, from that point of view, there is a need for further clarification as to why some authors take very strong position about the process of credit-creation by banks in the Islamic system and the deficit financing.

Secondly, in Section III where he has given us the balance sheet of a central bank, I find that from the Liabilities side note-issue is completely absent, while note-issuing is the major function of the central bank. Of course in the foot-note he says that other items not related to the discussion are ignored but later on in the text he does mention note-issue when he says that unlike traditional process of money creation, issuing money by the central bank is not a liability that is offset by holding government securities. But I think one has to face the fact that central bank in an Islamic economy will have to issue notes and it will have to have some backing for such notes. Even though the interest-bearing securities are not available, non-interest-bearing securities of the government can provide part of the backing. So, there is no mechanical problem involved in the central bank acting as a note-issuing authority and having it on the Liabilities side.

Now, I come to some of the questions raised by Dr. Ishaq Nadri. On the question of external shocks I think that from the point of view of a person who is not directly involved in model building, but rather taking it from a realistic point of view, I think that in actual practice it will not be very difficult to handle external shocks. For example, take a situation like the Korean War boom. Islamic banking system can easily handle it like the commercial banking system which is interest-based. What will happen is that the demand as well as prices of goods will increase. Therefore, the banks will be expected to provide more finance. Now because of the fact that prices have gone up in money terms or perhaps the demand has also gone up, more money can be created. Under the profit-sharing system or under the *Bai-Muajjal*, of course, monetary stability considerations will be different. Central bank will have to regulate the amount of credit so that it is compatible with monetary stability, but from purely mechanical point of view, the commercial banks in an Islamic banking system should be able to handle the shocks in exactly the same way as they will be handling the ordinary commercial transactions in a peace time economy.

The second question is how to handle the consumption loans in an Islamic economy. We have to bifurcate the consumer loans into two kinds. One is pure consumer loans to meet ceremonial expenditure etc., and the second is consumer durable financing. As far as consumer durable financing is concerned, there is perfect rationale in Islamic banking to finance this kind of activity provided the stage of development of that economy does require the promotion of the consumption of consumer durables which are not of a very essential nature. What the Islamic banks can do is that they can finance the firms which sell the goods on an instalment basis. As far as purely personal loans are concerned, a view has been expressed that the banks can deal with their clients on a personal level. But I think that this is a thing which will not be very much there in an Islamic system. Perhaps in acute situations it will be the institutions themselves in which the employees can get some personal loans from *Zakah* fund but not from the commercial banking system. About the third question that in an international environment what will prevent the individuals from shifting sources out of the interest-free economy? I do not think that this problem will be difficult at all. After all, in an interest-free economy, we are not thinking in terms of zero return to the depositors. We have always argued that in this system, if it can work in the right way, perhaps, the return to the depositors will be higher than in an interest-based system. So, in the transitional phase, if it works according to the theoretical formulation, the differential between the rate of return that a depositor gets in his own interest-free system and the international level will be positive rather than negative. So the incentive to move the funds out of the country will not be there. But even if otherwise, i.e. if it remains lower or is the same as international level, it will always be there. It has been pointed out in the literature that in the developing countries the capital is not being given the scarcity value that it really warrants and, therefore, the interest rate is actually lower than what it should be. So the problem exists even now as compared to the advanced countries. The funds might be moving out by calendestine means if there are foreign exchange controls. Even for affluent countries, in the off-shore banking sector there is a lot of movement of hot money from one centre to the other. So this will not be a problem which will be very peculiar to the Islamic banking system. As for the question that if there is a tax on idle balances will it be enforceable and will it be high enough to compel the holders of idle balances to relinquish them I think the idea in Islamic economy is not that people should move out completely from idle balances to the active balances. Islamic philosophy is that as far as possible the wealth should continue to circulate for productive purposes and the rate of *Zakah* is there to give an incentive to the people not to hold too much idle balances. But naturally for transaction purposes and for precautionary purposes even for speculative purpose, people will continue to hold some idle balances. The next question is that when we do not have interest-bearing securities, do we have an implicit interest rates structure and how that is determined? I think in the literature that has come up on this subject, it is clearly coming out that even though we will not have interest as such but for purposes of discounting future income streams and for project evaluation, there is a mechanism available in an Islamic economy which can serve as a discount factor. For example, in the case of Pakistan, even now we have the National Investment Trust which issues its units. The National Investment Trust stands ready to buy and sell these units in an unlimited amount. So they have the quality of liquidity. They have also been giving consistently good dividends. The rate of return on the NIT Unit itself can become the rate of reference for purposes of discounting future income streams and for project evaluation.

On question No. 6, I do not want to go into detail. I do not completely oppose the possibility of deficit financing provided there is economic rationale for that and we should not be scared by the word of deficit financing. As to the question that what the government has to offer to the public to persuade them to hold government certificates; I have no answer. In fact in the Council of Islamic Ideology and in the Panel of Economists and Bankers, we found that there is no way available in an Islamic economy for the government to borrow in a non-inflationary way the savings of the private sector. If an indexed bond becomes available and it is cleared by *Fuqaha* that may offer a possible means of lending money to the government.

Dr. Anas Zarqa

A significant contribution of this paper as I see it is its presentation of a variety of possible financial instruments for both private investor and monetary authorities in an Islamic economy. This contrasts sharply with the impression given by some writers that an Islamic economy has very limited range of instruments and policy options. Dr. Jarhi has given us wide spectrum of instruments, which will hopefully be more deeply studied in the future. In the development of the Islamic monetary theory, it is desirable that a large variety of options be explored. When it comes to implementing an Islamic financial system, that diversity of permissible tools and options becomes a valuable assurance of ability to cope with the unpredictable complications of reality.

Dr. Nevzat Yalcintas

I would draw your kind attention to the problem of deficit financing. I think that one of the threats to the Islamic banking is the lying in debt by the government, whether in government budget or state enterprises. In some countries banks are nationalised, so the government finances its deficit by the profit created by the banks. State enterprises are not working efficiently in many countries including my own country – Turkey. It may be so in Pakistan and in many other Muslim countries. If we link the system of deficit financing too much with the Islamic banking system, then the Islamic banking system can come to a bottleneck because of the financing of deficit and also because of enterprises which are not working efficiently.

Dr. Anwar Siddiqui

Whereas I agree with Dr. Zia-ud-Din that we should not necessarily dismiss deficit financing as an undesirable instrument, I would like to go along with Dr. Yalcintas on the point about the forcible financing of a continuing inefficient public sector. I do not have the exact figures but from whatever I know, it appears that the debt-equity-ratio is very high in the general scene of public enterprises in Pakistan. In some cases it is as high as 98-2 and by and large 80-20 is the picture. I had an opportunity as a member of the National Public Enterprise Committee to look into the financial structure of some of the public enterprises. Many of them suffer from this malady. Financing is being provided to them under government direction and there is very little possibility of this money being ever returned to the commercial banks. Therefore, I think that while there may be a case for deficit financing for social needs of the government like health, education, defence, etc., as far as commercial public enterprises are concerned, they should be treated at par with other commercial organizations in terms of getting finance from commercial banks. Unless they do that, there will be this danger of monopolising the credit and cutting into profits or even leading to losses to the depositors.

Dr. Muhammad Uzair

Dr. Ishaq Nadri has referred to the problem of consumer credit. I would submit that as far as the consumer credit is concerned, we should classify it in three heads: (1) basic needs, (2) articles for consumption which should be treated at best as comforts bordering with luxurious items, and (3) the unforeseen items of expenditure requiring some financial assistance. Under the basic needs, I would provide housing. Under the comforts and luxuries, I would include T.V., refrigerator or even an automobile; and under unforeseen items of expenditure, I would include prolonged illness or in some countries even expenditure on wedding.

As far as the basic needs are concerned, there is a possibility of setting up special institutions. As a matter of fact there already exist specialised institutions in most of the countries including Pakistan. These specialised institutions can function either completely independently of the government or with the help of the government or completely under the patronage of the government. In Pakistan, for example, from last year, the House Building Finance Corporation provides loans for building of houses. They have devised an arrangement of participation between the House Building Finance Corporation and the individual concerned. The basis of participation is the estimated rental value of the house built with the help of the Corporation. This rental value is assessed in the beginning, and then revised periodically. It is shared in the ratio in which the financing was contributed by the individual concerned and the Corporation. If in some Muslim countries, government does not want to involve itself in these activities, I think that the commercial banks in an interest-free banking system can adopt this style of financing. Now coming to the second kind of consumer credit, i.e. providing comforts, instead of financing this kind of credit from the demand side it can be contributed from the supply side, i.e. from the side of institutions or the companies which supply these consumer durables on credit. The commercial banks in an interest-free system may enter into profit-sharing system with such specialised agencies which deal in consumer durables if the government authorities or the central bank of the country feels that the consumer credit for durable consumer items should be provided in the social interest or they take the position that at least there is no harm in doing so.

The third category of the consumer credit relates to emergencies, e.g. prolonged sickness of someone in the family. That, in my opinion, would be a social-service-oriented consumer credit or non-commercial credit. Now there are several alternatives available to provide this part of the consumer credit. One alternative is a scheme of *qard-hasanah* for this purpose under the auspices of the government. However, there is another alternative. As far as current account in the banking system is concerned, they do not pay any interest and naturally they will continue to do so in an Islamic banking system. In my opinion, it seems to be unequitable to make money out of these deposits. So my suggestion is that it should be divided into two parts. One part could be utilized for *qard-hasanah* to meet such exigencies as I have mentioned like sickness and such other genuine necessities of people. The second part could be reserved for making over-draft facilities to some of the depositors for a very short-term loan, for example, advance for one week to such parties or clients which are well known for their credit worthiness and do a lot of business with the commercial banks concerned and the period involved is so short that profit-sharing may be not only impracticable but even unnecessary for such a short-term loan. This facility would be made available subject to an administrative limit which may be placed and the limit, for example, could be 50 per cent of the average balance in the current account deposits. This will be available only to the current account depositors and only to the extent of their deposits.

Dr. Yalcintas has raised a question about the efficiency of the public sector. As far as experience of Pakistan is concerned and as compared to the situation in some other developing Muslim countries, Pakistan is not doing badly. It is true that the ideal of efficiency has not been accomplished but compared to many other countries, it is still better. As far as the efficiency of the public enterprise in the context of banking is concerned, there has been only a slight decline in the level of efficiency. However, one of the reasons for only a slight deterioration in efficiency may be that banks were nationalised only six years back. The people who were operating the commercial banks were old people who entered the banking profession when the banks were still in the private sector. So they have been able to maintain the level of efficiency to some extent. In 15-20 years time, when an entirely new team will be running these banks, it is very hard to predict whether they will be able to retain the same level of efficiency or not.

Dr. Munawar Iqbal

I think that the questions raised by Dr. Nadri are very important and we should not sweep them under the rug by saying that they can be easily handled under the new Islamic system. If we want to adopt the new system, which we certainly do, then we will have to rise up to its requirements. In this particular context what is required is an extensive and efficient equity market and investment cooperatives, since in the new economic system the predominant modes of investment will be *mudarabah* and *sharakah*. We need these new institutions to be established on a very wide scale and if we do have them, then the exogenous shocks will work their way through these institutions to the real sector of the economy. But if we do not have these institutions then in the absence of securities market and the bonds market there will be a vacuum and it will be difficult to accommodate exogenous shocks. Therefore, I think it is a necessity that we establish an efficient equity market and investment cooperatives. My second point relates to Prof. Nadri's question whether an implicit interest rate structure can exist in an Islamic economy? The answer is obviously negative. If there is no interest there will not be an interest rate structure either. But there will exist a profit rate structure in the sense that if you commit funds for a shorter period, you will have a smaller share in the profits than in the case of long period commital of funds. My third point concerns idle balances. In an Islamic system, *Zakah* will be imposed on idle balances which will work as a disincentive to hold idle balances but if even after that somebody wants to keep idle balances then it is quite permissible in the Islamic system to keep speculative balances.

Dr. Anas Zarqa

The question of 100 per cent reserve ratio deserves detailed examination from an Islamic viewpoint. I can now make only two brief observations. That question may be approached from the technical angle, as done by the monetarist school who sees in the 100 per cent requirement the advantage of permitting accurate and direct control of the stock of money. The second approach which most of the writers in the field of Islamic economics take, does not necessarily deny this technical aspect but prefer to view the problem from the equity angle. Is it equitable to permit commercial banks to create credit? There are people including myself who believe quite firmly that it is inequitable. To give a brief example, think of an economy which is below full employment and where we can create some more credit for productive purposes without inflationary effect.

But a hidden subsidy or "seigniorage" is involved in the generation of derivative deposits by the banking system. This was clearly expounded by Dr. Chapra in his 1978 paper to the Makkah Seminar. Now the question is: who should benefit from credit creation which, in our example, is without cost to society?

Under the present system, the primary beneficiaries are the commercial banks and their customers. The rest of the public is just watching. But Islamic equity requires *all* of society to benefit. Society's fair share can be recouped if credit creation is confined to the central bank who extends credit to commercial banks on *mudarabah* basis. This is the way I understand Dr. Jarhi's call for a 100 per cent reserve system. And it seems closer to an Islamic concept of fairness. It is important to recognise that the stock of money will *not* be constant, but would be varied by the central bank direct expansion or contraction of credit.

Dr. Sultan Abu Ali

When the paper says the financial system then to my understanding it should include the money market and the capital market and the institutions of both the markets as well as their functions. I fail to see this distinction clear. It concentrates mainly on the banking system.

But as we know there are non-banking institutions such as insurance companies, etc., which are also dealing in this market. Another point is that the main objective in the whole economy as we all agree is the physical side, i.e. the production of goods and the real assets not the financial assets. But the financial aspects can enhance as well as hinder the real growth of the economy. So we want to see more clearly how an interest-free financial system can enhance the rate of growth of the physical aspect of the economy and this is actually what should be the main concern when one is discussing the financial side of the economy.

Dr. Abidin Ahmed Salama

Dr. Zarqa has raised the question of 100 per cent reserve requirement to defend the concern for equity. I wonder why should we be concerned that monetary policy should aim at achieving equity alone. This would create, of course, restrictions of credits and will create constraints on economic growth and I think that it will be better if we could use physical and non-physical measures to achieve equity rather than to create havoc in the money market and the credit market.

Dr. Ziauddin Ahmed

On account of this interesting debate on equity question I would like to make some comments. Even in an interest-based system I fail to see the point which Dr. Zarqa has made that in a capitalistic economy just because the banks are financing the industrialists it is against equity. He says, it is only the borrowers who benefit. In fact if the investment is soundly based and the central bank and the government authorities are careful about regulating the investment activity in the country then the whole economy really benefits. It is a different question as to how the benefits of development are shared. The whole thing is inter-twined with the fiscal policy and so many other policies regarding investment controls. But when the banks are providing credit within the regulations set by the central bank of the country and when a new industry is set up employment is generated, it creates demands for agricultural product and so agricultural sector benefits. There are all sorts of these linkages. So I am not persuaded by the arguments which have been put forward in favour of 100 per cent reserve requirement.

Dr. Omar Zubair

It seems to me that the analysis we have in this paper, could be thought of as a moving equilibrium model in which shocks disturb the equilibrium and we have to find out what is the result of such shocks. For example in Harrod's Model, the rate of capital accumulation, the rate of growth of population, the rate of growth of technology gives us what he calls warranted rate of growth. If you also include a trend the equilibrium would be a moving equilibrium. I expect that this idea could be similar to the author's analysis in the case of moving from one equilibrium to another point of equilibrium.

Agha M. Ghouse

The author has raised fundamental questions like monetary equilibrium and the role of the state. In my view the Islamic monetary system would operate from the 'supply side' of the economy instead of the 'demand side! At present, demand creates its own supply (of money) through demand deposits generated by lending. The resultant money supply is cleared by the allocative function of interest rate. However, in the Islamic system, flows of money and commodities (and services) would be in step. The function of resource allocation would be performed by planning strategy, response of private enterprise and the role of the state. In this context, I cannot appreciate the position taken by Dr. Al-Jarhi that the role of the state would shrink in the new system. Deficit financing has to be resorted to by the government not only to ensure optimum investment but also to transform the subsistence sector of the economy into the marketing and monetary sector.

Therefore, I would propose a revision of the paper, to make it more realistic to the organizational needs of the under-developed economies of the Islamic countries at present, by assigning an enhanced role to the state in matters of fiscal and monetary management. Indeed, for the integrated socio-economic Islamic system to be evolved and implemented the role of the state in the Islamic Society has to expand beyond that of the capitalist societies and still would be much less than the socialist societies.

Dr. Ishaq Nadri

I think I should first try to defend my proxy author. I think one of the interesting contribution which he has made is to provide us with a structure whereby we can have such an interesting discussion that we have had and I think I owe an apology by saying that my comments were confined to his paper and the structure that I saw in his paper. Some of the valuable comments which have been made are exactly the points which would enrich this paper. A point has been made about this being a general equilibrium or a moving equilibrium model. That it may very well be. But the issue of interest is that does this model have the stability characteristics and whether or not it will be able to be applied to dis-equilibrium situations which we might find ourselves in? The moving equilibrium models are very easy to construct but the issue or the problem we are facing requires a big deviation from that kind of models. I agree to most of the other things that have been stated and I think Prof. Jarhi will agree with them as well. I want to add two points to what I have said before. One is that in a paper like this I would like to see much more detail about the incentive system which would be incorporated. Why people ought to do the things they are doing? We are talking about a very very complex set of situations and if you are talking of applying the system to the real world you need to look at the incentive system. Why the savers will have to save in certain ways; we need to know, and we need to design that structure. Secondly, and very importantly, we need to discuss the role of state in the new economic order that we are talking about. Because many people have doubts about public enterprises and deficit financing by the government. One of the reasons that the author suggests for not having deficit financing is that he is afraid of the political manipulations of deficit financing. So consequently he says that the best way is that you go to the public and if you can raise the money from them then it is fine otherwise do not do it through the central bank. All other points that have been raised like the consumer loans, etc, are important ideas and should be incorporated but they bring the role of state securely in the midst of all this. I am not saying that there should be more state intervention or less but somewhere in this construction of the Islamic economics we need to discuss the role of modern state in the financial as well as the productive sector. The final point is the issue which has been raised that the financial sector is there only to facilitate the growth of the real sector. I think that the author has assumed by an implicit full employment assumption that the economy will grow at a certain rate given the rate of technological innovation. The question that he has posed is what would be the financial system that will simply keep that growth rate which is underlying or the warranted rate of growth without inflation and he was designing the structure of that. As for the incompleteness of his model in terms of capital markets and the financial structure other than the banking system and so on; I think they are all relevant points but in a paper you can do only so much. I agree with Dr. Zarqa that the fact that he has enumerated a series of instruments that can be operative in a financial market consistent with Islamic principles is the major contribution of the paper.

PART-II

ISLAMIC BANKING IN PRACTICE

Elimination of Interest from the Economy

Report
of
The Council of Islamic Ideology (Pakistan)

Preface*

In view of the clear and unequivocal commandments of the Holy Quran on the subject the elimination of *riba* is the bounden duty of an Islamic State. The Constitution of Pakistan 1973, in its article 227 provides that all existing laws shall be brought in conformity with the injunctions of Islam as laid down in the Holy Quran and *Sunnah.* Article 31 states that steps should be taken to enable the Muslims of Pakistan, individually and collectively, to order their lives in accordance with the fundamental principles and basic concepts of Islam. Article 37 dealing with Principles of Policy enjoins upon the State to eliminate *riba* as early as possible. There is complete unanimity among all schools of religious thought that the term *riba* covers interest in all its manifestations.

It is unfortunate that during the first three decades of the country's existence as an independent state no attention was paid to the elimination of *riba.* The work on finding ways and means to eliminate interest started in right earnest only after the President of Pakistan, General Muhammad Zia-Ul-Haq specifically asked the Council of Islamic Ideology on 29-9-1977 to prepare a blue-print of an interest-free economic system and later on the occasion of 12 *Rabiul-Awwal,* 1399 set a time limit of three years for the elimination of interest from the economy. All along, the President has not only taken a keen interest in the work of the Council but also in the practical implementation of its recommendations. As a result, concrete action has already been taken by the Government on the Council's Report on the introduction of *Zakah* and *Ushr* and its interim recommendations relating to the elimination of interest from the operations of National Investment Trust, Investment Corporation of Pakistan and House Building Finance Corporation.

*By (Dr.) Tanzil-ur-Rahman Chairman, Council of the Islamic Ideology, Pakistan.

To assist the Council in the delicate task of finding the ways and means to eliminate Interest *(riba)* from the country's economy, and to re-model the economic and financial system of the country in accordance with the injunctions of Islam, the Council appointed a Panel of Economists and Bankers in November, 1977. The Panel submitted its Report to the Council in February, 1980, which was considered by the Council in several meetings. While considering the Report, the Council modified or substituted some of the recommendations so as to bring them in conformity with the *Shari'ah* and finally adopted a consolidated Report in its meeting held at Karachi on 15th June, 1980.

The Report, therefore, is a product of the combined efforts of the experts in economics and banking and those of the *Shari'ah*. Now, the Council, in all humility, presents this Report to the public in general.

This Report, besides Introduction consists of 5 Sections with a Summary of Conclusions and Recommendations at the end. In the Section introductory the Report discusses the nature and the rationale of the prohibition of *riba* in Islam. The Section I entitled "Issues, Problems and Strategy" deals exhaustively with practical considerations in applying the profit/loss-sharing system, other possible devices for replacing interest and safeguards for the success of the new system. The Section II discusses in detail the mechanisms for the elimination of interest from the operations of the commercial banks. It provides detailed guidelines for re-orientating the financing operations of the commercial banks in respect of assistance to be provided to industry, agriculture, commerce, construction, transport and other sectors so as to eliminate interest. In respect of bank deposits, the Council has recommended an alternative system under which, after a transitional period, savings and time deposits will cease to earn a fixed return but would instead get a variable return. The Section III deals with ways and means of eliminating interest from the operations of specialized financial institutions. The Section IV deals with Central Banking and Monetary Policy in an interest-free economy. For influencing the allocation of productive resources in the interest-free system, the Report recommends that the State Bank be empowered to fix and vary its profit-sharing ratios in respect of its own financial assistance to banks and other financial institutions in respect of finance provided by them. The final Section of the Report deals with the elimination of interest from Government transactions. The Report points out that after the abolition of interest, it would not be possible for the Government to borrow from the financial institutions or the general public on the basis of interest. The borrowing requirements of the Government will have to be met largely by the State Bank on interest-free basis. However, it would have to be ensured that inflow of central bank money into the economy is kept within safe limit. Government borrowing from external sources will have to be continued for the time being on the basis of interest. The Council has recommended that efforts should be made to reduce dependence on foreign aid in general and interest-bearing foreign assistance in particular. In addition, efforts should be made to foster greater economic co-operation among Muslim countries so as to promote movement of capital on the basis of profit/loss-sharing or other non-interest basis. With such increased economic co-operation among Muslim countries it is not unlikely that, with the passage of time, non-Muslim aid-giving countries and international financial institutions may also begin to deal with Muslim countries on a basis compatible with *Shari'ah.*

The Council has recommended that a detailed blue-print for the switch over to the interest-free system should be drawn up by the Government in the light of the recommendations of the Council by the end of December, 1980. It has recommended the setting up of study groups for effecting such changes in banking laws and other legislation as may be necessitated by the proposed switch over. It calls for urgent action to familiarise the banking personnel with the new modes of financing and to motivate them to implement the new system with a missionary zeal. The Report expresses the hope that the Government of Pakistan would adopt the Council's Report on the elimination of interest as an essential element of the national policy package and would forge ahead with its practical implementation without any loss of time.

The Council has pointed out that the ideal alternatives to interest in an Islamic economic system are profit/loss-sharing and *qard-hasanah.* However, in view of the difficulties in the practical application of the system of profit/loss-sharing in certain spheres, the Council has endorsed the recommendations of the Panel of Economists and Bankers that certain other methods like leasing, hire-purchase, *Bai Muajjal,* investment auctioning and financing on the basis of normal rate of return with a clear provision for adjustment on the basis of actual operating results may also be used in interest-free banking operations. Cautioning against the danger that these other methods could be misused as a means for opening a back-door for interest, the Council has urged that a basic policy decision should be taken to the effect that with the passage of time the operational field of profit/loss-sharing and *qard-hasanah* should gradually be expanded while that of the other alternatives reduced.

The Council has also pointed out that the elimination of interest is but a part of the overall value system of Islam, and this measure alone cannot be expected to transform the entire economic system in accordance with the Islamic vision. It has, therefore, emphasised the need for reformatory measures at moral building and eradication of false values of life. It has also recommended a comprehensive reappraisal of the tax system as well as a thorough reform of the present auditing system to ensure the success of interest-free banking.

The Council recognizes the difficulties in the elimination of interest from transactions relating to international trade and aid and has, therefore, recommended that initially the objective should be to eliminate interest from domestic transactions. In this context, it has recommended an action plan spread over three phases so as to achieve complete elimination of interest from domestic transactions by the end of December, 1981. The Council has expressed its strong opposition to the setting up of any model bank or the opening of separate interest-free counters in commercial banks as, in its opinion, such measures are likely to entail perpetuation of the interest-based system and undermine the efforts at introducting interest-free banking in the country.

Nothing in the world is perfect and no word is the last word in any branch of knowledge, least of all in the field of Islamizing the economic concepts and practices, particularly in view of the complexities of the modern fiscal and economic system and practices as developed in the Western world. The efforts of the Council will be duly rewarded if this Report succeeds in providing a direction to the ultimate objective of eliminating interest *(riba)* from the economy of the Muslim World in general and that of Pakistan in particular.

Introduction

The elimination of interest occupies a key position in the establishment of the Islamic order. The phraseology of the verses of the Holy Quran as well as of the *Ahadith* which condemn the institution of interest clearly portrays the Islamic viewpoint in this regard. Pakistan being an ideological State, the abolition of *riba* has from the very beginning formed an integral part of State Policy as enshrined in her Constitution. In this connection, the Council of Islamic Ideology has frequently been called upon to delineate the true meaning of *riba* and to elucidate the verses of the Holy Quran pertaining thereto. The Council has all along expressed the view that the term *riba* encompasses interest in all its manifestations, irrespective of whether it relates to loans for consumption purposes or for productive purposes, whether the loans are of personal nature or of commercial type, whether the borrower is a government, a private individual or a concern, and whether the rate of interest is low or high. Yet, there has hitherto been hardly any noteworthy progress towards the elimination of interest from the country's economy. However, in the recent past, the President of Pakistan, General Muhammad Zia-Ul-Haq not only entrusted to the Council of Islamic Ideology the task of preparing a blueprint of an interest-free economic system but has also set a time limit of three years for the elimination of interest from the economy. Further, the Presidential declaration in regard to the time limit has been given the form of a Constitutional provision through an amendment in the Constitution which stipulates that the exclusion of the laws pertaining to financial matters from the jurisdiction of the *Shari'ah* Courts will be valid only for a period of three years.

With a view to formulating a framework for reorganising the economic system in conformity with the injunctions and teachings of Islam, the Council, soon after its reconstitution, appointed a Panel of Economists and Bankers which was assigned the responsibility, *inter alia,* of examining the technical aspects of the elimination of interest and recommending ways and means for reorganising the country's banking system in conformity with the *Shari'ah.* The Panel has accordingly submitted its recommendations to the Council which provide a workable basis for elimination of interest from the economy, to the maximum extent feasible under the present circumstances, indicating broadly the lines on which the new system should be organised. The Council has adopted these recommendations and the present Report of the Council is largely based on the work accomplished by the Panel. However, in adopting these recommendations, the Council has incorporated amendments, wherever necessary, so as to ensure complete conformity with the *Shari'ah.* The Council fervently hopes that the President of Pakistan and his colleagues would adopt the present Report as an essential element of the national policy package and would forge ahead with its practical implementation without any loss of time.

2. The Council wishes to place on record its deep appreciation of the contribution made by the Panel and for their tireless efforts, sincerity of purpose and maximum devotion of their intellectual powers and technical skills which enabled them to submit three valuable Reports in a relatively short span of two and a quarter year. The first Report of the Panel pertained to the introduction of *Zakah* in Pakistan which was followed by an Interim Report on the elimination of interest

from the operations of selected financial institutions. The two Reports, together with the comments and suggestions of the Council, have already been submitted to the Government. The third Report of the Panel represents the culmination of its efforts which commenced with its work on the Interim Report. It deals more comprehensively with the issues involved in eliminating interest from the economy as a whole and also indicates in considerable detail the measures needed to achieve the objective. It is the view of the Council that this Report of the Panel is a historic document which not only offers a practical basis for the elimination of interest in this country but would also prove to be a source of inspiration and guidance to others both for policy formulation and further study and research on the subject. By virtue of its scope and technique this document is perhaps the first comprehensive treatise written in the contemporary Muslim World through joint efforts of experts on economics and banking who possessed both practical experience in the field as well as commanded deep insight in the theoretical aspects of the formidable task entrusted to them. The basic work having been accomplished, the next step that needs to be taken by the Government immediately is the setting up of various working groups which should be charged with the task of working out the full details of the new system and suggest the necessary modifications in the relevant laws or prepare drafts of new laws that may be considered essential for effective implementation of the desired changes and to formulate a comprehensive and workable plan for action. These working groups should take up their work with a real sense of urgency and national duty. It also needs to be emphasised that during this whole process extreme care must be exercised to ensure that basic stipulations of the new system are faithfully adhered to.

3. The Council fully endorses the view expressed by the Panel that the elimination of interest is but a part of the overall value system of Islam and this measure alone cannot be expected to transform the entire economic system in accordance with the Islamic vision. Moreover, in proceeding in this direction it will be necessary to keep in view the fact that an interest-free banking system can successfully function and really prove to be fruitful only subject to the condition that simultaneously with its introduction strenuous efforts are made on a wide front to inculcate in the society such basic virtues as fear of God, honesty, trustworthiness, sense of duty and patriotism. Unfortunately, in the context of the introduction of Islamic laws this aspect has hitherto failed to receive the attention that it deserves. The need for reformatory measures at moral building and eradication of false values

of life was emphasised by the Council earlier while submitting its recommendations on the laws of *hudood* and the introduction of *Zakah*. However, now as the country is poised for the introduction of an interest-free banking system this need has increased immeasurably in its urgency. The Council, therefore, once again reiterates with utmost emphasis its recommendations that the mass media may forthwith be mobilised for launching a well thought-out persuasive campaign designed to bring home to the people the details of the new system, the need for change over to the new system both from the worldly point of view and in the Hereafter, as also the obligations that devolve on them for making the new system a success. The aim of the campaign should be not only to make the people conscious of the full meaning and purport of the new system but also to persuade them to willingly and wholeheartedly accept the challenge and to act with a missionary zeal.

4. The Council wishes to stress that with a view to ensuring the success of the new system of banking, it is of paramount importance that the Government should carry out a thorough reappraisal of the tax system, focusing in particular on the need for greatly simplifying the system of Income Tax. The need for this measure was earlier underscored by the Council while submitting its Report on the introduction of *Zakah* and it was pointed out in this context that proper collection of *Zakah* would be difficult to achieve so long as the Income Tax system was not simplified and made sufficiently easy for the assessees. Regrettably, however, this recommendation of the Council has yet to be given effect. In submitting its present Report, the Council wishes to express its deep concern in this regard once again, particularly in view of the fact that a thorough-going reform of the Income-Tax system is a *sine qua non* for the success of an interest-free banking system. This is because of the fact that under the new system, the income of the bank would crucially depend upon the profits of the business firms which receive financial assistance from them. If the existing system of Income Tax remains as it is the business firms would continue the malpractice of concealing their profits and maintaining multiple sets of accounts which would deprive the banks from their rightful share in the profits of these concerns and would thus adversely affect the earnings of the banks.

5. In regard to the operative aspects of the interest-free banking system, the Council considers it of vital importance to make it clear at the very outset that ideally the real alternatives to interest under an Islamic economic system are profit/loss-sharing or *qard-hasanah*, i.e. loaning without additional charge over and above the principal amount.

Although the recommendations contained in this Report are based largely on the principle of profit/loss-sharing, yet some of the recommendations lean on other methods such as "leasing", "hire-purchase", "*Bai Muajjal*", and "investment auctioning" in view of the difficulties faced in the practical application of the system of profit/loss-sharing in its pure form on account of the prevalent standards of morality in the society. The Council has, of course, incorporated the necessary modifications in these alternative methods so as to rule out the possibility of any built-in element of interest in them. However, it needs to be pointed out that these alternative methods, though free of the interest element in the form in which they are specifically laid down in this Report, are no more than a second best solution from the viewpoint of an ideal Islamic economic system. Moreover, there is also a danger that they could eventually be misused as a means for opening a back-door for interest along with its attendant evils. It is, therefore, imperative that the use of these methods should be kept to the minimum extent that may be unavoidably necessary under the given conditions and that their use as general techniques of financing must never be allowed. The Council, therefore, recommends that a basic policy decision may be taken to the effect that with the passage of time the operational field of profit/loss-sharing and *qard-hasanah* should gradually be expanded while that of the other alternatives reduced.

The Council is of the view that at present two factors militate against a wide-ranging application of the principle of profit/loss-sharing viz., (1) wide-spread prevalence of unethical practices in the society, and (2) illiteracy. It is, therefore, necessary to remove both of these factors if the objective of setting up of an ideal Islamic system is to be achieved. The Holy Quran and the *Ahadith* have laid great emphasis on honesty and fairness in dealings as well as on acquisition of knowledge. In fact, the Holy Quran specifically exhorts the believers to scribe the loan transactions, which is of great help in ensuring fairness in the dealings. We have, therefore, to bend all our energies and resources towards promoting honesty among the people and for banishing illiteracy. Once a substantial improvement in the standards of honesty in the society is achieved and literacy becomes wide-spread, then the above-mentioned alternative methods will be automatically rendered superfluous and the financial institutions will be able to operate purely on the basis of profit/loss-sharing and *qard-hasanah*.

6. In the modern era, the banking system plays a vital role in the economic sphere. For remodelling the banking system on Islamic lines, therefore, it is indispensable to make the necessary changes in respect

of all such matters as have a bearing on the operations of banks. Accordingly, the existing laws relating to sale of goods, mortgage, hire, lease, agency, loans, trust, partnership and defalcation etc., should be so amended as to make them conform with the *Shari'ah*. The Council, therefore, recommends that simultaneously with the initiation of the process of eliminating interest, the task of amending and remodelling of these laws may be taken in hand.

I

ISSUES, PROBLEMS AND STRATEGY

The Holy Quran explicitly and emphatically prohibits *riba*. There is complete unanimity among all schools of thought in Islam that the term *riba* stands for interest in all its types and forms. The phraseology of the verses in which people are instructed to shun interest and the severity of the admonition administered to those who do not abide by the divine injunction in this regard leave no doubt in one's mind that the institution of *riba* is wholly repugnant to the spirit of Islam. The Holy Quran says:

> "Those who swallow *riba* cannot rise up save as he ariseth whom the devil hath prostrated by (his) touch. That is because they say: Trade is just like *riba*: whereas Allah permitteth trading and forbiddeth *riba*. He unto whom an admonition from his Lord cometh, and (he) refraineth (in obedience thereto), he shall keep (the profits of) that which is past, and his affair henceforth is with Allah. As for him who returneth (to *riba*) such are rightful owners of the Fire. They will abide therein. Allah hath blighteth *riba* and made *Sadaqat* fruitful. Allah loveth not the impious and guilty."
>
> (II: 275-276)

The theme is continued in verses 278-279 of the same *Surah*:

> "O ye who believe, observe your duty to Allah and give up what remaineth (due to you) from *riba*, if ye are (in truth) believers. And if ye do not, then be warned of war (against you) from Allah and His messenger. And if ye repent then ye have your principal. Wrong not, and ye shall not be wronged."

1.2 The above-mentioned warning of "war from Allah and His messenger" clearly points that the institution of interest is something which runs counter to the Islamic vision of a just and exploitation-free economic and social order. The words that "Allah has blighteth *riba* and made *Sadaqat* fruitful" occurring in verse 276 of *Surah Al-Baqarah* bring out clearly the direction of the resource transfer that Islam encourages – it should be from the rich to the poor by way of *Sadaqat* and not the other way round through interest.

1.3 The rationale for prohibition of charging of interest on loans taken for consumption purposes is obvious. Such loans are usually taken by people of small means to meet urgent personal requirements as they have hardly any cushion of savings with which to meet such requirements. Prohibition of interest in so far as loans of this type are concerned rests mainly on humane considerations. The main rationale for prohibition of interest in the case of loans for production purposes stems from the concept of justice between man and man which is the cornerstone of the Islamic philosophy of social life. Uncertainty is inherent in a business enterprise irrespective of the time and space dimensions. The operating results of the enterprise cannot be foreseen and the occurrence of profit or loss and their magnitudes cannot be fully determined in advance. It is, therefore, a sheer injustice if the party providing money capital is guaranteed a fixed and pre-determined return while the party providing enterprise is made to bear the uncertainty all alone. On the other hand, a fixed interest rate can also be unjust to the lender of money in case the entrepreneur using this money earns a profit quite out of proportion to what he pays by way of interest.

1.4 The basis of co-operation between capital and enterprise which Islam cherishes is equitable sharing of the risks and gains between them. The following verse of the Holy Quran is quite explicit in this regard:

> "O ye who believe! devour not your substance among yourselves unlawfully, but let it be a trading among you by mutual agreement."
>
> (IV: 29)

The above verse can be interpreted to mean that taking away of each other's wealth, property or capital by unlawful means such as interest, gambling or fraud is prohibited while deriving benefit from each other's wealth, property or capital under an equitable business deal struck by mutual consent is permitted.

The essential element of "trading" is that the return on capital employed depends upon actual operating results of the business undertaken. To apply this principle to modern modes of business and finance it will be necessary to completely reorganise the currently prevailing banking practices and to replace interest by a system of profit/loss-sharing. Under a system of profit/loss-sharing, banks and other financial institutions will not get a fixed return on finance provided by them but will instead share in the profit/loss of the business enterprises to whom they provide the financial resources. Similarly, those who entrust their savings to banks and other financial institutions for a specified period will share in the profits/losses of banks. Replacement of the fixed interest system by a system of profit/loss-sharing would have far-reaching consequences and its successful functioning can greatly help in achieving greater social justice which is a cardinal objective of an Islamic society.

1.5 While the permissibility of the profit/loss-sharing (PLS) system under the *Shari'ah* and the undesirable concomitants of the interest-based system are beyond any doubt, serious reservations are often expressed about its successful applicability in our conditions for a number of reasons. The most important of these are as follows.

1.6 For profit/loss-sharing system to be instituted properly it is necessary that all business enterprises obtaining capital from banks and other financial institutions should maintain proper accounts and that this should be done honestly so as to reveal the true working results of the enterprises. The actual position, however, is that most of the enterprises either do not maintain accounts or do not maintain them properly or keep different sets of accounts for different purposes. Even the accounts of the firms in the corporate sector, which are audited by Chartered Accountants, often fail to reveal their true working results because of the wide-spread malpractice of deflating profits, inflating losses and showing fictitious losses. Some of the typical manipulations in this regard are as follows: (i) Over-valuation of opening inventory and under-valuation of closing inventory; (ii) Over-valuation of assets to inflate depreciation in order to reduce or eliminate the element of profit; (iii) Excessive remuneration charged by the Directors who are in most cases relatives of the entrepreneurs. The audit is of little avail in deciphering the true profit/loss position as the auditors are mostly concerned with the legality rather than the propriety and veracity of the expenditure shown.

1.7 At present these malpractices are resorted to mainly for evading taxes. The businessmen's point of view is that they are forced to maintain different sets of accounts because of the wide-spread corruption in the tax-collecting machinery. Moral values being what they are, introduction of the profit/loss-sharing system in the financial dealings of banks and other financial institutions can aggravate such malpractices. The likelihood of collusion between the staff of banks/ financial institutions and the parties seeking finance can not be ruled out. Malpractices of this type are known to exist even under the present system. However, it is apprehended that in view of the greater scope for ill-gotten gains through this malpractice under the profit/loss-sharing system there may be a stronger temptation for such collusion.

1.8 In view of the foregoing, the Council also gave consideration to a number of other possible devices to replace the fixed interest system which may be in conformity with *Shari'ah*. These are discussed below:

(a) Service Charge

1.9 If interest is replaced by a service charge, it would mean replacement of the present system by a system under which banks and other financial institutions would provide loans with full guarantee for repayment of the principal plus a service charge that may be just sufficient to cover the administrative costs of the financing institution. The Council is of the view that although this solution may appear to meet the requirement of *Shari'ah* in the literal sense, it would neither accord with the true spirit of Islam nor would it be advisable from the economic point of view. This is for the following reasons:

(i) Islam does not prohibit return on capital except in the form of interest. If it is possible for the financial institutions to engage in financing on profit/loss-sharing basis or any other profit-earning basis permitted by *Shari'ah* they could not be lawfully debarred from doing so.

(ii) Interest-free loaning with service charge would in essence mean providing capital resources at a very low cost. In a capital scarce economy, this would have serious consequences from the point of view of allocative efficiency.

(iii) Since the financial institutions would cease to earn any income except that for meeting their own administrative expenses, there would be no incentive to set up such institutions in the private sector as no return on the share capital would be available. The depositors also would not get any return. This would affect deposit mobilisation since the only incentive that would continue to remain available to the depositors would be safe-keeping of their money and possibly some ancillary banking services. A corollary to the adverse impact on deposit mobilisation by banks would be either a curtailment in their loaning or increased dependence on the central bank. The former may cause a slowdown in the development and growth of the economy if the genuine credit needs are not met while the latter may cause or aggravate inflationary pressures through excessive injection of high-powered money into the economy.

(iv) If interest is replaced largely by profit/loss-sharing arrangements, the power of the central bank to regulate bank credit through the discount rate mechanism could be replaced by the power to prescribe and vary the profit-sharing ratios for banks. However, under the system of interest-free loaning with service charge, the central bank would be completely bereft of any power to regulate credit flows with the help of changes in the cost of credit.

(v) A large number of depositors belong to lower income groups, including the weakest sections of the population such as retired people, widows, orphans, etc., who deposit their savings with banks both for safe-keeping and an assured income. On the other hand, the borrowers are mostly businessmen belonging to affluent sections of the population. Under the interest-free system with service charge, the strong and affluent would be the gainers while the weak and needy would be the losers which would aggravate the maldistribution of incomes and wealth and would certainly be contrary to what Islam stands for.

(b) Indexation of Bank Deposits and Advances

1.10 Under a system of indexation the liability of a borrower to the banking system would be adjusted in money terms to reflect the change in the value of money, as measured by a price index, during the period the borrowing remained outstanding. Lending by banks on this basis would enable them to compensate the depositors for the change in the value of money. Indexation may constitute a favourable factor for the growth of savings in an inflationary situation by preserving the real value of money savings. But indexation on the side of bank advances is likely to create a number of problems. It is well known that inflation affects profitability in various sectors in different ways. Recent experience in a number of developed and developing countries showed that profits in the commerce sector boomed in an inflationary situation while profits in the industrial sector did not rise in consonance with the rise in the general price level. Indexation of bank advances under such circumstances can greatly hurt productive activity. Agricultural sector is also likely to suffer because agricultural prices are often controlled by the Government or determined by international demand and supply factors. If the increase in the prices of agricultural products is less than the rise in the general price level, indexation, of banks advances will place the agricultural sector in a disadvantageous position compared to sectors where price rise is equal to or more than the rise in the general price level.

Under the *Shari'ah*, currency transactions are not treated differently from commodity transactions in as far as lending and borrowing are concerned. The basic principle is that the same quantity (units) should be returned as was borrowed even though the price of the commodity may have changed in the meantime. For example, if one maund of wheat has been borrowed, the borrower will have to return one maund of wheat even though the price of one maund wheat may have risen from Rs. 30.00 to Rs. 50.00 per maund or fallen to Rs. 15.00. Similarly, if the borrowing consisted of a specified amount of money, say, Rs. 1,000, the borrower will have to repay the same amount of money even if the value of rupee in terms of other goods and services may have changed during the period.

(c) **Leasing**

1.11 Leasing is a relatively new type of long-term financing method which is progressively gaining ground in the industrialised countries. There are two types of leasing viz., (a) "finance-lease" or "full payout" lease, and (b) "operating lease". The "finance lease" is based on a contract between the lessor and the lessee for hire of a specific asset selected from a manufacturer or vendor of such assets by the lessee. The lessor retains the ownership of the asset and the lessee has possession and use of asset on payment of specified rentals over a period. Though the lessor is the legal owner, the lessee is given the exclusive rights to the use of the asset for the duration of the contract. The rentals during the fixed "primary" period are sufficient to amortise the capital outlay of the leasing company and provide an element of profit. The primary period is closely related to the estimated useful life of the asset and the lessee is normally responsible for all operating costs such as maintenance and insurance. The lessee has also the option for a "secondary" period of lease in which the rentals are reduced to a nominal amount. The period of lease usually ranges from 5 to 15 years depending on the useful life of the asset.

1.12 The "operating lease" is more akin to short-term hire-purchase arrangement and is also referred to as "non-full pay-out" lease as rentals are insufficient to enable the lessor to recover fully the initial capital outlay. The residual value is recovered through disposal or re-leasing the equipment to other users. Operating leasing has mainly been confined to specific kinds of equipment such as computers, motor cars, photo-copiers and similar items.

1.13 The banks in Pakistan may provide medium- and long-term finance either directly or through their leasing subsidiaries to firms under leasing arrangements. This method would be less risky and ensure to the bank a reasonable profit margin without having to look into the accounts of the firms. However, as against the practice currently in vogue, the cost of insurance of the assets will have to be borne by the lessor in order to make this method conform to the principles of *Shari'ah.*

(d) Investment Auctioning

1.14 Another method for replacement of interest in the case of long- and medium-term financing in the industrial sector is the system of investment auctioning. Under this system, commercial banks may form a consortium with long-term financing institutions and formulate industrial projects with complete details. Thereafter, the consortium may announce the project with the assurance to make available the needed plant and machinery of specific description and call for bids from prospective investors for the purchase of the machinery. The consortium may fix a reserve price which may include a reasonable profit margin. It may also reserve the right to accept or reject any bid. The project may then be awarded to the highest bidder if the party is considered to be a sound one. Otherwise, the project may be awarded to the next highest bidder considered capable of efficient implementation and running of the project, provided the bid is higher than or at least equal to the reserve price. It will be the responsibility of the consortium to make the plant and machinery of the agreed specifications available to the successful bidder in accordance with the agreed time schedule while the bidder will be under obligation to accept this machinery from the consortium[1]. The agreement may also provide for necessary safeguards to the consortium against undue delay in implementing the project or possible malpractices on the part of the investor. The amount of the bid accepted would be repayable in instalments over the agreed period. The liability of the investor whose bid is accepted by the consortium would be independent of whether he earns a profit or incurs a loss.

[1]From the point of view of *Shari'ah*, there may appear to be ground for the objection to this form of contract because in a transaction of *istisna* the sale is not complete until the required goods are manufactured. But now-a-days huge machines are manufactured under contracts of *istisna* in accordance with specifications given by the purchaser in the minutest details. It would be very difficult for a manufacturer to manufacture these highly expensive machines in the absence of full assurance about their actual purchase. In making its recommendations in this regard, therefore, the Council has accepted Imam Abu Yusuf's opinion according to which a sale is treated to have been affected as soon as the contract of *istisna* is made. In the *Majallat al-ahkam al-adliyya* also the same opinion has been accepted.

1.15 The most significant advantage of this system from the economic point of view would be that the price paid by the investor for industrial machinery would adequately reflect the potential profitability of the project which is essential for efficient allocation of resources.

(e) Bai Muajjal

1.16 *Bai Muajjal* may be defined as sale under which the price of the item involved is payable on a deferred basis either in lump sum or in instalments. This system could be of considerable use in financing current input requirements of industry and agriculture as well as in the financing of domestic and import trade. For instance, if the current cost of a bag of fertilizer to the bank is Rs. 50, the bank may sell it through its agent to farmers needing bank finance at Rs. 55 subject to actual payment of this price after an agreed period. The bank would, however, pay Rs. 50 to its agent prior to or immediately after the supply of the fertilizer by the agent under its instructions. The possible mechanism in the case of domestic and import trade may be on the following pattern: A business firm needs finance from a bank to purchase/import an item from a domestic seller/manufacturer or foreign exporter. Instead of discounting a bill or making an advance, the bank under an agreement with the firm concerned may purchase/import the commodity on its own account and sell it to the firm at a price, to be settled in advance, which includes a mark-up over the cost price for a reasonable profit margin for the bank. Payment from the firm would be receivable by the bank after the agreed period.

Although to be in conformity with the *Shari'ah*, it is necessary that the sale item should come in the possession of the bank before being handed over to the other party, however, that would be sufficient for this purpose if the supplier from whom the bank has purchased the item sets it aside for the bank and hands it over to any person authorised by the bank in this behalf, including the person who has purchased the item in question[2].

1.17 This system commends itself for its relative simplicity as well as the possibility of some profit for the banks without the risk of having to share in the possible losses, except in the case of bankruptcy or default on the part of the buyer. However, although this mode of financing is understood to be permissible under the *Shari'ah*, it would not be advisable to use it widely or indiscriminately in view of the

[2]For reference, see *Fatawa Alamgiri*, Matba Rahimia, Deoband, Kitab al-Bai, Vol. III, Ch. 4, Section 3, p. 12.

danger attached to it of opening a back-door for dealing on the basis of interest. Safeguards would, therefore, need to be devised so as to restrict its use only to inescapable cases. In addition, the range of mark-up on purchase prices would also need to be regulated strictly so as to avoid arbitrariness and the possibility of recrudescence of interest in a different garb. The State Bank may, therefore, specify and from time to time review and vary the sub-sectors/items for which banks may provide the needed finance under *Bai Muajjal* arrangements. It may also lay down the range of the profit margin in general or separately for each sub-sector or item and may impose such other restrictions as may be deemed to be necessary with a view to avoiding the emergence of unhealthy practices.

(f) Hire-purchase

1.18 A variant of the hire-purchase system may be used in financing purchase of machinery and equipment as well as purchase of consumer durables in economically justifiable circumstances. Under this system, banks may finance the purchase of these items under a joint-ownership arrangement subject to provision of security or surety[3]. They would receive, in addition to repayment of the principal, a share in the net rental value (after allowing for depreciation) of these items in proportion to their outstanding share in total investment. The items may also be insured and the cost of insurance may be shared between the bank and the other party proportionately on the basis of their outstanding investment. However, unforeseen repairs may be entirely the responsibility of the user of the equipment.

(g) Financing on the Basis of Normal Rate of Return

1.19 Under this method a specialised public agency may determine the normal rate of return in each industry, business etc., and the banks may provide funds to the entrepreneurs with the assurance that the ascertained minimum rate of profit would be payable to the bank on the amount provided by it. The agreement should also provide that if the actual rate of profit exceeds the designated normal rate of return,

[3]From the point of view of *Shari'ah*, this opinion may be open to objection on the ground that in this contract hire is made contingent upon future sale. However, the *Fuqaha* have, on the basis of usage, tacitly approved the making of such conditions with hire as are customary and mutually agreed upon and are not likely to cause a dispute. According to them a conditional hiring can cause such disputes. Ibn Abidin, in his book *nashr al-urf*, has considered a number of conditions incorporated in a contract, which are governed by custom, as permissible. Since no dispute can be anticipated in case of hire-purchase governed by the method suggested, as visualised in the light of usage and custom, the Council has accepted the conditional contract of hire-purchase on the ground of necessity.

the difference would be voluntarily paid by the entrepreneurs to the financing institution. In case, however, the rate of profit turns out to be lower, or if there is a loss, the entrepreneur concerned would have to prove the same to the satisfaction of the specialised public agency in which event the bank will accept the lower rate of profit or share in the loss. The main advantage of this method is that the financing institution would not be burdened with the scrutiny of accounts of the parties to be so financed while the risk of fraud would be minimised. Moreover, it would facilitate financing of small business and industry which are generally not in a position to maintain proper accounts.

The Council, however, feels that although this method conceptually does not violate the principles of the *Shari'ah* because the basis of transactions is sought to be the actual operational results, while the normal rate of return has largely an indicative value, there is a strong possibility that its wide-spread use may in practice degenerate into pure interest with the passage of time. This is because if the actual profit turns out to be more than the normal rate of return, it would be unrealistic in view of the existing moral standards in the society to expect that this difference would be surrendered by the entrepreneur voluntarily to the bank. On the other hand, if the actual rate of return turns out to be lower than the normal rate, it would very often be difficult for the trader to prove it to the satisfaction of the agency concerned. Thus under both the situations the normal rate would tend to be the only basis of transactions. It is, therefore, apprehended that gradually there would cease to be any difference between the normal rate of return and interest. The Council, therefore, recommends that this method may be applied on a very limited scale and only wherever unavoidably necessary. Its use should be restricted to financing only those small entrepreneurs whose means are limited and who cannot be expected to maintain proper accounts or get them audited. It would be necessary that the proposed official agency keeps the normal rate of return continually under review in the light of changes in business conditions and notifies the revised rates so that the parties involved are not put to unnecessary inconvenience.

(h) Time Multiple Counter-loans

1.20 Another possible method of financing considered by the Council is the system of "time multiple counter-loans". The concept of counter-loans, in essence, is quite simple and can best be explained with the help of an example: Suppose a small trader A wishes to borrow Rs. 100 from a bank B for three months free of interest. B may provide the required loan to A if the latter, simultaneously with receiving the loan, deposits a fraction of the loan for a proportionately longer period, say Rs. 10 for 30 months. After three months, A repays Rs. 100 to B but B would pay back to A his deposit of Rs. 10 after the expiry of 30 months from the date of the deposit. During this period B can use this deposit or "counter-loan" for profit-earning investment. However, just as A would not be required to share the income earned by him by deploying the loan provided by B, the latter would also not pay any additional amount when A's deposit (counter-loan) matures.

The Council is of the view that it would not be correct to use this method by way of a permanent alternative system to the interest-based system. However, if it is desired that provision may be made for providing personal loans to people of small means, then instead of the above stipulations the banks may adopt it as a principle that they would provide loans for personal and non-productive purposes only to those persons who already hold accounts with them. In laying down the repayment schedule and the amount of the loan, however, the banks may keep in view the amount of the deposit of the applicant for the loan and the period over which he has maintained his deposit with the bank. The Pakistan Banking Council may evolve the appropriate procedure and rules in this regard.

(i) Special Loans Facility

1.21 A special loans facility, that is interest-free loans may be provided by banks and other financial institutions in such cases in which neither PLS nor any of the other alternative methods is feasible, provided that the projects/purposes for which finance is given are meant for general welfare of the community such as procurement of foodgrains by the Government to ensure stability in supplies and prices. However, in order to minimise the impact of such loaning on the profitability of the financial institutions, it should be ensured that it remains restricted to a scale considered absolutely necessary. The State Bank may provide the necessary guidelines or issue instructions in this regard to the financial institutions. It may also provide refinance facility to them. The Council also considered a proposal envisaging levy of a service charge by banks on such loans so as to cover the related cost incurred by them. It, however, came to the conclusion that in order to conform to the *Shari'ah,* the service charge will have to be on the basis of the actual cost incurred but the determination of the actual cost attributable to each loan would be difficult. The Council, therefore, recommends that in order to cover a part of the actual costs incurred by banks, they may fix a charge by way of an application fee, which should be uniform irrespective of the amount of the loan and its duration. Any other arrangement shall either be practically too difficult or would not conform to the *Shari'ah*. The Council considered another proposal stipulating that those financial institutions which do not avail of the refinance facility may be provided subsidy by the Government on the basis of the average rate of profit of the commercial banks in the relevant accounting period. The Council, however, felt that although the payment of subsidy to banks for their financing of special loans does not constitute interest in a strict sense, the provision of this subsidy would act as an incentive for the banks in providing such loans which makes this arrangement undesirable. In the opinion of the Council a more preferable course would be that banks provide the interest-free loans under the special loans facility against such deposits on which they do not have to pay any return to the depositors. However, should the resources available from such deposits with banks be found to be inadequate, provision of the subsidy could be resorted to if considered unavoidable.

1.22 The Council is of the view that to replace interest, use should be made of the profit/loss-sharing system as well as the devices discussed under item (c) to (i) above.

1.23 While evolving a workable mechanism for financing on profit/loss-sharing basis suited to our conditions, the Council has kept in view the *Fiqh* literature on the subject of *Sharakah* and *Mudarabah*. The stipulations pertaining to *Sharakah* provide that the partners are free to agree on any profit-sharing ratios irrespective of their capital contributions but losses are to be shared strictly in proportion to their respective capital contributions. It is felt that under the proposed profit/loss-sharing system, the division of profits between the financial institutions and business and industrial enterprises should not be left to be decided by the two parties but should be regulated by the central bank of the country. This will reduce unhealthy competition among the financial institutions and also enable the central bank to influence the allocation of resources among competing uses in accordance with national priorities and monetary policy considerations*. Under the new system, the respective capital contributions of the parties would continue to form the basis of profit/loss-sharing but banks and financial

*The mechanics of such a control system is discussed in detail in the Section on Central Banking and Monetary Policy.

institutions would not, as a rule, be entitled to the full amount of profit that corresponds to their capital contribution, their actual share being governed by the ratios to be prescribed by the central bank. For instance, if the profit assignable to a bank's capital contribution in a particular business on the basis of strict proportionality is Rs. 100 and the ratio prescribed by the regulating agency is 50:50, the profit accruing to the bank would be Rs. 50. The loss would, however, be shared strictly proportionately to the respective capital contributions.

For the purpose of profit/loss distribution, the respective capital contributions of the parties, utilised for varying periods, would be brought to a common denominator by multiplying the amounts with the number of days during which each particular item such as equity capital of the firm, its current cash surpluses, suppliers' credit as well as the finance provided by the bank were actually deployed in the business. In other words, the calculation of the respective capital contributions of the parties would be made on daily product basis. However, in no case the highest multiple to be used for calculating the daily product can exceed the total number of days covered by the accounting period. This is because it is in this period that the funds will have effectively contributed to the operating results of the firm. In making financing agreements with firms, the banks may insist on a clause to empower them to appoint a director of their own to look after their interest as financing partners. They may also be empowered to inspect the books of the firms and to call for any information relating to the business for which the banks have provided finance. In the case of banks' transactions with limited companies, the liability of banks would be limited to the amount of the financial assistance provided by them. However, in the case of their financing of individuals, partnership and other entities with unlimited liability, the banks' liability would also be unlimited. Nevertheless, in such cases they may impose a restriction to the effect that during the period of financing by the banks, the other party would not accept any additional financial liability, and in case such a liability is accepted without the banks' consent, then the banks would not share any responsibility for the same[4].

1.24 The viability of a financial institution crucially depends on smooth and unhindered return flow of funds provided by it to its

[4]The limited liability of the parties in the case of transactions with companies based on the fact that limited companies fall under the purview of personal law and, as in the case of individuals, the companies are also absolved of their liabilities after becoming insolvent.

clients. Under the present system the banks often make use of penal interest rates in cases of delay in repayments. With the abolition of interest they would be deprived of this instrument for bringing pressure to bear on the delinquent borrowers. The Council recommends that the penal rates of interest should be replaced by fines in cases of delay in repayment, except when it is caused by a genuine loss situation. However, the amount of the fine should not accrue to the banks, as this would tantamount to interest under the *Shari'ah*, but should be deposited in the Government treasury. Since delays and defaults without genuine reasons would not only be a breach of trust but also jeopardise the success of the new system the Council recommends that deterrent punishments should be provided to defaulters, which may include confiscation of property. Such delinquents should also be black-listed and debarred from any future financial assistance by banks.

The stipulations suggested above in regard to banks would also be applied in the case of specialised financial institutions.

1.25 For the success of the new system it will be imperative that banks enjoy free and unfettered discretion in respect of acceptance or rejection of financing proposals received by them on the basis of sound banking principles and criteria. In this connection, the Council considers it pertinent to draw attention to an important problem which the banks have been facing during the past several years. It is a well-known fact that a number of public sector enterprises are not operating efficiently. They are also subject to administrative controls in respect of pricing of their products. As a result, they have been incurring losses or showing nominal profits. Yet, the banks under official instructions are often obliged to meet their financing needs and have in the process been saddled with heavy overdues. Under the present system, this situation has only affected the profit margins of the banks. However, under the new system it would also affect the rate of return available to the depositors as it would be related to actual profits of the banks. The Council, therefore, strongly recommends that when the new system is adopted such public sector enterprises as do not meet the criteria of sound banking may either be financed by a separate public agency or the banks should be guaranteed the repayment of the capital and provided with a subsidy by the government equivalent to the average rate of profit of the banks in the relevant accounting period.

1.26 A thoroughly-going reform of the auditing system, which presently suffers from a number of weaknesses, will also be necessary for ensuring the success of the new system. There is need for a comprehensive re-appraisal of the existing laws and practices governing the role of auditors and for evolving a really independent auditing system. Towards this end the following measures deserve consideration:

(i) The financial institutions should be empowered to appoint auditors for auditing the accounts of the enterprises receiving financial assistance from them. This would afford a greater sense of security to the auditors and would be conducive to greater independence in the exercise of their functions.

(ii) Enterprises seeking financial assistance should also be required to introduce costing system which should be subjected to audit. At present most of the companies do not have a well designed costing system which could provide necessary information to auditors for checking the various costs incurred in the process of production.

(iii) The financial institutions should have well-organised audit departments in order to exercise a double check and carry out verification tests. This would help exert pressure on the enterprises to keep their records systematic, clean and straight. It would also help assessment of profitability forecasts on quarterly or half-yearly basis.

(iv) The Institute of Chartered Accountants should organise training courses for in-service auditors to equip them with necessary expertise to detect accounting subterfuges designed to conceal the true profit position.

(v) The Institute of Chartered Accountants would also organise research in order to evolve a new system of auditing suited to the requirements of an interest-free economy. The cost of such research work should be borne jointly by the Government and the financial institutions.

(vi) A committee of experts should be constituted by the Government to examine the existing Company Laws, Chartered Accountants Ordinance, Income Tax Law, Securities and Exchange Ordinance and other relevant laws and suggest suitable changes and new measures required to reform the present auditing system to bring these in line with the requirements of an interest-free economy. The committee should also make recommendations for the necessary changes in the mode and form of judicial action in cases of wilful concealment of profits.

1.27 The Council is conscious of the fact that the remodelling of the commercial banks' operations on the basis suggested in this Report would represent a radical departure from the traditional British pattern of banking on which the commercial banks in this part of the world have, for historical reasons, been operating. It must, however, be emphasised that in the broader international context, some features of the proposed system have already been in existence in the banking system of other countries. For instance, the German banks have from the very beginning been engaged in equity financing on a considerable scale and have aptly been termed as "all-purpose" banks. In Japan before the Second World War, commercial banks actively participated in underwriting of shares and in the post-war period also the under-writing business continues to be strongly influenced by them. In France the Banques d' Affaires, which represent an important part of the banking system, undertake investment financing on participation basis. In recent years, commercial banks in a number of countries have increasingly adopted new financing technique such as leasing, hire-purchase and the exercise of "convertibility options" which shift loans into equity.

1.28 The Council realises that the new system proposed by it would involve a certain amount of intervention by banks and other financial institutions in the management decisions of the firms to whom they provide financial assistance. However, such intervention is becoming a common practice even in the case of banks and other financial institutions which provide loan finance on a fixed interest basis. For example, a number of stringent conditions are being incorporated in loan agreements, such as conceding the right to the credit institutions to appoint one director on the Board of the borrowing concern, seeking permission of the financial institution concerned before issue of new share capital or obtaining of additional long-term loans or declaration of dividends. Loan agreements in many cases also give powers to the financial institutions to appoint auditors and to take over borrower company's management at any time of its choosing. While undertaking the under-writing operations the financial institutions also insist on "buyback" agreement, and in addition to collateral they insist on guarantees of particular amounts of dividends and commissions.

1.29 The significant fact is that the character of banks and their operating procedures and practices are largely determined by the national priorities and the particular situation obtaining in the country in which they operate. For instance, in spite of the long-enduring political association as well as ethnic and racial links between the United States and Britain, the development of banking in the United States has proceeded on a radically different pattern, reflecting deep imprints of the local conditions and the social attitudes and behaviour.

Moreover, with the changing requirements of the time even the British banks have departed from the traditional practice of confining themselves to short-term lending and have increasingly engaged in medium-term financing after World War II. It is also noteworthy that in recent years private savings institutions such as pension funds, investment institutions and insurance companies in Britain have assumed a role in equity and other long-term financing which closely approximates the role of commercial banks in Germany. Institutions of this type are exercising a powerful influence on corporate decisions in U.K. and a number of other industrially advanced countries.

1.30 Considering the variety of the practices of banks and other financial institutions and their roles in the economies of different countries, reorientation of bank financing in Pakistan on the lines suggested cannot be regarded as entering a field that is completely untried. At the same time, however, it cannot be denied that elimination of interest from the banking and financial system as a whole is a bold enterprise and, like any new system, it may initially be faced with problems and difficulties. The Council, however, feels that once the new arrangements proposed by it are put into practice and worked in right earnest, a process of evolution would be set in motion and practical solutions to the emerging problems would be found.

1.31 The Council gave consideration to the action plan that may be adopted for the elimination of interest from the economy. In this respect it considered three different options. The first was that a beginning may be made by setting up a model bank which may start operations on interest-free basis and, on the basis of experience gained from its working, the operations of the commercial banks and other financial institutions may be reorganised on interest-free basis subsequently. The second option was to prepare a comprehensive scheme for a complete switch-over to the interest-free economic system and then decide on the timing of such a switch-over. The third alternative was to eliminate interest from the economic system in a phased manner. The implications of each of these alternatives are discussed below.

1.32 The idea of setting up a model bank, though appealing at first sight, suffers from serious drawbacks. To undertake operations on a scale that may really contribute to the needed experience, the model bank would require large deposit resources which it would not be easy to mobilise for a new institution commencing operations on a radically different pattern. More importantly, if the borrowers have the choice between borrowing from other commercial banks at fixed rates of interest and securing resources from the model bank on the basis of profit-and-loss-sharing and other devices permissible under *Shari'ah*, the sponsors of highly profitable projects would most likely prefer to borrow from other commercial banks, while financing of less profitable and risky projects would fall to the lot of the model bank. If under the circumstances the model bank becomes highly circumspect and selective so as to avoid too much risk, its operations may remain confined to just a few lines of activity which could hardly blaze the trail for others. In case it is not deterred by this consideration, it would be saddled with high overhead costs and a low profit yielding investment portfolio which would not allow it to pay adequate profit to its depositors. This would pose even bigger problems for its deposit mobilisation efforts and in turn further affect its scale of operations. The model bank would, therefore, find itself caught in a vicious circle and the chances of its success would be slim indeed.

In this connection, the Council also considered a suggestion mooted in some quarters that initially only interest-free counters may be opened in the existing commercial banks which may operate simultaneously with interest-based banking. The suggestion also envisages that the depositors may be given option to keep their money with banks on PLS basis or on interest basis. The Council strongly opposes such a course of action because it is not only inappropriate but also extremely dangerous, as it is likely to entail a perpetuation of the interest-based system and to undermine the efforts at introducing the interest-free system in the country.

1.33 The second option did not commend itself to the Council as the elimination of an institution as deep-seated and pervasive as interest at one stroke at any future date and replacing it by a new system could give rise to a number of intractable problems of adjustment. The Council feels that problems of adjustment can best be handled if a sufficient period of transition is allowed.

1.34 The third option, that is, elimination of interest from the economy under a phased programme was considered by the Council to be the most practical and reasonable. It was in this perspective that the Council had earlier recommended the elimination of interest from the operations of the National Investment (Unit) Trust and the Investment Corporation of Pakistan as well as from housing finance provided by the House Building Finance Corporation and the commercial banks in the initial phase. The specification of the areas from which interest may be eliminated, to begin with, was governed by a number of considerations. In recommending the elimination of interest from the operations of N.I.T., the Council was mainly guided by the consideration that in the very beginning of gradual elimination of interest, people should be provided with an investment medium in which they could invest their savings without any religious inhibition. Among other financial institutions, I.C.P. was selected because a good part of its operations was even then free of interest so that complete elimination of interest from its operations could be effected with the least possible delay. Moreover, by the very nature of its functions, I.C.P. was an institution which would have been called upon to shoulder greater responsibilities in an interest-free system, and it was therefore appropriate that it should begin to be equipped for the purpose with utmost expedition. In recommending abolition of interest from housing finance, the Council sought to meet a basic need of the people on interest-free basis and to rid a major sector of the economy from interest.

1.35 The Council is happy to note that a beginning towards the elimination of interest has already been made with the implementation of the Presidential announcement of 12th *Rabiul Awwal,* 1399 A.H. that the N.I.T., H.B.F.C. and I.C.P. Mutual Funds would operate on interest-free basis as from July 1, 1979 and the decision announced in the last Budget that no interest will be charged by banks on production loans given to farmers cultivating holdings up to 12½ acres. The Council recommends that rest of the measures for the elimination of interest from domestic transactions should be taken in three clearly defined phases with specific time schedules as indicated in the following lines.

I. First Set of Measures to go into Effect on 1st July, 1980

There are a series of measures whose implementation does not require much preparation in advance. Decisions on several measures can be taken before the close of the current fiscal year so that they can go into effect as from 1st July, 1980. These measures are listed below:

(a) Government Transactions

(1) *Ad-hoc* treasury bills currently issued by the Federal Government to State Bank at a nominal rate of interest to meet part of the budgetary deficit or to meet specific financial needs may be issued on interest-free basis.

(2) The ways and means advances of the State Bank to the Federal and Provincial Governments should be provided free of interest.

(3) No interest should be charged by the State Bank on Goverment debtor balances.

(4) Government borrowing from commercial banks for financing commodity operations should be free of interest but subject to a service charge based on actual expenditure incurred in rendering such service while counter finance may be provided by the State Bank to commercial banks without charging any interest.

(5) The Federal Government may provide financial assistance to Provincial Governments for meeting their development and non-development expenditure without any charge.

(6) Loans from the Federal and Provincial Governments to local bodies, autonomous corporations etc. may be provided free of interest for financing non-profit-earning essential projects.

(7) Provident Fund balances of the employees of the Federal and Provincial Governments and their agencies on which interest is paid at present may be invested in N.I.T. Units and the return realised may be credited to such balances. Alternatively, Government may declare that Provident Fund balances would cease to earn interest as from 1st July, 1980 but Government would pay a variable bonus on such balances, the rate of which would be equal to the rate of the dividend declared by N.I.T. every year.

(8) *Taccavi* loans may be provided by the Provincial Governments free of interest.

(9) Loans by the Federal and Provincial Governments and their agencies to their employees for construction of houses, purchase of cars, motor cycles and cycles may be provided free of charge.

(10) The practice of charging penal interest on Government overdues may be replaced by imposition of appropriate fines.

(b) Operations of Banks and Other Financial Institutions

(1) Short-term finance to farmers other than those to whom loans are to be provided free of interest under the decision already taken last year, should no longer be provided on interest basis after 30th June, 1980 but should instead be given on the basis of *Bai Muajjal* arrangement or under the arrangement of *Bai Salam*.

(2) For financing purchase of houses or construction of houses by individuals, commercial banks may adopt the same system as has been adopted by the House Building Finance Corporation as from July last year. Financing of construction companies both for fixed investment and working capital should be strictly on profit/loss-sharing basis.

(3) Banks and the Small Business Finance Corporation may finance purchase of trucks, buses, taxis, vans, rickshaws and private cars under "hire-purchase" or *Bai Salam* arrangements. Advances for the purchase of cycles by the Small Business Finance Corporation may be provided free of interest.

(4) In case banks provide any personal loans, these should be not on the basis of interest but under the special loans facility arrangement.

(5) Loans to finance educational expenses may be provided to meritorious students without interest.

(6) The present loaning arrangement under the "Investors' Scheme" of I.C.P. may be replaced by a joint ownership scheme under which funds may be provided by I.C.P. to investors on the basis of profit/loss-sharing.

II. Second Set of Measures to go into Effect on 1st July, 1981

The second set of measures to go into effect on 1st July, 1981 should aim at eliminating interest completely from the assets side of the banks and other financial institutions in as far they pertain to domestic transactions. A detailed blueprint for the switch-over should be drawn up in the light of the recommendations of the Council on this subject by the end of December, 1980. The next six months should be used for effecting such changes in banking laws and other legislations as may be necessitated by the proposed switch-over. This period should also be used to familiarize the banking personnel with the new modes of financing and to motivate them to implement the new system with a missionary zeal. A vigorous campaign should be launched both through the mass media and discussions in seminars, symposia etc., in order to educate all sections of the society about the rationale and operational mechanics of the interest-free system.

With effect from the same date, that is 1st July, 1981, the remaining elements of interest in the domestic transactions of the Government should be eliminated. This would mean, among other things, abolition of the present system of raising resources through interest-bearing government bonds, savings certificates etc. With the non-availability of such resources it is likely that government will have to take recourse to increased borrowing from the State Bank. A Working Group should be set up as early as possible to suggest measures for increasing the receipts of the Government from other sources so that recourse to such borrowing is kept to the minimum.

III. Third Set of Measures to go into Effect from 1st January, 1982

In the final phase of the elimination of interest from domestic transactions, to take effect on 1st January, 1982, banks would cease to accept fresh deposits from the public on the basis of interest and would instead accept deposits on profit/loss-sharing basis. Inter-bank transactions would also be brought under profit/loss-sharing system. The State Bank would abandon the system of providing finance to banks and other financial institutions on the basis of interest and would bring about necessary changes in its monetary policy as set out in Section IV of this Report.

1.36 Elimination of interest from transactions relating to international trade and aid poses the most difficult problems. The best course in this regard appears to be that efforts for greater economic co-operation among Islamic countries should be accelerated so as to achieve interest-free international trade and aid at least among them. The Islamic Development Bank can also play an important role in this respect. However, the Council attaches a far greater importance to character building and exemplary behaviour on our own part so that we could set a practical example of the Islamic economic and ethical systems and thereby convince other countries about the blessings and virtues of the Islamic system. In that event, while these countries may not adopt our system on account of their internal constraints, they may nonetheless feel inclined to extend the co-operation to us on the basis of methods compatible with the *Shari'ah*.

II

COMMERCIAL BANKING

Commercial banking in Pakistan has recorded dynamic growth over the years. In the initial years after Independence the banking system was largely dominated by foreign banks. Bank offices were almost exclusively located in large cities and banks engaged themselves primarily in the financing of foreign trade and commerce. With the passage of time, the position has undergone a marked change both as a result of conscious policies pursued to promote the growth of Pakistani banks as well as the structural changes in the economy. Pakistani banks now occupy a predominant position both in respect of the branch network and the scale of banking operations. Banking facilities have been extended to cover even small towns and semi-urban and rural centres. There has been a significant diversification in their lending activities, with the share of the commerce sector in total bank credit recording an appreciable decline and the shares of other sectors, particularly manufacturing, showing a substantial rise.

2.2 The commercial banking sector in Pakistan is by far the largest intermediary between savers and investors. It mobilises the savings of the community by offering various types of deposit facilities and savings schemes. Resources thus mobilised are used for lending in various sectors of the economy and for investment in securities and shares. Like commercial banks in other countries they also discount trade bills, issue guarantees, provide remittance facilities and render miscellaneous agency services. At present most of the operations of the banks are conducted on the basis of interest.

2.3 This Section suggests alternative mechanisms for replacing interest in domestic banking transactions. As pointed out in the preceding Section, complete elimination of interest from international trade transactions cannot be achieved by the lone efforts of a single country. In the present global perspective, commercial banks operating in Pakistan will have to transact business with foreign banks on the basis of interest. However, measures should be taken to minimise the element of interest even in international trade transactions to the extent possible, and the steps that would need to be taken in this context have been indicated at appropriate places in this Section.

The modalities of the new system in regard to the operations of commercial banks are set out below.

A. FINANCING OPERATIONS

2.4 The financing operations of the commercial banks have been dealt with in the following paragraphs in respect of the various sectors of the economy viz., industry, agriculture, commerce, construction, transport and "other sectors" and personal loans.

I. Industry

2.5 Commercial banks provide credit to industries both for fixed investment and working capital requirements. Finance for fixed investment is provided by way of term loans or purchase of debentures or participation in underwriting and "bridge financing" arrangements. Working capital requirements are financed through grant of demand loans, cash credit, overdraft, opening of import L/Cs and bill discounting. Only commission is charged on the opening of L/Cs, while in all other cases finance is provided at fixed interest rates.

(a) Fixed Investment Financing

2.6 Each project submitted to the bank for fixed investment financing would be thoroughly scrutinised and the bank would provide financing facility only for projects considered viable. Projects submitted by parties which maintain accounts that are audited by Chartered Accountants may be financed under profit/loss-sharing arrangements. Parties which maintain accounts but do not get them audited by Chartered Accountants may be accommodated under "hire-purchase", *Bai Muajjal* or "leasing" arrangements and they may be induced to submit their accounts for proper auditing. Smaller parties who may not be in a position to maintain accounts may be financed under "normal rate of return", "hire-purchase" or *Bai Muajjal* arrangements and they may be induced to introduce at least some sort of accounting.

2.7 It is not necessary that banks should confine their financing activities only to projects received from other parties. Banks may themselves formulate new projects, singly or in collaboration with non-bank financial intermediaries. In such cases, the method of "investment-auctioning" may be used.

2.8 The financing agreements under the new system would have to provide specifically for monitoring by the banks of the actual performance of the concern financed by them so as to safeguard their interests. For this purpose, they should be free to inspect the projects and to call for any information and books of accounts of the concerns. The financing agreements may also empower the banks to appoint, if deemed necessary, a director on the Board of the concern, to demand security against such finance and to impose any conditions in regard to incurring of additional liabilities by the concern.*

2.9 Provision of finance for fixed industrial investment on profit/loss-sharing basis would necessitate the replacement of some of the existing techniques by new ones. At present financial assistance is

*Even at present the institutions providing credit often make similar stipulations in the loan agreements.

provided to projects during the gestation period under "bridge-financing" arrangements whereby the underwriters give an interim loan equivalent to the underwriting commitment at a fixed rate of interest. Although underwriting business as such is not repugnant to *Shari'ah*, the arrangement of bridge-financing, which is a basic ingredient of the "stand-by" technique of underwriting that is in vogue in Pakistan, makes this type of underwriting incompatible with *Shari'ah*. The Council recommends that the "stand-by" technique may be substituted by "firm commitment" underwriting under which the underwriters, instead of providing a bridge loan, actually take up a part of equity at the very inception of the project at a negotiated price which can be below the face value of the shares. The Council understands that "firm commitment" underwriting is not permissible at present under the Companies Act. It recommends that necessary changes may be made in the Companies Act to permit this form of underwriting.

2.10 Debenture financing, which at present is a very common method of financing fixed investment, specially for balancing, modernisation and expansion of the existing industrial units, may be replaced by the issuance of a new corporate security to be called the Participation Term Certificate (PTC). PTC would entitle its holders to share in the profits of the concern issuing it instead of receiving a fixed interest. The main features of PTC may be as follows:

(i) The issue of PTCs beyond certain limits should be subject to the approval of the Controller of Capital Issues.

(ii) Any changes in terms of the issue of the PTC, including pre-payment, should be subject to the mutual agreement of the issuers and the holders.

(iii) In order to provide protection to the purchasers of the PTCs, a Trustee borne on the approved list of the Controller of Capital Issues, may be appointed. The Trustee shall be responsible, among other things, for the appraisal of the projects, necessary legal documentation and end-use supervision. The Controller of Capital Issues may maintain a list of approved Trustees for the purpose. Issuers of the PTCs or their associates may not be appointed as Trustees.

(iv) PTC finance may be secured by a mortgage on the fixed assets of the company ranking *pari passu* with the charges created in favour of other providers of outside funds. There may also be a floating charge on the current assets.

(v) The company would be required to apply PTC proceeds exclusively for implementing the project. It would also maintain books of accounts and other records so as to reflect truly the financial position of the company and the results of its operations in conformity with generally accepted accounting principles.

(vi) On behalf of the PTC holders the Trustee would have the right to call for information from time to time from the company, to visit the premises where the plant and machinery of the company are located and the business of the company is conducted and to have access to records.

(vii) During the period PTCs remain outstanding, short-term financing from banks by the company shall be regulated in accordance with mutual agreement.

(viii) The losses, if any, will be certified by Chartered Accountants and the Trustees would have a say in the appointment of Chartered Accountants.

(ix) The statutory obligations of Chartered Accountants shall have to be enlarged.

(x) In the case of dispute, profits/losses may be determined by Arbitration. For this purpose a panel of arbitrators shall have to be maintained by the Controller of Capital Issues.

(b) Financing of Working Capital Requirements

2.11 Working capital requirements of industry are at present being met by banks through grant of cash credit, overdraft facility, demand loans and through discounting of bills of exchange. All these transactions involve interest. Under the new system banks could continue providing all these facilities under interest-free arrangements. In the case of firms maintaining proper accounts with which banks have regular dealings, working capital needs may be met under cash credit, overdraft and demand loan facilities through profit/loss-sharing on daily product basis. However, in regard to bills of exchange, the Council recommends as follows: Since the bank accepts the responsibility of realising the amount due to the drawer from the drawee, it is permissible under the *Shari'ah* that the bank may realise a commission for rendering this service. This commission will be variable according to the amount of the bill, but not according to the period of payment. The drawer will have to enter into two separate agreements with the banks, one pertaining to the appointment of the bank as his agent for the collection of the amount from the drawee on the due date and the other for receiving a loan in the amount equal to the value of bill. The bank's commission will be payable in advance and the loan will be free of interest. On collection of the bill, the bank will adjust the loan account of the drawer. In case the bill is dishonoured, the drawer will be liable for payment of the loan amount to the bank[5]. In the case of parties not maintaining proper accounts, finance may be provided under "normal rate of return" arrangements or *Bai Muajjal*. They may also be induced to adopt at least some sort of accounting.

2.12 Industrial concerns are often indebted to commercial banks as well as specialised industrial finance institutions at the same time. Finance for fixed investment is obtained from both commercial banks and specialised financial institutions while working capital is mostly obtained from commercial banks. It will be possible under the profit/loss-sharing arrangements to apportion profit/loss among the various providers of funds by taking into account the amount of the capital and the period during which it is employed*. A hypothetical example of profit/loss-sharing in respect of finance provided by a bank to an industrial unit is given below:

1. Let us assume that a textile Mill 'X' has been given the following facilities by Bank 'Y'.

(a) For Fixed Investment:

(1) Long-term rupee finance for renovation against second mortagage of its fixed assets: Rs. 2 million.

(2) Finance provided under underwriting commitment in respect of additional share floatation, the duration being a period of 100 days in the particular accounting year: Rs. 2 million.

(3) Payment against guarantee under PAYE scheme for import of additional spindles from abroad, the period for which the amount remained outstanding being 100 days: Rs. 2 million.

(b) For Working Capital:

(1) Cash credit limit of Rs. 35 million against raw material/ finished goods. The limit is assumed to have been fully utilised for 180 days.

(2) Demand loan limit of Rs. 5 million. The limit is assumed to have been fully utilised for 150 days.

(3) Occasional overdraft in its current account. The amount of overdraft is assumed at Rs. 1 million and used for 100 days.

(4) Inland L/C limit of Rs. 5 million for purchase of cotton. The

[5]For precedent of this technique see *Imdad al-fatawa*.

*While profit may be shared on the basis of any agreed ratio, loss will be shared strictly in proportion to the capital contribution of each party.

limit is assumed to have been fully utilised for 30 days.

(5) Import L/C limit of Rs. 2.5 million for import of man-made fibre etc. The limit is assumed to have been fully utilised for 52 days.

2. Suppose that, apart from finance provided by Bank 'Y', capital deployed by Mill 'X' during that particular accounting year consisted of the follows:

(a) Long-term:

	(Rs. in million)
(1) Paid-up capital:	20.00
(2) Reserves and unappropriated profit and loss:	2.00
(a) Reserves:	3.10
(b) Accumulated loss:	–1.10
(3) Foreign currency finance obtained from a non-bank financial institution:	2.70
(4) Participation Term Certificates issued:	6.40

(b) Short-term:

(1) Current maturity of foreign currency finance and PTCs: (90 days)	3.70
(2) Creditors, provisions & accrued charges: (30 days)	21.50
(3) Other liabilities: (90 days)	1.60
(4) Provision for taxation: (90 days)	0.80

3. The daily products of the respective capital contributions of Bank 'Y' and Mill 'X' and other providers of funds besides bank 'Y' would be as follows:

Bank Y	Daily Products	Mill 'X' and other providers of funds besides Bank 'Y'	Daily Products
A. Fixed Investment		A. Fixed Investment	
(i) Long-term finance (2x365)	730	(i) Capital (20x365)	7,300
(ii) Finance provided against underwriting (2x100)	200	(ii) Reserves (2x365)	730
(iii) Payments made according to guarantee issued under PAYE Scheme (2x100)	200	(iii) Foreign currency finance (2.7x365)	986
		(iv) PTCs (6.4x365)	2,336
Sub-Total (A)	*1,130*	*Sub-Total (A)*	*11,352*

B. Working Capital			**B. Working Capital**		
(i)	Cash Credit (35x180)	6,300	(i)	Overdues in respect of foreign currency finance and PTCs (3.7x90)	333
(ii)	Demand loans (5x150)	750	(ii)	Creditors, provisions and accrued charges (21.5x30)	645
(iii)	Overdrafts (1x100)	100	(iii)	Other liabilities (1.6x90)	144
(iv)	Inland L/C (5x30)	150	(iv)	Provision for taxation (0.8x90)	72
(v)	Import L/C (2.5x52)	130			
	Sub-Total (B)	*7,430*		*Sub-Total (B)*	*1,194*
	GRAND TOTAL (Y)	8,560		GRAND TOTAL (X)	12,546

4. Assumed distributable profit of the Mill: Rs. 7 million
5. Profit/loss distribution would be as follows:
   - (a) Profit attributable to long-term capital: Rs. 4.14 million
     - (i) On Mill's and other providers' capital contribution: Rs. 3.77 million
     - (ii) On Bank's capital contribution: Rs. 0.37 million
   - (b) Profit attributable to short-term capital: Rs. 2.86 million
     - (i) On Mill's and other providers' contribution: Rs. 0.40 million
     - (ii) On Bank's contribution: Rs. 2.46 million
   - (c) Supposing the maximum profit-sharing ratios fixed by the State Bank for banks in regard to fixed investment financing and working capital financing are 50% and 65% respectively, then the share of Bank 'Y' in the profit of Mill 'X' would be as follows:
     - (i) On fixed investment financing: Rs. 0.19 million
     - (ii) On working capital financing: Rs. 1.60 million

       TOTAL: Rs. 1.79 million
   - (d) The share of Mill 'X' and other providers of funds besides Bank 'Y' would be Rs. 5.21 million, which would be divided between the Mill and the other providers of funds in accordance with the terms agreed between them.

6. Assuming that the Mill 'X' incurs a loss of Rs. 7 million, its distribution would be as follows:
   - (a) Daily products of capital contributions:
     - (i) Bank 8,560
     - (ii) Mill and other providers of funds 12,546

(b) Distribution of loss:

(i) Bank: Rs. 2.83 million

(ii) Mill 'X' and other providers of funds: Rs. 4.17 million

II. Agriculture

2.13 Till early Seventies, commercial banks' involvement in agricultural finance was minimal. In 1972-73 it was decided to induct commercial banks actively in the field of agricultural finance. To expand the flow of bank credit to agriculture, the State Bank fixes every year mandatory targets for commercial banks in respect of small loans for agricultural production and loans for fixed investment. It also operates a credit guarantee scheme under which the State Bank shares with the commercial banks on 50:50 basis any bonafide losses incurred by them in respect of their small loans for agricultural production. The definition of small loans has varied from time to time, the present definition being loans given for agricultural production to farmers cultivating holdings up to subsistence level. Till recently, all loans given by the commercial banks to agriculturists were interest-bearing. However, in June, 1979 the Government decided that loans for agricultural production to farmers cultivating holdings up to 12½ acres be provided free of interest. The major portion of commercial banks' financial operations in agricultural sector relates to input-financing.

2.14 For determining an appropriate strategy for eliminating interest from commercial banks' financing of agriculture, the Council took into consideration the special characteristics of the agricultural sector. It noted that small farmers constitute the majority of the farming community. According to the 1972 Census of Agriculture, there were in all 3.8 million private farms in the country. Of these 89 per cent were of the size of less than 25 acres, covering 63 per cent of the total cultivated area. Moreover, a large number of farms were smaller in size than the subsistence holding. Farms of sizes below 12.5 acres constituted 68 per cent of the total private farms and covered 34 per cent of the total cultivated area. Recent data are not available. However, in view of the operation of the law of inheritance and the land reforms of 1972, it can be presumed that the number of small and below subsistence farms must have increased over the period at least in some regions. Thus, a vast number of the farmers in the country, specially those cultivating foodgrains, do not have much of a marketable surplus, and agriculture is a way of life for them rather than a business. The borrowing requirements of small farmers are normally for small amounts but their number runs in millions. Moreover, since most of the farmers are illiterate, even those who produce marketable surpluses are not in a position to maintain accounts of any description. On the other hand, there is a substantial number of farmers who cultivate larger farms and are engaged in farming as a business proposition. They are generally literate, more responsive to modern technological advances in farming practices and capable of adopting proper accounting practices.

2.15 Keeping in view the above perspective, the Council recommends that for meeting the short-term and medium- and long-term financing needs of the agricultural sector the following methods may be adopted under the new system.

1. Short-term Finance

2.16 Short-term finance is required by farmers mainly for purchase of inputs viz., seeds, fertilizers and pesticides. The Council feels that in providing seasonal finance to farmers, the commercial banks should make a distinction between farmers cultivating holdings up to the subsistence level and those cultivating holdings above the subsistence level. The former may be provided assistance in cash or kind under the proposed "Special Loans Facility" which means that farmers falling in this category will be expected to repay only the principal. Ordinarily such loans without costs should be provided out of funds raised by banks on interest-free basis. However, if such funds are not adequate, the banks may be provided a subsidy by the Government in respect of such loans on the basis of the average rate of profit of commercial banks during the relevant period. This method offers a number of advantages. It would not impose any financial burden on a poor section of the population and would help greatly in raising their standard of living. It would expedite the disposal of loan applications as banks would not have to carry out a detailed investigation of the production prospects of a myriad of farmers. The over-head costs of the banks in administering the scheme would also be lower compared to those that they would have to incur in case they provided these funds on PLS or some other profit-earning basis.

2.17 In the case of farmers cultivating holdings exceeding the subsistence level, banks may provide finance for purchase of inputs under *Bai Muajjal* or *Bai Salam*. The stipulations of *Bai Muajjal* have already been described. Under the *Bai Salam* arrangement, banks may enter into an agreement with the farmer for advance purchase of agricultural produce, specifying complete details of the commodity, its quality, price and the place and time of delivery and make the payment of the agreed amount at the time of the entering into the agreement. When the commodity is produced and supplied to the bank, on the appointed date, the bank is free to sell the commodity as it wishes. It must be emphasised, however, that *Bai Salam* is a special type of trading arrangement which is subject to strict stipulations and conditions as laid down in the Holy Quran and *Ahadith*. It will, therefore, be necessary to enact a law that may ensure the fulfilment of these conditions in all respects. It may also be pointed out that since there can be a danger of misuse of price fixation in advance as an exploitation device, an independent agency may have to be set up which should be responsible for exercising proper control on the price fixation in respect of *Bai Salam*.

2. Medium- and Long-term Agricultural Finance

2.18 Medium-term finance is provided by financial institutions for purchase of plough cattle and for poultry farming, dairy farming and repair of tubewells, tractors and attachments etc., while long-term finance is provided for purchase of tractors, sinking of wells, installation of tubewells, development and improvement of land and construction of storage etc. Replacement of interest in all these cases by a single substitute conforming to *Shari'ah* is not possible. The alternative methods that may be used to replace interest in bank financing for medium- and long-term in the agricultural sector are set out below:

(a) Plough Cattle

2.19 Borrowings for purchase of plough cattle are generally resorted to by small farmers. Profit/loss-sharing or hire-purchase do not appear to be feasible in their case. The Council feels that banks may provide loans for purchase of plough cattle to farmers cultivating holdings up to subsistence level free of any charge. Such loans should be provided by banks out of funds raised by them on interest-free basis. In case these are not adequate, the Government may provide subsidy to banks against these loans on the basis of the average rate of profit of commercial banks during the relevant accounting period. In other cases, finance for plough cattle may be provided under *Bai Muajjal* arrangements.

(b) Dairy and Poultry Farming

2.20 Small dairy and poultry farmers may be provided finance up to Rs. 10,000 free of interest while finance to medium and large dairy and poultry farmers may be provided under PLS or "normal rate of return" methods. The definitions of small, medium and large dairy and poultry farms would need to be formulated after due consideration. Banks may induce the farmers seeking finance from them to adopt proper accounting practices.

(c) Land Improvement and Development

2.21 In the case of farmers cultivating holdings up to subsistence level, finance may be provided free of charge out of funds raised on interest-free basis. Should these not be adequate, banks may be provided a subsidy by the Government on the amount of such loans on the basis of average rate of profit of the commercial banks in the relevant period. In other cases, PLS or "normal rate of return" methods may be adopted. Banks may induce the farmers seeking finance from them to adopt proper accounting practices.

(d) Purchase of Tractors, Installation of Tubewells, Digging of "Karezes" and Construction of Storage Facilities

2.22 Finance for purchase of tractors and installation of tubewells may be provided under PLS, *Bai Muajjal* or hire-purchase arrangements. Banks should induce the farmers, seeking finance from them to adopt proper accounting practices. The finance of "Karezes" may be provided under the special loans facility while construction of storages may be financed on the basis recommended by the Council for the construction of houses.

III. Commerce Sector

2.23 The commerce sector comprises of retail and wholesale business as well as export and import business. At present, these activities are being financed by banks through grant of demand loans, cash credit, over-draft facility, opening of import L/Cs on behalf of clients and discounting of bills. The Council recommends that under the new system, in the case of small retailers who are not in a position to maintain accounts, the banks may provide finance either under *Bai Muajjal* arrangements or under Special Loans Facility out of resources raised by them on interest-free basis. In case these are inadequate, the government may provide a subsidy to the banks on the amount of such loans on the basis of average rate of profit of the commercial banks in the relevant period. Banks may induce those seeking finance from them to maintain accounts.

In regard to bank financing under cash credit, over-draft, demand loans and discounting of bills, the same arrangements may be adopted as recommended in respect of financing of working capital requirements of industry. In the case of opening of letters of credit, the banks may charge a commission for the service rendered by them and they may not necessarily share in the profit/loss.

IV. Construction

2.24 For financing house construction by individuals, commercial banks may adopt the same system as was recommended by the Council in its Interim Report and has been put into practice by the House Building Finance Corporation. Financing of construction companies both for fixed investment and working capital may be strictly on PLS basis.

V. Transport

2.25 Banks may finance purchase of trucks, buses, taxis, vans, rickshaws and private cars under "hire-purchase" or *Bai Muajjal* arrangements.

VI. Other Sectors

2.26 These include mining and quarrying, electricity, gas, water and "services". Bank financing of these sectors has so far been of relatively lesser magnitude. With the exception of services sector, in which case banks may use any of the alternative methods of financing considered suitable, PLS seems to be the only practical basis for financing of other sectors. However, where finance is required for purchase of capital goods and machinery, such as generators or heavy drilling machines, techniques of *Bai Muajjal* or "Investment Auctioning" may also be used.

VII. Personal Loans

2.27 In addition to financing productive activities in various sectors of the economy, commercial banks at present also provide, on a relative limited scale, personal loans, e.g. for purchase of consumer durables, for financing higher studies of students within the country and abroad, for tiding over the needs of persons proceedings abroad for employment, for relief in calamity-stricken areas and for social ceremonies. Some of these loans are secured, e.g. "gold loans" provided against the security of gold ornaments, secured overdrafts allowed against "approved securities" and purchase of cheques granted against lien on the account of the customer. Clean overdrafts up to a limit of Rs. 25,000 are allowed against personal securities. Other loans, such as "student loans", "rains/flood loans", car, motor cycle and cycle loans and "overseas employment loans" are generally unsecured.

2.28 At present, interest is paid on personal loans in the same manner as on loans provided by banks for productive purposes. As such, the demand for personal loans is restrained by the cost element. Under the new system, no built-in device would be available to restrain the demand for personal loans which are usually taken for unproductive purposes.

It may be stressed that in an ideal Islamic society the recourse to personal loans is not considered desirable except in cases where satisfaction of the basic human needs or redeeming financial obligations are involved. Borrowings for lavish expenditure, artificial standard of living or conspicuous consumption are considered highly undesirable. It may also be mentioned that under the Islamic system the needy may not be expected to have to borrow because it is the duty of state to provide them assistance without any charge. This is because it is a cardinal objective of an Islamic state to establish a welfare society and the system of *Zakah* and *Sadaqat* as a means to achieve this objective. If a state is too poor to meet this obligation, it may make it obligatory for banks to provide such loans to a limited extent. The Council, therefore, recommends that under the new system banks may generally not provide any personal loans. However, meritorious students may be provided loans to finance their studies without interest. Consumer durables may also be financed under *Bai Muajjal* or "hire-purchase" arrangements on a restricted scale. As regards personal loans in calamity-stricken areas, these may be provided by the Government from the Federal Zakat Fund.

B. BANK DEPOSITS

2.29 The Council is of the view that elimination of interest from the deposits side of bank operations should be handled with utmost care. Commercial banks are the largest intermediaries between savers and investors in the country. Over the years, they have successfully gained the confidence of the savers and mobilised large amounts of savings in the form of bank deposits. It is, therefore, of crucial importance that the switch-over to the new system should be effected in a carefully planned manner so as to avoid any adverse effect on depositors' confidence and deposit mobilisation by banks. Keeping this objective in view, the Council feels that in the short transitional period needed for eliminating interest from the banks' financing operations, deposits may continue to be accepted by banks on the existing basis.

2.30 Under the new system, payment of a fixed return on savings and time deposits will have to be done away with and replaced by a variable return*. The mechanism of determining the return to depositors under the new system should be as follows:

2.31 Distributable profits/losses of banks would be computed by setting off the administrative expenses** payments due to the State Bank and other banks in respect of the accommodation provided by them, provision for taxes, and appropriation for reserves from the total earnings. The amount so arrived at would be distributed among capital and reserves and savings and fixed deposits while holders on current account deposits would share neither in the profit nor in the loss, if any. The calculation of the profit/loss would be made on the basis of daily product of the amounts. These daily products would be assigned different weights so as to ensure an edge for capital and reserves and longer-term deposits. The weights would be prescribed by the State Bank. The period of fixed deposits would be 6 months and its multiples. The various deposit schemes introduced by banks in recent years which are based on calculations of compound interest for attracting longer-term deposits would also be brought under the PLS system. Profits/losses would be computed and distributed at 6-monthly intervals.

2.32 An illustration of profit/loss distribution among the equity holders and savings and fixed deposit holders is provided by the following hypothetical exercise:

1. Bank's capital and reserves	200
2. Bank's total earnings	1000
3. Administrative expenditure, payments due to State Bank and other banks, provision for taxes and appropriation for reserves	300
4. Distributable profit	700

*However, fixed deposits outstanding on the date specified for elimination of interest from the deposit side may be allowed to run their course on interest basis but the holders of such deposits may be given the option for bringing them under the new system even before their maturity.

**Banks would be required to keep a strict vigilance on their administrative expenses so as to keep these to the minimum essential levels.

Profit distribution would be as follow:

Particulars	Amount	Period of deployment	Product of I & II	Weights	Weighted Daily Product	Share in Profits (Amount)
	(I)	(II)	(III)	(IV)	(V)	(VI)
1. Capital and reserves	200	180 days	36,000	1.00	36,000	119.7
2. Savings deposits	200	90 days	18,000	0.30	5,400	17.9
3. Fixed deposits						
(i) 3–6 months	200	180 days	36,000	0.30	10,800	35.9
(ii) 6 months to 1 year	200	180 days	36,000	0.40	14,400	47.9
(iii) 1-2 years	200	180 days	36,000	0.60	21,600	71.8
(iv) 2-3 years	200	180 days	36,000	0.70	25,200	83.7
(v) 3-4 years	200	180 days	36,000	0.80	28,800	95.7
(vi) 4-5 years	200	180 days	36,000	0.90	32,400	107.7
(vii) 5 years and above	200	180 days	36,000	1.00	36,000	119.7
				Total:	*210,600*	*700.0*

In case of loss the respective shares in losses would work out as follows:

1.	Bank's total earnings	100
2.	Administrative expenditure	300
3.	Total loss	200

Particulars	Amount	Period of deployment	Product of I & II	Share in Loss
	(I)	(II)	(III)	(IV)
1. Capital and reserves	200	180 days	36,000	23.53
2. Savings deposits	200	90 days	18,000	11.76
3. Fixed deposits:				
(i) 3–6 months	200	180 days	36,000	23.53
(ii) 6 months to 1 year	200	180 days	36,000	23.53
(iii) 1-2 years	200	180 days	36,000	23.53
(iv) 2-3 years	200	180 days	36,000	23.53
(v) 3-4 years	200	180 days	36,000	23.53
(vi) 4-5 years	200	180 days	36,000	23.53
(vii) 5 years and above	200	180 days	36,000	23.53
		Total:	*306,000*	*200.00*

2.33 The Council feels that under the new system, the nomenclature of deposits as well as the rules and procedures governing the operation of deposit accounts should for the time being remain unchanged in order to avoid the possibility of confusion. In this connection, the Council would like to stress that all the banking terms that are in vogue in the interest-based system cannot be continued under the new system. This is because the banking and financial terms are of two kinds: (i) Those evolved in the context of the interest-based system but would not suit the new system. For instance, finance provided on the basis of *Bai Muajjal* cannot be termed as loan. (ii) Those which can continue to be used under the new system as well. The Council is of the view that some changes in the banking terminology could be helpful in creating a feeling among the people that the country's economic system is undergoing a radical change and the old system is being replaced by a system which conforms to the teachings and injunctions of Islam.

The banks should continue to enjoy full discretion in regard to the deployment of the deposit resources. It also appears advisable that after the switch-over of deposits to the new system, the government may continue the guarantee at present provided to deposits of nationalised commercial banks for a transitional period of, say, two years. However, this guarantee would be in the nature of a moral obligation on the part of the Government but it cannot be enforced legally. In this connection it is pertinent to note that the underlying spirit of the Islamic system in so far as it pertains to investment is that any one who wishes to earn a profit in business should also accept the risk of loss. Therefore, this guarantee should be for a short period as recommended and should not be allowed to continue indefinitely[6].

2.34 The Council noted that at present the rates of return on deposits are uniform for all the commercial banks. However, since under the new system the rates of return on deposits would depend on the profits of the banks and would vary considerably, there may occur frequent shifts of deposits from banks with lower profitability to banks

[6]From the point of view of *Shari'ah*, there could have been no objection to this type of guarantee in case it was provided by a third party whose interests were not involved. However, on account of the fact that banks are nationalised institutions, there can be an objection under the *Fiqh* on the ground that the Government by virtue of its ownership of the banks itself become a party in the business deals. As such, this guarantee would in reality tantamount to interest. But a possible answer to this objection is that the guarantee being provided by the Government in this case is in its capacity as a *Wali al-amr* (guardian) and not as a business partner or interested party. Thus, in case it is required to indemnify any loss to the depositors the indemnity will be provided from the Government treasury and not from the banks' capital. Precedents also exist in support of this type of differentiation. For example, according to *Moatta Imam Malik*, Caliph Umar's sons Abd Allah and Ubayd Allah received loans from the *Bayat al-Mal* which they used, on their way back to Medina, for trading and therewith earned profit. Therefore, Caliph Umar declared this transaction as *mudarabah* and recovered fifty per cent of the profit from them, which was paid to *Bayt al-Mal*. The Caliph took this decision not in the capacity of a lender but in that of *Wali al-amr*. Hence, if the Government provides the guarantee of this type in its capacity as a *Wali al-amr*, then it would not be in the nature of interest. But because the guarantee relates to *mudarabah* property, which does not qualify for a guarantee, the Government guarantee should be treated as a moral obligation rather than as a statutory obligation.

with higher profitability, thereby causing dislocation. In order to avoid such a situation the Council recommends that there should be uniformity in the rates of return available on deposits held with nationalised commercial banks. This can be achieved by pooling their profits for distribution among deposit holders.

C. MISCELLANEOUS TRANSACTIONS

I. Inter-Bank Transactions

2.35 Commercial banks usually keep deposits with each other and, when needed, also avail of financial assistance mutually. At present these transactions are interest-bearing. After the elimination of interest, such transactions may be carried out under PLS arrangements on the basis of daily products of the amounts.

II. Financial Assistance from the State Bank

2.36 The State Bank provides financial assistance to commercial banks under its various refinance schemes as also to enable them to tide over temporary liquidity shortages. Under the new system, such assistance may normally be provided by the State Bank under PLS arrangements. A detailed discussion of the proposed arrangements in this regard will be found in Section IV of this Report.

III. Foreign Transactions of Banks Involving Interest

2.37 Foreign branches of Pakistani banks would have to conduct their operations on the basis of interest. Similarly, the foreign currency deposits held with commercial banks in Pakistan as well as certain other transactions of banks with banks abroad would also have to continue on the basis of interest. The Council recommends that in order to avoid merger of interest and non-interest income, the administration of foreign branches of Pakistani commercial banks may be entrusted to a separate Corporation. The foreign currency deposits held with commercial banks should also be transferred to this Corporation. This Corporation should not accept any local deposits.

The above position may continue until alternative arrangements conforming with the *Shari'ah* are evolved in regard to these transactions.

IV. Banks' Loans to Their Employees

2.38 Commercial banks' loans to their employees may be on the same lines as those suggested in case of the employees of the State Bank in Section IV.

III

SPECIALISED FINANCIAL INSTITUTIONS

Besides commercial banks, the financial system of Pakistan consists of a number of specialised financial institutions. The Council has already submitted its recommendations in respect of elimination of interest from the operations of National Investment (Unit) Trust, Investment Corporation of Pakistan and House Building Finance Corporation (Appendix I). The Council's recommendations relating to other specialised financial institutions* are contained in this Section.

1. Pakistan Industrial Credit and Investment Corporation (PICIC)

3.2 The Pakistan Industrial Credit and Investment Corporation (PICIC) was established in October, 1957 to provide finance to the private industrial sector in the form of long- and medium-term loans in local or foreign currencies, equity participation, purchase of debentures or underwriting of public issue of shares and debentures. It guarantees and counter-guarantees loans and obligations, arranges participation of local and external finance from private and institutional investors, helps facilitate creation, issue or conversion of capital in any form and acts as a trustee in this regard.

3.3 PICIC is a public limited company, with a paid-up capital of Rs. 79.68 million. Of this, 65 per cent is currently held by private investors and financial institutions in Pakistan and 35 per cent by foreign investors. Foreign shareholders consist mostly of financial institutions belonging to various industrialised countries. The International Finance Corporation (IFC), a member of the World Bank Group, also holds 3.5 per cent of the total paid-up capital.

3.4 On the assets side, PICIC's operations involving interest consist of: (a) debentures purchased; (b) loans in foreign currency as well as in local currency; and (c) deposits held with banks. On the liabilities side, interest is involved in: (a) debentures issued; (b) long-term Rupee borrowings; (c) line of credit in foreign currency; (d) borrowings from banks; and (e) borrowings from the State Bank of Pakistan.

3.5 The Council's recommendations for elimination of interest from PICIC's operations and its substitution by feasible arrangements consistent with the *Shari'ah* are given below. A noteworthy feature of PICIC which is distinct compared to other specialised financial insti-

*A specialised financial institution known as Bankers' Equity Ltd., has been established very recently. Since it will operate on the basis of equity participation and has yet to start functioning, it has not been considered necessary to include it in this Report.

tutions is that a portion of its share capital is also held by foreign investors. It is, therefore, necessary that the foreign shareholders be taken in confidence and requested to give their assent to the new arrangements. In case they are not agreeable, they may be given the option to disinvest their shares.

3.6 PICIC purchases and holds debentures of joint stock companies. After the cut-off date for the elimination of interest from the operations of PICIC, no new interest-bearing debentures may be purchased. Instead, it may purchase the Participation Term Certificates (PTCs) which have been proposed as a substitute for debentures in this Report. The existing holdings of debentures may also be converted into PTCs or equity participation with mutual consent of the parties concerned. In cases where the parties are not agreeable to such a conversion, the debentures may continue on interest-bearing basis till maturity.

3.7 The PICIC provides loans both in local currency and foreign currencies for periods of 10 to 15 years for acquisition of fixed assets. No loans are provided for meeting working capital requirements. The interest rate margins over its own borrowing rates in respect of both foreign currency and local currency lines of credit are fixed by the Government. After the cut-off date for the elimination of interest, PICIC may switch-over completely to interest-free forms of financing discussed in Section I. It may make use of the methods of PLS, investment auctioning, leasing, hire-purchase or *Bai Muajjal* as considered advisable. Foreign currency loans obtained by PICIC on the basis of interest would be guaranteed by the Government of Pakistan both in respect of principal and interest liability and it is hoped that on account of this guarantee foreign lenders would not insist that relending transactions pertaining to foreign loans should continue to be on the basis of interest.

3.8 A large proportion of PICIC's balances with banks consists of time deposits, while a small proportion is maintained in current accounts. After the elimination of interest from the deposits side of commercial banking, PICIC may hold its time deposits with banks on PLS basis.

3.9 Under its underwriting arrangements, PICIC provides bridge finance for periods between the establishment of companies and floatation of their shares for public subscription. Bridge financing, which carries interest, may be replaced by the system of "firm commitment" underwriting which is compatible with *Shari'ah*.

3.10 PICIC issues debentures to raise local currency resources for its Rupee loans. After the elimination of interest, PICIC may issue the proposed PTCs. The debentures already issued by PICIC may also be replaced by PTCs, to the extent possible, with the consent of the holders of such debentures, and the rest may be allowed to run their course.

3.11 PICIC has been securing long-term Rupee loans at concessional rates of interest from the Government of Pakistan. These loans are subordinated to the share capital of PICIC so as to broaden its equity base for borrowing purposes. After the elimination of interest, these loans may be converted into Government investment on PLS basis or replaced by PTCs to be issued by PICIC to the Government. In future, the Government may provide assistance to PICIC either under PLS arrangements or through purchase of its PTCs.

3.12 PICIC received a long-term loan of Rs. 30 million from the U.S. Government in 1967 through the Agency for International Development. The loan is repayable in twenty-one equal half-yearly instalments commencing from December, 1976. It carries interest at the rate of 5½ per cent of which ¾ per cent is payable to the USAID and 4¾ per cent to the Government of Pakistan. The outstanding amount as on December 31, 1978 was Rs. 22.9 million. The Government of Pakistan may forego the interest payment due to it from PICIC on this loan and instead share in PICIC's profit/loss related to the daily product of the amount of the loan. In the case of interest payment to USAID, the USAID may be approached to make the loan interest-free. If they do not agree, the existing arrangement may continue till the liability is fully discharged.

3.13 PICIC's foreign currency borrowings consist of loans from the World Bank, Asian Development Bank and other agencies. Since it does not appear possible at present to obtain such assistance on a basis other than interest, the Corporation may continue to obtain it on the basis of interest until viable alternative conforming to *Shari'ah* is available.

3.14 PICIC's borrowings from State Bank consist of cash credit, on which interest is payable at the bank rate, and loans under the State Bank's refinance scheme designed to promote local sale of Pakistani machinery on which interest is payable at 2 per cent below the rate charged to sub-borrowers by the Corporation. After the introduction of interest-free system, State Bank's assistance to PICIC may be provided on PLS basis. The profit-sharing ratio in respect of finance provided by the State Bank to PICIC under its refinance scheme for locally manufactured machinery may be kept suitably lower.

3.15 PICIC's other operations involving commission, project examination fee, fee for undertaking feasibility studies and charges for technical and managerial advice may continue on the existing basis.

2. Industrial Development Bank of Pakistan (IDBP)

3.16 The Industrial Development Bank of Pakistan was established in August, 1961 to meet the long- and medium-term credit needs, in foreign as well as local currency, in the private industrial sector, particularly for the development of small- and medium-sized new industrial units. The Bank provides medium- and long-term loans for the acquisition of fixed assets and short-term loans for meeting the working capital requirements. It also provides guarantees for loans raised by industrial concerns from other sources and invests in equity and debentures of industrial companies.

3.17 The Bank has a paid-up capital of Rs. 50 million held entirely by the Federal Government. Apart from share capital and reserves, the Bank's resources consist of deposits held by the public with it, borrowings from State Bank of Pakistan, loans from the Federal Government and foreign credits from institutions like Asian Development Bank, the World Bank, etc. The nature of IDBP's functions and operations is similar to that of PICIC. For elimination of interest from its operations, therefore, the changes required would also be similar to those suggested in the case of PICIC. It, however, differs from PICIC in so far as it also provides finance for working capital and accepts deposits from the public. In these respects, therefore, the recommendations made by the Council in regard to commercial banks would also apply to IDBP. To offer competitive return to depositors, IDBP should be free to determine its own profit-sharing ratios.

3. National Development Finance Corporation (NDFC)

3.18 The National Development Finance Corporation was established in 1973 to provide financial and technical assistance for the establishment of new enterprises and for balancing, modernisation and expansion of existing enterprises in the public sector. The functions and activities of the Corporation include: (a) provision of medium- and long-term loans in foreign and local currencies; (b) provision of loans for working capital requirements; (c) equity participation; (d) purchase of debentures; (e) underwriting; (f) issue of guarantee for local and foreign currency loans; (g) participation in loan syndication both in local and foreign currencies; (h) financing sale of locally fabricated machinery; and (i) mobilisation of savings through various deposit schemes.

3.19 The share capital of the Corporation is Rs. 120 million which is held entirely by the Government of Pakistan. Apart from the share capital and reserves, the resources of the Corporation consist of deposits of fixed maturities held with it, assistance from State Bank of Pakistan and foreign credits.

3.20 On the assets side, NDFC's operations involving interest pertain to loans advanced, debentures purchased and deposits held with commercial banks. On the liabilities side, interest is involved in its borrowings and deposits accepted by it. The functions and operations of NDFC are very similar to those of PICIC and, therefore, the changes required for elimination of interest from its operations would broadly be the same as those suggested in the case of PICIC. As regards deposits accepted by it, the required changes would be similar to those suggested in respect of deposits held by commercial banks. The specific recommendations of the Council for eliminating interest from NDFC's operations are as follows:

(a) Cash credit from the State Bank, which is currently available at the bank rate, may be provided on PLS basis. The concessionary refinance under the State Bank's scheme for locally manufactured machinery may also be on PLS basis but at a suitably lower ratio than that applicable to cash credit.

(b) The deposits accepted for medium- and long-term may continue to be subject to existing terms and conditions during the transitional period of, say, two years, as suggested in the case of commercial banks. Thereafter, fresh deposits may be accepted only on PLS basis and the Corporation may determine its own profit-sharing ratios. Deposits outstanding at the cut-off date may continue on interest basis but depositors may be given option for conversion of these deposits into PLS deposits.

(c) After the elimination of interest from the deposits side of commercial banks, NDFC's fixed deposits with commercial banks would also be on PLS basis.

(d) All foreign currency borrowings by NDFC would continue to be subject to the terms and conditions agreed with the foreign suppliers of credit till such time as alternative arrangements permissible under the *Shari'ah* are evolved. This means that interest would continue to be paid on foreign borrowings. However, in providing finance with the help of foreign currency loans, the Corporation may use PLS or other alternative methods, as suggested in the case of PICIC and IDBP.

(e) Local currency loans provided by the Corporation include long- and medium-term loans, loans for meeting working capital requirements and suppliers' credit. In addition, it participates in syndicate loans in conjunction with other financial institutions. Under the new system, term loans would be substituted by PLS and other methods as suggested above, while finance for working capital including opening of L/Cs may be provided under PLS arrangements or *Bai Muajjal*.

4. Agricultural Development Bank of Pakistan (ADBP)

3.21 The Agricultural Development Bank of Pakistan was established in 1961 by merging the Agricultural Development Finance Corporation (ADFC) and the Agricultural Bank of Pakistan (ABP). The Bank provides credit to individuals as well as corporate bodies engaged in agriculture and for development of agriculture which, according to the Bank's Charter, includes raising of crops, horticulture, fisheries, forestry, animal husbandry, poultry farming, dairy farming, bee-keeping and sericulture. Loans may also be granted for the cottage industries in rural areas. The Bank advances loans for short, medium and long terms. The short-term loans are given for financing the cost of seasonal inputs and thus cover items like seeds, fertilizers, labour charges, hire of bullock carts and small agricultural implements etc. Medium-term loans are given for periods exceeding 18 months but not exceeding five years. These are usually granted for purchase of agricultural implements, means of transport and light machinery, cattle and sheep breeding, dairy farming, poultry farming and reclamation of land. Long-term loans are given for periods exceeding five years and are meant for development purposes, like construction of ware-houses and cold storages, purchase of tractors and other heavy machinery, agro-industries, installation of tubewells and plantation of orchards etc.

3.22 The Bank's financial resources consist of its capital and reserves, different types of deposits and borrowings from domestic as well as foreign sources. ADBP's loaning operations pertain largely to loans in local currency and most of these are for long term. In 1978-79, for instance, 80 per cent of the loans disbursed were for long term, 11 per cent for short term and 9 per cent for medium term. The bulk of ADBP's loans (74.4% of the total) was for financing purchase of tractors. The shares of other categories were: seasonal inputs, such as seeds, fertilizer etc., (10.5%); draught animals (4.4%); tubewells (2.6%); poultry, dairy and marine fisheries (0.5% each); and miscellaneous (7.6%).

3.23 During 1978-79, 98.7 per cent of ADBP's total income and 68 per cent of its total expenditure was accounted for by interest receipts and payments.

3.24 ADBP's interest payments are on account of deposits accepted by it, borrowings from State Bank of Pakistan and loans from international institutions. After the elimination of interest, deposits accepted by the Bank should be subject to the same arrangements as those suggested for commercial banks and the Bank should be free to determine its own profit-sharing ratios. Loans received from the State Bank of Pakistan may be on PLS basis or even free of any charge if considered necessary. Borrowing from international agencies may continue to be interest-bearing until alternative arrangements compatible with *Shari'ah* become feasible. For its financing operations, the ADBP may adopt the same methods as suggested in the case of agricultural financing by commercial banks.

5. Small Business Finance Corporation (SBFC)

3.25 The Small Business Finance Corporation, previously known as the People's Finance Corporation (PFC), was established in 1972 to provide financial assistance to persons of small means. The Corporation provides finance on interest basis to all types of small business owned or sponsored by individuals or firms. These include shopkeepers and traders; owners of small scale and cottage industries; artisans; taxi/rickshaw/bus/truck owners; owners of power-driven fishing boats; professionals, such as physicians, surgeons, engineers, architects, chartered accountants, advocates etc., interested in setting up their business; small exporters and importers; and new entrants in business. The Corporation is authorised by law to provide loans up to a maximum limit of Rs. 50,000 to individuals and firms and up to Rs. 150,000 to cottage and small scale industries. To be eligible for borrowing from the Corporation, the net assets of such individuals and firms should not exceed Rs. 50,000. Cottage and small scale industries eligible for borrowing from the Corporation are defined as those the value of fixed assets of which, excluding the cost of land but including the amount of any loan advanced by the Corporation, does not exceed Rs. 300,000. The Corporation also provides loans for purchase of cycles and motor cycles.

3.26 The paid-up capital of the Corporation is Rs. 70 million, which is held as follows: Federal Government: Rs. 30 million; State Bank of Pakistan: Rs. 9.60 million; and nationalised commercial banks: Rs. 30.40 million.

3.27 Although the bulk of financing by SBFC is for productive purposes, financing of a few consumer durables such as motor cycles and cycles may technically be categorised as consumption loans even though loans for purchase of cycles or motor cycles help in increasing production by increasing mobility and efficiency of workers.

3.28 It is suggested that the Corporation may provide finance for purchase of trucks, wagons, taxis etc. on the basis of hire-purchase of *Bai Muajjal* while cycle advances may be provided free of cost. Financing of small industries, small business and for professions may be on the basis of "normal rate of return".

3.29 Other transactions of the Corporation involving interest include its deposits with banks and borrowings from the Government and commercial banks. After the elimination of interest, the Corporation's deposits maintained with banks would be treated in the same manner as other private sector deposits. Borrowings by the Corporation from the Government may be either free of cost or on PLS basis while those from commercial banks should be on PLS basis.

6. Equity Participation Fund

3.30 The Equity Participation Fund was created in 1970 by a special legislation to foster and accelerate the growth of small- and medium-sized industrial enterprises in the private sector in the less developed areas of the country. The Fund, which is administered by the Industrial Development Bank of Pakistan, is empowered to provide equity support in the form of direct pruchase of shares and underwriting of public issues of shares and offers bridge finance facilities for projects set up in less developed areas. The resources of the Fund consist of paid-up capital of Rs. 50 million of which Rs. 20 million is held by the Federal Government and Rs. 10 million each by the State Bank of Pakistan, Provincial Governments and institutional investors.

3.31 Except for bridge finance, interest is not involved on the assets side of the Fund. The Council, therefore, recommends that after the cut-off date, the Fund may adopt the system of "firm commitment" underwriting, as suggested in the case of commercial banks so as to avoid the bridge financing on interest-bearing basis. In case any interest element is involved on its liabilities side, it may be eliminated on similar lines as those suggested in respect of IDBP. The deposits held by the Fund with banks may continue to be interest-bearing until interest is eliminated from the deposits side of commercial banks, after which such deposits would be on PLS basis.

7. Federal Bank for Co-operatives (FBC) and Other Co-operative Credit Institutions

3.32 The co-operative credit structure in the country consists of three tiers. At the apex is the Federal Bank for Co-operatives which provides credit to the Provincial Co-operative Banks which form the middle tier of the system. The third tier consists of the primary co-operative credit societies.

3.33 The Federal Bank for Co-operatives was established in December, 1976 to improve the flow of credit to agriculture through the co-operatives and to assist the Federal and Provincial Governments in the development and revitalisation of the co-operative movement. It has a paid-up capital of Rs. 200 million of which the State Bank of Pakistan has subscribed Rs. 150 million, while the Federal Government and the four provincial governments together have subscribed Rs. 20 million and Rs. 30 million respectively. The Bank is the principal financial institution for meeting the credit needs of Provincial Co-operative Banks and multi-unit co-operative societies. It is authorised to: (i) accept money on deposit; (ii) borrow funds from the Federal Government, specified financial institutions and such other financial institutions in or out-side Pakistan as are approved by the Government; (iii) raise funds through issue and sale of bonds and debentures; (iv) make secured loans and advances to Provincial Co-operative Banks and multi-unit co-operative societies; and (v) invest its funds in Government securities and other approved securities and in the share capital of a Provincial Co-operative Bank and a multi-unit co-operative society up to specified limits.

3.34 There is one Provincial Co-operative Bank in each of the provinces with branches in different areas. It is the main agency for providing credit to primary co-operative credit societies. Agricultural co-operative credit societies represent the bulk of all types of co-operative societies. In 1977-78 the total number of agricultural co-operative credit societies in the country was 16,609 with a membership of 0.81 million.

3.35 The main source of funds for the co-operative credit institutions is the State Bank of Pakistan which provides loans to the Federal Bank for Co-operatives at a rate of interest which is 3 per cent below the bank rate. The Federal Bank for Co-operatives, in turn, provides loans to Provincial Co-operative Banks at 2 per cent below the bank rate while the latter provide loans to primary co-operative credit societies at 1 per cent below the bank rate. The ultimate borrowers receive loans from the primary co-operative credit societies at rates of interest which are 2–3 per cent above the bank rate.

3.36 The Council recommends that in general the financing operations of the co-operatives may be re-organised on the same lines as proposed in regard to the agricultural financing operations of the commercial banks viz., wherever PLS on actual basis is feasible, this method may be adopted while in other cases, normal rate of return, hire-purchase of *Bai Muajjal* may be made use of. In the case of farmers cultivating holdings up to subsistence level, the co-operatives may also provide interest-free loans for input financing. To the extent of these loans they may receive interest-free financial assistance from the provincial co-operative banks and this chain of interest-free loaning should extend back to State Bank's financial assistance to the Federal Bank for Co-operatives. However, in the case of financing carrying return under the various methods suggested, the provision of finance at all the consecutive stages may be on PLS basis with profit-sharing ratios rising at each lower tier. For instance, the State Bank may provide funds to the Federal Bank for Co-operatives with a profit-sharing ratio of 10:90, F.B.C. may provide to Provincial Co-operative Banks with a profit-sharing ratio of 20:80, while the Provincial Co-operative Banks may provide their assistance to co-operative credit societies with a profit-sharing ratio of 30:70.

3.37 Deposits of the co-operative banks and co-operative credit societies may be governed by the same stipulations as suggested in the case of deposits held by commercial banks.

3.38 The Council considers it necessary to stress that in view of the prevalent situation in the co-operative sector there is a great danger of misuse of the new system of financing in the form of undue pre-emption of funds by influential persons, concealment of profit, showing of fictitious losses and delays and defaults in repayments. It would, therefore, be necessary to bring about an improvement in the quality of management of the societies, tighten their supervision by the Provincial Co-operative Banks, expand the system of supervised financing and provide for deterrent penalties and punishments against malpractices of the kinds mentioned above.

8. Insurance Companies

3.39 Insurance business consists of Life Insurance and General Insurance. While the former pertains to life insurance of individuals, including group-term insurance, the latter covers fire, marine and some other types of insurance. Essentially, insurance is a means for covering risks collectively through creation of a common fund with the help of the premium paid by each member. The funds built up by insurance companies are presently invested mainly in interest-bearing securities and the benefit of these earn. This is the classical "Without Profits" business.

3.40 A good deal of insurance business is written on the assumption of a certain expected rate of return from premia received. The insurance company takes the profit if the rate of return on investment exceeds the premium assumption and assumes the loss if the rate falls below the premium assumption. This is the classical "Without Profits" business.

3.41 For many classes of business, the only practical way is to proceed on a "without-profits" basis. For example, temporary or "Term" insurances, where the policy covers a relatively short period, do not develop any substantial reserves, and it would be extremely expensive administratively to share out the meagre investment returns to the customers. Here the only practical way is either to assume no investment return and the insurance company keeps as a profit whatever little is earned or to assume some rate of investment return and make a corresponding reduction in the premium.

3.42 There is another category of business where substantial reserves are developed and where it is perfectly feasible to share out the investment income as and when earned to the policy-holders in one way or the other. This is the so-called "With Profits" business where the dividends or bonuses to policy-holders fluctuate upward or downward depending on the performance of the fund. However, even in "With-Profits" business it is not customary to assume a zero rate of return on investment. Instead usually a low rate of return is assumed and a specific bonus loading added to the premium. This is the procedure generally followed by insurance companies in Pakistan.

3.43 The Council is of the view that the existing system of insurance involves not only the element of interest but also that of gambling. It is necessary, therefore, that the insurance business should be organised on co-operative basis and its benefits should be confined to those people who are prepared to offer financial sacrifice for the sake of common good. Towards this end, the following measures are recommended:

3.44 Insurance, both life and general, should be organised on co-operative lines. Every person desiring to take insurance should pay to the company its specified premium. The income from these premia should be invested in profitable business and a portion of the annual profit so earned should be reserved for the distribution among the members. Distribution of profits may either be apportioned annually or adjusted toward payment of premium during the next year or allowed to accumulate and paid in lump sum at the time of maturity of the policy. Undistributed profits may be applied to building a reserve fund which may be utilised for payment of claims.

3.45 At the time of maturity of the life insurance policy the insured will be entitled to receive the principal along with the profit to his credit if any. However, if a person stops paying instalment before the maturity he will not be deprived of the principal amount paid by him although a condition may be imposed that payment will be made on a specified future date. For example, if a person had agreed to pay instalments for 15 years but stopped paying after one year, a condition can be imposed that he cannot withdraw the amount paid by him, say, before five years. However, if he has paid instalments for a fairly long period he may be paid the principal as also some part of the profit that may be due to him.

3.46 This procedure can be adopted in all those situations in which insurance is spread over a long period, such as life insurance, or those instances where one and the same insured keeps on renewing the contract as for example the third party insurance of vehicles or insurance of buildings, machines and ships. Some contracts of insurance are of an extremely short duration, related to a temporary phenomenon such as air travel or goods on high seas etc. For these types of insurance the Government may establish a separate trust whose function should be to invest the premia payment made by policy-holders and create a reserve fund. The money so invested and profit accruing therefrom would be the property of the trust. These should be used to meet the obligations on account of claims. Any other policy holder should neither be paid the principal nor profit from this fund, but the instalments paid should be treated as a subscription in favour of the trust.

IV

CENTRAL BANKING AND MONETARY POLICY

As the central bank of the country, the State Bank of Pakistan has been entrusted with the responsibility of regulating "the monetary and credit system of Pakistan and to foster its growth in the best national interests with a view to securing monetary stability and fuller utilisation of the country's productive resources"*. The reponsibilities and functions of the State Bank under the interest-free system will remain generally the same as at present. It would continue to perform all the functions of a modern central bank including the issue of currency

*Preamble to State Bank of Pakistan Act, 1956.

notes, regulation of money and credit, banker and adviser to the Government, and the ultimate reservoir of liquidity for the financial and banking systems.

4.2 Most of the monetary policy instruments available to the State Bank under the various banking laws of the country would also remain largely unaffected in an interest-free system. The regulatory weapons that would remain wholly or largely unaffected are: (a) Minimum cash reserve requirement; (b) Liquidity ratio requirement; (c) Overall ceilings on the lending and investment operations of banks; (d) Mandatory targets for providing finance to priority sectors; (e) Selective credit controls; (f) Issue of directions to banks on various aspects of banking operations not covered by specific policy instruments; and (g) Moral suasion. However, the Bank Rate Weapon would become redundant once interest is completely eliminated from the system. State Bank's financial assistance to banks and other financial institutions, which is also a device for regulating money and credit, would also undergo a change in so far as such assistance would need to be provided on the basis of profit/loss-sharing instead of fixed interest rates. Finally, the abolition of interest would also have some implications for open market operations.

4.3 The monetary policy instruments that will remain mostly unaffected under the new system are discussed first, while those which would need to be discarded or modified substantively are dealt with subsequently.

(a) Minimum Cash Reserve Requirement

4.4 The State Bank has the power to require banks to keep a certain minimum ratio of their demand and time liabilities in cash with it as also the power to vary this ratio whenever necessary. No interest is paid to banks on the cash reserve held by them with the State Bank. At present the ratio is 5 per cent of both demand and time liabilities*. Variation in minimum cash reserve requirement influences the ability of banks to provide finance to their clients and hence serves as an important monetary policy instrument. The State Bank will be able to use this instrument in interest-free system also. There would be necessitated only a minor change in law in respect of penalty for non-observance of the requirement. The present provision is that if at the close of any working day the balance held by any scheduled bank with the

*Liabilities for the purpose of this requirement do not include paid-up capital and reserve, any credit balance in the profit and loss account of a bink and any loan taken from the State Bank.

State Bank is below the minimum required, it has to pay interest on the amount of such shortfall to the State Bank at a penal rate which may be 3 to 5 per cent above the bank rate. This would need to be replaced by a provision not involving interest, such as the power on the part of the State Bank to impose fines per day related to the amount of the default.

(b) Liquidity Ratio Requirement

4.5 Liquidity ratio requirement signifies the statutory obligation of every scheduled bank to maintain a certain percentage of its total demand and time liabilities in Pakistan in the form of cash (including balances held with the State Bank of Pakistan), gold or unencumbered approved securities. At present, the liquidity ratio is 35 per cent of the demand and time liabilities in Pakistan of each bank. This requirement ensures that banks hold adequate liquid assets in the country to be able to meet their obligations. Variations in the liquidity ratio tend to affect the ability of banks to provide finance to the private sector, while variations in cash reserve requirement not accompanied by corresponding variations in the overall liquidity ratio largely affect the quantum of bank investment in government securities.

4.6 It would be possible to retain the liquidity ratio requirement as an instrument of monetary policy in the interest-free system also with the only change that securities held in the portfolios of banks will no longer be interest-bearing. After the abolition of interest banks would be required to replace their holdings of interest-bearing Government and other approved securities by such financial instruments as are permissible under *Shari'ah* and are approved by the Government for the purpose of meeting the liquidity requirement.

4.7 The State Bank's power to impose penal interest charges in case of non-fulfilment of this requirement would also need to be replaced on the same lines as suggested in regard to minimum cash reserve requirement.

(c) Overall Ceilings on the Lending and Investment Operations of Banks

4.8 The overall credit ceilings, which are presently prescribed in respect of credit expansion in the private sector on a quarterly basis, are designed to limit the overall credit expansion by commercial banks within the safe level of monetary and credit expansion estimated each year in the light of the Annual Plan targets for production and investment and the expectations about the balance of payments. Any bank which exceeds its credit ceiling is required to deposit with the State Bank an amount equal to the excess over its ceilings free of interest until it readjusts its position according to the prescribed ceiling. If the bank fails to make such a deposit with the State Bank, a penal interest rate is charged from it on the amount of excess over the ceiling.

4.9 No change in this system will be needed, except that the provision of penal interest rate will have to be replaced by a different system of penalty such as fine related to the quantum of excess over credit ceiling.

(d) Mandatory Targets for Providing Finance to Priority Sectors

4.10 Mandatory targets are prescribed for commercial banks by the State Bank on the recommendation of the National Credit Consultative Council to ensure the provision of at least the designated amounts of finance to specified sectors to help achieve the socio-economic objectives. Targets are presently given to banks for small loans for business and industry, small loans for agricultural production, loans for fixed investment in agriculture and loans for low-cost housing. There would be no bar to the use of this instrument in the interest-free system, the only change warranted being in respect of the provision relating to penal interest which could be amended on the same lines as suggested in the preceding paragraphs.

(e) Selective Credit Controls

4.11 The State Bank has also the powers to use selective or qualitative credit control measures for regulation of credit for specific purposes in the various sectors of the economy. As distinct from the general or quantitative credit control measures, which influence the cost and overall volume of credit, the selective credit controls influence mainly the distribution of direction of available credit. These controls are aimed at curbing an excessive use of credit for specific purposes or for encouraging the flow of credit towards desirable uses. This is achieved through the imposition by the State Bank of compulsory minimum margins to be retained by commercial banks or increase in the existing margin requirements and through withdrawal of or reduction in the existing compulsory minimum margin requirements. In addition, the maximum periods for which advances may be granted against certain commodities can also be prescribed by the State Bank. Selective credit controls are generally helpful in preventing undue rise in prices of essential commodities by regulating the availability of credit to the business community for the purchase and holding of these commodities. The State Bank has been using selective credit controls mainly to prevent speculative hoarding of foodgrains and other essential items. Since the exercise of the power to use selective credit controls does not involve any element of interest, it will continue to be exercised as hitherto. In the case of bank loans against the security of goods or opening of letters of credit for imports, the minimum margin requirements can continue to be prescribed, wherever necessary, while in the case of bank financing on profit/loss-sharing basis, minimum ratios of own contributions of the parties obtaining bank finance may be prescribed by the State Bank.

(f) Issue of Directions

4.12 Besides the powers to impose general and selective credit controls, the State Bank has also the power to issue directions to banks in general or to any individual bank in any matter such as the total amount of credit that may be extended for any purpose and the interest rates to be charged on deposits and advances. This power has hitherto been used by the State Bank in regard to prescribing the interest rates on deposits and advances as well as for fixing capital financing limits for individual banks.

4.13 The State Bank would continue to exercise this power as at present except that after the abolition of interest the present practice of prescribing maximum and minimum interest rates on advances and minimum rates on deposits would be replaced by prescription of maximum and minimum profit-sharing ratios on investments by banks and time and savings deposits held by them.

(g) Moral Suasion

4.14 Moral suasion signifies informal contacts, consultations and meetings between central bank authorities and commercial bankers with a view to discussing various issues and inducing individual banks, groups of banks or the entire banking system to follow the policy guidelines of the central bank without the issue of formal instructions or the use of statutory control weapons. Abolition of interest would not in any way affect the exercise of this power by the State Bank.

4.15 The regulatory instruments which would be affected by the abolition of interest and the possibilities of evolving alternative control mechanisms are discussed below.

(h) Bank Rate

4.16 The bank rate is the rate of interest normally charged by the

State Bank on rediscounting of the bills of exchange and other eligible commercial paper offered by the commercial banks as well as on its lendings against eligible collateral to scheduled banks and other financial institutions. Changes in the bank rate by the State Bank are followed by similar changes in the general interest rate structure in the economy. Thus, an increase or decrease in the bank rate indirectly affects the over-all demand for credit through a rise or fall in its cost to the borrowers. Somtimes the bank rate instrument is used in combination with other instruments such as open market operations and changes in cash reserve requirement or liquidity ratio requirement so as to reinforce in indirect effects on the demand for credit in the economy through a direct enhancement or reduction in the ability of banks to supply credit. Generally, the bank rate is raised when the demand for bank credit is considered by the central bank as excessive, causing inflationary pressures and balance-of-payments problems and vice versa. Whether and to what extent changes in the bank rate are effective in achieving the desired objective, of course, depends on a number of factors such as the stage of the development of money and capital markets, the state of competition in the economy, profit expectations vis-a-vis the quantum of change in the market interest rates brought about by the change in the bank rate and Government's fiscal policy. It is not proposed to discuss this issue here. However, the fact cannot be ignored that the interest rates which borrowers have to pay and whose level is largely determined by the bank rate do perform an allocative function whereby the flow of capital is directed only towards such uses in which the marginal efficiency of capital is higher than the rate of interest. It is true that all the uses with high rate of return on capital may not necessarily be the socially most desirable. In fact, some of the uses with low or even zero rate of return in the physical or financial sense, such as social overheads and investment in human capital, may really be very necessary and desirable both from the social point of view as well as the overall development of the economy. However, notwithstanding these limitations, the interest rate plays a vital role in the allocation process. Besides, the interest rate offered by banks and other financial institutions influences the level of savings held with them. Finally, it is also important to note that the financial intermediaries, like any other enterprise, also need to earn an income to meet their expenditures and to provide a reasonable return on their equities as also to those who save with them. The bank rate and interest rates would, therefore, need to be replaced by some kind of a device which may not be *riba* but nonetheless help in influencing the demand for and supply of investible funds.

4.17 There is a general consensus that interest rates on advances and deposits of banks and other financial institutions should be replaced largely by the system of profit/loss-sharing. It, therefore, appears to be the only appropriate course that the State Bank's power to vary the bank rate may be replaced by the power to fix its own profit-sharing ratio/ratios on its financial assistance to banks and other financial institutions which it may vary from time to time as necessary. In addition, the Bank may also be empowered to prescribe maximum and minimum profit-sharing ratios for banks in respect of the finance provided by them, which may be varied at any time if the situation so warrants. It may be noted that both in the case of State Bank's assistance to banks and other financial institutions and the latter's financing of the needs of their clients, who would assume the position of partners, the profit/loss-sharing would be only in respect of that portion of the actual profit/loss that corresponds to the proportional share of the financial assistance provided by them in the total amount of funds employed during the year or any other agreed period, and such share would be calculated on daily product basis. Some hypothetical examples, under varied assumptions of State Bank's profit/loss-sharing with commercial banks, are given below:

Hypothetical Examples of State Bank's Profit/Loss-sharing with a Commercial Bank on Financial Assistance to the Latter

Examples for sharing of profit

A. Commercial Bank

	Amount of advances/investments made by the commercial bank during a year.	Period of advance	Product of I and II
	(I)	(II)	(III)
1.	200	15 days	3,000
2.	200	30 days	6,000
3.	200	90 days	18,000
4.	200	180 days	36,000
5.	200 (for one year and beyond)	365 days	73,000
		Total:	*1,36,000*

Assumed profit of the commercial bank = Rs. 100/-

B. State Bank

Example

	Financial assistance to commercial bank	Period of the assistance	Profit-sharing ratio	Product of I, II & III
	(I)	(II)	(III)	
1.	20	15 days	0.5	150
2.	20	30 days	0.5	300
3.	20	90 days	0.5	900
4.	20 (e.g. for priority sectors)	180 days	Nil	–
5.	20	365 days	0.5	3,650
			Total:	*5,000*

$$\text{State Bank's share in commercial bank's profit} = \frac{5{,}000}{1{,}36{,}000} \times \frac{100}{1} = 3.67^{*}$$

Example 2

	Financial assistance to commercial bank	Period of the assistance	Profit-sharing ratio	Product of I, II & III
	(I)	(II)	(III)	
1.	20	15 days	0.6	180
2.	20	30 days	0.6	360
3.	20	90 days	0.6	1,080
4.	20 (e.g. for priority sectors)	180 days	0.1	360
5.	20	365 days	0.6	4,380
			Total:	*6,360*

$$\text{State Bank's share in commercial bank's profit} = \frac{6{,}360}{1{,}36{,}000} \times \frac{100}{1} = 4.68^{*}$$

*Earnings of SBP at bank rate of 10 per cent applied uniformly would be 3.73. However, if SBP advance under item-4 is treated as interest-free, as is the case under certain refinance schemes at present, then the earnings would be 2.74.

Example 3

Financial assistance to commercial bank (I)		Period of the assistance (II)	Profit-sharing ratio (III)	Product of I, II & III
1.	20	15 days	0.75	225
2.	20	30 days	0.75	450
3.	20	90 days	0.75	1,350
4.	20 (e.g. for priority sectors)	180 days	0.30	1,080
5.	20	365 days	0.75	5,475
			Total:	*8,580*

State Bank's share in commercial bank's profit = $\frac{8,580}{136,000} \times \frac{100}{1} = 6.31$*

Example 4

Financial assistance to commercial bank (I)		Period of the assistance (II)	Profit-sharing ratio (III)	Product of I, II & III
1.	20	15 days	0.9	270
2.	20	30 days	0.9	540
3.	20	90 days	0.9	1,620
4.	20 (e.g. for priority sectors)	180 days	0.3	1,080
5.	20	365 days	0.9	6,570
			Total:	*10,080*

State Bank's share in commercial bank's profit = $\frac{10,080}{1,36,000} \times \frac{100}{1} = 7.41$*

Example for sharing of loss

In case of loss, the respective shares would be as follows:

1. Assumed loss of the commercial bank — Rs. 100

2. Daily product of the amount of advances/investments made by the commercial bank — 136,000

*Earnings of SBP at bank rate of 10 per cent applied uniformly would be 3.73. However, if SBP advance under item-4 is treated as interest-free, as is the case under certain refinance schemes at present, then the earnings would be 2.74.

3. Daily product of State Bank's financial assistance to the commercial bank: 13,600

State Bank's share in loss: $\frac{13,600 \text{ X } 100}{136,00}$ = Rs. 10.00

Commercial bank's share in loss: $\frac{122,400}{136,000}$ = Rs. 90.00

4.18 The variations in the State Bank's own profit-sharing ratio/ratios on its assistance to banks and other financial institutions would affect their net margin of profit on the advances made through assistance from the State Bank, raising their margin of profit when the ratio is reduced and depressing it when the ratio is increased. Similarly, changes in the maximum and minimum profit-sharing ratios of banks would affect the profit margins of users of bank funds. This would exert the desired influence on the demand for bank funds in the economy in a similar fashion as changes in the bank rate. The differentiation in profit-sharing ratios as among various types of economic activity would in addition influence the allocation of resources in line with national policy objectives.

4.19 Hypothetical examples of the proposed profit/loss-sharing arrangements in respect of State Bank's assistance to commercial banks and other financial institutions have already been given. An elucidation of the proposed profit/loss-sharing arrangements between commercial banks and other financial institutions and their clients is provided below:

(i) The State Bank may fix maximum and minimum profit-sharing ratios for scheduled banks and such other financial institutions which are statutorily within its powers of regulation. The spread between the maximum and minimum is considered necessary to enable the bank concerned to use its discretion in offering terms to the parties according to their standing and to ensure a measure of competition among the banks. At the same time this arrangement would guard against undue discrimination on the part of banks among the parties seeking bank funds.

(ii) The maximum and minimum profit-sharing ratios may be fixed in accordance with the relative priorities of the various sectors of the economy, various institutions and various purposes. The Bank may, if it deems fit, also provide interest-free loans or refinance to any institution or for any sector or purpose.

(iii) Losses would be shared between the banks and their clients strictly in proportion to their repective capital contributions.

BANKS' PROFIT-SHARING RATIOS

Sector/Purpose	Maximum	Minimum
I. Industry:		
(a) Fixed investment:	50%	40%
(b) Working capital:	65%	55%
II. Exports and small business and industry:	**20%**	**10%**
III. All other sectors/purposes:	**70%**	**60%**

HYPOTHETICAL EXAMPLES OF BANKS' PROFIT/LOSS-SHARING WITH CLIENTS

I. Industry:

(i) Assumed Profit:	Rs. 400
(ii) Own Capital:	Rs. 1000
(iii) Bank Funds:	
(a) For fixed investment:	Rs. 1000
(b) For working capital:	Rs. 1000

The profit-sharing would be as follows:

Particulars	Amount (I)	Period of deployment (II)	Product of I and II
1. Own Capital:	1000	365 days	365,000
2. Bank Funds:			
(a) Fixed investment:	1000	365 days	365,000
(b) Working capital:	1000	180 days	180,000
		Total:	*910,000*

(i) Bank's share in profit:

	Maximum	Minimum
(a) On funds provided for fixed investment: $\frac{365{,}000}{910{,}000} \times \frac{400}{1} \times \frac{50/40}{100}$	80.22	64.18
(b) On funds provided for working capital: $\frac{180{,}000}{910{,}000} \times \frac{400}{1} \times \frac{65/55}{100}$	51.43	43.52
Total:	*131.65*	*107.70*

	Minimum	Maximum
(ii) Entrepreneur's share in profit:	268.35	292.30

In case of loss, the respective shares in the loss would be as follows:–

(i) Bank's share in loss: $\frac{400 \text{ X } 545{,}000}{910{,}000}$ = 240

(ii) Entrepreneur's share in loss: $\frac{400 \text{ X } 365{,}000}{910{,}000}$ = 160

II. Exports and small business and industry

(i) Assumed profit: Rs. 400

(ii) Entrepreneur's own resources: Rs. 1000

(iii) Bank funds: Rs. 1000

The profit-sharing would be as follows:

Particulars	Amount (I)	Period of deployment (II)	Product of I & II
1. Own Resources:	1000	180 days	180,000
2. Bank Funds:	1000	180 days	180,000
		Total:	*360,000*

(i) Bank's share in profit:

	Maximum	Minimum
$\frac{180{,}000}{360{,}000} \text{ X } \frac{400}{1} \text{ X } \frac{20/10}{100}$	40.00	20.00

	Minimum	Maximum
(ii) Entrepreneur's share in profit:	360.00	380.00

In case of loss, the distribution of the loss would as follows:

Assumed loss: Rs. 400

(i) Bank's share in loss: $\frac{180{,}000}{360{,}000} \text{ X } \frac{400}{1}$ = 200

(ii) Entrepreneur's share in loss: $\frac{180{,}000}{360{,}000} \text{ X } \frac{400}{1}$ = 200

4.20 In the existing system, changes in the bank rate not only influence the lending rates of the banks and other financial institutions, they also influence the rates of interest available on various types of savings and time deposits. Thus changes in the bank rate bring about changes in the demand for credit and also exert an influence on the savings mobilised by banks. It has already been noted that under the interest-free system the central bank would continue to be in a position to regulate the demand for bank finance by manipulating the profit-sharing ratios. It should also be possible to influence the mobilisation of savings through the banking system by central bank's directives in regard to the weights to be attached to banks' capital and reserves and deposits of various categories to be observed in the distribution of banks' profit.*

(i) State Bank's Financial Assistance to Commercial Banks and other Financial Institutions

4.21 The State Bank provides financial assistance to banks and certain other financial institutions not only in its capacity as "lender of the last resort" to tide over temporary liquidity shortages but also by way of refinance under schemes designed to encourage credit flows to priority sectors. Generally, the State Bank provids its financial assistance at bank rate. However, in certain cases, e.g. on its lendings to ADBP and Federal Bank for Co-operatives, it charges a concessional rate of interest. Concessional interest rates apply in the case of certain refinance schemes also while in the case of certain others, refinance is provided at zero rate of interest.

4.22 Abolition of interest would not require any change in the general nature of State Bank's lending and refinance to commercial banks and other financial institutions, except that the system of charging interest on loans will have to be replaced by profit/loss-sharing arrangements**. In general, the profit-sharing ratio to be announced by the State Bank would apply in these operations. However, in the case of transactions pertaining to priority areas such as agricultural financing and small business and industry, lower ratios may be applied. Refinance under the Export Finance Scheme may be provided as interest-free loan.

4.23 The State Bank also provides refinance to commercial banks against their loans to Government for commodity operations. At present, the rate of interest charged by commercial banks from the Government is 10¼ per cent and refinance is provided by the State Bank at 10 per cent. Since commodity operations of the Government

*A hypothetical example of profit distribution by banks among banks' capital and reserves and deposits of various categories has been given in the Section on Commercial Banking.

**Such an arrangement has already gone into effect in the case of State Bank's financial assistance to the House Building Finance Corporation.

by and large are not profit-oriented, but are designed for general welfare of the community, the Council recommends that, after the change-over, commercial banks should levy only a service charge on the loans provided for the purpose and the State Bank should provide refinance without any charge.

(j) Open Market Operations

4.24 Open market operations denote the sale/purchase of securities, primarily government securities, by the central bank to/from financial and other institutions as well as non-institutional investors. Sales are made when there is excess liquidity in the economy while purchases are made when the central bank desires to inject liquidity into the economy.

4.25 In Pakistan, open market operations have hardly been used as a credit control weapon in its own right mainly on account of the lack of a developed securities market in the country. Government securities are held largely by banks and other financial institutions who are under obligation to hold these securities to meet the statutory liquidity requirements.

4.26 With the abolition of interest, the central bank portfolio will in course of time be bereft of fixed interest government securities. The open market operations in the traditional sense will therefore cease to have any relevance in the context of State Bank's credit control policy. It may, however, be feasible after the introduction of interest-free system for the State Bank to issue its own variable dividend securities and to use these for open market operations. The holders of the securities would share with the State Bank in the profit/loss arising from its domestic transactions on the basis of the daily product of the capital deployed by the Bank from its own sources and the amount of funds received through sale of its securities.

4.27 It may be pointed out that the power of the State Bank for issue of its own securities would not be a novel addition to central bank powers because several other central banks, e.g. those of Sri Lanka, Korea, Philippines and several Latin-American countries already enjoy the power to issue their own securities and to sell or repurchase them for purposes of monetary stabilisation. The major difference would be that the securities issued by these central banks are interest-bearing while those proposed for issue by the State Bank would be on profit/loss-sharing basis.

4.28 Apart from the formulation and execution of monetary policy, the State Bank performs certain other functions. The implications of the abolition of interest for these functions as also for its miscellaneous domestic transactions are dicussed below:

(1) State Bank as Banker to Government, Banks etc.

4.29 The Federal and Provincial Governments and banks maintain their accounts with the State Bank. However, no interest is payable on these deposits. Abolition of interest will, therefore, involve no change in this respect.

4.30 As mentioned earlier, the State Bank also provides short-term loans and advances to Federal and Provincial Governments to enable them to tide over temporary gaps between revenue receipts and expenditure. Such loans and advances may be made by the State Bank to Federal and Provincial Governments free of interest. Since the State Bank's surplus profits in any case accrue to the Federal Government this change will not make any material difference, except for an implicit subsidy to the Provincial Governments.

4.31 The State Bank also subscribes to market loans issued by the Federal and Provincial Governments, thereby providing long- and medium-term credit to the Government. Under the new system it may not be feasible for the Government to issue fresh market loans because these could not yield any return that may be compatible with *Shari'ah*. It would, therefore, be necessary that the State Bank meets the long- and medium-term financial needs of the Government free of any charge.

4.32 State Bank's loans to banks and other financial institutions and purchase of bills etc., from them would be governed by the principle of profit-sharing in the prescribed ratio or ratios on daily product basis as explained in the hypothetical examples given earlier.

(2) State Bank as Bank of Issue

4.33 The note issue by the State Bank is backed by a minimum of Rs. 1,200 million worth of gold bullion and foreign exchange holdings and by government securities for the rest of the amount. No interest element is involved in the case of bullion but government securities are interest-bearing at present. However, under the new system, State Bank's holdings of government securities, irrespective of whether they are held for currency backing or otherwise, will be made interest-free. The case of foreign exchange is problematic. Foreign exchange holdings, whether kept by the Bank in the form of time deposits abroad or in the form of foreign securities are interest-bearing. It appears that the present position would have to be continued till a viable alternative becomes available.

(3) Dealings with International Financial Institutions and Foreign Aid Agencies

4.34 As the central bank of the country, the State Bank has to deal with the International Monetary Fund, World Bank and Asian Development Bank and has to maintain their accounts with it on which interest is paid. Interest is also paid on net use of the Special Drawing Rights allocated by the IMF to Pakistan as well as on PL-480 Counterpart Funds. In such cases, interest will continue to be paid until a viable solution is evolved in consultation with the parties concerned.

(4) Miscellaneous Domestic Transactions

4.35 State Bank gives advances to its employees for construction of houses and purchase of cars, motor cycles and cycles. Some of the advances to the employees are already interest-free. It is suggested that the advances which are at present interest-bearing may also be made interest-free subject to suitable quantitative limitations. Employees' Provident Fund balances on which currently interest is paid may be invested in N.I.T. Units which are guaranteed against capital loss by the Government. Interest involved in miscellaneous domestic transactions may be replaced by a service charge wherever feasible.

4.36 Muslim scholars are unanimously of the view that the major goals of economic policy in an Islamic society should be broadbased economic development and social justice. To achieve these objectives, it would be necessary to promote savings and investment, bring about an equitable distribution of incomes and wealth and ensure stability and fairness in all measures of value. The central bank should strive to so manage the banking system of the country as to generate the money and credit flows in line with the requirements of a realistic rate of economic growth without jeopardising monetary and economic stability. At the same time in order to help achieve a more egalitarian distribution of income and wealth, the central bank should not only ensure that all sections of the society which can make productive and efficient use of bank finance have access to the banking system but should also bring about a more equitable distribution of bank finance.

4.37 Monetary policy alone cannot achieve the socio-economic objectives of an Islamic society unless other Government policies also work in the same direction. It is a common experience that the effects of monetary policy are often negated by unduly expansionary fiscal policy, giving rise to inflation which causes social injustice and widespread miseries. Inflation really results in defrauding the people of the value of their earnings and savings. In the context of the following

Verse of the Holy Quran: "So give full measure and weight without defruading people in their belongings and do not corrupt the world after its reform. This is better for you if you are believers" (VII: 85), it is the bounden duty of an Islamic state to ensure reasonable stability in the value of money which is a measure of value for other goods and services as well as a store of value.

4.38 In view of this Divine injunction, there is a good ground to expect that Government of an Islamic state would so fashion its fiscal policy as to lend sufficient strength to monetary policy in achieving the desired stability in the value of money.

V

GOVERNMENT TRANSACTIONS

Interest figures prominently in both internal and external transactions of the Government. The Council's views in regard to matters related to the elimination of interest from Government transactions are given in this Section under the broad heads of: (i) Internal borrowings of the Federal and Provincial Governments, (ii) Government borrowings from external sources, (iii) Borrowings of local bodies, autonomous corporations etc., (iv) Provident funds, (v) *Taccavi* loans, (vi) Loans to Government employees, and (vii) Charge of penal interest rates.

I. Internal Borrowings of the Federal and Provincial Governments

5.2 Internal borrowings of the Federal Government take the form of market loans, treasury bills, treasury deposit receipts, loans from the State Bank and commercial banks and small savings schemes. Provincial Governments' borrowings consist of loans from the Federal Government, market loans and loans from the State Bank and commercial banks.

5.3 Market loans are raised both by the Federal and Provincial Governments to meet a part of their expenditures. The mechanism is to issue long- and medium-term securities carrying different rates of interest. The maturity periods of the existing securities range up to 1999. At present, the marketable government securities are taken up largely by institutional investors. After the abolition of interest, fresh market loans carrying a fixed rate of return will no longer be issued by the Federal and Provincial Governments. It would be difficult to raise resources on profit/loss-sharing basis as most of the items of Government expenditure are not amenable to equity financing. The borrowing requirements of the Government will therefore have to be met largely from the State Bank on interest-free basis. The Council recommends that the State Bank may provide necessary accommodation to the Government for medium and long terms. However, it must be ensured that injection of high-powered central bank money into the economy is kept within safe limits.

5.4 Treasury bills are of two types viz., *ad hoc* treasury bills and treasury bills on tap. *Ad hoc* treasury bills are issued by the Federal Government to the State Bank at a nominal rate of interest to meet specific financial needs. Their maturity period is usually three months, but they are renewable. After the abolition of interest, the Federal Government may issue interest-free *ad hoc* treasury bills.

5.5 Treasury bills on tap are also interest-bearing and their maturity period is three months. Since they are easily discountable with the State Bank they are purchased mainly by commercial banks to earn some income on short-term funds pending their utilisation in more remunerative and higher yielding assets. After the abolition of interest, there would be no viable basis for issue of treasury bills on tap in the market. Their issue would, therefore, have to cease and the Government could instead have recourse to short-term borrowing from the State Bank. The commercial banks may use their short-term funds, presently invested in treasury bills, in the inter-bank call money market on profit/loss-sharing basis.

5.6 Government Treasury Deposit Receipts are a relatively new financial instrument as compared to long-term government securities and treasury bills and have been in vogue since June, 1973. The GTDR scheme aimed at excluding Government sponsored specialised financial institutions from participating in the call money market in the interest of better control of bank liquidity while making available to them a remunerative avenue of investment for their surplus funds. Commercial banks are not allowed to purchase GTDRs. The maturity periods of GTDRs range from 3 months to one year and the rates of interest on them range from 8.25 per cent to 10.5 per cent as against 5.75 per cent on three months Treasury Bills. They are discountable with the State Bank. After the abolition of interest, the issuance of GTDRs would also have to cease and the specialised financial institutions would have to hold their surplus funds in other forms such as N.I.T. Units which are easily encashable.

5.7 The State Bank provides ways and means advances to the Federal and Provincial Governments within specified limits to meet their temporary financial needs. The ways and means advances are provided for a period of three months at agreed rates of interest. After the abolition of interest, all types of advances of the State Bank to the Government would have to be without any return.

5.8 Being banker to the Government, the State Bank maintains accounts of Federal as well as Provincial Governments. It receives payments for credit to these accounts and makes payment on behalf of Government by debiting these accounts. In the course of these transactions, the balances in these accounts may sometimes be over-drawn. The amounts over-drawn are designated as debtor balances and are subject to payment of interest. After the abolition of interest, no interest will be charged on debtor balances.

5.9 The Federal and Provincial Governments and some of their agencies borrow from the commercial banks for financing procurement of essential agricultural and other commodities with a view to ensuring regular supplies to public at reasonable prices. Commercial banks charge interest on these loans at a rate higher than the bank rate and are entitled to obtain counterfinance from the State Bank at the bank rate. As suggested in Section IV, commercial banks may continue to provide these loans to the Government but on interest-free basis subject to service charge which may be realised by way of a specified fee which would not vary with the amount, while counter-finance may be provided to them by the State Bank in the form of interest-free loan.

5.10 A number of small savings schemes introduced by the Government from time to time are in operation through the agency of Post Office Savings Banks and National Savings Centres. The savings media are Khas Deposit Certificates, National Deposit Certificates, Defence Savings Certificates, Savings Accounts, Fixed Deposit Accounts, Bonus Deposit Accounts and Khas Deposit Accounts. Interest is paid on the amounts deposited/invested and the interest income is exempt from income tax. The formalities involved in purchase/sale of certificates/bonds and in opening, closing and operation of the deposit accounts have been kept to the minimum. In addition, investment in certain savings media are also eligible for investment allowance for income tax purposes. The various certificates are issued and deposits accepted for varying maturity periods so as to suit the preferences of the savers. Interest rates payable also vary according to the maturities. The Government also issues Prize Bonds of various denominations on which, instead of interest payment, prizes are distributed on the basis of lucky draws.

5.11 There would be no scope for small savings schemes operating at present on the basis of interest. However, Post Office Savings Banks accounts may continue and their proceeds may be invested in N.I.T. Units or other suitable profit-earning avenues and the profit arising therefrom may be distributed among the deposit holders on the basis of daily product of their balances. The existing small savings certificates may be allowed to run their course. The Prize Bonds scheme has a built-in element of gambling and has been misused for tax evasion. The scheme may gradually be tapered off.

5.12 The Federal Government provides financial assistance to Provincial Governments to meet both their development and non-development expenditures and charges interest on such loans. The Federal Government may provide these loans to the Provincial Governments without any return after the abolition of interest.

5.13 The Federal Government also channels interest-bearing foreign loans to Provincial Governments. These may continue on the existing basis till a viable alternative compatible with *Shari'ah* is found in respect of borrowings from abroad.

II. Government Borrowings from External Sources

5.14 The Government of Pakistan has been borrowing substantial amounts from foreign governments and international financial institutions to finance economic development on which interest payments have to be made regularly. The Council feels that efforts should be made to reduce dependence on foreign aid in general and interest-bearing foreign assistance in particular. In addition, efforts should be made to foster greater economic co-operation among Muslim countries so as to promote movement of capital on the basis of profit/loss-sharing or other non-interest basis. With such increased economic co-operation among Muslim countries it is not unlikely that, with the passage of time, non-Muslim aid-giving countries and international financial institutions may also begin to deal with Muslim countries on a basis compatible with *Shari'ah*. For the time being, external borrowings will have to be continued on the basis of interest.

III. Borrowings of Local Bodies, Autonomous Corporations, etc.

5.15 The Federal and Provincial Governments provide loans to local bodies, autonomous corporations, etc. for both development and non-development purposes. After the abolition of interest, the Federal and Provincial Governments may provide interest-free loans to these bodies/corporations for financing such non-profit-earning projects as are considered essential. However, for profit-earning projects they may also obtain finance from banks/other financial institutions on a basis conforming to *Shari'ah*, provided that the financing institutions also consider these projects viable. Interest-bearing foreign loans channelled by the Government to these bodies would, however, need to be continued on the existing basis.

IV. Provident Funds

5.16 The Federal and Provincial Governments and their agencies pay interest on their employees' Provident Fund balances. After the abolition of interest, the Provident Fund balances of the employees may be invested in N.I.T. Units or other suitable investment media and the profits arising therefrom may be credited to the employees' Provident Fund accounts.

Another possibility is that Government, instead of paying interest on Provident Fund balances, should pay an annual bonus equivalent to the rate of profit declared by N.I.T.

V. *Taccavi* Loans

5.17 The Provincial Governments provide loans to farmers for agricultural development as well as for relief in times of distress and charge interest at fairly high rates. However, the amounts of loans as well as interest receipts on them are very small. The Council suggests that *Taccavi* loans may be provided by the Provincial Governments free of interest.

VI. Loans to Government Employees

5.18 The Federal and Provincial Governments provide loans to their employees for construction of houses and for purchase of cars, motor cycles etc., and charge interest thereon. Receipts from this source are, however, an almost insignificant proportion of total receipts. Interest on these loans can, therefore, be easily abolished. Interest-free loans for these purposes may be considered as part of the fringe benefits to the Government employees.

VII. Charge of Penal Interest Rates

5.19 The Government and its agencies in some cases charge penal rates of interest on their overdues. This practice may be replaced by imposition of appropriate fines.

SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

Introduction

The elimination of interest occupies a key position in the establishment of the Islamic order. Pakistan being an ideological state, the abolition of *riba* has from the very beginning formed an integral part of State Policy as enshrined in her Constitution. Yet there has hitherto been hardly any noteworthy progress towards the elimination of interest from the country's economy. However, in the recent past, the President of Pakistan not only entrusted to the Council of Islamic Ideology the task of preparing a blueprint of an interest-free economic system but has also set a time limit of three years for the elimination of interest from the economy. Further, the Presidential declaration has been given the form of a Constitutional provision. The Council, soon after its reconstitution, appointed a Panel of Economists and Bankers which was assigned the responsibility, *inter alia,* of examining the technical aspects of the elimination of interest and recommending ways and means for reorganising the country's banking system in conformity with the *Shari'ah.* The present Report of the Council is based largely on the work accomplished by the Panel. However, in adopting the recommendations of the Panel, the Council has incorporated amendments, wherever necessary, so as to ensure complete conformity with the *Shari'ah*. (para 1)

2. The basic work having been accomplished, the next step that needs to be taken by the Government is the setting up of various working groups which should be charged with the task of working out the details of the new system. It needs to be emphasised that during the whole process extreme care must be exercised to ensure that the basic stipulations of the new system are faithfully adhered to. (para 2)

3. The elimination of interest is but a part of the overall value system of Islam and this measure alone cannot be expected to transform the entire eonomic system in accordance with the Islamic vision. The need for reformatory measures at moral building and eradication of false values of life was emphasised by the Council earlier while submitting its recommendations on the laws of *hudood* and the introduction of *Zakah.* However, now as the country is poised for the introduction of an interest-free banking system, this need has increased immeasurably in its urgency. For this purpose the mass media need to be mobilised forthwith for launching a well thought-out persuasive campaign designed to bring home to the people the details of the new

system and persuade them to willingly and whole-heartedly accept the challenge and to act with a missionary zeal. (para 3)

4. With a view to ensuring the success of the new system of banking, the Government should carry out a thorough reappraisal of the tax system focussing in particular on the need for greatly simplifying the system of Income Tax. (para 4)

5. Ideally the real alternatives to interest under an Islamic economic system are profit/loss-sharing or *qard-hasanah,* i.e. loaning without additional charge over and above the principal amount. Although the recommendations are based largely on the principle of profit/loss-sharing, yet some of the recommendations lean on other methods in view of the difficulties faced in the practical application of the profit/loss-sharing system in its pure form on account of the prevalent standards of morality in the society. These alternative methods are, however, no more than a second best solution from the view point of an ideal Islamic economic system. This is because of the fact that although these alternative methods are free of the interest element in the form in which they are specifically laid down in this Report, there is a danger that this could eventually be misused as a means for opening a backdoor for interest along with its attendant evils. They should, therefore, be applied to the minimum extent that may be unavoidably necessary, and that their use as general techniques of financing must never be allowed. In this connection, a basic policy decision may be taken to the effect that with the passage of time the operational field of PLS and *qard-hasanah* should gradually be expanded while that of the other alternatives reduced. At the same time, efforts must be stepped up to bring about a substantial improvement in the standards of honesty in the society and to remove illiteracy, because both dishonesty and illiteracy militate against the success of the new system. (para 5)

6. For remodelling the banking system on Islamic lines it is indispensable to make necessary changes in the existing laws having a bearing on the operations of banks so as to bring these laws in conformity with the *Shari'ah.* The task of amending and remodelling these laws may be taken in hand simultaneously with the initiative of the process of eliminating interest. (para 6)

Section I: Issues, Problems and Strategy

The Holy Quran explicitly and emphatically prohibits *riba* and there is complete unanimity among all schools of thought in Islam that the term *riba* stands for interest in all its types and forms. (para 1.1)

2. The prohibition of interest in respect of consumption loans rests mainly on humane considerations while the main rationale for prohibition of interest in respect of loans for production purposes stems from the concept of justice which is the cornerstone of the Islamic philosophy of social life. The basis of co-operation between capital and enterprise which Islam cherishes is equitable sharing of the risks and gains between them, which is possible under a system of profit/loss-sharing (PLS). (paras 1.3-1.4)

3. Serious reservations are often expressed about the successful applicability of the PLS system in our conditions on account of the fact that most of the enterprises either do not maintain accounts or do not maintain them properly or keep different sets of accounts for different purposes. In this cotext, the Council gave consideration to a number of other possible devices also to replace the interest system, which may be in conformity with *Shari'ah.* (paras 1.5-1.8)

4. The alternative methods considered are as follows:

(a) Service Charge

If interest is replaced by a service charge, banks and other financial institutions would provide loans with full guarantee for repayment of the principal plus a service charge sufficient to cover the administrative costs of the financial institution. The Council came to the conclusion that although this solution may appear to meet the requirement of the *Shari'ah* in the literal sense, it would for a number of reasons, neither accord with the true spirit of Islam nor would it be advisable from the economic point of view. (para 1.9)

(b) Indexation of Bank Deposits and Advances

Under this system the liability of a borrower to the banking system would be adjusted in money terms to reflect the change in the value of money, as measured by a price index, during the period the borrowing remained outstanding. Lending by banks on this basis would enable them to compensate the depositors for the change in the value of money. It was felt that though indexation may constitute a favourable factor for the growth of savings in an inflationary situation by preserving the real value of money savings, its use on the side of bank advances would create a number of problems and may greatly hurt productive activity. Moreover, under the *Shari'ah,* currency transactions are not treated differently from commodity transactions in so far as lending and borrowings are concerned. As such, no allowance can be made for the change in the value of money. (para 1.10) *(c) Leasing*

Leasing is a relatively new method of long-term financing that is gaining popularity in the industrialised countries. Under this method, the lessor retains the ownership of the asset and the lessee has possession and use of asset on payment of specified rentals over a period. The use of this method can enable banks and other financial institutions to provide medium- and long-term finance either directly or through their leasing subsidiaries without having to look into the accounts of the firms. However, as against the existing practice, the cost of insurance of the assets will have to be borne by the lessor in order to make this method conform to the principles of *Shari'ah.* (paras 1.11-1.3)

(d) Investment Auctioning

Under this system, commercial banks may form a consortium with long-term financing institutions and formulate industrial projects with complete details. The consortium may then announce the project with the assurance to make available the needed plant and machinery of specific description and call for bids from prospective investors for the purchase of the machinery. The project may be awarded to the highest bidder if the party is considered to be a sound one. Otherwise, the project may be awarded to the next highest bidder considered capable of efficient implementation and running of the project. The most significant advantage of this system, from the economic point of view, would be that the price paid by the investor would adequately reflect the potential profitability of the project which is essential for efficient allocation of resources. (paras 1.14-1.15)

(e) Bai Muajjal

It is a sale under which the price of the item involved is payable on a deferred basis either in lump sum or in instalments. This system could be of considerable use in financing current input requirements of industry and agriculture as well as in the financing of domestic and import trade. However, although this mode of financing is understood to be permissible under the *Shari'ah,* it would not be advisable to use it widely or indiscriminately in view of the danger attached to its opening a back-door for dealing on the basis of interest. Safeguards would, therefore, need to be devised so as to restrict its use only to inescapable cases. (paras 1.16-1.17)

(f) Hire-purchase

Under this system, banks may finance the purchase of machinery and equipment as well as purchase of consumer durables under a joint-ownership arrangement subject to provision of security or surety. They would receive, in addition to repayment of the principal, a share in the net rental value of these items in proportion to their outstanding share in total investment. (para 1.18)

(g) Financing on the Basis of Normal Rate of Return

Under this system a specialised public agency may determine the normal rate of return in each industry, business etc., and the banks may provide funds to the entrepreneurs with the assurance that a certain minimum rate of profit would be payable to the bank on the amount provided by it. If the actual rate of profit exceeds the designated normal rate of return, the difference would be paid voluntarily by the entrepreneur to the financing institution. In case, however, the rate of profit turns out to be lower, or if there is a loss, the entrepreneur concerned would have to prove the same to the satisfaction of the specialised public agency, in which event the financing institution may accept the lower rate of profit or share in the loss. However, in view of the strong possibility that a wide-spread use of this method may in practice degenerate into pure interest it needs to be applied on a very limited scale and only where unavoidably necessary. (para 1.19)

(h) Time Multiple Counter Loans

Under this method a bank may give by way of interest-free loan a multiple of interest-free deposit by a client so that the product of the money and time for which money is given is the same in both the cases. It would, however, not be correct to use this method by way of a permanent alternative system to the interest-based system. However, in order to provide personal loans to people of small means banks may instead of the above stipulations, adopt it as a principle that they would provide loans for personal and non-productive purposes only to those persons who already hold accounts with them. In laying down the repayment schedule and the amount of the loan, however, the banks may keep in view the amount of the deposit of the applicant for the loan and the period over which he has maintained his deposit with the bank. (para 1.20)

(i) Special Loans Facility

Under this facility interest-free loans may be provided by banks and other financial institutions in cases where neither PLS nor any of the other alternative methods is feasible, provided that the purposes/

projects for which finance is given are for general welfare of the community. However, in order to minimise the impact of such loaning on the profitability of the financial institutions, it should be ensured that it remains restricted to a scale considered absolutely necessary. (para 1.21)

The Council is of the view that to replace interest, use should be made of PLS System as well as the devices under items (c) to (i). (para 1.22)

5. While evolving a workable mechanism for financing on profit/loss-sharing basis suited to our conditions, the Council has kept in view the *Fiqh* literature on the subject of *Sharakah* and *Mudarabah*. The stipulations pertaining to *Sharakah* provide that partners are free to agree on any profit-sharing ratios, but losses are to be shared strictly in proportion to the respective capital contributions. The Council, however, felt that under the proposed profit/loss-sharing system, the division of profits between the financial institutions and business and industrial concerns should be regulated by the central bank of the country. The financial institutions may also enjoy the powers of inspection of the projects and their books of accounts and to participate in the decision-making process. (para 1.23)

6. To ensure smooth and unhindered return flow of funds, delay in the payment of amounts due to the banks should attract a penalty for non-payment. However, the amount of the fine should not accrue to the banks but deposited in the Government treasury. Since delay and defaults without genuine reasons would not only be a breach of trust but also jeopardise the success of the new system, deterrent punishments should be provided to defaulters which may include confiscation of property. Delinquents should be black-listed and debarred from any future financial assistance by banks. (para 1.24)

7. For the success of the new system it will be imperative that banks enjoy free and unfettered discretion in respect of acceptance or rejection of financing proposals received by them on the basis of sound banking principles and criteria. Such public sector enterprises as do not meet the criteria of sound banking may either be financed by a separate public agency or the banks should be guaranteed the repayment of the capital and provided with a subsidy by the Government equivalent to the average rate of profit of the bank. A thorough-going reform of the auditing system, which presently suffers from a number of weaknesses, will also be necessary for ensuring the success of the new system. (paras 1.25-1.26)

8. The remodelling of the commercial banks' operations on the basis

suggested in this Report would represent a radical departure from the traditional British pattern of banking on which the commercial banks in this part of the world have been largely operating. However, in the broader international context a reorientation of bank financing on the lines suggested cannot be regarded as entering a field that is completely untried. It cannot be denied that elimination of interest from banking and financial system as a whole is a bold enterprise and problems and difficulties are sure to arise in the initial period. However, once the new arrangements are put into practice and worked in right earnest, a process of evolution would be set in motion and practical solutions to the emerging problems would be found. (paras 1.27-1.30)

9. The Council considered three different options with a view to suggesting an action plan for the elimination of interest from the economy. These were: (a) a model bank may be set up which may start operations on interest-free basis and, on the basis of experience gained from its working, the operations of the commercial banks and other financial institutions may be reorganised on interest-free basis subsequently; (b) a comprehensive scheme may be prepared for a complete switch-over to the interest-free economic system and then the timing of such a switch-over may be decided; (c) interest may be eliminated from the economic system in a phased manner. The third option was considered to be the most practical and reasonable. It was in this perspective that the Council had earlier recommended elimination of interest from the operations of N.I.T. and I.C.P. as well as from housing finance provided by H.B.F.C. and the commercial banks in the initial phase. A beginning towards elimination of interest in a phased manner has already been made with the switch-over of the N.I.T., H.B.F.C. and I.C.P. Mutual Funds to interest-free operations with effect from July 1, 1979 and the decision announced in the last budget not to charge any interest on bank loans for production purposes to farmers cultivating holdings up to 12½ acres.

The Council also considered a suggestion mooted in certain quarters that initially only interest-free counters may be opened in the existing commercial banks which may operate simultaneously with interest-based system and that depositor may be given the option to keep their money with banks on PLS basis or on interest basis. The Council strongly opposes such a course of action because it is not only inappropriate but also extremely dangerous, as it is likely to entail perpetuation of the interest-based system and to undermine the efforts at introducing interest-free banking in the country.

The Council has recommended that during the period of about 1 year and 8 months that now remains within the 3-year time limit set by the President the rest of the measures for elimination of interest from the domestic transactions should be taken in three clearly defined phases with specific time schedule. The first phase should start on July 1, 1980 and should cover selected Government transactions with the State Bank and commercial banks, certain inter-governmental financial transactions, Federal and Provincial Governments' loans to local bodies and autonomous corporations in respect of non-profit-earning but essential projects, *Taccavi* loans, loans to Government employees, employees' Provident Fund balances, penalty on Government overdues, commercial bank financing of seasonal needs of the farmers, housing finance by commercial banks, personal loans, Small Business Finance Corporation's financing of means of transport and loans by ICP under its investors' scheme.

The second phase to go into effect from July 1, 1981 should aim at eliminating interest completely from the assets side of the banks and other financial institutions in so far as they pertain to domestic transactions. In addition, the remaining elements of interest in the domestic transactions of the Government should be eliminated.

In the final phase of the elimination of interest from domestic transactions, to take effect on 1st January, 1982, banks should cease to accept deposits from the public on the basis of interest and switch-over to profit/loss-sharing. Inter-bank transactions would also be switched-over to profit/loss-sharing system and State Bank would abandon the system of providing finance to banks and other financial institutions on the basis of interest and would bring about necessary changes in its monetary policy as set out in Section IV of the Report. (paras 1.31-1.35)

10. Elimination of interest from transactions relating to international trade and aid, which poses the most difficult problems, should be covered in the third phase. It is necessary to accelerate the efforts for greater economic co-operation among Islamic countries so as to achieve interest-free international trade and aid at least among them. The Islamic Development Bank can also play an important role in this respect. At the same time, by setting a practical example of the Islamic economic and technical system we should seek to convince others about the blessings and virtues of the Islamic system. (para 1.36)

Section II: Commercial Banking

The Section suggests alternative mechanisms for replacing interest in domestic banking transactions. Complete elimination of interest from international trade transactions cannot be achieved by the lone efforts of a single country. However, measures should be taken to minimise the element of interest even in international trade transactions. (para 2.3)

2. Under the new system, banks may provide finance on PLS basis for fixed investment in industry to parties maintaining accounts audited by Chartered Accountants. Parties whose accounts are not audited by Chartered Accountants may be accommodated under "hire-purchase", *Bai Muajjal* or "leasing" arrangements. Smaller parties who may not be in a position to maintain proper accounts may be financed under "normal rate of return", "hire-purchase" or *Bai Muajjal* arrangements. (para 2.6)

3. Banks may also formulate new projects themselves singly or in collaboration with non-bank financial intermediaries, and the plant and machinery required for these projects may be financed by them on the basis of "Investment Auctioning". (para 2.7)

4. Under the new system the financing agreements would provide for monitoring by the banks of the actual performance of the projects financed by them so as to safeguard their interests. (para 2.8)

5. Finance provided for fixed industrial investment under bridge financing arrangements based on "stand-by" technique of underwriting, currently in vogue, is not compatible with *Shari'ah* and needs to be substituted by "firm commitment" underwriting technique. Since the firm commitment underwriting is not permissible under the Companies Act, necessary changes in the Act may be made to permit the use of this technique. (para 2.9)

6. Debenture financing may be replaced by the issuance of a new corporate security to be called the Participation Term Certificate (PTC). (para 2.10)

7. Working Capital requirements of industry are at present being met through grant of cash credit, overdrafts, demand loans and bill discounting arrangements. These facilities, with the exception of bills discounting, may be provided on PLS basis in the case of firms maintaining proper accounts and having regular dealings with the financing bank. In other cases, finance may be provided under "normal rate of return" arrangements or *Bai Muajjal*. In the case of bill discounting, the Council has recommended a procedure designed to bring this type of financing in conformity with the *Shari'ah*. (para 2.11)

8. In providing short-term finance to farmers, the commercial banks should distinguish between farmers cultivating holdings up to the subsistence level and those cultivating holdings above the subsistence

level. Farmers with subsistence holdings may be provided assistance in cash or kind without any charge under the "Special Loans Facility". Ordinarily such loans should be provided out of funds raised by banks on interest-free basis. However, if such funds are inadequate banks may be provided a subsidy by the Government in respect of such loans on the basis of the average rate of profit of commercial banks during the relevant period. (para 2.16)

9. Short-term finance to farmers with holdings above the subsistence level may be provided by banks under *Bai Muajjal* or *Bai Salam* arrangements. (para 2.17)

10. Medium- and long-term finance is required for pruchase and maintenance of agricultural machinery and implements, sinking of wells, installation of tubewells, land development, construction of storage, poultry and dairy farming etc. Replacement of interest in medium- and long-term financing in the agricultural sector by a single substitute conforming to *Shari'ah* is not possible. Therefore, the various alternative methods will have to be used for different purposes. (paras 2.18-2.22)

11. Under the new system, small retailers, who are not in a position to maintain accounts may be provided finance either under *Bai Muajjal* arrangements or under "Special Loans Facility" out of resources raised by them on interest-free basis. In case these are inadequate, the Government may provide a subsidy to the banks on the amount of such loans on the basis of average rate of profit of the commercial banks in the relevant period. In regard to bank financing of the commerce sector under cash credit, overdraft, demand loans and discounting of bills, the above arrangements as those recommended in respect of financing of working capital requirements of industry may be applied. In the case of opening of letters of credit, the banks may charge a commission for the service rendered by them and they may not necessarily share in the profit/loss. (para 2.23)

12. For financing house construction by individuals, commercial banks may adopt the same system as was recommended by the Council in its earlier Report and has been put into practice by the House Building Finance Corporation. Financing of construction companies both for fixed investment and working capital may be strictly on PLS basis. (para 2.24)

13. Banks may finance purchase of trucks, buses, taxis, vans, rickshaws and private cars under "hire-purchase" or *Bai Muajjal* arrangements. (para 2.25)

14. With the exception of services sector, in which case banks may use any of the alternative methods of financing considered permissible under the *Shari'ah*, PLS seems to be the only practical basis for financing of other sectors. In case of finance required for purchase of capital goods and machinery, techniques of *Bai Muajjal* or "Investment Auctioning" may also be used. (para 2.26)

15. Banks may generally not provide any personal loans. Loans to finance educational expenses of meritorious students may, however, be provided without interest. Purchase of consumer durables under economically justifiable conditions may be financed under *Bai Muajjal* or "hire-purchase" arrangements on a restricted scale. Personal loans in calamity-stricken areas may be provided by the Government from the Federal Zakat Fund. (paras 2.27-2.28)

16. In order to avoid any adverse effect on depositor's confidence and deposit mobilisation by banks, deposits in the short transitional period may continue to be accepted by banks on the existing basis. (para 2.29)

17. Under the new system, variable return would be payable on savings and time deposits on the basis of banks profits/losses. (para 2.30)

18. The nomenclature of deposits as well as the rules and procedures governing the operation of deposit accounts should remain unchanged for the time-being in order to avoid the possibility of confusion. However, some changes in the banking terminology could be helpful in creating a sense of the radical change in the system. The banks should also continue to enjoy full discretion in regard to the deployment of the deposits resources. The Government may also continue the guarantee provided to deposits of nationalised commercial banks for a short transitional period after the switch-over of deposits to the new system. (para 2.33)

19. In order to avoid frequent shifts of deposits from banks with lower profitability to banks with higher profitability, the rates of return on deposits held with nationalised commercial banks should be made uniform by pooling their profits for distribution among depositors. (para 2.34)

20. Inter-bank transactions may be carried out under PLS arrangements. (para 2.35)

21. The State Bank's financial assistance to commercial banks under its various refinance schemes as well as those for meeting temporary liquidity shortages may normally be provided under PLS arrangements. (para 2.36)

22. The operations of foreign branches of Pakistani banks, foreign currency deposits held with commercial banks in Pakistan and certain other transactions of banks with banks abroad would have to continue on the basis of interest. In order to avoid merger of interest and non-interest income, however, the administration of foreign branches of Pakistani commercial banks may be entrusted to a separate Corporation to which foreign currency deposits held with commercial banks should also be transferred. This Corporation should not accept local deposits. (para 2.37)

23. Commercial banks' loans to their employees may be on the lines suggested in the case of the employees of the State Bank. (para 2.38)

Section III: Specialised Financial Institutions

The Council has made its recommendations in respect of elimination of interest from the operations of N.I.T., I.C.P. and H.B.F.C. in an earlier Report. Its recommendations relating to other specialised financial institutions are contained in this Section. (para 3.1)

2. The assets of Pakistan Industrial Credit and Investment Corporation (PICIC) involving interest consist of debentures purchased, foreign and local currency loans and deposits held with banks. PICIC's liabilities involving interest are: debentures issued, line of credit in foreign currency and Rupee borrowings. (para 3.4)

3. Since a portion of PICIC's share capital is also held by foreign investors it appears necessary that the assent of foreign share-holders be obtained for the elimination of interest from its operations. In case they are not agreeable, they may be given the option to disinvest their shares. (para 3.5)

4. After the cut-off date for elimination of interest, PICIC may not purchase any new debentures but may instead purchase the proposed Participation Term Certificates (PTCs). (para 3.6)

5. PICIC provides loans in local and foreign currencies for acquisition of fixed assets at rates of interest fixed by the Government. After the cut-off date it may switch-over completely to interest-free forms of financing discussed in Section I. (para 3.7)

6. The deposits of PICIC with banks may be held on PLS basis after the elimination of interest from the deposits side of commercial banks. (para 3.8)

7. The present underwriting arrangements which give rise to bridge finance on interest basis may be replaced by the system of "firm commitment" underwriting which is compatible with *Shari'ah*. (para 3.9)

8. For raising local currency resources, PICIC may, instead of issuing

debentures, issue Participation Term Certificates. The debentures already issued may also be replaced by PTCs, to the extent possible, with the consent of the holders and the rest may be allowed to run their course. (para 3.10)

9. The long-term Rupee loans, secured by PICIC from the Government to broaden its equity base, may be converted into Government investment on PLS basis or replaced by PTCs to be issued by PICIC to the Government. Future Government assistance to PICIC may either be on PLS basis or through purchase of its PTCs. (para 3.11)

10. The Government of Pakistan may forego the portion of interest payable to it by PICIC on the long-term Rupee loan granted by the US-AID and may instead share in PICIC's profit/loss related to the amount of the loan. In respect of the portion of interest payable to USAID, an effort may be made that the USAID forego its interest claim. If they do not agree, then the existing arrangements may continue. (para 3.12)

11. PICIC's foreign currency borrowings may continue to be on interest-basis until a viable alternative conforming to *Shari'ah* is available. (para 3.13)

12. PICIC's borrowing from the State Bank may be on PLS basis, with a suitably lower profit-sharing ratio in respect of finance provided under the Refinance Scheme for locally-fabricated machinery. (para 3.14)

13. The functions and operations of Industrial Development Bank of Pakistan (IDBP) are similar to those of PICIC. The changes required for elimination of interest from its operations would, therefore, be similar to those suggested in the case of PICIC. However, it differs from PICIC in so far as it also provides finance for working capital and accepts deposits from the public. In these respects the recommendations in regard to commercial banks would also generally apply to IDBP. (para 3.17)

14. The operations of National Development Finance Corporation (NDFC) are similar to those of PICIC and IDBP. The changes required for elimination of interest from its operations would, therefore, be broadly the same as those suggested in the case of PICIC and IDBP. (paras 3.18-3.20)

15. In the case of the Agricultural Development Bank of Pakistan (ADBP), deposits accepted by it should be subject to similar arrangements as those suggested for commercial banks. Loans received from the State Bank may either be on PLS basis or free of cost. Borrowings from international agencies may continue to be interest-bearing until

alternative arrangements compatible with *Shari'ah* become available. Financing by ADBP with the assistance of both foreign loans and locally-raised resources would need to be on the same basis as outlined in respect of agricultural financing operations of commercial banks. (para 3.24)

16. The Small Business Finance Corporation (SBFC) at present provides financial assistance to persons of small means on interest basis. After the cut-off date it may provide finance for purchase of trucks, wagons, taxis etc., on the basis of "hire-purchase" or *Bai Muajjal* while cycle advances may be provided free of cost. Financing of small industries, small business and of professions may be on the basis of normal rate of return. The Corporation's deposits maintained with banks would be treated like other private sector deposits. Borrowings from the Government may either be free of cost or on PLS basis, while those from commercial banks may be on PLS basis. (paras 3.25-3.29)

17. In the case of the Equity Participation Fund (EPF), interest is involved only in bridge finance which may be done away with by adopting the system of "firm commitment" underwriting as suggested in the case of commercial banks. On the liabilities side, interest may be eliminated on lines similar to those suggested in respect of IDBP. (para 3.31)

18. The Federal Bank for Co-operatives (FBC) is the apex institution in the co-operative credit structure. The other two tiers of the co-operative credit system are Provincial Co-operative Banks and the primary co-operative credit societies. The Council recommends that the financing operations of the co-operatives may be reorganised on the same lines as proposed in regard to the agricultural financing operations of commercial banks. The State Bank's financial assistance to the co-operative credit institutions may be free of any charge in respect of their interest-free loans. However, in respect of their financing carrying return, the State Bank's financial assistance may be provided on PLS basis. (paras 3.32-3.36)

19. Deposits of the co-operative banks and co-operative credit societies may be governed by the same stipulations as suggested in the case of deposits held by commercial banks. (para 3.37)

20. To ensure the success of the new system, it would be necessary to bring about an improvement in the quality of management of the societies, tighten their supervision by the Provincial Co-operative Banks and expand the system of supervised financing. (para 3.38)

21. The system of insurance, in its present form, involves not only the element of interest but also that of gambling. It needs to be

organised on co-operative basis, along the lines indicated in the text, and its benefits should be confined to those people who are prepared to offer financial sacrifice for the sake of common good. (paras 3.43-3.46)

Section IV: Central Banking and Monetary Policy

The responsibilities and functions of the State Bank under the interest-free system will remain generally the same as at present and most of the monetary policy instruments available to the State Bank would also remain largely unaffected. However, the bank rate weapon would become redundant after interest is completely eliminated from the system. State Bank's financial assistance to banks and other financial institutions, which is also a device for regulating money and credit, would also undergo a change in so far as it would need to be provided on PLS basis instead of fixed interest rates. Abolition of interest would also have some implications for open market operations. (paras 4.1-4.2)

2. The State Bank would continue to use its power to require the scheduled banks to maintain minimum cash reserves with it against their demand and time liabilities and will continue to use this instrument under the interest-free system. Since the State Bank does not pay any interest on these reserves, no change in this regard will be needed. However, the State Bank charges penal rates of interest in cases of non-observance of this requirement by banks. This power may be replaced by the power to impose fines per day related to the amount of the default. (para 4.4)

3. It will be possible to retain liquidity ratio requirement as an instrument of monetary policy with the only change that the interest-bearing securities held in the portfolio of banks will have to be replaced by such financial instruments as are permissible under *Shari'ah*. The State Bank's power to impose penal interest in case of non-observance of the statutory requirement would also need to be replaced by the power to impose fines. (paras 4.5-4.7)

4. No change will be needed in regard to the instrument of prescribing overall credit ceilings for commercial banks with a view to regulating credit expansion in the private sector. However, the power of charging penal interest rates will have to be replaced by the power to impose fines. (paras 4.8-4.9)

5. Mandatory targets are prescribed by the State Bank for commercial banks to ensure the provision of at least the designated amounts of finance to specified sectors to help achieve the socio-economic objectives. No change will be required in this except that the

power to charge penal interest rates will have to be replaced by the power to impose fines. (para 4.10)

6. Selective credit controls which are used as a device for curbing an excessive use of credit for specific purposes or for encouraging the flow of credit towards desirable uses, do not involve any element of interest and would, therefore, continue to be made use of as at present. (para 4.11)

7. The State Bank's power to issue directives to banks would continue to be exercised. (paras 4.12-4.13)

8. Moral suasion, which signifies informal consultations between commercial banks and the central bank on various issues and for inducing the banks to follow the policy guidelines of the central bank, would not be affected in any way by the abolition of interest. (para 4.14)

9. The Bank Rate Weapon would need to be replaced by the power on the part of the State Bank to fix its profit-sharing ratio or ratios in respect of its own financial assistance to banks and other financial institutions as also the power to prescribe maximum and minimum profit-sharing ratios for scheduled banks in respect of finance provided by them. (paras 4.16-4.17)

10. The State Bank's power to prescribe minimum interest rates payable on savings and time deposits may be replaced by the power to prescribe weights to be given to these deposits for the purpose of profit distribution by the banks. (para 4.20)

11. The State Bank's role as "lender of the last resort" as well as the provision of refinance by it to commercial banks and other financial institutions would not be affected by the abolition of interest. However, under the new system such assistance would in general be provided under PLS arrangements or other alternative methods permissible under the *Shari'ah.* (paras 4.21-4.22)

12. Abolition of interest will not necessitate any change in respect of deposits of the Federal and Provincial Governments held with the State Bank since even at present no interest is paid on these deposits. (para 4.29)

13. The State Bank's short-term loans and advances to Federal and Provincial Governments, currently provided on interest basis, may be provided free of interest. (para 4.30)

14. As it would not be feasible under the new system for the Government to issue fresh market loans on terms compatible with *Shari'ah,* the medium- and long-term borrowing requirements of the Government would also need to be met by the State Bank free of any charge. (para 4.31)

15. The note issue by the State Bank is backed largely by government securities and holdings of foreign exchange both of which contain elements of interest. While the government securities would be made interest-free under the new system, foreign exchange holdings abroad may have to be continued on interest basis till a viable alternative becomes available. (para 4.33)

16. State Bank's transactions with international financial institutions and foreign aid agencies would have to be continued on the basis of interest until a viable solution is evolved in consultation with the parties concerned. (para 4.34)

17. State Bank's advances to its employees, which are at present interest-bearing may be made interest-free subject to suitable quantitative limitations. Employees' Provident Fund balances on which interest is paid at present may be invested in N.I.T. Units and profits earned on them credited to the employees' Provident Fund accounts. Interest involved in miscellaneous domestic transactions may be replaced by a service charge, wherever feasible (para 4.35)

18. The major goals of economic policy in an Islamic society are broad-based economic development and social justice. To help achieve these objectives, the central bank should strive to so manage the banking system as to generate money and credit flows in line with the requirements of a realistic rate of growth without jeopardising monetary and economic stability. At the same time, it should not only ensure that all sections of the society which can make productive and efficient use of bank finance have access to the banking system but should also bring about a more equitable distribution of bank finance. (para 4.36)

19. Monetary policy alone cannot achieve the socio-economic objectives of an Islamic society unless other Government policies also work in the same direction. The Government of an Islamic state should so fashion its fiscal policy as to lend sufficient strength to monetary policy. (paras 4.37-4.38)

Section V: Government Transactions

After the abolition of interest, fresh market loans carrying a fixed rate of interest would no longer be issued. It would be difficult to raise resources on PLS basis. The borrowing requirements of the Government will, therefore, have to be met by the State Bank on interest-free basis. (paras 5.1-5.3)

2. *Ad hoc* treasury bills, currently issued by the Federal Government to State Bank at a nominal rate of interest to meet specific

financial needs, may be issued on interest-free basis after interest is abolished. However, treasury bills on tap and Government treasury deposit receipts would no longer be issued. The Government could instead have recourse to short-term borrowing from the State Bank. (paras 5.5-5.6)

3. The ways and means advances of the State Bank to the Federal and Provincial Governments would be provided by the State Bank free of interest after interest is abolished. (para 5.7)

4. No interest will be charged by the State Bank on Government debtor balances. (para 5.8)

5. Government borrowings from commercial banks for financing commodity operations would be free of interest while counter-finance may be provided by the State Bank to commercial banks in the form of interest-free loans. (para 5.9)

6. There would be no scope for small savings schemes operating at present on the basis of interest. The existing small savings certificates would, however, be allowed to run their course while deposits in the Post Office Savings Banks Accounts may continue and their proceeds invested in profit-earning avenues and the profits arising therefrom may be distributed among depositors. The Prize Bonds scheme may be tapered off gradually. (para 5.11)

7. The Federal Government may provide financial assistance to Provincial Governments for meeting their development and non-development expenditure without any charge. The interest-bearing foreign loans channelled by the Federal Government to the Provincial Governments may, however, continue on the basis of interest till a viable alternative compatible with *Shari'ah* is found in respect of borrowings from abroad. (paras 5.12-5.13)

8. Government borrowings from external sources will have to be continued, for the time being, on the basis of interest. However, efforts should be made to reduce dependence on foreign aid and for greater economic co-operation among Muslim countries. (para 5.14)

9. Loans from the Federal and Provincial Governments to local bodies, autonomous corporations etc. may be provided free of interest for financing non-profit-earning essential projects. For profit-earning projects finance could also be obtained from banks/other financial institutions on a basis conforming with *Shari'ah*. Interest-bearing foreign loans channelled by the Government to these bodies would, however, need to be continued on the existing basis. (para 5.15)

10. Provident fund balances of the employees may be invested in N.I.T. Units or other suitable investment media and the profits arising

therefrom may be credited to the employees' Provident Fund accounts. (para 5.16)

11. *Taccavi* loans may be provided by the Provincial Governments free of interest. (para 5.17)

12. Loans by the Federal and Provincial Governments to their employees for construction of houses, purchase of cars, motor cycles etc. may be provided free of charge and considered as part of the fringe benefits to the Government employees. (para 5.18)

13. The practice of charging penal interest on Government overdues may be replaced by imposition of appropriate fines. (para 5.19)

APPENDIX I

INTERIM REPORT OF THE PANEL OF ECONOMISTS AND BANKERS ON THE ELIMINATION OF INTEREST

The Panel of Economists and Bankers, after the completion of its work on the introduction of *Zakah* and *Ushr*, was asked to give priority to the consideration of ways and means to eliminate interest from the financial system of the country. Already the Panel has held a number of meetings to consider this matter. It has been mainly engaged in the task of exploring alternative financial arrangements whereby, on the one hand, all traces of interest may be eliminated while, on the other hand, the multifarious financial requirements of the economy may continue to be met without any dislocation. The ground covered so far by the Panel has surely set in motion the process of crystalisation of potentially fruitful ideas. The Banker's Sub-Committee of the Panel has presented a detailed scheme for the elimination of interest from the commercial banking system. This has provided to the Panel a valuable basis for its discussion on the subject. Work has proceeded on ways and means of eliminating interest from other components of the financial system. On the basis of its deliberations so far, the Panel has come to the conclusion that though it is not yet in a position to submit the full set of its recommendations in regard to elimination of interest, it should make an Interim Report to the Council of Islamic Ideology containing its first recommendations on the subject.

2. The Panel is in complete agreement that interest has no place in an Islamic economy. However, it is mindful of the fact that interest is so deeply entrenched in the existing economic system that its elimination is sure to raise problems of great complexity. According to the economic thought and practice developed in the Western world interest is the kingpin of the modern financial system. It is unfortunate that though Islam prohibits interest, the economies of all Muslim countries at present operate on the basis of interest. Muslim thought also has remained nearly dormant in the field of money and banking for centuries so that there is very little in the available literature on which the Panel could draw in its work related to an interest-free economic system. A few experiments with interest-free banking that are being made in certain Muslim countries are too limited in their scope to be of any significant help in shaping a completely interest-free economic and financial system. The Panel therefore feels that measures to eliminate

interest from the economic system must follow a deep and thorough study of all the problems involved, and precipitate action should be avoided in this highly delicate field.

3. The Panel would like to emphasise that prohibition of interest is part of the overall value system of Islam. The most important ingredients of the Islamic socio-economic order are honesty, hard work, accountability to God, respect of each other's rights and *'Adl.* The Islamisation process, of which the gradual and orderly elimination of interest will be an essential part, will have to be fed by reformatory efforts at moral building and eradication of false values of life acquired by a prolonged contact with an un-Islamic economic and social system.

4. In view of the complexity of the task and the present moral texture of the society the Panel recommends a cautious approach in the matter of elimination of interest. The Panel gave careful consideration to various selected areas in which a phased programme for the elimination of interest could be initiated, and it was agreed that as a first step interest may be eliminated from the operations of the National Investment (Unit) Trust and the Investment Corporation of Pakistan as well as from housing finance provided by the House Building Finance Corporation and Pakistani banks. The details of how this may be done are given in the later part of this Report.

5. The specification of the areas from which interest may be eliminated to begin with has been covered by a number of considerations. In recommending the elimination of interest from the operations of N.I.T. the Panel has been mainly guided by the consideration that in the very first phase of gradual elimination of interest, people should be provided with an investment medium in which they can invest their savings without any religious inhibition. Among other financial institutions, I.C.P. has been selected because a good part of its operations is even now free of interest so that complete elimination of interest from its operations can be effected with the least possible delay. Moreover, by the very nature of its functions, I.C.P. is an institution which would be called upon to shoulder greater responsibilities in an interest-free system, and it is therefore appropriate that it should begin to be equipped for the purpose with utmost expedition. In recommending abolition of interest from housing finance the Panel seeks to meet a basic need of the people on interest-free basis and to rid a major sector of the economy from interest.

6. The Panel would like to underscore the point that transition to an interest-free system would have been a less complicated problem if the economy was more buoyant. Due to reasons which are well known

the profitability of industry has been adversely affected in recent years. The actual yield on equities has been rather low. On the other hand, on account of the inflationary situation and low rate of national savings, interest rates in the economy have gone on rising. Hence institutions like N.I.T. and I.C.P. which should normally deal mostly in equities had to take in interest-bearing securities in their portfolios to keep up a sufficiently attractive yield for their investors. Despite this Government had to guarantee a minimum return on N.I.T. Units to sustain investors' interest. Elimination of interest-bearing instruments from the portfolio of N.I.T. would involve a reduction in its income which would need to be compensated by enhanced subsidy by Government so long as the interest system continues to operate in the rest of the economy.

7. While making the transition to interest-free system it would be necessary to ensure that saving and investment processes are not hampered and allocation of investment resources is optimal, keeping in full view the scarcity of capital. The Panel feels that as the interest-free system evolves it would necessitate the creation of new financial instruments to replace the present interest-bearing securities. Immediate attention needs to be given in this context to the replacement of debentures by a financial instrument which is in conformity with *Shari'ah*. Companies need finance for varying periods and hence, in addition to equity, they have to be enabled to raise capital for specific time duration. The Panel is of the view that fixed period Profit/Loss Participation Certificates can take the place of debentures. For the sake of brevity, such certificates have been titled as Participation Term Certificates in the following section of the Report.

8. Measures that need to be taken to eliminate interest from the operations of N.I.T. and I.C.P. and from housing finance are indicated below:

a. National Investment (Unit) Trust

The National Investment (Unit) Trust was established in 1962 mainly to mobilise and pool small household savings through the sale of Units and to deploy these for productive investment in the corporate sector. The N.I.T. sells two types of Units viz., Registered Units and Bearer Units. Both types of Units are encashable at any time. However, while the former are encashable only through the Trust's authorised agents the latter are freely transferable. The income of N.I.T. consists partly of dividends on its holdings of corporate shares and partly of interest on its holdings of Government securities and corporate debentures. It also earns interest on balances which it holds with commercial banks in the form of fixed deposits. Another source of its income is capital gains realised from sales of the shares on the stock exchange from time to time. The aggregate income from all these sources, adjusted for operational costs, is distributed among the Unit holders annually. It will be seen from the above that basically the rate of return on investment in N.I.T. Units is not fixed but variable depending on the level of the net income earned during the year. However, for the past several years, the Federal Government has been guaranteeing a minimum rate of return to the Unit holders, which involves granting of some subsidy by the Government to the N.I.T. The Government also guarantees the minimum repurchase price. Moreover, investment in Registered Units up to 30 per cent of the Unit holder's annual income (subject to a maximum of Rs. 20,000), qualifies for tax relief as investment allowance under Section 15 AA of the Income Tax Act. Income of N.I.T. is exempt from income tax while the dividend income of Unit holders is also exempt from income tax up to a maximum of Rs. 10,000/00*.

Interest is involved in N.I.T.'s operations in the case of its investment in Government securities, debentures, shares of commercial banks and fixed deposits held by it with banks. For eliminating interest from the transactions of the N.I.T. the Panel recommends the following measures:

(i) N.I.T.'s holdings of Government securities, which amount to about Rs. 20 million and represent a small proportion (less than 3%) of its investment portfolio, may be sold to commercial banks/State Bank and the proceeds may be utilised for purchase of ordinary shares.

(ii) Debentures holdings constitute a significant proportion of N.I.T.'s total investments and amounted to Rs. 135.74 million or 19.52 per cent of N.I.T.'s investment portfolio as on 30th June, 1977. These may be sold to the commercial banks and/or converted into Participation Term Certificates with the consent of the issuing companies. These Certificates should be given the same treatment as the pre-tax deductable interest income in the profit and loss accounts of the companies concerned. This will not cause any revenue loss to the Government and will at the same time provide an incentive to the issuing companies to convert the debentures into Partici-

*This is in addition to the exemption up to Rs. 5,000 of dividend income from shares and another Rs. 5,000 from interest on government securities/bonds and approved debentures.

pation Term Certificates. In the hands of the recipient, the treatment of the income from these Certificates for tax purposes should be the same as in the case of dividend income. This measure would increase the marketability of the Certificates. N.I.T. also holds preference shares but the amount involved is not significant. It is recommended that these may also be disinvested in the same manner as debentures.

(iii) Holdings of banks' shares which constitute a small proportion (about 3%) of the N.I.T.'s investment portfolio and amounted to Rs. 20.5 million as on 30th June, 1977 may be sold to Government-sponsored financial institutions or to the Federal Government.

(iv) N.I.T. also holds substantial funds in the form of fixed deposits with banks. As on 30th June, 1977 these amounted to Rs. 47 million. Fixed deposits provide an avenue for deploying its surplus funds for earning income and also help in ensuring requisite liquidity as their maturity is so arranged that the cash balance requirements of N.I.T. are easily met. The Panel recommends that the fixed deposits may be liquidated and the proceeds used for purchase of shares. However, since the stock market at present lacks sufficient depth and the amount involved is quite sizeable the Panel suggests that the proceeds of fixed deposits may be deployed for selective purchase of ordinary shares from banks and from Government holdings of shares of nationalised industries.

After the dismantling of fixed deposits with banks, the N.I.T. would need to have a mechanism whereby it can invest its funds on short-term basis in shares and acquire necessary cash, whenever needed, by selling shares. Since in the present state of the stock exchange it cannot be taken for granted that N.I.T. will be able to acquire shares or replenish its cash resources by selling shares at short notice, the Panel recommends the adoption of the following two measures:

(a) An over-the-counter market may be opened by the I.C.P. for N.I.T. on the same lines as is provided by the institution for its investment account holders. Under this arrangement, I.C.P. should be provided with the list of shares held by the banks, other financial institutions and Federal and Provincial Governments which can be sold to N.I.T. as and when the N.I.T. has surplus funds for investment.

(b) Funds may be placed at the disposal of I.C.P. in the nature of a revolving fund for the sale and purchase of the shares. Whenever the need arises the N.I.T. may replenish its cash resources by selling shares from its portfolio to the I.C.P.

These measures would ensure that the N.I.T. is in a position to invest its surplus funds in non-interest income earning assets at any time and is also able to liquidate them whenever the need arises.

The Panel further recommends that in order to meet situations when N.I.T. may not be able to adequately meet its liquidity requirements through disinvestment from its portfolio on account of the risk of capital loss or undesirable repercussions on the stock market, it may be provided borrowing facilities by the State Bank free of interest. It may be mentioned that provision of this facility by the State Bank to the N.I.T. would not require any amendment in the State Bank of Pakistan Act.

With the elimination of the interest-bearing investments, N.I.T. is likely to suffer a fall in its income. In case the profitability of the companies whose shares are held by the N.I.T. and the conditions in the stock market do not improve markedly, the amount of subsidy which the Government has been providing to the N.I.T. to support the minimum repurchase price and the minimum return on the Units would need to be raised considerably. The Panel feels that continuation of Government guarantee of minimum repurchase price and minimum return on N.I.T. Units is essential for sustaining the interest of the investors for so long as the interest system continues to operate in the rest of the economy. The question of permissibility of a guarantee of this type is the transitional period from the viewpoint of *Shari'ah* may be decided upon by the Council of Islamic Ideology.

b. Investment Corporation of Pakistan

The I.C.P. was established in 1966 with the objectives of broadening the base of equity investments and encouraging the growth of the capital market in Pakistan. Its major functions consist of underwriting new issues of shares and debentures; maintaining investors' accounts and providing margin loans to the account holders; floating closed-end mutual funds; buying and selling shares on the stock exchange to help maintain stability in share values; managing investment portfolios on behalf of individual investors; and providing professional counsel for investments in the corporate sector.

Interest receipts and payments constitute substantial proportions of

I.C.P.'s earnings and expenditure. For instance, during the year 1976-77 interest accounted for Rs. 32.4 million or 57 per cent of total income and for Rs. 27.99 million or 63 per cent of total expenditure of I.C.P.* I.C.P's transactions involving interest consist of loans from Government of Pakistan and from the State Bank of Pakistan; issue of debentures; provision of bridging loans; loans under the Investors' Scheme; Mutual Funds operations; and interest on other investments and loans.

The Panel recommends the following measures to eliminate interest from the I.C.P.'s operations:

(i) *Debenture:* The existing debentures held by I.C.P. may either be disinvested to the commercial banks or converted into Participation Term Certificates with the consent of the issuing companies. The terms and conditions on these certificates would be the same as suggested in the section on N.I.T. The Panel feels that the second alternative would be preferable keeping in view the fact that in the financial plans of companies there is continuing need for term finance.

The Debenture Investment Scheme introduced recently by I.C.P. should be replaced by the Participation Term Certificate scheme.

(ii) *Underwriting:* There are three types of underwriting techniques that are usually adopted by investment banks viz., 'best effort', 'stand-by' and 'firm commitment'. The 'best effort' and the 'firm commitment' techniques are not currently in use in Pakistan. Normally the 'best effort' technique is followed in highly sophisticated capital markets which have a wide net work of brokers and investment salesmen. The 'firm commitment' technique has not been applied primarily because it presupposes freedom in negotiating the price of the new issues at a discount which is not permissible under the Companies Act at present. The only technique that is in vogue in Pakistan is the 'stand-by' technique. Owing to a variety of reasons this technique has given birth to bridge financing arrangements whereby the underwriters give an interim loan at fixed rate of interest equivalent to their underwriting commitment for meeting the financial needs of the sponsor during the gestation period of the projects. Although underwriting business as such is not repugnant to *Shari'ah*, the arrangement of bridge financing makes such type of underwriting incompatible with *Shari'ah*. The Panel feels that the present 'stand-by' technique of underwriting should be substituted by 'firm commitment' underwriting and neces-

*Interest involved in transactions relating to I.C.P. Mutual Funds is not included in these figures.

sary changes made in the Companies Act to provide freedom to the underwriter to negotiate the price of the new issues at a level below par value.

In case the present underwriting arrangements are substituted as recommended, the need for bridge financing, involving the element of interest, would be eliminated.

(iii) *Mutual Funds:* Mutual Funds are largely free of interest element. Interest payments are, however, involved in some mutual funds which have been advanced loans by the I.C.P. in order to compensate for the loss of income on investment in the shares of companies located in former East Pakistan. This interest element can be eliminated if Government takes over such shares.

On the income side, Mutual Funds receive fixed interest income on their deposits and debenture investments. The interest receipts on deposits are small in amount and represent interest payments by I.C.P. pending investment. Interest payment by I.C.P. to the Mutual Funds in this case may be substituted by an appropriate profit/loss-sharing arrangement. As regards debentures they should either be substituted by shares or replaced by Participation Term Certificates.

(iv) *Loans Under the Investors' Scheme:* Under the Investors' Scheme, the I.C.P., apart from rendering advisory services, provides margin loans to investors for investment in shares of public companies listed on the stock exchange and charges interest on such loans. The interest element involved in this scheme can be eliminated by replacing the present loaning arrangements by a joint ownership scheme, under which funds would be provided by I.C.P. to investors on the basis of profit/loss-sharing. The existing investors' accounts involving interest should be converted to the new system if investors so agree; otherwise they may be tapered off in course of time.

(v) *Loan from Government of Pakistan:* These comprise loans received from the Government of Pakistan during the period 1966–71. The outstanding amount of these loans as on 30th June, 1977 was Rs. 276.55 million or 64.6 per cent of the I.C.P.'s total borrowings. During 1976-77 interest payments on these loans by the I.C.P. constituted about 38 per cent of its overall interest payments. Thus a substantial part of the interest element on I.C.P.'s expenditure side would be eliminated if the outstanding interest-bearing loans of the Government are converted into Participation Term Certificates. Under this arrangement the Government will share in the profit or loss of the I.C.P. on a basis to be mutually agreed between the Government and the I.C.P. Any future assistance by the Government to the I.C.P. may also be on the same basis.

(vi) *Loans from the State Bank:* These loans are secured by the guarantee of the Government of Pakistan and carry interest at the bank rate. The outstanding amount of these loans as on 30th June, 1977 was Rs. 90 million and constituted 21 per cent of I.C.P.'s total borrowings. State Bank of Pakistan loans may also be converted into Participation Term Certificates. Any future assistance by the State Bank to the I.C.P. may be on the same basis.

(vii) *Amounts Received in Respect of Debentures Issued:* These represent the amounts received in respect of non-convertible Government guaranteed debentures issued by the Corporation. The debentures are redeemable at par in six annual instalments and bear interest at 2½ per cent per annum above the bank rate. The Corporation receives thereagainst a subsidy from the Government at the rate of 4 per cent per annum. The amount under this head stood at Rs. 61.8 million constituting 14.4 per cent of I.C.P.'s total borrowings. Interest payable on these debentures amounted to Rs. 10.5 million during 1976-77. These debentures may be converted into Participation Term Certificates to eliminate interest.

(viii) *Investment in Government Securities:* I.C.P.'s investments in Government Treasury Deposit Receipts, income tax bonds and compensation bonds are rather small and amounted to only Rs. 12.64 million or 2.8 per cent of its total investment as on 30th June, 1977. To eliminate interest income pertaining to this item, these securities may be sold to other financial institutions.

c. Housing Finance

At present loans for construction of houses or pruchase of built-up houses are being provided by the House Building Finance Corporation and commercial banks to the general public and by the Federal and Provincial Governments, banks and certain other institutions to their own employees. All housing loans provided to the general public by House Building Finance Corporation and commercial banks are interest-bearing. Loans provided to employees by Government and other employing institutions also carry interest except in a few cases where loans up to certain maximum amounts are free of interest.

The Panel recommends that the present system of loaning by House Building Finance Corporation and commercial banks which is based on interest may be substituted by a system whereby these institutions may provide funds to prospective builders of houses or purchasers of houses on joint ownership basis with rent-sharing arrangements. The procedure that may be followed is outlined below:

The prospective builder of the house will submit an application to the financing institution for financing the construction or purchase of house on a joint ownership basis that would subsist until the entire amount provided by the financing institution is repaid. The application would provide all the relevant information such as monthly income of the applicant, the amount he would invest from his own resources, whether he already owns a plot or wishes to complete a house thereon which cannot be completed for lack of own funds etc. or wishes to pruchase a built-up house.

The financing institution, if satisfied with bonafides of the applicant and the feasibility of his plan, would enter into an agreement for provision of housing finance on joint ownership basis. The term of the agreement may be roughly as follows:

1. The respective financial contributions of either party would be specified. The value of land on which house is to be constructed and any construction costs already incurred will be taken into account in determining a party's financial contribution.
2. The period of joint ownership will be specified in the agreement.
3. The schedule of instalment payments, after a mutually agreed grace period covering the actual construction of the house, will be set up. With the payment of successive instalments the share of the financing institution in the ownership of property would go on declining and will finally cease on payment of the last instalment.
4. The initial rental value of the house will be determined at the time of agreement (with the help of expert appraisers, if necessary) on the basis of quality of construction, accommodation, location and prevalent rents in the locality. The rental value will be reviewed and refixed after every three years.
5. The share of the financing institution in the rent would be on a *pro rata* basis and the amount payable to the financing institution by way of rent will go on declining with the successive payment of instalments. The calculated share in rent will allow for the usual rate of depreciation and payment of taxes and property dues.
6. In case the builder/purchaser of the house wishes to sell the house before the expiry of the agreement, he would be free to do so and any capital gain/loss would be shared between the two parties proportionately according to the respective outstanding shares.

7. The builder/purchaser of the house would also be free to terminate the joint ownership agreement by paying off the outstanding amount of investment of the financing institution at any time during the period of agreement.
8. The financing institution will have the right to terminate the agreement in case of fraud and to auction the property in the event of default in the payment of instalments and rent.

Apart from eliminating interest, the system suggested by the Panel above would provide substantial relief to prospective house builders/ purchasers. A person borrowing Rs. 1,00,000 for 20 years from House Building Finance Corporation has to pay at present a total of Rs. 1,64,000 by way of interest. An example worked out by the Panel on the basis of existing property tax structure in Karachi shows that under the proposed scheme if a person contributes Rs. 50,000 from his own resources and obtains Rs. 1,50,000 from House Building Finance Corporation and the initial rent fixed is Rs. 1,000 with a ten per cent escalation every three years, he will have to pay a total of only Rs. 71,000 by way of rent over a twenty year joint ownership agreement.

The Panel recognised the possibility of a notable rise in the demand for funds for housing following the introduction of the system proposed by it. The Panel, therefore, recommends that if such a situation develops and prices of construction materials and the wages of construction labour come under pressure, the financing institutions may be asked to appropriately reduce the maximum ceilings on their participations so as to protect the interests of the builders of small houses and bring pressure on builders of larger houses to use more of their own resources.

In the case of construction companies, funds would be provided by the financing institutions under a joint ownership agreement on profit-sharing basis.

As regards loans granted by the Federal and Provincial Governments, and other institutions to their employees, the Panel recommends that these should be provided free of any charge up to the maximum entitlements of the employees concerned and treated as a fringe benefit to them.

At present, the House Building Finance Corporation finances its loaning programme to a large extent from borrowings from the State Bank of Pakistan against issue of debentures bearing an interest rate at 2 per cent below the bank rate. The Panel recommends that after the House Building Finance Corporation switches over to the new system, the State Bank may provide assistance to it on profit/loss-sharing basis for specific periods.

Comments

Dr. M. Umer Chapra

The Government of Pakistan needs to be complimented for appointing the Panel of Economists and Bankers to prepare these Reports on the elimination of interest from the economic and financial system of the country in conformity with the teachings of the Quran and the *Sunnah*. This is the first time that a serious commitment of this nature has been expressed by the Government to mould the economy in the framework of Islamic values in an area which is generally considered to be the most difficult. I must in turn pay my respects to the members of both the Panels for having made a valuable contribution to the ongoing discussion not only in Pakistan but also in the whole Muslim World on the interest-free economy.

However, while expressing my admiration for the Report I would like to throw some light on certain aspects of the subject which I feel are important. I hope that these comments made in a humble spirit will be given due consideration by the Panels.

I. *Riba,* the Wider Meaning

The Panel has defined *riba* as equivalent to interest (First Report, p. 1) whereas the term *riba* has been given a considerably wider connotation in *Fiqh* literature than what the term interest conveys. Interest refers to what has been termed as *riba al-nasi'ah* or *riba al-jali* or *riba al-duyun* in the *Fiqh* literature. This is the kind of *riba* that is covered by the Quranic *ayah*. However, the *Sunnah* has also emphasized other aspects of *riba* generally termed as *riba al-fadl* or *riba al-khafi* or *riba al-buyu'*. This form of *riba* covers all forms of economic injustice, exploitation and unearned income (other than that, like inheritance and genuine gifts, allowed by the *Shari'ah*). Ibn 'Arabi has defined *riba* as all excess over what is justified by the consideration (كل زيادة لم يقابلها عوض).[1] According to the Holy Prophet a Muslim could indulge in *riba* in a number of ways.[2] That is why Caliph felt inspired to say that "You

[1] See the commentary of *ayah* 2:275 of the Quran in Muhammad bin Abdullah ibn 'Arabi, *Ahkam al-Quran* (Cairo: 'Isa al-Babi al-Halabi, 1957), Vol. 1. p. 242.

[2] Said the Holy Prophet:

الربا ثلاثة وسبعون بابا أيسرها مثل أن ينكح الرجل أمه وإن أربا الربا عرض الرجل المسلم۔

"*Riba* has seventy-three entrances, the least of them is like a person getting married to his own mother and the worst of them is that he degrades the honour of a Muslim" (Cited on the authority of Ibn Majah and al-Hakim, by Ibn Hajar al-'Asqalani, Bulugh al-Maram, Cairo, al-Maktabah al-Tajariyyah should abstain from *riba* as well as *ribah*" (فَدَعُوا الرِّبَا وَالرِّيبَةَ).[3] *Ribah* is from *rayb* which literally means doubt and refers to any income which has the semblance of *riba* or which raises doubts in the mind about its rightfulness. It covers all income derived from injustice to, or exploitation of, others.

Thus the elimination of *riba* from the economy would require the discussion of all forms of exploitation now prevalent in Pakistan or other Muslim countries. This would naturally make the subject so vast that the Panel would not be able to cover it. Nevertheless, in fairness to the Prophetic teachings about *riba*, it would have been desirable if the Report had at least made a mention of this point to indicate that the Report is concerned with the elimination of only one aspect of *riba* which is *riba al-nasi'ah*, and which pertains to the financial sector. It would be desirable if the Government of Pakistan were to appoint another panel to submit a report on other forms of economic exploitation and injustice in Pakistan to complete the study on the elimination of *riba* from the economy.

II. Some Fundamental Reforms

The Report has adopted the simple approach of assuming that merely the removal of interest from the banking system and replacing it by profit- and-loss-sharing (and some other devices) will be sufficient to make the prevalent banking system conform to the requirements of the *Shari'ah*. I wish to express my disagreement with this approach. Although the elimination of interest and its replacement by profit-and-loss-sharing is a necessary step it is not sufficient. Unless we introduce some fundamental reforms in the economy as well as the money and banking framework, it will not be possible for us to realize the goals stressed by Islam, particularly the goals of economic stability, socio-

al-Kubra, 1352, p. 170:851). The Holy Prophet also said:

مَنْ شَفَعَ لِأَخِيهِ شَفَاعَةً فَأَهْدَى لَهُ فَقَبِلَهَا فَقَدْ أَتَى بَابًا عَظِيمًا مِنْ أَبْوَابِ الرِّبَا

"Whoever makes a recommendation for his brother but accepts a gift offered by him has entered *riba* through a large gate") (Cited by *ibid* on the authority of Ahmad and Abu Dawud, p. 172:881), and

خِدَاعُ الْمُسْتَرْسِلِ رِبًا

"Deceiving a mustarsal (unknowing entrant into the market) is *riba*" (Cited on the authority of *Sunan al-Bayhaqi* by Jalal al-Din al-Suyuti, *al-Jami' al-Saghir*, Cairo: Abd al-Hamid Ahmad Hanafi, n.d., Vol. 2, p. 71).

[3]Cited by Muhammad bin Yazid ibn Majah, *Sunan* (Cario: 'Isa al-Babi al-Halabi 1953), Vol. 2, p. 764: 2276. See also the commentary on the word *ribah* in the footnote.

economic justice and equitable distribution of income and wealth.[4] Some of these essential reforms are briefly indicated below:

1. Deposits and the Social Trust

It needs to be clearly realized that when financial institutions mobilize savings through demand deposits they are acting only as agents for the society to whom the savings belong. Hence within the framework of the Islamic values of socio-economic justice, these deposits should be utilized for the broad-based welfare of the society and not the private benefit of a few individuals or families. Once this principle is clearly recognized, we may derive a number of corollaries from it that would help us cater to social welfare. Two of these corollaries are:

(a) The Government has the right to call upon banks to lend to it a certain reasonable proportion of demand deposits for financing socially beneficial projects in which profit-sharing is not feasible or desirable. It would, of course, be fair to demand that the Government should pay a service charge on the resources thus made available to it. The service charge should include on a *pro rata* basis not only the cost of mobilizing demand deposits but also the cost of insuring them and of rendering all services related to them. Once this obligation is accepted by banks the Government would not be forced to finance its entire deficit by borrowing from the State Bank, as the Panels have implicitly assumed.

(b) Bank credit coming out of the society's deposits should be so allocated that it helps realize general social welfare. The criteria for its allocation, as of other God-given resources, should be, first, the realization of the goals of the Islamic society, and, then, the maximization of private profit. This could be attained by ensuring that:

 (i) credit allocation leads to an optimum production and distribution of goods and services needed by a greater majority of society, and

 (ii) the benefit of credit goes to an optimum number of businesses in the country.

2. Wasteful Spending and Conspicuous Consumption

All wasteful spending and conspicuous consumption needs to be

[4]For an elaboration of this point see the final version of the author's paper, "Money and Banking in an Islamic Framework" to be published in the forthcoming volume on "Studies on Monetary and Fiscal Economics of Islam" by King Abdul Aziz University, Jeddah.

minimized from the private as well as public sectors to reduce their combined borrowing to the limits of what monetary expansion within a non-inflationary context can permit.

The lending activity of banks in the private sector should hence be so oriented that, without generating any inflationary heat, it contributes positively to the realization of broad-based economic welfare within the framework of socio-economic justice as conceived by Islam. This would require that bank credit be directed mainly toward the promotion of production, import and distribution of goods and services which are needed by all sectors of the society and which do not widen the consumption gap between the rich and the poor. For this purpose the banking system would have to be dovetailed with a realistic plan oriented to the fulfilment of the essential and genuine needs of the people. In the light of such a plan the State Bank should give guidance to banks about the purposes for which bank financing may not be provided. Moreover, the framework of social values and Government regulations would have to be changed in such a way that productive investment is eulogized and encouraged and wasteful spending is condemned and discouraged. The country's educational institutions and news media would have to play an important role in bringing about this social reform.

Wasteful spending must also be eliminated from the public sector to minimize the public sector borrowing requirement. The political leadership and bureaucracy would have to change its attitude towards public funds and realize that every rupee in the public treasury is a trust and must be spent honestly and efficiently for the welfare of the people. Unless this is done, the Government will have difficulty in reducing its budgetary deficits. Over the last decade (1969–1978) these deficits (excluding the use of cash balances) have been on the average about 44 per cent of total Government expenditure.[5] This deficit has been financed to the extent of about 55 per cent by external borrowing and 45 per cent by domestic borrowing. Of the domestic borrowing about 37 per cent has come out of the State Bank and the balance of 63 per cent from the private sector including the commercial banks and other financial institutions.

If Government deficits continue to be of the magnitude they have been in the past the domestic financing of these deficits will have to come only out of borrowings from the State Bank because borrowings from the private sector will be difficult in the absence of any return or coercion. The rate of inflation in Pakistan will, in this case,

[5]See Table 1.

TABLE 1

Budgetary Deficit of the Government of Pakistan
1969–1978

(Million Rupees)

	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	Total
1. Expenditure	7,307	7,904	7,987	8,784	11,128	14,520	19,525	22,390	24,564	30,793	154,831
2. Deficit	–2,891	–4,076	–2,721	–2,759	–4,375	–4,860	–11,867	–11,636	–10,354	–12,292	–67,831
3. (2) as % of (1)	40	52	34	31	39	33	61	52	42	40	44
4. Financing of (2), net borrowing:											
(a) Foreign	1,988	1,749	1,719	863	3,301	2,976	7,796	6,488	5,153	5,293	37,326
(b) Demestic	903	2,327	1,002	1,896 .	1,074	1,884	4,071	5,148	5,201	6,999	30,505
(i) State Bank	62	1,761	974	1,105	215	–937	1,398	2,780	3,476	583	11,417
(ii) Commercial Banks	477	23	36	1,380	1,371	–533	950	2,665	1,399	3,199	10,967
(iii) Others*	364	543	–8	–589	–512	3,354	1,723	–297	326	3,217	8,121
(iv) (ii) + (iii) as % of (b)	93.1	24.3	2.8	41.7	80.0	149.7	65.7	46.0	33.2	91.7	62.8

*Derived as a residual.
Based on data from IMF, *International Financial Statistics Yearbook, 1980*, p. 329.

be significantly higher than what it has been in the past. Thus, an important goal of Islamic society will have to be sacrificed if wasteful and unproductive spending by both the public and the private sectors is not minimized.

3. Increased Equity Financing

The obligation to abolish interest would make it indispensable that there be primary reliance on equity capital and little dependence on borrowed money in an Islamic economy. The Islamic economy would thus have to be essentially equity-based, compared with capitalism which is predominantly loan-based and in which a vast superstructure of finance is raised on a small foundation of equity capital. A greater equity base with a larger number of share-holders or partners would help reduce concentration of wealth and realize the Islamic goal of equitable distribution of income and wealth. Accordingly, all financial needs of a permanent nature, whether for fixed or working capital needs, would have to come out of equity and not borrowing. Borrowing should be resorted to only to the extent of bridge-financing and temporary shortages of funds resulting from new opportunities or seasonal peaks in business for which purpose it may not be possible or desirable to have an immediate or permanent increase in equity.

One of the first steps that would hence need to be taken to Islamize the economy is to make all firms, whether joint-stock companies or partnerships increase their equity base adequately to cover their capital needs of a relatively permanent nature. Consequently, all joint-stock companies should be required to float additional shares; the commercial banks may also take up a proportion of these. Here the role of the State Bank would be to monitor the price at which new shares are acquired by banks to ensure that the price is in keeping with what is justified by real assets and that there is no corruption.

4. Reducing the Power of Banks

In the capitalist framework society's resources mobilized by banks are utilized by them for enriching a few families. According to D. M. Kotz, ultimate power in the United States resides with the bankers who are the major stockholders in, and creditors of, the modern large corporations.[6] The Patman Committee concluded that the major banking institutions in the US were emerging as the single most important

[6] D. M. Kotz, *Bank Control of Large Corporations in the U.S.* (Berkeley: University of California Press, 1978), p. 148.

force in the economy[7] and warned that the growing bank control might result in restraints of competition and pose a serious conflict of interest problems.[8] The Securities and Exchange Commission's Report concluded that large institutions, particularly banks, have potential economic power to exert significant influence over many companies whose securities comprise their portfolios.[9] One of the primary reasons why banks tend to become the centres of control under capitalism is that capitalists who operate through a bank "obtain access to other peoples' capital."[10] It is hence not surprising that "the wealthiest and the most powerful capitalists operate through banks."[11]

If this problem of concentration of power is examined within the framework, not of interest-bearing loans, but of profit-and-loss-sharing with commercial banks participating in decision-making, appointment of directors and carrying out of verification tests then the danger of concentration of power in the hands of bankers will increase even more than in the capitalist system. It would, therefore, be important to think of effective measures to reduce the power of banks. If we do not do this we will be creating monsters who, by the economic power which they attained through other peoples savings, will be able to exercise enormous influence on people's destinies. The mere nationalization of banks, as already exists in Pakistan, will not be sufficient, because the place of businessmen and industrialists could be easily taken over by bureaucrats.

One of the measures that may be desirable is to have a larger number of banks and to ensure that none of them expands beyond a certain limit determined by the State Bank. If this is not done immediately, it should at least be borne in mind as a desirable step to be taken in the future. Secondly, banks should be required to provide financing to a larger number of entrepreneurs and not to provide more than a small proportion of their resources to any one business or family. Thirdly, they should not be allowed to acquire a controlling stock in any business. Fourthly, no one from among the bank's directors should be allowed to have a business of his own or to become a director in any other business to prevent commercial bank directors and managers

[7]United States' Congress, House Banking Currency Committee, Subcommittee on Demestic Finance, *Commercial Banks and Their Trust Activities: Emerging Influence on the American Economy*, 9oth Congress, 2nd Session, 1966, p. 5.

[8]*Ibid.*, p. 1.

[9]United States Securities and Exchange Commission, *Institutional Investor Study Report*, House Document 92-64 referred to the House Committee on Interestate and Foreign Commission, 1971, pt., 8, pp. 124-5.

[10]Kotz, *op. cit.*, p. 143.

[11]*Ibid.*, p. 149.

developing a vested interest in any specific business.[12] In other words, interlocking directorates involving bank directors should not be allowed other than in exceptional circumstances. Other specific measures may also need to be adopted by means of well-conceived and properly enforced laws to ensure that the Islamic banks do not only not lead to concentration of wealth and power as under capitalism, but also contribute to an equitable distribution of income and wealth in society.

For the same reason it may be added that while it is necessary to carry out a thorough checking of the accounts of the borrowing firms, this should be done through independent auditing firms and not by the banks themselves. It would be desirable to establish an Investment Audit Corporation (IAC) to examine the operations and accounts of borrowers and thus safeguard the interest of financial institutions, depositors and equity holders. The IAC should carry out the examination and audit of a random sample of all users of other peoples funds and also of firms specifically referred to them by financial institutions or investors. It must be appreciated that if the new system is implemented gradually, market forces will play an important role in ensuring honesty on the part of users of commercial bank funds. It will be difficult for a firm to cheat banks because the firm could be placed on the black list of all banks if it continuously tends to show an *ex poste* profit lower than its *ex ante* profit on the basis of which it obtained financing from the bank. It would also be necessary, as the Panel has rightly pointed out, to have a thorough-going reform of the auditing system with a view to improving the role of auditors and safeguard the interest of investors.

5. *A Sane Stock Market*

The greater resort to equity financing in an Islamic economy as suggested above will require the effective operation of both the primary and secondary capital markets to enable businesses to raise funds and

[12] In Germany where commercial banks hold shares in industries, it is charged that banks exercise undue influence on industry, not simply through their holdings but through their membership of company supervisory boards. Hence the German parliament has presently been considering a report on the "fundamental problems in the credit sector". The report recommends that banks should be restricted to a 25 per cent "plus one share" holding in non-banking concerns. This percentage, which offers certain tax advantages and veto rights under the German Corporation Law, is considered too high by others who have proposed a ceiling of 5 to 15 per cent. The report also calls for a greater disclosure of information about the professional commitments of supervisory board members. (See a report entitled "Banks Oppose Share Move" in the *Financial Times*, October 22, 1980, p. 42.

to provide liquidity to investors who cannot, or do not wish to, hold the equity they have acquired. It should be easy to get in and out of any equity that an investor wishes to acquire or sell. While the equity-oriented Islamic financial institutions could play an important role in this area the organization of a sane stock market would be indispensable in the interest of banks as well as other investors. Among the essential requisites for this would be to bring about firstly, a rational behaviour in stock prices, and secondly, reasonable rates of dividend, to inspire investors' confidence in stocks and shares. While the first would require elimination of unhealthy speculation, the second would require proper auditing of the profits of joint stock companies under a reformed auditing system and certain checks and balances on the powers of directors and management. It would be desirable for the Government of Pakistan to appoint a Panel to study the organization of a reformed stock market on the basis of the *Shari'ah* to act as a necessary complement to the Islamic banking system.

III. Monetary Policy[13]

Coming now to the question of monetary policy one might wish to emphasize that the State Bank will have to perform not only the functions of a modern central bank but also some additional functions within the Islamic framework. Two of these additional functions are: (a) to ensure, as indicated earlier, that the distribution of credit is in accordance with the socio-economic goals of Islam; and (b) to promote the development of a healthy equity-financing system in place of the present equity-plus-loan financing system. In addition, the State Bank will need to lay a greater stress on monetary and price stability in conformity with the values of Islam.

The State Bank should try to ensure a credit allocation which is in conformity with the goals of the *Shari'ah*. For this purpose the credit allocation must fulfil at least two characteristics. It should, on the one hand, help the nation produce all essential goods and services, and, on the other hand, bring about a distribution of credit in a broad-based manner to a maximum possible number of businesses to promote an equitable distribution of income and wealth in society. The Report has expressed the need for distribution of credit but has unfortunately not indicated how this is intended to be achieved. One of the normal

[13]This section should read in conjunction with the author's paper "Monetary Policy in an Islamic Economy" presented to the same Seminar at which this note will be discussed.

arguments given by banks for preferring large borrowers is that granting credit to small borrowers is very cumbersome and expensive. If this argument is valid, certain measures should be adopted to relieve the banks. The Government may, if necessary, subsidise the additional cost to banks of processing the loan applications of a large number of borrowers than what banks are willing to do under normal circumstances. The State Bank may also consider the establishment of a small-loans insurance scheme to be financed by a modest premium charged on all financing provided by the commercial banks.

To promote the development of a safe and vigorous equity financing system that would inspire the confidence of investors and effectively mobilise savings for the accelerated and balanced development of the country, the State Bank will have to play a crucial role in the Islamic system even though this role may not be considered to be important for modern central banks in the capitalist context. It will have to develop a sane stock market where prices reflect not any speculative fever but changes in underlying economic conditions. It will also have to promote the development of investment trusts and other auxiliary financial institutions with properly conceived and well-enforced laws to safeguard the interest of banks as well as other investors.

It should also be emphasized that Islam demands a greater commitment on the part of the Government and the State Bank to monetary and price stability.[14] The performance of Pakistan with respect to inflation has not been very encouraging over the last decade.[15] One of the reasons for this has been that monetary expansion has been considerably faster than the supply of real goods, and services.[16] Under no circumstances should this performance be repeated in the Islamic system. It is heartening to note that the Panel has emphasized monetary and price stability. However, the tools discussed in the Panel's Report, though helpful, may not be sufficient to ensure the realization of the desired goal.

[14]See M. U. Chapra, "The Islamic Welfare State and Its Role in the Economy" in K. Ahmad and Z. I. Ansari, *Islamic Perspectives* (U. K. Islamic Foundation, 1979), pp. 204-5.

[15]Consumer prices have more than trebled in Pakistan over the decade of Seventies; the consumer price index has risen from 100 in 1969 to 301 in 1979. Over the corresponding period, consumer prices in India have less than doubled with the index rising from 100 in 1969 to 198 in 1979. (See, IMF, *International Financial Statistics Yearbook, 1980*) lines 64 on pages 219 and 327.

[16]While monetary expansion was at the rate of 16.4 per cent per annum over the decade of the Seventies (1969-1979), the real output registered a growth of only 3.8 per cent per annum; consumer prices rose at the rate of 12.1 per cent per annum (Based on data given on the Pakistan pages in *ibid.*

One very significant evolution in monetary management over the past decade has been the widespread adoption of official targets for permissible growth in money and credit aggregates. This technique has been widely accepted by a growing number of central banks particularly among the OECD countries.[17] This is because of the shift in emphasis away from interest rates as intermediate targets of monetary policy towards quantitative norms for the growth of money stock,[18] and because monetary management has been found to be fairly successful if this technique is adopted.[19] The announcement effect of monetary targets tends to reduce inflationary expectations.[20] Monetary targetting also helps the development of coordinated packages of non-inflationary fiscal, credit and incomes policies. However, the goal of monetary stability has remained illusory in spite of monetary targetting, firstly, because governments which have become converts have not always been steadfast in fulfilling the demand of this technique for discipline in their fiscal policy, and secondly, because of the disturbing influence of speculative capital flows.

It would be desirable if the State Bank develops such target in the light of the economic goals of Pakistan, particularly price stability. This will indicate the maximum allowable growth in high-powered money through both fiscal deficits and State Bank credit to the commercial banks. Such monetary growth targets should, of course, be reviewed frequently to make whatever adjustments that are felt necessary in the light of changing circumstances. Given the monetary target and the control of high-powered money at source through regulating Government deficits and State Bank credit to commercial banks, the minor adjustments that would need to be made in high-powered money could be brought about through the other tools of monetary policy suggested by the Panel. This would, of course, require a firm determination on the part of the Government of Pakistan not to

[17]Bank for International Settlements, *The Monetary Base Approach to Monetary Control*, (Basle: B. I. S., Sept. 1980) p. 7. See also, *Banking System and Monetary Policy in the EEC* (London: *Financial Times*, 1974), p. 116.

[18]OECD, *Monetary Targts and Inflation Control*, (Paris: OECD, 1979), p. 2. The Report argues that "Manipulation of interest rates has not in all case proved a satisfactory way of achieving monetary restraint or of stabilizing monetary expansion under expansionary conditons" and that "Policies which are guided by quantitative objectives for the monetary base (or bank reserves and under which interest rate levels are – or can be seen to be – a by-pro have, therefore, come to seem increasingly attractive in some countries", p. 1.2.

[19]B. I. S., *op. cit.*, p. 63.

[20]*Ibid.*, p. 66.

overstep the fiscal deficit indicated by monetary targetting; capital flows which have been a frustrating element in some industrial countries need not be a disturbing factor in the economy of Pakistan. May we expect that the Government which is so anxious to implement the teachings of Islam with respect to *riba* will also be equally anxious to realize the Islamic goal of price stability?

Conclusion

It would be appropriate to emphasize here that the abolition of *riba* is not the only value of Islam. It is one of the many values. *Riba* cannot be successfully eliminated unless we reform our society in the light of Islamic teachings. This does not imply that the abolition of *riba* would wait until the society has been sufficiently reformed. However, it does imply that the Government should at least simultaneously start the reform of the society and the creation of the proper moral climate by using all its educational and propaganda machineries effectively for this purpose.

While I have made these comments for the consideration of the Panels, I should once again like to pay my compliments to the members of both the Panels for having prepared these valuable Reports which will be useful to policy makers not only in Pakistan but also in other Muslim countries.

Dr. Nejatullah Siddiqi

I offer my compliments to the Government of Pakistan for initiating a process which has led to the writing of these Reports on the elimination of interest from the economy by the Council of Islamic Ideology, the Panel of Economists and Bankers and the Committee headed by the Finance Minister. It is for the first time in modern history that the Islamic injunction against interest has been taken seriously at the highest level and a government has shown its determination to manage the economy without interest. I also wish to pay my respects to all the *Ulema*, economists and bankers involved in formulating these proposals which are likely to help not only the Government of Pakistan but also other Muslim peoples in reconstructing their economies in accordance with Islamic injunctions.

The very fact that these Reports are likely to form the basis of crucial decisions of far-reaching consequences, and that the decisions eventually taken in Pakistan may serve as a model for other governments and peoples, necessitates a very careful scrutiny of these proposals by all concerned so that the final outcome is in consonance with

Islamic principles and viable enough to stand the test of the times.

The following comments are offered in all humility to assist this process.

1. Profit-Sharing as the Chief Alternative to Interest

The chief alternative to interest, on the commercial level, can only be profit-sharing in accordance with the relevant Islamic rules. This has been noted in the Preface to the Council Report and emphasized repeatedly in later sections. *Qard-hasanah* is a service proposition and has to be organized as such through the banking system and other financial institutions and also through other agencies. It is gratifying to note that the Council has duly modified the 'new system' of sharing profits and losses proposed by the Panel in paragraph 1.27 of its Report (as also contained in the Committee Report on InterestFree Banking). It has stated categorically that "the loss would, however, be shared strictly proportionately to the respective capital contributions." (Council Report, 1.23). The system proposed in the other two Reports violated the *Shari'ah* and went against the Islamic approach to the respective roles of capital and enterprise in the productive process. Any departure from this approach, which regards losses as an erosion of equity (i.e. decrease in capital) and profits as a joint result of and reward for capital and enterprise, will lead us astray from the justice ordained by the *Shari'ah*. It is advisable, therefore, to be on our guard against any dilution of this approach.

It is in this context that I fail to understand why the Council has agreed to describe the proposed system as profit-and-loss-sharing instead of profit-sharing. Such a description is understandable as far as the Reports of the Panel and the Committee are concerned, as they explicitly provide for a sharing of the losses, accruing to the capital supplied by the banks, by the industry. The Council has rightly rejected this as being *ultra vires* of *Shari'ah*. It has strictly adhered to the Islamic position that whenever capital participates in an enterprise every capital owner bears the entire loss accruing to his capital. It is quite clear that neither the entrepreneur nor the other suppliers of capital actually 'share' the loss accruing to any particular supplier of capital. This is true of *sharakah*, in which all partners are suppliers of capital as well as of *mudarabah* in which a particular partner may be supplying no capital at all. The justice of this Islamic rule is quite evident, especially in case of simple *mudarabah*, as the working partner, in case of loss in enterprise, gets no reward for his labour and enterprise. He, too, bears a loss to that extent, though he is not obliged to compensate part or whole of the loss in capital supplied by the other partners. This being the case, and losses in the reports under consideration meaning accounting losses as they do always mean unless otherwise specified, it is advisable to describe the Islamic proposition as merely 'profit-sharing'. In fact the recent writers on interest-free banking based on *sharakah* and *mudarabah* use this description and avoid calling it a system of profit-and-loss-sharing which is, to say the least, confusing. In view of the fact that some economists and bankers till find it advisable to propose sharing of losses in violation of the relevant rules of the *Shari'ah* and against the Islamic approach to capital and enterprise, it is all the more necessary to avoid such a description.

In the light of the difficulties in the practical application of the profit-sharing system in certain spheres, explained in these Reports, the Council has rightly endorsed the need of using some other methods. The Council has, however, made it clear that it wants these other methods to be used very sparingly and that their role should decrease with the passage of time while the role of profit-sharing and *qard-hasanah* should expand (Preface to Council Report).

One is, however disturbed by the fact that the other methods suggested by the Panel are allowed to cover a very wide range of operations, which include some of those operations which could have been easily handled by the profit-sharing arrangement. An obvious example is the case for which the 'Investment Auctioning' device has been accepted, about which we have more to say later. Once we agree on the profit-sharing arrangement to be the chief alternative, it is advisable to provide categorically that any other method should be used only where the profit-sharing arrangement is not workable. Other methods should not be allowed as alternatives to profit-sharing, as they have been done at present.

This is all the more necessary when the other method under consideration, though found permissible by the Council, is nearer to interest and far removed from profit-sharing on two important counts:

1. The banks get back a definite sum of money in the future.
2. The rate of return to the capital invested by the bank is known in advance.

The very proximity of these 'alternative' arrangements to the present interest-based arrangements may see to it that they gradually replace profit-sharing even where it is introduced in the first instance, besides refusing to yield ground to it where it is installed from the very beginning. Permission to use these methods as 'alternatives' to profit-sharing is, therefore, likely to frustrate the Council's intention to expand the role of profit-sharing and reduce the role of other methods with the passage of time.

I would, therefore, recommend a categoric policy statement on this issue. It should be clearly laid down that any other method endorsed by the Council can be adopted only in cases where profit-sharing is found to be unworkable.

2. *Supplementary Methods of Eliminating Interest*

We have to examine the other methods suggested in the Reports under consideration not as alternatives to profit-sharing, where a profit-sharing arrangement is also feasible but as second best substitutes for it in cases where profit-sharing does not seem workable at present. In doing so we have to keep away as far as possible from devices which bear close proximity to the present interest-based arrangements in effect, though they may be different in formal legal details. Seen in this light the methods of Leasing, Hire-purchase, Financing on the basis of normal rate of return, Time multiple counter loans, and Special loan facility as modified by the Council (Council Report, paragraphs 1.13, 1.18, 1.19, 1.20, 1.21) seem to be alright. They can be applied within the limits and along with the safeguards proposed by the Council.

It is difficult, however, to say the same about *murabaha* as suggested by the Panel, (Pannel Report, 1.16) or *Bai Muajjal,* as approved by the Council (Council Report, 1.16). The Council has done well in modifying *murabaha,* which is based on a particular juristic opinion not shared by many eminent jurists, to *Bai Muajjal* which has relatively more secure foundations, despite the fact that it remains controversial. I do not propose to question the formal legal status of *Bai Muajjal* as defined by the Council: 'a sale under which the price of the item involved is payable on a deferred basis either in lump sum or in instalments' (Council Report, 1.16). I am afraid, however, that in practice it will become a cover for continuing the present interest-based transactions. Those needing finance for purchase or import of inputs would approach the banks to buy it for them with the commitment to buy it from the bank at a higher but deferred price. The mark-up will naturally tend to be higher, the longer the period of time involved. The banks will have guarantee of receiving back the price they actually pay plus a predetermined return as the result of the mark-up. For all practical purposes it will be as good for the bank as lending on a fixed rate of interest. This will create a tendency of preferring this method to profit-sharing or any of the other methods approved by the Council, since it helps in maintaining the *status quo.* I am disturbed by the fact that instead of confining the use of this method to situations where profit-sharing may not be feasible, the Panel and the Committee headed by the Finance Minister have already envisaged a very wide range of operations to be covered by this method (which they called *murabaha),* including the supply of working capital requirements "which may be financed by banks by way of sale of inputs on deferred payment basis by putting a mark-up on price of goods purchased by the financed industry".

Both the Council and the Panel are apparently aware of "the danger attached to it of opening a back-door for dealing on the basis of interest" (Council Report, 1.17; Panel Report, 1.17). The fact that they have nevertheless approved of this method must be construed, therefore, as an expression of their feeling that there are some 'inescapable cases' (Para 1.17 in Council as well as the Panel Report) where other methods, especially profit-sharing, are not workable. One such case seems to be the supply of fertilizers to farmers, which has been cited in their reports as an example.

I would prefer that *Bai Muajjal* is removed from the list of permissible methods altogether. Even if we concede its permissibility in legal form we have the over-riding legal maxim that anything leading to something prohibited stands prohibited. It will be advisable to apply this maxim to *Bai Muajjal* in order to save interest-free banking from being sabotaged from within.

Should some pressing situations defy any other solution we can, at the least, confine the use of *Bai Muajjal* specifically to them as a temporary measure, while prohibiting its use in other situations. There is no justification of using this method in financing working capital requirements of industry, as suggested in para 75 of the Committee Report quoted above, as this can easily be done on profit-sharing basis. One can, however, understand its application in the agricultural sector on a limited scale, to cover cases which cannot be handled by *Bai Salam* as proposed by the Council (Council Report, 2.17). Even in that case it will be advisable to specify the mark-up as well as the time period involved. Any other possible case of application of this method should first be thoroughly examined to see if it really defies profit-sharing, leasing, hire-purchase and financing on the basis of normal rate of return.

It is gratifying to note that the Council did not endorse the method of 'Investment Auctioning' as formulated by the Panel (Panel Report, 1.14). According to this formulation "the offer of the needed long term/medium term finance" is part of the package being 'sold' on deferred payment. But an offer to finance is not a valid object of sale in the *Shari'ah.* It would be an exchange of a smaller sum of money for a larger sum of money to be paid later – a clear case of the prohibited *riba.* Inclusion of another item in the package being sold, i.e. "industrial project with complete details" cannot legitimise this transaction. The Panel's argument that the transaction 'would be in the nature of a sale on deferred payment basis' is not convincing as the seller retains the ownership of the plant and machinery until full payment is made by the buyer. A genuine sale on deferred payment transfers the ownership to the buyer who becomes liable to payment on the agreed future date or dates.

The Council has modified the Panel's proposal to make it a genuine sale of plant and machinery, to be delivered on agreed dates, on deferred payment. The modified proposition is correct in formal law. What is questionable is the need to apply this method to a case to which profit-sharing can be applied without any difficulty. This violates the basic policy we have recommended above, a policy which also seems to have guided the Council as it has recommended gradual reduction in the role of other methods and expansion in the role of profit-sharing and *qard-hasanah.*

Apparently a justification in favour of this departure has been provided by the Council in paragraph 1.15 of its Report which reads: "The most significant advantage of this system from the economic point of view would be that the price paid by the investor for industrial machinery would adequately reflect the potential profitability of the project which is essential for efficient allocation of resources." But the heart of the matter is that potential profitability is uncertain; it cannot be known in advance. This is why the just Islamic system is based on the sharing of *expost* profits. What the buyer's bid would reflect is his estimate of the profit, not the actual profit. This estimate may or may not come true. Profit seeking capital is exposed to this uncertainty and it is not fair to transfer it entirely to the buyer as the Panel proposal seeks to do. The Panel's argument in paragraph 1.15 of its Report (which the Council has repeated with the replacement of 'scarcity value of capital' by 'potential profit of the project') seeks to do exactly what interest is presently doing: ensuring a guaranteed return to investment by the banks and transferring the risk entirely to the entrepreneur. How far the formally correct proposal of the Council changes this materially, deserves attention.

An efficient allocation of resources is ensured by the profit-sharing arrangement as argued in my paper 'Economics of Profit-sharing' presented to this Seminar. The argument of paragraph 1.15 quoted above does not, therefore, provide a special justification of 'Investment Auctioning in place of profit-sharing. But those who think that Investment Auctioning does something which profit-sharing fails to do must advocate the replacement of profit-sharing by Investment Auctioning all along the line. The Council is apparently not aware of this implication otherwise it would not have repeated the argument of paragraph 1.14 of the Panel Report. In endorsing this proposal it has not found it necessary to urge that this method should be used sparingly. This might result in an expanding role for the use of this method at the cost of the profit-sharing arrangement. This, in my view, will do serious damage to the system and frustrate the whole exercise, at least with respect to the industrial sector. Nothing will prevent the 'Consortium' to add the current rate of interest in similar economies to the market price of plant and machinery to arrive at their 'reserve price', leaving the 'auction' to bring them additional gains. Entrepreneurs, nowhere-else to go, will be constrained to 'buy' the project at whatever price they can. Instead of relieving them of the burden imposed by the unjust system based on interest, the 'Islamic' system with Investment Auctioning might leave the entrepreneurs worse off.

I am sure once these dangers are realised there will be no hesitation in dropping this proposal altogether. The profit-sharing arrangement supplemented by the methods of Leasing, Hire-purchase, Financing on the basis of Normal rate of Return and Time Multiple Counter-loans within the limits proposed by the Council as well as the methods of *Bai Muajjal* and *Bai Salam* applied in the agricultural sector with utmost caution, would be sufficient to replace interest in all sectors of the economy. It should be our endeavour, at the same time, to reduce the role of the supplementary methods to the minimum necessary so that profit-sharing becomes the dominant form of financing in the whole of the economy. Any other method like Investment Auctioning or use of *Bai Muajjal* on an extended scale will pull the system back to the *status quo* and retard its progress.

3. Action Plan for the Elimination of Interest

The Panel as well as the Committee have suggested that savings and fixed deposits may continue to be interest-bearing during a transitional period of two years. The Council has agreed to this as it is evident from the time table set in paragraph 1.35 of its Report. This proposal has the disadvantages of keeping away savers who wish to gain through deposits but do not want it in the form of interest which is prohibited. N.I.T. Units or I.C.P. Mutual Funds may not attract all as they lack the easy accessibility of bank deposits. The disadvantage can be removed by introducing profit-sharing (i.e. *mudarabah*) accounts from the very beginning, side by side with the (transitional) interest-bearing accounts. This may have some other advantages also as noted below.

The proposal to continue with interest-bearing deposits even after a switch-over to profit-sharing on the asset side is obviously based on the assumption that banks will earn sufficient profits to pay interest to their depositors and still retain some for the share-holders. By the same assumption there will be enough profits left after interest is paid on interest-bearing deposits to pay a dividend on profit-sharing deposits which is, at the least, equal to that rate, without jeopardizing the share-holders prospects. There is an even chance that the rate of dividend accruing to the profit-sharing deposits might be higher than the rate of interest on deposits. In either case introduction of profit-sharing accounts in the transitional phase will facilitate the eventual closure of the interest-bearing accounts by way of familiarising the people with the new method and allaying their doubts regarding it, if any. Should the operation of these accounts create any problem, they can be taken care of before the complete switch-over. A case in point is the suitable ratios of profit-sharing relating to the bank – businessmen and bank – depositor transactions. Whatever ratios are fixed in the first instance can be adjusted in the light of the experience of the transitional phase with a view to making the rate of dividends on profit-sharing deposits at least equal to the rate of interest on deposits on the eve of the change over.

If this suggestion is accepted the introduction of profit-sharing accounts in the transitional phase should be accompanied by a media drive to persuade the public to opt for these accounts in preference to the interest-bearing accounts. The success or failure of this drive would serve as an index of the popular enthusiasm for the new system which may help.

4. Towards the Goals of the Islamic Economy

Elimination of interest from the economy is obviously a means for the realisation of some higher ends, not an end in itself. The ways and means of eliminating interest should, therefore, be ultimately examined in the context of the goals of the Islamic system. In other words our job is not only to devise a system of banking and finance free of interest. The system should also be geared to the maximum realisation of the goals of economic system in Islam. The Reports under discussion have undoubtedly made a great contribution towards devising a system free of interest but they could not attend properly to the larger question of how effectively to direct the financial system towards the achievement of the Islamic goals of eradication of poverty, justice, stability and growth. I suggest that a review of the interest-free system from this point of view might result in significant improvements. One possible, area of improvement is to provide for a larger role for banks and other financial institutions, under the guidance of the Central Bank, in exploring the possibilities of increasing production and inviting labour and enterprise to avail of these opportunities with their participation. Projects designed to contribut directly to the incomes of the poorest sections of the population should receive greater attention and possibly direct patronage from special agencies set up for this purpose. A crucial factor for the success of the new system in terms of goal achievement is its projection as a system that cares for the majority of our masses who are weak and poor. The masses can be involved in the developmental process, which the banking and financial system is supposed to promote, only when they have the assurance that a fair share out of the fruits of development will flow to them. Their Islamic consciousness can be aroused and their energies mobilised for making this pioneering effort at Islamic reconstruction of economy a success provided they feel that the decision makers are sincerely orienting the system towards the achievement of the Islamic objectives, especially those related to eradication of poverty and reduction of inequalities in the distribution of income and wealth.

Another possible area of improvement upon the system of interest-free banking presented in these Reports is the dovetailing of this system with other crucial aspects of the economic system of Islam: a market free of unhealthy speculation and monopoly, a welfare oriented fiscal policy, a social security system based on *Zakah,* a just system of land tenure and a programme of removing the inequities in the initial distribution of wealth inherited from the past. This admittedly requires that elaborate schemes for these other changes are also available. It will be advisable to assign this task to special working groups so that the various blueprints relating to these different aspects of the Islamic economy could be integrated into one whole which is clearly and effectively directed towards the ultimate goals of the system. The Islamic reorganisation of banking and finance can reach its maturity only when it is put in that perspective and revised accordingly.

In conclusion I would like, once again, to place on record my deep appreciation of the work of the Council of Islamic Ideology, the Panel and the other working groups whose reports have been discussed above.

I also appreciate the invitation extended to me and other scholars outside Pakistan to comment on these Reports. May Allah help the *Ummah* in keeping to the Right Path and serving His cause.

[Before handing over the discussion to the floor, the chairman of the Session, Prof. Khurshid Ahmad, summed up the presentations of Dr. Ziauddin Ahmed and Mr. Abdul Jabbar Khan and the comments from the discussants – Dr. Umer Chapra and Dr. Nejatullah Siddiqi.]

Discussion

Prof. Khurshid Ahmad

There are three major areas, which have come up before us and I just want to identify them to facilitate discussion. First, abolition of interest is not the be-all and end-all of Islamization of economy and a number of supplementary and very fundamental changes would have to be needed. Some have been identified by our discussants, which relate to moral and motivational change, institutional and structural change and providing guidelines to the institutions keeping in view the socio-economic objectives of Islam. We have to further reflect in this respect and suggest whatever transformation or modification is needed even in the functions of the central bank and the commercial banks. This is one area. Some points have already come up. If some brothers want to supplement, then, please feel free to do so but please avoid repetition because on this part we can say a lot but I do not want our central issue to be clouded by being over-concerned about this area.

The second area which is the cruse of the problem is that the Council of Islamic Ideology has come up with this idea that during the period of transition we have to move towards profit-sharing to be the major alternative, but it has to be supplemented by a number of other instruments. They have been identified. I want you to reflect upon this and guide us as to what extent you feel this provides a viable alternative.

I emphasise that we have to keep in view that the situation which we are discussing is a phase of transition. We cannot neglect this phase of transition which has been emphasized again and again by the Panel and the Council of Islamic Ideology and by a number of other people who are trying to discuss these issues. The third area on which I want your guidance and help is as to what are the issues which have been rather left by the Panel or by the Council but which are integral to the evolution of this new financial system, e.g. the point brought in sharp focus by Prof. Siddiqi about consumption loan outside the present financial institution. If there are some other such areas which you want to identify we would like to be guided by you. So I may submit once again that we have these three major areas: Reforms which may not have been covered by these documents but which are essential; viability of alternatives that these Reports suggested and identification of supplementary areas which are integral to new financial system but which have not been touched. With these few submissions, I now open the discussion to the floor.

Dr. Nevzat Yalcintas

First of all I extend my compliments to the members of the Panel who prepared this excellent Report which is a very lucid, logical and frank report on the subject. I would like to refer to three points which, I think, were not deeply dealt within the Report. First, for the interest-free banking system in this country, I think, it is necessary to simultaneously bring the structural changes in the banking system in Pakistan. With the existing banking system, which seems to me rather based on the British understanding of the banking method and the concept, it will be very difficult to implement this new banking system. In my view the shape of the present banking system should be changed to an investment banking system rather than of a commercial type. I give the example of the banking of my own country. The banks which are in the investment field and which are doing their own investments are making much greater profit than those banks which confine themselves to only commercial operation. Secondly, I saw less emphasis on investment in shares. Banks can invest in selective companies by purchasing their shares. If the firms do not seem to be working satisfactorily you can sell their shares in the market.

Also a Mutual Fund for the small business can be encouraged all over the country – small funds created by the small businessmen themselves and with the help of the government. This can be organised by mutual cooperation on interest-free basis. Lastly, I have a suggestion for that part of the society who are obliged to borrow money for consumption purposes.

In Turkey, we observed that a lot of low income people acquire loan from the government or banks on the pretext of using it for building of houses or for farming. But they actually never used the funds for this purpose and instead financed their personal consumption from these loans. We, therefore, initiated a project according to which the banks will provide small loans to the low income groups for consumption purposes free of any interest. The government will, however, meet the banks' cost of providing these loans by paying these banks a serivce charge from the government's own budget. This scheme can be implemented in Pakistan also.

Dr. Sultan Abu Ali

I would like in the start to compliment the people who have participated in the Panel as well as the *Ulema* of the Council and the Government of Pakistan for the efforts which they made for this Report. I, however, would like to make a few remarks.

I would support what our brother Chapra has mentioned about the strength of commercial banks at the present time. Actually this is one aspect which should get more attention in our countries because we see commercial banks at the present time realising profits of 100 per cent of their capital in one year and this is an exploitative aspect of the community which contradicts the Islamic principles of social solidarity and consequently the Islamic principles of sharing the responsibilities. These powers of the commercial banks should be curtailed.

The other point which has been mentioned by brother Abdul Jabbar Khan is important. The businessmen and banks should cooperate in order to make the experience succeed and not that each partner should exploit the other. This is important in order to make it a successful experience. In this respect actually comes the point that abolition of *riba* is not the only thing which would lead to the Islamization of the society. It is true that our concern is mainly about *hudood* and *riba* is one of them but social atmosphere also should get more consideration in establishing the Muslim community. If *riba* is abolished then we have other principles and other values which can guarantee to a great extent that there will not be an excess demand for loan and the other fears which have to be sounded by economists that you will not be able to allocate scarce capital. We have other Islamic principles which would guarantee that this would not be realised.

In fact I would like to raise two other points which are related directly to the subject. One is the *mark-up scheme.* When the commercial banks, instead of giving letters of credit and loans for businessmen to finance their imports and the international trade would enter with them into a mark-up scheme, as I understand, this would mean that the businessmen will always sell the commodity at a higher price than its cost while at the present time we see there are instances where the internal prices might go lower at a certain stage than the price of this imported commodity. In that case, the businessmen might incur a loss. What would the bank bear in this case? Is the bank going to share the loss also or what shall we do? Under the present interest-bearing system the banks grant letter of credit and get their interest and charges. The banks do not have to do anything with the prices at which the goods will actually be sold. But when we adopt the mark-up system, are not we necessarily forcing the importer to sell at a higher price and thus are not we creating inflation in the economy? While reading the Panel's Report quickly I get the impression that the letter of credits would continue to be issued by the banks with interest. How would this be justified under an Islamic state?

Dr. Omar Zubair

I will be very brief and I will concentrate on the profit-sharing. I have been thinking for quite a long period of time on what is the alternative to the *riba* system and I will advance an idea which I have not yet fully developed but I would request the brothers to think over this idea. Suppose the state or the monetary authority could act as the sole *Mudarib* and the other banking system could collect the savings the contract would be a general contract between the state as the sole *Mudarib* and the community as a whole as *Arbabal Mal.* In this case the concept of normal rate of profit could come into the system whereby the risk would be shared by all the community since it seems to me that diversification lessens the risk element involved and it seems to me that in this scheme there will be no losses and there will be profit-and-loss-sharing in the sense that the community as a whole will share the losses and profits as well. Of course, this is the bare idea. It could be worked out and developed. I think the *Fiqh* and the jurists would not object to this because it really amounts to what the essence of the *Fiqh* is that it is not only profit-sharing but also loss-sharing as well but in essence the risk element is as well as the profit shared by all the community.

Dr. Mohamed Ariff

I have got three questions:

(a) It is not very clear whether deposits obtained under the PLS scheme will also be invested on the same basis.

(b) What measures are being taken to ensure that these PLS funds would be kept in a watertight compartment. I raise this question because there is a danger of these accounts being polluted by the interest-bearing operations as the same will be existing in the same institution.

(c) It appears to me that PLS partakes the functions and operations of investment banking and if it is true then are not we duplicating the functions which are already being performed by investment corporations or is it that there is going to be credit creation from the PLS accounts in the fashion of commercial banking operations?

I have some comments also:

(a) We were told that the Panel and the Council considered the idea of a model Islamic bank but it was rejected because it would not be viable as it would be located in a hostile environment. Previously I also used to subscribe to this idea but the other day we were told that the model banks have performed very successfully in other countries like Sudan, Kuwait and elsewhere. I wonder why we could not initiate it here. We can consider it as an alternative. Why cannot we take it as a possible complement to the prevalent vertical phasing out of the present system? The present scheme, I think, is a vertical phasing programme. One by one you phase out the existing institutions. But side by side I think you can set a model bank. It might hasten the process. Instead of considering it as an alternative we can consider it as a complementary step.

(b) The second comment is with respect to the concept of normal rate of profit which was just mentioned. It is a normal idea, to minimise cheating. I do not think there is anything un-Islamic about it because this rate is not predetermined and will vary from year to year. But I do see the danger that some borrowers or users of funds may bring down the actual profits to the normal rate of profits to escape a query. But one way out will be not to declare this figure and it should be an internal management thing.

(c) Finally, we were told about the Penalty for those who would not be behaving properly. I think side by side we should also have a reward or an incentive scheme for those who are making the system a success.

Dr. Muhammad Uzair

It is unavoidable that we have a phased programme. But I think if somehow government sector operations were not directly to be amended in the immediate future at least a beginning should have been made. First comes the State Bank. If State Bank had started the Islamization process before commercial banks, it would have been logically consistent and operationally it would have forced the commercial banks to follow the example set by State Bank.

It would have been desirable to start from the assets side but if the government and the experts on banking had chosen to start the phased programme it should have been started simultaneously from the liabilities side as well as assets side, i.e. a partial beginning from both the sides.

A beginning could also have been made by categories of deposits rather than by opening counters. For example, we could have started from the long-term deposits where the determination of profit is easier than say, in the case of saving bank account.

To allow the two schemes – interest-bearing bank and the interest-free counters under the same ceiling – seems a little contradictory as it places an unnecessary burden on the conscience and the faith of the people to make a clear choice between the two systems.

A mention has been made about the consumer credit or non-commercial credit as I would like to put it. From our distinguished friend Mr. Jabbar Khan I would like to be enlightened as to what percentage of the consumer credit constitutes out of the total business of commercial banks. If you know the real magnitude of the problem perhaps, it will be easier to solve the problem. I have discussed it in detail in the other session.

Dr. Ahmet Calicbay

The elimination of interest means getting rid of a mechanism by which monetary equilibrium is established. Now we, as Muslim economists, have to see that how can we realize our objective after putting an interest-free system in practice. At theoretical level very few things are impossible. We face the problems on the practical side.

By freeing economy from interest we eliminate a mechanism as well as a policy instrument. We, therefore, need either another policy instrument which can be used by the government to intervene in the market or we need a consistent mechanism which would work smoothly without needing any intervention from the government. In this field it seems necessary:

(1) to build a sophisticated model of interest-free economy which would be working with market mechanism, and government policies will be reconciled in a consistent manner;

(2) to educate people in general and administrators in particular; and

(3) to establish new institutions which could make the working of interest-free economy possible.

Furthermore, as some of the participants put it clearly, elimination of interest as an institution is not the whole thing. Islamic philosophy and principles require a new economic model, where not only material but also spiritual values should be combined into one and consistent model.

Dr. Muhammad Tahir

I disagree with Dr. Omar Zubair for calling a system where government is to be the *Mudarib* and the general public to be the financier, because this suggests that everything will be in the hands of the government hands thereby involving the government in the real activities and business of the country.

Secondly, I wonder if the Government of Pakistan has taken any step to educate businessmen and bankers to tackle the problem and to see what could be the solution of different problems. The basic solution always comes from the field and we have to involve practical businessmen and bankers in preparing programmes for the Islamization of the economy.

Dr. Hussain Mullick

I agree with Dr. Nejatullah Siddiqi that if the losses are eliminated, then they can change the name of the counter also. My second point is that when clients of the bank are also asked to have this type of accounts, i.e. the profit-and-loss-sharing accounts then, I think, some mechanism should be developed to allow them to have a say in the management as well as its whole investment activity. I am afraid that this has been not the case till now. I do not agree that it is difficult to have a model Islamic bank in Pakistan. It is time that a model Islamic bank should be established in Pakistan.

Dr. Syed Aftab Ali

I agree with Dr. Nejatullah Siddiqi on the question of investment auctioning that such devices may become a cover for normal interest-based transactions. I also agree with him that we should have started the programme of eliminating interest from the assets side rather than from the liabilities side. I have a suggestion to make. The type of experiments which are taking place these days in the Yugoslavian mixed economy where some sort of a framework of the collectivity of ownership of capital goods exists, I wonder if the same could be permissible under Islamic *Shari'ah*.

Dr. Wasim Ahmad

One thing which has been pointed out here is that there should be a rationalisation of expenditure both in the private and the public sector essentially to cut down unnecessary wasteful expenditure and eliminate what we may call *Israf* in the Islamic sense. I think this should be given a priority. We, however, need to establish some norms by which we may define that expenditure on certain items is unnecessary or wasteful. There has to be some department or division or some unit to establish the norms to distinguish between the necessary expenditure and *Israf*.

The second point relates to the emphasis on the teaching of the ideas that we are developing here. The general student, both at the under-graduate and post-graduate level, does not know very much about the Islamic economics. At the Master's as well as Post-graduate level, particularly in economics, there should be a systematic change brought about in the syllabi of these universities at various levels. Also history of Islam should be taught to all with special emphasis on the public accountability of the type that was shown during the *Khilafat-i-Rashida* period and other Muslim periods. These are necessary for a demonstration effect and to educate political leaders and bureaucrats in public sectors to avoid *Israf* as a part of religious obligation.

Dr. Mohammad Muslim Al-Raddadi

I just would like to make brief comments on the arguments advanced against the strength of commercial banks. I am not sure if there has been any right approach to judge the strength of commercial banks and whether it is a good or bad thing. There are a variety of considerations that should be taken into account. We should differentiate between the economic justice and the economic power. We know that these commercial banks could be a target of hostile institutions of the outside world and, therefore, their strength is essential and very important. When we say the concentration of power is the indication of failure of these banks without empirical study I think it is a serious matter. It should be studied empirically.

Mrs. Rehana Islam

My first question is addressed to Mr. Abdul Jabbar. He had mentioned earlier this morning that loans should be given out for productive purposes against hundred per cent demand current deposits.

I would like to know how far this is advisable on liquidity considerations. My second question is about advisability of opening PLS counters while there are already fixed deposits and current deposits under the same roof and how we would think that such a scheme would click if we take into account the climate of investment which is so uncertain. The Governor of the State Bank himself recently pointed out that savings in the economy are not generated at the desired level because of the geo-political compulsion in this region. Would it not have been better probably if the people were to be given a choice either to keep their money in current deposits, which would, of course, have no interest or to convert the time deposits into PLS deposits so they would either be the first to participate in profit-sharing and investment or switch to the current deposit. Here I do visualise that the Panel must have thought this as a very radical step. But they did not take into account that the staff of the commercial banks would .not be competent at one go to deal with such a substantial amount of funds because as Mr. Jabbar Khan would bear me out the current deposits and demand deposits from a very substantial portion of investible fund. The staff has to be trained because Islamization of banking is essentially a process of switching from commercial banking to investment banking.

Mr. Rao Sulaiman

My question relates mostly to the normal profit rate. It is not clear from the Panel Report, whether there will be a single rate or a whole chain of rates. If it is the single rate, then the first question is whether it might not have the same meaning as the rate of interest. If it is to be a whole chain of rate, how far down the line will we go. Mr. Jabbar Khan indicated that whatever may be the profit rate, it should also be used by the Income Tax Department for working out presumptive income in cases where acceptable accounts are not furnished. Now if this single rate is some sort of an average then the question will be that those whose actual profits happened to be below this average, they will be unneccessarily penalized from the Income Tax point of view. Also if a normal rate of profit is to be fixed by the central bank of the country, it would amount to a situation in which fiscal policy will be subordinate to the monetary policy. So if this question of normal profit rate is not spelt out in considerable detail, I think there would be quite a number of difficulties not only in the monetary field but also in the field of fiscal policy.

Dr. Mohammad Sakr

I would like to congratulate the people of Pakistan for their serious efforts to implement Islam. Actually our brothers here are innovative in the sense that they are trying to live according to the teachings of Islam. It is their duty because they have built a country from the start through great sacrifices in order to build an Islamic society and it is incumbent upon them to stand for the test to justify all the sacrifices, which have been undertaken for the establishment of this State. This in no way gives an excuse for other Muslim countries not to do the same. It is incumbent upon all of us to stand for Islam and to apply its institutions and legal system and so forth. Now concerning the role of the central bank in the new scheme, I am afraid all the instruments which are used in the traditional way cannot be applied in the new system. There have to be other means. More use has to be made of the fiscal policy. It should be integrated very well with the monetary policy in order to have a sound policy. The rate of interest, regardless of its criticism, plays a role in regulating the creation of credit and supply of money. But now since this instrument is no longer applicable in an interest-free economy, then there should be more integration of the monetary and fiscal policy. It could have been much better, if a separate report dealing with this issue was also prepared. The second point is financing consumer credit. In the present setting, this cannot find a place. A new way has to be found. *Qard-hasanah* is not the function of any commercial bank. Special arrangements can be made in order to satisfy the needs of this kind.

The mark-up is very dangerous because we cannot cover up interest by giving it another name. Either we have to say interest and stick to it until you find a way out. A sale should be a final sale.

The *mudarabah* or profit-sharing means sharing loss also in Islam. So the name should be profit-sharing not profit-and-loss-sharing because a *mudarabah* should go all the way and all the way means profit-sharing but in case of loss, the loss should be incurred according to the ratio of capital. There is nothing in *Fiqh* which could permit us to change this rule. If I contributed 10 per cent to the capital, can my loss be 15 per cent? In no *Fiqh* we can find a solution. I have been associated with the preparation of rules for the Islamic bank of Jordan. We spent 3 months in order to find a way out. There is no way out.

Mr. Sharafat Ali Hashmi

My first comment relates to the motivational aspect of non-interest-bearing finance, particularly the banking operations. Unfortunately the name given to our dealers in short-term credit, i.e. commercial banks is very misleading. The name orginally implied that these are the institutions that finance trade and commerce. But now it seems that the commercial bank means to run the bank on commercial lines, i.e. essentially for a profit motive. This is true that replacing interest rate with profit-sharing will take away the *riba* element in our financing operations but the banks need not operate strictly on profit motives. Many complications that have been posed and many difficulties indicated in these two Reports stem from the fact that we take for granted that our banks have to be profitable. In my view, in a nationalised banking sector profitability should be the least criterion. Banks should be looked upon as service institutions and even if they incur deficit on the profit side, this deficit should be met out of the public exchequer as a subsidy to this service sector. However, even if we allow for a moderate profitability in the banking sector, the bank need not make profit on every transaction it undertakes. Therefore, we have to identify a class of transactions where profit is not the motive. My other comment relates to the introduction of profit-and-loss-sharing counters and windows in the banks which have a significant portion still based on interest. This is putting the new experiment at a serious disadvantage.

Equity finance is expensive to begin with. The minimum required rate of return on equity capital far exceeds the going rate of interest in any money market or capital market. The reason is that the return on equity incorporates a price for risk taking also whereas the prime rate of interest has no element attributable to risk. Naturally in capitalistic economies, investors and entrepreneurs take advantage of the financial leverage and this debt capital being cheaper adds to the profits of the owners. So from users of funds point of view, given a choice, they will naturally prefer debt finance to equity finance. Thus our *riba*-free counters of profit-and-loss-share counters will have a serious disadvantage.

The other disadvantage stems from the fact that a significant interaction between monetary and fiscal aspect has not been taken into consideration. Under the present taxation laws, interest is tax deductable whereas dividend is not tax deductable. This makes equity financing more expensive. I would like to propose that for the time being, at least till such time as interest based and interest-free system co-exist, dividend payments may also be declared as tax exempt as in the case of interest. The alternatives that have been suggested to the profit-sharing system in the Panel's Report, sometimes come very close to the rate of interest and we have to guard against them. The Report recognises that problem, and is cautious at various points but when it comes to practice and it discusses the various sectors which will be covered by various alternatives it has a long list to be covered by alternatives, which they said they will be using very very sparingly. They have included a whole range of activities where they think they can use the alternatives. We have to watch against them so that we do not fall into a trap.

Dr. Munawar Iqbal

I would request the Panel to consider the idea of investment auctioneering once again because this may be very dangerous. First of all it may lead to concentration of wealth because if the investment funds are auctioned in a competitive market then the big industrialists will get most of the funds. What we should be trying to do as one of the objectives of Islamic system, is the reduction in inequality of income and concentration of wealth. Just as in the theory of international trade we have infant industry argument, we may, perhaps, have the same argument for infant entrepreneur. We have to encourage small entrepreneurs and small investors. This cannot be done in open auctioning. Secondly, this method will create a tendency to earn higher profits because whatever price they pay in getting the capital by bidding its price, they will have to earn profit over and above that. This will lead to profiteering and falsify the objectives of Islamic economy.

Mr. Fouad Abdul Gadir Agabani

I disagree with Dr. Ali that we should not allow the banks to earn high profits. High profits mean efficiency and there is nothing un-Islamic about being efficient.

I also disagree with taking assets and liabilities separately in the elimination of interest rate. What we are trying to do is to eliminate interest rate on loans but this does not mean providing free money.

I would also mention that all banks' interest is *riba* and is prohibited. Nobody can say anything other than that. I was misunderstood the other day and I apologize for that.

It is important to establish a follow-up department so that people do not get away with the bank's money and its share in the profit.

Agha Mohammad Ghouse

I like to highlight some problems specially for the private enterprise. Under the profit-and-loss-sharing system, we can visualise a more intensified competition among the major five banks not only to attract deposits under the new terms but also to seek out potentially successful and profit making commercial firms and industrial ventures. This is most welcome from the point of view of efficient allocation of resources. However, there is also a danger of production in the private sector either not increasing or even decreasing during the transitory period of the introduction of the interest-free monetary system. Take the case of the "sick" textile mills which are far from making profit and there are some other industries also but they are not getting adequate credit. Thus private sector may be unable to convince the banks to provide them capital. Meanwhile, the commercial banks which are accepting PLS savings and Term Deposits would always be under pressure to maximise their profit earnings and may actually prefer to lend to Government's trading operations in grains, TCP's imports, Cotton Corporation's export, Commercial Mark-ups and other public agencies operations which carry profit-returns without much risk. If bank resources are limited and if the above analysis is applicable, then the lending to the private sector will decline. This may lead to a decline in deposits also. We will then face a vicious circle of low deposits and low lendings on profit-and-loss-sharing basis especially in private sector. Therefore, the role of the State Bank of Pakistan becomes much more crucial in its policy for credit ceilings as well as for allocations between various sectors under the profit-and-loss-sharing system than under the interest-oriented system. I am sure that the State Bank of Pakistan is fully alive to all these consequences.

Dr. Monzer Kahf

I should definitely congratulate the people of Pakistan and its Government especially the banking system of this country for its big venture to eliminate the interest.

I hope that the interest-free counters will really be independent inside the banking or are autonomous and I know it is possible. We have made a feasibility study at one time in this field of establishing that kind of thing. In some of the commercial banks it is possible to make completely autonomous department based on interest-free transactions. I definitely subscribe to the idea of requesting these banks in Pakistan to extend the interest-free counters to their branches overseas.

The second point that I want to refer is for the essence of elimination of interest in Islam. The essence is prohibition. If we keep the same existing forms of lending by renaming them, I do not think we will be fulfilling the spirit of the prohibition of interest. I can see two major substitutes that are Islamic and within limit provided in Islam – the profit-sharing in all its forms and the *qard-hasanah*. In case of *qard-hasanah*, I agree with Dr. Sakr that we may need some different institutions than we have now. From the concepts like investment auctioning, I am, however, very much worried. It seems to me that it is nothing but finance auctioning and if it is so then this is nothing but an interest rate in a different form. The same is for Mark-up and the normal profit rate.

Dr. M. Fahim Khan

I want to mention only one of the proposals which is time multiple counter-loans. I want to point out that the scheme of time multiple counter-loan seems to be quite exploitative and, therefore, it should not be considered as an alternative to interest. If we can take a simple numerical example which the Panel's Report has mentioned and work out the expected profit on the amount lent and borrowed, we will see that the borrower has to pay much more than what he receives. I do not have the time to explain it on the blackboard but I think that can be worked out very easily.

Dr. Sharafat Ali Hashmi

I would say that multiple counter is hundred per cent un-Islamic. This amounts to selling a loan for a loan which is un-Islamic. Selling a loan for a loan has been specifically prohibited by the Holy Prophet (peace be upon him).

Dr. Darwish Saddig Gastaniah

I would like to point out that in our discussions we need to take care of the *Baitul Mal* along with taking into account the matter of the Islamic Bank. If Islamic banks want to do anything they will do so on commercial basis but as far as the provision of *qard-hasanah* and collection of *Zakah* are concerned, they have to be done by the *Baitul Mal*. We have to make some kind of studies about the importance of creating *Baitul Mal* in all the Islamic countries.

I like to point out that we can classify the borrowers from banks into three groups. First, there are the very big companies. I do not think they really need to borrow money from the international banks because they can afford to finance their projects through shares and through the Government support. The second group is the middle sized businessmen. I think it is better for them if they group themselves according to their specialisation. This group will get equity from the Islamic banks and not from the Government. Third is the private sector in small business. It is the responsibility of the Government to give them loans free of interest.

Dr. Omar Zubair

I do not agree that excessive rate of profit is allowed in Islam as mentioned by Mr. Agabani because it obviously does not reflect efficiency. Excessive profits reflect only the monopoly power which is not Islamic. This is simply usurption. I disagree completely with Dr. Monzer Kahf also on his approach to the idea of normal rate of profit. If we follow his advice then we have to close all the banks because the pooling system will not be workable. Each project has its own normal rate of profit and it will be very difficult to get the parties agree upon the idea of the pooling of profit rates.

Dr. Anas Zarqa

I feel a great deal of gratitude to the people and the Government of Pakistan for doing what nobody else has dared to do even though many would like to do viz take up any serious systematic and scientific querry for eradicating interest from society. I feel that this is really a very historic event and its importance should not be underestimated. I really wish that they would receive maximum publicity throughout the Muslim World for which it would need to be translated in Arabic and distributed widely. I am, however, not saying that everything in this Report is acceptable to every student of Islamic economics or to every man of *Shari'ah*. My major point is that in these Reports we find a systematic approach to a very delicate and important policy question from both the economic and *Shari'ah* side. The way the Panel was set up and the Council of Islamic Ideology was operating on this question should be considered a model for any Muslim society which want to deal with an important policy question having Islamic or other social implications. This sort of combination of men of *Shari'ah* and economists and bankers working in close collaboration for the solution of a problem is unique. I honestly feel that if there is a prize in the Muslim World for Islamic achievements and service then it must go to the people who worked for this Report and to the Government and to the people of Pakistan for taking this great historic step. I really wish that the Faisal Prize should go to the people who worked for this Report. Of course, a tremendous effort has been put in this and the amount of interest generated thereby is so much that now it is time to go ahead and apply.

As regards the application there are two frames of mind – one is timid and cautious. They are not sure that what Allah has prescribed can work. They would only wish others to take the initiative and if they win, then these people will follow in their footsteps. Nothing good happened in the world out of the people with this frame of mind. The people of Pakistan have taken a very courageous step and have tried to be first and Allah *subhanahu wa ta'ala* will have the reward for them that He promised for those who are willing to take the risk and take the first step and face the challenge of the unknown. Such people will be rewarded much much more than the people who wait and see. I wish that this matter of application be taken very seriously. The people in Pakistan do not realise the importance of what they have achieved and perhaps they take it more lightly than they should. They have achieved something outstanding and they should be very proud of it. They should now attend to the application of the Report and it should not be a timid application. It should be both an honest and full application.

I would first of all give support to Dr. Sharafat Hashmi's suggestion, who has made the point that when we have both the interest-free counters and the interest bearing banking co-existing with the existing tax laws, then we are putting *Halal* at a disadvantage and *Haram* at an advantage. The suggestion made by Dr. Hashmi is practical and should be implemented. I would like to point out the importance of the suggestion made by my brother just a while ago regarding the formation a group of certain companies or the market structure of industrial and commercial concerns. We know that the big companies are easy to audit and consequently since they have to keep record and so on, providing them the equity capital or *mudarabah* funds etc., would be rather easy to control. So is the case of medium size companies. It would be, therefore, desirable to encourage the formation of such companies as much as possible through various means. Of course, when he suggested the formation of large- and medium-size companies, this is not to say that ownership and control has to be large and concentrated.

The other suggestion is regarding speedy drafting of an audit and account authority. Dr. Chapra's previous paper has suggested a very very important thing that an independent audit company be established which will audit the accounts of the various companies which draw funds from banks. It will operate for the benefit of the banks and the businessmen but it will be an independent and very honest set-up so that the records of the businessmen will be unavailable even for the income tax authorities. Also some very severe penalty must be imposed on those who can be shown to have acted dishonestly. The third suggestion is the matter of short-term financing. Now we must understand that the matter of short-term financing is related to the way the business is built. We know that in the capitalist set-up banks essentially provide short-term loans. They will come to long-term loans only on exception. With the present type of banking, the businessmen have maintained the habit that when they set up an enterprise, they do not set sufficient amount of equity for the continuous needs of the working capital of the company. They always finance it from the short-term loans from the banks. Consequently, an artificial need of finance is created. Thus if I need to borrow every month Rs. 500 and pay it back every month it means I have not maintained sufficient funds for my continuous short term needs. Such continuous (or permanent short term) needs should be forced to be financed by equity participants.

The banks can say them that they keep coming to them for short-term loans implying that they do not have sufficient funds with them and, therefore, they should increase their equity rather than raising short-term loans.

Dr. M. M. Metwally

Abolishing interest would result in at least five problems:–

(1) How to achieve equilibrium in the money market?
(2) What rate of discount can be used if such discount is desirable?
(3) How is capital to be priced so that resources are optimally allocated within the economy?
(4) What criterion can be used in allocating funds to Government Projects?
(5) What alternatives would be available to replace short-term bonds or near money?

Equilibrium in the money market in economies where interest is abolished, can no longer, in my point of view be achieved, by the use of the monetary policy. This is particularly so since there will still be some demand for money for purposes other than the transactions or precautionary motives. Also profit ratios cannot be used as a monetary tool to clear the money mark as long as short-term bonds (or near cash) are not available and in particular if these ratios are not easy to change. To clear the money market in this situation you need a fiscal tool, perhaps along the lines suggested in my paper Fiscal Policy in an Islamic Economy, namely, a tax on idle cash.

If future discounting is necessary and desirable then you would need a global or macro rate of discount. The rates of profits on different equities can only be used at project or micro basis. The availability of a global or, as some prefer to call it, a representative rate of profit would also help in solving the third problem, namely, allocation of capital efficiency between different uses in the economy. It could also be used, as a criterion for allocating funds, by the Government.

The fifth problem, i.e. to find alternatives to short-term bonds is a serious one and may require a radical change in the structure of the economy particularly the ownership of industries.

Shaikh Mahmood Ahmad

In spite of the great value of technical working out of the manner in which various substitutes of interest can take over the function of interest, many of the alternatives suggested are undistinguishable from interest. If we are not merely concerned with form, but also with eradication of the exploitative content of interest which manifests itself in unemployment, inflation, polarization of wealth, social tension etc., a lot more of thinking will have to be done.

The only alternative which so far commands general acceptance, the one of profit-sharing, is not without its shortcomings. It was a form of personal credit, whereas we need a basis for impersonal, institutionalised credit. It can easily serve the corporate sector, but becomes unwieldy when we extend our operation to medium and small productive loans. From its very nature, it is incapable of application in the case of consumptional loans and Government loans.

The only alternative, so far suggested, which appears to be capable of responding to the various requirements of interest-less banking, namely Time Multiple Counter Loan Concept (TMCL), has not yet won wide enough acceptance. The objections against this concept are of two kinds: firstly, from persons who are very rightly concerned that it may not violate any provision of *Fiqh*, and secondly, from the bankers. Many of the objections raised from the religious point of view appear to have been met by the amendment made in this concept by the Islamic Advisory Council of Pakistan, before according its approval to it. It has stipulated that the counter loan should already be available to the credit institution, before any loan is advanced to the borrower, which appears substantially to water down the objections from the standpoint of *Fiqh*. It is for persons well versed in *Fiqh* to evaluate the extent to which any objection survives. For instance, one of the objections is that it is a conditional loan, which is not permissible. But *mudarabah* is also, perhaps, a conditional loan, granted on the condition of a specific percentage of profits. If after evaluating various objections and answers that come to mind, some residue of objections survives; it has to be evaluated against the possibility that in the absence of an allembracing alternative to interest, interest may continue to dominate our economics. Either we should evolve a substitute which is equally simple, workable, all-embracing, and free of all objections from the standpoint of *Fiqh*, or we should accept TMCL arrangement, until we evolve something better than this, in preference to continuing in a state of war with Allah and His Prophet, (peace be upon him).

[The General Discussion ends here, and the chairman asked the two official discussants and then the speakers to make concluding remarks.]

Dr. Nejatullah Siddiqi

Dr. Zarqa just raised the issue of short-term needs of business of the present day. He is right that there is nothing sacrosanct about these short-term needs. They are a creation of inherited system. I would, however, suggest that some of us might look into the matter, before we have it in empirical terms. It deserves scrutiny at the logical or theoretical level to see whether it is true that the need for short-term loans will decline in an interest-free system.

Then I am reinforced in my own views about investment auctioning and I think Dr. Munawar Iqbal has added to it quite a new point which deserves serious consideration by all those who still have a soft corner for that kind of approach. I think his point about likely concentration of wealth and the auction finance being swallowed by few big business houses is well taken and deserves consideration. Also his point relating to the forcing up of the rate of profit in economy as a whole deserves attention. This is the likely outcome. I think we will all agree with the suggestion of Dr. Sharafat Hashmi that now there is a discrimination between those who will receive dividends from profit and loss accounts and those who hold interest-bearing accounts and that this discrimination should be eliminated.

Winding up by Dr. Umer Chapra

Two of the questions were from Dr. Aftab Ali. One was about the reduction of the power of commercial banks so that they are not able to utilise their huge resources for benefitting a few individuals or families in the economy. I think this I have covered at length in my paper on Money and Banking in the Islamic Framework and to some extent in my comments on the Panel's Report.

The other question was about the stock market. How is it possible to make the stock prices reflect the underlying economic conditions? This is, of course, a very difficult question and I do not think at the moment I have the answer. How the prices can be regulated? Who will regulate them? Whether or not it should be some government authorities or some institutional set-up that will automatically take care of such problems? These are some of the questions to be answered. We, however, know that there is a substantial degree of speculation in the stock and commodity markets. So much so that some individuals are able to manipulate the market to their advantage. We know the recent incidence in the silver market by the Hunt Brothers who manipulated the market to the extent to which they were able to take up the price from \$ 8 to \$ 50 and they were able to make billions. They unfortunately failed as the God Almighty intervened for the small users of silver and they did not succeed. So how people are able to manipulate the market? There are a number of things that have been done. Some people sell the things that they do not even have them.

There is a *Hadith* that you cannot sell that you do not possess. But on the other hand, the *Fiqh* have also allowed *Bai Salam* and these things have to be studied together with the questions of purchases on margins and settlement of differences. Sometimes the people do not have the intention to pay at all or sell but they go to the market and to make speculative gains and they settle the difference. Whether or not these practices will be allowed in Islam are the questions that we have to examine and to propose a programme for a sane-stock market. I have suggested in my comments that the Government of Pakistan should establish a Panel to study the working of stock market in an Islamic framework but if this is not done then I would suggest that Muslim scholars should take up the task of preparing a comprehensive paper on this. Dr. Wasim asked me a question about how to determine the necessary spending of the government to save it from *Israf.* Of course, this is a very difficult issue but if any government want to do it I think they can easily determine where are the areas where savings can be done. I do not think you and I can go into it here. Dr. Raddadi also talked about the strength of the commercial banks. I think the term itself probably might have caused confusion. I am not against the strength of the commercial banks. They should be as strong as possible from the point of view of safety to the depositors. To that extent, the strength is desirable. But using this strength to benefit a few individuals is undesirable and this is what I am against.

Winding up by Dr. Ziauddin Ahmed

I find that most of the points raised here are in fact suggestions and therefore I do not have much to say. The suggestions made by the participants will surely be considered. There are, however, two important points needing some discussion. One is what sort of procedure be evolved for the valuation of inventories and the other question is how the profits would be determined because balance sheet has many items which can be used to show lower profits. Because we have here Mr. Abdul Jabbar Khan who is much more competent to answer the practical questions I request him to answer these questions on my behalf.

Winding up by Mr. Abdul Jabbar Khan

As far as the valuation of the inventories is concerned I feel that it is perhaps in connection with the mark-up or *Bai Muajjal.* In the case of mark-up, let me frankly admit that the present prevalent interest rate will be made on the basis of the valuation. But as I have suggested in my presentation that in due course of time the concept of normal rate of profit should make the basis because in due course of time there would be no interest rate structure in the Islamic society.

The second point is about the profits appearing in the balance sheet. I suggest that the profit-and-loss-sharing should be on half-yearly basis and a trial balance should be prepared by the company or by the borrowers. The sharing of profits and loss on half-yearly basis should be on the basis of income and expenditure statement or profit-and-loss-statement which is generally prepared by every business concern in a little more detail on half-yearly basis. My friend Sulaiman has mentioned about the normal rate of profit. Actually it will not be one rate of profit. It will be a set of different rates for different categories of industries. Even within the industry there would be different rates for different sectors of that industry. Some of the brothers have suggested that the structure of the banks be changed from commercial banks to investment banks. Let me first explain the trend in the business practices and procedures in Pakistan. The entrepreneur likes to keep the control of his enterprise in his hand and that means that in the equity he should at least hold a majority. If he has to hold the majority of equity, he would not like to broaden the base of the equity which has been so much advocated by most of the delegates and that is why in Pakistan for sometimes to come the loans for working capital will continue to be a major portion of the investment rather than the equity in our commercial banks. This being so the commercial banks will have to play an important role. Commercial banks will remain commercial banks rather than investment banks because investment banks, I understand, share only in equity. Another point is that the commercial banks should make more investment in the shares. The distinguished delegates need study of our stock exchange position. The stock market is not able to absorb even the surplus funds of the Investment trust and ICP. If we pump over commercial banks' deposits of 6 billion U.S. dollars into the stock, you can very well imagine the fate of the stock market in the country. The limitation is that the equity base of most of the companies is small compared to their loans. This is the trend of business in the country and we annot change it overnight. It will take some time. Let us hope if this trend changes.

Another point was about higher profits of banks. I think the distinguished delegates have overlooked the great services the banks are rendering in mobilizing the savings in the country.

Let me tell you that the banks are not making that much profit and our margin of profit is very small. The reason is that we have to make provision for all bad and doubtful debts. We have to write off after not only the interest but sometimes even the principal amount. We have to make provision for them.

Another point was about the letter of credit. In the case of letters of credit actually no financial accommodation is involved because it is just a sort of the promise the banks undertake through a letter to the importer that if he presents the documents then he will get payment. No money is involved until the documents are presented. After they are presented then they are not letters of credit and instead they are called import bills of exchange, and import bills of exchange have been based on mark-up basis. It is only a sort of service and we charge only a commission for this. This has been cleared by the Council of Islamic Ideology.

Now I take the case of marked-up imports. A delegate indicated that there is no risk involved because the bank would get the marked-up amount. In theory it is true there may not seem to be any risk. But in practice supposing if there is a fall in the market price and the goods have been imported, I will say hundred per cent chances are that the importer will leave the goods and the goods will fall to the share of the bank and the bank will have to sell whatever may be the marked-up price. The loss whatever is not recovered from the importers and from his securities. The loss will be of the bank. However, I agree that in the case of mark-up there are very little chances of loss. But there is one point in the case of mark-up. If the person or if the importer does not pay that price on the date on which he is supposed to make delivery, any period in excess of that he is utilising the banks' funds free of interest. To that extent the bank is undergoing a loss.

As regards PLS deposits, I would like to assure the delegates that our accounting is such that we will keep absolutely a separate account of PLS deposits and their deployment would not contain any element of interest. Although you may say that mark-up is another form of interest, yet since mark-up has been cleared by the Council we are abiding by it.

As regards commercial banks, I may assure, that we like to cover our transactions under profit-and-loss-sharing basis but you please keep in mind the three difficulties which I explained in my presentation this morning. The bankers in Pakistan would like to assure you that they would like to bring more and more transactions under the profit-sharing scheme.

Final Winding up by the Chairman: Prof Khurshid Ahmad

This is a very pleasant duty to sincerely thank the two main speakers and the discussants who have no doubt done their jobs very well and I am satisfied that the contributions from the floor have also been immense. I am sure, the time we have spent in the discussion has been an investment for all of us. Those of us who are acting as theoreticians and those of us who are acting as practitioners, both have benefitted from the points raised, questions posed and responses offered about the problem of the elimination of interest from our economy.

I am deeply impressed by the fact that a distinguished gathering like this has shown a kind of near consensus on this new approach which is being developed in this country and some other countries. Though profit-sharing is to be supplemented in the transitional phase by a number of other instruments, it has emerged as the chief alternative to the present interest based transaction in the banking and other financial institutions.

The other point that I would like to emphasize is that the House recognises the fact that the new destination that we want to reach is very different from the socio-economic realities with which we deal today and therefore, total change cannot come in one big leap. Hence a piece-meal approach may be needed. But this approach should be such that each step leads to the next step. We must not stop midway and we must not just substitute change ignoring the substance. Every step should take us away from the present model and bring us nearer to the new model.

This discussion has also shown that there are very important areas on which new work is needed at theoretical as well as practical level for which a feedback from the practitioners will also be needed.

Finally, I would like to say that the Panel of Economists and Bankers and the Council of Islamic Ideology have done a wonderful job on which we compliment them warmly and whole-heartedly and we lend our support and we pray for the success of this approach. We, however, hope that the Council of Islamic Ideology will not feel that they have done their job and that is it. We hope that they would have another Panel or a number of Panels which would on the one hand keep a constant eye on the experiment being made in the light of their recommendations, to see whether these steps being taken are bringing us nearer to the goal that we have in mind including the obstacles coming up and how they are to be tackled and on the other hand, they would take up those issues which have been raised but which needed further thinking, research, discussion, and dialogue. For this purpose three areas come to my mind very prominently. One is the question of indexing. In spite of the interest shown by economists and reservations expressed by *Fuqaha* I sincerely feel this is an area which deserves further investigation from the *Shari'ah* point of view as well as from the viewpoint of economic and banking practices. This is an area where working groups should be formed to undertake the study. The second area is of credit creation about which brother Siddiqi complained that it has not been taken up to the extent we had discussed it in the Makkah Seminar. I do feel that here is another potential area for further research and examination and a working group for this might be useful to undertake an indepth study of the issue. Then there is the question of normal profit. I do not think this should be disposed of or accepted off hand. I think it is an important area for further study and reflection. I hope that the Council of Islamic Ideology, International Centre for Research in Islamic Economics and other institutions would try to take up these issues and study them in depth and come up with reports for further discussion.

Other areas have also emerged from today's discussion where I think the Council of Islamic Ideology should apply themselves:

(a) The success of elimination of interest will depend on a number of changes in the economy at the level of formulation of our objectives of economic policy; at the level of formulating our development strategy; at the level of seeing how in the light of these objectives it will be necessary to bring about changes in the nature of certain institutions e.g. the profit motives. How it is to be modified in the Islamic framework? In the Islamic framework, the profit motive will have to be modified by altruistic considerations. The egoistic approach is not the only approach in Islamic framework. The institution of *Hisbah* also deserves to be attended to in order to act as a kind of a national vigilance on the system to see where are the violations taking place. As Dr. Umer Chapra pointed out, there are other forms of exploitation which may not be in the form of bank interest, which should also be attended to. The changes in the taxes, changes in the functions of central and commercial banks are other areas requiring immediate attention. All these areas need to be studied.

(b) The transformation of the existing structure into an Islamic structure will require establishment of certain new institutions. One important suggestion that has come up from the discussion is the institution of *qard-hasanah*. Whether this should be developed within the system of commercial banking or outside need to be studied. Other institutions required for the transformation should also be identified and studied.

With these few submissions I now conclude. I sincerely thank all of you and above all I very sincerely express our *Shukr* to Allah *subhanahu ta'ala* for enabling us to meet to discuss and giving *taufiq* to our brothers to make this intellectual effort and providing us so much food for thought and reflection. Without His mercy we could not have met and spent this time reflecting on an issue which is of immense importance for the future of *Ummah* in the 15th Century Hijra.

Islamic Banking as Practised Now in the World

*Dr. M. Fahim Khan**

To the modern Western Economists who consider interest to have a pivotal role in the economic life of a society and even to many of the Muslims who believe in interest as an essential element for economic development and growth, the Islamization of an economy may seem to be a mission impossible. This belief may be due to the fact that no working model or blueprint exists to support its practicality or highlight its practical implications.

Muslim Economists have been trying to present the interest-free economy in theoretical models but unless some successful working example is presented to both the businessmen and economists their logic, no matter how convincing, will remain doubtful.

During 1970s, individual efforts were made in various Muslim countries to establish interest-free banks. These efforts present not only an excellent working example for those who did not believe in the practicality of the institution but also provide a spade-work over which the infrastructure of interest-free banking for a country could be built-up.

This Report, based on the documents of the Islamic Banks of the world and discussions with the heads of these banks during my personal visits to these institutions, provides a detailed examination of these efforts. The first part of this Report describes the operations of these banks. The second part highlights those issues that need to be discussed in this Seminar.

PART – A

OPERATIONS OF ISLAMIC BANKS

Objectives of Islamic Banks

The organisations currently operating on Islamic Banking principles are listed at Annex 'A'. The objective of these Islamic Banks, in gener-

*Dr. M. Fahim Khan is Associate Professor in School of Economics, Islamic University, Islamabad.

al, is to promote, foster and develop the application of Islamic principles, law and tradition to the transaction of financial, banking and related business affairs and to promote investment companies, enterprises and concerns which shall themselves be engaged in business activities as are acceptable and consistent with Islamic principles, laws and traditions and in no event engaged in the alcoholic beverage trade, the receipt of interest forbidden by Islam, the gambling industry or the pork meat or in any other un-Islamic activity. The main principles of their banking are:

(i) Prohibition of interest in all forms of transactions.
(ii) Undertaking business and trade activities on the basis of fair and legitimate *(Halal)* profits.
(iii) Giving *Zakah.*
(iv) Prohibition of Monopoly.
(v) Cooperation for the benefit of society and development of all *Halal* aspects of business trade and investment that are not prohibited by Islam.

The Islamic Development Bank (the only bank of its kind working in Jeddah) has similar objectives except that the Bank's activities are oriented more towards development projects of the member countries rather than to commercial activities. According to the agreement of the Bank, "Islamic Development Bank aims to foster economic development and social progress of member countries, individually as well as jointly, in accordance with the principles of *Shari'ah*".

How The Islamic Banks Operate

Where the normal banking practices do not clash with the Islamic principles, the Islamic banks have adopted the current banking tools and procedures. Where any clash arises, the Islamic banks have devised their own tools and procedures to accomplish their banking activities. Such tools and procedures that have been devised so far are enumerated below:

A. DEPOSITS

Islamic Banks receive two types of deposits:

(a) deposits not committed for investment which take the form of current accounts or savings accounts, and
(b) deposits committed for investment which are called Investment Accounts.

Whereas Current Account is operated in the same way as it is operated in the conventional banking system, the Savings Accounts and Investment Accounts are operated differently as discussed below:

1. Savings Accounts

This is an account where the customers can deposit their savings. Though these depositors allow the banks to use their money, they get a guarantee of getting their full amount bank from the bank. In this case, the Bank guarantees their savings but is not obliged to pay any rewards to the savers. However, most of the banks are still paying either a cash reward from their profits at the end of their financial year or are giving some privileges to the holders of these accounts, e.g. providing financial support for small projects, sale of consumer durables or producers goods by instalments, distributing gifts etc. These rewards are discretionary and not obligatory and are paid only in case the bank is earning substantial profits. These accounts, however, were found to be attracting relatively very little deposits but some of the Islamic Banks (Kuwait Finance House and Dubai Islamic Bank, for example) were giving a significant profit (ranging between 5 to 6 per cent) on these accounts. On accounts that have no risks, this much profit is not understandable. Without facing any risk of loss, how can they share in the profit? The Savings Accounts share the net profit of the bank according to some agreed proportion.

2. Investment Accounts

These Investment Accounts can be of two types:

(a) Accounts with authorisation, and

(b) Accounts without authorisation.

In the accounts with authorisation, the account holder authorises the bank to invest this money in any one of its projects. After the expiry of a specified period, the account holder will get the profit. In case of investment accounts without authorisation, the account holder may choose any particular project for investment of his deposited money. (The account holder, may or may not specify the period of deposit.) The bank will give share to the account holder from the profit of that particular project which has been chosen by him according to agreed percentage. If the investment accounts are opened for a fixed period, the customer is not allowed to withdraw his money before the lapse of the specified period. If he does so, the customer either is not entitled to the share in profit at all or may be entitled to receive some discounted profit depending upon the duration of the deposit with the bank. These deposit schemes of Islamic banks have been able to attract a substantial number of depositors. The current annual report of Kuwait Finance House indicated that their number of account holders have reached a level of over 20,000 within a 2-year period which has surpassed their prediction based on the trend of the deposits of the other interest-based banks that were established in Kuwait. The amount of deposits in these accounts has shown even a higher increase. During 1979, the number of Savings Accounts in their bank increased by 255 per cent whereas the amounts of deposits in these accounts increased by 377 per cent. Other Islamic banks also have shown quite a respectable growth in their deposits. The deposits in four major Islamic banks which have been in operation for more than two years have now reached a level of more than 500 million U.S. dollars. These deposits registered a growth of about 150 per cent during 1979 which is a respectable growth when compared with the growth in the deposits of interest-based banks of similar vintage working in same areas. .

Investment accounts are generally popular in these banks. Savings Accounts are equally popular only in those banks where these accounts are entitled to share the profits of the bank. Where the Savings Accounts are not entitled to share the profits, the deposits in these accounts are negligible.

B. INVESTMENT ACTIVITIES

As the bank cannot earn interest by lending the money, therefore, the Islamic banks have to undertake investment to earn profit not only for the bank itself but also for the depositors in the investment account. The investment procedures based on the Islamic principles are given below:–

1. Musharkah (Equity Participation)

The banks and their clients agree to join in a temporary participation (not quite different from the joint venture concept) for effecting a certain operation within an agreed period of time. Both parties contribute to the capital of the operation (taken to mean, assets, technical and managerial expertise working capital etc.) in varying degrees and agree to divide the net profit in proportions agreed upon in advance. There is no set formula for profit-sharing and each case is dealt with on its own merits. Operations carried, according to this mode, can vary from weeks to years. In medium- and long-term operations, a self-liquidating form of participation can be agreed upon; whereby the ownership of the whole project or operation may pass to the partner (customer). The bank would have retrieved, in the meantime, an agreed share of profits. The bank may also permanently participate in any trading establishment or building or factory or agriculture till the liquidation of the firm, or may participate temporarily promising to withdraw its share by selling the same to the partners (and partners also promising the same) by paying the bank's amounts at once or on instalments as per mutual agreement among them. This procedure is also being applied to a few activities other than the investment project. Some of these activities are:

(i) *Letter of Credit.* If the importer fails to pay the full amount of the letter of credit at the time of the delivery of goods, the bank will not charge him any interest on postponing the payment and will instead, share in the profits of the importer at a ratio agreed upon in advance. Some of the Islamic banks, however, charge nothing if the amount is paid in full at the time of the delivery.

(ii) *Purchase of Property or Real Estate.* The bank may provide loans for such purchases on the basis of *musharkah.* The bank will assess the rent or annual income from the property or real estate and will share it according to the extent to which he is financing and according to the terms agreed in advance. As the client pays up the instalments of the loan, the bank's share in the income will be reduced till the whole property is transferred to the client.

2. Mudarabah or Qiradh (Agencies)

In this procedure of investment, bank contributes all the financing (and the customer contributes only his managerial efforts or labour) and gets again an agreed proportion of the profit actually realized. In both *mudarabah* and *musharkah,* both sides stand to incur any profit depending on the actual performance of the operation. In the *mudarabah* contract, however, the *mudarabah* (the partner offering his effort) will lose nothing but his labour (as the principal capital is not his) in case of financial loss resulting from normal business conditions. The bank who has financed the capital bears all the finance risks. This finance risk justifies the bank to claim his share in the profit. The client is, however, held responsible for the loss of capital, should this be the result of his negligence or wilful act. To guard against this, the bank may require a security from the customer.

3. Murabaha

This is a procedure where a partner approaches the bank that certain items (be it a commodity or otherwise) be bought for him and he agrees to pay the bank later on, upon the fulfilment of the actual buying, an agreed percentage of profit. In order to avoid any *riba* element one of the banks provides that the agreement of the bank and the actual execution of buying do not contribute any legal obligation (according to *Shari'ah*) on the partner to buy. Hence the risk is still that of the bank's. Until the partner fulfils his original promise of "rebuying" the commodity, the risk remains with the bank which justifies the profit. There is, however, also the practice of financing a mark-up with the binding on the buyer to buy the goods. This type of operation is most commonly being used in foreign trade and short-term transactions for purchasing raw materials etc. for the industrial establishments.

4. Bai Salam (Post Delivery Sale)

The bank buys certain goods on post delivery and pays the cost immediately or sells certain goods on post delivery and receives its cost immediately. In this sale, cost of goods is fixed and paid in advance but the delivery of the sold item is postponed or delayed up to a certain period. Similarly, the place of delivery, its expenses and quantities of the sold goods should also be fixed and defined as they are conditions for such a sale.

5. Leasing or Renting the Physical Capital/Equipment

The bank, in this case, purchases a physical capital/equipment and rents it to his client. This procedure can be converted into a reduced renting procedure whereby the customer, by paying every year an instalment of the value of equipment/physical capital, reduces the rent, till the whole equipment is owned by him and the rent is eliminated.

These tools of investments have theoretically been designed to apply to all sectors of the economy but in practice the investment activities have been found to be concentrating only to real-estate and trade sectors. Kuwait Finance House during their two years of operation concentrated on real-estate. This shared 100 per cent of their investment in 1978 and 94 per cent in 1979. This included rented residential buildings. Similarly, Dubai Islamic Bank described their operational strategy as "to prefer for projects which give quick returns".

Technically these banks are also supposed to invest in long-term and medium-term projects but practically most of their investment is short-run, perhaps, because of the prevalent trend in local markets (in the Middle East).

Mudarabah is more popular form of investment by the Islamic banks. Generally the banks have been found to be able to make 10 to 14 per cent profit on their investment activities. The Tables 1–3 show the profits on investment activities of some of the Islamic Banks:

TABLE 1

Islamic Investment Company of the Gulf

July 31, 1980

Mudarabah	Date of issue	Valuation $	Increase since inception $	1980 annualised increase per $ 100
1st mudarabah 3 years	1.1.79	118.30	18.30	12.60
2nd mudarabah (profits paid 31.5.80)	1.5.79	101.57	1.57	9.47
3rd mudarabah	1.10.79	1065.00	65.00	8.13
4th mudarabah	1.2.80	10.69	0.69	13.80
5th mudarabah 1 year	1.2.80	105.25	5.25	10.50
6th mudarabah 3 years	1.2.80	103.85	3.85	7.70
Monthly institutional mudarabah	Month of July			6.90

TABLE 2

Faisal Islamic Bank of Sudan
Dec. 31, 1979

Average profit on Investment Activities: 13.5 per cent.

TABLE 3

Kuwait Finance House
Dec. 31, 1979

Average Profit on Investment Activities: 10 to 12 per cent

C. BONDS AND SECURITIES

1. Al-Muqardha Bonds

This tool is utilized when a large amount is needed for a big project. The bonds carry shares in the profits of the project. An amount of the bond may be decreased in the same way as the participation is reduced in the case of *Mudarabah* or *Musharkah* or Renting. Two new Jordanian banking groups are working on the scheme to float "Income Bonds" to finance projects being built by the country's Ministry of Islamic Endowment and Religious Affairs. These bonds differ from the normal bonds in that they do not pay any guaranteed or fixed return to investors. The holders of the bond will take a percentage of the profits of the project that the bonds are financing. The basis of this bond is a participation contract through which one or more partners with their money (the beneficial owners) and another with his efforts (participant) get together to earn profit in a *Halal* trade. Profits will be divided between them on an agreed upon proportion.

2. Islamic Securities (Al-Mudarabah Certificates)

This is similar to the Islamic Bonds in nature and have the same basis as illustrated above. The Islamic Securities, however, are not issued for any specified project. Instead a *Mudarabah* (participation) company is established. This company issues a certificate which is a receipt for the money received and a guarantee by the *Mudarabah* Company to reimburse the proceeds of the company, if any, to the bearer of the certificate at the date of maturity and according to the amount with which he participated. These certificates, of course, bear the element of risk of losses, if any.

The *Mudarabah* Company will then invest all the money it receives in local or international enterprizes, in which it is conditioned that it must in no way contradict with the rulings of Islamic *Shari'ah*. With the assistance of a selected group of internationally experienced businessmen in the field of investment and the supervision of leading scholars in *Shari'ah*, the Islamic Investment Companies have prepared various proforma for *Mudarabah* Certificates.

D. LOANS

1. Loan Certificates

These are the certificates through which a *Mudarabah* Company receives Islamic Loans whose maturity is defined but which do not entail, in any way, share in the profits or losses. The Certificate is meant for such Muslims who do not want to take risk of investment but are willing to allow the use of their money for the benefit of and investment in the Islamic Community. Here the Muslim lender is shunning *riba* and is positively participating in a collective Islamic task aiming at spreading Islamic economy and above all the spreading of Allah's words.

The reimbursement of these loans, however, have a priority and their amount is guaranteed.

The public investors have the option to combine both the portfolio (*Mudarabah* Certificate and Loan Certificate) according to their desire for investment and their preference for risk.

2. Benevolent Loans

These loans are provided by banks and the objective of these loans is to produce benefits either for the general public or for charity. There is no interest or return on these loans. Though there is, a provision for a service charge to cover the cost of providing the loan, yet no bank is applying this charge except the Islamic Development Bank in Jeddah. All the commercial banks provide loans free of any charge if they have any provision of such loans.

The serivce charge, whenever applied to a loan, is claimed to be different from interest on the ground that it is not a fixed percentage of loan, but it is an absolute amount calculated by working out actual costs in providing the loan.

So far, the Islamic Banks are not inclined to provide these loans. Only the Islamic Development Banks are providing such loans for the social and infra-structural projects. The commercial banks have, however, shown willingness to provide personal non-productive loans without any charge after they get properly established and have accumulated enough funds. The criterion for the advancement of such loans will be based on:

(a) The nature of the need for which the loan is required.

(b) The credit of the client with the bank.

Thus an old client of the bank requiring loan for his son's education will have a priority over the new client requiring loan to buy an air-conditioner.

3. Short-term Loans

To meet short-term loan/credit requirement of the enterprises, the banks do have the provision to provide such loans without interest or any other charge. However, this too has not been very much in practice. The criterion for advancing such loans theoretically, is:

1. Specific credit needs of the firm.
2. Social priority attaching to the enterprise.
3. Nature of the security against loan.
4. Whether the credit seeker has also obtained term advances from the bank for the same enterprise.
5. Annual, monthly or weekly average of the applicant's balance in current account with the same bank.

Generally, the banks do not encourage the customers to overdraw. In special cases, this may be allowed with the fixation of the maximum date to adjust the said drawn amount. No interest or expenses are charged on such loans. This is treated as *qard-hasanah.*

4. *Bills of Exchange*

Bills of exchange are also treated under the *mudarabah* principles. Cash is provided against the bill on the condition of a claim in the profits from the sale of merchandise. An interest-free loan may also be advanced. No discounts are allowed in either case.

E. INSURANCE AND UNDERWRITING

Cooperative Insurance

Some of the banks are undertaking insurance as a subsidiary business of their organisation. This insurance is a sort of cooperative insurance. The principle is that all the losses have to be borne by the participants on cooperative basis. The participants will, however, share the profit arising out of the investment of the premium. This principle is being applied to life insurance too. The procedure is that all the participants (policy holders) at the maturity of their policy get all the amount that they had paid as premia plus the share in profit. If a policy holder dies before the maturity of his policy, he gets all the amount that he paid as premium plus the share in profits plus the remaining amount of the policy to be contributed by all the other participants. The participants contribute not only as part of their social obligation but also because they will get the same treatment.

F. PROFITABILITY OF ISLAMIC BANKS

All Islamic Banks are maintaining a satisfactory level of profitability. The profit rate on capital is ranging from 9 per cent to above 20 per cent. This compares almost at par with interest-based banks in their areas. On investment deposits the profits have been paid at the rate of 8 to 15 per cent.

G. RELATIONSHIP WITH OTHER BANKS

Islamic banks are doing business with other banks also in their countries strictly on Islamic principles. The working of Islamic banks has impressed the other banks even in non-Muslim countries particularly those in Europe which are now devising ways and means to do business with Islamic banks.

PART – B

ISSUES – FACING ISLAMIC BANKS

The Islamic banking as practised now in the world has generally been so far, quite successful. An examination of their working, however, raises a number of issues not only for themselves but also for countries like Pakistan embarking on a programme of Islamising the economy.

Before going into the discussion of issues, I describe the general peculiarities of these banks that give rise to these issues:

1. All the banks are very recently established. The oldest bank was established in 1973.
2. They are located or doing business mostly in the finance-rich countries and they probably have not faced the real problem of raising deposits.
3. They are individual banks working in isolation of the general banking system around them.
4. The banks' operational activities are similar to those of investment companies with no or almost non-existing pure loan account (with the exception of Islamic Development Bank in Jeddah). The commercial banks are particularly avoiding pure consumption loans.
5. The strategy of these banks generally seems to be to look for projects with quick returns. This has specifically been mentioned as "operational strategy" by one of the oldest Islamic Banks in its current annual report. This is also reflected by the facts that the real estate investment is generally one of the major investment activity of these banks.

With these features of the Islamic banks the following issues arise:-

1. Tools to Attract Depositors

The Islamic banks so far have done an extensive and intensive research in devising non-usurious procedures to utilize their funds. Very little research has been done in devising the tools to attract deposits. This may be so because they have not yet faced the shortage of deposits. But if they do not pay attention to devise the non-usurious tools to compete with the interest-bearing tools of raising deposits, then these banks are likely to face problem in their growth particularly when they are working side by side with the modern banks. So far Islamic banks have the following types of deposits which differ from the deposits in other banks:

1. Savings Accounts
2. Investment Accounts

On Savings Accounts they are not obliged to offer any reward because the amount of the savings is guaranteed and the holders of these accounts are not liable for any losses that the bank incurs. This account, therefore, can attract only those customers who have money to save but do not want to take a risk and also are not keen to earn profits on their savings. Though the investment account, has the attraction of getting a higher rate of return than the current rate of interest this account will attract only those people who have the money to save, want to earn money and are willing to take a risk.

For these two types of people, the Islamic banks have to compete with two institutions:

(a) Interest-based banks.
(b) Stock-market.

There is a third category of people i.e. those who have money and want to earn profit on their savings without taking any risk. This is a category of people not available to Islamic banks.

The deposit performance of some of the existing banks underlines the need of developing effective tools to attract deposits. Table 4 compares the current performance of Dubai Islamic Bank – one of the oldest Islamic banks – with an interest-based bank originating during the same period in the same area and of the same size.

TABLE 4

Performance of an Islamic Bank Compared with the Interest-based Bank in the Same Area

		Islamic Bank (Dh)	Interest based Bank (Dh)
Paid-up Capital	1978	50,000,000	25,000,000
Deposit	1978	127,700,000	309,497,932
	1979	172,700,000	772,862,461
Growth of Deposit	1979	35.2%	51.7%
Deposits as % of Capital Employed	1978	2.55	20.38
	1979	3.45	30.91

This is despite the fact that the Islamic bank is paying 6 per cent profit on the savings accounts which will generally not be entitled to any share in the profits of the bank. This slow growth in deposits may not necessarily be reflecting the failure of Islamic banks to attract deposits but the fact remains that in a society where interest-based banks are also allowed to exist, Islamic banks stand at a disadvantage. How they are going to successfully compete the interest-based banks is not clear from their current programmes. There has been a lot of theoretical discussion on the literature on Islamic banking as to how to save the depositors of investment accounts from the risk of the losses that the bank might incur. Islamic economists, in search of a viable alternative to interest-based banking, have suggested a number of schemes such as building reserves by the bank out of their good time earnings to compensate losses in bad time or launch deposit insurance with the backing of the central bank and the cooperation of all commercial banks and their depositors.

None of these schemes are so far operating and the depositors in the investment account stand liable to loss, should such possibility arise, though none of the banks so far have undergone such a possibility.

An effort on a large scale is needed to devise non-usurious tools (going beyond conventional devices) of banking that can raise the deposits for Islamic banks. The existing Islamic banks will have to do this research not only in their own interest but also in the greater interest of the Islamic countries who are Islamizing their societies.

2. Extra Management Burden of the Islamic Banks

Another factor that puts the Islamic banks at a disadvantageous position vis-a-vis the interest-based banks is that the Islamic banks have to supervise and in some cases manage the operation of the project that they are financing.

This problem is serious in developing countries where the business enterprises, generally, do not maintain proper accounts or keep different sets of account for different purposes.

The presence of such malpractices will raise the cost of Islamic banking. Unless such fool-proof devices are developed that do not entail these extra costs for Islamic bankers, the growth of Islamic banking activities are likely to be constrained considerably. The Islamic banks have devised certain strict rules and regulations so that they select only sound parties but these procedures not only discriminate them unfavourably against the other banks but also do not guarantee that their customers will be obliged to declare actual profits of their enterprise. None of the banks so far seem to have faced the problem perhaps, because either the Islamic banks have not expanded their business to the extent where they could feel this problem or because so far these banks have been dealing only in real-estate and trade business where such management problems may not be significant. This is, however, a problem that cannot be ignored.

3. Problems of the Borrowers of Pure Loan

The "Loan" (borrowing) has gained a prominent role in the present-day economic activities. Apart from the loans for commercial or productive needs, the loans are required for the personal consumption or non-productive needs. The Islamic banks with very limited funds for such loans will thus be ignoring the needs of quite a large class of population. Institutions will have to be developed to meet the society's demand for loan particularly for genuine consumption purposes. The following possibilities are worth considering:

a. Integrating *Zakah & Sadaqat* with the Banking System so as to give support to such vulnerable depositors of the bank as widow, old people etc. who would be supported on the basis of charities/or interest-free loans whenever the bank is running a loss or is not making a substantial profit. Islamic Economists have already discussed this possibility but it did not find favour with most writers. According to them it should be the responsibility of state. Though some of the Islamic banks do have a *Zakah* Fund it is not yet clear, how far they can be successful in meeting such needs of the society. Thus launching of an Islamic banking system will need to be synchronized with the development of an effective *Zakah* Fund by the state or the central bank.

b. Financing the Interest-Free Commercial Loan from pure savings accounts. All the Islamic banks have savings accounts which are meant for such depositors who do not want to stand liable for the losses and rather require their full amount to be guaranteed. These types of depositors, however, give the banks their consent to use their money. The banks use their money but are not obliged to pay them a share in the profit to the same extent to which they give to the depositors of the investment account. The amount for these deposits should obligatorily be used to provide the interest-free loans for consumption needs. Since the banks earn profits on the use of such deposits, therefore, the same should be used to finance the subsidy involved in interest-free loans. As the bank guarantees the full amount of saving to the depositors, the same can be compensated by the guarantee to be provided by the borrowers. The attraction of the provision of interest-free loan to depositors in the savings account will raise the Islamic banks' customers of savings accounts.

c. Developing a system of local community funds operated by local communities themselves. Such institution will support the loan requirements of the members of the community. These institutions will work on the principle of cooperation rather than on commercial basis. The potential for such a community cooperative exists very much in countries like Pakistan. A recent public opinion survey in Pakistan showed that majority of the population would be willing to lend money to friends and relations without any compensation.* Efforts by the state can organize such institutions where people's cooperation can be obtained as a part of a comprehesive social security programme.

Apart from these, the need (particularly in Pakistan where the whole system is to be switched-over to interest-free banking) is for an intensive research into the behaviour of the population of savers in general and of Muslim savers in particular to investigate:

The ways and means by which their behaviour could be modified to become consistent with the norms of Islamic economy and the alternative institutional framework that can supplement the Islamic banking system to meet all the needs of borrowers/savers.

4. Problems of Investment in Long Gestation Projects

The Islamic banks have been found to be investing generally in the projects with quick returns. This is perhaps because the banks have to pay a sizeable profit every year on the deposit and they cannot afford to have no profit for some time if they are competing with the interest-based banks. This means that the long gestation projects are not likely to be picked up by these banks. If this is true then this is not only reducing the long run efficiency of the Islamic banks vis-a-vis other banks but will also affect the growth in developing countries if there are no banks to finance such projects.

To shift to an interest-free system, therefore, one of the crucial requirement will be to develop an institutional framework that can provide adequate financing for long gestation and infra-structural pro-

*Public opinion on Islamic Economic Issues, Resluts of a Nation-wide Survey "conducted by Pakistan Institute of Public Opinion for Planning & Development Division, Government of Pakistan".

jects. Establishment of Islamic Development Banks alongwith Commercial Islamic Banks will, therefore, become essential when switching-over to an interest-free economy.

5. Need for Theoretical Research

It is generally believed that all theoretical issues relating to *riba*-free banking are settled and that now it is only a matter of practice. This view, generally held by all the practising Islamic banks (with the exception of Islamic Development Bank) is a little over optimistic particularly when there is a question of changing the system in a country. Most of the Islamic banks are privately owned and are working along with the interest-based banking system. There is little chance that the Islamic banking tools devised by these banks can be challenged. But when the question is of running a system under a government advice, there is likely to come up a number of questions that need to be clarified by Muslaim *Fuqaha* and *Mufti*s. Some of the issues for example are:

(a) Can a service charge be levied on pure loans. If the answer is in the affirmative, how this is to be calculated. What direct and indirect costs need be included in the calculation of this charge? How to envisage the costs in future without involving the interest element? This is a problem which both the Islamic Development Banks and the Islamic Commercial Banks will have to face when they advance pure loans.

(b) How to decide a margin of profit in trading, i.e. if a bank is supplying money to buy some merchandise should it or should not it charge any profit on it and if the answer is in the affirmative, what should be the rate of profit? In many cases such purchases may be a risk loss. If this is true then can the mark-up charged by the bank be considered as profit and not *riba*?

(c) How should the rent of physical capital be calculated so that it does not include the interest element?

These concepts, may theoretically not seem to have any practical problem, but as mentioned earlier, where it is a question of changing the whole system, these issues have to be settled in advance.

6. Use of Media

Another important issue that the Islamic banking, in general, has so far ignored is the use of media. Even the Muslims are not very much aware of the fact that the Islamic banking is being practised in the world. The banks have not ever used an effective media to publicise their activities. Some reports did appear in American newspapers about Islamic banking but they are not enough for a proper publicity of the Islamic system in this sphere.

ANNEX 'A'

LIST OF THE ISLAMIC BANKS AND INVESTMENT COMPANIES

1. Baitul Tamweel Al Kuwaitee, P. O. Box 24989 Kuwait.
2. Dubai Islamic Bank Deira, Dubai, United Arab Emirates.
3. Faisal Islam Bank of Egypt 1113, Karnish Al Nile street Ittehad Al Ishtraki Building, Cairo, Egypt.
4. Faisal Islamic Bank of Jordan, P. O. Box 3418 AMMAN, Jordan.
5. Faisal Islamic Bank of Sudan, P. O. Box 2415 Khartoum, Sudan.
6. Islamic Banking System 31, place De Paris Luxumbourg.
7. Islamic Bank of Bahrain, Bahrain.
8. Islamic Development Bank, Jeddah, Saudi Arabia.
9. Islamic Investment Co., Geneva, Switzerland.
10. Islamic Bank of Sharjah, Sharjah, UAE.
11. Investment Corporation of Pakistan, National Bank Building I.I. Chundrigar Road, Karachi, Pakistan.
12. House Building Finance Corp., Shaikh Sultan Trust Bldg., Beaumont Road, Karachi, Pakistan.
13. National Investment Trust, National Bank Building, I.I. Chundrigar Road, Karachi, Pakistan.

Comments

Mr. Fuoad Agabani*

1. Establishment

Faisal Islamic Bank (Sudan) (FIBS) was established on August 18th, 1977 under the F.I.B.S. Act of the National People's Council. It commenced operations officially on May 10th, 1978.

(a) Objective

The objective of the Bank was defined by the Act as being to "strive to consolidate community development through performing all banking, financial, commercial and investment business."

(b) Capital

The authorised capital of the Bank is LS. 10,000,000 of which LS. 3,656,246 was paid up up to 31.12.1979. This sum is expected to reach 5 million by the end of 1980. The capital of the Bank is divided between Sudanese (40%), Saudi (40%) and other Muslim share-holders (20%), mainly in the private sector.

(c) Exceptions and Exemptions

Under the F.I.B.S. Act, the Bank is excepted from the applications of :–

(a) the laws regulating service and post-service benefits; provided that the salaries, wages and post-service benefits which may be determined by the Bank shall not be less than the minimum provided for in such laws;

(b) the laws regulating insurance;

(c) the Auditor General Act, 1970 or any other enactment thereof;

(d) Sections 42, 44 and 45 of the Bank of Sudan (Central Bank) Act, 1959; provided that the same shall not curtail the powers of the Bank of Sudan to supervise and direct the credit policy of the Bank.

The said sections concern the determination of bank rates, reserve requirements and the restriction of credit activities by the Bank of Sudan.

Under the same Act, F.I.B.S. enjoys the following exemptions:–

*Mr. Fuoad Agabani is Manager of Research, Statistics and Information in Faisal Islamic Bank of Sudan.

(a) The property and profits of the Bank shall be exempted from all types of taxation.

(b) The funds deposited with the Bank for the purpose of investment shall be exempted from taxation. However, the Bank pays out *Zakah* calculated as 2½ per cent of all profits, capital and reserve, for the duration of the deposit period.

(c) The salaries, wages, gratuities and pensions of all employees of the Bank, the Chairman and members of its Board of Directors and the *Shari'ah* Supervisory Board shall be exempted from taxation.

(d) In addition, the Bank may enjoy any exemption or concession provided for in any other law.

(e) The Governor of the Bank of Sudan may exempt the F.I.B.S. from the provisions of the laws regulating exchange control within such limits as he may think appropriate. The Governor has, actually, exempted all dealing and movements of capital funds of F.I.B.S. and its deposits originating in foreign currencies from the Exchange Control Regulations.

Furthermore, the Act provides that:–

(a) the property of the Bank shall not be subject to confiscation, nationalisation, sequestration or forfeiture;

(b) the funds deposited with the Bank shall not be sequestered or forfeited except in accordance with a judicial order.

The above exceptions, exemptions and guarantees reflect the interest of the legislature in fostering the success of the Bank as the first experience in Islamic Banking in Sudan which may and is to be extended to other banks in the country.

(d) Management

The Board of Directors of the Bank is composed of Sudanese, Saudi and other Arab nationals in order to represent the distribution of the capital. All the staff of the Bank are Sudanese. The *Shari'ah* Supervisory Board (S.S.B) is established under the Bank's Articles of Association in order to make sure that the Bank's transactions conform to Islamic *Shari'ah* (law). The Bank has established two subsidiary companies: The Islamic Insurance Company and the Islamic Trade and Services Company.

2. Operational Methods

(a) Deposits

The Bank has three types of accounts:–

1. *Current Accounts.* These are interest-free and usually against charges.
2. *Savings Accounts.* These are interest and dividend-free and free of charge, with no restriction on amounts deposited, with ensured instantaneous withdrawal of funds on handing the pass-book.
3. *Investment Accounts.* The minimum for an investment deposit is LS.100 or equivalent. Drawing is unrestricted and instantaneous. But funds drawn before completing a period of 6 months forfeit their share in profits. Balances remaining for 6 months or more are eligible to receive a share of profits, proportionally to their quantity and duration, at the end of the financial year. The resulting profits are distributed between the depositor and the Bank in the ratio of 75 per cent to the depositor and 25 per cent to the Bank.

Technically, current and savings accounts are considered by the S.S.B. to be loans, while investment accounts are considered as being unconditional *Mudarabah* or *Qiradh* capital, as will be explained below.

(b) Investment

The Bank utilizes its own funds and part of the clients' deposits to finance investments in any of the following major methods:—

1. *Independent Investments.* As shown above, the Act enables the Bank to make its own direct investment. So far, this has been restricted to the establishment of the two subsidiary companies, one a trading company and the other an insurance company.

2. *Musharakah (Partnership).* Under this method, the Bank and the would-be customer agree to join in a partnership for effecting certain operations within an agreed period of time. Both parties contribute to the capital of the project and agree to divide the net profits in proportions determined in advance. There is no fixed formula for profit-sharing and each case is dealt with in its own merit. Such operations in practice vary in duration from a few weeks to a few months, or if need be, can go for years. In the case of medium- and long-term operations a "decreasing" form of participation is usually agreed on, whereby the ownership of the whole project passes to the client after an agreed period of time during which the Bank is

expected to have retrieved its principal plus a suitable share of profits. The Bank screens the client, appraises the project, monitors implementation and, if necessary, takes part in actual management in order to make sure that the anticipated results are achieved. It is the Bank's policy, however, to entrust management to its partners in the different joint-ventures. A percentage of the net profit is left to the partner in consideration of his role as manager. The rest of the profits are distributed between the Bank and partner according to their respective shares in the capital of the venture. The value of the fixed assets owned by the partner is estimated in money terms and included in his share of capital.

3. *Mudarabah or Qiradh.* Under this method, the Bank provides all the capital of the operation and the client is fully responsible for management. In consideration, the partner gets an agreed proportion of the net profits. In case of loss resulting from normal business activities, the Bank bears all the losses and the client loses only the profit that would have been the reward of his effort.

   The *Mudarabah* is of the "restricted" type whereby all the conditions of the operation are written into the contract.

4. *Murabaha Selling.* In this case, the Bank sells a commodity to the client for a pre-determined amount or rate of profit over and above total costs. Usually the commodity is provided to the order of the client according to definite specifications, but, following the ruling of the S.S.B., the client is not obliged to accept the commodity even if it is provided according to the given specifications.

5. *Collateral Policy.* The Bank requires the client to provide collateral to cover the Bank against the risks of neglect or wilful act of the partner but not against normal business risks. This conforms to Islamic *Shari'ah*.

   A higher rate of profits is usually asked (in the contract) if the payment is to be by instalments, again in accordance with the ruling of the *Shari'ah* Supervisory Board. This rate has to be fixed in advance as an absolute sum. It cannot be increased if payment is not made in time.

(c) Other Banking Services

The Bank provides most of other types of banking services like dealing in foreign exchange, effecting domestic and international transfers, collection of bills, opening letters of credit and issuing letters of guarantee, availing safe custody etc., for fixed charges. Significantly, no facility for discounting of bills is provided. But the Bank gives *qard-hasanah*, though very sparingly and on humanitarian basis. However, some over-drafts are allowed, free of charge, to reliable customers as a gesture of goodwill when a customer's account becomes temporarily negative.

(d) Branches

The Bank has, so far, five operating branches and two under establishment.

3. Performance up to 31.12.1979

(a) Investment Activities

The number of investment operations that the bank has entered into since commencement of operation on (10.5.1978) up to 31.12.1979 was 208. The total commitment of the Bank in these projects was LS. 27.6 million. 82 per cent of this amount went into trade and 17 per cent went into industry in the form of working capital.

During the said period, 68 of these operations were completed and liquidated. The Bank's total contribution to these operations was LS. 6.52 million, of which 63 per cent was for trade and 37 per cent for industry.

The total profits realized from liquidated operations was over LS. 879,000, showing an average rate of profit of 13.5 per cent. This represented 30 per cent of the Bank's gross revenues for the period.

(b) Total Profits

Gross income for the same period was about LS. 2.3 million, while current and capital expenditures added-up to about LS. 1.3 million, thus giving total net profits of about LS. 1 million. This gives a rate of return of 17.1 per cent on total resources actually utilized.

Profits were distributed to the shareholders at the rate of 15 per cent of the paid-up value of shares and 14.7 per cent of deposits of holders of investment accounts. *Zakah* amounting to LS. 125,097 was paid-out on the Bank's capital and net profits.

4. Comments on Performance

From the above it can be seen that business-wise the Bank has done well.

As an Ialamic institution, operating in a businesslike fashion, it has managed to tryout successfully most of the major forms of banking and investment activities permissible by the *Shari'ah*. As such it deserves to be considered a promising experience in practising comprehensive Islamic banking.

The provision of ordinary banking services has proved to be a profitable operation in itself and a good way to attract customers and to collect investible funds, both in local and foreign currencies. The Bank has proved to be successful with Sudanese expatriates working in other Arab countries.

The quality of the personnel of the Bank has proved to be major asset. The meticulous care with which most of them have been selected and the attractive terms of service provided by the Bank were not wasted.

Internally the Bank's branches attracted more than enough customers. In addition it must be admitted that some keen businessmen saw the Bank as a useful addition to their list of financiers.

The modes of finance provided by the Bank were not easily understood by most clients and were subject (in the beginning) to the wildest misinterpretations, e.g. :–

(a) Some thought that partnership always meant a 50 : 50 sharing of profits.

(b) Some thought that, under *mudarabah*, the Bank was entitled to profits only after the client has pocketed his own predetermined share of profits.

The usurious environment in which the Bank operated was inevitably partly biased against the Bank's mode of finance, for instance:–

(a) Interest paid by the client to other banks is included in "costs" and, therefore, legal sale-prices are inflated under the formula which allows profits to be calculated as a percentage over and above the costs for most goods.

(b) Interest is again deducted from taxable profits as an item of "costs".

(c) Most import licences are not granted except for goods enjoying credit facilities from the suppliers; and interest-rates for the facilities have to be specified explicitly.

Some of the difficulties encountered by the Bank in the field of investment were related to the clients themselves. To begin with, it took the Bank some time to establish a "list" of reliable clients who should also be competent businessmen and to set going a workable system of client screening which also means a market surveying system.

Some of the clients were unruly and tended to ignore the terms of the contracts defining the operations. Others were secretive about the real extent of their operations and their sale prices which were in many cases above the legal (though usually hypothetical) limits. Yet others were sluggish and prone to hoarding, reluctant to liquidate the operations in the agreed time and preferring to wait for "golden chances" to sell at "appropriate" periods, which meant a drag on the Bank's resources.

Most of these difficulties are notably related to the present inflationary and stringency economic conditions in the country and to the perhaps prevalent lack of control of the market. Reliable audited accounts are a rarity.

Other problems were related to the management side of the operations : an adequate and prompt system for project evaluation, processing, documentation, execution, follow-up and criteria for profit-sharing had to be created under great pressure of working conditions. This is particularly a very tricky question since there were no guidlines to go by.

It is my personal view, *ex-post*, that this could have been mitigated somewhat if more projects and market studies were made before the commencement of operation of the Bank. All this added up to some period of bewilderment and some losses at the beginning, which sheds an even more favourable light on the achievements just mentioned. In fact, tentative estimates for profits for the present year are even brighter, probably much better.

5. Recommendations

a. On the one hand, it is essential to expand as far as possible the (limited) framework of operational methods within which Faisal Islamic Bank (Sudan) and other Islamic banks now operate in fields of both resource accumulation and utilization. New types of accounts and deposits and new types of formulae for project financing have to be found. Recourse must be made to traditional and modern Islamic literature, and altogether new ideas must be derived from original Islamic sources (the Quran and *Hadith*).

On the other hand, greater clarity and simplicity must be derived from the available relevant *Shari'ah* literature, preferably in the form of fairly readable hand-books for the guidance of bank personnel and clients.

No Bank can do this single-handed. The holding of this Seminar is a very encouraging landmark. It is, therefore, hoped that enough emphasis shall be laid on the practical problems of Islamic Financial Institutions.

b. F.I.B.S. activities have so far been deliberately limited to short-term ventures. For long-term considerations more long-term operations are necessary. The availability of medium- and long-term resources must be explored.

It is pertinent to contemplate the possibility that some medium- and long-term capital can be channelled through Islamic Banks from rich to poor Islamic countries. The Islamic Development Bank should play the major role. This is already accepted by the authorities of the I.D.B. but has not proved to be very practical due to the inter-governmental constitution of the I.D.B. and its methods of operation.

I am, therefore, of the opinion that an International Islamic Bank is the logical next step in the cooperation of Islamic Banks. The capital of such a bank should be provided exclusively by the I.D.B. and the national Islamic banks, and its activity should be mainly the finance of bankable projects submitted by the national Islamic Banks. It should also act as a bank of last resort to the Islamic banks. The I.D.B. should take the initiative in this step.

c. The network of Islamic banks should be extended as soon as possible to cover all Islamic and other countries, so that no Islamic bank shall feel compelled to do business with a usurious bank. The existing Islamic banks should exchange their experience which should be made available to new Islamic banks.

d. Islamic insurance companies are a necessary adjunct to the operation of proper Islamic banking activities: since the practices of the existing insurance companies are not Islamic, and since insurance itself is a major financial business such Islamic insurance companies should cover the investments of the Islamic Banks and their clients and also the general public. The successful experience of the Islamic Insurance Company of F.I.B.S. should be very useful. Furthermore, an Islamic re-insurance company is urgently needed to cater for the re-insurance needs of the existing and forthcoming Islamic insurance companies.

Discussion

Dr. Fuoad Abdul Gadir Agabani

Islamic banks are capable of earning high profits and this has been the experience in the Faisal Islamic Bank of Sudan. In fact our bank is earning a profit to the point of embarrasement to us. This is so because traditional banks only lend money. They do not invest their money. Islamic banks invest their money, and, therefore, get more profit than what the traditional banks get. Islamic banks should give interest-free loans (*qard-hasanah*) to the needy people. The objective of Islamic banks should be to wipe out poverty from the society.

Dr. Taufiq Al-Ammar

Islam's stand on usury is decisive and unequivocal. Interest and *riba* are one and the same thing and they are prohibited in every form. Islam is a comprehensive system in which ethics is integral and not a supernumerary part.

Equity participation or direct investment by Islamic banks in socially desirable projects that meet the Islamic ethical criteria as indicated by the need of society as a whole will have to be taken into account before providing profit to individuals.

While the *riba*-free system is the distinguishing feature of the Islamic banks, it is not easy for them to extricate themselves from an international banking system based on the practice of usuary. The experience of the existing Islamic banks which are operating successfully can be used for mutual benefit.

The booklet entitled"One Hundred Questions and One Hundred Answers on Islamic Banking" which covers a large number of issues, should be translated into English and distributed to the banks in Pakistan.

Mr. Monem al-Ghousi

Brother Agabani has mentioned that they had excess profit which became embarrassing for them. The question that comes to my mind is whether Faisal Islamic Bank of Sudan is thinking in terms of profitability as their only objective or are they also thinking of social allocation of resources.

Dr. Umer Chapra

Dr. Fahim Khan brought a subject during his presentation about the use of *Zakah* for covering the loans given to widows and orphans or the needy people and he is of the opinion that the Islamic bank may also collect *Zakah* for this purpose. I wonder if this is advisable. *Zakah* is *Ibadah* whereas a bank is a commercial enterprise. *Zakah*, therefore, should not be mixed up with the commercial venture. If there are individuals who have suffered losses in business and they have become poor and have difficulties in repaying their loans they can of course, resort to *Baitul Mal* which will be operated by the state. The banks, should not be allowed to administer *Zakah* because if they do this then there is likelihood of misuse of the funds. There will be a conflict of interest in this case.

Dr. Muhammad Uzair

I confess that I have not been able to go through the Report of Dr. M. Fahim Khan but from the presentation which he has made, a couple of points arise in my mind. He has made a comparison between the interest-free bank and the conventional bank. I do not know whether he did not clear it or did not touch upon the point as to how a depositor sharing in the interest-free bank compares with the depositor in the conventional interest-based bank. He has emphasised the point that most of the interest-free banks working in the Muslim countries have tried to make quick returns. This was also corroborated by the point raised by Mr. Agabani that the profits are embarrassingly high. Dr. Fahim Khan has mentioned that the loans are given mostly for trade and real estate business. It is true that we want to avoid the institutions of interest but at the same time we have to do the things which are in the best interest of the national economy of the countries themselves. If the interest-free bank, in order to accelerate, depends on such businesses which help in distorting the allocation of the resource then this will not be desirable as this will be against the basic philosophy of Islam. If we want to choose only a limited number of loans where there is no risk of loss or almost no risk of loss and deliberately avoid such an allocation of funds which are in the longer interest of the economy then this, too, would not be desirable. He has mentioned also the points regarding the old people, widows and so forth and he has given an impression that in the interest-based system they are the gainer. Perhaps they might have been in the good old days. However, since the advent of the phenomenon of inflation, interest-oriented income at a fixed percentage always leaves the old people and widows at a disadvantage as compared to any other mode of investment. The solution in my opinion, as far as the old people and the widows are concerned, would be that these interest-free banking institutions could incorporate in their operations what is described in the United States as trust banking. Trust banking aims at providing a secure, safe and convenient source of income to the widows and the old people. These banks invest in shares and securities on behalf of these people. I think we may like to think of this possibility. I was very much impressed by Agabani's sense of humour; which is not very common.

Dr. Omar Zubair

It seems that Dr. Fahim Khan has been utilizing the efficiency criterion while comparing the performance of Islamic banks with the *riba*-based banks. This is not fair. We have to devise an Islamic criterion for the evaluation of Islamic banks which would reflect all the externalities arising out of these banks for Muslim *Ummah*.

Dr. Ziauddin Ahmed

To my mind it is not very clear as to why we should be embarrassed by the high profits made by the Islamic banks. These banks are simply sharing the fabulous profits which are arising in these economies that are not really functioning on pure Islamic lines. If you see the composition of depositors and borrowers, you would see that the depositors are small savers whereas the businessmen are the net debtors to the bank. The businessmen do not have credit balance. In this system, if the Islamic banks are earning good profit then they are performing a socially useful function because these profits are then passed on to the small savers. This does not happen in the case of interest-based banks who give a very small return to the depositors. The interest-based banks are increasing income inequalities whereas Islamic banks, by sharing profits, are simply distributing a part of the profit of big businessmen to the small depositors. From this point of view, I do not find it embarrassing at all that the Islamic banks are earning high profits.

Of course, in an ideal situation, there should not be such pockets of high profitability, but to achieve the ideal, as was said in the morning speeches, we have to think in terms of the totality of the system.

Dr. Fahim Khan has perhaps been rather too harsh in evaluating the performance of the Islamic banks by saying that they are not taking long-term projects and that they are taking projects of quick return etc. I think, we have to be very clear about the environment in which these Islamic banks are working. They are on trial. The whole world is watching them. They have to go a long way. They cannot take all types of activities in one go. Also you have to see that they are working in an environment which is full of hostility towards them. We also find that the central banks in these countries are not actively helping these banks. For example, in a situation of liquidity shortage the other interest-based banks can always get loans from the money market or from the central bank. This facility is not available to the Islamic banks. We have got results only for a year or two from these banks. We should not be impatient in complaining about their performance. The Islamic governments of these countries have a responsibility to make the Islamic banks progress and for that reason they will have to think in terms of changing their own legislation. They can be made subject to the inspection by the central bank as the other commercial banks are but they should be provided assistance in time of need on the basis compatible with *Shari'ah.*

Dr. Mohammad Abdul Mannan

I think the author has a lot of important points. I, however, want to mention that while evaluating the performance of the Islamic banks, it is important to take into account the composition of the beneficiaries of these banks. Our experience has shown that the loans are normally given to rich people of the poor country. These things are not expected to be repeated by Islamic banks. In his next evaluation, I think, Dr. Fahim Khan would take into account this aspect.

Dr. Fahim Khan has rightly pointed out the problem with the mark-up and service charge. Though there may apparently be no un-Islamic elements in these instruments, the same need to be thoroughly examined. Such instruments are likely to become another name of interest.

Now coming to the high profits earned by Islamic banks, which were termed as embarrassing by brother Agabani and hence defended by Dr. Ziauddin Ahmed, I would like to mention that these profits are likely to be in the nature of monopoly profits because other financial institutions are not allowed to compete by law. If these banks have assumed the character of monopoly then their profits do not give a good picture. Of course, if the monopoly is for the poor or in the greater interest of the community then it is a different issue. Such considerations need to be taken into account while evaluating the performance of Islamic banks.

Dr. Mahfooz Ali

First, one brief observation about the exhorbitant rate of profit in an interest-free banking system. The rate of profit must be high and this must be so by definition, because the system offers conditions for the auction of credit to the highest bidder and, given that, the rate of profit made in the interest-free banking system must, by definition, be higher than the one made under the interest-based banking system. Next Dr. Fahim Khan has made a very important central point. He has pointed out that if we are operating on a dual system of banking, a part of which is on interest-free basis and another part is based on interest-bearing operations, then the interest-free segment of banking is placed in a disadvantageous position to compete away the deposit from the other segment of the system which is functioning on the basis of interest. I think this a very vital point which Dr. Fahim Khan has made. The question arises as to what can we do to enable the interest-free banks which require a competitive edge over other banks which are operating on the basis of interest and this is to my mind the question to which Dr. Fahim Khan had tried to address himself. I would like to make the suggestion that perhaps it will do some good by eliminating first of all interest from the asset side. What, in Pakistan, we appear to be doing perhaps is that we are trying to eliminate interest from the liabilities side first. The question in that when you first eliminate interest from the liabilities side you face the problem of how to sustain the confidence of depositors, who have been accustomed to a guaranteed, predetermined return on the deposits. I would suggest that the interest be eliminated from the assets side first continuing with interest-bearing liabilities in the transitional phase. The result will be that when you eliminate interest from the assets side you create conditions in which the banking system will train itself with respect to the required managerial efficiency to improve the quality of advances and to create conditions in which the profitability will prevail. Side by side this will also enable them to sustain the confidence of depositors because you are continuing with the interest-bearing liabilities side. It will then be possible for you to switch over to interest-free basis on the liabilities side also without much difficulty. But if the solution adopted is just in reverse that first you eliminate interest from the liabilities side, then you are likely to run into the problem of how to motivate depositors to hold accounts with you.

Dr. Abidin Ahmed Salama

There is nothing wrong if the Islamic banks are making high profit because they have to face difficult times also. They can build up reserves in good times to face the bad times.

Dr. M. M. Metwally

It is no good saying that the Islamic Bank is a good bank because it makes a lot of profit. The idea is that you do not wish to replace interest or *riba* by higher profits because the whole idea about abolishing interest is not to exploit the borrower. What is the point of replacing one *riba* with another *riba*.

Dr. Ahmad Mohamad Ali

Brothers, I am sorry that we have very short time here and there are many points which have been raised. I am very much impressed by the general discussion that has taken place and I wish I could comment on a good number of these points. Unfortunately because of very short time, I am going to comment on two or three points. First of all, I discuss the service fee or the service charge on the loans which the bank gives to the member countries. We believe that this service fee is justified because the bank incur the expenses in this respect and it is not against the teachings of Islam. I do not think there is any doubt about that. The Islamic Development Bank in the beginning had a higher percentage of liquidity. They were not anxious at the beginning to get deposits. At the beginning the Bank was very reluctant to get any deposit but now the situation has changed and now the programme is to accept deposits from institutions, from governments and even from the individuals but we have a minimum which is equivalent to 250,000 dollars. We utilize this money in financing foreign trade between the member countries. Before six months they will not share any profits but if their deposits remain with the bank they would share the profits realized from the foreign trade financing. Now, I want to thank my brothers for their valuable papers, writings and contributions from the floor of this House. The discussions were very constructive and I am not saying this out of exaggeration but I am sure that it will serve a very useful purpose. The discussions were very important and valuable and it is important that you should continue these discussions. I thank you very much and I am also grateful for the hospitality of the people and the Government of Pakistan and thank His Excellency the President of the Islamic Republic of Pakistan for all the comforts that they have provided us.

Index

Publications of

INTERNATIONAL CENTRE FOR RESEARCH IN ISLAMIC ECONOMICS

King Abdul Aziz University, Jeddah

- ★ Contemporary Literature on Islamic Economics (M. N. Siddiqi)
- ★ Monetary and Fiscal Economics of Islam — An Outline of Some Major Subjects of Research (K. Ahmad [ed].)
- ★ Studies in Islamic Economics (K. Ahmad [ed].)
- ★ Rationale of Islamic Banking (M. N. Siddiqi)
- ★ A Behavioural Model of an Islamic Firm (M. M. Metawally)
- ★ Interest Rate and Intemporal Efficiency in an Islamic Economy: Issue Revisited (M. A. Chawdhury)
- ★ A Survey of Issues and a Programme for Research in Monetary and Fiscal Economics of Islam (M. Iqbal & F. Khan)
- ★ Institutional Settings of Islamic Economic Order (M. A. Mannan)
- ★ Muslim Economic Thinking (M. N. Siddiqi)
- ★ Scarcity, Choice and Opportunity Cost: Their Dimensions in Islamic Perspectives (M. A. Mannan)
- ★ Islamic Perspectives on Market Prices and Allocation . . . (M. A. Mannan)
- ★ Why is Islamic Economics Important (M. A. Mannan)
- ★ Recent Works on History of Economic Thought in Islam — A Survey (M. N. Siddiqi)

Publications of

INSTITUTE OF POLICY STUDIES

ISLAMABAD

- ★ Towards Monetary and Fiscal System of Islam (K. Ahmad)
- ★ Afghanistan Crisis: Implications and Options for Muslim World, Iran, and Pakistan (Tahir Amin)
- ★ Development Strategy for the Sixth Plan 1983-88
- ★ Pakistan's Energy Policy: Towards a New Strategy ([illegible])
- ★ Pakistan's Economic Challenge and the [illegible]
- ★ Muslim Women and Higher Education [illegible]
- ★ Muslim's Resistance in Central Asia [illegible]
- ★ Budget 1980-81 — Need for a New Str[illegible]
- ★ Planning Curricula for Natural Sciences [illegible]