Islamic Money and Banking
and
its Global Practice

University of Airlangga
Surabaya, Indonesia

May 14, 2011

Dr. Iraj Toutounchian
Professor (Emeritus) of Economics
Az-Zahra University
and
Tehran University
Let me start my talk with the following Holy Verse:

If the truth had been in accord with their desires, truly the heavens and the earth, and all beings therein would have been in confusion and corruption

Qur’an (23: 71).

A Review of Some Economic Principles and Facts:

1-Economics is based on property rights.
2-Property rights of any economic system emerge from its underlying ideology.
3-The hallmark of a metaphysical proposition [of an ideology] is that it is not capable of being tested; (Joan Robinson).
4-Any economic system requires a set of rules, an ideology to justify them, and a conscience in the individual which makes him strive to carry them out; (Joan Robinson).
5-A society cannot exist unless its members have common feelings about what is the proper way of conducting its affairs, and these common feelings are expressed in ideology; (Joan Robinson).
6-...without ideology we would never have thought of the question; (Joan Robinson).
7-...social life is impossible unless the pursuit of self-interest is mitigated by respect and compassion for others; (Joan Robinson).
8-The happiness of society depends on virtue; (Dr. Johnson).
9-...it is not possible to describe [an economic system] without moral judgments creeping in; (Joan Robinson).
10-The most powerful force in the universe is compound interest; (Albert Einstein).
11-The most powerful destructive force in the universe is compound interest; it is a weapon of mass destruction; (I. Toutounchian).
12-Out of every 100 Marks an average German family spends 1/3 goes to interest.
13-Economics is haunted by more fallacies than any other study known to man;(Hazlitt).

14-The purpose of studying economics is not to acquire a set of ready-made answers to economic questions, but to learn how to avoid being deceived by economists; (Joan Robinson).
15-Pareto optimality has little to say about the “correct” allocation of resources and says nothing about equity (justice).
16-We have, so far, recognized three economic systems; namely, Capitalism, Communism, and Islamic. Each of which is based on its own ideology.
17-Capitalism is based on individualism and self-interest, communism is based on social interest to the neglect of self-interest. While respecting both self and social interests in an Islamic economic system, social interest comes first and before self-interest, in decision making processes.
18-...the fundamental circumstances of justice, those features of the human situation that give rise to co-operation, are awareness of externalities in our environment, and awareness of self-bias in our character; (Gauthier).

19-Justice is beyond value; it is the most precious “public good” ever known to mankind.

20-Justice in a simple language might be something along the lines of “do as you would be done by”---treating others in the same manner as we expect to be treated by them.

21-Justice means equality only between equals. Equal treatment of unequals is injustice (Zulm).

22-...The sole purpose of Halal and Haram is to serve justice; (B. Sadre).

23-...the greed that knows no limit...is the very opposite of justice; (Gorringe).

24-The circumstances of justice may be described as the normal conditions under which co-operation is both possible and necessary; (J. Rawls).
25-...society is a real compound like the natural compound. But the synthesis is of minds and thoughts and of wills and wishes...Society conceived as a single physical unity is only a hypothesized abstraction; (M. Mutahhari).

26-The classical economists did not treat society as a co-operative...(Joan Robinson).

27-Pareto efficiency assumes that: there is no ‘society’ above and beyond individuals. So, in making value-judgments, we should only be interested in the welfare of individuals and nothing else.

28-Divine Rules have veto power. This power stems from the generality of the Divine Rules over the particularity of wisdom.

29-Divine rules are ignored in both capitalism communism but are an integral part of Islamic economic system.

30-The ultimate goal of an Islamic Economic system is to maintain justice.

31-Justice will be found from within the chains of causes of Islamic verdicts [Ahkam]; (B. Sadre).

32-Co-operation between and among real and legal entities, at all levels of societal echelon, transforms the zero-sum game of capitalism to an increasing-sum game of a Grand Co-operative Islamic Economic System.
Where the invisible hand fails to direct each person, mindful only for her own gain, to promote the benefit of all, co-operation provides a visible hand... Co-operation [is] the rational response to market failure; (Gauthier).

Co-operation in all activities, a long neglected catalyst in economic system, is a good example of large externality whose product, as a whole, goes beyond simple addition of countless actions.

Co-operation at all levels of economic activities bring about both integrated markets and optimal solution to economic problems due to justice maintenance.

The object of rational cooperative choice must be an optimal outcome....In non-cooperative interaction the core rationality property is equilibrium, whereas in cooperative interaction the core rationality property is optimality. (Gauthier)

Mutual unconcern in segmented markets of capitalism is not capable either to maintain stable equilibrium nor to reach justice.
38-There are more than sufficient rules, regulations and guidelines in Quran and Sunnah in constructing Islamic economic system.

39-Islamic economics can be defined as a “Grand Co-operative Economic System”. Such a system is full of Shariah-compliant positive externalities; negative externalities, as envisaged in Shariah, have to be avoided.

40-Profit maximization which is equivalent to cost minimization cannot be the goal of a firm in Islamic economic system.

41-Man is the main objective of Islamic economic system in that he has to be treated justly.

42-Man, as labor force, in an Islamic economic system has different options to play his role in the production function in the form of either wages, part of the revenue, part of the profit, or any other contracts which are in compliant with Shariah. This puts man (labor force) in a place different from other factors of production.
B-On Riba (interest) and its adverse effects on economic system:

1-Interest (Riba) borrows its origin from economic ideology. Any attempt to prove its existence/necessity or refute by using economic analysis is futile; so is the case of wage and rent.

2-It is a common error to assume interest as being reward to capital. Interest is return to money and profit return to capital, respectively.

3-Capital, in capitalism, is artificially kept scarce due to nominal rate of interest being positive; (Keynes).

4-Interest does not allow both stable prices and full employment to be maintained simultaneously.

5-Interest and its immediate derivative, speculation, does not allow transformation of money to capital to take place.

6-Interest is both necessary and sufficient for speculative activities.

7-...for every durable commodity we have a rate of interest in terms of itself,---a wheat rate of interest, a copper rate of interest, a house rate of interest, even a steel-plant rate of interest; (Keynes).

8-Zero nominal rates of interest are necessary condition for efficient resource allocation; (Friedman). Zero nominal rates of interest are not only necessary but sufficient for efficient resource allocation; (Chocheerlakota et al).

9-All commodities are subject to depreciation, but money, representing them is not only exempt from this general rule but also appreciates exponentially by the factor of interest rate.
C-General peculiarities of an Islamic Banking/Finance (A Simple Illustration):

---------------------------------------------------------------

1- Abolition of Riba (interest) will make it plausible to make use of different Islamic contracts. The diversity of these contracts match different needs of different entities; real or legal. Musharakah Contract plays the central role in Islamic Banking/Finance.

2- Depositors become quasi-share holders of an Islamic bank in that they share part of the profit (or loss) of the bank.

3- Clients or firms seeking for finance become partners of Islamic bank.

4- Islamic bank plays dual role: one as the advocate of depositors and the second one as the partner of firms.
5-In the conventional system changes in money are expected to bring about changes output and employment, via changes in the rate of interest, have rarely been successful. In an Islamic economic system, unlike capitalism, the availability of factors of production is the main cause of changes in the supply of money. This will make money an endogenously-determined variable in an Islamic economic system as opposed to money being exogenous in capitalism.

Symbolically:

Exogenous Money $\Delta M \rightarrow \Delta Q$ Capitalistic system

Endogenous Money $\Delta Q \rightarrow \Delta M$ Islamic economic system

6-Despite ambiguities that have long existed about distinction between money and capital among Western economists, it is herewith proposed that: As soon as money (i.e. potential capital) is legally combined with other factors of production it changes to actual capital:

$$M \otimes L \rightarrow \text{Actual Capital}$$

(example: Mudarabah Contract)

7-Money and/or debt market will disappear due to abolition of interest.

8-The transformation of potential capital, (M), to actual capital, (K), takes place in Islamic Banks which operate as Finance Houses as opposed to the conventional system in which banks are fund-intermediaries, i.e., Loan Houses.

8-1 The faster the rate of transformation of potential capital (M) to actual capital (K) the faster the rate of economic growth.

8-2 Islamic banks are there to do this transformation.

8-3 Conventional banks are not designed to do such transformation.

8-4 Any speculative activity hinders such transformation to take place.
9-Zero rate of interest does not imply that Qarad-ul-Hassan is the solution for all economic activities.

10-There are Shariah Compliant contracts that seem to be sufficient instruments to finance needs of both individuals and firms. To be able to properly launch these contracts requires different skills to advise finance seekers as opposed to the conventional system where valuable collateral makes it easy to grant loan.

11-To substitute Islamic Contracts for interest-based loans in the conventional system will change the character and nature of the banks from monetary institutions to financial institutions. They, in turn, change the legal character of money to that of capital and hence making it eligible to claim profit.
D-THE ADVERSE IMPACT OF HOARDING ON THE ECONOMY:

According to Wicksell: \[ S + \Delta M + DH = I \]

\[ H \equiv \text{Hoarding} \equiv \text{Liquidity preference} \equiv \text{speculation}; \]

\[ DH = \text{Dishoarding} = -H; \] If \( H > 0 \) \( \Rightarrow \Delta M = 0 \rightarrow S > I \rightarrow \text{unemployment} \)

Historical evidence: more than \( 1/3 \) of savings in USA goes to the money whirlpool and less than \( 2/3 \) goes to investment.
D-1-UNIDENTIFIED SUPPLY OF MONEY

• The investigation results obtained from the two appointed independent committees in US and UK show: due to problems faced as the result of speculative activities in the money market [money whirlpool], the supply of money cannot be defined. Further, if money is indefinable or includes a broad category of “assets” then monetary policy is impossible.

• According to R. S. Sayers, one of the committee members: “The difficulty of identification has derived from the two-fold nature of money [in capitalism]... as a medium of exchange and as a store of value [being synonymous with hoarding and speculation].”

. To most western economists, the concept of efficiency is based on Paretian value judgments which assume that: there is no “society” above and beyond the individuals. Thus one should be interested only in the welfare of individuals and nothing else.

This is an evidence for the fallacy of composition.

. Pareto optimality says nothing about justice.

. Nath: Pareto optimality is not necessarily superior to any non-optimum.
D-2 Pillars of Islamic economics:

Ultimate Goal

Interaction between and among pillars give rise to increasing-sum game in an Islamic Economic System.
Muslims feel bound to adhere to Islamic rules and injunctions because such rules, if carefully observed, are for their own well-being and benefits, whether they are able to understand and analyze them or not.

**D-3: General Remarks:**

1- To most western economists, the concept of efficiency is based on Paretian value judgments which assume that: there is no “society” above and beyond the individuals. Thus one should be interested only in the welfare of individuals and nothing else. This is an evidence for the fallacy of composition.

2-Pareto optimality says nothing about justice.

3-Pareto optimality is not necessarily superior to any non-optimum; (Nath).

4-In an Islamic Banking system the monetary policy tools of the conventional system become useless. The only powerful financial policy tool would be the profit ratio between Islamic bank (the financier) and the firm (the financee). This is not a “rate” to be considered as cost. This ratio should be treated as dividend to stocks.

5-Required Reserve Ratio (RRR) can be safely reduced down to zero without worrying about inflation due to money supply being an endogenous variable as opposed to it being exogenous in the conventional banking.

6-Money having been treated as an endogenously-determined variable can be increased as long as there are enough factors of production available.
7- INTEGRATED MARKETS VS SEGMENTED MARKETS

We, here, have attempted to avoid Neoclassical-Keynesian system to be dichotomized into independent real and monetary subsets. It is not, says Davidson, correct to separate monetary economics as has often been done. Hence, integrating money in Capital theory as envisaged with many more important and challenging issues throughout the discussions made in my recent book:”Islamic Money and Banking: Integrating Money in Capital Theory’; John Wiley & Sons; 2009.

Finally: If Islamic Banking is fully and successfully implemented, with no money market and absence of any speculative activities, we should observe:
(a) Stable price level.
(b) Full employment
(c) Equitable distribution of income and wealth
(d) Sustained economic growth
(e) No business cycle.

All above results mean a better place to live. This is the message of Islam for all; believers and non-believers.