A Summary of
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'TOWARDS A JUST MONETARY SYSTEM'

Introduction: The Perspective

The world economy is plagued by numerous problems: inflation, recessions, unemployment, high interest rates, unhealthy exchange rate fluctuations, extreme poverty, inequality, large balance of payments deficits and staggering debts. Effective indigenous solutions must analyse the root causes of the crises rather than its symptoms, something very much lacking in the Muslim world. Moral degeneration and consumerism displace focus on human needs and equitable distribution. Unfortunately, the contemporary banking system has mainly exacerbated these problems and created more instability. Meaningful solutions can only succeed by focusing on reforming human beings who will then remove the sources of the crisis. In addition, a healthy economic system requires a reformed banking system that must eschew excesses and inequality and instead, contribute to achieving growth, equity, and socio-economic well-being for all humanity. Islam is able to provide the blueprint for a just and workable solution for mankind. Its holistic approach to reform gives it an advantage in achieving sustainable welfare and socio-economic justice. The abolition of *ribā* (interest)- which is one of these reforms- is the starting point to a comprehensive reform agenda to achieve the socio-economic goals of Islam.

Chapter 1 – The Goals and Strategy

A successful reform agenda must incorporate two indispensable ingredients: goals and strategy. Some of the most important goals and functions of the Islamic money and banking system are: first, broad-based economic well-being, full employment and optimum economic growth; second, socio-economic justice and equitable distribution of income and wealth; third, stability in the value of money as the medium of exchange, unit of account, standard of deferred payments and a stable store of value; fourth, mobilisation and investment of savings for equitable economic development and return; fifth, effective rendering of all services normally expected from the banking system.

Central to the Islamic strategy for realising these goals are the integration of spiritual and moral aspects in all supposedly mundane aspects of life. Secondly, developing and implementing comprehensive, workable blueprint to actualise these goals. The third important ingredient of the Islamic strategy is the complimentary role of the state, to provide a healthy balance to individual freedom and the market- neither tilting to capitalism nor Marxism (communism). The money and banking system must also be reorganised and reformed to support the desired moral transformation, socio-economic regeneration, and political reform. Among elements of money and banking reforms are abolition of *ribā* and promotion of profit-and-loss sharing. Other elements must be designed by the Muslim countries depending on their circumstances and their relative position on the path of goal actualisation.

Chapter 2 – The Nature of *Ribā*

Socio-economic justice, one of the most indispensable characteristics of an ideal Muslim society, is required to be a way of life. To establish justice and eliminate exploitation in business transactions Islam requires the prohibition of all sources of 'unjustified' enrichment. One of the important sources of unjustified earning is receiving any monetary advantage in a business transaction without giving a just counter value such as in the case of *Ribā*, which is strictly prohibited in Islam. *Ribā* literally means increase, addition, expansion, or growth. Technically, it refers to the 'premium' that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or for an extension in its maturity. The term is used in two senses: *ribā al-nasī'ah* and *ribā al-fadl.*

Ribā al-nasī'ah comes from the root *nasa'a* (نسا) which means to postpone, defer, or wait, and refers to the time that is allowed for the borrower to repay the loan in return for the 'addition' or the 'premium'. Hence it refers to the interest on loans. The prohibition of *ribā al-nasī'ah* essentially implies that the fixing in advance of a positive return on a loan as a reward for waiting is not permitted by the *Sharī'ah*.

Islam, however, wishes to eliminate not merely the exploitation that is intrinsic in the institution of interest, but also that which is inherent in all forms of dishonest and unjust exchanges in business transactions. These are also encompassed by the generic term of *ribā al-fadl*, which is encountered in hand-to-hand purchase and sale of commodities. It covers all spot transactions involving cash payment on the one hand and immediate delivery of the commodity on the other. What is essentially being required is justice and fair play in spot transactions; the price and the counter value should be just in all transactions where cash payment (irrespective of what constitutes money) is made by one party and the commodity or service is delivered reciprocally by the other. Anything that is received as 'extra' by one of the two parties to the transaction is *ribā al-fadl*.

Chapter 3 – The Alternative

It is indispensable to bring about a pooling of resources for the production and distribution of goods and services to fulfil the needs of society. This must be organised within a just and either altruistic or mutually profitable manner. How can such pooling of resources be arranged if interest is abolished? The alternative must be arranged within the framework of two principles. Firstly, Islam recognises a legitimate role for the private sector and individual freedom with constraints based on the supremacy of moral values and socio-economic justice. Secondly, Islam does recognise the role of capital as a factor of production. However, it prohibits a predetermined positive rate of return in the form of interest. Islam requires profit-and-loss sharing in an equitable manner.

Within this framework, there are only two alternatives to interest-based lending: *qard hasan* and equity financing. *Qard hasan* is an altruistic loan which is returned at the end of the agreed period without any interest or share in the profit or loss of the business. Equity-financing is where the financier shares in the profit or loss of the business financed. It may have to be for either an indefinite period, as it is in the case of stocks of joint stock companies or shares in partnerships, or a definite (short, medium, or long) period as it is in the case of borrowed capital (loans, advances, bonds, and debentures). Aside from sharing the returns on investments, equity financing would require both financiers and entrepreneurs to share ownership, control, and risks of a business.

The channels that equity investment may take in an Islamic society are sole proprietorship, partnership including both *mudārabah* and *shirkah* (or a combination of sole proprietorship and partnership) and joint stock company. 'Cooperation' can also play an important role in an Islamic economy because of its harmony with the value system of Islam. Based on historical experience, all financial resources were initially mobilised based on either interest or *muqāradah* and *shirkah*. Islam, however, abolished the interest and organised the entire production and trade on the bases of *mudārabah* and *shirkah*. With the abolition of interest, economic activity in the Muslim world did not suffer any decline, rather there was increased prosperity.

Chapter 4 – Some Fundamental Reforms

It is not possible to establish an equity-based *ribā*-free economy and to realise Islamic objectives without a proper enabling environment. While the abolition of *ribā* is necessary, it would not be sufficient because it is not the only value which Islam stands for. The most important characteristics of an ideal Islamic environment are individual and social character, brotherhood, and justice. All Islamic values and institutions need to be revived for their realization. The systems of *zakāt* and '*ushr*, along with other relevant institutions, need to be revived to reinforce Islamic solidarity and a mutual support system. Additional reforms in saving and investing, increased equity financing, reducing the power of banks and having a sane stock market are also required.

The money and banking system must be organized and regulated to curb wasteful spending and mobilise savings by channelling them into socially productive uses. Measures should be adopted to reduce the power of banks. Since the deposits used by banks belong to the society, the power to create money should be considered a social prerogative and, therefore, the net income from money creation should be used for general welfare and particularly for the poor. The principle of avoiding wasteful expenditure and using resources efficiently also applies to the government. The criterion for undertaking any government expenditure should be that the total sacrifice made by the society in providing the resources is fully offset by the positive contribution to general social welfare and the realisation of the socio-economic goals of Islam.

All businesses in Muslim countries would have to become primarily equity based. A greater resort to equity financing will necessitate a more efficient organisation of both primary and secondary capital markets to enable businesses to raise funds. One key purpose would be to stabilize stock prices and dividends to inspire investors' confidence. The abolition of *ribā* coupled with cash stock purchases and transparency in the stock market, is instrumental in reducing instability and harm to the public.

Chapter 5 – Objections and Rationale

Objections against the *ribā*-free economy and rationale behind the prohibition of *ribā* must be properly understood. Firstly, it is criticised that an interest-free economy will not bring about optimum allocation of resources. There will also be little positive private sector saving and capital formation in an Islamic economy; featuring a wholly equity-based system that is highly unstable. These allegations use baseless assumptions; hence, invalid. Allocation of resources would be more efficient and equitable in an Islamic economy given the positive influence on saving and capital formation owing to justice and balance between entrepreneurs' and financiers' rights. The basic ingredients for sustained growth which are saving, investment, hard and conscientious work, technological progress, and creative management are all well promoted too.

Secondly, the *ribā*-free economy is argued to discourage savers because of possible losses on deposits associated with profit-and-loss-sharing banking. There is no doubt that the banks would suffer losses on some of their *mudārabah* investments, but that would be offset by profits on most other investments and under normal circumstances, the banks would be making a net profit. Actually, several measures could be adopted to reassure the depositors. Other than deposit insurance and loss-offsetting reserves, 'moral risk' of *mudārabah* investments can be minimised with a 'guarantee scheme' while 'business risk' can be mitigated by ensuring the soundness of a venture, proper 'scenario planning' and diversifying *mudārabah* portfolios.

Another objection is the claim that short-term loans would cease to exist since it is not possible to have any profit-sharing arrangement because of the difficulty in determining profit for such short periods. Since the risk of non-payment is associated even with such loans, it is argued, such short-term loans may not be forthcoming in an Islamic system. Most financing of a very short-term nature would hence have to be made part of the overall *mudārabah* or *shirkah* agreement to the mutual satisfaction of both the borrower and the lender. The cooperative movement could also play an important role in providing solutions for the very short-term financial stringencies of businesses.

A further problem pointed out relates to consumer credit and loans for big projects such as house construction. However, there should be no instalment finance credit in an Islamic society for consumer goods purchases which are unnecessary, or which do not make any difference in the 'real' well-being of people. Financing of other essential welfare-oriented durable consumer goods purchases would involve proper cash-flow planning and the raising of sufficient equity capital. If the profit element is not attractive and instalment sale of certain goods is still considered necessary on socio-economic grounds, specialised credit institutions and the government would have to come in.

The final objection concerns government borrowing needs as with no interest mechanism, the government could not finance its budgetary deficits. The Islamic response is that finance for normal recurring expenditures and projects would ideally be limited to tax revenues. Whereas non-recurring ones that are amenable to pricing and profit-sharing should be examined carefully and undertaken only if they are viable on a commercial basis and could realize the socio-economic goals. In the event that deficits are strongly justified, equity or lease financing and *awqāf* (charitable trusts); or even compulsory lending from commercial banks and the central bank, would be possible.

Chapter 6 – Institutional Setting

The following network of institutions are needed in achieving the socio-economic objectives of the Islamic society; the central bank, the commercial banks, non-bank financial institutions (NBFIs), specialised credit institutions, deposit insurance corporation (DIC), and investment audit corporation. Despite the apparent similarity with the capitalist framework, the objectives, mechanics, powers and the scope and responsibilities of these institutions would be entirely different. Like all central banks, the Islamic central bank should be responsible for the issue of currency, being the banker to the government, implement appropriate monetary policy, facilitate clearance and settlement of cheques and transfers, guide, supervise and regulate financial institutions, as well as being the lender of last resort to financial institutions. Nevertheless, the role of supervision and examination of financial institutions is more important in an Islamic system because of the greater risk that the banks would be shouldering in their business. Unlike the conventional central banks, it should also bear the responsibility of foreclosing the possibility of concentration of wealth and power in the hands of vested interests through the financial institutions and stabilising the real value of money to actualise sustained growth and to ensure socio-economic justice.

In addition to the abolition of *ribā*, the nature, outlook and operations of commercial banks would have to undergo a complete transformation. Since the activity of commercial banks is based primarily on the use of public funds, it is essential that public interest rather than individual or group interest be served by Islamic commercial banks. The creation of deposits by commercial banks, may be recognised in the Islamic system provided that (a) appropriate measures are taken to ensure that the creation of derivative deposits is in accordance with the non-inflationary financing needs of the economy, and (b) that the 'seigniorage' realised from derivative deposits benefits society as a whole.

A substantial part of commercial banks resources should come out of equity capital. They can mobilise funds through demand as well as *mudārabah* (savings, time and fixed) deposits. Demand deposits may, like their counterpart in the conventional system, be withdrawn on demand, be fully insured, and earn no return. Absence of return on demand deposits may help induce savers to get into equity and *mudārabah* deposits, thus increasing the availability of venture capital to businesses. *Mudārabah* deposits will, like equity, share in the profits and losses, if any, of the bank. In terms of financing, the most important and unanimously agreed upon form would be based on either *mudārabah*, *shirkah* or acquisition of shares of joint stock companies. Other forms of financing could include lease finance, an Islamic alternative to investment auctioning, or *Bay 'al-Mu'ajjal and Bay'al-Murābahah* (although it is advised that the latter not to be used widely or indiscriminately).

The other component of the institutional setting, non-bank financial institutions (NBFIs), represent investment trusts or banks, credit unions, cooperative societies, venture capitalists, and a range of other investment-management institutions. They too would mobilise funds through equity and *mudārabah* deposits and make them available to prospective investors. Since banks and NBFIs would be operating primarily on a profit-and-loss-sharing framework, they would tend to be more attracted by profit and would thus be more disposed to hunt for talent, innovation and promise rather than just collateral. They would have to make a more careful evaluation of applications for equity-oriented financing, and this would foster closer relations between banks and entrepreneurs. On the other hand, some sectors of the economy like small agriculturists, cottage industries' operators, artisans, and taxi and truck drivers, who may need to be encouraged and supported by credit availability, may be deprived from the services of banks and NBFIs. For this purpose, specialised credit institutions should be established by the government to extend either *mudārabah* advances or *qurūd hasanah to this groups*.

Additionally, a Deposit Insurance Corporation (DIC) should be established to insure demand deposits and help remove any adverse apprehensions and build confidence in the Islamic banks. The corporation should not, however, insure *mudārabah* deposits at either the commercial banks or the NBFIs. Another government-sponsored organisation, the Investment Audit Corporation (IAC) should be constituted with the objective of auditing the accounts of *mudāribs* who have obtained funds from commercial banks and NBFIs, whether in the form of equity or *mudārabah* advances. The objective is to safeguard the interest of financial institutions, depositors, and equity holders.

Chapter 7 – Monetary Policy

Given the abolition of interest and non-availability of discount rate and open-market operations in interest-bearing government securities, some questions naturally arise: What will be the mechanism to equate money demand and supply; how to make monetary policy effective in achieving the goals of an Islamic economy; and what will be the alternative to finance government budgetary deficits in a non-inflationary framework?

The strategy in an Islamic economy is that the demand for money arises from the transactions and precautionary needs which are determined largely by the level of money income and its distribution. The abolition of interest and the levy of *zakāt* would not only minimise the speculative demand for money and reduce the 'locking-in' effect of interest rates, but also impart greater stability to the total demand for money.

The monetary policy should be geared to generate money supply stock which is adequate to finance the potential growth in output within the framework of stable prices and other socio-economic goals of Islam. It is important to monitor the three major sources of monetary expansion: financing of government budgetary deficits by borrowing from the central bank, expansion of deposits through commercial bank credit creation, and 'monetisation' of the balance of payments surplus.

Within the framework of the strategy indicated above, it may be possible to suggest the instruments for monetary policy which may not only help regulate money supply in harmony with real money demand but also help fulfil the need for financing the government's 'genuine' deficits. The mechanics consist of six elements namely, target growth in M and M0, public share of demand deposits, statutory reserve requirement, credit ceilings, value-oriented allocation of credit and other techniques.

The non-availability of some of the traditional instruments of monetary policy should therefore 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 the cooperation between the central bank and the government is essential. 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 should be made by the central bank using the instruments at its disposal.

Chapter 8 – Evaluation

The Islamic value framework concentrates on transforming the individual and society. Islamic teachings ensure better resource usage, which would reduce inflationary pressures and create stable economic growth that promotes 'real' general well-being. The hope of getting a just reward for savings would induce the saver to invest his savings within the profit-and-loss-sharing framework. Since the banks and other financiers would be sharing in the risk, their stake in the ultimate outcome of business would substantially reduce speculative financing.

Better monetary health would prevail as profit-sharing ratios would not change erratically. The profit-sharing framework would ensure greater availability of risk and venture capital and greater participation in the evaluation of business projects by financial institutions. The instability introduced in exchange rates by interest rate fluctuations would also be reduced, creating a better climate for business planning and forecasting. The ability of the government to obtain funds without the high cost of interest would also introduce discipline in government spending along with the imperative that these be invested in projects of high social priority to help promote general social welfare. Overall, in addition to minimising unjustified enrichment and reducing inequalities, the Islamic system would perform better on several other planes, including resource allocation, savings and capital formation, economic efficiency and growth, and stability.

Chapter 9 – The Transition

Due to the centuries of degeneration, the Muslim ummah requires a complete transformation but which cannot be achieved merely by making some cosmetic changes in a few sectors of the society or the economy. It requires the revival of values, an improvement in the quality of the Muslim as a person and a reform of all aspects of the Muslim society, economy, government, and polity. This cannot be achieved in a short period but gradually over time. The family and the mosque should be enabled to play their indispensable role as character-building institutions. The systems of *zakāt* and *'ushr* need to be revived to reinforce Islamic solidarity. The spending and saving behaviour of people need to be brought into conformity with Islamic teachings. Many other needed reforms should also be introduced in the different fields of Muslim society, economy, and polity to eliminate corruption and exploitation and enforce justice and fair play.

The establishment of the Islamic money and banking system and the necessary reforms to the banking system need not, however, wait until a morally conscious ideal Muslim society has been brought into existence. The transition should be in gradual stages and must be accompanied by other reforms in the society. A number of steps need to be taken along with the socio-economic reform of the Muslim society to transform the conventional money and banking system. These steps include abolishing interest (with a grace period given), gradual increase of equity/loan ratio, reform of the tax system, reorganisation of the stock market along non-speculative Islamic lines, conversion of public sector projects that are amenable to commercial pricing to a profit and loss basis, gradual conversion of all interest based financial institutions to more desirable investment forms of *mudārabah*, *shirkah* and stocks and shares, the establishment of a number of auxiliary financial institutions such as investment trusts or banks, credit unions, cooperative societies, venture capitalists as well as specialised credit institutions, the Investment Audit Corporation, and the Deposit Insurance Corporation.

The major obstacle to the Islamisation process will however be the burdensome interest-bearing domestic and foreign debt of most Muslim countries. This requires sincere commitment on the part of the government and sacrifice and cooperation from the people.