

The Case Against Interest: Is It Compelling?

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1. Introduction

Four of the world's major religions (Judaism, Christianity, Hinduism and Islam), having a following of more than two-thirds of the world's population, have prohibited interest.¹ In sharp contrast with this prohibition, the entire international financial system is now based on interest and has been so for more than two hundred years. However, protests have been, and continue to be, made against interest.² These protests have been particularly prominent in the Muslim world where an effort is underway to replace the interest-based system of financial intermediation with the Islamic system.

The introduction of a new model of financial intermediation based on profit-and-loss sharing (PLS) is not an easy task. The difficulties involved in the changeover justifiably raise the question of why should we try to replace the conventional system which has been in existence for such a long time and has by now become highly sophisticated. Is the case against interest compelling and is there a strong rationale behind the transition? One reason for the change is the imperative of abiding by a religious value. This reason, though of prime importance to committed Muslims, may not have any appeal for those who are not so highly committed. It is, therefore, necessary to show that the interest-free financial system is superior to the interest-based system

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on the basis of both efficiency and equity, the two criteria on the basis of which any economic or financial system needs to be evaluated.

The interest-based system was always assumed to be inferior to the interest-free system on the criterion of equity or socio-economic justice. It was, however, considered to be superior on the criterion of efficiency. The persistent instability and crises to which the international financial system has become exposed over the last few decades and the problems that this has created have raised doubts about its superiority on the efficiency criterion. This paper is an attempt to discuss the primary cause of the crises and to show the contribution that the prohibition of interest can make towards greater financial stability as well as socio-economic justice.

2. The Financial Crises

The efficiency argument in favour of the conventional interest-based system of financial intermediation has been substantially weakened by the crises it has experienced over the last few decades.³ There is not a single geographical area or major country which has been spared the effect of these crises. Hence there is an uneasy feeling that there is something basically wrong somewhere. This has led to a call for comprehensive reform of the financial system to help prevent the outbreak and spread of financial crises or, at least, minimize their frequency and severity. The needed reform has come to be labelled 'the new architecture'.

There is perhaps no one who has challenged this call for a new architecture for the financial system. However, as Andrew Crockett, General Manager of the Bank for International Settlements and Chairman of the newly created Financial Stability Forum, has rightly pointed out: "a grand new design for the international financial system has still to be devised" (Crockett, March 2000, p.13). What could be the reason for the inability to prepare a convincing reform program in spite of so much investment in terms of time and effort? Could it be the failure to determine the ultimate cause of the crises?

3. The Roots of the Crises

A number of economists have made an effort to determine the causes of the crises. Some consider financial liberalization to be the cause in an environment where financial systems of many countries are not sound as a result of improper regulation and supervision (Glick, 1998; Bisignano, 1998).

Others feel that the ultimate cause is the bursting of the speculative bubble in asset prices driven initially by the excesses of financial intermediaries (Krugman, 1998). It has also been argued that the root cause of the crises was the maturity mismatch: short-term international liabilities were far greater than short-term assets (Chang and Velasco, 1998; and Radelet and Sachs, 1998). The available literature indicates a number of other causes as well.

Even though all these factors had some role to play in the crises, no consensus seems to have developed so far in pinpointing the ultimate cause or the cause of all causes. In the absence of a proper understanding of the ultimate cause, conflicting remedies have been proposed. This makes it difficult to lay down an effective reform programme. Hence the proposals for the new architecture have been unable to step beyond the basic principles of conventional wisdom which emphasize sound macroeconomic policies along with sustainable exchange rates, proper regulation and supervision, and greater transparency (for these principles, see Camdessus, 2000, pp.1 and 7-10). These principles are undoubtedly indispensable because, in the last analysis, all crises have their roots in unhealthy fiscal, monetary and exchange rate policies. Hence, no one has ever denied the need for their honest implementation. Nevertheless, these principles have been, and continue to be violated.

The violation of these principles brings to mind a number of questions. The first is about what is it that enables the continuation of macroeconomic imbalances, unsustainable exchange rates, and unhealthy financial practices over a prolonged period. One would expect that market discipline would normally be able to ensure the honest and effective implementation of these principles. However, the persistence of the crises suggests that either the market discipline does not exist or it is ineffective in preventing the continued rise in macroeconomic imbalances in the public sector and living beyond means in the private sector, such that it becomes possible to have excessive leverage and to blow the speculative bubble to the point of bursting.

A second related question is about why some of the countries that have followed sound fiscal and monetary policies have also faced crises. The ERM crisis of the early 1990s challenges the view that foreign exchange market crises stem from undisciplined fiscal and monetary policies. Many of the countries caught up in the crisis did not have overly expansionary policies (IMF, May 1999, p.67). Even the East Asian countries do not convincingly fit into the mould of unhealthy macroeconomic policies.

A third but equally important question is about why some of the apparently well-regulated financial systems like those of United States and the

United Kingdom have also faced crises and whether greater regulation, supervision and transparency will by itself help avoid the crises.

4. The Inadequate Market Discipline: Is This The Ultimate Cause?

It may not be possible to answer these questions without looking at the underlying reason for the failure to implement the basic principles of the new architecture in spite of their being a part of conventional wisdom. The primary cause in our view is the inadequate market discipline in the conventional financial system. Instead of making the depositors and the bankers share in the risks of business, it assures them of the repayment of their deposits or loans with interest. This makes the depositors take little interest in the soundness of the financial institution. It also makes the banks rely on the crutches of the collateral to extend financing for practically any purpose, including speculation. The collateral cannot, however, be a substitute for a more careful evaluation of the project financed. This is because the value of the collateral can itself be impaired by the same factors that diminish the ability of the borrower to repay the loan. The ability of the market to impose the required discipline thus gets impaired and leads to an unhealthy expansion in the overall volume of credit, to excessive leverage, and to living beyond means. This tendency of the system gets further reinforced by the bias of the tax system in favour of debt-financing – dividends are subject to taxation while interest payments are allowed to be treated as a tax deductible expense.

The system's inadequate market discipline is, however, not something new. It has existed all along with the development and spread of the conventional financial system. Then, why, one may ask, has there been greater volatility in the last two decades compared with what prevailed before? What has created the difference is the rise in the volume of funds as a result of rapid economic development after the Second World War, the revolution in information and communications technology, and the liberalization of foreign exchange markets. These developments are, however, a manifestation of human progress and cannot be blamed for the crises. When the volume of funds was small and there were also controls on their free movement, inadequate market discipline was not able to create havoc. However, now the position is different.

Therefore, instead of blaming the new developments, it would be more appropriate to examine carefully the fault line in the international financial system resulting from the lack of adequate market discipline because of the

absence of explicit risk-sharing. It is this fault line which makes it possible for the financier to lend excessively and also to move funds rapidly from place to place at the slightest change in the economic environment. A high degree of volatility thus gets injected into interest rates and asset prices. This generates uncertainty in the investment market, which in turn discourages capital formation and leads to misallocation of resources (BIS, *Annual Report*, 1982, p. 3). It also drives the borrowers and lenders alike from the long end of the debt market to the shorter end. Consequently, there is a steep rise in highly-leveraged short-term debt, which has accentuated economic and financial instability. The IMF has acknowledged this fact in its May 1998 *World Economic Outlook* by stating that countries with high levels of short-term debt are “likely to be particularly vulnerable to internal and external shocks and thus susceptible to financial crises” (p.83).

One may wish to pause here to ask why a rise in debt, and particularly short-term debt, should accentuate instability? One of the major reasons for this is the close link between easy availability of credit, macroeconomic imbalances, and financial instability. The easy availability of credit makes it possible for the public sector to have a high debt profile and for the private sector to live beyond its means and to have a high leverage. If the debt is not used productively, the ability to service the debt does not rise in proportion to the debt and leads to financial fragility and debt crises. The greater the reliance on short-term debt and the higher the leverage, the more severe the crises may be. This is because short-term debt is easily reversible as far as the lender is concerned, but repayment is difficult for the borrower if the amount is locked up in loss-making speculative assets or medium- and long-term investments with a long gestation period. While there may be nothing basically wrong in a reasonable amount of short-term debt that is used for financing the purchase and sale of real goods and services by households, firms and governments, an excess of it tends to get diverted to unproductive uses as well as speculation in the foreign exchange, stock and property markets.

The following discussion of the primary factors responsible for the (i) East Asian crisis, (ii) collapse of the hedge fund, Long-Term Capital Management (LTCM), and (iii) foreign exchange market instability will help explain why the easy availability of credit and the resultant steep rise in debt, particularly short-term debt, are the result of inadequate market discipline in the financial markets as a result of the absence of risk-sharing.

4.1 The East Asia Crisis

The Eastern tigers had been considered to be among the global economy's shining success stories. They had high domestic saving and investment rates coupled with low inflation. They also pursued healthy fiscal policies which could be the envy of a number of developing countries. Since one of the major causes of financial instability is the financing of government deficit by bonds or fixed-interest-bearing assets (see Christ, 1979; and Searth, 1979), the fiscal discipline of these countries should have helped save them from such instability. However, it did not. The rapid growth in bank credit in local currency to the private sector by domestic banks on the basis of easily available short-term inflows in foreign currency loans from abroad created speculative heat in the stock and property markets and generated a mood of "irrational exuberance" which pushed up assets prices far beyond what was dictated by fundamentals.

The large foreign exchange inflows from abroad also enabled the central banks to peg exchange rates. This helped provide the assurance needed by foreign banks for lending and, along with high domestic interest rates, attracted further inflows of funds from abroad in foreign currencies to finance direct investment as well as the ongoing boom in the assets markets. Since about 64 per cent of the inflows in the five seriously affected countries (South Korea, Indonesia, Thailand, Malaysia and Philippines) were short-term (BIS, June 1999, p. 10), there was a serious maturity and currency mismatch. This joined hands with political corruption and ineffective banking regulation to lend heavily to favoured companies, which became highly over-leveraged.

The fast growth of these companies was thus made possible by the availability of easy money from conventional banks who do not generally scrutinize the projects minutely because of, as indicated earlier, the absence of risk-sharing. It was the old mistake of lending on collateral without adequately evaluating the underlying risks. Had there been risk-sharing, the banks would have been under a constraint to scrutinize the projects more carefully, and would not have yielded even to political pressures if they considered the projects to be too risky. Therefore, there is a strong rationale in drawing the conclusion that one of the most important underlying causes of excessive short-term lending was the inadequate market discipline resulting from the absence of risk-sharing on the part of banks as well as depositors. It is very difficult for regulators to impose such a discipline unless the operators in the market are themselves rightly motivated. The assurances of receiving the deposits or the principal amount of the loan with the predetermined rate of return stands in the way.

There was a reverse flow of funds as soon as there was a negative shock. Shocks can result from a number of factors, including natural calamities and unanticipated declines in the economies of borrowing countries due to changes in interest rates or relative export and import prices. Such shocks lead to a decline in confidence in the borrowing country's ability to honour its liabilities in foreign exchange. The rapid outflow of foreign exchange, which would not have been possible in case of equity financing or even medium- and long-term debt, led to a sharp fall in exchange rates and asset prices along with a steep rise in the local currency value of the debt. Private sector borrowers who were expected to repay their debts in the local currency were unable to do so on schedule. There was a domestic banking crisis, which had its repercussions on foreign banks because of the inability of domestic banks to meet their external obligations.

Governments have only two options in such circumstances. The first is to bail out the domestic banks at a great cost to the tax payer, and the second is to allow the problem banks to fail. The second alternative is not generally considered to be politically feasible in spite of the recent calls to the contrary (Meltzer, 1998; Schwartz, 1998; and Calomiris, 1998). In a financial system which assures, in principle, the repayment of deposits with interest and does not, therefore, permit the establishment of Islamic banks because they provide such an assurance on income-earning investment deposits, it would be a breach of trust on the part of the governments to allow the violation of this principle. Moreover, there is also a presumption, right or wrong, that if the big problem banks are allowed to fail, the financial system will break down and the economy will suffer a severe setback as a result of spill-over and contagion effects. Hence the 'too big to fail' doctrine. The governments, therefore, generally feel politically safer in choosing the first alternative.

Since the domestic banks' external liabilities were in foreign exchange and the central banks' foreign exchange reserves had declined steeply, a bail out of external banks was not possible without external assistance, which the IMF came in handy to provide. This has, as indicated earlier, raised a storm of criticism and a call for the reform of the IMF itself by reducing its role (Schwartz, 1998; Meltzer, 1998). The IMF did not perhaps have a choice. Not having any way of assuring its influential members that its refusal to provide resources would not destabilize the entire international financial system, it chose the safer way out. The IMF bailout, however, got the debt unintentionally transferred from the private foreign banks to the central banks and the governments of the affected countries. Professor James Tobin, a Nobel Laureate, has hence rightly observed that "when private banks and businesses can borrow in whatever amounts, maturities and currencies they

choose, they create future claims on their country's reserves" (World Bank, 1998, p.3).

Discussion of the role of excessive reliance on short-term credit or inflow of funds in the Asian crisis need not lead to the false impression that this is not possible in industrial countries with properly regulated and supervised banking systems. The IMF has clearly warned of the existence of such a possibility by stating that "whatever their causes the market dynamics of surges and reversals are not peculiar to emerging markets and it is unrealistic to think that they will ever be completely eliminated" (IMF, Sept. 1998a, p.98). The boom in the U.S. stock market has been fed to a great extent by short-term flows of funds from abroad just as it had been in East Asia. Without easy availability of credit, the stock market boom could not have been sustained for so long. As soon as these inflows started drying there was a steep decline in the stock market. The same had happened in the late 1960s when confidence in the US Dollar declined as a result of the persistent U.S. budgetary and current account deficits. Consequently, there was a substantial outflow of funds from the U.S., leading to a steep fall in the U.S. gold and foreign exchange reserves, a significant depreciation in the Dollar's external value, and the demagnetization of gold. This flight away from the Dollar also fuelled worldwide inflation through a rise in international commodity prices.

4.2 The Collapse of LTCM

The collapse of the U.S. hedge fund, LTCM, in 1998 was also due to highly-leveraged short-term lending. Even though the name 'hedge fund' brings to mind the idea of risk reduction, "hedge funds typically do just the opposite of what their name implies: they speculate" (Edwards, 1999, p.189). They are "nothing more than rapacious speculators, borrowing heavily to beef up their bets" (*The Economist*, 17 October 1998, p.21). These hedge funds are left mostly unregulated and are not encumbered by restrictions on leverage or short sales and are free to take concentrated positions in a single firm, industry, or sector - positions that might be considered 'imprudent' if taken by other institutional fund managers (Edwards, 1999, p.190). They are, therefore, able to pursue the investment or trading strategies they choose in their own interest without due regard to the impact that this may have on others.

There is a strong suspicion that these hedge funds do not operate in isolation. If they did, they would probably not be able to make large gains and the risks to which they are exposed would also be much greater. They, therefore, normally tend to operate in unison. This becomes possible because

their chief executives often go to the same clubs, dine together, and know each other very intimately (Plender, 1998). On the strength of their own wealth and the enormous amounts that they can borrow, they are able to destabilize the financial market of any country around the world whenever they find it to their advantage. Hence, they are generally blamed for manipulating markets from Hong Kong to London and New York (*The Economist*, 17 October, 1998). Mahathir Muhammad, Malaysia's Prime Minister, charged that short-term currency speculators, and particularly large hedge funds, were the primary cause of the collapse of the Malaysian Ringgit in Summer 1997, resulting in the collapse of the Malaysian economy (September 1997, p.C1). It is difficult to know whether this charge is right or wrong because of the skill and secrecy with which these funds collude and operate. However, if the charge is right, then it is not unlikely that these funds may also have been instrumental in the collapse of the Thai Bhat and some other South Asian currencies.

The LTCM had a leverage of 25:1 in mid-1998, (BIS, June 1999, p.108) but the losses that it suffered reduced its equity (net asset value) from the initial \$4.8 billion to \$ 2.3 billion in August 1998. Its leverage, therefore, rose to 50:1 on its balance sheet positions alone. However, its equity continued to be eroded further by losses, reaching just \$600 million, or one-eighth its original value, on 23 September 1998. Since its balance sheet positions were in excess of \$100 billion on that date, its leverage rose to 167 times capital (IMF, December 1998, p.55). The Federal Reserve *had* to come to its rescue because its default would have posed risks of systemic proportions. Many of the top commercial banks, which are supervised by the Federal Reserve and considered to be healthy and sound, had lent huge amounts to these funds. If the Federal Reserve had not come to their rescue, there may have been a serious crisis in the U.S. financial system with spill-over and contagion effects around the world.⁴ If the misadventure of a single hedge fund with an initial equity of only \$4.8 billion could take the US and the world economy to the precipice of a financial disaster, then it would be perfectly legitimate to raise the question of what would happen if a number of hedge funds got into trouble.

A hedge fund is able to pursue its operations in secrecy because, as explained by Chairman of the Board of Governors of the Federal Reserve System, Alan Greenspan, it is "structured to avoid regulation by limiting its clientele to a small number of highly sophisticated, very wealthy individuals" (December 1998, p.1046). He did not, however, explain how the banks found it possible in a supposedly very well-regulated and supervised banking system to provide excessively leveraged lending to such "highly sophisticated, very

wealthy individuals” for risky speculation when it is well-known that the higher the leverage, the greater the risk of default. The unwinding of leveraged positions can cause major disruption in financial markets by exaggerating market movements and generating knock-on effects (*IMF*, December 1998, pp.51-53).

This shows that a crisis can come not merely because of improper regulation of banks, as it did in East Asia, but also in a properly regulated and supervised system, as it did in the U.S. Even though the hedge funds were not regulated, the banks were. Then why did the banks lend huge amounts to the LTCM and other funds? What were the supervisors doing and why were they unable to detect and correct this problem before the crisis? Is there any assurance that the regulation of hedge funds would, without any risk-sharing by banks, stop excessive flow of funds to other speculators?

4.3 Foreign Exchange Market Instability

The heavy reliance on short-term borrowing has also injected a substantial degree of instability into the international foreign exchange markets. According to a survey conducted by the Bank for International Settlements, the daily turnover in traditional foreign exchange markets, adjusted for double-counting, had escalated to \$1,490 billion in April 1998, compared with \$590 billion in April 1989, \$820 billion in April 1992 and \$1,190 billion in April 1995 (BIS, April 1998).⁵ The daily foreign exchange turnover in April 1998 was more than 49 times the daily volume of world merchandise trade (exports plus imports).⁶ Even if an allowance is made for services, unilateral transfers, and non-speculative capital flows, the turnover is far more than warranted. Only 39.6 per cent of the 1998 turnover was related to spot transactions, which have risen at the compounded annual rate of about 6.0 per cent per annum over the 9 years since April 1989, very close to the growth of 6.8 per cent per annum in world trade. The balance of the turnover (60.4 per cent) was related largely to outright forwards and foreign exchange swaps, which have registered a compounded growth of 15.8 per cent per annum over this period.⁷ If the assertion normally made by bankers that they give due consideration to the end use of funds had been correct, such a high degree of leveraged credit extension for speculative transactions may not have taken place.

The dramatic growth in speculative transactions over the past two decades, of which derivatives are only the latest manifestation, has resulted in an enormous expansion in the payments system. Greenspan, sitting at the nerve centre of international finance, himself finds this expansion in cross border finance relative to the trade it finances as startling (Winter 1998, p.3).

Such a large expansion implies that if problems were to arise, they could quickly spread throughout the financial system, exerting a domino effect on financial institutions. Accordingly, Crockett has been led to acknowledge that “our economies have thus become increasingly vulnerable to a possible breakdown in the payments system” (June 1994, p.3).

The large volume has also had other adverse effects. It has been one of the major factors contributing to the continued high real rates of interest which have tended to discourage productive investment. Foreign exchange markets, being driven by short-run speculation rather than long-run fundamentals, have become highly volatile. This impedes the efficient operation of these markets, injects excessive instability into them, and creates pressures in favour of exchange controls, particularly on capital transfers. The effort by central banks to overcome this instability through small changes in interest rates or the intervention of a few hundred million dollars a day has generally not proved to be significantly effective.

The Tobin tax on foreign exchange transactions has, therefore, been suggested to reduce the instability. This proposal needs to be reviewed against the ineffectiveness of the securities transaction tax which is levied on the sale of stocks, bonds, options and futures by a number of major industrial countries, including the US, the UK, France, Germany and Japan. This tax proved to be ineffective in preventing or even diluting the October 1998 stock market crash (Hakkio, 1994). Is there any guarantee that the foreign exchange transactions tax would fare any better? Critics of the Tobin tax have accordingly argued that even this tax would be ineffective. One of the reasons given for this is that the imposition of such a tax would be impractical. Unless all countries adopt it and implement it faithfully, trading would shift to tax-free havens. However, even if all countries complied, experienced speculators may be able to devise ways of evading or avoiding the tax because all countries do not have an effective tax administration.⁸

5. The Remedy

If heavy reliance on short-term debt, is desired to be curbed, then the question is about the best way to achieve this goal. One of the ways suggested, as already indicated, is greater regulation (Edwards, 1999; Calomiris, 1999; and Stiglitz, 1998). Regulations, even though unavoidable, cannot be relied upon totally because they may not be uniformly applied in all countries and to all institutional money managers because of the off-balance sheet accounts, bank secrecy standards, and the difficulty faced by bank examiners in accurately evaluating the quality of banks' assets. In such a

situation, there will be a flight of funds to offshore havens where almost half of all hedge funds are already located (Edwards, 1999, p.1919). Emerging market banking crises provide a number of examples of how apparently well-capitalized banks were found to be insolvent as a result of the failure to recognize the poor quality of their loan portfolio. Even the LTCM crisis shows how banks in an apparently well-regulated system can become entangled in a speculative spree. Thirdly, bringing banks under a water-tight regulatory umbrella may not only raise the costs of enforcement but also mislead depositors into thinking that their deposits enjoy a regulatory stamp of security.

This does not mean that regulation is not necessary. However, regulation and supervision would be more effective if they are complemented by a paradigm shift in favour of greater discipline in the financial system by making investment depositors as well as the banks share in the risks of business. Just the bailing-in of banks, as is being suggested by some analysts (Meltzer 1998, Calomiris 1998 and Yeager 1998), may not be able to take us far enough. What is necessary is not just to make the shareholders suffer when a bank fails, but also to strongly motivate even the depositors to be cautious in choosing their bank and the bank management to be more careful in making their loans and investments. Bank managers are better placed to evaluate the quality of their assets than regulators and depositors, and risk-sharing would motivate them to take the decisions that they feel are in the best interest of banks and depositors.

Therefore, it is necessary to reinforce regulation and supervision of banks by the injection of self-discipline into the financial system. This could be accomplished by making banks as well as shareholders and investment depositors (those who wish to get a return on their deposits) share in the risks of banking by increasing the reliance on equity and reducing that on debt, as is desired by the major religions. It would also be necessary to confine the availability of credit to the financing of real goods and services with some risk-sharing by the lender as well. Making the depositors as well as banks participate in the risk of business would motivate the depositors to take greater care in choosing their banks, and the bank management to assess the risks more carefully and to monitor the use of funds by the borrowers more effectively. The double assessment of investment proposals by both the borrower and the lender would help raise market discipline and introduce greater health into the financial system. The IMF has also thrown its weight in favour of equity financing by arguing that "Foreign direct investment, in contrast to debt-creating inflows, is often regarded as providing a safer and more stable way to finance development because it refers to ownership and

control of plant, equipment, and infrastructure and therefore funds the growth-creating capacity of an economy, whereas short-term foreign borrowing is more likely to be used to finance consumption. Furthermore, in the event of a crisis, while investors can divest themselves of domestic securities and banks can refuse to roll over loans, owners of physical capital cannot find buyers so easily” (IMF, May 1998, p.82).

Moreover, as Hicks has argued, interest has to be paid in good or bad times alike, but dividends can be reduced in bad times and, in extreme situations, even passed. So the burden of finance by shares is less. There is no doubt that in good times an increased dividend would be expected, but it is precisely in such times that the burden of higher dividend can be borne. “The firm would be insuring itself to some extent”, to use his precise words, “against a strain which in difficult conditions can be serious, at the cost of an increased payment in conditions when it would be easy to meet it. It is in this sense that the riskiness of its position would be diminished” (Hicks, 1982, p.14). This factor should tend to have the effect of substantially reducing business failures, and in turn dampening, rather than accentuating, economic instability.

Greater reliance on equity financing has supporters even in mainstream economics. Rogoff, a Harvard Professor of Economics, states that “In an ideal world equity lending and direct investment would play a much bigger role”. He further asserts that: “With-a-better balance between debt and equity, risk-sharing would be greatly enhanced and financial crises sharply muted” (1999, p.40). However, if, in addition to a better balance between debt and equity, the debt is also linked to the purchase of real goods and services, as required by Islamic teachings, it would take us a step further in reducing instability in the financial markets by curbing excessive credit expansion for speculative transactions. Thus it is not necessary to be pessimistic and to join Stiglitz in declaring that “volatile markets are an inescapable reality” (1999, p.6). The introduction of greater discipline in the financial system, which the prohibition of interest ensures, along with the more effective regulation and supervision and the other reforms mentioned above should go a long way in substantially reducing volatility in the financial markets and in promoting faster development.²⁹

6. Socio-Economic Justice

The above discussion has indicated that the absence of risk-reward sharing, which is an intrinsic characteristic of the interest-based financial system, has aggravated financial crises by adversely affecting discipline in the

system. Since stability of the financial system is indispensable for promoting trade and development and since the interest-free risk-reward sharing system has a clear advantage here, it may be considered superior to the interest-based system on the criterion of efficiency. This is, however, only one of the advantages of the interest-free financial system. It was not discussed in the earlier Islamic literature because excessive volatility in the financial markets is a more recent phenomenon.

It is now important to see whether the assumption about the superiority of the interest-free system with respect to the contribution that it can make to the realization of the universally cherished goal of socio-economic justice is realistic. Supporters of an interest-based financial system argue that interest was prohibited to prevent the exploitation of the poor resulting from the usurious rates of interest prevailing in those days. In addition, they argue that rates of interest are now much lower and the modern welfare state has also introduced a number of measures that fulfil the needs of the poor and prevent them from resorting to exploitative borrowing. Even though this is true to a certain extent, the living beyond means that the interest-based system has the tendency to promote leads to an indirect exploitation of the poor in different ways, two of which are their inadequate need fulfilment and insufficient employment opportunities for them.

6.1 Need Fulfilment

Financial intermediation on the basis of interest tends to allocate financial resources among borrowers primarily on the basis of their having acceptable collateral to guarantee the repayment of principal and sufficient cash flow to service the debt. End-use of financial resources does get considered but does not constitute the main criterion. Even though collateral and cash flow are both indispensable for ensuring repayment of loans, giving them undue weight leads to a relative disregard of the purpose for which borrowing takes place. Hence, financial resources go mainly to the rich, who have the collateral as well as the cash flow, and to governments, who, it is assumed, will not go bankrupt. However, the rich borrow not only for productive investment but also for conspicuous consumption and speculation, while the governments borrow not only for development and public well-being, but also for chauvinistic defence build-up and white elephant projects. This promotes living beyond means and does not, thereby, merely accentuate macroeconomic and external imbalances, but also squeezes the resources available for need fulfilment and development.

The ease of borrowing has enabled a number of developing countries to borrow excessively large amounts. This would not be possible in a risk-

reward sharing system. Borrowing, however, does not eliminate the ultimate sacrifice, it only postpones it. The debt-servicing burden continues to rise with the rise in debt and becomes unbearable, particularly if the borrowed amount is not used productively. A number of developing countries have a debt servicing burden exceeding 50 per cent of their total budgetary spending. The result is that they are unable to provide adequate budgetary resources for some of the most important national needs like education, health and rural and urban development. It is primarily the poor and the lower middle classes who suffer as a result of this. Poverty does not get reduced and inequalities of income and wealth continue to rise.

Ease of borrowing also creates problems for rich countries. The squeezing of resources for need fulfilment and productive investment resulting from conspicuous consumption and speculation has made it difficult for even rich countries like the United States to fulfil the essential needs of all their people in spite of their desire to do so and the abundant resources at their disposal. The continued U.S. budgetary deficits in the fifties and sixties, made possible by the interest-based system, led to an international financial crisis in the late 1960s and the early 1970s and the breakdown of the Bretton Woods system. The after-effects of that crisis continue to plague the world until now. There is a lurking fear that the re-emergence of budgetary deficits in the Bush administration in recent years might lead to a destabilization of the international financial system in the same way as it did in the late 1960s.

6.2 Full Employment

One of the most important requisites for generating full employment is the rise in a country's ability to invest. If this is to be achieved in a non-inflationary manner and without a rise in foreign debt, then it is necessary to have a rise in domestic savings. Unfortunately, there has been a decline in savings in almost all countries around the world. Gross domestic saving as a per cent of GDP has registered a worldwide decline over the last quarter century from 26.2 per cent in 1971 to 22.3 per cent in 1998. The decline in industrial countries has been from 23.6 per cent to 21.6 per cent. That in developing countries, which need higher savings to accelerate development without a significant rise in inflation and debt-servicing burden, has been even steeper from 34.2 per cent to 26.0 per cent over the same period.¹⁰

There are a number of reasons for this decline in saving. One of these is the living beyond means by both the public and the private sectors. This saving shortfall has been responsible for persistently high levels of real interest rates. This has led to lower rates of rise in investment, which have

joined hands with structural rigidities and some other socio-economic factors to reduce the rates of growth in output and employment.

Unemployment has hence become one of the most intractable problems of many developing as well as industrial countries. Unemployment stood at 9.2 per cent in the European Union in 1999, more than three times its level of 2.9 per cent in 1971-73.¹¹ It may not be expected to fall significantly below this level in the near future because the real rate of growth in these countries has been consistently lower than what is necessary to reduce unemployment significantly.¹² Even more worrying is the higher than average rate of youth unemployment because it hurts their pride, dampens their faith in the future, increases their hostility towards society, and damages their personal capacities and potential contribution. The problem is even more serious in developing countries where the proportion of population below the age of 18 is relatively high. Soon these boys and girls will enter the labour market. If employment opportunities are not created for them, these countries may experience a rise in social turmoil as well as crime.

A decline in speculation and wasteful spending along with a rise in saving and productive investment could be very helpful. But this may not be possible when the value system encourages both the public and the private sectors to live beyond their means and the interest-based financial intermediation makes this possible by making credit easily available without due regard to its end use. If, however, banks are required to share in the risks and rewards of financing and credit is made available primarily for the purchase of real goods and services, which the Islamic system tries to ensure, the banks will be more careful in lending and credit expansion will be in step with the growth of the economy. Unproductive and speculative spending may consequently decline and more resources may become available for productive investment and development. This may lead to higher growth, a rise in employment opportunities, and a gradual decline in unemployment.

7. The Islamic Financial System¹³

It is these weaknesses of the interest-based financial system which create a strong rationale for the introduction of a new system. This brings us to Islamic banking, which tries to remove interest, in step with the teaching of Islam and other major religions, and to introduce in its place the principle of risk-sharing. Since demand deposits do not participate in the risks financing by the financial institutions, they do not earn any return and must, therefore, be guaranteed. However, investment deposits do participate in the risks and must share in the profits or losses in agreed proportions. What this will do is

to turn investment depositors into temporary shareholders. Placing investment deposits in financial institutions will be like purchasing their shares and withdrawing them will be like redeeming these shares. The same would be the case when these institutions lend to, and get repaid by, businesses. They will be sharing in the risks of businesses they finance. This will raise substantially the share of equity in total financing and reduce that of debt. Equity will take the form of either shares in joint stock companies and other businesses or of profit-and-loss sharing (PLS) in projects and ventures through the *muḍārabah* and *mushārah* modes of financing.¹⁴

Greater reliance on equity does not necessarily mean that debt financing is totally ruled out. This is because all financial needs of individuals, firms or governments cannot be made amenable to PLS. Debt is, therefore, indispensable. Debt however, gets created in the Islamic financial system through the sale or lease of real goods and services via the sales-based modes of financing (*murābahah*, *ijārah*, *salam* and *istiṣnāʿ*). In this case, the rate of return gets stipulated in advance and becomes a part of the deferred-payment price. Since the rate of return is fixed in advance and the debt is associated with real good or services, it is less risky as compared with equity or PLS financing.

The predetermined rate of return on sales-based modes of financing may make them appear like interest-based instruments. They are, however, not so because of significant differences between the two for a number of reasons. Two of these are:

Firstly, the sales-based modes do not involve direct lending and borrowing. They are rather purchase and sale or lease transactions involving real goods and services. The Shariʿah has imposed a number of conditions for the validity of these transactions to ensure that the seller (financier) also shares a part of the risk to get a reward and that these modes do not deteriorate into interest-based borrowing and lending transactions. One of these conditions is that the seller (financier) must also share a part of the risk. This he does because of the second condition which requires that the seller (financier) must own and possess the goods being sold. The Shariʿah does not allow a person to sell what he does not own and possess.¹⁵ Once the seller (financier) acquires ownership and possession of the goods for sale on credit, he/she bears the risk. All speculative short sales, therefore, get ruled out automatically. Financing extended through the Islamic modes can thus expand only in step with the rise of the real economy and thereby help curb excessive credit expansion, which is one of the major causes of instability in the international financial markets.

Secondly, it is the price of the good or service sold, and not the rate of interest, which is stipulated in the case of sales-based modes of finance. Once the price has been set, it cannot be altered even if there is a delay in payment due to unforeseen circumstances. This helps protect the interest of the buyer in strained circumstances. However, it may also lead to a liquidity problem for the bank if the buyer wilfully delays payment. This is a major unresolved problem in Islamic finance and discussions are in progress among the jurists to find a solution.¹⁶

The share of PLS modes is so far relatively small in the financing operations of Islamic banks and that of sales-based modes is much higher. The reason may perhaps be that in the initial phase of their operations they do not wish to get exposed to risks which they cannot manage efficiently because of the lack of skilled manpower as well as the needed institutional infrastructure.¹⁷ Most scholars, however, feel that, even though the sales-based modes are different from interest-based financing and are allowed by the Shari'ah, the socio-economic benefits of the prohibition of interest may not be realized fully until the share of PLS modes rises substantially in total financing. It would hence be desirable for the use of PLS modes to gain momentum.

In the light of what has been stated above, some of the major characteristics of the Islamic financial institutions may be said to be as follows:

1. Islamic financial institutions reflect the movement directed towards eliminating the role of interest in human society in keeping with the teaching of Islam and other major religions. They try to mobilize resources through a number of Shari'ah-compatible ways. The most important of these are demand and investment deposits as well as shareholders' equity. Demand deposits do not participate in PLS and their repayment must, therefore, be fully guaranteed. The banks should be required to arrange a deposit insurance system for this purpose and the premium to be paid by them should come out of their earnings from the profitable use of these deposits. In contrast with this, investment deposits are mobilized on the basis of PLS rather than interest. This should motivate the depositors to monitor the affairs of their banks more carefully and to punish them by withdrawing their deposits if the banks' performance is not up to their expectations. The banks would, therefore, be under a constraint to manage their risks more effectively. An enabling regulatory and supervisory framework would be very helpful for this purpose. However, even though investment depositors participate in PLS,

there arises the question of whether they should bear only the market risks or also the risks related to fraud, carelessness, mismanagement and loan concentration. It may be desirable to protect them against these risks to raise their confidence in the financial system and to make the insurance provider as well as the supervisory authorities more careful in their assessment of the banks.

2. They render all the normal banking services which conventional banks are expected to render; and
3. Even though they require collateral just like conventional banks for extending finance, they cannot rely on it heavily because of risk-sharing. They will, therefore, be under an obligation to carry out a more careful evaluation of the risks involved.

It is this reform which Islamic banking is trying to bring about in the financial systems of Muslim countries to remove the role of interest in financial intermediation. The task is not easy. Nevertheless, substantial progress has been made by Islamic banks worldwide, even though the niche that they have been able to create for themselves in the total volume of international, or even Muslim world, finance is very small. This was to be expected because they are trying to make headway in a new system of financial intermediation in spite of an unfavourable environment without the help of the auxiliary or shared institutions that are needed for their successful operation.

What counts, however, is not the volume of their deposits and assets, but rather the respectability that the interest-free financial intermediation has attained around the world and the positive evidence that it has provided about the workability and viability of this new system. While in the 1950s and 1960s Islamic banking was only an academic dream, of which few people were aware even among educated Muslims, it has now become a practical reality. It has also attracted the attention of Western central banks like the Federal Reserve Board and the Bank of England, international financial institutions like the IMF and the World Bank, and prestigious centres of learning like the Harvard and Rice Universities in the United States and the London School of Economics and Loughborough and Durban Universities in the United Kingdom. It has also received favourable coverage in the Western press. Prospects for the future are expected to be better, particularly if the instability that now prevails in the international financial system continues to accentuate and leads to a realization that the instability cannot be removed by making cosmetic changes in the system but rather by injecting

into the system greater market discipline of the type that all the major religions emphasize.

8. Conclusion

Thus we see that there is a strong rationale behind the prohibition of interest by the major religions of the world. The rationale is not merely to prevent the exploitation of the poor but also to make the financial system healthier and more stable by injecting in it greater discipline. If the share of equity is increased and that of debt is reduced substantially, the volatility now prevailing in the international financial markets will hopefully be substantially reduced. The result may be even better if credit is confined primarily to the purchase or lease of real goods and services. As a result of this a great deal of the speculative expansion of credit may be eliminated. The ultimate outcome may be not only reduction in financial instability and greater socio-economic justice but also better allocation of resources and faster economic growth.

Notes

¹ For the Judaic and Christian views on interest see Johns, et. al., and Noonan (1957); and for the Hindu view, see Bokare (1993), p. 168.

² For some of these protests, see Mills and Presley (1999), pp. 101-113.

³ The instability started with the breakdown of the Bretton Woods System in 1971. Since then there have been a number of crises. The more important of these are the US stock market crash in October 1987, the bursting of the Japanese stock and property market bubble in the early 1990s, the breakdown of the European Exchange Rate Mechanism (ERM) in 1992-93, the bond market crash in 1994, the Mexican crisis in 1995, the East Asian crisis in 1997, the Russian crisis in August 1998, the breakdown of the US hedge funds in 1998, the Brazilian exchange rate crisis in 1999, and the steep decline in US stock prices in 2002.

⁴ This was clearly acknowledged by Greenspan in the following words: "Had the failure of the LTCM triggered the seizing up of markets, substantial damage could have been inflicted on many market participants, including some not directly involved with the firm, and could have potentially impaired the economies of many nations, including our own"; see Greenspan (1998), p. 1046.

⁵ The Bank for International Settlements (BIS) conducts a survey of foreign exchange markets every three years in the month of April. Results of the April 2001 survey became available after the completion of this paper. According to these results, average daily turnover was 19 per cent lower at around \$ 1210 billion compared with

that in 1998 (BIS, 2001, p.1). The major reason for this fall in the foreign exchange market turnover were, according to the BIS, the introduction of Euro, the growing share of electronic banking in the spot inter-bank market, and the consolidation in banking industry .

⁶ World trade (exports plus imports) rose from \$499.0 billion in April 1989 to \$908.7 billion in April 1998 (IMF, *International Financial Statistics*, CD-ROM and November 1998). The average value of daily world trade in April 1998 comes to \$30 .3 billion.

⁷ The decline in average daily turnover in April 2001, as indicated in footnote 7 was most pronounced in spot markets, where average daily turnover fell from \$568 billion to \$387 billion. Trading in forwards rose from \$128 billion to \$131 billion while that in swaps dropped from \$ 734 billion to \$656 billion (BIS, 2001, P.1 and Table 1 on p.3).

⁸ See the arguments in favour of and against the feasibility of the Tobin tax by various writers in Haq, Kaul and Grunberg (eds.) (1996).

⁹ A number of Islamic economists have argued this point. See, for example, Chapra, (1985), pp. 117-22; Chishti (1985); Mohsin Khan (1987); Mirakhor and Zaidi (1987), S. Siddiqi and Fardmanesh (1994). and a number of others.

¹⁰ Figures have been derived from the Table on “Consumption as per cent of GDP” in IMF, 2000 Yearbook, pp.177-79.

¹¹ OECD, *Economic Outlook*, December 1991, Table 2, p.7; and June 2000, Table 22, p.266.

¹² A question may be raised here about the current low rate of unemployment in the U.S. in spite of a substantial decline in household saving. There are a number of reasons for this. One of the most important of these is the large inflow of foreign funds which “has helped to fund a pronounced increase in the rate of growth of the nation’s capital stock” (Peach and Steindel, September 2000, p.1). Once there is a reversal of, or even a decline in, this inflow, it may be difficult to sustain the high rate of growth in output and employment. In addition the stock market may also experience a steep decline.

¹³ This section is based on Chapra and Khan (2000), pp.11-15.

¹⁴ Editors’ comment: For a description of these and other Arabic terms used in this and other papers in this volume, see the Glossary.

¹⁵ Exceptions to this rule are *salam* and *istiṣnāʿ* (see Glossary).

¹⁶ For a discussion of this problem, see Section 3.1 on the “Late Settlement of Financial Obligations” in Chapra and Khan, 2000.

¹⁷ For the needed institutional infrastructure, see Chapra and Ahmed (2002), pp. 79-84.

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