Book Review

Towards an Interest-Free Islamic Economic System

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The author, who is chief economist at the Banker's Equity Limited, an interest-free institution in Pakistan, earned his Ph.D. in 1983 from Boston University. This book, a revised version of his doctoral dissertation accepted at that university, is the first publication sponsored by the International Association for Islamic Economics in collaboration with the Islamic Foundation.

The study contains important lessons for both interest-bearing and the interest-free Islamic societies. Theoreticians and practitioners in finance can equally benefit from this timely publication. It is therefore a very useful addition to the literature in Islamic economics and in the "signalling theory" in finance, which are both new and fast growing areas of study.

Traditional banking is on the brink of crisis at present. The banks are failing at a post-depression record rate in the United States. Experts agree that a single event such as inability of the developing nations to service their debt, a steep fall in oil prices, withdrawal of petro-dollars from the traditional institutions, or a significant rise in the interest rates, can lead to future widespread failures of banking institutions. Traditional bankers in search of alternatives such as Islamic banking can benefit from Dr. Khan's rigorous cost benefit analysis.

Muslim societies interested in Islamization can recognize some of the difficulties pointed out by the author, especially the information or disclosure costs associated with interest-free financing. Material incentives, which frequently exceed the moral teachings of Islam in contemporary Muslim societies, may lead to dishonesty in reporting the costs and benefits of business projects among the concerned parties.

Chapter one outlines the objectives and organization of the study. Readers are informed that the origin of the principles of Islamic economics lies in the Qur'an, in tradition, and in practice of the first four caliphs who ruled after the prophet Muhammad, peace be on Him. Several contemporary Muslim societies are re-organizing their institutions to reflect Islamic teachings including prohibition of riba - usury or interest. Chapter two begins with the five verses from the Qur'an relating to riba. Then the juristic opinions on riba, particularly the views of Jaffer Shah and Yaqoob Shah are contrasted with the views given by Maulana Usmani and Maulana Maududi regarding the validity of interest on production loans. The author also presents positions taken by Maliki, Shafi'i and Hanafi schools on various forms of mudaraba - a contract in which one party, the financier, delivers capital to the other party, the entrepreneur, who uses it for trade or investment on the condition that profits will be shared in an agreed ratio. Modern Islamic banks are organized on the basis of a two-tier mudaraba: one modaraba between depositors and the bank and other mudaraba between the bank and the investors.

The core of the thesis is in chapters 3 and 4. Dr. Khan investigates, using a secular approach to economic analysis, the costs and benefits of replacing the interest-bearing system with an Islamic interest-free system. In chapter 3, the author provides a set of assumptions and their critical appraisal. Payoffs to the lenders and investors under the conventional interest-bearing financial system, called Fixed Returns Scheme, and the Islamic interest-free system, termed Variable Returns Scheme are described by two equations. The payoffs under each financing scheme are compared, using an advanced mathematical framework of probability theory and some well-known theorems in the theory of finance, to determine "which contract will be preferred in the credit market." The study demonstrates that the Islamic approach, represented by the Variable Returns Scheme is preferred by both the lenders (banks) and the entrepreneurs or borrowers (whom the author terms the investors) over the traditional scheme because the Islamic approach is Pareto optimal, a situation in which no one can be better off without making someone else worse-off.

In specifying the payoffs, the author runs into some errors. For example, the author defines a variable D to denote "all types of fixed payments," including "principal plus interest," (p. 38). But the payoff equations indicate that the variable D stands for (1 + rate of interest) in order to be consistent with the variable R representing (1 + rate of return on investment).

After establishing the superiority of the Islamic scheme over the traditional scheme, the author asks why the practice of debt financing is so common and the Islamic practices are very limited? The author, in chapter 4, finds an explanation for the observed incompatibility between his conclusions and the reality of the financial markets in the so-called Agency Theories, Signalling Theories and Information Theories in the literature on finance. He maintains that the entrepreneurs or "investors" in the interest-free society can materially benefit by cheating. The lenders must monitor performance of the financed projects to preserve their share stipulated in the financial contract. This is the so-called Moral Hazard Problem. Debt financing is popular, in his opinion, because the monitoring costs are minimized under debt financing. His explanation is theoretically convincing. It also reflects, at least in part, the hesitation of the contemporary Muslim societies in adopting an interest-free Islamic system.

In the last chapter, the author examines interest-free models presented by Dr. Muhammad Uzair, Dr. Muhammad Nejatullah Siddiqi, M. A. Mannan and S. M. Ahmed in the light of his findings. He also demonstrates that the Islamic system is relatively more stable than the traditional system. The author criticizes the Islamicity of the Participation Term Certificates issued by the Banker's Equity Limited, Pakistan, and makes recommendations that, he believes, will make them Islamic. This chapter also contains a brief review of interest-free financial institutions. The readers can find a more comprehensive review of Islamic financial institutions in a paper by Ziauddin Ahmad on *The Present State of Islamic Finance Movement*. In order to stay informed on a regular basis, however, the readers should consult the Islamic finance section in the monthly magazine, *Arabia - The Islamic World Review.*

Although one may agree with most of what Dr. Khan says, some of his statements are misleading. Dr. Khan writes on page 26, "Jurists who have tried to support the prohibition of Riba on economic grounds are usually guilty of the inclusion of moral issues." This ascription of "guilt" cannot be justified especially when the author is aware of the fact that economic enquiries very frequently entail social, moral and political matters. The present study itself analyzes a moral issue: prohibition of riba. The study, again, demonstrates that debt financing is predominant due to the Moral Hazard Problem.

On page 80, it is asserted that "no effort has so far been directed to rigorously investigate the implications of a system of profit sharing as it compares to the present system." This claim is exaggerated. The readers can find at least a half dozen publications listed on page 11 of the same study in the foreward written by Professor Khurshid Ahmad. Further studies can be found in the *Abstracts of Research in Islamic Economics*, by M. A. Mannan; *Islamic Economics : Annotated Sources in English and Urdu*, by Muhammad Akram Khan and the bibliographies prepared by Tariq Ullah, Volker Nienhaus and M. N. Siddiqi.

There are several errors and inconsistent statements. For example, the author writes on page 30 "Islamic economists have differed from the Hanafi school on the legal validity of productive Mudarabah," which contradicts the statement given on page 32 "Islamic economists have accepted that version of the Mudarabah contract which has been approved and elaborated on by juristis of the Hanafi school." Overall, however, it is a commendable work and good reading for both generalist and specialist.

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