

STABILITY IN AN INTEREST-FREE ISLAMIC ECONOMY: A NOTE

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In the context of the Islamic prohibition on interest, this note examines the implications of an equity-based banking system for the stability of the economy. Several arguments are adduced which suggest, contrary to Dr. Naqvi's (1981) claim, that equity-financing may promote stability.

I. Introduction

The strict prohibition of interest on loans constitutes one of the cardinal features of an Islamic economy. This prohibition, naturally, eliminates the loan market,¹ and implies that *all* business financing must be based on various forms of equity. It follows therefore that the Islamic economy is 'equity-based' in contrast to a capitalistic 'loan-based economy'.²

The question of the stability of an interest-free economy has recently engaged the attention of several Muslim economists. The general consensus³ suggests that elimination of interest, especially when coupled with other institutional features of an Islamic economy, tends to enhance stability. However, a dissenting view has recently been offered by Dr. Naqvi (1981, pp. 127 and 136), who argues that an equity-based economic system is unstable. This note seeks to evaluate Dr. Naqvi's view and identify its inadequacies.

¹ Some interest-free loans would still remain, essentially as a form of charity, and would have to be allocated among the needy by non-price mechanisms (Zarqa 1982, p. 46).

² See Chapra (1982, p. 152), and Al-Jarhi, (1981, pp. 8, 46-48).

³ See Chapra (1981a, p. 25), Ariff (1981, pp. 13, 299), Akram Khan (1982, pp. 238-251), and Siddiqi (1983a, pp. 86-88, 111-113). No attempt will be made here to summarise these views.

II. Methods of Examining Stability

The stability of any economic system may be evaluated either empirically or analytically. Empirically, the simulation of an econometric model of a given economy has been successfully tried to evaluate stability.⁴ The results of such investigations, however, lack the generality of analytical results. Even if one demonstrates that the economy of country X has been – by some criterion – more stable than that of country Y, it need not be true that country X, or other countries following the same system, will be more stable during other periods of time, or under different historical circumstances. Furthermore, this approach cannot be employed in the present case since a full-fledged Islamic economic system does not yet exist.

Analytical methods of examining stability have also been developed by economists and have provided important general results.⁵ Such methods have not yet been applied to study an Islamic economy and have in any case their own limitations. One such limitation is the fact that theoretically rigorous conclusions on stability usually require knowledge not only of algebraic signs but also of numerical magnitudes of the relevant economic parameters.⁶ More importantly, stability is quite responsive to government action and regulations, hence definitive analysis requires the specification of several institutional details.

All things considered, there appears to be room for offering some tentative remarks on the stability of an equity-based Islamic economy.

III. Mainstream Thinking

There are at least four reasons⁷ why an interest-free Islamic system may be expected to promote economic stability.

Investment

Many economists seem to agree that debt financing is a major factor

⁴ One pioneering effort is that of Adelman and Adelman (1959) who used the Klein-Goldberger model to see whether it produces, by simulation, fluctuations similar to those actually observed in the U.S. economy.

⁵ The extensive economic literature on the business cycle is focussed on this question. A classic example is Samuelson's (1939) analysis of the fluctuations arising out of the interaction of the multiplier and accelerator. New powerful techniques are now available to study analytically the stability of large multi-equation systems: see Murata (1975).

⁶ This conclusion is equally true for stability investigations of single markets as well as the macro-economy. See, for instance, Henderson and Quandt (1958, pp. 109-123) and Samuelson (1939).

⁷ They are not entirely independent, but it is convenient to separate them under four headings.

destablising investment in capitalist economies. In the words of Joan Robinson (1977, p. 1331): "When firms can raise outside finance direct from rentiers or through the banks, the system is liable to instability". This point has also been elaborated upon by Minsky (1977, pp. 301-307), whose position may be summarised as follows. Minsky maintains that a modern capitalist economy is based on a pervasive system of short-term financing of long term capital assets. That is, cash flows expected from such assets extended longer than the terms of debt contracted to acquire them. Under such a system of financing debt is repaid when due by issuance of new debt, i.e. refinancing is an on-going process. When expectations about future cash-flows and interest rates are fulfilled, refinancing is easily achieved, and contractual interest obligations are easily met from cash flows generated by the assets. But if expectations take a wrong turn (either interest rates go up or current cash flows go down) refinancing becomes difficult. Attempts then to acquire cash by selling assets bring asset values to a level below their past prices, or even below their current cost of reproduction. This brings investment to a halt, and brings down income and employment.

In view of the above analysis, one can better appreciate Henry Simon's view that "the danger of economic instability would be minimised if no resort were made to borrowing, particularly short term borrowing, and if all investments were held in the form of equity".⁸

In a similar vein, G.L. Bach (1977, p. 182) has argued regarding the stock market that, ". . . if rising stock prices have been heavily financed by borrowed money, a downturn in the market may precipitate a major collapse in stock prices as lenders call for cash, and may place serious financial pressure on banks and other lenders. A high market based on credit is thus far more vulnerable than a "cash" market, and is more likely to be a cyclically destabilizing force"

Speculation

The speculative demand for money, which is one source of instability in the Keynesian system, would be significantly reduced in an Islamic economy. For, on the one hand, the abolition of interest would do away with speculation on interest-bearing assets. Levying of Zakat, on the other hand, would discourage holding cash balances "in excess of transactions and precautionary needs." (Chapra, 1981b, p. 10).⁹ Furthermore, the force of Islam's moral injunction against hoarding should not be underrated.

⁸ Quoted in Chapra (1981a, p. 25).

⁹ What discourages hoarding is the fact that Zakat rate according to predominant juristic opinion, is heavier on hoards (2.5 per cent of asset value) than on productive assets of an equivalent value

Commodity speculation also would be significantly reduced in an Islamic economy. This is because *some* kinds of speculation are prohibited.¹⁰ Furthermore, interest bearing loans would no longer be available to fuel cumulative speculation. This is quite significant, for speculators would be limited to their own funds – no funds would be forthcoming to them on profit-sharing basis, unless the suppliers of such funds themselves wanted to speculate. Under interest financing, in contrast, even non-speculators when assured of a suitable collateral have the incentive to lend money to speculators. This is observed in international and domestic speculative booms.

Corporate Finance

Several of the above views gain further support at the micro level of the firm. It is well established in corporate finance that an increase in debt-financing (as opposed to equity-financing) of a firm increases its risk of insolvency and magnifies the relative fluctuations in its earnings (net of interest).¹¹ Firms that have higher debt-equity ratio are more likely to face financial collapse during cyclical down-turns because their fixed interest payments must still be met in the short run.¹² All equity-based firms, to be sure, must also generate 'normal' profits for their owners, but need do so over a number of years rather than every single year. The generation of 'normal' profits, in other words, does not impose financial risks on the firm as does the generation of interest payments.

International Finance

If we consider the international economy, it is often observed that "hot money" movements are a destabilizing factor, taking place (among

(10 per cent on net profit). Thus unless net profit per annum reaches 25 per cent of asset value, the effective Zakat rates would discourage hoarding. For juristic details see Al-Qaradawi (1980, Vol, 1, pp. 446-486).

¹⁰ A brief note on permissible vs. prescribed speculation is given by Zarqa (1981). But the range of juristic opinion on speculation is rather wide. M.A. Khan's (1982, pp. 240-242, 247-248), insightful and terse notes probably represent the more restrictive views in that range.

¹¹ For further discussion, see Shackle (1966, p. 142) and Baumol (1979, p. 627). We note now a basic mathematical reason why fixed interest payments must increase relative fluctuations in net earnings of a firm: Start from any fluctuating stream of net earnings, R_t , whose mean is \bar{R} and variance is $VAR(R)$. Relative fluctuations can be measured by the coefficient of variation: $VAR(R)/\bar{R}$. Now subtract a positive constant, c , representing annual interest payments, to get a new stream: $R'_t = R_t - c$. The addition of a constant term does not affect its variance. But the *mean* of the new stream is smaller, $\bar{R}' = \bar{R} - c < \bar{R}$, hence its coefficient of variation must become larger: $[VAR(R)/(\bar{R} - c)] > [VAR(R)/\bar{R}]$.

¹² See Leibling (1980, p. 78) and Chapra (1981a).

other things) in response to minor changes in interest rate differentials. The same cannot be said about profit rate differentials, as equity participation more often than not entails longer-term commitments that cannot be profitably undone in response to minor or transient changes in rates of profit. Hence, equity financing is intrinsically more stable than one based on interest.

IV. Another View

Dr. Naqvi (1981, p. 127) is of the view that a wholly equity-based system "will be highly unstable".¹³ This is because equity-financing, in contrast to interest-financing makes the return on investment "a function of business conditions in general and of the efficiency with which the enterprise is being run. Hence an element of uncertainty is introduced into the investor's expectations. Hence, to hedge against the probability of a loss, ways and means must be found, through some kind of deposit insurance scheme, to guarantee . . . the normal value of deposits. (Otherwise) . . . not only the banking system, but the entire economy will become highly unstable". (Naqvi, p. 136).

We shall take up now the main points in Naqvi's argument. The uncertainties facing any real investment (whether common to all business or specific to the given enterprise) are there regardless of how it is financed.¹⁴ Equity financing does not change the level of uncertainty, it only *redistributes* the consequences of uncertainty over all parties to a business. Debt-financing, in contrast, relieves the financier (misnamed "investor" in the above quotation) from uncertainty by shifting it on to the real investor (equity holder) who then alone bears the entire risk of the enterprise.

If any definite conclusion seems warranted, it would be opposite to Naqvi's. Equity financing, by spreading the same risk over more heads, would promote stability. Each party can absorb its modest share of a loss without significantly upsetting its normal activities or defaulting on its obligations, hence no panic reactions are generated among other business units.

Turning now to deposit insurance, we note that the desirability of some kind of such insurance has been acknowledged; it has in fact been advocated on equity and other grounds by some prominent Muslim economists.¹⁵

¹³ In taking this stand, Naqvi is quite explicit that he is not questioning the desirability of eliminating interest, but only calling attention to what he thinks is one potential trouble spot in global equity financing.

¹⁴ The financial risk of insolvency increases with debt, even though business risk, as expressed by fluctuations in earnings, stays the same. (We are using the terms: risk and uncertainty interchangeably in this paper).

¹⁵ Siddiqi (1983a, p. 24), who also gives reference to several economists sharing the same view. See also Al-Jarhi (1981, p. 232) Chapra (1982, p. 169-170), and Siddiqi (1983b, p. 51).

But deposit insurance has little to do with interest *vs.* equity financing. Rather, it has to do with fractional reserve banking system which always faces the risk of a panicky “run” on the banks – with many depositors asking to exchange their deposits for cash on short notice. In the U.S.A., for instance, the crucial factors that helped reduce the instability of laissez-faire banking and forestall financial panics were: (a) the regulation of activities and stipulation of minimum size for banks; (b) the establishment of a Central Bank with sufficient powers to stem collapse of the banking system; and (c) the government insurance of bank deposits.¹⁶ Before such reforms were introduced, according to Samuelson (1976, p. 292), “the American history of bank failures and losses to depositors used to be a grievous one . . . since establishment of the FDIC (Federal Deposit Insurance Corporation) a bank failure has become a rare . . . event”.

Another advantage of interest-financing, noted by Naqvi (1981, p. 136), is that: “the ‘shock-absorbing’ characteristics of the present limited-liability principle, on which the modern banking system rests, will be lost under the proposed profit-sharing (equity-financing) system. This is a big loss . . .”. He adds: “Interest-bearing debentures signify the principle of limited liability, since the holders of debentures are not responsible if a firm goes into liquidation”. (p. 111, n. 5).¹⁷

Naqvi wishes here to assert that debt financing of a business limits the maximum liability of a creditor – in case of default – to the amount of his debt. But what is so unique about this? We know that limited liability to loss is equally present in many forms of equity financing that are permitted in Islam, such as: (i) the limited liability of shareholders in a corporation (limited liability company); (ii) the liability of *Sabib-al-maal* (financier) in the Islamic *mudarabah* is limited to the amount of his financing, unless otherwise stipulated in the contract;¹⁸ finally in partnership (and other unincorporated business) where partners’ liability is in principle not limited, it is easy in practice to limit it. Partners can and very often do agree never to let their potential indebtedness exceed the value of their business assets.

It is thus unrealistic to think that limited liability is unique to interest-financing, or to presume that equity-financing and profit sharing are associated with unbounded liability.

¹⁶ There is no reason to deny a profit-sharing banking system similar institutional stabilizers.

¹⁷ I presume that Dr. Naqvi is *not* referring to “limited liability” in its usual meaning in business law (i.e., the limited liability of stock holders of a corporation). For, in that usual sense, it would be a gross error to claim that modern banking is based on (or that debentures signify) the principle of limited liability.

¹⁸ See, Al-Khayyat (1970, Vol.II, pp. 132-133, 210), Al-Misri (1981, pp. 191-192). For acceptability of corporations by several modern Muslim jurists see Al-Khayyat (1970, Vol.II, pp. 153-235).

V. Conclusion

It may be hoped that the preceding remarks have suggested that an equity-based (interest-free) Islamic system can contribute appreciably to economic stability, while an interest-based system predisposes the economy to instability.

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