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## ISLAM AND THE INTERNATIONAL DEBT PROBLEM

**M. U CHAPRA**
Saudi Arabian Monetary Agency, Riyadh

The external debt of developing countries acquired serious proportions in the early 1980s. Although the debt indicators have improved since 1987, the debt crisis persists and 'the international economic system is still in search of a lasting solution to the debt problem.[1] This makes it necessary to look at the magnitude of the debt, to examine the major reasons underlying this phenomenon, and to see how Islam may be able to help the debt-ridden Muslim countries handle their debt problem in an effective manner without seriously hurting the goals of both growth and equity.

### I. MAGNITUDE OF THE PROBLEM

The total external debt (EDT) of low- and middle-income developing countries covered by the World Bank Debtor Reporting System (DRS) rose at the rate of 8.3 per cent per annum during the decade of the eighties from $561.8 billion in 1980 to an estimated £1,146.7 billion in 1989 (see the table below). This rate was far in excess of the annual rate of growth of 3.4 per cent in the gross national product (GNP) of these countries and of 4.3 per cent in their exports of goods and services (XGS). The steep rise in debt has raised the EDT/GNP and EDT/XGS ratios to 41.7 and 186.6 per cent from 27.7 and 133.5 per cent respectively.

The EDT of low- and middle-income Muslim countries covered by the DRS is estimated to have risen at the somewhat higher rate of about 9.8 per cent per annum from £146.9 billion in 1980 to $340.8 billion in 1989 when their GNP and XGS rose at the rates of 1.8 and 6.3 per cent per annum. Their EDT constituted around 29.7 per cent of the EDT of

[1] Jacob Frenkel, Michael Dooley, and Peter Wickham, *Analytical Issues in Debt* (Washington, DC: International Monetary Fund, 1989):, 1.

**DEBT OF LOW- AND MIDDLE-INCOME DEVELOPING AND MUSLIM COUNTRIES**

(amounts in millions of dollars; g and ratios in per cent)

| | Developing countries | | | Muslim countries | | |
|---|---|---|---|---|---|---|
| | 1980 | 1989 | g | 1980 | 1989 | g |
| EDT | 561.8 | 1,146.7 | 8.3 | 146.9 | 340.8 | 9.8 |
| GNP | 2,025.4 | 2,748.4 | 3.4 | 412.8 | 485.5 | 1.8 |
| XGS | 420.9 | 614.6 | 4.3 | 87.9 | 152.2 | 6.3 |
| TDS | 91.0 | 135.7 | 4.5 | 18.6 | 41.5 | 9.3 |
| NTD | 19.1 | -39.8 | | 7.4 | -6.2 | |
| EDT/GNP | 27.7 | 41.7 | | 35.6 | 70.2 | |
| EDT/XGS | 133.5 | 186.6 | | 167.1 | 223.9 | |
| TDS/XGS | 21.6 | 22.1 | | 21.1 | 27.3 | |

g = compounded annual rate of growth.

ED1 = total external debt (includes both short- and long-term debt plus use of IMF credit).

GNP= gross national product.

XGS=exports of goods and services.

TDS = total debt service (principal repayments + interest payments).

NTD= net transfers on debt (loan disbursements net of TDS).

Data for low- and middle- income developing (including Muslim) countries are obtained from World Bank, World Debt Tables, 1990-91, i. 26. They cover only those countries that report to the World Bank Debtor Reporting System (DRS). The EDT estimated by the World Bank for ‘other developing countries’ amounted to $77 billion in 1980 and $114 billion in 1989 (ibid. 12). Low-income countries are defined by the World Bank as those in which GNP per capita was no more than $580, and middle-income countries are those in which GNP per capita was more than $580 and less than $6,000.

Data for Muslim countries are obtained from ibid. ii, which contains pages for 35 out of the 45 member countries of the Islamic Development Bank. GNP and XGS data are, however, not available for Lebanon beyond 1970. Hence Lebanon has been excluded from the table. Its EDT amounted to $490.7 million and $519.9 million in 1980 and 1989, while its TDS and NTD amounted to $51.7 millions and $54.0 million respectively in 1980 and $58.2 million and -$18.6 million respectively in 1989. Twenty out of these 35 countries fall into the low-income group and the remaining 15 into the middle-income group. Of the remaining 10 Muslim countries, four (Afghanistan, Iran, Iraq, and Libya) are classified by the World Bank as non-DRS (ibid. i. 124) and five as high-income economies. High-income Muslim countries, for which there are no pages in volume ii, are Bahrain, Brunei, Kuwait, Saudi Arabia, and UAE. Palestine, which is a member of the 1DB but has not yet gained freedom from Israeli occupation, naturally does not have a page.

all low- and middle-income developing countries when their GNP and XGS constituted only 17.7 per cent and 24.7 per cent.

This indicates the relatively greater indebtedness of Muslim countries. Fourteen out of the forty-five member countries of the Islamic Development Bank were classified by the World Bank as severely indebted and eleven as moderately indebted.[2]

The worrisome fact is that net transfers on debt (NTD) have become negative. The NTD has moved from + $19.2 billion in 1980 to —$39.8 billion in 1989. The corresponding figures for Muslim countries were $7.4 billion and —$6.2 billion. Negative NTD implies a transfer of real resources from the poor to the rich countries and necessitates the generation of a larger export surplus than is required to finance their import-export (M-X) gap. Since they are unable to do this in a way that is politically feasible, there is risk of default.

## II. THE ROOT CAUSE

There is a general consensus that the root cause of the high debt burden of low- and high-income developing countries is excessive domestic absorption, which refers to the aggregate of private and public consumption and investment outlays (C + I + G). If this had been due to productive investment and development, it would have led, over time, to an increase in their ability to export and to service their debt. However, this was not necessarily the case. Consumption rose and savings declined, creating a savings-investment (S-I) gap. It also induced a higher level of imports and further widened the M-X gap.

The S-I gap has been partly filled by monetary expansion, which has generated a high rate of inflation. The rate of inflation in low- and middle-income Muslim countries was 23.8 per cent in 1989. Although this rate was lower than the 78.8 per cent over all developing countries, it was substantially higher than the 4.5 per cent in industrial countries.[3] This differential in the rates of inflation between industrial and Muslim countries has led to a steep decline in the external value of their currencies. Since the governments, desiring to hold down the domestic cost of imports, did not adequately depreciate their currencies, these currencies have become generally overvalued. Overvalued currencies have had the effect of subsidizing imports at the cost of exports and of further widening the M-X gap. They have also necessitated exchange

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[2] The severely indebted countries were: Benin, Comoros, Egypt, Guinea, Guinea Bissau, Mali, Mauritania, Morocco, Niger, Nigeria, Senegal, Sierra Leone, Somalia, and Sudan. The moderately indebted countries were: Algeria, Bangladesh, Cameroon, Gabon, Gambia, Indonesia, Pakistan, Syria, Turkey, Uganda, and South Yemen (World Bank, World Debt Tables 1990—91, i. 122)

[3] IMF, *International Financial Statistics*, Yearbook, 1990, 117. The rate of change for Muslim countries is a weighted average calculated from the data on consumer price changes given for 24 low- and middle-income Muslim countries in this Yearbook (117—18), and the data for NNP given in World Bank, World Debt Tables, 1990—1991

controls, which breed corruption and inefficiency, create distortions in the allocation of resources, and exacerbate capital flight. The capital flight has further reduced their ability to finance their development out of their own resources and accentuated the need for external financing. The negative NTD has made such financing extremely difficult. This difficulty is expected to be further aggravated by the financial needs of the former Soviet Union, Eastern Europe, and the Gulf countries combined with the ever-increasing US budgetary deficits and the expected decline in the capital outflow from Japan.

## III THE SEARCH FOR A SOLUTION

The effort by the low-income and severely indebted countries to service such a high level of debt reduces growth, increases unemployment, and accentuates social tensions which breed political instability. A number of initiatives have therefore been taken worldwide to provide immediate relief through rescheduling, debt-forgiving, discounted debt buy-backs, and debt-equity swaps.[4]

All these methods of providing relief, though necessary, are short-term palliatives, and would tend to become recurring features of the debt phenomenon unless the benefiting countries undertook effective economic and financial restructuring to reduce their domestic absorption. A restructuring programme may not, however, be politically feasible unless it reduces domestic absorption in a way that leads to a minimum sacrifice in the goals of both growth and equity. Minimum sacrifice of the growth objective necessitates that the reduction in absorption be primarily in the consumption component of private- and public-sector absorption and not in productive investment. Minimum sacrifice of the equity objective demands that the decline in consumption be brought about in a way that makes the adverse effect of the reduction in absorption fall not on the poor, but rather on those who are better off and strong enough to bear the required austerity.

Restructuring of this nature requires two important ingredients: first, a filtering mechanism that is capable of filtering out those elements of absorption which do not promote growth and equity; and secondly, a motivating system that can induce the users of resources to undertake such filtering voluntarily without the use of regimentation or force. It is the contention of this paper that the Islamic value system incorporates

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[4] Both debt-rescheduling and debt-forgiving are encouraged by Islam (Qur'an 2:200). Discounted buy-back is in the nature of a partial forgiving of the debt. Debt-equity swap is a highly preferable measure in the light of Islamic values.

these ingredients in a way that could be more conducive to such restructuring than neoclassical liberalization.

## IV. THE NEOCLASSICAL RESTRUCTURING

The restructuring programme for reducing absorption that the developing countries are now being almost compelled by the IMF and the World Bank to adopt is based on neoclassical liberalization conceived within the secularist framework of the Enlightenment philosophy. It does not stand merely for less government. It also stands for value neutrality. Collective value judgements or moral values are not assigned an important role in the filtering process. Hence, the only filtering device is prices determined in the market by the free interaction of supply and demand, and the only motivating mechanism is self-interest to be served by higher income and maximum want satisfaction.

### 1. *Major components*

The most important components for adjustment that the IMF is able to come up with on the basis of its value-neutral liberalization are: (a) to reduce the role of government in the economy; (h) to allow the market to play its role; and (c) to liberalize foreign trade. It is argued that these components will help reduce aggregate domestic demand and help attain a sustainable external balance. They will also raise economic efficiency and promote supply.

A reduction in the role of the government in the economy will no doubt help introduce fiscal restraint and reduce the budgetary deficit, which is one of the major causes of excessive domestic absorption. It will also enable the private sector to play a greater and more effective role in the economy and, being better motivated in its own self-interest, contribute to greater efficiency. Greater reliance on the market will help in ‘getting the prices right’ (including interest rates and exchange rates) and giving the ‘right’ signals to economic agents. Market-oriented interest rates and prices will not only help restrain credit expansion and private-sector absorption but also remove the existing distortions and lead to a more efficient allocation of resources. While the neoclassical prescription implies a rise in the prices of most goods and services, it calls for restraint on real wages. It is argued that, even though this will ‘impose hardship on organised labour’[5] in the short run, the hardship

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[5] Peter S. Heller *et al.*, The Implications of Fund-Supported Adjustment Programmes for Poverty: Experience of Selected Countries, IMF Occasional Paper No. 58 (Washington, DC: IMP, May 1988), 17.

will ultimately be offset by higher growth and employment. Realistic exchange rates will themselves go a long way in expanding exports and reducing imports and thus reducing the current-account deficit. Outward orientation (liberalization of foreign trade) will, by removing import restrictions and encouraging exports, enable the adjusting country to take advantage of international trade to promote growth and to offset the recessionary effect of reduction in domestic absorption. If tariffs have to be used, they should preferably be low and uniform. Any discrimination will require value judgements which are not desirable; it will only lead to distortions which will adversely affect efficiency. Import-substitution should also be avoided because it does not have a great potential. Its target is basically the domestic market, which is limited; exports do not face such a quantitative limitation.

**2. *The logical flaw***

While neoclassical liberalization calls for a cut in overall private- and public-sector spending, it does not address itself to a change in the composition of such spending to improve the growth and equity performance of the economy. This leads to a serious flaw in the whole programme. If aggregate spending is to be cut and growth and equity are nevertheless to be promoted, then there has to be increased spending for these objectives. Unless this increase in spending is more than offset by a decline in some other spending, imbalances will not decline. This demands a discrimination between spending which does, and spending which does not, promote growth and equity. The desire to avoid value judgements leads neoclassical economics to abstain from making such a distinction. There is hence little stress on reducing ‘unnecessary’ consumer spending and on raising ‘productive’ investments. It is assumed that market-determined prices will automatically perform this function. There is likewise no emphasis on improving the quality and quantity of educational, health, housing, transport, and sanitation facilities for the poor to raise the quality of the human factor in development. Even a discussion of the supply side of Fund programmes is concerned primarily with providing better incentives to promote savings, investment, and exports through realistic prices, interest rates, exchange rates, and taxes. There seems to be hardly any concern about the impact of these incentives on need fulfilment and income distribution or on the kind of development that is needed to improve equity and reduce social tensions.

It has been honestly admitted by the IMF that ‘distributional issues are primarily an internal political concern.’[6] Hence, ‘mitigation of the

[6] IMF, Fund-Supported Programmes, Fiscal Policy, and Income Distribution, IMF Occasional Paper No.46 (Washington, DC: IMF, Sept. 1986), 1.

adverse distributional implication, of exogenous shock or of the economic adjustments necessitated by past, inappropriate policies has not been an explicit objective of Fund-supported programmes, even though these adjustment programmes have 'important distributional implications'.[7] Consequently, none of the IMF annual consultation reports on member countries ever discusses a member country's progress in removing poverty, fulfilling needs, and reducing inequalities. A country wins full laurels from the IMF if it succeeds in reducing the imbalances irrespective of whether this has been attained with any adverse effect on equity. Mr Barber Conable, the outgoing President of the World Bank, has frankly concluded that an IMF-designed adjustment programme 'will result in some temporary unemployment, and in real difficult short-term reductions in living standards which sometimes affect the poorest segment of the population most harshly'.[8] The palliative that the 'harsh' effect may he 'temporary' and 'short-term' does not reduce the shock because the likelihood is that this effect may not only be permanent but also cumulative. Mr Conable is not however wrong in his prediction about the impact of adjustment on the poor. His prediction is made within the framework of neoclassical economics. It is therefore important to see why the poor will be hit harshly by an adjustment programme cast in the mould of neoclassical economics.

***3. The inevitable inequity***

While there is no alternative to the use of the price mechanism for reducing imbalances and allocating resources efficiently, sole reliance on the price mechanism and conventional interest-based financial intermediation tends to operate against the realization of equity in a secularist value-neutral environment unless certain background conditions are satisfied. Some of the most indispensable of these conditions are: (a) harmony between individual preferences and social priorities; (b) equal distribution of income and wealth; (c) reflection of the urgency of wants by prices; and (d) perfect competition.

Given the absence of a moral filter and the complete freedom on the part of individuals to pursue their self-interest, there is nothing to motivate the sovereign consumers to take into consideration social priorities in resource use, specially when they have the resources to purchase whatever they desire in accordance with their individual prefer-

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7 IMF, Occasional Paper No. 58, op. cit. 1 and 32. See also TMF, Theoretical Aspects of the Design of Fund-Supported Adjustment Programmes, Occasional Paper No. 55, Sept. 987.

8 Barber Conable, 'Opening Remarks', in Vittorio Corho *et al.,* Growth Oriented Adjustment Programmes: Proceedings of a Symposium held in Washington, D.C., February 25—27, 1987 (Washington, DC: IMF/IBRD, 1987), 7.

ences, Resource use is likely to conform even less with social priorities if the sovereign consumers are subjected to a battery of sales promotion campaigns through mail and news media and a vast array of unwarranted wants is thus created. The unhindered expansion of wants compared with 'real' human needs tends to put a tremendous pressure on scarce resources, thereby reducing the ability of society to satisfy needs.

In such a secularist environment, only equal distribution of income and wealth could give everyone equal weight in influencing the decision- making process of the market. However, since there are substantial inequalities of income and wealth and since the rich are also permitted a far greater access to credit, they are able to buy whatever they wish at the prevailing prices. The IMF-designed adjustment programme, placing its reliance primarily on currency devaluation, higher prices, and higher interest rates, is not able to create any significant dent in their demand for status symbols and 'unnecessary' goods and services. They are thus able to divert scarce national resources, by the sheer weight of their 'votes', into products which command a lower priority on a social preference scale which has general need fulfilment as one of its primary objectives. The value-neutral price system is not even concerned with how many 'votes' an individual has and how he uses them.

The urgency of wants of different consumers cannot be compared by the willingness to pay the price. Even though the urgency for milk is the same for all children, irrespective of whether they are poor or rich, the amount of dollar votes that a poor family is able to cast for milk is not the same as those that a rich family is able to cast for status symbols. Hence Arthur Okun has rightly observed that markets 'award prizes that allow the big winners to feed their pets better than the losers can feed their children'.[9]

Perfectly competitive markets have remained an unrealized dream and are likely to remain so in the future, particularly because of the tendency of the conventional financial system to promote big business and concentration of wealth and power (see below, V. 2). The innumerable imperfections that exist in the market thwart the efficient operation of market forces and produce deviations from ideally competitive marginal cost pricing, thus leading to prices that do not reflect real costs or benefits.

Since no real world market is likely to satisfy the background conditions even approximately, there is a considerable distortion in the

[9] Arthur Okun, Equality and Efficiency: the Big Trade-off (Washington, DC: Brookings Institution, 1975), 11.

expression of priorities in the market-place.[10] The socially desired priorities do not get expressed in the market-place. However, since a secularist society is not willing to use value judgements needed for internalizing socially agreed priorities, there is a built-in tendency on the part of market forces to divert scarce resources to the satisfaction of inessential wants of the rich when even the basic needs of the poor remain unfulfilled. It is this aspect of liberalization which may unconsciously be at the back of Mr Conahle's mind when he makes the stark prediction about its effect on the poor. He assumes, and his assumption is realistic within his value-free framework, that nothing can be done to avoid the 'most harsh' effect on the poor.

## V. THE ISLAMIC STRATEGY

Since Islam makes an uncompromising commitment to socio-economic justice, it is indispensable for a Muslim society to prepare and execute an adjustment programme that would help reduce the imbalances without the 'most harsh' effect on the poor. This can be done if the use of resources is reduced for purposes that do not contribute positively to the realization of both efficiency and equity. Islam rules out the resort to regimentation and collectivization, and recognizes the crucial role of market forces in the allocation and distribution of resources. But it simultaneously requires the market forces to operate within a specified framework designed to ensure the realization of its socio-economic goals. It is not possible to go into all the elements of this framework in this brief paper.[11] Stress will hence be laid primarily on the role played by a double layer of filters, effective motivation, and a different system of financial intermediation to complement the price mechanism to remove excess absorption without compromising the goals of either efficiency or equity.

### *1. Filtering and motivation*

The first step in the efficient and equitable allocation of resources is the filtering out of all uses that do not contribute to the realization of these two goals. For this purpose Islam, like other major religions, considers it necessary to inject a moral dimension into the decision-making process

[10] See Samuel Brittan, *Two Cheers for Self-interest: Some Moral Pre-requisites for a Market Economy* (London: Institute of Economic Affairs, for the Wincot Foundation, 1985), 17.

[11] See, for this purpose, the author's hook, *Islam and the Economic Challenge* (Leicester, UK: Islamic Foundation and Herodon, VA: International Institute of Islamic Thought, 1992), 213—338.

of the market and hence into the adjustment programme. The moral filter does not displace the role of the price mechanism. It rather complements it by either creating more effectively the background conditions or minimizing the adverse effect of their absence on need fulfilment. This can have the effect of humanizing the operation of market forces.

Without a moral filter it is not possible for a society even to define efficiency and equity. As Frank Knight has rightly argued, the most important principle of physical science is that matter can neither be created nor be destroyed. Total output would hence always be equal to total input in physical terms. The correct definition of efficiency would hence be the ratio between not total output and total input, but rather 'useful' output and total input.[12] This means that a measure of 'usefulness' is needed to determine efficiency. Individual preferences are no doubt based on an individual's personal measure of 'usefulness', but this measure, arrived at within the framework of worldly self-interest, may not necessarily be in harmony with the scale of social priorities necessary for realizing the well-being of all. Subjecting individual preferences to a moral filter could help in creating such a harmony. If it is difficult to define efficiency without moral criteria, then it would be even more difficult to define equity without these because of its greater subjective content.

Two problems are encountered in the injection of a moral dimension into the operation of market forces. The first problem is that of developing a filter which is accepted by all members of society as absolute and beyond dispute. Even such an absolute filter may, however, be of little value if individuals are not motivated to abide by it. Hence, the second problem is that of motivating everyone not to make claims on resources without first passing them voluntarily through the moral filter.

Only a Divine sanction has proved to he effective in providing a moral filter which is absolute and beyond dispute. A number of logical arguments may be given in favour of this contention. First, rules of behaviour prepared by human beings tend to be influenced by the personal judgement of those who formulate them. It is not possible for them to remain impartial, particularly if they are committed to the serving of their own self-interest. If wealth and power are also not distributed equitably, it may he possible for the rich and the powerful to tilt these rules in favour of their own vested interest. Even the slightest

[12] Frank H. Knight, 'Social Economic Organisation', reprinted from his The Economic Organisation, 3—30 in W. Breit et al., *Readings in Microeconomics* (St Louis: Times/Mirror Mosley, 1986), 4. This argument of Frank Knight was brought to my attention by Professor Anas Zarqa of the Centre for Research in Islamic Economics at the King Abdulaziz University in Jeddah, Saudi Arabia.

doubt about impartiality would negate the chances of consensus. Secondly, human beings do not have the information necessary to assess the effects of their own actions on others, especially those more remotely affected by them. Therefore, they need an impartial, well-meaning, and knowledgeable outsider capable of visualizing such effects to provide them with rules of behaviour that can save others from the adverse effects of their actions.

Thirdly, the Supreme Being Who has created human beings is alone capable of understanding their nature, their needs, their strengths, and their limitations, and of serving as the Sole Guide and the only Source of all values.

The question of motivation still remains. The serving of self-interest undoubtedly plays a strong motivating role and any system that does not allow individuals to serve their self-interest may not work. The moral filter does not, however, hurt a person's self-interest. It gives self interest a longer-term perspective, by stretching it beyond the span of this world to the Hereafter. While the pursuit of worldly self-interest by an individual does serve social interest, as Adam Smith argued, it does so only where self-interest and social interest are in harmony. However, if there is a conflict, it is necessary to have some other motivation, if controls and coercion, which are not effective anyway, are to be ruled out. The concept of Hereafter has proved to be helpful. While an individual's self-interest may be served in this world by being selfish in the use of resources, his interest in the Hereafter cannot be served except by fulfilling his social obligations. It is this longer-term perspective of self-interest along with the individual's accountability before the Supreme Being which has the prospect of motivating him to hold his claims on resources within the limits of general well-being. Effective operation of the moral filter can thus complement the price mechanism in realizing both efficiency and equity and thereby reduce the need for excessive government intervention in the economy.

Islam requires Muslims to lead a simple and humble life.[13] This norm

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[13] See the Qur'an (7:31, 17:26-7, 25:67) for verses against waste and extravagance. The Prophet also spoke against extravagance and in favour of simplicity and humility in lifestyle. He discouraged waste of resources in times of scarcity as well as abundance (*Mishkat*, Kitab al-Taharah, Bab Sunan al-Wudu', from 'Abdallah ibn 'Umar ibn al-'As). He said: 'God has revealed to me to teach you to be humble so that no one wrongs others or shows arrogance' (*Sunan Abu Dawud*, Kitab al-Adab, Bab fi al- Tawadu', from 'lyad ibn Himar); and that: 'God does not look at those who wear clothes reflecting arrogance' (*Sahih al-Bukhari,* Kitab al-Libas, Bab man harrama zinat Allah, from Ibn 'Umar). He also said: 'Whoever abstains from wearing an expensive dress out of humility, in spite of being capable of doing so, will be summoned by God in the presence of all humanity on the Day of Judgement and given the option to wear any of the distinguished attires of faith that he wishes' *(Jami' al-Tirmidhi*, Kitab al-Zuhd, from Mu'adh ibn Anas al-Juhani); and: 'Eat and drink, give in charity, and dress up without extravagance or conceit' (Suyuti, *al-Jami al-Saghir*, from Ibn 'Umar, on the authority of *Musnad Ahniad*, Nasa'i, lbn Majah, and *Mustadrak* Hakim). The weight of the Qur'an and the Sunna is thus on the side of a simple lifestyle for Muslims, and the jurists have rightly concluded that vainglory and vying with each other for worldly symbols of prestige are *haram* (prohibited). (Sec 'Kitab al-Kasb' of al-Shaybani in al-Sarakhsi, *Kitab al-Mabsut*, xxx. 266-8.

has the potential of minimizing that portion of consumption which is not related to needs, and of therefore promoting saving. Nevertheless, in clear violation of this norm, Muslim countries have been following for decades the Western consumer culture, which measures a person's worth by the luxury of his living and the frequency of his purchases. Accordingly, expensive lifestyles, which even some of the rich industrial countries can hardly afford, have become a prestige symbol in all Muslim countries. The bandwagon effect of this, along with a number of unhealthy customs and ceremonies, extending from childbirth to marriage and death, is an unrealistic consumption pattern which is unwarranted by their resources. The victims are forced to live beyond their means and to resort to corruption and unethical means to cover the shortfall between income and unrealistic spending. Aggregate consumption has accordingly risen, savings have lagged behind, and capital formation based on domestic savings remains inadequate. Moreover, since most luxury goods and services carrying a snob appeal are of foreign origin, the pressure on foreign-exchange resources has risen steeply. The resources gap has had to be filled by external borrowings. This has contributed to a higher debt-servicing burden which has further squeezed resources available for need-fulfilment and development.

While this underscores the need for creating a harmony between consumer preferences and social priorities in resource use, the IMF adjustment programme gives individuals complete freedom to pursue their preferences and relies on prices to screen their claims so that they remain within the constraint of available resources. This freedom makes it possible for the rich in a secularist environment to use their purchasing power to buy what they want. Those who cannot afford luxuries also try to keep up with the 'pace-setters' by acquiring them through suppression of need satisfaction or corruption and unscrupulous means. Since the poor are unable to pay the higher prices for needs, there is an unintentional distortion in the allocation of resources in favour of status symbols and against their availability for need satisfaction. This increases the hardship of the poor and constitutes one of the main reasons why most governments trying to implement the IMF adjustment programme are forced by social and political unrest to abandon, or slow down the implementation of, the programme soon after its announcement.

Effective use of the moral filter would help cast consumer preference in the mould of social priorities and also motivate all individuals to use scarce resources in conformity with these priorities. Individuals are thus placed under a moral obligation to pass their claims on resources through the moral filter before they come to the market-place to cast their dollar votes. A substantial proportion of claims on resources may thus he eliminated even before it is expressed in the market. This should help reduce the imbalances with lower exchange-rate depreciation and a smaller rise in the cost of living. It should also have a favourable effect on both saving and investment and on economic growth.

The use of a double layer of filters (moral values as well as prices) however requires the classification of all goods and services into 'needs' and 'luxuries'. The term 'needs' may be used to refer to all those goods and services which fulfil a need or reduce a hardship and thus make a real difference in human well-being. The terms 'luxuries' and 'status symbols' may be used to cover all those goods and services which are desired mainly for their snob appeal and do not make a real difference to a person's well-being. Everything required for fulfilling needs, such as capital goods, raw materials, exports, imports, and physical and social infrastructure, is 'essential', while everything else does not fall into this category.

Preparing such a classification may not be a simple job. Islamic values could however be helpful. There is an intrinsic discussion in Islamic jurisprudence (*fiqh)* about necessities (*daruriyvat*), conveniences (*hajiyyat*), and refinements (*tahsiniyyat.* All of these, as defined by the *fuqaha'* (jurists), fall within the range of what have been termed needs and do not include luxuries or status symbols. Anything that goes beyond needs has been treated by the jurists as prodigality and self- indulgence and is strongly disapproved of.[14] This discussion in the *fiqh* literature could be developed further within the present-day perspective to enable Muslim countries to reduce their prevailing imbalances without compromising their socio-economic goals.

[14] For the definition of these terms within the perspective of *fiqh*, see Abu Ishaq al Sharibi, *Al-Muwafaqat fi Usul al-Shari'ah* (Cairo: Al-Maktabah al-Tijariyyah al-Kubra, n.d.), ii. 8-12; and Anas Zarqa, 'Islamic Economics: An Approach to Homan Welfare', in K. Ahmed, *Studies in Islamic Economics* (Leicester, UK: Islam Foundation, 1980), 13-15. Ahmed al-Najjar and Anas Zarqa have in fact argued that, in the light of Islamic teachings, nothing that a man uses (as a consumer or as a producer) is morally free, even if it may be economically free. ( Ahmad al-Naijar, *Al-Madkhal ila al-Nazariyyah al-iqtisadiyyah fi al-Islam* (Beirut: Dar al-Fikr, 1973), 32 ff.; and Anas Zarqa, op. cit. 13.) See also lmäm Hasan al-Banna, *Majmu'ah Rasa'il al-Imam Hasan al-Bannä* (Alexandria: Dar al-Da'wah, 1989), 268; and *Hadith al-Thulatha' lil-Imam Hasan al-Banna* (Cairo: Maktabah al-Qur'an, 1985), 410; and Sayyid Abul A'la Mawdudi, *Islam awr Jadid Ma'ashi Nazarriyat* (Lahore: Islamic Publications, 1959), 136-40.

Since Islam is not an ascetic religion, the classification of goods and services into needs and luxuries need not remain constant through space or time. As Islam allows a person to satisfy all his needs and even to go in for all those comforts that would increase his efficiency and well being, and as the classification of goods and services into the two categories would have to take into account the wealth and general standard of living in the given Muslim country, the perspective about needs is bound to undergo a change over time with the development of technology and the increase in wealth and general standard of living. In fact most Muslim countries are richer today and can afford a higher standard of need-fulfilment than the early Muslim societies. What is, however, indispensable is the satisfaction of all basic needs of all human beings (including non-Muslims) in a Muslim society. This goal cannot be realized unless the differences in consumption level which have been allowed in conformity with the status and income of individuals do not go beyond what the economy's resources can bear. They should not reflect snobbery or lead to wide social gaps that can only weaken the bonds of Islamic brotherhood.

The objective should not be to create a monotonous uniformity and drabness in Muslim society. Simplicity can be attained in lifestyles in spite of creativity and diversity. The criteria for classification into the two categories should hence be the Islamic consumption norms along with the availability of resources and the impact on brotherhood and social equality. Removal of the prevailing imbalances will have to be an additional criterion until these become manageable.

'Liberalization' may hence be construed in Muslim countries within the framework of Isamic values related to needs and luxuries. Production, import, and distribution of all goods and services falling within the category of needs should he liberalized. Market forces should be allowed to play their constructive role. The government should do all it can to provide the necessary incentives and facilities to increase the supply of goods and services falling within this category. Any indirect tax which is considered necessary to be imposed on these goods and services should be at a lower rate and graduated in the reverse order of their priority.

It would, however, he necessary not to liberalize the use of resources for luxuries and inessential goods to ensure that the imbalances decline and the allocation of resources reflects social and economic priorities. The price system alone, as argued earlier, cannot help bring about a change in consumer preferences. Moral reform is indispensable. It complements the price system by inducing even the rich to reduce unnecessary consumption voluntarily in spite of their purchasing power. However, moral reform may be ineffective when conspicuous consumption has become a part of the social frame of mind after being in vogue for a long time. It is necessary to change the social mood. Individuals cannot change the direction of the tide and are constrained to conform. Hence, for greater effectiveness in creating the needed social environment, it would be desirable to have the campaign for simple living accompanied, at least in the early phase and as long as the Islamic values have not become internalized and the imbalances remain a serious problem, by an officially imposed ban on luxuries, ostentatious ceremonies, unrealistic dowries, and the display of status symbols. The ban may not operate effectively unless violation of the simple-living norm acquires the characteristic of a social stigma. This may not be possible without a simultaneous effort to internalize Islamic values. The IMF practice of not allowing such a morally oriented liberalization makes it difficult for governments to ensure equity while trying to remove any imbalances, and thus weakens their determination to implement the adjustment programme.

**2. *Different system of financial intermediation***

The moral filter and motivating system may both fail to reduce the impact of income and wealth inequalities on the allocation and distribution of resources if financial intermediation does not also make a positive contribution. While there can be no difference of opinion on the need for a realistic price to allocate financial resources from the surplus to the deficit sectors, there can be a difference of opinion on which price would best serve the objectives of minimizing their inefficient and inequitable use.

Financial intermediation on the basis of interest tends to allocate financial resources among borrowers on the criteria of their ability to provide acceptable collateral to guarantee the repayment of principal, and sufficient cash flow to service the debt. End-use of financial resources does not constitute the main criterion. Financial resources hence go mainly to the rich who fulfil both these criteria. Since the rich borrow not only for investment hut also for conspicuous consumption, the resources available for need-fulfilment become squeezed.

Islam does not therefore find interest to be the appropriate price for efficient and equitable financial intermediation. It prohibits interest and reorganizes financial intermediation on the basis of profit-and-loss sharing. The financier is not assured of a positive rate of return. His return is linked to the ultimate outcome of the business financed. This should help make him more concerned about the end-use of funds. Financing would not then become available for any purpose just because the borrower has an acceptable collateral to offer and sufficient income to service the debt. It would rather be available if he has a worthwhile project and the necessary ability to manage it efficiently. It would also not be confined primarily to the rich. Even a poor entrepreneur could qualify. This has the potential of promoting both efficiency and equity.

The prohibition of interest was also an integral part of the value systems of both Judaism and Christianity. Islam however still clings to it because of its belief that it is difficult to realize the humanitarian goals of society (including need-fulfilment and equitable income distribution) without curbing the unproductive and inequitable use of scarce resources which the collateral-linked, interest-based intermediation has the tendency to promote.

**3. *Fiscal restraint***

While reducing private-sector absorption in an efficient and equitable manner would be helpful, it would not be sufficient. Governments have been equally, if not more, guilty of spending beyond what is warranted by their resources. Therefore aggregate government spending also needs to be subjected to a significant cut. The goal of socio-economic justice however demands that while aggregate spending is being cut, spending which is needed for promoting greater equity is not only not reduced but actually increased. Hence government expenditure programmes need to be restructured to reflect socio-economic priorities. Areas which have exerted a substantial pressure on government resources include: corruption, inefficiency and waste, subsidies that help the rich and the powerful rather than the poor, public-sector enterprises whose performance has been by and large disappointing and who have become a burden on the public exchequer, and excessive military spending which contributes in a substantial way to the debt burden and exerts a negative impact on economic development and socio-economic justice.

An important question that arises here is why the burgeoning fiscal deficits resulting from such unproductive spending have not forced governments to reduce spending and to increase the flow of resources through tax reform. One of the major reasons is the relatively easy availability of finance in conventional interest-based financial intermediation. This creates an unwarranted sense of financial ease, promotes unproductive projects whose benefits do not justify the costs, and contributes to a neglect of the reform of expenditure programmes and tax systems. It also enables governments to postpone the necessary adjustment and exacerbates budgetary and balance-of-payments deficits, thus increasing and perpetuating the need for borrowing. The continually rising debt-servicing burden further squeezes the resources for development, decelerate, growth, and accentuates unemployment and social tensions.

If the return on finance provided even to the public sector were made subject to the performance of the project, the lender would he compelled to take a greater interest in the nature of the project and its satisfactory management. Financing would not then be undertaken on the assumption that a sovereign debtor does not go bankrupt; it would rather be available mainly for projects about the productivity of which the financier is confident. Governments would not be able to obtain financing for defence build-up, unprofitable public-sector enterprises, and white-elephant projects. The new basis of financial intermediation may tend to create difficulties in the short run. In the long run, however, it would turn out to be a blessing because it would reduce wasteful and unproductive spending, force governments to seek ways of peaceful coexistence, and help avoid the back-breaking debt-servicing burden.

The abolition of interest would have another far-reaching effect. Industrial countries would nor be able to expand their exports to developing countries simply by providing suppliers' credits. They will have to reduce their protectionist barriers and enable the developing countries to increase their exports. They will have an interest in ensuring that the importing country has continued access to markets for its products. This will help remove a number of tariff and non-tariff harriers that obstruct the imports of agricultural and manufactured products by industrial countries from developing countries. UNCTAD has estimated the total economic cost of protectionist barriers against Third World countries to be as high as $700 billion annually in terms of export earnings — more than 50 per cent of the total current external debt of these countries."[15] If interest-based financing were not available and protectionist barriers were also not reduced by industrial countries, developing countries would be forced to review their import policies. Such a review would tend to affect the import of luxuries and inessential goods more severely in a value-positive adjustment programme.

The Islamic ban on interest will also make it indispensable for Muslim countries to create a proper investment climate for attracting foreign equity capital. Since the return on equity has tended to be attractive in many developing countries, there is no reason to believe that the creation of such a climate would not he able to induce a higher capital inflow. The rate of total return on equity investments in a number of developing countries was 33 per cent per annum during the five-year period 1984-89 according to the IFC Emerging Markets Composite Index. This comp-

[15] United Nations Conference on Trade and Development (UNCTAD), *Trade and Development Report*, 1985 (New York: United Nations, 1985), 123-4.

ares favourably with a rate of return of 20.3 per cent on the US benchmark Standard and Poor's Index of 500 stocks."[16] Any devaluation of the currencies of such countries may tend to be offset in due course by a corresponding appreciation in the value of their shares in terms of local currency. Given the attractive rate of return, the major local deterrent to capital inflow is the absence of a proper investment climate. Since only those countries which create such a climate will be able to attract foreign equity investment, all Muslim countries will be under pressure to restructure their policies.

The prohibition of interest by Islam will thus force Muslim governments to undertake fiscal reform. This does not necessarily mean return to a balanced-budget regime. While governments will have to raise their tax revenues to finance their recurring and unproductive (including defence) spending, they may be able to arrange the financing of their productive projects in a number of different ways, other than borrowing, acceptable to the *Shari'a*.[17] They may resort increasingly to leasing of infrastructure projects financed and implemented by the private sector on a competitive basis in accordance with government specifications. This will contribute to greater efficiency, lessen corruption, and also open up a wide avenue for greater co-operation between governments and the private sector. They may also find it possible to arrange some financing on the bases of instalment, deferred payment, and hire purchase. They may be able to invite private-sector participation in the equity of projects which are commercially viable, but the management of which it is not desirable to leave to the private sector for some overriding reason.

Governments may also find it necessary to encourage private philanthropists to construct and run as many as possible of the educational institutions, hospitals, housing schemes for the poor, orphanages, and other social-service projects. The institution of *awqaf* (charitable trusts)

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[16] See International Finance Corporation, *Emerging Stock Markets Facthook, 1990* (Washington, DC: IFC, April 1990), 39. The IFC Total Return Indexes include changes in prices, adjusted for changes in capitalization, as well as cash dividends received and dividends implicit in rights issues with a subscription price below the prevailing market price.

Of the nineteen countries included in the emerging stock markets composite index, only five are Muslim countries: Jordan, Malaysia, Nigeria, Pakistan, and Turkey. The IFC Factbook also gives stock market data for five other Muslim countries: Bangladesh, Egypt, Indonesia, Kuwait, and Morocco.

[17] A considerable amount of literature is now available on the alternatives. See, for example, NI. Anas Zarqa, 'Islamic Financing of Mute Social Infrastructure: a Suggested Mode Based on *Istisna*", a paper presented to the Seminar on Islamic Banking in Bahrain, 26—8 May 1990; M. U. Chapra, *Towards a Just Monetary System* (Leicester, UK: Islamic Foundation, 1985), 132—9 and 166—73; and M. Atiff and M. A. Mannan, *Developing a System of Financial Instruments* (Jeddah: IRTI, Islamic Development Bank, 1990).

played an important role over a greater part of Muslim history. Its rich potential has however remained untapped in the recent past for a number of reasons including expensive lifestyles and unsound tax policies of governments. The revival of this institution should help reduce significantly the government's burden in financing social-welfare projects. The reform of the tax system should also have the revival of this institution as one of its objectives. It may also the possible, but to a much smaller degree, for governments to borrow from the central banks to finance social-welfare projects. The Islamic imperative of maintaining price stability should serve as a constraint.[18] In case of emergencies, it may also be possible to resort to refundable taxes (interest-free borrowing). In extremely difficult circumstances, when the spending is considered indispensable in the overall public interest and the financing cannot be raised otherwise, it may be juristically permissible for a Muslim government to resort to conventional borrowing.[19]

None of these alternative methods of financing will create the financial ease that borrowing tends to create in the short run. Governments will hence be forced to accomplish more with less. They will have to internalize the Islamic value system and to restructure the economy to the extent feasible to enable the private sector to optimize its savings and investments and to play a greater role itself in removing market failure. They will have to introduce greater integrity in their own operations, establish proper priorities in spending, undertake a careful evaluation of the benefits and costs of all projects, and adopt cost-recovery methods in pricing public goods and services. Accordingly, it would be unrealistic for Muslim governments to talk of Islamization without making a serious effort to reduce their budgetary deficits. To avoid an excessive squeeze in the initial stage, governments may apply the prohibition gradually and not at one stroke, provided that they show a determination to reduce borrowing, which must become reflected in the annual absolute decline in their deficits financed by borrowing and monetary expansion.

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[18] See M. U. Chapra, *The Islamic Welfare State and its Role in the Economy* (Leicester, UK: Islamic Foundation, 1979), 14—15.

[19] This opinion is based on the Qur'anic verse related to certain specified items which have been prohibited but the use of which has been allowed in extremely dire circumstances. 'He has forbidden carrion, blood, pork and that which has been slaughtered in the name of other than God. However, if one is forced by dire necessity without wilful disobedience or transgression of the limit, no sin shall be on him. Certainly God is forgiving and kind' (Qur'an 2:173). There are a number of other verses with the same implication in the Qur'an (5:3, 6:145, 16:115, 6:119). This principle is applied by way of analogy to interest paid if there is a dire need for funds and no alternative arrangement is possible, provided that the borrowing is resorted to only to the extent absolutely necessary.