COMMENTS* ON THE REPORT OF THE COUNCIL OF ISLAMIC IDEOLOGY (PAKISTAN) ON THE ELIMINATION OF INTEREST FROM THE ECONOMY OF PAKISTAN

by
M. Umer Chapra

The Government of Pakistan needs to be complimented for appointing the Panel of Economists and Bankers to prepare these Reports on the elimination of interest from the economic and financial system of the country in conformity with the teachings of the Qur'an and the *Sunnah.* This is the first time that a serious commitment of this nature has been expressed by the Government to mould the economy in the framework of Islamic values in an area which is generally considered to be the most difficult. I must in turn pay my respects to the members of both the Panels for having made a valuable contribution to the ongoing discussion not only in Pakistan but also in the whole Muslim World on the interest-free economy.

However, while expressing my admiration for the Report I would like to throw some light on certain aspects of the subject which I feel are important. I hope that these comments made in a humble spirit will be given due consideration by the Panels.

1. Ribā, the Wider Meaning

The Panel has defined *ribā* as equivalent to interest (First Report, p. 1) whereas the term *ribā* has been given a considerably wider connotation in *Fiqh* literature than what the term interest conveys. Interest refers to what has been termed as *ribā al-nasi'ah* or *ribā al-jali* or *ribā al-duyun* in the *Fiqh* literature. This is the kind of *ribā* that is covered by the Quranic *ayah.* However, the *Sunnah* has also emphasized other aspects of *ribā* generally termed as *ribā al-fadl* or *ribā al-khafl* or *r ribā al-buyu'.* This form of *ribā* covers all forms of economic injustice, exploitation and unearned income (other than that, like inheritance and genuine gifts, allowed by the *Sharī'ah).* Ibn 'Arabi has defined *ribā* as all excess over what is justified by the consideration (كل زيادة لا يقابلها عوض).[١] According to the Holy Prophet a Muslim could indulge in *ribā* in a number of ways.[2] That is why [٣] Caliph felt inspired to say that "You should abstain from *ribā* as well as *ribah* (فدعوا الربا والريبة). *Ribah* is from *rayb* which literally means doubt and refers to any income which has the semblance of *ribā* or which raises doubts in the mind about its rightfulness. It covers all income derived from injustice to, or exploitation of, others.

Thus the elimination of *ribā* from the economy would require the discussion of all forms of exploitation now prevalent in Pakistan or other Muslim countries. This would naturally make the subject so vast that the Panel would not be able to cover it. Nevertheless, in fairness to the Prophetic teachings about *ribā,* it would have been desirable if the Report had at least made a mention of this point to indicate that the Report is concerned with the elimination of only one aspect of *ribā* which is *ribā al-nasiah,* and which pertains to the financial sector. It would be desirable if the Government of Pakistan were to appoint another panel to submit a report on other forms of economic exploitation and injustice in Pakistan to complete the study on the elimination of *ribā* from the economy.

II. **Some Fundamental Reforms**

The Report has adopted the simple approach of assuming that merely the removal of interest from the banking system and replacing it by profit- and-loss-sharing (and some other devices) will be sufficient to make the prevalent banking system conform to the requirements of the *Sharī'ah.* I wish to express my disagreement with this approach. Although the elimination of interest and its replacement by profit-and loss-sharing is a necessary step, it is not sufficient. Unless we introduce some fundamental reforms in the economy as well as the money and banking framework, it will not be possible for us to realize the goals stressed by Islam, particularly the goals of economic stability, socio-economic justice and equitable distribution of income and wealth.[4] Some of these essential reforms are briefly indicated below:

1. Deposits and the Social Trust

It needs to be clearly realized that when financial institutions mobilize savings through demand deposits they are acting only as agents for the society to whom the savings belong. Hence within the framework of the Islamic values of socio-economic justice, these deposits should be utilized for the broad-based welfare of the society and not the private benefit of a few individuals or families. Once this principle is clearly recognized, we may derive a number of corollaries from it that would help us cater to social welfare. Two of these corollaries are:

(a) The Government has the right to call upon banks to lend to it a certain reasonable proportion of demand deposits for financing socially beneficial projects in which profit-sharing is not feasible or desirable. It would, of course, be fair to demand that the Government should pay a service charge on the resources thus made available to it. The service charge should include on a pro *rata* basis not only the cost of mobilizing demand deposits but also the cost of insuring them and of rendering all services related to them. Once this obligation is accepted by banks the Government would not be forced to finance its entire deficit by borrowing from the State Bank, as the Panels have implicitly assumed.

(b) Bank credit coming out of the society's deposits should be so allocated that it helps realize general social welfare. The criteria for its allocation, as of other God-given resources, should be, first, the realization of the goals of the Islamic society, and, then, the maximization of private profit. This could be attained by ensuring that:

(i) credit allocation leads to an optimum production and distribution of goods and services needed by a greater majority of society, and

(ii) the benefit of credit goes to an optimum number of businesses in the country.

2. Wasteful Spending and Conspicuous Consumption

All wasteful spending and conspicuous consumption needs to be minimized from the private as well as public sectors to reduce their combined borrowing to the limits of what monetary expansion within a non-inflationary context can permit.

The lending activity of banks in the private sector should hence be so oriented that, without generating any inflationary heat, it contributes positively to the realization of broad-based economic welfare within the framework of socio-economic justice as conceived by Islam. This would require that bank credit be directed mainly toward the promotion of production, import and distribution of goods and services which are needed by all sectors of the society and which do not widen the consumption gap between the rich and the poor. For this purpose the banking system would have to be dovetailed with a realistic plan oriented to the fulfilment of the essential and genuine needs of the people. In the light of such a plan the State Bank should give guidance to banks about the purposes for which bank financing may not be provided. Moreover, the framework of social values and Government regulations would have to be changed in such a way that productive investment is eulogized and encouraged and wasteful spending is condemned and discouraged. The country's educational institutions and news media would have to play an important role in bringing about this social reform.

Wasteful spending must also be eliminated from the public sector to minimize the public sector borrowing requirement. The political leadership and bureaucracy would have to change their attitude towards public funds and realize that every rupee in the public treasury is a trust and must be spent honestly and efficiently for the welfare of the people. Unless this is done, the Government will have difficulty in reducing its budgetary deficits. Over the last decade (1969-1978), these deficits (excluding [5] the use of cash balances) have been on the average about 44 per cent of total Government expenditure. This deficit has been financed to the extent of about 55 per cent by external borrowing and 45 per cent by domestic borrowing. Of the domestic borrowing, about 37 per cent has come out of the State Bank and the balance of 63 per cent from the private sector including the commercial banks and other financial institutions.

TABLE 1
Budgetary Deficits of the Government of Pakistan
1969-1978

	1959	1970	1971	1972	1973	1974	1975	1976	1977	1978	T
1. Expenditure	7,307	7,904	7,987	8,784	11,128	14,520	19,525	22,390	24,564	30,393	154
2. Deficit	- 2,891	- 4,076	- 2,721	- 2,759	-4,375	-4,860	11,867	- 11,636	- 10,354	- 12,292	67,
3. (2) as % of (1)	40	52	34	31	39	33	61	52	42	40	44
4. Financing of (2), net borrowing:											
(a) Foreign	1,988	1,749	1,719	863	3,301	2,976	7,796	6,488	5,153	5,293	37,
(b) Domestic	903	2,377	1,002	1,896	1,074	1,884	4,071	5,148	5,201	6,999	30,
(i) State Bank	62	1,761	974	1,105	215	-937	1,398	3,780	3,476	583	11,
(ii) Commercial Banks	477	23	36	1,380	1,371	-533	950	2,665	1,399	3,199	10,
(iii) Others*	364	543	-8	-589	-512	3,354	1,723	-297	326	3,217	8,1
(iv) (ii) + (iii) as % of (b)	93.1	24.3	2.8	41.7	80.0	149.7	65.7	46.0	33.2	91.7	62.

If Government deficits continue to be of the magnitude they have been in the past the domestic financing of these deficits will have to come only out of borrowings from the State Bank because borrowings from the private sector will be difficult in the absence of any return or coercion. The rate of inflation in Pakistan will, in this case, be significantly higher than what it has been in the past. Thus, an important goal of Islamic society will have to be sacrificed if wasteful and unproductive spending by both the public and the private sectors is not minimized.

3. Increased Equity Financing

The obligation to abolish interest would make it indispensable that there be primary reliance on equity capital and little dependence on borrowed money in an Islamic economy. The Islamic economy would thus have to be essentially equity-based, compared with capitalism which is predominantly loan-based and in which a vast superstructure of finance is raised on a small foundation of equity capital. A greater equity base with a larger number of share-holders or partners would help reduce concentration of wealth and realize the Islamic goal of equitable distribution of income and wealth. Accordingly, all financial needs of a permanent nature, whether for fixed or working capital needs, would have to come out of equity and not borrowing. Borrowing should be resorted to only to the extent of bridge -financing and temporary shortages of funds resulting from new opportunities or seasonal peaks in business for which purpose it may not be possible or desirable to have an immediate or permanent increase in equity.

One of the first steps that would hence need to be taken to Islamize the economy is to make all firms, whether joint-stock companies or partnerships increase their equity base adequately to cover their capital needs of a relatively permanent nature. Consequently, all joint-stock companies should be required to float additional shares; the commercial banks may also take up a proportion of these. Here the role of the State Bank would be to monitor the price at which new shares are acquired by banks to ensure that the price is in keeping with what is justified by real assets and that there is no corruption.

4. Reducing the Power of Banks

In the capitalist framework, society's resources mobilized by banks are utilized by them for enriching a few families. According to D. M. Kotz, ultimate power in the United States resides with the bankers who are the major stockholders in, and creditors of, the modern large corporations.[6] The Patman Committee concluded that the major banking institutions in the US were emerging as the single most important force in the economy[7] and warned that the growing bank control might result in restraints of competition and pose a serious conflict of interest problems.[8] The Securities and Exchange Commission's Report concluded that large institutions, particularly banks, have potential economic power to exert significant influence over many companies whose securities comprise their portfolios.[9] One of the primary reasons why banks tend to become the centres of control under capitalism is that capitalists who operate through a bank "obtain access to other peoples' capital."[10] It is hence not surprising that "the wealthiest and the most powerful capitalists operate through banks."[11]

If this problem of concentration of power is examined within the framework, not of interest-bearing loans, but of profit-and-loss-sharing with commercial banks participating in decision-making, appointment of directors and carrying out of verification tests, then the danger of concentration of power in the hands of bankers will increase even more than in the capitalist system. It would, therefore, be important to think of effective measures to reduce the power of banks. If we do not do this we will be creating monsters who, by the economic power which they attained through other peoples savings, will be able to exercise enormous influence on people's destinies. The mere nationalization of banks, as already exists in Pakistan, will not be sufficient, because the place of businessmen and industrialists could be easily taken over by bureaucrats.

One of the measures that may be desirable is to have a larger number of banks and to ensure that none of them expands beyond a certain limit determined by the State Bank. If this is not done immediately, it should at least be borne in mind as a desirable step to be taken in the future. Secondly, banks should be required to provide financing to a larger number of entrepreneurs and not to provide more than a small proportion of their resources to any one business or family. Thirdly, they should not be allowed to acquire a controlling stock in any business. Fourthly, no one from among the bank's directors should be allowed to have a business of his own or to become a director in any other business to prevent commercial bank directors and managers developing a vested interest in any specific business.[12] In other words, interlocking directorates involving bank directors should not be allowed other than in exceptional circumstances. Other specific measures may also need to be adopted by means of well-conceived and properly enforced laws to ensure that Islamic banks do not only not lead to concentration of wealth and power as under capitalism, but also contribute to an equitable distribution of income and wealth in society.

For the same reason it may be added that while it is necessary to carry out a thorough checking of the accounts of the borrowing firms, this should be done through independent auditing firms and not by the banks themselves. It would be desirable to establish an Investment Audit Corporation (IAC) to examine the operations and accounts of borrowers and thus safeguard the interest of financial institutions, depositors and equity holders. The IAC should carry out the examination and audit of a random sample of all users of other peoples funds and also of firms specifically referred to it by financial institutions or investors. It must be appreciated that if the new system is implemented gradually, market forces will play an important role in ensuring honesty on the part of users of commercial bank funds. It will be difficult for a firm to cheat banks because the firm could be placed on the black list of all banks if it continuously tends to show an ex *poste* profit lower than its ex *ante* profit on the basis of which it obtained financing from the bank. It would also be necessary, as the Panel has rightly pointed out, to have a thorough-going reform of the auditing system with a view to improving the role of auditors and safeguard the interest of investors.

5. A Sane Stock Market

The greater resort to equity financing in an Islamic economy as suggested above will require the effective operation of both the primary and secondary capital markets to enable businesses to raise funds and to provide liquidity to investors who cannot, or do not wish to, hold the equity they have acquired. It should be easy to get in and out of any equity that an investor wishes to acquire or sell. While the equity-oriented Islamic financial institutions could play an important role in this area the organization of a sane stock market would be indispensable in the interest of banks as well as other investors. Among the essential requisites for this would be to bring about firstly, a rational behaviour in stock prices, and secondly, reasonable rates of dividend, to inspire investors' confidence in stocks and shares. While the first would require elimination of unhealthy speculation, the second would require proper auditing of the profits of joint stock companies under a reformed auditing system and certain checks and balances on the powers of directors and management. It would be desirable for the Government of Pakistan to appoint a Panel to study the organization of a reformed stock market on the basis of the *Sharī'ah* to act as a necessary complement to the Islamic banking system.

III. Monetary Policy [13]

Coming now to the question of monetary policy one might wish to emphasize that the State Bank will have to perform not only the functions of a modern central bank but also some additional functions within the Islamic framework. Two of these additional functions are: (a) to ensure, as indicated earlier, that the distribution of credit is in accordance with the socio-economic goals of Islam; and (b) to promote the development of a healthy equity-financing system in place of the present equity-plus-loan financing system. In addition, the State Bank will need to lay a greater stress on monetary and price stability in conformity with the values of Islam.

The State Bank should try to ensure a credit allocation which is in conformity with the goals of the *Sharī'ah.* For this purpose the credit allocation must fulfil at least two characteristics. It should, on the one hand, help the nation produce all essential goods and services, and, on the other hand, bring about a distribution of credit in a broad based manner to a maximum possible number of businesses to promote an equitable distribution of income and wealth in society. The Report has expressed the need for distribution of credit but has unfortunately not indicated how this is intended to be achieved. One of the normal arguments given by banks for preferring large borrowers is that granting credit to small borrowers is very cumbersome and expensive. If this argument is valid, certain measures should be adopted to relieve the banks. The Government may, if necessary, subsidise the additional cost to banks of processing the loan applications of a large number of borrowers than what banks are willing to do under normal circumstances. The State Bank may also consider the establishment of a small-loans insurance scheme to be financed by a modest premium charged on all financing provided by the commercial banks.

To promote the development of a safe and vigorous equity financing system that would inspire the confidence of investors and effectively mobilise savings for the accelerated and balanced development of the country, the State Bank will have to play a crucial role in the Islamic system even though this role may not be considered to be important for modern central banks in the capitalist context. It will have to develop a sane stock market where prices reflect not any speculative fever but changes in underlying economic conditions. It will also have to promote the development of investment trusts and other auxiliary financial institutions with properly conceived and well-enforced laws to safeguard the interest of banks as well as other investors.

It should also be emphasized that Islam demands a greater commitment on the part of the Government and the State Bank to monetary and price stability.[14] The performance of Pakistan with respect to inflation has not been very encouraging over the last decade.[15] One of the reasons for this has been that monetary expansion has been considerably faster than the supply of real goods and services.[16] Under no circumstances should this performance be repeated in the Islamic system. It is heartening to note that the Panel has emphasized monetary and price stability. However, the tools discussed in the Panel's Report, though helpful. may not be sufficient to ensure the realization of the desired goal.

One very significant evolution in monetary management over the past decade has been the widespread adoption of official targets for permissible growth in money and credit aggregates. This technique has been widely accepted by a growing number of central banks particularly among the OECD countries.[17] This is because of the shift in emphasis away from interest rates as intermediate targets of monetary policy towards quantitative norms for the growth of money stock[18] and because monetary management has been found to be fairly successful if this technique is adopted.[19] The announcement effect of monetary targets tends to reduce inflationary expectations.[20] Monetary targeting also helps the development of co-ordinated packages of non-inflationary fiscal, credit and incomes policies. However, the goal of monetary stability has remained illusory in spite of monetary targeting, firstly, because governments which have become converts have not always been steadfast in fulfilling the demand of this technique for discipline in their fiscal policy, and secondly, because of the disturbing influence of speculative capital flows.

It would be desirable for the State Bank to develop such targets in the light of the economic goals of Pakistan, particularly price stability. This will indicate the maximum allowable growth in high-powered money through both fiscal deficits and State Bank credit to the commercial banks. Such monetary growth targets should, of course, be reviewed frequently to make whatever adjustments that are felt necessary in the light of changing circumstances. Given the monetary target and the control of high-powered money at source through regulating Government deficits and State Bank credit to commercial banks, the minor adjustments that would need to be made in high-powered money could be brought about through the other tools of monetary policy suggested by the Panel. This would, of course, require a firm determination on the part of the Government of Pakistan not to overstep the fiscal deficit indicated by monetary targeting; capital flows which have been a frustrating element in some industrial countries need not be a disturbing factor in the economy of Pakistan. May we expect that the Government which is so anxious to implement the teachings of Islam with respect to *ribā will* also be equally anxious to realize the Islamic goal of price stability?

Conclusion

It would be appropriate to emphasize here that the abolition of *ribā is* not the only value of Islam. It is one of the many values. *Ribā* cannot be successfully eliminated unless we reform our society in the light of Islamic teachings. This does not imply that the abolition of *ribā sh*ould wait until the society has been sufficiently reformed. However, it does imply that the Government should at least simultaneously start the reform of the society and the creation of the proper moral climate by using all its educational and propaganda machineries effectively for this purpose.

While I have made these comments for the consideration of the Panels, I should once again like to pay my compliments to the members of both the Panels for having prepared these valuable Reports which will be useful to policy makers not only in Pakistan but also in other Muslim countries.

---

* These comments were made at a seminar held in Islamabad in January 1967 and published in Ziauddin Ahmed, et., al. (eds.), *Money and Banking in Islam* (Islamabad: Institute of Policy Studies, 1983), pp. 212-223. The Council Report is also reproduced in *ibid* on pp.103-211.

[1] See the commentary *of ayah 2:275 of* the Quran in Muhammad bin Abdullah ibn 'Arabi, *Ahkain al-Quran* (Cairo: 'Isa al-Babi al-Halabi, *1957), Vol. 1. p. 242.*

[2] Said the Holy Prophet.:

الربا ثلاثة وسبعون بابا أيسرها مثل أن ينكح الرجل أمه وإن أربا الربا عرض الرجل المسلم

"Ribā has seventy-three entrances, the least of them is like a person getting married to his own mother and the worst of them is that he degrades the honour of a Muslim" (Cited on the authority of Ibn Majah and al-Hakim, by Ibn Hajar al-'Asqalani, *Bulūgh al-Marām*, Cairo, al-Maktabah al-Tajariyyah al-Kubra, 1352, p. 170:851).

The Holy Prophet also said:

من شفع لأخيه شفاعة فأهدى له فقبلها فقد أتى بابا عظيما من أبواب الربا

"Whoever makes a recommendation for his brother but accepts a gift offered by him has entered *ribā* through a large gate") (Cited by *ibid* on the authority of Ahmad and Abu Dawud, p, 172:881), and

خدع المسترسل ربا

"Deceiving a mustarsal (unknowing entrant into the market) *is ribā"* (Cited on the authority of *Sunan al-Bayhaqi* by Jalal al-Din at-Suyuti, *al-Jami' at-Saghir,* Cairo: Abd al-Hamid Ahmad Hanafi, n. d., Vol. 2, p. 7-11).

[3] Cited by Muhammad bin Yazid ibn Majah, *Sunan (Cario: 'Isa* al-Babi al-Halabi 1953), Vol. 2, p. 764: 2276. See also the commentary on the word *ribah* in the footnote.

[4] For an elaboration of this point see the final version of the author's paper: "Money and Banking in an Islamic Framework" published in the book: Mohammad Ariff, ed., *Monetary and Fiscal Economics of Islam* (Jeddah: International Centre for Research in Islamic Economics, King Abdulaziz University, 1982), pp.145-186..

[5] See Table 1

* Derived as a residual.

Based on data from IMF, *International Financial Statistics Yearbook, 1980,,* p.329

[6] D. M. Kotz, *Bank Control of Large Corporations in the U.S.* (Berkeley: University of California Press, 1978), p. 148.

[7] United States' Congress, House Banking Currency Committee, Subcommittee on Domestic Finance, *Commercial Banks and their Trust Activities: Emerging Influence on the American Economy,* 9th Congress, 2nd Session, 1966, p. 5.

[8] Ibid., p. 1.

[9] United States Securities and Exchange Commission, *Institutional Investor Study Report,* House Document 92-64 referred to the House Committee on Interstage and Foreign Commission, 1971, pt., 8, pp. 124-5.

[10] Kotz, *op. cit., p.* 143

[11] *Ibid., p.* 149

[12] In Germany, where commercial banks hold shares in industries, it is charged that banks exercise undue influence on industry, not simply through their holdings but through their membership of company supervisory boards. Hence the German parliament has presently been considering a report on the "fundamental problems in the credit sector". The report recommends that banks should be restricted to a 25 per cent "plus one share" holding in non-banking concerns. This percentage, which offers certain tax advantages and veto rights under the German Corporation Law, is considered too high by others who have proposed a ceiling of 5 to 15 per cent. The report also calls for a greater disclosure of information about the professional commitments of supervisory board members. (See a report entitled "Banks Oppose Share Move" in the *Financial Times,* October 22, 1980, p. 42.

[13] This section should read in conjunction with the author's paper -Monetary Policy in an Islamic Economy" presented to the same Seminar at which this note will be discussed

[14] See M. U. Chapra, "The Islamic Welfare State and Its Role in the Economy", in K. Ahmad and Z. 1. Ansari, *Islamic Perspectives* (U. K. Islamic Foundation, 1979), pp. 204-5.

[15]

risen from 100 in 1969 to 301 in 1979. Over the corresponding period, consumer prices in India have less than doubled with the index rising from 100 in 1969 to 198 in 1979. (See, IMF, *International Financial Statistics Yearbook, 1980)* lines 64 on pages 219 and 327.

[16] While monetary expansion was at the rate of 16.4 per cent per annum over the decade of the Seventies (1969-1979), the real output registered a growth of only 3.8 percent per annum, consumer prices rose at the rate of 12.1 per cent per annum (Based on data given on the Pakistan pages in *ibid.*

[17] Bank for International Settlements, The Monetary Base Approach to Monetary Control, (Basle: B. I. S., Sept. 1980) p. 7. See also, Banking System and Monetary Policy in the EEC (London: Financial Times, 1974), p. 1.16.

[18] OECD, *Monetary Targts and Inflation Control* (Paris: OECD, 1979), p. 2. The Report argues that "Manipulation of interest rates has not in all cases proved a satisfactory way of achieving monetary restraint or of stabilizing monetary expansion under expansionary conditions" and that "Policies which are guided by quantitative objectives for the monetary base (or bank reserves and under which interest rate levels are - or can be seen to be - a by-pro have, therefore, come to seem increasingly attractive in some countries", p. 1.2.

[19]

[20] B. 1. S., *op. cit., p.* 63.