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# **THE CASE AGAINST INTEREST: IS IT COMPELLING?**

by

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## INTRODUCTION

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

The introduction of a new model of financial intermediation based on PLS is not an easy task. The difficulties involved in the changeover justifiably raise the question of why should anyone try to replace the conventional system which has been in existence for such a long time and has by now become highly sophisticated. Is the case against interest so compelling that a change needs to be considered seriously. One reason for the change is the imperative of abiding by a religious edict. This reason, though of prime importance to committed believers in Islam and other religions, may not have any appeal for those who are not so highly committed. It is, therefore, necessary to see whether the effort to remove interest from the financial system has any economic rationale. Such a rationale would exist if the PLS system can be shown to be capable of improving the realization of both efficiency and equity, the two criteria on the basis of which any economic or financial system needs to be evaluated.

The interest-based system was generally assumed to be superior to the interest-free system on the criterion of efficiency. It was, however, normally considered to be inferior on the criterion of equity or socio-economic justice. The persistent instability and crises to which the international financial system has become exposed over the last few decades and the problems that this has created have, however, raised doubts about its superiority on the efficiency criterion. This paper is

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<sup>1</sup> For the Judaic and Christian views on interest see Johns, et. al. (n.d.), and Noonan (1957); for the Hindu view, see Bokare, 1993, p. 168; and for the Islamic view, see Chapra, 1985, pp. 55-66, and Siddiqi, 2004, pp. 35-64.

<sup>2</sup> For some of these protests, see Mills and Presley, 1999, pp. 101-113.

an attempt to discuss the primary cause of the crises and to show the contribution that a risk-reward sharing system can make towards greater financial stability as well as socio-economic justice.

## **THE FINANCIAL CRISES**

The efficiency argument in favour of the conventional interest-based system of financial intermediation has been substantially weakened by the crises it has experienced over the last few decades.<sup>3</sup> There is not a single geographical area or major country which has been spared the effect of these crises. Hence there is an uneasy feeling that “something is wrong with the global financial system.” (Stiglitz, 2003, p.54). This has led to a call for comprehensive reform of the financial system to help prevent the outbreak and spread of financial crises or, at least, minimize their frequency and severity. The needed reform has come to be labeled ‘the new architecture’.

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

## **THE ROOTS OF THE CRISES**

A number of economists have made an effort to determine the causes of the crises. Some consider financial liberalization to be the cause in an environment where financial systems of many countries are not sound as a result of improper regulation and supervision (Glick, 1998; Bisignano, 1998). Others feel that the ultimate cause is the bursting of the speculative bubble in asset prices driven initially by the excesses of

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<sup>3</sup> By some reckonings, there have been 100 crises in the past 35 years (Stiglitz, 2003, p.54) The more important of these crises are the US stock market crash in October 1987, the bursting of the Japanese stock and property market bubble in the early-1990s, the breakdown of the European Exchange Rate Mechanism (ERM) in 1992-93, the bond market crash in 1994, the Mexican crisis in 1995, the East Asian crisis in 1997, the Russian crisis in August 1998, the breakdown of the US hedge funds in 1998, the Brazilian exchange rate crisis in 1999, and the steep decline in US stock prices in 2002.

financial intermediaries (Krugman, 1998). It has also been argued that the root cause of the crises was the maturity mismatch: short-term international liabilities were far greater than short-term assets (Chang and Velasco, 1998; and Radelet and Sachs, 1998). The available literature indicates a number of other causes as well.

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

The violation of these principles brings to mind a number of questions. The first is about what is it that enables the continuation of macroeconomic imbalances, unsustainable exchange rates, and unhealthy financial practices over a prolonged period. One would expect that market discipline would normally be able to bring about a correction in these by ensuring honest and effective implementation of the basic principles of conventional wisdom. Why is it that market discipline is unable to prevent macroeconomic imbalances in the public sector and living beyond means in the private sector? What is it that makes it possible to have excessive leverage which is one of the major factors that lead speculative bubbles to the point of bursting? Is it because there is inadequate market discipline?

A second related question is about why some of the countries that have followed sound fiscal and monetary policies have also faced crises. The ERM (European Exchange Rate Mechanism) crisis of the early 1990s challenges the view that foreign exchange market crises stem from undisciplined fiscal and monetary policies. Many of the countries caught up in the crisis did not have overly

expansionary policies (IMF, May 1999, p.67). Even the East Asian countries do not convincingly fit into the mould of unhealthy macroeconomic policies.

A third but equally important question is about why some of the apparently well-regulated financial systems like those of United States and the United Kingdom have also faced crises and whether greater regulation, supervision and transparency will by themselves help avoid such crises.

### **THE INADEQUATE MARKET DISCIPLINE: IS THIS THE ROOT CAUSE?**

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

The system's inadequate market discipline is, however, not something new. It has existed all along with the development and spread of the conventional financial system. Then, why, one may ask, has there been greater volatility in the last two decades compared with what prevailed before? What has created the difference is the rise in the volume of funds as a result of rapid economic development after the Second World War, the revolution in information and communications technology, and the liberalization of foreign exchange markets. These developments are, however,

a manifestation of human progress and cannot be blamed for the crises. When the volume of funds was small and there were also controls on their free movement, inadequate market discipline was not able to create havoc. However, now the position is different.

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

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

of real goods and services by households, firms and governments, an excess of it tends to get diverted to unproductive uses as well as speculation in the foreign exchange, stock and property markets. Jean-Claude Richet President of the European Central Bank, has rightly pointed out that “a bubble is more likely to develop when investors can leverage their positions by investing borrowed funds” (2005, p.4).

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

#### **(i) The East Asia Crisis**

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

The large foreign exchange inflows from abroad also enabled the central banks to peg exchange rates. This helped provide the assurance needed by foreign banks for lending and, along with relatively high domestic interest rates, attracted further inflows of funds from abroad in foreign currencies to finance direct investment as well as the ongoing boom in the assets markets. Since about 64 per cent of the inflows in the five seriously affected countries (South Korea, Indonesia, Thailand, Malaysia and Philippines) were short-term (BCBS, June 1999, p. 10), there was a

serious maturity and currency mismatch. This joined hands with political corruption and ineffective banking regulation to lend heavily to favoured companies, which became highly over-leveraged.

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

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

Governments have only two options in such circumstances. The first is to bail out the domestic banks at a great cost to the tax payer, and the second is to allow the problem banks to fail. The second alternative is not generally considered to be politically feasible in spite of the recent calls to the contrary (Meltzer, 1998; Schwartz, 1998; and



Calomiris, 1998). In a financial system which assures, in principle, the repayment of deposits with interest, it would be a breach of trust on the part of the governments to allow the violation of this principle. Moreover, there is also a presumption, right or wrong, that if the big problem banks are allowed to fail, the financial system will break down and the economy will suffer a severe setback as a result of spill-over and contagion effects. Hence the 'too big to fail' doctrine. The governments, therefore, generally feel politically safer in choosing the first alternative of bailing out the banks.

Since the domestic banks' external liabilities were in foreign exchange and the central banks' foreign exchange reserves had declined steeply, a bail out of external banks was not possible without external assistance, which the IMF came in handy to provide. This has, as indicated earlier, raised a storm of criticism and a call for the reform of the IMF itself by reducing its role (Schwartz, 1998; Meltzer, 1998). The IMF did not perhaps have a choice. Not having any way of assuring its influential members that its refusal to provide resources would not destabilize the entire international financial system, it chose the safer way out. The IMF bailout, however, got the debt unintentionally transferred from the private foreign banks to the central banks and the governments of the affected countries. Joseph Stiglitz, a Nobel Laureate, has, however, rightly observed that "private debts should not be converted into public debts – a mistake that was made in many instances as a result of pressure from Western banks and governments" (2003, p.58). Professor James Tobin, another Nobel Laureate, has also concluded that "when private banks and businesses can borrow in whatever amounts, maturities and currencies they choose, they create future claims on their country's reserves" (World Bank, 1998, p.3).

Discussion of the role of excessive reliance on short-term credit or inflow of funds in the Asian crisis need not lead to the false impression that this is not possible in industrial countries with properly regulated and supervised banking systems. The IMF has clearly warned of the existence of such a possibility by stating that "whatever their causes the market dynamics of surges and reversals are not peculiar to emerging markets and it is unrealistic to think that they will ever be completely eliminated" (IMF, Sept. 1998, p.98). The continued rise in the US public as well as private sector spending has been possible because of short-term flows of funds from abroad just as it had been in East Asia.

## **(ii) The Collapse of LTCM**

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

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

The LTCM had a leverage of 25:1 in mid-1998, (BIS, June 1999, p.108) but the losses that it suffered reduced its equity (net asset value) from the initial \$4.8 billion to \$ 2.3 billion in August 1998. Its leverage, therefore, rose to 50:1 on its

balance sheet positions alone. However, its equity continued to be eroded further by losses, reaching just \$600 million, or one-eighth its original value, on 23 September 1998. Since its balance sheet positions were in excess of \$100 billion on that date, its leverage rose to 167 times capital (IMF, December 1998, p.55). There was, thus, a tier upon tier of debt which became difficult to manage. The Federal Reserve *had* to come to its rescue because its default would have posed risks of systemic proportions. Many of the top commercial banks, which are supervised by the Federal Reserve and considered to be healthy and sound, had lent huge amounts to these funds. If the Federal Reserve had not come to their rescue, there may have been a serious crisis in the U.S. financial system with spillover and contagion effects around the world.<sup>4</sup> If the misadventure of a single hedge fund with an initial equity of only \$4.8 billion could take the US and the world economy to the precipice of a financial disaster, then it would be perfectly legitimate to raise the question of what would happen if a number of the 6,000 or so hedge funds got into trouble.<sup>5</sup>

A hedge fund is able to pursue its operations in secrecy because, as explained by Chairman of the Board of Governors of the Federal Reserve System, Alan Greenspan, it is “structured to avoid regulation by limiting its clientele to a small number of highly sophisticated, very wealthy individuals” (December 1998, p.1046). He did not, however, explain how the banks found it possible in a supposedly very well-regulated and supervised banking system to provide excessively leveraged lending to such “highly sophisticated, very wealthy individuals” for risky speculation when it is well-known that the higher the leverage, the greater the risk of default. The unwinding of leveraged positions can cause major disruption in financial markets by exaggerating market movements and generating knock-on effects (*IMF*, December 1998, Pp.51-53).

This shows that a crisis can come not merely because of improper regulation of banks, as it did in East Asia, but also in a properly regulated and supervised system, as it did in the U.S. Even though the hedge funds were not regulated, the

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

<sup>5</sup> The figure for hedge funds is from *The Economist*, 12 June 2004, p. 72.

banks were. Then why did the banks lend huge amounts to the LTCM and other funds? What were the supervisors doing and why were they unable to detect and correct this problem before the crisis? Is there any assurance that the regulation of hedge funds would, without any risk-sharing by banks, stop excessive flow of funds to other speculators?

### **(iii) Foreign Exchange Market Instability**

The heavy reliance on short-term borrowing has also injected a substantial degree of instability into the international foreign exchange markets. According to a survey conducted by the Bank for International Settlements, the daily turnover in traditional foreign exchange markets, adjusted for double-counting, had escalated to \$1,830 billion in April 2004 compared with \$ 1,200 billion in April 2001, \$1,490 billion in April 1998 and \$590 billion in April 1989 (BIS, September 2004).<sup>6</sup> The daily foreign exchange turnover in April 2004 was more than 37 times the daily volume of world merchandise trade (exports plus imports).<sup>7</sup> Even if an allowance is made for services, unilateral transfers, and non-speculative capital flows, the turnover is far more than warranted. Only 35 per cent of the 2004 turnover was related to spot transactions, which have risen at the compounded annual rate of about 1.9 per cent per annum over the 15 years since April 1989. The balance of the turnover (65 per cent) was related largely to outright forwards and foreign exchange swaps, which have registered a compounded growth of 11.8 per cent per annum, far more than the growth of 7.6 per cent per annum in world trade over this period.<sup>8</sup> If the assertion normally made by bankers that they give due consideration to the end use of funds had been correct, such a high degree of leveraged credit extension for speculative transactions may not have taken place. High leverage has had the effect of driving foreign

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<sup>6</sup> The Bank for International Settlements (BIS) conducts a survey of foreign exchange markets every three years in the month of April. The daily global foreign exchange turnover has increased continuously since the first survey in April 1989 except in 2001. The major reasons for this fall in 2001 were, according to the BIS, the introduction of Euro, the growing share of electronic banking in the spot inter-bank market, and the consolidation in banking industry (BIS, 2001, p.1).

<sup>7</sup> World trade (exports plus imports) rose from \$499.0 billion in April 1989 to \$1489.7 billion in April 2004 (IMF, *International Financial Statistics*, CD-ROM and September 2004). The average value of daily world trade in the month of April during these two years comes to \$16.6 and \$49.7 billion respectively.

<sup>8</sup> The decline in average daily turnover in April 2001, as indicated in footnote 6, was most pronounced in spot markets, where average daily turnover fell from \$568 billion to \$387 billion. Trading in forwards rose from \$128 billion to \$131 billion while that in swaps dropped from \$ 734 billion to \$656 billion (BIS, 2001, p.1 and Table 1 on p.3).

exchange markets by short-term speculation rather than long-run fundamentals. This has made them highly volatile, injected excessive instability into them, and adversely affected the efficient operation of these markets. The effort by central banks to overcome this instability through small changes in interest rates or the intervention of a few hundred million dollars a day has generally not proved to be significantly effective.

The dramatic growth in speculative transactions, of which derivatives are only the latest manifestation, has also resulted in an enormous expansion in the payments system. Accordingly, Crockett has been led to acknowledge that "our economies have thus become increasingly vulnerable to a possible breakdown in the payments system" (June 1994, p.3). Even Greenspan, sitting at the nerve center of international finance, himself finds this expansion in cross border finance relative to the trade it finances as startling (Winter 1998, p.3). Such a large expansion implies that if problems were to arise, they could quickly spread throughout the financial system, exerting a domino effect on financial institutions.

The Tobin tax on foreign exchange transactions has, therefore, been suggested to reduce the instability. This proposal needs to be reviewed against the ineffectiveness of the securities transaction tax which is levied on the sale of stocks, bonds, options and futures by a number of major industrial countries, including the US, the UK, France, Germany and Japan. This tax proved to be ineffective in preventing or even diluting the October 1998 stock market crash (Hakkio, 1994). Is there any guarantee that the foreign exchange transactions tax would fare any better? Critics of the Tobin tax have accordingly argued that even this tax would be ineffective. One of the reasons given for this is that the imposition of such a tax would be impractical. Unless all countries adopt it and implement it faithfully, trading would shift to tax-free havens. However, even if all countries complied, experienced speculators may be able to devise ways of evading or avoiding the tax because all countries do not have an effective tax administration.<sup>9</sup>

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<sup>9</sup> See the arguments in favor of and against the feasibility of the Tobin tax by various writers in Haq, Kaul and Grunberg (eds.), 1996.

#### iv) **The Prevailing Imbalances in the US Economy**<sup>10</sup>

The United States has been doing well over the past few years by most measures of overall economic performance. Nevertheless, the large and growing discrepancy between what it produces and what it consumes rings a worrisome note not only for the US but also for the world economy. The US trade account has been persistently in deficit since the late 1970s and the current account has also been in a similar state since the mid-1980s. The current account deficit has reached a record of 6.3 percent of GDP. As a result of these persistent deficits, the US net foreign indebtedness has reached a record high in both absolute terms as well as a percent of GDP

The current account deficit is a reflection of the public sector budgetary deficit and the private sector saving deficiency. The federal government has spent more than what it has taken in every year since 1970 except for a brief respite between 1998 and 2001. The budget has moved from a surplus of \$236 billion in fiscal year 2000 to a deficit of \$400 billion in 2004 (Kohn, 2005, pp.1-2). The US private sector net saving (saving by households and businesses minus investment) has been negative since the mid-1990s as a result of the borrowing and spending spree by both households and firms. The personal saving rate has been declining since the mid-1990s (*The Economist*, 2005, p. 87) and in 2004, the households saved only one percent of the after tax income compared with 8 percent on average from 1950 – 2000 (Kohn 2005, p.1). Nevertheless investment in real estate and plant and equipment is high. This has generated a saving discrepancy that should have pushed up interest rates. This has not happened because of the inflow of funds from abroad, particularly from China and Japan. Low interest rates have generated a boom in residential real estate prices. The resultant increase in household net worth, combined with low interest rates, has had the effect of boosting consumer spending further at the cost of saving.

This raises the question of why has it been possible for the imbalances to persist for such a long period without an early correction being brought about by market forces. The reason, as discussed earlier, is the lack of adequate market

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<sup>10</sup> See the address entitled “*Imbalances in the US Economy*” by Donald Kohn, Member of the Board of Governors of the US Federal Reserve System, at the 15<sup>th</sup> Annual Hyman Minsky Conference, the Levy Economics Institute of Bard College, Annandale on Hudson, New York, 22 April 2005 (BIS Review, 28/2005).

discipline in the financial system. Why should the public and private sectors curtail spending when interest rates are low and it is easy to borrow? Borrowing is easy because of the absence of risk sharing by both the depositors and banks in the risks of banking business. Even if market forces are unable to impose fiscal discipline on the US government, it can at least lead to a decline in lending to the private sector. The resultant rise in saving might be able to offset the impact of public sector deficits.

This brings into focus the crucial question of how long will the foreigners be willing to continue lending. Confidence in the strength and stability of the dollar is necessary to enable it to serve as a reserve currency. What will happen if the deficits continue, create loss of the confidence in the dollar, and lead to an outflow of funds from the US? This is not just a theoretical question. In the last 30 years, the dollar has experienced four bouts of marked depreciation. Since nearly two-thirds of the world's foreign exchange holdings are still in dollars, a movement out of the dollar into other currencies and commodities, as happened in the late-1960s, could lead to a sharp fall in the exchange rate of the dollar, a rise in interest rates and commodity prices, and a recession in the US economy. This might lead the whole world into a prolonged recession. The correction would then come with a vengeance when market discipline could have led to it much earlier with significantly less suffering.

## **THE REMEDY**

If heavy reliance on short-term debt, is desired to be curbed, then the question is about the best way to achieve this goal. One of the ways suggested, as already indicated, is greater regulation (Edwards, 1999; Calomiris, 1999; and Stiglitz, 1998). Regulations, even though unavoidable, cannot be relied upon totally because they may not be uniformly applied in all countries and to all institutional money managers because of the off-balance sheet accounts, bank secrecy standards, and the difficulty faced by bank examiners in accurately evaluating the quality of banks' assets. In such a situation, there will be a flight of funds to offshore havens where almost half of all hedge funds are already located (Edwards, 1999, p.1919). Emerging market banking crises provide a number of examples of how apparently well-capitalized banks were found to be insolvent as a result of the failure to recognize the poor quality of their loan portfolio. Even the LTCM crisis shows how banks in an apparently well-regulated system can become entangled in a speculative spree. Thirdly, bringing

banks under a water-tight regulatory umbrella may not only raise the costs of enforcement but also mislead depositors into thinking that their deposits enjoy a regulatory stamp of security.

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

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



borrowing is more likely to be used to finance consumption. Furthermore, in the event of a crisis, while investors can divest themselves of domestic securities and banks can refuse to roll over loans, owners of physical capital cannot find buyers so easily” (IMF, May 1998, p.82).

This may raise an objection that investment depositors are generally risk averters and, unlike equity investors, would not like to expose their capital to risk. Forcing them to take risk may create insecurity and difficulty for them and their families. To avoid such a problem, it should be possible for banks to invest the funds provided by risk averting investment depositors in less risky assets. The banks may also be required to build adequate loss-offsetting reserves so that the depositors do not have to suffer losses. Such an approach should have the added advantage of making the banks more effective in managing their risks and, thereby, making the banking system safer and healthier.

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

Greater reliance on equity financing has supporters even in mainstream economics. Rogoff, a Harvard Professor of Economics, states that “In an ideal world equity lending and direct investment would play a much bigger role”. He further asserts that: “With-a-better balance between debt and equity, risk-sharing would be greatly enhanced and financial crises sharply muted” (1999, p.40). However, if, in addition to a better balance between debt and equity, the debt is also linked to the purchase of real goods and services, as required by Islamic teachings, it would take us a step further in reducing instability in the financial markets by curbing excessive

credit expansion for speculative transactions. Thus it is not necessary to be pessimistic and to join Stiglitz in declaring that “volatile markets are an inescapable reality” (1999, p.6). The introduction of greater discipline in the financial system, which the prohibition of interest has the potential of ensuring, along with a more effective regulation and supervision, should go a long way in substantially reducing volatility in the financial market and promoting faster development?<sup>11</sup>

## **SOCIO-ECONOMIC JUSTICE**

The above discussion has indicated that the absence of risk-reward sharing, which is an intrinsic characteristic of the interest-based financial system, has aggravated financial crises by adversely affecting discipline in the system. Since stability of the financial system is indispensable for promoting trade and development and since the interest-free risk-reward sharing system has a clear advantage here, it may be considered superior to the interest-based system on the criterion of efficiency. This is, however, only one of the advantages of the interest-free financial system. It was not discussed in the earlier Islamic literature because excessive volatility in the financial markets is a more recent phenomenon.

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

### **Need Fulfillment**

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<sup>11</sup> A number of Islamic economists have argued this point. See, for example, M.N. Siddiqi, 1983; Chapra, 1985, pp. 117-22; Chishti, 1985; Mohsin Khan, 1987; Mirakhor and Zaidi, 1987; S. Siddiqi and Fardmanesh, 1994; and a number of others.

Financial intermediation on the basis of interest tends to allocate financial resources among borrowers primarily on the basis of their having acceptable collateral to guarantee the repayment of principal and sufficient cash flow to service the debt. End-use of financial resources does get considered but does not constitute the main criterion. Even though collateral and cash flow are both indispensable for ensuring repayment of loans, giving them undue weight leads to a relative disregard of the purpose for which borrowing takes place. Hence, financial resources go mainly to the rich, who have the collateral as well as the cash flow, and to governments who, it is assumed, will not go bankrupt. However, the rich borrow not only for productive investment but also for conspicuous consumption and speculation, while the governments borrow not only for development and public well-being, but also for excessive defense build-up and unproductive projects. This does not merely accentuate macroeconomic and external imbalances, but also squeezes the resources available for need fulfillment and development. A decline in bank lending for speculative and unproductive projects, which a PLS system carries the potential of bringing about, can therefore be very healthy.

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

Ease of borrowing also creates problems for rich countries. The squeezing of resources for need fulfillment and productive investment resulting from conspicuous consumption and speculation has made it difficult for even rich countries like the United States to fulfill the essential needs of all their people in spite of their desire to do so and the abundant resources at their disposal. The continued U.S. budgetary deficits in the fifties and sixties, made possible by the interest-based system, led to an international financial crisis in the late 1960s and the early 1970s and the breakdown of the Bretton Woods system. The after-effects of that crisis continue to plague the world until now.

There is a lurking fear that the re-emergence of budgetary deficits in the United States in recent years during the tenure of President Bush might lead to a destabilization of the international financial system in the same way as it did in the late 1960s.

### **Full Employment**

One of the most important requisites for generating full employment is the rise in a country's ability to invest. If this is to be achieved in a non-inflationary manner and without a rise in foreign debt, then it is necessary to have a rise in domestic savings. Unfortunately, there has been a decline in savings in almost all countries around the world. Gross domestic saving as a percent of GDP has registered a worldwide decline over the last quarter century from 26.2 percent in 1971 to 23.2 percent in 2002. The decline in industrial countries has been from 23.6 percent to 19.3 percent. That in developing countries, which need higher savings to accelerate development without a significant rise in inflation and debt-servicing burden, has been even steeper from 34.2 percent to 28.1 percent over the same period.<sup>12</sup>

There are a number of reasons for this decline in saving. One of these is the living beyond mean by both the public and the private sectors. This saving shortfall has been responsible for persistently high levels of real interest rates. This has led to lower rates of rise in investment, which have joined hands with structural rigidities and some other socio-economic factors to reduce the rates of growth in output and employment.

Unemployment has hence become one of the most intractable problems of many developing as well as industrial countries. Unemployment stood at 8.8 percent in the European Union in January 2005, more than three times its level of 2.9 percent in 1971-73.<sup>13</sup> It may not be expected to fall significantly below this level in the near future because the real rate of growth in these countries has been consistently lower

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Figures have been derived from the Table on "Final Consumption Expenditure as percent of GDP" in IMF, 2000 and 2004 Yearbooks, pp.177-79 and 121-22 respectively. See also "The great Thrift Shifts in *The Economist*, 9 April 2005, 3-26.

<sup>13</sup> OECD, *Economic Outlook*, December 1991, Table 2, p.7; and OECD Website on Main Economic Indicators, March 2005.

than what is necessary to reduce unemployment significantly.<sup>14</sup> Even more worrying is the higher than average rate of youth unemployment because it hurts their pride, dampens their faith in the future, increases their hostility towards society, and damages their personal capacities and potential contribution. The problem is even more serious in developing countries where the proportion of population below the age of 18 is relatively high. These boys and girls will soon enter the labour market. If employment opportunities are not created for them, these countries may experience a rise in social turmoil as well as crime.

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

## **THE ISLAMIC FINANCIAL SYSTEM<sup>15</sup>**

It is these weaknesses of the interest-based financial system which create a strong rationale for the introduction of a new architecture for the international financial system. This brings us to Islamic banking, which tries to remove interest and introduce in its place the principle of risk- reward sharing. Since demand deposits do not participate in the risks of financing by the financial institutions, they do not

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<sup>14</sup> A question may be raised here about the current low rate of unemployment in the U.S. in spite of a substantial decline in household saving. There are a number of reasons for this. One of the most important of these is the large inflow of foreign funds which “has helped to fund a pronounced increase in the rate of growth of the nation’s capital stock”(Peach and Steindel, September 2000, p.1). Once there is a reversal of, or even a decline in, this inflow, it may be difficult to sustain the high rate of growth in output and employment. In addition, the stock market may also experience a steep decline, creating a spillover effect for the whole world economy.

<sup>15</sup> This section is based on Chapra and Khan, 2000, pp.11-15.

earn any return and must, therefore, be guaranteed. However, investment deposits do participate in the risks and must share in the profits or losses in agreed proportions. What this will do is to turn investment depositors into temporary shareholders. Placing investment deposits in financial institutions will be like purchasing their shares and withdrawing them will be like redeeming these shares. The same would be the case when these institutions lend to, and get repaid by, businesses. They will be sharing in the risks of businesses they finance. This will raise substantially the share of equity in total financing and reduce that of debt. Equity will take the form of either shares in joint stock companies and other businesses or of PLS in projects and ventures through the *mudarabah* and *musharakah* modes of financing.<sup>16</sup>

Greater reliance on equity does not necessarily mean that debt financing is totally ruled out. This is because all financial needs of individuals, firms or governments cannot be made amenable to PLS. Debt is, therefore, indispensable. Debt, however, gets created in the Islamic financial system through the sale or lease of real goods and services via the sales-based modes of financing (*murahabah*, *ijarah*, *salam* and *istisna*). In this case the rate of return gets stipulated in advance and becomes a part of the deferred-payment price. Since the rate of return is fixed in advance and the debt is associated with real good or services, it is less risky as compared with equity or PLS financing. The predetermined rate of return on sales-based modes of financing may, however, make them appear like interest-based instruments. They are, however, not so because of significant differences between the two for a number of reasons. Two of these are:

Firstly, the sales-based modes do not involve direct lending and borrowing. They are rather purchase and sale or lease transactions involving real goods and services. The *Shari'ah* has imposed a number of conditions for the validity of these transactions. One of these conditions is that the seller (financier) must also share a part of the risk to be able to get a share in the return. This he cannot avoid doing because of the second condition which requires that the seller (financier) must own and possess the goods being sold. The *Shari'ah* does not allow a person to sell what

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<sup>16</sup> For a description of these and other Arabic terms used in this paper, see the Appendix.

he does not own and possess.<sup>17</sup> Once the seller (financier) acquires ownership and possession of the goods for sale on credit, he/she bears the risk. All speculative short sales, therefore, get ruled out automatically. Financing extended through the Islamic modes can thus expand only in step with the rise of the real economy and thereby help curb excessive credit expansion, which is one of the major causes of instability in the international financial markets.

Secondly, it is the price of the good or service sold, and not the rate of interest, which is stipulated in the case of sales-based modes of finance. Once the price has been set, it cannot be altered even if there is a delay in payment due to unforeseen circumstances. This helps protect the interest of the buyer in strained circumstances. However, it may also lead to a liquidity problem for the bank if the buyer willfully delays payment. This is a major unresolved problem in Islamic finance and discussions are in progress among the jurists to find a solution that is *Shari'ah* compliant.<sup>18</sup>

The share of PLS modes is so far relatively small in the financing operations of Islamic banks and that of sales-based modes is predominantly high. The reason may perhaps be that the task is difficult and in the initial phase of their operations these banks do not wish to get exposed to risks which they cannot manage effectively. They are not properly equipped for this in terms of skilled manpower as well as the needed institutional infrastructure.<sup>19</sup> Most scholars, however, feel that, even though the sales-based modes are different from interest-based financing and are allowed by the *Shari'ah*, the socio-economic benefits of the prohibition of interest argued above may not be realized fully until the share of PLS modes rises substantially in total financing. It would hence be desirable for the use of PLS modes to gain momentum.

Substantial progress has been made by Islamic banks worldwide, even though the niche that they have been able to create for themselves in the total volume of international or even Muslim world, finance is very small. This was to be expected because they are trying to make headway in a new system of financial intermediation

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<sup>17</sup> Exceptions to this rule are *salam* and *istisna* (See the Appendix).

<sup>18</sup> For a discussion of this problem, see Section 3.1 on the "Late Settlement of Financial Obligations" in Chapra and Khan, 2000.

<sup>19</sup> For the needed institutional infrastructure, see Chapra and Ahmed, 2002. pp. 79-84.

without the help of trained staff and of auxiliary or shared institutions that are needed for their successful operation. What counts, however, is not the volume of their deposits and assets, but rather the respectability that the interest-free financial intermediation has attained around the world and the positive evidence that it has provided about the workability and viability of this new system. While in the 1950s and 1960s Islamic banking was only an academic dream, of which few people were aware even among educated Muslims, it has now become a practical reality. It has also attracted the attention of Western central banks like the Federal Reserve Board and the Bank of England, international financial institutions like the IMF and the World Bank, and prestigious centres of learning like the Harvard and Rice Universities in the United States and the London School of Economics and Loughborough and Durham Universities in the United Kingdom. It has also received favorable coverage in the Western press. Prospects for the future are expected to be better, particularly if the instability that now prevails in the international financial system continues to accentuate. This may lead to a realization that the instability may be difficult to remove by making cosmetic changes in the system. It is rather necessary to inject greater market discipline into the system. The interest-free risk-reward sharing system can help inject such a discipline.

## **CONCLUSION**

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



## GLOSSARY OF ARABIC TERMS

Some of these terms have a much wider meaning. It is, however, not possible to encompass this in a glossary. Given below is the basic sense in which these terms have been generally used.

- Ijara,*** : Leasing.
- Istisna-*** : Refers to a contract whereby a manufacturer (contractor) agrees to produce (build) and deliver a certain good (or premise) at a given price on a given date in the future. This is an exception to the general *Shari ah* ruling which does not allow a person to sell what he does not own and possess. As against *salam* (q.v.), the price here need not be paid in advance. It may be paid in instalments in step with the preferences of the parties or partly at the front end and the balance later on as agreed.
- Mudarabah*** : An agreement between two or more persons whereby one or more of them provide finance, while the others provide entrepreneurship and management to carry on any business venture whether trade, industry or service, with the objective of earning profits. The profit is shared by them in an agreed proportion. The loss is borne only by the financiers in proportion to their share in total capital. The entrepreneur's loss lies in not getting any reward for his/her services.
- Murabahah*** : Sale at a specified profit margin. The term is, however, now used to refer to a sale agreement whereby the seller purchases the goods desired by the buyer and sells them at an agreed marked-up price, the payment being settled within an agreed time frame, either in instalments or lump sum. The seller bears the risk for the goods until they have been delivered to the buyer. *Murabahah* is also referred to as *bay mu'ajjal*.
- Musharakah*** : An Islamic financing technique whereby all the partners share in equity as well as management. The profits can be distributed among them in accordance with agreed ratios. However, losses must be shared according to the share in equity.
- Salam*** : Sale in which payment is made in advance by the buyer and the delivery of goods is deferred by the seller. This is also, like *Istisna* , an exception to the general *Shari'ah* ruling that you cannot sell what you do not own and possess.
- Shari'ah*** : Refers to the divine guidance as given by the Qur'an and the *Sunnah* and embodies all aspects of the Islamic faith, including beliefs and practices.
- Sunnah*** : The *Sunnah* is the most important source of the Islamic faith after the Qur'an and refers essentially to the Prophet's example as indicated by his practice of the faith. The only way to know the *Sunnah* is through the collection of *ahadiths*, which consist of reports about the sayings, deeds and reactions of the Prophet, peace and blessings of God be on him.

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