

**Zahid Husain Memorial Lecture Series — No. 7**



# **The Impact of Interest-Free Banking on the Economy**

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بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

## THE IMPACT OF INTEREST-FREE BANKING ON THE ECONOMY

Distinguished guests and colleagues:

السَّلَامُ عَلَيْكُمْ وَرَحْمَةُ اللَّهِ تَعَالَى وَبَرَكَاتُهُ

First, please allow me to express my most sincere thanks to Mr. Kazi, the Governor of the State Bank of Pakistan, who has granted me the privilege of addressing such a distinguished audience on this auspicious occasion of the Zahid Husain Memorial Lecture Series instituted on the 25th anniversary of the State Bank of Pakistan. It is indeed an honor.

### INTRODUCTION

In our contemporary world mankind's efforts to achieve economic and social progress have become entangled in a struggle among "the great ISM's": **Capitalism**, **Communism**, and the various forms of **Socialism**. This struggle is being waged relentlessly in every corner of the world.

An alternative to these systems, however, does exist. It is an approach which does not adopt any of "the great—ISM's" as a whole, but rather chooses from among them what is most suitable to meet the prevailing conditions in a given country. This "amalgam" approach is being practiced most extensively in the developing countries of the so-called "Third World." All of us are acutely aware that most of our Islamic nations fluctuate in their inclination toward the conventional systems, the "great—ISM's", in pursuing economic and social development endeavors.

In light of what I have just said, Pakistan must be acclaimed for having made its unswerving commitment to the implementation of an economic system based on Islamic principles. As a Muslim and an economist I salute this propitious decision taken by His Excellency the President, General

Zia-ul-Haque. Furthermore, I applaud and congratulate the sincere dedication of the community of religious scholars, academicians, businessmen, and technical experts in the various fields whose efforts have produced a working Islamic economic environment which will **إِنشَاءَ اللَّهِ** continue to pave the way to righteousness, justice, and prosperity for your country.

### Some Theoretical Observations

In turning to the focus of my topic today, the impact of interest-free banking on the economy, I wish to begin with a few comments which form the theoretical foundation for the ensuing discussion.

First, I feel we must regard the entire issue from two distinct angles: (1) that of the general impact on the effectiveness of the development plan as a whole and (2) that of the specific economic impact which is the result of all Islamic Banking activity as I envision it.

Next, I wish to address an important point concerning one of the basic reasons, in my opinion, for the inability of most developing countries to achieve economic progress or produce an effective program for rapid and sustained growth.

We have all observed that the majority of the attempts to stimulate advancement in the Third World, including the Muslim countries, reach bottlenecks and dead ends despite a wide range of reforms and related efforts. More perplexing is the enigma of why this happens when the very same types of efforts have proven effective in both the East and West.

A crucial fact emerges: the success of any development scheme is directly correlated with the degree of participation of the citizenry in the growth process. The people—the masses—must, in one way or another, be involved at every stage from conceptualization and planning to reaping the benefits of the plan's achievements. This is the **sine qua non** for avoiding their alienation and convincing them that the programs are truly in their interest. Without this input virtually all development efforts are doomed.

It may be asked, how and why have the Communist East and Capitalist West achieved this positive consensus while the Islamic countries have not? The answer lies in that the systems which have emanated from both East and West are products of their societies' materialist philosophies which are, in turn, the legacy of the experience of many generations. A European feels no sense of remoteness or trepidation in dealing with his environment.

The Muslim peoples, however, have only recently awakened, only to find themselves prisoners of this philosophy or that ideology, and having little understanding of the concepts behind them or their historical background. They are unable to assimilate what they have no feeling or sympathy for and thus precluded from meaningful involvement in the system. Indeed, the populations of virtually all Muslim countries are characterized by negativism and apathy; counteracting this trend will only come about by linking the legal system and institutions to the peoples' mindset whose fount is the intellectual legacy of Islam. Concepts such as **haram** and **halal** are firm principles in the Muslim's *weltanschauung* and any system whose underpinnings conflict with his values will, sooner or later, be rejected.

Pakistan has, **بِإِذْنِ اللَّهِ**, paved the way for an effective growth strategy by adopting a governmental outlook which is consonant with the beliefs and values of the Pakistani people. In return, their participation and willingness to share the burden of responsibility may be expected, these being an absolute requirement for national development. An equally important requirement, however, is the creation of institutions to translate the energy of the people into activities directed at contributing to the nation's growth.

### **Islamic Banking as an Institution of Development/Why Commercial Banks Don't Meet the Need**

The economic impacts of a financial institution are inextricably linked to the philosophy and principles of the particular system of which it is a part. This is because the philosophy and theoretical foundations of that system govern and limit the instruments used by the institution. In turn, each instrument has various economic, social, and technical impacts on the institution itself.

As an example, the philosophy of the commercial banks is based on the premise that money is to be dealt with like any other item to be traded and they regard as axiomatic that one who saves money deserves compensation in kind, since he controls a commodity which has a certain value.

It follows logically that money, to the commercial banks, is in fact nothing but a commodity whose value is determined by supply and demand in the market. Also axiomatic to the banks which operate according to this philosophy is that they try to obtain this commodity in large quantities at as cheap a price as possible. Naturally, they seek out sources who control

the necessary quantities, namely, wealthy individuals and large commercial establishments, and offer them incentives in order to induce them to give the banks control over their financial resources.

In modern history every country has worked to create the necessary means to attract sources of capital. The most important of these is the banking system which, at least in appearance, facilitates financial transactions. A result of the creation of this system has been the priority given by the money merchants to short-term transactions, since a major portion of clients cannot afford to relinquish their financial assets for a long period. Thus a demand for short-term funds is also created, of course with the stipulation that a price will be paid. It is this short-term demand which allows the banks to realize their huge profits, since both the principal and interest must be repaid quickly-to be lent out again-whether the endeavor for which the loan was taken out was successful or not.

Among the economic impacts of this practice are:-

1. making the rich richer and the poor poorer, since the banks must act in the former's interests, they being the major source of the bank's profits;
2. creating an imbalance in the various sectors of the economy, thus restraining rapid balanced growth;
3. causing dysfunctions in the mechanisms of distribution and ownership;
4. inflation;
5. neglect of important long-term investment by the private sector, requiring the government to bear the burden;
6. fomentation of a breakdown in the system of human relations among individuals, as well as between individuals and institutions.

In clear contrast to the above, Islamic banks have a perception of capital which views its value in terms of its function, rather than as a commodity. Of course the value of this function, in a specific transaction, cannot be determined until the outcome of the endeavor can be appraised. This approach requires our Islamic banks to follow a set of policies which are radically different from the commercial banks' and to formulate a unique set of administrative operating procedures and financial instruments as well.

At this point I wish to comment on two observations made by my colleague, the Governor of the State Bank of Pakistan. The first of these I concur with wholeheartedly: (Quote)

Merely saying that it (sic., the Islamic banking system) should be free of **riba** is not enough. There can be a number of structures which are free of **riba**. The question is that, apart of being free of **riba**, the structures should be responsive to the Islamic economic system that we are envisaging.

Therefore, when we are judging any sort of structure which is set up, there should be at least three criteria. First, does it involve elimination of **riba** in a real sense as enjoined by Islam; two, is it conducive to the Islamic economic structure that is envisaged; and three, whether it is viable and stable and can last.<sup>1</sup>

I do not, however, share his respected opinion in the following:

The issue of the nature of money is merely a theoretical issue and it is not really of practical importance.

I feel that failure to clarify this particular point will give rise to confusion on the part of those working within the system and lead to dangerous practical mistakes which could threaten the future of Islamic banking. On the contrary, I believe that resolution of this theoretical point is a fundamental requirement for formulating the necessary administrative structures and operating procedures for the organization.

### **Islamic Banking as an Instrument of Behavioral Change**

Now I would like to treat the question of the mobilization of capital within the Islamic banking philosophy. A clear understanding of this philosophy should stimulate the Islamic banks to create regulatory and administrative policies which advocate the monitoring of the flow of capital and the performance of its monetary function as it passes from individuals to institutions. That is, to keep track of spending patterns toward the goal of creating financial instruments which will stimulate the flow of capital into the Banks. This endeavor cannot be haphazard or ambivalent; it must be an active policy designed specifically to modify spending behavior.

All of us are aware that the number one problem facing our societies is that of behavior, be it of children, the man in the street, the farmer,

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1. Kazi, Journal of Islamic Banking & Finance VOL 1 No. 2 Spt. 84 page 12. Quarterly publication of the International Association of Islamic Banks Karachi (Asian Region).

laborers, employees, or the leaders of society. We also know that behavior modification cannot be achieved by warnings or sermons. A specific type of behavior modification, however, can be achieved with the direction provided by the Islamic banks and I base this contention on documented practical experience.

Theoretically speaking, behavior can be modified in a relatively short time if the benefits or rewards which the change will produce are perceived as outweighing the pain or difficulty involved in making it. In regard to financial behavior, the Islamic bank, by virtue of the philosophy prescribed for it, has a unique system for distinguishing between the true saver and the investor or individual with a proclivity for investment. Furthermore, we have the capacity to satisfy both inclinations and it is this capacity which enables our banks to affect the behaviour of all citizens within a brief period of time. This can be done in the context of a sound economic foundation which does not influence profitability or the ability to perform.

#### **The Impacts of Changing Individuals' Spending Behavior on the Society, the Banks, and the Economy**

Decades of research by experts in psychology and education in the field of Islamic banking activity have produced the conclusion that one of the most effective means of modifying individual behavior is through the promotion of the habit of controlling spending or what may be called fostering a "saving mindset." Practical experience has proven that this can be achieved easily and with minimal expense if a scientific approach based upon an analysis of existing social conditions is used. Discussions of such an approach from both a theoretical and practical point of view may be found in many of the publications of the International Association of Islamic Banks. Specific titles include: **Banks without Interest**, **Introduction to the Theory of Islamic Economics**, part of one **The Practical and Theoretical Encyclopedia of Islamic Banking**, and **One Hundred Questions and One Hundred Answers About Islamic Banks**.

Here I would like to point out the findings of an expert in Education whose research indicated the existence of certain personality traits in individuals who manifested the "saving mindset."<sup>1</sup> These included self-reliance, self control, Discipline and a propensity to plan before acting, broadmindedness, a sense of fairness, satisfaction, and optimism. I think we would all

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1. Ansari, "The Social Function of Saving," (In Arabic), *The Social Education Yearbook*, Cairo, 1965, pp. 65—107.

concur that the rapid and comprehensive advancement of our society requires its members to possess these and other similar positive attributes.

A relationship becomes evident here and I shall draw on another statement of His Excellency the Governor as an introduction:

The Banking system's . . . . health will depend upon the health of the clients of the bank on the one hand, and the depositor of the bank on the other.<sup>2</sup>

On a broader scale we may say that the society's health depends upon the materials wellbeing of its members. Islamic Banking promotes well being in this age dominated by materialism. It can provide the economic medicine our people need to cure the ills of our society. I feel it is no exaggeration to say that Islamic Banking, if practiced in its true form, is uniquely capable of providing a solution to the material problems of the Muslim World.

Some of you may wonder if such a grand goal is within the role of a financial institution. The affirmative reply is based upon the philosophical difference between an Islamic financial institution and one serving a similar function outside Islam. To the latter, curing society's ills is at most a peripheral concern, if it is considered at all. In an Islamic system, however, contributing to the overall welfare of the **ummah** is a **raison d'être** and the effectiveness which with this is done is a gauge against which all of the other activities of the institution can and should be measured.

Another issue is that in economically underdeveloped societies the range of incomes is such that only a small group of individuals have excess capital for investment via banking facilities. This group usually consists of merchants and businessmen who control excess capital related to their commercial ventures. We know that there is only a small amount of risk capital for long-term investment, which could produce a high rate of return. It follows that, in these circumstances, it is neither feasible for banks to achieve profit enough to cover their administrative expenses, nor to distribute a return high enough to be an incentive for those who might have an inclination to invest. The only solution is the creation of a long-term source of capital via pooling assets, and here we have reached an impasse. (Western experts, by the way, have worked around this position through the provision of foreign aid).

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2. Kazi, *Journal of Islamic Banking* . . . p. 13.



Overcoming this problem may be achieved easily by promoting wide-scale individual saving, which can be done, as mentioned above, through modification of spending behaviour. This would provide the readily available and uninterrupted source of long-term funds crucial for overall growth.

Yet another question may arise here concerning costs. Since we know that the key to this issue is gaining the confidence of the population by providing good service via sound mechanisms, we may imagine that the start-up costs for the organization are relatively high. In reality, however, if we compare these to the scale of the continuing positive impact on the economy which may be expected to ensue, we find the outlays to be very reasonable in economic terms.

### **Qurud Hasanah: A Tool for Development<sup>1</sup>**

Islamic Bankers have long believed that one of the best methods of modifying individual behavior toward the goal building a resource pool for long-term investment is by granting productive **qurud hasanah**. These loans are made without a collateral requirement, which the borrower could probably not produce anyway.

Through **qurud hasanah** a numerically significant sector of the population which traditionally suffers from low output, such as laborers and young people in training, is provided with a means to raise their standard of living and become more self-sufficient. More specifically these loans:

1. expand the society's economic base
2. create potential clients for the Bank
3. increase savings and help guide consumption properly
4. forge improved interpersonal relations among individuals and institutions in the finance process by fostering feelings of mutual co-operation and eliminating those of exploitation
5. combat unemployment
6. support large industrial concerns by strengthening support services
7. provide training for Bank personnel in the form of experience which is superior to what they would learn in a classroom environment
8. engender confidence in the Bank by supporting families who will later take part in the investment process
9. expand markets through the increase of purchasing power.

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1. Prof. Abdul Jabbar Khan, among others, view *qurud hasanah* as a form of philanthropy. Journal of Islamic Banking p. 27.

All these can be achieved through this one endeavor aimed at providing incentives for the beneficiaries to make their resources available to the Bank. Furthermore, **qurud hasanah** have an advantage in that they are relatively simple and inexpensive to administer. They only require, for example, that the Bank set certain conditions for granting the loan. These could include the stipulation that the borrower be a regular client of the Bank, be a member of the community in the area where the Bank is located, possess experience in a specific field, be a practitioner of a profession, or be a person with a good reputation in the area in the vicinity of the Bank. In undertaking this activity the Bank engages in education for development. **Qurud hasanah**, both as an expression of Islamic solidarity and an innovative method of development financing, offer Islamic Banking the potential to succeed in an area where many other agencies and governments have failed.

### **The Role of Musharakah Financing**

Yet another form of financing available to the Islamic Banks is what we know as **musharakah**. This method creates a relationship between the client and the Bank of partner dealing with partner, and not debtor and creditor. Its basis is mutual interest and aspirations.

The Bank, for its part, must put all of its resources at the disposal of the client and do its utmost to insure, with Allah's help, the success of the project. The client, on the other hand, must cooperate fully with the Bank in administering his activity and working to solve problems which might arise.

The positive effects of this type of financing include:

1. it directly rewards and provides more incentive to human labor, thereby drawing nonbankable classes into the productive circle of the economy
2. it links use of funds directly to social and economic priorities. Since no single rate of interest is given or taken there is great flexibility in the cost of financing. This is a potential weapon for manipulating growth of certain sectors rather than others
3. it achieves a just means of distributing the return between the investor and the financing agency
4. it is a type of cooperation which stimulates the giving of extra effort, since the investor has had credit extended to him by an

agency which will stand with him to weather a crisis, regardless of the outcome

5. it has been tried and proven to achieve a higher rate of return to both parties. This is an incentive for investments in high-risk projects which hold benefit for the Society
6. it requires that the financing be of a project of growth investment to have real value for the economy.

The question has arisen concerning the difficulty of **musharakah** financing because of the lack of the appropriate ethical standards: On this point Abdul Jabbar Khan has commented:

It is said that **musharakah** financing, although most suited from both the **Sharia** point of view as well as the bank's point of view, will be used selectively and only in those cases where management of the client is efficient, experienced in the line, and straightforward in dealings and the project is a profitable one. One must do something to safeguard against the weak moral fibre of the society.<sup>1</sup>

In response I would reply that this is not an excuse and that the task of the Islamic Banks is to be role model which influences the society in a positive way, and not intimidated by its shortcomings.

Another question that has come up concerns the difficulty of conducting studies on the conditions of **musharakah**. Here I wish to clarify the role of feasibility studies. Since the Islamic Banks are, by definition, development oriented it puts more burden on them, being a risk-taking partner, to try to insure the feasibility of its ventures. However, when I say feasibility studies I do not mean to impose scrutiny which is so rigorous as to be an obstacle to the project's execution, but rather new ways to identify the viability of the projects. These should be low cost and conform to the nature of Islamic institutions and their obligation.

## Conclusion

I have explained previously how the rules for loans and work methods can change the nature of relationships in the society. What has been said holds true for all of the efforts of the Islamic Banks in their striving to be a positive communal force, working toward changing societal ethics in the

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1. Khan, Abdul Jabbar Journal of Islamic Banking P. 43

direction of the model described for us by our prophet, صَلَّى اللهُ عَلَيْهِ وَسَلَّمَ. The task of Islamic economics in particular has been eloquently set forth by Mr. Kazi:-

When thinking of an Islamic economic system we are thinking of freedom of choice for the individual within certain limitations, equality of opportunity to all citizens, prevention of exploitation of man by man, and growth of the economy sufficient to provide for the basic needs of the society. Now it is in this context that any banking structure has to be judged. What are the functions to be performed by the banking system in this context? What role could they play in bringing about the fruition of Islamic economics? It is not merely the elimination of **Riba**: the banking system has to do much more than that. It has to be a participant in the development process.<sup>2</sup>

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2. Kazi, Journal of Islamic Banking P 12.