Comments of

Shamim Ahmad Siddiqui*

on

Non-Interest Resource Mobilization for Public Capital Projects — the Use of Islamic Endogenous Loans

By Rodney Shakespeare

(1) This is a very interesting paper on the issue of financing of public projects without involving the institutions of interest. By and large, I am sympathetic to many of the ideas presented in this paper. The author is vehemently against the institution of interest. He is perturbed to see the power of the commercial banks who not only use the money owned by the shareholders and the depositors, but even money created from nothing to impose interest on the borrowers. He has little hope that the economies based on western capitalist ideologies will ever recognise the problems created by the institution of interest and consider to do away with it unless they could observe an economic system that uses an alternative mechanism. As Islam clearly prohibits this institution, he earnestly believes that Muslim societies are in a position to come up with a viable alternative and may also influence western economic thinkers. The author asks Muslims economists and financial experts to go beyond the Qur'ānic injunction that prohibit interest and look at the benefits of an alternative mechanism. He calls for adopting a new paradigm and reject the notion that modern market economies cannot function without interest. On this I am in total agreement. I also share his view that the ownership of capital and the income generated by it should be spread through the masses. In my view, this has always been one of the major goals of Islamic banking and finance.[1]

(2) After reading it several times, I have the impression that on a number of issues, perhaps due to the space limitation, the author has chosen not to go for a detail analysis or discussion. Also, he seems to be more interested in bringing in a change in the way we think about the working of the commercial banks in today's capitalist system. What I intend to do in this report is to (i) add some further arguments in favour of some of the points made in the paper (ii) suggest to the author to make clarifications on some issues that I think are not very clear to the

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[1] Another goal or capability of *profit and loss sharing* Islamic banking is to provide financial stability. For further discussion of potential benefits of Islamic banking, please see Siddiqui (1994 a) and Siddiqui and Fardmanesh (1994b).

reader, and (iii) give some of my own proposals to strengthen his case for a new economic paradigm (that avoids institution of interest).

(3) As the title of the paper suggests, the main thrust of the paper is to propose that all public projects be financed through the central bank's own money which he describes as the "*endogenous money*" contrary to the conventional treatment of that money as "*exogenous money*". Conventionally, endogenous money is referred to the money created by the banking system through advancing loans as banks are required to keep only a fraction of their deposits as cash. As per author's criticism of conventional use of endogenous and exogenous money is concerned, in my opinion, it does not have an effect on his main arguments unless he shows that conventional economics somehow puts greater 'value' to endogenous money compared to the exogenous money referred to the money created by the central bank directly. If this is the case, references could be cited.

(4) The author claims that public projects, if financed through the commercial banks, cost more because of the payment of interest. By avoiding interest, cost of the project could be substantially brought down or more projects could be undertaken for the same outlay. One point that has been emphasized at several places in the paper is that, public projects financed by the Islamic endogenous money or the central bank's money will not create inflation as they would increase the productive capacity of the country. I suggest the issue of inflation be given more space in the paper. There could be several reasons for a period of inflation in a country. One possible reason is an excess demand (relative to supply) for goods and services that is created by income generated through the work on huge public projects even if financed by the central bank's *endogenous* money. If the country is able to produce the goods and services demanded by the receivers of new income without increasing their prices, there won't be inflation. Alternatively, with a comfortable level of foreign exchange reserve and favourable current account, the country may allow a liberal import regime to prevent excess demand in different markets. Many oil producing countries have launched huge public works programme with their own money (i.e., central bank's money) without experiencing any inflation.[2] However, if none of these two is possible, then there is a possibility of inflation if the increase in demand for goods and services is more than increase in supply or increase in supply is only possible at higher prices. Many developing countries have experienced this problem when they tried to finance public projects by excessive increase in money supply whether or not this increase in money supply was made through printing of central bank money or by allowing the banking system, through different monetary policy instruments, to create more money. Even if projects are funded by foreign sources, prices may go up if there are bottlenecks in the supply of essential commodities.

[2] Brunei Darussalam is one such country where money supply has no impact on inflation rate as most of the goods are freely imported and the exchange rate is very stable due to huge foreign exchange reserve and continued trade surplus.

It is true that government public projects like dams, highways and other infra structure projects have the potential to increase the productive capacity of a country. However, the gestation period for such projects is generally long whereas income and demand for goods and services is generated much earlier creating upward pressure in prices unless supply is fairly elastic. A prudent government, however, could make a better planning by efficiently choosing the size of public projects outlay and the corresponding amount of central bank's money depending on its production capacity and its ability to import essential commodities. One way out would be to use a part of the newly created money, and come up with appropriate incentives package for domestic as well as foreign direct investors, to increase the productive capacity of the country for different goods and services to meet the anticipated increase in their demand.

An interesting example in this regard is Pakistan that has recently experienced relatively high economic growth and started mega projects. However, instead of making sure that essential commodities are available at stable prices, it increased the support prices of many agricultural goods and was slow on formulating and implementing an appropriate import policy of essential commodities. The result has been an abnormal increase in inflation that has shadowed the otherwise impressive increase in Gross Domestic Product.

(5) The author raises the issue of bank's ability to create money and has asked the question, "*Who (society or the banking system) has the ultimate right to create money* (and, if wished, to impose interest)? To be fair, we must admit that this right to create money is given by the government through the central bank by allowing the banks to use bulk of their deposits to invest. The banks are technically financial intermediaries channelling the funds from the surplus units (households and businesses) of the economy towards the deficit units (households and businesses and the governments). Furthermore, the profits made through this process are supposed to go to the depositors (the shareholders of the banks in a profit and loss sharing Islamic banking system), and the government through taxes. Of course the profits are relatively higher when banks are allowed to create money (required to keep only a fraction of their deposits as cash or reserve) than what it would be otherwise. There is, therefore, a need to see if the profits earned by the banks are fairly distributed among the depositors, government (representing the society) that allowed fractional reserve banking, and the shareholders of the bank. If it could be shown that at present, the banking sector is making abnormal profits and not paying an appropriate amount of tax to the government or they are not paying reasonable rate of returns to the depositors, proper actions could be taken.[3]

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[3] Indeed, this comment is made in the context of modern western system of banking based on the institution of interest. It is claimed that under this system the banks provide many services to their depositors free of cost (including financial intermediation) and they also pay for insuring the deposits.

One can also suggest that commercial banks may not be allowed to create money and asked to keep 100% percent reserve unless the depositors agree to put their savings in an investment account and agree to allow the banks to use their money for investment purposes. Of course in that case the depositors may have to take some risks of the investments made by the banks and they also demand a relatively higher expected rate of return. The central bank can also have an investment account with all the banks and allow them to utilise this amount for making proper investment. The government would become an active partner along with those depositors who decide to put their savings in investment accounts. Practically, this is an Islamic banking model that I think should get the attention of Islamic bankers.

(6) In my opinion, it is important to recognize why commercial banks under the current capitalist system are naturally reluctant to opt for long term social projects. One of the main aspects of the western banking system is that it guarantees the value of deposits and any interest payable on them and the right of the depositors to withdraw their money from different accounts accordingly. A number of instruments and regulations are formulated to make sure that this does happen. The banking sector remains under the surveillance of the central bank. The types of investment the banks can make are restricted. The banks are not supposed to be heavily indulged in risky investments including trading in stocks. The idea is to make loans or investment where the principal and interest accruable is made safe through the requirement of appropriate collateral. Furthermore, as the banks have to give interest at regular intervals, they normally invest in businesses that could guarantee positive returns at regular intervals. This prevents many of them from directly investing in the long-term public or private projects. They rather opt for short term fixed return loans and short and medium term government and corporate bonds to earn “certain income” at regular intervals. I will comment in coming paragraphs that the whole situation changes when we consider a *profit and loss sharing* Islamic banking system.[4]

(7) The idea of 100% reserve is not new and had been proposed earlier by prominent western economists in the context of conventional banking system and its destabilising ability to expand or contract money supply in the economy. The case of Islamic banking system would be somewhat different. If the banks are required to run under *profit and loss sharing* Islamic banking system, the one hundred percent reserve requirement should be imposed on non-investment accounts. Banks should neither be allowed to use these accounts for investment nor should they be required to pay any returns. They can use their own (share holders’) funds and the *investment* deposits owned by the public and the government to make

[4] The implications of *profit and loss sharing* Islamic banking where most of the funds will be used for equity finance would be quite different from the current Islamic banking system that heavily uses debt like financing and fails to achieve any thing significantly different from the conventional banking system.

loans and invest. There will not be any money creation by the banks. The money could only be created by the central bank and channelled to the market through its investment accounts in all commercial banks. The government would then get a proper return on its accounts. This way the benefit of creating money will directly go to the society. The investment depositors and the government will effectively become shareholders of the bank. The government in particular and the investment depositors in general would be able to influence banks' direction of investment. I am sure the author who, like me, wants to see a larger number of ordinary people becoming owners of the capital should favour this outcome.

The author claims that interest is an unnecessary tax imposed by the banks and it increases the cost of the projects. Of course public as well as private projects could be executed without payment of interest if the funds are available without cost. That is only possible if the government provides all the necessary funds with zero interest. As we have discussed earlier, this may not be always possible without creating a period of inflation. Under the Islamic banking framework we just discussed in the previous paragraphs, the central bank or the government may allow the commercial banks to use money in its accounts at the banks to finance particular projects at a very low or even zero charges. The banks could be paid for its services by the government, again through its accounts at the banks and if necessary through new money creation. The criteria to select a project that meets efficiency and distributive requirements could be chalked out between the banks and government representatives.

(8) The author says that economists would defend interest as a payment for abstinence, waiting or time preference. He, however, asks why the banks should be charging interest, that do nothing of this sort. However, if one accepts the notion that banks' ability to create money depends on the savings and deposits made by general public who must be rewarded through interest (for their act of saving and making a sacrifice as they have positive time preference), the bank may have a case for charging interest. For this reason, it is important to deal with the issue of time preference in more detail.

Bohm Bawerk, the most influential thinker to defend interest, had claimed that people who are otherwise rational in their economic decisions behave *irrationally* when it comes to making inter-temporal choices for consumption due to their defective imagination. Siddiqui (2002) attempts to see if people in general are really *irrational* and have defective imagination. Like Frederick et al (2002), he shows that what is being labelled as discounting of future payments and time preference could actually be a reflection of avoidance of uncertainty or impact of inflation or missing an investment opportunity or a combination of these and more factors.[5]

[5] Frederic et al (2002), pp. 381-83.

In his pioneer work on discounting in project evaluation under an Islamic economic system, Zarqa (1983) rigorously dealt with the issue of time value of money and concluded that a positive time preference is neither a principle of rationality nor an empirically established predominant tendency among consumers. It is simply one of the three tendencies among consumers, the other being zero and negative time preference each of which is rational and observable under its own conditions.[6] Zarqa (1983) provides a good survey of the issue of time preference in western economic tradition. He claimed that the overemphasis on positive time preference among some western economists could be ideologically explained by its presumed suitability as defence of the institution of interest against Marxist attacks.

If the case of positive time preference is weakened, then it could be argued that people primarily save for their future needs and do not necessarily deserve a positive return on their savings. If they want the value of their savings to grow (a rational and legitimate desire) they should be asked to invest themselves or through different financial intermediaries. It is then the responsibility of the government to provide a fair and conducive environment to meet the legitimate need of all people whether they are able to make big or small savings. It is important to note that in many countries the bulk of bank funds consist of large number of deposits held by small savers. In the current system most of them receive a very low rate of return on their savings as they are not recognised as the real investors and agree to opt for fixed returns. The *profit and loss sharing* Islamic banking system is a step to provide a fair alternative to the legitimate need of the people.

The next goal for those who oppose the institution of interest is to show that interest is not indispensable. According to Ali Khan, "… interest is not indispensable for the functioning of a private ownership economy."[7] He also claims to show the irrelevance of the rate of interest, assuming it exists, for an optimum allocation of resources in an idealized model of a private ownership economy.[8] Muslim economists and others in the west or east who are against the institution of interest should join hands and continue to work in theoretical and practical fields for a viable alternative.

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[6] Zarqa (1983), p. 209. He further argued that as time preference need not always be positive, it couldn't provide a valid base for discounting. He, however, claimed that discounting is one of the definite requirements for efficiency in investment in both the private and the public sectors. He suggested that, for private projects, rate of return on projects with similar risks should be an appropriate rate of discounting. Zarqa (1983), p. 219. For pubic projects the discount rate should be adjusted downward to reflect the common view that such projects are less risky and the objectives are more complex. Zarqa (1983), pp. 230-31.

[7] Please see Ali Khan's comments on Zarqa (1983) in Ziauddin Ahmed, Munawar Iqbal and M. Fahim Khan (eds.) *Fiscal Policy and Resource Allocation in Islam*, International Centre for Research in Islamic Economics, King Abdul Aziz University, Jeddah & Institute of Policy Studies, Islamabad, p. 242-243.

[8] Ibid, p.243.

(9) It should be recognised that people (and states and their agencies) have need for financial resources for both consumption and investment purposes and a society has to develop a mechanism and system to meet these needs in a way that is fair and efficient. However, what is fair may be looked at differently among different societies and even within a particular society. The results of a recent case study of Cambodia Women's Development Agency (CWDA) will be interesting to quote. CWDA is an NGO in Cambodia that provides short term loans to its clients on an annual rate of interest of 60% (5 % per month).[9] The results of the study show that almost all borrowers who have received loans from this NGO are satisfied and would continue to borrow in the future. The reason is that these borrowers are very poor and small loans taken from this NGO allow them to do small business and get a much higher *monthly* rate of profit than the 5% rate of interest per month. These people have liquidity constraint and do not have access to any government loan and loans from commercial banks. The NGO has developed a method of loan collection that is very effective and it covers its operating costs. The default rate is very low.

It could be argued that most of the clients of this NGO are unable to get a full time job on the on going wage rate or the wage rates are very low. They welcome a loan that allows them to make a good income even though the rate of interest is extremely high.

In an Islamic system individuals could also provide small funds or a private commercial firm on *muḍārabah* basis to the cash strapped people. This could generate a reasonable rate of return to both providers and the users of the funds. Alternatively, the Islamic government can establish special organisations (such as the Khushali Bank in Pakistan) or NGOs and ask them to provide loans on zero interest and the cost of running such organisations are covered through general tax revenues or money creation by the central bank.

(10) For other people who may not be so poor, loans for consumer durables such as automobiles and housing could be provided by some government agencies. Alternatively, they could be provided by the commercial banks by using the money available through central banks' accounts in the banks. The government could then pay a lump sump amount to the banks for handling such loans that should be much lower than what normally banks charge to their borrowers for consumption loan. Indeed these loans will be provided to the consumers for their essential needs and not promoting unwarranted consumerism that many commercial banks are involved today (*not excluding* those who claim to be Islamic banks).

This consumerism had gone so bad that even a rich country like Brunei had to impose ceilings on the amounts commercial banks (including the Islamic banks) can lend to the consumers. This has to be done after it was noted that for years a

[9] Vien Ky (2005) "A Critical Study of Lending Policies of Cambodian Women's Development Agency: A Case Study of a Non-Government Organization", MBA Thesis, Faculty of Business, Economics and Policy Studies, University of Brunei Darussalam.

very large number of households in the country were heavily indebted. The advice given by religious leaders to avoid over-spending and be prudent, were generally unheeded by the general public who were simply lured by the availability of loans by the commercial banks. Most of these loans were used for buying goods that were either not essentials or could be bought with lower spending. Apparently, the same commercial banks failed to inject enough funds as loans to new small or medium size enterprises. I completely agree with the author who criticises the banks for promoting consumerism and calls for a better utilisation of their funds to spread ownership of capital and increase the productive capacity of the economy.

(11) People save for their children and for their own possible needs in their old age and for future uncertainties. It can be argued that, normally, household savings decisions are independent of the expected rates of returns on those savings.[10] After the saving decision is made by a household, another decision is made about the composition of the portfolio which varies according to the risk averseness and the rate of returns and other characteristics of different assets. If risk free assets are not available, people can still diversify their portfolio specially if there are avenues provided by the economy.

As I have suggested elsewhere, an Islamic reform in stock markets where most transactions would be made on expected dividend payments rather than speculation would provide such an avenue to both the savers as well as to those who need funds for investments. Indeed, not all users of funds will be able or eligible to issue shares to raise funds. For many of them, especially for those who run small or medium enterprises, commercial banks as well as special lending institutions will be needed. As said earlier, in order to avoid interest, the government (meaning the society as a whole) would need to meet the cost of running specialised lending institutions. In old days population was less and the need of funds for consumption and investment was limited. Individuals in the society were supposed to support those who need resources for consumption or small amount needed for doing businesses. As the societies have become larger and complex, things cannot be handled at individual levels and the society has the responsibility to do it through the agencies of the government.

Similarly, not all the people will find it convenient to directly participate in the stock markets or even deal with the brokers. However, if the stock markets become places where economic agents primarily go for dividend income rather than speculative capital gains, commercial banks could be allowed to put a substantial part of their deposits in stock markets (like mutual funds) and pay relatively higher returns to their depositors. The other part of commercial bank deposits could be

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[10] I have qualified this statement by "normally" to allow the possibility where a very high possibility of getting an abnormally high return over a reasonably short period of time, may influence the society as a whole to increase savings at the margin.

used to invest in equity based modes of Islamic finance such as *muḍārabah* and *mushārakah*.

Muḍārabah and *mushārakah* are pre-Islamic. They became more significant after the advent of Islam that clearly prohibited interest. The use of these techniques was relatively easier in simple societies where people knew each other and transaction costs were low. Siddiqui (1994a) discusses the problems of implementing a *profit and loss sharing* Islamic banking and concludes that they are not insurmountable. One should also admit that there are many advantages of modern society that were not available earlier such as book keeping, forensic accounting, monitoring techniques, information technology, legal and juristic framework, etc. Furthermore, the structure of equity based techniques of finance could be changed in a way that they become acceptable to both parties without altering its essential characteristics.[11]

Another advantage of the modern world is the use of paper money and government's ability to create it. It also allows her to collect taxes more efficiently and easily. Together it gives her tremendous control and authority to eradicate interest and promote social justice a cherished goal of Islam.

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[11] For instance, it is argued that Islamic banks or providers of the funds could be allowed to look into the accounts of their user of funds or in their major business decisions.

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