The Pakistan Development Review
Vol. XXII, No. 1 (Spring 1983)

Book Review

Muhammad Nejatullah Siddiqui. *Issues in Islamic Banking: Selected Papers.* Leicester: The Islamic Foundation. 1983. 152pp. Author and Subject Indexes.

The book under review is a compilation of the author's articles and lectures that highlight the prominent developments in the literature on the subject of Islamic banking and inform the reader of the current state of debate on it. One of the earliest and main contributors to this topic is the author himself. The focus of this review will mainly be on "Economics of Profit-Sharing", which is the title of the fourth chapter of the book and is among his latest contributions. This chapter is a significant contribution as it is the first attempt to formalise the concept of profit-sharing into an analytical model and, therefore, demands closer scrutiny. However, in the remaining chapters of the book, the author has drawn attention to some of the fine points made in the literature on this topic. Since some of these points appear to be controversial to me, I will briefly discuss them before moving on to the analytical chapter of the book.

The author claims that Islamic economists have scored a valid point by *"demonstrating"* that *Zakat* will discourage hoarding (p. 18). That this claim is justified is not clear, particularly because hoarding is not even defined. In economics hoarding is money which is kept out of circulation, like the proverbial money that is hidden under the blanket. The author's contention would only be true if these hoarded funds were deposited after *Zakat* was instituted on bank accounts, so that their social contribution towards welfare was being fulfilled. In fact, individuals with such a heightened social conscience would pay *Zakat* voluntarily anyway rather than being motivated by the instituting of *Zakat* to draw funds out of hoarding and into bank accounts, i.e. bring more funds into circulation in order to pay *Zakat*.

On the other hand, if *Zakat* is applied to bank deposits, then hoarding in the sense defined above may well increase. Since, administratively, there is no easy way to identify these funds, it is not easily possible to subject them to *Zakat*. If hoarding is defined as funds in saving accounts as opposed to investment or profit-sharing accounts, then *Zakat* may effect a reallocation of funds in favour of profit-sharing accounts. In fact, *Zakat* in saving accounts, in conjunction with the elimination of a risk-free saving option, could well induce purchase of jewellery or land or induce conspicuous consumption. In the last case inflationary forces in an economy would be exacerbated, depending on the state of real capital formation and supply-side bottlenecks.

The author argues that concentration of power resides with banks because power results from the possession of "abstract capital", and banks presumably have the inherent capacity to concentrate liquid wealth in their hands (p. 83). This ducks the issue of the economic power that results from the ownership of productive assets. In fact, this omission coincides with the marked failure of Islamic economists to deal in an operational manner with the division of surplus within the firm. The focus has been exclusively on the division of surplus between the entrepreneurs (borrowers), financial intermediaries, and depositors (lenders).

The author also attests the widely held belief among Islamic economists that saving is unlikely to be affected by a change from interest-based transactions to profit-sharing (p.93). The Keynesian idea of saving being largely a function of income is used to support this argument. Modern macroeconomic theory has considerably refined the Keynesian consumption function, and the impact of interest rate on consumption and, hence, saving through the asset-effect is now a part of standard theory. Apart from this indirect positive relationship of interest rate and saving, refutation of the direct positive relationship between them can only be based on an extensive survey of empirical literature on this issue in a particular developmental context.

Dr. Siddiqui has also brought together several arguments that are often used to indicate the strength of the profit-sharing financial system in contrast with an interest-based one. He correctly points out that there would be a reallocation of wealth from the *rentier* to the entrepreneurial class (p. 73). Also, where a fixed return is guaranteed, the banks may choose to favour the more credit-worthy who may also be the more influential. In a profit-sharing arrangement, the bank will have to consider the profit forgone when choosing to advance a loan to an influential client rather than to one whose project indicates a greater expected return. Another point made is that interest as a fixed, predetermined return is included in the cost of production, and under competitive conditions this would entail a lower level of production. Given a significant degree of market concentration, it would also imply a higher price. As to the charge that banks will understate profits to the depositors, the author believes that pure competition among banks would eliminate this danger (p. 64). The danger that firms would understate profits to the banks will similarly be reduced in a competitive environment where firms compete for loans, and where their track record would determine their future loan procurements. Nevertheless,

there is a great danger that someone may default on a large loan due to questionable personal ethics.

In fact, it is on this point that I find several Islamic econcomists, including Dr. Siddiqui, to be at fault methodologically. He assumes that the Islamic spirit would call for cooperation among economic agents for the achievement of common goals (p. 98). Both the entrepreneur and the lender would want to see a higher profit, but the entrepreneur will clearly have an incentive to retain as much as possible of these profits. It is methodologically incorrect to assume behavioural postulates which in fact have to be empirically verified. In other words, it is unacceptable to rely for the success of institutional reform on behavioural postulates like altruism or co-operation, whose implicit presence in average social behaviour has not been empirically verified. What is at issue here is the fundamental institutional change in Muslim societies as they exist now, and not in idealised Islamic societies where most institutional change may well be redundant. The author is certainly within his rights to work within certain specified value and institutional parameters. However, these premises need to be explicitly stated. If they are, the model may then have less contemporary relevance although it may perhaps be a useful exercise in itself.

In the fourth chapter of the book the author has developed a practical operational model of profit-sharing which is suggested as the route towards establishing an interest-free financial system. The rest of this review is devoted to comments on this model.

The model presented is a partial-equilibrium comparative static model that is intended to determine the shares of the three parties to a profit-sharing contract. One set of demand and supply curves for loanable funds (in profit-share/investment space) is illustrated as determining shares between the banks and the lenders and another set between the banks and the borrowers. In neither case are the demand and supply curves carefully modelled or derived but are merely presented as a logical inevitability. This is not a defensible position. For example, the demand curve for borrowers is in effect an investment schedule underlying which is an extremely complex theory of business investment behaviour. With regard to the demand curve, as presented by the author (p. 104), it is not clear what causes some entrepreneurs to invest earlier and others later when the borrowers' profit-share declines. Why does everyone not wait? Once again, underlying the supply curve of loanable funds is the theory of portfolio management. Deriving the supply schedule formally is possible, and the process yields some rich insights.

The author also makes some errors with regard to the comparative static framework of the model. Expectations of borrowers and lenders are stated to be identical and based on some function of past profits (p. 102). Since information flows to borrowers and lenders are unlikely to be the same, these assumptions are unrealistic. When the author does allow for differences in expectations, the source of these differences is not explained.

There are several other problems in the details of the analysis. The author should introduce another variable (say, P′) to represent expected profits. As the analysis stands, a change in P represents movements along the curves and not a shift in the curves. If this problem is taken care of, then there remains considerable arbitrariness in the model which attempts to explain variation in profit shares in response to a change in expected profits (pp. 106-107). The first arbitrary element in the model is the assertion that the supply for loanable funds will shift less than the demand for loanable funds. There is no reason why this should always be the case. The second arbitrary element is the bank's refraining from matching the entrepreneurs increase in funds by a corresponding increase. Since they both have the same expectations there is no justification for such behaviour. In fact, the author's analysis indicates (p. 106) that the banks would have no incentive for doing this and that they will manipulate the market (i.e. by restraining their demand for funds to be less than the increased demand of entrepreneurs) to ensure a greater profit-share for themselves. In other words we don't have a model of a free and competitive financial market that has the ability to explain the variation in profit-shares.

In the comparative statics of the model, profits are implicitly assumed to be independent of the level of investment. This assumption is not warranted and the inability to allow for the feedback effect is a limitation of the partial-equilibrium framework. Nonetheless, the existence of the feedback should be recognised and the probable direction of the movement towards a new equilibrium indicated.

Perhaps the most serious error relates to the recommendation in this framework for monetary policy. Having allegedly arrived at the market-determined profit-shares, the author is quite willing to relegate them as a tool of monetary policy. If profit-shares reflect the realities of the saving and production process, changing them at will to suit the requirements of monetary policy will clearly lead to a misallocation of resources.

Since the primary objection to a conventional financial system is ethical, any advantages or disadvantages it may have in an economic realm would in the final analysis not count for the reformer. However, the trade-offs do need to be accurately appraised to help in instituting a workable alternative option to the interest-based one.

I have two final objections. First, the author insists that profit-sharing and not PLS (profit-and-loss-sharing) is the appropriate concept (p. 135). I do not find the argument convincing, based as it is on a distinction between accounting and real losses. Surely an economist's concern should be with real losses, and the entrepreneur does stand to lose the return on his time and effort in the PLS contract.

Second, the author has taken it for granted throughout the whole book that an overall change from interest-based transactions to ones without interest (in this case profit-sharing) is the only social option. The current practice in the Middle-Eastern countries is to have profit-sharing banking as an option along with conventional

banking. To me, spiritual merit appears to be greater in a voluntary choice of the interest-free option than in having it as the only choice under compulsion. I would not dispute that the provision of such an option should be the duty of all states that represent Muslims.

The latter objection brings to the fore the importance of viewing this work in the larger context of initiating an Islamic economic system. Even if the analysis was made more spohisticated along the lines suggested in the body of this review, it would do no more than yield more useful insights into the workings of the financial system based on PLS. This leaves the major issues unaddressed.

First, what is to be the basis of a transition of a community to an Islamic footing? One of the minimum conditions for this must be the expression of mass sentiment for such a change, and a full and active mass participation in the revolutionary process that it entails. Secondly, the fervour for such change could be viewed as prompted by a will to create a more just society for all, and one which allows Muslims to live in concordance with their fundamental beliefs. It is not necessary to assume that the process of social change will entail a moral revolution that will once and for all transform social behaviour into a more altruistic one, thereby bringing a just society into existence. To do so is neither realistic nor warranted by the Islamic dialectical view of human nature.

To transform society for attaining social justice, or the Islamic concept of *al-ʿAdl,* the rules would have to be radically altered so that social agents and institutions are no longer able to thrive on exploitation. For a start, such change would entail elimination of *riba* in all its manifest form (apart from interest) such as monopoly rents, hoarding, and absentee rents. This process would take more than marginal tinkering with the existing capitalist system, even though it would not necessarily rule out decision-making by the market-process.

Despite his prominence in the field of Islamic economics, Dr. Siddiqui is among a majority who seem to have, perhaps inadvertently, created a misconception about the basis and nature of the social change needed to bring about an Islamic system.

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