THE WISDOM OF PROHIBITION OF INTEREST

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Interest is prohibited because it is unfair (*zulm*).

In the case of productive loans the borrower may sometime lose, yet interest based lending obliges him/her to repay the principal plus interest. Some time the borrower may reap huge profits, yet the lender gets only the stipulated rate of interest, which is usually a very small part of the actual profits.

Modern researches have shown that interest has bad consequences for the economy. It results in inefficient allocation of society's resources. It also contributes to the instability of the system.

Islamic economics research has shown that the economic system can function without interest. A system using profit-sharing modes where possible and trade based modes, e.g. *murabaha*, leasing, etc. where necessary, will be more equitable, more efficient and more stable than the current interest based system.

In the case of consumption loans, if it is for food, drinks, clothing, etc. necessary for survival, charging interest violates the nature of social life, which requires cooperation, care, and help of the needy by the well to do. If the loan is for consumer durables aiming at increase in efficiency, *murabaha* provides a safer, better way of financing than interest based lending.

Let us have a closer look.

PRODUCTIVE LOANS

Prohibition of interest means prohibiting the exchange of present money for future money, with an increase. Those who need present money in order to use it in economic enterprise with a view to making profits are obliged, because of this prohibition, to adopt other means. There are, broadly speaking, two other means available. They can enter into a profit-sharing arrangement with the owner of money. Or they can ask the money owner to buy the things they need for the business and sell those things to the business at a price higher than the purchase price, to be paid after a specified period of time. Both these alternatives to interest based finance are better in their consequences for the economy.

The profit sharing arrangement may either involve the money owner in management, in which case it becomes a partnership, or it may leave management to the one taking the money, in which case we call it *mudaraba.* In both cases the money owner shares the resulting profits in proportions agreed upon. But in both cases he or she bears the loss in capital if and when it occurs. However, the entrepreneur becomes liable to loss in capital if he or she violates the terms of agreement regarding the nature and scope of business, etc.

This mode of finance exposes the money owner to some risk but it may bring him or her higher returns. It is fair to the business partner, as it does not oblige him/her to bear losses occurring despite good, honest management. It is better for the society as it allocates resources on the basis of expected profits from the project being financed, which reflects productivity. The interest-based finance allocates investment funds on the basis of creditworthiness of fund seekers, and creditworthiness does not reflect productivity. It reflects only ownership, which may be inherited or due to past achievements which do not necessarily indicate the soundness of current projects. It has the added advantage of the projects being financed being double checked, once by the fund seeker and secondly by the fund supplier, as their rewards/returns depend on the actual outcome of the project itself.

In the interest free Islamic environment savers can share with banks the risks associated with choosing the right investment. Banks share the risks as well as decision making with the businesses they finance. As compared with the current situation risk and decision-making, hence economic enterprise, will involve a much larger section of the population in an interest free Islamic economy.

Profit-sharing finance synchronizes payment obligations of firms with its revenue accruals, thus removing a great source of instability in the system. Interest based finance subjects the firm to a rigid schedule in which the amounts due for payment as well as the dates payment is due does not take the current project status into account. This may oblige the firm either to borrow (usually at a higher interest rate) or to sell its products at a lower than expected price in order to meet its contractual payment obligations. The third alternative is default, which sends shock waves through the system.

Should the fund owner not like to expose his/her funds to the relatively higher risks involved in profit-sharing, or the business party be unwilling to share profits, they can resort to one of the several trade based modes of finance mentioned above. They save the fund owner from loss and bring him/her a positive return to their capital. But the risk of default remains, though a collateral can cover it. On the other hand the business party has the advantage of keeping all the profits to itself. But it bears all the risks of business including that of the loss of capital, as it has to pay the price of the goods and services obtained on credit.

Murabaha and other trade-based modes of finance create debts. But these debts cannot be traded except at par value, which prevents them from ballooning into several times their original volume. Since they arise in the process of supplying real goods and services, they do not have much expansionary effect on the system. This is quite unlike interest-based finance in which debts are created on the basis of creditworthiness of borrowers and they are traded like any other commodity, sometimes serving as collaterals against more debts. The financial sector then acquires a life of its own independent of and only tenuously linked with the real sector of the economy. This makes it vulnerable to speculation bordering on gambling in which risks are created for the purpose of taking risk, with no relation to the production of wealth.

It will be seen that in the *murabaha* finance unlike interest based debt finance changes in spending will automatically be reflected in changes in demand and supply of goods and services. No modern economy can function without credit. But the way credit is created in the absence of interest rules out the possibility of excessive debt creation or its continued accumulation at an accelerated rate because the price to be paid in future for goods and services supplied in the present once determined can not be increased. No debt crisis can take place in a system without interest in which all debt is for goods and services supplied and, most likely, against collateral.

A decreased role for debt in the economy would have far reaching consequences for international movement of capital, the terms and conditions of its entry into and exit from countries. There would be no room for sudden mass movements of funds as happened in South East Asia during 1997-98, with disastrous consequences.

CONSUMER CREDIT

We can now look at consumer credit. It is good for people to be able to acquire a refrigerator, a car or a house early in their earning life. It increases efficiency, their earning capacity. They are, generally speaking, able to pay in installments out of their future earnings. There are two ways of doing so. The conventional interest based system would either provide a loan to be repaid with interest, or supply the durable good against a mortgage paid in installment, ownership being transferred to the user when the mortgage is fully paid up. Islamic financial institutions are supplying these goods on the basis of *murabaha*. Ownership belongs to the user from day one; the price (higher than the spot price) is paid in installments over a period of time. The financier generally maintains a lien on the durable till payment is complete. The difference in comparison to interest-based loan is clear. The difference in installment sale lies only in the *murabaha* price being fixed once for all, no roll over of the debt being allowed. Both systems are able to supply durables on lease, often ending in the user owning the durable. Even though currently the market rate of interest provides a benchmark for the rate of mark up in *murabaha* or leasing it is not obvious that it will continue doing so in a system in which interest is abolished. It is more likely that the rate of mark up in an interest free market economy will be determined by supply and demand, whereas the rate of interest in modern economies has largely become a policy determined variable. It can be reasonably claimed that the Islamic arrangement meets the need and is not at a disadvantage in this regard.

As regards lending for meeting urgent basic consumption needs like food, Islam obliges the lender to do it as a courtesy (Of course it forces nobody to lend). These are the cases in which, most probably, no future income is in view for the seeker of the loan. In the last resort, the society owes it to these indigent members to help them tide over the difficulty, but it is more efficient if it is done person to person or in the voluntary sector through charitable institutions/NGOs.

The conventional system, by legitimizing interest, leaves a section of these needy individuals to the mercy of loan sharks.

CONCLUSIVE REMARKS

Like many other evils, the practice of charging a fixed positive return to loan capital has survived strictures from all world religions and condemnation by all moral philosophers. In the earlier days the role of capital in the economy was much less important than it is today. Humanity has much more to suffer because of making interest the linchpin of its financial system in a globalized world using huge quantities of capital. As briefly mentioned above much of the inequity, inefficiency and instability of the modern economy owes itself to interest. It is also a major stumbling block in the way of a moral approach to the global economy based on sharing of resources and caring about the weak and the poor. It is time the negative economic role of interest and all realized its immoral nature.

The wisdom of prohibition of interest lies in the divine hand guiding men and women towards a better economy and a better society.