ISLAMIC FINANCE AND BANKING: CHALLENGE OF THE 21ST CENTURY

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Keynote Address by Prof Khurshid Ahmad*

The Islamic Society of North America and all the cosponsors deserve our thanks for taking this timely initiative to hold the First International Conference on Islamic Finance and Banking. As I have to cover a rather vast area within a short span of time, excuse me if I try to be rather short, yet precise. I propose to confine myself to essential points, and as such may not go into details.

Let me submit that in my view. Islamic Finance and Banking is no longer just a theory, a dream. In fact it is now a reality, albeit an emerging, evolving and fast growing reality. In view of their religious and ethical commitment, Muslims have never compromised on the concept of Riba. For 1200 years they developed and successfully managed a thriving economy on a Riba-free basis. They were a major actor in the arena of world economy.

Muslims constituted the bulk of what now goes as the Third World. The position of this Third World in the 18th century vis-a-vis the West was in no way inferior. They lost the game in the following centuries of industrialization and western imperialism. But the relative share of the Third World in world manufacturing output at the advent of the 19th century was three times higher than that of Europe and the per capita level of industrialization was comparable till 1800. The economies of the Muslim countries were.

By and large, supported by a financial system that was not tainted with Riba. Paul Kennedy gives a snap-shot view of the world from 1750 to 1900. A quick look will show that we are talking of economies at reasonable levels of sophistication:

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Note: This is an extended version of the keynote address delivered by the author to the "First International Coherence on Islamic Finance and Banking", held in Houston, USA in July, 1998. Under the auspices of the Islamic Society of North America (ISNA), Association of Muslim Social Sciences (AMSS), Rice University Chair on Islamic Economics, and others, Relative Shares of World Manufacturing Output*

Region/Country	1750	1800	1830	1860	1900
Europe	23.2	28.1	34.2	53.2	62.0
Russia	5.0	5.6	5.6	7.0	8.8
U.K	1.9	4.3	9.5	19.9	18.5
USA	0.1	0.8	2.4	7.2	23.6
Third World	73.0	67.7	60.5	36.6	11.0
Pakistan/India	24.5	19.7	17.6	8.6	1.7

Per Capita Levels of Industrialization f 1750-1900V
(Relative to UK in 1900 = 100)

Region/Country	1750	1800	1830	1860	1900
Europe	8	8	11	16	35
Russia	6	6	7	8	15
U.K	10	16	25	64	100
USA	4	9	14	21	69
Third World	7	6	6	4	2
Pakistan/India	7	6	6	3	1

The scenario materially changed in the following two centuries of Western domination. In 1800 Europe occupied or controlled 35 percent of the land surface of the world. In 1878 its control extended to 67 percent of the world and in 1914 it reached the high water mark of 84 percent. A new economic system was imposed on the world, an offspring of marriage between, capitalism and imperialism.

The last two hundred years are also characterized by a global economic system based on riba. The kingpin of the post-industrial revolution financial system had been interest. Muslim countries were also overwhelmed and overtaken by this new economic order. Some Muslim intellectuals, Ulema, Fuqaha, and intellectuals did try to develop, at an academic level, a critique of interest as also of Capitalism and Imperialism as economic and political systems. They also came up with suggestions and proposals as to how an alternative system can be established.

*Source: The Rise and fall of Great Powers by Paul Kennedy, Random House, New York, 1987, p.l49.

Maulana Abul A'la Mawdudi, Imam Mohammed Baqar Sadr, Dr Anwar Iqbal Qureshi, Dr Nijatullah Siddiqui, Dr Muhammad Uzair and Dr Ahmad al-Najjar were amongst the pioneers of this movement[1]. Yet their efforts remained theoretical exercises. It was only in the last forty years that material change has taken place and major developments have been taken in four directions.

First, at the academic level, professional economists and bankers have overtaken the field and tried to build on the foundations laid down by the Ulema, Fuqaha and intellectuals. Secondly, serious efforts at institutional level have been made to establish riba-free financial, investment and banking institutions. Thirdly, universities, research institutions, international professional organizations (including some Western universities and professional associations) have begun and developed academic, training and research programs in different areas of Islamic economics, banking and finance- and as such initiated a process of widening the academic horizon and making research inputs towards facing the problems that are bound to arise with the introduction of riba-free systems and instruments. Finally, at the state level initiatives began to be taken to switch over the national financial system from riba to riba-free basis. At least in Pakistan, Iran, Sudan and Malaysia such efforts began to take off. At the global level also the establishment of the Islamic Development Bank and its research institution. Islamic Research and Training Institute, represent major developments to establish a net work of financial arrangements and institutions within the Muslim World. That is why I regard the last forty years as a period of major break-through moving towards not only greater sophistication and professionalization in the discipline but also transition from theoretical formulations towards practical experimentation.

Very elementary efforts were made in Pakistan in 1950s; both in cooperative as well as commercial sectors[2].In Egypt two pioneering experiments were made. First in the form of Mit-Ghamr Bank (1963-1967) combining the idea of German saving bank with the principles of rural financing within the framework of Islamic value's. This was followed by the establishment of Nasr Social Bank in 1971-760, to help in particular the weaker sections of the society. In Malaysia a major break-through was achieved with the establishment of Tabung Haji (1963), a specialized financial institution to mobilize savings and enable Muslims to participate in investments, industry, commerce and plantation in accord with Islamic principles and also to provide for the protection, control and welfare of Muslims while on pilgrimage (Hajj) through various facilities and services of Tabung Haji. With a modest start with 1,281 depositors in 1963 and a total of M$ 46,600 in deposits by mid 1985 it arose to a million deposits with total deposits exceeding one billion Malaysian dollars[3].

1975 stands out as a landmark in the emergence of contemporary Islamic Banking. The Islamic Development Bank was established at the Ummah level, with the full backing of the Islamic Foreign Ministers' Conference. Dubai Islamic Bank was also established in the same year. This was followed by an emerging stream of Islamic banks: 3 in 1977, 2 in 1978, 2 in 1979, 1 in 1980, 4 in 1981, 3 in 1982, 10 in 1983, 5 in 1984 and 1 in 1985. By 1985 there were 35[4]. The number of Islamic banks, financial and investment institutions, according to a survey by the International Association for Islamic Banks, is now over 200. Their deposits are over $ 80 billion, their assets around $ 200 billion and they are operating in some forty countries of the world, including a number of non-Muslim countries.

A new development in the field is represented by the emergence of what can be described as trans-national groups like the Dar al-Mal al-Islami and al-Barakah-Dallah Group. We also find that the traditional, western riba based banks are now beginning to take interest in interest-free banking. Around a dozen leading European and American banks and finance houses are now operating interest-free savings and investment programs. Even Dow Jones are developing on Islamic index to attract Muslim capital. We also find that the riba-free principle is being extended to the fields of insurance (takaful. leasing (ijara) and real estate finance. New Islamic financial instruments are being developed and used successfully. Prof Rodey Wilson of Durham University, UK has recently prepared a study for the Financial Times, London which gives a fair review of the landscape of contemporary Islamic Banking as an emerging and expanding field[5].

This being the situation, it is fair to claim that Islamic Banking is no longer a mere dream or just a theory; it is a reality. Yet I must add a reality at a nascent stage. That is why I called it an emerging, evolving, and fast growing reality.

Three Major Models

Analyzing this Islamic financial global landscape, one finds that these experiments can be grouped under three scenarios, each representing a distinct model:

First, in the private sector - there are banks, financial institutions, investment companies, leasing companies, mutual funds trying to operate without interest. They are primarily owned by private investors and entrepreneurs, although in respect of some there is a degree of financial participation by some governments or international financial institutions. In some countries special laws have been enacted to enable interest-free banks to operate effectively with necessary depositor security. Two major financial groups of Faisal-Daral Mai al-Islami and al-Barakah-Dallah belong to this category.

Second, at least three countries have tried to make a beginning in the direction of developing a state sponsored process of elimination of riba from among the entire banking system. Instead of establishing interest-free banks in the private sector, the strategy was to first establish 'interest-free counters' within the system, and then extend the interest- free system to the whole banking sector, so as to operate on new principles under the protection of state policy and central bank guidelines. The objective remains to finally cleanse the whole economy of interest. Pakistan partially initiated the process in 1980 and moved towards total change in 1985 but I am sorry to say that the process was frustrated somewhere in the middle. Primarily because of lack of political will the new system could not be established and the process somewhat aborted. Iran and Sudan are still moving in that direction, with a long mileage yet to cover. They have not followed exactly the same routes yet the strategy of total and state-sponsored change is common. The aim is not just one or some Islamic banks at the micro level, but transformation of the entire financial and banking system and ultimately the whole economy so as to conform to Islamic norms.

Third, the model which Malaysia has introduced is a mix of the two. On the one hand they have established under the legal framework of the country a totally riba-free Islamic bank with a distinct law and identity and along with that on the other, they have created a mechanism through which any conventional bank could also have a riba free window within the system. Some fifty two conventional banks have opened such riba-free counters. In this system the two streams of riba-free and riba-based banking can somehow co-exist and compete with each other.

Presently the Islamic Ummah is trying to experiment with these three models[6].

What is Islamic Banking?

Now is the time to pause for a moment and try to clearly identity what constitutes Islamic Banking.

First, let us start with a foundational concept. The concept and role of money is crucial to any financial system. In an Islamic system money is primarily and exclusively a measure of value, a means of exchange and a standard for deferred payment. But distinct from the ethos of Western economics and conventional banking, money is not regarded as a commodity in itself, to be bought, sold and used to beget money. As a logical consequence of that in an Islamic framework money has to operate through some real economic activity or service. It is a facilitator and an intermediary, not ap active self-contained agent in itself Capital is productive, not money per se. It is a means towards production, through creative entrepreneurial efforts. It is to be an instrument towards value-added through physical expansion of the economy; In other words real economic progress and development consist in expansion of the physical and human aggregates of the economy via creation of assets, products and services, and not merely in the form of fiduciary financial expansion. It is through such a generation of wealth that well-being takes place and the relationship between money-economy and physical-economy remains in real equilibrium. Wealth does not create islands of affluence in an ocean of poverty and deprivation. Money never becomes the objective, the hero of the cast. It remains an intermediary and an instrument for real productive effort, for asset creation, for value- added and for expansion of physical economic activity in a manner that benefits all sectors and participates in the economy.

The next basic point is that there are two methods or processes through which financial cooperation takes place. First is direct investment. That is people who have money in excess of their needs and people who have productive ideas and' expertise — entrepreneurs, innovators, producers, workers, traders join hands to pool their resources for further production and exchange. Those with excess funds through direct investment provide others with these resources to move the wheels of productive machinery and trade processes. This is the oldest and one of the most common forms of productive cooperation between money and entrepreneurship.

But there is also a second process and that is through financial intermediation. Instead of direct investment there emerges a series of banks, financial institutions, mutual funds etc. which act as intermediaries between savers and producers. They are the intermediary institutions through which savings can be mobilized and canalized for investment. The emergence of such institutions has transformed the economic landscape. They have been able to mobilize savings on a vast scale and in an institutionalized manner and make them available for production and other uses. The economic explosion of our times has been financed by this process. That is a very genuine role of banking and financial institutions. In principle direct investment as well financial intermediation are accepted as part of the Islamic framework.

But the crucial point is that whether it is direct investment or financial intermediation, there cannot be a fixed predetermined return on capital, loan able funds or credits. That does not mean that Islam stands for zero rate of interest. That is where some confusion persists. Islam does not deny a return on capital. It holds that capital is productive, as it leads to greater value added, and as such is entitled to a share from what it is instrumental in producing. There has to be a reward for capital. That is just and reasonable. But what Islam challenges is that capital or money or loan able funds have no right to an assured reward without sharing the risks of enterprise or project. It has to be a variable return based on actual performance of the project, enterprise, or the economy as a whole. Islam prohibits a reward without sharing risks or having a stake in the economic venture. That is the basic premise. So Islam says that if you want to give money to someone by way of a loan, to help him in need, you go for qard-e-hasan where you are assured of your principal amount, but no increase on that. But if you are interested in a return, it has to go with risk-sharing. Reward and risk must go together. Interest is prohibited in all its forms, whether it is simple or compound, low rate or high rate, personal or institutional, private or public, consumption loan or productive investment — whatever be the category, any predetermined, fixed increase without sharing the risks of the project or enterprise is riba and is prohibited. It is only the principal amount that is justified in loan transactions. But if you want to share the fruits and the rewards, and sky's the limit that has to be on the basis of sharing the risk as well as sharing the reward. Otherwise it is exploitation and zulm for one or the other, the lender or the creditor.

Let me sum up by submitting that in an Islamic framework there is room for qard- e-hasan where the principal is guaranteed, but there is no increase on that; as also for investment where return is justified but not in a pre-determined form for one party, an ex ante assured return, but return for both based on real performance of the project i.e. ex post facto. That is just for both the parties.

Major Characteristics of Islamic Banking

Now we are in a position to spell out some of the major characteristics of the Islamic system of banking and finance. In my view five such characters deserve special mention:

First, Islamic finance stands for a system of equity-sharing and stake-taking. It operates on the principle of a variable return based on actual productivity and performance of the projects, specific or general, individual or institutional, private or public. Economic cooperation may assume as many forms as may be desired, both at micro and or macro levels but the principle remains one of the equity and reward' sharing arid not of simple loan-interest relationship as in capitalism.

Secondly, a very crucial point relates to the whole vision of an Islamic economy. Islamic banking, as part of that vision represents a revolutionary departure from the conventional system. Islam wants the entire economy, all monetary and business dealings to move from a debt-based relationship, a debt-based economy to an equity-based and stake-taking economy. This is a revolutionary change as it calls for a new psychology and a new approach to the economy. It demands of all the actors within the economy to participate in the productive system and does not allow some to become a rentier class. This is distinct from the capitalistic approach where the whole economy is geared to making money by manipulating, managing and creating money and serving the interests of the rentier class. This is the root cause of exploitation in society and leads to grossly inequitable distribution of income and wealth in the economy.

Thirdly, Islamic approach is rooted in an ethical framework. As such it represents not only a shift from a debt-based economy to an equity-based economy, but also a movement from purely pecuniary and hedonistic profit-taking; to a gainful economy that is also characterized by ethical norms and social commitments. The ethical and social dimensions are crucial to all economic activities. There is a framework of halal (permissible and desirable) and haram (prohibited and undesirable) within which all economic activity, private and public, has to take place. The moral filter plays a crucial role in this system. And this filter operates at different levels, the conscience of the entrepreneur and the firm, the social climate of society, the legal framework, the supervisory and guiding role of the state and government. An activity which would be treated in the capitalistic system as productive because it is supposed to be satisfying some demand (e.g. pornography, gambling, prostitution, promotion of alcohol etc.) in the Islamic framework would be unacceptable. So ethical and social dimensions are integral to the Islamic economic approach. What are the objectives for which money is being acquired? Would that benefit individuals, the society and the humanity? Would it lead to establishment of a just, honorable, sustainable society, or result in exploitation, moral degeneration; social tensions and inequities? These questions are as relevant to decision-making as the financial profitability and economic -viability of an activity or project. This is integral to the system, and not peripheral, or outside its pale, under the garb of value-neutrality.

Fourthly, Islamic finance and banking is entrepreneur-friendly. It is directed not towards mere financial expansion, but towards physical expansion of economic production and services. Money does not beget money. It is expected to finance talent, innovative spirit, new ideas, skills and opportunities. It is expected to result in greater decentralized economic activity and more equitable distribution of resources and wealth in the society. Conventional banking operates on the principle of financial collateral, with the result that concentration of wealth, income and power takes place on a vast scale. More money you have, more you can get. The emphasis shifts from viability of a project to the financial worth of the borrower. If you lack collateral, you stand a very poor chance to get loans irrespective of the viability or feasibility of the project and intrinsic trustworthiness of the person. The focus shifts altogether in an Islamic system. Collateral is not irrelevant, but is cut to size. Instead trustworthiness of the person and viability and usefulness of the project become more important. A more human approach is adopted which would result in greater distributive justice, equity, along with ensuring diffusion of resources in the society by going to the grass-roots, to the community development and individuals that go to make it. As such the small saver, investor, trader and producer become more important. It is community oriented and talent and entrepreneur-friendly.

Fifthly, the Islamic system is non-inflationary. This is a very important and fundamental characteristic of Islamic banking. Banker's almost uncontrolled powers to create credit are, among others, at the root of inflationary pressures. The de-linkage between financial expansion, money supply and physical expansion of the economy is a result of the financial and banking dynamics of our time. Islamic finance and banking restores equilibrium between these three variables. Stability in the value of money is a primary goal of an Islamic economy[7]. The measure of value must have a degree of stability; otherwise the economic fundamentals would get disturbed. The poor are the worst sufferers. That must be rectified. Islamic banking operates within limits that ensure stability in the value of money and an almost inflation-free economy.

In my view these five characteristics make the Islamic system of banking and finance distinct and unique. These are some of the major characteristics of Islamic banking and finance. While it is very clear that the system's distinctive feature is its interest-free character, it does not begin and end with that. There are other very crucial dimensions, like a positive vision of an equity-sharing and stake-taking economy, non-inflationary character and the ethical and social welfare dimensions in respect of savings and investment policies. Of course Islamic economic system has other dimensions that further strengthen and develop the egalitarian character and people-orientation of the system. Islamic banking and finance is a part of this ethical, humanitarian and justice-targeted socio-economic system.

Why Islamic Banking?

In order to understand the real challenges of the 21st century, it is important to reflect for a while on some of the major changes that have taken place during the last two centuries and in the context of those transformations spell out the rationale and a role for Islamic banking.

The central issue is that the contemporary financial system is exploitative, unjust, discriminatory, unstable and crisis-generating. There is no denying some positive contributions that have been made by the banking and financial system towards the promotion of economic development and global capitalism. But when a balance sheet of achievements and failures is made, its failures outweigh and out-number. To claim that modern banking system has been an unmixed blessing is doing violence to facts and gruesome realities of world economy. As such it is worthwhile to reflect on the ethical as well as economic and social imperatives that call for a change from interest-based banking and financial system to an equity-based, stake-taking system where money is primarily a means and a measure, a servant and not the master: a system in which money does not beget money but money is used as a facilitator for greater production of goods and services resulting not merely in increasing the number of billionaires but producing real well-being for the people in the context of a developing, conserving and sustaining economy.

First and foremost as Muslims, for us prohibitionist of riba is a religious and moral imperative. Islam forbids interest in all its forms. The Qur'an uses the strongest terms for its prohibition. It challenges that those who are not prepared to leave dealing in interest, should be prepared for war from Allah and His messenger[8]. A Muslim society cannot exist what to say of prosper while it is at war with Allah and His messenger. There must be a cease-fire, before we can hope for Allah's blessings and bounty. But it is not Islam alone that has prohibited interest. All major religious and ethical systems have prohibited interest. So whether you look at Judaism, Christianity, Buddhism or Hinduism, interest was originally forbidden. Similarly all ethical and religious systems throughout history have forbidden it. Confucius, Socrates, Plato, Aristotle and all major medieval thinkers and theologians stood against interest and regarded it as a form of exploitation and tyranny (zulm). It was only during the last 200 years that legitimization of interest has taken place. For that matter one of the intellectual frauds perpetuated was to change the nomenclature: usury was replaced by 'interest'; as if usury was forbidden and not interest. Usury was exorbitant/high interest rate, interest was supposed to be reasonable/low rate. But that is a myth.

If we look into the history of interest rates we will find that rates vary from 0.01% to 10,000%. Even today, while in Japan the going rate is 1%, in UK it is 8-10%, in Pakistan it is 20-24%, in Turkey over 80%. The plastic money that is increasingly being used all over the world carries a rate between 18 to 30%. Sidney Homer, in A History of Interest Rates sums up as follows his conclusion based on a survey of interest rates from Hammurabi's times to our own:

"A bird's eye view of the history of interest rates will unsettle most preconceived ideas of what is a high rate or an average rate. Each generation tends to consider normal the range of interest rates with which it grew up; rates much higher suggest a crisis or seem extortionate, while rates much lower seem artificial or inadequate. Almost every generation is eventually shocked by the behavior of interest rates because, in fact, market rates of interest in modern times have rarely been stable for long. Usually they are rising or falling to unexpected extremes. A student of the history of interest rates will not be surprised by volatility. His backward- looking knowledge will not tell him where interest rates will be in the future, but it will permit him to distinguish a truly unusual level of rates from a mere change.

"It is easy enough to cite seemingly fancifully interest rates. In fact, we do not have to look beyond our own century to find the highest and lowest rates, in the entire span of this history: 10,000 percent high in Berlin; 0l percent low in New York, Both rates were quoted on standard money-market credits under very unusual circumstances. This is a range of one million to one.

"Hammurabi's legal limit of 20 percent per annum on loans in silver cannot be usefully compared with today's money-market interest rates. It was well above twentieth-century rates on prime business loans, savings bonds, savings deposits and the like, but was below 30-42 percent per annum legal limits and actual charges in many states of the United States for small personal loans. It will be very difficult, throughout this history, to compare like rates with like rates. There are more types and varieties of credit contracts in ancient and modern history than are dreamed of in the philosophy of the modem bond salesman."[9]

High or low rate is relative and irrelevant. To us as Muslims, and to all men of religion, it is illegitimate because it has been forbidden by God, the Sovereign and Law- Giver. It is against religion, against ethical values and against the interests 'bf humanity.

Having said so, the role of interest in economy and history also deserves to be examined on the economic and social criteria. On deeper reflection we are forced to conclude that interest has been one of the greatest menaces to humanity and economy. The glamour and glitter of the riba-based system is deceptive, not real. When we reflect on the economic theory and practice, particularly during the 19th and 20th centuries, we find some very disturbing trends. Some of the more important ones that deserve to be noted are as follows:

1. A systematic effort was made to drive a wedge between Economics and Ethics. Economics, which had always been a part of the overall ethical system of a society and civilization, was turned into an autonomous, self-contained disciple. In a craze for making it a 'positive science', it was delinked from values and socio-ethical norms on which the human society and civilization are based. It was ignored that even Adam Smith's An Inquiry into the Wealth of Nations (1776) was preceded by and

rooted in .the values he emphasized as cardinal to human situation in his Theory of Moral Sentiments (1759).

"Self-interest" of An Inquiry was to go hand-in-hand with the concept of "prudence" spelled out in the Theory of Moral Sentiments. The ethical and moral roots of economics were severed. Its normative character sacrificed at the altar of so-called positivism. Consequently over the years economics became neutral towards values amoral and consequently a dismal science not concerned with the ethical, social, humanitarian and environmental consequences of its concepts and policies. It was in this climate that God Mamon replaced God the Creator and Source of Guidance.

2. All religious and moral systems were man-centered in the sense that their ultimate objective was human well-being and establishment of justice among human beings in all walks of life, legal, political, social and economic. During these centuries of capitalist development the concepts of justice and equity were relegated to the oblivion. Initially economic effort and all wealth-generating activities were geared toward human well-being and equity. In fact 'wealth' and 'well-being' were almost synonymous But in the modern phase 'wealth' and 'well-being' no longer meant the same thing. Gradually the concept of desirable and undesirable, even of productive and non-productive effort began to become irrelevant. 'Needs' were replaced by 'wants' tied to the purchasing power and the length of the purse. Efficiency became the new catch word. People-centeredness was replaced by wealth-centeredness. 'Growth' became the rallying cry. 'Consumption must grow', 'production must grow', 'money must grow' became the new targets, irrespective of their consequences for ecology, conservation, distributive justice, grass-root well-being, and needs of society and posterity. Delinking of economics, investments and markets from justice and well-being lies at the root of the crisis of contemporary economies, local, national and global.

3. Monetization of the economy and the new role of interest and interest-based financial and banking institutions led to the establishment of a debt-based economy at national and global levels. A debt-based economy is bound to primary and predominantly serves the interests of only certain sections of the society, particularly the rentier classes. This system, over the years, leads to transfer of money, wealth and resources, from the many towards the few, from the poorer people, regions and countries, towards the richer people, regions and countries. It is the weak and the under-privileged who suffer; it is the powerful and the rich that prosper.

4. Finally a delinking takes place between the physical economy, the process of real asset-creation and value-addition in terms of more production of useful grounds and services on the one hand, and the monetary and financial expansion in the economy. Money no longer acts simply as a medium and a measure; it becomes a commodity and an object in its own right. The historical role of money as an intermediary for exchange (commodity-money-commodity-C-M-C) gets transformed into money-commodity- money (M-C-M) as Marx rightly identified. But that is not the end. In the contemporary phase of capitalist development the relationship between monetary and physical aggregate has totally changed. Now with the advent of future options, claims, derivatives and swaps, we have entered a world where even M-C-M is being rendered into M-M-M. According to the World Economic Outlook (IMF, Oct. 1996, p. 167) between 1986 and the end of '1994 the total notional principal of outstanding exchange traded derivatives contracts, including interest rate futures and options, grew at an average rate of 40 percent from $ 0.6 trillion to $ 8.9 trillion. In the same period, annual turnover rose from $ 315 million contracts to $ 1,142 million contracts. The balloon of the financial economy is expanding at an alarming pace, via speculation, while the real economy is only crawling at an uneasy pace. According to a recent study in foreign exchange markets financial derivatives are being exchanged at a rate of $ 1.2 trillion per day. This is almost 50 times more than the daily physical international trade in goods and services. Similar is the situation in domestic economies of developed countries. Emphasis has shifted from asset- creation to making money by speculation in respect of claims over claims on assets. It is a make-believe world of financial players who are creaming off billions without contributing to real value-added in society and its spill-over's for human well-being.

Let me substantiate this situation by bringing a few quotations from some of the perceptive writers of our times:

John Gray, in his recent work False Dawn: The Delusions of Capitalism says:

"Most significantly, perhaps transactions in foreign exchange markets have now reached the astonishing sum of around $ 1.2 trillion a day - over fifty times the level of world trade. Around 95 percent of these transactions are speculative in nature, many using complex new derivative financial instruments based on futures and options. According to Michael Albert, 'the daily volume of transactions on the foreign exchange markets of the world holds some $ 900 billion - equal to France's annual GDP and some $ 200 million more than the total foreign currency reserves of the world's central banks'.

This virtual financial economy has a terrible potential for disrupting the underlying real economy as seen in the collapse in 1995 of Barings, Britain's oldest bank. Together with the accelerating development of global capital markets on which it stands, the virtual economy is a phenomenon unknown in the world's economic history.[10]"

Joe Roglay, a regular columnist of The Financial Time, London laments; [11]

"Liberal economists, promote marketisation of everything in sight adding to the sense of isolation that lurks within so many of us. Wealth creation is an amoral pursuit. It is what is done with wealth that matters. The population of billionaires is growing NOT all of them are generous to the poverty stricken.

"Only a belief in the spiritual self can soften the effects of this counter-human revolution. Alas, the defenders of the spirit are divided, sulking in their tents all over the place. Lacking cohesion, their strength once irresistible is draining away."

James Robertson, in a very perceptive study, Future Wealth: A New Economics for the 21st Century writes:

"Unlike both the capitalist and socialist versions of conventional economics, then, the 21st century economy must be based on recognition that people are moral beings whose freedom as such should not be narrowly bound by impersonal parameters laid down by market and state. • The 21st century economy must accept, as an aspect of self-reliance, that people need space in which to exercise moral responsibility and choice in their economic lives. Measures designed to allow this free space to people as individuals, and also to groupings of people in local economies and national economies (especially in Third World), must be part of the new economic order…………

"The new economics must thus transcend the materialist assumptions of a conventional economics: that economic life is reducible to production and consumption; that wealth is a kind of product that has to be created before it can be consumed; and that wealth production and wealth consumption are successive stages in a linear process which converts resources into waste. It must reinterpret the manipulative concern of conventional economics with the production and distribution of wealth and the allocation of resources, into a developmental concern with how to enable people to meet their needs, develop themselves, and enhance the resources and qualities of the natural world. It must recognize that because human beings are moral beings the basic questions about economic life are moral questions…………[12]

James Robertson's observations on the role of interest and need for an interest-free economy also deserve to be noted:

"The pervasive role of interest in the economic system results in the systematic transfer of money from those who have less to those who have more. Again, this transfer of resources from poor to rich has been made shockingly clear by the Third World debt crisis. But it applies universally. It is partly because those who have more money to lend, get more in interest than those who have less; it is partly because those who have less, often have to borrow more; and it is partly because the cost of interest repayments now forms a substantial element in the cost of all goods and services, and the necessary goods and services looms much larger in the finances of the poor than of the rich.

"When we look at the money system that way and when we begin to think about how it should be redesigned to carry out its functions fairly and efficiently as part of an enabling and conserving- economy, the arguments for an interest-free, inflation-free money system for the twenty-first century seem to be very strong."[13]

In a recent book, One World Ready or Not: The Many Faces of Global Capitalism, by William Greider observes that the rich nations of the world are acting like ancient usurers, lending money to the desperate poor on terms that cannot possibly be met and thus acquiring more and more control over the lives" and assets of the poor. This is done mainly by commercial banks and private capital, but amplified and policed by the public lending institutions. The real profit on owning US bonds was 8.2% in the 1990s compared to 6.7% in the 1980s and 8.8% during the 1920s after which there was the great crash (1929). This exorbitant return to rentier classes is to be seen in the context of the fact that across the twentieth century the average real return on holdings of long term bonds has been only 1.6%.''[14] In other words creditors are at present receiving returns on their wealth 5 times the average level real economies are functioning.

Because of the interest-debt system, societies are being drowned in debts. In 1901 the total domestic debt of USA was only $ 1 billion; today it is over $ 4 trillion, with some $ 1.3 trillion in external debt. This is four thousand times increase over the century. So the richest country of the world is also the most indebted country, both domestically and internationally. According to recent studies in the U.S., every household's debt has reached an astonishing 91% of its disposable income compared with 65% in 1980. Debts contracted via plastic cards invite 18-30% rates of interest, punishing terms on all standards. Yet interest remains an innocent helper in the economy. The fact, however, is that a debt based economy is the most exploitative of them all — ultimately the system works against the common man, against the poor, and against the small entrepreneur, who go to make up the back-bone of the economy. It is only the rentier class that gains. The Economist (London, May 30, 1998) comments editorially that in America there were only 13 billionaires in 1952, but in 1996/7 they have increased to 170. This is accompanied by the impoverishment of the poor and generation of ever-increasing inequalities in society.

The contemporary capitalist economies that have been reared on the foundations of interest and debt are very deceptive. Their apparent affluence conceals the miseries and deprivations they have generated. They are exploitative as well as unstable. The system is unjust and violative of all human values. Let me conclude this part by one more quote from James Robertson's latest work Transforming Economic Life: A Millennial Challenge:

"Today's money and finance system is unfair, ecologically destructive and economically inefficient. The money-must-grow imperative drives production (and thus consumption) to higher than necessary levels. It skews economic effort towards money out of money, and against providing real services and goods.

"The transfer of revenue from poor people to rich people, from poor places to rich places, and from poor countries to rich countries by the money and finance system is systematic..............One cause of the transfer of wealth from poor to rich is the way interest payments and receipts work through the economy. Dividing people into ten sections of equal size, a German study (Kennedy M. Interest and Inflation Free Money: Creating an Exchange Medium that Works for Everybody and Protects the Earths, New Society, Philadelphia, 1995) suggested that the effect of interest is that the richest section receive far more than it pays, the second richest receives a little more, and other eight receive less. The result is a substantial transfer of money from the poorest majority to the rich minority.

"The transfer of money from poorer to richer localities takes place through the automatic working of the national and international banking and financial networks. Third World debt in the 1980s and 1990s illustrate some of the causes and effects of systematic transfer of wealth from poorer to richer countries. International interest rates rose and so did the cost of imported know-how and technologies, while international commodity prices fell. Through no fault of their own, indebted Third World countries found themselves with escalating debts, resulting from higher interest rates and composite prices to be paid and reduced foreign exchange. (Out of $ 1,200 billion owed by the Third World to the First World in 1990, only $ 400 billion constituted original borrowing. The rest consisted of accrued interest and capital liabilities). The response of the International Monetary Fund and the World Bank was to prescribe development that placed even greater emphasis on the export of commodities at low world prices....

"The money-must grow imperative is ecologically destructive..... (It) also results in a massive world-wide diversion of effort away from providing useful goods and services, into making money out of money. At least 95% of the billions of dollars transferred daily around the world are for purely financial transactions, unlinked to transactions in the real economy.

"People are increasingly experiencing the workings of the money, banking and finance system as unreal, incomprehensible, unaccountable, irresponsible, exploitative and out of control. Why should they lose their houses and their jobs as a result of financial decisions taken in distant parts of the world? Why should the national and international money and finance system involve the systematic transfer of wealth from poor people to rich people, and from poor countries to rich countries? Why should someone in Singapore be able to gamble on the Tokyo stock exchange and bring about the collapse of a bank in London? Why, when taking out pension, should people have to rely on advice corrupted by the self-interest of the advisers? Why do young people trading in derivatives in the City of London get annual bonuses larger than the whole annual budgets of primary schools? Do we have to have a money arid financial system that works like this? Even the financier George Soros has said ("Capital Crimes", Atlantic Monthly, January, 1997) that "the untrammeled intensification of laisser-faire capitalism and the extension of market values into all areas of life is endangering our open and democratic society. The main enemy of the open society, I believe, is no longer the Communist but the Capitalist threat."[15]

The same author raises some other very pertinent questions in the context of the havoc wreaked by the interest-debt system and the possibilities that the next century may offer to restructure the financial and banking system of the world on alternate foundations - something Islamic banking is aiming to do and offering as an alternative, not only to the Muslim Ummah, but to the entire humanity. After re-affirming that "the effects of interest include transferring money from poor to rich, accelerating resource, extraction and environmental damage, and diverting effort to making money out of money" Robertson raises the succinct questions:

"Why the process of issuing new money into the economy (i.e. credit creation) been delegated by governments to the banks, allowing them to profit from issuing, it in the form of interest-bearing loans to their customers? Should governments not issue it directly themselves, as a component of a citizen's income?

"Would it be desirable and possible to limit the role of interest more drastically than that, for example by converting debt into equity throughout the economy? This would be in line with Islamic teaching, and with earlier Christian teaching, that usury is sin. Although the practical complications would make this a goal for the longer term, there are strong arguments for exploring it - the extent to which economic life world-wide now depend on ever-rising debt, the danger of economic collapse this entails, and the economic power now enjoyed by those who make money out of money rather than out of risk-bearing participation in useful enterprises.

"May there be a role for negative interest rates? These were proposed early this century by Silvio Gessel (from whom Keynes said the future would learn more, than from Marx). The Austrian local currency experiments of 1930s required each currency note to be revalidated every month by attaching a special Stamp costing 2%ofitsvdue. This stimulated the local economy by encouraging people to spend, not hoard, the local currency. Could other liquid financial assets, like current bank balances, be subject to negative interest rates? And would that be a good idea...

"The shift to a people-centered, ecologically sustainable economic system will require corresponding shift in the services offered by conventional financial institutions and the further developments of new financial institutions. The latter include ethical, green and social banks, micro-credit banks, credit unions and other grass-roots people's banks which provide credit for people and localities, unable to get it from conventional financial institutions."[16]

The Challenge of the 21st Century

In the light of above submissions let us clearly try to identify the real challenge humanity is facing at the close of the 20th and the advent of the 21st century. The challenge comes from the lop-sided financial and economic system into which humanity finds itself entrapped. The divorce between ethics and economics, between religion and society, between well-being and wealth is at the rot of this crisis. Another major challenge comes from the unguarded and extended role of money, from a means and a measure, to a commodity and a mysterious tool to beget more money without adding real value to the economy and without increasing the flow of useful goods and services. The disastrous consequences of this process towards driving whole societies and humanity at large into the hands of rentier classes, rendering vast majorities into a suffering mass. The result is increase in inequalities of income and wealth, huge transfer of resources from the many and the poor to the few and the rich, people and regions. This is the predicament of mankind, posing the greatest threat to the future. The interest-debt regime, with banks powers to create credit and the financial system's fiduciary expansion via futures and derivatives have increased manifold the exploitative character of the system as also made it extremely unstable and vulnerable.

Because of the role of interest, coupled with two distinct roles of banking and financial institutions, i.e. credit creation and derivatives, the world economy has reached a point where reform and restructuring have become unavoidable if total disaster is to be avoided. It is now being a question of survival for all. With over $ 65 trillion worth of derivatives circulating in a world whereas the combined GDP of all the l88 countries of the world is around $ 30 trillion only, where are we heading? And who are the major players in this world of financial speculation - almost 80% of this trade is in the hands of some two dozen big hanks and hedge houses! The threat is not only to economy, but to the very human society and civilization. The world economy is turning into a bubble and in this bubble; we are blowing more and more air only to keep it afloat. But how long can such bubble economies last? Ten years back Japanese economy was thriving and beginning to challenge the strongest economy of the world - the USA. Five years back the Japanese economy began to be described as a bubble economy. Now the bubble has burst and we are seeing the consequences. What has happened to East Asian tigers? Even U.S. economy has its stakes. Last six months The Economist has twice expressed apprehension about the American economy is in danger of becoming a bubble economy. It is worthwhile that we open our eyes before a real crash takes place.[16A]

Our critique of interest and interest based banking is rooted in religious and moral premises, but it is also based on sound economic grounds. It is based on the demands of justice and the vision of an economy and society that caters for the well-being of all human beings and does not serve the interests of a few sharks only who live: by preying on others. It is this vision of tomorrow that prompts us to move towards a new paradigm in economics and finance. It should be the concern of all human beings, in all parts of the world.

Because of globalization, I am sure, no country is safe. While the 20th century will also be remembered for its great achievements in the fields of technology, science and informatics, which I don't deny, but the other side of the picture is also important. The forces of globalization riding on the back of an exploitable system are becoming a threat to human society and values. The way out lies in a new approach may I submit that the 21st century-needs to address itself, from the economic viewpoint to at least five basic issues:

1. Need to bring about spiritual and moral re-awakening. Key lies in re-discovering the relationship between ethics and economics. This is the core issue. Ethics must not be confined to private conduct. It must be the pace-setter for individual

character as well as group behavior and socio-economic policies, at the local, national and global levels.

2. Move towards the establishment of a new world order, which is non-hegemonistic. What a shame that we talk of democracy and human rights, but the whole world system is based on hegemony of the powerful. Human rights and democracy are on lips. But what is the reality? Even one of the five veto-holding countries, can nullify a united resolution of the entire world. Look into any international organization, the UN, the IMF and the World Bank, the WTO - everywhere we find hegemonistic trends shattering the dreams of democracy, power-sharing, participatory development, and co-operative relationships. Authentic Pluralism is the answer. Co-existence and not a clash of civilization is the need of the hour. Political, cultural and religious pluralism alone can lead us towards a world enjoying peace, affluence and justice.

3. Re-discovering the' importance of physical and human capital formation and production of real goods and services. Physical and human dimensions of development deserve to be re-emphasized. The role of money has to be redefined and creation of physical aggregates — products and services that are useful for mankind be made the objective of all developmental effort. Untrammeled financial expansion has. Distorted the balance between monetary and real economic aggregates. The balance has to be restored by cutting financial economy to its real size; control credit creation and re-emphasize the development of local economies, public utilities, basic and consumption industries and effective distributive mechanism.

4. The need for equitable distribution of wealth and income at all the three levels that is: globally between countries, within each country and region, and at the level of individuals and households in every society, constitute the other basic challenge.

5. Market economy with social responsibility, moral commitment and positive role of the state to ensure fulfillment of social ideals and respect for the rules of the game. Laissez-faire and Command economies both have failed. To swing from one to the other is not the answer. It is the golden mean between market economy and social responsibility that can set the house of economy in order. Both go hand in hand to ensure freedom, prosperity and justice for all. As such a three sector economy - private voluntary - altruistic and public sector with complete harmony amongst them may provide the organizational model for the 21st century.

Islamic Banks and the Future

Now if we reflect on these challenges, we find that Islamic banks and Islamic economics are destined to play a very important role in the making of the future. This calls for a move from a debt-based economy — an unjust, exploitative and inequitable economy — towards a risk-sharing, stake-holding, participatory, community-oriented and people-friendly economy. Therein lies the key role that Islamic economics. Islamic financial institutions and the Muslim states can play in order to make the next century closer to our vision of a just and balanced society. That would also mean that the centrality of the productive criteria w6uld have to be rediscovered. The financier should become a real investor, prepared to play a participatory role as investor along with the entrepreneur. In the western banking system, because of the collateral, the banker moves in only when he smells of prospects of bankruptcy. In an Islamic system, as the bank is also an investor it remains an active participant throughout. As such the bank would be concerned with and respond to early warning signals if things start going wrong. As mistakes can be set right before the rot goes too far. The system would be more stable and transparent. In such a system there would be an automatic adjustment of real assets and their financial counterparts. In the conventional banking system there is no such mechanism for adjustment. It is, therefore, hoped that banking that operates on Islamic principles will ensure growth with financial stability, equity and distributive justice. It could be sustainable both horizontally, that is at a particular time and vertically deep into the future. The ecological dimensions and the needs of the future generations would be equally taken care of.

The Task Ahead

The challenge is grave and multi-dimensional. The dangers and threats are too serious and alarming to be ignored. But the task is also gigantic. Islamic banking has offered a new approach. But the experience and contributions made so far are far short of what is required. As such it is important that a realistic assessment of what is to be done must be made. Man lives by hope. But man cannot live merely by hope! Effort, planning, training, management and creativity are all required to face the challenges ahead. What should Islamic banking do to initiate a global process deserve to be explored? Some tentative ideas are expressed below:

To recap the Islamic approach is rooted in a different vision of the economy: one that is equity-based as against a credit-based one. Not that there would not be a possibility for loan transactions - Qard Hasan exists at a certain level to meet genuine individual or business needs. But the structure of the economy would be on a very different foundation — capital and entrepreneurship would be co-participants, sharing the risks as well as the rewards of the enterprise.

Islam encourages trade and commerce. Profit is not only permissible; it is encouraged as a positive value. Instead of fixed rate of return geared to an assumed rate of profit^ Islam provides for a variable rate of return based on actual profits. This is the basis on which Islam wants capital and entrepreneurship to co-operate and co-participate in the production process. Islamic societies were able to develop a number of financial instruments and institutions during the first millennium of Islamic history although the economic system is much more complex today. Islamic banking movement is an effort to develop an alternate system in the context of the contemporary economy.

However, it deserves to be noted that the abolition of interest is only one aspect of Islamic economics. Islam aims at establishing a just economic order, based on clearly spelled out economic rights and concepts of property, contracts, work and distribution of income and wealth. It stipulates a framework of values and disvalues, desirables and undesirables and hedges the market mechanism with a moral filter so as to ensure efficiency and equity in the processes of allocation of resources;

The role of state has also been clearly defined. Islamic state is neither a neutral police state of Laissez-faire type nor a totalitarian state of the socialist order. There is a limited scope for intervention in order to achieve specific objectives. Islam also emphasizes the need for stabilization of prices and protection of the value of money. In such an economy, banks are not mere financial intermediaries but also play an active role in developing and maintaining a certain pattern of economy, serving certain socio-moral objectives as well. Of course, banks are not expected to act as charities, philanthropic organizations or mere "welfare institutions", but the welfare, equity and stability dimensions are as relevant to the banking ethos in an Islamic scheme as are considerations of security efficiency, optimality and profitability. Definitely there would be trade-offs. As such the objective is to achieve a balance between efficiency and equity, between profitability and welfare, and between expansion and stability; Traditional banking is also trying to discover the moral dimension in a limited sense! The whole movement towards ethical banking is an instance in point[17] but that is something on the periphery - and not even the whole periphery. Ethics and social objectives are central to Islamic banking - and that is why Islamic banking is not mere interest-free banking. It is much more than that. It represents a new and vastly different vision of the whole economy.

The basic idea of Islamic banking is to devise an efficient and equitable system of profit-sharing (PLS). The efficiency property derives from its insistence on the linkage between the financial and the real sectors of the economy. While the equity property is based on maximizing the rate of return on deposits, depending on the length of the period for which they are held.

But to make Islamic banking efficient and equitable its profitability - that is, the difference between the rate of return on advances and the rate of return on the deposits (which is also referred to in the literature, as the 'spread') - should be maximized. Yet another requirement is that the risk element inherent in the bank's operation is minimized, and scrupulously managed.

The connection between the efficiency and the profitability properties is provided by the fact that, as established by many empirical studies, the level of economic activity is the most significant determinant of the growth of deposits and advances, and of the 'spread'. In other words, to maximize the profitability of the banking system, economic policy must aim at enhancing the growth rate of output and creation of effective demand. Whence follows that the Islamic banking by strengthening the link between the financial and real sectors of the economy also raises the potential level of social profitability as against that of traditional banks.

The link between the superior equity and efficiency of Islamic banking derives from the requirement that the profits (and the losses) made by such banks are shared in accord with moral (and binding) principles of justice and beneficence (adl WA ihsarij). Thus, given the normal operating expenses incurred by Islamic banks and the rate of return on their advances, the potential rate of return on deposits would b^ generally higher than that offered by the traditional banks.

The linkage between the riskiness, the efficiency, the equity, and the profitability of Islamic banking rests on its ability to devise an investment portfolio which, on the one hand, satisfies the preferences of the risk-averse investors and those of the risk takers (i.e. those who take no risk and those who can afford a lot of risk); while, on the other hand, it should reflect the state of economic activity in the society.

Apart from any considerations for efficiency, equity and profitability, there is the case for the PLS instruments because they seem to reflect mo^ faithfully the principles of Shari 'ah. Such instruments also set Islamic banking (based on equity-finance) apart from traditional banking (based on debt finance). In other words, the PLS instruments make the Islamic nature of banking most visible. The revolutionary potential this type of banking bears for the future is beginning to be realized by an increasing number of Western economists and bankers.

A study by the Development Centre of the OECD oh Arab and Islamic Batiks touch upon this aspect. The author, Ms. Traute Wohler-Scharf, says:

"If the South proposes now, with Islamic banking principles, a new 'concept of socio-economic interaction (profit-sharing systems, focus on small and medium-sized innovative entrepreneurs, with the major objective of economic asset creation, etc.), it would be a contribution to co-operation concepts so far mainly propounded by the countries of the industrialized world.

Islamic banking is trying to change the relationship between finance on one hand and industry and commerce on the other this new relationship is the basis of the Islamic economic system being set up. Though Islamic principles have yet to be put to the test in the competitive environment of international finance, the two systems are similar in that they both strive for closer ties between financial intermediation and economic asset creation.

Islamic banks could make a useful contribution to economic growth and development, particularly in a situation of recession, stagflation and low growth levels, because the core of their operations is oriented towards productive investments. All countries, both in the North and in the South, heed more venture capital. Loan capital is available, particularly in industrialized economies, but at the high interest rates. However, even medium- scale entrepreneurs there find it difficult to raise, sufficient risk capital for expansion and innovation. This has acted; as a brake on productivity and economic growth in the North:

Thus, practical and intermediate co-operation possibilities exist between Islamic banks and enterprises all over the world. The intermediate process remains to be folly developed".[18]

Professor John R. Presley and J.G. Sessions of Loughborough University (UK) have in the May 1994 issue of the journal of the Royal Economic Society of Britain, The Economic Journal, tried to examine this central contribution of Islamic principles of finance. The authors, after regretfully noting that the:

"Western economists have been somewhat remiss in the last decade in failing to recognize what has the appearance of a new paradigm in economics - that of Islamic economics."

They conclude:

> "A riba contract creates an explicit mapping between the compensation and the input of capital...The prevalent method of Mudarabah-financing tries compensation on the outcome of the project. Mudarabah therefore allows the contract to control the managers' incentive to exert effort directly, since this effort affects the relationship between capital investment and the! Outcome of the project Under a Mudarabah contract the manager is let free to choose the individually optimal level of investment in each state contingent on his contractually specified level of effort. Such-a contract permits a mean-variance improvement in capital investment - average investment is increased whilst inefficiently large fluctuation around this level is reduced...We have shown that the use of the prevalent alternative method of financier remuneration (i.e. Mudarabah) will, under certain conditions, lead to an enhanced level of capital investment on account of the ability of Mudarabah to act as an efficient revelation device"[19]

Islamic banking, if properly developed on the fundamental principles expounded by Islam, is destined to play a crucial role in reconstructing the economy in the 21st century on very sound foundations. But let me say in all honesty that promising beginning is only in its larval stage. The comprehensiveness is yet to be fully translated into reality. The movement has a long way to go to become truly representative of the original concept. The efforts that are being made with seriousness and dexterity to eliminate riba from financial dealings, however welcome, have a long mileage to achieve. It is a fact that those experiments are being made in a climate - both domestic and external - which is anything but congenial. The moral fibre of the society is weak. The legal framework is antagonistic. The tax system is partial towards the interest system and almost inimical to a profit-sharing system. The state of competition between the Islamic and traditional banking systems is such that most of the odds are against the Islamic system. In this context whatever progress has been made is path-breaking. Yet it deserves to be acknowledged that these efforts represent only first steps in the direction of Islamic banking. Present day interest free banks have relied rather too heavily on those permissible instruments of financing which are closest to the traditional system like. Murabah (mark-up) and Ijara (leasing) - Almost 80 to 90 percent lending has been done through these instruments. The real alternate instruments of Mudarabah (trustee-financing) and Musharika (profit-sharing) have been resorted to only to a very limited extent. Other ethico-social objectives have also not received the importance they deserve. Greater success has been achieved in the field of deposit- mobilization; particularly many untapped sources have been drawn upon. But the socially beneficial and development and welfare oriented utilization of these resources has left much to be desired. Employment generation and flow of resources towards the lower and middle classes of the society, particularly in the rural sector, where great potential as well as the greatest needs exist, has not taken place. So is the question of efficient utilization of funds. That is why it would be unfair to judge the success or otherwise of the Islamic banking scheme mainly on the basis of the limited and partial experiment that is presently being made. The experiment is not even halfway through. The mileage yet to" be covered is crucial. The distinctive character of the system is yet to unfold and take shape. Then and then alone the scope and extent of the experiment could be fully and realistically appreciated.

However, looking at the actual experience, at least in some countries, the rate of return offered by the Islamic banks has been generally lower than that offered by the traditional hanks before the Islamic banking was introduced.

The investment portfolio held by the Islamic banks has generally favored trade- related over production-related activities, short-term profitability over long-term profitability, and private profitability over social profitability. The heavy concentration in few assets of short-term duration has typically lowered the stability of the Islamic bank's portfolios and has increased the degree of their risk.

In practice, there has been an overwhelming preference by the users of loan able funds for the mark-up instruments over the PLS instruments, which have been overshadowed in the bank's portfolios. The real rate of return (adjusted for the inflation rate) has been generally lower, if not negative, while that on the bank loan it is strictly positive.

In view of these challenges from within and the major difficulties and bottlenecks from without, the Islamic banks have to make a Herculean effort towards implementing Islamic financial norms in such a manner that efficiency, profitability and equity are achieved simultaneously.

It is also submitted that the system of auditing of bank accounts must be upgraded to determine their legitimate operating expenses and the monitoring of the cases of bank default or other deviations from the norm. This should be an integral part of Islamic banking review (indeed, of any responsible banking). In other words, the information basis of Islamic banks must be widened and made readily available with the help of modern computer-based technologies - which allow the storage, the processing and the dissemination of relevant information in a very short time and at least cost. This is basic, because the information cost typically rises when Islamic banking is introduced. For instance, the depositors will have to evaluate the relative performance of competing banks to reach a decision about where to invest their funds. On the other hand, the bank will have to seek greater and timely information about the use of the funds it, makes available to the entrepreneurs.

The cases of loan default must be dealt with severely in Islamic banks as they amount to khiyanat (deception and fraud), which is a great sin in Islam. In general, any misappropriation of bank funds should be declared a social crime.

To satisfy the equity requirement, the difference between the rate of return on bank deposits and that on bank advances should be as small as possible - making due allowance for the bank's operating expenses, as determined by authorized auditors.

The Islamic banks should evolve innovative portfolios to suit the risk preferences of different classes of savers. It would be morally indefensible to make all classes of savers to bear the same degree of risk - irrespective of their capacity to take risk (which depends on the size of their respective incomes, savings, etc.). The Islamic banks should also show enterprising spirit by funding projects of a longer-term nature and where the social profitability of investment is higher than their private profitability - which typically covers all areas where external economies are large (health, education, infra-structure investment, etc.)

To lower the incidence of risk and uncertainty, a system of deposit insurance may have to be instituted. On the side of bank advances, the legal structure governing private property rights should be clarified and strengthened. The evolution of effective supervisory mechanisms at different levels, horizontal and vertical, also poses a critical challenge that must be met unequivocally.

While the present writer firmly believes that the Islamic banking can come of age only in an economy and society that is committed to total Islamization and where real transformation is produced as a result of a comprehensive movement, consisting of. Islamically oriented behavior of the individual and socio-economic reforms based on Islamic values, he belongs to that group of economists who regard the contemporary Islamic-banking movement, despite all its weaknesses, as a positive development which bears great promise for the future.

It should also be mentioned that despite fundamental differences with the traditional banking there is a vast area of co-operation between the two streams. After all venture capital has played a very important role in the development of the world economy.

Investment banking has been an integral part of banking more prominently in the German and French traditions of banking.

Unit trusts and investment houses are operating as major financial institutions in the world today. EFC as against IMF and World Bank has gone into equity financing as part of international developmental effort. I do not think Western bankers would be averse to the idea of developing new modes of co-operation with the Islamic banks and financial institutions if they are presented with economically viable projects. If Bosphores Bridge - a billion dollar project - could be financed through venture capital/why not hundreds of other projects? Once this new commonality of interest, based not on traditional 'interest' but some form of equity-sharing - is built, I am sure new avenues of co-operation can be explored. Huge untapped resources exist in the Muslim world and one of the reasons why they remain untapped is Muslims' reluctance to go for interest-based financial instruments and institutions. Recent surveys have shown that even , in Saudi Arabia, between 40-60 percent of the households that have a relatively high per capita income do not have a bank account. A large number of those who keep deposits have refused to take interest.[20]

The situation is not different in other Muslim countries and even with the Muslim communities in many Western countries. This potential is yet to be tapped fully. Moreover, Islamic banking principles and instruments are not relevant to the Muslims only. They have universal applicability. Some recent trends in world capital movements show clear shift towards equity investment and venture capital. Net private capital flows (direct investment, net portfolio investment and other longer and short-term net investment flows to developing countries were $10.1 billion on average during 1973-77, which increased to $27.4 billion during 1978-82, and to $117.8 billion during 1989-95. The actual figure for 1998 is $ 155 billion. As against this, net official flows, mainly debts, were $11.1 billion during 1973-77, $23.4 billion during 1978-82, declined to $16.4 billion, average during 1989-95.[21] if these trends provide some clue to the future; they suggest greater scope for equity-investment in the coming decades.

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2. See Sheikh Irshad Ahmad, interest Free banking Karachi, Orient Press of Pakistan 1951.
3. “Evolution of Islamic Banking" in Khurshid Ahmad (ed.) Elimination of Riba from the economy, Institute of Policy Studies, Islamabad, 1995, pp.350-54.
4. Ausaf Ahmad, Development and Problems of Islamic Banks, Jeddah, IRTI, IDB, 1987, Table 1, p.9.
5. Rodney Wilson, Islamic Finance, Finance House, Financial Publishing, London, 1997.
6. For details see: Ausaf Ali op.cit: Rodey Wilson, Islamic Finance, op.cit.
7. Al-Qur'an: 6: 152; 7:85; 11:84-85; 17:35; 26 : 18.
8. Al-Qur'an: 2: 279. It is worth noting that the Qur'an condemns and prohibits riba (interest/usury) in most powerful terms and makes it very clear that one is entitled to the principal amount only, and nothing more.

"Those who gorge themselves on riba behave but as he might behave whom Satan (Devil) has confounded with his touch; for they say "Buying and selling is but a kind of riba - while God has made buying and selling lawful and riba unlawful. Hence, whoever becomes aware of his Sustainer's admonition thereupon desists (from riba), may keep his past gains, and it will be for God to judge him: but as for those who return to it - they are destined for the fire, therein to abide. God deprives usurious gains of all blessings, whereas He blesses charitable deeds with manifold increase. And God does not love anyone who is stubbornly ingrate and persists in sinful ways.... O' you who have attained to faith! Remain conscious of God, and give up all outstanding gains from usury if you are believers; for if you do not then know that you are at war with God and His Apostle. But if you repent, then you shall be entitled to the return of your principal (amount only); you will do no wrong and neither will you be wronged. If, however, (the debtor) is in difficult circumstances, (grant him) a delay until a time of ease: and it would be for your own good - if you but knew it - to remit (the debt entirely) by way of charity". (The Qur'an: 2: 275-281).

9. Sidney Homer, A history of interest rates, Rutgers University Press, New Brunswick, 2nd ed.,1977,p.6.
10. John Gray, False Dawn: The Delusions of Capitalism, Grunte Books, London, 1998, p.62.
11. Time for Religions to Merge or Bust", The Financial Times, London, Dec. 20-21.1997.
12. James Robertson, Future Wealth: A New Economics *for the 21st Century,* Cassel Publications. London. 1990, pp.21-28.
13. ibid, pp. 130-131.
14. William Greider, One World, Ready or Not, Simon and Schuster, New York, 1997.
15. James Robertson, Transforming Economic Life: A Millennial Challenge, Green Books, Devon, 1998, pp.51-54; George Soros has also developed his theme in his latest book The Crisis of Global Capitalism, Little, Brown & Co., London, 1998. He has come out with a frontal attack on 'Market Fundamentalism' and pleaded for the control and management of global financial flows.
16. James Robertson, ibid, pp. 57-58.

16A. See a recent study of Peter Warburton, Debt & Delusion, Allen Lane, The Penguin Press. London, 1999 The author comes to the eye-opening conclusion that "The promise of economic freedom held out by the dismantling of state ownership and control has been subverted by a personal and collective enslavement to debt. The parallel accumulation of financial wealth since the early 1980s has obscured this painful reality, but history warns that this situation is unsustainable. When stripped of their capital gains in equities and bonds, today's rising generations will appear overburdened by interest payments and debt repayments schedules. Far from commencing a golden era of economic liberty and individual choice, millions are teetering on the edge of debt default and misery". He further says, "Apart from financial mismanagement, the only other essential ingredient of the west's predicament is the personal arid collective addiction to debt. Indeed, the most significant aspect of financial mismanagement is the failure to confront debt addiction and warn of its consequences." He ends his Preface on a personal note worth reflecting upon: "When the opportunity arose to become free of debt in 1995, 1 took it and have not regretted it for one moment. I urge the readers of this book to take or make the opportunity to do likewise"(p. xi-xiii)

17. See James J. Lynch Ethical Banking: Surviving in an Age of Default, Macmillan, London, 1991.
18. Traute Wohlers-Scharf, Arab and Islamic Banks, new business partners for developing countries; OECD, Paris, 1983, p.95.
19. J. R.Presley and J. G. Sessions, "Islamic Economics: The Emergence of a New Paradigm", The Economic journal, Vol.104, No.424, May 1994, p.595.
20. See R. Wilson, Banking and Finance in the Arab Middle East. Macmillan, London, 1983; N. A. Sherbiny, Oil and the Internationalization of Arab Banks, Oxford, Institute of Energy Studies, 1985.
21. International Capital Markets: Developments, Prospects and Key Policy Issues by Takatoshi Itu and David Folkerts-Landau., IMF, Washington, September 1996, pp.5-6. The figure for 1998 is from an article of Joseph Steglitz, Chief Economist and Senior Vice President of World Bank, originally published in International Herald Tribune ('Dawn' May 1, 1999)