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Seventh Harvard University Forum on Islamic Finance
**Integrating Islamic Finance in the Mainstream - Regulation,
 Standardization and Transparency**

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**An Islamic Money Supply as the Means to
 Integration**

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Abstract

The fundamental requirements of modern Islam include:- a concept of overall vision, understanding and distinctiveness — the unicity concept • free markets • private property • economic efficiency • social and economic justice • no inflation • no riba/interest • a direct connection between the money supply and the real economy • an ethical ethos

Unfortunately the present system of ‘free market’ finance capitalism is deficient to an extent in most, if not all, of the requirements even though many of them are extolled in ‘free market’ rhetoric.

There can be no true integration of Islamic Finance into the mainstream unless the requirements are properly accommodated. This can be done by developing a supply of Islamic endogenous (as defined) money i.e., central bank-issued interest-free loans directed at various forms of productive capacity and generally administered by the banking system on private property, wide ownership and market principles. The productive capacity would come into being at half the present cost and be counter-inflationary.

1. The requirements of modern Islam

The fundamental requirements of modern Islam include:-
a concept of overall vision, understanding and distinctiveness Ñü the unicity concept

- free markets
- private property and widespread ownership of productive capital
- economic efficiency
- social and economic justice
- no inflation
- no riba /interest
- a direct connection between the money supply and the real economy
- an ethical ethos

However, the present system of 'free market' finance capitalism is deficient in all of the requirements even though many of them are extolled in 'free market' rhetoric and propaganda.

2. The deficiencies of 'free market' finance capitalism in respect of the Islamic requirements

The foremost requirement for an Islamic economy is one of overall vision, understanding and distinctiveness — the **unicity concept** or *tawhid*. The leading Islamic writers say that *tawhid* embraces all aspects of life. They affirm the need for distinctiveness because, without distinctiveness, the *ummah* will never free itself from control by others. They fully understand that a paradigmatic change is involved with a need to develop a coherent foundation taking account of a wide range of studies rather than a narrow legalistic approach. They advocate modern study and knowledge. Moreover, the unicity concept is essential for positive change.

Yet neoclassical economics has no genuine sense of overall relatedness. It separates the economy from society and denies the need for morality in economics. At the same time, it hypocritically claims that all its outcomes are just and believes that, in a very fundamental way, it has no need to change because it is the perfection of the development of history.

Secondly, Islam requires **free markets** yet, although the labor markets

today are relatively free, the markets for productive capital are not free. They are unfree so that, throughout the world, productive capital is narrowly owned generally by around 5% of the population. As things stand, it will remain narrowly owned and 'free market' finance capitalism is better described as unfree market finance capitalism.

The third Islamic requirement — **for widespread ownership of productive capital** — is intimately connected with free markets but, because of the lack of freedom in present capital markets, private property in productive capital is not widely spread, which is a big mistake. Apart from the obvious political and societal virtues of wide capital ownership, there is the economic benefit coming from spreading what, increasingly, is the major contributor to wealth creation — productive capital. With wide ownership comes the spreading not only of productive power but also of the associated consuming power thus ensuring a proper balancing of supply and demand as required by Say's Theorem (Law).

The fourth Islamic requirement — **economic efficiency** — is connected to both free markets and private property. It is fundamental to market theory that who or what creates the wealth should get the resulting income. But this does not happen at present. Moreover, it is fundamental to market theory that there cannot be a genuine balancing of supply and demand unless productive capacity is spread so that those with reasonable consuming needs can fulfil them. This also does not happen at present. In summary, there cannot be genuine market efficiency unless there is the spreading of productive, and hence consuming, capacity which results from widespread capital ownership.

The fifth Islamic requirement — for **social and economic justice** — is connected to the requirements for free markets, private property, widespread ownership of productive capital with economic efficiency, and also to the requirement for an interest-free money supply. Such supply is essential if productive capacity, both public and private, is to be created at half the present cost.

Generally, conventional neoclassical economics believes that social and economic justice cannot be furthered without decreasing economic efficiency — i.e., conventional economics thinks efficiency and justice are incompatible. In thinking this, it is wrong. With a proper use of an interest-free money supply, social and economic justice on the one hand and efficiency on the other are compatible. Indeed, they are related so that the one reinforces the other. In the true Islamic economy justice creates the efficiency and the efficiency creates the justice.

Islam is opposed to **inflation**. It desires a stable level of prices and even counter-inflation — an increase both in wealth and money's purchasing power. Yet, today, all economies have inflation. Over decades, the amount of money in an economy always increases. This is primarily due to the banking system which creates money out of nothing and then adds interest. In many countries well over 90% of the money supply is created in this way. The overall increase in the amount of money is due to the money

for the principal being created (and, when repaid, cancelled) but not created for the interest. Therefore, if there is to be enough money in the economy, there is a continual need for more and more money to be created. But since this money is also interest-bearing, the need for more money creation increases even further..... The inevitable result is not only inflation but also individuals, corporations, towns, cities and nations being put into rocketing and often unrepayable, debt. On a world scale, the situation is now serious and could result in a collapse of the whole global economic system.

Inflation and debt are structural parts of the present system. Inflation will never be moderated, let alone eliminated, unless the interest-bearing nature of the present money supply is understood and an alternative interest-free money supply instituted.

Riba/ interest is viewed by Islam as wrong yet the present system and its main money supply is based on interest-bearing debt. Moreover, present Islamic Banking (whether it likes admitting it or not) is a part of that system. Islamic Banking bravely endeavours to avoid the appearance of interest by using various legal devices, yet the underlying reality is that at the heart of the present system — of which Islamic Banking is now a part — is the creation of interest-bearing money by the banks. Islamic Banking should not be condemned for this — it is doing its best in a difficult, if not impossible, situation.

As for the Islamic requirement for a direct connection between the money supply and the real economy, the present banking system does several things including administering various sorts of financial arrangements. But, where investment is concerned, its prime claim is that it directs resources towards the real economy. Yet, despite the claim, it does not do so. Today, most of the new money supply goes into consumer credit, derivatives, a huge rise in existing asset prices (particularly houses), and to putting individuals, corporations, towns, cities and whole societies into ever-increasing debt. Debt debilitates, and interest-bearing debt destroys. Therefore the conventional fundamental justification for the present banking system — that it allocates resources efficiently — is an untruth.

Lastly, Islam requires an ethical ethos. It says there can be no economics without morality. There are many aspects to this — they range from a desire for an overall sense of relatedness (tawhid) to a simple concept of justice, ethical investment or better accounting practice. But conventional economics eschews morality because it thinks that all the outcomes of the unfree market are just. It thinks that the present economy and society are the same thing or rather that society does not exist. Thus the work of a carer (who sometimes has to work for 24 hours at a time and is often unpaid) is ignored as not being part of 'the economy'.

In sum, because of the acute discrepancy between the realities and rhetoric of unfree market finance capitalism on the one hand, and the fundamental requirements of Islam on the other, unfree market finance capitalism without modification is unacceptable.

3. Interest is not necessary

Islam views interest as wrong but saying that riba/ interest is wrong is not something which has much, if any, resonance with non-Muslims, still less with the supporters of unfree market finance capitalism. “Wrong?” they say, “Who cares if it’s wrong? It’s a necessary part of the system.”

But those non-Muslims and supporters get a huge shock when they are told that, certainly where productive capacity is concerned, interest is not necessary. Interest today is usually a bundle of things, of which only some are necessary. Thus administrative cost is necessary, profit is necessary and, in particular circumstances, some provision for collateral may be necessary, but interest itself (which puts the world into more and more debt) is not.

There are, of course, the traditional justifications for interest. But the arguments of Nassau Senior, Alfred Marshall, and Eugen von Bohm-Bawerk all boil down to two things — that suppliers of money are allegedly ‘waiting’ or ‘abstaining’ and that the payment of interest by the borrower is the price for getting something (or rather, its value in the form of money) now rather than having to wait.

However, today, there is no need for ‘waiting’. Money today is created out of nothing. So where is the justification for interest? Where is the justification for something which locks onto a debt and, because of the effects of compound interest, sends it rocketing up exponentially? Interest today is in effect a massive tax whose benefits go not to the government but to the banking system.

There is one last conventional attempt to justify the imposition of interest and it lies within conventional savings doctrine which says that, before there can be investment, there must be financial savings and physical savings.

At first it sounds sensible to say that, before there can be investment, money must be obtained, and bricks, cement and labour, for example, must be available. But suppose — as is the case — that the money is created out of nothing by the pressing of computer buttons and suppose — as is the case — that the bricks, cement and labour are easily available (even though, when in short supply, their prices can rise or, if necessary, alternatives are available). Where, then, is the justification for conventional savings doctrine? There is none.

Outdated concepts such as the time value of money and conventional savings doctrine are presented to the populace as unchallengeable, eternal, truths. In reality, they are cynical deceptions designed to maintain the malignant grip of interest-bearing money and other undesirable features of unfree market finance capitalism such as rich-poor division, the pushing of money into anything except productive capacity and economic

colonialism.

Very clearly, an Islamic money supply is required.

4. An Islamic money supply and Islamic endogenous loans

a) Conventional definition of endogenous money

The conventional definition of endogenous money is that it:—

- issues from the banking system
- has interest attached
- serves the efficiency and resource-allocating purposes of a market economy

However, it should be noted that, in reality, only a small percentage of the money supply is directed towards the real economy and the rest goes towards consumer credit, derivatives, a huge rise in existing asset prices and to generally putting the whole world into ever-increasing debt. Thus the key conventional fundamental justification for the present banking system is, at best, weak.

b) Islamic definition of endogenous money

In contrast to conventional endogenous money, an Islamic money supply is a modification of present practice so that there can be central bank issuance of interest-free loans for the purposes of productive capacity. The issuance: —

- is administered by the banking system, and is ultimately repayable to the central bank
- does not have interest attached
- is *always* directed at productive capacity and thus serves the real economy, efficiency and resource-allocating purposes of a market economy
- has wide ownership, social and economic justice purposes

It should be stated bluntly, however, that, whenever any modification of the monetary system is proposed, conventional minds usually react by misconstruing what is being said. Thus, whereas the new Islamic endogenous loans are, like any other loans, repayable, the conventional minds allege that non-repayable 'printed' money is being issued. Whereas the new Islamic endogenous loans are totally directed at productive capacity, they allege that the loans are not so directed. Whereas the Islamic endogenous loans cannot be inflationary (in fact they are counter-inflationary), they allege the loans will create an inflation akin to that of Germany in 1923. Where something new and positive is concerned, such the hostility, there sometimes seems to be no limit to what the conventional mind will allege.

5. Interest-free issuance by the central bank

The question arises as to whether there is a limit to the issuance of production-directed interest-free loans from the central bank. If the loans are genuinely directed at productive capacity which has undergone a market scrutiny to ensure that the investment can pay for itself, then there need be no limit. Moreover, because of the linkage with the real economy, Islamic loans issuing from the central bank are not only, over time, non-inflationary, but counter-inflationary.

a) Gold or other commodity backing

Yet conventional minds, prepared to allege anything, will still claim that Islamic endogenous loans must be inflationary so, to stifle the allegation (and to do something which is not done at present), the currency would have gold or other commodity backing). The relation with gold or other commodity would act as a restraint on central bank issuance although, such the counter-inflationary effect of Islamic loans, it could be sensible at times to remove the restraint.b) 100% reserve requirement and credit issued by the central bank for productive investment

The banks and banking system today endlessly create money. They are the real source of inflation and it happens because of the practice of fractional reserve banking which allows a bank to lend many times its reserves. But, because a bank only creates money for the principal of a loan and not for the interest, the banking system as a whole must continually increase the overall amount of debt if the economy is not to collapse. The fractional reserve system is why house prices, for example, have been rapidly rising right the way around the world and some form of bust is inevitable.

So, with an Islamic money supply for productive capacity, it will also be policy, over time, to increasingly restrain the banking system from creating new money. This would be done by gradually increasing (eventually to 100%) the reserves that a bank must deposit with the central bank. Thus, as interest-bearing money from the banks decreases, interest-free loans (from the central bank, but administered by the banking system) will increase thereby fulfilling the need of an economy for credit to be made available for productive investment.

Banks would thus become essentially depository and investing institutions who could only lend depositors' money with the agreement of depositors (although they would have other functions e.g., administering interest-free loans for productive capacity). The banking system will then be doing what the public believes banks do Ñü and what the banking system allows the public to believe Ñü namely, lending its own and its depositors' money!

Increasingly, there will be less need for control of the economy via interest rates. The overall volume of money in the economy context will be the key factor and the central bank could change the percentage of reserves a bank must deposit. Islamic endogenous loans start with the central bank and eventually get repaid to the central bank. The use of the loans would be confined to public and environmental capital projects, small and

start-up businesses and large corporations as long as wide capital ownership is furthered. Because of no interest the general result would result in a halving at least of the cost of new productive capacity and a huge reduction in debt.

6. The choice in respect of an Islamic money supply of interest-free loans for productive capacity

Is there any relatively straightforward practical way of achieving the Islamic requirements of unicity, free markets, private property, economic efficiency, social and economic justice, no inflation, no riba/interest, a direct connection between the money supply and the real economy, and an ethical ethos? Furthermore, is there any relatively straightforward practical way of integrating Islamic finance into the mainstream?

Yes, there is. This short paper can only be a brief outline of what is a huge subject but the Islamic requirements and the integration are all essentially connected with one thing — an Islamic money supply of interest-free loans for productive capacity.

In respect of that Islamic money supply there are two main choices:–

EITHER

It is instituted and integrated into the existing system of unfree market finance capitalism. This is done simply by ensuring that there is a stream of interest-free loans available for forms of productive capacity. Over time, the stream will ensure the implementation of the Islamic requirements whose beneficial consequences will soon become apparent to, and over time serve the needs of, all people. If it institutes the stream of interest-free loans the unfree market will at last be honouring (rather than dishonouring) its own rhetoric and so become a true free market.

OR

It is not instituted and integrated into the existing system of unfree market finance capitalism whereon Islamic societies can be expected to institute for themselves the stream of interest-free money and thus have the beneficial consequences of its institution. The result will be that Islamic societies and their economies will become true free markets with a new distinctive identity. They will therefore achieve material, moral and intellectual success in contrast to the laggards — presumably non-Islamic societies — which choose not to use interest-free loans for productive capacity.

7. Uses and consequences of Islamic endogenous loans

Islamic endogenous loans combine efficiency with social and economic

justice. Taking the general form of state-issued, interest-free loans (administered by the private banking system) they are directly related to the real economy, made repayable and, when repaid, are cancelled or cancellable thus ensuring that productive assets always back a society's currency.

The loans have four main uses:-

Public capital investment thereby allowing hospitals, housing, roads, bridges, libraries, sewage works, fire stations, water supply, schools etc. to be constructed for one half, or one third of the present cost. Over time, the National Debt would reduce. However, the capital projects can still, if wished, be built by the private sector, managed by the private sector, even owned by the private sector. The key point is that the cost, at the very least, is being halved.

Private capital investment if such investment creates new owners of capital and is part of policy to enable all individuals, over time, on market principles, to become owners of substantial amounts of productive capital. By using central bank-issued interest-free loans, administered by the banking system on market principles, a large company/ corporation would get cheap money as long as new shareholders are created.

Green capital investment, particularly for clean, renewable energy. At present, using interest-bearing loans, a lot of green technology is not financially viable. With interest-free loans, however, it would become viable. Thus we could have, for example, clean electricity through tidal barrages, dams, windmills, wave machines, solar electricity, and geothermal power stations.

Small and start-up businesses thereby freeing them from the crushing pressure of interest-bearing debt. (In the case of small and start-up businesses, there would be no requirement for wide ownership.)

A supply of Islamic endogenous loans is of immense importance because it is capable of ensuring, among other things:-

- economic and social justice
- an end to, or at least a lessening of, the imposition of interest
- a direct linking of new money to productive capacity
- a widespread ownership of productive capital
- a new economic system which, by a proper use of interest-free loans, spreads productive capacity to all individuals in the population so that they produce (and thus earn) independently of whether or not they also have a conventional job
- an increase in political freedoms through the spreading of economic power
- an efficient wealth creation
- policy to unite inhabitants who have different linguistic, religious, geographical and ethnic backgrounds
- an ability of a society to control its own destiny as opposed to being ruled by outsiders and others

8. Provenance of Islamic endogenous money

The concept of Islamic endogenous money goes back to 1995, and certainly to 1997, in the work of Professor Masudul Alam Choudhury who is the leading Islamic economics and finance academic expert and is the author of a most remarkable and extensive range of books and papers.

However, looking at the situation in a second way, endogenous money (i.e., central bank-issued interest-free loans, administered by the banking system, and directed at productive capacity if wide ownership is involved) has been in existence for nearly fifty years in the writings of binary economics. In the last five years, moreover, the basic concept has been expressed in *Seven Steps to Justice* by Rodney Shakespeare & Peter Challen and in several papers given at Islamic academic conferences all of which dealt essentially with the connection between the money supply and the real economy.

And, looking at the situation in a third way, interest-free loans for public capital projects are probably being used in the present — Malaysia is believed to be experimenting with such loans and, of late, has achieved some remarkable feats of construction — and have certainly been used in the past. Interest-free loans for public capital projects have been used by the Channel Island of Guernsey over the years. Guernsey has minimal national debt. Canada used the loans (1939 -1974) and many Canadian municipalities are now again demanding their use. After 1935 New Zealand used such loans — for hydropower schemes, railways, state housing etc. — and had a remarkably prosperous period. In the USA, 3,400 governmental bodies (local boards, towns, cities etc) and six State governments are known to support the idea — a Bill (HR 1452) reached Congress but was defeated by powerful vested interests.

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The reasons for the narrow ownership include:-

- a theoretical misconception of the time value of money
- an outdated savings doctrine
- a misunderstanding of who or what physically creates the wealth
- a failure to devise a modern method of providing collateral.

Robert Ashford & Rodney Shakespeare (1999), *Binary Economics – the new paradigm*.

Jean Baptiste Say himself realised that the Theorem (Law) which, today, is attributed to him (in fact, it is in Adam Smith) does not work unless there is a spreading of capital ownership. Thus Adam Smith, who saw labour as the main, if not sole, creator of wealth, had got things wrong. In 1803, JB Say wrote this remarkable passage:- "To the labor of man alone he (Smith) ascribes the power of producing values. This is an error. A more exact analysis demonstrates that all the values are derived from the operation of labor, or rather from the industry of man, combined with the operation of those agents which nature and capital furnish him. Dr. Smith did not, therefore, obtain a thorough knowledge of the most important phenomenon in production; this has led him into erroneous conclusions, such, for instance, as attributing a gigantic influence to the division of labor, or rather to the separation of employments. *This influence, however, is by no means inappreciable or even inconsiderable; but the greatest wonders of this description are not so much owing to any peculiar property in human labor, as to the use we make of the powers of nature. His ignorance of this principle precluded him from establishing the true theory of machinery in relation to the production of wealth.*" (Italic emphasis supplied).

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For example, conventional accounting and capitalism in general claim that a company's main responsibility is to create profit and a maximum return for stockholders. But a truly modern economy also requires a social responsibility. Sofyan Syafri Harahap & Yuswar Z. Basri, *Socioeconomic Disclosure of Islamic and Conventional Banks in "Money and Real Economy"* ed. Masudul Alam Choudhury, 2005.

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However, other broad options are also unacceptable. Hard-line socialism and communism have inefficient command economies and dictatorial political structures. They are also atheistic. Moderate socialism and social democracy are forms of unfree market finance capitalism. They may have a much greater sense of social justice than the unfree market but they also have a greater inefficiency.

Thus Sir Josiah Stamp, director of the Bank of England during the years 1928 ? 1941, stated:- "The modern banking system manufactures money out of nothing. The process is perhaps the most astounding piece of sleight of hand that was ever invented. Banking was conceived in iniquity and born in sin. Bankers own the Earth. Take it away from them, but leave them the power to create money, and with the flick of the pen they will create enough money to buy it back again... Take this great power away from them and all great fortunes like mine will disappear, and they ought to disappear, for then this would be a better and happier world to live in. But if you want to continue to be slaves of the banks and pay the cost of your own slavery, then let bankers continue to create money and control credit." JK Galbraith said:- "The process by which banks create money is so simple that the mind is repelled..... It is, moreover, one that is almost breathtaking in its audacity." JK Galbraith (1975), *Money: Whence it came, where it went*.

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The possibility of an independent development of something which is the equal of, even better than, the existing system is important not only because of the Islamic desire to develop something which is new and distinctive but because neoclassical 'free market' finance capitalism makes the arrogant hubristic assumption that it is the perfection of the development of history and that, apart from minor modifications, nothing much better could ever come into existence. The hubris is expressed in Francis Fukuyama (1992), *The End of History*.

If Islam is to give a moral, intellectual and material lead to the world its economy must be completely distinctive. Without that distinctiveness, the ummah will never free itself from control by others. Masudul Alam Choudhury (1997), *Money in Islam* and (2003), *The Islamic World-System: A Study in Polity-Market Interaction*. Choudhury spearheads the call for Islam to have a distinctive way forward and use endogenous money. See also Choudhury (1989), *Islamic Economic Co-operation*; (1990), *Journal of Economic Cooperation Among Islamic Countries*; and (1998), *Reforming the Muslim World*.

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