



Munich Personal RePEc Archive

# **Moving Beyond Rhetoric: Can Islamic Banking become Mainstream in Pakistan**

Mamoon, Dawood

University of Islamabad

14 October 2017

Online at <https://mpra.ub.uni-muenchen.de/81973/>

MPRA Paper No. 81973, posted 16 Oct 2017 20:38 UTC

# Moving Beyond Rhetoric: Can Islamic Banking become Mainstream in Pakistan

By

Dawood Mamoon  
Dean and Professor

School of Management and Economics  
University of Islamabad

(Harvard Business School Affiliate: 2013-2017)  
(George Mason University Affiliate: 2016-2018)  
(Member World Economic Survey Expert Group)

Abstract:

Challenging economic theory that is developed at micro level is a common practice among macro-economic behaviors of conventional economic system. In this context the paper analyses Islamic banking that tries to bring an interest free financial system. The paper explains the circumstances that may lead to a universal application of Islamic banking in Pakistan. This is done after presenting a detailed discussion on the rational for conventional banking.

*Keywords: Islamic Banking, Capitalism, Islamic Economics, Interest Rates*

## 1. Interest Rates as a Return to Capital:

The concept of interest payment is one of the building blocks of economic theory. The idea is simple. Every economic activity should be compensated duly. Since economic activities differentiate in nature, their respective rewards must carry the property too. Hence it was logical to conclude that labor earns wage; Entrepreneur receives profit; Land brings rent and capital is paid interest. With time the economic theory progressed as the factors of production continue to diversify.

Let me start the argument by focusing on capital and subsequently theory of interest rates in order to evaluate whether interest rates are indispensable in financial apparatus of the economy or they can be readily forsaken for alternative financial concepts contemplated in Islamic financial paradigm. Let us first understand what is meant by the expression 'capital'? Today, capital is a very abstract concept which has different forms e.g. human capital, social capital and environmental capital, etcetera. In finance, the term capital is used for an interest bearing monetary asset. Any financial instrument, which has a rate of return associated with it, is known as financial capital/asset. Banks generate capital by floating variety of instruments in the market. The difference in the instruments is primarily based on two factors: interest rate and maturity date. These financial instruments are open for public. The idea is that every person is an investor as long as he has resources or savings to his disposal. Let us say, if a person has a savings of Rs 100, he has an opportunity to make an investment. However, this is not a big amount to carry out any physical investment. Whereas acquiring a financial instrument from a bank is a more attractive option. First, his funds are stashed in a secure place. Secondly, he shall

receive an extra amount on the savings depending on the agreed rate of return which in turn depends upon the maturity of the financial asset he shall obtain. Banks attract public savings with this incentive mechanism. After generating deposits from the public, the banks lend money to the investors. The interest rate, charged on the bank loans, is known as lending rate. The lending rate depends upon the principal amount of the loan plus the maturity date. If the loans are for short term they carry higher interest rates and vice versa. It is up to the borrowers to choose a loan amount with particular lending rates with a certain maturity date - which ever is deemed feasible for their investments. This is how, in a traditional financial set up, banks play a role of an intermediary by channeling the savings into efficient investments in an economy.

## **2. Islamic Banking versus Conventional Banking**

However, this form of return for financial capital is criticized by the proponents of Islamic banking much severely. They argue that financial instruments must be based on profit and loss sharing rather than interest payment in order to include the uncertainty factor. Their line of argument is that investments carry an element of risk. Any individual who decides to open a business is prone to incur a loss as well as profit. Banks, which primarily play the role of intermediaries, should share the risk for the businesses they are helping to finance. The people who are depositing money in the banks should also be open to the risks, the investors are taking. The idea is that if an investor, who has borrowed the money from a financial institution, incurs losses, he should not be made to face the whole brunt of it. Similarly if he incurs profits, the profit has to be shared equally among all stake holders. The existence of pre determined interest rates are prone to exploitation. In case of a loss, the investor is exploited because he still has to pay the predetermined amount to the bank. The public who have saved their money in the banks also receive a predetermined amount, irrespective of the losses incurred by the investment carried out against their finances. In case of a profit, the banks and the public is exploited because they are, by default, left out. Thus in Islamic banking profit and loss has to be shared by all the stake holders: investors, banks and the public - in order to reach an equitable outcome.

Although such a system based on Shariah seems appealing, it fails to accommodate the dynamics of a contemporary financial system. Let us evaluate the two systems on the base of efficiency. A very relevant question can be asked: why does in the first place public decide to put money in banks?

Every person, who earns also consumes and saves - whereas savings can have many motives. People primarily save for precautionary purposes like unforeseen outcomes in life. Additionally, People might also save in order to forego their present consumption for the future one. It is true for salaried people. Partly they save in order to utilize their savings after retirement. People also save for well-being and improvement in their lives i.e., education, health etc. In short, one of the very common motives to save is to improve earnings by investing in physical or non physical assets. This motive is identified as a speculation motive by Maynard Keynes (See Keynes, 1936), whereby every individual acts as an investor to perk up his asset base. Every individual, as an investor, has a certain assortment of capital to his disposal. His choice of accumulating further resources depends upon his readiness to take risks. Readiness to take risks, in turn, much depends upon the initial income levels.

A person with low income shall be most careful regarding his savings. Much or all of his savings would be for precautionary purposes. He shall be a risk averse than a risk taker. Given a choice, he shall invest his savings where risk is minimum and return is maximum. For low and lower-middle income earners, channeling their savings into physical assets is generally not a feasible option because of high costs involved. Banks provide them with a less risky and less costly option: Any body after paying a trivial amount to the bank can open a deposit and earn a certain rate of interest on it. However earning a nominal interest rate on a financial institute does not actually mean an increase in savings with time. It much depends upon the inflation rate in the economy. The real rates of return might be negative on the deposits if inflation rate is higher than the nominal interest rates. Nevertheless, putting an asset in a bank is a much wiser option than to keep it in a closet - because in the former case one is somewhat compensated for the inflationary trends in the economy in addition to the safety element.

Similarly an investor on a higher level of income-chain, with adequate resources to incur a physical investment, might also put a portion of his earnings in a bank. There can be many reasons for that. One of the reasons is that any resourceful and rational investor also wants to diversify his portfolio by availing different opportunities of investment. He shall like to maximize his overall returns and minimize the overall risk regardless of being a risk taker or a risk averter. His portfolio ideally would involve physical investments as well as investments in financial assets. Thus depositing some of his wealth in a bank is one of the pre-requisite steps towards portfolio diversification and minimization of overall risk he is taking as an investor.

Simulate pls

In real life, many financial institutions work simultaneously to cater the demand and supply of finance in the economy. For example, in a typical developing country like Pakistan we have public banks, private commercial banks, private investment banks, leasing companies etc. Each bank offers a number of financial instruments to the public. As mentioned above these instruments are differentiated on the basis of rates of return. Pakistan also has secondary financial markets. These markets generally known as stock exchanges also facilitate the supply and demand of finance in the Pakistani economy. The primary difference is that they offer financial instruments which have an element of risk sharing. Many companies float their shares in the stock markets to generate finance for their investments. However the price of the shares primarily depends upon the retained earnings of the firm. If a company is performing well, the stock price will rise - enabling the stock holder to receive a premium in case he wants to sell the stocks at prevailing higher price. In case of loss, the stock prices plummet, decreasing the value of stock holdings of investors. In short stock markets provide an option to the investors to generate resources by acquiring or floating a risk sharing financial instrument. This makes stocks riskier financial assets than banking deposits. The amount of risk depends upon the returns and the volatility of general stock price index. For example in America, before 2008 financial crises, people used to put their life long savings and retirement funds in form of stocks. These stocks normally belonged to billion dollar corporate giants indulged in ecommerce or telecom and were known for bringing high returns. Little did the common American know that in the wake of 2008 financial crises most of these companies shall succumb to accounting scandals and devour them of their life long savings? It is clear that putting one's speculative financial assets in a high return- risk sharing instrument like stocks in a developed country like America can also end up being too risky. Thus bank deposits provide a docile but safe investment arrangement especially, in a developing country where the macro economic situation is uncertain and

volatile, a bank deposit is a more debonair and secure investment than risky stock holdings.

Now the Islamic Banking paradigm which calls for the abolition of the fixed interest rates in a banking sector does not really fit in this equation because Islamic Banking recommends profit & loss sharing over fixed interest rates on banking deposits. As explained above, the low income or lower middle income groups are risk averse investors. Or to put it more clearly, the savings incurred by them are based on precaution rather than speculation: Lower is the level of risk, their savings are exposed to - the better off they shall be. Thus banks not only secure their savings but compensate them for depreciation (from inflation) by paying them a certain amount of nominal interest rate. Under Islamic banking such people shall be discouraged to stash their savings in banks because their savings are now prone to losses as well as profits and greater risks. It only needs basic knowledge of monetary economics to realize that Islamic banking shall squeeze the credit and money creation in an economy because it does not cater any more for risk-averse savers. Another bad news under Islamic banking for domestic banks shall be the loss of those affluent investors who have put their money in the banks only to diversify their portfolio in an effort to maximize their returns and minimize their risks. The banks which earlier provided them with relatively risk free option shall now compete for their riskier ventures in stock markets or goods markets.

To make it short, working for a pure national Islamic banking system, when the world is following the capitalist financial system is an exercise which can at best be explained as futile. The prove in this respect is that despite much rhetoric regarding interest rate abolition in our country, which is also adorned by Supreme court ruling recently, Pakistan has failed to devise a comprehensive framework whereby our financial system can be readily transformed into an Islamic one. We need to realize that Islamic banking under the influence of capitalism is just another of the creative option for the investors who are looking for portfolio diversification and nothing more than that. Though if somebody really thinks that Islamic banking is the best option to be implemented on a national level, he better invent new economic theory where agents of economic activity are re-defined so that the concept of interest rate be replaced by a one which is consistent with shariah. Till then, we have no choice but to deal with interest rates which in capitalist economic theory are simply reward for capital - nothing more, nothing less.

### **3. Way Forward for Islamic Banking: Challenging Conventional Economics is Profitable**

Moore's Law that is a well established, accepted and tested phenomenon of technology efficiency also indirectly determines the price of innovation and that is time. However this law suggests that there is a negative relationship between innovation and its price. This is in contrast to the basic law of supply where price and output has a positive relationship. Less and less time is being required to bring further innovation to technology. So what it tells about conventional law of supply that defines price having a positive relationship with output. Well macro economic observations have already contradicted fundamentals of economic theory. For example through the process of outsourcing that is the prime motivation for globalization, multinationals have actually able to continuously decrease their costs of production and thereby presented their consumers with decreasing prices and higher output. In short, like in demand side in supply side too, price has a negative relationship with output in practice for multinationals. In this context, Islamic banking provides a very lucrative option where

profit and loss sharing principle suggests that price of capital would always be lower for borrowers and lenders alike. This is a dream come true for Thomas Pickety (2014) type critique on capitalism. Islamic banking can really be welfare enhancing and make capitalism socially viable for developing countries.

However such would happen when the risks of losses on investment would have a low probability. A stable economy ensures to provide an environment of business competitiveness so that local businesses flourish and eventually expand beyond intra national and intra-regional boundaries. There are micro economic factors as well as macro economic factors of business competitiveness. Micro economic competitiveness deal with the firm's journey from input organization to output management. Input organization deals with issues like leadership, human resources, research and development, learning by doing, academia-industry relationship, and soft and hard innovation processes. Output management is mostly about location of production where proximity to local, national and international cluster is taken into consideration. Macro-economic competitiveness of businesses is defined under the quality of prevalent social, political, economic and legal institutions in a country. The binding constraints for competitiveness at macro level also mean a country is a democracy located in a peaceful region where domestic, regional and international commerce takes place freely and efficiently.

Islamic Banking is a concept introduced, promoted and practiced by pre dominantly Muslim countries like Pakistan. Most of these countries score really low on business competitiveness both at micro level and macro level. In short this means that probability of loss is higher for businesses than probability of success. In other words, success of Islamic banking is highly correlated with establishment of not only robust social, political, economic and legal institutions but a country like Pakistan should promote peace in the region and strengthen democratic culture within. Without achieving and creating an environment of micro as well as macro competitiveness, Islamic banking that works on interest free principle may not become main stream.

References:

Picketey, T (2014), 'Capital in 21<sup>st</sup> Century' Belknap Press

Keynes, J., M. (1936), ' General Theory of Employment, Interest and Money', Macmillan Press