Comments on "Stabilization and Growth In an Open Islamic Economy"

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Stabilization and Growth in an Open Islamic Economy by A. Mirakhor and I. Zaidi focuses on the following major issues of concern to Islamic economics: savings and investment in a zero-interest economy, the role of monetary policy (known to economists as the management of the interest rate), open market operations, and the reserve ratio as it is used to stabilize the economy, real versus financial sectors, the rate of return on real assets versus the cost of fund acquisition, and last but not least, the inflow and outflow of capital to an Islamic economy. This paper should be looked at as a serious attempt by Muslim economists to position Islamic economics in the literature of economics, using the same tools and instruments which invite other economists to respond, positively or negatively, to their concepts and views. This dialogue is essential in gaining support and creating awareness among a wider spectrum of specialized scholars.

Mirakhor and Zaidi establish the following propositions:

1. In a zero-interest economy, savings and investment are unlikely to decline.
2. A financial system based upon a framework of profit sharing would be more efficient in resource allocation.
3. The agents of development in a 'conventional' economy are savers and investors. In an Islamic economy the same two agents exist but they usually act differently, in the sense that they are both entrepreneurs.

These three propositions are quoted from previous works by Iqbal and Mirakhor, Khan, Haque, and others. However, the model developed in this paper adds a fourth proposition, which is that a monetary policy can be used to affect output in an open Islamic economy.

One tends to agree with these four propositions based upon the logical presentation and the equilibrium model's development. The general equilibrium model rests on the assumption of imperfect but gross substitution among four assets, namely, currency, bank deposits, bank equities, and physical capital. This implies that the partial derivative of the asset demand function with respect to the own rate is positive, while with respect to an alternative rate, it is negative or zero. This assumption is essential to the model's validity. The three partial derivatives *drh*, *drl*, *drk* with respect to *dG* have to move in the same direction so as to institute the impact of monetary policy on output. Gross substitution ensures this one directional movement, and imperfect substitution dampens the expansion of bank intermediation.

At this stage, one should critically evaluate the substitutability assumption. Bank deposits, bank equities, and currency are all financial assets; they have the property of being substitutable though imperfectly. Infact, one may doubt whether physical and financial assets may be substituted. The rate of return on physical capital, i.e., the marginal efficiency of capital, is determined by long-term expectations of future returns. Returns on financial assets floated by the banking sector are determined by short-term expectations. In a nonzero interest economy the relationship between short-term and long-term interest rates is governed by three theories: the expectation theory, the liquidity preference theory, and the segmentation theory. These theories conclude that movements in the long-term interest rates are not necessarily related to movements in the short-term interest rates. By the same analogy, the assumption that short-term rates of return tend to affect long-term rates of return need to have further supportive evidence.

Another strong proposition of the paper is that although the greater flexibility in the rates of return increases the short-term international capital flows offset to monetary policy, the adoption of Islamic banking will lead to sustained medium or long-term capital

outflows. Our intuition is that in an equity economy and in the absence of fixed guaranteed returns, capital movements, both inflows and outflows, tend to be more or less sustainable depending upon foreign expectations of movements of equity returns.

Mirakhor and Zaidi's model is developed as a deterministic model. The Modern Portfolio Theory (Sharpe and *et al.*) explains rates of return on equity in a probabilistic form. The prominent Capital Asset Pricing Theory (CAMP) states that

$E(R_j) = R_f + B\ (E(R_m) - R_f)$;

$E(R_j)$ = Expected rate of return on stock j;

R_f = Risk free rate of return, if $R_f = 0$, model's conclusion is still valid;

$E(R_m)$ = The expected rate of return on the market portfolio;

$$B = \frac{\text{Cov}(Rj\ Rm)}{\text{Var } M};$$

= Systematic risk.

This implies that the 'expected returns' rather than 'returns' should be included in the model specification in an Islamic monetary system. Whether expected rates of return on equity can best be explained by CAMP or the most recently developed arbitrage theory need to be studied. The point that must be emphasized here is that probabilistic models should be used to explain rates of return in an Islamic economic system rather than in the conventional monetary policy deterministic models.

The last point in the Mirakhor and Zaidi model is the absence of risk analysis in the overall specification of the model—more specifically, the absence of a country risk factor in the D^* equation. This equation explains foreign demand for investment deposits as a function of the rate of return on investment deposits, less foreign or world interest rate and the expected depreciation of the domestic currency. No one would expect all Muslim economies to have a country risk factor equal to zero; in fact, a Muslim country, with its own distinctive economic and political conditions, may carry a positive country risk factor. In the case of running the D^* equation in a risk-analysis

system, country risk as an argument of this equation should be included.

Another point related to specifying the D^* equation is the inclusion of a world interest rate. Though this is relevant when comparing investment in non-Islamic economies to investment in Islamic economies, a more appropriate exogenous variable would be a weighted average expected rate of return in other Muslim countries. Foreign investment usually compares world opportunities both to Muslim economies' investment opportunities and to one Muslim economy's investment opportunities.

There are a few remaining points worth mentioning. The relationship between bank shareholders and bank depositors in the decision making process concerning the management of an Islamic bank and the fair and equitable distribution of bank profit, invites further analysis by Muslim bankers. The comparison of the marginal efficiency of capital (MEC) to the financial cost of capital is artificial in an Islamic project evaluation context. In an interest-based economy the MEC is different from the cost of capital. But in a zero-interest economy the rate of discount for investment projects would be the MEC or the internal rate of return (IRR), depending upon whether it is determined ex-post or ex-ante.