

Comments on “Stabilization and Growth In an Open Islamic Economy”

Hanaa Kheir-El-Din

Stabilization and Growth in an Open Islamic Economy is a well written and well thought out paper. It is very informative and in some places illuminating. It represents a serious and profound attempt to study both the short- and long-term stabilization and growth effects of a banking system that operates on the basis of risk and profit sharing in an open economy.

First, I would like to make a general comment that concerns the paper's overall approach. In the context of a Muslim forum where, presumably, we believe in Islam and its political, social and economic superiority, the search should not be to determine whether the Islamic system is more or less stable than the 'conventional' one, or whether the Islamic system is more or less conducive to growth or more or less capable of adjusting to microeconomic disturbances. Rather, the search should be concerned with finding economic tools—whether original or conventional—which, in accordance with the shari'ah, optimally achieve the objectives of the economy; and after determining these economic tools finding their economic properties and effects. The paper, not following this approach, instead, alters the 'conventional' relationships to fit the Islamic requirements and then compares the results in the two cases. As a result, the authors often sound apologetic and seem to imply that the conventional system is the ideal standard to be used to assess any other system.

The following are comments relating to details of the paper.

When comparing the Islamic system with the conventional one, it is alleged that in an Islamic system, there would be “a more cautious, selective and perhaps more efficient project selection by savers and investors” than in the conventional interest-based system. I do not see any justification to this conclusion so long as the convention-

al system offers, in addition to the fixed-interest yielding assets, the possibility of profit sharing through equity holding. On the contrary, one may argue that the coexistence of both kinds of assets in the conventional system makes the choice of profit-sharing projects more selective and more efficient.

When the authors describe the Islamic financial system, they mention two principal models of Islamic banking. The first one requires that "demand deposits must be paid to the depositors on demand and has no specific reserve requirement." The second "stipulates a 100 percent reserve requirement for the demand deposits [and] . . . no reserve requirement for investment balances." The first allegation is not clear and one wonders why, for safety and confidence purposes, demand deposits should not be subject to a specific reserve requirement in an Islamic banking framework, thus liberating a set proportion of these deposits to be used in financing further projects and enhancing the potential of the bank to earn profits. As for the latter allegation, it reminds one of the medieval goldsmiths' practices of safe-keeping deposits. Given that the likelihood of withdrawing all demand deposits simultaneously is slim, it has no justification. This point of view has already been advanced by previous writers in the field. Thus, in both kinds of models it is not plausible in terms of their reserve requirements, to treat demand deposits in the Islamic banking framework differently from those in the conventional banking system.

We turn now to the general equilibrium model. It is developed to specify how rates of return on various financial and real assets are determined and is used to illustrate how monetary policy may, through altering these rates, affect investment, output and the balance of payments (see Section IV). Several remarks may be registered about the model offered in the paper.

First, the model is based on the main assumption that "there are three financial assets and one real asset, and the set of excess demand equations for these assets determines the rate on the assets, given the values of the various exogenous variables." Formulated this way, the model disregards an essential feature of an Islamic

economy, namely, that the rate to the financial assets is determined by the rate of return on the real asset. To capture this feature, the model should include relationships to specify the factors that determine various returns on the financial assets as a function of the return on physical capital. Thus, rd , rl rh should somehow be directly related to rk .

Second, rl is defined as the rate on bank loans. What does this represent in an Islamic context? Is it the rate at which the commercial bank borrows from the central bank on an equity participation basis? If it is, then the term is misleading and should be replaced with a more accurate one. In general, the terms 'loans' and 'borrow' often used in this section and in the following section are misleading, as they imply the obligation of the receiver of the funds to repay at least the principal, regardless of the outcome of the ventures in which they were employed. However, this is not true in an Islamic system where repayment of the principal more or less depends on the outcome of the venture.

Third, equation (7) expresses the rate on bank deposits, rd , as a function of the rate of bank loans, rl , thus reflecting the influence of the conventional way of thinking on the authors. Instead, it seems that any of these rates should be tied to rk , the rate of return on physical capital.

Fourth, in coefficients matrix A shown in the Appendix, the first element, i.e., the coefficient of drh in the first equation, is missing a third term, namely, $+ p_{rh}$, which represents the effect of changes in rh on the demand by the domestic private sector on bank equity.

Fifth, the first remark mentioned above is further illustrated by the result that the central bank may affect the supply of reserves "through variations in its stock of bank equity shares dG , which in turn alters the cost of borrowing for the banks." This statement is confusing and does not seem to accord with the requirements of an Islamic system. Instead, the central bank, through affecting the supply of reserves and thus the funds available for financing real investments, should affect the rate of return on physical capital, which in

turn should affect the rates of return on other financial assets. There is here a question of causality that has to be settled.

Concerning the paper's use of G to refer to both government holding of bank equities (in equations 10 through 12) and to government spending for consumption-type goods and services (in equations 13 and 14), as is well-known, one should avoid using the same notation to refer to different variables.

In Section V, the paper begins to discuss the effect that comes from the prohibition of interest and the resulting increased uncertainty on both savings and investment. The argument concerning the effect of an interest free economy on investment is sound; however, the argument concerning its effect on saving is refutable and implies a confusion between the decision to save and to invest. The return on saving, according to current economic thinking, is not a major determinant of saving. As correctly mentioned in the paper, saving is a behavioral decision determined by the form of the utility function of the individual which, in Islam, emphasizes work and moderation in consumption, thus enhancing saving. However, the decision concerning the form in which these savings are held, is subject to another set of variables of which risk and relative return are essential components. In this context, the role of zakah is essential in discouraging hoarding and stimulating the search for investment financing, either directly through *mudārabah* or *mushārah*, or indirectly through investment deposit.

Finally, Section V is concerned with investigating the capacity of the Islamic financial system to "repay its foreign loans" or "to service the existing large external debt." One should mention that the current account deficit, in an Islamic framework, would be financed either through a reduction of foreign assets or through direct foreign investment. The latter is available only for productive ventures. Financing nonproductive ventures (such as imports) or nonreturn-yielding investments (such as infrastructure) would be financed through grants, or through constraining external spending to the available domestic resources. Thus, talking about external debt or foreign loans seems to be in conflict with a basic condition of an Islamic system.