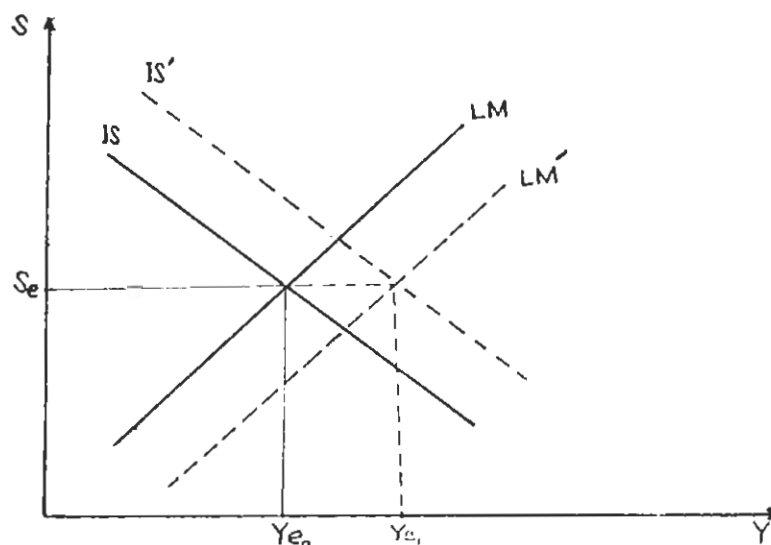


Chapter VI

POLICY IMPLICATIONS

In this chapter we shall investigate the effects of uncertainty to be created by the elimination of predetermined fixed rate of return on financial transactions. Essentially, the study is geared to evaluate the manner in which the monetary and fiscal policies shall be operative and the resultant effects on savings and investments.

Our macro economic model requires significant degree of coordination between monetary and fiscal policies in order to achieve the objectives of high employment and economic growth. This effect can be shown with the help of figure 1, showing the initial equilibrium by continuous lines and later equilibrium by dotted lines representing IS-LM curves.



Since in an Islamic economy there is no debt financed expansion, the government will consequently not pay interest on its debts, monetary expansion shall be commitment to fiscal expansion through the equity market, therefore increase in output will take place with little or no increase in bank's rate of profit(s).

If only fiscal measures are adopted to increase output then government will increase its expenditures by issuing equity participation through the Capital Market. Without simultaneous monetary measures, 'crowding out' of private investment due to appreciable increase in 'S' would not correspondingly increase output to desired level. Therefore in the absence of monetary expansion it will be difficult to keep 'S' within the appropriate limits conducive to investment expansion.

On the other hand, if only expansionary monetary measures are adopted, it would lead to decrease in BRP(S) through equity market which in turn will increase investment, but at the expense of weak financial intermediation due to consequential decrease in depositor's rate of profit (DRP) which would most likely lag behind the decrease in BRP due to bank's eagerness to sustain deposits. What basically needs to be assessed are the elasticities of consumption and equity demand. An increase in money supply in equity based system will increase

investment if and only if the money demand is less sensitive to changes in income than changes in equity demand. When money supply is increased, it creates an excess supply in money market and an increase in consumption demand, hence corresponding increase in the transaction demand for money at the expense of demand for equities. If the net effect of these two forces is a net reduction in equity demand than BRP would be depressed to an undesirable level, analogous to the concept of 'liquidity trap'.¹

In an Islamic economy, in the absence of bond market money financed fiscal policy will clearly increase output. In the event of non-existence of fixed return, the question arises as to how the fiscal deficits are to be financed? It has been asserted that government is to conduct its affairs strictly in accordance with Islamic prescriptions, inefficiency and waste to be eliminated and to have plausible Justification for all expenditures. If at all the deficit persists the government would have the option to reform taxation or raise money supply. As far as the impact of increase in money supply is concerned a few consequences are presented above.

¹Similar deductions are also drawn by Habibi (1991), pp. 125-132.

The extent to which rationalisation of taxes is concerned it is emphasised that progressive taxation would be somewhat sufficient without fuelling inflationary pressures on the economy.²

After establishing the fact that a close and simultaneous coordination is required between fiscal and monetary policies in an Islamic economy, we now proceed to investigate the effect of the adoption of equity based financial system upon the key variables of savings and investment.

In an Islamic banking system there are certain limitations imposed by *Shariah*, however Islamic banks will basically perform the same functions as in case of conventional banks i.e. to act as financial intermediaries. However the absence of a fixed and predetermined rate of interest is the main feature distinguishing the two systems.

In an Islamic system return to bank's liabilities is a direct function of their return on asset portfolios and as the assets are created in response to investment opportunities in real sector, the subsequent return on such financing shall depend upon the productivity of the real sector. In

²Kemal (1992) has highlighted the need of progressive taxation as a source to fund fiscal deficits with reference to Pakistan.

such a system, depositors will enter into a profit and loss sharing contract with the bank. The bank in turn will invest these surplus funds in the real sector on profit and loss sharing mechanism with the borrower. The bank will also accept demand deposits with no return payable to depositors holding such funds.

In wake of the adoption of this system and the introduction of consequential uncertainty of return, we will now proceed to look into the basic economic behaviour of the agents involved in the system.³

Generally, it is perceived that one of the major drawbacks of Islamic banking based upon uncertain rate of return is the decline in savings. It is basically an empirical question, whether savings would increase or decrease in an Islamic economic system. Although studies conducted do show positive correlation between interest and savings, yet the study conducted by (Haque and Mirakhor) 1987⁴ concludes by the fact that there is no strong theoretical reason to believe that saving will

³Although the requirement of honesty for success of Islamic Banking system is very stringent, however, in order to keep our analysis simple, we shall emphasise upon it later in the concluding chapter. Chapter III of this thesis has already dealt with this problem.

⁴Please see conclusion of Haque and Mirakhor, (1987), "Saving Behaviour in an Economy, Without Fixed Interest".

decline as a result of introducing an Islamic banking system. Keeping this conclusion still a notion and claiming the fact that the trends in positive growth of savings or a positive correlation of savings with interest shall be distorted by increased uncertainty, then it can also be claimed that the banks may and will select yielding projects professionally and diversify its lending portfolios to impede the fluctuations in returns so as to give its depositor a sustainable growth in terms of DRP which would be conducive for greater deposit mobilisation.⁵

In terms of the quantum of investment, one can easily infer from the foregoing that it would increase as a result of diversification of lending portfolios. Moreover as no fixed cost for capital is to be provided as a part of firm's profit calculations, the marginal productivity can be taken to a point where maximum profits are obtained without the constraints of meeting fixed cost of capital.⁶ In terms of contractual relationship between the bank, the saver and the borrower based upon profit and loss sharing system, the system is more elastic to economic shocks and

⁵Policy initiation in this direction, however, requires development of an extensive legal, institutional and professional infrastructure coupled with high information costs.

⁶Please see Haque and Mirakhor (1987), p. 158, "Optimal Profit-Sharing Contracts and Investment in an Interest-Free Islamic Economy.

remote from market failures.⁷

CONCLUSION

Based upon the above analysis, it can be concluded that an interest free economy is feasible and operative. The system is less exploitative in the sense that in case of losses, the burden is shared, consequently the evils of debt problems will not arise in such a system. It is more stable in terms of fluctuations and economic shocks. Monetary and fiscal policies are effective and have to be implemented through close coordination.

⁷Please see Khan (1986), p. 19.

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