Mohsin S. Khan and Abbas Mirakhor

Monetary Management In An Islamic Economy


Comments:

AMIR KIA
Carleton University, Department of Economics, Ottawa, Ontario, Canada.

The authors provide an excellent review of the existing views on a financial system that would be consistent with the precepts of Islam. The ideas are all well defined and explained. However, only a few points may be worth mentioning:

- The authors start with the fact that the fundamental sources of Islam, i.e., Qur’an and Sunnah, do not provide any direct or detailed guidance on the management of money. Both sources explicitly prohibit charging interest. In fact, according to the authors (p.4), it is this restriction that makes monetary management in an Islamic system differ in a very basic and important way from that in a conventional capitalist system. It would have also been useful to add that Islamic economics is a school of thought and, consequently, does not teach us a specific theory in monetary management, production, consumption, etc. It only tells us, e.g., not to charge interest, what to consume or not to consume, what to produce or not to produce, etc., but does not teach us how to manage money or a theory of consumption and production.

Early Muslim scholars, according to the authors, attribute only three functions to money, i.e., (i) a medium of exchange, (ii) a standard of value and (iii) a unit of account, but rejected its function as a store of value for which money could be sought as an end in itself. However, what was ignored, in my opinion, is that money also acts as a mean of deferred payments. Namely, the value of a debt in the future can easily be measured by money. We know that under a zero-interest environment current and future nominal values of a debt are the same, but not necessarily the real value of a debt. In reality, inflation exists and so the real value of a debt falls with the increase in prices. Here money acts to measure the value of a debt in different inflationary environments. Furthermore, money, like any commodity, can be used as a store of value, but contrary to other commodities has perfect liquidity. There is no reason, I think, to ignore this function of money in an Islamic economy where hoarding money
is an act of injustice. The store of value is a characteristic of money which exists in any economic system. However, the use of this function of money is discouraged in Islam.

- In the explanation of the banking system in an Islamic economy, the authors state that the need for financial intermediaries in the Islamic system arises precisely for the same reason as that in the traditional interest-based system. The financial intermediaries’ role in a general sense “is the exploitation of the imperfections in the financial markets.” However, the authors’ definition of imperfections includes various characteristics of financial intermediaries and market incompleteness. This definition creates some confusion since a market is imperfect when the borrowing and lending rates or the buying and selling prices are not the same, while an incomplete market exists when the supply of instruments available with particular features is insufficient to satisfy the desires of investors. If the market is incomplete, it benefits a financial institution or a direct borrower to exploit the opportunity by tailoring an instrument to the unfilled desires of investors, whether those desires have to do with the size of the loan maturity, protection, call feature, cash-flow characteristics, etc. (1) It is not relevant to talk of market imperfection in an Islamic-based banking system as both borrowing and lending rates are zero.

In a conventional interest-based banking system the revenue of a bank arises from market imperfection as well as fees and commissions while in an Islamic-based banking system the revenue is generated by fees and commissions (administered prices). Because of the principle of transmutation (i.e., the alteration of financial assets from one nature or substance to another nature or substance) and market incompleteness - and not market imperfection as the authors state - financial intermediaries are essential for market efficiency in an Islamic-based banking system.

- Under Section iv, the authors correctly claim that the prohibition against interest provides natural opportunities for the integration of financial markets. However, to my understanding, they do not explain how this is possible. I think if markets are efficient arbitrage activities lead to the integration of financial markets with or without the prohibition against interest.

- Finally, the authors ignored the implementation of monetary policy in a high-inflationary environment as well as in an open economy under an Islamic system. Namely, it would have been useful to explain how monetary policy is conducted in an Islamic economy in a high-inflationary environment and, most importantly, when the economy is open and capital is highly mobile.