

AN ANALYSIS OF ISLAMIC ECONOMIC MODEL

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ABSTRACT

The aim of this paper is to discuss some economic Islamic models given by some prestigious Islamic economists. The Islamic model is one of the examples for international economies in the starting of new millennium. It has its evaluation in the 1970s as an alternate to conventional banking system. The model is based on profit loss sharing and would not be based on interest. The study will focus on the proposed model and will discuss the issues that the model will be supposed to address. It was also address whether the model is applicable to Pakistan economy or not it will also be discussed. As we know that there is dual banking system in Pakistan. In order to make banking system to be truly Islam, there should be legal prohibition of riba. In other words, riba should be made unlawful and whoever deals with it can be prosecuted by law. By prohibiting riba, it will force the bank to be more creative in offering financing products rather than just loaning money. The study will attempt to show the comparison between conventional system and Islamic financial and discusses whether the Islamic system works smoothly on the economy of Pakistan. It also shows that Pakistan should change its dual banking system in Islamic banking system to change structure change. In addition, Islamic financing contract require real activities to be created. There will not be loans to finance extravagance lifestyle which is the source of bankruptcies among the younger generation. It is strongly recommended that Pakistan should enforce truly Islamic financial system to sustain its economy and avoid another economic crisis in the future.

Keywords: *Islamic economic model, conventional economic model, Riba, Banking System*

INTRODUCTION

In the starting of new millennium, the Islamic model is one of the examples for international economies. It has its evaluation in the 1970s as an alternate to conventional banking system. The model would not be based on interest but are based on profit loss sharing.

The findings of the model were taken from Islamic values taken from sharia religion. However, the basic difference between the Islamic model and the capitalistic model is prohibition given by the Koran and so, to do not ask for the interest rate at the time of repayment of loans. This is applicable “for loans for both types of productive activities and for consumption purposes.

Shari ‘a, no doubt, encourages the principle of profit-loss sharing between banks and businessmen as an approach to promote the spirit of brotherhood and cooperation in business relations. In contracts tolerable risk and uncertainties cannot exist. Islam has strongly ordered not to involve all types of gambling. Gambling is speculative, and any kind of speculation is prohibited in Islam. It is due to the fact that the buyer is involved in an economic activity aimed to make profit through trading and not through dishonest appropriation of others’ property.

Amartya Sen who got the noble prize in the field of economics was of the opinion of ethic economy. His view point was Islamic one. He gave the example of Islamic finance when private finance as Zakat is a main source of mobilizing the resources in an Islamic economy. It is wealth sharing tax and paid to per capita income systematically. An ideal society is based on two basic rules: justice and solidarity”. This is the simple mechanism: good and committed Muslim must find wealth and happiness sharing a percentage of their wealth to sustain and help poor and it is an efficient application of zakat. This is no doubt

practically implementing redistribution of national resources and decreases' the gaps between rich and the poor.

So both theories are based on different concepts. One value the money while the other value the social norms to manage crisis.

During this age of globalization, the material and spiritual well-being cannot be imagined separately. Islamic welfare model is promoted after the failure of the neo liberal politics model given by western colonialism. Islam stresses on welfare expenses on health and education through zakat.

The founder of modern economy Adam smith was in favor of capitalism where the aim of an individual is profit maximization. In the modern age a more social model is worked where companies manager are caring about the welfare of all individuals involved in contracts not just shareholders as a part of corporate social responsibility. Norms and moral values play an important part in types of transactions. Indeed, Islamic model is different from Adam smith model.

The western 2008 crisis reveal that western system was not successful and Islamic financial system should come forward to remove such crisis.

When we look at the south East Asian economies Malaysia is the prominent example. It is based on hybrid model; mixture of both conventional and Islamic banking system. The system shows that it is really possible to combine both. The model was developed during the decade 1991-2000.

In this case follow Mahmud Shaltut who is well-known jurist at Azhar statement, it will depend on the banks' attitude and public economic governance to sustain development. Over 120 Islamic investments banks today, born out in about fifty different countries for a total amount of \$ 800 billion, on the other hand over three hundred Islamic commercial banks are spread all over the world. Poor and Standard data had demonstrated that the growing Islamic capital flown do not depends just on those countries which have adopted the Islamic structure also into both social and public institutions, such as Pakistan or Iran.

For example, in Turkey, private sector is leading this new model. On the same lines, the other sixty-five countries allowed offering Islamic services through the intermediation system. Follow this theory, Islamic model widespread could be disillusioned just by fiscal monetary, or direct foreign investment limiting control.

This paper will discuss two economic models given by famous writers in Islamic economics (i.e. Mohsin S. Khan¹ and Abbas Mirakhor²). The paper will discuss the main features of the model and how it will be able to solve current era economic problems. It will also explore some of the issues discussed by the proposed models according to the Pakistan context, where Islamic and conventional banking system is working side by side. It is hoped that this paper will be able to support the view that Islam has the answer to correct current economic problem and also proposed for the change of dual banking system to totally Islamic in Pakistan.

ORGANIZATION OF PAPER

This paper will review some studies related to Islamic economics. It further will discuss two economic models in terms of its theory, explaining power and characteristics. This paper will also discuss the impact of the models to economic issues in particularly on its effect to stabilize the banking system and the effect of exchange rate regimes to an economy. In addition, these issues will also be looked at in the context of Pakistan. The final section will make recommendations and concludes this paper.

REVIEW OF LITERATURE

The worldwide financial crisis has provoked academics and policy makers to hunt for some different intermediates for financial businesses to accompaniment the prevailing system. Islamic finance, based on Shariah-defined principles, probably been the standard way to minimize prevalent risks linked with

financial dealings. This system eliminates interest, betting (gambling), speculation, and complicated derivatives, which are measured as key aspects of dehumanization indoors culture. In the same way, the recent model said to have sustainable development goals which delivers extra opening for Islamic finance to produce such long-term benefits because as its basic binding principles are linked with familiarly preservation.^{3 4} The statements are in according to the existing view of Islamic banking and the sustainability models (institutional and welfarist) associated with Chaprra and Isma'ili replicas of Islamic banking system^{5 6}. Similarly, According to Khan (1986)⁷ the basic theory on which modern system of Islamic banking and finance based is linked with social wellbeing through effective distribution of financial and capital resources aimed for attaining growth and evolution. However, it is mixed idea about Islamic banking and finance educations that is producing paths aimed at establishment of foundations or signifying latest visions that will support the system. As previous suggested, Islamic economics and finance concepts are in process of maturing still ⁸. Similarly, Ibrahim (2015)⁹ proposes that Islamic financial educations need to emphasis and reproduce the genuine basic theories of Islamic finance, while further work of (Berg et al. 2016¹⁰; Kamla et al. 2008¹¹; Khan 1991¹²) suggests the real-life data application to authenticate the earlier initial concepts. Therefore, this is not to be realized without thorough appraisal of preceding & present practical studies provides highlights, assessments, recommendations, and endorsements for the future. However, present work emphasis on the assessment of the Islamic financial sector with committed to deliver practical insight on either conjunction or departure of the system from its theoretical foundations of Sharia guidelines. Khan (1986) argued that former privileges describing the Islamic financial structure as major system that works in extra efficient way with greater solidity, thus producing added effectiveness

in policies than conservative peers. According to Bashir 1983 the prior model was verified created on the inevitability supposition of a one-year passé.

Thus, these discoveries' significance and validity essential stay more assessed through integrating supplementary topical economic, social, and environmental fluctuation Within a small interval of time, one more finding (Al day'el & Hassan 1998¹³) confirmed the past claim of Darrat (1988)¹⁴ with a lengthy plane investigation of fifteen countries. In spite of the prior analyses of the Islamic economic and financial system (Kuran 1995¹⁵; Kuran 1983¹⁶), the universal retort hip the dominant period has given practical and hypothetical suggestion (Ebrahim & Safadi 1995¹⁷). In the same way, the successive empirical studies provide the feasibility of Islamic investment (Alḥabshi & Shaukat 2015¹⁸; Bashir & Darrat 1992¹⁹; Bashir et al. 1993²⁰). Khan (1991) concluded that Islamic financial and economic organizations consume the possibilities for providing resolution to socio economics problems which disastrous to be explained through the traditional examples of neoclassical economics. Hence, analysis of the present studies that subordinate the main factors of the Islamic finance scheme covers the system for a strong considerate of whether the organization at this current stretch agree by his previous claims.

This research is based on objective of analyzing the current empirical and practical work on Islamic banking and existing extra guidelines for forthcoming work. The review is not enough to incorporate the whole early work done on this subject but slightly discovers that majority of work is published in the highly rated journals. This research paper distinguishes from previous primary survey based studies which emphases explicitly on problems of Islamic banking and finance such as financial constancy (Belouafi et al. 2015²¹; Odeduntan & Adewale 2015²²) risk involved in rate of return (Kassim and Zainol 2012²³) and its performance in fulfilling the demand of modern world (Moisseron et al. 2015)²⁴ relationship of bank and its growth factors interest rate (Ellouz and

Bellalah 2004)²⁵ norms for collection (Maḥfooz & Ahmed 2014²⁶; Nawi et al. 2013²⁷); evaluation of theory and practice (Ahmed 1989²⁸ and Tahir 2007²⁹); competitive analysis with conservative banks (Zaher & Hassan 2001)³⁰; Malaysian milieu (Musaeva et al. 2014)³¹; experimental revisions (Abedifar et al. 2015³²; ‘Alam & Riḍvi 2017³³); impartialities (Masih et al. 2016)³⁴ and sustainability. Although, not many of these studies were able to syndicate the thematic and sub-themes that assorted from hypothetical to real world issues with deliberation to societal effect through purpose of sharia, financial inclusion, and disclosure even with their vigorous role in the Islamic financial system. However, this extant research aims to fill this gap through involving present studies with past ones for serious evaluation and recommendations for future research studies. This research paper also objects to provide a link between the earlier and the subsequent empirical studies of Islamic financial literature to determine possible consistency or deviance within the contextual findings. Thus, this will provide additional implications to theory, practice, and future research. The paramount target of this research paper is to subsidize providing sensible thought that will peak the gap between practice and theory and hereafter support the system to establishment of industrial sector and strengthen social happiness generally.

Timūr Kuran (as cited in Rosser, 2004) is skeptical that Islamic economics is able to solve the global economic problems. In fact, he believed that it is just a presentation by the Muslims to correct Western misconception towards Islam. Rosser (2004)³⁵ opined that this assessment by Kuran is correct, in particular at the backdrop of the September 11 incident in the United States (U. S.). However, Kuran may be alone in his argumentation since other writers think differently. Most authors are confident that Islamic economics is at par, if not better, than interest-based economics. According to Khan (1986), Islamic banks are more stable than conventional banks during crises because it arrives at

equilibrium faster. In his paper, Khan (1986) corrects the perception that interest-free is the only difference between Islamic and conventional banks. In fact, it is the equity-based deposit that brings about the stability in Islamic banks. Here, the deposits are treated as equity of the bank. In other words, the depositors are similar to the shareholders.

Every company depends on their shareholders for business capital. The capital will be employed to purchase the assets or inventories and pay salaries or other expenses. As owners, shareholders share the profits and losses of the companies. By viewing depositors as shareholders, it imposes higher responsibilities on the part of the depositors and the banks. As shareholders, the depositors will always be vigilant about their investment. It will force the bank to invest the deposits in high return assets or projects to avoid withdrawals. This is because, any changes to the value of assets will always be followed by the value of liabilities (or equities) of the bank. If the bank did not perform well, the depositors will immediately withdraw their deposits. The constant equality between the assets and liabilities is the source of stability to the bank. In contrast, there seems to be less flexibility in the conventional banks. Due to the guaranteed of capital (i.e. deposits) and returns (i.e. interest rate) embedded in conventional banking, it may result in matching problem between the assets and liabilities. As an example, during the period of high interest rates, there will be more deposits (i.e. a liability to the bank) but less financing (i.e. an asset of the bank). This rigidity according to Khan (1986) prevents automatic adjustment which can be detrimental to the banking system. It can be said that Khan (1986) has shown that Islamic banking is not only about Shariah (i.e. interest-free) but also has economic value. In addition, Mirakhor (1987)³⁶ detailed about the Islamic economic system. In his paper, Mirakhor (1987) discussed about the value proposition of this economic system which may be appealing to most

governments. Among the notable issues discussed by the author are in respect of property rights, economic justice and the role of the state.

MODEL AND METHODOLOGY

Our model is based on the model used by Khan (1986), and has its description in two cases, in first case it is the model with fixed prices and in the second case it is the model with flexible prices.

There are three different markets in the system the money market, the capital market and the goods market. In case of capital market only bank borrowings are considered so banks are only financial intermediaries. Moreover, banks are assumed to keep zero net worth and not to hold any reserves shares. In the goods market, it is further assumed that there is slow adjustment in the goods market and it is a closed economy. In the basic model with fixed prices, the capital market and the money market will always be at equilibrium due to the non-guarantees of nominal value of the shares (i.e. deposits). In addition, the real income will slowly adjust to the excess aggregate demand. In the basic model with flexible prices, however, the changes of real value of shares from reduction in real income may cause the capital market not to be in equilibrium with the money market during the short run and may require some quick government intervention to restore equilibrium. If this disequilibrium is not corrected quickly, it may result in instability similar to conventional banking system. This will be discussed further in the section on economic issues (i.e. stabilization). Mirakhor (1993) extended the Khan (1986) model to explain about the equilibrium in a non-interest open economy. Mirakhor (1993) focused on two characteristics of Islamic economic system; namely it should not have fixed and pre-determined returns and the rate of return of financial assets should be determined by real sector. Mirakhor (1993) model is first based on a closed economy and later includes the effect of an open economy. There are two basic

assumptions applied by Mirakhor (1993) in the open economy model which are assets available for foreign purchase is only equities and domestic investors do not require foreign interest-based assets.

In the closed economy model, equipoise is achieved at a market degree of return which will associate the level of investment per unit of real capital anticipated by the firms and the quantity of savings per unit of real capital that the households are willing to save at the market rate (Mirakhor, 1993). According to Mirakhor (1993), the long-run equilibrium of the system depends only on the rate of growth of the labor force, n . In the open economy model, however, changes in exchange rate will have an impact on the economy. Devaluation will result in reduction of real wealth of domestic equity holder, which will result in an instantaneous portfolio adjustment whereby the domestic equity shares are sold for money. The cheaper equity shares will then be bought by foreign investors who will increase foreign equity holdings in the economy. Simultaneously, there will be an improved balance of trade as there will be more export (cheaper) than import (more expensive). These adjustments in capital accounts (i.e. from sale and purchase of equities) and trade accounts (i.e. from imports and export) will result in equilibrium of the economy. Mirakhor (1993) model tries to explain the impact of not having interest rate to the economy. It is found that interest-free environment will not have any negative impact on the economy. In other words, there is no requirement to have interest for an economy to be at equilibrium.

ATTRIBUTE AND EXPLAINING POWER OF THE MODEL

Khan (1986) presented his model according to the assumptions of Classical and Keynesian. His model is really a macroeconomic model where he shows the interaction between the capital market, money market and goods market. There are several restrictive assumptions employed to make his model workable as

mentioned above. It should be noted that the banking environment in Khan (1986) can only exist in an Islamic financial system which was not discussed in his paper. The model explains the impact of interest-free banking to economic stability as compared to the conventional banking system. The problem of conventional banks is caused by the guaranteeing of deposit and return. In order to avoid such problem,

Islam advocates that deposits are treated as shares in the banks. It is well known that the returns to shareholders (i.e. dividends) are not guaranteed. In addition, shareholders may also lose their investments (i.e. shares) if the company that they are investing in collapse. Due to the fact that the deposits and returns of conventional banks are guaranteed, any reduction in real income by the bank will not result in instantaneous adjustment to the deposits (aka real value of shares in Islamic banks) amount. Assuming that the banks losses are enormous, it may require insurance or government guarantee to cover the deposits. Mirakhor (1993) model, however, is a microeconomic model. Rather than looking at all aspects of the economy, he focused on the workings of the supply and demand between the buyers and sellers of equities and goods. Mirakhor (1993) tried to be less restrictive by imposing minimal assumptions in explaining his model. Mirakhor (1993) model explains about the equilibrium in a non-interest open economy. It was found that even without interest-bearing asset, there will not be any effect on the equilibrium of the economy whether it is a closed or an open one. His model refutes the allegation that interest is vital in an economy or an economy cannot function without interest rates.

ECONOMIC ISSUES

In this section, two economic issues will be discussed in terms of the stability of the banking system (i.e. Khan, 1986) and the impact of currency revaluation or devaluation (i.e. Mirakhor, 1993) to an economy. Another issue that can be related to the Mirakhor (1993) model is in respect of exchange rate policy.

Stability of the Banking System

The major change between Islamic banks and conservative banks are, of course, interest rates.

Riba-based banking system has twisted all financing agreements into loaning contracts. Therefore, being interest-free is not the only different features of Islamic banks or Islamic financing. Khan (1986) put forward a model that shows that the problem with conventional banking is not only about guaranteeing the interest rate but also the deposit as well. His model explained how interest-free banking avoids instability in the economy. The non-existence of pre-determined return on investment and guarantee of capital allows for rapid adjustment between assets and liabilities of the banks. It avoids panic or bank runs which will cause banks to face liquidity problems. In addition, the government guarantee does not help either because it may just create false impression that there is ample liquidity when in fact, any intervention is really to reduce the future wealth but in a delayed fashion. It is imperative that Islamic banks observed and adhered to the real values or principles of Islam in their operation to be stable as mentioned in Khan (1986). All financing contracts like *mudāraba*, *musharaka*, *ijāra* and *murabahah* should not be used just to circumvent *riba*. These contracts have rules that should not be confused with conventional financing. As an example, an *ijāra* financing contract that relieved the owner from taking ownership responsibilities will be an operating lease instead. There is dual banking environment in Pakistan where there are Islamic banks and conventional banks. The Pakistani government has yet to allow any banks to collapse even during the previous economic crisis to avoid domino effect in the banking sector which will trigger instability of economic system. Nevertheless, the repave been blends between the banks to support them. It is tuff to check whether Islamic banks are more sustainable than conservative banks in Pakistan meanwhile the local Islamic banks are holdings of the conventional banks. If

there is real competition, Islamic banks should be more efficient than their conventional counterpart in order to survive and win their customers. The Islamic banks should be able to show that they can give better returns over and above the interest rate in addition to giving good intermediary services. It is believed that although there is a downside risk of investment, track record of Islamic banks will be able to attract investors and create a niche market for them.

Exchange Rate Regimes

Mirakhor (1993) explains the impact of changes in exchange rates to the equity holdings and balance of trade. According to him, during devaluation, there will be an increase in foreign equity holdings but an improved balance of trade. Revaluation, on the other hand, will result in reduction of foreign equity holdings as foreign investors sell their shares. However, it will be at the expense of the balance of trade as there is higher aggregate consumption expenditure while the level of output is fixed. Currency revaluation and devaluation may be used to increase trade competitiveness but it should be done properly. In other words, there should be valid reason for such action. Revaluation and devaluation that do not have strong basis will result in market correction of the currencies and bring it back to earlier position. In terms of the exchange rate policy, Pakistan has turned to the fixed exchange rate policy during the previous economic crisis. Although there is no problem in adopting such policy, the capital control enforced to maintain the fixed exchange rate caused foreign investors to lose confidence in this country. It is important that Pakistan continues to adopt a consistent exchange rate policy to rebuild investors trust and encourage foreign trade.

RECOMMENDATION AND CONCLUSION

The study has focus on the proposed model and discusses the issues that the

model will be supposed to address. whether the model is applicable to Pakistan economy or not it will also be discussed. It has been mentioned earlier that there is dual banking system in Pakistan. In order for the banking system to be truly Islam, there should be legal prohibition of riba. In other words, riba should be made unlawful and whoever deals with it can be prosecuted by law. By prohibiting riba, it will force the bank to be more creative in offering financing products rather than just loaning money. In addition, Islamic financing contract require real activities to be created. There will not be loans to finance extravagance lifestyle which is the source of bankruptcies among the younger generation. It is strongly recommended that Pakistan should enforce truly Islamic financial system to sustain its economy and avoid another economic crisis in the future.

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